A WHIRLWIND TOUR OF THE INTERNAL REVENUE CODE'S AT-RISK AND PASSIVE ACTIVITY LOSS RULES*

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Editors' Synopsis: After providing a glimpse at the historical computation of business operating profit or loss, the authors describe the use of tax shelters as well as legislative responses to them. The authors examine the at-risk and passive activity loss rules, detailing the scope of these rules and offering guidance in the computation of deductions and losses.

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I. THE HISTORICAL COMPUTATION OF BUSINESS
   OPERATING PROFIT OR LOSS

Historically, nothing in the Internal Revenue Code (“Code”) required
taxpayers to isolate the income and deduction items attributable to each
separate trade or business conducted by the taxpayer, to compute the
separate operating profit or loss attributable to that trade or business, and
then to add or subtract the result to or from net income from other sources.
Indeed, the language of sections 62 and 63, defining “adjusted gross
income” and “taxable income,” respectively, indicates quite the contrary;
taxable income is to be computed on a “global” basis, first adding together
gross income from all sources and then subtracting all deductions.
Although the concept of adjusted gross income (“AGI”) in section 62 sorts
deductions into two classes that are taken into account serially in reducing
gross income to taxable income, under section 62 all trade or business
deductions are subtracted globally in moving from gross income to AGI.\textsuperscript{1} Thus, a "loss" incurred in the conduct of a particular trade or business that is attributable to aggregate deductions exceeding gross income from the same trade or business is not a separately identifiable income tax deduction. Nevertheless, in practice, when computing taxable income each year, individual taxpayers generally separately compute the net operating profit or loss from each distinct trade or business in which they are engaged and then aggregate the results together with income and deduction items attributable to nonbusiness activities. The Internal Revenue Service ("Service") income tax forms generally require such preliminary business-by-business computations. Sole proprietors report each trade or business on a separate Schedule C, Form 1040; partners separately report their distributive share from each partnership, but not from each business the partnership conducts.

For many years, the Code has permitted taxpayers who incur a "net operating loss" ("NOL") from a trade or business that exceeds their other income (reduced by some, but not all other deductions) to subtract that year's NOL from the taxable income of a prior or subsequent year in which the taxpayer had taxable income. Section 172 provides the rules governing NOL carrybacks and carryforwards. For profitable businesses, however, global computation has been the almost universal rule. In some cases, however, the operating profits and losses of particular businesses must be separately computed not merely for reporting purposes, but also in determining the amount of tax actually owed.

During the 1960s and 1970s, many taxpayers began to take advantage of the global computation rule by investing in businesses that required very little time commitment, were capital intensive, and were leveraged heavily, thereby claiming depreciation and interest deductions attributable to these investments as an offset to income from other sources.\textsuperscript{2} These "tax shelters" took many different forms, but they typically involved passive investments in syndicated limited partnerships to which the investors contributed relatively little cash, with the partnership financing the acquisition of assets through nonrecourse mortgages. Investors rarely used financing on which they were personally liable. The most common

\textsuperscript{1} See I.R.C. § 62(a)(1) (West 2001).
investments were in real estate (such as apartment buildings and shopping centers), oil and gas drilling, equipment leasing, and farming ventures, although tax shelters involving many other types of property also flourished. Many of these ventures were not economically viable investments apart from the tax savings to be realized from the deduction of the losses against the investors' other income. Frequently, the project at best produced a break-even before-tax cash flow; all or most of the investor's return was realized through tax savings. Too many of these ventures were little better than fraudulent.

Responding to a dramatic increase during the 1960s and 1970s in the use of tax shelters that took advantage of the long-standing rule allowing taxpayers to use excess deductions generated from a trade or business activity to offset income realized from wholly unrelated sources, the Service began vigorously attacking tax shelters by disallowing on audit deductions based on exaggerated values and other abuses, and by publishing rulings giving advance warning of the position that it would take. Congress concurrently enacted a series of therapeutic provisions designed to restrict the future use of tax shelters. Unlike the administrative attacks by the Service, which focused almost exclusively on "abusive" tax shelters, these congressional forays modified long-standing substantive rules of taxation, and the effects of these substantive changes extend far beyond the tax shelter arena in which they made their debut.

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4 See, e.g., United States v. Barstow, 733 F.2d 842 (11th Cir. 1984) (upholding conviction for violation of tax laws by purchasing property through partnership at inflated prices and thereby affecting depreciation values); United States v. Carruth, 699 F.2d 1017 (9th Cir. 1983) (upholding conviction for conspiracy to defraud United States by promoting tax shelter limited partnerships claiming deductions based on nonexistent transactions); United States v. Drape, 668 F.2d 22 (1st Cir. 1982) (upholding conviction for filing fraudulent income tax return after tax was altered by participation in tax shelter).
6 See, e.g., STAFF ON JOINT COMM. ON TAXATION, supra note 2, at 209-14 (discussing reasons for the changes).
7 See id.
II. The Tax Shelter Problem

The tax shelters Congress sought to curb took many forms but ordinarily had the following two features in common: (1) the investors (whom promoters of syndicated arrangements often brought together, usually in the form of limited partnerships) put up relatively little cash and hence had little to lose if the venture failed, and (2) the venture borrowed heavily on a nonrecourse or other basis entailing no personal liability for the investor, thus allowing the investor's deductions for depreciation, amortization, intangible drilling and development costs, business expenses, interest, or other items greatly to exceed the cash outlay. This leveraging aspect of virtually all classical tax shelters was based on the taxpayer's long-established right to deduct interest, business expenses, and other out-of-pocket items when they are paid or incurred, even if they are defrayed with borrowed funds, and on the fact that depreciation and amortization are computed on the full adjusted basis of property, even if the taxpayer finances the purchase with nonrecourse debt.\(^8\) The resulting large deductions were not offset solely against income produced by the tax shelter itself but could be applied against salaries, professional fees, dividends, interest, and business income of all types. This resulted in dramatic reductions in the investor's current tax liabilities and corresponding large increases in spendable funds.

The most popular investments for tax shelters were real estate, cattle, oil and gas ventures, movie production, and equipment leasing involving property such as airplanes, fleet vehicles, and computers. However, promoters and investors were not particular when searching for prospects. Railroad boxcars, lithographs, video tapes, and virtually anything else could serve as an investment vehicle, provided it crammed an abnormal amount of deductions into the first year or two of the taxpayer's participation. The taxpayer usually accomplished this by taking advantage of statutory provisions for the write-off of rapid depreciation or amortization of capital outlays.\(^9\) As for the nonrecourse borrowed funds required for leverage, they sometimes reflected nothing more than the inflated purchase cost of an investment the seller of which was adequately compensated by

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\(^8\) See generally Crane v. Comm'r, 331 U.S. 1 (1947).

the down payment.\textsuperscript{10} If the inflated balance of the alleged price were actually paid, so much the better from the seller’s perspective; however, even if nothing more were paid, the alleged debt served to promote sales of the shelter by promising inflated deductions to investors.

A. Tax Shelter Mechanics

The typical tax shelter was based on the combination of a tax preference (i.e., a tax rule that understates the amount of income from a particular kind of business activity) and an interest expense deduction.\textsuperscript{11} Two related numerical examples may be helpful in understanding how an interest expense deduction could turn a preference into a tax shelter. Suppose a taxpayer buys a building for $100. During the first year, the rental income from the building, net of all expenses except depreciation, is $10. During the same year, economic depreciation—the actual decline in value of the building—is $2. The net economic income from the building is $10 - $2 = $8. Now suppose the tax system accurately measures the taxpayer’s economic income in all respects but one. To encourage investment in buildings, it provides for a tax preference—an accelerated depreciation deduction of $5, instead of the $2 of economic depreciation. With the preference, the taxpayer’s taxable income from the building is $10 - $5 = $5. Taxable income thus understates economic income by $3, the amount by which the allowable depreciation deduction exceeds the economic depreciation. The $3 artificial portion of the depreciation deduction is a tax preference because it excludes $3 of economic income from taxable income. The investment is not a tax shelter, however, in the commonly accepted sense of that term. A tax shelter is an investment that

\textsuperscript{10} See, e.g., United States v. Philatelic Leasing, Ltd., 794 F.2d 781 (2d Cir. 1986) (upholding an injunction against the promotion of tax shelters based on gross overvaluation of printing plates); Franklin’s Estate v. Comm’r, 544 F.2d 1045 (9th Cir. 1976) (a purchase with a nonrecourse purchase-money mortgage given to a seller in a transaction with no down payment did not transfer equity in real estate interest to a “purchaser;” depreciation and interest deductions were disallowed); Rev. Rul. 79-432, 1979-2 C.B. 289 (denying deductions with respect to lithographic plates with inflated value); see also Robert H. Mundheim, General Counsel to the Treasury Department, Developing Standards for Tax Attorneys, 15 DAILY TAX REP. J-1, Jan. 22, 1986 (remarks before Securities Regulation Institute, Jan. 18, 1980, regarding legal opinions disclaiming knowledge of obviously inflated purchase price).

generates artificial tax losses that taxpayers can use to offset (shelter) income from other sources. The effect of the depreciation preference is only to reduce the taxable income from the investment, not to shelter unrelated income.

However, a taxpayer could use the same $3 depreciation preference to create a tax shelter, in the absence of relevant limitations on the deductibility of interest expense. Suppose the taxpayer buys the same building as in the previous example, but with borrowed money. If the interest rate on the $100 loan is eight percent, the taxpayer must pay $8 in interest during the first year. The taxpayer therefore has no net economic income from the investment: $10 - $2 - $8 = $0. If the interest is fully deductible, the taxpayer has a $3 loss from the investment for taxable income purposes: $10 - $5 - $8 = -$3. If the taxpayer can use this $3 deductible loss to offset $3 of taxable income from any other source, including income from personal services, the debt-financed investment in the building is a tax shelter. The investment becomes profitable only because of the tax savings it generates.

The amount by which taxable income understates economic income is the same ($3) in both examples. In the first example, economic income was $8 and taxable income was $5. In the second example, economic income was zero and taxable income was -$3. In each case, the $3 overstatement of depreciation created the $3 disparity between economic income and taxable income. The difference between the two examples is thus not in the amount of the preference but in the nature of the income that is untaxed because of the preference. The interest deduction shifts the effect of the preference from an understatement of income from the tax-preferred activity to the offsetting (sheltering) of unrelated income.  

B. Nonstatutory Remedies for Tax Shelter Abuses

In theory, leveraged tax shelters could only defer tax liabilities, not eliminate them. If the investment was successful, it would in time generate net income equaling or exceeding the expenditures deducted in the shelter’s early years. Including this income on the investor’s return would increase taxable income by at least as much as the taxable income of the earlier years was reduced by the deductions. Even if the investment failed, its termination ordinarily would generate income equal to the amount of

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12 See id. at 508-09.
unpaid nonrecourse debt that was taken into account in computing the prior deductions. However, some, or perhaps many, investors in failed shelters inadvertently or deliberately failed to report these amounts. In any event, even those taxpayers who eventually reported income equal to or exceeding their prior deductions had an opportunity in the interim to invest or spend the amount of taxes saved. Thus, even if a tax shelter’s only effect was a deferral of taxes, it was attractive to many taxpayers. Furthermore, by entering into a new shelter when the original one began to generate income, taxpayers could avert the evil day; and, even if this were not feasible, the taxpayer might be in a lower tax bracket (e.g., as a result of retirement) when deferral ended.

Once the Service geared itself to deal with the tax shelter problem, it issued numerous rulings disallowing deductions in egregious situations, and on audit and in litigation, it successfully disallowed many unwarranted claims. The courts branded some shelters as shams or, more delicately, as lacking in “economic substance,” because the shelters held out no reasonable hope of economic success and hence served no function other than to create deductions or other tax allowances. An alternative but

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13 See Tufts v. Comm’r, 461 U.S. 300, 309-10 (1983) (the amount realized on the transfer of property encumbered by nonrecourse mortgages is not less than the outstanding encumbrance even though the fair market value of the property is less); see generally Joshua D. Rosenberg, Better to Burn Out Than to Fade Away? Tax Consequences on the Disposition of a Tax Shelter, 71 CAL. L. REV. 87 (1983).
15 See, e.g., Bohrer v. Comm’r, 945 F.2d 344 (10th Cir. 1991), aff’d Glass v. Comm’r, 87 T.C. 1087 (1986) (disallowing purported losses on straddle transactions on London Metal Exchange because the transactions were “shams” and without “economic substance”); Rose v. Comm’r, 868 F.2d 851 (6th Cir. 1989) (finding that the transaction lacked economic substance apart from the tax benefits); Friendship Dairies, Inc. v. Comm’r, 90 T.C. 1054 (1988) (stating that the transaction lacked economic substance because it had no opportunity for profit apart from tax benefits); Falsetti v. Comm’r, 85 T.C. 332 (1985) (stating that a real estate tax shelter was a sham); Rice’s Toyota World, Inc., 81 T.C. at 184 (denying computer leasing tax shelter deductions based on a sham transaction); see also Bryant v. Comm’r, 928 F.2d 745 (6th Cir. 1991) (stating that the proper test for whether a transaction lacked economic substance is not whether in the light of hindsight the taxpayer made a wise investment but rather whether the taxpayer made a bona fide investment versus purchasing
similar ground for disallowance in some cases was the taxpayer’s failure to establish that the activity was “engaged in for profit” within the meaning of section 183.\textsuperscript{16} The courts accepted other shelters, at least arguendo, as economically viable, but disallowed or severely reduced the deductions claimed because the price purportedly paid for the underlying assets (and hence the basis for computing depreciation and other deductions) was found to be inflated—for example, by transfers among related parties or by the inclusion of nonrecourse debt that was extremely unlikely to be paid off.\textsuperscript{17}

In other cases, the Service established that unscrupulous promoters actually had never engaged in the transactions described in their prospectuses, but had instead simply decamped with the cash advanced by eager, gullible, or greedy investors. The result was that the investors might be entitled to deductions for their down payments, on the theory that these amounts had been embezzled or stolen,\textsuperscript{18} but the much larger deductions

\textsuperscript{16} See, e.g., Estate of Baron v. Comm’r, 798 F.2d 65 (2d Cir. 1986) (finding no nontax profit motive in master recording investment); Elliott v. Comm’r, 84 T.C. 227 (1985), aff’d by order, 782 F.2d 1027 (3d Cir. 1986) (determining the objective was not to make business profits but to obtain tax benefits from investment in the publication rights to a novel); Sutton v. Comm’r, 84 T.C. 210 (1985), aff’d per curiam, 788 F.2d 695 (11th Cir. 1986) (declaring that investment in refrigerated highway trailers lacked bona fide profit motive).

\textsuperscript{17} See, e.g., Estate of Baron, 798 F.2d at 65 (finding nonrecourse notes too speculative to be included in the basis because they were payable only from the venture’s profits, and alternatively, the investment had no profit motive); Elliott, 84 T.C. at 227 (stating that nonrecourse loans “offer obvious opportunities for trifling with reality” and holding that the purported debt in the case was not “genuine”); see also Cherin v. Comm’r, 89 T.C. 986 (1987) (disallowing deductions for a cattle breeding tax shelter because the taxpayer never acquired the benefits and burdens of ownership of the cattle); Coleman v. Comm’r, 87 T.C. 178 (1986), aff’d by order, 833 F.2d 303 (3d Cir. 1987) (stating that the investor in an elaborate sale and leaseback of computer equipment had not acquired a depreciable interest).


\textsuperscript{18} See, e.g., Viehweg v. Comm’r, 90 T.C. 1248 (1988) (disallowing theft deduction for
claimed for depreciation, drilling expenses, or other items, which ordinarily are based on the investor's share of nonrecourse debt were disallowed, because the investors had no property to be depreciated, no oil wells were actually drilled, etc.19

Because most of these tax shelters, however, were grounded largely in the legitimate application of substantive provisions of the Code, albeit in contexts that Congress may not have intended when it enacted the provisions, the revenue loss from tax shelters was not easily stemmed by the Service. In cases involving sham transactions, overvaluations, and misapplication of substantive provisions, the Service vigorously and successfully attacked on the administrative front.20 After a number of years, the Service also began attacking tax shelter transactions that, although otherwise legitimate, were profitable only because of the tax benefits and therefore were not activities conducted for profit.21 Nevertheless, the vast majority of tax shelters were beyond attack, except by Congress.

C. The Legislative Response to Tax Shelters

Beginning in 1976, Congress entered the fray against tax shelters by enacting a number of provisions restricting the taxpayer's right to apply tax shelter deductions against income from unrelated sources (e.g., salaries and dividends), as well as by providing administrative tools and penalties to attack abusive tax shelters. The major substantive rules from the congressional attack on tax shelters are the "at-risk" rules of section 465 and the "passive activity loss" rules of section 469.22 The sweep and mechanics of these provisions differ, but they share an important characteristic: Both abrogate the prior rule of global computation of

out-of-pocket investment in a failed tax shelter that under state law involved no fraudulent misrepresentations, and stating that the record was "devoid of evidence suggesting that [the taxpayer] ... did not get what he bargained to get").

19 See, e.g., Carruth, 699 F.2d at 1021 (illustrating the defendants' knowledge that the limited partners' deductions taken on their tax returns were based in part on nonexistent transactions and that the Treasury would be deprived of substantial sums in tax revenues).

20 See, e.g., supra note 5.

21 See, e.g., Rose, 868 F.2d at 851 (holding that taxpayers had no honest profit motive and that the venture was void of economic substance); Estate of Baron, 798 F.2d at 65 (finding that the purchase of the recording rights was not an activity engaged in for profit by the taxpayers).

22 Section 469 was enacted in 1986.
taxable income, requiring instead that the income and deductions attributable to particular activities be netted out separately and that net losses from such activities be deducted against income from other sources only to a limited extent. Although section 465 has at all times since its enactment applied only to activities involving nonrecourse financing, and even then not to all such activities, section 469 applies to any trade or business in which the taxpayer does not "materially participate."

As a result of the restrictions imposed by these provisions, particularly section 469 with its requirements that all "losses" be traced to the particular trade or business activity that generated the loss, characterizing the federal income tax system as one based on a global computation of taxable income is no longer accurate. Since 1987, this compartmentalization approach has caused the Code to resemble the traditional British income tax's schedular system in some respects. However, the Code does not adopt the British practice of prescribing separate tax schedules for each of the taxpayer's sources of income, the Code permits some netting between schedules.

Between 1976 and 1986, Congress enacted a number of statutory rules to discourage the use of tax shelters. Most of these provisions provide administrative tools to facilitate the Service's enforcement of imposed penalties for highly questionable valuations or over-imaginative interpretations of the availability of deductions. As noted above, however, the provisions effected major substantive changes in the rules for computing taxable income. The first such rule is in section 465, which prescribes the "at-risk" limitations on deductions. Because section 465 failed to curb the proliferation of tax shelters to the extent Congress desired, in 1986 Congress added section 469, thus dramatically restricting the ability to

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23 For other examples of this "basketing" or "schedular" approach, see section 163(d) (investment interest), section 183 (hobby loss rules), section 280A (disallowing certain expenses concerning home offices and vacation rental homes) and section 1211 (West 2001) (limiting capital losses).
27 Section 465 was enacted in 1976 and subsequently was amended to broaden its sweep.
deduct any "passive activity losses" currently. As a result of section 469, in particular, the tax shelter industry as it was known in the 1970s and early 1980s has been closed almost completely.

III. "AT-RISK" LIMITATION ON LOSSES

A. Introduction

To reduce the tax-avoidance potential of leveraged tax shelters, section 465 modifies the following two structural features of the tax system on which classical pre-1976 tax shelters depended: (1) the aggregation of all ordinary income and deductions, regardless of their sources, in computing taxable income, and (2) the taxpayer's right to deduct expenditures financed with funds borrowed on a nonrecourse basis. Section 465 modifies the aggregation principle by segregating all income and deductions for each "activity" the taxpayer conducts. Within each segregated compartment, deductions can be applied up to the full amount

28 Both of these provisions abrogate the long-standing rule of global computation of taxable income and require that the net income or loss from the business activities within their respective jurisdictions be computed separately, thus restricting the deductibility of the net losses. Although sections 465 and 469 have been the major substantive players in the government's war against tax shelters, the administrative and penalty provisions enacted in the last twenty years cannot be ignored; they also may apply in cases not involving traditional tax shelters. Among the most important of these provisions are the following:

1. sections 6111 and 6112, respectively requiring tax shelter organizers (as specifically defined) to register the arrangement with the Service not later than the day when interests are first offered for sale, and requiring organizers and sellers of interests in "potentially abusive" tax shelters (as defined) to maintain lists of investors. Sections 6707 and 6708, impose penalties for failure to comply with section 6111 or section 6112, respectively.
2. section 6700, imposing penalties for promoting abusive tax shelters.
3. section 7408, authorizing civil actions to enjoin promoters of abusive tax shelters from engaging in activities subject to penalties under section 6700 (or section 6701, relating to penalties for aiding and abetting understatement of tax liability).
4. section 448(a)(3), requiring tax shelters (as specifically defined) to use the accrual method for reporting income and deductions.
5. sections 6662(b)(2) and 6662(d), imposing penalties for substantial underpayments (as defined) unless substantial authority supports the taxpayer's position or the return discloses the item and its treatment, but providing that taxpayers can avoid the penalty for tax shelters (broadly defined) only if they reasonably believed that the treatment on their returns was more likely than not correct.
6. sections 6662(b)(3) and 6662(e), imposing penalties for understatements of tax liability attributable to certain valuation overstatements.
of the income the same activity produces. If, however, the deductions attributable to the activity exceed the income from the activity, the net loss can be deducted against income from other activities only to the extent of the taxpayer's at-risk investment in the activity producing the loss. Furthermore, even if section 465 allows the loss, the loss may be subject to disallowance under section 469, if the taxpayer does not materially participate in the activity that generated the loss, or if the activity is the taxpayers' holding of either real or personal property for rental.  

To be considered at risk under section 465, the taxpayer must either invest or otherwise commit personal funds or property to the investment or incur personal liability for borrowed funds. These requirements reflect a value judgment that a net loss in a covered activity should be deductible against income from other activities only to the extent that it entails a "true" loss. Nevertheless, the at-risk principle of section 465 does not generally supplant or repeal the basic rule that expenditures are deductible even if they are financed with nonrecourse debt. For example, a taxpayer with only one business still can apply all deductions, regardless of how the expenditures are financed, against the taxpayer's income, and the taxpayer may carry a net loss over to other taxable years as an NOL under section 172. Indeed, taxpayers investing in tax shelters fully include nonrecourse-financed expenditures up to the income produced by the segregated activity, and they carry forward excess deductions for application in the same manner in later years.  

B. Covered Taxpayers and Activities

Section 465 can apply to transactions and activities far removed from the targeted area of tax shelter activity. Therefore, delineating the taxpayers and activities that it covers and, conversely, those exempted from its jurisdiction is important.

As far as taxpayers are concerned, section 465(a)(1) limits the ability to deduct losses incurred by individuals (including trusts, estates, and

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29 See infra Part IV.
31 See I.R.C. § 465(a)(2).
32 See Peters, 77 T.C. at 1164-1165 (1981) (at-risk rules apply to section 465(c)(1) activities irrespective of whether they are used as tax shelters); see also Glenn E. Coven, Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept, 74 CAL. L. REV. 41 (1986).
noncorporate members of partnerships) and certain closely held C corporations.\textsuperscript{33} S corporations are not directly subject to section 465, but because they are pass-through entities, their shareholders report their deductions and losses, and are themselves subject to the limitations of section 465.\textsuperscript{34}

Section 465 applies to virtually any business or profit-making activity a covered taxpayer conducts, although the section most often is encountered in partnership investments. Section 465(c)(1)\textsuperscript{35} explicitly covers (1) holding, producing, or distributing motion picture films or videotapes; (2) farming, within the broad definition of section 464(e); (3) leasing section 1245 property as defined by section 1245(a)(3) (which primarily includes business equipment but also some items of tangible realty other than buildings and their structural components); (4) exploring for or exploiting oil and gas resources; and (5) exploring for or exploiting geothermal deposits.\textsuperscript{36} In 1978, section 465(c)(3) was enacted to extend coverage to any other activity the taxpayer engages in as a business or for income production.\textsuperscript{37} This expansive provision omits nothing, covering such diverse fields as manufacturing, wholesale and retail trade, rendition of personal and professional services, and investing in marketable securities—no matter how remote from the epidemic of tax shelters that evoked the enactment of section 465.

Section 465(b)(6), however, provides an important exception for real property.\textsuperscript{38} Section 465(b)(6) considers taxpayers engaged in the activity

\textsuperscript{33} C corporations are subject to section 465 only if they satisfy the personal holding company stock ownership rules of section 542(a)(2). These rules encompass any corporation with more than 50\% of its stock (by value) owned at any time during the last half of the taxable year by not more than five individuals. Because direct, indirect, and constructive ownership is taken into account in determining the number of individual shareholders owning the requisite amount of stock, virtually all closely held corporations satisfy the stock ownership test; if a corporation’s outstanding stock is owned by fewer than ten individuals, the stock ownership test of section 465(a)(1)(B) is automatically satisfied. Section 465(c)(7) excepts from section 465 certain “qualifying businesses” of some C corporations otherwise subject to section 465.

\textsuperscript{34} See, e.g., Van Wyk v. Comm’r, 113 T.C. 440, 445-448 (1999) (pursuant to section 453(b)(3), an S corporation shareholder was not at risk for amounts lent to the corporation because he borrowed the funds from another shareholder to reloan them to the corporation).

\textsuperscript{35} Section 465(c)(1) was enacted in 1976.

\textsuperscript{36} See I.R.C. § 465(c)(1).

\textsuperscript{37} See I.R.C. § 465(c)(3).

of holding real property, other than mineral properties, to be at risk for their share of any "qualified nonrecourse financing" secured by the real property used in the activity, even though nonrecourse debt normally is not taken into account in determining the taxpayer's at-risk amount when applying section 465. Such debt qualifies under section 465(b)(6) if it is supplied or guaranteed by a federal, state, or local agency or is lent by a person actively and regularly engaged in the business of lending money. However, persons related to the taxpayer are not qualified creditors unless the financing is "commercially reasonable" and is extended on substantially the same terms as loans to unrelated persons.\textsuperscript{39} Under no circumstances can the creditor be a person from whom the taxpayer acquired his interest, who received a fee in connection with the sale of the interest to the taxpayer, or who is related to any such seller or promoter.\textsuperscript{40} Furthermore, even if a qualified creditor extends the loan, the loan will not be considered at-risk if it is convertible into an equity interest in the property.\textsuperscript{41}

C. Separation and Aggregation of Covered Activities

The determination of whether a group of transactions constitutes one activity or separate activities can significantly affect the impact of section 465. For example, if two real estate projects—apartment buildings, for example—constitute a single activity, losses from one can be applied freely against income from the other, and the taxpayer may then have no net loss from the activity for section 465(a)(1) to limit.\textsuperscript{42} If, however, each property constitutes a separate activity, losses from an unprofitable property can be applied against income from a profitable property only to the extent of the taxpayer's at-risk investment in the loss property.\textsuperscript{43} Some activities, such as oil wells, are subject to special rules. Under section 465(c)(2), each oil and gas property (as defined in section 614) is a separate activity; thus, all wells on the same "property" constitute a single activity, but a taxpayer with wells on two or more properties is engaged in two or more separate activities for purposes of section 465. Under section 465(c)(2), a similar rule applies to each of the specifically covered

\textsuperscript{39} See \textit{Staff of Joint Comm. on Taxation}, \textit{supra} note 2, at 257-60.

\textsuperscript{40} See \textit{id.} at 258.

\textsuperscript{41} See \textit{id.} at 259.

\textsuperscript{42} See \textit{I.R.C.} § 465(c)(2).

\textsuperscript{43} See \textit{id.}
activities named in section 465(c)(1).\textsuperscript{44}

When Congress extended the application of section 465 to all business and income-producing activities, it did not divide specifically the multitude of activities covered by section 465(c)(3) into separate activities. Instead, Congress authorized the Service to perform this Herculean task by promulgating regulations for the segregation or aggregation of these activities and to take their “tax shelter characteristics” into account in prescribing the necessary rules. Although proposed regulations covering a wide range of issues under section 465 were promulgated in 1979, the regulations—which still have not been finalized—fail to address this issue; e.g., the proposed regulations provide no assistance in determining whether two apartment buildings operated on adjoining parcels of land by the same owner constitute one activity or two. If, for example, the owner operates the buildings as an integrated complex, they seemingly should constitute a single activity; however, if the owner operates them independently, they may constitute separate activities.\textsuperscript{45}

D. Losses Subject to At–Risk Limitation

Section 465 permits deductions incurred in an activity to be applied freely against income generated by that activity and intervenes only when a taxpayer attempts to use a loss incurred in a covered activity to reduce income from other sources. Section 465(d) defines the amount subject to the at–risk limitation—and thus not currently deductible—as the excess of (1) the deductions allowable for the taxable year that are allocable to a covered activity over (2) the income received or accrued by the taxpayer from the activity during the same taxable year. The result is the net loss resulting from the covered activity. It should not be confused with a “loss” deductible under section 165(a), which is merely a transactional item that is taken into account in determining whether the taxpayer incurred an overall loss from the activity within the meaning of section 465(d).

\textsuperscript{44} See I.R.S. Notice 89-39, 1989-1 C.B. 681 (permitting aggregation for film and videotape, farming, oil and gas, and geothermal activities conducted by a partnership or an S corporation).

\textsuperscript{45} The application of section 469 also requires determining the scope of an activity in cases such as that described in the text, but the standards that section 469 applies are different. The scope of an activity for purposes of section 465 is more asset specific, and therefore narrower, than the scope of an activity for purposes of section 469. See STAFF OF JOINT COMM. ON TAXATION, supra note 2, at 246 n.40.
Any disallowed loss is carried forward to the next taxable year. This loss should be applied against the income, if any, from the loss activity and, if the taxpayer’s at-risk investment increases, against income from other activities. In accordance with the manifest legislative intent, the proposed regulations allow the unlimited carryforward of disallowed amounts. Long-standing proposed regulations also prescribe rules that allocate specially treated items, such as tax preference items and long-term and short-term capital losses, between the loss year and the later years to which disallowed losses are carried. They also determine the order in which items carried forward from two or more loss years are to be applied.

E. Computation of At-Risk Amount

The heart of section 465—or, from the taxpayer’s perspective, its fist—is section 465(b). Section 465(b) prescribes the amount that taxpayers have at risk in a covered activity, because this limits the amount of loss allocable to a covered activity that the taxpayer can use to offset income from other sources. Reflecting its function as a weapon against leveraged tax shelters, section 465(b) is designed to separate genuine losses of the taxpayer’s investment in the covered activity from ostensible losses that have not yet pinched the taxpayer because the underlying expenditures were financed though an arrangement under which the taxpayer does not actually bear an ultimate risk of loss, e.g., on a nonrecourse basis. Computing the taxpayer’s at-risk amount can be complicated, as described below.

1. Contributions of Money and Property

Under section 465(b)(1)(A), the taxpayer is at risk to the extent of the money and property the taxpayer contributed to the activity, including the cost of acquiring an interest in the activity. Property is taken into account to the extent of its adjusted basis, regardless of its market value, because the adjusted basis reflects the taxpayer’s “tax” investment in the property—the amount that can be deducted, for example, if the property

46 See Prop. Treas. Reg. § 1.465-2(b) (1979); see also Treas. Reg. § 1.1398-2 (1994) (transferring at-risk carryover amounts to the taxpayer’s bankruptcy estate; on termination of the estate, any remaining carryovers revert to the taxpayer).
becomes worthless in conducting the activity. A partner is at risk not only with respect to actual contributions to the partnership but also for any amounts that the partner may be required to contribute to the partnership in the future.\textsuperscript{49} Money the taxpayer borrows from a third party on personal credit and then invests in an activity, whether a sole proprietorship, partnership, or S corporation, is treated as borrowing with respect to the activity. The investment is considered at-risk only if the borrowing transaction passes muster under the several subsections of section 465 dealing with the treatment of borrowed funds.\textsuperscript{50}

2. Borrowed Amounts

The taxpayer is also at risk for amounts borrowed with respect to the activity to the extent of (1) the taxpayer’s personal liability for repayment\textsuperscript{51} or (2) the net fair market value of property pledged as security for repayment of the debt. Partners are at risk for any portion of the partnership’s debts for which the partner bears the ultimate personal liability.\textsuperscript{52}

\textsuperscript{49} Compare Pritchett v. Comm’r, 827 F.2d 644, 647 (9th Cir. 1987) (holding that limited partners subject to a cash call were at risk for a potentially required contribution), with Callahan v. Comm’r, 98 T.C. 276, 283 (1992) (holding that partners were not at risk for a cash call obligation contingent on partnership insolvency because the agreement permitted individual partners to elect at any time before insolvency not to be subject to cash call obligations after insolvency).

\textsuperscript{50} See Van Wyk, 113 T.C. at 448 (holding that pursuant to section 453(b)(3), an S corporation shareholder was not at risk for amounts lent to the corporation because the shareholder borrowed the funds from another shareholder to lend them to the corporation).

\textsuperscript{51} See Berger v. Comm’r, T.C.M. (RIA) ¶94,298 (1994) (when the taxpayer voluntarily and without consideration converted nonrecourse debt into recourse debt, the taxpayer was not at risk because the conversion of debt to recourse was unenforceable); Follender v. Comm’r, 89 T.C. 943, 949 (1987) (finding the taxpayer liable for the principal but not the interest on a note due in ten years and rejecting the Service’s argument that the at-risk amount is net present value of the future payment); Durkin v. Comm’r, 87 T.C. 1329, 1378 (1986), aff’d, 872 F.2d 1271 (7th Cir. 1989) (holding that long-term recourse debt that was convertible to nonrecourse debt on the happening of certain events and that was “without business purpose and executed solely to gain tax benefits” did not give rise to at-risk amount, and other short-term debt was at-risk).

\textsuperscript{52} See Melvin v. Comm’r, 88 T.C. 63, 75 (1987), aff’d, 894 F.2d 1072 (9th Cir. 1990) (holding that partners are at risk for the partnership’s debt obligations even if the debt is payable in later years, and partners are obligors “of last resort” even if the partnership may be able to discharge debt from its own resources, but each partner’s liability is limited to the partner’s pro rata share of debt, and a partner is entitled to reimbursement from the others if that partner pays more than that amount); Abramson v. Comm’r, 86 T.C. 360, 375 (1986) (where each partner guaranteed a ratable share of the partnership’s nonrecourse debt, each partner was at risk in the amount he guaranteed because “each partner’s liability . . . ran
Sections 465(b)(2) and 465(b)(4) disqualify nonrecourse financing even if the value of the pledged property so amply covers the indebtedness that the likelihood of default is remote. However, if the nonrecourse debt satisfies the special conditions under section 465(b)(6)\textsuperscript{53} for “qualified nonrecourse financing,” applicable to taxpayers engaged in the activity of holding real property, sections 465(b)(2) and 465(b)(4) do not disqualify the financing. A taxpayer is not at risk with respect to a borrowed amount unless the taxpayer is realistically liable for repaying borrowed funds if the net income from the activity plus the value of the property used in the activity and securing the debt are insufficient.\textsuperscript{54}

Section 465(b)(3) disqualifies amounts borrowed from persons with an interest in the activity (other than as creditors) or from persons related to the taxpayer (as defined in section 267(b) or section 707(b), with certain modifications). For example, amounts a limited partner in a tax shelter borrows from the general partner or from the taxpayer/investor’s relatives are disqualified.\textsuperscript{55} Likewise, an S corporation shareholder is not at risk with respect to the basis of stock the acquisition of which was financed by borrowing the purchase price, or contribution, from another shareholder in the corporation.\textsuperscript{56} A lender is deemed to have an interest in the activity only if the lender has either a capital or a net profits interest in the activity.\textsuperscript{57} A capital interest is an interest in the activity that is distribut

directly to the [obligee] and each partner’s liability was personal\textsuperscript{\textdagger}).

Even though the at-risk amount is determined with reference to partnership liabilities, each partner’s at-risk amount is not a partnership item that a partnership-level audit proceeding can determine, but rather is an affected item that a partner-level proceeding must determine. \textit{See Hambrose Leasing} 99 T.C. at 305 (1992).
\textsuperscript{53} \textit{See supra} text accompanying notes 38-41.
\textsuperscript{54} \textit{See Berger, T.C.M. (RIA)} ¶ 94,298 (holding that the taxpayer’s motive for assuming the liability is irrelevant).
\textsuperscript{55} \textit{See} Rev. Rul. 80-327, 1980-2 C.B. 23 (putting the taxpayer at risk only to the extent of the cash down payment because the taxpayer borrowed the balance from a general partner, who has an interest other than that of a creditor); \textit{Peters, 77 T.C. at} 1164-65 (1981) (the disqualification of amounts borrowed from related persons applies to section 465(c)(1) activities whether or not the taxpayers used the activities as tax shelters). \textit{But see Levy v. Comm’r, 91 T.C. 838, 868 (1988)} (holding investor/lessors in an installment sale-leaseback transaction were at risk when the creditor/lessee’s interest was not one that might realistically cause the creditor to act contrary to how an independent creditor would act).
\textsuperscript{56} \textit{See Van Wyk, 113 T.C. at} 446 (holding that an S corporation shareholder was not at risk where the shareholder borrowed funds from another shareholder to relend them to the corporation).
\textsuperscript{57} Prop. Treas. Reg. § 1.465-8(b). \textit{Compare} Pritchett v. Comm’r, T.C.M. (P-H) ¶ 89,021
able on liquidation of the activity. 58 Exclusion from the taxpayer’s at-risk amount of borrowing from other persons with an interest in the activity or from related parties currently is limited to the activities specified in section 465(c)(1). Activities brought under the scope of section 465 by section 465(c)(3)—for example, certain research and development activities—are subject to this rule only as provided in regulations, and the Service has not issued final regulations on this point. 59

Pledged property cannot be counted in the at-risk amount if the taxpayer either uses it in the activity or directly or indirectly finances it with debt secured by property contributed to the activity. 60 For example, if the taxpayer borrows on a nonrecourse basis against the taxpayer’s residence, contributes the funds to a covered activity, and then pledges activity property as security for the nonrecourse debt, the latter is viewed as the true security for the debt. Therefore, the debt is disqualified, just as it would have been if the taxpayer had borrowed the funds solely on the security of the activity property.

In some cases the borrower may be at risk for some debts but not for

(1989), aff’d by order, 944 F.2d 908 (9th Cir. 1991) (holding that a mineral royalty interest only provides the lender an interest as a creditor, but a mineral net profits interest provides the lender an interest other than as a creditor) with Waddell v. Comm’r, 86 T.C. 848 (1986), aff’d, 841 F.2d 264 (9th Cir. 1988) (if payments on a note are contingent on profits, the holder of the note has an interest other than as a creditor); and Brady v. Comm’r, T.C.M. (P-H) ¶ 90,626 (1990) (the right to rental payments computed with respect to gross receipts is not a prohibited interest). Krause v. Comm’r, 92 T.C. 1003 (1989), aff’d sub nom. Hilderbrand v. Comm’r, 28 F.3d 1024 (10th Cir. 1994) (the promotor-creditor did not have a prohibited interest where profits and capital interests were limited to securing repayment of loan), and Rubin v. Comm’r, T.C.M. (P-H) ¶ 89,484 (1989) (a creditor- lienholder’s right to act as the property owner’s agent to sell or release equipment on the termination of an existing lease is not a prohibited interest), and Bennion v. Comm’r, 88 T.C. 684 (1987) (if a taxpayer is liable primarily to general creditors in a chain, and the ultimate creditor, who may proceed directly against the taxpayer on default, has no interest in the activity, the taxpayer is at-risk even though intermediate creditors have an interest in the activity).

58 See Brady, T.C.M. (P-H) ¶ 90,626 (determining that a creditor who leased equipment from the owner and subleased the equipment to the user did not have a capital interest in the owner’s leasing activity).

59 See I.R.C. § 465(c)(3)(D); Alexander v. Comm’r, 95 T.C. 467, 473 (1990), aff’d by order sub nom. Stell v. Comm’r, 999 F.2d 544 (9th Cir. 1993) (interpreting § 465(c)(3)(D) to state that § 465(b)(3) only applies to the extent provided in regulations prescribed by the Secretary to an activity described in § 465(c)(3)(A), and that regulations have not been prescribed to date).

others, or at risk with respect to a portion of a debt but not with respect to the balance. The former situation occurs, for example, when one loan is from an unrelated creditor with no interest in the activity and another is from a partner in the activity.\footnote{See Bennion, 88 T.C. at 695.} The latter case occurs, for example, when the taxpayer personally guarantees only a portion of a nonrecourse debt or is protected from loss by a collateral agreement that assures indemnification for only a portion of the amount that the taxpayer is required to pay on a recourse note.\footnote{See Durkin, 87 T.C. at 1380.}

3. **Protection Against Loss**

Under section 465(b)(4), no amount may be included in the taxpayer’s at-risk investment to the extent that nonrecourse financing, guarantees, stop-loss agreements, or similar arrangements protect the taxpayer against loss.\footnote{Insurance against casualties or tort liabilities, however, does not ordinarily constitute protection against loss within the meaning of section 465(b)(4). See Prop. Treas. Reg. §§ 1.465-5, 1.465-6(b), 1.465-6(c).} Because nonrecourse financing is not at-risk initially under section 465(b)(2), section 465(b)(4) is aimed at other arrangements that achieve a similar effect. The proposed regulations set forth examples of other arrangements that constitute protection against loss,\footnote{See Prop. Treas. Reg. § 1.465-6; see also Rev. Rul. 81-283, 1981-2 C.B. 115 (recourse loan, which debtor could change to nonrecourse loan at end of secured property’s useful life by making specified payment, placed debtor at risk only for cash actually paid plus amount required to convert to nonrecourse loan); Rev. Rul. 82-225, 1982-2 C.B. 100 (treating recourse obligation that obligor could convert to nonrecourse under certain conditions as nonrecourse because conditions had no substantial economic relationship to activity); Rev. Rul. 82-123, 1982-1 C.B. 82 (a note that the borrower could change recourse to nonrecourse if the Service determined that the tax benefits described in the prospectus were not available was nonrecourse ab initio); Rev. Rul. 83-133, 1983-2 C.B. 15 (provision allowing investor to be relieved of liability on recourse note by withdrawing from project and transferring property securing note to third party was protection against loss within meaning of section 465(b)(4)).} and numerous cases have applied section 465(b)(4) to a wide variety of arrangements. As a practical matter, the issue of whether or not a taxpayer is at risk is “resolved on the basis of who realistically will be the payor of last resort if the transaction goes sour and the secured property associated with the transaction is not adequate to pay off the debt.”\footnote{Levy, 91 T.C. at 869.} Any contractual arrangements effectively limiting or eliminating any risk of economic loss
may result in an investor being treated as not at risk.\textsuperscript{66} Rights granted by law must be taken into account as well. Thus, for example, a guarantor of a nonrecourse debt is not at risk if the guarantor would have a right of subrogation against another person if the guarantor were called on to honor the guarantee.\textsuperscript{67} If another party is obligated to reimburse the taxpayer for any out-of-pocket payments the taxpayer made in connection with an investment, including satisfaction of the taxpayer’s own recourse obligation, the taxpayer would be protected against loss within the meaning of section 465(b)(4). Whether the guarantor might default or be bankrupt when called upon to indemnify the taxpayer will not be considered unless such a factor contributes to the taxpayer facing a realistic possibility of an economic loss.\textsuperscript{68} Each transaction must be analyzed on its particular facts to account for the substance and commercial realities of the financing arrangements.\textsuperscript{69}

Some of the more difficult cases involve complex sale and leaseback transactions resulting in a circular flow of funds in which the owner-lessee’s obligations on a purchase-money recourse promissory note equal the rent received for the property, and all payments are made by

\textsuperscript{66} See Cooper v. Comm'r, 88 T.C. 84, 112 (1987) (holding that a taxpayer was protected against a loss by an option to put property to tax shelter promotor for the balance due on a debt); Capek v. Comm'r, 86 T.C. 14, 49 (1986) (holding that an investor who purportedly borrowed money with recourse from one entity controlled by a tax shelter promoter and invested the money with another entity controlled by the same promoter had a stop-loss arrangement because the amounts falling due under the borrowing were equal to the minimum entitlements under the investments); Porreca v. Comm'r, 86 T.C. 821, 836 (1986) (when notes were purportedly with recourse during a specified period, but no substantial payments were required during the period and the notes could be made nonrecourse by a small payment at the end of the period, the taxpayer was protected from loss within the meaning of section 465(b)(4)). But see Laureys v. Comm'r, 92 T.C. 101 (1989), nonacq. on this issue; acq. on other issues (deciding that offsetting positions in “butterfly” options traded on the Chicago Board of Options Exchange are not “similar arrangements” under section 465(b)(4)).

\textsuperscript{67} See, e.g., Peters v. Comm'r, 89 T.C. 423 (1987) (a limited partner who guaranteed partnership debt was not at risk for the guaranteed amount because if he paid the debt he had a right of subrogation against partnership); Brand v. Comm'r, 81 T.C. 821 (1983) (finding that a limited partner who guaranteed repayment of a loan to the partnership was not at risk for the amount of the loan guaranteed, because he was entitled to reimbursement from primary obligor).

\textsuperscript{68} See Whitmire v. Comm'r, 109 T.C. 266, 277 (1997).

bookkeeping entries rather than actual payment. One court of appeals has held that circular offsetting obligations that may insulate the taxpayer from ever satisfying a debt out of personal resources are not a loss-limiting arrangement under section 465(b)(4) if personal liability exists under the "worst case" scenario.\textsuperscript{70} However, the remaining courts of appeals\textsuperscript{71} follow the Tax Court in analyzing these cases on the basis of their particular facts.\textsuperscript{72} In most cases the courts apply section 465(b)(4) if the

\textsuperscript{70} Compare Martuccio v. Comm'r, 30 F.3d 743 (6th Cir. 1994) (the circular offsetting structure of payments does not require the per se application of section 465(b)(4); under the worst case scenario, the taxpayer would be liable on the note and thus at-risk), and Emershaw v. Comm'r, 949 F.2d 841, 849 (6th Cir. 1991) ("a loss-limiting arrangement within the meaning of [section] 465(b)(4) is a collateral agreement protecting a taxpayer from loss after the losses have occurred, either by excusing him from his obligation to make good on losses or by compensating him for losses he has sustained" (emphasis in original) and thus a circular sale and a leaseback is not a loss-limiting arrangement), with Leach v. Comm'r, 74 A.F.T.R.2d (RIA) 6555 (6th Cir. 1994) (applying section 465 to a sale and leaseback transaction because the partnership's obligee guaranteed the partnership's obligations, and thus distinguishing Emershaw because that case involved a guarantee of the partnership's obligations by a third party). See also Pledger v. United States, 236 F.3d 315 (6th Cir. 2000) (finding that the taxpayer was not the obligor of last resort because the lessee and the lender were subsidiaries of a corporation that guaranteed the lease payments, and even if the lessee became insolvent, the taxpayer would never be called upon to pay anything because the guarantor and the lender did not act independently and thus were essentially the same company).

\textsuperscript{71} See Waters v. Comm'r, 978 F.2d 1310, 1317 (2d Cir. 1992) (holding that investors in sale and leaseback transaction who gave intermediary a partially recourse note with a circular flow of funds effected through bookkeeping entries were not personally liable); Young v. Comm'r, 926 F.2d 1083, 1088 (11th Cir. 1991) (holding that investors in a sale and leaseback transaction with a circular flow of funds effected through bookkeeping entries, who gave the intermediary a partially recourse note, were not personally liable because the intermediary purchased the leased equipment on a wholly nonrecourse basis and "[t]he stated recourse liabilities of the taxpayers were not realistically subject to collection after a discharge of the nonrecourse note"); Am. Principals Leasing Corp. v. United States, 904 F.2d 477, 483 (9th Cir. 1990) (holding that circular debt obligations are an "other" arrangement negating at-risk qualification, and the possibility of a third party's insolvency is not to be considered; moreover, an "arrangement" need not be contractually binding to fall within section 465(b)(4)); Moser v. Comm'r, 914 F.2d 1040, 1049-50 (8th Cir. 1990) (finding that the taxpayer was not at-risk where the only other party in the chain of liability who conceivably might attempt to enforce the notes against the taxpayer would owe the taxpayer an exactly offsetting amount of rent).

\textsuperscript{72} Compare Levien v. Comm'r, 103 T.C. 120 (1994), aff'd by order, 77 F.3d 497 (11th Cir. 1996) (holding that the taxpayer was not at risk with respect to notes in a circular sale and leaseback transaction involving precisely offsetting obligations that bookkeeping entries extinguished because the test is based on economic reality, and the taxpayer is not necessarily entitled to a "worst case scenario" analysis), and Moser, T.C.M. (P-H) \S 89,142
taxpayer has no realistic personal liability.

4. Changes in At-Risk Amount

Section 465(b)(5) provides that losses the taxpayer incurs in a covered activity and deducts from another activity's income reduce the taxpayer's at-risk amount in the former activity; without such an adjustment, the taxpayer could use the same commitment year after year. The proposed regulations provide a network of at-risk accounting rules, including provisions for increasing the at-risk amount by the taxpayer's net income from the activity or payments of nonrecourse debt principal and for decreasing the amount by withdrawals of funds from the activity.

Although the taxpayer's at-risk amount limits the extent to which the taxpayer can apply the losses incurred against income from other activities, a withdrawal of funds from the activity or the conversion of qualified debt to a nonrecourse obligation can still cause the at-risk amount to drop below zero. Under section 465(e), the taxpayer's below-zero, at-risk amount must be included in gross income. The below-zero, at-risk amount is then treated as a deduction allocable to the activity, and it may be deducted in subsequent years, subject to the at-risk limitations applicable to those years. The effect of section 465(e) is to allow the taxpayer to recapture deductible losses allocable to a covered activity if, over time, they exceed the sum of the taxpayer's at-risk amount and the income, if any, reported from the activity.

IV. Passive Activity Deductions and Losses

A. Introduction

Despite the limitations on the availability of tax shelter deductions imposed by the at-risk rules of section 465, tax shelters continued to flourish in the late 1970s and early 1980s. Limiting deductions to the taxpayer's at-risk amount did not eliminate tax sheltering based on recourse purchase-money indebtedness or on real estate tax shelters, both

(1989) (finding that a circular sale and leaseback transaction was an arrangement protecting investors against loss), with Martuccio, 30 F.3d at 743 (holding that the taxpayer was at risk under the worst case scenario), rev'g T.C.M. (RIA) ¶ 92,311 (1992) (deciding that the taxpayer was at risk only for the equity investment), and Emershaw, T.C.M. (RIA) ¶ 90,246 (1990) (deciding that a circular sale and leaseback transaction was not an arrangement protecting the taxpayer from risk of loss).
of which the at-risk rules largely exempt.\textsuperscript{73} In 1986, Congress responded to the deficiencies of section 465,\textsuperscript{74} not by curing them, but by enacting section 469, which superimposes an entirely new and separate limitation on deductions attributable to "passive activities."\textsuperscript{75} By imposing severe restrictions on "passive activities," Congress demonstrated both a newfound seriousness in its battle against tax shelters and an impressive flair for the oxymoronic.

Section 465 focuses on the nonrecourse indebtedness factor common to most tax shelters, but section 469 focuses on another common characteristic of these activities—the absence of investor participation in the day-to-day affairs of the partnership or other business entity. Just as section 465 does, section 469 overrides the previously existing norm of global computation and requires compartmentalization of income and deduction items. Unlike section 465, however, section 469 applies to virtually every trade or business in which the owner does not "materially participate," without regard to the method of financing the business. Consequently, many individual taxpayers are required to compute separately the net profit or loss from each different trade or business in which they are engaged. After the individual taxpayers compute net profit or loss, they apply the section 469 rules to determine the extent to which they can use the losses derived from one business to offset income derived from another business. Thus, the tentacles of section 469 reach far beyond the tax shelter investments that were the target of Congress in enacting the passive activity loss rules. Only individuals who either materially participate in or who make a profit in every business that they own escape the broad reach of section 469.

In brief, section 469 prohibits taxpayers from using deductions that exceed recognized income from passive activities to eliminate tax liability allocable to income from any other source, such as salaries, professional fees, interest, dividends, gains from the sale of stock and other capital assets, and the net income of businesses in which the taxpayer actively

\textsuperscript{74} See Martin J. McMahon, Jr., Reforming Cost Recovery Allowances for Debt Financed Depreciable Property, supra note 3.
participates.\textsuperscript{76} Although section 469 is broader in this respect than section 465, compartmentalization under section 469 is not as complete as under section 465; the losses from one passive activity can be applied against income from other passive activities.\textsuperscript{77} Disallowed losses are carried over to future years and may be deducted against passive income in those years or used in the global computation of taxable income when the taxpayer sells the passive activity that generated the disallowed loss.\textsuperscript{78}

Considered together, section 469 and section 163(d) constitute a "two-basket" approach to tax shelter limitations. One basket, governed by section 469, applies to passive business activities; another basket, governed by section 163(d), applies to portfolio investments, such as in assets producing interest, dividends, royalties, and other forms of nonbusiness investment income. Active business income, including personal services income, is not within either basket. Thus, under section 469, losses from a passive activity may offset income from other activities in the passive activities basket, but may not offset either portfolio income or active business income until the taxpayer disposes of his entire interest in the passive activity. Similarly, investment interest expense may offset income in the portfolio basket, but investment interest expense may not offset either passive activity income or active business income. To ensure that the jurisdictions of section 163(d) and section 469 do not overlap, section 163(d)(4)(D) provides that investment income and expenses do not include "any income or expenses taken into account under section 469 in

\textsuperscript{76} See Carlstedt v. Comm'r, T.C.M. (RIA) ¶ 97,331 (1997) (holding that a taxpayer could not deduct losses from partnership in which he did not materially participate against income from S corporation in which he did materially participate).

The regulations provide, however, that casualty losses (as defined for purposes of section 165(c) or section 165(i)) with respect to property used in a passive activity are not treated as passive activity deductions. See Treas. Reg. § 1.469-2(d)(2)(x)(1995). Such losses are currently deductible, subject to sections 165 and 1231, without regard to section 469. However, if a casualty results in a gain (because insurance reimbursement exceeds the adjusted basis of the property and section 1033 is not applicable), the gain will be a passive activity gain, unless the gain is attributable to the reimbursement of a loss claimed in a prior year as a nonpassive loss. See Treas. Reg. § 1.469-2(c)(7)(vi); see also I.R.S. Notice 90-21, 1990-1 C.B. 332.

\textsuperscript{77} See I.R.C. § 469(d)(1). With respect to the scope of income from an activity, see Rev. Rul. 92-92, 1992-2 C.B. 103 (providing that discharge of indebtedness income is passive activity income to the extent the indebtedness has been allocated to passive activities under Temp. Treas. Reg. § 1.163-8T).

\textsuperscript{78} See I.R.C. § 469(b), (g).
computing income or loss from a passive activity,” and section 163(d)(3)(B)(ii) provides that investment interest does not include any interest taken into account in computing passive activity income or loss under section 469.

B. Taxpayers Subject to Limitation

The passive loss rules of section 469 apply to individuals, estates, trusts, closely held C corporations, and personal service corporations.79 Partnerships and S corporations are not directly subject to the rules but, as conduits for tax purposes, their income and deduction items are taken into account on the individual income tax returns of their partners or shareholders, at which point the limitations of section 469 are imposed.80 Personal service corporations and closely held C corporations are subject at the corporate level to the passive loss rules, even though other C corporations are exempt. This application of section 469 is necessary to prevent individuals from evading section 469 by incorporating their investment portfolios or by forming corporations that would undercompensate them for their personal services and invest the resulting retained profits in tax shelters.81

C. Activities Covered

Section 469 limits deductions for losses and credits attributable to a “passive activity,” which section 469(c)(1) defines as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.82 In addition, pursuant to section 469(c)(2), any

79 See I.R.C. § 469(a)(2).
80 See St. Charles Inv. Co. v. Comm’r, 232 F.3d 773, 776 (10th Cir. 2000), rev’d 110 T.C. 46 (1998) (holding that because section 469(b) expressly provides that the carryover of suspended passive activity losses shall be treated as an item with respect to the activity in the next year “except as otherwise provided in this section (469),” the section 1371(b)(1) limitation on carryovers from C corporation years to S corporation years was inapplicable).
81 A C corporation is a “closely held” C corporation only if more than 50% of its stock is held at some time during the last half of the taxable year by five or fewer persons, taking into account attribution. See I.R.C. §§ 469(j)(1)(B), 465(a)(1)(B), 542(a)(2), 544(a), 1361(a)(2). A “personal service corporation” is a corporation the employees of which own more than 10% of its stock, and its principal activity is providing personal services that its employees “substantially performed.” See I.R.C. §§ 469(j)(2); I.R.C. § 269A(b) (West 2001).
82 See I.R.C. §§ 469(a)(1), 469(c)(1); see also generally Edelberg v. Comm’r, T.C.M. (RIA)
rental activity is passive regardless of the taxpayer's participation level.\textsuperscript{83} Section 469 defines the term "trade or business" more broadly than for general purposes; thus, it includes research and experimentation activity within the meaning of section 174 and, to the extent provided by regulations, investment activities with respect to which section 212 allows deductions.\textsuperscript{84} The Treasury likely will extend passive trade or business treatment only to those activities generating section 212 deductions that may produce losses, such as limited partnerships trading in securities. Traditional portfolio-type investments that generally produce positive income should not be brought within the sweep of section 469 because to do so would work to defeat its purpose.\textsuperscript{85}

The two most crucial definitions in applying section 469 are the meanings of "material participation" and "activity." Nevertheless, the statute provides no meaningful guidance with respect to either, and guidance is found only in the regulations.

1. \textit{Material Participation}

Material participation by a taxpayer requires that the taxpayer be involved in the operations of the activity on a regular, continuous, and substantial basis.\textsuperscript{86} Although section 469 provides no further guidance as to the activity level required to satisfy the material participation requirement, the regulations provide detailed mechanical tests for determining

\begin{footnotesize}
\begin{itemize}
  \item 95,386 (1995), \textit{aff'd by order}, 111 F.3d 896 (11th Cir. 1997) (holding that income received from a third party's trade or business as a contingent sales price on the sale of the goodwill of taxpayer's business, which was not itself a passive activity, was either investment or portfolio income, not passive activity income that passive activity losses could offset).
  \item See infra text accompanying notes 127-33. The passive loss rules do not apply to any rental activity subject to § 280A because the taxpayer uses the dwelling as a residence. See I.R.C. § 469(j)(10); see also Chapin v. Comm'r, T.C.M. (RIA) ¶ 96,056 (1996) (applying Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A), the rental condominium was not a "rental activity" subject to \textit{per se} passive activity status under section 469(c)(2) because the average lease period was seven days or less; nevertheless, the rental condominium was a passive activity because taxpayer did not materially participate).
  \item See I.R.C. §§ 469(c)(5), 469(c)(6).
  \item See Temp. Treas. Reg. § 1.469-2T(c)(3) (1988); H.R. REP. NO. 99-841, at II-138 (1986). However, interest expense attributable to a portfolio-type investments is subject to section 163(d).
  \item See I.R.C. § 469(h)(1). For married taxpayers, a spouse's material participation may be attributed to the other spouse, without regard to whether they file a joint return. See I.R.C. § 469(h)(5); Temp. Treas. Reg. § 1.469-5T(f)(3).
\end{itemize}
\end{footnotesize}
material participation, which generally count the number of hours the taxpayer devotes to the activity.\textsuperscript{87} The Service's choice to rely primarily on mechanical rules is somewhat surprising because the committee reports indicate that a facts-and-circumstances test generally should be determinative.\textsuperscript{88}

Under the regulations, a taxpayer materially participates in an activity if the taxpayer meets any one of the following tests: (1) the taxpayer devotes more than 500 hours to the activity in the year;\textsuperscript{89} (2) the taxpayer's participation constitutes all of the participation in the activity of any individual; (3) the taxpayer participates in the activity for more than a hundred hours during the year and the taxpayer's participation is not less than that of any other individual;\textsuperscript{90} (4) the activity is a trade or business,

\textsuperscript{87} See Temp. Treas. Reg. § 1.469-5T(a).
A closely held C corporation or personal service corporation material participation in an activity that it conducts so shareholders holding more than one-half its stock's value materially participate in the business. See I.R.C. § 469(h)(4); see also Temp. Treas. Reg. § 1.469-1T(g)(3). In addition, a closely held C corporation that is not a personal service corporation materially participates in the business if (1) at least one full-time employee of the corporation is active in the management of the business throughout the taxable year; (2) at least three employees, each of whom owns no more than 5% of the corporation's stock, work full time in the business throughout the year; and (3) deductible expenses of the business, other than depreciation, interest, and taxes, exceed 15% of gross income. See I.R.C. §§ 469(h)(4)(B), 465(e)(7)(C).

\textsuperscript{88} See S. REP. NO. 99-313, at 730-36 (1986); H.R. REP. NO. 99-841; see also STAFF OF JOINT COMMITTEE ON TAXATION, supra note 2, at 235-42.

\textsuperscript{89} See Harrison v. Comm'r, T.C.M. (RIA) ¶ 96,509 (1996) (finding the taxpayer's testimony and co-venturer's testimony that the taxpayer spent more than five hundred hours engaged in treasure hunting expedition was credible evidence of the taxpayer's material participation in the activity); Gregg v. United States, 87 A.F.T.R.2d (RIA) 337 (D. Ore. 2000) (the taxpayer failed to satisfy the five hundred hour test, even though he worked approximately one hundred hours in the two-month short taxable year of an LLC's organization, because no short-year adjustment is available for hours of participation).

\textsuperscript{90} Compare Pohoski v. Comm'r, T.C.M. (RIA) ¶ 98,017 (1998) (deciding a taxpayer, who resided in California, presented credible evidence that he spent more than a hundred hours managing the rental of one Hawaiian condominium unit, which was rented for an average rental period of less than seven days, and that he spent more time in the activity than employees of the condominium management company, including front desk staff and maid service, but he did not present credible evidence with regard to a second Hawaiian condominium unit; only "actual time spent on rental" by condominium management company personnel was considered), with Scheiner v. Comm'r, T.C.M. (RIA) ¶ 96,554 (1996) (deciding that a taxpayer who devoted more than one hundred hours to activities on a condominium-hotel management board did not materially participate in the business because full-time employees spent more time in connection with rental activities, and the
the taxpayer participates in the activity for more than one hundred hours (but not more than five hundred hours) during the year, and the taxpayer's total participation in all such trade or business activities during the year exceeds five hundred hours; (5) the taxpayer materially participated in the activity for five of the preceding ten taxable years; (6) the activity is a personal service activity in which the taxpayer materially participated for any three preceding years; or (7) based on all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis. Only work a business owner customarily performs counts if the purpose of performing other work is solely to meet the quantitative hours test. Time spent in performing services as an investor does not count unless the taxpayer also engages in daily management functions. Qualifying under the facts-and-circumstances test is subject to special restrictions. First, participation in an activity for one hundred hours or less during the year can never qualify as material participation under this test. Second, management services may qualify as material taxpayer's argument that other individuals' hours of work benefitting the entire complex must be prorated by the number of units did not change the result because the taxpayer's work on board would also be prorated under that theory), and Oberle v. Comm'r, T.C.M. (RIA) ¶ 98,156 (1998) (holding that a taxpayer who owned a charter yacht did not materially participate in the chartering activity by cleaning and winterizing the yacht and providing routine maintenance because the taxpayer's participation was not more than the yacht broker's, who exercised the daily management responsibility of chartering the yacht, including routine cleaning and servicing).

91 See generally Machado v. Comm'r, T.C.M. (RIA) ¶ 95,526 (1995), aff'd by order, 119 F.3d 6 (9th Cir. 1997) (holding that the taxpayer's uncorroborated testimony about the time the taxpayer spent in the activity was insufficient to establish material participation); Chapin, T.C.M. (RIA) ¶ 96,056 (finding that the taxpayers did not materially participate in a condominium rental activity by thoroughly cleaning the condominium unit after each season because their participation was not regular and continuous in light of daily management by the rental agent and weekly cleaning by cleaning service); Mordkin v. Comm'r, T.C.M. (RIA) ¶ 96,187 (1996) (upholding Temp. Treas. Reg. § 1.469-5T; owner of two rental condominium units operating in a hotel-like manner did not materially participate under the facts and circumstances test, despite arguably satisfying the more-than-a-hundred-hours-of-work test, because other persons performed management services for compensation).

92 See Temp. Treas. Reg. § 1.469-5T(f)(2)(ii); see also generally Toups v. Comm'r, T.C.M. (RIA) ¶¶ 93,359 (1993) (finding that the taxpayer did not satisfy the more-than-one-hundred-hours-of-work test with respect to a vacation cottage); Serenbetz v. Comm'r, T.C.M. (RIA) ¶ 96,510 (1996) (deciding a condominium owner provided only investor-type services, such as participation in condominium owners association meetings and financial matters, and not day-to-day services in connection with rental activity).

participation under the facts-and-circumstances test only if no person other than the taxpayer receives compensation for managing the activity, or no other person devotes more time to managing the activity than does the taxpayer. Merely approving financial planning objectives or accepting or rejecting recommendations regarding the provision of the activity’s product, business locations, and personnel, while delegating other responsibilities, will not suffice.

Generally, an individual who works full-time in a business materially participates in that business. Part-time activities clearly are the most vulnerable under the regulations. Although the taxpayer’s use of employees or contract labor to perform daily functions of the business does not prevent the taxpayer from materially participating, the work of the employees and agents is not imputed to the taxpayer. Thus, a general partner or sole proprietor does not automatically qualify simply by virtue of the individual’s status.

The regulations provide a special rule dealing with “significant participation activities,” a concept for which the statute does not provide. A significant participation activity is any activity in which the taxpayer participates for more than one hundred hours during the year, but in which the taxpayer does not materially participate. If gross income for the year from all significant participation activities exceeds passive activity deductions from these activities, all of the activities are aggregated into a single, passive activity for the year. A portion of the income from the aggregated activities is then recharacterized as active rather than passive income.

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95 See generally Goshorn v. Comm’r, T.C.M. (RIA) ¶ 93,578 (1993) (deciding that the taxpayer did not materially participate in a boat-chartering activity by performing management services, including budget analysis, negotiating insurance and financing, and inspecting the boat, because his services were meager compared to the marina that performed all the services to charter the boat, including taking reservations, preparing the boat for sailing, and checking and cleaning it afterward).
98 However, for an agricultural or farming activity, a taxpayer’s bona fide exercise of management power on a regular, continuous, and substantial basis, without any such involvement in operations, may suffice in some cases. See H.R. REP. NO. 99-841, at II-148.
2. Definition of "Activity"

Because material participation is determined on an activity-by-activity basis, delimiting the scope of each activity in which the taxpayer invests or participates is crucial to applying section 469.101 For example, a partner might materially participate in one activity the partnership conducts but not in another. Thus, the partner’s share of partnership income and losses attributable to the activity in which the partner materially participates will be taken into account without regard to the limitations of section 469. The passive loss rules, however, will govern the partner’s share of the other partnership income and losses. This result is neither consistently pro-taxpayer nor consistently pro-government. If the active activity generates a loss while the passive activity generates income that tax shelter deductions may offset, the taxpayer benefits from the two-activity approach; however, if the active activity generates income and the passive activity generates a loss, the taxpayer/partner must report net income even though the partnership incurred an overall loss for the year. Generally, however, if the taxpayer continues to hold an interest in a venture or ventures, a broad definition of the term activity will be more favorable to the extent that the taxpayer’s material participation in one phase of the venture enables the taxpayer to claim as active losses the losses generated in another phase of the venture. On the other hand, a narrow definition of activity might benefit the taxpayer at a later stage because on the enterprise’s sale, suspended losses would become deductible only upon the disposition of the taxpayer’s entire interest in the activity.102

Once again, section 469 itself offers only limited assistance in determining the scope of various activities. The legislative history states that the guiding principle is that a single activity includes those "undertakings [that] consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss."103 Applying

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102 See Part IV.B.2. (describing the rules for allowance of suspended losses on the disposition of an activity, and discussing strategic considerations in treating related ventures as separate activities or as a single activity).
this standard, the committee reports conclude that a taxpayer is engaged in a different activity with respect to each different good or service the business provides, unless the goods and services are customarily, or for business reasons, provided together. Under this principle, a department store is a single activity even though the store sells a wide variety of goods. On the other hand, a vertically integrated business, such as a business that manufactures goods and sells them at retail, may constitute two separate activities. Furthermore, two undertakings to provide the same goods or services may be separate activities, such as separate rental real estate properties at different locations. An integrated real estate project, however, should be classified as a single activity. Finally, the legislative history clearly states that operations conducted by two or more separately organized entities (e.g., two or more separately incorporated retail outlets) may be treated as a single activity for section 469 purposes if the day-to-day functions are sufficiently integrated.104

The Service initially promulgated extraordinarily detailed temporary regulations governing the method of determining the scope of an activity under section 469.105 These temporary regulations were widely criticized as overly long and complex, burdensome, and mechanically inflexible. In response to the criticism, the Service allowed the temporary regulations to expire and then promulgated more flexible regulations defining the scope of an activity under section 469.106 The regulations adopt a facts-and-circumstances approach to identifying a taxpayer’s separate business activities. Multiple business or rental activities are treated as a single activity depending on “whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.”107 The following five evidentiary factors listed in the regulations are

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104 See, e.g., S. REP. 99-313, at 738-41 (discussing the characterization of different undertakings as a single activity).
106 See Treas. Reg. § 1.469-4 (as amended in 1995). The final regulations are generally effective for taxable years ending after May 10, 1992. For taxable years ending on or before May 10, 1992, taxpayers must apply Temporary Treasury Regulation section 1.469-4T. For the taxable year that includes May 10, 1992, taxpayers may apply the rules in Temporary Treasury Regulation section 1.469-4T rather than the rules in the final regulations.
107 Treas. Reg. § 1.469-4(c)(2).
given the greatest weight: (1) similarities and differences in the type of business; (2) the extent of common control; (3) the extent of common ownership; (4) geographical location; and (5) business interdependency, such as "the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or ... [share] a single set of books and records." The regulations permit activities to be grouped even if they are undertaken by distinctly different entities, such as a closely held corporation, subject to section 469, and a partnership or limited liability company, if the taxpayer has an ownership interest in both entities.

A taxpayer may group activities by applying any reasonable method to the relevant facts and circumstances. However, the regulations impose a consistency requirement; once a taxpayer has grouped activities, the taxpayer may not regroup them unless the original grouping was inappropriate or a material change occurred that makes the original grouping clearly inappropriate. Additionally, subject to qualifying limitations, the taxpayer generally may treat the disposition of substantially all of an activity as a complete disposition of a separate activity, thus allowing suspended losses. The Service may group the activities differently from the taxpayer only if the taxpayer’s grouping fails to reflect one or more appropriate economic units and a principal purpose of the taxpayer’s grouping is to circumvent the underlying purposes of section 469.

The regulations provide taxpayers with significant flexibility in determining the scope of an activity. For example, if a taxpayer owns a bakery and a movie theater at a shopping mall in Cincinnati and a bakery and a movie theater in Louisville, depending on other relevant facts and circumstances it may be reasonable (1) to group the movie theaters and

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108 Id.
109 See Treas. Reg. §1.469-4(d)(5); see generally Gregg v. United States, 87 A.F.T.R.2d (RIA) 337 (D. Ore. 2000) (allowing a taxpayer to aggregate the activities of an L.L.C. in which the taxpayer was a member with those of a closely held C corporation which the taxpayer controlled, and holding that the taxpayer does not need to conduct the activities simultaneously for the activities to be grouped).
111 See Treas. Reg. § 1.469-4(e).
112 See Treas. Reg. § 1.469-4(g) (as amended in 1995).
113 See Treas. Reg. § 1.469-4(f).
bakeries into a single activity, (2) to group the Cincinnati movie theater and bakery into a single activity and the Louisville movie theater and bakery into a different activity, or (3) to treat each movie theater and bakery as a separate activity.\textsuperscript{114}

Rental activities generally may not be grouped with nonrental business activities unless one of the activities is insubstantial relative to the other.\textsuperscript{115} The regulations provide an exception if each owner of the activities has the same proportionate interest in each activity. When the exception applies, the item from the rental activity attributable to rentals to the trade or business activity may be grouped with the trade or business activity, but items attributable to rentals to other persons may not be grouped with the trade or business activity.\textsuperscript{116} The regulations absolutely prohibit grouping a real property rental activity with a personal property rental activity unless the personal property is provided in connection with the real property (e.g., rental of furnished apartments).\textsuperscript{117}

If a taxpayer is a partner or a shareholder in an S corporation, application of the rules is more complex. First, the partnership or S corporation groups its activities under the general rules.\textsuperscript{118} Next, the individual partners or shareholders must group their interests in activities conducted directly or through partnerships or S corporations. Individual partners, however, may not separate activities that they have grouped at the entity level.\textsuperscript{119} In addition, the regulations impose special limitations on grouping by limited partners (and limited entrepreneurs as Code section 464(e)(2) defines) of activities conducted through different limited

\textsuperscript{114} See Treas. Reg. § 1.469-4(c)(3), ex. (1).
\textsuperscript{115} See Treas. Reg. § 1.469-4(d). Rental activities are defined as activities that are rental activities under Temp. Treas. Reg. § 1.469-1T(e)(3). See Treas. Reg. § 1.469-4(b)(2). See generally Glick v. United States, 96 F. Supp. 2d 830 (S.D. Ind. 2000) (deciding that 116 limited partnerships that owned rental real estate, in all of which taxpayer held a general partnership interest, should be aggregated with an S corporation in which taxpayer owned 93.6% of the stock and as to which taxpayer materially participated; S corporation was formed specifically to manage the limited partnerships' rental property, thus the partnerships and the corporation were an "appropriate economic unit" under the regulations; in addition, the corporation's trade or business activities—managing the real estate—were "insubstantial" relative to the partnerships' rental activities).
\textsuperscript{116} See Treas. Reg. § 1.469-4(d).
\textsuperscript{117} See Treas. Reg. § 1.469-4(d)(2).
\textsuperscript{119} Id.
partnerships—such activities generally may not be grouped.\textsuperscript{120}

3. \textit{Limited Partnerships}

Section 469(h)(2) specifically provides that except as provided by regulation, a limited partner's interest will not be treated as an interest with respect to which the partner materially participates. This conclusive presumption is based on the universally applicable state law restrictions on participation in partnership affairs by limited partners who wish to retain their limited liability.\textsuperscript{121} The Treasury, under the broad power Congress delegated to it to treat limited partners as materially participating, has promulgated regulations that provide two exceptions to the statutory rule. First, a limited partnership interest held by a general partner is not treated as a limited partnership interest.\textsuperscript{122} Whether or not the taxpayer materially participates is determined for both interests together by applying the generally applicable tests. Second, a limited partner who does not hold a general partnership interest materially participates if he meets one of the following three tests for material participation: (1) the five hundred-hour test, (2) the "material participation in five out of the past ten years" test, or (3) the "material participation in a personal service activity during three prior years" test.\textsuperscript{123} One district court has held that a member of a limited liability company should not necessarily be treated as a limited partner under the regulations, thereby permitting an L.L.C. member—at least one who was not totally passive—to establish material participation under any of the seven tests available to general partners, and not merely under one of the three tests available to limited partners.\textsuperscript{124}

To forestall attempts to convert portfolio income into passive activity income (which can be offset by passive activity losses) by holding portfolio investments in limited partnerships, section 469(e)(1) provides that interest, dividends, annuities, royalties, and the gain or loss from the sale of property producing such income (whether recognized by a partnership or otherwise) will in no event be attributed to a passive

\textsuperscript{120} See Treas. Reg. § 1.469-4(d)(3).
\textsuperscript{121} See, e.g., CAL. CORP. Code § 15632 (West 1991); 805 ILL. COMP. STAT. ANN. 210/303 (West 1993); N.Y. PARTNERSHIP LAW § 96 (McKinney 1988).
\textsuperscript{123} See Temp. Treas. Reg. § 1.469-5T(e)(2).
\textsuperscript{124} See Gregg v. United States, 87 A.F.T.R.2d (RIA) 337; see also Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(B) (defining a limited partner with reference to liabilities for the entity's debts under state law; does not automatically apply to all members of an L.L.C.).
activity.\textsuperscript{125} Income from publicly traded limited partnerships has much in common with portfolio income, such as dividends. To prevent its sheltering by losses from tax shelter limited partnerships, section 469(k) requires that the passive loss rules be applied separately to income and losses from each publicly traded limited partnership. Thus, if a taxpayer has net income from publicly traded limited partnerships and net losses from other limited partnerships, the taxpayer cannot deduct the losses against the income. In addition to all of these protections, section 469(l)(3) gives the Treasury broad authority to promulgate regulations "requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity."\textsuperscript{126}

4. Rental Activities

Subject to an exception in section 469(c)(7), section 469(c)(2) treats any "rental activity" as a passive activity irrespective of the taxpayer's material participation. Section 469(j)(8) defines rental activity as any activity in which payments are principally for the use of tangible property. Thus, for example, if the taxpayer owns and manages an apartment building in addition to having a full-time job in an unrelated business (e.g., as an airline pilot or physician), losses the taxpayer incurs in the apartment activity may not be deducted against income from salary or portfolio income except to the limited extent allowed under the special rule for real estate rental activities section 469(i) provides.

Rental businesses that involve short-term leasing with heavy turnover, especially in which significant services are performed in connection with each rental, are not subject to this per se rule. Under the regulations, an activity is not a rental activity if the average period of customer use is seven days or less, or if the average period of use is more than seven days but not more than thirty days and the taxpayer provides significant personal services in connection with the use.\textsuperscript{127} Examples of exempt

\textsuperscript{125} Section 469(1)(2) apparently empowers the Treasury to alter this rule by regulation.
\textsuperscript{126} I.R.C. § 469(l)(3).
\textsuperscript{127} See Temp. Treas. Reg. §§ 1.469-1T(e)(3)(ii)–1.469-1T(e)(3)(iv); see also Tarakci v. Comm'r, T.C.M. (RIA) ¶ 2000-358 (2000) (applying Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(D) and (vi)(C) to except from the passive activity loss rules equipment rental activity in which the taxpayer materially participated); Welch v. Comm'r, T.C.M. (RIA) ¶ 98,310 (1998) (losses incurred by taxpayer-carpenter in renting to various employers his tools and equipment, for his own use in the course of his employment, was an activity separate from his employment, and because the average rental period was for less than thirty
activities include short-term leasing of automobiles or equipment for which the lessor provides all maintenance, and hotel or motel room rentals. The regulations also treat as a nonrental activity *de minimis* rental income from property held principally for the purpose of realizing gain on its sale. On the other hand, long-term leasing of vehicles, "dry" leasing of airplanes, and leasing property under a net lease are rental activities subject to section 469.

If the same taxpayer conducts both rental activities and other activities with respect to the same property, the two activities must be separated in applying section 469. For example, constructing an apartment building is a separate activity from later renting the apartments. In the same vein, ownership of an office building that the taxpayer uses partially to conduct a business and the rest of which the taxpayer rents to third parties, would be bifurcated into two different activities; the nonrental activity would be classified as passive or active depending on the extent of the taxpayer's participation.

To prevent end-running the passive activity loss limitations by generating passive activity income, the regulations characterize as nonpassive any income derived from leasing property to an activity in which the taxpayer materially participates. For example, in *Schwalbach v. Commissioner* a taxpayer received rental income from real property he

days and taxpayer performed significant services relating to the rental of the tools and equipment, e.g., repair, maintenance and, transportation, pursuant to Temp. Treas. Reg. § 1.469-1T(e)(3)(ii), the tool rental activity was not a passive activity; *Mordkin*, T.C.M. (RIA) ¶ 96,187 (a condominium rental business was not a section 469(c)(2) rental activity that was per se passive because the average period of customer use was less than seven days).


130 See S. REP. NO. 99-313, at 743 (discussing the scope of rental activity).


132 111 T.C. 215 (1998) (upholding the validity of Treas. Reg. §§ 1.469-2(f)(6) and 1.469-4(a)); see also Fransen v. United States, 191 F.3d 599, 601 (5th Cir. 1999) (applying Treas. Reg. § 1.469-2(f)(6) to all of rental income from property owned by a husband and wife and rented to C corporation in which the husband, but not the wife, held stock, and deciding that under Temp. Treas. Reg. § 1.469-5T(f)(3), participation in an activity by one spouse is treated as participation by the other); Krulowski v. Comm'r, 114 T.C. 366, 371 (2000) (applying Treas. Reg. § 1.469-2(f)(6) to taxpayer who rented one building at a loss to a wholly-owned C corporation in which he did not materially participate, and rented
leased to a professional services corporation, through which he and another person conducted a dental practice, and in which he owned half the stock. The court characterized the taxpayer's rental income as nonpassive income, and the taxpayer was unable to offset the rental income with the taxpayer's passive activity losses from other sources.\textsuperscript{133}

5. \textit{Rental Real Estate Activities of Persons in Real Property Business}

For taxable years beginning after 1993, section 469(c)(7) provides a special rule for taxpayers engaged in a real estate business on a substantial basis.\textsuperscript{134} If more than one half of the personal services the taxpayer performs during the year are performed in one or more real property trades or businesses in which the taxpayer materially participates and the taxpayer performs more than 750 hours of services in these activities,\textsuperscript{135} then any real property rental activity in which the taxpayer materially participates (within the meaning of section 469(h)) is not treated as a passive activity under the automatic rule of section 469(c)(2).\textsuperscript{136} Once the automatic rule of section 469(c)(2) is negated, the taxpayer's material participation results in the rental activity not being subject to section 469 at all. Thus, the losses are fully deductible against the taxpayer's income from all sources.

\textsuperscript{133} \textit{See id.} at 225; \textit{see also} Sidell v. Comm'r, 225 F.3d 103, 109 (1st Cir. 2000) (applying Treas. Reg §1.469-2(f)(6) to recharacterize as nonpassive rental income received by a grantor trust from taxpayer/grantor's wholly owned C corporation in which he materially participated).

\textsuperscript{134} \textit{See I.R.C.} § 469(c)(7). Any pre-1994 suspended losses from a real estate activity that is no longer considered a passive activity by virtue of section 469(c)(7) are treated as losses from a former passive activity pursuant to section 469(f)(1).

\textsuperscript{135} \textit{See I.R.C.} § 469(c)(7)(B). Participation as an employee is not counted unless the taxpayer owns more than 5% of the employing entity. \textit{See I.R.C.} § 469(c)(7)(D)(ii); \textit{see also} Treas. Reg. § 1.469-9(c)(5) (2000) (if taxpayer is 5% owner-employee for only a portion of the year, activities during that portion of the year are taken into account); Pungot v. Comm'r, T.C.M. (RIA) ¶ 2000-606, at 344 (holding that section 469(c)(7)(D)(ii) did not violate the equal protection clause by treating a nonowner employee less favorably than a 5% owner).

For closely held C corporations subject to section 469, the test is met if more than 50% of the corporation's gross receipts are from real estate businesses in which the corporation materially participates. \textit{See I.R.C.} § 469(c)(7)(D)(i).

\textsuperscript{136} \textit{See generally} Treas. Reg. § 1.469-9.
A real property trade or business means any real property development, redevelopment, construction, acquisition, conversion, rental, management, leasing, or brokerage business.\textsuperscript{137} Work performed in managing real estate, however, is counted as participation in a real estate activity only to the extent the work involves management of the taxpayer's own rental real estate.\textsuperscript{138} Section 469(c)(7) was intended primarily to benefit real estate developers by allowing them to deduct losses from rental operations against income from development activities, but its sweep is much broader. Thus, for example, a real estate broker may deduct losses from an apartment building against commission income from the broker's real estate brokerage business or against interest and dividends wholly unrelated to real estate activities, provided the broker materially participates in the apartment building business. Whether a taxpayer materially participates in a rental real estate activity is determined separately with respect to each interest, unless the taxpayer elects to aggregate all real estate activities.\textsuperscript{139}

A married couple filing a joint tax return qualifies under section 469(c)(7) only if one of the spouses individually satisfies both prongs of the test for determining if a taxpayer is engaged in a real property business; however, material participation is determined by taking into account both spouses' activities.\textsuperscript{140} If one spouse is engaged in a real estate business, losses from that spouse's material participation in rental real estate activities may be deducted against all income on the joint return. However, if only one spouse is engaged in the real estate business, the other spouse's losses from rental real estate activities can be deducted only as passive activity losses.

6. \textit{Working Interests in Oil and Gas Properties}

Pursuant to a special rule in section 469(c)(3), owning a working interest in an oil or gas property is not a passive activity, even though the owner does not materially participate, provided the taxpayer holds the

\textsuperscript{137} See I.R.C. § 469(c)(7)(C).
\textsuperscript{138} See Treas. Reg. § 1.469-9(e)(3)(ii).
\textsuperscript{139} See Treas. Reg. § 1.469-9(e)(1), (e)(4), (g). See Kosonen v. Comm'r, T.C.M. (RIA) ¶ 2000-107, at 591 (aggregating losses from seven rental real estate properties on Schedule E did not constitute a valid election to treat the properties as a single activity, and it did not matter that the Service had not yet published guidance concerning how to make an election).
\textsuperscript{140} See Treas. Reg. § 1.469-9(e)(4).
interested directly or through an entity that does not limit the taxpayer's liability. Thus, a working interest in an oil and gas property held in a general partnership in which the taxpayer does not materially participate is per se not a passive activity; but, if the taxpayer is a limited partner, the exception does not apply and the interest is passive. If the interest is held in an S corporation, the normal material participation rules are determinative.

Section 469(c)(3)(B) requires that if any losses have been allowed under the exception, the net income from the activity in future years must also be treated as nonpassive income, even if the taxpayer’s relationship to the activity changes so that the activity otherwise would be passive. Thus, passive activity losses cannot offset the net income in the future years.

F. Losses Subject to Disallowance

For individuals, trusts, and estates, section 469(a)(1) disallows deductions for aggregate passive activity losses in excess of aggregate passive activity income for the taxable year. Although the statute does not clearly require the computation of income and loss on an activity-by-activity basis, the carryover rules require such a computation as a practical matter. Pursuant to section 469(j)(4) the Treasury has promulgated regulations for computing losses on an activity-by-activity basis and allocating disallowed passive activity losses among activities. Within each activity, disallowed losses are further allocated among

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141 See Temp. Treas. Reg. § 1.469-1T(e)(4); Treas. Reg. § 1.469-1(e)(4)(v). See generally STAFF OF JOINT COMM. ON TAXATION, supra note 2, at 250-57 (a working interest in oil and gas property is not a passive activity; therefore, losses and credits from activity can offset each other); Stephen J. White, Impact of Passive Loss Rules on Owners of Oil and Gas Interests, 68 J. TAX’N 342 (1988) (noting that the Temporary Regulations section 1.469-1T(e)(A) mirrors section 469(c)(3)(A)).

142 See ROBERT J. HAFT & PETER M. FASS, 1986 TAX SHELTERED INVESTMENT HANDBOOK § 5.03 (Clark Boardman Co. Ltd., 1986).

143 A husband and wife filing a joint return are treated as one taxpayer for this purpose. See Temp. Treas. Reg. § 1.469-1T(j)(1).

Section 469(e)(2) provides a more lenient rule permitting a closely held C corporation (other than a personal service corporation) to deduct passive losses against active business income. Passive losses may not be deducted, however, against dividends, interest, annuities, royalties from investment property, and gains on dispositions of property (other than interests in passive activities) that is held for investment.

deductions. The income from any particular passive activity is the amount by which the gross income from the activity exceeds the otherwise allowable deductions (e.g., trade or business expenses, interest, section 164 taxes, accelerated cost recovery system and depreciation deductions, and losses under section 165) allocated to it. A loss from a passive activity is the excess of deductions allocated to the passive activity over gross income from the activity. These general rules are subject to several modifications, described below.

The policy underlying section 469 is that passive business losses should offset only passive business income and should not be deductible against either personal services income or portfolio income (until a taxpayer disposes of his entire interest in the passive activity). To further this policy, section 469 includes rules designed to prevent taxpayers from avoiding the limitations on passive loss deductions through the strategy of combining a passive loss activity with personal services income or portfolio income. Suppose, for example, a lawyer is a limited partner in a partnership generating passive losses. Suppose also that the lawyer performs and receives compensation for legal services for the limited partnership. Treating the compensation as passive income from the lawyer's limited partnership interest would allow it to be sheltered by the lawyer's share of partnership losses. Pursuant to section 469(e)(3), however, earned income may not be taken into account in computing passive activity income or loss. This segregation of the earned income from the passive loss prevents a taxpayer from using the loss to shelter the income.

For a similar reason, section 469(e)(1) provides that passive activity income does not include interest, dividends, annuities, or royalties unless the passive activity receives the income in the ordinary course of its business. This prevents taxpayers from stuffing passive activities with assets generating portfolio income in order to deduct passive losses against

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146 See Temp. Treas. Reg. § 1.469-1T(f)(2)(i)(B); see also H.R. REP. NO. 99-841, at II-139 (1986); Fowler v. Comm'r, T.C.M. (RIA) ¶ 93,295 (1993) (a sole proprietor who occupies part of a building and rents the remainder of the building to others does not compute rental income by imputing the constructive rental payment from the active business to the real estate rental business).
portfolio income. The legislative history gives the example of a limited partnership that publishes a magazine at a tax loss and that also holds profitable portfolio investments in stocks and bonds. Each limited partner must account for the portfolio income separately from the magazine losses and cannot offset the portfolio income with those losses.\textsuperscript{149} Similarly, interest received on an installment note arising from the sale of property held for rental is portfolio income, not passive activity income.\textsuperscript{150} On the other hand, dividends received by a brokerage firm on its own account and in the ordinary course of business are passive income for a partner who does not materially participate, but not for a partner who does materially participate. Section 469(e)(1)(B) specifies that the return on working capital of a passive activity business is considered not to have been derived in the ordinary course of its business; thus, interest earned on working capital of a passive activity business is not passive income. Gain or loss on the disposition of any property that produces nonpassive income or that is held for investment, such as raw land, is likewise excluded in computing passive activity income or loss.\textsuperscript{151} The regulations expand the principle that so-called positive income sources cannot generate passive activity income (e.g., income from a covenant not to compete cannot be passive activity income).\textsuperscript{152} Expenses allocable to earning income that is not taken into account under section 469 are also excluded from the computations.\textsuperscript{153}

Section 469(l)(2) provides that the Treasury “shall” promulgate regulations “which provide that certain items of gross income will not be

\textsuperscript{149} See S. REP. NO. 99-313, at 729.
\textsuperscript{150} See Char-Lil Corp. v. Comm’r, T.C.M. (RIA) ¶ 98,457 (1998), aff’d by order, 232 F. 3d 900 (10th Cir. 2000) (interest on notes received by a closely held corporation on the sale of real property held for rental rather than for sale to customers in the ordinary course of business).
\textsuperscript{151} See More v. Comm’r, 115 T.C. 125, 135 (2000) (holding that gains incurred by an individual Lloyds of London underwriter on the sale of stock acquired before the underwriting activity began, which secured a letter of credit posted to cover loss claims against the underwriter, was portfolio income that could not be offset by the passive activity losses from the insurance claims).
\textsuperscript{153} See generally STAFF OF JOINT COMM. ON TAXATION, supra note 2, at 231-35.
taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income).” Pursuant to this authority, the Treasury has issued proposed regulations permitting the offsetting of “self-charged” interest incurred in lending transactions. Absent the proposed regulations, if a partner, or S corporation shareholder, loaned money to his partnership or S corporation, the interest income received would not be passive activity income, but the partner’s or shareholder’s share of the interest expense passed through from the entity might be a passive activity loss that could not be deducted against the interest income. This hardship would be alleviated under the proposed regulations by characterizing a portion of the interest income as passive activity income.

The Treasury has not, however, issued any regulations dealing with self-charged items other than interest. In Hillman v. Commissioner, the Tax Court held that section 469(l)(2) was self-executing, i.e., Congress intended to extend self-charged treatment not only for interest, but also for other appropriate items. Accordingly, the taxpayer, who had passthrough nonpassive income from an S corporation that performed management services for real estate partnerships in which the taxpayer was a partner, was entitled to offset the nonpassive management fee income with the corresponding passive deductions. On appeal, however, the Fourth Circuit Court of Appeals reversed the Tax Court’s decision. The court stated that “nothing in the plain language of I.R.C. § 469 suggests that an exception to I.R.C. § 469(a)’s general prohibition against a taxpayer’s deducting passive activity losses from nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself.” The court reasoned that the taxpayer’s argument for ignoring the plain language of the statute could prevail only if one of “two extremely narrow exceptions to the Plain Meaning Rule” applied: (1) “when literal application of the statutory language at issue produces an

154 I.R.A. § 469(l)(2)
156 See I.R.C. § 469(e)(1).
157 The proposed regulations also would characterize as passive activity income, rather than portfolio income, a portion of a partner’s share of partnership interest income attributable to loans to the partner.
158 114 T.C. 103, 114 (2000), rev’d, 250 F.3d 228 (4th Cir. 2001).
159 See Hillman v. Comm’r, 250 F.3d 228 (4th Cir. 2001), rev’g 114 T.C. 103 (2000).
160 Id. at 232.
outcome that is demonstrably at odds with clearly expressed congressional intent to the contrary” or (2) “when literal application of the statutory language at issue ‘results in an outcome that can truly be characterized as absurd, i.e., that is so gross as to shock the general moral or common sense.’” According to the court, neither of those situations was present.

The structure of section 469 makes income-producing passive activities attractive to taxpayers, because unrelated passive losses can shelter the passive income from such activities. However, section 469(I)(3) authorizes the Treasury to frustrate the taxpayer’s quest for passive income by promulgating regulations “requiring net income or gain from a . . . passive activity to be treated as not from a passive activity.” The legislative history indicates that this authority is to be exercised to prevent taxpayers from sheltering positive income sources with losses from passive business activities. Among its prime targets, therefore, are investments that economically resemble portfolio investments but that nevertheless fall within the technical definition of a passive activity (e.g., ground leases that produce income without significant expenses). Pursuant to this authority, the regulations provide for recharacterization of income from (1) certain “significant participation activities;” (2) rental of property less than thirty percent of the basis of which is subject to depreciation; (3) equity-financed lending activities; (4) rentals received in connection with development of property in which the taxpayer materially participated; (5) renting property to an activity in which the taxpayer materially participates, such as a professional partnership; and (6) partnerships and S corporations engaged in licensing intangible property.

The operation of section 469 is illustrated by the example in Table 1, which assumes that the taxpayer (1) received a salary of $100,000 and interest and dividends totaling $10,000, (2) had a distributive share of a loss from a general partnership in which he materially participated of $15,000, (3) had a distributive share of a loss from a limited partnership of $20,000, and (4) had a distributive share of income from another limited partnership of $5,000. The taxpayer’s AGI for the year is $95,000, which

161 Id. at 233.
is computed as follows:

**TABLE 1. Adjusted Gross Income Computed Under Passive Loss Rules**

1. Nonpassive activity income
   a. Salary $100,000
   b. Interest and dividends $10,000
   c. Total $110,000

2. Nonpassive activity loss (15,000)

3. Passive activity income 5,000

4. Allowable passive activity loss
   a. Passive activity loss $20,000
   b. Passive activity income (line 3) 5,000
   c. Lesser of line 4.a. or 4.b. (5,000)

5. Adjusted gross income (line 1.c. plus line 3 minus lines 2 and 4.c.) 95,000

In the absence of section 469, AGI would be $80,000. AGI is $15,000 greater with the application of section 469 because of the disallowance of the $15,000 by which the $20,000 loss from one passive activity exceeds the $5,000 income from the other passive activity.

**G. Credits Subject to Disallowance**

Section 469(a)(1) disallows any "passive activity credit," which section 469(d)(2) defines as the excess of the sum of all credits otherwise allowable for the taxable year that are attributable to passive activities over the regular tax liability allocable to those activities.\(^{164}\) Thus, if a taxpayer has an aggregate passive activity loss for the year, no passive activity credits are allowable. Because most credits are highly specialized, this provision has a more limited impact than the loss deferral rules, although in particular cases its impact can be significant.

Section 469(i)(6)(B) generally allows the low-income housing credit under section 42 and the rehabilitation investment tax credit under section

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\(^{164}\) See generally STAFF OF JOINT COMM. ON TAXATION, supra note 2, at 223-25.
47 to be claimed by "natural persons"—individuals, but not trusts—holding an interest in a real estate rental activity, even though the taxpayer does not participate in the activity to any extent. Thus, these credits may be available even to a limited partner. But these credits may offset taxes on only $25,000 of income from nonpassive activities. Furthermore, section 469(i)(3) provides that the $25,000 amount for the rehabilitation credit is phased out, on a deduction-equivalent basis, by fifty percent of the amount by which the taxpayer's AGI exceeds $200,000, under the principles that apply to the rental real estate exception, described below.

H. Rental Real Estate Exception

Section 469(i) relaxes the strictures of the passive loss rules by allowing natural persons and certain decedents' estates to reduce their nonpassive income by up to $25,000 of rental real estate losses or the deduction equivalent of passive activity credits incurred in any year in which the individual "actively participated"—a less exacting standard than material participation—in the rental real estate activity. The $25,000 limit is a per taxpayer ceiling, and if the taxpayer has losses from two or more rental activities, they are aggregated to determine whether the exception applies. Active participation real estate losses are deducted against net passive income from all other activities, including active participation real estate income, before being deducted against nonpassive

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165 See I.R.C. § 469(i)(4) for its limited availability to estates.

166 Section 469(j)(5) defines the "deduction equivalent" of passive activity credits as the "amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits." I.R.C. § 469(j)(5).

167 See generally STAFF OF JOINT COMM. ON TAXATION, supra note 2, at 242-45. See Schetzer v. Comm'r, T.C.M. (RIA) ¶ 99-252 (1999) (holding that the special treatment accorded to real estate rental activities in section 469(i) that is denied to rental of tangible personal property is not an unconstitutional denial of equal protection).

The natural persons limitation excludes trusts from the exception. See H.R. REP. NO. 99-841, at II-142. A decedent's estate is eligible for the first two years after the decedent's death, if, and only if, the decedent actively participated. See I.R.C. § 469(i)(4)(A).

Section 469(i) does not apply to real estate rental activity losses originally incurred in a year in which the taxpayer did not actively participate and that are carried over under § 469(b) to a year in which he does actively participate.

168 Section 469(i) does not cover married individuals filing separate returns unless they live apart throughout the taxable year. For eligible married individuals filing separately, the ceiling is reduced to $12,500 and the phase out of the exemption begins at $50,000. See I.R.C. § 469(i)(5).

169 See I.R.C. § 469(i)(2).
income within the $25,000 ceiling.\textsuperscript{170} For example, an individual with $70,000 of salary income has passive activity income of $10,000 from passive activity \textit{A}, income of $22,000 from active participation rental real estate activity \textit{B}, and a loss of $60,000 from active participation rental real estate activity \textit{C}. Of the loss from activity \textit{C}, $32,000 is deducted against the income from activities \textit{A} and \textit{B}, $25,000 is deducted against nonpassive income, and only $3,000 of the active participation real estate loss is not deductible for the year incurred.\textsuperscript{171} The disallowed loss is carried over under section 469(b) to subsequent years.\textsuperscript{172} This computation is illustrated by the example in Table 2.

\textbf{TABLE 2. Active Participation Rental Real Estate Losses}

1. Gross income
   a. Salary $70,000
   b. Activity A 10,000
   c. Activity B 22,000
   d. Total $102,000

2. Allowable active participation real estate loss
   a. Passive activity income
      i. Activity A $ 10,000
      ii. Activity B 22,000
      iii. Total $ 32,000
   b. Active participation real estate loss (Activity C) $(60,000)
   c. Active participation real estate loss deductible against passive activity income (lesser of line 2.a.iii. or line 2.b.) $(32,000)

\textsuperscript{170} See I.R.C. § 469(i)(6).
\textsuperscript{171} See H.R. REP. NO. 99-841, at II-141.
\textsuperscript{172} If the taxpayer has more than one rental activity that generated a loss, or if the taxpayer has active participation real estate rental losses exceeding $25,000 and other disallowed passive activity losses, the disallowed amounts must be allocated among all of the separate activities generating losses.
d. Active participation real estate loss deductible against active income
   i. Ceiling $(25,000)
   ii. Loss not deducted against passive income (line 2.b. minus line 2.c.) $(28,000)
   iii. Allowable deduction (lesser of line 2.d.i. or line 2.d.ii.) $(25,000)

e. Total allowable deductions (line 2.c. plus line 2.d.iii.) $(57,000)

3. Adjusted gross income (line 1.d. minus line 2.e.) $45,000

4. Carryover active participation real estate deduction
   (line 2.d.ii. minus line 2.d.iii.) $3,000

Carried over losses are allowable in future years under the rental real estate exception, rather than under the general rules applying to passive losses, but only if the taxpayer qualifies to claim losses under the special rule in the carryover year.173

Congress provided this relief because it believed taxpayers who provide significant services in real estate rental activities have nontax motivations warranting treatment different from that accorded to tax shelters generally.174 Nevertheless, the active participation rental real estate exception is of limited benefit to the taxpayer. Not only do allowable deductions have a $25,000 ceiling (with no provision for inflation adjustments), but the ceiling is reduced by half of the amount by which the taxpayer’s AGI, before taking into account any passive activity loss, exceeds $100,000. Thus, if a taxpayer’s AGI equals or exceeds $150,000, no active participation real estate losses are deductible against income that is not passive activity income. For example, if a taxpayer has a salary of $120,000 and an active participation rental real estate loss of $24,000, the $25,000 ceiling is reduced by $10,000 (i.e., 50% of ($120,000–$100,000)) to $15,000. For purposes of calculating the phaseout, AGI is not reduced by the $24,000 rental real estate passive loss.

174 See STAFF OF THE JOINT COMMITTEE ON TAXATION, supra note 2, at 255.
With this ceiling thus reduced, only $15,000 of the $24,000 loss is deductible. The disallowed portion of the loss (i.e., $9,000) may be carried over and allowed in a later year against passive income under the general carryover rules or against any income under section 469(i).

The active participation standard of section 469(i) is less stringent than the normal material participation standard of section 469(c)(1)(B) because real estate rental activities generally require less personal service than other businesses. Accordingly, regular, substantial, and continuous involvement in operations is not required as long as the taxpayer has a significant and bona fide role in management.\(^{175}\) Furthermore, a spouse’s participation is taken into account by attribution. Thus, for example, if a husband and wife are co-owners of a property, but only one of them manages the property, the nonparticipating spouse is deemed to participate actively; therefore, the entire loss from the property may be taken into account, whether or not they file a joint return. Mere ratification of decisions of an agent hired as a professional manager, however, will not suffice. Thus, being a general partner in a real estate partnership does not alone assure that the taxpayer has met the active participation standard.

Furthermore, an individual who does not own at least ten percent of all interests in the activity (aggregating the interests of spouses) at all times during the period that the activity was conducted is conclusively presumed not to have participated actively.\(^{176}\) For example, a co-owner or partner with a five percent interest in the property is not actively participating even if the individual manages the rental activities and receives ten percent of the net cash flow to reflect the services provided. Even if the individual described above acquired a full ten percent interest at the midpoint of the taxable year, the individual would not qualify for the active participation exception with respect to the losses incurred during the second half of the year (prorating deductions such as depreciation over the entire year). However, the individual would qualify as actively participating the next year.\(^{177}\) Finally, section 469(i)(6)(C) provides that regardless of the percentage interest held, a limited partner cannot actively participate with respect to the limited partnership interest; if the partner also holds a

\(^{175}\) See I.R.C. § 469(i)(6)(A).

\(^{176}\) See I.R.C. § 469(i)(6)(A).

\(^{177}\) See H.R. REP. NO. 99-841, at II-141.
general partnership interest, however, that interest may qualify.\footnote{The Service has authority to promulgate regulations under which limited partners may be treated as actively participating. See I.R.C. § 469(i)(6)(C).}

I. Treatment of Disallowed Losses and Credits—Carryovers

Section 469(b) allows any passive activity loss or credit disallowed under section 469(a) to be carried over to the succeeding year, in which it is treated as a deduction or credit for that year.\footnote{Treasury Regulation section 1.1398-1 provides that passive activity loss carryovers are transferred to a taxpayer's bankruptcy estate, and on termination any remaining carryovers revert to the taxpayer.} If section 469(a) applies again in that year, another carryover is allowed; thus, losses and credits can be carried over until used.

Although the carryover computation itself does not necessitate allocating the disallowed loss among the taxpayer's various passive activities, the rules for allowing deferred losses in full on the taxable disposition of an activity require that this be done as a practical matter. The interrelationship of the at-risk rules and the passive loss rules also requires this allocation. If an activity entails nonrecourse financing, deductions must first pass through the filter of section 465 before section 469 is applied, and the taxpayer's at-risk amount in an activity may differ in succeeding years. The regulations provide the mechanical rules for these computations and they also allocate disallowed losses among loss activities in proportion to the respective loss incurred in each activity.\footnote{See Temp. Treas. Reg. § 1.469-2T(d)(6) (coordinating section 469 with other restrictions on deductions); Temp. Treas. Reg. § 1.469-1T(f)(2)(i) (allocating disallowed deductions).}

To apply provisions such as the capital loss limitation of section 1211 and the section 1231 hotchpot, the disallowed loss must be allocated with respect to each activity among the various deduction items that contributed to the loss. In many instances, the resulting allocations will be of only theoretical interest. Nevertheless, because in many other instances it will be important to identify the exact deduction that was disallowed and carried over, the regulations provide for this computation.\footnote{See Temp. Treas. Reg. § 1.469-1T(f)(2)(ii).}

If depreciation deductions are attributable to a disallowed passive activity loss, the basis of the depreciable property is nevertheless reduced by the otherwise allowable depreciation deduction.\footnote{See St. Charles Ins. Co. v. Comm'r, 110 T.C. 46, 60 (1998), rev'd on other grounds, 232}
sale of the property not involving the complete disposition of the activity in which the property was used, the gain recognized is not reduced by the amount of the suspended depreciation deductions.\textsuperscript{183} That the depreciation deductions have not yet produced a tax benefit, and might never produce a benefit unless the conditions for releasing them from suspension are met, is irrelevant.

J. Treatment of Former Passive Activity Losses

When a taxpayer materially participates in an activity that was a passive activity for prior years, the income and deductions from the activity for the year in which the taxpayer materially participates do not give rise to passive activity income or loss.\textsuperscript{184} Any remaining previously disallowed passive activity losses with respect to the former passive activity that have been carried over under section 469(b) to years in which the taxpayer materially participates continue to be passive activity losses, but section 469(f)(1) permits the taxpayer to deduct those carried over losses against the nonpassive income from that activity recognized in future years in which the taxpayer materially participates. To the extent that carried over losses from the former passive activity exceed net income from the activity in any year, the losses are deductible in that year only against passive activity income.\textsuperscript{185}

K. Allowance of Losses on Disposition of Activity

Section 469 is intended to disallow artificial losses, not true economic losses.\textsuperscript{186} Thus, when the taxpayer sells an investment in a passive activity, deferred losses generally are allowed in the year of sale.\textsuperscript{187} To the extent that any of the deferred losses are artificial, an equally artificial gain on the disposition will offset them. True economic losses, however, will be recognized. Not all dispositions qualify for recognition of deferred losses, and special rules are provided for some of the most common methods of

\textsuperscript{183} See id. at 61 (citing S. REP. No. 99-313 (1986)).
\textsuperscript{184} See I.R.C. § 469(f).
\textsuperscript{185} See I.R.C. § 469(f)(1).
\textsuperscript{186} However, because section 469 applies to equity-financed activities as well as debt-financed activities, based solely on whether the taxpayer materially participates in the activity, section 469 may defer true economic losses.
\textsuperscript{187} See I.R.C. § 469(g).
disposition. However, none of the rules allows for the use of deferred credits on disposition because credits are inherently artificial. But credits do continue to be available under the carryover rules.

Section 469(g)(1)(A) allows all of the deferred deductions with respect to an activity to be claimed on a fully taxable disposition of the taxpayer’s entire interest in the activity. To claim these losses, the taxpayer must have adequate records isolating the portion of previously disallowed passive losses attributable to the activity that were not allowed as deductions against other passive activity income in the years between the year of disallowance and the disposition. Eligible dispositions encompass sales, taxable exchanges, and abandonments, but exclude tax-deferred exchanges, such as contributions to partnerships and corporate reorganizations, even if gain is recognized in part. In the case of an activity conducted as a sole proprietorship, the disposition must encompass all of the assets used to conduct the activity. If a partnership or an S corporation conducts the activity, the sale by the taxpayer of the taxpayer’s entire partnership interest or all of the taxpayer’s stock generally will suffice, but a sale of less than the entire interest will not suffice. On the other hand, the sale by the entity of all the assets used in an activity allows the partners or shareholders to deduct shares of deferred deductions attributable to that activity, even though the partnership or S corporation continues to conduct other activities and the taxpayer continues to hold an interest in the entity. Deferred deductions attributable to other passive activities of the entity continue to be held in suspense. For publicly traded limited partnerships that avoid classification as corporations under section 7704, however, section 469(k)(3) requires the disposition of all of a partner’s interest in the partnership before section 469(g) allows any deferred losses.

Gain or loss on a fully taxable disposition generally is treated as

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188 See id.
189 See I.R.C. § 469(b).
190 See generally STAFF OF JOINT COMM. ON TAXATION, supra note 2 at 225-30. Section 469(g)(1)(C) gives the Service regulatory authority to limit the amount of losses allowed on the disposition of a passive activity. See H.R. REP. NO. 100-4333, at 32 (1988).
192 See S. REP. NO. 99-313, at 725.
193 For rules governing allocation of gain on the sale of a partnership interest among its passive and nonpassive activities, see Temp. Treas. Reg. § 1.469-2T(e)(3).
passive gain or loss, and the deferred losses are allowed against income in the following order: (1) income from the passive activity, including gain, if any, recognized on the disposition; (2) net income or gain for the year from all other passive activities; (3) any other income or gain. If, however, any of the deductions allowed under this rule are capital losses, either on the disposition or as deferred deductions allowed by reason of the disposition, the limitations of section 1211 take precedence. Thus, only $3,000 of capital losses, including both deferred losses allowed by reason of the sale and capital losses, if any, realized on the sale, as well as all other capital losses recognized during the year, may be deducted against ordinary income.

Because disallowed passive activity credits are not allowed even on a taxable disposition, section 469(j)(9) permits taxpayers to increase their basis in the activity immediately prior to a disposition if, and to the extent that, the credit resulted in a prior decrease in the basis of the property generating the credit. The balance of the suspended passive activity credits attributable to the activity may be claimed against regular taxes attributable to passive income for the year, including taxes attributable to the gain on the sale of the activity. Any remaining credits carry over to future years to be claimed against regular taxes on passive income from other activities, even though the taxpayer no longer holds the passive activity that generated the credit.

A taxable disposition to a related party, as defined in sections 267(b) and 707(b)(1), will not trigger allowance of suspended losses. The loss will be allowed to the original transferor, however, if and when the related party disposes of the activity in a fully taxable transaction. Furthermore, sales to unrelated parties must be bona fide; sham transactions, wash sales, and sales coupled with a right to repurchase or the like will not trigger allowance of the deferred losses.

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195 See generally Brad D. Williams & John W. Cullins, The Application of the First Set of Passive Loss Regulations to Partnerships, 5 J. PARTNERSHIP TAX’N 195 (1988). The statutory direction in this regard, which formerly appeared in section 469(g)(1)(C), was repealed in 1988, but the result described in the text does not appear to be affected.
196 See I.R.C. § 1211.
197 See I.R.C. § 469(b).
198 See I.R.C. § 469(g)(1)(B).
If the triggering disposition is an installment sale to which section 453 applies, losses are not allowed in full in the year of the sale; instead, suspended losses will be allowed as the installment gain is recognized. For example, if section 453 requires twenty percent of the gross profit from the sale to be recognized in the years of the disposition, then twenty percent of the suspended losses will be allowed in that year. Subject to this restriction, losses on an installment sale are treated in the same manner as in an all-cash disposition.

The requirement that the taxpayer disposes of his entire interest in the activity to claim suspended losses raises a number of problems, not the least of which is defining the scope of an activity. As described earlier, the proposed regulations ameliorate the problem by deferring to the taxpayer's initial characterization, unless it is inappropriate, and by foreclosing midstream taxpayer-initiated recharacterizations of the scope of an activity.

The proposed regulations create considerable room for tax planning in delineating the scope of an activity. The planner must consider both the treatment of losses while the taxpayer continues to hold the activity and the treatment of losses on disposition. Consider two different situations. First, suppose the taxpayer is involved in two related loss-producing ventures, and he materially participates in one but not in the other. In that case, the taxpayer will want to characterize the two ventures as a single activity in which the taxpayer materially participates. Assuming the characterization is accepted, the taxpayer will have escaped section 469 altogether. Second, suppose a taxpayer is involved in two related loss-producing ventures, and the taxpayer materially participates in neither. In that case, both ventures will be subject to section 469 whether the taxpayer characterizes them as one activity or two. By characterizing them as separate activities, however, the taxpayer will be able to deduct suspended losses on one venture if the taxpayer disposes of it while retaining the other venture.

Determining whether the taxpayer has disposed of his entire interest is complicated by the fact that a single entity may conduct more than one

\[200\] See I.R.C. § 469(g)(3).
\[201\] If one venture is profitable and the other is not, and the taxpayer materially participates in the profitable venture but not in the loss-producing venture, the taxpayer will again want to treat the two ventures as a single activity, so that the loss-producing venture will not be subject to section 469.
activity. For example, a partnership or an S corporation and one or more other entities can combine to conduct a single activity. Thus, although a taxpayer need not dispose of the partnership interest to claim deferred losses from an activity if the partnership disposes of the activity, disposing of a partnership interest does not assure that the taxpayer has disposed of his entire interest in an activity if he retains an interest in another entity that continues to conduct a business with a substantial economic relationship to the partnership business.\textsuperscript{202}

If a taxpayer disposes of less than the entire interest, disposes of it in a wholly or partially nontaxable transaction, or sells it to a related party, the previously disallowed losses remain in suspense to be allowed against passive income currently or in some future year, or on the completion of the disposition.\textsuperscript{203} In the case of an initial disposition in a nontaxable transaction, such as contribution to a partnership or a section 1031 like-kind exchange, the suspended losses, to the extent not deducted against passive income during intervening years, will be allowed on the fully taxable sale of the property received in the earlier exchange.\textsuperscript{204} If gain is recognized on the nonqualified disposition, the gain is passive gain that will be aggregated with all other passive income in determining the extent to which passive losses will be allowed for the year.\textsuperscript{205}

Under section 469(g)(2), disposition of a passive activity by death triggers allowance of deferred deductions to the extent that they exceed the step-up in the basis of the property in the transferee’s hands under section 1014. Losses allowed under this rule are claimed on the decedent’s final return. The balance of the deferred deductions attributable to the activity are permanently nondeductible because they do not represent a true economic loss.

Disposition of a passive activity by gift does not trigger disallowed losses because the disposition is not a fully taxable transaction.\textsuperscript{206} Furthermore, under section 469(j)(6), the transferor is denied the right to carry over to future years the disallowed losses and credits attributable to the transferred activity. Instead, the deferred losses are added to the

\textsuperscript{202} See Staff of the Joint Comm. on Taxation, supra note 2, at 225.


\textsuperscript{204} See Staff of the Joint Comm. on Taxation, supra note 2, at 226.

\textsuperscript{205} See id.

\textsuperscript{206} See I.R.C. § 469(j)(6).
transferor's basis in the transferred activity immediately before the transfer. Thus, under section 1015, the deferred losses augment the transferee's basis in the activity, unless the proviso of section 1015(a), relating to fair market value in cases of loss, applies. If the gift is of only a portion of the taxpayer's interest in the activity, these rules apply with respect to an allocable portion of the suspended deductions; the remainder continue to carry over for the transferor.

The gift rules also should apply to transfers between spouses or former spouses incident to a divorce, which are governed by section 1041. A significant difference in this case, however, is that the limitation of loss basis in the transferee's hands to fair market value at the date of the transfer does not apply. Thus, the transferee will not suffer a permanent loss of any of the disallowed deductions as a result of the transfer. But the transferee will not have the deferred losses available currently to offset passive income; they will be available only through recovery of basis on a sale of the property. Section 469(g)(1), which allows suspended losses upon the disposition of an activity, should not control the use of this addition to basis, but it will apply to any passive losses generated and suspended while the transferee holds the activity.

V. CONCLUSION

The at-risk rules of section 465 and the passive activity loss rules of section 469 are sometimes criticized for the complexity they have added to the Code. These rules should not be condemned for complexity, however, without considering a type of simplicity that they have fostered. As a result of the enactment of these rules, particularly the passive activity rules (as well as certain other provision in the Tax Reform Act of 1986 such as longer depreciation schedules for real estate and the repeal of the investment tax credit), the historic tax shelter industry has been virtually shut down. Large numbers of mostly nonproductive transactions that

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207 See the first sentence of section 1015(a).
208 See I.R.C. §§ 469(b), (j)(6).
209 Compare I.R.C. § 1041(b)(2) with I.R.C. § 1015(a).
210 See I.R.C. § 469(j)(6).
211 To be sure, a new corporate tax shelter industry based primarily on financial products has risen in its place. These new tax shelters, however, are based on exploiting entirely different anomalies in the Code and regulations. See generally Ira B. Shepard & Martin J. McMahon, Recent Developments in Federal Income Taxation: The Year 2000, 5 FLA. TAX REV. 109, 211-23 (2001) (discussing recent developments in corporate tax shelters).
previously absorbed significant amounts of capital and generated huge transaction costs have been eliminated.

Section 469 disallows actual economic losses incurred by passive business owners, as well as tax shelter losses,212 and this might be criticized as overly broad.213 On the other hand, there may be no administratively practical way of distinguishing real economic losses of passive business owners from artificial tax shelter losses (prior to the disposition of the activity). If so, passive business owners with real economic losses are civilian casualties—lamented, but unavoidable—in the war on tax shelters.

It might have been preferable for Congress to have eliminated accelerated depreciation and expensing of certain capital outlays and to have tightened section 465 even further but to have continued to permit the deduction of passive losses. These changes likely would have significantly reduced the number of new shelters and obviated the need for the passive activity loss rules. But Congress did not do so, and it is not likely to eliminate accelerated depreciation—if anything, Congress is likely to further accelerate depreciation deductions. Thus, on balance, the tax system benefits from the type of simplicity fostered by sections 465 and 469. Without these rules, complex tax shelters would flourish.

212 Compare the Limitation on Artificial Loss proposal of the Treasury in 1973, which would have deferred only losses attributable to accelerated cost recovery tax expenditures. DEPARTMENT OF THE TREASURY, PROPOSALS FOR TAX CHANGE 94-104 (1973).
213 See Martin J. McMahon, Jr., Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Take Care of Itself, 50 WASH. & LEE L. REV. 459, 490 (1993). The stated rationale for enacting the passive activity loss rules was as follows: “[I]n order for tax preferences to function as intended their benefit must be directed primarily to taxpayers with substantial and bona fide involvement in the activities to which the preferences relate.” S. REP. NO. 99-313, at 716 (1986).