MODERN TRAGEDIES AND MYTHS: THE PASSIVE ACTIVITY LOSS RULE

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I. INTRODUCTION

Writers in ancient Greece produced a plethora of myths and tragedies. Myths were written to explain perplexing and complex ideas and concepts to man, while tragedies grew out of death.

In enacting the Tax Reform Act of 1986 [hereinafter TRA],[1] Congress provided ample opportunity for modern development of tragedies and myths. A major theme of the TRA was the elimination of tax shelters; the tragic death knell was sounded with the addition to the Internal Revenue Code of section 469, the passive activity loss limitation provision.[2] While

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1. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

2. The Tax Reform Act of 1986 addressed tax sheltering through several other provisions of the Internal Revenue Code. The TRA eliminated investment tax credits and severely curtailed the real property portion of the Accelerated Cost Recovery System [hereinafter ACRS].

media attention focused on the goal of simplifying the tax laws, the passive activity loss rules are complex both in structure and concept. Consequently, Congress specifically authorized the Department of the Treasury to develop regulations which define, explain, and provide guidelines regarding the passive activity loss rules.[3] Thus, modern myths were developed through the legislative process and may be created through regulatory actions.

An understanding of the tragedy and myths surrounding the new passive activity loss rules is critical to the development of plans for minimizing income tax liability. For many taxpayers, these rules may be the key to designing economically viable real estate deals, investment decisions, and certain business transactions. Yet caution must be utilized by the taxpayers and their financial planners, attorneys, and accountants since the rules are extremely complicated (with their complexity compounded by the Treasury's recently issued proposed and temporary regulations). They may produce unexpected results, as certain provisions appear to bear no cogent relationship to economic reality.

Prior to the TRA, individuals could eliminate or reduce their potential income tax liability by offsetting income from a variety of sources with deductions and credits produced by tax shelter investments. Critics complained that these tax deductions and credits were often paper losses in excess of the true economic costs shouldered by the taxpayers, and that such taxpayers (usually high bracket individuals) realized tax advantages at the expense of other taxpayers and the federal treasury. To remedy this problem Congress added section 469 to the Internal Revenue Code. That statute restricts taxpayers' ability to shelter compensation for services (active income), and interest, dividends, royalties, and the gain on the sale of nonbusiness investments (portfolio income), with losses and credits produced by traditional tax shelters and similar passive activities. In other words, section 469 limits the deductibility of losses attributable to tax shelter activities.[4]

II. The General Passive Activity Loss Rule

The general rule of section 469 provides that deductions and credits from passive activities are permitted to the extent of income from passive

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The recovery period for real property was extended from 19 years to 27½ years for residential realty and to 31½ years for nonresidential property. Special attention was also given to the at-risk rules of section 465 of the Code. Congress extended the at-risk rules to encompass real estate in order to restrict opportunities for overvaluation of property and to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no equity in the property.

3. I.R.C. § 469(l) (Supp. IV 1986).

4. Clearly, however, tax shelters have not been destroyed. Investors may continue to place their capital funds in economically sensible tax shelter investments. The income generated by those investments may be offset by the losses they produce.

activities.[5] This rule prevents a taxpayer from offsetting active or portfolio income with passive losses. Yet excess passive deductions and credits are not forfeited by the taxpayer. Rather, section 469(b) contains a timing provision: the disallowed amounts may be suspended and carried forward (not back) to be used in future years. The suspended losses may then be applied either against income generated by passive activities or against income realized upon disposition of the passive activity.[6]

Congress realized that the general rule of section 469 might create unintended results. Thus, as discussed below, section 469 includes several exemptions, exceptions, and limitations on the scope of the rule.

III. Taxpayers Subject to Section 469

Taxpayers subject to the passive activity loss rules of section 469 include any individual, estate, trust, closely held C corporation, and personal service corporation. A "closely held C corporation" is defined in section 465(a)(1)(B) as a C corporation in which fifty percent of the stock is held by five or fewer individuals. This definition clearly excludes S corporations, C corporations in which fifty percent or less of the stock is owned by five or fewer individuals, and C corporations in which more than fifty percent of the stock is owned by more than five individuals. In general, the definition of a "personal service corporation" includes a corporation which has as its

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5. Passive activity gross income generally is all income recognized during a taxable year which is derived by the taxpayer from a passive activity. There are several exceptions to this general definition, including gain recognized on the disposition of certain substantially appreciated property and on the disposition of appreciated property utilized by a taxpayer in an activity which has changed from passive to nonpassive.

Passive activity deductions are deductions resulting from a passive activity. Section 1.469-2T(d)(2) of the temporary Treasury regulations lists nine deductions which are excluded from the passive activity classification:

(1) An expense directly allocable to portfolio income—*e.g.*, expenses incurred with respect to generating interest on investments, royalties, dividends, and gain on the sale of an investment;

(2) Dividends-received deduction;

(3) Certain interest expenses;

(4) Loss recognized on the disposition of portfolio assets;

(5) State, local, and foreign income taxes;

(6) Miscellaneous itemized deductions subject to the two percent floor;

(7) Charitable contributions;

(8) Net operating loss and capital loss carryforward;

(9) Loss disallowed under I.R.C. §§ 704(d), 1366, and 465 in a tax year beginning prior to January 1, 1987. Temp. Treas. Reg. § 1.469-2T(d)(2) (1988).

6. Several limitations exist with respect to the deductibility of suspended losses upon disposition of the passive activity. Section 469(g)(1)(B) prohibits the deduction if the disposition of the activity is considered to be a sham—that is, if it occurs between related parties as defined in I.R.C. §§ 267(c), 707(b)(1). Additionally, suspended credits from passive activities are not allowed upon disposition of the activities because credits are not considered to be related to the measurement of passive losses. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 725 (1986).

principal activity the performance of personal services by employee-owners.[7]

IV. Definition of Passive Activity

Whether a taxpayer is subject to the restrictive passive activity loss rules depends, in part, on whether he is engaged in one or more passive activities. While the statute and the temporary regulations issued in February 1988, do not define the term "activity" and do not provide guidance as to whether certain undertakings are to be considered as one integrated activity or several separate activities, they do define "passive activity" to include any rental activity and any trade or business activity in which the taxpayer does not materially participate during the taxable year.[8]

A. *Rental Activity*

A "rental activity" is any activity from which income is derived primarily for the use of tangible personal and real property.[9] Additionally, where property is held out for rent, it may be considered rental property even if no rental income is actually derived from it in a tax year.[10]

Yet the scope of the definition of rental activity is narrower than appears at first blush. Activities which immediately precede the rental activity, which are conducted by the same persons or take place in the same location, or which are associated with, but do not involve, renting tangible real or

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7. I.R.C. § 469(j)(2) (Supp. IV 1986).

8. I.R.C. § 469(c) (Supp. IV 1986); Temp. Treas. Reg. § 1.469-1T(e) (1988).

Yet the Senate Finance Committee stated that an activity is composed of "undertakings [which] consist of an integrated and interrelated economic unit, conducting in coordination with or reliance upon each other, and constituting an appropriate unit the measurement of gain or loss." Two or more substantially different products or services generally would be considered two or more separate activities.

More recently, the Internal Revenue Service has released a transitional definition of the term "activity." Notice 88-94, 1988-35 I.R.B.

This transitional rule is to be utilized with regard to activities conducted during taxable years ending prior to the issuance of forthcoming temporary regulations § 1.469-4T. This section of the regulations has been reserved for the purpose of defining an "activity."

Notice 88-94 provides that a taxpayer may apply "any reasonable method" to treat operations in which he has an interest as one or more activities. The notice cites methods considered to be "reasonable." Generally it will be reasonable for a taxpayer to treat as one activity those operations which provide similar goods or services. Vertically integrated business operations (*e.g.*, those involving manufacturing, wholesaling, and retaining of the same goods) may reasonably be considered either one activity or several separate activities. Operations conducted at the same location and owned by the same persons in substantially the same proportions may reasonably be considered one activity. It will be deemed reasonable for a taxpayer to treat rental real estate operations as either a single activity or as multiple activities. But nonrental real estate activities, such as construction, generally cannot be treated as part of a rental activity; instead it would be reasonable to treat the construction as a separable activity.

9. I.R.C. §§ 469(c)(2), (j)(8) (Supp. IV 1986).

10. Temp. Treas. Reg. 1.469-IT(e)(3) (1988).

personal property, are deemed to be separate activities apart from the rental activity.[11] For example, one such activity is the construction of a building which occurs prior to the leasing of the residential or commercial units within the building.[12]

The temporary Treasury regulations indicate six exceptions to the definition of rental activity.[13] An activity involving the use of tangible property is not rental activity for a taxable year if the activity fits into any one of the following categories:

(1) The average rental period is seven days or less;

(2) The average rental period is thirty days or less and significant personal services are provided to the customer;[14]

(3) Extraordinary personal services are provided to the customer in connection with the use of the tangible property;

(4) Rental is incidental to nonrental activity;

(5) The property is customarily made available during defined business hours for nonexclusive use by various customers; or

(6) The owner of an interest in a partnership or S corporation in his ownership capacity provides property rent-free for the entity's use in a nonrental activity.

Category one might include the rental of a vacation condominium unit or home, if rented on the average for seven days or less. Although such an activity will not be considered rental activity, it may be considered a trade or business activity and thus a passive activity if the owner does not materially participate.

The temporary regulations indicate that category three would include the use by patients of a hospital's boarding facilities where the use of the room is incidental to the services provided by the medical staff.[15] Likewise, the use by students of a school's dormitories will not be considered to constitute rental activity if incidental to the receipt of personal services from the school's faculty.[16] Another possible example might be a car rental business which rents, cleans, maintains, and repairs cars for short-term lessees.

The temporary regulations specify four situations to which category four applies: first, where the rental property is held for investment—that is,

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11. *See* S. REP. No. 313, 99th Cong., 2d Sess. 743 (1986).

12. *Id.*

13. Temp. Treas. Reg. § 1.469-1T(e)(3)(ii) (1988).

14. Temp. Treas. Reg. § 1.469-1T(e)(3)(iv) (1988) indicates that significant personal services can be performed only by individuals. The definition excludes certain services: (1) those necessary to permit lawful use of the property; (2) those performed in connection with the construction, improvement, or major repair of the property; and (3) those which would be performed in connection with long-term rentals of high-grade commercial or residential property. No quantitative standard is supplied; the test involves facts and circumstances.

15. Temp. Treas. Reg. § 1.469-1T(e)(3)(v) (1988).

16. *Id.*

where it is held to realize gain from appreciation[17] and the gross rental income is less than two percent of the lesser of the unadjusted basis or fair market value of the property;[18] second, where the property is used in a trade or business owned by the individual and the gross rental income is insubstantial as tested by the above two percent standard;[19] third, where the property is held for sale to customers in the ordinary course of business and is sold within the taxable year;[20] fourth, where lodging is rented to an employee for the employer's convenience.[21] A fifth category might include sports facilities, such as golf courses, swimming pools, or tennis courts, where customers can purchase daily or monthly passes to use the facilities.

Therefore, situations might be designed to fall either within or outside the definition of rental activity; the former plan might trigger the passive activity loss rules while the latter could avoid application of the rules. One must, however, be aware that if the activity is excepted from the definition of rental activity, it may be considered a trade or business activity. In that event, in order to escape the passive activity loss rules, the taxpayer must materially participate in the activity.[22]

B. *Trade or Business Activity*

An activity is considered a trade or business activity for purposes of section 469 if it is actively conducted within the meaning of section 162 or if it is entered into for the production of income (i.e., as an investment) within the meaning of section 212.[23] Moreover, section 469(c)(5) defines trade or business to include activities which generate research and experimental expenditures deductible under section 174, even if the trade or business has not formally commenced. The temporary regulations have a section reserved for future identification of other activities which may not meet the stated statutory definition but nevertheless will be treated as a trade or business for purposes of the passive activity loss rules.[24]

C. *Material Participation*

A taxpayer materially participates in an activity if he or his spouse is involved in the trade or business activity on a "regular, continuous or substantial" basis throughout the taxable year.[25] Any taxpayer who materially participates in the trade or business activity is presumed not to be involved

17. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(B)(1) (1988).
18. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(B)(2) (1988).
19. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(C)(3) (1988).
20. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(D) (1988).
21. Temp. Treas. Reg. § 1.469-1T(e)(3)(vi)(E) (1988).
22. Temp. Treas. Reg. § 1.469-1T(e)(3)(i) (1988).
23. I.R.C. § 469(c)(6)(B) (West Supp. 1988).
24. Temp. Treas. Reg. § 1.469-1T(e) (1988).
25. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).

in a tax shelter but rather in an activity in which he intends to produce an economic profit.[26] For this reason, a taxpayer who materially participates in a trade or business will be considered to be involved in an activity to which the restrictive rules of section 469 do not apply.

Until the Treasury issued the temporary regulations, the sole standard to be applied in determining whether a taxpayer was materially participating in an activity was subjective; it was a facts and circumstances test.[27] While the temporary regulations left the facts and circumstances test intact, they expanded the tests to include six other alternatives, all of which are objective.[28] Commentators have criticized these tests as exceeding legislative intent and as transforming a purely qualitative standard into a quantitative one. Clearly such a transformation will burden the taxpayer with new recordkeeping tasks.

Under the temporary regulations the term "participation" includes any work performed by an individual in connection with an activity in which he owns a direct or indirect interest at the time that the work is performed.[29] Participation may be proved by any reasonable means; contemporaneous reports may be utilized but are not necessary to demonstrate it.[30] The material participation standard is satisfied if an individual shows with respect to a trade or business activity any of the following:

(1) Participation for more than five hundred hours during the taxable year;[31]

(2) Participation constituting substantially all of the participation by individuals in the activity during the taxable year;[32]

(3) Participation for more than one hundred hours during the year and such participation is not less than that of any other individual for the taxable year;[33]

(4) The activity constitutes a significant participation activity and the individual's participation exceeds five hundred hours in all significant participation activities for the taxable year;[34]

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26. I.R.C. § 469(c)(1)(B) (West Supp. 1988).

27. S. Rep. No. 313, 99th Cong., 2d Sess. 728-32 (1986). *See also* Temp. Treas. Reg. § 1.469-5T(a)(7) (1988).

28. Temp. Treas. Reg. §§ 1.469-5T(a)(1)-1.469-5T(a)(6) (1988).

29. Temp. Treas. Reg. § 1.469-5T(f) (1988).

30. Temp. Treas. Reg. § 1.469-5T(f)(4) (1988).

31. Temp. Treas. Reg. § 1.469-5T(a)(1) (1988).

32. Temp. Treas. Reg. § 1.469-5T(a)(2) (1988).

33. Temp. Treas. Reg. § 1.469-5T(a)(3) (1988).

34. Temp. Treas. Reg. § 1.469-5T(a)(4) (1988). Significant participation and significant participation activity are concepts which do not appear in § 469. Critics have contended that the addition of these concepts in the temporary regulations exceeded the delegated authority of the Treasury. These concepts are defined in Temp. Treas. Reg. § 1.469-5T(c). Significant participation is defined by the temporary regulations as more than one hundred hours of participation in a taxable year. An activity is deemed to be a significant participation activity if it constitutes a trade or business activity and if the individual does not materially participate in it.

(5) Material participation in the activity for any five of the ten preceding taxable years (a safe harbor presumption);[35]

(6) Material participation in the activity for any three preceding taxable years, where the activity constitutes a personal service activity (such as law, engineering, medicine);[36] or

(7) The facts and circumstances indicate participation on a regular, continuous, and substantial basis during the taxable year.[37]

The material participation standard is also applied to C corporations and to personal service corporations. These entities will be treated as materially participating in an activity if one or more shareholders, holding a combined total of more than fifty percent of the stock, materially participate, or if the C corporations meet the terms of section 465(c)(7)(C).[38] General partners in partnerships can satisfy the material participation test under certain circumstances, but limited partners generally are presumed not to participate materially.[39] However, in three situations a limited partner is considered to participate materially:

(1) The limited partner participates in the activity for more than five hundred hours in the taxable year;

(2) The limited partner participated in the activity for any five of the preceding ten years; or

(3) The limited partner materially participated in the activity for any three years prior to the taxable year and the activity is a personal service.[40]

Thus, whether an activity will be considered passive or not depends in large part on whether or not the taxpayer materially participates in the activity. This is significant where a taxpayer desires to offset passive losses which either are produced in the current taxable year or were disallowed and suspended from a prior taxable year. The taxpayer may attempt to generate passive income with which to offset the passive losses. This clearly means that a passive activity must render a profit. One seemingly obvious

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The temporary regulations provide a whipsaw result if an individual significantly participates in a significant participation activity. If the activity is profitable, pursuant to Temp. Treas. Reg. § 1.469-2T(f)(2), the income will be treated as nonpassive. But if the activity produces losses, § 1.469-5T treats the losses as passive. The intention of the individual is irrelevant. These regulations prevent, perhaps unfairly, taxpayers from generating passive income from activities in which they minimally participate.

35. Temp. Treas. Reg. § 1.469-5T(a)(5) (1988).

36. Temp. Treas. Reg. § 1.469-5T(a)(6) (1988).

37. Temp. Treas. Reg. § 1.469-5T(a)(7) (1988). The facts and circumstances test will be met only if the individual participates in the activity for more than one hundred hours during the taxable year. Moreover, management activities performed by the individual will not be considered unless he has been engaged in more management services than any other individual and no other individual receives compensation for his management services.

38. I.R.C. §§ 469(h)(4)(A), (B) (West Supp. 1989).

39. I.R.C. §469(h)(2) (West Supp. 1989).

40. Temp. Treas. Reg. § 1.469-5T(e)(2) (1988). That section of the proposed regulation defines a limited partnership interest.

means of achieving this end is for the taxpayer to restrict his participation in the activity so that he does not meet any of the material participation tests. Yet, as a result of the recent temporary regulations, generating passive income is not necessarily a simple task.

V. Plans Designed to Generate Passive Income to Offset Passive Losses: Will Such Income Be Recharacterized as Nonpassive?

Great caution must be utilized in designing a financial transaction or an investment plan for a taxpayer since the actual tax result might differ from that intended and expected. The temporary regulations could be the culprit, as they include several mandatory rules which recharacterize certain income—which without the regulations might be considered passive—as nonpassive income. These rules were designed by the Treasury in an effort to keep taxpayers from manipulating the passive loss rules by generating passive income. While critics have attacked the Treasury for exceeding its regulatory authority in creating these rules, they presently must be heeded.

One rule involves the disposition of appreciated assets utilized in an activity. Gain realized on the disposition of such assets is considered income from the activity.[41] In general, the nature of the activity in the year of asset disposition controls for purposes of determining the character of the income: if the activity is not a passive activity in the year of asset disposition, all gain will be recognized as nonpassive income regardless of whether the appreciation was attributable in whole or in part to a taxable year or years for which the activity was a passive activity.[42]

There are, however, several exceptions to this general rule. First, if the asset was utilized in more than one activity during the twelve months prior to its disposition, the amount realized and the adjusted basis of the asset (in other words, the appreciation) must be allocated among the activities and characterized accordingly.[43] (A caveat exists to this allocation treatment. If the appreciated asset was used predominantly in one activity during the twelve months prior to its disposition, and on the date of the disposition its fair market value does not exceed the lesser of $10,000 or ten percent of the fair market value of all assets used in the activity, the gain may be allocated exclusively to the predominant activity.[44]) A second exception to the general rule on asset disposition provides that, upon the disposition of a "substantially appreciated" asset, all of the gain will be treated as nonpassive income unless the asset was used in a passive activity either for twenty percent of the period held or for the entire twenty-four month period before its

41. Temp. Treas. Reg. § 1.469-2T(c)(2) (1988). This treatment also applies to the disposition of a partnership interest or S corporation stock.

42. *Id.*

43. *Id.*

44. *Id.*

disposition.[45]

Another mandatory rule found in the temporary regulations which requires recharacterization of income involves the rental of nondepreciable property, such as land. If depreciable property is also rented in the activity and its unadjusted basis is less than thirty percent of all property rented in the activity, the rental income from the activity will be deemed nonpassive portfolio income.[46]

The temporary regulations recharacterize rental income where an individual or entity rents an asset to a trade or business in which the individual or entity materially participates. Although rental activity is passive, the proposed regulations treat the net rental income as nonpassive. Material participation in a trade or business generally causes an activity to be treated as nonpassive, and it appears that the Treasury considers that this principle prevails over the characterization of rental activity as passive.[47]

Another exception to the general rule on asset disposition involves property rented incidentally to its development. The proposed regulations consider the gain on disposition of a developed asset, such as land on which a commercial or residential structure has been constructed, as nonpassive income unless the property was rented for twenty-four months prior to its disposition and the taxpayer neither materially nor significantly participated in the asset's development.[48] The rationale is that the primary intention of the taxpayer was to enhance the property's value through its development, which is considered a trade or business activity.

The significant participation activity rule of the temporary regulations provides that if a taxpayer significantly participates in an activity, net income from the activity is nonpassive.[49] However, if the taxpayer significantly participates in the activity and it produces net losses, the losses are considered passive. Participation is significant if it involves more than one hundred hours of participation in a taxable year—that is less than two hours per week—but less than five hundred hours in that year.[50]

It is clear from these recharacterization rules that the Treasury does not intend to allow taxpayers to generate passive income with which to offset current tax year excess passive losses. Instead, the taxpayer must suspend the passive losses for use in a future year or upon disposition of his entire interest in the passive activity.

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45. *Id.* A "substantially appreciated" asset is one for which the fair market value of the property exceeds 120% of its adjusted basis on the date of disposition. Temp. Treas. Reg. § 1.469-2T(c)(2)(iii)(C) (1988).

46. Temp. Treas. Reg. § 1.469-2T(f)(3) (1988).

47. *Id.*

48. Temp. Treas. Reg. § 1.469-2T(f)(5) (1988).

49. Temp. Treas. Reg. § 1.469-2T(f)(5)(C) (1988).

50. Temp. Treas. Reg. §§ 1.469-2T(f)(2) and 1.469-5T(a)(3) (1988). *See also supra* note 36.

VI. Statutory Relief for Taxpayers

Several statutory provisions exist which may offer relief to a taxpayer.

A. *Suspended Passive Losses*

As previously mentioned, passive activity losses generally are allowed only to the extent of passive activity income. Thus, passive activity losses may not be netted against active or portfolio income.[51] If a passive activity produces losses in excess of its income in a taxable year, the excess may be utilized to offset net income from other passive activities. Any excess passive loss remaining is disallowed and suspended to be carried over indefinitely; it can be used in future years either to offset net passive income or upon the taxpayer's disposition of his entire interest in the passive activity.[52]

Application of the disallowance and suspension process becomes challenging as a result of special allocation rules formulated by the temporary regulations. These allocation rules involve the ratable allocation of disallowed losses among passive activities as well as among the passive activity deductions within each passive activity.[53] Moreover, another set of special rules applies where the activity which produced the suspended losses ceases to be a passive activity. In that event the suspended losses continue to be characterized as passive losses, but they may be used to offset nonpassive income from the former passive activity.[54]

The Revenue Act of 1987[55] added a special passive loss provision applicable to publicly traded partnerships—those whose securities are traded on an established securities market, such as the New York Stock Exchange, or are readily traded on a secondary market or its equivalent, such as an over-the-counter market. The special provision requires that the passive loss rules must be applied separately to items from each publicly traded partnership.[56] Consequently a taxpayer's net income from passive activities due to his partnership interest is not considered passive income under the passive activity loss rules. Such income cannot offset either losses from other publicly traded partnerships nor losses from other passive activities. Excess losses from a publicly traded partnership may be suspended and applied against that same partnership's net income in a future year, or they may be utilized when the taxpayer disposes of his interest in the partnership.

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51. Temp. Treas. Reg. § 1.469-2T(f)(2) (1988). An exception applies to certain C corporations which are not personal service corporations. Those corporations can use passive losses to offset active income but not portfolio income.

52. Tax Reform Act of 1986: Conference Committee Report at II-137 (P-H Sept. 20, 1986).

53. Temp. Treas. Reg. § 1.469-2T(f)(2) (1988).

54. *Id.*

55. Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (codified as amended in scattered sections of 26 U.S.C.).

56. *Id.*

If a taxpayer disposes of his entire interest in a passive activity by gift or by death, another set of rules applies. In a disposition by a gift, the suspended passive activity losses are not allowed as a deduction in any taxable year; instead, the adjusted basis of the interest transferred by gift is increased by the amount of the suspended passive losses.[57] Where the transfer of an interest occurs as a result of the taxpayer's death, suspended passive losses are allowed as a deduction on the decedent's final income tax return, but only to the extent that the suspended losses exceed the basis step-up in the hands of the transferee.[58]

Thus, while the general rule applicable to disallowed and suspended losses appears simple, it is made complex by recently added statutory provisions and the temporary regulations.

B. *Active Participation in Rental Activities—Section 469(i) Relief*

A measure of relief from the harshness of the passive activity loss rules is provided by section 469(i). That provision applies only to individuals who actively participate in the rental of real property. In general, section 469(i) provides that passive losses from active participation in rental real estate activities are utilized first to offset passive income from such activities.[59] Excess passive losses from these rental activities are then applied against income from other passive activities.[60] After this double netting process, the individual taxpayer becomes entitled to offset $25,000 of income from other sources (active and portfolio) in the taxable year.[61] Again, at first blush this relief provision sounds generous; but its application is limited. The $25,000 offset is phased out ratably when the individual has adjusted gross income (computed without reference to passive losses) between $100,000 and $150,000.[62] Individuals with adjusted gross income of $150,000 or more will receive no such relief.

C. *Oil and Gas Working Interests*

Another area of legislative generosity is the exception granted to oil and gas working interests. Section 469(c)(3)(A) provides that ownership of an oil or gas working interest is not regarded as a passive activity if the taxpayer owns the interest directly or indirectly through an entity which does not limit the taxpayer's liability with respect to the working interest.[63] Thus, for

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57. *Id.*
58. *Id.*
59. Tax Reform Act of 1986: Conference Committee Report at II-141 (P-H Sept. 20, 1986).
60. *Id.*
61. *Id.*
62. *Id.*
63. Temp. Treas. Reg. § 1.469-1T(e)(4)(i) (1988).

example, if a taxpayer holds a general partnership interest (and not a limited partnership interest or stock in an S corporation) in oil or gas properties, the income or loss from the activity will be treated as nonpassive.

D. *Phase-in Rule for Loss Deductibility*

Taxpayers having interests in passive activities acquired prior to January 1, 1987, are entitled to utilize a phase-in rule so that part of their passive losses may offset nonpassive income. Section 469(m) provides that for 1988, a taxpayer may use forty percent of his net passive losses which would otherwise be disallowed and suspended to offset nonpassive income; in 1989, twenty percent of such losses can be used against nonpassive income; and in 1990, ten percent of such net passive losses can offset active income.[64] Thereafter, the phase-in rule provides no more leniency.

VII. Conclusion

Clearly, the modern tragedies that Congress and the Treasury have recently inflicted on taxpayers are: (1) the sounding of the death knell for traditional tax shelters, (2) the complexity of the passive loss rules which accomplish this goal, and (3) the problems which will arise from the administration of the rules. The modern myth that Congress created was the alleged simplification of the Internal Revenue Code. Yet these modern tragedies and the myth do suggest planning opportunities. While the tax considerations may make Herculean the task of creating economically sound financial plans, business deals, and real estate transactions, these are not impossible objectives. Careful attention must be given to classifying activities as passive and nonpassive and, after heeding statutory and regulatory exceptions, exemptions, and limitations (such as the income reclassification rules in the temporary regulations), to matching as closely as possible the income and losses from each. By utilizing these new and complex concepts of matching, a taxpayer will maximize his tax sheltering capability.

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64. Tax Reform Act of 1986: Conference Committee Report at II-138 (P-H Sept. 20, 1986).