

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

(TD 8495)

RIN 1545-A061

**Passive Activity Loss Limitations—  
Developer Rule**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final and temporary regulations.

**SUMMARY:** This document contains final and temporary regulations relating to the limitations on passive activity losses and credits. The final regulations clarify the treatment of tenant solicitation (lease-up services) for purposes of applying the income recharacterization rules that are part of these limitations. The final regulations affect taxpayers who develop, rent out, and then sell certain property less than 12 months after the rental starts.

**DATES:** These regulations are effective November 4, 1993.

These regulations apply to tax years ending after May 10, 1992.

**FOR FURTHER INFORMATION CONTACT:** Martin Schaffer, (202) 622-3080 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background.**

This document contains final regulations under §§ 1.469-2T (f)(5) (ii), (iii), and (iv) of the temporary regulations. Section 1.469-2T(f)(5) was first issued by TD 8175, 53 FR 5686 (February 25, 1988), and was amended by TD 8253, 54 FR 20527 (May 12, 1989), and TD 8318, 55 FR 48107 (November 19, 1990). Section 1.469-2T(f)(5)(i) was adopted as final by TD 8417, 57 FR 20747 (May 15, 1992).

No written comments and no requests for a public hearing were received in response to the cross reference notice of proposed rulemaking (PS-071-89) published November 19, 1990, 55 FR 48135.

This document also amends the temporary regulations to provide cross references to the final regulations.

**Explanation of Provisions**

The preamble to the temporary regulations explains the final regulations.

**Effective Date**

The final regulations are effective for tax years ending after May 10, 1992 (see § 1.469-11(a)(1) of the regulations).

**Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for these regulations was submitted to the Small Business Administration for comment on its impact on small business.

**Drafting Information**

The principal author of these regulations is Martin Schaffer of the Office of Assistant Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service. However, other persons from the IRS and the Treasury Department participated in their development.

**List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

**Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

**PART 1—INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*.

**Par. 2.** Section 1.469-0 is amended by:

1. Revising the entries for designated § 1.469-2, paragraphs (f)(5) (ii) through (iv).
2. Revising the entries for designated § 1.469-2T, paragraphs (f)(5) (ii) through (iv).
3. The revisions read as follows:

§ 1.469-0 Table of contents.

\* \* \* \* \*

§ 1.469-2 Passive activity loss.

\* \* \* \* \*

(f) \* \* \*

(5) \* \* \*

(ii) Commencement of use.

(iii) Services performed for the purpose of enhancing the value of property.

(iv) Examples.

\* \* \* \* \*

§ 1.469-2T Passive activity loss (temporary).

\* \* \* \* \*

(f) \* \* \*

(5) \* \* \*

- (ii) Commencement of use [Reserved].
- (iii) Services performed for the purpose of enhancing the value of property [Reserved].
- (iv) Examples [Reserved].

**Par. 3.** Section 1.469-2 is amended by revising paragraphs (f)(5) (ii) through (iv) to read as follows:

§ 1.469-2 Passive activity loss.

\* \* \* \* \*

(f) \* \* \*

(5) \* \* \*

(ii) *Commencement of use*—(A) *In general.* For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(1) The taxpayer owns an interest in the property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) *Value-enhancing services.* For purposes of this paragraph (f)(5)(ii), the term value-enhancing services means the services described in paragraphs (f)(5) (i)(C) and (iii) of this section, except that the term does not include lease-up. Thus, in cases in which this paragraph (f)(5) applies solely because substantial lease-up remains to be performed (see paragraph (f)(5)(iii)(C) of this section), the twelve month period described in paragraph (f)(5)(i)(B) of this section will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out for rent and is in a state of readiness for rental on that date.

(iii) *Services performed for the purpose of enhancing the value of property.* For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

(iv) *Examples.* The following examples illustrate the application of this paragraph (f)(5):

*Example 1.* (i) A, a calendar year individual, is a partner in P, a calendar year partnership, which develops real estate. In 1993, P acquires an interest in undeveloped land and arranges for the financing and construction of an office building on the land. Construction is completed in February

1995, and substantially all of the building is either rented or held out for rent and in a state of readiness for rental beginning on March 1, 1995. Twenty percent of the building is leased as of March 1, 1995.

(ii) P rents the building (or holds it out for rent) for the remainder of 1995 and all of 1996, and sells the building on February 1, 1997, pursuant to a contract entered into on January 15, 1996. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is \$50,000 for 1995 and \$30,000 for 1996. All of A's losses from the rental of the building are disallowed under 1.469-1(a)(1)(i) (relating to the disallowance of the passive activity loss for the taxable year). A's distributive share of P's gain from the sale of the building is \$150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) The real estate development activity that A holds through P in 1993, 1994, and 1995 involves the performance of services (e.g., construction) for the purpose of enhancing the value of the building. Accordingly, an amount equal to A's net rental activity income from the building may be treated as gross income that is not from a passive activity if A's use of the building in an activity involving the rental of the building commenced less than 12 months before the date of the disposition of the building. In this case, the date of the disposition of the building is January 15, 1996, the date of the binding contract for its sale.

(iv)(A) A taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(1) The taxpayer owns an interest in the item of property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, A's use of the building in an activity involving the rental of the building commenced on March 1, 1995, less than 12 months before January 15, 1996, the date of disposition. Accordingly, if A materially (or significantly) participated in the real estate development activity in 1993, 1994, or 1995 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income from the building for 1997 equal to A's net rental activity income from the building for 1997 is treated under this paragraph (f)(5) as gross income that is not from a passive activity. Under paragraph (f)(9)(iv) of this section, A's net rental activity income from the building for 1997 is \$70,000 (\$150,000 distributive share of gain from the disposition of the building minus \$80,000 of reasonably allocable passive activity deductions).

*Example 2.* (i) X, a calendar year taxpayer subject to section 469, acquires a building on February 1, 1994, when the building is 25 percent leased. During 1994, X rents the

building (or holds it out for rent) and materially participates in an activity that involves the lease-up of the building. X's activities do not otherwise involve the performance of construction or other services for the purpose of enhancing the value of the building, and X does not hold the building (or any other building) for sale to customers in the ordinary course of X's trade or business. X sells the building on December 1, 1994.

(ii) (A) Under paragraph (f)(5)(iii)(C) of this section, lease-up is considered a service performed for the purpose of enhancing the value of property unless more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Under paragraph (f)(5)(ii)(B) of this section, however, lease-up is not considered a value-enhancing service for purposes of determining when the taxpayer commences using an item of property in an activity involving the rental of the property. Accordingly, X's acquisition of the building constitutes a commencement of X's use of the building in a rental activity, because February 1, 1994, is the first date on which—

(1) The taxpayer owns an interest in the item of property;

(2) Substantially all of the property is held out for rent; and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, X disposes of the property within 12 months of the date X commenced using the building in a rental activity. Accordingly, an amount of X's gross rental activity income for 1994 equal to X's net rental activity income from the building for 1994 is treated under this paragraph (f)(5) as gain that is not from a passive activity.

*Example 3.* The facts are the same as in Example 2, except that at the time X acquires the building it is 60 percent leased. Under paragraph (f)(5)(iii)(C) of this section, lease-up is not considered a service performed for the purpose of enhancing the value of property if more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Therefore, additional lease-up performed by X is not taken into account under this paragraph (f)(5). Since X's activities do not otherwise involve the performance of services for the purpose of enhancing the value of the building, none of X's gross rental activity income from the building will be treated as income that is not from a passive activity under this paragraph (f)(5).

Par. 5. Section 1.469-2T is amended by revising paragraphs (f)(5)(ii) through (iv) to read as follows:

**§ 1.469-2T Passive activity loss (temporary).**

(f) \* \* \*

(ii) *Commencement.* [Reserved] See § 1.469-2(f)(5)(ii) for rules relating to this paragraph (f)(5)(ii).

(iii) *Services performed for the purpose of enhancing the value of*

*property.* [Reserved] See 1.469-2(f)(5)(iii) for rules relating to this paragraph (f)(5)(iii).

(iv) *Examples.* [Reserved] See § 1.469-2(f)(5)(iv) for examples relating to this paragraph (f)(5)(iv).

Margaret Milner Richardson,  
Commissioner of Internal Revenue.

Approved: October 13, 1993.

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 93-27002 Filed 11-3-93; 8:45 am]

BILLING CODE 4830-01-U