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CHAPTER 4

Application of the New Section 469 Regulations
in a Real Estate Development Scenario

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§ 4.01 INTRODUCTION

This article explores the impact of the second set of Section 469
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regulations\(^1\) by applying those regulations (as well as other Section 469 rules that were not affected by the second set of regulations) to a hypothetical series of transactions involving the acquisition, holding, and development of a parcel of land by a partnership, followed by sales by the partnership of portions of the developed land and the improvements thereon. The principal purpose of the article is to give the reader an opportunity to take a "dry run" through the Section 469 minefield in such a context, so that the many factual and legal issues that arise will not be encountered for the first time while advising a client. In addition, the article is intended to familiarize the reader with (i) the step-by-step analytical approach that must be employed if the new regulations are to be applied correctly, (ii) certain surprising conclusions regarding the application of some of the rules, and (iii) some of the areas in which only conjecture, and not answers, can be supplied.

The remainder of this article consists of four parts. The first part sets forth a summary of relevant portions of the new regulations, the first set of regulations, and the statute. The summary is not intended to be a comprehensive exposition of the rules described. It is simply an introduction to certain rules that are relevant to the case study discussed below.\(^2\) More detailed analyses of the rules are presented in the context of the subsequent discussion of the case. The second part sets forth the facts of the case study to be discussed. The third part lists (i) the taxpayers in the case study who must be considered separately and (ii) the phases of the case study that must be considered separately. The fourth part explains the application of Section 469 and the new regulations to the facts presented.

§ 4.02 SUMMARY OF APPLICABLE RULES

[1] Definition of "Passive Activity"

[a] General Rule

The definition of the term "passive activity", which is set forth

\(^2\) It is assumed that the reader is generally familiar with the rudiments of Section 469 and the first set of regulations.
in the statute and the first set of regulations, and was not changed by the second set of regulations, is simple. An activity is a passive activity if and only if it is either (i) a "rental activity" or (ii) a "trade or business activity" in which the taxpayer does not materially participate. The determination of whether an activity is a passive activity is made separately for each taxable year.

[b] Definition of "Rental Activity"

The general definition of the term "rental activity" was not changed by the second set of regulations. Subject to certain exceptions, an activity is treated as a rental activity for a taxable year if tangible property is held in connection with the activity during the year, and either (i) the gross income from the activity for the taxable year consists principally of amounts paid by customers for the use of the property, or (ii) the property is not used by customers but is held for such use, and the gross income from the activity (for all years, presumably) is expected to consist principally of amounts paid by customers for the use of the property. Thus, an activity cannot be a rental activity for a taxable year unless, during that year, property held in connection with the activity is either (i) actually rented or (ii) held for rent.

[c] Definition of "Trade or Business Activity"

The definition of "trade or business activity" was modified substantially in the second set of regulations. The definition in the first set of regulations was self-contained and generally applied for a taxable year only if the taxpayer actually conducted a trade or business (within the meaning of Section 162) during the year. The new definition, however, relies entirely on a cross-reference to the term "business and rental operations," which was introduced in the new regulations defining the term "activity." As seen below, an important consequence of the cross-reference is that an activity may be treated, for purposes of Section 469, as a "trade or business activity" for a taxable year even though it does not yet rise to the level of a Section 162 trade or business. In general, the new...
regulations provide that an activity is a trade or business activity for a taxable year if and only if, for that 1 year, (i) the activity is not a rental activity and (ii) it "involves the conduct . . . of business and rental operations . . . that are not treated as incidental to an activity of holding property for investment."5

[d] Definition of "Business and Rental Operations"

The term "business and rental operations" is defined to include all endeavors that (i) are engaged in for profit or for the production of income and (ii) satisfy any one of the following four conditions for the taxable year:

(A) They "involve" the conduct of a trade or business,6 or

(B) They are conducted in anticipation of "such endeavors becoming a trade or business,"7 or

(C) They involve making tangible property available for use by customers,8 or

(D) Section 174 expenses are paid or incurred with respect to the endeavors.9

The second condition, relating to "anticipation" of a trade or business, is a radical departure from the first set of regulations, which generally did not treat economic operations as a possible constituent of a passive activity until those operations amounted to either the rental of property or the actual conduct of a trade or business. The anticipation rule, however, is not well-developed in the regulations, and leaves unanswered the following questions:

• What does it mean for endeavors to be conducted in anticipation of "such endeavors becoming" a trade or business? How does one determine whether an antici-

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5 Reg. § 1.469-1T(e)(2).
6 Reg. § 1.469-4T(b)(2)(i)(A)(1). Note that, since the term "business and rental operations" appears to refer to the very smallest possible unit of economic activity, a given set of economic operations frequently will not constitute a trade or business on their own, even though it is part of a trade or business. The author believes that the term "involve" is intended to mean "(i) constitute or (ii) are part of a larger set of operations that constitutes."
pated future trade or business will be treated as a continuation of particular endeavors that are conducted in the current year?  

- **What is the treatment of endeavors conducted in anticipation of such endeavors becoming a rental activity that will not or may not amount to a trade or business?** The regulations do not appear to treat such endeavors as business and rental operations. If this is correct, how does one determine whether, e.g., the holding of raw land is conducted in anticipation of conducting a future trade or business or a future rental?  

[e] *Treatment of Stock in a C Corporation*

The new regulations expressly provide that, for purposes of Section 469, a taxpayer's activities do not include any operations conducted by the taxpayer through a nonpassthrough entity such as a C corporation. Therefore, stock in a C corporation generally cannot be treated as an interest in a passive activity or a former passive activity.

The new regulations also provide, however, that if a taxpayer transfers an interest in an activity to a C corporation at a time when deductions or credits from the activity are suspended under Section 469 (i.e., at a time when the activity is a "loss activity," to use the language of the regulations), the taxpayer's interest in the activity through the corporation continues to be treated as an interest in a passive activity solely for purposes of applying the regulations.

10 Based on conversations with Treasury attorneys, it is the author's understanding that the regulations may be amended to provide that for-profit operations that are conducted in anticipation of "the conduct of a trade or business" (rather than "such endeavors becoming a trade or business") will be treated as business and rental operations. If the regulations are amended in this fashion, these questions will be eliminated.

11 Based on conversations with Treasury attorneys, it is the author's understanding that the regulations are likely to be amended to treat as business and rental operations all for-profit operations that are conducted in anticipation of making tangible property available for use by customers. If the regulations are so amended, the for-profit holding of raw land should always be treated as a business and rental operation unless the land is held for investment only.

12 Reg. § 1.469-4T(b)(2)(ii)(B).

13 See I.R.C. §§ 469(f)(1) and (f)(3) for rules regarding former passive activities.
relating to the "allocation" of the disallowed passive activity loss among the taxpayer's passive activities, and the suspended deductions and credits therefore may be freed from disallowance under Section 469 to the extent the taxpayer has income from passive activities in subsequent years.\textsuperscript{14}

If a taxpayer transfers to a C corporation all of his or her interest in a loss activity, it is likely that all suspended deductions (but not credits) from the activity are allowed (even if the taxpayer does not have income from other passive activities) when all of the taxpayer's stock in the corporation is sold or exchanged to an unrelated party in a taxable transaction.\textsuperscript{15} As a general matter, no portion of such deductions should be allowed until all of the stock is sold. In the case of a cooperative housing corporation ("CHC"),\textsuperscript{16} however, one or more shares of stock constituting less than all of the taxpayer's stock in the corporation may represent the taxpayer's entire interest in an activity consisting of a single dwelling unit and that unit's share of the common areas in the cooperatively owned property. In such a case, it is possible that the taxpayer's suspended deductions from that activity will be allowed upon a taxable sale or exchange of those shares.

\textsuperscript{14} Reg. \textsection{} 1.469--1T(f)(4)(ii). The regulations literally provide that the taxpayer's interest \textit{in the corporation} is treated as a continuing interest in a passive activity. This construction suggests that if a taxpayer's interests in two separate activities are transferred to a C corporation, the taxpayer's interest in the corporation is thereafter treated as an interest in a single passive activity. It may be noted, however, that if it is the Treasury's intent that I.R.C. \textsection{} 469(g)(1)(A) may apply to a sale of a share of stock in a cooperative housing corporation where the share represents an apartment unit that was treated, before incorporation, as a separate activity (see text following this note), it may be more appropriate to treat the taxpayer's continuing indirect interest in each pre-incorporation activity as a separate activity.

Note also that Reg. \textsection{} 1.469--1T(f)(4)(ii) contains the cross-reference "for purposes of this paragraph (f)(4)." The cross-reference is erroneous and should read: "for purposes of this paragraph (f)." See Reg. \textsection{} 1.469--1T(f)(4)(ii) Ex. (5)(ii), which makes sense only if Reg. \textsection{} 1.469--1T(f)(4)(ii) applies for all purposes of Reg. \textsection{} 1.469--1T(f).


\textsuperscript{16} See I.R.C. \textsection{} 216 for rules relating to cooperative housing corporations.
Definition of "Undertaking," the Basic Component of an "Activity"

Overview

The definition of "activity" in the regulations consists of an elaborate set of rules for constructing activities out of more elemental components, referred to as "undertakings."\(^\text{17}\) The rules for aggregating undertakings into activities are discussed in § 4.02[3].\(^\text{18}\) The undertaking rules are discussed in this § 4.02[2].

The "undertaking" rules in the regulations establish a two-step process for identifying a taxpayer's undertakings. First, the taxpayer's "business and rental operations" are grouped into tentative undertakings, referred to in the regulations as "paragraph (c) undertakings," on the basis of the location or locations in which the operations are conducted.\(^\text{19}\) Second, the rental component (if any) of each paragraph (c) undertaking is examined, and, in some cases, the rental and nonrental components of the paragraph (c) undertaking are treated as separate undertakings. The first step in this process is summarized in § 4.02[2][b]. The second step is summarized in § 4.02[2][c].

The Single-Location Rule

Under the single-location rule, a group of business and rental operations of a taxpayer generally is treated as part of a single separate undertaking if and only if (i) the operations are conducted at the same location,\(^\text{20}\) (ii) "income-producing operations" are conducted at the location,\(^\text{21}\) and (iii) the operations are directly owned by the same person (for this purpose, the term "person"

\(^\text{17}\) See Reg. § 1.469–4T(a)(3) for a general, nonauthoritative discussion of the undertaking rules, and Reg. § 1.469–4T(a)(4) for a similar discussion of the activity rules.

\(^\text{18}\) The only aggregation rules discussed in this article are those that are pertinent to the analysis of the case study presented below.

\(^\text{19}\) Reg. § 1.469–4T(d)(1). Such a tentatively identified undertaking is referred to in the regulations as a "paragraph (c) undertaking" because the location-based rules under which the undertaking is tentatively identified are contained in Reg. § 1.469–4T(c).

\(^\text{20}\) Reg. § 1.469–4T(c)(2)(i)(A).

\(^\text{21}\) Reg. § 1.469–4T(c)(2)(i)(B).
includes a pass-through entity such as a partnership). 22

The regulations provide that operations are conducted at the same location if they are conducted in the same physical structure or in “close proximity” to each other. 23 The term “close proximity” is not defined with precision. Some guidance, however, is found in two examples in the regulations. One example concludes that two stores in the same shopping mall are in close proximity. 24 The other example concludes that two stores that are several blocks apart are not in close proximity. 25

The term “income-producing operations” is defined more precisely. 26 For purposes of the case study presented below, it should be noted that income-producing operations include, in addition to the actual production of property, 27 business and rental operations that are conducted in reasonable anticipation of (i) the production of property or (ii) “transactions in which customers take physical possession . . . of property that is made available for their use” (i.e., the rental of property). 28

c] Separation of “Rental Undertakings”

The rental operations that are conducted at a location are treated as an undertaking that is separate from trade or business operations conducted at the location (and are referred to as a “rental undertaking”) 29 unless either (i) the rental operations, considered as a separate activity, would not constitute a rental activity for the taxable year, 30 or (ii) a de minimis rule (known as the “80–20” rule) applies for the taxable year. 31 The 80–20 rule applies for any year in which the gross income from either the rental operations or the nonrental operations at the location constitutes less than 20 of the gross income from the “paragraph (c) undertaking” at the

22 Reg. § 1.469–4T(c)(2)(i)(A) and (c)(2)(v).
23 Reg. § 1.469–4T(c)(2)(ii)(B).
24 Reg. § 1.469–4T(c)(4) Ex. (2)(i).
25 Reg. § 1.469–4T(c)(4) Ex. (3)(i).
26 See Reg. § 1.469–4T(c)(2)(iv).
28 See parenthetical language in Reg. § 1.469–4T(c)(2)(iv).
29 Reg. § 1.469–4T(d)(1)(i) and (d)(1)(ii).
30 Reg. § 1.469–4T(d)(2)(i).
31 Reg. § 1.469–4T(d)(2)(ii) and (d)(2)(iii).
location.\textsuperscript{32} For purposes of the foregoing rules, "rental operations" include, subject to certain exceptions, all operations that involve making tangible property available for use by customers, together with related services.\textsuperscript{33}

[3] Construction of "Activities" Out of "Undertakings"

[a] General Rules for Trade or Business Undertakings

A separate trade or business undertaking generally may be treated as a separate activity for purposes of the disposition rules in Section 469(g),\textsuperscript{34} but often must be aggregated with related undertakings to form a larger activity for purposes of determining whether the taxpayer materially or significantly participates in that activity.\textsuperscript{35} The principal aggregation rule illustrated by the case study presented below requires the aggregation, in certain cases, of trade or business undertakings that are "similar" and "commonly controlled."\textsuperscript{36} A second aggregation rule discussed briefly in the case study requires the aggregation, in certain cases, of trade or business activities (determined after the application of other aggregation rules) that are commonly controlled and constitute a "single integrated business."\textsuperscript{37}

\textsuperscript{32} Id. The term "paragraph (c) undertaking" is explained in N. 19 and accompanying text.

\textsuperscript{33} Reg. § 1.469–4T(d)(3).

\textsuperscript{34} Reg. § 1.469–4T(o) provides that a taxpayer may elect to treat each trade or business undertaking in which he or she owns an interest as a separate activity, notwithstanding the mandatory aggregation rules discussed in the text below. Under Reg. § 1.469–4T(o)(6), however, such an election is disregarded for purposes of determining whether the taxpayer materially or significantly participates in the resulting activities. Accordingly, the primary effect of a "paragraph (o)" election with respect to an undertaking is that the undertaking is treated as a separate activity for purposes of the disposition rules under I.R.C. § 469(g). The latter rules are described briefly in § 4.02[5].

\textsuperscript{35} See Reg. § 1.469–4T(f) (aggregation of similar, commonly controlled undertakings), Reg. § 1.469–4T(g) (aggregation of commonly controlled undertakings that constitute a "single integrated business"), and Reg. § 1.469–4T(h) (aggregation of professional service undertakings).

\textsuperscript{36} See Reg. § 1.469–4T(f).

\textsuperscript{37} See Reg. § 1.469–4T(g).
[b] Aggregation of Similar, Commonly Controlled Trade or Business Undertakings

A taxpayer’s interests in separate trade or business undertakings must be treated as part of the same activity if—

- The undertakings are commonly controlled;\(^{38}\)
- The undertakings are “similar,” in that each undertaking has “predominant operations” (i.e., operations that account for more than 50 percent of the undertaking’s gross income) and the predominant operations of both undertakings are in the same line of business;\(^{39}\) and
- Any of three taxpayer-specific conditions is satisfied with respect to the undertakings.

The taxpayer-specific conditions are:

- The taxpayer’s interests in the undertakings are held through the same passthrough entity;\(^{40}\)
- The taxpayer owns, with respect to each undertaking, either a direct interest in the undertaking or more than a ten percent interest in the passthrough entity that directly owns the undertaking;\(^{41}\) or
- The taxpayer would be treated as materially participating or significantly participating in the activity resulting from aggregating the undertakings.\(^{42}\)

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\(^{38}\) Reg. § 1.469–4T(f)(2) and (j).
\(^{39}\) Reg. § 1.469–4T(f)(2) and (f)(4). Undertakings also are considered to be “similar” for purposes of this aggregation rule if they are “vertically integrated” within the meaning of complex rules in the regulations. The vertical integration rules do not apply to the case study presented below, and will not be discussed in this article.

\(^{40}\) Reg. § 1.469–4T(f)(2)(i). Note that this condition is satisfied with respect to undertakings A and B where, for example, a taxpayer owns an interest in partnership X, which itself owns interests in partnerships Y and Z, and partnerships Y and Z conduct undertakings A and B, respectively. See Reg. § 1.469–4T(f)(5) Ex. (4)(ii).

\(^{41}\) Reg. § 1.469–4T(f)(2)(ii) and (3). Rules for determining a taxpayer’s percentage interest in a passthrough entity are provided in Reg. § 1.469–4T(j)(3); Reg. § 1.469–4T(f)(2)(iii). This requirement is satisfied where the taxpayer is treated as materially or significantly participating in any one of the similar, commonly controlled undertakings, as well as where the taxpayer is treated as so
For purposes of this aggregation rule, lines of business are to be identified in revenue procedures.\textsuperscript{43} It should be noted that, under the revenue procedure currently in effect, real estate development and virtually all real estate services are treated as part of the same line of business.\textsuperscript{44}

[c] \textit{Aggregation of Commonly Controlled Trade or Business Activities That Constitute a Single Integrated Business}

Undertakings that are tentatively treated as separate activities because they are not aggregated under the rule for similar, commonly controlled undertakings, as well as activities that result from application of that rule, may be further aggregated into larger activities if (i) they are commonly controlled, and (ii) the operations of the two activities constitute a "single integrated business" under a facts-and-circumstances test outlined in the regulations. Facts and circumstances that, under the regulations, indicate that the operations of two activities are part of a single integrated business include the following:\textsuperscript{45}

\begin{itemize}
  \item They are conducted at the same location;
  \item They are accounted for as a unit in the taxpayer's primary accounting records;
  \item Either of the foregoing conditions is typically satisfied when similar operations are conducted by persons other than the taxpayer;
  \item They are directly owned by the same person;
  \item They involve products or services that are commonly provided together;
  \item They serve the same customers;
  \item They use the same personnel, facilities, or equipment;
  \item They are conducted in coordination with or reliance upon each other;
\end{itemize}

\textsuperscript{43} Reg. § 1.469-4T(f)(4)(iv).
\textsuperscript{45} See Reg. § 1.469-4T(g)(3).
- Any of the operations are incidental to the remainder of the operations;
- The operations depend upon each other for their economic success; and
- The operations are conducted under the same trade name.

The foregoing facts-and-circumstances test is quite vague, since the regulations do not indicate either (i) what weight should be given to each listed factor, or (ii) how many of the factors must be present before activities must (or may) be integrated under the rule.

[d] Meaning of “Commonly Controlled”

For purposes of the aggregation rules described above, the regulations encourage aggregation by defining “control” very broadly, taking all facts and circumstances into account, and including “any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.” The foregoing definition of “control” is copied verbatim from the regulations under Section 482, which empowers the Commissioner, in certain circumstances, to reallocate gross income, deductions, credits, or other allowances among commonly controlled entities or businesses. Although the definition has been interpreted, for purposes of Section 482, in numerous judicial decisions, it is not clear whether and to what extent those interpretations will be considered controlling for purposes of Section 469, since the Section 469 regulations parrot the language of the Section 482 regulations but do not actually incorporate Section 482 or the regulations regulations thereunder by reference. In any event,

46 The regulations actually use the phrase “controlled by the same interests” rather than the phrase “commonly controlled”. The latter phrase will be used in this article, however, because it is easier to read, write, and say.

47 Reg. § 1.469-4T(b)(1).

48 See Reg. § 1.482-1(a)(3).

49 One cannot avoid noting that the “common control” issue arises under I.R.C. § 482 only when the Commissioner has reason to believe that items have been inappropriately shifted from one business or entity to another. As a practical matter, an inappropriate, but intended, shifting of items (as opposed to, e.g., a theft) can occur only when one person (or group of persons) has sufficient control over both businesses or entities to enrich one at the expense of the other nonfraudulently. That practical element of a I.R.C. § 482 common-control
the definition of “common control” is not precise and has been the subject of much debate.

The regulations also provide that two undertakings are “rebut-tably presumed” to be commonly controlled if any five or fewer persons (i.e., individuals or C corporations) collectively own (directly or indirectly) more than 50 percent of both undertakings, taking into account each person’s percentage interest in an undertaking only to the extent it does not exceed that person’s percentage in the other undertaking.56 The regulations provide no guidance, however, regarding the kinds of facts and circumstances that would suffice to rebut the presumption.

[e] Special Rule for Rental Real Estate Undertakings

A single rental real estate undertaking generally may be either (i) aggregated with other rental undertakings to form a larger rental activity or (ii) divided into multiple rental undertakings (which may be treated as separate activities or recombined with other such undertakings into mix-and-match activities), at the option of the taxpayer.51 For purposes of these rules, a “rental real estate undertaking” is a rental undertaking in which at least 85 percent of the unadjusted basis of the property made available for use by customers is attributable to real property.52
Unfortunately, the taxpayer's ability to divide a rental real estate undertaking into multiple activities is limited to a significant, albeit uncertain, extent by two provisions in the regulations relating to (i) the portions of a pre-division undertaking that may be treated as a separate activity, and (ii) the time at which an election to divide a rental real estate undertaking into smaller pieces may be made. The first provision states that an election to treat a portion of a pre-division rental real estate undertaking as a separate undertaking may be made only if that portion of the undertaking "can be separately conveyed under applicable State and local law (taking into account the limitations, if any, imposed by any special rules or procedures, such as condominium conversion laws, restricting the separate conveyance of parts of the same structure)." The second provision states that, if two or more portions of a pre-division rental real estate undertaking are treated (under the paragraph in the regulations relating to rental real estate undertakings) as part of the same activity for any taxable year ending after August 9, 1989, those portions must be treated as part of the same activity in each succeeding taxable year.

The first provision strongly suggests (although not unequivocally) that, for example, an election to treat individual rental apartments in a building as separate undertakings cannot be made until the taxpayer has fully complied with any procedures established by local law as a condition of conveying apartments separately. The second provision, when read in conjunction with the first, has led several observers to conclude that if, for any taxable year, the taxpayer cannot make an election to divide a rental real estate undertaking into multiple activities because, e.g., condominium conversion procedures have not been completed, or if the taxpayer can make the election but simply fails to do so, the taxpayer is forever foreclosed from making such an election, even if separate conveyance first becomes permissible (or first becomes desirable) in a subsequent year.

The foregoing conclusion, however, simply represents one

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54 Reg. § 1.469-4T(k)(3).
55 These restrictions on the separate-undertaking election may be relaxed in future regulations, due in part to criticisms based on the foregoing interpretation of the rules.
possible interpretation of the regulations. The author believes that the better interpretation is that an election to divide an undertaking into multiple undertakings may be made at any time, without regard to the treatment of that undertaking as a single activity in prior years, as long as the undertaking has not been electively aggregated with other undertakings in prior years. The basis for this interpretation is explained in § 4.05[11][a], below.

Moreover, even if the author's interpretation is incorrect, it may be possible to overcome the obstacle of a missed election simply by conveying portions of the leased property to separate passthrough entities. Note, in this regard, that the election to divide a pre-division rental real estate undertaking into multiple undertakings presupposes the existence of a pre-division undertaking that includes multiple sub-units. Suppose, however, that a passthrough entity that is technically precluded from making an election with respect to such a pre-division undertaking (because, e.g., it failed to make such an election in a prior year) simply transfers each sub-unit to a separate lower-tier passthrough entity. After the transfer, the business and rental operations attributable to each sub-unit should be treated as a separate undertaking under the general rules of Regulations Section 1.469-4T(c), obviating any need to make an election to divide the original undertaking. Nothing in the regulations seems to prevent this result, and the author believes it would be inappropriate for the Service to object to such a transaction on business-purpose grounds when (i) the policy-based reasons for the election restrictions (if any) are not compelling, and (ii) the regulations are so detailed and precise so much emphasis on form.

[4] Treatment of Gain or Loss From Sale of Property

[a] Overview

The treatment, for purposes of Section 469, of gain or loss from the sale or other disposition of property is determined under a set of complex rules, certain of which are summarized below. Most of the rules set forth below were included in the first set of regulations. The rules relating to dealer sales, however, did not appear until the second set of regulations.

The rules relating to dispositions of property fall into two
categories. The first category consists of rules for allocating gain and loss among a taxpayer’s activities. The second category consists of rules for characterizing gain or loss, i.e., for determining whether gain or loss allocated to an activity is passive or nonpassive.

[b] Gain and Loss Allocation Rules

[i] Time-of-Disposition Rule

The basic rule for allocating gain or loss from a disposition of property among a taxpayer’s activities provides that such gain or loss is treated as gain or loss from the activity in which the property is used at the time of the disposition. The foregoing rule is referred to herein as the “time-of-disposition rule.”

[ii] Twelve-Month Rule

Notwithstanding the time-of-disposition rule, if property was used in more than one activity during the twelve-month period ending on the date of disposition (whether concurrently or consecutively), any gain or loss from the disposition is allocated among the activities in which the property was used during that period. The foregoing rule is referred to herein as the “twelve-month rule.”

[iii] Special Rules for Dealer Sales

Under the first set of regulations, application of the foregoing allocation rules to a sale of property arguably was unclear in the case of an item of property that, during all or part of the twelve-month period ending on the date of its sale was simultaneously (i) held for sale to customers in a “dealing activity” and (ii) used in a nondealing activity. In particular, one might have argued that such property was “used in” the dealing activity as well as the nondealing activity, and that the time-of-disposition rule and


57 Reg. § 1.469–2T(c)(2)(i) (in the case of gain) and Reg. § 1.469–2T(d)(5)(i) (in the case of loss). The regulations do not prescribe any method for allocating gain or loss, but simply say that the allocation must “reasonably reflect the use of [the property] during such 12-month period.”
two-month rule provided no basis for allocating gain or loss from the sale to one or the other of the activities.

The first set of regulations contained a rule providing that, if an item of rented property was sold in a dealer sale, the rental of the property for the taxable year in which the property was sold was treated as "incidental to" the use of the property in a dealing activity, and therefore was not treated as use of the property in a rental activity.\(^{58}\) No rules were provided, however, for property used in a nonrental activity while held for sale to customers.

The second set of regulations repealed the foregoing rule relating to rentals incidental to dealing, and provided in its place a more comprehensive (and, naturally, more complex) set of rules governing the treatment of property that is held for sale to customers at the time of its disposition. Those rules are summarized below.

Property That is Used in a Nondealing Activity Incidental to Principal Purpose of Holding it for Sale to Customers. If an item of property is "held in a dealing activity" at the time of its disposition, and either (1) the taxpayer acquired and held the property principally for the purpose of selling it to a customer in the ordinary course of a trade or business, or (2) the taxpayer used the property in nondealing activities for no more than 80 percent of the time that the taxpayer held the property (taking into account periods during which the property was simultaneously held for sale to customers and used in nondealing activities), then, for purposes of characterizing gain or loss from the disposition of the property, the property is treated as though it had been "used" exclusively in the dealing activity for the entire time it was offered for sale to customers.\(^{59}\) This rule is referred to hereinafter as the "dealer rule."

Property That is Held for Sale to Customers Incidental to Primary Use in a Nondealing Activity. If an item of property is "held in a dealing activity" at the time of its disposition, but (1) the taxpayer did not acquire and hold the property for the principal purpose of

\(^{58}\) See Reg. § 1.469–1T(c)(3)(vi)(D), as in effect prior to its amendment by T.D. 8253.

\(^{59}\) Reg. § 1.469–2T(c)(2)(v)(B) (in the case of gain) and Reg. § 1.469–2T(d)(5)(iii)(A) (in the case of loss).
selling it to customers in the ordinary course of business, and (2)
the taxpayer used the property in one or more nondealing activities
(whether or not the property was simultaneously held for sale to
customers) for more than 80 percent of the time that the taxpayer
held the property, then, for purposes of characterizing gain or loss
from the disposition, the use of the property in the dealing activity
is ignored, and the property is treated as though, during the dealing
period, the property was used by the taxpayer "in the last
nondealing activity in which [it] was used prior to its
disposition."60

Since the author believes that this special "rule" arguably yields
the same result that would have followed in the absence of any rules
relating to property held for sale to customers, it will not be
referred to in this article as a "rule" at all, but simply as the
nonapplication of the "dealer rule" described in § 4.02[4][b][iii].

Meaning of "Held in a Dealing Activity". For purposes of the
foregoing rules, an item of property is treated as "held in a dealing

60 Reg. § 1.469-2T(c)(2)(v)(A) (in the case of gain) and Reg.
§ 1.469-2T(d)(3)(iii)(A) (in the case of loss). The period for which the property
is intended to be treated as used "in the last nondealing activity of the taxpayer in
which such . . . property was used prior to its disposition" is unclear. The
regulations literally seem to provide that such treatment applies for the entire time
that the property was held for sale to customers. If that is true, however, use in
other nondealing activities also is ignored. Thus, for example, if (i) an item of
property is used in nondealing activity A for six months and then in nondealing
activity B for another six months, (ii) the property is sold in a dealer transaction
at the end of the second six months, and (iii) the property is held for sale to
customers in a "dealing activity" for the entire twelve-month period during which
it is used in the two activities, the property appears to be treated, for purposes of
Reg. § 1.469-2T(c)(2), as though it had been used only in activity B for the entire
twelve months. Such a result is difficult to justify. Another possible (albeit
strained) interpretation of the literal language of the regulations is that the deemed
use of the property in the most recent nondealing activity is effective at the "time
of the disposition" only. That interpretation is also unsatisfactory, however, since
it leaves intact the dilemma of how to treat the property for periods of
simultaneous dealing and nondealing "use" during the twelve months preceding
the disposition.

The better answer (although technically inconsistent with the regulations) is
that the use of the property in the dealing activity should simply be ignored for all
periods during which the property was also used in nondealing activities, and the
remainder of the rules in Reg. § 1.469-2T(c)(2) should then apply as they would
have applied if the property had never been held for sale to customers.
activity" only if the property is held in an activity that involves "holding similar property" for sale to customers in the ordinary course of a trade or business (within the meaning of Section 1221(1)). The regulations do not explain exactly what it means for property to be "held in" such an activity, but an example in the regulations expressly equates "holding an interest in property in a dealing activity" with "the marketing of the property." This suggests that property is treated as "held in" the activity that includes the business and rental operations of marketing the property. The regulations also do not explain what is meant by the term "similar property". Possibly, all real property is intended to be treated as "similar," but this is not certain. At any rate, as a result of the "similar property" requirement, it appears that a taxpayer cannot be treated as holding an item of property in a "dealing activity" if that item of property is the only property that the taxpayer holds for sale to customers in the ordinary course of business in the activity in which the item is held for sale.

Determination of "Principal Purpose." A taxpayer's principal purpose for acquiring and holding an item of property presumably must be determined under all of the facts and circumstances. The regulations, however, establish a rebuttable presumption that a taxpayer has acquired and held an item of property for the principal purpose of selling it to customers in the ordinary course of a trade or business if any one of the following conditions is satisfied:

- The property was used in nondealing activities of the taxpayer for less than 24 months; or
- The property was used in nondealing activities of the taxpayer for less than 20 percent of the property's Section 168 recovery period; or
- The property was held for sale to customers during more than 25 percent of the period during which the property was used in nondealing activities of the taxpayer.

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64 Id. Query whether this condition is always (or ever) satisfied in the case of nondepreciable property such as land.
The regulations do not indicate what type of factual showing would suffice to rebut the foregoing presumption. It should be noted, however, that the principal-purpose test is satisfied with respect to an item of property only if the taxpayer both acquired and held the property for the principal purpose of selling it to a customer. Thus, for example, the presumption might generally be rebutted where the taxpayer uses property in a nondealing activity for a significant period before the property is first offered for sale.

[c] Gain and Loss Characterization Rules

[i] Year-of-Disposition Rule

The basic rule for characterizing a taxpayer's gain or loss from a disposition of property provides that the portion of such gain or loss that is allocated to an activity is treated as passive if and only if that activity is a passive activity of the taxpayer for the year of the disposition.66 The foregoing rule is referred to herein as the “year-of-disposition rule.” (The reader should be careful to distinguish from the time-of-disposition rule, discussed above.)

[ii] Former Nonpassive Property Rule

If an item of property is “substantially appreciated” at the time it is disposed of (i.e., if its fair market value exceeds its adjusted basis by more than 20 percent), any gain from the disposition that is treated as gain from a passive activity after the application of the year-of-disposition rule is nonetheless treated as nonpassive unless the property was used in one or more passive activities of the taxpayer for either (i) the entire 24-month period preceding the disposition or (ii) 20 percent of the taxpayer's holding period for the property.67 The foregoing rule is referred to herein as the “former nonpassive property rule.”

[iii] Self-Developed Property Rule

If (i) a taxpayer reports gain for a taxable year from the sale of a

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66 This is not stated expressly in the regulations, but is the only plausible reading of Reg. §§ 1.469–2T(c)(2)(i)(A)(2) and (c)(2)(i)(A)(3) in conjunction with the allocation rules discussed above. See also Reg. § 1.469–2T(d)(5)(i) (which makes the gain rules applicable to losses).

67 Reg. § 1.469–2T(c)(2)(iii).
rental property, (ii) any part of the gain is treated as income from a rental activity after application of the allocation rules described in § 4.02[4][b], and (iii) the taxpayer materially participated or significantly participated, for any year, in an activity that involved enhancing the value of the property by, e.g., designing, developing, constructing, renovating, or leasing the property, then (iv) the portion of the income and gain from the property for the taxable year that is otherwise treated as passive income or gain from a rental activity is recharacterized as nonpassive income. The foregoing rule is referred to herein as the "self-developed property rule." 68

The self-developed property rule does not apply to an item of property if, prior to the sale of the property, the property was rented for at least twelve months. 69 However, the rental of an item of property is not treated as commencing for this purpose until the "value-enhancement" services performed with respect to the property (including lease-up) are complete. 70


Section 469(g)(1)(A) generally provides that a taxpayer's previously disallowed losses from a passive activity may be treated as nonpassive for the taxable year in which the taxpayer transfers to an unrelated party his or her entire interest in the activity (whether or not the activity is still a passive activity) in a transaction in which all realized gain or loss is recognized. The amount of suspended losses treated as nonpassive under this provision is equal to the excess of (i) the taxpayer's losses from the activity (including current and suspended losses) over (ii) the taxpayer's net income for the year from other passive activities.

68 The self-developed property rule is set forth in Reg. § 1.469–2T(f)(5)(i). The rules identifying the specific income and gain subject to recharacterization are set forth in Reg. §§ 1.469–2T(f)(9)(iii) and (f)(9)(iv).

69 Reg. § 1.469–2T(f)(5)(i)(B). Note that, under the first set of regulations, a 24-month rental period was required to cleanse a property of its self-developed "taint."

70 Reg. § 1.469–2T(f)(5)(ii). Treasury and IRS attorneys have indicated that the requirement that lease-up be completed may be modified so that the requirement is satisfied when lease-up is substantially complete.
Regulations under this provision are currently reserved.\textsuperscript{71}


Section 469(f) provides a partial framework for dealing with suspended deductions and credits that, for a taxable year, are allocable to an activity that is not a passive activity. The principal subdivisions of Section 469(f) provide that:

- Such deductions and credits are not allowed simply because the activity to which they are allocable is not a passive activity, but, rather, they continue to be subject to disallowance under Section 469;\textsuperscript{72} and

- Such deductions and credits may be netted against income (and related tax liability, in the case of credits) from the activity to which they are allocated, as well as income (and related tax liability) from the taxpayer's passive activities.\textsuperscript{73}

- These rules provide only a partial framework for dealing with suspended deductions and credits allocable to a nonpassive activity because Section 469(f)(1), by its terms, applies only to deductions and credits allocable to a "former passive activity." The term "former passive activity" is defined in Section 469(f)(3) to include only an activity that "is not a passive activity for the taxable year, but . . . was a passive activity for any prior taxable year." This is problematic because, in many circumstances, a suspended deduction or credit may be allocable to an activity that is not and never was a passive activity.\textsuperscript{74}

Another problem arises when gain from the disposition of an item of property is treated as gain from a nonpassive activity (e.g., a nonpassive "dealing" activity) while deductions attributable to the use of the property in prior years were, and continue to be, allocated to a different,

\textsuperscript{71} See Reg. § 1.469-6T.
\textsuperscript{72} I.R.C. § 469(f)(1)(C).
\textsuperscript{73} I.R.C. § 469(f)(1)(A) and (B).
\textsuperscript{74} This may happen if, for example, property that is used in a passive activity in one year is used in a nonpassive activity in a subsequent year. See Reg. § 1.469-1T(f)(4)(C)(A), which provides that a taxpayer's deductions and credits that are disallowed for a taxable year shall be allocated among the taxpayer's activities for the succeeding taxable 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."
NEW SECTION 469 REGULATIONS § 4.03[2]

passive, activity.\textsuperscript{75}

§ 4.03 FACTS OF CASE STUDY

[1] Introduction

As indicated at the beginning of this article, the case to be analyzed involves a series of transactions in which a partnership acquires, holds, and develops a parcel of land, and then sells portions of the developed land and the improvements thereon. The facts of the case study will be presented in significant detail. While this may be daunting (although certainly less daunting than many real-life situations), the author believes that the time involved in absorbing all of the facts will be justifiable because it is simply impossible to resolve many Section 469 issues without considerable detailed information, and it is better to learn this on a "dry run" than when advising a client.

[2] Cast of Characters

(i) PS, the focus of the case study, is a limited partnership organized at the beginning of 1990 for the purpose of acquiring undeveloped land and holding it for future sale, rental, or development. The partnership interests in PS are held by the following persons in the following percentages:

- OGP (general partner) — 2 percent
- MGP (general partner) — 3 percent
- LPs (limited partners) — 95 percent

(ii) OGP is an individual, and serves as PS's operating general partner. OGP is responsible for supervising all of the day-to-day operations of PS throughout the life of the partnership. OGP will work in PS's operations for more than 500 hours each year once PS begins time-consuming operations. OGP also works for more than 500 hours each year in other, unrelated, real estate operations (including real estate development and management, but not dealing) which OGP owns and controls.

\textsuperscript{75} See Reg. § 1.469-2T(c)(2)(v)(B) (discussed in § 1.02[4][b][iii], supra), under which gain from a dealer sale of property may be treated as gain from a dealing activity of the taxpayer even though the taxpayer has historically used the property in another activity.
(iii) MGP is a general partnership, and serves as PS’s managing general partner. MGP generally is not involved in PS’s day-to-day operations. All of PS’s major partnership decisions must be ratified by a majority of the general partnership interests, however, and since MGP in fact plays an active role in the major-decision process, MGP effectively controls the operations of PS. MGP also owns and controls a wide range of unrelated real estate operations, including real estate development, management, and dealing, and all of MGP’s partners (who are individuals) are involved in one or more of MGP’s real estate operations on a substantially full-time basis. None of MGP’s partners, however, works for more than 100 hours in any year in connection with PS’s operations. OGP has no interest in MGP or in any of MGP’s operations other than those conducted through PS, and none of MGP’s partners has any interest in any of OGP’s operations other than those conducted through PS.

(iv) The LPs are all individual limited partners, none of whom holds more than a one percent interest in PS. None of the limited partners holds an interest in MGP or in any operations of MGP or OGP (other than those conducted through PS), and none of the LPs does any work in connection with any operations conducted by PS, OGP, or MGP.

(v) None of PS’s owners (direct or indirect) is related to any other, other than through the ownership of partnership interests as described above.


(i) On January 1, 1990, PS uses borrowed funds to purchase a tract of undeveloped land ("Tract X"), which PS believes will appreciate in value. PS expects to hold Tract X for at least two years before making a firm decision whether to sell the tract in an unimproved state, lease it to a third-party developer, or develop it. In 1990, PS realizes no gross income, and PS’s only expenses are for interest, property taxes, and insurance.

(ii) At the beginning of 1991, PS decides that it will not sell Tract X, but will hold it, either for development or for rental. PS does not decide, however, whether it will lease Tract X to a third-party developer or develop the land itself. In 1991, as in 1990,
PS realizes no gross income, and PS’s only expenses are for interest, property taxes, and insurance.

(iii) At the beginning of 1992, PS decides to improve Tract X with a cluster of buildings (including residential and office buildings, a hotel, and retail stores), prepares a preliminary site plan, and files applications for zoning variances and building permits. The site plan and applications are prepared in an office (not at the Tract X location) rented by PS, and are prepared by unrelated individuals hired by PS. In 1992, PS realizes no gross income and incurs expenses for interest, property taxes, insurance, and the costs of renting an office and preparing the site plan and applications.

(iv) In 1993, PS’s applications are approved, and PS constructs six separate buildings, consisting of two office buildings (Office Buildings A and B), each with a small ground-floor restaurant, two apartment buildings (Apartment Buildings C and D), a hotel, and a retail store. The construction work is done entirely by unrelated contractors hired by PS. The residential, office, and retail space is to be leased to tenants, and PS is to operate the restaurants and the hotel. PS realizes no gross income in 1993. Assume that all of PS’s expenses are capitalized.

(v) On January 1, 1994, PS begins to offer the residential, office, and retail space for rent, and begins to operate the restaurants and the hotel. The residential, office, and retail space in each building is leased out at a rate of ten percent per month, and the buildings are fully leased as of November 1, 1994. All of the leases are for terms of at least six months. Hotel rooms are rented for an average of two nights. PS derives net losses in 1994 from every phase of its operations (including the rental of the residential, office, and retail space, the operation of the restaurants, and the operation of the hotel). For all of 1994, PS derives 30 percent of its gross income from operation of the restaurants and the hotel, and 70 percent of its gross income from rental of the offices, apartments, and retail store.

(vi) On July 1, 1994, PS offers Office Building A (but none of the other buildings) for sale, and engages in sufficient marketing activities to be considered to hold Office Building A for sale to customers in the ordinary course of PS’s trade or business. PS’s marketing operations are conducted in an office in Office Building
A, and the marketing is done by unrelated individuals hired by PS. PS continues to offer Office Building A for sale to customers at all times after July 1, 1994, until the building is actually sold (on December 1, 1995).

(vii) On March 1, 1995, PS sells Office Building B and the hotel. (At no time was either building held for sale to customers in the ordinary course of business.) On December 1, 1995, PS sells Office Building A. PS realizes a gain on the sale of each of the three buildings.

(viii) Before taking into account the gain realized from the sales of Office Buildings A and B and the hotel, PS derives net losses in 1995 from every phase of its operations (including the rental of the residential, office, and retail space, the operation of the restaurants, and the operation of the hotel).

(ix) In 1996, PS derives net losses from its remaining operations, namely, the rental of the residential and retail space.

(x) At the close of business on January 1, 1997, PS converts Apartment Building C into a condominium and contributes Apartment Building D to a newly organized C corporation, which is a cooperative housing corporation ("Coop Corp"). Each share of Coop Corp stock represents PS's entire interest in a single apartment unit (including the apartment's share of the common areas in Apartment Building D). PS immediately begins to hold the apartment units in Building C and the shares of Coop Corp stock for sale to customers in the ordinary course of PS's trade or business. PS's marketing operations with respect to Apartment Building C are conducted in an office in Apartment Building C. PS's marketing operations with respect to Apartment Building D are conducted in an office in Apartment Building D. All of the marketing is done by unrelated individuals hired by PS. Most, but not all, of the condominium units, and most, but not all, of the shares of stock, are sold in 1997. Gain is realized on every sale.

(xi) Additional apartment units in Apartment Building C are sold in 1998, but at least one unit is unsold as of the end of the year.

(xii) Since all of the planning, construction, and marketing work is done by unrelated persons hired by PS, MGP enters into no transactions with PS, and derives no fees in connection with any of PS's operations.
§ 4.04 SUBJECTS FOR ANALYSIS IN CASE STUDY

[1] Introduction

An attempt to resolve Section 469 issues generally is not undertaken in a vacuum but, rather, is undertaken because of a concern about the treatment under Section 469 of particular items of income and loss of a particular taxpayer. For example, in the context of a hypothetical series of transactions such as those occurring in this case, a tax practitioner might be asked, "Will an LP's distributive share of PS's carrying costs in 1990 be subject to disallowance under Section 469?" or "Will OGP's distributive share of PS's gain from the sale of Office Building B be treated as passive income?" The discussion presented in § 4.05 will attempt to address the application of Section 469 and the regulations to most questions of this type that might be asked in the context of this case. The lists set forth immediately below are intended to serve as a reminder of the numerous items any of which could serve as the focus of a practitioner's inquiry.

[2] Classes of Taxpayers Requiring Separate Consideration

- *OGP*, PS's operating general partner.
- The *individual partners of MGP*, PS's managing general partner, all of whom are assumed to be similarly situated.
- The *LPs*, all of whom are assumed to be similarly situated.


- PS's 1990 expenses for interest, taxes, and insurance.
- PS's 1991 expenses for interest, taxes, and insurance.
- PS's 1992 expenses for interest, taxes, insurance, rental of the office, and preparation of site plans and applications.
- PS's 1994 operating losses from the office rentals, apartment rentals, retail store rentals, restaurants, and hotel.
- PS's 1995 operating loss from Office Building B.
- PS's 1995 gain from the sale of Office Building B.
- PS's 1995 operating loss from the hotel.

* PS's 1995 gain from the sale of the hotel.
* PS's 1995 operating loss from Office Building A.
* PS's 1995 gain from the sale of Office Building A.
* PS's 1995 and 1996 operating losses from the retail store, rentals and apartment rentals.
* PS's 1997 operating losses from Apartment Building C.
* PS's gain from sales of condominium units in Apartment Building C.
* PS's 1997 carryover deductions from Apartment Building D.
* PS's 1997 gain from sales of shares of stock in Coop Corp (representing dwelling units in Apartment Building D).
* PS's 1998 operating losses from Apartment Building C.
* PS's 1998 gain from sales of condominium units in Apartment Building C.

§ 4.05 ANALYSIS OF CASE STUDY


The ultimate question that must be asked with respect to each taxpayer owning a direct or indirect interest in PS is whether that taxpayer's distributive share of any of PS's 1990 expenses is a passive activity deduction and therefore is subject to potential disallowance under Section 469. Taking into account the Section 469 regulations promulgated to date, the answer to this question involves the following *preliminary* analytical steps:

* A deduction (other than a Section 469(b) carryover deduction) can be a passive activity deduction only if it "arises . . . in connection with the conduct of an activity that is a passive activity for the taxable year."\(^{76}\)

* The regulations identify "activities" for purposes of Section 469 solely by reference to previously identified "undertakings," which are themselves treated as single separate activities, aggregated into larger activities, or

\(^{76}\) Reg. § 1.469–2T(d)(1).
Basic economic operations conducted by a taxpayer (referred to in the regulations as "endeavors") therefore can be treated as part of an "activity" for purposes of Section 469 only to the extent that those endeavors constitute, or are part of, one or more "undertakings."

An undertaking consists only of "business and rental operations." Any endeavors that are not business and rental operations therefore cannot be part of an "undertaking," cannot be part of an "activity," and cannot be part of a "passive activity."

Accordingly, no taxpayer's distributive share of any of PS's 1990 expenses can be a passive activity deduction unless PS's 1990 endeavors constitute "business and rental operations."

Recall that, in 1990, PS's only endeavors consist of the acquisition and holding of Tract X, and that PS's only expenses incurred in connection with those endeavors are carrying costs (i.e., interest, taxes, and insurance). Recall also that the definition of "business and rental operations" is in two parts. PS's 1990 endeavors clearly satisfy the first part of that definition, since they are "engaged in for profit or the production of income."

It does not appear, however, that PS's 1990 endeavors satisfy the second part of the definition. First, those endeavors, i.e., the acquisition and holding of raw land, probably do not amount to the conduct of a Section 162 trade or business. Second, the endeavors do not involve "making tangible property available for use by customers." Third, the endeavors do not involve any research and experimental expenditures. Thus, PS's 1990 endeavors can be business and rental operations only if they "are conducted in anticipation of such endeavors becoming a trade or business."

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77 See generally Reg. § 1.469-4T(a)(4).
78 See Reg. § 1.469-4T(b)(2)(i)(A).
79 See Reg. § 1.469-4T(c)(1).
80 See Reg. § 1.469-4T(b)(2)(i)(A).
81 See Reg. § 1.469-4T(b)(2)(i)(A)(2).
During all of 1990, PS's expectation is that it will either (i) hold Tract X for appreciation and then sell it, or (ii) lease Tract X to a third-party developer, or (iii) develop Tract X itself. Since PS's first possible future and, perhaps, PS's second possible future as well, do not involve the conduct of a trade or business, it is difficult to see how PS can be treated in 1990 as holding Tract X in anticipation of conducting a trade or business.

Accordingly, PS should not be viewed as conducting business and rental operations in 1990, and no person's distributive share of PS's 1990 expenses should be treated as arising in connection with a passive activity.85


The analysis of PS's 1991 expenses proceeds along the same lines as the analysis of PS's 1990 expenses. The only difference between the 1990 facts and the 1991 facts is that, in 1991, PS's possible futures no longer include a sale of Tract X in an unimproved state. Thus, PS's possible futures are limited to (i) the leasing of Tract X to a third-party developer, and (ii) the actual development of Tract X. The second possible future presumably involves the conduct of a trade or business. The first possible future, however, may not. If PS is even considering the possibility of leasing Tract X to a developer under an arrangement that would not cause PS to be treated as engaged in a trade or business, PS should not be treated as holding Tract X "in anticipation of" conducting a trade or business and, therefore, should not be viewed as conducting business and rental operations in 1991. Thus, assuming the facts support the contention that PS ultimately may lease Tract X under such an arrangement, no taxpayer's distributive share of PS's 1991 expenses should be treated as arising in connection with a passive activity.

85 It is possible, of course, that PS's 1990 deduction for interest must be treated as investment interest subject to limitation under I.R.C. § 163(d), and that PS's 1990 deduction for insurance must be treated as a miscellaneous itemized deduction subject to limitation under I.R.C. § 67, in the case of one or more taxpayers owning interests in PS.

[a] Identification of Business and Rental Operations

As of the beginning of 1992, PS has decided to improve Tract X itself. Therefore, even if PS's 1992 endeavors (i.e., holding Tract X and preparing the site plan and applications) do not amount to the conduct of a trade or business, those endeavors probably are conducted in anticipation of such endeavors becoming a trade or business, within the meaning of the regulations, and therefore should be considered to be business and rental operations.\footnote{Suppose, as a digression, that PS had formed its development intent in the middle of 1992, rather than at the beginning of the year. Would PS's 1992 endeavors be treated as business and rental operations for only part of the year? If so, what consequences would ensue? The regulations do not provide explicit guidance on this issue. It appears, however, that the only endeavors that could be treated as business and rental operations for the year would be the endeavors conducted after the formation of the development intent. Thus, if PS's development intent were formed in the middle of 1992, it would be reasonable to take the position that PS's expenses incurred prior to the formation of that intent do not give rise to passive activity deductions. Obviously, the difficulty of establishing the date on which the requisite intent was formed would be considerable.}

This, of course, merely helps us across the threshold of our Section 469 inquiry, since the deductible expenses incurred by PS in 1992 in connection with PS's business and rental operations\footnote{It is assumed for purposes of this analysis that some or all of PS's 1992 expenses are not required to be capitalized.} are passive activity deductions of a taxpayer holding an interest in PS only if those operations are part of an activity that is a passive activity of that taxpayer. Thus, we must now identify the Section 469 activity (or activities) to which PS's 1992 expenses are attributable. Moreover, portions of that identification process must be performed separately for each taxpayer owning an interest in PS, since the "aggregation" rules in the regulations may require a taxpayer's interest in business and rental operations conducted by a partnership to be aggregated with other business and rental operations conducted by the taxpayer outside that partnership.

[b] Identification of PS's Undertakings

The first step in identifying the activity or activities to which
PS's deductible expenses are attributable is to identify PS's undertaking(s). It should be noted that an undertaking, as opposed to an activity, may be identified by examining the business and rental operations of a partnership without regard to the varying external circumstances of the partnership's partners. This is because, under one of the basic undertaking rules in the regulations, business and rental operations that are not directly owned by the same "person" are not treated as part of the same undertaking.\(^{88}\)

In general, each location in which a partnership conducts "income-producing operations" is treated as a separate undertaking.\(^{89}\) In this case, there are two locations at which PS arguably conducts income-producing operations. These are (i) the site of Tract X, and (ii) PS's office, in which the site plan is prepared.

The holding of Tract X, which occurs where Tract X is located, is an "income-producing operation" because it is "conducted in reasonable anticipation" of the production of property (namely, the development of Tract X). The preparation of the site plan also could be viewed as an income-producing operation, on the ground that it involves the actual production of property (namely, the plans).

If both the holding of Tract X and the preparation of the site plan are treated as income-producing operations, PS must be treated as conducting two undertakings, since a separate location at which income-producing operations are performed is always treated as the site of a separate undertaking.\(^{90}\) It is possible, however, that the preparation of the site plan does not constitute production of the type of "property" that the drafters of the regulations had in mind when they defined "income-producing operations." If it does not, then PS's rental of its office, and its operations conducted in the office (namely, the preparation of the site plan and applications) should be viewed as "support operations" (i.e., non-income-producing operations at a location that involves the provision of

\(^{88}\) Reg. § 1.469-4T(c)(2)(i)(A).

\(^{89}\) Reg. § 1.469-4T(c)(1) and (c)(2). The term "income-producing operations" is defined in Reg. § 1.469-4T(c)(2)(iv).

\(^{90}\) Reg. § 1.469-4T(c)(1) and (c)(2)(i)(A).
property or services to an undertaking at another location),\textsuperscript{91} and the expenses attributable to those operations should be taken into account as expenses attributable to any activity that includes the undertaking conducted by PS at the location of Tract X.\textsuperscript{92}

The author believes that the regulations may reasonably be interpreted to justify treating PS's operations at its office as either income-producing operations or support operations. For the remainder of this analysis, however, it will be assumed that the operations at the office are support operations, and that the holding of Tract X and the preparation of the site plan and applications therefore constitute a single undertaking in 1992.

The next step in the analysis involves identifying the activity or activities of which PS's undertaking is a part. That identification process must be performed separately for each taxpayer owning an interest in PS. In this case, all of MGP's partners are assumed to be similarly situated, and all of the LPs are assumed to be similarly situated. Therefore, separate analyses must be performed for (i) OGP, (ii) MGP's partners, and (iii) the LPs.

[c] \textit{Identification of OGP's Activities}

As we begin the process of identifying OGP's activity or activities that include PS's undertaking, the following four facts stand out:

- OGP owns interests in numerous operations in the real estate line of business (hereinafter referred to as OGP's outside "undertakings"), all of which OGP controls;
- OGP is designated the operating general partner of PS and supervises PS's day-to-day operations;
- PS's undertaking involves the holding of land and other operations, all of which are conducted in anticipation of real estate development; and
- OGP would be treated as materially participating, for 1992, in the activity that would result if PS's undertaking were aggregated with OGP's other real estate undertakings.

\textsuperscript{91} Reg. § 1.469–4T(c)(2)(ii)(B).
\textsuperscript{92} Reg. § 1.469–4T(c)(2)(ii)(A).
Since, in the case of a materially participating taxpayer, the regulations require the aggregation of commonly controlled undertakings in the same line of business, one might assume that OGP's interest in PS's undertaking must be included in the same activity as OGP's interests in OGP's other real estate undertakings. Such an assumption, however, would be incorrect. The aggregation rule in the regulations for similar, commonly controlled undertakings is constructed in a highly technical fashion, and, in this case, the technical requirements of the rule are not satisfied.

In general, the aggregation rule for similar, commonly controlled undertakings applies to two undertakings only if they are in the same line of business.\(^3\) For this purpose, an undertaking is considered to be in a line of business only if the undertaking has "predominant operations" in that line of business.\(^4\) An undertaking has predominant operations in a line of business only if more than 50 percent of the undertaking's gross income is attributable to operations in that line of business.\(^5\) If an undertaking generates no gross income, it cannot have predominant operations, cannot be in a line of business, and cannot be aggregated with any other undertaking under this aggregation rule. In this case, PS's undertaking (which consists of holding land and preparing documents) generates no gross income. Accordingly, it simply cannot be aggregated with other undertakings under the aggregation rule for similar, commonly controlled undertakings, notwithstanding our natural intuition to the contrary.

Is it possible, however, that the drafters of the regulations intended an undertaking to be treated as having predominant operations in a line of business for a taxable year, even if it generates no gross income for that taxable year, if more than 50 percent of the gross income to be generated by the undertaking in future taxable years is expected to be in that line of business? In considering this possibility, it may be noted that references to particular taxable years are conspicuously absent from the rules relating to undertakings.

\(^3\) Reg. § 1.469–4T(f)(4)(i). Two undertakings also may be treated as similar if they are "vertically integrated," under rules set forth in Reg. § 1.469–4T(f)(4)(iii). The complex vertical-integration rules are not relevant to this case study.

\(^4\) Id.

\(^5\) Reg. § 1.469–4T(f)(4)(ii).
ings that are similar because they have predominant operations in the same line of business. It is unlikely, however, that such an application of the rule, even if intended, could be applied with much success. In the instant case, for example, although PS's 1992 operations are real-estate related, how can the ultimate sources of PS's future gross income be predicted? With the benefit of hindsight, we know that PS's future gross income will be derived from rental operations, restaurant operations, hotel operations, casual sales of property, and dealer sales of property. As of the end of 1992, however, it is possible that any of those operations or income-generating transactions will not materialize. It is reasonable, therefore, to conclude that an undertaking can have predominant operations for a taxable year only if it generates gross income for that year.

Assume, however, that PS's undertaking is treated as having predominant operations in the real estate line of business. If this assumption is made, must OGP's interest in PS's undertaking be aggregated with OGP's other real estate undertakings under the aggregation rule for similar, commonly controlled undertakings? Not necessarily. This aggregation rule applies only if OGP is treated as "controlling" PS's undertaking.

96 Reg. § 1.469-4T(f)(4)(ii) provides that two undertakings are similar if there are predominant operations in each undertaking and the predominant operations of each undertaking are in the same line of business. This rule does not, by its terms, apply for any particular taxable year, and it does not require the predominant operations of an undertaking to be identified with respect to any particular taxable year. Reg. § 1.469-4T(f)(4)(ii) provides that an undertaking's predominant operations are identified by reference to the gross income of the undertaking. This rule, like the preceding rule, does not, by its terms, apply on a year-by-year basis, and it does not specify that an undertaking's gross income for any particular taxable year must be taken into account.

97 It is possible, of course, that the regulations will be amended in the future to require the identification of predominant operations in some other manner, so as to permit the aggregation of one undertaking with other undertakings prior to the first taxable year in which the former undertaking generates gross income. One obvious approach would be to substitute the term "expenditures" for the term "gross income". There is no indication, however, that the Treasury is currently considering such an amendment.

98 Note that, if PS's undertaking were treated as having predominant operations in the real estate line of business and OGP were treated as controlling PS's undertaking, that undertaking would be aggregated with OGP's other real estate undertakings for 1992 because OGP would be treated as materially participating
ment satisfied in this case? Unfortunately, although the regulations defining “control” appear to be expansively drafted, they provide no basis for concluding either (i) whether management power that is limited to supervision of day-to-day operations constitutes “control,” or (ii) whether OGP can be treated as controlling PS’s undertaking if MGP also is so treated.99 Under these circumstances, the regulations appear to justify taking either the position that OGP does control PS’s undertaking or the position that OGP does not control the undertaking.

Finally, if we assume that (i) OGP is treated as controlling PS’s undertaking, but (ii) PS’s undertaking is not aggregated with OGP’s other estate undertakings under the aggregation rule for similar, commonly controlled undertakings on the ground that PS’s undertaking does not have predominant operations in the real estate line of business, is aggregation nonetheless required on the theory that PS’s undertaking and OGP’s other real estate undertakings are part of a “single integrated business?”100 Again, the answer should be “no since PS’s undertaking is not conducted at the same location as OGP’s other undertakings, is not accounted for as a unit with such undertakings, is not directly owned by the same person as such undertakings, does not serve the same customers as such undertakings, is not conducted in coordination with such undertakings, etc.101

Based on the foregoing, OGP’s interest in PS’s undertaking is treated as a separate activity of OGP for purposes of Section 469.

for 1992 in the combined activity that would result from such aggregation. See Reg. § 1.469-4T(f)(2)(iii).

99 Moreover, the examples in the regulations fail to flesh out the facts-and-circumstances definition of “control”. The only example in which this definition is applied concludes that two partnerships owned by the same partners are commonly controlled on the basis of the following simplistic facts: “[T]he partnership agreements of both [partnerships] provide that no action may be taken or decision made on behalf of the partnership without the unanimous consent of the partners. Moreover, each partner actually participates in, and agrees to, all major decisions that affect the operations of either partnership.” Reg. § 1.469-4T(j)(3) Ex. (I).

100 See Reg. § 1.469-4T(g).

101 See Reg. § 1.469-4T(g)(3).
[d] Treatment of 1992 Deductions Allocated to OGP

The deductions allocated by PS to OGP in 1992 are subject to potential disallowance under Section 469 only if the activity conducted through PS constitutes a passive activity of OGP. The activity does not constitute a rental activity, since no tangible property held in connection with the activity is used by customers or held for use by customers. The activity, therefore, is a trade or business activity, and is a passive activity of OGP for 1992 if and only if OGP does not materially participate in the activity for 1992.

The facts set forth in § 4.03 are insufficient to enable us to determine whether OGP materially participates in PS’s activity for 1992, and, in any event, it is not the author’s purpose to discuss the degree and type of participation that would constitute material participation. Let us, however, make the alternative assumptions that OGP (i) materially participates in PS’s activity for 1992 and (ii) does not materially participate in PS’s activity for 1992. What is the impact of each assumption on the treatment of the 1992 deductions allocated to OGP by PS?

If OGP does not materially participate in PS’s activity for 1992, the activity is a passive activity of OGP for the year. Does it follow that all of the 1992 expenses allocated to OGP by PS are passive activity deductions? Not necessarily. It should be recalled at this point that we were able to conclude that PS’s activity is a passive activity without first concluding that PS is engaged in a trade or business in 1992 for purposes of Section 162.102 If, in fact, PS is not engaged in a trade or business in 1992, PS’s 1992 deductions other than those for interest and taxes probably are treated as miscellaneous itemized deductions.103 Any deductions that are so treated are specifically excluded from treatment as passive activity deductions and therefore are not subject to limitation under

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102 Note that, under I.R.C. § 469(c)(6)(B), the Treasury is empowered to treat an activity as a “trade or business activity” for purposes of I.R.C. § 469 even if expenses attributable to the activity are allowable as deductions under I.R.C. § 212. Reg. § 1.469-4T(b)(2)(ii), which defines the term “business and rental operations” to include endeavors that are engaged in for profit or the production of income and are conducted in anticipation of a trade or business (but are not part of an existing trade or business) appears to derive its authority from I.R.C. § 469(c)(6)(B).

103 See I.R.C. § 67.
Moreover, if OGP does materially participate in PS’s activity for 1992, it does not necessarily follow that the 1992 expenses allocated to OGP by PS are active business deductions. If, under the facts presented herein, PS is not engaged in a Section 162 trade or business in 1992, the following possible consequences must be considered: (i) OGP’s share of PS’s interest expense may be treated as investment interest subject to limitation under Section 163(d), (ii) OGP’s share of PS’s expenses other than interest may be treated as investment expenses under Section 163(d)(4)(C), and (iii) OGP’s share of PS’s expenses other than interest and taxes may be subject to limitation under Section 67.105

[e] Identification of MGP’s Partners’ Activities

The process of identifying the activity of MGP’s partners in which PS’s 1992 undertaking is included is identical to the process applied to OGP, and the conclusion reached is the same. Thus, PS’s undertaking is treated as a separate activity of each of MGP’s partners.

When we considered the application of aggregation rules to OGP, we concluded that the existence of “common control” was uncertain. The same conclusion must be reached with respect to MGP, although for slightly different reasons. Although MGP has the effective ability to make all major partnership decisions of PS, it is not clear whether major decision-making, or effective veto power, is sufficient to constitute the sort of control that the drafters

104 Reg. § 1.469–2T(d)(2)(vii). The author believes that this result is not intended by the drafters of the regulations. When Reg. § 1.469–2T(d)(2)(vii) was adopted in the first set of regulations, it probably had no effect whatsoever, since, under the first set of regulations, operations that were conducted in anticipation of a trade or business, but did not amount to the actual conduct of a trade or business, could not be treated as a passive activity. When the definition of “trade or business activity” was changed in the second set of regulations (see Reg. § 1.469–1T(e)(2)(ii), defining “trade or business activity” and Reg. § 1.469–4T(b)(2)(ii), defining “business and rental operations”), the drafters probably would have deleted Reg. § 1.469–2T(d)(2)(vii) as a conforming amendment if they had thought of it.

105 A discussion of these possibilities is beyond the scope of this article.
of the regulations had in mind. Thus, as in OGP's case, the author believes that the regulations may be read to justify taking either the position that MGP does control PS's undertaking or the position that GP does not control the undertaking.

It may be noted that, if PS's undertaking were considered to have predominant operations in the real estate line of business and MGP is viewed as controlling PS's undertaking, PS's undertaking would be treated as part of the same activity of MGP's partners as MGP's other real estate undertakings for either of two of the "taxpayer-specific" reasons described in § 4.02[3][b]. First, each of MGP's partners would be treated as materially participating in the resulting activity. Second, all of the undertakings, including PS's undertaking, are held through MGP.

[f] Treatment of 1992 Deductions Allocated to MGP's Partners

As in OGP's case, the deductions allocated by PS to MGP's partners in 1992 (other than miscellaneous itemized deductions) are subject to potential disallowance under Section 469 if the activity conducted through PS constitutes a passive activity of those partners. Unlike OGP, however, MGP's partners clearly do not materially participate for 1992 in the trade or business activity conducted through PS. Accordingly, that activity is a passive activity of MGP's partners, and the deductions allocated to them by PS in 1992 (other than miscellaneous itemized deductions)

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106 Presumably, MGP may be viewed as having more "control" than OGP because MGP is able to prevent OGP from taking actions that OGP might like to take, while OGP does not have a similar power over MGP. Such a conclusion would suggest that power that is more final but seldom exercised is more "controlling" than power that is less final but frequently exercised. Of course, if that principle were taken to its logical conclusion, one might conclude that only the LPs have ultimate control of PS, since the LPs probably have the power to remove the general partners. It is doubtful, however, that the drafters of the regulations intended the control test to be interpreted in such a manner that control could always be vested in limited partners by giving them broad removal powers in the partnership agreement.

107 See Reg. § 1.469-4T(f)(2)(ii).

108 See Reg. §§ 1.469-4T(f)(2)(i) and (f)(5) Ex. (4), which provide that a taxpayer's interests in commonly controlled undertakings that are in the same line of business also are treated as part of the same activity if the taxpayer's interests in both undertakings are held through the same partnership.

109 See Ns. 102—104 and accompanying text.
must be reported as passive activity deductions. Note that this conclusion holds even if it is determined that the 1992 deductions allocated to OGP must be reported as investment interest and other non-business deductions. As explained above, the apparent inconsistency is attributable to the fact that, under the Section 469 regulations, expenses that are incurred “in anticipation” of a trade or business may be treated as expenses arising in connection with a passive activity even if they are not trade or business expenses deductible under Section 162.\(^{110}\)

[g] Identification of the LPs' Activities

The LPs do not own interests in any real estate operations that are controlled by the persons that control PS's undertaking. Therefore, PS's undertaking is a separate activity of each of the LPs.

[h] Treatment of 1992 Deductions Allocated to the LPs

Since none of the LPs does any work in connection with the activity conducted through PS, the activity is a passive activity of each of the LPs, and all of the deductions allocated to them by PS in 1992 (other than miscellaneous itemized deductions\(^{111}\)) are passive activity deductions.

[4] 1993—A Year Without Income or Deductions

PS realizes no gross income and incurs no deductible expenses in 1993. Yet, as will be seen below in § 4.05[7][d][iii], it is still necessary to identify the 1993 activities that include PS's 1993 operations, because the nature of those 1993 activities may have a significant effect on the treatment of income realized in subsequent years.

[a] Identification of PS's Undertakings

PS's business and rental operations in 1993 are different from PS's business and rental operations in 1992. In 1992, PS merely held land and prepared plans and applications, while, in 1993, PS is engaged in the physical construction of buildings and other land

\(^{110}\) See I.R.C. § 469(c)(6) and Reg. § 1.469-4T(b)(2)(ii)(A)(1).

\(^{111}\) See Nr. 102—104 and accompanying text.
improvements. Nonetheless, the partnership-level characterization of PS's undertaking is the same in 1993 as in 1992. Notwithstanding the radical differences in operations, PS is still conducting business and rental operations in a single location, and income-producing operations are still conducted at that location.\textsuperscript{112} Therefore, in 1993, PS continues to be treated as conducting a single undertaking. Moreover, since that undertaking does not involve making property available for use by customers, or holding property for such use, the undertaking is a trade or business undertaking, just as in 1992.\textsuperscript{113}

[b] Identification of Activities

Application of the activity-identification rules also yields the same results in 1993 as in 1992. Since PS's undertaking generates no gross income in 1993, it cannot be treated as part of the same activity as any other undertaking under the aggregation rule for similar, commonly controlled undertakings.\textsuperscript{114} Moreover, for the reasons set forth in § 4.05[3][c], the facts and circumstances do not suggest that PS's undertaking, and any other undertaking, are part of a "single integrated business."\textsuperscript{115} Therefore, the aggregation rule for integrated businesses also does not apply.

Accordingly, PS's 1993 undertaking, consisting of operations relating to the construction of buildings and land improvements, is treated as a separate activity for purposes of applying Section 469 to OGP, to the partners of MGP, and to the LPs.

\textsuperscript{112} In 1992, PS's "income-producing operations" were PS's operations that were conducted "in anticipation of" the production of property. In 1993, of course, PS's "income-producing operations" are the actual production of property. In this regard, it is clear that the drafters of the regulations intended the term "production" to encompass such terms as "manufacture", "building", "installation", and "construction", notwithstanding the specific use of such terms in other provisions of the tax laws, such as I.R.C. § 469(f). See Reg. § 1.469–4T(c)(4) Ex. (b)(ii), which states that the construction of a building constitutes the "production of property" within the meaning of Reg. § 1.469–4T(c)(2)(iv).

\textsuperscript{113} See Reg. § 1.469–4T(d), which provides rules for the identification of rental undertakings.

\textsuperscript{114} See Reg. § 1.469–4T(f).

\textsuperscript{115} See Reg. § 1.469–4T(g).

[a] Identification of PS's Undertakings

In 1994, as in each preceding year, PS's operations must be reexamined, and PS's undertaking(s) must be identified from scratch. This re-identification process produced no changes when it was performed for 1993. In 1994, however, the number and character of PS's undertaking(s) are not the same as in the two preceding years.

In 1994, it will be recalled, PS owns and operates six separate fully-constructed buildings, consisting of two rental office buildings (each containing a small restaurant operated by PS), two rental apartment buildings, a hotel operated by PS, and a retail store rented to a third party. All of PS's 1994 operations are “business and rental operations,” and all of those operations are “income-producing operations.” The first step in identifying PS's 1994 undertaking(s) is to identify the location(s) at which PS conducts its income-producing operations.

The regulations state that 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."116 PS's operations obviously are not conducted in the same physical structure, but are conducted in six separate structures. Thus, all of PS's operations that are conducted in any single building are conducted at the same location, and operations that are conducted in separate buildings are conducted at the same location if and only if the separate buildings are considered to be in "close proximity."

The regulations do not provide detailed guidance on what constitutes "close proximity." However, one example in the regulations concludes that two stores located in separate structures in the same shopping mall are in close proximity,117 while another example concludes that two stores that are "several blocks" apart are not in close proximity.118 On the basis of these examples, one would probably be justified in concluding that all of PS's buildings are in close proximity. (Note that the buildings are described above

116 Reg. § 1.469-4T(c)(2)(iii)(B).
117 Reg. § 1.469-4T(c)(4) Ex. (2).
118 Reg. § 1.469-4T(c)(4) Ex. (3).
as constituting a "cluster.") Of course, if the space between two buildings in a single development is sufficient, a contrary position also might be appropriate as to those buildings. For purposes of the remainder of this case study, it will be assumed that all of PS's buildings are treated as part of a single location.

Under the basic single-location undertaking rule, therefore, all of PS's operations in all six buildings are treated as part of a single undertaking. As noted above, an undertaking is only tentatively identified under the single-location rule, and is referred to as a "paragraph (c) undertaking."

The second step in the process of identifying PS's undertaking(s) is to apply the special rules for determining whether a paragraph (c) undertaking includes (or is) a rental undertaking.119 Under these rules, unless the "80–20" de minimis rule applies, any "rental operations" conducted by PS at its location generally must be treated as a rental undertaking that is separate from the undertaking consisting of PS's nonrental operations.

In this case, PS does conduct rental operations at its single location. The rental operations consist of (i) the rental of the office space in Office Buildings A and B, (ii) the rental of apartments in Apartment Buildings C and D, and (iii) the rental of the retail store.120 The 80–20 rule applies only if either the rental operations or the nonrental operations account for less than 20 percent of the aggregate gross income of the paragraph (c) undertaking at the location.121 Since, in this case, PS derives 70 percent of its 1994 gross income from its rental operations, and 30 percent of its 1994 gross income from its nonrental operations, the 80–20 rule does not apply for 1994. Accordingly, since the rental operations at PS's location (including the office, apartment, and retail store rentals),

119 See Reg. § 1.469–4T(d).
120 The term "rental operations" generally encompasses all operations that involve "making tangible property available for use by customers and the provision of property and services in connection therewith." Reg. § 1.469–4T(d)(3)(i). It is assumed, however, that PS's rental of rooms in the hotel is not treated as part of PS's "rental operations" because the rental of hotel rooms falls within an exception for "real property provided for short-term use." See Reg. § 1.469–4T(d)(3)(ii). Operation of the restaurants also is excepted from PS's "rental operations" virtue of an exception for "property made available to licensees." See Reg. § 1.469–4T(d)(3)(iii).
121 Reg. §§ 1.469–4T(d)(2)(ii) and (d)(2)(iii).
if considered as a separate activity, would constitute a rental activity, those operations are carved out from the paragraph (c) undertaking and treated as a separate rental undertaking.122 The nonrental operations at the location (including the restaurant operations in the office buildings and the hotel operations in the separate hotel building) are treated as a single trade or business undertaking.

Thus, after application of the special rules for rental operations, PS is treated as conducting two undertakings at its location—a rental undertaking and a trade or business undertaking.123

The final step in identifying PS’s undertakings is the elective division of PS’s rental undertaking into multiple undertakings. Since PS’s rental undertaking is a rental real estate undertaking, PS may elect to treat any portion of the leased property used in that undertaking as a separate undertaking, as long as that portion of the leased property "can be separately conveyed under applicable State and local law."124

It is assumed, for purposes of the remainder of this case study, that PS elects for 1994 to treat its rental operations as consisting of the greatest possible number of rental real estate undertakings, hence as consisting of the greatest possible number of separate activities,125 since such an election will maximize the ability of

122 Reg. § 1.469–4T(d)(1)(iii).
123 It may be noted that the results would be quite different if we had concluded that each of PS’s six buildings is a separate "location." If that were the case, the 80–20 rule would be applied on a building-by-building basis. If we assume that, as to each office building, the 1994 gross income from the restaurant operations conducted in the building constitutes less than 20 percent of the combined gross income for 1994 from all of the operations conducted in the building, the rental operations and restaurant operations in that building would not be treated as separate undertakings in 1994, and the single undertaking conducted in the building would be a rental undertaking in 1994. Moreover, the retail store and each apartment building would constitute a separate rental undertaking, and the hotel would constitute a separate trade or business undertaking.
124 Reg. § 1.469–4T(k)(2)(iii).
125 Reg. § 1.469–4T(b)(1) provides that, except as otherwise provided in the regulations, a separate undertaking is treated as a separate activity. Once an effective election to divide a rental real estate undertaking into multiple undertakings is made under Reg. § 1.469–4T(k)(2)(iii), no provision in the regulations prevents the treatment of each of those multiple undertakings as a
PS's owners to deduct suspended losses in the event of a disposition by PS of a portion of its rental operations. Presumably, this means that the two individual apartment buildings, the rental portion of each of the two office buildings, and the retail store all are treated as separate activities.¹²⁶

[b] Identification of Activities

The aggregation rule for similar, commonly controlled undertakings will not cause a taxpayer's interest in PS's trade or business undertaking to be treated in 1994 as part of the same activity as another undertaking in which that taxpayer owns an interest unless (i) in 1994, PS's trade or business undertaking has "predominant operations" that are in the same line of business as the predominant operations of the other undertaking, and (ii) the two undertakings are commonly controlled. In this case, the predominant operations in PS's trade or business undertaking are in either the "hotels and other lodging places" line of business¹²⁷ or the "eating and drinking places" line of business.¹²⁸ Assuming that neither OGP, nor any of MGP's partners, nor any of the LPs, owns an interest in a separate activity. It should be noted that each individual taxpayer owning a direct or indirect interest in a rental real estate undertaking must make a separate election to divide that undertaking under Reg. § 1.469–4T(k)(2)(iii). That election may be made with respect to an undertaking, however, only if each pass-through entity through which the individual owns his or her interest in the undertaking also makes the election to divide the undertaking. Reg. § 1.469–4T(k)(2)(iii)(B). Each person making an election to divide an undertaking (including the individual taxpayer and the pass-through entity (or entities) through which the pre-division undertaking is held) must document the election by showing the multiple undertakings on a schedule attached to that person's tax return.

¹²⁶ Some Treasury and IRS attorneys have expressed the view that individual apartment units in an apartment building cannot be treated as separate undertakings prior to the time the owner of the building has complied with any procedures established by local law as a condition of conveying apartment units separately. The regulations are not entirely inconsistent with this view, but also may be interpreted to mean that a portion of leased property that could be conveyed separately if the owner complied with such procedures may be treated as a separate undertaking. See Reg. § 1.469–4T(k)(2)(iii)(A). In any event, as explained in § 4.02[3][c], the author believes that an election to treat each apartment unit may be made once separate conveyance becomes permissible.


commonly controlled undertaking in either of these lines of business, PS's trade or business undertaking is not aggregated with other undertakings of any of those taxpayers under the aggregation rule for similar, commonly controlled undertakings, and is treated as a separate activity of each of those taxpayers, subject only to the aggregation rule for integrated businesses.

It does not appear that PS's trade or business activity and any other activity in which any of these taxpayers owns an interest should be treated as part of a single integrated business. Accordingly, PS's trade or business undertaking is treated as a single, separate activity of each taxpayer owning an interest in PS.

c) Treatment of PS's 1994 Losses

PS's rental activities are passive activities of every taxpayer owning an interest in PS. Accordingly, the 1994 gross income and expenses attributable to PS's rental activities constitute passive activity gross income and passive activity deductions of each such taxpayer.

PS's trade or business activity is a passive activity of any taxpayer who owns an interest in PS and does not materially participate in the activity. OGP materially participates in PS's trade or business activity in 1994, but the LPs and the partners of MGP do not. Therefore, the 1994 gross income and expenses attributable to PS's trade or business activity constitute passive activity gross income and passive activity deductions of the LPs and MGP's partners, but are active business income and deductions of OGP.129

It should be noted that certain of the 1992 deductions allocated by PS to the LPs and to MGP's partners were treated as passive activity deductions. To the extent those deductions were not allowed (because those taxpayers did not have passive income from

129 It may be noted that, if (i) each building owned by PS were treated as a separate location, and (ii) the gross income from the restaurant operations in either of the two office buildings constituted less than 20 percent of the gross income from all operations conducted in that building, OGP's share of the gross income and deductions attributable to the restaurant operations in that building would be treated as passive activity gross income and deductions since, in that event, those operations would be treated under the 80–20 rule as part of the rental activity conducted in the building. See Reg. § 1.469–4T(d).
other sources in 1992 or 1993), the deductions remain in suspense, have been carried forward to 1994 under Section 469(b), and must now be allocated among the 1994 activities. The regulations state that, in such a situation, the suspended deductions must be allocated among the new activities in a manner that "reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the [old] activity."\(^\text{130}\) Although the regulations provide no helpful guidance on what would be considered reasonable, in this case it probably would be reasonable to allocate the suspended deductions, which are attributable to the costs of carrying Tract X in anticipation of development, among PS's 1994 activities in proportion to the amount of land used in each such activity.\(^\text{131}\)

[6] Introduction to Analysis of Dispositions

Once an activity of a taxpayer has been identified, and it has been determined that the activity is a passive activity of that taxpayer for a taxable year, it is usually safe to assume that all items of gross income and deduction arising from the operation of the activity during the year will be treated as passive activity gross income and deductions. This assumption is much less safe when gain or loss is realized from a disposition of property used in the activity. In such a case, a number of quite complicated rules relating to dispositions must be considered. All of those rules but one address only the characterization of the gain or loss realized on the disposition. The exception is the self-developed property rule; when that rule applies, operating income or loss from the property for the year of disposition, as well as gain (if any) from the disposition, also must be taken into account.

The following sections will methodically analyze all of the rules that must be taken into account in characterizing items of income and deduction from an activity for a taxable year in which gain or loss is realized from a disposition of property used in the activity. The analysis will follow a sequence of steps that the author believes

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\(^{130}\) Reg. § 1.469–1T(f)(4)(i)(A).

\(^{131}\) The examples in Reg. § 1.469–1T(f)(4)(iii) purport to provide guidance on this issue, but the examples assume as given facts the results of the most difficult determination, namely, the determination of the amounts of gross income and deductions from an activity that are attributable to its constituent operations.
is most appropriate in light of the logic of the regulations. This sequence is generally as follows, although not every step will apply to every case:

- Identify activities.
- Determine the treatment of operations without regard to dispositions of property.
- Apply rules for allocating gain or loss among activities.
  - Special rules for dealer sales.
  - Time-of-disposition rule and twelve-month rule.
- Apply rules for characterizing gain or loss from disposition.
  - Year-of-disposition rule.
  - Former nonpassive property rule.
  - Self-developed property rule.
- Consider possible allowance of losses upon taxable disposition of entire interest in activity.
- Consider treatment of items from former passive activities.


[a] Identification of Activities in Which Operations in Office Building B Are Included

In 1995, as in 1994, PS conducts (i) a single trade or business undertaking (consisting of the operation of a hotel and two restaurants) and (ii) five rental undertakings (consisting of the rental operations in Office Building A, Office Building B, Apartment Building C, Apartment Building D, and the retail

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132 In § 4.05[9][c][i], we will consider the possible effects of the fact that PS's trade or business undertaking in 1995 also includes "business and rental operations" that involve holding Office Building A for sale to customers. For purposes of the analysis of Office Building B, however, those possible effects will be ignored.
store).\textsuperscript{133} It is assumed that, as in 1994, no taxpayer owning an interest in PS's trade or business undertaking also owns an interest in another, commonly controlled undertaking with predominant operations in the restaurant line of business or the hotel line of business. It is also assumed that, as in 1994, PS and every person owning a direct or indirect interest in PS (i.e., each of OGP, MGP, MGP's partners, and the LPs) make appropriate elections to treat each separately conveyable leased property of PS (i.e., each building) as a separate undertaking.

On the basis of the foregoing assumptions, the operations conducted in Office Building B include (i) a separate rental activity consisting of the rental of the office space in the building, and (ii) restaurant operations that are part of a trade or business activity that includes the operation of the hotel and the restaurant operations in Office Building A.

[b] Treatment of Operations Without Regard to Gain From Sale

The rental activity conducted in Office Building B is a passive activity of every taxpayer owning an interest in PS, without regard to their respective levels of participation in the activity. Thus, each such taxpayer's gross income and deductions from the operation of that activity are passive activity gross income and deductions.\textsuperscript{134}

OGP materially participates in PS's trade or business activity for

\textsuperscript{133} It should be emphasized that the conclusions regarding PS's 1995 undertakings should not properly be assumed without a good deal of additional analysis. In particular, since all of PS's operations constitute a single "paragraph (c) undertaking" at the Tract X location, consideration should be given to the possibility that the "80-20" rule of Reg. § 1.469-4T(d)(2) may (i) cause PS's rental operations to be treated as part of a trade or business undertaking at the location or (ii) cause PS's nonrental operations to be treated as part of a rental undertaking at the location. In this regard, it may be noted that the regulations do not provide guidance on the extent to which gain from the sale of rental property is treated as "income attributable to rental operations," or whether the fact that a rental property is sold in a dealer sale has any bearing on this treatment. This issue is simply disregarded here, and is addressed in detail in § 4.05[11][a] (in connection with the treatment of PS's 1997 sale of condominium units in Apartment Building C).

\textsuperscript{134} It should be noted that the special $25,000 exemption for losses from active participation rental real estate activities (see I.R.C. § 469(i)) cannot apply in this case, because each taxpayer owning an interest in PS owns less than a 10 percent interest in the activity of renting Office Building B. See I.R.C. § 469(i)(6)(A).
1995. Accordingly, that activity is not a passive activity of OGP, and OGP’s gross income and deductions from the operation of the restaurant in Office Building B are nonpassive items.

Neither the LPs nor the partners of MGP materially participate for 1995 in PS’s trade or business activity, however. Thus, that activity is a passive activity of those taxpayers, and their gross income and deductions from the operation of the restaurant in Office Building B are passive activity gross income and deductions.

[c] Allocation of Gain Among Activities

When gain or loss is recognized from the disposition of an item of property, the time-of-disposition rule and the twelve-month rule must be applied (taking into account the special rules for dealer sales) to determine the amount of such gain or loss that is allocable to each activity in which the property was used around the time of the disposition. Once the gain or loss is allocated under those rules, a second set of rules is applied to determine whether the allocated amounts are passive or nonpassive.

[i] Special Rules for Dealer Sales\(^{135}\)

It is necessary to consider the special rules for dealer sales before considering the time-of-disposition rule and the twelve-month rule, because the effect of the dealer rule, when it applies, is to deem the property to be used in a certain manner for purposes of applying the latter rules. The dealer rule, however, applies only in the case of property that is “held in a dealing activity” at the time it is sold.\(^{136}\) Since Office Building B was never marketed to customers, it is assumed that Office Building B was not “held in a dealing activity” at the time it was sold,\(^{137}\) and that the dealer rule therefore does not apply.

\(^{135}\) The special rules for dealer sales are set forth in Reg. § 1.469–2T(c)(2)(v), and are summarized in § 4.02[4][b][iii], supra.

\(^{136}\) Reg. § 1.469–2T(c)(2)(v)(B).

\(^{137}\) Although the regulations do not explain how to determine whether property is “held in” a dealing activity, the author believes it is reasonable to assume that property is not so held unless it is held for sale to customers in the ordinary course of the taxpayer’s trade or business. Consistently with this view, an example in the regulations appears to equate “the marketing of the property” with holding the property in a dealing activity. Reg. § 1.469–2T(c)(2)(v)(C) Ex. (I)(ii).
[ii] Time-of-Disposition Rule and Twelve-Month Rule

The time-of-disposition rule and the twelve-month rule must be applied separately to the office space and the restaurant space in Office Building B because, at some time prior to the disposition of the building (for all of 1994 and the first two months of 1995, in fact), the two portions of the building were used in separate activities.\textsuperscript{138} Note that gain attributable to the underlying land sold in connection with Office Building B also must be allocated among PS’s activities under the time-of-disposition rule and the twelve-month rule. Since, during the period that the two portions of the building were used in separate activities, the land was used in both activities simultaneously, these rules must be applied to the land separately.\textsuperscript{139}

At the time of the disposition of Office Building B, the office space in the building is used in the rental activity consisting of the rental of that space. Moreover, the office space was used solely in that activity for the entire twelve-month period immediately preceding the disposition. Therefore, under the time-of-disposition rule and the twelve-month rule, all of the gain attributable to the office space is allocated to the rental activity.

The analysis of the gain attributable to the restaurant space is identical. At the time of the disposition of the building, and at all times during the preceding twelve-month period, that space was used solely in PS’s trade or business activity (i.e., the activity consisting of PS’s restaurant and hotel operations). Therefore, all of the gain attributable to the restaurant space is allocated to the trade or business activity.

\textsuperscript{138} Reg. § 1.469–2T(c)(2)(i)(C)(J).

\textsuperscript{139} At this point, some readers may find some additional detail useful. The time-of-disposition rule and the twelve-month rule apply separately to each “interest in property” disposed of by the taxpayer. The regulations define a separate “interest in property” as “any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity.” Reg. § 1.469–2T(c)(2)(i)(C)(I). In this case, (i) the rental portion of Office Building 5 was used in the rental activity at a time when the restaurant space was not so used, (ii) the restaurant space was used in the trade or business activity at a time when the office space was not so used, and (iii) the underlying land was used in both activities simultaneously at a time when all parts of the building were not used in both activities simultaneously.
The land, however, was used in both the rental activity and the trade or business activity at the time of disposition and for the entire preceding twelve-month period. Therefore, under the twelve-month rule, the gain attributable to the land must be allocated between the two activities in a manner that "reasonably reflects the use of the [land]" in the activities.140 Presumably, an allocation based on the square footage of the building space used in each of the two activities should be reasonable. Other allocation methods also might be reasonable.

[d] Characterization of Allocated Gain

Once an amount of gain or loss is allocated to an activity, it must be tested under a series of rules to determine whether it constitutes passive activity gross income. The year-of-disposition rule is the basic characterization rule and applies in every instance. In some cases, however, gain (but not loss) that is characterized as passive under the year-of-disposition rule may be recharacterized as nonpassive under the former nonpassive property rule or the self-developed property rule. Not surprisingly, the regulations contain no rules that work in the opposite direction. Thus, gain that is characterized as nonpassive under the year-of-disposition rule must always be treated as such on the taxpayer's return.

[i] Year-of-Disposition Rule

The year-of-disposition rule provides that gain that is recognized by a taxpayer for a taxable year and is allocated to an activity is treated as passive if and only if the activity is a passive activity of the taxpayer for the taxable year in which the disposition occurred.141

Since the activity of renting the office space in Office Building B is a passive activity of every taxpayer owning an interest in PS, each such taxpayer's share of the gain attributable to the office space (and the gain from the land that is allocable to the rental activity)

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140 Reg. § 1.469–2T(c)(2)(ii). The regulations literally provide that the amount realized and adjusted basis must be separately allocated. In this case, however, there is no reason to allocate the two items differently. Since both items are allocated in the same proportion, it is simpler to allocate the net gain.

141 Reg. § 1.469–2T(c)(2)(i)(A).
is treated, under the year-of-disposition rule, as passive activity gross income.

As indicated above, OGP materially participates in PS's trade or business activity for 1995. Accordingly, that activity is not a passive activity of OGP in 1995, and OGP's share of the gain from the disposition of the restaurant space in Office Building B (and the gain from the land that is allocable to PS's trade or business activity) is nonpassive gain.

Neither the LPs nor MGP's partners materially participate for 1995 in PS's trade or business activity, however. Thus, that activity is a passive activity of those taxpayers in 1995, and each such taxpayer's share of the gain from the disposition of the restaurant space in Office Building B (and the gain from the land that is allocable to the trade or business activity) is treated, under the year-of-disposition rule, as passive activity gross income.

[ii] Former Nonpassive Property Rule

Under the former nonpassive property rule, gain from the sale of an item of property may be treated as nonpassive even though the gain is tentatively treated as passive under the year-of-disposition rule. The former nonpassive property rule potentially applies to gain from the disposition of an item of property if (i) the property is "substantially appreciated" at the time of its disposition, and (ii) the property was formerly used by the taxpayer in one or more nonpassive activities (including investment "activities"). For purposes of this case study, we will assume that the office space and the restaurant space in Office Building B are "substantially appreciated" when the building is sold. Therefore, if the property at issue here was formerly used in one or more nonpassive activities, we must consider the details of the former nonpassive property rule.

Like the year-of-disposition rule, the former nonpassive property rule must be applied separately to (i) the office space in Office Building B, (ii) the restaurant space in the building, and (iii) the

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142 For this purpose, property is treated as "substantially appreciated" if its fair market value exceeds its adjusted basis by more than 20 percent. Note that property may be treated as substantially appreciated even if it was not appreciated at all when it was last used in a nonpassive activity.
land underlying the building. Starting with the office space and the restaurant space, was either of these portions of Office Building B formerly used in a nonpassive activity? As to the LPs and MGP's partners, the answer to this question is "no," since none of those individuals materially participated for any year in a business activity in which Office Building B was used or constructed. As to OGP, however, the answer is not entirely clear. Even if we assume that OGP materially participated in the 1993 trade or business activity that involved the construction of the building, should property under construction be considered to be "property used" in the construction activity? There is no obviously correct technical answer. The policy behind the former nonpassive property rule, however, suggests that such property should be treated as used in the construction activity. For purposes of the remainder of this analysis, therefore, it will be assumed that the answer is "yes," that the building was formerly used in a nonpassive activity of OGP, and that the building must be tested under the quantitative tests for avoiding the former nonpassive property rule for purposes of characterizing OGP's gain.

The analysis of the underlying land is more straightforward. We have concluded that in 1990 and, probably, in 1991, the holding of

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143 Reg. § 1.469–2T(c)(2)(i)(C)(l).

144 It should be emphasized at this point that the former nonpassive property rule applies only in the case of gain that would be passive without regard to the rule. Since we have already concluded, on the basis of the year-of-disposition rule, that OGP's share of the gain from the restaurant space in Office Building B (and OGP's share of the gain from the land that is allocable to the trade or business activity) is nonpassive, we are now considering only (i) the gain attributable to the office space (and allocable gain from the land), and (ii) the LPs' and MGP's partners' shares of the gain attributable to the restaurant space (and allocable gain from the land).

145 Interestingly, the former nonpassive property rule does not apply to substantially appreciated property that was formerly used in trade or business activities in which the taxpayer significantly participated but did not materially participate. This omission is probably due to an oversight on the part of the drafters of the regulations. There is no indication, however, that the rule will be expanded to apply to such property.

146 The policy behind the former nonpassive property rule is to prevent unrealized property appreciation that is attributable to a nonpassive activity from being treated as passive gain because the gain is realized at a time when the property is used in a passive activity. See T.D. 8175 (Preamble, "Significant Policy Issues," § VII.C.).
Tract X did not constitute "business and rental operations," and therefore was not part of a passive activity. Thus, the underlying land was formerly used in a nonpassive activity of every taxpayer owning an interest in PS and must be tested under the quantitative tests for avoiding the former nonpassive property rule for purposes of characterizing every such taxpayer's gain.

There are two such quantitative tests. Under one test, the former nonpassive property rule does not apply to a taxpayer's gain from an item of property if the property was used in "a passive activity" for the entire 24-month period ending on the date of the disposition.\(^{147}\) That test is satisfied with respect to the LPs and MGP's partners, since, as to those partners, the construction activity in which the land was "used" by PS in 1993, as well as the rental and trade or business activities in which the land was used from January 1, 1994, through March 1, 1995, were passive activities. The former nonpassive property rule therefore does not apply to the LPs or to MGP's partners. This quantitative test is not satisfied with respect to OGP (as to either the building or the underlying land), however, since the construction activity in which the land and Office Building B were "used" from March 1, 1993, through December 31, 1993, was not a passive activity of OGP.

Under the other test, the former nonpassive property rule does not apply to a taxpayer's gain from an item of property if the property was used in one or more nonpassive activities for at least 20 percent of the taxpayer's holding period for the property.\(^{148}\) That test is satisfied with respect to OGP's interest in the land because (i) the land was held by PS for 62 months (January 1, 1990, through March 1, 1995), and (ii) it was used only in passive activities for 14 months (January 1, 1994, to March 1, 1995).\(^{149}\) That test is also satisfied with respect to OGP's interest in the office space in the building because (i) that property was held by PS for no

\(^{147}\) Reg. § 1.469-2T(c)(2)(iii)(A)(2). The author believes that the phrase "a passive activity" is intended to mean "one or more passive activities."

\(^{148}\) Reg. § 1.469-2T(c)(2)(iii)(A)(1).

\(^{149}\) It should be remembered that, in OGP's case, we are concerned only with the portion of the gain from the land that is allocable to the office rental activity. This is so because OGP's share of the gain from the land that is allocable to the trade or business activity is treated as nonpassive without regard to the former nonpassive property rule.
more than 26 months (January 1, 1993 (the beginning of construction), through March 1, 1995), and (ii) like the land, the office space was used exclusively in passive activities for 14 months (January 1, 1994, through March 1, 1995).

Accordingly, the former nonpassive property rule does not apply to any gain from the disposition of Office Building B.

[iii] Self-Developed Property Rule

The self-developed property rule potentially applies to any taxpayer owning an interest in PS who materially or significantly participated in any activity that involved services performed for the purpose of enhancing the value of Office Building B, unless the self-developed “taint” was removed from office Building B through the building’s use in a rental activity for at least twelve months. For this purpose, property is not treated as used in a rental activity until the value-enhancement services performed in the taxpayer’s activity (including lease-up) are complete. In this case, since Office Building B was not fully leased until November 1, 1994, and it was sold on March 1, 1995, the building was not leased for a long enough period to cleanse it of any self-developed taint.

OGP materially participated in PS’s trade or business activity that involved the development and construction of Office Building B. Therefore, the self-developed property rule applies to OGP, and an amount of OGP’s gross income from the rental activity in which Office Building B is used in 1995, equal to OGP’s share of the “net rental activity income” from Office Building B for 1995 (i.e., (i) the gain from the sale of the office space (and allocable gain from the underlying land), minus (ii) the loss from rental operations for the year), is treated as nonpassive.

Note that, if PS derives net income or gain in 1995 from the operation of the restaurant in Office Building B (taking into account gain from the sale of the restaurant space, and the allocable gain from the land), that income or gain is not subject to recharacterization under the self-developed property rule, because that income and gain is not taken into account in computing the “net rental activity income” from the building.150

150 See Reg. § 1.469-2T(f)(9)(iii) and (f)(9)(iv), which define “gross rental activity income” and “net rental activity income”, respectively.
The LPs and MGP’s partners did not materially participate or significantly participate for any year in any activity involving the enhancement of the value of Office Building B. Therefore, the self-developed property rule does not apply to those taxpayers.

[iv] **Conclusions Regarding Treatment of Gain**

- The gain from the sale of Office Building B is divided into three separately analyzed components: (i) the gain attributable to the office space, (ii) the gain attributable to the restaurant space, and (iii) the gain attributable to the underlying land.

- All of the office-space gain is treated as gain from the activity of renting the space. All of the restaurant-space gain is treated as gain from PS’s trade or business activity. The gain attributable to the land is allocated between the two activities, possibly on the basis of the respective square footages of the office and restaurant space in Office Building B.

- OGP’s gain from the restaurant space (and an allocable portion of the gain from the land) is treated as nonpassive under the year-of-disposition rule, because OGP materially participates in PS’s trade or business activity for 1995.

- The gain from the office space (and an allocable portion of the gain from the land), as well as the gain from the restaurant space (and an allocable portion of the gain from the land) that is allocated to the LPs and to MGP’s partners, is treated as passive under the year-of-disposition rule, because the activity of renting the office space is a 1995 passive activity of all of the partners, and PS’s trade or business activity is a 1995 passive activity of the LPs and MGP’s partners.

- The self-developed property rule applies to OGP’s “net rental activity income” from the 1995 activity of renting the office space in Office Building B. Thus, any net income derived by OGP from that activity (taking into account the gain from the sale that is attributable to the office space and an allocable portion of the gain from the land) is treated as nonpassive.

- Neither the former nonpassive property rule nor the self-developed property rule applies to the LPs or to MGP’s partners. Therefore, their share of all of the gain from the sale of Office Building B is passive gain.
[a] Identification of Activities in Which Operations in the Hotel Are Included

As noted in § 4.05[7][a] above, PS's 1995 hotel operations are included in a single trade or business activity with PS's 1995 restaurant operations in Office Buildings A and B. See § 4.05[7][a].

[b] Treatment of Operations Without Regard to Gain From Sale

Since PS's 1995 hotel operations and restaurant operations are included in the same trade or business activity, the gross income and deductions from the operation of the hotel are treated in the same manner as the gross income and deductions from the operation of the restaurant in Office Building B. See § 4.05[7][b].

c] Allocation of Gain Among Activities

Since (i) the hotel is not held in a “dealing activity” at the time of its sale, and (ii) PS's hotel operations and restaurant operations were included in a single trade or business activity for the entire twelve-month period preceding the sale, the gain from the sale of the hotel is allocated among activities in the same manner as the gain attributable to the restaurant space in Office Building B. See § 4.05[7][c].

[d] Characterization of Allocated Gain

The gain from the sale of the hotel is characterized in the same manner as the gain attributable to the restaurant space in Office Building B. Thus, the gain allocated to OGP is treated as nonpassive under the year-of-disposition rule, and the gain allocated to the LPs and to MGP's partners is treated as passive. Note that the self-developed property rule cannot apply to any part of the gain from the sale of the hotel, since none of that gain constitutes "gross rental activity income."\(^{151}\)

\(^{151}\) See Reg. § 1.469–2T(f)(9)(iii).

[a] Identification of Activities in Which Operations in Office Building A Are Included

As noted in § 4.05[7][a], above, PS's 1995 restaurant operations in Office Building A are included in a single trade or business activity with PS's 1995 hotel operations and PS's 1995 restaurant operations in Office Building B. The rental operations in Office Building A, however, constitute a single rental activity consisting of solely of renting the office space in Office Building A.

[b] Treatment of Operations Without Regard to Gain From Sale

The rental activity conducted in Office Building A, like the rental activity conducted in Office Building B, is a passive activity of every taxpayer owning an interest in PS, without regard to their respective levels of participation in the activity. Thus, each such taxpayer's gross income and deductions from the operation of that activity are passive activity gross income and deductions.152

Since PS's 1995 restaurant operations in Office Building A and the remainder of PS's 1995 restaurant and hotel operations are included in the same trade or business activity, the gross income and deductions from the operation of the restaurant in Office Building A are treated in the same manner as the gross income and deductions from the operation of the restaurant in Office Building B. See § 4.05[7][b].

[c] Allocation of Gain Among Activities

[i] Special Rules for Dealer Sales

As noted in § 4.05[7][c][i], above, it is necessary to consider the special rules for dealer sales before considering any of the other rules relating to gain or loss from the disposition of property, because the effect of the dealer rule, when it applies, is to deem the property to be used in a certain manner for purposes of applying the other rules.

152 See N. 129, regarding the inapplicability in this case of the $25,000 exemption for losses from active participation rental real estate activities.
As a threshold matter, the dealer rule applies to the disposition of an item of property with respect to a taxpayer only if the property is “held in a dealing activity” of the taxpayer at the time of disposition.\textsuperscript{153} Property is treated as held in a dealing activity only if it is held in an activity “that involves holding similar property” for sale to customers.\textsuperscript{154} In order to determine whether the dealer rule applies to the disposition of an item of property, therefore, it is necessary to identify the activity in which it is “held,” and to determine whether other “similar” property is held for sale to customers in the same activity.

At the time Office Building A is sold, no other property is held by PS for sale to customers. Therefore, PS’s own operations cannot amount to a “dealing activity” for purposes of applying the dealer rule to the sale of Office Building A. It follows that the dealer rule cannot apply to any taxpayer’s share of the gain from the sale of Office Building A (even though, by hypothesis, the building is sold to a customer in the ordinary course of PS’s trade or business) unless, as to that taxpayer, the 1995 activity in which the building is held by PS includes dealing operations conducted outside PS.

We have previously reached the following conclusions regarding the 1995 activities that include PS’s 1995 operations (see § 4.05[7][a]):

\begin{itemize}
  \item In 1995, PS conducts a single trade or business undertaking (consisting of the operation of a hotel and two restaurants) and five rental undertakings (consisting of the rental operations in (i) Office Building A, (ii) Office Building B, (iii) Apartment Building C, (iv) Apartment Building D, and (v) the retail store).
  \item Each of the rental undertakings is treated as a separate rental activity.
  \item PS’s trade or business undertaking has predominant operations in the hotel line of business or the restaurant line of business. Since no taxpayer owning an interest in PS owns an interest in another, commonly controlled undertaking with predominant operations in either the hotel line of business or the restaurant line of business,
\end{itemize}

\textsuperscript{153} Reg. § 1.469–2T(e)(2)(v)(B).
PS's trade or business undertaking is treated as a separate activity of each such taxpayer.

We reached the foregoing conclusions, however, by ignoring the possible effects of the fact that PS's trade or business undertaking in 1995 includes "business and rental operations" that involve holding Office Building A for sale to customers. We must now consider those possible effects.

As noted above, a trade or business undertaking is considered to have predominant operations in a particular line of business only if a majority of the undertaking's gross income is "attributable to operations in" that line of business. Let us now assume that the gross income from the sale of Office Building A (i.e., the gain realized on the sale) exceeds all of the gross income from the operation of PS's hotel and restaurants (including the gain from selling the hotel and the restaurant space in Office Building B). Since Office Building A was held for sale to customers in the ordinary course of PS's trade or business, and "dealing" in real estate presumably is in the real estate line of business, should we now conclude that PS's 1995 trade or business undertaking is actually in the real estate line of business, rather than in the hotel or restaurant line of business, and therefore is potentially aggregable with commonly controlled real estate undertakings of PS's owners?

The question is not an easy one to answer. The regulations provide no guidance on how to determine whether gain from the sale of an item of property like Office Building A is "attributable to operations in a [particular] line of business." One obvious possibility, however, is to look for guidance by analogy in the rules relating to the allocation among activities of gain from the

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155 See N. 132.
157 Note that any activity including PS's single trade or business undertaking may be aggregated with another activity under the "integrated business" rule (see Reg. § 1.469–4T(g)) only if the two activities are conducted in their entirety as a single integrated business. Since PS's business includes restaurant and hotel operations for 1994 and a significant part of 1995, it is assumed that this aggregation rule does not apply.
158 See Reg. § 1.469–4T(f)(4)(ii), in which this phrase appears.
disposition of property.\textsuperscript{159} Thus, for example, we might surmise that gain from the disposition of an item of property should be treated as "attributable to" the line of business of the operations in which the property was used at the time of the disposition and during the preceding twelve months. In fact, this is a very natural reading of the regulations (although it is not technically required, since the gain-allocation rules allocate gain among activities, not "operations"). when we try to apply the gain-allocation rules to determine whether the activity in which the property is held is a "dealing activity," however, we encounter a vexing circularity, since, as discussed above, (i) the gain-allocation rules rely on a prior identification of the activity in which the property is used, but (ii) that activity-identification depends on the still prior application of the dealer rule.

Until further guidance on this issue becomes available, the author believes that the solution that may be most consistent with the treatment in the existing regulations of gain from sales of property (although not a required solution) is to treat gain from a sale of property as attributable to operations in a particular line of business by applying the time-of-disposition rule and the twelve-month rule, but \textit{without regard to the dealer rule if a determination that the dealer rule applies can be made only by first assuming that it applies}.\textsuperscript{160}

In the case under consideration here, the dealer rule potentially applies only to MGP’s partners, since they are the only taxpayers owning interests in PS who also own interests in outside undertakings that involve dealing in real estate.\textsuperscript{161} However, the dealer rule may apply to MGP’s partners \textit{only if} Office Building A is treated as “held in” an activity of MGP’s partners that includes the real estate

\textsuperscript{159} These are the rules in Reg. § 1.469–2T(c)(2)(i) and (c)(2)(ii), which allocate gain from the disposition of property among the activities in which the property was used at the time of the disposition and during the preceding twelve months.

\textsuperscript{160} The author believes that, in the absence of the dealer rules, gain from the sale of property that is (i) used in a nondealing activity, and (ii) simultaneously held for sale to customers, would be treated as gain from the nondealing activity.

\textsuperscript{161} It is assumed herein that any real estate, but no other property, may be considered “similar” to Office Building A, within the meaning of Reg. § 1.469–2T(c)(2)(v)(A)(1)(ii)(A). It should be noted, however, that the regulations do not define the term “similar.”
dealing operations that MGP conducts outside PS. Under the aggregation rules in the regulations, the undertaking of PS in which Office Building A is held may be included in the same activity as MGP’s real estate dealing undertakings under the aggregation rule for similar, commonly controlled undertakings only if the gain from the sale of Office Building A is treated as attributable to operations in the real estate line of business.\footnote{162} If the dealer rule is not taken into account, the gain from the sale of Office Building A should be treated as attributable in part to a rental activity and in part to operations in the hotel or restaurant line of business. Therefore, the gain-allocation rules can be used to make the dealer rule apply only if it is already assumed that the dealer rule applies.\footnote{163} Therefore, following the approach suggested above, the dealer rule does not apply.\footnote{164}

\footnote{162} It is possible, of course, that the Service will take the position that an individual partner may be treated as holding his or her interest in a partnership property in an activity that includes none of the partnership’s own undertakings. If the Service takes this position, all technical bets are off, since the regulations provide no precedent for simply ignoring entity lines. The author’s working hypothesis, however, is that it is the partnership directly holding the property, and not the partners or other “upstream” taxpayers, that “holds” the partnership property, and that the activity in which the property is held for purposes of Reg. \$ 1.469-2T(c)(2)(v)(B) therefore must be an activity that includes the partnership’s own undertakings.

\footnote{163} If the dealer rule were assumed to apply, (i) Office Building A arguably would be treated as used in operations in the real estate line of business (as part of PS’s trade or business undertaking), (ii) the gain from the sale of the building would be treated as gross income attributable to operations in that line of business, and (iii) since that gross income would represent more than 50 percent of the gross income from PS’s trade or business undertaking, the undertaking would be treated as having predominant operations in the real estate line of business and potentially would be aggregated with MGP’s other real estate undertakings. Since those other undertakings involve holding real estate (i.e., “similar property”) for sale to customers, Office Building A would be treated as “held in a dealing activity,” and the dealer rule would therefore apply. This conclusion is reached, however, only by first assuming that the dealer rule applies.

\footnote{164} It should not be forgotten that PS’s marketing operations are conducted by PS’s own unrelated agents in an office in Office Building A. If, on the other hand, PS’s marketing operations were conducted at MGP’s office by MGP’s employees, the conclusion probably would be different. In that case, PS’s marketing operations would be treated as a separate trade or business undertaking of PS, and probably would not be aggregated with the location. Under these circumstances, the marketing of Office trade or business undertaking conducted by PS at the
Thus, in this case, the author believes that the gross income from the sale of Office Building A should not be treated as gross income in the real estate line of business, and the conclusion that PS's trade or business undertaking does not have predominant operations in the real estate line of business should not be disturbed.

Accordingly, Office Building A should not be treated as "held in a dealing activity," and the dealer rule should not apply to the gain from the disposition of the building.

[ii] **Time-of-Disposition Rule and Twelve-Month Rule**

Since the dealer rule does not apply to the gain from Office Building A, the application of the time-of-disposition rule and the twelve-month rule to Office Building A is the same as the application of those rules to Office Building B. See § 4.05[7][c][ii].

[d] **Characterization of Allocated Gain**

[i] **Year-of-Disposition Rule**

The application of the year-of-disposition rule to Office Building A is the same as the application of that rule to Office Building B. See § 4.05[7][d][i].

[ii] **Former Nonpassive Property Rule**

The application of the former nonpassive property rule to Office Building A is the same as the application of that rule to Office Building B. See § 4.05[7][d][ii].

[iii] **Self-Developed Property Rule**

The application of the self-developed property rule to Office Building A is similar in all respects but one to the application of that rule to Office Building B. See § 4.05[7][d][iii]. The important difference is that Office Building A is sold on December 1, 1995, more than twelve months after the completion of the value-

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Tract X Building A initially would be treated as a separate activity conducted through PS, and would be ripe for aggregation with MGPP's real estate operations under the "integrated business" rule. See Reg. § 1.469-4T(g).

165 The actual numbers in the calculations are different, of course, since the buildings were sold on different dates, but the conclusions are the same.
enhancement activities performed with respect to the building (lease-up was completed on November 1, 1994). Therefore, the rule does not apply to OGP.


Assuming that appropriate elections are made each year, PS’s retail store and apartment Buildings C and D all constitute separate rental activities for purposes of identifying the activities of every taxpayer owning an interest in PS. Therefore, PS’s 1995 and 1996 operating losses from those buildings are passive losses of each such taxpayer.


[a] Identification of Activities in Which Operations in Apartment Building C Are Included

As we move into 1997, it is important to emphasize once again that PS’s activities as of the beginning of one taxable year are not necessarily the same as PS’s activities as of the end of the preceding taxable year. Thus, as we seek to determine the treatment of PS’s 1997 transactions, we must start the activity-identification from scratch.

The identification of the 1997 activities that involve operations in Apartment Building C presents two difficult questions:

- First, are the dealing operations in the building treated as part of a trade or business undertaking, and, if so, are the rental operations in the building included in that undertaking or treated as part of a rental undertaking?

- Second, if the rental operations in the building are treated as part of a rental undertaking, may the rental of each apartment be treated as a separate rental activity?

Let us begin our analysis by recalling that, in 1997, PS conducts

166 See Reg. § 1.469–4T(k)(5). Since all of these buildings would be treated as part of a single undertaking absent an election under Reg. § 1.469–4T(k), a schedule of the separate undertakings must be attached each year to the return of (i) PS, (ii) MGP, (iii) QGP, (iv) each of the LPs, and (v) each of MGP’s partners.
three types of operations at a single location. These are (i) the rental of apartments in Apartment Building C, (ii) the marketing of condominium units in Apartment Building C, and (iii) the marketing of shares in Coop Corp. Let us now assume that, during 1997, PS derives $100 of gross income from renting apartments in Apartment Building C, $1,000 of gross income from sales of condominium units, and $1,000 of gross income from sales of Coop Corp shares. Under these assumptions, the 80–20 rule for identifying rental undertakings causes PS's single "paragraph (c) undertaking" to be treated as consisting of both a trade or business undertaking and a rental undertaking only if the $1,000 of gross income from sales of condominium units is treated as "attributable to rental operations." If this gross income is not so treated, only $100 of PS's $2,100 of 1997 gross income is attributable to nonrental operations, and the rental and nonrental operations are treated as a single trade or business undertaking.

The regulations, however, provide no guidance on (i) the extent to which gain from a sale of rental property is treated as "gross income attributable to rental operations," or (ii) whether the fact that the sale is a "dealer" sale has any bearing on this treatment. There is a striking similarity between this issue and the problem of attributing gain from such sales to "operations" in a particular "line of business" for purposes of applying the aggregation rule for similar, commonly controlled undertakings (discussed in § 4.05[9][c][ii], above).

With regard to the latter issue, the author suggested that the solution that seems most consistent with the treatment in the existing regulations of gain from sales of property (although not a required solution) is to treat gain from a sale of property as attributable to operations in a particular line of business by applying principles analogous to the time-of-disposition rule and

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168 Under Reg. § 1.469-4T(d)(2)(ii), if less than 20 percent of the gross income from a "paragraph (c) undertaking" is attributable to rental operations, the rental operations are not treated as a separate undertaking.
the twelve-month rule, \textsuperscript{169} but without regard to the dealer rule\textsuperscript{170} if a determination that the dealer rule applies can be made only by first assuming that it applies. It is not at all clear to the author that applying a similar approach to the issue under consideration in this section (i.e., the determination of whether gain from a dealer sale of rental property is attributable to rental or nonrental operations for purposes of the "80–20" rule) produces appropriate results. However, since no other approach is obviously preferable, let us see where this approach takes us.

In fact, if we follow this approach, we reach what is perhaps a surprising conclusion. We begin by assuming that the dealer rule does not apply. Under the time-of-disposition rule and the twelve-month rule, all of the gain from sales of condominium units in Apartment Building C therefore is initially treated as gain from property used in a rental activity, hence (according to our hypothesis) as gross income “attributable to rental operations.”\textsuperscript{171} Therefore, $1,100 of PS’s 1997 gross income appears to be treated as income from rental operations, and it appears that the rental of apartments in Building C is treated as a separate rental undertaking. However, we must continue our analysis to the bitter end. Even if we tentatively conclude that the gain from sales of apartments in Building C is treated as gross income from rental operations, we must not forget that a trade or business undertaking is nonetheless conducted at the same location (i.e., the undertaking involving holding shares of Coop Corp stock for sale in the ordinary course of business\textsuperscript{172}), and any activity that includes that undertaking arguably involves holding for sale to customers.

\textsuperscript{169} See Reg. § 1.469–2T(c)(2)(i) and (c)(2)(ii), respectively.
\textsuperscript{170} See Reg. § 1.469–2T(c)(2)(v).
\textsuperscript{171} The author believes that, in the absence of the dealer rule, gain from the sale of property that is (i) used in a nondealing activity, and (ii) simultaneously held for sale to customers, would be treated as gain from the nondealing activity.
\textsuperscript{172} There is no uncertainty about whether the gain from sales of Coop Corp shares should be treated as gain from rental or nonrental operations, since the shares themselves are not used in a rental activity. Also, it might be noted that the marketing of condominium units in Apartment Building C probably should be treated as part of the trade or business undertaking at PS’s location, even if gross income from sales of those units is tentatively treated as attributable to rental operations. This treatment, however, does not affect the conclusions reached below.
property that is "similar" to the Building C apartments (since the Coop Corp shares represent interests in apartment units). Moreover, it is probable that the dealer rule is intended to be applied as though property that is held for sale to customers is considered to be "held in" the trade or business activity that includes any trade or business undertaking that exists in the location where the marketing of the property is conducted. Thus, in this case, the apartments in Apartment Building C probably must be treated as "held in a dealing activity." Finally, we reach the following bewildering conclusion: If the other requirements of the dealer rule are satisfied, and the apartments therefore are treated as used in the dealing activity for purposes of allocating gain from the sales between PS's rental and nonrental operations, it is possible that enough gross income from the sales will be allocated to the nonrental operations to cause the rental operations in the building to be treated as part of a trade or business undertaking. If, on the other hand, the other requirements of the dealer rule are not satisfied, the apartments will be treated as used in rental operations only, and those rental operations will be treated as part of a rental undertaking.

Let us assume for the remainder of this section that the rental operations in Apartment Building C are treated as part of a rental undertaking.

At first blush, the second question raised at the beginning of this section seems simple, since (i) all of the operations in Apartment Building C involve the long-term rental of apartments, and (ii) appropriate elections have been made each year to treat Apartment Building C as a separate rental estate undertaking (hence as a separate activity). If no further steps are taken, then, all of the operations in Apartment Building C are included in a single separate rental activity.

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172 If this assumption is incorrect, the author is not sure what principles should be applied to determine whether property is "held in" a dealing activity.

174 For reasons explained below in § 4.05[9][c][ii], gain allocated under the twelve-month rule to the rental activity in which Apartment Building C was used in 1996 should not be treated as gain from dealing operations.

175 In fact, we will ultimately conclude in § 4.05[9][c][ii] that the other requirements of the dealer rule are not satisfied. Therefore, this assumption will not be withdrawn.
Suppose, however, that PS and its owners recognize that, since some of the apartment units in the building are unsold as of the end of 1997, benefits might be obtained from treating each unit (or, in any event, the group of units actually sold during 1997) as a separate undertaking, hence as a separate activity.\textsuperscript{176} The question that arises is whether PS and its owners may now make a valid election to treat a portion of Apartment Building C as a separate undertaking.

In this regard, the regulations provide:

All rental real estate undertakings or portions of such undertakings that are treated [under the special rules for rental real estate undertakings] 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.\textsuperscript{177}

Since all of the units in Apartment Building C were treated as part of the same activity for 1994, 1995, and 1996, some commentators would read this regulation to require that those units be treated as part of the same activity for all subsequent years, including 1997. The author does not believe, however, that there is any sound policy-based reason to prevent PS from electing to divide Apartment Building C into multiple activities for the first year in which separate conveyance of individual units is possible.\textsuperscript{178} Moreover, under a very plausible reading of the regulations, such an election is technically permissible, since the units in Apartment Building C were previously treated as part of the same activity, not under the special rules for rental real estate

\textsuperscript{176} Separate-activity treatment could produce benefits under the disposition rules of I.R.C. § 469(g)(1)(A) in some circumstances. If (i) the sum of the current operating losses and suspended losses allocable to a unit (a "loss unit") for the taxable year in which the unit is sold exceeds the gain from the sale of the unit, (ii) at least one unit in the building is unsold as of the end of the year, and (iii) the taxpayer does not have sufficient net passive income from other activities to absorb the excess losses, I.R.C. § 469(g)(1)(A) will permit the excess losses to be deducted only if the loss unit (or a group of units including the loss unit, all of which have been sold as of the end of the year) is treated as a separate activity.

\textsuperscript{177} Reg. § 1.469-4T(k)(3). The actual language that stands in the place of the bracketed language in the quoted passage reads: "under this paragraph (k)."

\textsuperscript{178} In fact, the author can see no sound policy-based reason for many of the restrictions on elections under Reg. § 1.469-4T.
undertakings, but under the basic single-location rule.\textsuperscript{179} It is therefore assumed that PS and its owners may validly elect for 1997 to treat each apartment unit in Apartment Building C as a separate activity, and that such an election is made.

[b] Treatment of Operations Without Regard to Gain From Sale

Whether Apartment Building C is treated as consisting of one activity or many, each activity that includes a portion of the operations in the building is a rental activity. Thus, all of the 1997 gross income and deductions attributable to those operations (disregarding, for the moment, gain from sales of units) are passive activity gross income and deductions of every taxpayer owning an interest in PS.

Of course, we must also account for the previously suspended passive activity deductions from the 1996 activity consisting of the rental of all of the apartments in Apartment Building C (the "building-wide activity"). If PS had not elected to treat each unit as a separate activity for 1997, those deductions would simply be treated under Section 469(b) as arising in 1997 in the building-wide activity. The 1997 election to subdivide the building-wide undertaking into multiple activities, however, makes it necessary to allocate the suspended deductions among the resulting single-unit activities.

The regulations state that, in such a situation, the suspended deductions must be allocated among the new activities in a manner that "reasonably reflects the extent to which each such activity continues the business and rental operations that constituted the [old] activity."\textsuperscript{180} Although the regulations provide no helpful guidance on what will be considered reasonable, an allocation in this case based on, e.g., relative square footage or relative fair market value of the apartments should be respected.\textsuperscript{181}

\textsuperscript{179} Under Reg. § 1.469–4T(c) and (d), all of the rental operations conducted by PS are treated as part of the same activity. PS and its owners have elected under Reg. § 1.469–4T(k) to treat Apartment Building C as a separate activity, but the treatment of the individual apartment units in the building as part of the same activity is not a result of that election or of any of the rules in Reg. § 1.469–4T(k).

\textsuperscript{180} Reg. § 1.469–1T(0)(4)(i)(A).

\textsuperscript{181} The examples in Reg. § 1.469–1T(0)(4)(iii) purport to provide guidance on this issue, but the examples assume as given facts the results of the most difficult
[c] Allocation of Gain Among Activities

[i] Special Rules for Dealer Sales

As previously noted, the dealer rule applies only to property that is “held in a dealing activity” of the taxpayer.\textsuperscript{182} Property is treated as held in a dealing activity if it is held in an activity “that involves holding similar property” for sale to customers.\textsuperscript{183} Since, during the period that each apartment in Apartment Building C is held for sale to customers by PS, PS’s trade or business undertaking involves holding “similar property” for sale to customers (i.e., the other apartments in Apartment Building C and, perhaps, the shares of Coop Corp stock), any activity of any of PS’s owners that includes PS’s trade or business undertaking is treated as a “dealing activity” for purposes of applying the “dealer rule” to the sale of the apartment. Therefore, the dealer rule potentially applies to each apartment in Apartment Building C for purposes of applying the regulations to every taxpayer owning an interest in PS.

Even if property is “held in a dealing activity,” however, the property is treated under the dealer rule as used in a dealing activity only if either (i) the property was used in nondealing activities for no more than 80 percent of the time it was held by the taxpayer,\textsuperscript{184} or (ii) the property was “acquired and held” for the principal purpose of selling it to a customer in the ordinary course of business.\textsuperscript{185} Since the apartment units in Apartment Building C were used in nondealing activities for 100 percent of the time they were held by PS, the first alternative requirement is not satisfied. Moreover, under the facts of this case, the “principal purpose” requirement does not appear to be satisfied either. Following is an explanation of the latter conclusion.

First, it may be noted that (i) all of the apartments in Apartment Building C were used in nondealing activities for more than 24

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\textsuperscript{182} Reg. § 1.469–2T(c)(2)(v)(B).


\textsuperscript{184} Reg. § 1.469–4T(c)(2)(v)(A)(I)(ii)(B) and (c)(2)(v)(B).

\textsuperscript{185} Reg. § 1.469–4T(c)(2)(v)(A)(I)(ii)(C) and (c)(2)(v)(B).
months,¹⁸⁶ and (ii) none of the apartments sold in 1997 was offered for sale to customers for more than 25 percent of the time it was used in nondealing activities.¹⁸⁷ Accordingly, no taxpayer owning an interest in PS is presumed to have acquired and held any of the apartments sold in 1997 for the principal purpose of selling it to customers.¹⁸⁸ Moreover, in this case, the facts and circumstances do not suggest that any of the apartments was acquired and held for the principal purpose of selling it to a customer, since none of the apartments was offered for sale to customers until it had been used in a rental activity for at least three years.¹⁸⁹

Accordingly, even though the apartment units in Apartment Building C are “held in a dealing activity,” the dealer rule does not apply to the gain realized from the sale of the units for purposes of applying the regulations to any taxpayer owning an interest in PS.

(ii) Time-of-Disposition Rule and Twelve-Month Rule

The twelve-month rule technically applies to every 1997 sale of an apartment unit in Apartment Building C, because, although each unit was used in a single-unit rental activity during 1997,¹⁹⁰ each unit was used in a larger rental activity consisting of the rental of all of Apartment Building C for the pre-1997 portion of the twelve-month period preceding the sale of that unit. Accordingly, a fraction of the gain from the sale representing the fraction of the

¹⁸⁶ Each unit was used in a rental activity from January 1, 1994, through the date of sale, a period of at least three years for every unit.
¹⁸⁷ A unit sold on December 1, 1997, would have been offered for sale for one year and used in a rental activity for four years. The offering period for such a unit would be precisely 25 percent (but not more than 25 percent) of the unit’s rental period.
¹⁸⁸ See Reg. § 1.469–2T(c)(2)(v)(A)(1)(ii), which provides two quantitative tests under which a rebuttable presumption may be established that the taxpayer holds property for the principal purpose of selling it to customers.
¹⁸⁹ In a case such as this, where a substantial period elapses between the time that property is placed in service and the time that the property is first offered for sale to customers, the author believes that the “principal purpose” requirement should not be met unless there is compelling evidence that the property would not have been acquired but for the expectation that it would be offered for sale in a dealing context.
¹⁹⁰ Recall that we are assuming valid elections have been made to treat each unit in Apartment Building C as a separate activity.
twelve-month period that fell in 1996 must be treated as gain from the building-wide rental activity. This allocation generally should have no important practical consequences, however, since both the single-apartment activity and the building-wide activity are rental activities.\footnote{Note that, if the dealer rule applied to the sale of the unit, the allocation could have important consequences. Since the dealer rule would cause the unit to be treated as used in a dealing activity only for the period during which the unit was offered for sale (Reg. § 1.469–2T(c)(2)(v)(B)), any gain allocated to the activity in which the unit was used prior to the dealing period (i.e., prior to 1997) could not be treated as gain from the dealing activity. Note also that if (i) the gain from the sale of a unit is less than the sum of the current and suspended losses attributable to the unit, and (ii) the taxpayer has overall losses from other passive activities, the allocation of gain to the previously conducted building-wide activity arguably should increase the amount freed from disallowance under I.R.C. § 469(g)(1)(A). This is because gain allocated to the building-wide activity arguably should be treated as reducing the disallowed losses from the other activities, rather than reducing the net losses from the unit sold (which would be deductible under I.R.C. § 469(g)(1)(A) in any event).

\footnote{Although the building-wide activity in which Apartment Building C was used in 1996 is not an activity at all in 1997 (but, rather, is continued through other activities), and therefore arguably is described in the phrase “is not a passive activity of the taxpayer for the taxable year of the disposition” (see Reg. § 1.469–2T(c)(2)(i)(A)(3)), it is doubtful that the Service would argue on this basis that the gain should be treated as non passive. In fact, the twelve-month allocation rule and the year-of-disposition characterizations fail to take account of the fact that, under the twelve-month rule, gain or loss may be allocated to any activity that does not exist in the taxable year of the disposition. If the drafters of the regulations had thought about the issue, they probably would have written a rule similar to the rule in Reg. § 1.469–1T(f)(4)(i)(A), which allocates carryover deductions from a “loss activity” among successor activities conducted in the carryover year. That rule provides that carryover deductions from the “loss activity” must be allocated among the taxpayer’s activities in the carryover 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.”}}
property rule or the self-developed property rule applies, all of that gain should be treated as passive as to every taxpayer owning an interest in PS.

[ii] **Former Nonpassive Property Rule**

The former nonpassive property rule does not apply to gain from the sale of any apartment unit in Apartment Building C, because all of the property sold (including the underlying portion of Tract X) was used in one or more passive activities for the entire 24-month period ending on the date of the sale.\(^{193}\)

[iii] **Self-Developed Property Rule**

Since Apartment Building C was fully leased as of November 1, 1994, and none of the units was sold until 1997, every unit in Apartment Building C was leased for a long enough period to cleanse it of any self-developed "taint" (twelve months is all that is necessary for this purpose).\(^{194}\) and the self-developed property rule does not apply to any taxpayer owning an interest in PS.

[iv] **Conclusion Regarding Treatment of Gain**

The gain from the sale of each apartment unit in Apartment Building C is treated as passive with respect to every taxpayer owning an interest in PS.

[g] **Application of Section 469(g)**

Assuming that valid elections have been made to treat each apartment unit in Apartment Building C as a separate activity, Section 469(g)(1)(A) should apply to each sale of a unit. Thus, if the sum of (i) the current (1997) loss from the unit and (ii) the suspended (pre-1997) loss allocated to the unit exceeds the gain

Similarly, when gains loss from a disposition of property is allocated under the twelve-month rule to an activity that is not conducted during the taxable year of the disposition, the character of that gain or loss as passive or nonpassive should, to the extent possible, be determined by reference to the passive or nonpassive character (in the year of the disposition) of the activities that continue the business and rental operations of the discontinued activity.

\(^{193}\) See Reg. § 1.469-2T(c)(2)(ii)(A)(2). Every apartment in Apartment Building C was used in a rental activity at all times after January 1, 1994.

\(^{194}\) See § 1.02(4)[c][iii], supra.
realized on the sale of the unit, and the taxpayer does not have net income from other passive activities against which the excess loss can be offset, the excess loss is treated as a nonpassive loss.\footnote{195}

\[12\] Treatment of PS’s 1997 Sale of Shares of Stock in Coop Corp (Representing Apartments in Apartment Building D)

\[a\] Identification of Activities After Incorporation of Coop Corp

As a general matter, after the incorporation of Coop Corp, the rental of Apartment Building D no longer constitutes an activity of any taxpayer owning an interest in PS.\footnote{196} The regulations provide, however, that since deductions from the terminated activity of renting the building are suspended under Section 469 at the time of incorporation, each such taxpayer’s indirect stock interest in Coop Corp is treated as an interest in a passive activity for purposes of the rules in the regulations dealing with the treatment of disallowed deductions.\footnote{197}

It follows that, for purposes of Section 469 and the regulations (other than the rules dealing with the treatment of previously disallowed deductions from the rental of Apartment Building C), PS’s 1997 business and rental operations consist only of (i) the rental of apartments in Apartment Building C, (ii) the marketing of condominium units in Apartment Building C, and (iii) the

\footnote{195}{Interestingly, the twelve-month rule, discussed in § 4.05[1][c][ii] above, appears to cause varying results under T.R.C. § 469(g)(1)(A) in this case, depending on the date on which a unit is sold. This results from the fact that, the later in the year a unit is sold, the greater the fraction of the gain from the sale that is allocated to the activity consisting of the rental of that unit (as opposed to the 1996 building-wide rental activity in which the unit was previously used). If a taxpayer owning an interest in PS has other passive activities with net losses in 1997, the allocation of an additional dollar of gain to the pre-1997 building-wide activity increases by one dollar the (deductible) net loss from single-unit activity while reducing by one dollar the (nondeductible) net loss from other passive activities, thus yielding an extra dollar of deductions for the year.}

\footnote{196}{Reg. § 1.469–4T(b)(2)(ii)(B).}

\footnote{197}{See Reg. § 1.469–1T(f)(4)(ii). The regulations relating to the treatment of passive activities continued through C corporations contain a confusing drafting error (see N. 14 supra), but their intended meaning is substantiated by an example. See Reg. § 1.469–1T(f)(4)(iii) Ex. (6).}
marketing of shares in Coop Corp. As we concluded in § 4.05[11][a], above, these operations are grouped into (i) one or more rental undertakings (consisting of the rental of apartments in Apartment Building C), and (ii) a single trade or business undertaking (consisting of the marketing of condominium units and Coop Corp shares).

It may be noted that, in 1997, all of the gross income from PS's trade or business undertaking is attributable to dealing operations in the real estate line of business (assuming that gain from dealer sales of stock in a housing cooperative is treated as gross income from real estate operations). Therefore, assuming PS's trade or business undertaking and MGP's real estate undertakings are considered to be commonly controlled, those undertakings are treated as part of the same trade or business activity of MGP's partners, and, since MGP's partners work in MGP's undertakings on a full-time basis, the combined activity is an active business of those taxpayers. Of course, since OGP works in PS's undertaking for more than 500 hours during 1997, any activity of OGP in which PS's trade or business undertaking is included is an active business of OGP.

[b] Treatment of Gain From Sales of Coop Corp Shares

The character of gain from sales of shares in Coop Corp must be determined under the rules in the regulations relating to gain from dispositions of stock in a C corporation. In general, gain from the sale of stock in a C corporation is treated as "portfolio income," and is excluded from treatment as passive activity gross income. However, since PS's gain from sales of Coop Corp shares is "derived in the ordinary course of an activity of . . . dealing in . . . property," and "such activity constitutes a trade or business," PS's gain is not treated as portfolio income. Accordingly, each taxpayer's share of such gain is treated as income from that taxpayer's activity that includes PS's trade or business undertaking.

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198 PS's rental of apartments in Apartment Building D for the first day of 1997 is disregarded here.
199 See Reg. § 1.469–4T(j), discussed in § 4.02[3][c], supra.
200 See Reg. § 1.469–4T(f), discussed in § 4.02[3][b], supra.
201 Reg. § 1.469–2T(c)(3)(i)(C).
202 Reg. § 1.469–2T(c)(3)(ii)(D).
Thus, the gain allocated to the LPs is passive, the gain allocated to OGP is nonpassive, and the gain allocated to MGP's partners is nonpassive if we assume that MGP is treated as "controlling" PS's trade or business undertaking.

[c] Application of Section 469(g)

A taxpayer's suspended deductions from an activity are allowed under Section 469(g)(1)(A) only when the taxpayer's entire interest in the activity is disposed of. Since each share of Coop Corp stock represents PS's entire interest in a single apartment unit, may the sale of a single share of Coop Corp stock be treated as a Section 469(g)(1)(A) disposition of the apartment unit represented by the share?

The apparent technical difficulty with reaching this result is that the separate apartments in Apartment Building D may not have been separately conveyable under applicable State and local law until the moment after the building was transferred to Coop Corp, while, after the transfer, the rental operations conducted through Coop Corp are not included, for purposes of Section 469, in the activities of any taxpayer owning an interest in PS, and, therefore, arguably cannot be the subject of an election under Regulations Section 1.469-4T(k)(2)(iii).203

Nonetheless, there is no sound, policy-based reason for preventing the application of Section 469(g)(1)(A) to suspended losses from a Coop Corp apartment unit upon the sale of the share of stock representing the unit. Moreover, the author believes it is technically possible to read the regulations in a manner that permits an election to be made for 1997 to treat each apartment unit in Apartment Building D as a separate activity.204 Accord-

203 See Reg. § 1.469-4T(b)(2)(ii)(B).
204 The election under Reg. § 1.469-4T(k)(2)(iii) to treat a portion of a leased property as a separate undertaking applies "for a taxable year" and applies "if such portion of the leased property can be separately conveyed." As of the time an election under this provision is made for 1997 (i.e., when 1997 returns are filed in 1998), it may reasonably be argued that portions of Apartment Building D can be separately conveyed (by means of conveyances of Coop Corp shares). Moreover, if such an election is made, it applies for the entire 1997 taxable year, including the portion of the year (however brief) before the transfer of Apartment Building D to Coop Corp. Since each apartment unit in Apartment Building D is thus treated as
ingly, the author believes that the better view is that Section 469(g)(1)(A) does apply to the sale of each share of Coop Corp stock (assuming appropriate elections are made).

If the author is correct, Section 469(g)(1)(A) provides that the excess of (i) the loss for the year from the disposed-of single-unit activity (including carryover losses allocable to the activity), over (ii) the taxpayer's net income from all other passive activities for the year, is treated as a nonpassive loss. This has an interesting consequence in the case of any taxpayer for whom PS's trade or business undertaking is included in a passive activity. Suppose, for example, that (i) a share of Coop Corp stock representing Apartment X ("Share X") is sold, (ii) an LP's share of the gain from the sale is $100, (iii) the LP's share of the suspended losses allocable to Apartment Unit X is $60, (iv) no other items of income or deduction of PS are taken into account by the LP for the year, and (v) the LP has $100 of suspended passive activity deductions from other activities. How is the LP treated? The conceptually "correct" answer would seem to be that the LP derives $40 of net passive income from the disposition of Share X, that $40 of the LP's other suspended passive activity deductions may be deducted, and that the remaining $60 of other deductions continue to be disallowed.

That is not the answer produced by Section 469(g)(1)(A), however. Since the $100 of gain from the sale of Share X is not attributable to the Apartment Unit X activity, but is attributable to PS's dealing activity, the $100 of gain is offset against the LP's other passive activity deductions, and the $60 suspended loss allocable to Apartment Unit X is allowed in full.

d) Former Passive Activity Rule

Let us now consider how OGP would be treated under the facts of the foregoing example. Unlike the LP's gain, OGP's $100 gain from the sale of Share X is nonpassive. Therefore, OGP has zero net income from "other" passive activities, OGP's $60 of sus-
pended losses from Apartment Unit X are allowed in full, and OGP’s $100 of other passive activity deductions continued to be disallowed. Can it be argued under these circumstances that suspended losses from unsold apartment units in Apartment Building D can be used to offset OGP’s $100 of gain from the sale of Share X under the former passive activity rule? Probably not, since the trade or business activity from which the gain is derived is not the same activity as the rental activities from which the losses were derived.\footnote{There is a sense, however, in which PS’s dealing activity “continues the business and rental operations” of the formerly conducted activities of renting the apartments in Apartment Building D, and an argument certainly can be made that (i) the suspended deductions from the rental activities should be “allocated” to the dealing activity, and (ii) since the dealing activity continues the business and rental operations of rental (i.e., passive) activities, it is a “former passive activity.”} Obviously, there are many questions to be answered in this area.


[a] Special Rules for Dealer Sales

Once 1998 begins, the period during which the remaining condominium units in Apartment C have been offered for sale exceeds 25 percent of the period during which those units were used in rental activities.\footnote{Accordingly, under the regulations, it}
is rebuttable presumed that all units sold in 1998 were acquired and held for the principal purpose of selling the units to customers in the ordinary course of business.\textsuperscript{209} Let us assume for the sake of argument that the presumption cannot be rebutted.\textsuperscript{210}

If (i) property is held in a dealing activity at the time of its sale, and (ii) the property was acquired and held for the principal purpose of selling it to customers in the ordinary course of business, then the gain or loss from the sale is allocated among the taxpayer's activities as though the property had been used exclusively in the dealing activity for the entire period that the property was offered for sale.

Since all of the units in Apartment Building C were offered for sale for all of 1997, the units sold in 1998 are treated as though they were used exclusively in the trade or business activity conducted through PS (the "dealing activity") both at the time of sale and for the preceding twelve months. Thus, all of the gain from the sale of each unit in 1998 is treated as gain from PS's trade or business activity.

Since OGP materially participates for 1998 in OGP's activity that consists of PS's trade or business undertaking, OGP's gain from 1998 sales of units in Apartment Building C is nonpassive.

It is very likely that MGP's partners also materially participate for 1998 in their activity that includes PS's trade or business undertaking, on the ground that PS's trade or business undertaking probably has "predominant operations" in the real estate line of business and therefore is aggregated with MGP's own real estate undertakings under the aggregation rule for similar, commonly controlled undertakings.\textsuperscript{211} Accordingly, MGP's partners' gain

\textsuperscript{210} As noted above, the author believes that the taxpayer should not be treated as "acquiring and holding" property for sale to customers where a significant period elapses between the acquisition of the property and the time marketing commences, unless there is hard evidence that the property would not have been acquired but for the expectation of marketing it to customers. In this case, the Apartment Building C condominium units were not marketed until three years after they were placed in service. Perhaps that fact is in itself sufficient to rebut the presumption that the apartment units were acquired principally with a dealing purpose.
\textsuperscript{211} This aggregation rule is set forth in Reg. § 1.469–4T(f) and is summarized
from the 1998 sales of units in Apartment Building C also is nonpassive.

The LPs do not materially or significantly participate in any activity that includes PS's trade or business undertaking. Accordingly, their gain from such sale is passive.

[b] Application of Section 469(g)

The issues raised by Section 469(g) in connection with the 1998 sales of condominium units in Apartment Building C generally are the same as the issues raised by the 1997 sales of shares of Coop Corp stock. The difference is that, in the case of the 1998 sales, the rules relating to activities continued through a C corporation are not relevant. The conclusions, however, are the same. Thus, assuming that the 1997 election to treat each apartment unit as a separate activity was valid (and was made again in 1998), Section 469(g)(1)(A) should apply to each sale of a unit. Moreover, since the gain from the sale of each unit is treated as gain from an activity including PS's trade or business undertaking, and not as gain from the activity involving the rental of the apartment, the suspended losses attributable to a unit at the time it is sold are computed without regard to the gain realized from the sale. For a discussion of the consequences of this computation, see § 4.05[12][c].

c] Former Passive Activity Rule

The issues raised by the former passive activity rule in connection with the 1998 sales of condominium units in Apartment Building C generally are the same as the issues raised by the 1997 sales of shares of Coop Corp stock. The difference is that, in the case of the 1998 sales, the rules relating to activities continued through a C corporation are not relevant. The conclusions, however, are the same. Thus, since the trade or business activity to which the gain from sales of units is allocated is not the same activity as the rental activities with respect to which deductions are suspended, it does not appear that the former passive activity rule applies. Since, however, there is a sense in which the dealing

in § 4.02[3][b]. The application of this aggregation rule to MGP's partners for 1997 is discussed in detail in § 4.05[12][a]. The rule is applied to MGP's partners in 1998 for reasons that are similar to those discussed in that section.
activity "continues the business and rental operations" of such rental activity (or activities), the issue is not free from doubt. See § 4.05[2][d].