

materially participate. In addition, until the enactment of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), all rental activities (including those in which a taxpayer materially participated) were passive.

OBRA 1993 added a new section 469(c)(7), which provides that rental real estate activities of qualifying taxpayers are not subject to the rule that treats all rental activities as passive. Thus, a rental real estate activity of a qualifying taxpayer is not passive if the taxpayer materially participates in the activity. Second, the new rules provide that each of a qualifying taxpayer's interests in rental real estate is treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as a single activity.

To qualify for this treatment under section 469(c)(7) for a taxable year, a taxpayer must perform, during that year, over 750 hours of personal services, and over half of the taxpayer's total personal services, in real property trades or businesses in which the taxpayer materially participates. A closely held C corporation is treated as satisfying these tests if more than 50 percent of its gross receipts for the taxable year are derived from real property trades or businesses in which it materially participates. For purposes of the qualification tests, a real property trade or business is defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Explanation of Provisions

1. Treatment of Rental Real Estate Activities of Qualifying Taxpayers

The proposed regulations provide that a rental real estate activity of a qualifying taxpayer will remain passive for a taxable year unless the taxpayer materially participates in the activity. This rule applies to all rental real estate activities of a qualifying taxpayer, including those giving rise to expenses described in section 212 of the Code.

2. Determination of Rental Real Estate Activities

The proposed regulations provide that the election to treat all interests in rental real estate as a single activity is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer unless there is a material change in the taxpayer's facts and circumstances and the election is revoked. In addition, the regulations clarify that an electing taxpayer's limited partnership interests in rental real estate are combined with

the taxpayer's other interests in rental real estate into a single rental real estate activity. The regulations also clarify that interests in rental real estate cannot be combined with other trades or businesses of the taxpayer into a single activity. For this purpose, however, any rental real estate that a taxpayer groups with a trade or business activity under § 1.469-4(d)(1)(i) (A) or (C) is not treated as an interest in rental real estate.

3. Treatment of Limited Partners

Section 469(c)(7) provides that the new rules for rental real estate activities are not to be construed as affecting the determination of whether a qualifying taxpayer materially participates with respect to any interest in a limited partnership as a limited partner. Thus, material participation with respect to a limited partnership interest is determined in accordance with section 469(h)(2), which provides that limited partners are treated as material participants only to the extent provided in regulations. The existing temporary regulations provide that material participation can generally be established by satisfying one of seven tests, but only three of these tests can be used to establish material participation with respect to limited partnership items. Accordingly, the proposed regulations provide that a qualifying taxpayer generally must establish material participation in a rental real estate activity held, in whole or part, through limited partnership interests under one of the three tests available to limited partners under the temporary regulations. This rule does not apply if the taxpayer elects to treat all interests in rental real estate as a single activity and less than 10 percent of the taxpayer's gross rental income from the activity is attributable to limited partnership interests. In that case, the taxpayer may use any of the seven tests under the temporary regulations to establish material participation in the activity.

4. Qualification Tests

As noted above, a taxpayer qualifies for the treatment prescribed in section 469(c)(7) by performing personal services in real property trades or businesses in which the taxpayer materially participates. The proposed regulations provide that, for purposes of the qualification tests, the determination of a taxpayer's real property trades or businesses is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances, but the determination must generally be applied consistently from year to year.

The proposed regulations also provide that material participation in a real property trade or business is determined under the generally applicable rules of the existing temporary regulations.

5. Coordination With Former Passive Activity Rules

The proposed regulations clarify the treatment of suspended losses and credits allocable to a nonpassive rental real estate activity. They provide that the former passive activity rules of section 469(f) apply. Thus, the suspended loss or credit may be used to offset income from, or tax liability allocable to, the rental real estate activity, and any remaining loss or credit is treated as a loss or credit from a passive activity.

6. Coordination With \$25,000 Offset for Rental Real Estate Activities

The proposed regulations clarify that a suspended loss or credit attributable to a nonpassive rental real estate activity may qualify under section 469(i) as a loss or credit from a rental real estate activity in which the taxpayer actively participates. Under section 469(i), such a loss or credit may be used to offset nonpassive income or tax liability attributable to nonpassive income, subject to a \$25,000 limitation and an adjusted gross income phaseout. The proposed regulations also clarify that the \$25,000 limitation is not reduced by losses or credits that are allowable under section 469(c)(7).

7. Regrouping Under the Activity Rules

The regulations defining an activity for purposes of section 469 (§ 1.469-4) include a consistency requirement. Once a taxpayer has grouped activities, they may not be regrouped unless the grouping is clearly inappropriate or there has been a material change in the facts and circumstances. The proposed regulations provide an exception to the consistency requirement for the first taxable year in which section 469(c)(7) applies. In that year, a taxpayer is permitted to regroup its activities to the extent necessary or appropriate to avail itself of the new rules.

The proposed regulations also provide that a taxpayer who adopted (or retained) a grouping of activities under Project PS-1-89 (the proposed definition of activity regulations) published in 1992 may regroup activities in the first taxable year in which the taxpayer determines tax liability under the rules of the final definition of activity regulations rather than under the proposed definition of activity regulations. The regulations also clarify that, in the first taxable year in