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(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

[T.D. 8175, 53 FR 5724, Feb. 25, 1988; 53 FR 15494, Apr. 29, 1988; T.D. 8253, 54 FR 20542, May 12, 1989; T.D. 8417, 57 FR 20758, May 15, 1992]

§ 1.469–4 Definition of activity.

(a) *Scope and purpose.* This section sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. A taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships.

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

(1) *Trade or business activities. Trade or business activities* are activities, other than rental activities or activities that are treated under § 1.469–1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that—

(i) Involve the conduct of a trade or business (within the meaning of section 162);

(ii) Are conducted in anticipation of the commencement of a trade or business; or

(iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

(2) *Rental activities. Rental activities* are activities that constitute rental activities within the meaning of § 1.469–1T(e)(3).

(c) *General rules for grouping activities*—(1) *Appropriate economic unit.* One or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(2) *Facts and circumstances test.* Except as otherwise provided in this section, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469—

(i) Similarities and differences in types of trades or businesses;

(ii) The extent of common control;

(iii) The extent of common ownership;

(iv) Geographical location; and

(v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

(3) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. Taxpayer *C* has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping *C*'s activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities. Moreover, once *C* groups these activities into appropriate economic units, paragraph (e) of this section requires *C* to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances makes it clearly inappropriate.

Example 2. Taxpayer *B*, an individual, is a partner in a business that sells non-food

items to grocery stores (partnership *L*). *B* also is a partner in a partnership that owns and operates a trucking business (partnership *Q*). The two partnerships are under common control. The predominant portion of *Q*'s business is transporting goods for *L*, and *Q* is the only trucking business in which *B* is involved. Under this section, *B* appropriately treats *L*'s wholesale activity and *Q*'s trucking activity as a single activity.

(d) *Limitation on grouping certain activities.* The grouping of activities under this section is subject to the following limitations:

(1) *Grouping rental activities with other trade or business activities*—(i) *Rule.* A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under paragraph (c) of this section and—

(A) The rental activity is insubstantial in relation to the trade or business activity;

(B) The trade or business activity is insubstantial in relation to the rental activity; or

(C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

(ii) *Examples.* The following examples illustrate the application of paragraph (d)(1)(i) of this section:

Example 1. (i) *H* and *W* are married and file a joint return. *H* is the sole shareholder of an S corporation that conducts a grocery store trade or business activity. *W* is the sole shareholder of an S corporation that owns and rents out a building. Part of the building is rented to *H*'s grocery store trade or business activity (the grocery store rental). The grocery store rental and the grocery store trade or business are not insubstantial in relation to each other.

(ii) Because they file a joint return, *H* and *W* are treated as one taxpayer for purposes of section 469. See §1.469–1T(j). Therefore, the sole owner of the trade or business activity (taxpayer *H–W*) is also the sole owner of the rental activity. Consequently, each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. Accordingly, the grocery store rental and the grocery store trade or business activity may be grouped together (under paragraph (d)(1)(i) of this section) into a single trade or business activity, if the grouping is appropriate under paragraph (c) of this section.

Example 2. Attorney *D* is a sole practitioner in town *X*. *D* also wholly owns residential real estate in town *X* that *D* rents to third parties. *D*'s law practice is a trade or business activity within the meaning of paragraph (b)(1) of this section. The residential real estate is a rental activity within the meaning of §1.469–1T(e)(3) and is insubstantial in relation to *D*'s law practice. Under the facts and circumstances, the law practice and the residential real estate do not constitute an appropriate economic unit under paragraph (c) of this section. Therefore, *D* may not treat the law practice and the residential real estate as a single activity.

(2) *Grouping real property rentals and personal property rentals prohibited.* An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.

(3) *Certain activities of limited partners and limited entrepreneurs*—(i) *In general.* Except as provided in this paragraph, a taxpayer that owns an interest, as a limited partner or a limited entrepreneur (as defined in section 464(e)(2)), in an activity described in section 465(c)(1), may not group that activity with any other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the grouping is appropriate under the provisions of paragraph (c) of this section.

(ii) *Example.* The following example illustrates the application of this paragraph (d)(3):

Example. (i) Taxpayer *A*, an individual, owns and operates a farm. *A* is also a member of *M*, a limited liability company that conducts a cattle-feeding business. *A* does not actively participate in the management of *M* (within the meaning of section 464(e)(2)(B)). In addition, *A* is a limited partner in *N*, a limited partnership engaged in oil and gas production.

(ii) Because *A* does not actively participate in the management of *M*, *A* is a limited entrepreneur in *M*'s activity. *M*'s cattle-feeding business is described in section 465(c)(1)(B)

(relating to farming) and may not be grouped with any other activity that does not involve farming. Moreover, *A*'s farm may not be grouped with the cattle-feeding activity unless the grouping constitutes an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

(iii) Because *A* is a limited partner in *N* and *N*'s activity is described in section 465(c)(1)(D) (relating to exploring for, or exploiting, oil and gas resources), *A* may not group *N*'s oil and gas activity with any other activity that does not involve exploring for, or exploiting, oil and gas resources. Thus, *N*'s activity may not be grouped with *A*'s farm or with *M*'s cattle-feeding business.

(4) *Other activities identified by the Commissioner.* A taxpayer that owns an interest in an activity identified in guidance issued by the Commissioner as an activity covered by this paragraph (d)(4) may not group that activity with any other activity, except as provided in the guidance issued by the Commissioner.

(5) *Activities conducted through section 469 entities*—(i) *In general.* A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section. Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities, in accordance with the rules of this section. A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

(ii) *Cross reference.* An activity that a taxpayer conducts through a C corporation subject to section 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. See § 1.469–2T(c)(3)(i)(A) and (c)(4)(i) for the rules regarding dividends on C corporation stock and compensation paid for personal services.

(e) *Disclosure and consistency requirements*—(1) *Original groupings.* Except as provided in paragraph (e)(2) of this section and § 1.469–11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years. Taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years.

(2) *Regroupings.* If it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe.

(f) *Grouping by Commissioner to prevent tax avoidance*—(1) *Rule.* The Commissioner may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup under paragraph (e) of this section) is to circumvent the underlying purposes of section 469.

(2) *Example.* The following example illustrates the application of this paragraph (f):

Example. (i) Taxpayers *D*, *E*, *F*, *G*, and *H* are doctors who operate separate medical practices. *D* invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

(ii) For each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute

an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of section 469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to section 469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under section 6662 against the taxpayers in appropriate circumstances.

(g) *Treatment of partial dispositions.* A taxpayer may, for the taxable year in which there is a disposition of substantially all of an activity, treat the part disposed of as a separate activity, but only if the taxpayer can establish with reasonable certainty—

(1) The amount of deductions and credits allocable to that part of the activity for the taxable year under § 1.469–1(f)(4) (relating to carryover of disallowed deductions and credits); and

(2) The amount of gross income and of any other deductions and credits allocable to that part of the activity for the taxable year.

(h) *Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).* See § 1.469–9 for rules for certain rental real estate activities.

[T.D. 8565, 59 FR 50487, Oct. 4, 1994, as amended by T.D. 8645, 60 FR 66499, Dec. 22, 1995]

§ 1.469–4T Definition of activity (temporary).

(a) *Overview*—(1) *Purpose and effect of overview.* This paragraph (a) contains a general description of the rules contained in this section and is intended solely as an aid to readers. The provisions of this paragraph (a) are not a substitute for the more detailed rules contained in the remainder of this section and cannot be relied upon in cases in which those rules qualify the general description contained in this paragraph (a).

(2) *Scope and structure of § 1.469–4T.* This section provides rules under which a taxpayer's business and rental operations are treated as one or more activities for purposes of section 469 and the regulations thereunder. (See paragraph (b)(2)(ii) of this section for the definition of business and rental operations.) In general, these rules are divided into three groups:

(i) Rules that identify the business and rental operations that constitute an undertaking (the undertaking rules).

(ii) Rules that identify the undertaking or undertakings that constitute an activity (the activity rules).

(iii) Rules that apply only under certain special circumstances (the special rules).

(3) *Undertaking rules*—(i) *In general.* The undertaking is generally the smallest unit that can constitute an activity. (See paragraph (b)(1) of this section for the general rule and paragraph (k)(2)(iii) of this section for a special rule that permits taxpayers to treat a single rental real estate undertaking as multiple activities.) An undertaking may include diverse business and rental operations.

(ii) *Basic undertaking rule.* The basic undertaking rule identifies the business and rental operations that constitute an undertaking by reference to their location and ownership. Under this rule, business and rental operations that are conducted at the same location and are owned by the same person are generally treated as part of the same undertaking. Conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person. (See paragraph (c)(2)(i) of this section.)

(iii) *Circumstances in which location is disregarded.* In some circumstances, the undertaking in which business and rental operations are included does not depend on the location at which the operations are conducted. Operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated (see paragraph (c)(2)(iii)(C) of this section). In addition, operations that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location are treated, in effect, as