Reg. Section 1.469-9(e)(2)

Rules for certain rental real estate activities

(a) Scope and purpose. This section provides guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities.

(b) Definitions. The following definitions apply for purposes of this section:

(1) Trade or business. A trade or business is any trade or business determined by treating the types of activities in §1.469-4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.

(2) Real property trade or business. The following terms have the following meanings in determining whether a trade or business is a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(i) Real property.

(A) In general. The term real property includes land, buildings, and other inherently permanent structures that are permanently affixed to land. Any interest in real property, including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Tenant improvements to land, buildings, or other structures that are inherently permanent or otherwise classified as real property under this section are real property for purposes of section 469(c)(7)(C). However, property manufactured or produced for sale that is not real property in the hands of the manufacturer or producer, but that may be incorporated into real property through installation or any similar process or technique by any person after the manufacture or production of such property (for example, bricks, nails, paint, and windowpanes), is not treated as real property in the hands of any person (including any person involved in the manufacture, production, sale, incorporation or installation of such property) prior to the completed incorporation or installation of such property into the real property for purposes of section 469(c)(7)(C) and this section.

(B) Land. The term land includes water and air space superjacent to land and natural products and deposits that are unsevered from the land. Natural products and deposits, such as plants, crops, trees, water, ores, and minerals, cease to be real property when they are harvested, severed, extracted, or removed from the land. Accordingly, any trade or business that involves the cultivation and harvesting of plants, crops, or certain types of trees in a farming operation as defined in section 464(e), or severing, extracting, or removing natural products or deposits from land is

not a real property trade or business for purposes of section 469(c)(7)(C) and this section. The storage or maintenance of severed or extracted natural products or deposits, such as plants, crops, trees, water, ores, and minerals, in or upon real property does not cause the stored property to be recharacterized as real property, and any trade or business relating to or involving such storage or maintenance of severed or extracted natural products or deposits is not a real property trade or business, even though such storage or maintenance otherwise may occur upon or within real property.

(C) Inherently permanent structure. The term inherently permanent structure means any permanently affixed building or other permanently affixed structure. If the affixation is reasonably expected to last indefinitely, based on all the facts and circumstances, the affixation is considered permanent. However, an asset that serves an active function, such as an item of machinery or equipment (for example, HVAC system, elevator or escalator), is not a building or other inherently permanent structure, and therefore is not real property for purposes of section 469(c)(7)(C) and this section, even if such item of machinery or equipment is permanently affixed to or becomes incorporated within a building or other inherently permanent structure. Accordingly, a trade or business that involves the manufacture, installation, operation, maintenance, or repair of any asset that serves an active function will not be a real property trade or business, or a unit or component of another real property trade or business, for purposes of section 469(c)(7)(C) and this section.

(D) Building.

(1) In general. A building encloses a space within its walls and is generally covered by a roof or other external upper covering that protects the walls and inner space from the elements.

(2) Types of buildings. Buildings include the following assets if permanently affixed to land: Houses; townhouses; apartments; condominiums; hotels; motels; stadiums; arenas; shopping malls; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

(E) Other inherently permanent structures.

(1) In general. Other inherently permanent structures include the following assets if permanently affixed to land: Parking facilities; bridges; tunnels; roadbeds; railroad tracks; pipelines; storage structures such as silos and oil and gas storage tanks; and stationary wharves and docks.

(2) Facts and circumstances determination. The determination of whether an asset is an inherently permanent structure is based on all the facts and circumstances. In particular, the following factors must be taken into account:

(i) The manner in which the asset is affixed to land and whether such manner of affixation allows the asset to be easily removed from the land;

(ii) Whether the asset is designed to be removed or to remain in place indefinitely on the land;

(iii) The damage that removal of the asset would cause to the asset itself or to the land to which it is affixed;

(iv) Any circumstances that suggest the expected period of affixation is not indefinite (for example, a lease that requires or permits removal of the asset from the land upon the expiration of the lease); and

(v) The time and expense required to move the asset from the land.

(ii) Other definitions.

(A) Real property development. The term real property development means the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (that is, land covered by timber-producing forest). Improvement of land may include any clearing (such as through the mechanical separation and removal of boulders, rocks, brush, brushwood, and underbrush from the land); excavation and gradation work; diversion or redirection of creeks, streams, rivers, or other sources or bodies of water; and the installation of roads (including highways, streets, roads, public sidewalks, and bridges), utility lines, sewer and drainage systems, and any other infrastructure that may be necessary for subdivision, further development, or construction of residential or commercial buildings, or for the establishment, cultivation, maintenance or improvement of timberlands.

(B) Real property redevelopment. The term real property redevelopment means the demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for the establishment and cultivation of new timberlands.

(C) through (G) [Reserved]

(H) Real property operation. The term real property operation means handling, by a direct or indirect owner of the real property, the day-to-day operations of a trade or business, under paragraph (b)(1) of this section, relating to the maintenance and occupancy of the real property that affect the availability and functionality of that real property used, or held out for

use, by customers where payments received from customers are principally for the customers' use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, under §1.469-1T(e)(3)(iv) and (v), to customers in conjunction with the customers' incidental use of the real property or physical space. If the real property or physical space is provided to a customer to be used to carry on the customer's trade or business, the principal purpose of the business operations must be to provide the customer with exclusive use of the real property or physical space in furtherance of the customer's trade or business, and not to provide other significant or extraordinary personal services to the customer in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately. However, for purposes of and with respect to the preceding sentence, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer's use of the real property or physical space.

(I) Real property management. The term real property management means handling, by a professional manager, the day-to-day operations of a trade or business, under paragraph (b)(1) of this section, relating to the maintenance and occupancy of real property that affect the availability and functionality of that property used, or held out for use, by customers where payments received from customers are principally for the customers' use of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services, under §1.469-1T(e)(3)(iv) and (v), to customers in conjunction with the customers' incidental use of the real property or physical space. If the real property or physical space is provided to a customer to be used to carry on the customer's trade or business, the principal purpose of the business operations must be to provide the customer with exclusive use of the real property or physical space in furtherance of the customer's trade or business, and not to provide other significant or extraordinary personal services to the customer in addition to or in conjunction with the use of the real property or physical space, regardless of whether the customer pays for the services separately. However, for purposes of and with respect to the preceding sentence, other incidental personal services may be provided to the customer in conjunction with the use of real property or physical space, as long as such services are insubstantial in relation to the customer's use of the real property or physical space. A professional manager is a person responsible, on a full-time basis, for the overall management and oversight of the real property or properties and who is not a direct or indirect owner of the real property or properties.

(iii) Examples. The following examples illustrate the operation of this paragraph (b)(2):

(A)

Example (1). A owns farmland and uses the land in A's farming business to grow and harvest crops of various kinds. As part of this farming business, A utilizes a greenhouse that is an inherently permanent structure to grow certain crops during the winter months. Under the rules of this section, any trade or business that involves the cultivation and harvesting of plants, crops, or trees is not a real property trade or business for purposes of section 469(c)(7)(C) and this section, even though the cultivation and harvesting of crops occurs upon or within real property. Accordingly, under these facts, A is not engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(B)

Example (2). B is a retired farmer and owns farmland that B rents exclusively to C to operate a farm. The arrangement between B and C is a trade or business (under paragraph (b)(1) of this section) where payments by C are principally for C's use of B's real property. B also provides certain farm equipment for C's use. However, C is solely responsible for the maintenance and repair of the farm equipment along with any costs associated with operating the equipment. B also occasionally provides oral advice to C regarding various aspects of the farm operation, based on B's prior experience as a farmer. Other than the provision of this occasional advice, B does not provide any significant or extraordinary personal services to C in connection with the rental of the farmland to C. Under these facts, B is engaged in a real property trade or business (which does not include the use or deemed rental of any farm equipment) for purposes of section 469(c)(7)(C) and this section, and B's oral advice is an incidental personal service that B provides in conjunction with C's use of the real property. Nevertheless, under these facts, C is not engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section because C is engaged in the business of farming.

(C)

Example (3). D owns a building in which D operates a restaurant and bar. Even though D provides customers with use of the physical space inside the building, D is not engaged in a trade or business where payments by customers are principally for the use of real property or physical space. Instead, the payments by D's customers are principally for the receipt of significant or extraordinary personal services (under §1.469-1T(e)(3)(iv) and (v)), mainly food and beverage preparation and presentation services, and the use of the physical space by customers is incidental to the receipt of these personal services. Under the rules of this section, any trade or business that involves the provision of significant or extraordinary personal services to customers in conjunction with the customers' incidental use of real property or physical space is not a real property trade or business, even though the business operations occur upon or within real property. Accordingly, under these facts, D is not engaged in a real

property trade or business for purposes of section 469(c)(7)(C) and this section.

(D)
Example (4). E owns a majority interest in an S corporation, X, that is engaged in the trade or business of manufacturing industrial cooling systems for installation in commercial buildings and for other uses. E also owns a majority interest in an S corporation, Y, that purchases the industrial cooling systems from X and that installs, maintains, and repairs those systems in both existing commercial buildings and commercial buildings under construction. Under the rules of this section, any trade or business that involves the manufacture, installation, operation, maintenance, or repair of any machinery or equipment that serves an active function will not be a real property trade or business (or a unit or component of another real property trade or business) for purposes of section 469(c)(7)(C) and this section, even though the machinery or equipment will be permanently affixed to real property once it is installed. In this case, the industrial cooling systems are machinery or equipment that serves an active function. Accordingly, under these facts, E, X and Y will not be treated as engaged in one or more real property trades or businesses for purposes of section 469(c)(7)(C) and this section.

(E)
Example (5).

(1) F owns an interest in P, a limited partnership. P owns and operates a luxury hotel. In addition to providing rooms and suites for use by customers, the hotel offers many additional amenities such as in-room food and beverage service, maid and linen service, parking valet service, concierge service, front desk and bellhop service, dry cleaning and laundry service, and in-room barber and hairdresser service. P contracted with M to provide maid and janitorial services to P's hotel. M is an S corporation principally engaged in the trade or business of providing maid and janitorial services to various types of businesses, including hotels. G is a professional manager employed by M who handles the day-to-day business operations relating to M's provision of maid and janitorial services to M's various customers, including P.

(2) Even though the personal services that P provides to the customers of its hotel are significant personal services under §1.469-1T(e)(3)(iv), the principal purpose of P's hotel business operations is the provision of use of the hotel's rooms and suites to customers, and not the provision of the significant personal services to P's customers in conjunction with the customers' incidental use of those rooms or suites. The provision of these significant personal services by P to P's customers is incidental to the customers' use of the hotel's real property. Accordingly, under these facts, F is treated as owning an interest in a real property trade or business conducted by or through P and P is treated as engaged in a real property trade or business for purposes of section 469(c)(7)(C) and this section.

(3) With respect to the maid and janitorial services provided by M, M's operations affect the availability and functionality of real property used, or held out for use, by customers in a trade or business where payments by customers are principally for the use of real property (in this case, P's hotel). However, M does not operate or manage real property. Instead, M is engaged in a trade or business of providing maid and janitorial services to customers, such as P, that are engaged in real property trades or businesses. Thus, M's business operations are merely ancillary to real property trades or businesses. Therefore, M is not engaged in real property operations or management as defined in this section. Accordingly, under these facts, M is not engaged in a real property trade or business under section 469(c)(7)(C) and this section.

(4) With respect to the day-to-day business operations that G handles as a professional manager of M, the business operations that G manages is not the provision of use of P's hotel rooms and suites to customers. G does not operate or manage real property. Instead, G manages the provision of maid and janitorial services to customers, including P's hotel. Therefore, G is not engaged in real property management as defined in this section. Accordingly, under these facts, G is not engaged in a real property trade or business under section 469(c)(7)(C) and this section.

(3) Rental real estate. Rental real estate is any real property used by customers or held for use by customers in a rental activity within the meaning of §1.469-1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under §1.469-4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of this section.

(4) Personal services. Personal services means any work performed by an individual in connection with a trade or business. However, personal services do not include any work performed by an individual in the individual's capacity as an investor as described in §1.469-5T(f)(2)(ii).

(5) Material participation. Material participation has the same meaning as under §1.469-5T. Paragraph (f) of this section contains rules applicable to limited partnership interests in rental real estate that a qualifying taxpayer elects to aggregate with other interests in rental real estate of that taxpayer.

(6) Qualifying taxpayer. A qualifying taxpayer is a taxpayer that owns at least one interest in rental real estate and meets the requirements of paragraph (c) of this section.

(c) Requirements for qualifying taxpayers.

(1) In general. A qualifying taxpayer must meet the requirements of section 469(c)(7)(B).

(2) Closely held C corporations. A closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements of section 469(c)(7)(D)(i). For purposes of section 469(c)(7)(D)(i), gross receipts do not include items of portfolio income within the meaning of §1.469-2T(c)(3).

(3)Requirement of material participation in the real property trades or businesses. A taxpayer must materially participate in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the requirements of paragraph (c)(1) of this section.

(4)Treatment of spouses. Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of section 469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under §1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.

(5)Employees in real property trades or businesses. For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

(d)General rule for determining real property trades or businesses.

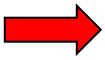
(1)Facts and circumstances. The determination of a taxpayer's real property trades or businesses for purposes of paragraph (c) of this section is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in section 469(c)(7)(C). A taxpayer's grouping of activities under §1.469-4 does not control the determination of the taxpayer's real property trades or businesses under this paragraph (d).

(2)Consistency requirement. Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of paragraph (c) of this section, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.

(e)Treatment of rental real estate activities of a qualifying taxpayer.

(1)In general. Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity. Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of

the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.



(2)Treatment as a former passive activity. For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity under section 469(f) if disallowed deductions or credits are allocated to the activity under §1.469-1(f)(4).

(3)Grouping rental real estate activities with other activities.

(i) In general. For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under §1.469-5T.

(ii) Special rule for certain management activities. A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§1.469-5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

(4)Example. The following example illustrates the application of this paragraph (e).
Example.

(i) Taxpayer B owns interests in three rental buildings, U, V and W. In 1995, B has $30,000 of disallowed passive losses allocable to Building U and $10,000 of disallowed passive losses allocable to Building V under §1.469-1(f)(4). In 1996, B has $5,000 of net income from building U, $5,000 of net losses from building V, and $10,000 of net income from building W. Also in 1996, B is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of B under paragraph (e)(1) of this section, unless B makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If B makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether B materially participates in the combined activity.

(ii) Effective beginning in 1996, B makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. B works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if B conducts this management function through a separate

entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of B in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000 + $10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000 + $10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings U, V and W are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), B may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, B has $30,000 ($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

(f)Limited partnership interests in rental real estate activities.

(1)In general. If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest (within the meaning of §1.469-5T(e)(3)), the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in §1.469-5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

(2)De minimis exception. If a qualifying taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, paragraph (f)(1) of this section does not apply. Thus the taxpayer may determine material participation under any of the tests listed in §1.469-5T(a) that apply to rental real estate activities.

(g)Election to treat all interests in rental real estate as a single rental real estate activity.

(1)In general. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under §1.469-4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

(2)Certain changes not material. The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

(3)Filing a statement to make or revoke the election. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). The taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must contain a declaration that the taxpayer is revoking the election under section 469(c)(7)(A) and an explanation of the nature of the material change.

(h)Interests in rental real estate held by certain passthrough entities.

(1)General rule. Except as provided in paragraph (h)(2) of this section, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under §1.469-4(d)(5). If the passthrough entity grouped its rental real estate into separate rental activities under §1.469-4(d)(5), each rental real estate activity of the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer. However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(2)Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity. If a qualifying taxpayer owns, directly or indirectly, a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the passthrough entity's grouping of activities under §1.469-4(d)(5). However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(3)Special rule for interests held in tiered passthrough entities. If a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier entity's grouping of activities under §1.469-4(d)(5).

(i)[Reserved]

(j)$25,000 offset for rental real estate activities of qualifying taxpayers.

(1)In general. A qualifying taxpayer's passive losses and credits from rental real estate activities (including prior-year disallowed passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under section 469(i). The amount of losses or credits allowable under section 469(i) is determined after the rules of this section are applied. However, losses allowable by reason of this section are not taken into account in determining adjusted gross income for purposes of section 469(i)(3).

(2)Example. The following example illustrates the application of this paragraph (j).

Example.

(i) Taxpayer A owns building X and building Y, both interests in rental real estate. In 1995, A is a qualifying taxpayer within the meaning of paragraph (c) of this section. A does not elect to treat X and Y as one activity under section 469(c)(7)(A) and paragraph (g) of this section. As a result, X and Y are treated as separate activities pursuant to section 469(c)(7)(A)(ii). A materially participates in X which has $100,000 of passive losses disallowed from prior years and produces $20,000 of losses in 1995. A does not materially participate in Y which produces $40,000 of income in 1995. A also has $50,000 of income from other nonpassive sources in 1995. A otherwise meets the requirements of section 469(i).

(ii) Because X is not a passive activity in 1995, the $20,000 of losses produced by X in 1995 are nonpassive losses that may be used by A to offset part of the $50,000 of nonpassive income. Accordingly, A is left with $30,000 ($50,000 − $20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of X to offset any income from X and passive income from other sources. Therefore, A may offset the $40,000 of passive income from Y with $40,000 of passive losses from X.

(iii) Because A has $60,000 ($100,000 − $40,000) of passive losses remaining from X and meets all of the requirements of section 469(i), A may offset up to $25,000 of nonpassive income with passive losses from X pursuant to section 469(i). As a result, A has $5,000 ($30,000 − $25,000) of nonpassive income remaining and disallowed passive losses from X of $35,000 ($60,000 − $25,000) in 1995.