Dated: December 14. 1995.

Robert C. Livingston,

Director, Office of New Animal Drug Evaluation, Center for Veterinary Medicine.

[FR Doc. 95–31199 Filed 12–21–95; 8:45 am]

BILLING CODE 4160–01–F

21 CFR Part 558

New Animal Drugs; Change of Sponsor

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect a change of sponsor for two new animal drug applications (NADA's) from Farmland Industries, Inc., to A. L. Pharma, Inc.

EFFECTIVE DATE: December 22, 1995.

FOR FURTHER INFORMATION CONTACT: Thomas J. McKay, Center for Veterinary Medicine (HFV–102), Food and Drug Administration, 7500 Standish Pl., Rockville, MD 20855, 301–827–0213.

SUPPLEMENTARY INFORMATION: Farmland Industries, Inc., Kansas City, MS 64116, has informed FDA that it has transferred the ownership of, and all rights and interests in, approved NADA's 46–415 (Tylosin Premixes) and 91–749 (Tylosin-Sulfa Premixes) to A. L. Pharma, Inc., One Executive Dr., Fort Lee, NJ 07024. Accordingly, the agency is amending the regulations in 21 CFR 558.625 and 558.630.

List of Subject in 21 CFR Part 558

Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 558 is amended as follows:

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

1. The authority citation for 21 CFR part 558 continues to read as follows:

Authority: Secs. 512, 701 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b, 371).

§ 558.625 [Amended]

2. Section 558.625 *Tylosin* is amended in paragraph (b)(83) by removing ''021676'' and adding in its place ''046573''.

§ 558.630 [Amended]

3. Section 558.630 *Tylosin and sulfamethazine* is amended in paragraph (b)(10) by removing ''021676'' and by adding ''046573'' in numerical order.

Dated: December 14, 1995.

Robert C. Livingston,

Director, Office of New Animal Drug Evaluation, Center for Veterinary Medicine.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8645]

RIN 1545–AS38

Rules for Certain Rental Real Estate Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing rules for rental real estate activities of taxpayers engaged in certain real property trades or businesses. The regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993, and affect taxpayers subject to the limitations on passive activity losses and passive activity credits.

DATES: These regulations are effective on January 1, 1995. See § 1.469–11 for applicability.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (TD 8645), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to: CC:DOM:CORP:T:R (TD 8645), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: William M. Kostak at (202) 622–3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545–AS38. The estimated annual burden per respondent varies from 0.10 hours to 0.25 hours, depending on individual circumstances, with an estimated average of 0.15 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document amends 26 CFR part 1 to provide rules relating to the treatment of rental real estate activities of certain taxpayers under the passive activity loss and credit limitations of section 469. Section 469 disallows losses from passive activities to the extent they exceed income from passive activities and similarly disallows credits from passive activities to the extent they exceed tax liability allocable to passive activities. In general, passive activities are activities in which the taxpayer does not 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 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. Further, section 469(c)(7) provides 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.

On January 10, 1995, the IRS published in the Federal Register a notice of proposed rulemaking (60 FR 2557) to provide guidance regarding section 469(c)(7). A number of public comments were received concerning the proposed regulations, and a public hearing was held on May 11, 1995. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

I. General Background

The proposed regulations provide rules for determining whether a taxpayer qualifies for treatment under section 469(c)(7). The proposed regulations also provide rules for determining the rental real estate activities of qualifying taxpayers for purposes of section 469. Except for modifications in response to comments received on the proposed regulations,

the final regulations generally adopt the rules contained in the proposed regulations.

II. Public Comments

Several comments requested that the Service reconsider the rule in the proposed regulations prohibiting qualifying taxpayers from grouping rental real estate activities with other activities in determining whether the taxpayers materially participate in the rental real estate activities. After careful consideration, the final regulations adopt the rule in the proposed regulations because that position is consistent with the statutory language and the legislative history.

Several comments suggested that the rule in the proposed regulations prohibiting the grouping of rental real estate activities with other activities be modified to allow qualifying taxpayers to group the activities of development or construction of rental real estate with rental real estate activities. The final regulations do not adopt this modification because in most cases development and construction activities are separate and distinct from rental activities. In addition, this modification would introduce significant administrative difficulties in determining which development activities or construction activities qualify. However, the IRS and Treasury Department invite comments concerning whether the material participation tests in § 1.469–5T(a) should be amended to include a look-back material participation test for taxpayers significantly involved in the development or construction of their rental real estate interests.

Several comments requested clarification regarding whether a qualifying taxpayer's participation in a management activity may count towards material participation in a rental real estate activity if the management activity includes the management of rental real estate owned by the taxpayer. The final regulations clarify that a qualifying taxpayer may participate in a rental real estate activity through participation in a management activity. In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate. The final regulations also clarify that a qualifying taxpayer who owns rental real estate through an entity, including a C corporation that is subject to section 469, may count work performed by the taxpayer in managing the rental real estate of the entity in establishing material participation in the taxpayer's rental real estate activities. Thus, if a qualifying taxpayer owns some interests in rental real estate through a closely held C corporation and makes the election to treat all interests in rental real estate as a single activity, the aggregate rental real estate activity will include those interests held through the closely held C corporation for purposes of material participation.

One comment requested that the regulations modify the definition of trade or business to clarify that a taxpayer's real property trades or businesses are determined without regard to the taxpayer's grouping of activities under § 1.469–4. The final regulations clarify that a taxpayer's grouping of activities under § 1.469–4 does not control the determination of the taxpayer's real property trades or businesses for purposes of this section.

Several comments requested that the regulations provide a detailed definition of real property trades or businesses beyond the cross-reference to section 469(c)(7)(C). However, to avoid complex and mechanical rules, the final regulations do not adopt a detailed definition of real property trades or businesses. Instead, the regulations provide that taxpayers may use any reasonable method for determining their real property trades or businesses.

Several comments requested that the final regulations modify the rule in the proposed regulations providing that only employees who are five-percent owners of their employer at all times during the taxable year may treat personal services performed as an employee as services performed in a real property trade or business. The comments suggested that the regulations should take into account personal services performed by employees that are five-percent owners for a significant portion of a taxable year. In response to these comments, the final regulations are modified to provide that an employee may count services performed in a real property trade or business during the portion of the taxable year that the employee is a five-percent owner in the employer.

Several comments requested clarification concerning whether a qualifying taxpayer that makes an election to treat all interests in rental real estate as a single activity will be treated as having a single rental real estate activity for purposes of the former passive activity rule under section 469 (f). In addition, comments requested that the regulations be modified to provide that qualifying taxpayers that make the aggregation election will be treated as having separate activities for purposes of the disposition rules under section 469(g) and § 1.469–4(g). In response to these comments, the final regulations clarify that a qualifying taxpayer that makes the election to treat all interests in rental real estate as a single rental real estate activity will be treated as having a single activity for all purposes of section 469, including sections 469(f) and (g). The statutory language and the legislative history do not support a rule allowing a qualifying taxpayer to treat all interests in rental real estate as a single activity for purposes of material participation and section 469(f), but as separate activities for purposes of section 469(g).

In addition, in response to comments, the final regulations provide an example illustrating the operation of the former passive activity rule for qualifying taxpayers that make the election to treat all interests in rental real estate as a single activity. This example illustrates that qualifying taxpayers that make the aggregation election may use current net income from the aggregate rental real estate activity to offset the prior-year disallowed passive losses of the aggregate rental real estate activity, regardless of which rental real estate interests within that activity produced the income or prior-year losses.

Some comments requested that the regulations permit qualifying taxpayers to make or revoke the aggregation election on an amended income tax return. After careful consideration of this issue, the final regulations adopt the rule in the proposed regulations that aggregation elections must be made or revoked on an original return. The final regulations provide, however, that the election may be revoked in any year in which the facts are materially changed from those in the taxable year for which the election was made.

In addition, one comment requested clarification as to what constitutes a material change in the facts and circumstances that would allow a taxpayer to revoke an aggregation election. However, the final regulations do not provide an example or bright-line rule for determining when a material change in the facts and circumstances has occurred, because this determination is intended to be a broad factual inquiry. Providing an example or bright-line rule may inappropriately restrict the scope of that inquiry.

One comment requested the modification of the rule in the proposed regulations that the aggregation election has no effect in years the taxpayer is not a qualifying taxpayer. Instead, the comment suggested that, for ease of administration and compliance, the

aggregation election should be binding and irrevocable for all future years, including years in which the taxpayer is not a qualifying taxpayer. However, the final regulations adopt the rule in the proposed regulations because the position advocated by the comment would be unfavorable to many taxpayers and would not significantly improve administration.

Several comments requested that the regulations modify the rule in the proposed regulations treating each rental real estate interest of a passthrough entity as a separate interest of a person owning a fifty-percent or greater interest in the capital, gain, loss, income, deduction, or credit of the entity at any time during a taxable year. A commentator stated that this rule is burdensome on many passthrough entities and should be eliminated or modified. The final regulations modify this rule so that it applies only when a qualifying taxpayer owns a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year. Accordingly, this rule will not apply if a qualifying taxpayer owns a fifty-percent or greater interest in a single item of income or deduction but does not own a fifty-percent or greater interest in the overall capital, profits, or losses of the passthrough entity.

In response to one comment, the final regulations also clarify the application of the fifty-percent ownership rule to tiered passthrough entities. The final regulations provide that if a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate of the lower-tier entity will be a separate interest in rental real estate of the upper-tier entity.

In response to another comment, the final regulations clarify that section 469(i) applies after the rules of section 469(c)(7) are applied. Accordingly, the $25,000 offset will be applied only against passive losses from rental real estate activities, and not against losses that are allowable as a result of section 469(c)(7). In addition, the final regulations clarify that adjusted gross income for purposes of section 469(i) is not reduced by any losses from rental real estate that are allowable as a result of section 469(c)(7).

Several comments requested a modification to the effective date provision, to provide that aggregation elections made for taxable years beginning before January 1, 1995, are not binding for future years. Because taxpayers had sufficient notice of the rules of section 469(c)(7) and these regulations, this modification is unnecessary and would add administrative complexity. Accordingly, the final regulations adopt the effective date provision of the proposed regulations.

Finally, in response to a comment, the activity regrouping rule of § 1.469–4(e)(2) is clarified to provide that a taxpayer may not regroup activities unless the taxpayer's original grouping was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.

III. Effective Dates

In general, section 469(c)(7) applies for taxable years beginning after December 31, 1993. These regulations are effective for taxable years beginning on or after January 1, 1995. These regulations are also effective for elections under section 469(c)(7)(A) and paragraph (g) of these regulations that are made with returns filed on or after January 1, 1995.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has 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 preceding 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 William M. Kostak, Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and 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 is amended by adding an entry in numerical order to read as follows:

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

Section 1.469–9 also issued under 26 U.S.C. 469(c)(6), (h)(2), and (l)(1).

Par. 2. Section 1.469–0 is amended by:

1. Revising the entry for § 1.469–4(h).
2. Revising the heading for § 1.469–9 and adding entries for paragraphs (a) through (j) of § 1.469–9.
3. Revising the entry for § 1.469–11(b)(2) and removing the entries for § 1.469–11(b)(2)(i) and (ii).
4. Revising the entry for § 1.469–11(b)(3).
5. Adding an entry for § 1.469–11(b)(4).
6. The revisions and additions read as follows:

§ 1.469–0 Table of contents.

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§ 1.469–4 Definition of Activity.

* * * * *

(h) Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7).

* * * * *

§ 1.469–9 Rules for certain rental real estate activities.

(a) Scope and purpose.
(b) Definitions.
(1) Trade or business.
(2) Real property trade or business.
(3) Rental real estate.
(4) Personal services.
(5) Material participation.
(6) Qualifying taxpayer.
(c) Requirements for qualifying taxpayers.
(1) In general.
(2) Closely held C corporations.
(3) Requirement of material participation in the real property trades or businesses.
(4) Treatment of spouses.
(5) Employees in real property trades or businesses.
(d) General rule for determining real property trades or businesses.
(1) Facts and circumstances.
(2) Consistency requirement.
(e) Treatment of rental real estate activities of a qualifying taxpayer.
(1) In general.
(2) Treatment as a former passive activity.
(3) Grouping rental real estate activities with other activities.
(i) In general.
(ii) Special rule for certain management activities.
(4) Example.
(f) Limited partnership interests in rental real estate activities.
(1) In general.
(2) De minimis exception.
(g) Election to treat all interests in rental real estate as a single rental real estate activity.
(1) In general.
(2) Certain changes not material.
(3) Filing a statement to make or revoke the election.
(h) Interests in rental real estate held by certain passthrough entities.

(1) General rule.
(2) Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.
(3) Special rule for interests held in tiered passthrough entities.
(i) [Reserved].
(j) $25,000 offset for rental real estate activities of qualifying taxpayers.
(1) In general.
(2) Example.
* * * * *

§ 1.469–11 Effective date and transition rules.
* * * * *
(b) * * *
(2) Additional transition rule for 1992 amendments.
(3) Fresh starts under consistency rules.
(i) Regrouping when tax liability is first determined under Project PS–1–89.
(ii) Regrouping when tax liability is first determined under § 1.469–4.
(iii) Regrouping when taxpayer is first subject to section 469(c)(7).
(4) Certain investment credit property.
* * * * *

Par. 3. Section 1.469–4 is amended by revising paragraphs (e) (1) and (2) and (h). The revisions read as follows:

§ 1.469–4 Definition of Activity.

* * * * *
(e) * * *
(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.
* * * * *
(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.

Par. 4. Section 1.469–9 is revised to read as follows:

§ 1.469–9 Rules for certain rental real estate activities.

(a) *Scope and purpose.* This section provides guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities.
(b) *Definitions.* The following definitions apply for purposes of this section:
(1) *Trade or business.* A *trade or business* is any trade or business determined by treating the types of activities in § 1.469–4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.
(2) *Real property trade or business. Real property trade or business* is defined in section 469(c)(7)(C).
(3) *Rental real estate. Rental real estate* is any real property used by customers or held for use by customers in a rental activity within the meaning of § 1.469–1T(e)(3). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469–4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of this section.
(4) *Personal services. Personal services* means any work performed by an individual in connection with a trade or business. However, personal services do not include any work performed by an individual in the individual's capacity as an investor as described in § 1.469–5T(f)(2)(ii).
(5) *Material participation. Material participation* has the same meaning as under § 1.469–5T. Paragraph (f) of this section contains rules applicable to limited partnership interests in rental real estate that a qualifying taxpayer elects to aggregate with other interests in rental real estate of that taxpayer.
(6) *Qualifying taxpayer.* A *qualifying taxpayer* is a taxpayer that owns at least one interest in rental real estate and meets the requirements of paragraph (c) of this section.
(c) *Requirements for qualifying taxpayers*—(1) *In general.* A qualifying taxpayer must meet the requirements of section 469(c)(7)(B).
(2) *Closely held C corporations.* A closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements of section 469(c)(7)(D)(i). For purposes of section 469(c)(7)(D)(i), gross receipts do not include items of portfolio income within the meaning of § 1.469–2T(c)(3).
(3) *Requirement of material participation in the real property trades or businesses.* A taxpayer must materially participate in a real property trade or business in order for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the requirements of paragraph (c)(1) of this section.
(4) *Treatment of spouses.* Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of section 469(c)(7)(B). In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under § 1.469–5T(f)(3), regardless of whether the spouses file a joint return for the year.
(5) *Employees in real property trades or businesses.* For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.
(d) *General rule for determining real property trades or businesses*—(1) *Facts and circumstances.* The determination of a taxpayer's real property trades or businesses for purposes of paragraph (c) of this section is based on all of the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services. Depending on the facts and circumstances, a real property trade or business consists either of one or more than one trade or business specifically described in section 469(c)(7)(C). A taxpayer's grouping of activities under § 1.469–4 does not control the determination of the taxpayer's real property trades or businesses under this paragraph (d).
(2) *Consistency requirement.* Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of paragraph (c) of this section, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and

circumstances that makes the original determination clearly inappropriate.

(e) *Treatment of rental real estate activities of a qualifying taxpayer*—(1) *In general.* Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity. Each interest in rental real estate of a qualifying taxpayer will be treated as a separate rental real estate activity, unless the taxpayer makes an election under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity. Each separate rental real estate activity, or the single combined rental real estate activity if the taxpayer makes an election under paragraph (g), will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g). However, section 469 will continue to be applied separately with respect to each publicly traded partnership, as required under section 469(k), notwithstanding the rules of this section.

(2) *Treatment as a former passive activity.* For any taxable year in which a qualifying taxpayer materially participates in a rental real estate activity, that rental real estate activity will be treated as a former passive activity under section 469(f) if disallowed deductions or credits are allocated to the activity under § 1.469–1(f)(4).

(3) *Grouping rental real estate activities with other activities*—(i) *In general.* For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under § 1.469–5T.

(ii) *Special rule for certain management activities.* A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§ 1.469–5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

(4) *Example.* The following example illustrates the application of this paragraph (e).

Example. (i) Taxpayer *B* owns interests in three rental buildings, *U, V* and *W*. In 1995, *B* has $30,000 of disallowed passive losses allocable to Building *U* and $10,000 of disallowed passive losses allocable to Building *V* under § 1.469–1(f)(4). In 1996, *B* has $5,000 of net income from Building *U*, $5,000 of net losses from Building *V*, and $10,000 of net income from Building *W*. Also in 1996, *B* is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of *B* under paragraph (e)(1) of this section, unless *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If *B* makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether *B* materially participates in the combined activity.

(ii) Effective beginning in 1996, *B* makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. *B* works full-time managing the three buildings and thus materially participates in the combined activity in 1996 (even if *B* conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of *B* in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000+$10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000+$10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings *U, V* and *W* are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), *B* may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, *B* has $30,000 ($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

(f) *Limited partnership interests in rental real estate activities*—(1) *In general.* If a taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest (within the meaning of § 1.469–5T(e)(3)), the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation. Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in § 1.469–5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

(2) *De minimis exception.* If a qualifying taxpayer elects under paragraph (g) of this section to treat all interests in rental real estate as a single rental real estate activity, and the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than ten percent of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year, paragraph (f)(1) of this section does not apply. Thus the taxpayer may determine material participation under any of the tests listed in § 1.469–5T(a) that apply to rental real estate activities.

(g) *Election to treat all interests in rental real estate as a single rental real estate activity*—(1) *In general.* A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under § 1.469–4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

(2) *Certain changes not material.* The fact that an election is less advantageous to the taxpayer in a particular taxable year is not, of itself, a material change

in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

(3) *Filing a statement to make or revoke the election.* A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). The taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable. A taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. This statement must contain a declaration that the taxpayer is revoking the election under section 469(c)(7)(A) and an explanation of the nature of the material change.

(h) *Interests in rental real estate held by certain passthrough entities*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, a qualifying taxpayer's interest in rental real estate held by a partnership or an S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity under § 1.469–4(d)(5). If the passthrough entity grouped its rental real estate into separate rental activities under § 1.469–4(d)(5), each rental real estate activity of the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer. However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(2) *Special rule if a qualifying taxpayer holds a fifty-percent or greater interest in a passthrough entity.* If a qualifying taxpayer owns, directly or indirectly, a fifty-percent or greater interest in the capital, profits, or losses of a passthrough entity for a taxable year, each interest in rental real estate held by the passthrough entity will be treated as a separate interest in rental real estate of the qualifying taxpayer, regardless of the passthrough entity's grouping of activities under § 1.469–4(d)(5). However, the qualifying taxpayer may elect under paragraph (g) of this section to treat all interests in rental real estate, including the rental real estate interests held through passthrough entities, as a single rental real estate activity.

(3) *Special rule for interests held in tiered passthrough entities.* If a passthrough entity owns a fifty-percent or greater interest in the capital, profits, or losses of another passthrough entity for a taxable year, each interest in rental real estate held by the lower-tier entity will be treated as a separate interest in rental real estate of the upper-tier entity, regardless of the lower-tier entity's grouping of activities under § 1.469–4(d)(5).

(i) [Reserved].

(j) *$25,000 offset for rental real estate activities of qualifying taxpayers*—(1) *In general.* A qualifying taxpayer's passive losses and credits from rental real estate activities (including prior-year disallowed passive activity losses and credits from rental real estate activities in which the taxpayer materially participates) are allowed to the extent permitted under section 469(i). The amount of losses or credits allowable under section 469(i) is determined after the rules of this section are applied. However, losses allowable by reason of this section are not taken into account in determining adjusted gross income for purposes of section 469(i)(3).

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

Example. (i) Taxpayer *A* owns building *X* and building *Y*, both interests in rental real estate. In 1995, *A* is a qualifying taxpayer within the meaning of paragraph (c) of this section. *A* does not elect to treat *X* and *Y* as one activity under section 469(c)(7)(A) and paragraph (g) of this section. As a result, *X* and *Y* are treated as separate activities pursuant to section 469(c)(7)(A)(ii). *A* materially participates in *X* which has $100,000 of passive losses disallowed from prior years and produces $20,000 of losses in 1995. *A* does not materially participate in *Y* which produces $40,000 of income in 1995. *A* also has $50,000 of income from other nonpassive sources in 1995. *A* otherwise meets the requirements of section 469(i).

(ii) Because *X* is not a passive activity in 1995, the $20,000 of losses produced by *X* in 1995 are nonpassive losses that may be used by *A* to offset part of the $50,000 of nonpassive income. Accordingly, *A* is left with $30,000 ($50,000–$20,000) of nonpassive income. In addition, A may use the prior year disallowed passive losses of *X* to offset any income from *X* and passive income from other sources. Therefore, *A* may offset the $40,000 of passive income from *Y* with $40,000 of passive losses from *X*.

(iii) Because *A* has $60,000 ($100,000–$40,000) of passive losses remaining from *X* and meets all of the requirements of section 469(i), *A* may offset up to $25,000 of nonpassive income with passive losses from *X* pursuant to section 469(i). As a result, *A* has $5,000 ($30,000–$25,000) of nonpassive income remaining and disallowed passive losses from *X* of $35,000 ($60,000–$25,000) in 1995.

Par. 5. Section 1.469–11 is amended as follows:

1. Paragraph (a)(2) is amended by removing ''; and'' and adding '';'' in its place.

2. Paragraph (a)(3) is redesignated as paragraph (a)(4) and a new paragraph (a)(3) is added.

3. Paragraph (b)(1) is revised.

4. The heading for paragraph (b)(2) is revised; the headings for paragraphs (b)(2)(i) and (b)(2)(ii) are removed; paragraph (b)(2)(ii) is removed, and paragraph (b)(2)(i) is redesignated as paragraph (b)(2).

5. Paragraph (b)(3) is redesignated as paragraph (b)(4).

6. A new paragraph (b)(3) is added.

The added and revised provisions read as follows:

§ 1.469–11 Effective date and transition rules.

(a) * * *

(3) The rules contained in § 1.469–9 apply for taxable years beginning on or after January 1, 1995, and to elections made under § 1.469–9(g) with returns filed on or after January 1, 1995; and

* * * * *

(b) * * * (1) *Application of 1992 amendments for taxable years beginning before October 4, 1994.* Except as provided in paragraph (b)(2) of this section, for taxable years that end after May 10, 1992, and begin before October 4, 1994, a taxpayer may determine tax liability in accordance with Project PS–1–89 published at 1992–1 C.B. 1219 (see § 601.601(d)(2)(ii)(b) of this chapter).

(2) *Additional transition rule for 1992 amendments.* * * *

(3) *Fresh starts under consistency rules*—(i) *Regrouping when tax liability is first determined under Project PS–1–89.* For the first taxable year in which a taxpayer determines its tax liability under Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of Project PS–1–89.

(ii) *Regrouping when tax liability is first determined under § 1.469–4.* For the first taxable year in which a

taxpayer determines its tax liability under § 1.469–4, rather than under the rules of Project PS–1–89, the taxpayer may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year and must regroup its activities if the grouping in the preceding taxable year is inconsistent with the rules of § 1.469–4.

(iii) *Regrouping when taxpayer is first subject to section 469(c)(7).* For the first taxable year beginning after December 31, 1993, a taxpayer may regroup its activities to the extent necessary or appropriate to avail itself of the provisions of section 469(c)(7) and without regard to the manner in which the activities were grouped in the preceding taxable year.

* * * * *

Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved: December 12, 1995.

Leslie Samuels,

Assistant Secretary of the Treasury (Tax Policy).

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26 CFR Part 1

[TD 8646]

RIN 1545–AT49

Allocation and Apportionment of Research and Experimental Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document provides guidance concerning the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources within and without the United States. This document affects taxpayers that have income from United States and foreign sources and that have made expenditures for research and experimentation that the taxpayer deducts under section 174 of the Internal Revenue Code of 1986.

EFFECTIVE DATE: January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Carl Cooper at (202) 622–3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On May 24, 1995, the IRS published a notice of proposed rulemaking and notice of public hearing in the Federal Register (60 FR 27453) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 861 of the Internal Revenue Code of 1986. Section 1.861–8(e)(3) of the Income Tax Regulations provides rules regarding the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from sources inside and outside the United States.

The notice of proposed rulemaking proposed three principal changes to the existing regulations. First, allocation of research and experimental expenditures to three-digit SIC code product categories of gross income would be permitted. Second, the percentage of research and experimental expenditures that may be exclusively apportioned to United States source income under the sales method of apportionment under § 1.861–8(e)(3)(ii) would be increased from 30 percent to 50 percent. Third, use of the optional gross income methods of apportionment would constitute a binding election to use such methods in subsequent years. The election would not be revocable without the prior consent of the Commissioner. The three changes were proposed in part on the basis of an economic study performed by the Treasury Department pursuant to Rev. Proc. 92–56 (1992–2 C.B. 409), ''The Relationship Between U.S. Research and Development and Foreign Income,'' which was published by the Treasury Department simultaneously with the proposed regulations.

Written comments responding to the notice were received, and a public hearing was held on September 8, 1995.

Regarding the determination of product categories under § 1.861–8(e)(3)(i)(B) of the proposed regulations, commenters suggested that the rule requiring a taxpayer to determine relevant product categories by reference to the three-digit classification of the Standard Industrial Classification Manual should be modified to allow determinations by reference to the five-digit classifications of the Manual. This suggestion was not adopted, because such a rule would too narrowly restrict the necessarily broad scope of the deduction. The IRS continues to believe that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation.

Commenters suggested that the regulations permit taxpayers to determine product categories by reference to two- or three-digit categories at the annual election of the taxpayer. This suggestion was not adopted. The regulations provide that a taxpayer may determine product categories by reference to two- or three-digit categories. A taxpayer may aggregate, disaggregate or change a previously selected SIC code category if the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in product category is appropriate. This rule provides a simple and workable format for balancing the need for consistency with the desire for flexibility.

Referring to current § 1.861–8(g) *Example 6* (which has been redesignated *§ 1.861–17(h) Example 4*), commenters suggested that the regulations allow the use of the Wholesale Trade SIC code category with respect to sales from any other category. The current § 1.861–8(g) *Example 6* was not correct on this point and does not override the rule stated parenthetically in the list of two digit SIC code categories in present § 1.861–8(e)(3)(i)(A) that wholesale trade may not be combined with other product categories. The final regulations include this rule along with *Example 6* corrected to conform to the rule.

Regarding the exclusive place of performance apportionment rule under § 1.861–8(e)(3)(ii)(A) of the proposed regulations, commenters suggested adding a rule providing that if the ratio of foreign research and experimental expenditures in a three digit SIC code category of all foreign affiliates of a United States consolidated group over foreign affiliate sales in that SIC code category exceed fifty percent of the ratio of United States consolidated group research and experimental expenditures in that SIC code category over United States consolidated group sales in that SIC code category, then the United States consolidated group research and experimental expenditures should be exclusively apportioned to United States source gross income. This suggestion has not been adopted. Although a foreign affiliate may incur substantial research and experimental expenditures in a given product category, the foreign affiliate may still benefit from the research and experimental expenditures of the United States consolidated group. See *Perkin-Elmer Corporation* v. *Commissioner,* 103 T.C. 464 (1994).

Regarding the optional gross income methods of apportionment under § 1.861–8(e)(3)(iii) of the proposed regulations, commenters suggested that