REPORT #626

TAX SECTION

New York State Bar Association

REPORT ON TEMPORARY AND PROPOSED REGULATIONS
UNDER SECTION 469

Prepared by
the Committee on Income from Real Property
and the Committee on Personal Income

September 18, 1989

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TAX SECTION
New York State Bar Association

September 18, 1989

The Honorable Fred T. Goldberg
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of the Report are Victor F. Keen and Thomas V. Glynn.

The report generally agrees with the substantive positions taken in the proposed regulations. However, we are increasingly concerned about the complexity introduced into the tax system by recent statutory enactments and the related regulations. Our concern is particularly strong with respect to those provisions' that potentially may affect large numbers of taxpayers either because the provisions actually affect them or because they must examine those provisions in the course of conscientious compliance efforts. The passive activity loss provisions and the two installments of regulations (with more still to come) stand as a prime example of such complexity.

This is not a complaint with the proposed regulations as such. While there is room for useful debate on whether the proposed regulations might be simplified in one way or another, the Report concludes that on balance the regulations are not unreasonable in relation to the complexity that must be dealt with, particularly because the statutory

provisions are new and the concepts and issues involved novel. We do, however, question whether many taxpayers and their advisers will be able, or even inclined to try, to cope with these complex rules. That concern leads us to urge that weight be given to greater simplicity, rather than complexity, in tax legislation and regulations even if the result in specialized cases is imperfection or lack of guidance.

In terms of substantive issues, the Report supports the basic approach of creating an expansive, but flexible, definition of "activity" by using inclusive aggregation rules tempered with taxpayer options for non-aggregation. It notes that the elective provisions should help mitigate any undue harshness of the regulations' expansive bias and recommends that an additional election to disaggregate operations be made available. The Report also generally supports: (1) the decision to define the operative unit - an "undertaking" - primarily in terms of location rather than function because of the greater certainty that approach provides; (2) the efforts to establish "bright line" tests for the aggregation rules; and (3) because of the irrelevance of taxpayer participation in the case of rental activities, the separation of rental and non-rental operations in most cases and the greater flexibility accorded taxpayers to combine or divide rental real estate operations. For pragmatic reasons, the Report does not favor extending the more liberal rental real estate combination/ division rules to non-real estate activities, at least at this time.

The Report also makes a number of further recommendations for technical changes within the basic approach and structure of the proposed regulations.

Sincerely,

Wm. L. Burke
Chair

WLB/JAPP
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TAX SECTION
New York State Bar Association

September 18, 1989

Ms. Marianne Evans Editor
Tax Notes Today
6830 N. Fairfax Drive
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Dear Ms. Evans:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report

Very truly yours,

Wm. L. Burke
Chair

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TAX SECTION
New York State Bar Association

September 18, 1989

Mrs. Sharon w. Potter
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Washington, D.C. 20036

Dear Mrs. Potter:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report.

Very truly yours,

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TAX SECTION
New York State Bar Association

September 18, 1989

Ms. Dorothy Coleman
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Dear Ms. Coleman:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report.

Very truly yours,

WLB/JAPP
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Wm. L. Burke
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TAX SECTION
New York State Bar Association

September 18, 1989

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Dear Mr. Kracov:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report.

Very truly yours,

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Wm. L. Burke
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TAX SECTION
New York State Bar Association

September 18, 1989

Mr. Scott Schmedel
Wall Street Journal
World Financial Center
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Dear Scott:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report.

Very truly yours,

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Wm. L. Burke
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TAX SECTION
New York State Bar Association

September 18, 1989

Timothy J. McCormally, Esq.
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Dear Tim:

Enclosed is a report by our Committees on Personal Income and Income from Real Property on the Second Installment of the Temporary and Proposed Regulations under Section 469. The principal draftsmen of this report are Victor F. Keen and Thomas V. Glynn.

The principal comments and recommendations are summarized in the transmittal letter and pages 6-17 of the Report.

Very truly yours,

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Wm. L. Burke
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REPORT ON TEMPORARY AND PROPOSED REGULATIONS UNDER SECTION 469

(SECOND INSTALLMENT)

Prepared by
the Committee on Income from Real Property
and the Committee on Personal Income

New York State Bar Association Tax
Section

September 18, 1989

New York State Bar Association

Tax Section

Committee on Income from Real Property

Committee on Personal Income

Report on Temporary and Proposed Regulations under Section 469 (Second Installment)[1]

I. Introduction.

Section 501(a) of P.L. 99-514, the Tax Reform Act of 1986, added Section 469 to the Internal Revenue Code.[2] Amendments to Section 469 were included in the Revenue Act of 1987, P.L. 100-203, and the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647.

Section 469 creates a new category of activities -- "passive activities" - and provides that individuals, estates, trusts, personal service corporations and, in a modified manner, closely held C corporations generally cannot use passive activity losses and passive activity credits to reduce tax liability relating to compensation income, portfolio income or active business income. The first installment of temporary

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[1] This report was prepared by Victor F. Keen, Thomas V. Glynn, Michael Hirschfeld, Stuart Rosow, Patricia B. Brennan, Martin Edelstein, Edward A. Morgan, Ann-Elizabeth Purintun, Robert D. Schachat, Aleena R. Shapiro and Martin Shenkman. Helpful comments were received from Renato Beghe, Arthur Feder, Gordon Henderson and Donald Schapiro.

[2] Except where otherwise specified, all section references herein are to the Internal Revenue Code of 1986, as amended, and all paragraph references are to Temp. Treas. Reg. SS 1.469-1T through 1.469-11T.

regulations under Section 469 was issued (and published for comment as a notice of proposed rulemaking) on February 25, 1988 (T.D. 8175) (the “First Installment”). In a report dated July 28, 1988, we commented on certain aspects of the First Installment. A number of key provisions of Section 469 were not covered in the First Installment. Additional temporary regulations were issued (and published for comment as a notice of proposed rulemaking) in the Federal Register on May 12, 1989 (T.D. 8253) (the “Second Installment”). This report comments on certain aspects of the Second Installment.

II. Overview of Second Installment.

In addition to making-certain conforming, clarifying and corrective changes in the First Installment, the Second Installment defines the term “activity” under Section 469. The portion of the Second Installment dealing with how taxpayers should identify their activities for purposes of Section 469 (S 1.469-4T) will for convenience be referred to as the “activity regulations”.

The definition of activity is relevant for determining whether given business and rental operations are a trade or business activity or rental activity to which Section 469 applies. Once an activity has been identified, it can be determined whether the taxpayer (i) has materially or significantly participated (in the case of a trade or business activity) in the activity, (ii) has actively participated (in the case of a rental real estate activity) in the activity for purposes of the $25,000 offset, or (iii) has disposed of his entire interest in the activity.

The definition is also relevant for identifying pre-enactment interests and for applying certain of the transitional rules.

The activity regulations adopt a “building-block” approach under which a taxpayer’s business and rental operations are organized into “undertakings”. An undertaking generally consists of all the business and rental operations of the same person conducted at the same physical location. However, if the operations at one location consist of both rental operations and nonrental operations, the operations generally must be divided into two undertakings. Operations that are not conducted at any fixed location or are conducted at the’ customer’s place of business are treated as part of the undertaking with which the operations are most closely associated. Operations characterized as support operations are similarly associated with one or more undertakings not conducted at the same location.

In general, an undertaking is the smallest unit that can be treated as an activity. The basic rule under the activity regulations is that each undertaking in which a taxpayer owns an interest is treated as a separate activity of the taxpayer. However, additional rules may require or permit a taxpayer to aggregate two or more undertakings into a single activity. Subject to certain consistency rules, taxpayers generally may elect to fragment their rental real estate undertakings and to combine such undertakings or portions thereof into activities in any manner they choose.

In the case of trade or business undertakings, taxpayers are permitted to elect to treat any undertaking that otherwise would be aggregated with other undertakings as a separate activity (except for the purpose of measuring participation). Thus, any loss on the disposition of the undertaking, as well as any suspended losses and credits allocated to the undertaking, will be allowable at the. time of disposition without limitation by Section 469.

The activity regulations contain the following provisions:

Paragraph -4T(a) contains a useful overview and summary.

Paragraph -4T(b) contains a statement of the general rule and sets forth certain definitions of general application.

Paragraph -4T(c) contains the definition of “under-taking”; defines-and provides rules for the treatment of “support operations”; defines “location”, “income-producing operations”, and “ownership by the same person”; provides guidelines for making “facts and circumstances” determinations regarding the relationships between “operations” and “locations”; and provides a series of examples.

Paragraph -4T(d) provides rules for determining when rental operations are treated as part of an undertaking that includes nonrental operations and when such operations are treated as a separate undertaking.

Paragraph -4T(e) contains special rules for oil and gas operations.

Paragraph -4T(f) contains rules under which a tax-payer’s interests in two or more trade or business undertakings are aggregated and treated as part of the same activity.

Paragraph -4T(g) contains rules under which a tax-payer’s interests in two or more trade or business activities (after application of the aggregation rules of Paragraph -4T(f)) which constitute an integrated business (determined on a facts and circumstances basis) are treated as a single activity.

Paragraph -4T(h) contains special aggregation rules applying only to a taxpayer’s interests in two or more professional service undertakings.

(Paragraph -4T(i) is reserved.)

Paragraph -4T(j) contains rules for determining whether undertakings (or activities) are “controlled by the same interests” for purposes of applying the aggregation rules and for certain other purposes.

Paragraph -4T(k) provides special elective rules for identifying and aggregating rental real estate undertakings.

(Paragraph -4T(1) is reserved.)

Paragraph -4T(m) provides that the activities of a consolidated group and each member thereof shall be determined as if the consolidated group were one taxpayer.

Paragraph -4T(n) provides that the activity regulations shall apply to a taxpayer’s interest in business and rental operations held through a publicly traded partnership as if the taxpayer had no interest in any other business and rental operations.

Paragraph -4T(o) provides rules under which, for disposition purposes but not for purposes of measuring participation, a taxpayer may elect to treat as a separate activity an undertaking (other than a rental real estate undertaking) that would otherwise be treated as part of an activity that includes other undertakings.

Paragraph -4T(p) contains transitional rules for applying the activity regulations.

III. Major Conceptual Comments on Activity Regulations.

While the activity regulations are obviously “complex”, the question is whether they are unnecessarily so. This question must be answered in light of the magnitude of the task presented to the drafters by the requirements of the statute, and the success achieved in meeting those requirements. On balance, ve believe that the regulations are no more complex than is necessary to implement a complex statute that is replete with new concepts and new terminology, intentionally rejects existing well-defined standards, and delegates a broad grant of authority to the Secretary. The complexity problem lies with the statute. However, we also believe that the level of complexity in the Internal Revenue Code and the Regulations has reached the point where it is counterproductive.

When experienced, able tax experts must pore over statutes and regulations for hours on end to divine their meaning, we question whether the system can realistically expect “voluntary compliance” from those without access to such experts. Accordingly, we urge that significant effort be devoted, in the legislative and administrative processes, to the drafting of statutes and development of regulations that tend to simplify, rather than complicate, the existing burdensome set of rules and regulations. This effort is particularly necessary for rules, such as those under discussion, that apply to large numbers of individual taxpayers, many or most of whom do not have access to advisors sufficiently specialized to become expert in the interpretation of such extraordinarily complex rules.

We applaud the recent statement by Treasury officials to the effect that future regulation projects will have a shorter, simpler orientation. In that endeavor, we urge that each major regulation project include a well-developed statement of the theoretical underpinnings of the regulations, to enable taxpayers, their advisors and Internal Revenue Service personnel to have a firm foundation on which to bridge the gaps between the shorter and simpler regulations and the “undealt with” transactions that inevitably will arise.

The application of the passive activity loss rules requires a clear definition of activity. Moreover, that definition must be constructed in such a way as to prevent evasion or abuse of the rules. As stated in the General Explanation of the Tax Reform Act of 1986:

> Defining separate activities either too narrowly or too broadly could lead to an evasion of the passive loss rule. For example, an overly narrow definition would permit taxpayers to claim losses against salary, portfolio, or active business income by selectively disposing of portions of their interests in activities with respect to which there has been depreciation or loss of value, while retaining any portions with respect to which there has been appreciation. An overly broad definition would permit taxpayers to amalgamate undertakings that in fact are separate, and thus to use material participation in one under-taking as a basis for claiming without limitation losses and credits from another undertaking.[3]

The overall approach of the activity regulations has been to create an expansive definition of activity through the mechanism of aggregation rules, the most important of which aggregates commonly controlled undertakings that are in the same line of business or that otherwise are “similar”.

Among the fundamental decisions reflected in the activity regulations are the following:

(a) To define the operative unit, “undertaking”, on the basis of location rather than function.

(b) To require aggregation of trade or business undertakings that are controlled by the same interests and are in the same line of business or are otherwise “similar”.

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[3] Staff of the Joint Committee on Taxation, General Explanation of the Tax-Reform Act of 1986, 100th Cong., 1st Sess. 245 (1987).

(c) To require extensive aggregation of professional service undertakings.

(d) To permit rental real estate undertakings to be combined or divided at the election of the taxpayer, subject to certain consistency rules.

(e) To permit taxpayers to elect to treat an undertaking (other than a rental real estate undertaking) as a separate activity, notwithstanding the applicability of an aggregation rule, for disposition purposes (but not for purposes of measuring participation).

As acknowledged in the preamble to the Second Installment, operations that are completely unrelated may be treated as part of a single undertaking merely because they are conducted at the same location. Notwithstanding that possibility, we believe that the virtue of certainty in applying the rules supports this decision of the drafters. We believe that the location rule should produce a clear and appropriate result in the vast majority of cases. However, we have suggested in our detailed comments that taxpayers be permitted to elect, in limited and compelling circumstances, to treat operations conducted at the same location as separate undertakings. We find support for this suggestion in the fact that, since an undertaking consists of operations conducted at the same location and owned by the same person, in many circumstances taxpayers could avoid the treatment of two unrelated operations as a single undertaking simply by holding one of the operations through a passthrough entity.

In requiring aggregation of trade or business undertakings that are controlled by the same interests and are in the same line of business or are vertically or horizontally integrated, the drafters have clearly chosen to adopt an expansive definition of activity for purposes of determining the level of a taxpayer's participation. This approach seems to reflect a concern that a narrow definition of activity would enhance the opportunity for taxpayers to utilize income from operations in which they did not materially participate (passive income generators, or "PIGs") to absorb losses from passive activities. Of less concern, apparently, was the consequent increase in the opportunity for losses from nonrental operations to qualify as other than passive activity losses.

On the other hand, the regulations' expansiveness in aggregating nonrental undertakings for the purpose of determining participation is tempered by the provision of an election to treat a nonrental undertaking as a separate activity for disposition purposes notwithstanding that it is aggregated with other undertakings for purposes of measuring participation. Moreover, in the case of rental real estate activities (where participation is generally not a factor), the activity regulations grant taxpayers considerable latitude in aggregating or fragmenting undertakings, subject to certain consistency rules.

We believe that the structure adopted by the drafters represents a sensible and workable approach based for the most part upon objective standards that permit certainty of results in the great majority of cases. Moreover, the various elective provisions will permit taxpayers to avoid what otherwise might have been unfair or inappropriate results without, we believe, compromising the basic integrity of the statutory purpose.

IV. Comments on Significant Policy Issues.

The preamble to the Second Installment identifies certain "significant policy issues". This section of our report comments on some of those issues.

A. Definition of Undertaking.

Under the activity regulations, an activity generally consists of one or more undertakings. Location and ownership are the primary factors that identify the business and rental operations that constitute an undertaking. The preamble states that for the large number of taxpayers who conduct all their business operations at a single location, either directly or through a single passthrough entity, the determination that such operations constitute a single undertaking is the only analysis required under the activity regulations. In addition, the preamble states that the use of location and ownership as the primary factors in determining undertakings contributes to certainty. We concur in both of these assessments.

Certain operations are included in an undertaking without regard to the location at which the operations are conducted (i.e., operations that are not conducted at a fixed place of business, operations that are conducted at the customer's place of business, and support operations).

The Service contemplates that reasonable methods will be used to determine the undertaking with which such operations are to be associated and that any reasonable method will be respected. It has solicited views as to whether detailed rules should be provided for making such determinations. We do not believe that such rules are necessary. (The list of significant factors set out in Paragraph -4T(c)(3) is helpful in this regard.) However, we recommend that the regulations give one or more examples of methods the Service considers reasonable for allocating income and expenses of support operations to an undertaking conducted at a difference location.

B. Rental Undertaking.

Because all rental activities are passive, whereas other activities may or may not be passive depending upon the degree of the taxpayer's participation, it was thought inappropriate to include in a single undertaking both rental and nonrental operations. Accordingly, under an exception to the basic undertaking rules, rental and nonrental operations are generally treated as separate undertakings, even where commonly owned and conducted at the same location. However, the rule requiring the separation of rental and nonrental operations into separate undertakings does not apply if more than 80% of the aggregate income from the operations is attributable to one class of operations. We agree with this rule.

C. Aggregation of Nonrental Undertakings.

Trade or business undertakings generally are aggregated where the undertakings are controlled by the same interests and are engaged in similar businesses. The application of these rules for the most part involves objective rules and tests. The relevant factors are the line of business (if any) from which 50% or more of an undertaking's gross income is derived and whether the undertaking provides more than 50% (by value) of its property and services to related undertakings or obtains more than 50% (by value).of its property and services from related undertakings. For this purpose, lines of business are determined on the basis of the Standard Industrial Classification (SIC) of the U.S. The determination of common control is made on the basis of all the facts and circumstances, but there is a rebuttable presumption that common control exists if more than 50% of the interests in the undertakings are owned by the members of a group of five or fewer persons. The aggregation rules are generally inapplicable to small interests except where they are held through the same passthrough entity.

As with the definition of undertaking, the aggregation rules have, insofar as possible, opted for bright-line, objective tests. Except in the case of the "super-aggregation" rule in Paragraph -4T(g), they generally do not require (or permit) an inquiry into "all the facts and circumstances".

Thus, there will inevitably be cases in which aggregation will be required (or not permitted) where such result is arguably inappropriate. Nevertheless, we believe that the benefits of objective rules outweigh the fact that in isolated cases the aggregation rules may produce inappropriate results. Moreover, we believe that the existence of the election to treat an undertaking as a separate activity for disposition purposes makes such instances of inappropriate aggregation significantly less troublesome.

Separate, and significantly broader, aggregation rules apply to professional service undertakings. The Service believes that broader aggregation rules are appropriate because of its view that all such undertakings share certain similarities and that it is increasingly common for such undertakings to provide services in more than one field. As indicated in our specific comments, we are in general agreement with this approach.

D. Rental Real Estate Undertakings.

With the exception of the $25,000 offset, a taxpayer's participation in rental real estate activities is irrelevant to the application of the passive activity loss rules. For this reason, the rigid and highly articulated rules for identifying and aggregating nonrental undertakings do not apply to rental real estate undertakings. Instead, the activity regulations generally permit taxpayers an election to organize their rental real estate operations into activities in any manner they choose (by combining or fragmenting rental real estate undertakings), subject to certain consistency rules.

We agree with this treatment of rental real estate undertakings. However, as indicated in our specific comments, there are certain problems relating to the time at which the election to divide a rental real estate undertaking must be made.

Without articulating a reason for limiting this election to rental real estate undertakings, the Treasury has solicited comments as to whether such an election should be extended to rental operations involving personal property."

While we perceive no conceptual reason why real property should be accorded different (and more favorable) treatment in this regard, there may be some practical reasons for limiting the election to real property. For example, given the significance of location in determining the scope of an undertaking, there may be more flexibility in creating separate undertakings involving personal property. Moreover, if an election to divide undertakings were permitted in the case of personal property, there would be the problem, not generally present with real estate, of determining the proper number of different units into which an undertaking could be subdivided. For example, into how many undertakings would a business consisting of the rental of 5,000 video cassettes (or 500 automobiles) be divisible under such an election?

On balance, we believe that, for the present, this election should be limited to real property.

E. Election to Treat Nonrental Undertakings as Separate Activities.

While the aggregation rules are mandatory in the case of nonrental undertakings for purposes of the application of the participation rules, taxpayers are permitted to elect to treat art undertaking as a separate activity for disposition purposes even if it is otherwise aggregated with other undertakings. This election is limited by consistency rules similar to those applicable to the election permitted in the case of rental real estate undertakings. We believe that this election provides valuable flexibility to taxpayers and is a significant helpful feature in the structure of the activity regulations.

In some cases a nonrental undertaking may be conducted so as to enhance the value of other undertakings to the detriment of its own value. Since the economic income or loss from such an undertaking cannot be accurately determined at the time of its disposition., the Service is considering adopting a rule under which a disposition of such an undertaking would not be treated as a disposition of the taxpayer’s entire interest in an activity.

Although we believe that the proposed rule is an appropriate one, we believe that the regulations should not (and perhaps could not) identify all or even most of the circumstances to be covered by the proposed rule. We think the regulations might well provide that the rule will apply where two (or more) commonly controlled undertakings have dealt with one another in such a manner that, under principles similar to the principles of Section 482, a significant adjustment to the gross income -or deductions of any of such undertakings would be appropriate (with some guidance on how to determine when such an adjustment is significant).

In addition, it would be helpful for the regulations to provide an example of the abuse sought to be prevented.

V. Technical Comments on Temporary Regulations.

A. Amendments to First Installment.

1. Coordination with Other Rules.

Paragraph -1T(d)(2) is revised to clarify that a passive activity deduction that is not disallowed for the taxable year under Section 469 may nonetheless be disallowed for the taxable year under either Section 613A(d) or Section 1211. Prior to the amendment, this paragraph referred only to Section 1211.

Comment: We agree that this is an appropriate change.

2. Definition of “Trade or Business.”

Paragraph -1T(e)(2) is revised so that “trade or business activity” is now defined as an activity (within the meaning of S 1.469-4T) if and only if such activity (i) is not a rental activity for the year in question and (ii) involves the conduct during such taxable year of business or rental operations (within the meaning of Paragraph -4T(b)(2)(ii)) that are not treated under Paragraph -1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment.

The principal changes in the definition are that new Paragraph -4T(b)(2)(ii)(A) provides that “business and rental operations” include endeavors engaged in for profit or the production of income that are conducted in anticipation of such endeavors becoming a trade or business, or that involve making tangible property available for use by customers.

Comment: The reference in Paragraph -1T(e)(2)(ii) to “business or rental operations” should be conformed to the term actually used in Paragraph -4T(b)(2)(ii), “business and rental operations”.

3. Average Period of Customer Use.

Paragraph - IT(e)(3)(iii) is revised to specify new, more detailed rules for determining an activity’s average period of customer use. This is now a weighted average equal to the sum of the “average use factors” for each class of property held in connection with the activity. Property may be organized into classes using any method under which items of property for which the daily rent differs significantly are not included in the same class.

Comment: Some guidance should be given on the meaning of the term “significantly”. For example, is a rental of $29.95 per day for a subcompact car “significantly” different from a rental of $69.95 per day for a luxury sedan? We recommend that “significant difference” be defined in relative terms with a de minimis exception (e.g., daily rents the higher of which is more than 50% greater than the lower will be considered significantly different, unless the difference is less than $50 and less than 400%).

Consideration should also be given to establishing a safe harbor based upon the similarity of the rental property, so that, for example, all autos held in an auto rental activity could be included in a single class.

The “average use factor” for a class of property is the average period of customer use for that class multiplied by the fraction obtained by dividing the activity’s gross rental income attributable to such class by the activity’s total gross rental income. The average period of customer use for a class of property is determined by dividing the aggregate number of days in all periods of customer use for property in such class during a taxable year (taking into account only periods that end during such taxable year or that include the last day of such taxable year) by the number of such periods of customer use. Each period during which a customer has a continuous or recurring right to use an item of property, determined without regard to whether the customer actually uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals of an agreement, is treated as a separate period of customer use. Taxpayers may determine the duration of a period of customer use that includes the last day of the taxable year on the basis of reasonable estimates.

Comment: We believe that the regulations as revised provide a desirable amount of detail and a generally reasonable methodology for determining the average period of customer use.

However, the recordkeeping needed to perform the calculation could be quite burdensome for small businesses. We therefore recommend that a de minimis rule be provided for small rental businesses pursuant to which a rental business with gross receipts of less than a specified dollar amount would be able to determine the average period of customer use by including all its rental assets in a single class.

4. Rentals Incidental to Nonrental Activities.

Paragraph -1T(e)(3)(vi) (specifying the only circumstances in which the rental of property is treated as incidental to a nonrental activity of the taxpayer) is amended by deleting Paragraph -1T(e)(3)(vi)(D), which had provided that the rental of property during the taxable year in which it is sold or exchanged in a taxable transaction shall be treated as incidental to an activity of dealing in such property if at the time of the sale or exchange the property is held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

Comment: We believe it is appropriate that the rental of property held by a taxpayer for sale or rent should not, in the year in which the property is sold, be treated as incidental to a nonrental activity for purposes of determining whether an activity is a rental activity, even if the taxpayer's frequency of sale and purpose for holding the property in question are sufficient to constitute the taxpayer a "dealer" with respect to the property.

5. Carryover of Disallowed Deductions and Credits.

Paragraph -1T(f)(4), dealing with the carryover of disallowed deductions and credits, is significantly expanded. Paragraph -1T(f)(4)(i) now provides that if any deductions or credits from an activity are disallowed for a taxable year under the passive activity rules, the disallowed deductions or credits must be allocated among the taxpayer's activities in the succeeding year in a manner that reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the loss activity in the prior year. (Example (3) illustrates several allocation methods that will ordinarily satisfy this requirement.) The disallowed deductions or credits are then treated as deductions or credits for the succeeding taxable year from the activity to which they are allocated. Paragraph -1T(f)(4)(ii) provides that if a taxpayer continues all or part of the business and rental operations that constitute a loss activity through a C corporation or similar entity (i.e., an entity from which the owners derive only portfolio income), then the taxpayer's interest in such entity shall be treated as an interest in a passive activity that continues such operations for purposes of the rules dealing with carryovers of disallowed deductions and credits.

Comment: In our report dated July 28, 1988, we recommended that the allocation of a taxpayer's disallowed passive activity loss among the taxpayer's passive activities pursuant to the rules of Paragraph -IT(f)(2) recognize the fact that certain "allowed" losses are allowed only because of their status as losses from pre-enactment activities. We reiterate that recommendation. We believe that the changes to Paragraph -1T(f)(4) are desirable. However, we note that Example (3) appears to assume that taxpayers will be able to identify the gross income and deductions attributable to portions of what is treated as a single undertaking under the rules of Paragraph -4T(c) (in the example, a restaurant and catering service conducted at the same location.) We believe this assumption may be unrealistic in some cases. We therefore recommend that the example suggest one or more reasonable methods of allocating the disallowed loss from the restaurant/catering activity where it is not possible to identify the disallowed deductions attributable to the restaurant operations and the catering operations.

6. Disposition of Substantially Appreciated Property.

Paragraph -2T(c)(2)(iii) (dealing with dispositions of substantially appreciated property formerly used in nonpassive activities) is amended to provide that for purposes of Paragraph -2T(c)(2)(iii), an interest in property shall be treated as an interest in property used in an activity other than a passive activity and as an interest in property held for investment for any period during which such interest is held through a C corporation or other entity from which the owners derive only portfolio income.

The example illustrating the change deals with an individual who is a stockholder of a C corporation that converts to S corporation status and thereafter sells an asset that had been used in a rental activity. After applying the rules set forth in Paragraph -2T(c)(2)(iii) to determine whether the property was used in a passive activity (of the taxpayer) for either 20% of the period during which the taxpayer held his interest in the property or the entire 24-month period ending on the date of disposition, the example holds that the taxpayer's gain on the sale is portfolio income, not passive activity income.

Comment: Even though the taxpayer does not avoid any detriment or obtain any benefit under the Section 469 rules during the period in which the property is held through the C corporation, we think the new rule produces an appropriate result.

7. Use of Property by Prior Owners.

New paragraph -2T(c)(2)(iv) provides that if a tax-payer acquires an interest in property in a transaction other than a nonrecognition transaction (as defined in Section 7701(a)(45)), the ownership and use of such interest prior to the transaction shall not be taken into account in determining whether gain from any subsequent disposition of the interest is treated as passive activity income under Paragraph -2T(c)(2).

Comment: The example illustrating this rule deals with an acquisition from a partnership, a passthrough entity. The same rule clearly applies to an acquisition from a nonpassthrough entity, and we suggest that an example be added to demonstrate this point.

8. Certain Property Held in “Dealing” Activities.

New paragraph -2T(c)(2)(v) provides for circumstances in which holding an interest in property in a “dealing” activity will, for purposes of the rules relating to the treatment of gain from a disposition of an interest in property, be treated as the use of such interest in the last “nondealing” activity of the taxpayer in which such interest was used prior to its disposition. The special rule applies if (i) at the time of the disposition the taxpayer holds the interest in property in a dealing activity (i.e., an activity that involves holding similar property primarily for sale to customers in the ordinary course of a trade or business), (ii) one or more other activities of the taxpayer are nondealing activities (i.e., do not involve holding similar property for sale to customers in the ordinary course of a trade or business), (iii) the interest was used in such other activity or activities for more than 80% of the period during which the taxpayer held such interest, and (iv) the interest was not acquired and held by the taxpayer for the principal purpose of selling such interest to customers in the ordinary course of a trade or business.

For purposes of determining whether a taxpayer acquired and held an interest in property for the principal purpose of selling the interest to customers in the ordinary course of a trade or business, there is a rebuttable presumption that such purpose exists if the period during which the interest was used in nondealing activities of the taxpayer does not exceed the lesser of 24 months or 20% of the recovery period of the property, or if the interest was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25% of the period during which such interest was used in nondealing activities of the taxpayer. For this purpose, the mere existence of a purchase option in a lessee does not constitute the offering of property for sale to customers. Where the special rule does not apply to a disposition of an interest in property held in a dealing activity, the use of the interest in a nondealing activity of the taxpayer for any period in which such interest is also offered for sale is treated as the use of such interest in the taxpayer's dealing activity.

Comment: We believe that it is appropriate for the regulations to deal with these issues. However, the rules are complicated and difficult to apply, and we suggest that this problem may not need such a complex solution. In the last sentence of Example (1)(iv), "nonrental" should be changed to "nondealing".

9. Rules Applicable to Oil and Gas Activities.

Paragraph -2T(c)(6) "(dealing with gross income from certain oil or gas properties) is revised to specify in greater detail the rules applicable when income from an oil or gas property is treated as income from an activity other than a passive activity. The changes clarify that it is the intent of the drafters that income from any oil or gas property that includes an oil or gas well is to be treated as income other than passive income if any of the taxpayer's loss from the well was treated, solely by reason of the special rules of Paragraph -1T(e)(4) (and not by reason of the taxpayer's material participation in the activity), as a loss that is not from a passive activity. The rule also applies to any property the basis of which is determined in whole or in part by reference to the basis of property described in the preceding sentence.

Comment: As we indicated in our earlier report, we believe that Paragraph -2T(c)(6) goes beyond the authority of Section 469(c)(3)(B). Where losses from the drilling of a well have been treated as nonpassive despite the taxpayer's lack of material participation, we recommend that the income from the property that is treated as nonpassive be limited to the total income times the ratio of the nonpassive deductions incurred in developing the property to the total deductions incurred in developing the property.

10. Certain Payments to Partners.

Paragraphs -2T(e)(2)(ii) and (iii) (specifying rules for certain payments to partners or their successors in interest) are reordered and revised. The treatment of payments to which Section 707(c)-(guaranteed payments) or Section 736(b) (payments made in exchange for a retired or deceased partner's interest in partnership property) applies is unchanged. Paragraph -2T(e)(2)(iii)(B), relating to payments in liquidation of a partner's interest in unrealized receivables and goodwill, provides that if any income is taken into account by the retiring partner (or any other person that owns an interest in such partner if such partner is a passthrough entity) or the deceased partner's successor in interest as a result of such a payment, the percentage of such income that is treated as passive activity gross income shall not exceed the percentage of passive activity gross income that would be included in the gross income that the retiring or deceased partner (or other person) would have recognized if such unrealized receivables and goodwill had been sold at the time the liquidation of the partner's interest commenced. The portion of a payment under Section 736(a) that is allocable to unrealized receivables and goodwill is to be determined in accordance with the principles employed for determing the portion of a payment made under Section 736 that is treated as a distribution under Section 736(b).

Comment: The changes made to these provisions are appropriate. It may be desirable to specify the circumstances that will constitute the commencement of the liquidation of the partner's interest. That is, it should not be possible to avoid the application of this rule by delaying the distribution of amounts from the partnership to a year after the year of retirement. (Paragraph -2T(e)(2)(iii)(A) provides a similar rule for payments in exchange for a partner's interest in partnership property under Section 736(b), and the recommended clarifying change would be equally applicable in the case of such payments.)

11. Recharactarization of Passive Activity Income in Certain Circumstances.

Paragraph -2T(f)(5)(i) (which recharacterizes passive activity income under certain circumstances where the rental of property is considered incidental to development activity) is amended to limit its application to transactions in which the property in question is used in an activity involving the rental of the property for less than 12 months, rather than for less than 24 months, before the property is disposed of. (For this purpose, the date of disposition is the date on which the taxpayer enters into a contract to sell or obtains a put.) The definition of commencement of use (which starts the 12-month period running), set forth in Paragraph -2T(f)(5)(ii), is altered significantly to provide that the 12-month period does not start running until the performance of the services that enhance the value of the property is complete.

Finally, the rule relating to lease-up services is amended to provide that lease-up services are treated as performed for the purpose of enhancing the value of an item of property only if, at the time the taxpayer acquires an interest in the property, a substantial portion of the property is not leased. (The relevant time for determining whether a substantial portion of the property is not leased was originally the time the taxpayer commences using the property in an activity involving the rental of the property.)

Comment: We agree that it is appropriate to recharacterize income from the rental or disposition of rental property as income from an activity that is not a passive activity under the circumstances and in the manner set forth in Paragraph -2T(f)(5). As a theoretical matter, one could justify an allocation of the income between the rental activity and the nonpassive activity (e.g., by requiring a determination of the fair market value of the property at the time rental use begins), but such a rule would be difficult to administer; we concur with the decision to take an all-or-nothing approach. However, we believe that the standards for determining “commencement of use” should be changed. First, we believe that a more familiar standard -- the “placed in service” standard of Section 167 -- is preferable the standard set forth in Paragraph -2T(f)(5)(ii), “first held out for rent and ... in a state of readiness for rental”. Although the placed in service standard is sometimes difficult to apply, at least it is based upon an existing body of authority.

Second, the “substantially all” standard should be quantified. We recommend the use of an 80% standard - an entire building should be deemed to be placed in service (or held out for rent and in a state of readiness for rental) if at least 80% of the floor area or 80% of the fair rental value of the space is placed in service (or held out for rent and in a state of readiness for rental). Where a portion of a building is sold (as in a condominium) the test should be applied with respect to the portion sold. Third, the rule should deal with a situation in which the taxpayer engages in a substantial renovation or rehabilitation of a property and should treat the renovation or rehabilitation as a separate item of property. Finally, we question the appropriateness of the provision that delays the start of the relevant time period until after the completion of lease-up services, which are an essential part of the business of renting real property. The rule as drafted might delay indefinitely the commencement of use of rental real estate in a difficult market.

12. Definition of Gross Rental Activity Income.

Paragraph -2T(f)(9)(iii) is revised to define gross rental activity income for a taxable year from an item of property as any passive activity gross income (determined without regard to the special recharacterization rules of Paragraphs -2T(f)(2) through (6)) that is income for the year derived from the rental or disposition of such item of property and, in the case of income derived from the disposition of such item of property, is income derived from an activity that involved the rental of such item of property during the 12-month period ending on the date of disposition.

Comment: We recommend that Paragraph -2T(f)(5)(ii) (defining when the use of an item of property in an activity involving the rental of such property commences) be amended by adding “and paragraph (f)(5)(iii)” immediately after “paragraph (f)(5)(i)(B)”. As currently drafted, Paragraph -2T(f)(9)(iii) would appear to provide that gross rental income for the taxable year from property held out for rent but not actually rented during the 12-month period ending on the date of disposition does not include income from the disposition of the property. We assume that such a result is unintended; if it is intended, we recommend that it be changed.

13. Passive Activity Credits.

Section -3T of the regulations (dealing with passive activity credits) is revised by changing Paragraph -3T(e) and adding a new Paragraph -3T(f). Revised Paragraph -3T(e) provides that any credit described in Section 38(b) (the investment credit, the targeted jobs credit, the alcohol fuels credit, the research credit and the low income housing credit) is taken into account in computing the current year business credit for the first taxable year in which the credit is subject to Section 469 and is not disallowed by Section 469 and the regulations thereunder. New Paragraph - 3T(f) provides that in the case of certain

dispositions or changes in use of in-vestment tax credit property described in Section 47(a), adjustments shall be made to the amount of the taxpayer's carried over disallowed passive activity credits.

Comment: It would appear that the purpose of new Paragraph -3T(f) is to provide that where there has been a recapture event with respect to suspended passive activity credits, the amount of the suspended passive activity credits is reduced to reflect the fact that unused credits with respect to the property subject to the disposition or change in use are no longer available and therefore should be subtracted from the amount that has been carried over to the current year. It would be helpful to have an example illustrating the application of this rule.

14. Determining the Extent of an Individual's Participation._

Paragraph -5T(f)(1) (the general rule for determining the extent of an individual's participation in an activity) formerly provided that any work done by an individual in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest at the time the work is done shall be treated as participation of such individual in the activity. This paragraph is revised to strike the parenthetical reference to direct or indirect ownership.

Comment: Presumably this change was made because the parenthetical reference was rendered unnecessary by the general

rule in new paragraph -4T(b)(2)(ii)(B) to the effect that, for purposes of Section 469 and the regulations thereunder, a taxpayer's activities do not include operations conducted through entities other than passthrough entities.

B. Definition of Activity.

1. Overview.

Paragraph -4T(a) contains a general description of the activity regulations. It is intended solely as an aid to readers and cannot be relied upon in cases in which the more detailed rules in the remainder of the activity regulations qualify the general description contained in Paragraph -4T(a).

Comment: We commend the drafters of the activity regulations for including this highly useful overview. It serves as an excellent introduction to the scope and structure of the activity regulations. In summarizing the undertaking rules, activity rules, and special rules relating to the definition of activity, Paragraph -4T(a) provides sufficient detail for the reader to gain a solid working understanding of the actual operation of the activity regulations without becoming bogged down in minutiae. Furthermore, notwithstanding the caveat against-reliance on the overview, we believe that the proper treatment in a great number of relatively simple cases can be determined on the basis of this summary.

2. General Rule and Definitions of General Application.

Paragraph -4T(b)(1) presents the general rule of the activity regulations: Each undertaking in which a taxpayer owns an interest is treated as a separate activity of the taxpayer. (Under Paragraphs -4T(f), (g) and (h), certain nonrental undertakings must be treated as part of the same activity; Paragraph -4T(k) provides special rules for identifying the rental real estate undertakings, or portions thereof, that are included in an activity.)

Paragraph -4T(b)(2) provides two definitions of general application:

(a) “Passthrough entity” means a partnership, S corporation, estate or trust.

(b) The term “business and rental operations” is generally defined as all endeavors engaged in for profit or the production of income that satisfy one or more of the following conditions for the taxable year:

(i) They involve the conduct of a trade or business or are conducted in anticipation of becoming a trade or business;

(ii) They involve making tangible property available for use by customers; or

(iii) Research or experimental expenditures paid or incurred with respect to such endeavors are deductible (or would be deductible if such treatment were elected) under Section 174.

Under Paragraph -4T(b)(2)(ii)(9), for purposes of applying Section 469' and the regulations thereunder, a taxpayer's activities do not include operations that the taxpayer conducts through one or more entities other than passthrough entities. Thus, as the example illustrates, a taxpayer's participation in a business conducted by a closely held C corporation (an entity other than a passthrough entity) is not taken into account in determining whether the taxpayer materially or significantly participates in any activity.

Comment: We do not believe that the rule provided in Paragraph -4T(b)(2)(ii)(B) is properly a qualification of the general definition of "business and rental operations". It is concerned solely with which operations taxpayers can include as part of their activities. Accordingly, we recommend that this rule be stated separately as a second rule of general application (in addition to the rule currently set forth in Paragraph -4T(b)(1)).

3. Undertaking.

Paragraph -4T(c) defines "undertaking". In general, an undertaking is the smallest unit that can be treated as an activity.

a. General Rule.

The general rule, provided in Paragraphs -4T(c)(1) and (2)(i), is that business and rental operations that constitute a separate source of income production are treated as a single separate undertaking. (Other rules, discussed below, apply in the case of certain rental and oil and gas operations.)

Business and rental operations are treated as a separate source of income production, in general, if and only if (i) the operations are conducted at the same location and are owned by the same person and (ii) income-producing operations owned by such person are conducted at such location.

Comment: In general, we believe the location rule is helpful and provides certainty in defining an undertaking. However, as the preamble to the Second Installment concedes, one consequence of the reliance on location in the definition of undertaking is that completely separate, functionally unrelated operations may be swept into the same undertaking, while in many cases taxpayers should be able to structure the ownership of the operations so as to avoid this result, we nevertheless believe that the regulations should provide for a limited exception to the basic undertaking rule. In light of the drafters legitimate concerns relating to uncertainty and recordkeeping burdens, we believe that the exception should take the form of a taxpayer election to treat certain undertakings as multiple undertakings for disposition purposes (though not for purposes of determining participation), similar to the election provided in Paragraph -4T(o) (allowing an undertaking to be treated as a separate activity for disposition purposes). In addition, to help insure that the exception is properly limited, we recommend that an election to treat a single undertaking (other than a rental real estate undertaking) as multiple undertakings be available only in the case of business and rental operations for which separate records are maintained

and only to the extent that such multiple undertakings, if owned by different persons but controlled by the same interests, would not be aggregated under the rules of Paragraph -4T(f), (g) or (h). We believe that these conditions, together with the element of taxpayer choice, should sufficiently address the concerns expressed by the Service.

i. "Location" is defined in Paragraph -4T(c)(2)(iii) as a fixed place of business at which business and rental operations are regularly conducted. Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another. (Oil and gas operations that are conducted for the development of a common reservoir are considered conducted within close proximity of one another.) Examples of the operation of the location rule, at Paragraph -4T(c)(4), include:

(a) A sole owner of a department store and restaurant conducts both businesses in the same building; the operations are treated as a single undertaking.

(b) The same owner also operates an automotive center in the shopping mall within which the department store and restaurant are located; all three operations are conducted within close proximity of each other and are therefore treated as a single undertaking.

(c) Where the automotive center is located several blocks from the shopping mall, it is not included in the same undertaking as the department store and restaurant but is treated as a separate undertaking.

Comment: We believe the definition of location needs further clarification. What constitutes “close proximity” is unclear. Example (2) states in conclusory fashion that two operations conducted in the same shopping mall are conducted within close proximity of one another, but in Example (3), “several blocks” does not constitute close proximity. It is difficult to justify the different results in these two examples in purely spatial (as opposed to functional) terms, since some shopping malls encompass more than “several blocks”. We recommend, therefore, that close proximity be defined in terms of real property concepts and/or distance (e.g., on the same parcel or contiguous parcels, or less than 1,000 feet apart).

Paragraph -4T(c)-(2) (iii) (D) provides that if business and rental operations are not conducted at a fixed place of business or are conducted on a customer’s premises, they are treated as conducted at the location with which they are most closely associated (other than the customer’s premises). Such determination involves consideration of all the facts and circumstances, with the following relationships between operations conducted at such location and other operations generally being the most significant: (i) whether such operations are treated

as a unit in accounting records or are conducted under the same trade name; (ii) the extent to which other persons conduct similar operations at one location or treat similar operations as a unit in accounting records; (iii) the extent to which the operations involve products or services that are commonly provided together, serve the same customers, use the same personnel, facilities, or equipment, are conducted in coordination with or reliance upon each other, or depend on each other for economic success; and (iv) the extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations.

ii. "Ownership by the same person" is defined in Paragraph -4T(c)(2)(v) as direct ownership by one individual, trust, estate, partnership, association or corporation. Indirect ownership is not taken into account for purposes of this rule. (Although ownership by the same person is required for a single undertaking, separate undertakings may be included in the same activity under the aggregation rules of Paragraphs -4T(f), (g) and (h) if the undertakings are controlled by the same interests under the rules of-Paragraph -4T(j).)

Comment: It is unclear whether, for purposes of the activity regulations, a grantor trust is to be treated as a separate person or is to be disregarded. The regulations should explicitly address this question. We believe the proper result is for the grantor to be treated as the direct owner of business and rental operations held by a grantor trust.

iii. "Income-producing operations" are defined in Paragraph -4T(c)(2)(iv) as business and rental operations that are conducted at a location and relate to, or are conducted in reasonable anticipation of, (i) the production of property at such location, (ii) the sale of property to customers or the performance of services for customers at such location, (c) transactions in which customers take physical possession of property at such location, or (iii) any other transactions that involve the presence of customers at such location.

Comment: Central to the definition of income-producing operations is the presence of customers at the location where the operations are conducted. However, operations involving the production of property are regarded as income- producing operations whether or not customers are present. While we agree that the production of property should properly be regarded as an income-producing operation, we note that this, rule can produce arguably anomalous results. Thus, operations that would otherwise constitute support operations (discussed below) because they supply property to an undertaking owned by the same person and conducted at a different location become income-producing operations (and thus a separate undertaking) if they involve "production" of the property provided. On the other hand, where the property supplied is not "produced" or where it is services that are supplied, the operations may constitute support operations and therefore not constitute a separate undertaking. (Compare Examples (11) and (12) in Paragraph -4T(c)(4).)

b. Support Operations.

Paragraph -4T(c)(2)(ii) provides that support operations conducted at a location are not treated as part of an undertaking under the general undertaking rules. Instead, the income and expenses attributable to support operations that are reasonably allocable to an undertaking conducted at a different location are taken into account in determining the income or loss from the activity or activities that include such undertaking.

Business and rental operations conducted at a location are treated as support operations to the extent that such operations are not income-producing operations, are owned by the same person who owns an undertaking conducted at a different location, and involve the provision of property or services to such undertaking.

Comment: Example (7) of Paragraph -4T(c)(4) demonstrates that operations conducted at a location (a warehouse supplying the taxpayer's own grocery store and grocery stores owned by others) may be bifurcated into support operations and a separate undertaking, if both income-producing operations and support operations are included in such operations. (It is also clear that operations which involve the provision of property or services to income-producing operations conducted at the same location are not treated as "support operations" but as part of an undertaking conducted at such location.)

For ease of recordkeeping, it would make sense to have a safe harbor so that de minimis support operations could be treated under the general undertaking rules rather than accounted for under the special rule for support operations. For example, such a rule might provide that if, of the business and rental operations conducted at a location that are not income- producing operations and involve the provision of property or services to income-producing operations conducted at the same or a different location and owned by the same person, less than 20% would be treated as support operations but for the safe harbor, no part of such operations shall be treated as support operations. Such a rule would be analogous to the 80/20 rule of Paragraphs -4T(d)(2)(ii) and (iii) for not separating certain rental and nonrental operations at the same location.

4. Rental Undertaking.

Paragraph -4T(d) provides special rules that apply when an undertaking (within the meaning of Paragraph -4T(c)) includes both rental and nonrental operations.

a. General.

Under Paragraph -4T(d)(1), operations that are treated as a single undertaking under the general undertaking rules (a “paragraph (c) undertaking”) are generally treated as two separate undertakings if they consist of both rental operations and nonrental operations. The income and expenses that are reasonably allocable to each such undertaking are taken

into account in determining the income or loss from the activity or activities that include such undertaking.

An undertaking (determined after application of the special rule) is treated as a rental undertaking if and only if, when considered as a separate activity, it would constitute a rental activity as defined in Paragraph -1T(e)(3). This definition requires the activity to be one in connection with which tangible property is used, or held for use, by customers and the gross income attributable to the activity to represent amounts paid for use of such property, with a number of exceptions relating to average period of customer use, personal services, etc.

A paragraph (c) undertaking’s rental operations are all of the undertaking’s business and rental operations that involve making tangible property available for use by customers and providing connected services. Rental operations do not, however, include (i) operations that involve making short-term real property available for use by customers (where the average period of customer use for all the real property of the same type is 30 days or less), if such operations, considered as a separate activity, would not constitute a rental activity, or (ii) operations that involve making tangible property available during business hours for nonexclusive use by various customers.

b. Exceptions.

The special rule does not apply for a taxable year in which (i) the rental operations of the paragraph (c) undertaking, considered as a separate activity, would not constitute a rental activity, (ii) less than 20% of the gross income of such undertaking is attributable to rental operations, or (iii) less than 20% of the gross income of such undertaking is attributable to nonrental operations.

Comment: The Paragraph -4T(d) exception that does not separate a paragraph (c) undertaking into rental and nonrental undertakings where one or the other type of operation predominates is a helpful simplifying rule.

5. Special Rules for Certain Oil and Gas Operations.

Paragraph -4T(e) provides a special rule for an oil or gas well treated as nonpassive solely by reason of Section 469(c)(3) and Paragraph -1T(e)(4) (the working interest exception). That is, the special rule applies where the taxpayer would not otherwise be treated as materially participating for the taxable year in the activity in which such well would be included. If the special rule applies, the well is treated as an undertaking that is separate from other undertakings in determining the activities of a taxpayer for a taxable year, even if there are other oil and gas operations owned by the same person and conducted for the development of a common reservoir. In addition, the aggregation rules in Paragraphs -4T(f) and (g) do not apply to the well. Thus, each oil or gas well subject to the special rule is treated as a separate activity.

In any year in which a well is not subject to the special rule (either because the taxpayer holds his interest through an entity that limits his liability or because the taxpayer materially participates for the taxable year in the activity in which such well is included), the well is subject to the general rules for identifying and aggregating undertakings.

Comment: We agree that a special rule is required for operations that qualify for the oil and gas working interest exception, particularly in view of the special rule in Paragraph -2T(c)(6) (relating to the treatment of income from a well with respect to which the taxpayer benefited from the working interest exception).

6. Certain Trade or Business Undertakings Treated as Part of the Same Activity.

Paragraph -4T(f) provides aggregation rules under which a taxpayer's interests in two or more trade or business undertakings are treated as part of a single activity. The term "trade or business undertaking" does not include a rental undertaking (as defined in Paragraph -4T(d)), an oil or gas well that is treated as a separate undertaking under Paragraph -4T(e), or a professional service undertaking (as defined in Paragraph -4T(h)).

a. Aggregation.

Paragraph -4T(f)(2) provides that a taxpayer's interests in two or more trade or business undertakings that are similar and controlled by the same interests (within the meaning of Paragraph -4T(j)) shall be treated as part of the same activity for any taxable year in which the taxpayer:

(i) Owns interests in each such undertaking through the same passthrough entity;

(ii) Owns a direct or substantial indirect interest in each such undertaking; or

(iii) Materially or significantly participates in the activity that would result if such undertakings were treated as part of the same activity.

Comment: We recommend that the phrase "a taxpayer's interests in two or more trade or business undertakings" be changed to "two or more trade or business undertakings in which a taxpayer owns an interest" to conform to the usage of Paragraph -4T(b)(1).

Paragraph -4T(f)(3)(i) provides that a taxpayer owns - a substantial indirect interest in an undertaking for a taxable year if at any time during such taxable year the taxpayer's ownership percentage (determined in accordance with Paragraph -4T(j)(3)) in a passthrough entity that directly owns such undertaking exceeds ten percent. A coordination rule in Paragraph -4T(f)(3)(ii) provides that a taxpayer shall be treated

as owning a substantial indirect interest in each of two or more undertakings for any taxable year in which:

(a) Such undertakings are treated as part of the same activity of the taxpayer under Paragraph -4T(f)(2)(i) (i.e., the taxpayer owns an interest in each such undertaking through the same passthrough entity); and

(b) The taxpayer owns a substantial indirect interest in any such undertaking.

Comment: The rule in Paragraph -4T(f)(3)(ii) is one (perhaps the simplest) of several "coordination rules" contained in the activity regulations. Understanding these rules is among the most difficult challenges presented by the regulations. We recommend that a bare-bones example illustrating how each such coordination rule works be provided immediately following the statement of the rule. For example, the rule in Paragraph -4T(f)(3)(ii) could be illustrated as follows:

> A owns 5% of partnership PI and 20% of partnership P2. PI owns undertaking x and 80% of P2. P2 owns undertaking y. A owns interests in undertakings x and y through PI; therefore x and y are treated as part of the same activity of A. A owns a substantial indirect interest (through P2) in undertaking y; therefore A is treated as owning a substantial indirect interest in undertaking x.

b. Similar Undertakings.

General. Under Paragraph -4T(f)(4)(i), in general, two undertakings are similar if and only if there are predominant operations in each such undertaking and the pre-dominant operations of both undertakings are in the same line of business. Under Paragraph -4T(f)(4)(ii), there are predominant operations in an undertaking if more than 50% of the undertaking's gross income is attributable to operations in a single line of business.

Paragraph -4T(f)(4)(iv) provides that the Commissioner shall establish lines of business by revenue procedure (viz., Rev. Proc. 89-38). If, however, business and rental operations are not included in lines of business established by the Commissioner, such operations must still be included in one or more lines of business on a basis that reasonably reflects (i) similarities and differences in the property or services provided and in the markets to which they are provided and (ii) the treatment within the established lines of business of operations that are comparable in their similarities and differences.

Comment: Because Paragraph -4T(f)(4)(iv) is a definitional provision relating to the general rule in Paragraph -4T(f)(4)(i), we recommend placing it before Paragraph -4T(f)(4)(iii), which contains the rules for vertically- integrated undertakings.

ii. Vertically-integrated undertakings. Paragraph -4T(f)(4)(iii) provides rules under which “vertically- integrated” undertakings are treated as similar. These rules apply if an undertaking (the “supplier undertaking”) provides property or services to other undertakings (the “recipient undertakings”).

(A) Supplier undertaking similar to recipient under-taking (“A”). If the supplier undertaking and the recipient undertaking are controlled by the same interests and the supplier undertaking predominantly involves the provision of property and services to the recipient undertaking (i.e., the recipient undertaking obtains more than 50% (by value) of all property and services provided by the supplier undertaking), the supplier undertaking is treated as similar to the recipient undertaking. For purposes of this determination, if a supplier undertaking and two or more recipient undertakings that are similar are controlled by the same interests, such recipient undertakings are treated as a single undertaking.

(B) Recipient undertaking similar to supplier under-taking (“B”). If the supplier undertaking and the recipient undertaking are controlled by the same interests and the supplier undertaking is the predominant provider of property and services to the recipient undertaking (i.e., the supplier undertaking provides more than 50% (by value) of all property and services obtained by

the recipient undertaking), the recipient undertaking is treated as similar to the supplier undertaking.

Comment: We recommend the addition of a rule, similar to the rule contained in Paragraph -4T(f)(4)(iii)(A)(1), to the effect that, for purposes of this determination, if a recipient undertaking and two or more supplier undertakings that are similar are controlled by the same interests, such supplier undertakings shall be treated as a single undertaking.

(C) Coordination rules (Paragraph 4T(f)(4)(iii)(C)).

(1) "B" does not apply if under "A":

(a) the supplier undertaking is treated as an undertaking that is similar to any recipient undertaking;

(b) the recipient undertaking is treated as a supplier undertaking that is similar to another recipient undertaking; or

(c) another supplier undertaking is treated as an undertaking that is similar to the recipient undertaking.

(2) If "A" applies to a supplier undertaking, the supplier undertaking is treated as similar to undertakings that are similar to the recipient undertaking and is not otherwise treated as similar to undertakings to which the supplier undertaking would be similar without regard to Paragraph -4T(f)(4)(iii).

(3) If “B” applies to a recipient undertaking, the recipient undertaking is treated as similar to undertakings that are similar to the supplier undertaking and is not otherwise treated as similar to undertakings to which the recipient undertaking would be similar without regard to Paragraph -4T(f)(4)(iii).

Comment: It would be helpful to have simple examples designed solely to illustrate the application of the coordination rules. We also recommend changing “shall not otherwise be treated as similar ... without regard to paragraph (f)(4)(iii)” to “shall not be treated as similar to any undertaking under paragraph (f)(4)(i)”.

7. Integrated Businesses.

Paragraph -4T(g) provides a “super-aggregation” rule under which a taxpayer’s interests in two or more trade or business activities (determined after the application of the aggregation rules of Paragraph -4T(f)) are treated as a single activity. Trade or business activities are aggregated under this rule if their operations constitute a single integrated business and the activities are controlled by the same interests (within the meaning of Paragraph -4T(j)).

Comment: In Paragraph -4T(g)(2), we recommend that the phrase “a taxpayer’s interests in two or more trade or business activities” be changed to “two or more trade or business activities in which a taxpayer owns an interest” and that “of the taxpayer” be inserted following “a single activity” to conform to the usage of Paragraph -4T(b)(1).

In determining whether the operations of two or more trade or business activities constitute a single integrated business, all the facts and circumstances are taken into account. The following factors are generally the most significant: (i) whether such operations are conducted at the same location, treated as a unit in accounting records, owned by the same person or conducted under the same trade name; (ii) the extent to which other persons conduct similar operations at one location or treat similar operations as a unit in accounting records; (iii) the extent to which the operations involve products or services that are commonly provided together, serve the same customers, use the same personnel, facilities, or equipment, are conducted in coordination with or reliance upon each other, or depend on each other for economic success; and (iv) the extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations.[4]

Comment: Although the use of a “facts and circumstances” test- to ascertain whether two or more trade or business activities constitute an “integrated business” contributes a degree of uncertainty to the definition of activity, we believe this is unavoidable. Moreover, we believe the factors

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[4] Paragraph -4T(c)(3) uses essentially the same tests to determine the location with which operations not conducted at a fixed place of business are most closely associated.

listed, along with the examples, provide a reasonable degree of guidance

8. Certain Professional Service Undertakings Treated as a Single Activity.

Paragraph -4T(h) provides special aggregation rules for professional service undertakings. These rules are generally broader than the aggregation rules for trade or business undertakings set forth in Paragraphs -4T(f) and (g). A professional service undertaking is an undertaking that derives more than 50% of its gross income from the provision of services that are treated (for purposes of Section 448(d)(2)(A) and the regulations thereunder) as services performed in the fields of health, law, engineering, architecture, accounting, actuarial* science, performing arts, or consulting.

Under Paragraph -4T(h)(2), a taxpayer's interests in two or more professional service undertakings are treated as part of the same activity if the undertakings (i) are controlled by the same interests (within the meaning of Paragraph -4(t)(j)) or (ii) involve the provision of significant similar services or significant related services.

Comment: Example (3) of Paragraph -4T(h)(4) makes clear that the aggregation rule for professional service under-takings is not limited to situations where the taxpayer holds his interests simultaneously. We believe this should be made explicit in the text. We also recommend that the phrase "a taxpayer's interests in two or more professional service undertakings" in Paragraph -4T(h)(2)(i) be changed to "two or more professional

service undertakings in which a taxpayer owns an interest", and that the phrases "a taxpayer's interests in" and "interests in" be deleted from Paragraphs -4T(h)(2)(ii) and (iii), to conform to the usage of Paragraph -4T(b)(1).

For purposes of the aggregation rule, (i) services in any of the listed fields other than consulting are treated as similar to all other services in the same field, (ii) the similarity of consulting services is determined on the basis of all the facts and circumstances, (iii) services are significant professional services where more than 20% of an undertaking's gross income is attributable to services in one of the listed fields (or to similar services in the consulting field), (iv) two professional service undertakings involve the provision of significant similar services where significant professional services provided by one of the undertakings are similar to significant professional services provided by the other undertaking, and (v) two professional service undertakings involve the provision of significant related services where one of the undertakings derives more than 20% of its gross income from customers that are also customers of the other undertaking

Comment: The regulations should explicitly state that services in any of the listed fields are not similar to services in any other field.

Under coordination rules contained in Paragraph -4T(h)(2)(iii), a taxpayer's interests in two or more professional service undertakings (the "original undertakings") that are treated as part of the same activity under the foregoing rules are generally treated as interests in a single professional services

undertaking (the “aggregated undertaking”) for purposes of reapplying those rules. However, if any original undertaking included in an aggregated undertaking and any other undertaking not so included involve the provision of significant similar or related services, the aggregated undertaking and the other undertaking are treated as undertakings that involve the provision of significant similar or related services.

Comment: It would be helpful to have simple examples designed solely to illustrate the application of the coordination rules.

9. Control by the Same Interests and Ownership Percentage (Paragraph -4T(j)).

A taxpayer’s interests in undertakings that are “controlled by the same interests” may be aggregated into a single activity under the rules of Paragraph -4T(f), (g) or (h). Paragraph -4T(j)(1) provides that all the facts and circumstances are taken into account in determining whether undertakings are commonly controlled. For this purpose, any kind of control, direct or indirect, however exercisable and whether or not legally enforceable, will suffice. Under Paragraph -4T(j)(2), common control is rebuttably presumed to exist where undertakings are part of the same common-ownership group.

Comment: While reliance on a “facts and circumstances” test may be necessary in unusual circumstances and to prevent abuse, we would prefer to see bright-line, objective tests on which taxpayers can rely (rather than mere rebuttable presumptions). In addition, the regulations should make clear that where there is little commonality of economic interests, common managerial control is insufficient to cause aggregation. (For example, several limited partnerships should not be considered commonly controlled solely because they have a common one percent managing general partner.)

In general, two or more undertakings are part of the same “common ownership group” where the sum of the common- ownership percentages of any five or fewer persons (other than passthrough entities) exceeds 50%. A person’s common ownership percentage with respect to two or more undertakings is the person’s smallest ownership percentage in any such undertaking. If an undertaking of a taxpayer is part of two or more common ownership groups, all of the taxpayers’ undertakings that are part of any such group are treated as part of a single common ownership group.

A person’s ownership percentage in an undertaking or a passthrough entity includes any interest held directly and the person’s share of any interest held through one or more passthrough entities. For this purpose, an S corporation shareholder’s interest is based on stock ownership, a trust or estate beneficiary’s interest is not taken into account, and a partner’s

interest is determined on the basis of the greater of his percentage interest in partnership capital or his largest distributive share of any item of income or gain (disregarding Section 707(c) guaranteed payments). In determining a person's ownership percentage in an undertaking or passthrough entity, such person is treated as the owner of any interest owned by a related person (based on Section 267(b) or 707(b)(1)). If two or more persons are treated under the foregoing rule as owning the same interest in an undertaking, the person whose ownership maximizes the common ownership percentage is treated as the owner.

Comment: The regulations adopt a capital/profits approach to determining a partner's interest in a partnership. We believe this overall approach is appropriate. However, we believe that measuring a partner's profits interest based upon the largest distributive share of any item of income or gain can lead to gross distortions in the case of special allocations, qualified income offsets, minimum gain chargebacks, etc. Any single item may be so small or remote as to have little if any relevance to the overall economic relationships among partners. At a minimum, a substantiality or materiality requirement should be added and any allocation required pursuant to Section 704(c) should be disregarded.

10. Identification of Rental Real Estate Activities.

Paragraph -4T(k) provides special rules under which taxpayers can generally combine rental real estate undertakings or portions thereof into activities in any manner they choose.

A “rental real estate undertaking” is defined in Paragraph -4T(k)(1)(ii) to mean a rental undertaking (within the meaning of Paragraph -4T(d)) in which at least 85% of the unadjusted basis (within the meaning of Paragraph -2T(f)(3)) of the property made available for use by customers is real property. The term “real property” means “any tangible property other than tangible personal property (within the meaning of S 1.48-Kc)))”.

Comment: The term “rental real estate undertaking” is defined in terms of making real property available for use by customers. To avoid having the applicability of this provision to real property subleasing operations determined by the vagaries of local property law, it should be made explicit that the definition includes the subleasing of real property. In addition, for the same reason, the regulations should confirm that art apartment in a cooperative housing corporation is to be treated as real property in all cases, regardless of whether the stock of such corporation is characterized as real property under state law. Finally in the case of subleasing, we recommend art election to apply the 85% test to fair market value rather than unadjusted basis, since the lessee/sublessor may not be in a position to ascertain the unadjusted basis of the property. (We assume that the lessee’s basis -- if any -- in the lease would not be relevant for this purpose.

Paragraph -4T(k)(2)(i) generally permits a taxpayer To treat two or more rental real estate undertakings (determined after the application of Paragraphs -4T(k)(2)(ii) and (iii) as a single activity or as separate activities. Paragraph -4T(k)(2)(ii) provides that a taxpayer must treat two or more rental real estate undertakings is a single undertaking for a taxable year if any passthrough entity through which the taxpayer holds such undertakings treats such undertakings as a single activity on its applicable return. (The applicable return of a passthrough entity for a taxable year of a taxpayer is the return reporting the passthrough entity’s income, gain, loss, deductions and credits taken into account by the taxpayer for such taxable year.) Paragraph -4T(k)(2)(iii) provides that, notwithstanding that a taxpayer’s interest in leased property would otherwise be treated as used in a single rental real estate undertaking the taxpayer may generally treat a portion of the leased property as a rental real estate undertaking that is separate from the undertaking or undertakings which the remaining portion of the property is treated as a but only if (i) such portion of the leased property can be conveyed separately under applicable state and local law a (ii) the taxpayer holds such leased property directly or through one or more passthrough entities each of which the such portion of the leased property as a separate activity applicable return for the taxpayer’s taxable year.

Comment: The meaning of “can be separately conveyed” should be clarified. Must a separate conveyance of a portion of the property be legally possible during the taxable year in question? Where action by state or local authorities would be required to divide the property, must application to the proper authorities have been made (or other action indicating an intent to divide been taken)? Or is it sufficient that state and local law would allow such a division of the property in a future year?

For example, in the case of a residential condominium conversion, will the division of residential real property into separate undertakings corresponding to each apartment be allowable only after a declaration of condominium has been filed? We note that the consistency requirement of Paragraph -4T(k)(3) prohibits the division of a rental real estate undertaking into smaller components once it has been treated as a single undertaking for a taxable year ending after August 9, 1989. If a taxpayer acquires residential rental real estate for the purpose of condominium conversion but is not permitted to divide the property into multiple undertakings until the property is converted, the opportunity to make the election may be lost forever.

We recommend an approach in which multiple undertaking treatment may be elected for the year in which application for division of the property into multiple parcels is made or other actions consistent with such subdivision are taken (such as the filing of a preliminary offering plan in the case of a cooperative

offering). In addition, we believe consideration should be given to modifying the consistency rule so that where the election to treat a single undertaking as multiple under-takings could not have been made in a prior year (because the separately conveyable test -- however stated --was not met), treatment consistent with that of the prior year is not required.

Paragraph -4T(k)(3) requires consistency once a treatment has been adopted under Paragraph -4T(k). Thus, all rental real estate undertakings (or portions thereof) that are treated under Paragraph -4T(k) as part of the same activity for a taxable year ending after August 9, 1989, must be treated as part of the same activity in each succeeding taxable year.

Comment: Paragraph -4T(k) contains three consistency rules: (i) a taxpayer must follow a passthrough entity's treatment of two or more undertakings as a single activity (Paragraph -4T(k)(2)(ii)); (ii) a taxpayer must follow a passthrough entity's failure to treat a portion of leased property as a separate activity (Paragraph -4T-(k)(2)(iii)(B)); and (iii) once a treatment is adopted under Paragraph -4T(k), such treatment must be followed in succeeding taxable years (Paragraph -4T(k)(3)). (We note that a taxpayer is not required to follow a passthrough entity's treatment of a portion of leased property as a separate activity.) Presumably, the primary reason for these consistency requirements is to permit proper tracing of losses. The requirements place a substantial premium on advance planning.

We believe the consistency rules require clarification on several points. First, we note that the regulations do not appear to give explicit permission for passthrough entities to aggregate and fragment rental real estate undertakings, although such permission is implicit. Second, the regulations' reference to a passthrough entity's treatment of multiple undertakings as a single activity (or of a portion of leased property as a separate activity) is confusing. We believe that, in general, the activity regulations require only taxpayers, not passthrough entities, to identify their activities. In addition, Paragraph -4T(k)(5) refers to a person's (including a passthrough entity's) treatment of a rental real estate undertaking as multiple undertakings (or vice versa). For the sake of clarity and consistency, we recommend the following changes:

(a) Add a provision to the effect that, except as otherwise provided in paragraph -4T(k)(2)(ii) or (3), a person (including a passthrough entity) may treat multiple rental real estate undertakings as a single undertaking for a taxable year and, except as otherwise provided in Paragraph -4T(k)(2)(iii) or (3), a person (including a passthrough entity) may treat a rental real

estate undertaking as multiple undertakings for a taxable year;

(b) Amend Paragraphs -4T(k)(2)(ii) and (iii) by changing “activity” to “undertaking” each time it appears; and

(c) In addition to the consistency rule in Paragraph -4T(k)(3) (which would apply only to undertakings aggregated by a taxpayer under Paragraph -4T(k)(2)(i)), add a consistency rule requiring all persons (including passthrough entities) to act consistently over time in treating a rental real estate undertaking as multiple undertakings (or vice versa).

We also believe additional clarification is needed with regard to the application of the Paragraph -4T(k) consistency rules when changes in ownership take place. For example, what if a person becomes the direct owner of an undertaking formerly held through a passthrough entity? Example (5) in Paragraph -4T(o)(8) strongly suggests that the consistency rules continue to apply. This should be made explicit in the statement of the rules. What if a person contributes an undertaking to a passthrough entity? Presumably the contributor is still bound by the year-to-year consistency rule. (Otherwise, a taxpayer could avoid the rule simply by contributing property to his wholly owned S corporation.) But if the contributor is to have the information necessary to satisfy the consistency

requirement, the passthrough entity must also be bound by the contributor’s prior treatment. If a partnership is treated as terminated under Section 708(b)(1)(B), we would expect that the newly reconstituted partnership (and its partners) would continue to be bound by the terminated partnership’s treatment of multiple undertakings as a single undertaking (or vice versa). All of these issues should be clarified in the regulations, preferably in the formulation of the rules and not only in examples.

Paragraph -4T(k)(5) provides that a person (including a passthrough entity) treats a rental real estate undertaking as multiple undertakings (or vice versa) only if such treatment* is reflected on a schedule attached to the tax return. In the case of treatment of multiple rental real estate undertakings as a single undertaking, the year-to-year consistency rule of Paragraph -4T(k)(3) or the entity consistency rule of Paragraph -4T(k)(2)(ii) may override this rule.

Comment: We believe the regulations should expressly state what information the required schedule must contain. Also, since the year-to-year consistency rule of Paragraph -4T(k)(3) may require the continuation of treatment of a rental real estate undertaking as multiple undertakings, the regulation should state that the consistency rule may override the evidence of treatment rule in such cases.

paragraph -4T(k)(6) provides that Paragraph -4T(k) shall not apply to a rental real estate undertaking if less

than 30% of the unadjusted basis of the real property used or held for use by customers in such undertaking is depreciable under Section 167.

Comment: This provision is presumably intended to preclude the combination or separation of rental real estate undertakings to avoid the recharacterization rule for non-depreciable property under Paragraph -2T(f)(3). This appears to be both necessary and appropriate.

It is not entirely clear whether a taxpayer can divide a rental real estate undertaking to create an undertaking as to which less than 30% of the unadjusted basis is depreciable, so that the recharacterization rule applies to create portfolio income. It appears that such creation of portfolio income is possible, since Paragraph -4T(k)(6) presumably applies only to rental real estate undertakings within the meaning of Paragraph -4T(k)(1)(ii) (i.e., determined before the application of Paragraphs -4T(k)(2)(ii) and (iii)). Example (5)(ii) should be expanded to indicate whether or not the taxpayer may treat the shopping center and the vacant lot as multiple undertakings under Paragraph -4T(k)(2)(iii). There appears to be no reason why such treatment should not be permitted.

11. Consolidated Groups.

Paragraph -4T(m) provides that the activities of a consolidated group and of each member thereof shall be deter-mined as if the group were one taxpayer.

Comment: We believe this is the appropriate rule.

12. Publicly Traded Partnerships.

Under Paragraph -4T(n), the rules of Section -4T of the regulations apply to a taxpayer's interest in business and rental operations held through a publicly traded partnership (within the meaning of Section 469(k)(2)) as if the taxpayer had no interest in any other business and rental operations.

Comment: We believe this is the correct treatment where a taxpayer also holds interests in-business and rental operations directly or through non-publicly traded passthrough entities. There is some merit to a position permitting or requiring aggregation of interests held through two or more publicly traded partnerships. Arguably, the result should be no different than if the activities were conducted through a single publicly traded partnership, in which case they would be aggregated. However, the statute clearly requires that Section 469 be applied separately to each publicly traded partnership.

13. Elective Treatment of Undertakings as Separate Activities.

Paragraph -4T(o) permits a person (including a pass-through entity) to elect to treat an undertaking (other than a rental real estate undertaking) as an activity separate from the remainder of the activity in which such undertaking would otherwise be included (under Paragraph -4T(f), (g) or (h)). Such treatment applies for all purposes other than measurement of material or significant participation. Thus, for purposes of loss utilization upon disposition of the taxpayer's entire interest in the undertaking covered by an election, the undertaking will be treated as a separate activity.

Comment: Given the bias of the regulations towards the aggregation of a taxpayer's interests in various business and rental operations, we believe that this election represents a salutary balancing of another policy consideration involved in the passive activity loss rules - the recognition of economic losses at the appropriate time. As indicated in our comments relating to Paragraph -4T(c), we believe that, based upon essentially the same balancing of policy considerations, a similar election should be made available for certain components of a single undertaking. However, because it is important that the Service be able to verify the taxpayer's calculations during the life of the activity and at the time of disposition, we recommend that the election be available only if the undertaking or operation sought to be treated as a separate activity is accounted for separately in a schedule that is part of or attached to the taxpayer's tax returns. Absent such a reporting requirement, such an election would have significant abuse potential.

Paragraph -4T(o) contains two consistency rules: (i) a person (including a passthrough entity) must treat interests in two

or more undertakings as part of the same activity for a taxable year if any passthrough entity through which the person holds such undertakings treats such undertakings as part of the same activity on its applicable return; and (ii) if a person (including a passthrough entity) treats undertakings as part of the same activity on a return for a taxable year ending after August 9, 1989, such person may not treat such undertakings as part of different activities under Paragraph -4T(o) for any subsequent taxable year.

Comment: Set forth in our comments relating to the consistency rules of Paragraph -4T(k) are certain observations that may also be applicable to the election under Paragraph -4T(o) (e.g., regarding the use of the term “activity” in connection with passthrough entities, the application of the rules when changes in ownership take place, etc.)

We question the necessity for the entity consistency rule set forth in Paragraph -4T(o)(3), since it does not appear to us that Paragraph -4T(f), (g) or (h) requires or permits a passthrough entity to aggregate undertakings into activities.
If this is correct, the passthrough entity would presumably provide separate information to its interest holders with respect to each undertaking conducted by it. Assuming that the

primary (if not sole) objective of the entity consistency rule is to permit taxpayers electing separate activity treatment to properly trace losses, we believe each holder of an interest in the passthrough entity should be able to make the Paragraph -4T(o) election independently. In that case, the references to “person” in Paragraphs -4T(o)(2) and (4) should be changed to “taxpayer”.

On the other hand, if the drafters of the regulations intend that passthrough entities be permitted to aggregate undertakings into activities and not be required to furnish to their interest holders information regarding the separate gross income and deductions of such aggregated undertakings, the regulations should explicitly so provide. In. addition, the regulations should adopt entity consistency rules under Paragraphs -4T(f), (g) and (h) requiring interest holders to aggregate undertakings aggregated by their passthrough entity. (In that case, our comments regarding the use of the term “activity” in the context of the consistency rules of Paragraph -4T(k), and some of our suggestions for changes in language, would no longer be appropriate.)

14. Special Rule for Taxable Years Ending before August 10, 1989.

Paragraph -4T(p) provides a transition rule allowing taxpayers to organize their business and rental operations into activities for taxable years ending before August 10, 1989, either under the rules of Paragraphs -4T(b) through (n) or under any other reasonable method. Unreasonable methods include any method that treats rental operations and nonrental operations (other than ancillary operations) as part of the same activity, includes in a passive activity any oil or gas well that would be treated as a separate undertaking under Paragraph -4T(e)(1), includes in a passive activity any interest in a dwelling unit that would be

treated as a separate activity under Paragraph -4T(k)(7), or is inconsistent with the taxpayer's method of organizing business and rental operations into activities for the taxpayer's first taxable year beginning after December 31, 1986. Any disallowed passive activity deductions or credits for the last taxable year ending before August 10, 1989, are to be allocated among the taxpayer's activities for the first succeeding taxable year using any reasonable method.

Comment: Clarification is needed as to the application of the transitional rule to interests held through passthrough entities. Although the regulations refer to a taxpayer's activities, we believe that passthrough entities, like other persons, need time to acquaint themselves with the new rules and therefore should have the benefit of the transitional rule for their taxable years ending before August 10, 1989. However, it is not clear whether the selection of a "reasonable method" is to be made by the passthrough entity at the entity level, or by the owners at the owner level, and it is difficult to see how a calendar year taxpayer would be able to apply the regulations for his 1989 taxable year if a fiscal year passthrough entity in which he has an interest organized its operations under some other reasonable method. This difficulty is particularly troublesome in the case of the special elections under Paragraphs -4T(k) and (o), where consistency rules apply. For example, under Paragaph -4T(o)(3), if a passthrough entity treated interests in two or more undertakings as part of the same activity on its return for the year ending June 30, 1989, a person holding an interest in the passthrough entity would also have to treat such undertakings as part of the same activity on his 1989 return. Under Paragraph 4T(o)(4), the taxpayer, having treated the undertakings as part of the same activity on his 1989 return, would not be permitted to treat such undertakings as part of different activities for any subsequent taxable year. We believe the best way to solve this

problem is to extend transitional relief for interests held through passthrough entities to the taxpayer’s first taxable year for which the applicable return of the passthrough entity is for a taxable year ending after August 9, 1989.

We believe the regulations should also provide that a taxpayer who has used a per se unreasonablie method (e.g., treating rental and nonrental operations as part of the same activity) may use any reasonable method in a subsequent taxable year ending before August 10, 1989, notwithstanding that such method is inconsistent with the taxpayer’s prior method. Otherwise, unless the taxpayer files an amended return changing the earlier method, the regulations would appear to require application of the activity regulation rules for a subsequent year ending before August 10, 1989.