REPORT # 585

TAX SECTION

New York State Bar Association

PRELIMINARY REPORT
ON TEMPORARY AND PROPOSED REGULATIONS
UNDER SECTION 469

by
the Committees on Income from
Real Property and Personal Income

July 28, 1988

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New York State Bar Association

August 3, 1988

Section 469 Regulations

Dear Larry:

I enclose our preliminary report concerning the temporary and proposed regulations under Code Section 469, prepared by members of the Committees on Income from Real Property and Personal Income. The principal authors of the report were Thomas V. Glynn, James S. Halpern, Michael Hirschfeld and William H. Weigel. Helpful comments were received from Samuel Brodsky, William Burke, Carolyn Ichel, Robert Levinsohn, Donald Schapiro, David Watts and Ralph Winger.

The report recognizes that the passive activity statutory rules are complex and that the regulations must be drafted in a manner that prevents taxpayers from manipulating their business activities so as to have the best of both worlds-- passive income in income years and active losses in loss years. We believe, however, that the final regulations would benefit from an increased use of objective standards and safe harbors. We also believe that, in general, whether an activity produces income or loss, the same standard should be applied for purposes of determining the active or passive character of the activity. We further believe the final regulations should devote some attention to the concept of “positive income sources” as that term is: used in the legislative history of Section 469, and that several of the per se non-passive rules should be revised to be more closely aligned with that standard.

Please note that we have not commented on all aspects of the initial set of temporary and proposed regulations, in large part because we believe that the definition of the term “activity” will have such a significant impact that our comments will be more meaningful after that definition is proposed. Accordingly, we contemplate that we will be submitting additional comments as additional sections of the regulations are proposed.

Sincerely,

Herbert L. Camp

The Honorable Lawrence B. Gibbs,
Commissioner of Internal Revenue,
1111 Constitution Avenue, N.W.,
Washington, D.C. 20224

Copies w/encl. to The Honorable O. Donaldson Chapoton,

Assistant Secretary of Treasury for
Tax Policy,
U. S. Treasury Department,
1500 Pennsylvania Avenue, N.W.,
Washington, D.C. 20220

Dennis E. Ross, Esq.,
Deputy Assistant Secretary for
Tax Policy,
Department of Treasury,
Main Treasury Building,
1500 Pennsylvania Avenue,
N.W.,
Washington, D.C. 20220

Dana L,. Trier, Esq.,
Tax Legislative Counsel,
Department of Treasury,
Mein Treasury Building,
1500 Pennsylvania Avenue, N.W.,
Washington, D.C. 20220

Ronald A. Pearlman, Esq.,
Chief of Staff,
Joint Committee on Taxation,
1015 Longworth,
House Office Building,
Washington, D.C. 20515

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PRELIMINARY REPORT
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Prepared by the

Committees on Income from Real Property

and Personal Income

New York State Bar Association

Tax Section

July 28, 1988

New York State Bar Association Tax Section

Committee on Income from Real Property

Committee on Personal Income

Preliminary Report on Temporary and Proposed Regulations under Section 469[1]

I. Introduction.

Section 501(a) of P.L. 99-514, the Tax Reform Act of 1986 (the “1986 Act”), added Section 469 to the Internal Revenue Code.[2] Amendments to Section 469 were included in the Revenue Act of 1987, P.L. 100-203 (the “1987 Act”). In addition, certain amendments to Section 469 are currently pending in the Technical Correction Bills of 1988 (H.R. 4333 and S. 2238, referred to herein as the “Technical Corrections Bills”). In general, Section 469 creates a new category of activities— “passive activities”-- and provides that in the case of individuals, estates, trusts, personal service corporations and, in a modified manner, closely held C corporations, passive activity losses and passive activity credits generally may not be used to reduce tax liability

[1] This report was prepared by Thomas V. Glynn, James S. Halpern, Michael Hirschfeld and William H. Weigel. Helpful comments were received from Samuel Brodsky, William Burke, Carolyn Ichel, Robert Levinsohn, Donald Schapiro, David Watts and Ralph Winger.

[2] Except where otherwise specified, all Section references herein are to sections of the Internal Revenue Code of 1986 (the "Code") and all regulation paragraph references are to paragraphs of Temp. Treas. Reg. §§1.469-1T through 1.469-11T.

relating to compensation income, portfolio income or active business income. Temporary regulations were issued (and also published for comment as a notice of proposed rule making) in the Federal Register on February 25, 1988 at pages 5686 and 5733 (T.D. 8175 and LR-14-88).[3] This report comments on certain aspects of the Temporary Regulations. A number of key provisions of Section 469 were not covered in T.D. 8175 and LR-14-88 and, accordingly, we anticipate that we will have further comments on the Temporary Regulations after further guidance on those reserved issues is published.

II. Outline of Statutory Provisions.

Section 469(a) of the Code applies to individuals, estates, trusts,[4] personal service corporations (and, in a modified manner, closely-held C corporations). It requires those taxpayers to identify their “passive activities”[5] and determine their aggregate losses and aggregate income from all passive activities for the taxable year, and provides that, with certain exceptions, any excess of such loss over such income

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[3] For convenience, the temporary and proposed regulations will be referred to herein as "Temporary Regulations."

[4] The application of Section 469 to trusts, estates and their beneficiaries is reserved in the Temporary Regulations (Paragraphs -8T; -5T(g)).

[5] The term "activity" is not defined in the statute and is reserved in the Temporary Regulations (Paragraph -4T).

(the “passive activity loss”) is not currently deductible.[6] Similarly, such taxpayers must determine the sum of their credits from all passive activities allowable for the taxable year; with certain exceptions, such credits are not allowed to the extent that they exceed the taxpayer's regular tax liability for the taxable year allocable to all passive activities.[7]

Section 469(b) provides that suspended losses and suspended credits are treated as deductions or credits allocable to the same passive activities in the next taxable year.

Section 469(c) defines the term “passive activity” to mean any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate. The term passive activity includes any rental activity, regardless of whether the taxpayer materially participates in the activity, or whether it constitutes a trade or business. The

[6] These losses will be referred to as "suspended losses."

[7] These credits, referred to herein as "suspended credits," are those under Section 27(b) (the Section 936 credit), Section 28 (credit for clinical testing expenses for certain drugs for rare diseases or conditions), Section 29 (credit for producing fuel from a non-conventional source), and Section 38 (general business credits, including the investment credit determined under Section 46(a), the alcohol fuels credit determined under Section 40(a), the targeted jobs credit determined under Section 51(a), the credit for increasing research activities determined under Section 41(a) and the low income housing credit determined under Section 42(a)).

term “passive activity” does not, however, include any working interest in any oil or gas property held by the taxpayer directly or through an entity that does not limit the liability of the taxpayer with respect to such interest. The term trade or business is not defined in Section 469, but includes any activity involving research or experimentation within the meaning of Section 174 and, to the extent provided in regulations, any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under Section 212.

Section 469(d) defines the terms “passive activity loss” and “passive activity credit.”

Section 469(e) provides a number of special rules to be used in determining income or loss from a passive activity. First, there shall not be taken into account gross income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business. Second, income or loss attributable to an investment of working capital is treated as not derived in the ordinary course of a trade or business. Third, interest expense properly allocable to the above categories of gross income, and expenses other than interest that are clearly and directly allocable to such gross income, are also not taken into account. Fourth, gain or loss attributable to the disposition of property producing a type of income described income described above or held for investment is not taken into account,[8] but any interest in a passive activity is not treated as property held for investment. Fifth, in the case of closely held C corporations (other than personal service corporations), net active income for the year may be offset by passive activity losses for the taxable year, with a similar rule applying to passive activity credits. Finally, earned income (defined by cross reference to Section 911(d)(2)(A)) is not taken into account in computing the income or loss from a passive activity for any taxable year.

Section 469(f) provides rules relating to the tax treatment of an activity that was a passive activity of the taxpayer for any prior taxable year but is not a passive activity of the taxpayer for the current taxable year. In general, those rules provide that any unused deductions allocable to such activity shall be offset against the income from such activity for the year; that any unused credits allocable to such activity shall be offset against the regular tax liability allocable to such activity for the taxable year; and that any deductions or credits remaining after the application of these offset rules shall continue to be treated as arising from a passive activity.

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[8] The Technical Corrections Bills would limit this exclusion to gain or loss not derived in the ordinary course of a trade or business.

Similarly, Section 469(f) also provides that if a taxpayer ceases for any taxable year to be a closely held C corporation or a personal service corporation, the passive activity limitations continue to apply to losses or credits to which they applied for any preceding taxable year, in the same manner as if the taxpayer continued to be a closely held C corporation or a personal service corporation, whichever is applicable.

Section 469(g) provides that if during the taxable year a taxpayer disposes of his entire interest in any passive activity or former passive activity, then, in general, if the disposition is a fully taxable transaction, (i) any loss from the activity that had not previously been allowed as a deduction and (ii) (if the activity is a passive activity for the year of the disposition)[9] any losses realized on the disposition, are not treated as passive activity losses. Instead, the losses are allowable, first against income or gain from the passive activity for the taxable year (including any gain recognized on the disposition), second against net income or gain for the taxable year from all other passive activities, and third, against all other income or gain. This loss utilization rule does not apply to dispositions where the person acquiring the interest is

[9] The Technical Corrections Bills would remove this limitation.

a related person within the meaning of Section 267(b) or Section 707(b)(1); in that event, the loss utilization provision does not apply until the year in which the related party disposes of the interest to an unrelated party. Where the interest in the passive activity is transferred at death, the loss utilization rule applies to the extent that the losses not previously allowed are greater than the basis increase that occurs with respect to the transferred property; any loss to the extent of the basis increase is not allowed as a deduction for any taxable year. The treatment of suspended losses where property is disposed of by gift is governed by Section 469(j), and is discussed below. Finally, Section 469(g) provides that where there is an installment sale of an entire interest in a passive activity, the loss utilization rule applies proportionately as income from the installment sale is recognized.[10] The loss utilization rule applies only to suspended losses; suspended credits generally expire if the disposition of the property does not generate sufficient passive tax liability to utilize them.

Section 469(h) of the Code defines the term "material participation." Section 469(h)(1) provides that a taxpayer

[10] In general, the rules relating to treatment of losses on dispositions are reserved in the Temporary Regulations. (Paragraph -6T).

shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis.[11] Section 469(h)(2) provides that except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates. Section 469(h)(3) provides rules relating to the material participation in farming activities of certain retired individuals and, surviving spouses. Section 469(h)(4) provides that a closely held C corporation or personal service corporation shall be treated as materially participating in an activity if[12] one or more shareholders holding stock representing more than 50% by value of the stock of the corporation materially participate in the activity or, in the case of a closely held C corporation other than a personal service corporation, (1) during the entire 12-month period ending on the last day of the taxable year, the corporation had at least one full-time employee substantially all the services of whom were in the active management of the business; (2) during that same time period the corporation had at least three full-time non-owner employees substantially

[11] Certain items relating to the definition of material participation are reserved in the Temporary Regulations. (Paragraph -5T(b)(1)).

[12] The Technical Corrections Bills would change this to "only if."

all the services of whom were services directly related to such business; and (3) the amount of deductions attributable to the business that are allowable to the taxpayer solely by reason of Sections 162 and 404 for the taxable year exceeds 15% of the gross income from the business for the year. Section 469(h)(5) provides that in determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.

Section 469(i) of the Code provides rules pursuant to which individuals who actively participate in rental real estate activities will not be subject to the limitations of Section 469(a). This benefit is limited to $25,000 ($12,500 in the case of married individuals filing separate returns who do not live together at any time during the year, and zero otherwise) of deductions or the deduction equivalent[13] of credits and is phased out for taxpayers with higher incomes, with the phase out starting at $100,000 of adjusted gross income (excluding passive activity losses) and being complete when adjusted gross income reaches $150,000 (excluding passive activity losses). An individual will not be treated as actively participating for any period if at any time during the period the value of the

[13] At a 28% tax rate, $25,000 of deductions equates to $7,000 of credits.

interest of the individual and his or her spouse in the activity in question is less than 10% of the value of all the interests in the activity. Section 469(i) also provides that no interest as a limited partner in a limited partnership is treated as an interest with respect to which the taxpayer actively participates;[14] that in determining whether a taxpayer actively participates, the participation of a taxpayer's spouse shall be taken into account; and, finally, that the active participation requirement does not apply to low income housing tax credits and rehabilitation investment tax credits, with a substitution of a $200,000 adjusted gross income phaseout threshold for those credits.

Section 469(j) of the Code provides certain definitions and special rules. Section 469(j)(1) provides that the term “closely held C corporation” means any C corporation in which at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned directly or indirectly by or for not more than five individuals. (This definition is made by way of a cross reference to Sections 465(a)(1)(B) and then to 542(a)(2), and presumably incorporates the constructive ownership rules of Section 544.) Section 469(j)(2) provides that the term “personal service corporation” has the meaning

[14] The Technical Corrections Bills would give the Secretary regulatory authority to change this rule.

given that term by Section 269(A)(b)(1) (with certain modifications), namely, a corporation the principal activity of which is the performance of personal services if such services are substantially performed by employee-owners.

An employee-owner is any employee who owns, on any day during the taxable year, any of the outstanding stock of the personal service corporation. The attribution rules of Section 318 (with certain modifications) apply for purposes of determining stock ownership of a personal service corporation. A corporation is not treated as a personal service corporation unless more than 10% of the value of the stock in the corporation is held by employee-owners. Section 469(j)(4) provides rules for the allocation among activities of the passive activity loss and passive activity credit and the $25,000 amount provided in, subsection (i). Section 469(j)(5) provides rules for the calculation of the deduction equivalent of credits from passive activities. Section 469(j)(6) provides that the basis of any interest in a passive activity disposed of by gift is increased by the amount of any passive activity losses[15] allocable to such interest, and provides that such losses shall not be allowable as a deduction for any taxable year. Section 469(j)(7) provides that the passive activity loss of a taxpayer shall be computed

[15] The Technical Corrections Bills clarify that this refers to suspended losses.

without regard to qualified residence interest. Section 469(j)(8) provides that the term “rental activity” means any activity where payments are principally for the use of tangible property.[16] Section 469(j)(9) provides for an election to increase the basis of property by the amount of any disallowed passive activity credits that had reduced the basis of the property, but only in the case of fully taxable dispositions.

Section 469(k) of the Code, which was added by the 1987 Act, provides that the rules of Section 469 are applied on an entity-by-entity basis in the case of publicly traded partnerships, except that this separate entity rule does not apply to low income housing tax credits or rehabilitation investment tax credits, to the extent that those credits exceed the regular tax liability attributable to income from the partnership.[17]

Section 469(1) provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry

[16] The treatment of income, deductions and credits from certain rental real estate activities is reserved in the Temporary Regulations. (Paragraph -9T).

[17] The application of Section 469 to publicly traded partnerships is reserved in the Temporary Regulations. (Paragraph -10T). The Partnership Committee of the Tax Section submitted a report dated September 23, 1987 on Section 469(k)(3) of the Code.

out the provisions of Section 469, including regulations that specify what constitutes an activity, material participation or active participation; regulations that provide that certain items of gross income will not be taken into account in determining income or loss from any activity; regulations that require that income or gain from a limited partnership or other passive activity be treated as not from a passive activity; regulations that provide for the determination or the allocation of interest expense; and regulations that deal with changes in marital status and changes between joint returns and separate returns.

Section 469(m) provides a limited phase-in of the disallowance of losses and credits for interests held on or before October 22, 1986. The 1986 Act and the 1987 Act also provide certain transition rules for low income housing that are not enacted as part of the Code.

III. Overview of Temporary Regulations.

Paragraph -1T contains rules relating to the disallowance of the passive activity loss and passive activity credits; identifies the taxpayers to which the restrictions apply; provides for the general effect of Section 469 under other provisions of the Code; contains definitions of essential terms, including “passive activity,” “trade or business activity,” and “rental activity”; provides special treatment of certain losses from oil and gas working interests; provides rules dealing with the trading of personal property and the rental of a dwelling unit; provides for the treatment of disallowed passive activity losses and credits; provides for the application of the passive loss and credit limitations to C corporations; and sets forth rules relating to the treatment of spouses filing joint returns.

Paragraph -2T contains definitions of and rules for computing the passive activity income, deductions and losses; defines portfolio income; contains rules requiring that income from certain passive activities be treated as income that is not from a passive activity; provides rules for losses resulting from the disposition of an activity; coordinates the application of certain other disallowance provisions; provides special rules for partners and S corporation shareholders; and requires the recharacterization of passive income in certain circumstances.

Paragraph -3T contains rules for computing the passive activity credit.

Paragraph -5T contains rules defining the term “material participation.”

Paragraph -11T provides rules relating to effective dates and transition rules.

A number of key issues are reserved for future regulations, including rules determining what is an activity, rules relating to the allowance of losses on dispositions of interests and activities, rules relating to the treatment of self charged expenses, rules relating to the application of Section 469 to trusts, estates and their beneficiaries, rules relating to the application of the $25,000 allowance under Section 469(i), rules relating to the treatment of publicly traded partnerships and rules relating to the application of the passive loss and credit limitations in the case of former passive activities that change status from year to year.

IV. Major Conceptual Comments.

1. Complexity and Uncertainty. It is evident that Section 469 will add a substantial degree of complexity and uncertainty to the business and tax affairs of those engaging in transactions within its scope. The transactions to which Section 469 applies are by definition legitimate business transactions, not shams, tax motivated transactions or hobbies, because the suspension rules of Section 469 apply to deductions that have survived other disallowance rules, and Section 469 does not differentiate between so-called paper losses (e.g., losses attributable to depreciation, accrued interest and other “non-cash” items) and actual out-of-pocket expenses. The complexity results from the layering of a complicated new set of concepts

on top of already complex rules, and applying those new concepts to existing transactions. The uncertainty results from the use of subjective standards. Because we believe that uncertainty in the tax law is undesirable, we believe that the basic orientation of the regulations should be, to the maximum extent possible, to establish objective standards and safe harbors and to minimize the use of undefined subjective standards.

2. Regulatory Discretion. Section 469(1) authorizes the Secretary to “prescribe such regulations as may be necessary or appropriate to carry out provisions of this section . . . .” The paragraphs that follow in Section 469(1), authorizing regulations inter alia, to define activity, material participation and active participation, to provide that certain items of gross income will not be taken into account in determining income or loss from an activity, and to require that net income or gain from a limited partnership or other passive activity be treated as not from a passive activity, are an admittedly broad grant of authority. However, we believe that the regulations exercising that authority must retain a focus on the fact that the purpose of Section 469 is to (a) permit the use of losses (and credits) from a passive activity against current or future income (and taxes) from other passive activities, and not only against future income from the loss- or credit-producing activity, and (b) prevent the use of such losses and credits against “positive income sources,”

such as compensation for services or portfolio income.[18] Stated differently, it is clear that apart from publicly traded partnerships, Section 469 does not limit the use of losses from one passive activity to income from that activity. Although we recognize that Section 469(1) authorizes legislative, not merely interpretative, regulations, and although we agree that it is appropriate that Section 469 be interpreted in a manner that prevents taxpayers from whipsawing the Treasury by generating active losses and then passive income from the same transaction, in a number of instances, the Temporary Regulations appear to impose such a limitation, and appear to conflict with clear statements in the legislative history in a manner' that may exceed the authority of the statute. For example, we question whether the Temporary Regulations exceed the Secretary's statutory authority in characterizing an activity as passive or non-passive on the basis of whether the activity produces a loss or income, rather than on the basis of the extent of the taxpayer's activities, and in attempting to identify potentially profitable new trades or businesses (such as equity financed lending, or trading intangible property) that might be arranged as investments for persons with suspended passive activity losses, and characterizing them as non-passive, without due

[18] Report of the Committee on Finance, United States Senate, to accompany H.R. 3838 at 719; S. Rep. No. 99-313, 99th Cong., 2nd Sess. (May 29, 1986) (The "Senate Report").

regard to the dichotomy established in the legislative history of Section 469 between passive activities, on the one hand, and positive income sources, on the other hand.[19]

Although the term “positive income sources” is unfortunately not defined in the statute or the legislative history, some specific references to the term in the legislative history that do shed some light on its meaning all incorporate the concept that “positive income sources” exclude income sources that bear or are likely to bear any significant deductible expenses:

> “Salary and portfolio income are separated from passive activity losses and credits because the former generally are positive income sources that do not bear, at least to the same extent as other items, deductible expenses.” (Emphasis added) (Senate Report at 719).

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[19] The propriety of entering into bona fide transactions structured in a manner that will minimize taxes is well established. See Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972):

> "4 Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring . . . . to minimize taxes. Perhaps the classic statement of this principal is Judge Learned Hand's comment in his dissenting opinion in Commission v. Newman, 159 F.2d 848, 850-851 (CA-2, 1947):
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>> 'Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.'"

> "Portfolio investments ordinarily give rise to positive income, and are not likely to generate losses . . . ." (Emphasis added) (Senate Report at 728).

See also the clarification in the Conference Report[20] of the description of the Secretary's regulatory authority, which gives three limited examples of instances in which it would be appropriate to exercise the authority; (1) ground rents that produce income without significant expenses (a transaction that seems clearly to fall on the non-passive side of the above-described dividing line); (2) related party transactions that in effect reduce active business income and increase passive business income (clearly a potentially abusive transaction because the transaction involves related parties); and (3) activities previously generating active business losses that would permit the taxpayer intentionally to seek to treat as passive at a time when they generate net income, in this fashion circumventing the rule (also a potentially abusive situation, with the taxpayer attempting to have the best of both worlds).

Based on the foregoing, we question whether the regulations should (a) arrive at a different conclusion on the issue whether an activity is active/portfolio or passive when a

[20] Conference Report to Accompany H.R. 3838, H.R. Rep. No. 99-841, 99th Cong., 2d Sess. (September 18, 1986) at II-147 (The "Conference Report").

loss is produced than the conclusion would be if income were produced; (b) use a different active or material participation standard for losses than is used for income and gains; or (c) attempt to establish categories of trades or businesses that will be treated as portfolio, not passive, without basing that treatment on a conclusion that such investments are not likely to bear significant deductible expenses.[21]

V. Comments on Significant Policy Issues.

The preamble to the Temporary Regulations contains an extensive list of significant policy issues. This section of our report comments on some of those significant policy issues.

1. The effect of Section 469 on other provisions.

A. Paragraph -1T(d)(1) provides that the characterization of items of income or deduction as passive does not affect the treatment of the items under any other provision of the Code, so that for example, an item of capital gain that is categorized as passive income is still treated as capital gain for purposes of determining the allowable capital loss for the year. We agree with this conclusion.

B. paragraph -1T(d)(3) provides that, in general, a deduction that is disallowed under Section 469 is not taken

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[21] This third standard is not applicable to net leases of depreciable property because it is clear in the legislative history that such activities are passive. Conference Report at II-138.

into account as a deduction allowed for the taxable year for any other purpose of Subtitle A of the Code. We agree with this conclusion.

2. <u>Definition of passive activity</u>.

A. The Internal Revenue Service (the "Service") is still studying the possibility of treating certain activities carried on in connection with the trade or business that do not themselves constitute the conduct of a trade or business, and certain Section 212 activities, as trade or business activities for purposes of Section 469. We do not have any comment on this issue at this time.

B. Paragraph -1T(e)(3) provides six exceptions to the general rule defining rental activity. The second exception applies to activities involving the use of tangible personal property in which, (a) on average, the period for which each customer uses the property is greater than seven days but not greater than 30 days and (b) significant personal services are provided, excluding services not performed by individuals and certain "excluded services" that are considered to be customary. The third exception applies to an activity involving the use of tangible personal property where extraordinary personal services are provided. Although we have more specific comments on these provisions below, we note here that as a policy matter the use of standards that are not clearly defined, such as excluded “customary” services, “significant” services and “extraordinary” services can be expected to create a substantial degree of uncertainty for taxpayers and the Service, and it is reasonable to anticipate difficult administrative problems in evaluating the types of services that will fall into these three categories because the Temporary Regulations are attempting to separate into discrete categories what is essentially a continuum of services.

The sixth exception applies to property provided by a partner, S corporation shareholder or joint venture to the partnership, S corporation or joint venture for use by that entity in a non-rental activity, where the taxpayer does not rent the property to the entity but provides it to the entity in the taxpayer's capacity as an owner. We agree with this characterization.

3. Special rules treating certain activities as non-passive.

A. Paragraph -1T(e)(4) provides rules relating to working interests in oil or gas properties that the taxpayer holds directly or through an entity that does not limit the taxpayer's liability with respect to such interest. Initially, Paragraph -1T(e)(4)(i) applies this rule on a well-by-well basis, so that, for example, in the case of a taxpayer who owns a working interest in one part of a tract through a limited partnership and owns a working interest in another portion of the tract directly or through a general partnership, the working interest exception would apply to the expenses incurred in drilling a well on the second tract, but would not apply to the expenses incurred in drilling a well on the first tract. Given that the working interest exception is intended to apply only to those who are exposed to the unlimited economic risk of the drilling activity, we agree with the well-by-well approach. We suggest that the proposed regulations be clarified to indicate that ownership of a working interest through a series of entities that do not limit liability (e.g., through an investment in a general partnership that invests in a joint venture to drill a well) is also eligible for the working interest exception.

Paragraph -2T(c)(6) abandons this well-by-well approach to provide that income from any oil and gas property, the value of which is “directly enhanced” by activities benefiting from the working interest exception is treated as not from a passive activity. As is noted below in Section VI, we have some comments on the scope of this rule.

Paragraph -1T(e)(4)(ii) also deviates from the well-by-well rule by providing that notwithstanding the working interest exception, a portion of the taxpayer's deductions from an oil and gas well will be treated as passive activity deductions (and a corresponding portion of any gross income from the well <u>for such year</u> will be treated as passive activity gross income) if (a) the taxpayer has a net loss for the year from the well and (b) economic performance occurs with respect to expenses deducted for the taxable year, at a time when the taxpayer holds the interest through an entity that limits liability. We agree with this general rule. However, we believe that the rule should provide even-handed treatment for a transaction in which the taxpayer has net income from the property for the year and that in those circumstances a portion of the gross income from the property for the year should be treated as passive activity gross income.

4. <u>Treatment of Spouses Filing a Joint Return</u>.

Paragraph -1T(j) adopts a general rule that married persons filing a joint return are considered as one taxpayer for purposes of Section 469, including specifically the material participation test in Section 469(h)(5) and the active participation test in Section 469(i)(6)(D). There are two exceptions to this general rule. First, if any deductions or credits are disallowed, the disallowed deductions and credits attributable to each spouse's activities must be separately identified. Second, for purposes of the working interest exception, married persons are treated as separate taxpayers. The reasons stated for this latter result is that the unlimited liability of one spouse, which renders that spouse eligible for the working interest exception, does not result in unlimited liability for the other spouse and thus should not render the other spouse eligible for the working interest exception unless that other spouse also incurs unlimited liability as a result of his or her own investment vehicle. We agree with the general rule and with the exceptions. We suggest that the regulations be clarified to state explicitly that the second exception does not apply to the income characterization rule of Paragraph -2T(c)(6).

5. Identification of Items of Gross Income and Deduction from Passive Activities. Part VIII of the preamble to the Temporary Regulations invites comment on the question whether the regulations should address how particular items of gross income and deduction are allocated to passive activities. We agree that the approach taken by the Temporary Regulations is appropriate. Any attempt to codify rules governing such allocations is likely to be either enormously complex and confusing to taxpayers, practitioners and the IRS or to be too vague to be useful. The recently issued interest allocation regulations already provide guidance concerning the one item of deduction which is perhaps most easily manipulated. If any effort in this direction were to be made, we suggest that one or more safe harbors be established. Thus, for example, expense

allocations might be respected if based upon the relative revenues derived from different activities, or upon the relative unadjusted basis, or relative fair market value of assets used in the activities.

VI. Technical Comments on Temporary Regulations.

Paragraph -1T(e)(3). Rental Activity:

(A) General Rule: A passive activity includes any “rental activity” regardless of whether the taxpayer materially participates in the activity. Section 469(c)(2). The term “rental activity” means any activity where payments are principally for the use of “tangible property”. Section 469(j)(8). This term excludes the lease of intangible property. Recommendation: The regulations should clarify that a sublease of tangible property constitutes a rental activity, even though the lessee-sublessor's interest may constitute intangible property. The term “principally” should be quantitatively defined, and the basis on which the determination is made should be specified. As is noted below, one of the Examples includes a situation in which the value of the services provided exceeds 50% of the amount charged. Under a common meaning of the term “principally,” the payments in this Example would not be “principally” for the use of the property. Nevertheless, the Exam- pie concludes that the activity is a rental activity. This apparent conflict should be reconciled. We recommend consideration of a 50% safe harbor, so that if the cost of the services provided exceeds 50% of the total costs incurred, the activity would not be a rental activity.

(B) Exceptions: Paragraph -1T(e)(3)(ii) sets forth six[22] exceptions to the definition of rental activity:

(1) Seven Day Rule: If the average period of customer use is seven days or less, then the property is not rental property. Paragraph -1T(e)(3)(ii)(A). This could include a parking lot or video rental store. While most hotels have an average room rental period of seven days or less, certain hotels (such as those in resort areas as well as condominium hotels) have an average room rental period of more than seven days and may turn out to be rental activities unless they come within the other exceptions noted herein. We believe that such a result would be inappropriate. We suggest that some consideration be given to the possibility of combining the seven day and thirty day tests into one category.

(2) Thirty Day and Significant Personal Services Rule: Property will not be considered rental property if the average period for which each customer uses the property is greater than seven days but not greater than thirty days and "significant personal services" are provided by or on behalf of the

[22] We anticipate that we may have comments in a subsequent report on the fourth, fifth and sixth exceptions, which are not discussed herein.

owner of the property in connection with making the property available for use by customers. Paragraph -1T(e)(3)(ii)

(B). This could include a hotel. Recommendation: An example should be included indicating that the operation of a traditional resort hotel does not constitute a rental activity even if the average period of customer use exceeds 7 days. Such an example could provide as follows:

> "Example (N). The taxpayer is engaged in an activity of owning and operating a resort hotel. For the taxable year, the average period of customer use exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exits, stairways, and lobbys, and collecting and removing trash, the taxpayer provides daily maid and linen services, restaurant, bar and room service and recreational facilities, including swimming pools, tennis courts and other athletic facilities, either at no additional charge or subject to a user charge. The cleaning of public areas and collecting and removing trash are excluded services (within the meaning of Paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high grade residential real property. However, the personal services performed in connection with a traditional resort hotel constitute significant personal services within the meaning of Paragraph (e)(3)(iv) of this section. Accordingly, the activity is not a rental activity."

In determining whether personal services provided to customers are significant, "all of the relevant facts and circumstances" shall be taken into account. Relevant facts and circumstances include "the frequency with which said services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property." Paragraph -1T(e)(3)(iv)(A).

Example (2) in Paragraph -1T(e)(3)(viii) indicates that where the average period of use is 30 days or less and the value of the services “exceeds 50 percent of the amount charged for the use of the equipment,” significant services are provided in connection with the rental of the property and therefore the activity is not deemed a rental activity. Example (4) in Paragraph -1T(e)(3)(viii) notes that when the value of the services performed is less than 10 percent of the rental charged, the services are not significant and a rental activity exists. Recommendation: We recommend that the percentage tests be established as safe harbors and be moved into the regulatory definitions of significant personal services in Paragraph -1T(e)(3)(iv)(A). We recommend that the test be changed to a comparison of the cost of providing the services to the total costs incurred, because of the difficulty of determining the value of the services provided. Furthermore, we recommend that Example (2) be clarified to indicate that the activity would also be characterized as non-passive under the general rule of Paragraph -1T(e)(3)(i)(B), because the amount paid cannot be “principally” for the use of tangible property where the value of the services exceeds 50% of the amount charged.

For services that comprise 10 percent or more but do not exceed 50 percent of the total value of the rental, there is uncertainty as to how to meet the significant services test.

Recommendation: We recommend that a narrower window be drawn or a bright line test be adopted so as to allow taxpayers greater certainty in knowing the tax consequences of their operations. Furthermore, it is difficult to determine whether the “valuation of services” approach in the Examples is workable, since the regulations have not yet defined “activity”. For example, does the activity of running a hotel encompass the operation of the hotel restaurants, room service, health club and sports (such as tennis, golf, swimming and skiing) and entertainment facilities? Should this be the result even where there may be a separate charge for such facilities, since the hotel customer may nevertheless be paying a premium for the presence of such services? Accordingly, we may have further comments on this issue after the “activity” regulations are proposed. However, even in advance of clarification on that issue, we recommend that the percentage safe harbor for establishing significant services be reduced below the 50% figure cited in Example 2.

In determining whether significant personal services are rendered, the regulations exclude:

(1) Services necessary to permit the lawful use of the property,

(2) Services performed in connection with the construction of improvements to the property or in connection

with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by a customer, and

(3) Services provided in connection with the use of any improved real property that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (such as cleaning and maintenance of common areas, routine repairs, trash collection and elevator service). Paragraph -1T(e)(3)(iv)(B).

Comment: The regulations should illustrate the application of the “significant personal services” rule to, e.g., nursing homes of varying care levels. Furthermore, since hospitals and nursing homes are required to provide various types of services under applicable state licensing procedures, the regulations should provide that services required to obtain appropriate operating licenses do not come within the exclusion for “services necessary to permit the lawful use of the property.”

(3) Extraordinary Personal Services. If the average period of customer use is more than 30 days but extraordinary personal services are provided by or on behalf of the owner in connection with making the property available for use by

customers, the property is not rental property. Paragraph -1T(e)(3)(ii)(C). This could apply to a hospital. Comment: The regulations should include an example applying this rule to, e.g., nursing homes with different care levels, and to other retirement home situations. Extraordinary personal services are provided if "the use by the customers of the property is incidental to their receipt of such services." This includes the use of a hospital's boarding facilities by patients and the use by students of a boarding school's dormitory. Paragraph -1T(e)(3)(v). An example indicates that the providing of services having a value that exceeds 50 percent of the amount charged for the use of the property was not sufficient to constitute extraordinary services. Thus, the activity was held to be a rental activity. Paragraph -1T(e)(3)(viii), Example (1). Recommendation: The regulations should set forth a minimum percentage threshold that would delineate when extraordinary personal services are performed. In addition, the Example should be revised so that the facts do not support the conclusion that the activity is not a rental activity because it fails the "principally" test.

(4) Incidental Rental Activity: A rental activity will not be found to exist if the actual rental activity is incidental to certain non-rental activities of the taxpayer. Paragraph -1T(e)(3)(ii)(D). The Temporary Regulations provide that the rental of property will be treated as incidental to a non-rental activity only in the four following cases:

(a) Property Held for Investment: An insubstantial amount of rental income (i.e., gross rental income less than two percent of the lesser of (i) the unadjusted basis of such property or (ii) the fair market value of such property) is derived from renting property incidental to an activity of holding such property for investment. Comment: This test is presumably based on the principle that rental at a below market yield indicates that the property is being held for a purpose other than rental. While we agree with this principle, we do not believe that the relationship between yield and adjusted basis supports this essentially economic conclusion. For example, the property in question may be high-value, low-basis property that has appreciated in value or has been acquired by gift or in a recognition transaction (such as a like-kind exchange). Recommendation: The test based on unadjusted basis should be deleted, or the test should be changed to permit the taxpayer to elect to use either unadjusted basis or fair market value.

(b) Lodging: The rented property is lodging provided to the taxpayer's employees (or to the employee's spouse or dependents) for the convenience of the taxpayer.

(c) Property Used in a Trade or Business: An insubstantial amount ofrental income (determined by applying the two percent rule noted above) is derived from property that was recently used in a trade or business of the taxpayer (i.e., property that was predominantly used in a trade or business activity during the year or during two or more of the preceding five years). Recommendation: The "insubstantiality" test should be modified as recommended in (a) above.

(d) Property Held for Sale to Customers: The property is held for sale to customers in the ordinary course of a trade or business and is in fact sold during the taxable year.

Paragraph -1T(e)(3)(vi); see also Paragraph -1T(e)(3)(viii), Examples 5, 6 and 7.

(5) Non-Exclusive Use: The property will not be treated as rental property if the taxpayer customarily makes the property available during defined business hours for non-exclusive use by various customers. Paragraph -1T(e)(3)(ii)(E). This can include a golf course. See Paragraph -1T(e)(3)(viii), Example 10. Comment: The Regulations should indicate how this rule applies to activities involving a combination of exclusive and exclusive use, such as airports, campgrounds, marinas, etc.

(6) Imputed Rental Activity: Rental property does not include property used in a non-rental activity of a partnership or S corporation in which the taxpayer owns an interest if the taxpayer does not rent the property to the partnership or S corporation but provides the property in his capacity as an owner of such an interest. Paragraph -1T(e)(3)(ii)(F). Thus, if a partner contributes the use of property to a partnership, none of his distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in Section 707(c), i.e., a guaranteed payment, is not income from a rental activity under any circumstances. Paragraph -1T(e)(3)(vii). See also Paragraph -1T(e)(3)(viii), Example 8 (crop-share lease).

(C) Rental Real Estate - Scope of Activity: This is not addressed in the Regulations, although the legislative history indicates that rental activities are to be defined narrowly. We anticipate that there will be numerous problems associated with determining the scope of an activity involving real estate construction and development, sales of co-op and condo units in a mixed use project, etc., and we expect that we will have comments on these issues in a subsequent report. In the interim, however, we recommend that the definition of the scope of an activity should not depend upon whether income or loss is generated.

Paragraph -1T(e)(4). Special Rule for Oil and Gas Working Interests. Paragraph -1T(e)(4)(i) provides, in general, that an interest in an oil or gas well drilled or operated pursuant to a working interest is not an interest in a passive activity for the taxable year if at any time during the year the taxpayer holds the working interest directly or through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of the well pursuant to such working interest. This determination is made on a well-by-well basis. The status of the activity as a non-passive activity does not depend on any material participation by the taxpayer.

Paragraph -1T(e)(4)(ii) provides that if the taxpayer holds the working interest during a portion of the year through an entity that does limit the taxpayer's liability with respect to the drilling or operation of the well, and if without the special working interest rule the interest would be an interest in a passive activity, then if the taxpayer has a net loss from the well for the year, the deductions attributable to the well and allocable to the tax year in question are treated as passive activity deductions to the extent that economic performance with respect to those deductions occurs during the portion of the year in which the taxpayer's only interest in the working interest is held through the liability-limiting entity. These deductions are referred to as "disqualified" deductions. In addition, a ratable portion of the taxpayer's gross income from the oil or gas well for the year is treated as passive activity gross income for the year. This ratable portion is determined on the basis of the ratio of the deductions treated as passive activity deductions to the total deductions attributable to the well that are allocable to the year. “Economic performance” is determined by cross-reference to Code Section 461(h), with certain modifications. Paragraph -1T(e)(4)(ii)(B) provides that deductions and losses treated as passive pursuant to this rule are also treated as passive for purposes of the general rules relating to disallowed passive activity losses and the rules relating to carryovers of disallowed passive activity losses and credits. Paragraph -1T(e)(4)(ii)(C)(1) provides that the deductions allocable to the year are the deductions that arise during the year under the taxpayer's accounting method and the deductions carried over to the year under the rules relating to disallowed passive activity losses and credits.

Comment: The special rule for oil and gas working interests is intended to be limited to those investors who are willing to accept an unlimited and unprotected financial risk proportionate to their ownership interests in the oil and gas activities. Senate Report at 717-718. Accordingly, we agree with the rule that treats deductions and a proportionate part of the gross income for the year from the activity as passive when part of the deductions were incurred through a limited liability entity. However, we recommend that this rule apply both to transactions in which the taxpayer has a net loss from the well for the year and to transactions in which the taxpayer has net income from the well for the year.

Paragraph -1T(e)(4)(v) provides that an entity will limit the liability of the taxpayer if the working interest is held through a limited partnership as a limited partner; through a corporation; or through an interest in any other entity that under applicable state law limits the potential liability of the interest holder for all obligations of the entity to a determinable fixed amount. For this purpose, a loss limitation that arises other than as a result of the legal characteristics of the entity, such as indemnification agreements, stop loss arrangements, insurance or any similar arrangement or combination of arrangements, are disregarded. Comment: We agree that this is the correct interpretation of the statute.

Paragraph -1T(e)(4)(v), Example (2) provides that an entity does not limit liability if under applicable law the taxpayer has unlimited several liability for the taxpayer's proportionate share of costs and expenses. Comment: The Temporary Regulations provide that the issue whether an entity limits liability is determined under applicable state law. Since the focus of the special rule is on the taxpayer's potential economic exposure, the determination whether an entity limits liability should be made by reference to whatever law will in fact determine that liability. Accordingly, the regulation should be expanded to include a reference to state, foreign or other applicable law.

Paragraph -2T(c)(6). Gross Income from Certain Oil and Gas Properties. Paragraph -2T(c)(6) provides that passive activity gross income for any year does not include an amount of the taxpayer's gross income for the year from “an oil or gas property” equal to the net income for the year from such property if any loss from a working interest in such property was characterized as a non-passive activity loss in any previous (post-1986) year solely by reason of the special rule in Paragraph -1T(e)(4). The same rule applies to any property, the basis in which is determined in whole or in part by reference to the basis of a property described in Paragraph -2T(c)(6). The term “property” is defined not by reference to Code Section 614(a) and the regulations there-under, but to mean any “property,” the value of which is directly enhanced by any drilling, logging, seismic testing or other activities, any part of the costs of which were borne by the taxpayer as a result of holding the working interest described in Paragraph -2T(c)(6). Three examples illustrate the application of this rule. Comment: We are sympathetic to the desire to prevent the avoidance of the subsequent year income rule of Code Section 469(c)(3)(B) by exploiting adjacent wells drilled through limited liability entities at the expense of the production from the initial well. However, we believe that Paragraph -2T(c)(6) goes beyond the authority of Section 469(c)(3)(B), because we believe that under traditional canons of statutory construction, the term “property” in the phrase “net income from such property” must have the same meaning as the word “property” appearing 20 words earlier in the phrase “working interest in any oil and gas property.” Since we believe that the Temporary Regulations correctly interpret the term “property” in Paragraph -1T(e)(4)(i) on a well-by-well basis (this interpretation being consistent with the legislative history; see Senate Report at 745), we recommend that in the circumstances described in Paragraph -2T(c)(6), the income from the (broadly defined) property be characterized as non-passive income on a pro rata basis, determined by reference to the aggregate non-passive and passive costs of drilling all the wells drilled on the property. Furthermore, the differences between the degree of enhancement in value resulting from the activities described in Example 1 and the enhancement resulting from the activities described in Example 3 are very subtle, and yet the Examples reach different conclusions.[23] We believe that a brighter dividing line is needed, and we suggest that Paragraph -2T(c)(6) be revised to include two different concepts in use in the oil and gas industry. First, where the initial well is drilled pursuant to a venture or other agreement that contains an identified “area of mutual interest,” the area that would be included in the term “property” should not extend beyond the area of mutual interest of the initial well. Second, the standard of “direct enhancement of value” should be changed to a “proven” standard analogous to that described in Proposed Reg. §1.613A-7(p). Finally, we recommend that the regulations be clarified to indicate that the broad definition of property will not in any event include property acquired by the taxpayer after the completion of the initial well, since in the case of such property any “direct enhancement of value” from the drilling

[23] Example 1 states that ". . . P develops information indicating that the reservoir in which the [first] well was drilled underlies [another] tract as well . . . ." Example 3 states that ". . . T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X").

of the initial well would generally have primarily benefited the taxpayer's seller rather than the taxpayer.

Paragraph -1T(e)(6). Trading of Personal Property. Paragraph -1T(e)(6) establishes a special rule providing, in effect, that an activity of trading personal property for the account of the owner(s) of interests in the activity will not be treated as a passive activity, no matter how regular, continuous and substantial the trading activities. This rule is evidently intended to be an exception to the rule of Paragraph -2T(c)(3)(ii)(D), which excludes from portfolio income "[i] Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business."[24] The term "personal property" is defined by cross reference to Section 1092(d) to mean any personal property of a type that is actively traded.

We recognize that the tax law has never drawn a clear line between those transactions in investment securities that rise to the level of "trading" and those that constitute mere investing. We presume that the reason for the proposed automatic portfolio income treatment of any such income in Paragraph -1T(a)(6) is based upon the difficulty of drawing such a line and the fear that any such line might invite abuse by taxpayers

[24] We recommend that this point be clarified by a cross reference.

seeking to obtain passive income treatment for what is, in essence, investment income, and we agree that taxpayers should not be able to obtain passive income treatment for investment activity by simply pooling that activity in a limited partnership. Nonetheless, the rigidity of such a rule may be inappropriate in cases in which the activity is regular, continuous and substantial enough to qualify clearly as a trade or business. Accordingly, we believe that a safe harbor exception should be considered under this rule. This safe harbor might appropriately be based upon the ratio of expenses incurred to gross income along the lines of Section 163(d)(4)(A) of the 1954 Code, or on the "turnover" rate or average holding period of the assets used in the activity. The rule of Section 851(b)(3) (denying regulated investment company status for entities actively trading securities) could provide a useful analogy. Thus, the safe harbor might apply to any activity in which at least 60% of its gross income is derived from the sale or other disposition of stock or securities held for less than three months. Alternatively, the safe harbor might apply to any activity if the weighted average holding period of all stock or securities sold or otherwise disposed of is less than three months. We also recommend that as to income or loss from activities not coming within the safe harbor exception, the regulations contain a cross reference to Section 163(d), to make clear that income and expenses from activities that are not passive will be treated as investment income and expense.

Paragraph -1T(f)(2). Allocation of Disallowed Passive Activity Deductions. Paragraph -1T(f)(2) provides, in effect, that the disallowed passive activity loss is allocated ratably among all passive activities giving rise to it. This rule may produce surprising results in the case of activities entered into before and after the enactment date of Section 469. Suppose, for example, that a taxpayer in 1987 had a loss of 100 from a pre-enactment activity (the “Old Activity”) and a loss of 100 from a post-enactment activity (the “New Activity”) and no passive income from other sources. The total passive activity loss allowed for 1987 would be 65, with 135 being carried over. Under Paragraph -1T(f)(2), it appears that the 135 carryover loss would be allocated equally between the Old Activity and the New Activity. Because the economics of the New Activity may well have been based upon the assumption that all of the loss would be carried over, we question whether the ratable allocation rule is appropriate in this circumstance. Accordingly, we recommend that the allocation of disallowed losses recognize the fact that certain allowed losses are allowed only because of their status as losses from pre-enactment activities, and to that extent cannot be “disallowed” losses.

Paragraph -1T(g). Application of Rules to C Corporations. Paragraph -1T(g) provides rules applying Section 469 to C Corporations. Although generally inapplicable to C corporations, Section 469 does apply to any (a) closely held C corporation and (b) personal service corporation. Paragraph -1T(g) defines the terms “personal service corporation” and “closely held corporation.” The Temporary Regulations provide rules for applying the material participation standard to corporations. Pursuant to the statute, the passive activity loss of a closely held C corporation is determined in a manner that takes into account the “net active income” of the corporation for the taxable year. The Temporary Regulations discuss the calculation of net active income. A detailed example is provided. Lastly, the Temporary Regulations discuss the calculation of a closely held corporation's passive activity credit.

1. Paragraph –1T(g)(1) -- In general.

Subparagraph 1 provides that, accept as otherwise to be provided in Paragraph -1T(k) (which will deal with former passive activities and changes in status of corporations), Section 469 does not apply to any corporation that is not (a) a personal service corporation or (b) a closely held corporation for the taxable year.

2. Paragraph -1T(g)(2) -- Definitions.

a. The term personal service corporation is defined in Section 469(j)(2) with reference to an organization described in Section 269A(b)(1), with certain modifications. Paragraph -1T(g)(2)(i) defines the term personal service corporation for purposes of Section 469 to mean a C corporation that is a personal service corporation for the taxable year within the meaning of Treas. Reg. §1.441-4T(d). We agree with the reference to Treas. Reg. §1.441-4T(d) to define a personal service corporation, since that section implements Section 441(i), which contains a definition of personal service corporation identical to that found in Section 269A(b)(1). We do not object to the restriction in the definition that limits personal service corporations to C corporations. We note, however, that the statute is not so limited. However, we find that treatment consistent with the treatment adopted both in the statue and in the regulations with regard to S corporations as “pass-through” entities.

b. Section 469(j)(1) defines the term “closely held C corporation” to mean any C corporation that is described in Section 465(a)(1)(B). Paragraph —1T(g)(2)(ii) uses the term “closely held corporation,” rather than the term closely held C corporation. The term is defined to mean a C corporation that, for the taxable year, meets the stock ownership requirements of Section 542(a)(2), with certain modifications. Since that is the Section referenced in Section 465(a)(1)(B), we find that “short-hand” reference convenient. The term “closely held corporation” is further defined to exclude any corporation that is a personal service corporation for the year. That exclusion is not found in the statute. Moreover, although we are sympathetic to the exclusion, we suggest that it would be an appropriate modification for a technical correction. Section 469(e)(2)(A) speaks in terms of a “closely held C corporation (other than a personal service corporation).” The same phraseology is used in Section 469(h)(4)(B). Thus, the language of the statute does not indicate that Congress intended the term closely held corporation to exclude personal service corporations.

3. Paragraph -1T(q)(3) -- Participation of Corporations. This paragraph modifies the rules regarding both material participation and significant participation so that they apply appropriately to personal service corporations and closely held corporations. Participation by a corporation is determined with regard to participation by certain individuals. Modifications are made to the rules regarding participation by a individual in effect to take into account his status as an agent of the corporation (and not as a person whose material participation is being tested for his own account). Paragraph -1T(g)(3)(iii)(A) and (B). Those modifications are appropriate.

Section 469(h)(4)(A) states that a closely held C corporation or personal service corporation shall be treated as materially participating in an activity if one or more shareholders holding stock representing more than 50% (by value) of the outstanding stock of such corporation materially participate in an activity. Paragraph -1T(g)(3)(i)(A), implementing that direction, requires that the shareholder in question hold, <u>directly or indirectly</u>, the requisite value of stock. That interpretation of the statue seems reasonable. However, we suggest that the term “directly or indirectly” be defined for purposes of that rule. We suggest that the Section 544 attribution rules be used, because the “closely held” test is defined by reference to Section 542. We make the same observation with regard to the use of the term “directly or indirectly” in Paragraph —1T(g)(3)(ii)(B) (dealing with significant participation by a corporation).

4. Paragraph -1T(g)(4) -- <u>Modified Computation of Passive Activity Loss in the Case of Closely Held Corporations</u>. Section 469(e)(2) modifies the general rule with regard to passive activity losses to allow the

deduction of such losses of a closely held C corporation as against the “net active income” of such a corporation. A similar rule applies in the case of any passive activity credit of a closely held C corporation. This portion of the regulations implements those rules. The term “net active income” is defined in Paragraph -1T(g)(4)(ii). The definition expands on the definition of net active income found in the Code. The modifications, however, reflect rules found in other portions of the Temporary Regulations, which are generally applicable in determining a taxpayer's passive activity loss. For instance, a corporation's net active income for the taxable year is determined without regard to gross income that is treated under Paragraph -2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity. The Examples at Paragraph -1T(g)(4)(iii) are excellent, describing in detail the application of Section 469 to a closely held corporation. We would suggest, however, the addition of an example dealing with a personal service corporation.

5. Paragraph -1T(g)(5). Allowance of Passive Activity Credit of Closely Held Corporations to Extent of Net Active Income Tax Liability.

A. The rules in this paragraph implement the general instruction in Section 469(e)(2)(A) that a rule similar to the rule allowing a closely held C corporation's passive activity loss to offset net active income shall apply with regard to any passive activity credit of the corporation.

Thus, Paragraph -1T(g)(5) provides that a closely held corporation's passive activity credit for the taxable year is decreased by the corporation's net active income tax liability for the year. For purposes of that rule, a closely held corporation's net active income tax liability is the regular tax liability that is applicable to the corporation's net active income, reduced by all credits other than credits from passive activities. Those rules seem adequately to implement the direction in the statute. However, the rules are complicated and an understanding of them would be enhanced by the inclusion of an example illustrating their application.

Paragraph -1T(h) -- Special Rules for Affiliated Group Filing Consolidated Return. Paragraph -1T(h) provides rules for applying Section 469 and the regulations there-under to an affiliated group of corporations filing a consolidated return for the taxable year (a “consolidated group”). Under those rules, a consolidated group generally is treated as a single taxpayer. We agree with the approach of the regulations and note that it is consistent with Section 105(a)(9) of the Technical Corrections Bills.[25] Consistent

[25] Section 105(a)(9) would amend Section 469 of the Code to provide that, except as provided in regulations, all members of a consolidated group shall be treated as one corporation.

with the general approach of the Temporary Regulations, a single passive activity loss and passive activity credit are computed for such group. Similarly, the status of each member of a consolidated group as a personal service corporation or closely held corporation is the same as the status of the group, determined as though the group constituted a single corporation. In making that determination, and in applying the participation tests set forth in Paragraph -1T(g)(3), only shareholders of the common parent of the group are treated as shareholders of the hypothetical single corporation. Rules are provided that allocate a consolidated group's disallowed passive activity loss and credit among the group's members. Rules that deal with intercompany transactions also are provided.

1. Paragraph -1T(h)(1) -- <u>In General</u>. Subparagraph 1 introduces the rules of paragraph (h).

2. Paragraph -1T(h)(2) -- <u>Definitions</u>. Subparagraph 2 provides relevant definitions.

3. Paragraph -1T(h)(3) -- <u>Disallowance of Consolidated Group's Passive Activity Loss or Credit</u>.

Subparagraph 3 applies the general rules provided in Paragraph -1T(a) (passive activity loss and credit disallowed) to a consolidated group and specifies that the group's passive activity loss or credit is computed by taking into account the separate passive activity gross income, passive activity deductions, net active income (in the case of a group treated as a closely held corporation), and credits from passive activities of each member.

4. Paragraph -1T(h)(4) -- Status and Material Participation of Members.

a. Subparagraph 4 first sets forth the rule, discussed above, that the consolidated group is to be treated as a single corporation. Thus, each member is to be treated as a closely held corporation or personal service corporation for the taxable year if the group is so treated for the year. Also, the determination whether an activity conducted by one or more members of the group is a passive activity is to be determined with reference to the group's participation in the activity.

b. For purposes of determining the status of a consolidated group as a closely held corporation or personal service corporation, and for purposes of determining whether the group materially participates in an activity, the group is treated as a single corporation and only the outstanding stock of the common parent is treated as out-standing stock of such corporation. Although that rule is convenient, we wonder, particularly with regard to the determination of material participation by a corporation (under the rule of Paragraph -1T(g)(3)), whether disregarding stock ownership by shareholders of members of the group other than the common parent is appropriate. Although not stated, we assume that the rule of the subparagraph is applied for purposes of determining significant participation under Paragraph -1T(g)(3)(ii) of the regulations.

5. Paragraph -1T(h)(5) -- Modifications of Rules for Identifying Disallowed Passive Activity Deductions and Credits. Subparagraph 5 provides rules for allocating disallowed passive activity losses and credits of the group among its members and then, if more than one passive activity is engaged in by a member, among activities of that member. The rules of this subparagraph seem reasonable and we see no objection to them.

6. Paragraph -1T(h)(6) -- Transact ions Between Members of a Consolidated Group. Subparagraph 6 contains rules relating to intercompany transactions (within the meaning of Treas. Reg. §1.1502-13(a)(1)). Those rules generally are intended to attribute all items of income and deduction of all members that are attributable to an intercompany transaction to the activities of the purchasing member (within the meaning of Treas. Reg. §1.1502-13(a)(1)). That rule is convenient. It is, however, open to manipulation where, for instance, material participation is arranged with regard to one or the other of the selling or purchasing member but not both.

7. Paragraph -1T(h)(7) -- Disposition of Stock of a Member of an Affiliated Group. Subparagraph 7 treats any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under Treas. Reg. §1.1502- 19(a)) as portfolio income. Apparently, loss is not automatically so treated. No rule is provided with regard to losses. We question whether the rule of this regulation is appropriate where the subsidiary is a member of the group. The rule seems inconsistent with the notion of the group as a hypothetical single corporation. We would recommend further consideration of a rule that would disregard the separate corporate status of a subsidiary where it is a member of the group.

8. Paragraph -1T(h)(8) -- Disposition of Property Used in Multiple Activities. Subparagraph 8 discusses the application to a consolidated group of the rules found in Paragraphs — 2T(c)(2)(H) or (iii) or -2T(d)(5)(ii) (concerning the disposition of property used in multiple activities or substantially appreciated property). This rule is consistent with treating the group as a hypothetical single corporation and we agree with it.

Paragraph -2T(c)(2). Characterization of Gain at Time of Disposition. Paragraphs -2T(c)(2)(i)(A)(2) and (3) provide, in effect, that in the case of gain realized upon disposition of an activity, the character of that activity as passive *vel non* is determined by looking to the taxable year of the disposition rather than prior years. We note that such a rule has the virtue of simplicity and certainty, both of which are desirable, and we agree that the regulations should generally prevent taxpayers from creating passive income by converting non-passive activities into passive activities in the year of sale. However, we question whether this rule is desirable and suggest that consideration be given to whether it should be amended or deleted in the final regulations. The rule can be viewed as undesirable because it can either invite tax-motivated distortions of economic activity in the year of disposition or adversely effect taxpayers who determine the level of their year of sale activities solely on the basis of pre-tax profit maximization. Thus, for example, a taxpayer owning a patent or other intangible producing non-passive activity income under the rule of Paragraph -2T(c)(3)(B) might be motivated to expend disproportionate amounts in the year of sale in order to satisfy the 50% of income safe harbor contained in Paragraph -2T(c)(3)(iii)(B)(2)(ii)(a). Conversely, taxpayer that was not a material participant in a passive activity might be discouraged from taking economically necessary disposition-related actions in the year of sale because it would have an adverse tax impact.

Moreover, the Temporary Regulations contain various special provisions designed to assure that in most cases the year-of-disposition rule can only operate to the detriment of the taxpayer and that rule may therefore be perceived to be unduly weighted in favor of revenue considerations. Thus, for example, the rules of Paragraph -5T(a)(5) and (6) make it difficult or impossible to transform a material participation activity into a passive activity.[26] Similarly, Paragraph -2T(c)(2)(iii) contains a rule designed to prevent the treatment of gain from the disposition of substantially appreciated property formerly used in a non-passive activity as an item of passive activity gross income. We believe that it might be more appropriate if the determination of whether disposition gain or loss is from a passive activity were based upon a broader look at all or a substantial portion of the period during which the taxpayer held the property.[27] For example, either a pro rata allocation (based on the ratio of the number of years of passive status to the number of years of ownership) or a preponderance determination (based on whether the activity was passive for the majority of the period of ownership) might be more appropriate.

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[26] We have assumed that the "look back" rules of Paragraphs -5T(a)(5) and (6) are applicable to determinations in the year of disposition, although the regulations should probably clarify this point.

[27] Such a concept is not entirely foreign to the Temporary Regulations. Paragraph -2T(c)(2)(iii)(A)(1) characterizes substantially appreciated property based upon its use during "20 percent of the period during which the taxpayer held [his] interest in [the] property."

Our one reservation on this issue relates to the difficulty of determining the level of the taxpayer's participation in an activity in 1986 and earlier years. We believe that it would be inappropriate to condition the availability of favorable tax treatment in post-1986 years on the ability to prove or disprove participation levels for 1986 and earlier years, since such proof will depend on recordkeeping that would not have been necessary in those earlier years. Although we recognize that such a rule might be viewed as producing a “no-lose” result for the taxpayer with respect to activities engaged in prior to 1987, on balance it appears reasonable to us that the regulations adopt a presumption rebuttable only by the taxpayer, that an activity had the same character in years before 1987 as it does in years after 1986.

Paragraphs -2T(d)(1) and -2T(d)(8). Interaction with Section 465, Section 704(d) and Other Restrictions. Paragraphs -2T(d)(1) and -2T(d)(8) provide in effect that a deduction will not be taken into account for Section 469 purposes until the taxable year in which it would otherwise be allowable. Accordingly, if a deduction for a particular taxable year is limited by Section 704(d) or Section 465 and is then allowed (prior to application of Section 469) in a later taxable year, the determination whether the deduction arises from a passive activity is made as of the later taxable year. Thus, for example, whether or not the material participation standard is met would be determined as of the later taxable year. We believe that this rule conflicts with the Code's requirement of annual tax accounting. If a taxpayer has not satisfied the material participation standard for the year in which the loss actually arose but was disallowed under Section 469, he should not be rewarded for his increased participation in a subsequent year in which the loss would be allowed under Section 469, and conversely a taxpayer who has satisfied the material participation standard in the earlier year should not also have to satisfy a material participation standard in the subsequent year in which the Section 469 requirements are met.[28] We recognize that under the rules of Paragraphs -5T(a)(5) and (6) the taxpayer may in many cases automatically satisfy the material participation standard in the later year because of having satisfied it in the earlier year. Nonetheless, we believe that in many cases in which Paragraph -2T(d)(8) does have an impact, that impact could be inappropriate.

Paragraph -2T(f). Other Special Recharacterization Rules. Paragraph -2T(f) sets forth a series of other special rules recharacterizing certain income that otherwise would be treated as passive activity income. Some of these rules are based upon statements in the legislative history of Section 469, but others lack such support. These represent a substantial effort to codify some of the more difficult definitional problems associated with Section 469, although in some respects they raise concerns relating to complexity, equity or validity, which we believe require further attention. Two of these special rules are discussed below, and as to the others, including the rental of non-depreciable property rule of Paragraph -2T(f)(3), the taxpayer-enhanced property rule of Paragraph -2T(f)(5) and the self-rented property rule of Paragraph

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[28] The Preamble raises a concern as to the complexity of a rule which looks back to prior years. We do not see why such a rule, looking back as far as January 1, 1987, would be materially more complex than the year-of-sale rule, since taxpayers are on notice that records regarding material participation should be maintained from January 1, 1987 forward.

-2T(f)(6), we anticipate that we will submit comments in a subsequent report.

Paragraph -2T(f)(2). Special Rule for Significant Participation. Our comments on this provision are included in our discussion of Paragraph -5T below.

Paragraph -2T(f)(4). Equity Financed Lending Activities. Paragraph -2T(f)(4) in effect treats income from any lending activity as portfolio income if the debt-to-equity ratio of the activity is less than 4-to-1, even if that activity would otherwise qualify as an active trade or business. As we indicated above in our discussion of the rule relating to the trading of personal property, we agree that taxpayers should not be able to convert investment income into passive activity income by the simple expedient of contributing the investment funds to a limited partnership. However, we have some concerns about the scope this rule. First, if the activity is determined to be a trade or business (i.e.. an activity not giving rise to portfolio income) for purposes of Paragraph -2T(c)(3)(ii)(A), we question whether the activity should be held to different standards than applied to other trades or businesses. Of course, if an equity-financed lending activity were a “positive income source” (an activity not likely to bear any significant deductible expenses), the position in the Temporary Regulations could be justified under Section 469(1)(2).

It is questionable, however, whether all equity-funded lending should be so characterized. True lending businesses, like other businesses, are subject to a wide variety of risks that make them qualitatively different from mere investments, and will have an operating business's normal level of deductible operating expense. The write-downs of and continuing uncertainty over third-world loans by major banking institutions illustrates the reality of these risks. Accordingly, we recommend that consideration be given to an expense-related test along the lines of Section 542(c)(6)(C) of the Code, with the test percentage established in part by reference to the debt- equity level. Such a test should exclude from the “passive activity” category a simple aggregation of portfolio investment, which would have a very low expense level. Second, if there is to be a debt-equity rule, the 4-to-l debt to equity ratio can be viewed as being a rather high threshold. Numerous businesses operate with lower debt-to-equity ratios, including some lending businesses. Finally, Paragraph -2T(f)(4)(ii)(B), which excludes liabilities incurred principally for the purpose of increasing the debt-to-equity ratio, might be difficult to apply and could foster much uncertainty and litigation, similar to that generated under Sections 269, 1221, 341 and various other “principal purpose” rules in the tax law. The need for this rule should be reexamined if the expense level test is adopted.

Paragraph -2T(f)(7). Licensing of Intangibles. Paragraph -2T(f)(7) establishes a special rule treating income from the licensing of intangibles as not passive activity income if the taxpayer has acquired her interest after the development of the intangible and does not have substantial current deductions related to the activity. This rule raises concerns for reasons similar to those applicable to the equity-financed lending rule. In particular, the rule adds substantial complexity to the already difficult determination under Paragraph -2T(c)(3)(iii)(B) of whether the royalty income is or is not portfolio income. Having satisfied those tests (which are designed to assure that the activity rises to the level of a trade or business), it is questionable whether the taxpayer should be subject to additional tests that arise only if she has acquired her interest after the development of the intangible. A rule of this type based upon timing of acquisition has not been applied to any other type of business under the Temporary Regulations. It appears that satisfaction of the test in Paragraph -2T(c)(3)(iii)(B) should be sufficient to characterize the activity as potentially passive, regardless of when the taxpayer acquires her interest.

Paragraph -5T. Material Participation. Paragraph -5T provides rules relating to the definition of material participation. Section 469(h)(1) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a basis that is “regular, continuous, and substantial.” Paragraph -5T elaborates on this definition by providing seven tests (one of which is qualitative) for determining whether an individual will be treated as materially participating in an activity for the taxable year.[29] These seven tests generally focus on quantifying the time spent by the taxpayer, and not on what he or she does. Under the first, set forth in Paragraph -5T(a)(1), an individual materially participates in an activity for the taxable year if he participates for more than 500 hours during such year. According to the Preamble, this test will restrict “deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable

[29] The Temporary Regulations state that participation may be proven by any reasonable means. Daily time reports, logs or other similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means include but are not limited to "identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries." Thus, although the Temporary Regulations clearly provide that detailed time records are not required, some evidence of hours worked will obviously be necessary and the more detailed the better. The end result could in effect be rather burdensome recordkeeping requirements. Further, while we are sympathetic to the Service's desire to avoid another "car log" episode, we are concerned about the possibility that taxpayers who do not keep "daily time reports, logs or other similar documents" in reliance on the statement in the Temporary Regulation that such items are "not required" may find that such documents will turn out to be the only acceptable proof when a return is examined. Consider, for example, a taxpayer who worked in an activity "all day" every Saturday, taking off only the two Saturdays during her two-week vacation. That taxpayer would fail the 500 hour test if the workday was 9 hours and 45 minutes long and pass if it was 10 hours + long. Even if the taxpayer had a calendar indicating the days worked, is it reasonable to expect that the taxpayer would be able to establish the length of the workday without daily time reports?

year to any such investment.” The Service additionally believes that “income from an activity in which an individual participates for more than 500 hours during a taxable year is not properly classified as income from a passive activity.” Although the 500 hour test seems to constitute an arbitrary dividing line, with no specific antecedent in the legislative history, we agree that an objective safe harbor is appropriate, and we believe that 500 hours per year is certainly “substantial”—since at the rate of one 10-hour day a week it is 25% of a 40-hour work week.

Under the second test, provided in Paragraph -5T(a)(2), a taxpayer materially participates if her participation constitutes substantially all of the participation in the entity for the year. We recommend that the regulations provide a quantitative definition of the term “substantially all.”

Under the third test, provided in Paragraph -5T(a)(3), a taxpayer materially participates in an activity if he participates in the activity for more than 100 hours during the taxable year and his participation in the activity for the year is not less than the participation in the activity of any other individual (including non-owners). Paragraph -5T(k) (Example 3) illustrates this rule with reference to a two- person partnership conducting an activity entirely on Saturday in which the two partners, B and C, each worked every Saturday for 8 hours. The Example concludes that B materially participates because B participates for more than 100 hours and B's participation is not less than the participation of any other person. We assume that C in the Example would also be treated as materially participating. We recommend that the “not less than” test be changed to a “not substantially less than” test, and that an objective standard for “substantially” be adopted to avoid a situation in which the issue of B's or C's material participation would turn on whether the other worked one hour (or, indeed, one minute) more during the year.

Under the fourth test, provided in Paragraphs -5T(a)(4) and -5T(c), an individual is treated as “significantly participating” in an activity for a taxable year if she participates for more than 100 hours during the year. The concept of “significant participation” is not contained in Section 469 or the Committee Reports. A significant participation activity generally becomes an activity in which the taxpayer materially participates if the individual's aggregate participation in all significant participation activities during the taxable year exceeds 500 hours. Paragraph -5T(a)(4). The Preamble states that “an individual who devotes more than 500 hours during a taxable year to several activities, each of which is a significant activity of such individual, should be treated similarly to an individual who devotes an equivalent amount of time to a single activity.” This general principle is fair and neutral. However, where the taxpayer is involved in a number of “significant participation” activities but does <u>not</u> accumulate 500 hours in those activities, the significant participation rule loses its neutrality. Under Paragraph -2T(f)(2), if the activities produce net income, the net income is not passive activity income. If, on the other hand, the activities produce a net loss, the net loss is subject to Section 469 limitations.[30] Although we have a number of concerns about the significant participation rule, it is difficult to give definitive comments in the absence of a definition of the term activity. We agree that the material participation rule ought to be crafted to prevent taxpayers from generating passive income from an activity in income years and active losses from the same activity in loss years by slight changes in their participation levels, particularly in view of the fact that taxpayers are in control of both their activity levels and their recordkeeping. However, unless it turns out that the definition of activity is exceedingly narrow (in which case the significant participation rule could be viewed as an activity- aggregating amelioration of that definition) we question whether the concept of significant participation activities is appropriate. First, if material participation

[30] The actual statement of this rule in the regulations is somewhat more complex, because it takes account of the possibility that a taxpayer will have several activities with respect to which his participation is in the 100-to-500 hour range. The procedure under Paragraph -2T(f)(2)(i) is to net the income and loss from all such activities, thus applying the special rule only to the overall net income (if any) from all such activities and allowing the gross income from all such activities to be offset by deductions from all such activities. A formula is then provided to allocate the recharacterized amount among the various activities giving rise to it.

is to be determined on an activity-by-activity basis, then we question whether the “significant participation” concept, and the aggregation of significant participation activities to create a material participation activity, has a statutory basis. Second, we are concerned that the complexity inherent in the classification of 100-to-500 hour activities will impose a difficult burden on taxpayers and the Service. Given the complexity of these rules and the interaction of one activity with others, it will in many cases be impossible for a taxpayer to have any clear understanding prior to the end of the taxable year whether an activity is or is not subject to the passive activity rules. Finally, if this rule is retained, there is an opportunity for significant audit controversy, because activities in which a taxpayer participates for more than 100 hours and meets the test of Paragraph -5T(a)(3) are not included as significant participation activities (Paragraph -5T(c)(1)(ii)). Accordingly, a taxpayer might be in the difficult position of having to establish that he did not meet the test of Paragraph -5T(a)(3) in respect of one 101-hour activity so that he can meet the test of Paragraph -5T(a)(4) with respect to three other 134-hour activities. We question whether the Service and the courts will have adequate resources to deal with these determinations.

Paragraphs -5T(a)(5) and (6). Material Participation in Prior Years. Paragraphs -5T(a)(5) and (6) provide that an individual materially participates in an activity if she materially participated in the activity during any five of the ten years immediately preceding the taxable year in question. Additionally, an individual materially participates in a personal service activity in which he has materially participated in any three taxable years prior to the present taxable year. A personal service activity is an activity involving performance of personal services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.

The Service included these rules because it believes "that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood rather than a passive investment."[31] In particular, the Service does not believe that "withdrawal from a longstanding active business or from a personal service business that has been active for a substantial period should convert an individual's earnings from the business to passive income."[32] Income from such businesses, according to the Service, generally is part of the earned income base that Section 469 was intended to protect. In general, we agree with the goals sought to be achieved through this rule. Even though this rule may appear inconsistent with the statements in the

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31 Preamble to Temporary Regulations, p. 60-61.

32 Id. at 61.

Committee Reports, which indicate that the determination whether a taxpayer is involved in an activity on a regular, continuous and substantial basis is to be made separately for each taxable year, we believe that a more limited application of these concepts would be a valid exercise of the Secretary's authority under Section 469(1)(3), as that authority is explained at page 11-147 of the Conference Report. For example, if a taxpayer actively engaged in a trade or business becomes ill, and as a result his or her participation level is reduced, we believe that it would be appropriate for the pre-illness characterization of the taxpayer's activity to be carried over for a reasonable period of time. Accordingly, we recommend that the rule set forth in Paragraph -5T(a)(5) be modified to provide that in circumstances in which the income in question constitutes principally a return on capital values in the business, as distinguished from compensation for past personal services, the rule applies only when the change in activity level was made intentionally with a purpose to circumvent the rules of Section 469.[33]

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[33] Senate Report at 731 ("Material participation of a taxpayer in an activity is determined separately for each taxable year. In most cases, the material participation (or lack thereof) of a taxpayer in an activity is not expected to change from year to year, although there will be instances n [sic] which it does change.")

Paragraph -5T(b)(2). Certain Participation Insufficient to Constitute Material Participation. Paragraph -5T(b)(2) sets forth a list of activities that are not to be taken into account in determining whether an individual is treated as materially participating in an activity for the taxable year for purposes of the facts and circumstances set forth in Paragraph -5T(a)(7). Paragraph -5T(b)(2)(ii) provides that an individual's services performed in the management of an activity shall not be taken into account for that purpose unless (a) there is no other paid manager of the activity and (b) no individual performs management services for the activity that exceed (in terms of hours) the amount of the services performed by such individual. This rule seems to be premised on a conclusion that an activity with one paid manager cannot legitimately have another bona fide part-time manager, a factual premise which, in our view, lacks support.[34] When the success of the activity can be shown to depend in large part upon the individual's exercise of business judgment, we recommend that the “no other paid manager” test be deleted, and that any standard based on a comparison of the amount of services rendered by the taxpayer to the amount of services rendered by any other person be a “not substantially less than” standard, rather than a “not less than” standard. In this regard, the term “substantially” should be quantified.

[34] We note that this rule may be viewed as discriminating against persons doing business in partnership form in favor of persons doing business in a sole proprietorship format.

Paragraph -5T(f). <u>Participation</u>. Paragraph -5T(f)(2) provides that work done in connection with an activity shall not be treated as participation in the activity if it is not of a type that is customarily done by an owner of such an activity and one of the principal purposes for the performance of the work is to qualify under the material participation rules. We believe that this test should be reexamined on the basis that the first standard may be unadministerable. Example 7 in Paragraph -5T(k) concludes that when the spouse of an owner of a professional football team works as an office receptionist for an average of 15 hours per week during the year, the work done by the spouse is not treated as participation in the activity (because work as an office receptionist is not work of a type customarily done by an owner of a football team). We are unaware of any body of law that can be consulted in determining what work is “customarily done by an owner.” Prom our own experience, however, we know that answering telephones, making photocopies, stuffing Federal Express envelopes late at night and removing trash from a conference room table to prepare for a subsequent meeting is work “customarily done” by the owners of a law firm when the need arises. We expect that this type of activity also occurs in many other industries, particularly in the case of small or start-up businesses. On the other hand, we appreciate that custodial or clerical activities do not usually constitute the majority of the activities of an owner of a business, and we recommend either that this test be modified to provide that it only applies to situations in which substantially all the activity constituting the material participation is activity “not customarily done by an owner,” and in which it cannot be established that this activity was not done with the proscribed tax avoidance purpose. If this test is left in the regulations, taxpayers who satisfy, for example, the more than 500 hour test of Paragraph -5T(a)(1) or the more than 100 hour test of Paragraph -5T(a)(3) will then have to maintain records to establish that each hour of service meets the “customarily done by an owner” standard of Paragraph -5T(f)(2)--a result that we believe would be undesirable.