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Reg. Section 1.469-1(f)(4)(iii), Example 4

General rules.

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(f)(4) Carryover of disallowed deductions and credits --

(i) In general. In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under § 1.469-1T (f)(2) or (f)(3) (the loss activity) --

(A) The disallowed deductions or credits is allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

(ii) Business continued through C corporations or similar entities. If a taxpayer continues part or all of a loss activity through a C corporation or similar entity (C corporation entity), the taxpayer's interest in the C corporation entity shall be treated for purposes of this paragraph (f)(4) as an interest in a passive activity that continues that loss activity in whole or part. An entity is similar to a C corporation for this purpose if the owners of interests in the entity derive only portfolio income (within the meaning of § 1.469-2T(c)(3)(i)) from the interests.

(iii) Examples. The following examples illustrate the application of this paragraph (f)(4). In each example, the taxpayer is an individual whose taxable year is the calendar year.

Example 1. (i) The taxpayer owns interests in a convenience store and an apartment building. In each taxable year, the taxpayer's interests in the convenience store and the apartment building are treated under § 1.469-4 as interests in two separate passive activities of the taxpayer. A \$ 5,000 loss from the convenience-store activity and a \$ 3,000 loss from the apartment-building activity are disallowed under § 1.469-1T(f)(2) for 1993. Under § 1.469-1T(f)(2), the \$ 5,000 loss from the convenience-store activity is allocated among the passive activity deductions from that activity for 1993, and the \$ 3,000 loss from the apartment-building activity is treated similarly.

(ii) In 1994, the convenience store is continued in a single activity, and the section 469 activities that constituted the apartment building is similarly continued in a separate activity. Thus, the disallowed deductions from the convenience-store activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's convenience-store activity in 1994. Similarly, the disallowed deductions from the apartment-building activity for 1993 must be allocated to the taxpayer's apartment-building activity in 1994. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the convenience-store activity in 1994 are treated as deductions from that activity for 1994, and the disallowed deductions allocated to the apartment-building activity for 1994 are treated as deductions from the apartment-building activity for 1994.

Example 2. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under § 1.469-4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A \$ 10,000 loss from the activity is disallowed under § 1.469-1T(f)(2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under § 1.469-4 as interests in two separate passive activities of the taxpayer.

(ii) Under § 1.469-1T(f) (2), the \$ 10,000 loss from the restaurant and catering activity is allocated among the passive activity deductions from that activity for 1994. In 1995, the businesses that constituted the restaurant and catering activity are continued, but are treated as two separate activities under § 1.469-4. Thus, the disallowed deductions from the restaurant and catering activity for 1994 must be allocated under paragraph (f) (4) (i) (A) of this section between the restaurant activity and the catering activity in 1995 in a manner that reasonably reflects the extent to which each of the activities continues the single restaurant and catering activity. Under paragraph (f) (4) (i) (B) of this section, the disallowed deductions allocated to the restaurant activity in 1995 are treated as deductions from the restaurant activity for 1995, and the disallowed deductions allocated to the catering activity in 1995 are treated as deductions from the catering activity for 1995.

Example 3. (i) In 1993, the taxpayer acquires a restaurant and a catering business. Assume that in 1993 and 1994 the restaurant and the catering business are treated under § 1.469-4 as an interest in a single passive activity of the taxpayer (the restaurant and catering activity). A \$ 10,000 loss from the activity is disallowed under § 1.469-1T(f) (2) for 1994. Assume that in 1995, the taxpayer's interests in the restaurant and the catering business are treated under § 1.469-4 as interests in two separate passive activities of the taxpayer. In addition, a \$ 20,000 loss from the activity was disallowed under § 1.469-1T(f) (2) for 1993, and the gross income and deductions (including deductions that were disallowed for 1993 under § 1.469-1T(f) (2)) from the restaurant and catering business for 1993 and 1994 are as follows:

	Restaurant	Catering business
1993:		
Gross income	\$ 20,000	\$ 60,000
Deductions	40,000	60,000
Net income (loss)	(20,000)	
1994:		
Gross income	40,000	50,000
Deductions	fn1 30,000	fn2 70,000
Net income (loss)	10,000	(20,000)

fn1 Includes \$ 8,000 of deductions that were disallowed for 1993 ($\$ 20,000 \times \$ 40,000 / \$ 100,000$).

fn2 Includes \$ 12,000 of deductions that were disallowed for 1993 ($\$ 20,000 \times \$ 60,000 / \$ 100,000$).

(ii) Under paragraph (f)(4)(i)(A) of this section, the disallowed deductions from the restaurant and catering activity must be allocated among the taxpayer's activities for the

succeeding year in a manner that reasonably reflects the extent to which those activities continue the restaurant and catering activity. The remainder of this example describes a number of allocation methods that will ordinarily satisfy the requirement of paragraph (f) (4)(i) (A) of this section. The description of specific allocation methods in this example does not preclude the use of other reasonable allocation methods for purposes of paragraph (f) (4) (i) (A) of this section.

(iii) Ordinarily, an allocation of disallowed deductions from the restaurant to the restaurant activity and disallowed deductions from the catering business to the catering activity would satisfy the requirement of paragraph (f) (4) (i) (A) of this section. Under § 1.469-1T (f) (2) (ii), a ratable portion of each deduction from the restaurant and catering activity is disallowed for 1994. Thus, \$ 3,000 of the 1994 deductions from the restaurant are disallowed ($\$ 10,000 \times \$ 30,000 / \$ 100,000$), and \$ 7,000 of the 1994 deductions from the catering business are disallowed ($\$ 10,000 \times \$ 70,000 / \$ 100,000$). Thus, the taxpayer can ordinarily treat \$ 3,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and \$ 7,000 of the disallowed deductions as deductions from the catering activity for 1995.

(iv) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 would also satisfy the requirement of paragraph (f) (4) (i) (A) of this section. If the restaurant and the catering business had been treated as separate activities in 1994, the restaurant activity would have had net income of \$ 10,000 and the catering activity would have had a \$ 20,000 loss. Thus, the taxpayer can ordinarily treat all \$ 10,000 of disallowed deductions as deductions from the catering activity for 1995.

(v) Ordinarily, an allocation of disallowed deductions between the restaurant activity and catering activity in proportion to the losses from the restaurant and from the catering business for 1994 (determined as if the restaurant and the catering business had been separate activities for all taxable years) would also satisfy the requirement of paragraph (f)(4)(i)(A) of this section. If the restaurant and the catering business had been treated as separate activities for all taxable years, the entire \$ 20,000 loss from the restaurant in 1993 would have been allocated to the restaurant activity in 1994, and the gross income and deductions from the separate activities for 1994 would be as follows:

	Restaurant	Catering business
Gross income	\$ 40,000	\$ 50,000
Deductions	42,000	58,000
Net income (loss)	(2,000)	(8,000)

Thus, the taxpayer can ordinarily treat \$ 2,000 of the disallowed deductions as deductions from the restaurant activity for 1995, and \$ 8,000 of the disallowed deductions as deductions from the catering activity for 1995.



Example 4. (i) The taxpayer is a partner in a law partnership that acquires a building in December 1993 for use in the partnership's law practice. In taxable year 1993, four floors that are not needed in the law practice are leased to tenants; in taxable year 1994, two floors are leased to tenants; in taxable years after 1994, only one floor is leased to tenants and the rental operations are insubstantial. Assume that under § 1.469-4, the law practice and the rental property are treated as a trade or business activity and a separate rental activity for taxable years 1993 and 1994. Assume further that the law practice and the rental operations are a single trade or business

activity for taxable years after 1994 under § 1.469-4. The trade or business activity is not a passive activity of the taxpayer. The rental activity, however, is a passive activity. Under § 1.469-T(f)(2), a \$ 12,000 loss from the rental activity is disallowed for 1993 and a \$ 9,000 loss from the rental activity is disallowed for 1994.

(ii) Under § 1.469-1T(f)(2), the \$ 12,000 loss from the rental activity for 1993 is allocated among the passive activity deductions from that activity for 1993. In 1994, the business of the rental activity is continued in two separate activities. Only two floors of the building remain in the rental activity, and the other two floors (i.e., the floors that were leased to tenants in 1993, but not in 1994) are used in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section between the rental activity and the law-practice activity in a manner that reasonably reflects the extent to which each of the activities continues business on the four floors that were leased to tenants in 1993. In these circumstances, the requirement of paragraph (f)(4)(i)(A) of this section would ordinarily be satisfied by any of the allocation methods illustrated in Example 3 or by an allocation of 50 percent of the disallowed deductions to each activity. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the rental activity in 1994 are treated as deductions from the rental activity for 1994, and the disallowed deductions (\$ 6,000) allocated to the law-practice activity in 1994 are treated as deductions from the law-practice activity for 1994.

(iii) Under § 1.469-1T(f)(2), the \$ 9,000 loss from the rental activity for 1994 is allocated among the passive activity deductions from that activity for 1994. In 1995, the rental activity is continued in the taxpayer's law-practice activity. Thus, the disallowed deductions from the rental activity for 1994 must be allocated under paragraph (f)(4)(ii) of this section to the taxpayer's law-practice activity in 1995. Under paragraph (f)(4)(i)(B) of this section, the disallowed deductions allocated to the law-practice activity are treated as deductions from the law-practice activity for 1995.

(iv) Rules relating to former passive activities will be contained in paragraph (k) of this section. Under those rules, any disallowed deductions from the rental activity that are treated as deductions from the law-practice activity will be treated as unused deductions that are allocable to a former passive activity.

Example 5. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is \$ 5,000, and the entire loss is disallowed under § 1.469-1T(f)(2) of this section.

(ii) Under § 1.469-1T(f)(2), the taxpayer's \$ 5,000 loss from the rental activity is allocated among the taxpayer's deductions from that activity for 1993. In 1994, the rental activity is continued through a C corporation, and the taxpayer's interest in the C corporation is treated under paragraph (f)(4)(ii) of this section as a passive activity that continues the rental activity (the C corporation activity) for purposes of allocating the previously disallowed loss. Thus, the disallowed deductions from the rental activity for 1993 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1994, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from the C corporation activity for 1994.

(iii) Treating the taxpayer's interest in the C corporation as an interest in a passive activity that continues the business of the rental activity does not change the character of the taxpayer's dividend income from the C corporation. Thus, the taxpayer's dividend income is portfolio

income (within the meaning of § 1.469-2T(c)(3)(i)) and is not included in passive activity gross income. Accordingly, the taxpayer's loss from the C corporation activity for 1994 is \$ 5,000.

Example 6. (i) The taxpayer owns stock in a corporation that is an S corporation for the taxpayer's 1993 taxable year and a C corporation thereafter. The only activity of the corporation is a rental activity. For 1993, the taxpayer's pro rata share of the corporation's loss from the rental activity is \$ 5,000, and the entire loss is disallowed under § 1.469-1T(f)(2). The taxpayer has \$ 2,000 in income from other passive activities for 1994, and as a result, only 60% of the taxpayer's loss from the C corporation activity (\$ 3,000) is disallowed for 1994 under § 1.469-1T(f)(2).

(ii) Under § 1.469-1T(f)(2), the \$ 3,000 disallowed loss from the C corporation activity is allocated among the passive activity deductions from that activity for 1994. In effect, therefore, 60 percent of each disallowed deduction from the rental activity for 1993 is again disallowed for 1994.

(iii) Under paragraph (f)(4) of this section, the taxpayer's interest in the C corporation is treated as a loss activity and as an interest in a passive activity that continues the business of that loss activity for 1995. Thus, the disallowed deductions from the C corporation activity for 1994 must be allocated under paragraph (f)(4)(i)(A) of this section to the taxpayer's C corporation activity in 1995, and are treated under paragraph (f)(4)(i)(B) of this section as deductions from that activity for 1995.

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