TAXATION SECTION OF THE DISTRICT OF COLUMBIA BAR
EXECUTIVE SUMMARY OF COMMENTS ON SECTION 469(c)(7)
PERTAINING TO PASSIVE LOSS RELIEF FOR REAL ESTATE PROFESSIONALS

I. GENERAL

These comments relate to Treasury Regulations to be issued under the passive loss relief provision for real estate professionals that was included in the Omnibus Budget Reconciliation Act of 1993.

II. AREAS WHERE GUIDANCE IS NEEDED

A. Former Passive Activities

1. Taxpayers should be permitted to apply the statutory activity grouping rules of section 469(c)(7)(A) for 1994 notwithstanding the consistency requirement contained in Prop. Treas. Reg. § 1.469-4(g).

2. If taxpayers treat all of their interests in rental real estate as a single activity as permitted by section 469(c)(7)(A), then under the former passive activity rule of section 469(f), any income or gain from the combined activity should be offset by all suspended losses from the combined activity, regardless of the activity groupings used in earlier years.

3. The disposition of any part of the combined activity that was properly treated as a separate activity in earlier years should be treated as a disposition of a "substantial part" of the activity for purposes of Prop. Treas. Reg. § 1.469-4(k). Thus, provided the taxpayer can clearly establish the carryover and current income amounts attributable to that part of the activity, section 469(g) will apply.

B. Treatment of Limited Partners

The Treasury and Internal Revenue Service should confirm that the last sentence of section 469(c)(7)(A) simply clarifies that notwithstanding the aggregation election, for purposes of determining material participation, a taxpayer's activity in a limited partnership still must satisfy one of the three tests set forth in the regulations. In addition, if the taxpayer combines interests in rental real estate held as a limited partner with other interests held directly, as a general partner, or through an S corporation, the taxpayer should be limited to the three tests applicable to limited partners.

C. Aggregation of Rental and Non-Rental Activities

The Treasury and Internal Revenue Service should issue guidance that allows taxpayers who qualify for relief under section 469(c)(7)(B) or section 469(c)(7)(D) to aggregate all real property trades or businesses as defined in section 469(c)(7)(C) for purposes of the passive loss rules, including rental and non-rental real property trades or businesses.

D. Other Issues

1. The Treasury and Internal Revenue Service should consider issuing guidance that provides that a taxpayer will be deemed to have made the election to treat all of his or her interests in rental real estate as a single activity, unless the taxpayer elects to treat each of the interests as separate activities.

2. In determining whether more than 50 percent of a closely-held C corporation's gross receipts for a taxable year are derived from real property trades or businesses in which the corporation materially participates, the term "gross receipts" should include only the gross receipts from trades or businesses.

TAXATION SECTION

The District of Columbia Bar

June 22, 1994

**COMMENTS ON SECTION 469(c)(7)
PERTAINING TO PASSIVE LOSS RELIEF
FOR REAL ESTATE PROFESSIONALS**

The following comments represent the views of the Taxation Section of the District of Columbia Bar (the "Section"). Primary drafting authority for this report was exercised by Blake D. Rubin, Christian M. McBurney and Charles C. Hwang of the Pass-Through Entities and Real Estate Committee.[1/] The contact person for this report is Blake D. Rubin, whose telephone number is (202) 429-6211.

1/ The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and do not represent those of the District of Columbia Bar or its Board of Governors.

The comments expressed have been approved by the Steering Committee and Tax Policy Task Force of the Section of Taxation of the District of Columbia Bar, which Section has approximately 1,500 members. The Steering Committee pf the Section of Taxation is chaired by Patricia G. Lewis. The Section's Tax Policy Task Force is chaired by Roderick A. DeArment and William J. Wilkins. The Pass-Through Entities and Real Estate Committee is chaired by Blake D. Rubin.

W1:18540

1250 H Street, NW, Sixth Floor, Washington DC 20005-3908 202/626-3463 Sections Infoline 202/626-3455 FAX 202/626-3453

We understand that the Treasury and the Internal Revenue Service (the "Service") are in the process of developing guidance regarding the passive loss relief that was included in the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"). The Section submits the following comments as recommendations for guidance. In preparing guidance, the Section requests that the Treasury and the Service act consistently with the manifest intent of Congress in enacting the passive loss relief provision to provide assistance to the real estate industry by liberalizing the treatment of real estate professionals under the passive loss rules.

I. Introduction

A. Pre-1994 Law

Under section 469[2/] as it existed prior to the 1993 Act, losses from rental activities, including rental real estate, were per se passive -- that is, they were considered passive regardless of the taxpayer's level of participation.[3/] Therefore, even an individual who worked full-time in the real estate business could deduct losses from rental real estate only to the extent of income from other passive activities. As a result, losses from rental real estate could not be used to offset income from other real estate related activities with respect to which the taxpayer materially participated, such as management, leasing and brokerage. The only exception to this

---

2/ Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended.

3/ I.R.C. § 469(c)(2).

rule, which allows individuals who actively participate in rental real estate activities to treat up to $25,000 of rental real estate losses as nonpassive, is phased out at adjusted gross income levels above $100,000. A closely-held C corporation may use passive losses to offset active income, but not portfolio income such as interest and dividends.

B. 1993 Act Provision

Congress recognized that the passive loss rules as applied to real estate professionals were "unfair."[4/]

In response, as part of the 1993 Act, Congress modified the passive loss rules by adding section 469(c)(7). That provision is described below.

For taxable years beginning after December 31, 1993, taxpayers who meet certain "super-material participation" tests with respect to real estate activities -- i.e., real estate professionals -- generally are not subject to the per se passive rule with respect to rental real estate. Rather, the activity that includes the rental real estate is active or passive depending on whether the taxpayer materially participates. Losses allowed by reason of the existing $25,000 exemption are determined before the special rule for real estate professionals.

4/ See House Ways and Means Committee Report No. 103-11, H.R. 2141, 103d Cong., 1st Sess. ("House Report") 175 (1993). More specifically, the House Report provides as follows:

> The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income. The committee bill modifies the passive loss rule to alleviate this unfairness.

Id.

An individual qualifies for exemption from the per se passive rule if (i) more than half of the personal services which the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates (the "more-than-half test"), and (ii) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[5/] The term "real property trade or business" is defined to mean any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.[6/]

Under existing regulations, the material participation standard is generally satisfied if a taxpayer spends more than 500 hours working in an activity during the taxable year.[7/] However, under the new provision, personal services performed as an employee are not be treated as performed in a real estate trade or business unless the person performing the services has more than a five percent ownership interest in the employer.[8/]

New section 469(c)(7)(A)(ii) provides that, if the relief provision applies to a taxpayer for the taxable year, section 469 shall be applied as if each interest in rental real estate were a separate activity. However, the taxpayer is permitted to elect to treat all interests in rental real estate as a single activity.

5/ I.R.C. § 469(c)(7)(B).

6/ I.R.C. § 469(c)(7)(C).

7/ Treas. Reg. § 1.469-5T(a)(1).

8/ I.R.C. §§ 469(c)(7)(D)(ii); 416(i)(1)(B).

II. AREAS WHERE GUIDANCE IS NEEDED

A. Former Passive Activities

1. Fact Pattern

The interaction of the new relief provision with the existing rules for "former passive activities" raises an issue of importance to many taxpayers. The issue is illustrated by the following fact pattern.

A owns three separate rental real estate projects. Each project is operated through a separate entity. Prior to 1994, A treated each real estate project as a separate activity in accordance with Temp. Treas. Reg. § 1.469-4T and Prop. Treas. Reg. § 1.469-4.[9/] Project #1 has suspended section 469 losses of $1,000,000, Project #2 has suspended section 469 losses of $2,000,000, and Project #3 has suspended section 469 losses of $2,500,000. In 1994, A disposes of Project #1 and realizes gain of $1,750,000. A satisfies the requirements of section 469(c)(7).

2. Issue

Can the $750,000 excess gain on Project #1 (i.e., the remaining gain after offsetting the suspended losses from Project #1) (the "Excess Gain") be offset by some of the suspended losses from Projects #2 and #3?

9/ Prop. Treas. Reg. § 1.469-4(c)(1) generally provides that one or more activities are treated as a single activity "if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." Prop. Treas. Reg. § 1.469-4(c)(2) states that this determination depends upon all the relevant facts and circumstances and allows taxpayers to use "any reasonable method of applying the facts and circumstances in grouping activities." Treas. Reg. § 1.469-4T(k)(2)(i) generally permitted taxpayers to treat two or more rental real estate undertakings as either a single activity or as separate activities.

3. Summary Conclusion

A should be able to offset the Excess Gain with a like amount of suspended losses from Projects #2 and #3.

4. Analysis

a. Treatment As Former Passive Activities

Prior to the enactment of the passive loss relief provision in the 1993 Act, the Excess Gain would have been passive and therefore could be offset by a corresponding amount of suspended losses from Projects #2 and #3, regardless of whether the projects were treated as a single activity or as multiple activities.[10/]

As a result of the passive loss relief provision contained in the 1993 Act, A's gain on the disposition of Project #1 will be active.[11/] Moreover, A's rental real estate projects will constitute one or more "former passive activities" under section 469(f). Under section 469(f)(1)(A), if an activity is a former passive activity, then any suspended losses attributable to that activity are offset against the income from the activity. Under section 469(f)(1)(C), any remaining carryover losses "shall continue to be treated as arising from a passive activity."

b. Result If Rental Projects Are Separate Activities

If, for 1994, A treats the three rental real estate projects as separate activities, then the suspended losses from Projects #2 and #3, which retain their passive character by vir-

---

10/ See section 469(d)(1).

11/ See Treas. Reg. § 1.469-2T(c)(2)(i)(A). For simplicity, this analysis ignores the possible application of the allocation rule of Treas. Reg. § 1.469-2T(c)(2)(ii) relating to the disposition of property used in more than one activity during the 12-month period preceding disposition.

tue of the former passive activity rule, would not be available to offset the Excess Gain, which is active income. Thus, A would be worse off than if the passive loss relief provision had not been enacted. We submit that this is not what Congress intended when it passed the relief provision.

c. Result If Rental Projects Are One Activity

If, for 1994, A is able to treat the three rental real estate projects as a single activity, then the suspended losses from Projects #2 and #3 should be available to offset the Excess Gain from Project #1. The regulations provide the following example:

> (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 § 1.469-1T(f)(2), a $12,000 loss from the rental activity is disallowed for 1993 and $9,000 loss from the rental activity is disallowed 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.[12/]

In the instant case, the business and rental operations of each of the three separate rental activities are continued through the combined activity in 1994. Accordingly, the Excess Gain from Project #1 should be offset by carryover losses attributable to Projects #2 and #3. Any remaining suspended losses should be treated as deductions from a former passive activity.

d. Effect Of Consistency Rule

Prop. Treas. Reg. § 1.469-4(g) provides that a change in the grouping of activities is not permitted unless the original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate. The enactment of the special rules in section 469(c)(7) regarding the grouping of rental real estate activities should be read to override this consistency requirement at least for 1994, the first year in which the new statutory rule regarding activity grouping applies. Accordingly, for 1994 and future years, A should be permitted to treat Projects #1, #2 and #3 as a single activity notwithstanding the consistency rule.

12/ Treas. Reg. § 1.469-1(f)(4)(iii), Example 4.

e. Application Of Section 469(g)

Section 469(g) generally provides that if a taxpayer disposes of his entire interest in any passive activity (or former passive activity), any suspended losses from the activity become fully deductible. Prop. Treas. Reg. § 1.469-4(k) generally permits a taxpayer to apply section 469(g) if there is a disposition of a "substantial part" of an activity. This rule applies only if the taxpayer can establish with reasonable certainty the amount of carryover deductions and credits and the amount of income for the year attributable to the part of the activity that is disposed of. The disposition of any of Projects #1, #2 or #3 should be treated as the disposition of a "substantial part" of a former passive activity for this purpose.

5. Administrative Guidance Requested

We urge the Treasury and the Service to confirm that:

1. Taxpayers are permitted to apply the statutory activity grouping rules of section 469(c)(7)(A) for 1994 notwithstanding the consistency requirement contained in Prop. Treas. Reg. § 1.469-4(g).

2. If taxpayers treat all of their interests in rental real estate as a single activity as permitted by section 469(c)(7)(A), then under the former passive activity rule of section 469(f), any income or gain from the combined activity may be offset by all suspended losses from the combined activity, regardless of the activity groupings used in earlier years.

3. The disposition of any part of the combined activity that was properly treated as a separate activity in earlier years will be treated as a disposition of a "substantial part" of the activity for purposes of Prop. Treas. Reg. § 1.469-4(k). Thus, provided the taxpayer can clearly establish the carryover

and current income amounts attributable to that part of the activity, section 469(g) will apply.

B. Treatment Of Limited Partners

1. Fact Pattern

The last sentence of section 469(c)(7)(A) states that "[n]othing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner." As illustrated by the following fact pattern, this cryptic sentence raises an important issue for taxpayers who own interests in rental real estate as limited partners:

B owns interests in rental real estate in four different ways: (i) directly; (ii) through partnerships in which B is a limited partner; (iii) through partnerships in which B is a general partner; and (iv) through S corporations. B spends more than 750 hours working in connection with these rental real estate projects during the taxable year, and this constitutes more than one-half of the personal services performed by B in trades or businesses during the year.

2. Issue

Does the last sentence of section 469(c)(7)(A) preclude B from qualifying for relief?

3. Summary Conclusion

The sentence in question is intended to clarify that the present law rules for material participation by a limited partner still apply in determining whether the limited partner materially participates with respect to rental real estate activities. If B elects to aggregate rental real estate activities

held as a limited partner with rental real estate activities held directly, as a general partner or through an S corporation, only the material participation tests applicable to limited partners will apply.

4. Analysis

a. The Statute

Section 469(c)(7)(A) provides as follows:

> (A) IN GENERAL - If this paragraph applies to any taxpayer for a taxable year --
>
> (i) paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and
>
> (ii) this section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.
>
> Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner. [Emphasis added].

b. The Need For Guidance

Press reports of speeches given by certain government officials have created confusion regarding the meaning of the underscored sentence. Some press reports have been interpreted to mean that passive loss relief is not available if the taxpayer owns interests in rental real estate as a limited partner. Other press reports have indicated that neither the statutory rule that each interest in rental real estate is a separate activity, nor the statutory election to treat all interests in rental real estate as a single activity, apply with respect to rental real estate held as a limited partner.

c. Interpretation Of The Statute

The Treasury and the Service should clarify promptly that the sentence in question simply confirms that present law rules for material participation by limited partners continue to apply. Specifically, regulations under section 469 generally provide that if an individual meets any one of seven specified tests, the individual will be treated as materially participating in the activity for the taxable year.[13/] However, in the case of an individual who is a limited partner, only three of these seven tests are applicable in determining whether the individual materially participates in the activity carried on through the limited partnership.[14/] Thus, under the regulations, it is significantly more difficult for an individual to satisfy the material participation standard for activities held as a limited partner than for other activities.

An individual engaged in the real estate business qualifies for relief under new section 469(c)(7) if more than 50 percent of the personal services performed in trades or businesses by the taxpayer during the year are performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer spends more than 750 hours during the year in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(B). Therefore, an initial determination must be made as to each real property trade or business in which the taxpayer materially participates. In addition, as discussed below, for taxpayers who meet the test of section 469(c)(7)(B), a determination must be made as to whether the taxpayer materially participates in the activity that includes the taxpayer's interests in rental real estate. Thus,

---

13/ See Treas. Reg. § 1.469-5T(a)(1)-(7).

14/ See Treas. Reg. § 1.469-5T(e)(2).

the tests for material participation remain highly relevant under the new relief provision.

The House Ways and Means Committee Report explains the sentence in question as follows:

> Material participation has the same meaning as under present law. Thus, as under present law, except as provided in regulations, no interest as a limited partner in a limited partnership is treated as an interest with respect to which the taxpayer materially participates. The election permitting a taxpayer to aggregate his rental real estate activities for purposes of determining whether such activities are treated as not passive under the provision is not intended to alter present law with respect to material participation through limited partnership interests.[15/]

As the legislative history indicates, the last sentence of section 469(c)(7)(A) is intended to clarify that notwithstanding the aggregation election, in order to meet the material participation standard with respect to an activity held as a limited partner, the taxpayer must satisfy one of the three tests set forth in the regulations. In addition, where the taxpayer elects to aggregate interests in rental real estate held as a limited partner with other interests in rental real estate held directly, as a general partner, or through an S corporation, the taxpayer should be limited to the three tests applicable to limited partners.

5. Administrative Guidance Requested

We urge the Treasury and Service to confirm that the last sentence of section 469(c)(7)(A) simply clarifies that notwithstanding the aggregation election, for purposes of determining material participation, a taxpayer's activity in a

---

15/ House Report at 176.

limited partnership still must satisfy one of the three tests set forth in the regulations. In addition, if the taxpayer combines interests in rental real estate held as a limited partner with other interests held directly, as a general partner, or through an S corporation, the taxpayer should be required to meet one of the three tests applicable to limited partners.[16/]

C. Aggregation Of Rental And Non-Rental Activities

1. Fact Pattern

One of the most important issues relating to the application of the new passive loss relief provision concerns the aggregation of rental and non-rental real estate activities. The issue is illustrated by the following example:

C heads one of the largest real estate development organizations in the United States. C spends more than 3,000 hours per year developing rental real estate, and this constitutes more than one-half of the personal services performed by C in trades or businesses. C currently owns, through partnerships, interests in more than 100 different rental real estate projects previously developed by C. However, virtually all of C's working time is devoted to the development of new projects; virtually none is devoted to the completed rental projects. In the aggregate, C's interests in the completed rental projects produce a net loss. In addition, C has significant income from portfolio investments.

2. Issue

16/ We note that nothing in the Prop. Treas. Reg. § 1.469-4 prohibits the aggregation of interests held as a limited partner with other interests. We do not believe that the last sentence of section 469(c)(7)(A) should be interpreted to prohibit such aggregation.

Can C's losses from the completed rental projects offset C's income from portfolio investments?

3. Summary Conclusion

C clearly meets the requirements for relief from the passive loss rules contained in section 469(c)(7)(B). Nevertheless, C will not be able to offset losses from the completed rental projects against portfolio income unless C is permitted to treat the development and rental of real estate as a single activity.

4. Analysis

a. The Test For Relief Under Section 469(c)(7)(B)

As previously described, under section 469(c)(7)(B), the passive loss relief provision applies to an individual if (i) more than 50 percent of the taxpayer's personal services performed in trades or businesses during the year are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) the taxpayer spends more than 750 hours during the year in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(C) defines "real property trade or business" to mean any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business. C clearly meets the two-prong test of section 469(c)(7)(B) by virtue of his participation in real estate development.

b. Importance Of The Activity Determination

Because C qualifies for relief, under section 469(c)(7)(A)(i), C's rental real estate activities are not treated as per se passive under section 469(c)(2). Rather, the status of C's rental real estate as active or passive depends on whether C materially participates in the activity in which the rental real estate is included. If rental real estate is treated as an activity separate from real estate development, then C will not materially participate in the separate rental activity, and C's losses from the completed rental properties will continue to be passive. On the other hand, if rental real estate and real estate development are treated as one activity, then C will materially participate in the combined activity, and his losses from the completed rental properties will be active.

c. Combining Rental And Non-Rental Real Property Trades Or Businesses

The statutory language of the passive loss relief provision does not directly address the issue of whether rental real estate and other real property trades or businesses may be combined into a single activity. Proposed regulations issued under section 469 in May, 1992 provide that a rental activity may not be grouped with a non-rental trade or business activity unless either the rental activity is insubstantial in relation to the non-rental activity or the non-rental activity is insubstantial in relation to the rental activity.[17/] Under these proposed regulations, C would not be permitted to aggregate his real estate development and rental real estate activities.

These proposed regulations were issued prior to the enactment of section 469(c)(7). They are an appropriate implementation of the statutory regime as it existed in May, 1992.

17/ Prop. Treas. Reg. § 1.469-4(d).

Under that regime, all rental activities were per se passive under section 469(c)(2). The regulatory "Chinese wall" between rental and non-rental activities was engineered to prevent taxpayers from circumventing the per se passive rule by combining rental and non-rental activities and treating the combined activity as a non-rental activity in which the taxpayer materially participates.

However, the passive loss relief provision repeals the per se passive rule for taxpayers who meet the test for relief. For such taxpayers, the regulatory "Chinese wall" between rental real estate and non-rental real estate activities is now inappropriate. The development of real estate is, in effect, a manufacturing process which culminates in production of a product -- a finished building. Treating the development of real estate as a separate activity from its rental would be like treating the manufacture of a product as a separate activity from the sale of the product to the manufacturer's customers. Except for the need to protect the integrity of the per se passive rule, which has been repealed for taxpayers qualifying for relief, such treatment would be inappropriate.

Apart from the prohibition on combining rental and non-rental activities, Prop. Treas. Reg. § 1.469-4(c)(1) generally provides that one or more activities are treated as a single activity "if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469." Certainly, under this test, the manufacture of a product could not be treated as a separate activity from the realization of the value created in the manufacturing process through sale of the product to the manufacturer's customers. Likewise, for taxpayers who meet the test for relief under section 469(c)(7), real estate development should not be treated as separate from real estate rental.

Moreover, the legislative history of the passive loss relief provision strongly suggests that Congress intended to permit taxpayers who meet the test for relief to treat all real property trades or businesses enumerated in section 469(c)(7)(C), including rental, as a single activity. For example, the House Ways and Means Committee Report states:

> The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from non-rental real estate activities or against other types of income such as portfolio investment income. The committee bill modifies the passive loss rule to alleviate this unfairness.[18/]

As noted above, because of the per se passive rule applicable prior to the enactment of the passive loss relief provision, a taxpayer's material participation in a rental activity was irrelevant. Thus, the reference in the underscored language to "a real estate trade or business in which [the taxpayer] materially participates" must refer to a non-rental real estate trade or business. Read in this light, the quoted language from the Committee Report clearly indicates that Congress intended that a taxpayer who meets the test for relief by working in a non-rental real estate trade or business in which he materially participates would be permitted to offset losses from rental real estate against income from non-rental and portfolio sources. This Congressional intent will be frustrated unless the regulatory "Chinese wall" is eliminated for taxpayers who meet the test of the new relief provision.

18/ House Report at 175 (Emphasis added).

5. Administrative Guidance Requested

The Treasury and Service should issue guidance that allows taxpayers who qualify for relief under section 469(c)(7)(B) to aggregate all real property trades or businesses as defined in section 469(c)(7)(C), including rental and non-rental.

D. Other Issues

1. Election To Treat All Interests in Rental Real Estate As A Single Activity

Section 469(c)(7)(A) permits taxpayers to elect to treat all of their interests in rental real estate as one activity. In the great majority of cases, taxpayers will find it to their advantage to make this election. In order to treat losses from rental real estate as non-passive under section 469(c)(7), the taxpayer must materially participate in the activity that includes the rental real estate. In general, making the election to treat all interests in rental real estate as a single activity will make it easier to meet the hourly thresholds under Treas. Reg. § 1.469-5T and therefore meet the material participation standard.[19/] Furthermore, making the election will also prove beneficial if rental real estate held before 1994 is disposed of thereafter at a gain. Failure to make the election can create the issue discussed at Part II.A above.

This situation is reminiscent of the "consistency rule" under section 338(e). Under that provision, if a corporation acquires a company by means of a stock purchase and also acquires

---

19/ A taxpayer may benefit by not aggregating activities. If the taxpayer has net income from real estate rental activities and passive losses from another source, the taxpayer may prefer not to materially participate, so that the rental real estate income can be offset by the unrelated losses.

any asset of the target (or a target affiliate), the statute provides that the purchasing corporation is deemed to make a section 338 election. Nevertheless, until their recent amendment, temporary Treasury regulations under § 1.338-4T(f)(6) generally provided that an "affirmative action" carryover basis election (rather than a section 338 election) would be deemed to be made in such a circumstance. More recently, the regulatory regime has been simplified by Treas. Reg. § 1.338-4, which applies a carryover basis rule in lieu of the deemed section 338 election contemplated by section 338(e) and the "affirmative action" carryover basis election of the earlier regulations.

The failure to make the election to treat all interests in rental real estate as one activity is a trap for the unwary. Accordingly, the Treasury and the Service should consider issuing guidance that provides that a taxpayer will be deemed to have made the election to treat all of his or her interests in rental real estate as a single activity, unless the taxpayer elects to treat each of the interests as separate activities.

2. "Gross Receipts" Test for Closely-Held C Corporations

A special test applies for determining whether a closely-held C corporation qualifies for relief under the new rules. Specifically, in the case of a closely-held C corporation, the per se passive rule will not apply for rental real estate activities if more than 50 percent of the corporation's gross receipts for the taxable year are derived from real property trades or businesses in which the corporation materially participates.[20/] Under existing regulations, a C corporation materially participates in an activity if (i) shareholders who own more than 50 percent of the stock of the corporation materially participate in the activity or (ii) the corporation

---

20/ I.R.C. § 469(c)(7)(D)(i).

has at least one full-time employee substantially all of whose services are in the active management of the activity, and three full-time non-owner employees substantially all of whose services are directly related to the activity.[21/]

Unless and until administrative guidance is issued, the gross receipts test applicable to closely-held C corporations will create great uncertainty, particularly for corporations that are members of an affiliated group. The principal reason for this is that the legislation offers no guidance as to the definition of "gross receipts."

The term "gross receipts" is used in several other places in the Code, each time with a definition that is specific to the provision in question. Thus, for purposes of the Domestic International Sales Corporation rules, gross receipts is defined as the total receipts from the sale, lease, or rental of property held primarily for sale, lease, or rental in the ordinary course of trade or business, and gross income from all other sources.[22/] For purposes of the passive income limitations applicable to certain S corporations, however, gross receipts from dispositions of capital assets (other than stock and securities) are taken into account only to the extent of capital gain net income.[23/]

The uncertainty is magnified in the case of an affiliated group of closely-held C corporations, where intercompany sales, loans and other arrangements come into play.

[21/] Treas. Reg. § 1.469-5T(h)(1), -1T(g)(3)(i).

[22/] I.R.C. § 993(f).

[23/] I.R.C. § 1362(d)(3)(C).

In preparing guidance as to the meaning of the term "gross receipts," we urge that the Treasury and the Service consider the intent of Congress to provide relief to real estate professionals, including owners of closely-held C corporations. Specifically, "gross receipts" should include only the gross receipts from trades or businesses.[24/] If the gross revenue from activities which are not from trades or businesses are taken into account, unfair results can occur. This is particularly true regarding the net gain from the sale of an interest in stock or securities, where the sale is for portfolio investment purposes only and is not part of a trade or business of selling such interests. Consider a closely-held C corporation that earns $1,000,000 a year from rental real estate and satisfies the material participation test. During the year, the corporation invests $200,000 of its net earnings in Treasury bills. The corporation typically purchases Treasury bills for $200,000 and sells them shortly thereafter. In the aggregate the corporation buys six Treasury bills in six different transactions for a total amount of $1,200,000 and sells them within the same year for a total amount of $1,250,000. If the term "gross receipts" is defined to include the gross revenues, less than 50 percent of the corporation's gross receipts will be treated as in real property trades or businesses in which the corporation materially participates, and the corporation will therefore not qualify for passive loss relief. This would not be appropriate.

Interpreting the term "gross receipts" to include only the gross receipts from trades or businesses would make the treatment of closely-held C corporations consistent with the

---

24/ One Capital Hill staffer has publicly stated that Congress intended that the term "gross receipts" for purposes of the passive loss relief provision should include only the gross receipts from trades or businesses. See "Real Estate Panel Focuses on New Tax Law," Tax Notes 930 (Aug. 13, 1993)

treatment of individuals. In order for an individual to qualify for relief under section 469(c)(7), more than 50 percent of the personal services which the individual performs in trades or businesses during the taxable year must be performed in real property trades or businesses in which the individual materially participates. Similarly, in order for a closely-held C corporation to qualify for the relief, guidance should provide that more than 50 percent of the corporation's gross receipts from trades or businesses during the taxable year must be derived from real property trades or businesses in which the corporation materially participates.