

Reg. Section 1.469-2T(f)(3)

Passive activity loss (temporary).

...

(f) Recharacterization of passive income in certain situations—

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

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

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

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

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

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

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

	X	Y	Z	
Passive activity gross income		\$ 600	\$ 700	\$ 900
Passive activity deductions		(200)	(1,000)	(300)
 Net passive income		 400	 (300)	 600

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



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

Example. C is a limited partner in a partnership. The partnership acquires vacant land for \$300,000, constructs improvements on the land at a cost of \$100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for \$600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements (\$100,000) equals 25 percent of the unadjusted basis of all property (\$400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

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

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

(B) The taxpayer's net passive income from the activity for such year

shall be treated as not from a passive activity.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is \$20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is \$11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(2) of this section.

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

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

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing \$9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by \$20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is \$19,000 (A's distributive share of \$2.2 million of gross interest income less A's distributive share of \$300,000 of expenses described in paragraph

(f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense (\$990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is \$8,550 (\$19,000 x \$9 million/\$20 million).

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

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

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

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

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

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

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

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

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

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property--(i) In general. If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(3) of this section (the "development entity") after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of

an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

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

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

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

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

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

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

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

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at the time the taxpayer acquired the interest in the entity.

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

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

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

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

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

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

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

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

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

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

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

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

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