fund established after Aug. 16, 1986, not be subject to current income tax and that if contributions to such account or fund are not deductible then the account or fund be taxed as a grantor trust, prior to repeal by Pub. L. 100–647, title I, §1018(f)(5)(B), Nov. 10, 1988, 102 Stat. 3582.

§ 469. Passive activity losses and credits limited

(a) Disallowance

(1) In general

If for any taxable year the taxpayer is described in paragraph (2), neither—

(A) the passive activity loss, nor

(B) the passive activity credit,

for the taxable year shall be allowed.

(2) Persons described

The following are described in this paragraph:

(A) any individual, estate, or trust,

(B) any closely held C corporation, and

(C) any personal service corporation.

(b) Disallowed loss or credit carried to next year

Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or credit allocable to such activity in the next taxable year.

(c) Passive activity defined

For purposes of this section—

(1) In general

The term ''passive activity'' means any activity—

(A) which involves the conduct of any trade or business, and

(B) in which the taxpayer does not materially participate.

(2) Passive activity includes any rental activity

Except as provided in paragraph (7), the term ''passive activity'' includes any rental activity.

(3) Working interests in oil and gas property

(A) In general

The term ''passive activity'' shall not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity which does not limit the liability of the taxpayer with respect to such interest.

(B) Income in subsequent years

If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a loss which is not from a passive activity, then any net income from such property (or any property the basis of which is determined in whole or in part by reference to the basis of such property) for any succeeding taxable year shall be treated as income of the taxpayer which is not from a passive activity. If the preceding sentence applies to the net income from any property for any taxable year, any credits allowable under subpart B (other than section 27(a)) or D of part IV of subchapter A for such taxable year which are attributable to such property shall be treated as credits not from a passive activity to the extent the amount of such credits does not exceed the regular tax liability of the taxpayer for the taxable year which is allocable to such net income.

(4) Material participation not required for paragraphs (2) and (3)

Paragraphs (2) and (3) shall be applied without regard to whether or not the taxpayer materially participates in the activity.

(5) Trade or business includes research and experimentation activity

For purposes of paragraph (1)(A), the term ''trade or business'' includes any activity involving research or experimentation (within the meaning of section 174).

(6) Activity in connection with trade or business or production of income

To the extent provided in regulations, for purposes of paragraph (1)(A), the term ''trade or business'' includes—

(A) any activity in connection with a trade or business, or

(B) any activity with respect to which expenses are allowable as a deduction under section 212.

(7) Special rules for taxpayers in real property business

(A) In general

If this paragraph applies to any taxpayer for a taxable year—

(i) paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and

(ii) this section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.

Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.

(B) Taxpayers to whom paragraph applies

This paragraph shall apply to a taxpayer for a taxable year if—

(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in which a spouse materially participates shall be determined under subsection (h).

(C) Real property trade or business

For purposes of this paragraph, the term ''real property trade or business'' means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

(D) Special rules for subparagraph (B)

(i) Closely held C corporations

In the case of a closely held C corporation, the requirements of subparagraph (B) shall be treated as met for any taxable year if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

(ii) Personal services as an employee

For purposes of subparagraph (B), personal services performed as an employee shall not be treated as performed in real property trades or businesses. The preceding sentence shall not apply if such employee is a 5-percent owner (as defined in section 416(i)(1)(B)) in the employer.

(d) Passive activity loss and credit defined

For purposes of this section—

(1) Passive activity loss

The term ''passive activity loss'' means the amount (if any) by which—

(A) the aggregate losses from all passive activities for the taxable year, exceed

(B) the aggregate income from all passive activities for such year.

(2) Passive activity credit

The term ''passive activity credit'' means the amount (if any) by which—

(A) the sum of the credits from all passive activities allowable for the taxable year under—

(i) subpart D of part IV of subchapter A, or

(ii) subpart B (other than section 27(a)) of such part IV, exceeds

(B) the regular tax liability of the taxpayer for the taxable year allocable to all passive activities.

(e) Special rules for determining income or loss from a passive activity

For purposes of this section—

(1) Certain income not treated as income from passive activity

In determining the income or loss from any activity—

(A) In general

There shall not be taken into account—

(i) any—

(I) gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business,

(II) expenses (other than interest) which are clearly and directly allocable to such gross income, and

(III) interest expense properly allocable to such gross income, and

(ii) gain or loss not derived in the ordinary course of a trade or business which is attributable to the disposition of property—

(I) producing income of a type described in clause (i), or

(II) held for investment.

For purposes of clause (ii), any interest in a passive activity shall not be treated as property held for investment.

(B) Return on working capital

For purposes of subparagraph (A), any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.

(2) Passive losses of certain closely held corporations may offset active income

(A) In general

If a closely held C corporation (other than a personal service corporation) has net active income for any taxable year, the passive activity loss of such taxpayer for such taxable year (determined without regard to this paragraph)—

(i) shall be allowable as a deduction against net active income, and

(ii) shall not be taken into account under subsection (a) to the extent so allowable as a deduction.

A similar rule shall apply in the case of any passive activity credit of the taxpayer.

(B) Net active income

For purposes of this paragraph, the term ''net active income'' means the taxable income of the taxpayer for the taxable year determined without regard to—

(i) any income or loss from a passive activity, and

(ii) any item of gross income, expense, gain, or loss described in paragraph (1)(A).

(3) Compensation for personal services

Earned income (within the meaning of section 911(d)(2)(A)) shall not be taken into account in computing the income or loss from a passive activity for any taxable year.

(4) Dividends reduced by dividends received deduction

For purposes of paragraphs (1) and (2), income from dividends shall be reduced by the amount of any dividends received deduction under section 243, 244, or 245.

(f) Treatment of former passive activities

For purposes of this section—

(1) In general

If an activity is a former passive activity for any taxable year—

(A) any unused deduction allocable to such activity under subsection (b) shall be offset against the income from such activity for the taxable year,

(B) any unused credit allocable to such activity under subsection (b) shall be offset against the regular tax liability (computed after the application of paragraph (1)) allo-

cable to such activity for the taxable year, and

(C) any such deduction or credit remaining after the application of subparagraphs (A) and (B) shall continue to be treated as arising from a passive activity.

(2) Change in status of closely held C corporation or personal service corporation

If a taxpayer ceases for any taxable year to be a closely held C corporation or personal service corporation, this section shall continue to apply to losses and credits to which this section applied for any preceding taxable year in the same manner as if such taxpayer continued to be a closely held C corporation or personal service corporation, whichever is applicable.

(3) Former passive activity

The term ''former passive activity'' means any activity which, with respect to the taxpayer—

(A) is not a passive activity for the taxable year, but

(B) was a passive activity for any prior taxable year.

(g) Dispositions of entire interest in passive activity

If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) Fully taxable transaction

(A) In general

If all gain or loss realized on such disposition is recognized, the excess of—

(i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over

(ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),

shall be treated as a loss which is not from a passive activity.

(B) Subparagraph (A) not to apply to disposition involving related party

If the taxpayer and the person acquiring the interest bear a relationship to each other described in section 267(b) or section 707(b)(1), then subparagraph (A) shall not apply to any loss of the taxpayer until the taxable year in which such interest is acquired (in a transaction described in subparagraph (A)) by another person who does not bear such a relationship to the taxpayer.

(C) Income from prior years

To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section.

(2) Disposition by death

If an interest in the activity is transferred by reason of the death of the taxpayer—

(A) paragraph (1)(A) shall apply to losses described in paragraph (1)(A) to the extent such losses are greater than the excess (if any) of—

(i) the basis of such property in the hands of the transferee, over

(ii) the adjusted basis of such property immediately before the death of the taxpayer, and

(B) any losses to the extent of the excess described in subparagraph (A) shall not be allowed as a deduction for any taxable year.

(3) Installment sale of entire interest

In the case of an installment sale of an entire interest in an activity to which section 453 applies, paragraph (1) shall apply to the portion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale (realized or to be realized when payment is completed).

(h) Material participation defined

For purposes of this section—

(1) In general

A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—

(A) regular,

(B) continuous, and

(C) substantial.

(2) Interests in limited partnerships

Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.

(3) Treatment of certain retired individuals and surviving spouses

A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.

(4) Certain closely held C corporations and personal service corporations

A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if—

(A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or

(B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

(5) Participation by spouse

In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.

(i) $25,000 offset for rental real estate activities

(1) In general

In the case of any natural person, subsection (a) shall not apply to that portion of the pas-

sive activity loss or the deduction equivalent (within the meaning of subsection (j)(5)) of the passive activity credit for any taxable year which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).

(2) Dollar limitation

The aggregate amount to which paragraph (1) applies for any taxable year shall not exceed $25,000.

(3) Phase-out of exemption

(A) In general

In the case of any taxpayer, the $25,000 amount under paragraph (2) shall be reduced (but not below zero) by 50 percent of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $100,000.

(B) Special phase-out of rehabilitation credit

In the case of any portion of the passive activity credit for any taxable year which is attributable to the rehabilitation credit determined under section 47, subparagraph (A) shall be applied by substituting ''$200,000'' for ''$100,000''.

(C) Exception for commercial revitalization deduction

Subparagraph (A) shall not apply to any portion of the passive activity loss for any taxable year which is attributable to the commercial revitalization deduction under section 1400I.

(D) Exception for low-income housing credit

Subparagraph (A) shall not apply to any portion of the passive activity credit for any taxable year which is attributable to any credit determined under section 42.

(E) Ordering rules to reflect exceptions and separate phase-outs

If subparagraph (B), (C), or (D) applies for a taxable year, paragraph (1) shall be applied—

(i) first to the portion of the passive activity loss to which subparagraph (C) does not apply,

(ii) second to the portion of such loss to which subparagraph (C) applies,

(iii) third to the portion of the passive activity credit to which subparagraph (B) or (D) does not apply,

(iv) fourth to the portion of such credit to which subparagraph (B) applies, and

(v) then to the portion of such credit to which subparagraph (D) applies.

(F) Adjusted gross income

For purposes of this paragraph, adjusted gross income shall be determined without regard to—

(i) any amount includible in gross income under section 86,

(ii) the amounts excludable from gross income under sections 135 and 137,

(iii) the amounts allowable as a deduction under sections 199, 219, 221, and 222, and

(iv) any passive activity loss or any loss allowable by reason of subsection (c)(7).

(4) Special rule for estates

(A) In general

In the case of taxable years of an estate ending less than 2 years after the date of the death of the decedent, this subsection shall apply to all rental real estate activities with respect to which such decedent actively participated before his death.

(B) Reduction for surviving spouse's exemption

For purposes of subparagraph (A), the $25,000 amount under paragraph (2) shall be reduced by the amount of the exemption under paragraph (1) (without regard to paragraph (3)) allowable to the surviving spouse of the decedent for the taxable year ending with or within the taxable year of the estate.

(5) Married individuals filing separately

(A) In general

Except as provided in subparagraph (B), in the case of any married individual filing a separate return, this subsection shall be applied by substituting—

(i) ''$12,500'' for ''$25,000'' each place it appears,

(ii) ''$50,000'' for ''$100,000'' in paragraph (3)(A), and

(iii) ''$100,000'' for ''$200,000'' in paragraph (3)(B).

(B) Taxpayers not living apart

This subsection shall not apply to a taxpayer who—

(i) is a married individual filing a separate return for any taxable year, and

(ii) does not live apart from his spouse at all times during such taxable year.

(6) Active participation

(A) In general

An individual shall not be treated as actively participating with respect to any interest in any rental real estate activity for any period if, at any time during such period, such interest (including any interest of the spouse of the individual) is less than 10 percent (by value) of all interests in such activity.

(B) No participation requirement for low-income housing, rehabilitation credit, or commercial revitalization deduction

Paragraphs (1) and (4)(A) shall be applied without regard to the active participation requirement in the case of—

(i) any credit determined under section 42 for any taxable year,

(ii) any rehabilitation credit determined under section 47, or

(iii) any deduction under section 1400I (relating to commercial revitalization deduction).

(C) Interest as a limited partner

Except as provided in regulations, no interest as a limited partner in a limited part-

nership shall be treated as an interest with respect to which the taxpayer actively participates.

(D) Participation by spouse

In determining whether a taxpayer actively participates, the participation of the spouse of the taxpayer shall be taken into account.

(j) Other definitions and special rules

For purposes of this section—

(1) Closely held C corporation

The term ''closely held C corporation'' means any C corporation described in section 465(a)(1)(B).

(2) Personal service corporation

The term ''personal service corporation'' has the meaning given such term by section 269A(b)(1), except that section 269A(b)(2) shall be applied—

(A) by substituting ''any'' for ''more than 10 percent'', and

(B) by substituting ''any'' for ''50 percent or more in value'' in section 318(a)(2)(C).

A corporation shall not be treated as a personal service corporation unless more than 10 percent of the stock (by value) in such corporation is held by employee-owners (within the meaning of section 269A(b)(2), as modified by the preceding sentence).

(3) Regular tax liability

The term ''regular tax liability'' has the meaning given such term by section 26(b).

(4) Allocation of passive activity loss and credit

The passive activity loss and the passive activity credit (and the $25,000 amount under subsection (i)) shall be allocated to activities, and within activities, on a pro rata basis in such manner as the Secretary may prescribe.

(5) Deduction equivalent

The deduction equivalent of credits from a passive activity for any taxable year is the amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits.

(6) Special rule for gifts

In the case of a disposition of any interest in a passive activity by gift—

(A) the basis of such interest immediately before the transfer shall be increased by the amount of any passive activity losses allocable to such interest with respect to which a deduction has not been allowed by reason of subsection (a), and

(B) such losses shall not be allowable as a deduction for any taxable year.

(7) Qualified residence interest

The passive activity loss of a taxpayer shall be computed without regard to qualified residence interest (within the meaning of section 163(h)(3)).

(8) Rental activity

The term ''rental activity'' means any activity where payments are principally for the use of tangible property.

(9) Election to increase basis of property by amount of disallowed credit

For purposes of determining gain or loss from a disposition of any property to which subsection (g)(1) applies, the transferor may elect to increase the basis of such property immediately before the transfer by an amount equal to the portion of any unused credit allowable under this chapter which reduced the basis of such property for the taxable year in which such credit arose. If the taxpayer elects the application of this paragraph, such portion of the passive activity credit of such taxpayer shall not be allowed for any taxable year.

(10) Coordination with section 280A

If a passive activity involves the use of a dwelling unit to which section 280A(c)(5) applies for any taxable year, any income, deduction, gain, or loss allocable to such use shall not be taken into account for purposes of this section for such taxable year.

(11) Aggregation of members of affiliated groups

Except as provided in regulations, all members of an affiliated group which files a consolidated return shall be treated as 1 corporation.

(12) Special rule for distributions by estates or trusts

If any interest in a passive activity is distributed by an estate or trust—

(A) the basis of such interest immediately before such distribution shall be increased by the amount of any passive activity losses allocable to such interest, and

(B) such losses shall not be allowable as a deduction for any taxable year.

(k) Separate application of section in case of publicly traded partnerships

(1) In general

This section shall be applied separately with respect to items attributable to each publicly traded partnership (and subsection (i) shall not apply with respect to items attributable to any such partnership). The preceding sentence shall not apply to any credit determined under section 42, or any rehabilitation credit determined under section 47, attributable to a publicly traded partnership to the extent the amount of any such credits exceeds the regular tax liability attributable to income from such partnership.

(2) Publicly traded partnership

For purposes of this section, the term ''publicly traded partnership'' means any partnership if—

(A) interests in such partnership are traded on an established securities market, or

(B) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

(3) Coordination with subsection (g)

For purposes of subsection (g), a taxpayer shall not be treated as having disposed of his entire interest in an activity of a publicly traded partnership until he disposes of his entire interest in such partnership.

(4) Application to regulated investment companies

For purposes of this section, a regulated investment company (as defined in section 851) holding an interest in a qualified publicly traded partnership (as defined in section 851(h)) shall be treated as a taxpayer described in subsection (a)(2) with respect to items attributable to such interest.

(*l*) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations—

(1) which specify what constitutes an activity, material participation, or active participation for purposes of this section,

(2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),

(3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,

(4) which provide for the determination of the allocation of interest expense for purposes of this section, and

(5) which deal with changes in marital status and changes between joint returns and separate returns.

(m) Phase-in of disallowance of losses and credits for interest held before date of enactment

(1) In general

In the case of any passive activity loss or passive activity credit for any taxable year beginning in calendar years 1987 through 1990, subsection (a) shall not apply to the applicable percentage of that portion of such loss (or such credit) which is attributable to pre-enactment interests.

(2) Applicable percentage

For purposes of this subsection, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable years beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10.

(3) Portion of loss or credit attributable to pre-enactment interests

For purposes of this subsection—

(A) In general

The portion of the passive activity loss (or passive activity credit) for any taxable year which is attributable to pre-enactment interests is the lesser of—

(i) the amount of the passive activity loss (or passive activity credit) which is disallowed for the taxable year under subsection (a) (without regard to this subsection), or

(ii) the amount of the passive activity loss (or passive activity credit) which would be disallowed for the taxable year (without regard to this subsection and without regard to any amount allocable to an activity for the taxable year under subsection (b)) taking into account only pre-enactment interests.

(B) Pre-enactment interest

(i) In general

The term ''pre-enactment interest'' means any interest in a passive activity held by a taxpayer on the date of the enactment of the Tax Reform Act of 1986, and at all times thereafter.

(ii) Binding contract exception

For purposes of clause (i), any interest acquired after such date of enactment pursuant to a written binding contract in effect on such date, and at all times thereafter, shall be treated as held on such date.

(iii) Interest in activities

The term ''pre-enactment interest'' shall not include an interest in a passive activity unless such activity was being conducted on such date of enactment. The preceding sentence shall not apply to an activity commencing after such date if—

(I) the property used in such activity is acquired pursuant to a written binding contract in effect on August 16, 1986, and at all times thereafter, or

(II) construction of property used in such activity began on or before August 16, 1986.

(Added Pub. L. 99–514, title V, §501(a), Oct. 22, 1986, 100 Stat. 2233; amended Pub. L. 100–203, title X, §10212(a), Dec. 22, 1987, 101 Stat. 1330–405; Pub. L. 100–647, title I, §1005(a)(1)–(9), (11), (12), title II, §2004(g), title VI, §6009(c)(3), Nov. 10, 1988, 102 Stat. 3387–3389, 3603, 3690; Pub. L. 101–239, title VII, §7109(a), Dec. 19, 1989, 103 Stat. 2322; Pub. L. 101–508, title XI, §§11704(a)(6), 11813(b)(16), Nov. 5, 1990, 104 Stat. 1388–518, 1388–555; Pub. L. 103–66, title XIII, §13143(a), (b), Aug. 10, 1993, 107 Stat. 440, 441; Pub. L. 104–188, title I, §§1704(d)(1), (e)(1), 1807(c)(4), Aug. 20, 1996, 110 Stat. 1878, 1902; Pub. L. 105–277, div. J, title IV, §4003(a)(2)(D), Oct. 21, 1998, 112 Stat. 2681–908; Pub. L. 106–554, §1(a)(7) [title I, §101(b)], Dec. 21, 2000, 114 Stat. 2763, 2763A–599; Pub. L. 107–16, title IV, §431(c)(3), June 7, 2001, 115 Stat. 68; Pub. L. 107–147, title IV, §412(a), Mar. 9, 2002, 116 Stat. 53; Pub. L. 108–357, title I, §102(d)(5), title III, §331(g), Oct. 22, 2004, 118 Stat. 1429, 1477.)

AMENDMENT OF SECTION

For termination of amendment by section 901 of Pub. L. 107–16, see Effective and Termination Dates of 2001 Amendment note below.

REFERENCES IN TEXT

The date of the enactment of the Tax Reform Act of 1986, referred to in subsec. (m)(3)(B), is the date of enactment of Pub. L. 99–514, which was approved Oct. 22, 1986.

AMENDMENTS

2004—Subsec. (i)(3)(F)(iii). Pub. L. 108–357, §102(d)(5), inserted ''199,'' before ''219,''.

Subsec. (k)(4). Pub. L. 108–357, §331(g), added par. (4).

2002—Subsec. (i)(3)(E)(ii) to (iv). Pub. L. 107–147 added cls. (ii) to (iv) and struck out former cls. (ii) to (iv) which read as follows:

''(ii) second to the portion of the passive activity credit to which subparagraph (B) or (D) does not apply,

''(iii) third to the portion of such credit to which subparagraph (B) applies,

''(iv) fourth to the portion of such loss to which subparagraph (C) applies, and''.

2001—Subsec. (i)(3)(F)(iii). Pub. L. 107–16, §§431(c)(3), 901, temporarily substituted '', 221, and 222'' for ''and 221''. See Effective and Termination Dates of 2001 Amendment note below.

2000—Subsec. (i)(3)(C) to (F). Pub. L. 106–554, §1(a)(7) [title I, §101(b)(1), (2)], added subpar. (C), redesignated former subpars. (C) to (E) as (D) to (F), respectively, and generally amended heading and text of subpar. (E), as redesignated. Prior to amendment, text read as follows: ''If subparagraph (B) or (C) applies for any taxable year, paragraph (1) shall be applied—

''(i) first to the passive activity loss,

''(ii) second to the portion of the passive activity credit to which subparagraph (B) or (C) does not apply,

''(iii) third to the portion of such credit to which subparagraph (B) applies, and

''(iv) then to the portion of such credit to which subparagraph (C) applies.''

Subsec. (i)(6)(B). Pub. L. 106–554, §1(a)(7) [title I, §101(b)(3)(B)], substituted '', rehabilitation credit, or commercial revitalization deduction'' for ''or rehabilitation credit'' in heading.

Subsec. (i)(6)(B)(iii). Pub. L. 106–554, §1(a)(7) [title I, §101(b)(3)(A)], added cl. (iii).

1998—Subsec. (i)(3)(E)(iii). Pub. L. 105–277 amended cl. (iii) generally. Prior to amendment, cl. (iii) read as follows: ''any amount allowable as a deduction under section 219, and''.

1996—Subsec. (c)(3)(B). Pub. L. 104–188, §1704(d)(1), inserted at end ''If the preceding sentence applies to the net income from any property for any taxable year, any credits allowable under subpart B (other than section 27(a)) or D of part IV of subchapter A for such taxable year which are attributable to such property shall be treated as credits not from a passive activity to the extent the amount of such credits does not exceed the regular tax liability of the taxpayer for the taxable year which is allocable to such net income.''

Subsec. (g)(1)(A). Pub. L. 104–188, §1704(e)(1), reenacted heading without change and amended text generally. Prior to amendment, text read as follows: ''If all gain or loss realized on such disposition is recognized, the excess of—

''(i) the sum of—

''(I) any loss from such activity for such taxable year (determined after application of subsection (b)), plus

''(II) any loss realized on such disposition, over

''(ii) net income or gain for such taxable year from all passive activities (determined without regard to losses described in clause (i)),

shall be treated as a loss which is not from a passive activity.''

Subsec. (i)(3)(E)(ii). Pub. L. 104–188, §1807(c)(4), amended cl. (ii) generally. Prior to amendment, cl. (ii) read as follows: ''the amount excludable from gross income under section 135,''.

1993—Subsec. (c)(2). Pub. L. 103–66, §13143(b)(1), substituted ''Except as provided in paragraph (7), the'' for ''The''.

Subsec. (c)(7). Pub. L. 103–66, §13143(a), added par. (7).

Subsec. (i)(3)(E)(iv). Pub. L. 103–66, §13143(b)(2), inserted ''or any loss allowable by reason of subsection (c)(7)'' after ''loss''.

1990—Subsec. (i)(3)(B), (6)(B)(ii). Pub. L. 101–508, §11813(b)(16)(A), substituted ''rehabilitation credit determined under section 47'' for ''rehabilitation investment credit (within the meaning of section 48(*o*))''.

Subsec. (k)(1). Pub. L. 101–508, §11813(b)(16)(B), substituted ''rehabilitation credit determined under section 47'' for ''rehabilitation investment credit (within the meaning of section 48(*o*))''.

Subsec. (m)(3)(A). Pub. L. 101–508, §11704(a)(6), substituted ''pre-enactment'' for ''preenactment''.

1989—Subsec. (i)(3)(B), (C). Pub. L. 101–239 added subpars. (B) and (C) and struck out former subpars. (B) and (C) which read as follows:

''(B) SPECIAL PHASE-OUT OF LOW-INCOME HOUSING AND REHABILITATION CREDITS.—In the case of any portion of the passive activity credit for any taxable year which is attributable to any credit to which paragraph (6)(B) applies, subparagraph (A) shall be applied by substituting '$200,000' for '$100,000'.

''(C) ORDERING RULE TO REFLECT SEPARATE PHASE-OUTS.—If subparagraph (B) applies for any taxable year, paragraph (1) shall be applied—

''(i) first to the passive activity loss,

''(ii) second to the portion of the passive activity credit to which subparagraph (B) does not apply, and

''(iii) then to the portion of such credit to which subparagraph (B) applies.''

Subsec. (i)(3)(D), (E). Pub. L. 101–239 added subpar. (D) and redesignated former subpar. (D) as (E).

1988—Subsec. (e)(1)(A)(ii). Pub. L. 100–647, §1005(a)(1), inserted ''not derived in the ordinary course of a trade or business which is'' after ''gain or loss''.

Subsec. (g)(1)(A). Pub. L. 100–647, §1005(a)(2)(A), amended subpar. (A) generally. Prior to amendment, subpar. (A) read as follows: ''If all gain or loss realized on such disposition is recognized, any loss from such activity which has not previously been allowed as a deduction (and in the case of a passive activity for the taxable year, any loss realized on such disposition) shall not be treated as a passive activity loss and shall be allowable as a deduction against income in the following order:

''(i) Income or gain from the passive activity for the taxable year (including any gain recognized on the disposition).

''(ii) Net income or gain for the taxable year from all passive activities.

''(iii) Any other income or gain.''

Subsec. (g)(1)(C). Pub. L. 100–647, §1005(a)(2)(B), substituted ''Income from prior years'' for ''Coordination with section 1211'' in heading and amended text generally. Prior to amendment, text read as follows: ''In the case of any loss realized on the disposition of an interest in a passive activity, section 1211 shall be applied before subparagraph (A) is applied.''

Subsec. (g)(2)(A). Pub. L. 100–647, §1005(a)(3), substituted ''paragraph (1)(A)'' for ''paragraph (1)'' and ''to losses described in paragraph (1)(A)'' for ''to such losses''.

Subsec. (g)(3). Pub. L. 100–647, §1005(a)(4), substituted ''(realized or to be realized'' for ''realized (or to be realized)'' and ''is completed)'' for ''is completed''.

Subsec. (h)(4). Pub. L. 100–647, §1005(a)(5), inserted ''only'' before ''if''.

Subsec. (i)(1). Pub. L. 100–647, §1005(a)(6), substituted ''in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year)'' for ''in the taxable year in which such portion of such loss or credit arose''.

Subsec. (i)(3)(D). Pub. L. 100–647, §6009(c)(3), added cl. (ii) and redesignated former cls. (ii) and (iii) as (iii) and (iv), respectively.

Subsec. (i)(6)(C). Pub. L. 100–647, §1005(a)(7), substituted ''Except as provided in regulations, no'' for ''No''.

Subsec. (j)(6)(A). Pub. L. 100–647, §1005(a)(8), inserted ''with respect to which a deduction has not been allowed by reason of subsection (a)'' after ''to such interest''.

Subsec. (j)(10), (11). Pub. L. 100–647, §1005(a)(9), added pars. (10) and (11).

Subsec. (j)(12). Pub. L. 100–647, §1005(a)(11), added par. (12).

Subsec. (k)(3). Pub. L. 100–647, §2004(g), added par. (3).

Subsec. (m). Pub. L. 100–647, §1005(a)(12), substituted ''interest'' for ''interests'' in heading.

Subsec. (m)(1). Pub. L. 100–647, §1005(a)(12), added par. (1) and struck out former par. (1) which read as follows: ''In the case of any passive activity loss or credit for any taxable year beginning in calendar years 1987 through 1990 which—

''(A) is attributable to a pre-enactment interest, but

''(B) is not attributable to a carryforward to such taxable year of any loss or credit which was disallowed under this section for a preceding taxable year,

there shall be disallowed under subsection (a) only the applicable percentage of the amount which (but for this subsection) would have been disallowed under subsection (a) for such taxable year.''

Subsec. (m)(2). Pub. L. 100–647, §1005(a)(12), added par. (2) and struck out former par. (2) which resulted in substituting ''65'', ''40'', ''20'', and ''10'' for ''35'', ''60'', ''80'', and ''90'' respectively, in second column.

Subsec. (m)(3)(A). Pub. L. 100–647, §1005(a)(12), added subpar. (A) and struck out former subpar. (A) which read as follows: ''The portion of the passive activity loss for any taxable year which is attributable to pre-enactment interests shall be equal to the lesser of—

''(i) the passive activity loss for such taxable year, or

''(ii) the passive activity loss for such taxable year determined by taking into account only pre-enactment interests.

For purposes of this subparagraph, the deduction equivalent (within the meaning of subsection (j)(5)) of a passive activity credit shall be taken into account.''

1987—Subsecs. (k) to (m). Pub. L. 100–203 added subsec. (k) and redesignated former subsecs. (k) and (*l*) as (*l*) and (m), respectively.

EFFECTIVE DATE OF 2004 AMENDMENT

Amendment by section 102(d)(5) of Pub. L. 108–357 applicable to taxable years beginning after Dec. 31, 2004, see section 102(e) of Pub. L. 108–357, set out as a note under section 56 of this title.

Pub. L. 108–357, title III, §331(h), Oct. 22, 2004, 118 Stat. 1477, provided that: ''The amendments made by this section [amending this section and sections 851 and 7704 of this title] shall apply to taxable years beginning after the date of the enactment of this Act [Oct. 22, 2004].''

EFFECTIVE DATE OF 2002 AMENDMENT

Amendment by Pub. L. 107–147 effective as if included in the provisions of the Community Renewal Tax Relief Act of 2000 [H.R. 5662, as enacted by Pub. L. 106–554], to which such amendment relates, see section 412(e) of Pub. L. 107–147, set out as a note under section 151 of this title.

EFFECTIVE AND TERMINATION DATES OF 2001 AMENDMENT

Amendment by Pub. L. 107–16 applicable to payments made in taxable years beginning after Dec. 31, 2001, see section 431(d) of Pub. L. 107–16, set out as a note under section 62 of this title.

Amendment by Pub. L. 107–16 inapplicable to taxable, plan, or limitation years beginning after Dec. 31, 2012, and the Internal Revenue Code of 1986 to be applied and administered to such years as if such amendment had never been enacted, see section 901 of Pub. L. 107–16, set out as a note under section 1 of this title.

EFFECTIVE DATE OF 1998 AMENDMENT

Amendment by Pub. L. 105–277 effective as if included in the provision of the Taxpayer Relief Act of 1997, Pub. L. 105–34, to which such amendment relates, see section 4003(*l*) of Pub. L. 105–277, set out as a note under section 86 of this title.

EFFECTIVE DATE OF 1996 AMENDMENT

Section 1704(d)(2) of Pub. L. 104–188 provided that: ''The amendment made by paragraph (1) [amending this section] shall apply to taxable years beginning after December 31, 1986.''

Section 1704(e)(2) of Pub. L. 104–188 provided that: ''The amendment made by paragraph (1) [amending this section] shall apply to taxable years beginning after December 31, 1986.''

Amendment by section 1807(c)(4) of Pub. L. 104–188 applicable to taxable years beginning after Dec. 31, 1996, see section 1807(e) of Pub. L. 104–188, set out as an Effective Date note under section 23 of this title.

EFFECTIVE DATE OF 1993 AMENDMENT

Section 13143(c) of Pub. L. 103–66 provided that: ''The amendments made by this section [amending this section] shall apply to taxable years beginning after December 31, 1993.''

EFFECTIVE DATE OF 1990 AMENDMENT

Amendment by section 11813(b)(16) of Pub. L. 101–508 applicable to property placed in service after Dec. 31, 1990, but not applicable to any transition property (as defined in section 49(e) of this title), any property with respect to which qualified progress expenditures were previously taken into account under section 46(d) of this title, and any property described in section 46(b)(2)(C) of this title, as such sections were in effect on Nov. 4, 1990, see section 11813(c) of Pub. L. 101–508, set out as a note under section 45K of this title.

EFFECTIVE DATE OF 1989 AMENDMENT

Section 7109(b) of Pub. L. 101–239 provided that:

''(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section [amending this section] shall apply to property placed in service after December 31, 1989, in taxable years ending after such date.

''(2) SPECIAL RULE WHERE INTEREST HELD IN PASS-THRU ENTITY.—In the case of a taxpayer who holds an indirect interest in property described in paragraph (1), the amendments made by this section shall apply only if such interest is acquired after December 31, 1989.''

EFFECTIVE DATE OF 1988 AMENDMENT

Amendment by section 1005(a)(1)–(9), (11), (12) of Pub. L. 100–647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99–514, to which such amendment relates, see section 1019(a) of Pub. L. 100–647, set out as a note under section 1 of this title.

Amendment by section 2004(g) of Pub. L. 100–647 effective, except as otherwise provided, as if included in the provisions of the Revenue Act of 1987, Pub. L. 100–203, title X, to which such amendment relates, see section 2004(u) of Pub. L. 100–647, set out as a note under section 56 of this title.

Amendment by section 6009(c)(3) of Pub. L. 100–647 applicable to taxable years beginning after Dec. 31, 1989, see section 6009(d) of Pub. L. 100–647, set out as a note under section 86 of this title.

EFFECTIVE DATE OF 1987 AMENDMENT

Amendment by Pub. L. 100–203 effective as if included in the amendments made by section 501 of the Tax Reform Act of 1986, Pub. L. 99–514, see section 10212(c) of Pub. L. 100–203, set out as a note under section 58 of this title.

EFFECTIVE DATE

Section 501(c) of Pub. L. 99–514, as amended by Pub. L. 100–647, title I, §1005(a)(10), title IV, §4003(b)(2), Nov. 10, 1988, 102 Stat. 3388, 3644, provided that:

''(1) IN GENERAL.—The amendments made by this section [enacting this section] shall apply to taxable years beginning after December 31, 1986.

''(2) SPECIAL RULE FOR CARRYOVERS.—The amendments made by this section shall not apply to any loss, deduction, or credit carried to a taxable year beginning after December 31, 1986, from a taxable year beginning before January 1, 1987.

''[(3) Repealed. Pub. L. 100–647, title IV, §4003(b)(2), Nov. 10, 1988, 102 Stat. 3644.]

''(4) INCOME FROM SALES OF PASSIVE ACTIVITIES IN TAXABLE YEARS BEGINNING BEFORE JANUARY 1, 1987.—If—

''(A) gain is recognized in a taxable year beginning after December 31, 1986, from a sale or exchange of an

interest in an activity in a taxable year beginning before January 1, 1987, and

''(B) such gain would have been treated as gain from a passive activity had section 469 of the Internal Revenue Code of 1986 (as added by this section) been in effect for the taxable year in which the sale or exchange occurred and for all succeeding taxable years,

then such gain shall be treated as gain from a passive activity for purposes of such section.''

SAVINGS PROVISION

For provisions that nothing in amendment by section 11813(b)(16) of Pub. L. 101–508 be construed to affect treatment of certain transactions occurring, property acquired, or items of income, loss, deduction, or credit taken into account prior to Nov. 5, 1990, for purposes of determining liability for tax for periods ending after Nov. 5, 1990, see section 11821(b) of Pub. L. 101–508, set out as a note under section 45K of this title.

AMOUNTS ATTRIBUTABLE TO ACTIVITIES SUBJECT TO LIMITATIONS UNDER SECTION 469 TREATED AS DEDUCTION ALLOCABLE TO SUCH ACTIVITY

Section 1005(c)(11) of Pub. L. 100–647 provided that: ''If—

''(A) any amount was disallowed as a deduction under section 163(d) of the Internal Revenue Code of 1954 [now 1986] (as in effect on the day before the date of the enactment of the Reform Act [Oct. 22, 1986]),

''(B) such amount would (but for this paragraph) be treated as investment interest paid or accrued by the taxpayer in the taxpayer's first taxable year beginning after December 31, 1986, and

''(C) the taxpayer makes an election under this paragraph at such time and in such manner as the Secretary of the Treasury or his delegate shall prescribe,

to the extent such amount is attributable to an activity subject to the limitations of section 469 of the 1986 Code, such amount shall not be treated as investment interest but shall be treated as a deduction allocable to such activity for such first taxable year. Subsection (m) of section 469 of the 1986 Code and section 501(c)(2) of the Reform Act [Pub. L. 99–514, set out as an Effective Date note above] shall not apply to any amount so treated.''

TRANSITIONAL RULE FOR LOW-INCOME HOUSING

Section 502 of Pub. L. 99–514, as amended by Pub. L. 99–509, title VIII, § 8073(a), Oct. 21, 1986, 100 Stat. 1965; Pub. L. 100–647, title I, § 1005(b), Nov. 10, 1988, 102 Stat. 3389, provided that:

''(a) GENERAL RULE.—Any loss sustained by a qualified investor with respect to an interest in a qualified low-income housing project for any taxable year in the relief period shall not be treated as a loss from a passive activity for purposes of section 469 of the Internal Revenue Code of 1986.

''(b) RELIEF PERIOD.—For purposes of subsection (a), the term 'relief period' means the period beginning with the taxable year in which the investor made his initial investment in the qualified low-income housing project and ending with whichever of the following is the earliest—

''(1) the 6th taxable year after the taxable year in which the investor made his initial investment,

''(2) the 1st taxable year after the taxable year in which the investor is obligated to make his last investment, or

''(3) the taxable year preceding the 1st taxable year for which such project ceased to be a qualified low-income housing project.

''(c) QUALIFIED LOW-INCOME HOUSING PROJECT.—For purposes of this section, the term 'qualified low-income housing project' means any project if—

''(1) such project meets the requirements of clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B) [of the Internal Revenue Code of 1986] as of the date placed in service and for each taxable year thereafter which begins after 1986 and for which a passive loss may be allowable with respect to such project,

''(2) the operator certifies to the Secretary of the Treasury or his delegate that such project met the requirements of paragraph (1) on the date of the enactment of this Act [Oct. 22, 1986] (or, if later, when placed in service) and annually thereafter,

''(3) such project is constructed or acquired pursuant to a binding written contract entered into on or before August 16, 1986, and

''(4) such project is placed in service before January 1, 1989.

''(d) QUALIFIED INVESTOR.—For purposes of this section—

''(1) IN GENERAL.—The term 'qualified investor' means any natural person who holds (directly or through 1 or more entities) an interest in a qualified low-income housing project—

''(A) if—

''(i) in the case of a project placed in service on or before August 16, 1986, such person held an interest in such project on August 16, 1986, and such person made his initial investment after December 31, 1983, or

''(ii) in the case of a project placed in service after August 16, 1986, such person made his initial investment after December 31, 1983, and such person held an interest in such project on December 31, 1986, and

''(B) if such investor is required to make payments after December 31, 1986, of 50 percent or more of the total original obligated investment for such interest.

For purposes of subparagraph (A), a person shall be treated as holding an interest on August 16, 1986, or December 31, 1986, if on such date such person had a binding contract to acquire such interest.

''(2) TREATMENT OF ESTATES.—The estate of a decedent shall succeed to the treatment under this section of the decedent but only with respect to the 1st 2 taxable years of such estate ending after the date of the decedent's death.

''(3) SPECIAL RULE FOR CERTAIN PARTNERSHIPS.—In the case of any property which is held by a partnership—

''(A) which placed such property in service on or after December 31, 1985, and before August 17, 1986, and continuously held such property through the close of the taxable year for which the determination is being made, and

''(B) which was not treated as a new partnership or as terminated at any time on or after the date on which such property was placed in service and through the close of the taxable year for which the determination is being made,

paragraph (1)(A)(i) shall be applied by substituting 'December 31, 1988' for 'August 16, 1986' the 2nd place it appears.

''(4) SPECIAL RULE FOR CERTAIN RURAL HOUSING.—In the case of any interest in a qualified low-income housing project which—

''(A) is assisted under section 515 of the Housing Act of 1949 [42 U.S.C. 1485] (relating to the Farmers' Home Administration Program), and

''(B) is located in a town with a population of less than 10,000 and which is not part of a metropolitan statistical area,

paragraph (1)(B) shall be applied by substituting '35 percent' for '50 percent' and subsection (b)(1) shall be applied by substituting '5th taxable year' for '6th taxable year'. The preceding sentence shall not apply to any interest unless, on December 31, 1986, at least one-half of the number of payments required with respect to such interest remain to be paid.

''(e) SPECIAL RULES.—

''(1) WHERE MORE THAN 1 BUILDING IN PROJECT.—If there is more than 1 building in any project, the determination of when such project is placed in service shall be based on when the 1st building in such project is placed in service.

''(2) ONLY CASH AND OTHER PROPERTY TAKEN INTO ACCOUNT.—In determining the amount any person invests in (or is obligated to invest in) any interest, only cash and other property shall be taken into account.

''(3) COORDINATION WITH CREDIT.—No low-income housing credit shall be determined under section 42 of the Internal Revenue Code of 1986 with respect to any project with respect to which any person has been allowed any benefit under this section.''

[Section 8073(b) of Pub. L. 99–509 provided that: ''The amendment made by subsection (a) [amending section 502 of Pub. L. 99–514, set out above] shall take effect as if included in section 502 of the Tax Reform Act of 1986 on the date of its enactment [Oct. 22, 1986].'']

§ 470. Limitation on deductions allocable to property used by governments or other tax-exempt entities

(a) Limitation on losses

Except as otherwise provided in this section, a tax-exempt use loss for any taxable year shall not be allowed.

(b) Disallowed loss carried to next year

Any tax-exempt use loss with respect to any tax-exempt use property which is disallowed under subsection (a) for any taxable year shall be treated as a deduction with respect to such property in the next taxable year.

(c) Definitions

For purposes of this section—

(1) Tax-exempt use loss

The term ''tax-exempt use loss'' means, with respect to any taxable year, the amount (if any) by which—

(A) the sum of—

(i) the aggregate deductions (other than interest) directly allocable to a tax-exempt use property, plus

(ii) the aggregate deductions for interest properly allocable to such property, exceed

(B) the aggregate income from such property.

(2) Tax-exempt use property

(A) In general

The term ''tax-exempt use property'' has the meaning given to such term by section 168(h), except that such section shall be applied—

(i) without regard to paragraphs (1)(C) and (3) thereof, and

(ii) as if section 197 intangible property (as defined in section 197), and property described in paragraph (1)(B) or (2) of section 167(f), were tangible property.

(B) Exception for partnerships

Such term shall not include any property which would (but for this subparagraph) be tax-exempt use property solely by reason of section 168(h)(6).

(C) Cross reference

For treatment of partnerships as leases to which section 168(h) applies, see section 7701(e).

(d) Exception for certain leases

This section shall not apply to any lease of property which meets the requirements of all of the following paragraphs:

(1) Availability of funds

(A) In general

A lease of property meets the requirements of this paragraph if (at all times during the lease term) not more than an allowable amount of funds are—

(i) subject to any arrangement referred to in subparagraph (B), or

(ii) set aside or expected to be set aside,

to or for the benefit of the lessor or any lender, or to or for the benefit of the lessee to satisfy the lessee's obligations or options under the lease. For purposes of clause (ii), funds shall be treated as set aside or expected to be set aside only if a reasonable person would conclude, based on the facts and circumstances, that such funds are set aside or expected to be set aside.

(B) Arrangements

The arrangements referred to in this subparagraph include a defeasance arrangement, a loan by the lessee to the lessor or any lender, a deposit arrangement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, prepaid rent (within the meaning of the regulations under section 467), a sinking fund arrangement, a guaranteed investment contract, financial guaranty insurance, and any similar arrangement (whether or not such arrangement provides credit support).

(C) Allowable amount

(i) In general

Except as otherwise provided in this subparagraph, the term ''allowable amount'' means an amount equal to 20 percent of the lessor's adjusted basis in the property at the time the lease is entered into.

(ii) Higher amount permitted in certain cases

To the extent provided in regulations, a higher percentage shall be permitted under clause (i) where necessary because of the credit-worthiness of the lessee. In no event may such regulations permit a percentage of more than 50 percent.

(iii) Option to purchase

If under the lease the lessee has the option to purchase the property for a fixed price or for other than the fair market value of the property (determined at the time of exercise), the allowable amount at the time such option may be exercised may not exceed 50 percent of the price at which such option may be exercised.

(iv) No allowable amount for certain arrangements

The allowable amount shall be zero with respect to any arrangement which involves—

(I) a loan from the lessee to the lessor or a lender,

(II) any deposit received, letter of credit issued, or payment undertaking agreement entered into by a lender otherwise involved in the transaction, or