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Structuring Real Estate Investments and Transactions After TRA 1986

Charles H. Egerton

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I. New Passive Activity Loss Limitations

A. Overview of passive activity limitations. One of the principal objectives of the Tax Reform Act of 1986 ("TRA '86") was to put an end, once and for all, to the widespread use of tax shelters by high income taxpayers to minimize or avoid taxes on their regular sources of income. Both Congress and the Reagan administration believed that there was a growing perception on the part of the general public that the income tax system was unfair and that only those who could not afford high priced tax attorneys or CPA's paid any significant taxes. Since the federal income tax is imposed primarily through a self-assessment system, any significant erosion of public confidence in the fairness of the system could pose a serious threat to the effectiveness of the income tax to generate needed revenues.

The principal Congressional response to the tax shelter dilemma was the addition of new §469 which imposes limitations on the use of losses and credits from "passive activities" to shelter income from other sources. Section 469 requires taxpayers to whom it applies to divide all of their income, deductions and credits into two separate "baskets." The first basket ("passive basket") consists of items attributable both to trade or business activities in which the taxpayer does not "materially participate" and to certain rental activities. All other income, deductions and credits are included in a second basket ("active basket"). Deductions generated by a passive basket activity may

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only be used to offset income from the passive basket (and, hence, may not be applied to shelter income from the active basket) until the taxpayer disposes of his entire interest in the activity.

Limited exceptions to these general rules exist for working interests in oil and gas wells and for certain rental real estate interests held by individuals with moderate income.

By enacting the passive activity loss ("PAL") limitation rules of new §469, Congress sought to remove the very underpinning of the tax shelter market -- the ability to offset income derived from ordinary sources with losses generated by trade or business or rental activities in which the taxpayer plays a largely passive role. It should be noted that the new passive loss rules do not deprive taxpayers of deductions. They simply defer them. However, since most tax shelters are designed to produce tax benefits through accelerating deductions and deferring income, the deferral of deductions and credits created by the passive loss rules should generally prove effective for the Treasury in combating tax shelters.

B. Who is subject to the PAL restrictions? The PAL limitations of §469 are applicable to the following classes of taxpayers:

1. Individuals, estates and trusts. §469(a)(2)(A); Regs. §1.469-1T(b).

    a. While the PAL rules do not apply to S corporations or partnerships, the distributive shares of income, deductions and credits of the shareholders or partners (if they are included in classes of taxpayers subject to the PAL rules) will be limited under §469(a).

2. Closely held C corporations. §469(a)(2)(B).

    a. A "closely held C corporation" is a corporation in which five or fewer shareholders own, directly or indirectly, more than 50% in value of the outstanding stock, and which is not a personal service corporation. See, §§469(j)(1), 465(a)(1)(B), and Regs. §1.469-1T(g)(2)(ii).

    b. The PAL rules apply only to a limited extent to closely held C corporations. See, Part E.3. infra.

c. Since C corporations other than closely held C corporations and personal service corporations are not subject to the PAL rules, a market for traditional tax shelters may continue for these corporate taxpayers.

3. Personal service corporations. §469(a)(2)(C).

a. Personal service corporations are those described in §269A(b)(1), with certain modifications. §469(j)(2), Regs. §§469-1T(g)(2)(i) and 1.441-4T(d). In other words, they are corporations whose principal activity is the performance of services and such services are substantially performed by employee-owners. Generally, this includes a corporation more than 10% of whose stock is owned by employee-owners.

i. An employee-owner for purposes of §469 includes any employee who directly or indirectly (by attribution) owns <u>any</u> stock in the corporation. §469(j)(2)(A).

b. "Personal services" are defined as services rendered in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts and consulting. Regs. §§1.469-1T(g)(2)(i) and 1.441-4T(d).

C. <u>Passive activities</u>.

1. General. Section 469(c) and Regs. §1.469-1T(e)(1) define a "passive activity" to include two separate types of activities:

a. Any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate.

i. Section 469(c)(5) and Regs. §1.469-1T(e)(2)(i)(A)(2) also indicate that any activity involving research and development is to be considered a "trade or business," even if such activity would not otherwise have risen to the level of a trade or business.

ii. Section 469(c)(6)(B) states that, to the extent provided in Treasury regulations to be promulgated under §469, any activity which generates expenses that are deductible under §212 may be treated as a trade or business. The temporary regulations issued in February, 1988 do not include these provisions (i.e., they are reserved).

iii. In regard to the special treatment of research and development activities and other activities conducted for profit (with respect to which expenses are deductible under §212), the Report of the Conference Committee provides that "[T]he conferees anticipate that the exercise of this authority may be appropriate in certain situations where activities other than the production of portfolio income are involved. This regulatory authority is meant to cause the passive loss rule to apply with respect to activities that give rise to passive losses intended to be limited under the provision, but that may not rise to the level of a trade or business." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-138 (hereinafter, the "C. Rpt." or the "Conference Report").

iv. For discussion of "material participation," see Part I.C.3., infra.

b. Passive activities also include any "rental activity," without regard to whether the taxpayer materially participates in the activity. See, §§469(c)(2), 469(c)(4) and Regs. §1.469-1T(e)(1)(ii).

i. A "rental activity" is defined in §469(j)(8) as ". . . any activity where payments are principally for the use of tangible property." See, also, Regs. §1.469-1T(e)(3)(i).

ii. For a discussion of rental activities, see Part C.4., infra.

c. By special exception, a passive activity does not include a working interest in any oil or gas property which the taxpayer either owns directly or through an entity in which the taxpayer's liability is not limited (e.g., as a limited partner or a shareholder of an S corporation).

2. What constitutes an "activity"? Perhaps the most illusive and difficult task under §469 will be the determination of what constitutes an "activity." Section 469 does not define an activity and the temporary regulations issued in February, 1988 have reserved this section for future regulations. However, the Senate Finance Committee Report states as follows:

> "The determination of what constitutes a separate activity is intended to be made in a realistic economic sense. The question to be answered is what undertakings consist of an integrated and interrelated economic unit , conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss." S.Rept. No. 313, 99th Cong. 2d Sess. 739 (1986) (hereinafter, the "S. Rpt." or the "Senate Report").

a. The determination of what constitutes a separate "activity" is important for several reasons. For example, if a taxpayer is allowed to combine two or more activities, he would only need to establish material participation for one of those activities in order to avoid the passive loss rules.

   Moreover, separation of activities is very important in the case of a disposition in order to determine whether the taxpayer has disposed of his entire interest in the activity which, as will be noted below, will enable him to then deduct any suspended PALS.

   i. The material participation (with respect to trade or business activities) and active participation (with respect to rental activities) tests are applied on an activity-by-activity basis.

b. There is no necessary correlation between an activity and an entity. Thus, a partnership might be simultaneously engaged in two or more separate activities and the mere fact that they are all conducted by the same entity is immaterial.

   i. The determination of whether an activity conducted by a pass-through entity (e.g., a partnership or S corporation) is a passive activity with respect to a particular taxpayer is to be made at the individual rather than the entity level. The Senate Report indicates that the determination of whether a taxpayer is materially participating in an activity is to be made at the individual level, regardless of whether the activity is conducted by the taxpayer as a sole proprietor or through a pass-through entity. S.Rpt. 720; see, also, S.Rpt. 740.

c. The Senate Report states that the hobby loss provisions of §183 and the Regulations thereunder provide a useful analogy for defining an "activity." S.Rpt. 739. However, the presumption contained in Reg. §1.183-1 (d)(1) that the taxpayer's characterization of an activity will be respected unless artificial will not be adhered to for purposes of §469. S.Rpt. 739.

d. As a general rule, providing two or more substantially different products or services involves engaging in more than one activity. S.Rpt. 739. For example, the operation of a restaurant and a liquor store will involve two separate activities. However, if different products are sold together for good business reasons, such as the appliance and clothing sections of a department store, they will most likely be viewed as a single, integrated activity. Id.

e. Different stages in the production and sale of a product that are not performed as an integrated activity will be viewed as separate activities. S.Rpt. 740. The Senate Report cites as an example the operation of a retail gas station and the exploration and drilling for oil and gas as activities that, while related, will probably be treated as separate activities for purposes of §469. Id.

f. The Senate Report includes several statements pertaining to real estate. It is noted that two or more real estate rental projects built and managed in different locations will probably be treated as separate activities. S.Rpt. 740. However, a rental real estate project consisting of contiguous structures, or a shopping center consisting of multi-structures which are operated as an integrated activity will be regarded as a single activity. Id.

   i. The Conference Report includes a "clarification" with respect to rental activities to explain that the performance of services incidental to the activity, such as a coin laundry in a rental apartment complex, will not be treated as separate activity. C.Rpt. II-148. This de minimus rule will not apply, however, if a significant amount of services are rendered (such as valet laundry and cleaning service for guests of a hotel). Id.

g. If an undertaking is accorded special treatment under the passive loss rules, it will not be treated as a part of the same activity with any other undertakings that are not accorded the same treatment under such rules. Thus, for example, compensation for services rendered is always treated as active income. Such income will not be treated as passive even though the activity with respect to which such payment is made would otherwise be accorded passive status with respect to the taxpayer.

h. Example: The ABC Partnership constructs a commercial office building on property it recently acquired. When completed, the project will consist of office space, a managed day care center for children of employees of tenants, a managed parking lot and spaces for specialty shops which will be leased to tenant/operators. Partner A receives a guaranteed payment of $200,000 for overseeing the development and construction of the project. Partner B will also be entitled to fees for renting and managing space in the project. Under the facts and circumstances test set forth in the Senate Report, the project could consist of as many as eight separate activities. The development/construction and rental/management functions may be viewed as separate activities. In addition, both of such functions may also be treated as having been performed for the following separate activities: office tower, parking lot, day care center and specialty shops. Finally, the guaranteed payments to A and B will constitute "active income" to them, even though received with respect to activities that might otherwise be passive as to A and B. <u>See</u>, §469(e)(3) and Regs. §1.469-2T(e)(2).

i. On August 11, 1988, the Service issued Notice 88-94 to provide temporary guidance to taxpayers in determining the scope of an "activity" for purposes of §469. The guidelines contained in Notice 88-94, which establish transitional rules pending issuance of new Regs. §1.469-4T, are very flexible and allow a taxpayer to treat his operations as either one or more activities "under any reasonable method." The Notice offers the following guidance in determining what will be a "reasonable method":

   i. It will generally be reasonable to treat operations that involve the provision of similar goods or services as part of the same activity.

   ii. Business operations that are vertically integrated (e.g., manufacturing, wholesaling and retailing substantially similar properties) may be treated as part of the same activity. However, the Notice also indicates (without specifying the likely circumstances) that each of the steps in a vertically integrated operation may also be reasonably treated as separate activities.

   iii. Business operations conducted at the same location which are owned by substantially the same persons in substantially the same proportions may be treated as a single activity.

iv. In perhaps the most surprisingly flexible category, the Notice provides that the treatment of rental real estate operations as either a single activity or as multiple activities will be considered reasonable. However, the Notice points out that it is <u>not</u> reasonable to treat rental operations as part of a trade or business (i.e., a non-rental operation), or to treat non-rental operations as part of a rental activity, <u>unless</u> the operations are ancillary to the major operation and are insubstantial vis-a-vis the activity as a whole. The Notice also reaffirms that a construction/development operation will always be separate from a rental operation (even though involving the same piece of property).

The Notice provides that it is to be regarded as an "administrative pronouncement" that may be relied upon to the same extent as a revenue ruling or revenue procedure.

j. The recordkeeping tasks associated with compliance with the new passive activity rules will be mind-boggling, especially with respect to pass-through entities. For example, a partnership must issue a separate schedule (to be attached to Form K-1) to each partner <u>for each separate activity</u> since (as noted above) the material participation and active participation tests of §469 are applied at the individual (i.e., partner) level for each separate activity.

3. Material participation.

a. The material participation standard is a key element of the passive loss limitation rules. In the view of Congress, tax preferences should only be allowed to shelter income from active sources if they are derived from activities in which the taxpayer has a substantial and <u>bona fide</u> involvement. S.Rpt. 716. The Senate Report cites several reasons for incorporating the material participation standard into the passive loss rules.

i. "A taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value." S.Rpt. 716.

ii. A material participation standard reduces the importance of tax reduction features of an investment, and thereby increases the importance of the economic features of the investment. Id.

iii. The material participation standard will assist in deterring taxpayers from investing in artificial tax shelters to offset income from ordinary sources. Id.

b. Material participation is defined in §469(h)(1) as participation which is:

i. regular,

ii. continuous, and

iii. substantial.

c. Material Participation Tests Under Temporary Regulations. Temporary regulations were released in February 1988 covering a portion of the passive loss rules. Regs. §1.469-5T deals exclusively with material participation.

i. Under Regs. §1.469-5T(a), an individual will be deemed to have materially participated in an activity for the taxable year if he meets any one of the following seven criteria with respect to such activity:

a. Taxpayer participates in the activity for more than 500 hours during such year. Regs. §1.469-5T(a)(1). See, discussion in part 1 of "Comments on Material Participation Standards Contained in Temporary Regulations," prepared by ABA Tax Section Special Task Force on Passive Activity Losses, attached as Exhibit "A" ("ABA Comments").

b. Taxpayer's participation in the activity for such taxable year constitutes substantially all of the participation of all individuals (including both owners and non-owners) in the activity for such year. Regs. §1.469-5T(a)(2).

i. Note that there is no minimum number of hours associated with this test. See, part 5, ABA Comments (Exhibit "A" attached).

c. Taxpayer participates for more than 100 hours in the activity for such year and his participation is not less than the amount of participation by any other person (whether an owner or non-owner) in the activity for such year. Regs. §1.469-5T (a)(3).

d. The activity is a "significant participation activity" ("SPA") of the taxpayer for the taxable year and the taxpayer's aggregate participation in all SPAs during such year exceeds 500 hours. Regs. §1.469-5T(a)(4). A "significant participation activity" is defined in Regs. §1.469-5T(c)(2) as an activity in which the taxpayer participates for over 100 hours during the taxable year. The SPA rules are a two-edge sword in the temporary regulations since they are employed both in defining material participation and again in another portion of the temporary regulations as a weapon in the Commissioner's arsenal to restrict taxpayers' ability to generate passive income that may be offset against their passive losses. See, part 3, ABA Comments (Exhibit "A" attached).

e. If the taxpayer has materially participated (determined without regard to this particular test) in an activity for at least five out of the last ten taxable years immediately preceding the current taxable year, such taxpayer will automatically be deemed to have participated in the activity for the current taxable year. Regs. §1.469-5T(a)(5). For discussion of this test, see part 4, ABA Comments (Exhibit "A" attached). Note that in applying the 10-year look-back test, material participation for taxable years beginning prior to January 1, 1987, is to be tested solely under the more than 500 hour rule. Regs. §1.469-5T(j).

f. If the activity is a "personal service activity" and if the taxpayer materially participated in such activity for any three taxable years (whether or not consecutive) preceding the current taxable year, he will automatically be deemed to have participated in such activity in the current taxable year. Regs. §1.469-5T(a)(6). An activity is a "personal service activity" if such activity involves the performance of personal services in either (1) the fields of health, law, engineering, architecture, accounting, actuarial service, performing arts or consulting, or (2) any other trade or business in which capital is not a material income producing factor. Regs. §1.469-5T(d). See, discussion of this rule in part 4, ABA Comments (Exhibits "A" attached).

g. If, based upon all the facts and circumstances, the taxpayer participates in the activity on a regular, continuous and substantial basis during the taxable year, he will be deemed to have materially participated in such activity. Regs. §1.469-5T(a)(7). In applying this test, the rules of Regs. §1.469-5T(b) are to be followed. These rules are intentionally restrictive, particularly with regard to reliance upon management services, because the Treasury has clearly opted for quantitative rather than qualitative material participation standards. The test of Regs. §1.469-5T(a)(7), the only one of the seven tests which is qualitative by nature, is intended to be used sparingly and apparently only as a test of last resort. <u>See</u>, discussion in part 2, ABA Comments (Exhibit "A" attached).

ii. Each of the seven tests described in Regs. §1.469-5T(a) compares the taxpayer's <u>participation</u> against a defined standard. Regs. §1.469-5T(f) defines "participation" as work performed by an individual (or by such individual's spouse -- <u>see</u>, §469(h)(5) and Regs. §1.469-5T(f)(3)) ". . . in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest at the time the work is done."

<u>a</u>. Work performed in an activity will be disregarded and not treated as participation if (1) such work is not customarily done by an owner of such activity, <u>and</u> (2) one of the principal purposes of such work is to avoid the disallowance of any loss or credit by §469. Regs. §1.469-5T(f)(2)(i).

<u>b</u>. Work performed by a taxpayer in his capacity as an investor in the activity will also be disregarded and not treated as participation <u>unless</u> the taxpayer is directly involved in the day-to-day management or operations of the activity. Regs. §1.469-5T(f)(2)(ii). Investor-type work is defined in such Regulation to include:

_i_. Studying and reviewing financial statements and reports;

_ii_. Preparing summaries or analyses of finances or operations for the taxpayer's own use; and

iii. Monitoring the finances or operations in a non-managerial capacity.

iii. Special rules pertaining to participation by limited partners are also contained in the temporary regulations. §469(h)(2) provides that a limited partner will not be deemed to materially participate in any activity conducted by the partnership except as otherwise provided in the regulations.

_a_. Regs. §1.469-5T(e)(1) reflects this statutory mandate. A limited partnership interest is defined in Regs. §1.469-5T(e)(3)(i) as an interest:

_i_. designated as a limited partnership interest in the partnership agreement or certificate, regardless of whether the holder is deemed to have limited liability under state law; or

_ii_. with respect to which the liability of the holder is limited to a determinable or fixed amount under applicable state law, regardless of how the partner's interest is characterized in the governing partnership document.

In addition, Regs. §1.469-5T(e)(3)(ii) provides that a partnership interest held by a taxpayer as a limited partner will _not_ be treated as a limited partnership interest if the taxpayer is also a general partner in the partnership at all times during the taxable year (or for such portion of the partnership's taxable year that the taxpayer was a partner in the partnership). Thus, a partner who is both a general partner and a limited partner under the partnership document will not be regarded as a limited partner. This simply means that the automatic assumption of non-material participation applicable to limited partners does not apply. Presumably this specific provision overrides Regs. §1.469-5T(e)(3)(i)(A) which provides generally that a partner designated as a limited partner under the partnership agreement will be regarded as such.

b. Treasury opted to exercise its regulatory power to override the general rules applicable to limited partnership interests by providing that if a partner (whether general or limited) meets the material participation tests of Regs. §§1.469-5T(a)(1) ($500+ hour test), 1.469-5T(a)(5) (the 5-out-of-10 year rule), and 1.469-5T(a)(6) (personal service activity rule), in a taxable year he will be deemed to have materially participated in the activity for such year, regardless of the fact that he may meet the definition of a limited partner.

iv. The temporary regulations contain very flexible requirements for proving the extent of a taxpayer's participation in an activity. Regs. §1.469-5T(f)(4) allows a taxpayer to establish his participation "by any reasonable means," and states as follows:

"Contemporaneous daily time reports, logs or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries."

d. The material participation standard as described in the legislative history:

i. The material participation standard is based in part upon the material participation standards under §§1402(a) (relating to self-employment tax) and 2032A (relating to valuation of farm property for estate tax purposes). S.Rpt. 732. However, because the §469 version of "material participation" is more rigorous, cases and administrative decisions under §§1402(a) and 2032A will not necessarily have precedential value under §469. (*See*, Regs. §1.469-5T(b)(2) which flatly states that such cases and decisions will *not* have precedental value under §469).

a. For example, the material participation standard of §§1402(a) and 2032A might be satisfied by periodic consultation with respect to management decisions, but would not be met under §469 unless such consultations rose to the level of regular, continuous and substantial involvement. *Id.*

ii. The Senate Report states that the presence or absence of material participation is to be determined on the basis of relevant facts and circumstances. S.Rpt. 732. In making this determination, the taxpayer's activities (as well as those of his or her spouse) with respect to the activity throughout the year will be examined. The test is also applied on a year-by-year basis. *Id.* at 731. Thus, a taxpayer could conceivably meet the standard in one year but fail to meet it the next.

iii. In examining the facts and circumstances, the following factors are cited in the Senate Report (pp. 732-735) as relevant:

   a. The taxpayer's involvement in the activity must relate to operations. This contemplates that participation will be "hands on work" including active management, but not management which involves a purely passive, advisory role. S.Rpt. 732.

   b. A taxpayer will most likely have materially participated in an activity if it is his principal business. Conversely, if an activity is not his principal business, he is less likely to meet the material participation requirement, but it is still possible. S.Rpt. 732, 733.

   c. Another "highly relevant" factor is whether and how regularly the taxpayer is present at the place or places where the principal operations of the activities are conducted. However, physical presence is neither an absolute requirement nor an absolute guarantee of compliance with the standard. S.Rpt. 733.

      i. An investor who acquires an interest in a barge hauling grain down the Mississippi River may materially participate by riding on the barge on a regular basis (not as a passenger but as an active performer of substantial services).

      ii. Alternatively, the investor may also meet the standard without being present on the barge by working on a regular basis to find new customers for the barge and negotiating contracts for hauling their products.

d. Performance of management functions is treated no differently than rendering other services or performing physical work under the material performance test. Management services will only be given significant weight if the taxpayer has knowledge and experience in running the business. Even if the taxpayer possesses such knowledge and experience, this will not be sufficient if he merely approves management decisions made by paid advisors. S.Rpt. 734, 735. However, the Conference Report appears to somewhat soften the Senate Report's apparent bias against management services by stating that " . . . despite the difficulty in many circumstances of ascertaining whether the management services rendered by an individual are substantial and bona fide, such services are likely to be so when the individual is rendering them on a full-time basis and the success of the activity depends in large part upon his exercise of business judgment." C.Rpt. II-148.

e. Providing legal, tax or accounting services as an employee or independent contractor to an entity will not ordinarily constitute material participation (other than in the activity of providing such services to the public). S.Rpt. 735.

f. The activities of agents or employees of the business will not be attributed to the taxpayer for purposes of the material participation test. S.Rpt. 735.

g. If the taxpayer performs everything that is to be done with respect to the activity, the standard will probably be met, even though the actual amount of work to be done is relatively modest. C.Rpt. II-148.

iv. The Conference Report also added the "line of business" rule to assist some taxpayers in meeting the material participation standard. If a taxpayer works full time in a line of business consisting of one or more business activities, the Conference Report states that he will generally be considered as materially participating in all of such activities (except with respect to rental activities because material participation is not a factor in such activities) even if he is involved in management rather than operations. C.Rpt. II-147, 148.

a. In the absence of the line of business rule, an individual who spreads his time among several activities might not be able to meet the rigorous material participation standards for any of such activities. For example, assume that the ABCD Partnership owns and operates four specialty men's shops in different locations, and that A, B, C and D (respectively) each manage one shop and devote full time to the management of such shop and to the overall affairs of the partnership (such as purchasing and financing inventory, advertising and other policy decisions). In the absence of the line of business rule, it is likely that each partner would only be deemed to have materially participated in the one shop he manages. However, the line of business rule treats each partner as materially participating in all of such activities.

The application of the line of business rule becomes more difficult if two different, but related, businesses are involved. For example, assume that the ABCD Partnership was involved in land development and sales (business No. 1) and condominium development and sales (business No. 2). A and B work primarily in business No. 1 and C and D devote the bulk of their time to business No. 2. It remains to be seen whether the regulations to be issued under §469 will treat these as part of the same line of business or as two unrelated businesses.

b. Unfortunately, the Conference Report does not define or even give examples of a line of business. This raises many questions as to how the rule is to be applied. For example, will the following activities with respect to non-rental real estate constitute part of the same line of business?

i. development

ii. construction

iii. sales of lots or condominium units

iv. operation of a hotel

v. operation of a nursing home

c. The temporary regulations do not contain a line of business test. However, it is anticipated that future regulations dealing with the definition of an activity will also contain line of business rules.

v. Special rules for applying the material participation standard to agricultural activities are provided in both the Senate and Conference Reports.

a. A taxpayer performing services which generate income that is treated as self-employment income from a farming activity under §1402 will generally be regarded as meeting the test. S.Rpt. 733, 734.

b. Participation in management decisions with respect to an agricultural activity that is *bona fide* and undertaken on a regular, continuous and substantial basis may also satisfy the material participation criteria. C.Rpt. II-148. Included within this category would be decision-making regarding the following:

   i. Crop rotation, selection and pricing.

   ii. Incurring embryo transplant or breeding expenses.

   iii. The purchase, sale or lease of capital items such as cropland, animals or equipment.

   iv. Breeding and mating decisions.

   v. Selection of herd or crop manager who would function at the direction of the taxpayer. *Id*.

vi. Several colloquies on the floor of the Senate during the TRA '86 debate on the issue of whether a taxpayer who owns a condominium hotel room (i.e., a single unit that is included in a rental pool with other units owned by other owners) would meet the material participation standard are helpful in gaining insight in how Congress envisioned the material participation standard would be applied. Senator Packwood, the then Chairman of the Senate Finance Committee, stated that the test can be met if the taxpayer participates on a regular, continuous and substantial basis in the following decisions:

   a. establishment of unit rental rates;

   b. establishment and review of hiring and other personnel policies including review of management personnel;

c. review and approval of periodic and annual audited financial reports;

d. preparation of operating and capital expenditure budgets;

e. establishment of financial reserve requirements;

f. selection of banks;

g. participation in meetings concerning the hotel unit with agents and contract management personnel to review operations and business plans and to conduct on-site inspections;

h. participation in off-site business promotion activities;

i. establishment of procedures for payment of the hotel unit expenses;

j. review of personal property tax assessments and procedures for payment of property taxes; and

k. establishment of responsibility for debt service payment. 132 Cong. Rec. S.8244-8246 (June 24, 1986) and S. 13958 (September 27, 1986).

The colloquies also note that mere ratification of management decisions (such as through check-a-box forms) will not satisfy the standard. Presumably, the taxpayer's degree of knowledge and experience in the hotel business will also be a relevant factor. See, S.Rpt. 734.

e. Material participation by closely held C corporations and personal service corporations. A corporation subject to the passive loss rules (i.e., both a closely held C corporation and a personal service corporation) will be deemed to be materially participating in an activity engaged in by the corporation if one or more of its shareholders who hold(s) more than 50% in value of the stock (regardless of class or series) of the corporation materially participate. §469(h)(4)(A) and Regs. §1.469-1T(g)(3)(i)(A).

i. Each shareholder must be independently tested for material participation in the activity. See, S.Rpt. 735, 736. Thus, for example, if a corporation has five shareholders who each own 20% of its stock and three of the shareholders materially participate in an activity, the corporation will be deemed to be materially participating in the activity.

ii. Section 469(h)(4)(B) and Regs. §1.469-1T (g)(3)(ii)(B) also provide an alternate method of satisfying the material participation test for closely held C corporations (but not personal service corporations). Under this alternative, a closely held C corporation will be deemed to be materially participating with respect to any taxable year if:

   a. it has at least one full-time employee substantially all of whose services are devoted to the active management of the activity;

   b. it has at least three full-time non-shareholder employees substantially all of whose services are directly related to the activity; and

   c. the amount of deductions attributable to such activity which are allowable to it solely by reason of §§162 (trade or business expenses) and 404 (certain deferred compensation payments for employees) exceeds 15% of the gross income from such activity. §§469(h)(4)(B) and 465(c)(7)(C)(i)-(iii).

iii. Regs. §1.469-1T(h) provides that the foregoing tests are to be applied on a consolidated basis for an affiliated group of corporations filing a consolidated return. For purposes of applying the §469 rules, the various constituent corporations are treated as one corporation and only the outstanding stock of the common parent will be taken into account in determining if it is a closely held C corporation or a personal service corpration. Regs. §1.469-1T(h)(4)(ii).

f. Material participation by trusts and estates.

i. An estate or non-grantor trust will be treated as materially participating in an activity if an executor or trustee, in his capacity as such, participates in the activity. S.Rpt. 735.

a. The material participation of one or more beneficiaries will apparently have no impact upon the determination of material participation.

ii. In the case of a grantor trust, the test is applied at the grantor level. S.Rpt. 735, fn 21.

iii. Rules governing material participation by a trust or estate are not included in the temporary regulations and are reserved for future regulations. See, Regs. §1.469-5T(g).

4. Rental activities.

a. As previously noted, a rental activity is treated as a passive activity without regard to whether the taxpayer materially participates in such activity. §469(c)(2) and (4).

i. The Senate Report explains why rental activities were included within the classification of passive activities without regard to material participation on the part of the taxpayer as follows:

> "The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct such activities, make clear that the

effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities." S.Rpt. 718.

ii. A rental activity is defined in §469(j)(8) as ". . . any activity where payments are principally for the use of tangible property."

iii. The temporary regulations contain comprehensive provisions which both refine the definition of a rental activity and provide guidance in the application of the rental activity tests.

<u>a</u>. Regs. §1.469-1T(e)(3) establishes the general rule that an activity will be a rental activity for a taxable year if:

<u>i</u>. tangible property held in connection with the activity is used by customers or held for use by customers; and

<u>ii</u>. the gross income attributable to the activity for such year represents amounts paid or to be paid principally for the use of such tangible property (or, in the case of an activity in which tangible property is held for use by customers, the expected gross income from such activity will meet this test).

This test is to be applied without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease.

<u>b</u>. Six exceptions to this general rule are described in Regs. §1.469-1T(e)(3)(ii). These exceptions focus upon the fact that payments in a

rental activity must be "principally for the use of tangible property." Thus, if a significant portion of the payments is for services, the activity may be a non-rental activity. The six exceptions are as follows:

i. The average period of customer use of such property is seven days or less. Regs. §1.469-1T (e)(3)(ii)(A). Rules for computing such average use are found in Regs. §1.469-1T(e)(3)(iii).

ii. The average period of customer use of such property is thirty days or less and significant personal services are provided in connection with making the property available for use by customers. Regs. §1.469-1T(e)(3)(ii)(B).

(1) "Significant personal services" are determined under a facts and circumstances test but do not include "excluded services." Relevant facts and circumstances include the frequency services are provided, the type and amount of labor required to perform the services, and the value of such services relative to the amount charged for use of such property. Regs. §1.469-1T(e)(3)(iv)(A).

(2) "Excluded services" are defined in Regs. §1.469-1T(e)(3)(iv)(B) as:

(a) Services necessary to permit the lawful use of property;

(b) Services representing capital expenditures with respect to the property that extend the property's useful life for a period substantially longer than the average period for which such property is used by the customers; and

(c) Services provided with respect to any improved real property that are customarily provided in connection with long term rentals of high grade commercial or residential real properties (such as cleaning and maintenance of common areas, routine repairs, trash collection, elevator service and security at entrances or perimeters).

iii. Extraordinary personal services are performed for customers in connection with making such property available for use by them. Regs. §1.469-1T(e)(3)(ii)(C). (Note that the number of days of use is not a factor under this test.)

(1) "Extraordinary personal services" are those provided in connection with the use of property by customers only if performed by individuals and the use of the property is incidental to the receipt of the services. Regs. §1.469-1T(e)(3)(v). The

temporary regulations cite as an example a patient in a hospital who has incidental use of the hospital's physical facilities while receiving health care services.

iv. The rental of such property is incidental to a non-rental activity of the taxpayer. Regs. §1.469-1T(e)(3)(ii)(D). Guidance in applying this exception to various types of property is found in Regs. §1.469-1T(e)(3)(vi) which provides in part as follows:

(1) Property Held for Investment. Rentals will be deemed incidental to property held for investment if:

(a) The principal purpose for holding such property during the taxable year is to realize gains from its appreciation in value, and

(b) The gross rental income from the property for such taxable year is less than 2% of the lesser of (i) the unadjusted basis (determined without regard to any adjustments described in §1016 which reduce basis) or (ii) the fair market value of such property.

(2) Property Used in a Trade or Business. Rentals will be deemed incidental to property used in a trade or business if:

(a) The taxpayer owns an interest in the trade or business;

(b) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five immediately preceding taxable years; and

(c) The gross rental income from the property during such year is less than 2% of the lesser of the property's unadjusted basis or its fair market value.

(3) Property Held for Sale to Customers. Rentals during the taxable year in which the property is sold or exchanged (in a taxable transaction) will be incidental if at the time of such sale or exchange the property is held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

v. The taxpayer customarily makes property available during normal business hours for nonexclusive use by various customers. Regs. §1.469-1T(e)(3)(ii)(E). An example would be a public golf course which charges greens fees for use and is open to customers on a daily basis. See, Regs. §1.469-1T(e)(3)(viii) (Example 10).

vi. The provision of property by the taxpayer to a passthrough entity in which the taxpayer owns an interest if such property is used (or is available for use) by the entity in an activity. Regs. §1.469-1T(e)(3)(ii)(F). Thus, if a taxpayer contributed the use of property to a partnership in which he was a partner, no portion of his distributive share of partnership income nor any guaranteed payments described in §707(c) would be treated as rental income with respect to such property. See, Regs. §1.469-1T(e)(3)(vii). However, the rule only applies if such property is furnished to the passthrough entity by the taxpayer in his capacity as an owner of an interest in such entity.

iv. Scope of rental activity. The scope of a rental activity is very narrow. The Senate Report states that although ". . . other activities may immediately precede the rental activity, be conducted by the same persons, or take place in the same general location, they are not treated as a part of the rental activity. . . " S.Rpt. 743.

a. Example 1: In the case of a commercial office building, the construction of the building is considered a separate activity from the rental of the building, even if the same people are involved throughout. Id.

b. Example 2: A partnership conducts a travel agency business in a ten-story building that it owns. The partnership occupies three floors in which it conducts its advertising business. The remaining seven floors are leased out to tenants. This will be treated as two separate activities -- the travel business and a rental activity (with respect to the lease of seven floors of the building). Id.

i. Note: In the case of a project that is treated as a mixture of two or more rental and non-rental activities, the Senate Report states that all income, expenses and credits must be appropriately allocated to the rental and non-rental activities. S.Rpt. 743.

c. Separate rental projects at different locations will generally be treated as separate activities, even if operated by the same taxpayer. S.Rpt. 740.

i. However, if separate buildings are part of a single integrated project, such as a shopping center, they will constitute one rental activity. Id.

D. Portfolio income.

1. Segregation of portfolio income. Having identified each passive activity in which a taxpayer is engaged, the next step is to examine each such activity and separate the net portfolio income from other income, deductions and credits in order to finally determine the net income or loss from the passive activity.

2. What is portfolio income? Section 469(e)(1)(A) and Regs. §1.469-2T(c)(3) instruct that in the computation of income or loss from a passive activity the following items will not be taken into account:

a. Gross income from interest, dividends, annuities or royalties (other than those derived in the ordinary course of a trade or business);

b. Expenses (other than interest) "clearly and directly" allocable to such gross income;

c. Interest expense "properly allocable" to such gross income;

d. Gain or loss attributable to the disposition of property producing income described in a. above; and

e. Gain or loss attributable to the disposition of investment property (provided that such property is not an interest in a passive activity).

This process results in the computation of "net portfolio income."

3. Rationale for excluding portfolio income from passive activity. The Senate Report explains why portfolio income is to be excluded from the computation of income and loss from a passive activity in the following manner:

> "Portfolio investments ordinarily give rise to positive income, and are not likely to generate losses which could be applied to shelter other income. . . To permit portfolio income to be offset by passive losses or credits would create the inequitable result of restricting sheltering by individuals dependent for support on wages or active business income, while permitting sheltering by those whose income is derived from an investment portfolio." S.Rpt. 728.

4. Special rules for determining gross portfolio income.

a. "Dividends" include dividends on C corporation stock, S corporation stock (but only to the extent provided in §1368(c)(2)), and on interests in REITs, RICs and REMICs (i.e., real estate mortgage investment conduits). Regs. §1.469-2T(c)(3)(i).

b. Income of a type that is generally regarded as portfolio income (e.g., interest, dividends, royalties and gains from the sale of securities) will nevertheless not be classified as such if it is derived in the ordinary course of a trade or business. S.Rpt. 729, Regs. §1.469-2T(c)(3)(i) and (ii).

i. For example, interest received by a bank on its outstanding loans or dividends and gains from the sale of securities received by a securities broker/dealer will usually be regarded as trade or business income rather than portfolio income.

ii. Interest, dividends, etc. derived from the investment of working capital by a business will not be treated as derived from a trade or business (and will thus be classified as portfolio income). §469(e)(1)(B). The Senate Report states:

> "Although setting aside such amounts may be necessary to the trade or business, earning portfolio income with respect to such amounts is investment-related and not a part of the trade or business itself." S.Rpt. 729, 730.

iii. Interest earned on installment sales of inventory items in the ordinary course of the taxpayer's business as well as interest charged customers for payments on overdue receivables will be trade or business income rather than portfolio income.

c. Gains or losses from the sale of assets that generate portfolio income in the hands of the taxpayer, such as stocks or other securities, will be portfolio income or losses. §469(e)(1)(A)(ii).

d. Gains or losses derived from the sale of interests in a general or limited partnership, stock in an S corporation, or an interest in a grantor trust which would normally be considered as "investment assets," will generally not generate portfolio income if they represent interests in passive activities. Regs. §1.469-2T(e)(3). However, gains or losses from the sale of an interest in a passthrough entity such as an S corporation or a general or limited partnership, require further special examination.

i. If the holder of an interest in a passthrough entity sells his interest, a "ratable portion" of any gain or loss derived from such sale will be treated as gain or loss from the disposition of each separate activity owned by the passthrough entity Regs. §1.469-2T(e)(3)(ii)(A).

  a. Rules for determining the "ratable portion" attributable to each activity are contained in Regs. §1.469-2T(e)(3)(ii)(B). As a general rule, gains or losses are allocated among the various activities operated by the passthrough entity in the same proportions as the taxpayer's share of gains or losses that would have been allocated to the taxpayer if the passthrough entity itself had disposed of each such activity and such taxpayer's share of such gains or losses from the hypothetical dispositions were then determined. See, Regs. §1.469-2T(e)(3)(ii)(B)(1) and (2)

  b. For purposes of identifying the activities of the passthrough entity to which gain or loss is allocated, all portfolio assets owned by the passthrough entity will be grouped together and treated as being held in a single investment activity. Regs. §1.469-2T(e)(3)(v)

  c. Special exceptions to these rules are found in Regs. §1.469-2T(e)(3)(iii) and (iv).

ii. Once the gains or losses from the disposition of an interest in the passthrough entity have been allocated among the various activities as provided above, the characterization of such gains or losses as passive, active or portfolio is then determined under Regs. §§1.469-2T(c)(2) (re: gains) and 1.469-2T(d)(5) (re: losses).

e. The Conference Report contains special "self-charged interest" rules pertaining to loans made by a taxpayer to a flow-through entity in which he has an equity interest. For example, assume that A, who owns a 25% interest in the ABCD Partnership, in which A does not materially participate, loans $100,000 to the partnership on January 1, 1987, with respect to which he charges interest at 10% per annum. The partnership pays A $10,000 in interest on December 31, 1987. The normal presumption is that A would have $10,000 of interest income and a $2,500 interest expense (representing his 25% distributive share of ABCD's deductible interest). The $10,000 interest income is clearly portfolio income, but if the $2,500 distributive share of partnership interest expenses is classified as a deduction attributable to a passive activity, it could not be offset against the $10,000 portfolio income under §469(a). However, the Conference Report provides that ". . . to the extent that a taxpayer receives interest income with respect to a loan to a pass-through entity in which he has an ownership interest, such income should be allowed to offset the interest expense passed through to the taxpayer from the activity for the same taxable year." C.Rpt. II-147.

   i. In order to prevent abuses of the rule in the case of partnerships, the Conference Report also provides that the taxpayer's allocable share of the partnership's interest expense may not be increased by any special allocations of such expenses to the taxpayer. Id.

   ii. See, Exhibit "B" at end of outline entitled "ABA Task Force On Passive Losses: Issues Relating to Self-Charged Interest Rule" for discussion of additional issues arising under this rule.

   iii. The self charged interest rules have been reserved for future treatment in the temporary regulations. See, Regs. §1.469-7T.

f. Section 469(l)(2) requires the Treasury to issue regulations which provide that certain items of income will not be taken into account in determining the income or loss from a passive activity. The Conference Report states that "[T]he conferees intend that this authority be exercised to protect the underlying purpose of the passive loss provision, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities." C.Rpt. II-147. The temporary regulations list a number of instances in which reclassification is deemed appropriate including the following:

i. Significant Participation Activities. Regs. §1.469-2T(f)(2) provides for the conversion of a ratable portion of the gross income from each "significant participation activity" ("SPA") of the taxpayer for the taxable year from passive to active if gross income from all the taxpayer's SPAs for the taxable year exceed the passive activity deductions from all such SPAs for such year.

   a. A SPA is any trade or business activity in which the taxpayer participates in excess of 100 hours during the taxable year but in which the taxpayer does not materially participate. Regs. §§1.469-2T(f)(2)(ii) and 1.469-5T(c)(2).

   b. This is a very broad provision that can result in a trap for the unwary. See, discussion contained in part 3 of ABA Comments (Exhibit "A").

ii. Rental of Non-Depreciable Property. Regs. §1.469-2T(f)(3) is designed to apply to ground rentals, and provides that an amount of gross income from designated non-depreciable property equal to the net income from such property will not be regarded as passive income (and presumably will be reclassified as portfolio income). This provision will apply if less than 30% of the unadjusted basis of property owned by the lessor taxpayer and held by him for use by customers in a rental activity is depreciable under §167.

iii. Net Interest from Passive Equity-Financed Property. Under Regs. §1.469-2T(f)(4), if a taxpayer is deemed to have an interest in an equity-financed lending activity, a portion of his otherwise passive income from such activity will be reclassified as portfolio income.

   a. An activity is deemed to be an "equity-financed lending activity" if it is an activity involving a trade or business of lending money and the average outstanding balance of liabilities incurred in the activity does not exceed 80% of the average outstanding balance of interest-bearing assets held in the activity for such year. (Note: This appears to encourage a high degree of leveraging to avoid the impact of this rule, but careful attention must be paid to Regs. §1.469-2T(f)(4)(ii)(B) which is designed to discourage incurring debt solely to avoid this test.)

iv. Net Income from Property Rented Incidental to Development Activity. Under Regs. §1.469-2T(f)(5), the net income from a rental activity for a taxable year will be converted from passive to active with respect to an item of rented property if:

   a. Any gain from the sale or other taxable disposition of the property is included in the taxpayer's income for such taxable year;

   b. The use of such property in the rental activity commenced less than 24 months before the date of disposition of such property (and the date of disposition is deemed to occur on the date such property first becomes subject to an oral or written sale or option agreement for a fixed or determinable consideration); and

c. The taxpayer either materially participated or significantly participated for any taxable year in an activity that involved the performance of services designed to enhance the value of such property (e.g., "dealer activity"). Enhancementtype services include construction, renovation and lease-up. Regs. §1.469-2T(f)(5)(iii).

v. Property Rented to a Non-Passive Activity. Under Regs. §1.469-2T(f)(6), a portion of the income from the rental of property by a taxpayer to a trade or business in which the taxpayer materially participates will be converted from passive to active.

a. Rentals from properties that were the subject of a binding written lesae or other agreement entered into before the date the temporary regulations were filed in the Federal Register.

g. Section 469(k) added by the Omnibus Budget Reconciliation Act of 1987 ("OBRA"), imposed additional new restrictions upon interests in passive activities held through a "publicly traded partnership" (hereinafter, a "PTP"). Under new §469(k), the limitations of §469 are to be applied separately to items of income, deduction and credit from each PTP. Thus, the net passive income from one PTP cannot be offset by the net passive losses from another PTP.

i. The definition of a PTP found in §469(k)(2) is extremely broad and raises far more questions than it answers.

ii. Unfortunately, guidance in the interpretation of §469(k) has been reserved for future Regulations. Regs. §1.469-10T.

5. Expenses attributable to portfolio income. The provisions of §469(e)(1)(A), which prescribe the method of computing portfolio income, require that gross portfolio income be reduced by (i) expenses

(other than interest) "clearly and directly allocable" to such income, and (ii) interest expense "properly allocable" to such income.

The netting of interest and expenses against gross portfolio income was added in the Conference Report. See, also, C.Rpt. II-146.

a. In Announcement 87-4, IRS News Release I.R. 86-177 (December 31, 1986), the Service stated that temporary regulations would be issued for purposes of §§163(d) (investment interest), 163(h) (personal interest), and 469 which will provide that interest expense (other than qualified residence interest) will generally be allocated on a tracing basis. (These regulations were subsequently issued in part on 7/2/87 as Temp. Reg. §1.163-8T). In other words, the proceeds of the debt will be traced to the actual use to which they are put.

   i. For example, the Announcement states that interest on debt incurred to purchase a passive activity will be taken into account in computing the income or loss from the passive activity.

   ii. In addition, the Announcement also states that interest on debt incurred to purchase an interest in a partnership or stock in an S corporation will be characterized based upon the nature of the activities conducted by such entity and the material participation (or lack thereof) on the part of the taxpayer (in his capacity as a partner or shareholder).

      a. Thus, if the entity is engaged in the active conduct of a trade or business in which the taxpayer materially participates, the interest will be treated as interest paid or incurred in connection with a trade or business under §163(h)(2)(A).

      b. If, however, the taxpayer did not materially participate in the trade or business, it will be treated as interest incurred in connection with a passive activity.

b. Regs. §1.469-2T(d)(4) sets forth the ground rules for allocating expenses to portfolio income under the "clearly and directly allocable" standard.

E. PAL computations and operational rules.

1. Identification of income, deductions and credits attributable to passive activities. Once an activity has been identified and a determination has been made that it is passive, and after the net portfolio income from such activity has been separated, the next step is to ascertain the income, deductions and credits attributable to that passive activity.

a. If the passive activity is one of several activities conducted by an entity such as an S corporation or a partnership, it will be necessary to allocate income, expenses and credits to the various activities. Some items may be readily allocated because they obviously pertain only to a specific activity such as income from rental of a building comprising the sole asset of the activity, depreciation on an asset used solely in one activity, etc. However, items such as general administrative and overhead expenses incurred by the entity which may benefit two or more activities must be allocated in an equitable manner among the various activities conducted by the entity. See, generally, Regs. §§1.469-1T(f), 1.469-2T(c) and 1.469-2T(d) for rules governing allocatins.

b. Interest on indebtedness of an entity will be allocated among the various activities conducted by the entity by actual tracing of the loan proceeds to the activities to which they were applied. See, Announcement 87-4, Part D.5.a., supra; and Temp. Reg. §1.163-8T.

c. Earned income (within the meaning of §911(d)(2(A)) is never treated as passive income, even if received for services rendered in connection with a passive activity. §469(e)(3).

2. Treatment of losses and credits. The teeth to the PAL rules are found in their treatment of losses and credits from passive activities. §469(a)(1) provides that if a taxpayer subject to the PAL rules has a passive activity loss ("PAL") or a passive activity credit ("PAC"), the taxpayer may not use such losses or credits to offset his income or taxes from non-passive sources.

   a. A PAL is the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for the taxable year. §469(d)(1); Regs. §1.469-2T(b).

   b. A PAC is the amount by which the sum of certain specified credits from all passive activities allocable for the taxable year exceeds the regular tax liability of the taxpayer for the taxable year allocable to all passive activities. §469(d)(2); Regs. §1.469-3T(a).

   c. Example: Taxpayer has $20,000 loss from a limited partnership engaged in the equipment rental business (which taxayer did not materially participate in), $10,000 net income from a rental property in which the taxpayer does not actively participate and $100,000 of salary in 1991. The $10,000 income from the rental property would be offset by an equivalent amount of loss from the limited partnership since both are passive activities and income and losses from passive activities are netted against one another. However, the additional $10,000 of loss in the limited partnership (i.e., $20,000 loss less $10,000 applied to offset $10,000 of income from the rental property) may <u>not</u> be applied against the $100,000 of salary.

   d. PALS which are disallowed under §469(a)(1) are carried forward indefinitely, but may not be carried back, and are allowed in subsequent years against passive activity income. §469(b); Regs. §1.469-1T(f)(4). Suspended losses attributable to a passive activity which the taxpayer has not been able to deduct for lack of sufficient passive income may nevertheless be deducted in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a fully taxable transaction. §469(g). (<u>See</u> discussion under Part VII, <u>infra</u>.)

i. Suspended losses retain their character when they are carried forward.

ii. The Senate Report, elaborating on §469(j)(4), sets forth ground rules governing the ordering of suspended losses.

> "If any passive losses are not deductible in any given year, the amount of the suspended losses from each passive activity is determined on a pro rata basis. With respect to each activity, the portion of the loss that is suspended, and carried forward, is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year. <u>This allocation is necessary in order to determine the suspended losses for any particular activity, which are allowed in full upon a disposition."</u> S.Rpt. 722 (emphasis added).

<u>See</u>, Regs. §1.469-1T(f)(2) for rules governing identification of disallowed passive activity losses.

iii. The determination of whether a loss is suspended under §469 is made <u>after</u> application of the at-risk rules of §465, as well as other provisions relating to the measurement of income. Regs. §1.469-2T(6). The "other provisions" would include basis limitation rules of §§704(d) (for partnerships) and 1366(d) (for S corporations) which limit the amount of losses that may flow through to a partner or shareholder. The Senate Report also provides as follows:

> "Amounts at risk are reduced even if deductions which would be allowed under the at-risk rules are

suspended under the passive loss rule. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule. However, if an amount at risk or basis has been reduced by a deduction not allowed under the passive loss rule, the amount at risk or basis is not again reduced when the deduction becomes allowable under the passive loss rule." S.Rpt. 723, fn 9.

iv. Due to a change made by the Conference Committee from the original version of §469 adopted by the Senate, interest on debt attributable to a passive activity will be governed by §469 rather than the investment interest rules. C.Rpt. II-140.

a. However, §163(d)(4)(E), added by TRA '86, provides that any portion of passive losses allowed as a deduction due to the transitional phase-in rules under §469(l) (see, discussion in Part H.,, infra) will reduce the investment income against which investment interest may be offset.

3. Special rules for closely held C corporations. A closely held C corporation, other than a personal service corporation, may offset its losses from passive activities against both its income from passive activities and its "net active income." §469(e)(2)(A) and Regs. §1.469-1T(g)(4)(i). "Net active income" is taxable income computed without regard to (i) any income or loss from a passive activity, (ii) any item comprising net portfolio income or loss, and (iii) certain other items of income and deduction specified in Regs. §1.469-1T(g)(4)(ii). §469(e)(2)(B) and Regs. §1.469-1T(g)(4). Under §469(e)(2)(A), a similar rule applies for PACS. Thus, closely held C corporations enjoy special treatment under the PAL rules --they may deduct their PALS against both income from passive activities and income from the active conduct of their businesses, but not against portfolio income.

4. $25,000 exemption for rental real estate activities.

a. Section 469(i) relaxes the PAL disallowance rules of §469(a) to a limited extent with respect to certain rental real estate activities. Although "rental activities" (as defined in §469(j)(8)) are automatically classified as passive without regard to a taxpayer's material participation in the activity, Congress believed it appropriate to carve out a limited exception for certain rental real estate because ". . . a rental real estate investment in which the taxpayer has significant responsibilities with respect to providing necessary services, and which serves significant nontax purposes of the taxpayer, is different in some respects from the activities that are meant to be fully subject to limitation under the passive loss provision." S.Rpt. 736.

i. The general disallowance rules of §469(a) are relaxed under §469(i) to the extent of allowing up to $25,000 of passive losses to be offset against active income for any taxable year. The exception also applies to credits attributable to passive activities based upon their "deduction equivalent." §§469(i)(1) and 469(j)(5). The temporary regulations issued in February, 1988 do not cover the $25,000 exemption. Treatment of this area has been reserved for future regulations. See, Regs. §1.469-9T.

ii. The $25,000 exception phases out to the extent of 50% of the amount by which the taxpayer's adjusted gross income for the taxable year exceeds $100,000 (except that, in the case of the rehabilitation and low income housing credits, the phase out begins at $200,000). Thus, if a taxpayer's adjusted gross income exceeds $150,000 (or $250,000 in the case of the rehabilitation or low income housing credits), the exception becomes inapplicable. Note: The higher phase out limit for low income housing credit generally only applies to property placed in service prior to January 1, 1990.

a. For purposes of §469(i), adjusted gross income is computed without regard to I.R.A. contributions, social security benefits and PALS. ¶469(i)(3)(D).

iii. Section 469(i)(3)(C) provides that the phase out of the $25,000 exception will be applied to absorb deductible PALS first and then to the credits.

iv. The $25,000 exception and the phase out amounts are all reduced by 50% for married individuals filing separately. §469(i)(5).

a. However, the $25,000 exception will be denied altogether to married taxpayers who file separately if they live together at any time during the taxable year. §469(i)(5)(B).

b. The $25,000 exception applies only to individual taxpayers (i.e., natural persons) and, to a limited extent, to estates. §469(i)(1) and (4).

c. The exception also is limited to rental real estate activities in which the taxpayer actively participates.

i. "Active participation" is not defined in §469, but the Committee Reports provide some guidance. It is clear that active participation is a less stringent standard than material participation. See, S.Rpt. 737. The Senate Report provides as follows:

> "The difference between active participation and material participation is that the former can be satisfied without regular, continuous and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and

bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions." S.Rpt. 737, 738.

a. A taxpayer who rents a duplex may meet the active participation test even if he hires a rental agent and others to provide services such as repairs provided that the taxpayer makes the decisions described above.

   i. However, just as in the case of the material participation standard, services provided by an agent will not be attributed to the taxpayer and ". . . a merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, is insufficient." S.Rpt. 738.

b. A taxpayer will not be deemed to have actively participated in a rental real estate activity if at any time during the taxable year the taxpayer (and his spouse) owned less than 10% by value of all interests in the activity. §469(i)(6).

   i. Caveat: Discounts for lack of marketability and lack of control may cause a taxpayer who owns a 10% interest (or even a larger percentage interest) to fail to meet the 10% in value test.

   ii. Note: Value may be difficult to establish for a general partnership interest if special allocations of profits, losses and/or cash flow are made.

c. An interest as a limited partner in a rental real estate activity will automatically fail to meet the active participation test. §469(i)(6)(C).

d. The Senate Report indicates that a lessor of property pursuant to a net lease is ". . . unlikely to have the degree of involvement which active participation entails." S.Rpt. 738.

e. In applying the active participation test with respect to a taxpayer, the participation of his spouse in the activity will be attributed to him. §469(i)(6)(D).

f. Active participation is not required with respect to the low income housing or rehabilitation credits. §469(i)(6)(B).

ii. An estate of a deceased taxpayer will be deemed to actively participate in the rental real estate activity for the first two taxable years ending after the date of death _if_ the decedent actively participated in such activity prior to his death. §469(i)(4)(A).

a. The $25,000 exemption for the estate will be reduced by the amount of exemption allowable to the surviving spouse for any taxable year of such spouse ending with or within the estate's taxable year. §469(i)(4)(B).

d. The Conference Report establishes the following rules for applying losses from rental real estate activities in which the taxpayer actively participates:

i. Step 1: Such losses are first netted against profits and losses from all other rental real estate activities in which the taxpayer actively participates.

ii. Step 2: If Step 1 produces a net loss, such loss is then netted against net passive income (if any). Presumably this means that all passive activity income and losses are netted <u>before</u> determining the amount eligible for the $25,000 allowance.

iii. Step 3: If the net rental real estate losses determined under Step 1 exceed the net passive income from other activities netted against it in Step 2, the excess (up to the $25,000 limit and subject to the phase out rules discussed above) can be applied against active and portfolio income.

iv. Step 4: Any rental real estate losses in excess of the amounts allowed under Step 3 to be deducted against other income can be carried forward to the next taxable year and will retain their character as §469(i) losses provided that the taxpayer has actively participated in the activity for such subsequent taxable year. C.Rpt. II-141, fn 2.

C.Rpt. II-141.

F. <u>Former passive activities</u>.

1. Unused losses and credits. Section 469(f)(1) deals with the treatment of unused losses and credits attributable to a passive activity which are carried over to a taxable year in which the activity is no longer considered a passive activity (e.g., the taxpayer, who did not materially participate in the activity in the prior taxable year, has now upgraded the level of his activity so that he is deemed to materially participate in the current taxable year). Under §469(f)(1), the unused losses and credits will retain their status as PALS and PACS. Thus, they may be applied against income and taxes (respectively) from (i) the activity that produced them and (ii) other passive activities in the current year but, to the extent that they exceed such profits and/or taxes, may not be applied against active income or, in the case of unused PACS, applied against taxes on active income.

2. Change of status of corporation. If a closely held C corporation or a personal service corporation changes its status such that it is no longer in either category, similar rules apply. Section 469(f)(2) provides that in such instances carryovers of PALS and PACS retain their status as such.

3. The temporary regulations issued in February, 1988, have reserved treatment of former passive activities and changes in the status of corporations for future regluations. See, Regs. §1.469-1T(b).

G. Dispositions of interests in passive activities.

1. Overview. One of the underlying Congressional assumptions is that suspended PALS should not be deductible until the taxpayer disposes of his entire interest in a passive activity as reflected in the following excerpt from the Senate Report:

> "The effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that may occur, especially where debt financing is used heavily. Only when a taxpayer disposes of his interest in an activity is it possible to determine whether a loss was sustained over the entire time that he held the interest." S.Rpt. 717.

2. General rule for fully taxable dispositions of entire interests in passive activities. Section 469(g)(1) provides that any suspended PALS attributed to a specific passive activity (together with any PALS attributable to such activity for the current taxable year and/or attributable to the disposition of such activity) will be released from the restrictions on deductibility under the passive loss rules upon a fully taxable disposition of the taxpayer's entire interest in the activity to an unrelated party.

    a. Section 469(g)(1) releases suspended PALS but not suspended PACS. The rationale for not releasing PACS is not clear.

i. Any unused PACS may continue to be carried forward and will be subject to the annual limitations (i.e., limited to regular tax attributable to passive activities and the credit equivalent of $25,000 for rental activities).

ii. Under §469(j)(9), upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the taxpayer may elect to increase the basis of property comprising the activity _if_ such property was previously subject to a basis reduction attributable to a credit which was suspended under §469(a). The increase in basis will be equal to the unused portion of the credit (i.e., the portion of the credit not previously applied to reduce taxes attributable to a passive activity). This increase in basis will serve to reduce gain or increase loss from the disposition of the property.

   _a_. If the election is made, the unused credit will no longer be available to apply against the taxpayer's tax liability. In other words, there will be no double tax benefit.

   _b_. It is unclear when or how the election is to be made. Section 469(j)(9) states ". . . the transferor may elect to increase the basis of such property _immediately before the transfer_. . ." The underscored phrase would appear to modify "the basis of such property," which is the most sensible interpretation, but it is also possible to interpret the phrase to refer to the time of making the election. The Conference Report contains an example which, after reciting the facts, states: "Immediately prior to the disposition, the taxpayer may elect to increase basis of the credit property. . ." This seems to suggest that the "immediately before" language refers to the time for making the election. Such an interpretation would seem unduly restrictive, but until the regulations are issued it would probably be advisable to make an election under §469(j)(9) prior to any disposition.

b. In order to release the suspended PALS, there must be a disposition of the taxpayer's entire interest in a fully taxable transaction to an unrelated party.

i. Disposition of entire interest. A disposition of the taxpayer's entire interest requires that a taxpayer dispose of all of his interest held directly or indirectly through, for example, a grantor trust, a partnership, or an S corporation. Thus, if a taxpayer held a 50% interest in an activity and held the remaining 50% through a grantor trust, both of such interests must be disposed of in order to meet the "full disposition" requirement.

a. If a partnership or S corporation holds an interest in two or more activities, a disposition of its entire interest in the activity will be treated as a full disposition of such interest by its partners or shareholders (respectively). S.Rpt. 725. Based upon a change in the Conference Report, the rule also applies to a limited partnership as well. C.Rpt. II-145.

ii. Fully taxable transaction. "A fully taxable disposition generally includes a sale of the property to a third party at arms length, and thus, presumably, for a price equal to its fair market value." S.Rpt. 725.

a. This requirement contemplates that all realized gain arising from the disposition is recognized. Thus, a disposition in a nonrecognition transaction such as a contribution of the interest to a corporation under §351, to a partnership under §721, or a tax free exchange under §1031, will not release suspended losses. S.Rpt. 725, 726.

i. However, if a gain is recognized because of (for example) the presence of boot, such gain will be treated as passive income and thus may absorb PALS or PACS at least to the extent of such recognized gain. S.Rpt. 726, 727.

ii. The Conference Report notes that if the disposition would not be treated as a taxable disposition under general tax principles, it also will not free up any suspended PALS. C.Rpt. II-143. Examples cited include sham transactions, wash sales and transfers not properly treated as sales due to the presence of a put, call or similar repurchase rights. Id.

iii. Unrelated party. Suspended PALS will not be released unless the disposition is to an "unrelated party." The determination of who will be a related party is to be made by applying the rules of §267(b) and §707(b)(1). §469(g)(1)(B). If a disposition is made to a related party, the suspended PALS will remain in suspense (except that they may be applied against any gain recognized on the disposition) and may be carried forward by the taxpayer and not by the related party transferee. When the transferee ultimately disposes of the entire interest in a fully taxable transaction to an unrelated party (i.e., unrelated to the original taxpayer/ transferor), the taxpayer may then claim the balance of the suspended PALS.

c. Suspended PALS which are released under §469(g) are applied against taxable income in the following manner:

i. First, against income or gain from the passive activity disposed of (including gains arising from the disposition itself). §469(g)(1)(A)(i).

ii. Second, against net income or gain for the taxable year from all passive activities.

iii. Third, against any other income or gain.

See, §469(g)(1)(A). This can be illustrated by the following example:

> Taxpayer sold his entire interest in a passive activity and recognized a taxable gain of $50,000 on the sale. The taxpayer had suspended PALS attributable to the activity of $50,000 and had incurred an additional $20,000 of losses with respect to the activity in the taxable year in which it was disposed of. Finally, the taxpayer had $100,000 of income from active sources and $10,000 of passive income from other passive activities in the taxable year. The $70,000 of suspended PALS ($50,000 from prior years and $20,000 for the current year) would be applied as follows:
>
> a. $50,000 of PALS would be applied against the gain from the sale of the passive activity.
>
> b. $10,000 of PALS would be applied next against other passive income.
>
> c. The remaining $10,000 of PAIS would be applied against $10,000 of active income.

d. Despite the fact that income and losses from all passive activities are aggregated each year in determining the taxpayer's net passive loss (or net passive income), it is imperative that the taxpayer maintain adequate records that will reflect the amount of suspended PALS attributable to each passive activity in order to determine how much suspended PALS are to be released from a disposition of a passive activity. If the taxpayer holds interests in passive activities through one or more pass-through entities which, in turn, hold multiple passive activities, the taxpayer should insist on receiving a separate breakdown for each activity from each entity.

i. Section 469(j)(4) provides that passive activity loss, passive activity credit (and the $25,000 exemption for rental real estate activities) shall be allocated among activities "on a pro rata basis in such manner as the Secretary may prescribe."

e. If any PALS released upon a disposition that meets the requirements of §469(g)(1) are capital losses, the deduction limitations of §1211 will be applicable. Thus, if the taxpayer has suspended PALS of $40,000 attributable to a passive activity, all of which are capital losses, and has no other passive income, no capital gains and $100,000 of active income in the taxable year of disposition, only $3,000 of PALS may be applied against $100,000 of active income due to the limitations of §1211. The remaining $37,000 of capital losses may be carried forward and will no longer be considered PALS. C.Rpt. II-144.

f. In the case of an installment sale of a taxpayer's entire interest in a passive activity with respect to which the taxpayer's gains are reported under §453, the suspended PALS are allowed in each year of the installment obligation, in the ratio that gain recognized in such year bears to the total gain to be recognized over the entire course of the installment obligation. §469(g)(3).

i. IRS Notice 87-8 (IRS News Release I.R.-86-174, December 24, 1986) provides that temporary regulations under §469 will be issued which will provide that ". . . gain from a sale in a taxable year beginning before January 1, 1987, is not income from a passive activity for purposes of section 469 even if the gain is reported on the installment method and is recognized in a taxable year beginning after December 31, 1986."

g. Caveat: However, the Technical Corrections Act of 1987 (found in identical bills designated as H.R. 2636 and S. 1350--hereinafter, the "Tech. Corrections Act") would overturn this holding. <u>See</u>, §105(a)(10) Tech. Corrections Act. Tech. Corrections Act would authorize Treasury to issue "anti-abuse" regulations to deal with activities which produce positive income in the initial years, but a loss upon disposition. <u>See</u>, Tech. Correction Act §105(a)(2)(B). In the preamble to the February, 1988 temporary regulations Treasury announced that it will not enforce the rule announced in Notice 87-8 unless and until it is adopted in future regulations.

3. Disposition upon death. Section 469(g)(2) provides that a transfer of a deceased taxpayer's interest in a passive activity occurring by reason of his death will be treated as a disposition meeting the requirements of §469(g)(1). However, the suspended PALS may be claimed on the taxpayer's final return only to the extent that they exceed the step-up in basis allowed to his heirs under §1014. The remainder of the suspended PALS will become permanently nondeductible. Since no provision is made in §469(g)(2) with respect to suspended PACS, it is assumed that such PACS will be eliminated (except to the extent that they may be applied against net passive activity income for the decedent's final taxable year).

a. The §469(g)(2) rules apparently apply on an activity-by-activity basis. This may prove helpful as illustrated by the following example:

Example: Taxpayer held two rental buildings prior to his death. Building 1 had a basis of $10,000, a fair market value of $50,000 and suspended PALS of $30,000. Building 2 had a basis of $40,000, a fair market value of $60,000 and suspended PALS of $25,000. Upon the taxpayer's death, his heirs will take a new stepped-up basis under §1014 of $50,000 in Building 1 and $60,000 in Building 2. At the time of the taxpayer's death, no suspended losses are allowable with respect to Building 1 because the step-up in basis of $40,000 under §1014 exceeds the suspended PALS of $30,000. However, since the step-up in basis with respect to Building 2 is $20,000 and suspended PALS are $25,000, $5,000 of the suspended PALS attributable to Building 2 will be deductible on the decedent's final return. (It should be noted that if §469 had required that the suspended PALS from passive activities be aggregated rather than analyzed on an activity-by-activity basis, no suspended PALS would have been deductible under this example.)

4. Disposition by gift. If a taxpayer makes a gift of his entire interest in a passive activity, §469(j)(6) provides that the taxpayer's basis in such interest immediately prior to the transfer will be increased by the amount of the suspended PALS attributable to the activity. Section 469(j)(6) further provides that no deduction will be allowed with respect to such PALS (i.e., no double tax benefit). The Senate report also provides that if the taxpayer gives away less than his entire interest in the passive activity, an "allocable portion" of any suspended losses will be added to the basis.

    a. A footnote to the Senate Report indicates that for purposes of determining the donee's loss in any subsequent sale or other disposition of the gifted interest, the donee's basis may not exceed the fair market value of the interest at the time of the gift. S.Rpt. 726, fn 12; <u>See</u>, <u>also</u>, §1015(a). From a planning standpoint, if a taxpayer holds an interest in a passive activity that has depreciated in value below its basis, he should consider selling it rather than gifting it. A sale will at least release the suspended PALS as compared with the gift which may result in a permanent loss of the benefits associated with the suspended PALS.

    b. The application of this seemingly simple rule under §469(j)(6) may nevertheless be difficult. For example, how would the "step-up" attributable to the suspended PALS be allocated among the various assets comprising the activity? If the activity is held through a flow-through entity such as a partnership or S corporation, will the basis in the partnership interest (or the S corporation stock) be increased? What about the basis of the partnership (or the S corporation) in its assets comprising the passive activity?

5. Abandonment. The Conference Report notes that an abandonment of a taxpayer's entire interest in a passive activity that would constitute a fully taxable event will be treated as a taxable disposition under §469, thus releasing suspended PALS. C.Rpt. II-143, 144. For example, if a taxpayer owns rental property which he abandons in a taxable event which would give rise to a deduction under §165(a), the abandonment will trigger the suspended PALS attributable to the rental (passive) activity.

6. Change in nature of activity. A change in the nature of an activity does not constitute a disposition under §469(g)(1). C.Rpt. II-145. Thus, for example, when a real estate construction activity is completed and the project converts to a rental real estate activity, no disposition will be deemed to have occurred which will trigger the release of suspended PALS.

H. Effective date and phase-in rules.

1. Effective date. The restrictions imposed under §469 are generally applicable to PALS incurred in taxable years beginning after December 31, 1986, and to PACS attributable to property placed in service in such years. TRA '86 §501(c)(1). However, the §469 limitations will not apply to any loss, deduction or credit carried over to a taxable year beginning after December 31, 1986, from a taxable year beginning before January 1, 1987. TRA §501(c)(2).

2. Transition rules. Under §469(l) and Regs. §1.469-11T(b), interests in passive activities attributable to "pre-enactment interests" are eligible for a special phase-in rule that exempts a portion of PALS and PACS from the limitations of §469. The portion of the PALS and PACS disallowed is determined under the following table:

Taxable Year Beginning In:	Percentage Disallowed
1987	35%
1988	60%
1989	80%
1990	90%
1991 and thereafter	100%

a. "Pre-enactment interests" are defined in §469(l)(3)(B) and Regs. §1.469-11T(c) as any interest in a passive activity held by the taxpayer on October 22, 1986 (the date of enactment of TRA '86) and at all times thereafter.

i. Any interest acquired after October 22, 1986, pursuant to a written binding contract in effect on such date and at all times thereafter, will be treated as held on October 22, 1986, for purposes of the phase-in rules. §469(l)(3)(B)(ii). See, Regs. §1.469-11T(c)(7) and 1.469-11T(c)(5) for a discussion of what constitutes a "binding contract," and for the effect of additional capital contributions made after October 22, 1986, to the activity.

ii. Interest must not only be "held" on October 22, 1986, but must actively be placed in service on or prior to that date. §469(l)(3)(B)(ii). Special rules are also included for property acquired pursuant to written binding contracts in effect on August 16, 1986 (date of Conference Committee action) and for construction beginning on or before August 16, 1986. See, §469(l)(3)(B)(iii).

b. No phase-in is available for alternative minimum tax purposes. Thus, the passive loss limitations on deductibility of PALS are applicable in full without regard to the phase-in rules for purposes of computing a taxpayer's alternative minimum tax liability.

c. If a taxpayer owns both pre-enactment and post-enactment interests in passive activities, §469(l)(3)(A) provides instructions on calculating the amount of PALS qualifying for the phase-in. Under §469(l)(3)(A), it is first necessary to determine the amount that will be disallowed under §469(a) in the absence of the phase-in. The phase-in relief then applies to the lesser of (i) the taxpayer's total passive loss or (ii) the passive loss computed by taking into account only pre-enactment interests.

i. For example, assume the taxpayer has $100 of PALS attributable to pre-enactment interests that would be disallowed in the absence of the phase-in rules, and $60.00 of passive income from post-enactment interests. Thus, the taxpayer would have a "total passive loss" of $40.00. The phase-in applies to the lesser of (i) $100.00 (representing passive losses computed by taking into account only pre-enactment interests) or (ii) $40.00 (representing total passive losses). Thus, the phase-in will apply to $40.00 of PALS.

ii. For purposes of this rule, pre-enactment and post-enactment passive losses are calculated by including PACS in a deduction-equivalent sense. §469(l)(3)(A); C.Rpt. II-150.

d. See, C.Rpt. II-150 for rules governing carryforwards of PALS and PACS disallowed under the phase-in rules.

e. The applicable phase-in percentage applies to passive losses net of any portion of such loss that is allowed against non-passive income under the $25,000 exception for rental real estate. C.Rpt. II-150.

f. Special rules are also included for qualified low income housing projects under TRA §§501(c)(3) and 502.

II. New or Revised Limitations on Deductions and Credits Affecting Real Property.

A. Interest expenses.

1. Legislative intent. Most of the new restrictions applicable to the deductibility of interest affect non-corporate taxpayers. These changes were attributable to Congress' concern that the deductibility of interest without regard to how the proceeds of the underlying debt were applied (with some exceptions such as old §163(d) and §265) created a disincentive to save and resulted in a mismeasurement of income. See, Bluebook 263.

2. Overview of changes. Deductions for interest paid or accrued are now subject to new restrictions imposed by TRA '86 in the form of §§469 (re: passive activity losses), 163(d) (re: investment interest), and 163(h) (re: personal interest). These new provisions are designed to limit or prohibit the deduction of interest against unrelated sources of income.

   The determination of the deductibility of interest paid or accrued requires at the outset that the taxpayer categorize interest expenses as follows:

   a. Active trade or business interest.

   b. Passive activity interest.

   c. Investment interest.

   d. Personal interest.

   e. Qualified residence interest.

   Each category of interest is subject to different limitations. With the exception of active trade or business interest (which may be deducted against all sources of income), interest in each category may in general only be deducted against income sources related to that category.

   The disallowance of interest under the new rules is phased in over a 4-year period, commencing with taxable years beginning in 1987 and running through taxable years beginning in 1990, as follows:

Taxable Year Beginning In:	Percentage Disallowed
1987	35%
1988	60%
1989	80%
1990	90%
1991 et seq.	100%

3. Active trade or business interest. Interest on debt allocable to a trade or business in which the taxpayer materially participates (see, §469(h)) will be fully deductible under §163(a). For a discussion of rules governing allocation of interest to specific activities, see, II.A.8., infra.

4. Interest allocable to passive activities. The deductibility of interest attributable to passive activities will be limited under the rules discussed in Part I, supra. It should be noted that interest allocable to portfolio income derived in connection with a passive activity must be segregated and would be limited under the investment interest rules of §163(d) rather than the passive loss rules of §469. See, §469(e)(1)(A)(i)(III).

5. Investment interest limitations. Pre-TRA '86 rules limiting deductions for investment interest have been toughened under the Act. Section 163(d), as amended by TRA '86, provides that the investment interest of a taxpayer other than a corporation will be deductible solely against net investment income. §163(d)(1). Any unused investment interest may be carried forward (but not back) to succeeding taxable years and will be treated as investment interest paid or accrued by the taxpayer in such succeeding years. §163(d)(2).

   a. "Investment interest" is defined in §163(d)(3) as interest ". . . paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." §163(d)(3)(A). Note: §105(c)(1), Tech. Corrections Act redefines investment interest as interest ". . . which is paid or accrued on indebtedness <u>properly allocable to</u> property held for investment." [emphasis added.]

b. Under §163(d)(5), "property held for investment" is property which:

   i. Produces income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business (i.e., portfolio assets);

   ii. Property held for future appreciation, such as investment real estate, but which is not trade or business or personal use property; and

   iii. Any interest held by a taxpayer in an activity involving the conduct of a trade or business in which the taxpayer does not materially participate, but is not a passive activity.

c. The principal limitation of §163(d)(1) derives from the fact that investment interest will only be deductible to the extent of net investment income. "Net investment income" is defined unceremoniously in §163(d)(4)(A) as the excess of investment income over investment expenses. Section 163(d)(4)(A) contains rules governing the computation of each of these components.

   i. Investment income consists of gross income from property held for investment together with net gains attributable to the disposition of property held for investment. Section 163(d)(4)(B). This is similar to the pre-TRA '86 definition and includes income from interest, dividends, annuities and royalties not derived from a trade or business, but does <u>not</u> include rents (which are passive income with the possible exception of ground rents if the regulations ultimately classify ground rents as portfolio rather than passive income). In addition, capital gains (both long term and short term) from the sale of investment properties are included.

ii. "Investment expenses" are allowable deductions (other than interest) directly connected with the production of investment income. See, §163(d)(4)(C). These would include, for example, brokerage commissions and fees for investment advice.

a. These include expense attributable to the portfolio income derived from a passive activity. §469(e)(1)(A)(II).

b. The definition of investment expenses is the same as pre-TRA '86 law, except as follows:

i. These expenses are only deductible to the extent they exceed the new 2% of adjusted gross income floor rule (see, new §67) applicable to miscellaneous expenses. C.Rpt.II-153,154. In computing the amount of expenses that exceed the 2% floor, noninvestment expenses are disallowed first.

ii. If depreciation or depletion deductions are allowed with respect to investment property, such deductions must be computed under the same method for purposes of computing net investment income as the taxpayer uses in computing taxable income (i.e., taxpayer cannot use a more conservative longer depreciation period or a straight-line method rather than the accelerated method otherwise used by the taxpayer). Bluebook 265.

iii. "The investment interest limitation is not intended to disallow a deduction for interest expense which in the same year is required to be capitalized (e.g., construction interest subject to sec.263A) or is disallowed under sec.265 (relating to tax-exempt interest)." C.Rpt.II-154.

d. The investment interest limitation rules, as amended by TRA '86, are effective for taxable years beginning after December 31, 1986. Most importantly, the new rules apply to interest on both pre-87 and post-86 debt. However, phase-in rules apply as follows:

i. A portion of the investment interest that would otherwise be disallowed under §163(d)(1) will nevertheless be allowed to the extent of a portion of the "ceiling amount" that was allowed under pre-TRA '86 law. The ceiling amount is $10,000 ($5,000 in the case of married taxpayers filing separate returns and $0 in the case of a trust). §163(d)(6)(C). The application of the ceiling amount rules is stated in a very convoluted manner in §163(d)(6)(A) and (B), which language is modestly improved by §105(c)(3) of Tech. Corrections Act. The effect of these provisions is to <u>allow</u> deductions for investment interest to the extent of (i) net investment income, plus (ii) a <u>portion</u> of the ceiling amount determined as follows:

<u>Taxable Year Beginning In:</u>	<u>Portion of Ceiling Amount Allowed</u>
1987	65%
1988	40%
1989	20%
1990	10%
1991 et seq.	0%

For example, if a calendar year taxpayer who is married and files a joint return had investment interest of $50,000 and net investment income of $30,000 in 1987, $36,500 of investment interest would be deductible ($30,000 attributable to net investment income plus 65% of $10,000 or $6,500). The remaining $13,500 of investment interest expenses would be disallowed and carried forward to future years.

ii. The benefit of the ceiling amount phase-out provision may be offset by the requirement of §163(d)(4)(E) that net investment income be *decreased* by the taxpayer's portion of *his* passive activity losses that are deductible under the passive loss phase-in rules.

a. For example, assume that the taxpayer in the prior example also had PALs attributable to pre-enactment interests in 1987 of $20,000. Under §469(1), the taxpayer would be allowed to offset $13,000 of such PALS (65% of $20,000) against nonpassive income. Under §163(d)(4)(E), the taxpayer's net investment income must therefore be reduced to $17,000 ($30,000 minus $13,000). Thus, the amount of investment interest deductible by the taxpayer in 1987 would be $23,500 ($17,000 of net investment income plus $6,500 under the ceiling amount phase-out rule).

b. The reduction of net investment income under §163(d)(4)(E) is calculated *without regard* to the portion of passive losses attributable to rental real estate activity in which the taxpayer "actively participates" (within the meaning of §469(i)(6)). This mitigation for active rental real estate activities applies without regard to the $25,000 offset of §469(i).

6. Personal interest. The limitation on the deductibility of interest that has drawn attention from the greatest number of people is the disallowance of deductions for personal interest under §163(h)(1). The limitation applies to all taxpayers other than corporations.

   a. Personal interest includes all interest other than the following:

      i. Trade or business interest (other than the trade or business of performing services as an employee).

      ii. Investment interest.

iii. Passive activity interest.

iv. Qualified residence interest, and

v. Interest on deferred estate taxes payable under §6163 or §6166.

See, §163(h)(2) and Regs. §1.469-9T(b)(1).

b. Examples of personal interest are interest on auto loans, interest on loans to purchase appliances, interest on credit cards (to the extent credit was obtained to purchase personal items) and interest on tax deficiencies.

c. Personal interest rules are effective for taxable years beginning in 1987, regardless of when indebtedness incurred. The disallowance is phased in over a 4-year period in the same manner as investment interest rules. See, §163(h)(6).

7. Qualified Residence Interest. An exception to the blanket disallowance of personal interest is provided for "qualified residence interest" under §163(h)(2)(D). The definition of "qualified residence interest," which is contained in §163(h)(3), was originally added by TRA '86 but substantially modified by OBRA, effective for taxable years beginning after December 31, 1987. (Note: temporary regulations contained in Regs. §1.163-10T dealing with qualified residence interest were issued prior to OBRA and thus do not reflect the OBRA changes.)

a. Qualified Residence Interest After OBRA. Qualified residence interest is defined in §163(h)(3) as interest paid or accrued on (1) "acquisition indebtedness" with respect to any "qualified residence" of the taxpayer, or (2) "home equity indebtedness" with respect to any "qualified residence" of the taxpayer.

i. "Acquisition indebtedness" means debt incurred in acquiring, constructing or substantially improving any qualified residence of the taxpayer and which is secured by such residence. §163(h)(3)(B)(i). It also includes any debts secured by such residence resulting from any refinancing of any other acquisition indebtedness to the extent that the principal amount of the new debt does not exceed the principal amount of the refinanced (i.e., prior) debt. Id.

a. The aggregate amount of acquisition indebtedness for any taxable year cannot exceed \$1,000,000 (\$500,000 for a married taxpayer filing a separate return). §163(h)(3)(B)(ii).

b. Any debt incurred prior to October 13, 1987, the interest on which meets the requirements of "qualified residence interest" under §163(h)(3) prior to its amendment by OBRA, will be treated as "acquisition debt." §163(h)(3)(D).

   i. Any refinancing of such pre-October 13, 1987 indebtedness will also qualify as acquisition indebtedness to the extent that it does not increase the principal amount of the refinanced (i.e., prior) debt. §163(h)(3)(D)(iii)(II). However, this refinancing rule applicable to pre-October 13, 1987 debt will not apply after the maturity date of the original pre-October 13, 1987 debt or, if the principal amount of such original debt is not amortized over its term (e.g., payable interest only for five years with a balloon payment on the fifth anniversary), the refinanced debt will only continue to automatically qualify through the expiration of the term of the first refinancing of such debt or until a date which is 30 years after the date of the first refinancing, whichever occurs first. See, §163(h)(3)(D)(iv)(II).

ii. The $1,000,000 limit on acquisition indebtedness will be reduced by the aggregate outstanding principal amount of all pre-October 13, 1987 debt which is treated as "acquisition debt." §163(h)(3)(ii).

ii. "Home equity indebtedness" is defined in §163(h)(3)(C) as any debt (other than acquisition debt) secured by a qualified residence to the extent that the outstanding principal amount of such debt does not exceed the lesser of: (1) $100,000 ($50,000 in the case of a married taxpayer filing a separate return), or (2) the excess of the fair market value of such residence over the acquisition debt.

a. No tracing of proceeds is required for home equity debt. Thus, such debt may be incurred to acquire personal items such as a car or boat, passive activities or any other type of property (except to the extent provided in Regs. §1.163-10T(b)).

iii. OBRA did not change the definition of a "qualified residence."

b. Pre-OBRA Rules. Prior to its amendment by OBRA, §163(h)(3) defined "qualified residence interest" as interest paid or accrued on indebtedness secured by any property which, at the time the interest is paid or accrued, is a qualified residence of the taxpayer. Thus, there was no tracing of debt proceeds such as we now have with respect to acquisition indebtedness. However, qualified residence interest did not include any portion of debt secured by a qualified residence to the extent that such debt exceeded <u>the lesser of</u> the following:

   i. The fair market value of the qualified residence, or

   ii. The sum of:

      <u>a</u>. The taxpayer's basis in the residence (determined after special adjustments), plus

      <u>b</u>. The aggregate of the taxpayer's qualified indebtedness (i.e., certain debt incurred to fund medical or educational expenses).

c. Debt is "secured" when there is a mortgage or other security interest that has been perfected under local law on the property. <u>See</u>, generally, Regs. §1.163-10T(o). The Tech. Corrections Act would add a new subparagraph to §163(h)(5) (and which would be designated as §163(h)(5)(C)) to also encompass security interests which would otherwise be enforceable except with respect to special homestead or other debtor protection laws peculiar to the taxpayer's state of residence. <u>See</u>, §105(c)(8), Tech. Corrections Act. Regs. §1.163-10T(o)(2) also includes such a provision. A security interest in stock in a cooperative housing project will also qualify. <u>See</u>, §163(h)(5)(B) and Regs. §1.163-10T(q).

d. A "qualified residence" means the principal residence of the taxpayer (within the meaning of §1034) and one other residence selected by the taxpayer which is used by him as a "residence" (within the meaning of §280A(d)(1)). See, Regs. §1.163-10T(p) for more definitive rules applicable to "principal residences."

   i. A residence will include a condominium or cooperative unit as well as a houseboat or house trailer that meet the requirements of §280A. Regs. §1.163-10T(p)(ii).

   ii. Normally a dwelling unit must be used by the taxpayer to the greater of 14 days or 10% of the total days the unit was used during the taxable year in order to qualify as a residence. However, if a taxpayer does not meet this test for personal usage but also does not rent the unit at any time during the year, the unit may still qualify as a "qualified residence." See, §163(h)(5)(A)(iii); Regs. §1.163-10T(p)(iii); and Tech.Corrections Act §105(c)(7).

   iii. In the case of married taxpayers filing a joint return, the residence may be owned by either spouse or jointly by both. See, Bluebook 267.

   iv. If married taxpayers file separately, each may claim one residence unless they enter into a written agreement authorizing one taxpayer to claim two residences. §163(h)(5)(A)(ii)(II).

e. Note that for alternative minimum tax purposes, a deduction is allowed for "qualified housing interest" which is more narrowly defined than "qualified residence interest." §56(b)(1)(C) and §56(e). Under §56(e), qualified housing interest consists of interest on debt incurred in acquiring, constructing or substantially rehabilitating a principal residence or a second residence. Thus, interest on home equity indebtedness (and acquisition indebtedness that is pre-October 13, 1987 debt that was not traceable to improvements to the property) would not be deductible for AMT purposes. Note also that there is no aggregate cap on qualified housing interest. Interest on debt incurred to refinance qualified residence debt will qualify to the extent that the principal amount is not increased. See, §56(e)(1).

8. Temporary regulations governing allocation of interest. On July 2, 1987, temporary regulations were published in the Federal Register which relate to the allocation of interest expenses for purposes of applying the passive activity loss, investment interest and personal interest limitation rules. These new temporary regulations, which are both lengthy and complex, nevertheless generally establish fair and workable rules allocating interest.

   a. Overview of temporary regulations. Interest on debt is allocated in the same manner as the debt to which it relates. Debt is, in turn, allocated by applying a tracing approach In other words, once the proceeds of the debt come under the control of the taxpayer, the debt will be allocated based upon the use (or uses) to which the taxpayer applies the debt proceeds. Temp. Reg. §1.163-8T(a)(3).

      i. Note: Allocation of debt proceeds (and the corresponding allocation of interest associated with that debt) will not be tied to the asset that is pledged to secure that debt except with respect to qualified residence interest. See, Temp. Reg. §1.163-8T(c)(1).

   b. General rules.

      i. If debt proceeds are disbursed by the lender directly to a person other than a taxpayer-borrower in connection with the taxpayer's purchase of property or services, the taxpayer will be deemed to have applied such debt proceeds to the acquisition of such property or services (to the extent so applied). Temp. Reg. §1.163-8T(c)(3)(i).

ii. If the taxpayer assumes debt (or takes property subject to debt) in connection with the purchase or use of property or for services, the taxpayer will be regarded as having received the proceeds and applied them to the acquisition or use of such property or services. Temp. Reg. §1.163-8T(c)(3)(ii).

iii. Debt proceeds that are deposited in the taxpayer's bank account will be treated as an investment expenditure and will be regarded as property held for investment (regardless of whether such account is interest bearing). Temp. Reg. §1.163-8T(c)(4)(i). Such proceeds shall continue to be classified as having been expended for investment purposes until the proceeds are used to make another expenditure. Id.

a. If debt proceeds are placed in the taxpayer's bank account and such account contains both borrowed and unborrowed funds, the debt proceeds are, as a general rule, deemed to be expended first. Temp. Reg. §1.163-8T(c)(4)(ii). If the proceeds of two or more debts are deposited in the same account, the proceeds will be deemed expended in the order they were deposited (i.e., a FIFO approach). Id. However, there are two exceptions to these general "ordering rules."

i. The taxpayer may elect to treat any expenditures made from the account within 15 days after the debt proceeds were deposited as having been made from such debt proceeds. Temp. Reg. §1.163-8T(c)(4)(iii)(B).

ii. If the bank account consists solely of the debt proceeds and interest earned thereon, the taxpayer may elect to treat any expenditures as having been made first from the interest to the extent thereof. Temp. Reg. §1.163-8T(c)(4)(iv).

iv. If the taxpayer receives the proceeds of any debt in cash, he may elect to treat any cash expenditures made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof. Temp. Regs. §1.163-8T(c)(5)(i). Such expenditures will relate back to the date the loan was taken out. *Id*. In the absence of such an expenditure within 15 days, debt proceeds received in cash will be allocated to personal expenditures. Temp. Reg. §1.163-8T(c)(5)(ii).

c. Reallocation of debt. Debt which has been allocated to a capital expenditure (i.e., to an asset) will be reallocated to another expenditure on the earlier of (i) the date on which the proceeds from the sale of the original asset are used to make another capital expenditure or (ii) the date on which the character of the first expenditure changes (e.g., when a trade or business asset is converted to personal use). Temp. Reg. §1.163-8T(j)(1).

i. Debt proceeds that were initially deposited in the taxpayer's bank account and which are subsequently expended to purchase an asset or services will be reallocated from the initial characterization as an investment expenditure to, for example, a passive activity expenditure if the taxpayer applies the debt proceeds held in such account to the purchase of a residential rental apartment complex. Temp. Reg. §1.163-8T(j)(1)(iv).

d. Repayments and refinancings. If all or any portion of a debt is repaid and if such debt was initially allocated to more than one expenditure the debt will be treated under Temp. Reg. §1.163-8T(d)(1) as having been repaid in the following order:

   i. Amounts allocable to personal expenditures.

   ii. Amounts allocable to investment expenditures and passive activity expenditures (other than rental real estate activities in which the taxpayer actively participates).

   iii. Amounts allocable to rental real estate activities in which the taxpayer actively participates.

   iv. Amounts allocable to former passive activities.

   v. Amounts allocable to trade or business expenditures.

   Thus, the repayments will be applied so as to minimize the limitations on the deductibility of interest.

   If debt is refinanced the new debt will be allocated to the same expenditures to which the old debt had been allocated. The amount of the refinancing debt allocated to any such expenditures will be equal to the amount of the original debt allocated to such expenditures that was repaid with the refinancing proceeds. Temp. Reg. §1.163-8T(e)(1); See, Example in Temp. Reg. §1.163-8T(e)(2) for an illustration of the application of this rule.

e. Effective dates. Temp. Reg. §1.163-8T generally applies to interest paid or accrued in taxable years beginning after December 31, 1986, regardless of when the debt was incurred. Temp. Reg. §1.163-8T(n). A number of transitional rules apply.

B. Uniform capitalization rules as applied to real properties. New §263A, added to the Code by TRA '86, establishes uniform capitalization rules for costs incurred in the manufacture or construction of property and with respect to the purchase of property for resale. See, generally, §263A(b). These new rules apply to both real and personal property. Id.

1. Application to real property constructed by taxpayer for own use. New §263A establishes rules which both codify and expand the holding in Idaho Power Co. v. Commissioner, 418 U.S. 1 (1974), requiring a taxpayer to capitalize both direct and indirect costs incurred in the development and construction of real property for his own use. The principal change resulting from the application of the new rules to self-use real properties will be the required capitalization of indirect costs.

a. Sections 263A(a)(1)(B) and (a)(2)(B) require capitalization of " . . . such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property." Indirect costs to be allocated include, for example, general and administrative costs, an allocable portion of depreciation on equipment used for construction of the property, and compensation and fringe benefits payable to the taxpayer's employees who work on the project. See, S. Rpt. 141, 142.

2. Dealer properties. Similar capitalization rules apply to real properties developed or acquired by a taxpayer for resale in the ordinary course of his trade or business. See, §263A(b)(2)(A).

3. Personal use property. The uniform capitalization rules will not apply to real properties developed and/or constructed by the taxpayer for his own use other than in a trade or business or in an activity conducted for profit. §263A(c)(1).

4. Application to Construction Period Interest Expense. Old §189 (relating to the mandatory capitalization of construction period interest and taxes) has been repealed and new interest capitalization rules are imposed under §263A(f) applicable to real properties developed and/or constructed by the taxpayer for his own use. Recently, the IRS has issued Notice 88-99, I.R.B. 1988-36 (September 6, 1988), which provides additional guidance on the interest capitalization rules of §263A(f).

   a. Section 263A(f)(1) requires capitalization of interest expenses paid or incurred during the "production period."

      i. The production period commences with respect to any property when "production" of the property begins and ceases when the property is ready to be placed in service. Section 263A(f)(4)(B). Notice 88-99 provides that for purposes of the interest capitalization rules, the production period of real property generally begins when physical activity is first performed upon the property. Notice 88-99 gives as examples of physical activity, the grading or clearing of land, the excavation of foundations or lines for utilities, the performance of mechanical activities such as plumbing or electrical work upon a building that is being rehabilitated or improved, or any other work relating to the construction or improvement of real property.

   b. The indebtedness potentially subject to the interest capitalization rules of §263A(f) includes only "eligible debt" as defined in Notice 88-99. Eligible debt includes all debt of the taxpayer other than debt with respect to which the interest is:

      i. Permanently nondeductible. See Reg. §1.163-8T(m)(7)(ii).

      ii. Personal interest within the meaning of §263(h)(2).

      iii. Qualified residence interest within the meaning of §263(h)(3).

iv. Debt incurred by an organization that is exempt from federal income tax under §501(a), except to the extent that interest on such debt is directly connected with the organization's unrelated trade or business within the meaning of §512.

c. Eligible debt subject to the uniform capitalization rules of §263A(f)(2) includes only those amounts of eligible debt equal to or less than a particular property's "accumulated production expenditures". Accumulated production expenditures include expenditures such as planning and design activities which are incurred before the production period of the property begins, as well as the cost of all land and materials acquired before the production period begins. Notice 88-99.

d. The interest required to be capitalized on eligible debt up to the amount of the property's accumulated production expenditures under §263A(f)(1) includes:

i. Interest on debt directly attributable to the property's production expenditures (e.g., interest on a construction loan). Section 263A(f)(2)(A)(i). Notice 88-99 refers to this type of debt as "traced debt".

ii. After determining the amount of traced debt directly attributable to a property's production expenditures, §263A(f)(2) then requires that any other eligible debt be assigned to any remaining production expenditures and that the interest on such debt be capitalized, to the extent that the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred. See §263A(f)(2)(A)(ii). Notice 88-99 refers to such debt as "avoided cost debt". A taxpayer's avoided cost debt is to be allocated pro-rata to the production expenditures of its qualified properties (i.e., property subject to the interest capitalization rules, which includes all real property), based on the ratio of each property's cost to the aggregate cost of all qualified properties under production. Notice 88-99.

a. As stated above, the indirect interest required to be capitalized under §263A(f)(2)(A)(ii) is to be determined utilizing an "avoided cost approach." In other words, if a taxpayer who has other debt previously incurred and which (but for this rule) is not related to the real estate project in question, uses existing monies to pay the development/construction costs of the project, the avoided cost rule would hold that such monies could have been applied instead to the repayment of the other debt as being attributable to such project. *See*, S. Rpt. 144. This rule is applied regardless of the taxpayer's subjective intentions and regardless of the particular facts and circumstances surrounding the taxpayer's operations. *See*, Notice 88-99.

e. Section 263A(f) also requires the capitalization of interest on debt used to produce qualified property. Notice 88-99 provides that taxpayers are required to include in production expenditures the adjusted bases of equipment and facilities which are used in a "reasonably proximate manner" to produce qualified property. Examples of such items include machinery directly used to produce qualified property or components thereof, assembly-line structures, structures used in the production process, buildings, leaseholds and improvements thereon and other similar types of property. Notice 88-99 also gives as reasonable examples of expenditures *not* typically used in a reasonably proximate manner to produce qualified property, administrative operations, personnel operations (i.e., recruiting, hiring and maintaining personnel records of employees), purchasing operations, accounting and data service operations, data processing, security services and legal documents.

f. Notice 88-99 also addresses the issue of when interest is "paid or incurred." Section 263A(f) requires the capitalization of interest that is "paid or incurred" during the production period. Generally, Notice 88-99 prescribes that taxpayers using the cash method of accounting capitalize interest that was "paid" during the production period and that taxpayers using an accrual method of accounting capitalize interest that was "incurred" during the production period. However, Notice 88-99 also provides that forthcoming regulations will require taxpayers using the cash method of accounting to capitalize any interest pertaining to traced or avoided cost debt if such interest is unpaid as of the end of the property's production period and was incurred during the production period.

g. Notice 88-99 provides that taxpayers may use any reasonable method, consistently applied, in calculating the amounts of traced or avoided cost debt. However, the Notice also provides that a taxpayer may <u>not</u> use a method which involves computations that are made less frequently than on a monthly basis, <u>unless</u> the taxpayer can demonstrate that no significant difference will occur between the method it has chosen and a method which is based on monthly computations.

h. Notice 88-99 also provides taxpayers with the option of avoiding the tracing rules. Notice 88-99 provides that a taxpayer may elect to treat all of its traced debt as debt under the avoided cost method, regardless of the actual disbursement of debt proceeds to specific expenditures. In this way, taxpayers may avoid the potential administrative complexities of determining and accounting for the amount of all traced debt under Reg. §1.163-8T.

i. Notice 88-99 additionally sets forth rules for capitalizing the interest expenses of parties related to a taxpayer producing qualified properties. In the case of related parties, Notice 88-99 sets forth that either the "deferred asset method" or the "substitute cost method" may be used in order to comply with the interest capitalization requirements of §263A.

i. Under the deferred asset method, a related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized under §263A, using avoided cost principles, had the producing taxpayer itself incurred the interest on the eligible debt of the related party ("related party avoided cost debt").

ii. However, Notice 88-99 also provides that taxpayers may avoid the complexity of the deferred asset method by electing to use the substitute cost method. Under the substitute cost method, the producing taxpayer capitalizes, during each year of the production period, certain substitute costs in lieu of the taxpayer's related parties being required to capitalize interest on their related party avoided cost debt. The substitute costs consist of a pro-rata amount of all the taxpayer's costs that would be otherwise deductible by the taxpayer for its current taxable year, after application of all provisions of the Code. Examples include marketing and advertising expenses, as well as certain types of general and administrative expenses not otherwise subject to capitalization under §263A.

iii. Additionally, Notice 88-99 provides that though the related party avoided cost debt rules generally are applicable only to related parties, they may be applied in any other case in which the producing taxpayer and any other person are engaged in a transaction with the principal purpose of avoiding the interest capitalization requirements of §263A(f).

j. Notice 88-99 also addresses the application of the interest capitalization rules to flow-through entities. The general rule is that the interest capitalization rules are applied first at the entity level and then at the beneficiary level. For example, the interest capitalization rules are applied first at the level of the partnership, and then at the level of the partners to the extent that such partnership has insufficient debt to support its production or construction expenditures. Section 263A(f)(2)(C); see also, S. Rpt. 144. Thus, with respect to any flow-through entity producing qualified property, the entity must first capitalize interest on its traced and avoided cost debt allocable to its own production expenditures and then, if production expenditures of the flow-through entity exceed its traced and avoided cost debt, the deferred asset method of capitalizing and recovering costs must be applied unless the entity elects the use of the substitute cost method as described above. Likewise, Notice 88-99 requires that interest expense incurred on eligible debt of a flow-through entity be generally treated as having been incurred by the owners of the entity for purposes of again applying the interest capitalization rules to the owners' production expenditures. However, Notice 88-99 sets forth two de minimus rules.

i. First, owners of a flow-through entity will not be subject to the avoided cost rules with respect to the production expenditures of the entity if the owner owns 20% or less of the entity during all of the owner's taxable year and the owner's respective aggregate share in the entity's production expenditures of all qualified property being produced by the flow-through entity, during the production period of the property, reduced by the entity's traced and avoided cost debt allocable to such expenditures, is equal to or less than $250,000, calculated no less frequently than on a monthly basis.

ii. Similarly, interest expense of a flow-through entity will not be required to be capitalized with respect to the production expenditures of an owner if the owner owns 20% or less of the entity during all of the owner's taxable year and the aggregate amount of otherwise deductible interest expense included in the owner's distributive share is less than $25,000.

5. Effective date. The uniform capitalization rules apply generally to costs incurred after December 31, 1986, in taxable years ending after such date. Although not clear, apparently the interest capitalization rules will also apply to interest paid after December 31, 1986, on debt incurred prior to that date.

C. Depreciation changes. Changes to the methods of depreciating tangible property have become regular occurrences since ERTA in 1981. TRA '86 implements the latest round of modifications by introducing a modified accelerated cost recovery system. Section 168, as modified by TRA '86, provides that depreciation of tangible property is to be determined by using (i) the applicable depreciation method, (ii) the applicable recovery period, and (iii) the applicable convention. §168(a). Changes effected by TRA '86 applicable to real estate both lengthen the recovery periods over which the costs of depreciable real property may be recovered and also re-introduce concepts that have not been a part of the depreciation provisions since prior to ERTA.

1. Recovery periods. The new recovery periods for depreciable real properties are 27-1/2 years for residential rental property and 31-1/2 years for nonresidential real properties. §168(c).

a. "Residential rental property" is defined as a building in which 80% or more of the gross rental income is derived from "dwelling units." See, §168(e)(2)(A) and §167(j)(2)(B). A "dwelling unit" is a house or apartment used to provide living accommodations in a building or structure but would not include a building such as a hotel or motel in which more than 50% of the units are rented on a transient basis. §167(k)(3)(C). Under the 80% rule, a mixed-use building (e.g., an office/apartment building) cannot qualify as a residential rental property unless 80% or more of the rental revenues are derived from the dwelling units. For this purpose, two or more buildings located in the same tract may be treated as an integrated unit if they are managed and operated together as a single economic unit. Reg. §1.167(j)-3(b)(1)(ii).

2. Method. Depreciable real property must be depreciated utilizing the straight line method. §168(b)(3). Salvage value will be ignored for this purpose. §168(b)(4).

3. Conventions. The convention applicable to both residential rental property and non-residential real property is the mid-month convention. §168(d)(2). Under this convention real property placed in service or disposed of during any month will be treated as having been placed in service or disposed of on the mid-point of such month. §168(d)(4)(B). Thus, if a building is acquired and placed in service by a calendar year taxpayer on September 30, 1987, it will be deemed to have been placed in service on September 15, 1987, under the mid-month convention and the taxpayer may claim 3-1/2 months of depreciation deductions.

4. Alternative depreciation system. An alternative depreciation method is required in some cases and otherwise made available by election in other cases under §168(g). Depreciation of depreciable real property under §168(g) will be over 40 years (without regard to whether the property is residential or non-residential real property) on a straight line basis and utilizing a mid-month convention. §168(g)(2). The alternative depreciation system, as applied to real estate, is required for tax-exempt use property (as defined in §168(h)) and tax-exempt bond financed property (as defined in §168(g)(5)), and may be elected for other types of real properties on a property-by-property basis under the provisions of §168(g)(7).

5. Additions or improvements. Depreciation deductions for additions or improvements to real property must be computed in the same manner as the depreciation deductions for the real property added onto or improved would have been computed if such property had been placed in service on the same date as the addition or improvements. §168(i)(6). Thus, separate component depreciation (i.e., depreciation of components over shorter useful lives than the underlying property) will not be permitted.

a. The applicable recovery period for the addition or improvement will commence on the later of:

i. The date on which the addition or improvement is placed in service, or

ii. The date the underlying property is placed in service. See, §168(i)(6)(B).

6. Recapture. TRA '86 does not eliminate the recapture rules of either §1245 or §1250, and these provisions will continue to apply to real property placed in service prior to 1987. However, neither §1245 nor §1250 will apply to buildings placed in service in 1987 or thereafter since these structures must be depreciated on a straight line basis.

7. Leasehold improvements. TRA '86 simplifies the rules governing depreciation of leasehold improvements. Under §168(i)(8), any building erected (or other depreciable improvements made upon) leased property must be depreciated under the normal depreciation rules of §168. This rule will apply regardless of the term of the lease. Any recovered cost basis remaining at the expiration of the lease term will be utilized to compute gain or loss at the expiration of the lease term.

8. Minimum tax. Taxpayers must use the alternative depreciation method in computing alternative minimum taxable income. See, §56(a)(1). Thus, a taxpayer must maintain two sets of books -- one for regular tax purposes and the other for computing the alternative minimum tax, in order both to compute current taxable income (and current alternative minimum taxable income) and to compute gain or loss on disposition of the asset.

9. Effective dates. New §168 generally applies to real property placed in service after December 31, 1986. Transitional rules apply authorizing the use of pre-TRA '86 ACRS rules for property constructed, reconstructed or acquired pursuant to a binding written contract in existence on March 1, 1986.

D. Expansion of at risk rules to include real property.

1. At risk rules in general. The at risk rules were originally enacted in 1976 as part of the joint Congressional/Treasury campaign against tax shelters. These rules apply to individual taxpayers as well as C corporations in which five or

fewer individuals own more than 50% in value of the stock of the corporation. §465(a)(1). The objective of the at risk rules is to prevent a taxpayer from deducting losses in excess of his true economic investment in an activity. See, Bluebook 255. Prior to TRA '86, the at risk rules applied to an activity involving a trade or business or involving property held for the production of income, but the holding of real property was specifically excluded from these rules.

A taxpayer is initially treated as being at risk with respect to an activity to the extent of:

a. The amount of money and the adjusted tax basis of any property contributed by him to the activity. §465(b)(1)(A).

b. Amounts borrowed with respect to the activity to the extent of the taxpayer's allocable share of such debt and to the extent the taxpayer is personally liable on such debt. Prop. Reg. §1.465-24(a)(2)(i).

c. The taxpayer's allocable share of nonrecourse debt if (and only if) the taxpayer has pledged assets to secure the debt and such assets are not assets which have otherwise been contributed to the activity. Prop. Reg. §1.465-25 (a)(1).

adjusted each year by the taxpayer's share of income, and decreased by his share of losses and distributions from the activity. See, generally, Prop. Reg. §§1.465-22 and 23.

Losses which cannot be deducted in any taxable year due to the application of the at risk rules may be carried forward to subsequent taxable years. §465(a)(2).

2. Extension to real estate. Congress removed the exemption of real estate from the application of the at risk rules in TRA '86 for real property placed in service after 1986. In addition, if a taxpayer acquires an interest in a pass-through entity at any time after 1986, the changes effected by TRA '86 will apply to such taxpayer's allocable share of the losses after December 31, 1986, which are attributable to all real properties owned by such entity without regard to when such properties were placed in service.

3. Exception for qualified nonrecourse financing. The sting of TRA '86's extension of the at risk rules to real estate has been partially alleviated by the addition of new §465(b)(6)which treats a taxpayer who engages in an activity of holding real estate as being at risk to the extent of his share of any "qualified nonrecourse financing" which is secured by real property used in the activity. The elements of qualified nonrecourse financing are as follows:

   a. Debt must be secured by real property used in such activity. §465(b)(6)(A).

   b. Debt must be borrowed by the taxpayer with respect to the activity of holding real property. §465(b)(6)(B)(i).

      i. The activity of holding real property includes the holding of personal property and the provision of services <u>incidental to</u> making the real property available as living accommodations. §465(b)(6)(E)(i).

      ii. Principal problem in applying this "incidental" rule is determining where the line is to be drawn in service related real property projects such as life care facilities, nursing homes and vacation resorts.

   c. Lender must be a qualified person, or must be a federal, state or local government (or instrumentality thereof), or the debt must be guaranteed by a federal, state or local government. §465(b)(6)(B)(ii).

      i. A "qualified person" includes persons actively and regularly engaged in the business of lending money such as banks, savings and loans, credit unions and life insurance companies. <u>See</u>, Bluebook 258.

      ii. Seller financing will not qualify. <u>See</u>, §§465(b)(6)(D) and 46(c)(8)(D)(iv)(II).

      iii. Lender may not have received a fee with respect to the taxpayer's investment in the property. This is designed to preclude promoters from supplying loans and is not aimed at points or service fees customarily charged by banks and other lending institutions in conventional financing packages. Cf., Bluebook 258.

iv. Lender generally cannot be a related party (within the meaning of §168(e)(4)). See, §§465(b)(6)(D) and 46(c)(8)(D)(I). However, a loan from a related party may still be treated as qualified nonrecourse debt if it meets the other criteria described above plus the following:

a. Terms of loan must be "commercially reasonable and on substantially the same terms as loans involving unrelated persons." §465(b)(6)(D)(ii). Thus, there must be a written, unconditional promise to pay on demand or on a specified date or dates; interest must be charged at market rates (determined by taking into account the maturity of the loan); term of loan must not exceed useful life of property; and right to foreclose must not be limited except as otherwise provided by local law. See, Bluebook 258, 259.

b. Related party relaxation rules will not be construed to authorize seller financing. See, Bluebook 258.

d. Debt must be nonrecourse (i.e., no personal liability). §465(b)(6)(B)(iii).

e. Debt cannot be convertible. §465(b)(6)(B)(iv).

4. Partnerships. In the case of a partnership, a partner's share of any qualified nonrecourse debt of the partnership will be determined in accordance with the portion of such debt allocated to him under §752 and the Treasury Regulations issued (and to be issued) thereunder. §465(b)(6)(C).

5. Aggregation rules. The aggregation rules of §465(c)(3)(B) generally will apply to an activity of holding real estate. See, Bluebook 260.

6. Transfers of property subject to qualified nonrecourse debt. In the case of a transfer of the property, debt that was qualified nonrecourse

financing to the original borrower will continue to be so in the hands of the transferee provided that all criteria continue to be met. See, Bluebook 260.

III. Special Considerations in Planning for Dispositions of Real Estate After TRA '86.

A. Dealer vs. investor issue revisited. The changes under TRA '86 to the taxation of capital gains may have a significant impact upon the manner in which taxpayers and their advisors approach the dealer vs. investor issues that have traditionally been the focus of much of their attention in planning real estate investments.

1. Changes applicable to individuals. For individual taxpayers, TRA '86 repeals §1202 (which contained a deduction for 60% of long term capital gains) effective for taxable years beginning after December 31, 1986. Thus, in general, capital gains and ordinary income will be taxed at the same rates. However, TRA '86 also provides that the maximum tax rate applicable to long term capital gains recognized in taxable years which begin in 1987 will be 28%. This is significant for two reasons:

a. The maximum rate applicable to ordinary income in 1987 is 38-1/2%. Thus, there will still be a 10-1/2% rate differential between long term capital gains and ordinary income in 1987.

b. If the rates applicable to ordinary income ever increase, it is apparently the intent of Congress that the 28% rate applicable to long term capital gains will remain intact (subject, of course, to Congress changing its mind). It should be noted that the entire capital gain and loss structure of the Code was left intact which would readily facilitate a shift back to a distinction in the manner of taxing capital gains and ordinary income.

While the taxation of long term capital gains has been altered by TRA '86, the treatment of capital losses remains largely unchanged. Thus, long term capital losses of an individual taxpayer are still only deductible against the taxpayer's capital gains plus $3,000. However, TRA '86 does repeal the rule that a taxpayer must use $2.00 of long term capital losses to offset $1.00 of ordinary income in computing the $3,000 special deduction.

2. Changes in corporate area. TRA '86 makes similar adjustments to the taxation of capital gains and losses of corporations. For taxable years beginning in 1987, the alternative rate applicable to a corporation's net capital gains is increased from 28% to 34% (subject to a special transitional rule applicable to taxable years which begin in 1986 and end in 1987 -- with net capital gains recognized in 1986 taxable at a 28% rate and the balance recognized in 1987 taxable at the new 34% rate).

   The rules applicable to net capital losses remain unchanged after TRA '86. Thus, capital losses of a corporation will be fully deductible against capital gains, but may not be used to offset ordinary income (there is no counterpart to the $3,000 deduction available to individual taxpayers in the corporate area).

3. Will taxpayers now wish to achieve dealer status?

   a. Pros.

      i. In 1988 and subsequent years, tax rates applicable to ordinary income and long term capital gain will be the same.

      ii. Losses from sales of dealer real property will be deductible in full, but long term capital losses will remain subject to stringent limitations (but, caveat, if taxpayer does not materially participate in the dealer activity, his losses may be restricted under the passive loss rules).

      iii. Interest on debt associated with the trade or business of selling real estate is not subject to the investment interest limitation rules (but, caveat, once again, possible passive loss restrictions if taxpayer does not materially participate in the activity).

      iv. Trade or business expenses are not subject to the new limitations on miscellaneous expenses which apply to investments.

   b. Cons.

      i. Congress might restore rate differential between long term capital gains and ordinary income (entire set of capital gain provisions is left intact -- only applicable rates changed).

ii. Proportionate disallowance rules of new §453C and new alternative minimum tax treatment of certain installment obligations will apply to restrict all installment sales of <u>dealer</u> real property which may eliminate or substantially diminish the benefits of installment reporting (<u>See</u>, discussion in III.B., <u>infra</u>). These restrictions will not apply to investment real estate unless the property was either used in the taxpayer's trade or business or was held for rental purposes (and, in either event, would only apply if the sales price of such real property exceeds $150,000). <u>See</u>, §453C(e)(1)(A).

B. <u>Installment Sales</u>.

1. Prior law. Installment reporting provisions have long been included in the Code for the salutary purpose of enabling a seller whose sale proceeds will be fully or partially deferred until later years to pay his taxes proportionately as he receives his money. The installment sales provisions were substantially revised by the Installment Sales Act of 1980, a statutory model that was widely acclaimed both for its equity and its simplicity.

2. TRA '86 changes. Not content to leave well enough alone, Congress, in search of revenues, couldn't resist tinkering with the installment reporting provisions once again.

The first inequity in the installment sales area identified by Congress is described in the Senate Report as follows:

> "The committee believes that the ability to defer taxation under the installment sales method is inappropriate in the case of gains realized by dealers in ordinary income assets, and also with respect to gains realized on certain business or rental property, to the extent that the taxpayer has been able to receive cash from borrowing relating to its installment obligations." S.Rpt. 123.

In response to this perceived inequity, TRA '86 enacted the so-called "proportionate disallowance rule," which limited the use of the installment sales method on certain sales of property based on the amount of the outstanding indebtedness of the seller. TRA '86 §811 enacting §453C. Additionally, TRA '86 required both individuals and corporations to report the full amount of any gains arising from sales of dealer real estate as well as certain sales of real estate held either in the taxpayer's trade or business or for rental purposes in computing such taxpayer's alternative minimum tax liability. In other words, for alternative minimum tax purposes, TRA '86 completely disallowed installment reporting for sales of dealer real estate as well as for certain sales of real estate held in the taxpayer's trade or business or for rental purposes.

3. Overview of proportionate disallowance rule. One of the major changes made to the installment reporting rules by TRA '86 was the enactment of the overly complex proportionate disallowance rule.

    a. The proportionate disallowance rule applied to installment obligations (referred to as "applicable installment obligations") arising from one of three types of transactions: (1) dispositions of personal property occurring after February 28, 1986, by a person who regularly sold or otherwise disposed of personal property on the installment plan; (2) dispositions of real property occurring after February 28, 1986, by a dealer in real property; and (3) dispositions of real property occurring after August 16, 1986, which property was used in the seller's trade or business or held for the production of rental income, but only if the sales price of such property exceeded $150,000. These types of installment obligations were referred to as "applicable installment obligations." §453C(e)(1)(A)(i).

b. In general, the proportionate disallowance rule set forth a formula for calculating the amount of the taxpayer's indebtedness outstanding during the taxable year which was allocable to his applicable installment obligations (referred to as the "allocable installment indebtedness"). §453C(b). The rule treated the allocable installment indebtedness as a payment on applicable installment obligations of the taxpayer which arose during the taxable year and which were outstanding as of the close of such taxable year. §453C(a)(2). The amount deemed received by the taxpayer under the proportionate disallowance rule was subject to the normal installment sales rules, and as such, the seller was required to recognize gain (determined in accordance with the gross profit ratio on the particular contract) on the amount he was deemed to receive during the taxable year under the proportionate disallowance rule.

c. As subsequent payments were actually received by the taxpayer on his applicable installment obligations, no gain was to be recognized by him to the extent that the payments on the obligations did not exceed the allocable installment indebtedness attributable to such obligation (i.e., there was a tax-free recovery of amounts previously deemed received by the taxpayer under the proportionate disallowance rule on such installment obligations). §453C(c)(1). On receipt of actual payments on applicable installment obligations, the allocable installment indebtedness attributable to the obligation on which the payment was received was reduced by the amount of such payment. §453C(c)(2).

d. The formula set forth under the statute for calculating the taxpayer's allocable installment indebtedness (the amount which is deemed to be received by the taxpayer as a payment on applicable installment obligations during the taxpayer year) may be summarized in the following equation:

$$\text{Taxpayer's Average Quarterly Indebtedness (taxpayer's indebtedness as of the end of each quarter of his taxable year + 4) }\underline{\text{or}}\text{, in the case of }\underline{\text{a}}\text{ non-dealer taxpayer, taxpayer's outstanding indebtedness as of the close of his taxable year} \times \frac{\text{Face amount of taxpayer's Applicable Installment Obligations outstanding at the close of his taxable year}}{\text{Face amount of }\underline{\text{all}}\text{ of taxpayer's installment obligations} + \text{Adjusted basis of all other assets of the taxpayer}} - \text{Allocable Installment Indebtedness attributable to Applicable Installment Obligations arising in prior taxable years that are outstanding as of the close of the taxable year (i.e., prior deemed payments).}$$

e. The Internal Revenue Service recently issued Reg. §§1.453C-1T through 9T addressing various aspects of the proportionate disallowance rule. T.D. 8224 (September 7, 1988).

4. TRA '86 alternative minimum tax rules. In addition to subjecting a taxpayer to the proportionate disallowance rule for regular tax purposes, TRA '86 also required that, in computing alternative minimum taxable income for all taxpayers (individual and corporate), the entire gain attributable to the installment sale of property which would be treated as giving rise to an applicable installment obligation for §453C purposes had to be reported in full (i.e., no deferral of income was allowed) (<u>See</u>, §56(a)(6) prior to its amendment by the Revenue Act of 1987).

5. Overview of Revenue Act of 1987 changes. Congress, apparently realizing that it had made a mistake in passing an extremely complex law (the proportionate disallowance rule) to deal with a relatively simple abuse of pledging an installment sales contract as security for a loan, repealed the proportionate disallowance rule in the Omnibus Budget Reconciliation Act of 1987 ("OBRA"). The changes to the installment sales rules made by OBRA can be segregated into two categories: (1) changes affecting use of the

installment sales method by dealers; and (2) changes affecting use of the installment sales method by nondealers.

6. Dealer sales under OBRA. Whereas the provisions enacted by TRA '86 dramatically reduced the benefit of the installment sales method to dealers of real and personal property by means of the proportionate disallowance rule and the alternative minimum tax, OBRA generally denies dealers (in real or personal property) use of the installment sales method altogether. §453(b)(2)(A) and §453(l). Thus, a dealer in real or personal property must recognize the full amount of gain on sale of property in the year of sale even if the dealer does not receive full payment in the year of sale.

   a. The new rules disallowing the use of the installment sales method by dealers do not, however, apply to the following types of dispositions: installment sales of property used or produced in the trade or business of farming as defined in §2032A(e)(4) and (5) - §453(l)(2)(A); installment sales of timeshare rights in residential real property for not more than six weeks per year - §453(l)(2)(B)(ii)(I); and installment sales of residential lots if the taxpayer (or any related person) is not to make any improvements with respect to such lot - §453(l)(2)(B)(ii)(II).

   b. In order for a taxpayer to utilize the installment sales method for sales of timeshare rights and residential lots under §453(l)(2)(B), the taxpayer must elect to report such sales on the installment method and must make interest payments to the Internal Revenue Service (as calculated below) for the period beginning on the date of the sale and ending on the date such payment is received. §453(l)(3). The interest is calculated by multiplying the applicable federal rate (compounded semi-annually) in effect at the time of the sale by the amount of the tax for the taxable year which is attributable to payments received during the taxable year on the installment sales obligations for which the election has been made. No interest is due for payments received in the taxable year of disposition from which the installment sale obligation arises. §453(l)(3)(B).

c. As a planning tip, dealers who sell property on an installment sales basis should plan either to: (1) receive sufficient payments on the installment sales obligation during the taxable year of the sale to enable the dealer to pay the income tax liability attributable to the sale; or (2) make sure that the purchaser's obligation to pay the installment payments is amply collateralized, guaranteed and fully negotiable so that the dealer can pledge the obligation for a loan to enable the dealer to pay the tax liability attributable to the sale.

d. The repeal of the installment sales method for dealers of real and personal property is generally effective for installment sales obligations arising from dispositions occurring after December 31, 1987. OBRA §10202(e)(2)(A). Additionally, OBRA sets forth a special rule for dealer dispositions occurring after February 28, 1986, and before January 1, 1988. This rule provides that in the case of an applicable installment obligation arising from a disposition before January 1, 1988, the proportionate disallowance rule will apply to such installment sales obligation for tax years ending after December 31, 1986, and before January 1, 1988 (e.g., taxable years ending December 31, 1987, for calendar year taxpayers). Additionally, this rule provides that if any realized gain from a dealer disposition on the installment plan occurring after February 28, 1986, and before January 1, 1988, remains to be recognized as of the first day of the first taxable year of the taxpayer beginning after December 31, 1987 (e.g., January 1, 1988, for a calendar year taxpayer), such remaining gain must be taken into account as a §481(a) accounting adjustment over a period of not more than four years beginning with the taxpayers' first taxable year beginning after December 31, 1987. OBRA §10202(e)(2)(B).

7. Non-dealer sales under OBRA. Rather than prohibiting use of the installment sales method altogether (as was done with respect to dealers), new §453A as enacted by the Revenue Act of 1987 replaces the proportionate disallowance rule with a less harsh provision that places certain restrictions on installment sales obligations arising from the disposition of real property used in the taxpayer's trade or business or held for the production of rental income, the sales price of which property exceeds $150,000. Such installment sales obligations are referred to as "non-dealer real property installment obligations." OBRA also repealed the provision of the Code which denied taxpayers use of the installment sales method on nondealer real property installment obligations for alternative minimum tax purposes. Under OBRA, taxpayers may use the installment sales method with respect to non-dealer real property installment obligations for alternative minimum tax purposes.

   a. The first restriction placed on non-dealer real property installment obligations by new §453A provides that to the extent the face amount of all such obligations which arose during the taxable year and which are outstanding as of the close of such taxable year exceeds $5,000,000, then interest on the "deferred tax liability" attributable to such obligations must be paid to the Internal Revenue Service by the taxpayer.

   b. The second restriction placed on non-dealer real propert installment obligations by §453A provides that, regardless of the $5,000,000 threshold set forth above, such obligations will be subject to the pledging rules of §453A(d).

c. The deferred tax liability and pledging rules generally do not apply to installment obligations arising from the following types of dispositions: (1) dispositions (by an individual) of "personal use property" within the meaning of §1275(b)(3) - §453A(b)(3)(A); (2) dispositions of property used or produced in the trade or business of farming within the meaning of §2032A(e)(4) or (5) - §453A(b)(3)(B); or (3) dispositions of timeshare rights and residential lots described in §453(l)(2)(B), provided that the interest payment rules of §453(l)(3) are applied to such installment sales obligations - §453A(b)(4).

d. For purposes of determining whether a taxpayer has a non-dealer real property installment obligation (i.e., whether the sales price of the property exceeds $150,000), all sales or exchanges which are part of the same transaction (or series of related transactions) are treated as one sale or exchange. §453A(b)(5).

e. If a non-dealer real property installment obligation is outstanding as of the close of any taxable year, the taxpayer's tax is to be increased by the product of: (1) the "applicable percentage" of the "deferred tax liability" with respect to such non-dealer real property installment obligation; multiplied by (2) the underpayment rate in effect under §6621(a)(2) for the month with or within which the taxable year of the taxpayer ends. §453A(c)(2). The term "deferred tax liability" is defined as the product of the amount of gain with respect to a non-dealer real property installment obligation which has not been recognized as of the close of such taxable year, multiplied by the maximum rate of tax in effect under §1 or §11, whichever is appropriate, for such taxable year. §453A(c)(3) The term "applicable percentage" means, with respect to non-dealer real property installment obligations arising in any taxable year, the percentage determined by dividing the portion of the aggregate face amount of all non-dealer real property installment obligations outstanding as of the close of such taxable year in excess of $5,000,000, by the aggregate face amount of nondealer real property installment obligations outstanding as of the close of such taxable year. §453A(c)(4).

Expressed as an equation, a taxpayer's increase in tax liability due to non-dealer real property installment obligations is calculated as follows:

Interest on Deferred Tax Liability =

§6621(a)(2) underpayment rate in effect for month with or within which taxable year ends

times

Aggregate face amount of non-dealer real property installment obligation outstanding as of the end of the taxable year - $5,000,000
____
Aggregate face amount of non-dealer real property installment obligations outstanding as of the end of the taxable year

times

Amount of unrecognized gain with respect to non-dealer real property installment obligations as of the end of such taxable year

times

Maximum rate of tax in effect under §1 or §11 for such taxable year

f. If any non-dealer real property installment obligation is pledged as security for any indebtedness (referred to as "secured indebtedness"), the net proceeds of the secured indebtedness is treated as a payment received on such non-dealer real property installment obligation as of the later of: (1) the time which the indebtedness becomes secured; or (2) the time the proceeds of such secured indebtedness ar received by the taxpayer. §453A(d)(1). However, the amount treated as received under the pledging rules by reason of any secured indebtedness cannot exceed the excess (if any) of the total contract price under the non-dealer real property installment obligation, over any portion of the total contract price received under the contract before the secured indebtedness was incurred (including amounts previously treated as received under the pledging rules). As payments are actually received on non-dealer real property installment obligations which have been subject to the pledging rules, such amounts are recovered tax-free to the extent such proceeds have already been treated as received under the pledging rules. §453A(d)(3). Additionally, the pledging rules provide that indebtedness is secured by a nondealer real property installment obligation to the extent that payment of principal or interest on such indebtedness is directly secured (under the terms of the indebtedness or any underlying arrangements) by any interest in such non-dealer real property installment obligation. §453A(d)(4).

g. The new restrictions placed on non-dealer real property installment obligations by §453A are generally effective for installment obligations relating to dispositions occurring in taxable years beginning after December 31, 1987. OBRA §10202(e)(1). However, taxpayers having nondealer real property installment obligations may elect to have the new rules apply in lieu of the proportionate disallowance rule for taxable years ending after December 31, 1986, with respect to dispositions and pledges occurring after August 16, 1986. §10202(e)(3). A taxpayer having non-dealer real property installment obligations will generally find it advantageous to elect out of the proportionate disallowance rule if the face amount of such taxpayer's non-dealer real property installment obligations do not exceed $5,000,000 (and as such, will not be subject to the deferred tax liability rules) and such taxpayer has not pledged his non-dealer real property installment obligations as security for a loan.

h. The new pledging rules of §453A(d) generally apply to non-dealer real property installment obligations pledged to secure any secured indebtedness after December 17, 1987. Additionally, if the taxpayer elects out of the proportionate disallowance rule, the pledging rules will apply to taxable years ending after December 31, 1986. OBRA §10202(e)(3)(B).

i. The amendments allowing use of the installment sales method with respect to non-dealer real property installment obligations for alternative minimum tax purposes apply to dispositions in taxable years beginning after December 31, 1986. Presumably, the amendments made to the alternative minimum tax also apply to dispositions made after August 16, 1986, and before January 1, 1987, since, for purposes of the proportionate disallowance rule, such dispositions were deemed to have been made after December 31, 1986.

C. Like Kind Exchanges of Real Properties.

1. Overview. Section 1031 provides an exception to the general rule of §1001(c) that gains or losses arising from the sale or exchange of property are to be recognized for tax purposes. Nonrecognition of gain or loss is provided for under §1031 in the case of exchanges of "like kind properties" (other than stocks, securities, partnership interests and similar properties, and other than "dealer properties" and properties held primarily for sale) which

are held for productive use in a trade or business or for investment. §1031(a)(1) and (2). Section 1031 is frequently employed in real estate transactions, although its use is not confined to real property, in order to defer taxes on disposition. If a taxpayer sells property at a gain, his ability to acquire replacement property is limited because he has only net, after-tax proceeds to reinvest. On the other hand, if the taxpayer can arrange to effect a qualifying exchange of properties under §1031 he is able to acquire replacement properties utilizing the full purchasing power of pre-tax dollars.

Section 1031 is a <u>deferral</u> provision. Just as in the case of most <u>deferral</u> provisions under the Code, §1031(d) exacts a price for nonrecognition of gain in the form of a basis adjustment. <u>See</u> discussion under C.3.d., <u>infra</u>.

The provisions of §1031 are <u>not</u> elective. If the conditions of §1031 are met, nonrecognition is mandated which sometimes catches unwary taxpayers when a loss rather than a gain is realized in the transaction. §1031(c); <u>see</u>, <u>United States v. Vardine</u>, 305 F.2d 60 (2d Cir. 1962).

2. <u>Legislative history</u>

a. Pre-1921 law. Prior to 1921 all exchanges of tangible properties, even though they were of "like kind," were treated as taxable transactions. Revenue Act of 1918, §202(b).

b. Statutory predecessors of §1031. The Revenue Act of 1921 created a special nonrecognition rule for exchanges of property not having a "readily realizable market value". Moreover, even if such property had such an ascertainable market value, nonrecognition treatment was still accorded if the property acquired was of "like kind or use" to the property relinquished and if the relinquished property was held " . . . for investment, or for productive use in trade or business (not including stock in trade or other property held primarily for sale) . . ." Revenue Act of 1921, §202(c). In 1923 the statute was amended to preclude the availability of nonrecognition treatment for exchanges of stock and securities and in 1924 it was further amended to delete the "readily realizable market value" provision.

c. Legislative intent. One court has focused on the "readily realizable market value" standard originally incorporated in the 1921 edition of the statute and determined that the underlying legislative rationale for nonrecognition was to avoid administrative difficulties in valuing properties for the purposes of computing gain or loss. Century Electric Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), cert. denied, 342 U.S. 954 (1952). However, the better view seems to be that the statute was intended to provide nonrecognition in instances where the taxpayer continues his investment in essentially the same kind of property as the property disposed of and his gain or loss is merely "theoretical." H.R. Rept. No. 704, Revenue Act of 1934, 73d Cong., 2d Sess., 1939-1 (Pt. 2) C.B. 554, 564; Jordan Marsh Co. v. Commissioner, 269 F.2d 453, 456 (2d Cir. 1959).

3. Statutory requirements and mechanics of section 1031

a. General rule. Section 1031(a)(1) provides as follows: No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment.

b. Exceptions. Section 1031(a)(2) provides as follows: "This subsection shall not apply to any exchange of (A) stock in trade or other property held primarily for sale, (B) stocks, bonds or notes, (C) other securities or evidences of indebtedness or interest, (D) interests in a partnership, (E) certificates of trust or beneficial interests, or (F) choses in action."

c. Essential elements of an exchange qualifying for nonrecognition treatment under §1031.

i. Property. Only certain types of "property" are eligible for nonrecognition treatment under §1031.

a. The properties must be of a "like kind" as discussed in C.3.c.iv., infra.

b. The properties may not be "...stock in trade or other property held primarily for sale, stocks, bonds, or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action." §1031(a)(2).

i. "Stock in trade"--Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979).

ii. "Property held primarily for sale"--Bernard v. Commissioner, 26 T.C.M. 858 (1967); Griffin v. Commissioner, 49 T.C. 253 (1967); and Klarkowski v. Commissioner, 24 T.C. 1827 (1965), aff'd. on another issue, 385 F.2d 398 (7th Cir. 1967).

iii. "Choses in action"--Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979); Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), aff'd. per curiam, 503 F.2d 556 (9th Cir. 1974).

iv. "Certificates of trust or beneficial interest"--Rutland v. Commissioner, 36 T.C.M. 40 (1977).

v. "Partnership interest"--Prior to the enactment of §1031(a)(2)(D) by TRA '84, the

Service and the Tax Court disagreed as to whether an exchange of partnership interests qualified for nonrecognition treatment under §1031. In Estate of Meyer v. Commissioner, 503 F.2d 566 (9th Cir. 1974), aff'g. per curiam 58 T.C. 311 (1972), nonacq. 1975-1 C.B. 3, the Service argued that partnership interests could not be exchanged tax-free under §1031 because partnership interests constituted choses in action which were specifically excluded from §1031 by the parenthetical clause of §1031(a) prior to its amendment rejected this argument and held that the exchange of general partnership interests in different partnerships with similar assets fell within the purview of §1031. However, the Tax Court did find that the exchange of a general partnership interest for a limited partnership interest did not qualify for nonrecognition treatment under §1031 despite the similarity of the underlying assets of the partnerships involved. Despite its defeat in Estate of Meyer, the Service continued to take the position that exchanges of partnership interests did not fall within §1031, and in Rev. Rul. 78-135, 1978-1 C.B. 256, the Service ruled that an exchange of general partnership interests would not qualify under §1031. The Tax Court again rejected the Service's position and reaffirmed its own position in Gulfstream Land & Development Corp. v. Commissioner, 71 T.C. 587 (1979). See also, Long v. Commissioner, 77 T.C. 1045 (1981) (exchange of 50% interest in general partnerships with real estate as the underlying assets qualified under §1031) and Pappas v. Commissioner, 78 T.C. 1078 (1982) (exchange of general partnership interests qualified as a like kind exchange under §1031).

Despite the position taken by the Tax Court, TRA '84 rejected the Tax Court's position and codified the Service's position taken in Rev. Rul. 78-135 that exchanges of partnership interests are excluded from §1031. Section 1031(a)(2)(D). However, the House Committee Report makes it clear that §1031(a)(2)(D) excludes only exchanges of interests in different partnerships, so that partnership interests in the same partnership may be exchanged tax-free under §1031. H.R. Rep. No. 98-432, 98th Cong., 2nd Sess. 1231-1234 (1984). Query, whether an exchange of a limited partnership interest for a general partnership interest in the same partnership will qualify under §1031? Though the House Committee Report language arguably covers this situation, Estate of Meyer, supra would seem to indicate to the contrary. The Service's position on exchanges of a limited partnership interest for a general partnership interest of the same partnership is set forth in Rev. Rul. 84-52, 1984-1 C.B. 57. Rather than treating the transaction as an exchange, Rev. Rul. 84-52 analyzes such a transaction as a distribution of a new partnership interest to the converting partner or partners in exchange for a contribution of their old interests to the partnership under §721. Consequently, under the Service's view, a partner converting his general partnership interest for a limited partnership interest (or vice versa) in the same partnership will recognize no gain or loss on such conversion unless there is a reduction in such partner's share of partnership liabilities under Regs. §1.752-1(e) such that the deemed distribution of money to the converting partner under §752(b) exceeds such partner's adjusted basis in his partnership interest. §731(a)(1).

c. The interest must constitute "property" and not a right to income. Compare Commissioner v. P. G. Lake, 356 U.S. 260 (1958) (mineral rights in the form of carved out oil payment did not constitute "property" for purposes of §1031) with Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941) and Rev. Rul. 68-331, 1968-1 C.B. 352 (undivided oil interests and overriding royalties qualified as "property.") Under Regs. §1.1031(a)-1(c), a leasehold interest with 30 years or more to run is considered as "property," but see, Pembroke v. Commissioner, 70 F.2d 850 (D.C. Cir. 1934) and Rev. Rul. 66-209, 1966-2 C.B. 299 which hold that if a fee owner merely carves out a 30-year leasehold interest from his fee ownership and exchanges it for real property, the leasehold interest will not be treated as property because it will be more in the nature of an assignment of income such as that found in P. G. Lake, supra.

ii. Properties must be held for productive use in trade or business or for investment. The regulations under §1031 neither define "held for productive use in trade or business" nor "investment." However, for useful analogies see §§1231 and 167 regarding trade or business properties and §1221 regarding investment properties.

a. Property held for productive use in a trade or business may be exchanged for property to be held for investment or vice versa. Regs. §1.1031 (a)-(1)(a).

b. The properties must be held for productive use in a trade or business or held for investment. Thus, if property which would otherwise qualify under §1031 is promptly disposed of, in a taxable transaction, it will not be eligible because it is not held for the required purpose. See Black v. Commissioner, 35 T.C. 90 (1960). The Service has also taken the position that if property received in an exchange which would otherwise qualify under §1031 is promptly disposed of in a non-taxable transaction, such property will not be eligible for §1031 treatment because it was not "held" for the required purposes. See, e.g., Rev. Rul. 75-292, 1975-2 C.B. 333 (property received in a purported §1031 exchange immediately transferred to a controlled corporation under §351 ineligible for §1031 nonrecognition treatment). However, in Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd. 753 F.2d 1490 (9th Cir. 1985), the Tax Court found that a prearranged transfer of real property received in a like kind exchange to a partnership in return for an interest in the partnership satisfied the holding requirement of §1031(a). The Court's holding was limited to those situations in which a taxpayer exchanges property for like kind property with the intent to contribute it to a partnership for a general partnership interest. The court distinguished Rev. Rul. 75-292, supra, on the following grounds: (1) a corporation is an entity separate and apart from its shareholders while a partnership is an association of the partners making up the partnership and (2) a like kind exchange in conjunction with a §351 transfer "viewed as a whole" results in the exchange of property for stock, a transaction expressly excluded from §1031. Continued reliance on the Magneson decision, however, is uncertain in light of the enactment of §1031(a)(2)(D) by TRA '84. Section 1031(a)(2)(D) expressly excludes a partnership interest as like kind property. See also, Bolker v. Commissioner, 81 T.C. 782 (1983) aff'd. 85-1 U.S.T.C. ¶9400 (9th Cir. 1985), which held that a prearranged exchange of real property received in a §333 tax-free liquidation for like kind property qualified under §1031(a). (The court found that whether an exchange of like kind property is preceded by, or suc ceeded by, a tax-free acquisition or transfer of property should not affect nonrecognition treatment under §1031(a)).

iii. Exchange. Section 1031(a) specifically limits its application to exchanges (as opposed to sales or other forms of disposition) of property. While the presence or absence of an exchange would normally be self-evident, the issue may become obscured in the case of multi-party exchanges discussed in C.4., infra. Moreover, even though the parties may have clearly contemplated an exchange, if they attempt to short cut the formalities of an exchange, especially in the case of three cornered exchanges (see discussion in C.4., infra), the result may be a sale rather than an exchange. Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Swaim v. United States, 81-2 U.S.T.C. ¶9575 (5th Cir. 1981); Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd. per curiam, 377 F.2d 534 (9th Cir. 1967).

iv. Like Kind. The regulations adopt a liberal construction of "like kind" for purposes of applying the nonrecognition rules:

> ". . . The words 'like kind' have reference to the nature or character of the property and not to its grade or quality . . . The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class." Regs. §1.1031(a)-1(b).

In the case of real estate, as noted in the above quoted portion of the Regulations, improved real estate may be exchanged for unimproved real estate, and city real estate may be exchanged for a ranch or farm. Regs. §1.1031 (a)-1(c). Similarly, a leasehold interest with 30 years or more to run may, if it represents the taxpayer's entire interest in the property (see discussion under "Property" C.3.ii.a., supra), be exchanged for a fee interest in real property. Regs. §1.1031(a)-1(c), and an undivided interest as a tenant in common may also be exchanged for a fee title. Rev. Rul. 73-476, 1973-2 C.B. 300.

c. Boot. The general rule for nonrecognition treatment set forth in §1031(a) requires that qualifying property must be exchanged solely for other qualifying property. However,

§1031(b) provides that if an exchange would otherwise be eligible for tax-free exchange treatment under §1031(a) but for the presence of some nonqualifying property ("boot"), any gain realized in the transaction (i.e., economic gain) will be recognized for tax purposes to the extent of the sum of money and the fair market value of the nonqualifying property received. If the exchange results in a realized loss (i.e., an economic loss) and boot is received, §1031(c) provides that the loss will not be recognized.

i. Example of operation of "boot" rule. TP, who owns TP Land with a fair market value of $100,000 and a tax basis of $50,000, enters into an exchange with X who owns X Land with a fair market value of $80,000. X transfers X Land to TP plus $20,000 in exchange for TP Land. TP's realized gain will be computed as follows:

$ 80,000	Fair market value of X Land received
+20,000	Cash received
$100,000	Total consideration
-50,000	Basis in TP Land transferred
$ 50,000	Realized gain

Under §1031(b), $20,000 of TP's total realized gain of $50,000 must be recognized (i.e., reported for tax purposes) due to the receipt of $20,000 of boot (cash) by TP.

ii. Three forms of boot. "Boot" can be received in three different forms.

a. Cash

b. Nonqualifying property

i. Property which is not "like kind." §1031(a)(1).

ii. Property which is not held for productive use in a trade or business or for investment. §1031(a)(1).

iii. Stock in trade or other property held primarily for sale, stocks, bonds, or notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action. §1031(a)(2).

c. Relief from liabilities either through assumption of such liabilities by the other party to the exchange or by a conveyance of property to the other party subject to an existing liability and mortgage. Regs. §1.1031(b)-1(c).

iii. Netting of boot. In many exchanges a taxpayer will both give and receive boot. In such instances the regulations tolerate some "netting" of boot.

a. Under Regs. §1.1031(b)-1(c), liabilities of the taxpayer encumbering his property which are either assumed or taken subject to by the other party to the exchange may be offset, or "netted," against liabilities encumbering the other party's property which are either assumed or taken subject to by the taxpayer in the exchange. Although not specifically stated in the statute, Regs. §1.1031(d)-2, Ex. 2 makes it clear that if the taxpayer assumes or takes property subject to existing debt such debt will reduce the amount of gain realized.

b. Liabilities of the taxpayer encumbering his property which are assumed or taken subject to by the other party to the exchange may also be offset by cash given by the taxpayer to such other party. Regs. §1.1031(d)-2, Exs. 1 and 2; Barker v. Commissioner, 74 T.C. 555 (1980). Query, may nonqualifying property given by the taxpayer also be netted against mortgage indebtedness of the taxpayer which is assumed or taken subject to by the other party to the exchange? Dicta in the Tax Court's Barker decision suggests that it may. 74 T.C. 555 (1980). See also, Ltr. Rul. 8003004 (Sept. 19, 1979).

c. A taxpayer who receives cash or nonqualifying property to compensate for a difference in net values in the properties (fair market value less mortgage) cannot offset such boot by boot given in the form of assumption of debt by the taxpayer encumbering the property received (or taking subject to such debt). Regs. §1.1031(d)-2, Ex. 2; Barker, supra; Coleman v. Commissioner, 180 F.2d 758 (8th Cir. 1950). This rule is apparently predicated upon the assumption that the taxpayer receiving the cash or other nonqualifying property is free to use it for whatever purposes he desires and is not necessarily required to apply it in reduction of the "excess" mortgage indebtedness assumed.

i. Query, in an effort to avoid receiving cash, may the taxpayer and the other party to the exchange agree that the taxpayer will refinance his mortgage to the level necessary to eliminate the necessity of receiving cash from the other party? If this is done in anticipation of the exchange, the additional debt so created may nevertheless be treated as a cash payment. Cf. Shubin v. Commissioner, 67 F.2d 199 (3rd Cir. 1933), cert. denied, 291 U.S. 664 (1933) and Rev. Rul. 73-555, 1973-2 C.B. 159 involving the impact of mortgaging property immediately prior to sale on "payments received in the year of sale" under §453 (installment sales provisions); but see, 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), acq., 1976-2 C.B. 2, nonacq., 1976-2 C.B. 3; and Garcia v. Commissioner, 80 T.C. 491 (1983) (increase of mortgage on property to be received in like-kind exchange as precondition to exchange in order to avoid recognition of boot gain due to relief of liability on property given up respected as legitimate debt).

ii. Query, also, whether the other party to the exchange may reduce the level of his indebtedness to eliminate the payment of cash? See Garcia, supra.

iii. A legitimate method of minimizing or eliminating the receipt of boot is to have the other party to the exchange construct desired improvements on the property to be received by the taxpayer in the exchange with the monies that would otherwise have been paid as boot. See, Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); and J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4.

d. Example of effects of boot netting rule (adapted from Regs. §1.1031 (d)-2, Ex. 2). TP owns the TP apartment house. On June 15, 1981, the TP apartment house has an adjusted tax basis in TP's hands of $100,000, a fair market value of $220,000 and is subject to a mortgage of $80,000. Thus, the net fair market value of the TP apartment house on June 15, 1981, is as follows:

$220,000	Fair market value
-80,000	Mortgage
$140,000	Net fair market value

X owns the X apartment house which on June 15, 1981, has an adjusted tax basis in X's hands of $175,000, a fair market value of $250,000 and is subject to a mortgage of $150,000. Thus, the net fair market value of the X apartment house on June 15, 1981, is as follows:

$250,000	Fair market value
-150,000	Mortgage
$100,000	Net fair market value

On June 15, 1981, TP and X exchange the TP apartment house for the X apartment house. Since the TP apartment house has a net fair market value $40,000 greater than the X apartment house, X pays TP $40,000 in cash at closing. Each apartment house is transferred subject to the existing indebtedness which is assumed by the parties. The tax treatment of TP and X is as follows:

i. Tax treatment of TP:

$250,000	Fair market value of X apartment house received
+ 80,000	Mortgage on TP apartment house assumed by X
+ 40,000	Cash
$370,000	Total consideration received
-100,000	Adjusted tax basis in TP apartment house
-150,000	Mortgage on X apartment house assumed by TP
$120,000	Net realized gain

For purposes of §1031(b), the amount of net boot received by TP is $40,000 and, thus, $40,000 of TP's realized gain must be recognized for tax purposes. This figure was computed by netting \$80,000 of the \$150,000 mortgage assumed by TP against the \$80,000 mortgage encumbering the TP apartment house assumed by X. However, although TP assumed \$70,000 more indebtedness of X (\$150,000 minus \$80,000), this excess may not be offset against the \$40,000 of cash boot received by TP.

ii. Tax treatment of X:

\$220,000	Fair market value of TP apartment house received
+150,000	Mortgage on X apartment house assumed by TP
\$370,000	Total consideration received
-175,000	Adjusted tax basis in X apartment house
- 80,000	Mortgage on TP apartment house assumed by X
- 40,000	Cash paid by X
\$ 75,000	Net realized gain

For purposes of §1031(b), the amount of net boot received by X is \$30,000 with the result that \$30,000 of X's realized gain must be recognized for tax purposes. X received boot in the amount of \$150,000 by virtue of TP's assumption of the mortgage on the X apartment house, but X was entitled to offset this by both the \$80,000 mortgage assumed by X on the TP apartment house and the \$40,000 in cash paid by X to TP.

iv. Installment reporting of recognized gains. Prior to the Installment Sales Revision Act of 1980 ("Installment Sales Act"), it was difficult to qualify for installment reporting of the taxpayer's gain resulting from the receipt of boot in the form of an installment note because the receipt of qualifying property was treated as a "payment in the year of sale" for purposes of the 30% test under §453(b)(2)(A) prior to its amendment by the Installment Sales Revision Act of 1980. Mitchell v. Commissioner, 42 T.C. 953 (1964), acq., 1965 2 C.B. 6. However, under current §453(f)(6), "payments" do not include qualifying properties received in a §1031 exchange and installment obligations are not taxed in the year of receipt. Thus, if a taxpayer wishes to spread his recognized gain attributable to boot received in a §1031 exchange, he may negotiate for receipt of an installment note from the other party in lieu of cash or other nonqualifiying property. (Caveat, recent changes to installment reporting rules under TRA 86 and OBRA discussed in III.B., supra). For purposes of reporting the taxpayer's taxable gain upon receipt of installment payments in a §1031 transaction, the taxpayer's basis will first be allocated to qualifying property received to the extent of its fair market value with the excess (if any) being applied against the installment payments. See Prop. Regs. §1.453-1(f).

d. Basis and holding periods. Section 1031 is a deferral provision. Like most deferral provisions in the Code, it exacts a price for nonrecognition in the form of a reduction in basis in qualifying property received in a §1031 exchange.

   i. General rule. Section 1031(d) provides that the basis of qualifying (like kind) property received in a §1031 exchange is equal to the basis of the property transferred, reduced by any cash received and any loss recognized (which would be attributable to exchange of "boot properties"), and increased by any gain recognized.

_a_. The basis of property received by a taxpayer in a §1031 exchange may also be increased by the amount of any cash paid by the taxpayer. Regs. §1.1031(d)-2, Ex. 2. Brokers' commissions paid by the taxpayer will also increase the taxpayer's basis in the newly acquired property Rev. Rul. 72-456, 1972-2 C.B. 468.

_b_. If two or more qualifying properties are received in the exchange, the taxpayer's basis must be allocated between such properties in proportion to their relative fair market values. Rev. Rul. 68-36, 1968-1 C.B. 357; _Mitchell v. Commissioner_, 42 T.C. 953 (1964), _acq._, 1965-2 C.B. 6.

_c_. If both qualifying property and boot are received in the exchange, basis will first be allocated to boot to the extent of its full fair market value. For example, assume TP has TP property with a fair market value of $100,000 and a tax basis of $50,000 and he exchanges it for X property (which is like kind property) with a fair market value of $80,000 plus securities with a fair market value of $20,000. $20,000 of TP's $50,000 realized gain must be recognized due to the presence of the $20,000 of boot (securities). TP's basis in the X property would be computed as follows:

$50,000	Basis in TP property
+20,000	Gain recognized
$70,000	Total basis of qualifying and nonqualifying property
-20,000	Basis allocable to securities (fair market value of securities)
$50,000	Basis of X property

_d_. Any liabilities encumbering the taxpayer's property which are assumed or taken subject to by the other party to the exchange will be treated the same as cash received for purposes of the basis computation rules. §1031(d) (last sentence).

i. If both of the properties exchanged are encumbered by mortgages, and assuming that no other boot is given or received other than in the form of mortgages, the basis of the acquired property would be computed as follows:

  Basis of property surrendered
- Mortgage on property surrendered
+ Mortgage on property received
+ Gain recognized

  Net adjusted basis of newly acquired property

e. The basis provisions of §1031(d) provide the mechanism through which gains which are not initially recognized under §1031(a) will eventually be taxed. In essence, the tax basis of the newly acquired property is reduced under §1031(d) by the amount of the unrecognized gain. Thus, when the newly acquired property is later disposed of in a taxable transaction the "latent gain" will then be recognized. In the interim, if the newly acquired property is depreciable property the basis for depreciation is correspondingly less, thus reducing the amount of depreciation deductions the taxpayer may claim. Of course, if the taxpayer should die prior to disposition of the newly acquired property, his estate would be entitled to a stepped up basis in the property under §1014 and the latent gain would then be eliminated.

ii. Holding period. Tacking of holding periods is authorized under §1223(1) with respect to qualifying properties if such properties are either capital assets, as defined in §1221, or properties described in §1231.

e. Relationship to depreciation recapture provisions.

i. Section 1245. Section 1245(b)(4) carves out an exception to the general recognition forcing rule of §1245(a) and provides that if property is disposed of and gain is not recognized in whole or in part under §1031, then the amount of gain to be recognized under §1245(a)(1) shall not exceed the <u>sum</u> of the following:

<u>a</u>. The amount of gain recognized on the disposition (determined without regard to §1245--<u>i.e.</u>, due to the presence of boot), <u>plus</u>

<u>b</u>. The fair market value of <u>non</u>-Section 1245 property that is not taken into account under <u>a</u>.

If only like kind ("qualifying") properties are exchanged, then no gain will be recognized under §1245 except to the extent that the fair market value of the §1245 property disposed of exceeds the fair market value of the §1245 property received. <u>See</u> §1245(b)(4)(B). On the other hand, <u>if</u> gain is recognized on the §1031 exchange because of the presence of boot, then the potential §1245 recapture income will be recognized subject to the limitations set forth in <u>a</u>. and <u>b</u>. above.

ii. Section 1250. Section 1250(d)(4) provides that if properties are exchanged and gain is not recognized in whole or in part under §1031, then the amount of §1250 gain that is to be recognized will be limited to the <u>greater of</u> the following:

<u>a</u>. The amount of gain recognized under §1031 (<u>i.e.</u>, due to the presence of boot), <u>or</u>

b. The excess of the amount of realized §1250 gain over the fair market value of the §1250 property received in the exchange.

It should be noted that, under §1250(e) there will be no tacking of holding periods in a §1031 exchange of §1250 properties for the purposes of determining the "applicable percentage" under the recapture phase-out rules.

f. Different treatment of parties to exchange. It is permissible to have one party to an exchange qualify for nonrecognition treatment under §1031 while the other party does not. See, e.g., Rev. Rul. 77-297, 1977-2 C.B. 304.

4. Multi-party exchanges

a. Factual setting. The original draftsman of §1031 and its predecessor provisions undoubtedly envisioned its application in "barter" transactions in which each party owned property that the other party desired and they would simply exchange these properties. In reality, however, this rarely occurs. In most instances, if X wishes to acquire the taxpayer's property he probably will not own property that the taxpayer would like to acquire in an exchange and, further, X probably would have little interest in participating in a land exchange but for the fact that this may be the only method by which he can acquire the taxpayer's property. In such a situation X may agree to accommodate the taxpayer by acquiring property selected by the taxpayer for the sole purpose of swapping it for the taxpayer's property. Thus, another party, the owner ("C") of the property that the taxpayer would like to acquire in the exchange is interjected into the picture. This scenario and a number of variations thereof is referred to as a "multi-party exchange." Most multi-party exchanges fall into one of two molds--the "three cornered exchange" and the "four party exchange."

i. Three cornered exchange. A typical three cornered exchange derives its name from the fact that it involves three participants--the taxpayer who owns TP property; X who wants to acquire the TP property; and C, who owns the C property that TP would like to acquire. The transaction is usually structured in one of two ways.

<u>a</u>. In the most common pattern, X will acquire the C property from C and immediately thereafter exchange it with TP for the TP property. The net result of these transactions is that TP acquires the C property in a §1031 exchange; C sells his property in a taxable transaction; and X ends up with the TP property and is "out of pocket" the cost of the C property.

<u>b</u>. Another popular variation of the three cornered exchange involves TP exchanging TP property with C for the C property. C, having just acquired the TP property in the exchange, immediately thereafter sells the TP property to X. The net result of this transaction is the same as i. above.

ii. Four party exchange. The four party exchange is similar to the three cornered exchange except that an "accommodation party" (<u>i.e.</u>, a "fourth party" in addition to the taxpayer, X and C) assumes a role in the transaction. In many instances the intended purchaser (X) of the taxpayer's property is unwilling or unable to acquire the property that the taxpayer wishes to acquire in the exchange. In order to effectuate the transfer the accommodation party (usually a title company, a bank or, in some instances, an attorney for one of the parties) will either acquire the desired exchange property, exchange it for the taxpayer's property, and then sell it to X or, alternatively, acquire the exchange property and resell it to X who then exchanges it for the taxpayer's property.

b. Essential elements of multi-party exchanges.

i. Evolution of the multi-party exchange. Initially the Service considered multi-party exchanges as being outside the realm of §1031 and took the position that they were tantamount to a taxable sale followed by a reinvestment of the proceeds. Fortunately for the taxpayer, the early decisions in this area adopted a liberal construction of §1031 as it applied to multi-party exchange situations and established a pro-taxpayer trend that, with some judicial deviations, has been liberalzed to an even greater extent in recent years. See, e.g., Mercantile Trust Co. of Baltimore v. Commissioner, 32 BTA 82 (1935), acq., XIV-1 C.B. 13; J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); and Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963) which represent the early line of cases applying an expansive application of §1031 to multi-party exchanges; and Biggs v. Commissioner, 81-1 U.S.T.C. ¶9114 (5th Cir. 1980); Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); Barker v. Commissioner, 74 T.C. 555 (1980) Brauer v. Commissioner, 74 T.C. 1134 (1980); Hayden v. United States, 82-2 U.S.T.C. ¶9604 (D.Wyo. 1981); and Garcia v. Commissioner, 80 T.C. 491 (1983), acq. 1984-1 C.B. 1; are more recent and, if anything, more liberal (pro-taxpayer) decisions than their predecessors.

a. Realistically, there is a fine line dividing the characterization of many, if not most, multi-party exchanges as §1031 exchanges rather than as taxable sales and reinvestments. The courts have utilized several familiar tax doctrines-"substance over form," "step transaction" and "constructive receipt"--to analyze the factual basis of multi-party exchanges to support their findings of exchange treatment. For a discussion of the application of these three doctrines in the area of multi-party exchanges, see Guerin, "A Proposed Test for Evaluating Multiparty Like Kind Exchanges," 35 Tax L. Rev. 547, 555-586 (1980). However, "one cannot escape the impression that if it were not for the fact that the early decisions in three-party exchange cases applied Section 1031 in a liberal manner, and later decisions 'followed the leader' on the basis of stare decisis, there might have been a trend against the taxpayer's position." Dean, "Three-Party Exchanges of Real Estate," 17 Tulane Tax Inst., 131, 137.

b. After numerous setbacks, the Service finally capitulated and acknowledged the applicability of §1031 in "standard" types of multi-party exchanges. Rev. Rul. 75-291, 1975-2 C.B. 333 and Rev. Rul. 77-297, 1977-2 C.B. 304.

c. Despite the favorable trend of the cases, several decisions stand out as a clear warning to taxpayers and their counsel that the formalities of an exchange must be adhered to: Carlton v. Commissioner, 385 F.2d 238 (5th Cir. 1967); Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd. per curiam, 377 F.2d 534 (9th Cir. 1967); Halpern v. United States, 286 F.Supp. 255 (N.D. Ga. 1968); Swaim v. United States, 79-2 U.S.T.C. ¶9462 (N.D. Tex. 1979), aff'd. 81-2 U.S.T.C. ¶9575 (5th Cir. 1981), Meadows v. Commissioner, 42 T.C.M. 611 (1981); Allen v. Commissioner, 43 T.C.M. 1045 (1982); Anderson v. Commissioner, 49 T.C.M. 1352 (1985); and Lee v. Commissioner, 51 T.C.M. 1438 (1986). In a Tax Court decision holding in favor of the taxpayer, the Tax Court made the following observation:

> "The 'exchange' requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the substance of a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash . . . yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must at least on occasion, engender different results." Barker v. Commissioner, 74 T.C. 555 (1980).

ii. Essential elements. Despite the liberal trend of the cases in this area, the Courts have set down certain prerequisites for recognition of multi-party exchanges as valid §1031 exchanges.

a. There must be an intent to effect an exchange. In most multi-party exchanges, the purchaser ("X") reserves the option to pay cash for the taxpayer's property which, if exercised, would preclude the applicability of §1031. If the contract is not properly drafted, the true intent of the parties (i.e., whether to effect a sale or exchange) is often difficult to determine. The Fourth Circuit Court of Appeals in Coastal Terminals, Inc. v. United States, made the following observation in this regard:

> "Whether the transaction constituted a sale or an exchange for income tax purposes depends on the intent of

> the parties and this intent is to be ascertained from all relevant facts and circumstances, and of necessity the case is largely dependent upon circumstantial evidence." 320 F.2d 333, 337 (emphasis added).

For other cases in which the intent factor was stressed by the Courts, see Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975) acq., 1976-2 C.B. 2, nonacq., 1976-2 C.B. 3; and Barker v. Commissioner, 74 T.C. 555 (1980). However, the intent of the parties to effect an exchange will not be sufficient in and of itself to characterize an otherwise defective transaction as a §1031 exchange. Carlton v. Commissioner, 385 F.2d 238 (5th Cir. 1967); and Rogers v. Commissioner, 44 T.C. 126 (1965), aff'd. per curiam, 377 F.2d 534 (9th Cir. 1967).

b. An "exchange" must actually be consummated. Carlton v. Commissioner, supra; Coupe v. Commissioner, 52 T.C. 394 (1969) acq., 1970-2 C.B. xix; Rogers v. Commissioner, supra; Swaim v. United States, 81-2 U.S.T.C. ¶9575 (5th Cir. 1981); Meadows v. Commissioner, 42 T.C.M. 611 (1981); Allen v. Commissioner, 43 T.C.M. 1045 (1982); Anderson v. Commissioner, 49 T.C.M. 1352 (1985); and Lee v. Commissioner, 51 T.C.M. 1438 (1986).

c. The "other parties" to the transaction must not be the taxpayer's agents. This is a crucial determination, especially in four party exchanges, and represents one of the Service's principal points of attack in some recent cases. However, the Courts have thus far been very tolerant in this area, even to the point of ignoring strong circumstantial evidence of the existence of an agency relationship between the taxpayer and the accommodation party, so long as there is no express agency agreement between the taxpayer and the accommodation party. See Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935), acq., XIV-1 C.B. 13; J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962) acq., 1963-2 C.B. 4; Coupe v. Commissioner, supra; and Biggs v. Commissioner, 81-1 U.S.T.C. ¶9114 (5th Cir. 1980). However, the IRS apparently takes the position that an agency relationship will depend upon who has assumed the risk in the acquisition of the exchange property. See Rev. Rul. 77-297, 1977-2 C.B. 304.

d. The taxpayer must not actually or constructively receive cash in the transaction. Swaim v. United States, 81-2 U.S.T.C. ¶9575 (5th Cir. 1981). Halpern v. United States, 286 F.Supp. 255 (N.D. Ga. 1968); Barker v. Commissioner, 74 T.C. 555 (1980); Coupe v. Commissioner, 52 T.C. 394 (1969) acq., 1970-2 C.B. XIX; see generally, Rev. Rul. 77-297, 1977-2 C.B. 304.

c. Permissible actions in multi-party exchanges.

i. Exchange contract may provide for alternative cash sale. Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935), acq., XIV-1 C.B. 13; and Rev. Rul. 77-297, 1977-2 C.B. 304.

ii. Taxpayer may require other party to construct improvements on new property which taxpayer will acquire in the exchange. Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; Rev. Rul. 75-291, 1975-2 C.B. 333.

iii. Taxpayer may locate suitable property to be received in exchange and may negotiate for acquisition of such property. Coastal Terminals, Inc. v. United States, supra; Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coupe v. Commissioner, 52 T.C. 394 (1969), acq., 1970-2 C.B. VIX; Rutland v. Commissioner, 36 T.C.M. 40 (1977); and Garcia v. Commissioner, 80 T.C. 491 (1983).

iv. Taxpayer may loan money to other party to enable him to acquire and/or improve property to be received by taxpayer in the exchange. 124 Front Street, Inc. v. Commissioner, 65 T.C. 6 (1975), acq., 1976-2 C.B. 2, nonacq., 1976-2 C.B. 3; Coupe v. Commissioner, supra; Biggs v. Commissioner, 81-1 U.S.T.C. ¶9114 (5th Cir. 1980).

v. Other party to exchange need not actually take title to exchange property. W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948); Rutland v. Commissioner, 36 T.C.M. 40 (1977); Biggs v. Commissioner, 81-1 U.S.T.C. ¶9114 (5th Cir. 1980); and Brauer v. Commissioner, 74 T.C. 1134 (1980).

vi. Taxpayer may reimburse other party for his closing costs incurred to acquire exchange property. Biggs v. Commissioner, 81-1 U.S.T.C. ¶9114 (5th Cir. 1980); Rutland, supra.

vii. A general caveat with respect to use of too many, or all, of the above referenced actions was sounded by the Tax Court in Barker:

> "Notwithstanding those deviations from the standard multiple-party

exchanges which have received judicial approval, at some point the confluence of some sufficient number of deviations will bring about a taxable result. Whether the cause be economic and business realities or poor tax planning, prior cases make clear that taxpayers who stray too far run the risk of having their transactions characterized as a sale and reinvestment."

d. Nonsimultaneous exchanges.

i. Description. A great deal of interest, both on the part of taxpayers and the Service, has focused on developments in the area of nonsimultaneous multi-party exchanges. The fact pattern is as follows: The taxpayer owns property which he desires to exchange (rather than sell) for suitable like kind property in a §1031 exchange. X desires to acquire the taxpayer's property and is willing to cooperate in effecting a tax-free exchange. However, the taxpayer may not have located suitable property for exchange or, if located, the exchange property may not be available for an immediate exchange. The taxpayer and X agree that the taxpayer will transfer his property to X now in exchange for X's promise to acquire suitable exchange property and convey it to the taxpayer within some given time frame.

ii. Issues in nonsimultaneous exchanges and case history. Several issues arise within the context of a nonsimultaneous exchange.

a. Has there been an "exchange"? If "exchange" is given its customary meaning, it would presumably encompass only a simultaneous, reciprocal transfer of properties between the two parties. However, case law has not adopted such a literal interpretation of "exchange" for the purposes of §1031. Redwing Carriers, Inc. v. Tomlinson, 339 F.2d 652 (5th Cir. 1968); Starker v. United States, 602 F. 2d 1341 (9th Cir. 1979); Starker v. United States, 432 F.Supp. 864 (D.C. Ore. 1977); J. H. Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962), acq., 1963-2 C.B. 4; and Rutherford v. Commissioner, 37 T.C.M. 1851 (1978).

b. Are the initial transfer of the taxpayer's property to X and the subsequent transfer of the exchange property by X to the taxpayer "steps in a single, integrated transaction"? The application of the step transaction doctrine in the area of §1031 exchanges has been summarized as follows:

> "When a series of related steps is part of a preconceived plan, they should be regarded as one transaction in determining whether taxable gain or loss is recognized. On the other hand, where there is no interdependency between the steps, each must be treated separately in determining tax consequences. In order to determine whether the doctrine should apply, the test is whether the steps were so mutually, interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.'" Guerin, "A Proposed Test for Evaluating Multiparty Like Kind Exchanges," 35 Tax L. Rev. 547, 577 (1980) citing American Bantam Car Co., 11 T.C. 397, 405 (1948), aff'd. per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950).

Other authors have postulated that the proper application of the step transaction doctrine to nonsimultaneous multiparty exchanges should be as follows:

> ". . . the integrated transaction doctrine should be interpreted so that a Taxpayer should not be denied Section 1031 treatment when he parts with title to the Original Property in exchange for something other than the immediate receipt of title to the Exchange Property, so long as the acquisition of the 'something' is a step in the acquisition of the Exchange Property, and does not give the Taxpayer the option to terminate the transaction and be left with the cash value of the Original Property." Levun and Gehring, "Like Kind Exchanges: Is Simultaneity a Requirement?", Vol.34, No. 1, The Tax Lawyer, 119, 131 (1980).

c. Is X's promise to convey exchange property to the taxpayer at a future date a "chose in action" or, alternatively, a "cash equivalent" which would not qualify as like kind property? At least two courts have held that it is not (Starker v. United States, 602 F.2d 1341 (9th Cir. 1979); and Coupe v. Commissioner, 52 T.C. 394, 409 (1969), acq., 1970-2 C.B. VIX), and the enactment of §1031(a)(3) by TRA '84 leaves no doubt that such promises will not be viewed as choses in action or cash equivalents.

iii. IRS position on nonsimultaneous exchanges prior to TRA '84. The Service initially approved a nonsimultaneous exchange in Ltr. Rul. 7938087 on June 22, 1979. However, on November 8, 1979, the Service announced that it was reconsidering its position on nonsimultaneous exchanges in Ltr. Rul. 8005049. Finally, on August

25, 1980, the IRS revoked Ltr. Rul. 7938087 stating that " . . . it has been concluded that the nonsimultaneous nature of the exchange in this case does not satisfy the requirements of section 1031 . . ." Ltr. Rul. 8046122. Thus, prior to TRA '84, the Service took the position that simultaneity was a requirement for §1031 treatment. However, _see_ Rev. Rul. 57-451, 1957-2 C.B. 295 in which IRS held that simultaneity was _not_ required in the case of a §1036 exchange.

iv. Status of the law prior to TRA '84. Notwithstanding the announced position of the IRS in Ltr. Rul. 8046122 to the contrary, case law indicated that simultaneity was not, per se, a requirement for qualification under §1031. _Starker v. United States_, 602 F.2d 1341 (9th Cir. 1979); _Starker v. United States,_ 432 F.Supp. 864 (D.C. Ore. 1977); _Redwing Carriers, Inc. v. Tomlinson_, 339 F.2d 652 (5th Cir. 1968); and _Rutherford v. Commissioner_, 37 T.C.M. 1851 (1978). _See also_, Rev. Rul. 61-119, 1961-1 C.B. 395.

v. Time and identification limits imposed by TRA '84. Because of uncertainty and potential abuses in non-simultaneous exchanges under §1031, Congress acted to permit nonsimultaneous exchanges under certain limited conditions with its enactment of §1031(a)(3) in TRA'84. Specifically, the General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, pages 243-247 (Staff of Joint Committee on Taxation) provides the following reasons for enactment of §1031(a)(3): (1) in nonsimultaneous exchanges, the transaction more closley resembles a sale of one property followed by a purchase of a second property rather than an exchange; (2) the rationale for nonrecognition treatment in like kind exchanges regarding the difficulty of valuing property which is exchanged solely or primarily for similar property is less applicable to deferred like kind exchanges because in such nonsimultaneous exchanges the transferred property must be valued at a specific or near-specific dollar amount in order to determine the aggregate value of the properties that the taxpayer may receive in the future; and (3) Congress was concerned that the like kind exchange rules, absent time limitations, significantly expanded the ability of taxpayers to avoid recognition of gain on deferred payment sales, especially when used in conjunction with the installment sales rules. Specifically, §1031(a)(3) requires the following:

a. Identification. Property will not be treated as like kind property unless the property is identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange. The Conference Committee Report indicates that property may be identified in the contract between the parties or by designation of the property unequivocally in writing within the prescribed period. Additionally, the Conference Report provides that identification is satisfied if the contract designates a limited number of properties that may be received, and the particular property to be transferred will be determined by contingencies beyond the control of both parties. "For example, if A transferred real estate in exchange for a promise by B to transfer property 1 to A if zoning changes are approved and property 2 if they are not, the exchange would qualify for like kind treatment." H.R. Rep. No. 98-861, 98th Cong., 2nd Sess. 866 (1984).

b. Receipt of property. Property will not be treated as like kind property unless it is received no later than the <u>earlier of</u>: (1) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange; or (2) the due date (deteremined with regard to extensions) for the transferor's return of the tax imposed for the taxable year in which the transfer of the relinquished property occurs.

vi. Unsettled questions in area of nonsimultaneous exchanges.

a. If a nonsimultaneous exchange takes place over two (2) taxable years and the conveying taxpayer's property is encumbered at the time it is conveyed to the other property, is this automatically "boot" or must this determination await receipt of the exchanged property to determine if the exchanged property will also be subject to an encumbrance that may be offset under the "boot netting rules"?

b. If the taxpayer is given the right to demand cash if property is not identified within 45 days, will this constitute constructive receipt of cash disqualifying the transaction as a §1031 exchange? Such a right should *not* result in constructive receipt by the taxpayer since if property is not identified within such 45-day period, the exchange will not in any event qualify under §1031, and as such, the taxpayer should be given the option to take cash or property.

vii. Consider whether a nonsimultaneous exchange may be classified as an "installment sale" under §453:

a. An "installment sale" is defined in §453(b)(1) as ". . . a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." *See also* Temp. Reg. §15A.453-0(b)(1). Consequently, a

Starker-type transaction fits squarely within the terms of §453. Note, however, that the §453 issue was not raised in Starker because the transactions involved arose prior to the Installment Sales Revision Act of 1980 and no election was made to bring the transactions within old §453 although the taxpayer could presumably have made such an election. See Rev. Rul. 65-155, 1965-1 C.B. 356.

i. The fact that some or all future installments are to be paid in "property" will not preclude the application of §453 treatment. Temp. Reg. §15A.453-1(b)(3); see also Temp. Reg. §15A.453-1(c)(5) pertaining to foreign currency which is treated as "property" (not "money") for purposes of §453.

b. As noted C.3.c.iv., supra, §453(f)(6) is designed to facilitate the joint use of §1031 with the installment reporting provisions of §453.

c. Congress expressly recognized the possibility of combining non-simultaneous like kind exchanges and the installment sale rules in TRA '84 since one of the reasons for enacting §1031(a)(3) was to curb the indefinite deferral of gain by using deferred exchanges in conjunction with the installment reporting method. H.R. Rep. No. 98-432, Pt. 2, 98th Cong. 2d Sess. 1233 (1984).

viii. How can the taxpayer who conveys his property today in the expectation of receiving qualifying, like kind property in the future obtain satisfactory security to assure that the other party to the transaction will honor his obligations? Several alternatives might be considered:

a. The "standby letter of credit". The taxpayer might require the other party to deliver a standby letter of credit which is nonnegotiable, nontransferable and issued by a bank or other financial institution to secure the other party's performance. Such a standby letter of credit will not be treated as a "payment" for the purposes of §453 (Temp. Reg. §15A.453-1(b)(3)(i) and (iii)) and presumably will not be treated as boot under §1031.

b. Use of escrow fund. Under this arrangement the other party to the exchange would place cash or other liquid assets in an escrow account to secure performance. However, under "old §453" the Service successfully asserted that such an arrangement was tantamount to the receipt of cash. *Oden v. Commissioner*, 56 T.C. 569 (1971); *Pozzi v. Commissioner*, 49 T.C. 119 (1967); Rev. Rul. 79-91, 1979-1 C.B. 179. Moreover, the proposed regulations under §453 carry over this concept. *See* Temp. Reg. §15A.453-1(b)(3)(i).

However, in *Garcia v. Commissioner*, 80 T.C. 491 (1983), *acq.*, 1984-1 C.B. 1, funds were deposited in escrow by the transferee to purchase property to be identified in the future by the taxpayer. The Service argued that taxpayer was in constructive receipt of the funds when deposited. However, the Tax Court held that substantial restrictions on the withdrawal of the funds, such as the transferee, not the taxpayer, having the right to terminate the escrow if suitable property was not found within sixty (60) days of the creation of the escrow, prevented the Service from invoking the constructive receipt doctrine.

c. Security interests in like kind property of other party. If the other party has valuable real property which would qualify as "like kind property", the taxpayer might accept a mortgage or other form of security interest in such property to assure performance under the deferred exchange contract.

d. Use of trust as accommodation party. This has been a favored technique in California for several years since the advent of Starker. Under this technique, the taxpayer would convey his property to the trustee who would then sell the property to the other party and obtain the proceeds. The proceeds would then be utilized to acquire replacement property (and perhaps to construct improvements thereon) which would then be conveyed to the taxpayer by the trustee. Once again, the constructive receipt doctrine exemplified in cases such as Oden, supra, and Pozzi, supra, discussed above, must be considered. A trust might avoid the problems described in Oden and Pozzi if the taxpayer is prohibited from gaining access to the monies held in trust and if the terms of the trust clearly specify that the monies held in trust from the sale of the taxpayer's property are to be applied solely for the purchase of qualifying exchange property (and possibly constructing improvements thereon). Cf. Porterfield v. Commissioner, 73 T.C. 91 (1979). Moreover, if a trust is to be used, care should be taken to insure that the trustee is not deemed to be an agent of the taxpayer. See, Mercantile Trust Co. of Baltimore v. Commissioner, 32 B.T.A. 82 (1935), acq., XIV-1 C.B. 13; Coupe v. Commissioner, 52 T.C. 394 (1969), acq., 1970-2 C.B. xix; and Rutland v. Commissioner, 36 T.C.M. 40 (1977).

D. <u>Rolling options</u>. Taxpayer owns a large tract of undeveloped land consisting of approximately 4,000 acres which has been in taxpayer's family for three generations. The land is now ripe for development and taxpayer has received several overtures from developers to acquire his property for as much as $20,000,000. However, all offers received thus far would have required taxpayer to hold a substantial purchase money mortgage and to subordinate to the purchaser's development loans. Taxpayer and his tax adviser have been leery of these proposals both because of the economic risks involved and because of the problems associated with installment reporting after TRA '86 and OBRA.

Recently taxpayer received an innovative proposal from a major developer with a substantial net worth and a proven track record. The developer has offered to acquire taxpayer's property in a series of four "rolling options." Under this approach, most of taxpayer's property would be divided into four separate parcels which would be designated as "Option Parcels 1 through 4." The balance of the property would be earmarked for development into a golf course, entry way and principal access road that would service the entire property (the "Amenities Properties").

The developer would initially pay taxpayer $1,000,000 as consideration for an option to purchase Option Parcel 1 and the Amenities Properties for a total purchase price of $5,000,000, which option would remain open for a period of 18 months. The 18-month period is designed to enable taxpayer to pursue and obtain the necessary permits and approvals from federal, state and local governmental agencies to develop the property. If the option is exercised, the $1,000,000 option monies will be applied against the purchase price for Option Parcel 1 and the Amenities Properties. If the option lapses, the money would be forfeited.

The purchase prices for Option Parcels 2 through 4 would also be agreed upon in advance as well as the time and sequence that such options would be exercisable. The prices would be negotiated and would take into account the fact that taxpayer must hold these properties off the market during the applicable option periods and that the property would appreciate in value both because of inflation and due to development of the contiguous properties.

At the time of exercise of each of Option Parcels 1 through 3, developer would also be required to pay an additional $500,000 to taxpayer as consideration for the remaining options, which monies would also apply against the purchase prices of such parcels if exercised or would be forfeited if the options were allowed to lapse. The purchase price for each Option Parcel would be payable in cash at closing.

This proposal provides developer with downside protection since he retains the ability to walk away from the project at any time before fully exercising all of his options and thereby limiting his investment to the properties previously purchased plus any forfeitable option monies paid for future options. Deverloper has also been advised by his accountants that any costs associated with future options (i.e., options that have not yet been exercised) need not be reflected as debts on his balance sheet since there is no obligation for him to pay these amounts until the options are exercised.

Although taxpayer is called upon to assume an additional degree of economic risk under this proposal, there are several aspects of the offer which appeal to him. First, the total purchase price for taxpayer's properties (consisting of the aggregate prices of Option Parcels 1 through 4 together with the Amenities Properties) is significantly higher than the prices offered by other developers which is attributable (in part) to the fact that taxpayer will be required to hold his property off the market for a substantial period of time. Under deverloper's offer, taxpayer will be given the right to approve all preliminary and final land plans as well as overall development plans since these plans would impact the value of taxpayer's remaining properties if one or more of the options are not exercised. Further, even if developer allowed one or more options to lapse, presumably the value of any property that taxpayer Dog would be left with would be enhanced in value by reason of the development of the contiguous properties. Finally, there are some significant tax advantages to taxpayer inherent in this proposal which will be discussed below.

1. Option monies. Despite the fact that taxpayer will have unrestricted use of the $1,000,000 of option monies from the point in time that he receives them, he will not be taxed on these monies until the options to which they relate are either exercised or lapse. See, Virginia Iron, Coal & Coke Co. v. Commissioner, 37 B.T.A. 195 (1938), aff'd. 99 F.2d 919 (4th Cir.1938), cert.denied, 307

U.S. 630; Kitchin v. Commissioner, 340 F.2d 895 (4th Cir.1965); Koch v. Commissioner, 67 T.C. 71 (1976); and Hicks v. Commissioner, 37 T.C.M. 1540 (1978). The reason behind these rulings is that the taxability of the payments cannot be determined until the options either lapse or are exercised.

a. If an option is exercised and the option monies are applied against the purchase price, the monies will be treated as having been received in a sale or exchange of the option properties. §1234(a)(1); Reg. §1.1234-1(a). Even if the option monies are not applied against the purchase price, the Tax Court in Koch v. Commissioner, 67 T.C. 71 (1976) held that the same rule applies.

b. If the option lapses, the option monies must be reported by the optionor (taxpayer in this case) in his taxable year in which the lapse occurred and such amounts would be ordinary income. Reg. §1.1234-1 (b); Rev.Rul. 57-40, 1957-1 C.B. 266.

2. Installment reporting. If the rolling option transaction is properly structured and constitutes a true series of options, the installment sale provisions, including the new proportionate disallowance and alternative minimum tax rules added by TRA '86, should not apply.

3. Capital gains. Since taxpayer's property has been held by him for investment purposes, all of the gain from the sale of the property should be taxed as long term capital gains (which, in 1987, will be taxed at a more favorable rate than ordinary income). The Internal Revenue Service, however, may argue that a portion of the option prices should be recharacterized as ordinary income on the grounds that disguised interest is built into these options prices.

a. The Service has argued that option payments are tantamount to interest and should be taxed as such, but this position was rejected by the Tax Court. See, Koch v. Commissioner, 67 T.C. 71 (1976).

b. The original issue discount rules of §§1271 through 1275 should not apply since a true option contract would not constitute a "debt instrument" as defined in §1275(a)(1). See, §1274(a). In Koch, supra, the Tax Court found that an option contract does not constitute a "debt" (67 T.C. at pp. 82, 83), and this rationale would also seem to negate the presence of a "debt instrument".

EXHIBIT "A"

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

TASK FORCE OF PASSIVE ACTIVITY LOSSES

COMMENTS ON MATERIAL PARTICIPATION STANDARDS
CONTAINED IN TEMPORARY REGULATIONS

1. The 500-Hour Primary Participation Test. The Temporary Regulations rely primarily upon quantitative standards to measure material participation in contrast to the legislative history which has a distinctly qualitative bias. Compare Treas.Reg. §1.469-5T(a)(1), (3), and (4) with Sen.Rpt. 732-735. While qualitative standards may be more theoretically pure, it is submitted that the passive loss rules will be more administrable and understandable if material participation is tested under quantitative criteria. Thus, we agree with Treasury's threshold decision to incorporate primarily quantitative measurements in the Temporary Regulations.

Although Treas.Reg. §1.469-5T(a) sets forth seven alternative criteria for determining whether a taxpayer has materially participated in an activity, the primary test is found in Treas.Reg. §1.469-5T(a)(1). This test would require a taxpayer to participate in an activity in excess of 500 hours per year to qualify. The 500-plus hour test is neither expressly nor impliedly adopted in either §469 or in the Committee Reports. The question must, therefore, be asked whether such a standard is consistent with the requirement of §469(h) that the taxpayer's participation be "regular, continuous and substantial." It is clear from the explanation of §469(h) set forth in the Senate Finance Committee Report that this is to be a rigorous standard, requiring the taxpayer to have "substantial and bona fide involvement," and one that is most likely to be met ". . . in cases where involvement in the activity is the taxpayer's principal business." Sen.Rpt. 716,732. It is submitted that the 500-plus hour test falls short of such a standard. Consider, for example, that the test can be met by a husband and wife who each devote slightly in excess of five hours each weekend for 50 weeks to an activity. Since the participation of a spouse is imputed to the other spouse under §469(h)(5) and Treas.Reg. §1.469-5T(f)(4), this seemingly minimal amount of activity would constitute "material participation." This seems to us to fall short of the rigorous standards clearly envisioned by the draftsmen of §469, which was as much as 1,850 hours per year.

We suggest that the minimum hours for qualification be increased from 500 hours to 1,000 hours per year. This number comes closer to the rigorous standard contemplated by §469(h), yet it is low enough that it should not force a substantial number of taxpayers to rely on the qualitative facts and circumstances test of Treas.Reg. §1.469-5T(a)(7). There is admittedly a delicate balance involved in determining just where the line should be drawn. For example, if the minimum number of hours were increased to 1,850 hours, it is reasonable to assume that more taxpayers would seek to justify their participation as material under the qualitative facts and circumstances test than if the test were set at 1,000 hours. This, in turn, would undermine the very reason for adopting a quantitative test in the first place and would engender more uncertainty as well as more litigation.

The reason we propose a 1,000-hour test is that we believe this level of participation in an activity is the minimum which is consistent with the purpose of §469. It also represents the minimum number of hours that an employee must work in order to be regarded as "full time" for fringe benefit purposes. It must be emphasized that the theory underlying §469 was not to prevent taxpayers from generating passive income but, rather, to limit the ability of taxpayers to generate losses which could be utilized to offset their active and portfolio income. Congress believed that losses should be available to offset income only if the taxpayer participated in the activity which generated the loss on a regular, continuous and substantial basis. The 500-hour material participation standard in Treas.Reg. §1.469-5T(a)(1) is not consistent with this purpose, particularly since it can be satisfied by a taxpayer who devotes as little as ten hours per week to an activity. The proposed 1,000-hour standard would make it more difficult for taxpayers to generate active losses (i.e., the taxpayer would have to devote 20 hours per week to an activity) yet still maintain a quantitative rule which would be easy for the Service to administer.

2. <u>The Facts and Circumstances Test of Treasury Regulations §1.469-5T(a)(7).</u> Under Treas.Reg. §1.469-5T(a)(7), a taxpayer will be deemed to have materially participated in an activity if, based on all the facts and circumstances, his participation is regular, continuous and substantial during the taxable year in question. The rules of Treas.Reg. §1.469-5T(b) are to be applied in making this determination. Unfortunately, a description of the general rules to be applied in the facts and circumstances test has been reserved for future regulations. However, Treasury did include provisions imposing certain restrictions upon the facts and circumstances test in Treas.Reg. §1.469-5T(b)(2) which considerably narrow the scope of this test, regardless of what general guidelines are ultimately promulgated in future regulations.

Treas.Reg. §1.469-5T(b)(2)(ii) states that a taxpayer's services performed in the management of an activity are not to be considered in determining whether the taxpayer materially participated in the activity during the year unless (1) the taxpayer was the only person performing management services for the activity who received compensation for such services (within the meaning of section 911(d)(2)(A)), and (2) no other person who performs management services in the activity during such year devotes more hours of service to the activity than the taxpayer. In addition, Treas.Reg. §1.469-5T(b)(2)(iii) provides that no taxpayer will be deemed to have materially participated in an activity under the facts and circumstances test during a taxable year unless such taxpayer participates in such activity for more than 100 hours.

The facts and circumstances test of Treas.Reg. §1.469-5T(a)(7) is the only one of the seven material participation tests contained in the Temporary Regulations that is based directly on the statute. See, section 469(h)(1). Since a substantial portion of the discussion contained in both the Senate Finance Committee Report and the Conference Committee Report on material participation deals with such a facts and circumstances test, guidance is available as to the factors Congress believed relevant in applying this test. The suggestion in Treas.Reg.§1.469-5T(b)(2) that there may be special treatment of management services for purposes of the material participation test appears to be inconsistent with the legislative history. The Senate Finance Committee Report, in discussing the role of management services, provides as follows:

> "In determining material participation, the performance of management functions generally is treated no differently than rendering other services or performing physical work with respect to the activity. However, a merely formal or nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, does not constitute material participation." Sen.Rpt. 734.

The quoted language evidences the recognition on the part of the statutory draftsmen that management services are to be treated no differently than other services in the material participation evaluation, but at the same time recognizes the potential for gamesmanship on the part of the taxpayers who purport to be "involved" in management, but whose involvement is superficial and is neither substantial nor bona fide. However, the Senate Finance Committee Report also suggests some reasonable guidelines for determining the substantiality of management services. The Report notes that the taxpayer's knowledge and experience in the business, the degree of his involvement (i.e., is he performing merely ministerial services, or are his management services crucial to the success or failure of the business), his involvement (or lack thereof) in actual operations, and the regularity of his presence at the place or places of business of the activity, can all be used to insure that a taxpayer's involvement measures up to the regular, continuous and substantial benchmark. See, Sen.Rpt. 732-735.

It is certainly not unreasonable for Treasury to narrow the scope of the facts and circumstances test under Treas.Reg. §1.469-5T(a)(7) in view of its decision to rely primarily upon quantitative criteria. Presumably a taxpayer would not attempt to rely on the qualitative facts and circumstances test unless his participation was less than 500 hours during the year and unless he also failed to meet any of the other criteria. Thus, the potential for abuse in the residue of cases that would seek shelter under the facts and circumstances test is much greater. For this reason, we agree that the requirement contained in Treas.Reg. §1.469-5T(b)(2)(iii) that a taxpayer be prohibited from relying on the facts and circumstances test if his participation in the activity for the taxable year does not exceed 100 hours is both reasonable and necessary. However, we believe the special rules for management services go beyond the legislative intent as evidenced by the Senate Report.

It is suggested that the restrictions set forth in Treas.Reg. §1.469-5T(b)(2)(ii) be deleted and replaced with standards pertaining to management services more consistent with those set forth in the Senate Finance Committee Report. These standards should also incorporate the clear warnings against reliance upon superficial involvement under the guise of rendering management services, although it is assumed that the more flagrant cases, such as the check-a-box cattle feeding "managers," would already be eliminated under the 100-plus hour minimum participation requirement.

It should be noted that our recommended standard would preclude a taxpayer whose participation in an activity during the year was less then 500 hours and who failed to meet any of the other criteria, from using the rules of Treas.Reg. §1.469-5T(b)(2)(ii) to "game" the Service, such as by hiring an employee to render management services and paying him a salary in order to intentionally fail the test and thereby convert active income into passive. Consider also the inequity that would result from the existing standards if two partners, A and B, devoted 450 hours and 445 hours, respectively, in rendering bona fide management services in connection with the same activity and neither received any compensation described in section 911(d)(2)(A). (Assume for the purposes of this example, that another non-owner employee renders in excess of 450 hours of service such that Treas.Reg. §1.469-5T(a)(3) will not apply.) Partner A may be deemed to materially participate while Partner B would automatically fail the test because Partner A performed management services in the activity that exceeded the number of hours of services performed by B. If, on the other hand, A and B both receive compensation described in section 911(d)(2)(A) for their services, neither would be deemed to comply. This seems to yield an inherently inequitable result in both cases, particularly in view of the number of hours of service (whether management or otherwise) rendered by each of the two partners. It is submitted that the situations described in both examples would be more adequately dealt with under our proposals than under the restrictive test contained in Treas.Reg. §1.469-5T(b)(2)(ii).

3. Significant Participation Rules. The Temporary Regulations introduce a unique concept, the "significant participation activity," which serves a dual role in the material participation area. A significant participation activity ("SPA") is defined in Treas.Reg. §1.469-5T(c)(2) as participation by a taxpayer in an activity in excess of 100 hours during the taxable year.

Under Treas.Reg. §1.469-5T(a)(4), a taxpayer will be deemed to have materially participated in all of his SPAs during the taxable year if his aggregate participation in all SPAs during such year exceeds 500 hours. If, on the other hand, the aggregate participation of the taxpayer in SPAs during the taxable year is equal to or less than 500 hours, and if the aggregate gross income generated during the taxable year by all of the taxpayer's SPAs exceeds the aggregate gross deductions from such SPAs, a "ratable portion" (as defined in Treas.Reg. §1.469-2T(f)(2)(i)) of the income from those SPAs that have generated net income for the year will be treated as non-passive income.

The significant participation activity rules have no precedent either in the statute or in the legislative history, and in our view represent neither a reasonable interpretation of the statute nor a necessary cause for invoking the Treasury's anti-abuse authority under §469(l).

In one respect, the SPA rules are far too lenient. The possibility that a taxpayer could participate 101 hours in each of five different trade or business activities and (without more) be deemed to materially participate in all of them appears totally incongruous with a rigorous, "regular, continuous and substantial" standard. The Conference Committee Report addresses an aggregation of hours somewhat similar to this, but only if the activities are related in a "line of business" <u>and</u> if the taxpayer works full time in the aggregation of activities. See, Conf.Rpt. II-147 and 148. However, the Conference Report discussion of the line of business test was apparently repudiated in the Blue Book. Explanation of the Joint Committee, at 240. The aggregation of SPAs test found in Treas.Reg. §1.469-5T(a)(4) falls far short of even the standard contained in the Conference Report.

As set forth above in the discussion concerning the 500-hour rule, there appears to be a theoretical problem underlying the aggregation of SPAs for purposes of satisfying the material participation test. When Congress enacted §469, it wanted to guarantee that a taxpayer could not offset income from salaries and portfolio investments with losses from activities to which the taxpayer devoted little time. The special rule for SPAs would permit taxpayers to do precisely this; the losses from an activity to which the taxpayer devotes as little as two hours per week would be fully deductible.

Indeed, there appears to be no justification for the special treatment of SPAs in either the statutory language, legislative history or theory of §469. The aggregation of SPAs for purposes of the material participation test may simply be a means to justify the treatment of income from SPAs under the re-characterization rules of Treas.Reg. §1.469-2T(f)(2). These re-characterization rules are also suspect, however, for the same reasons: (i) there is no basis for such rules in §469 or its legislative history; and (ii) the rules appear contrary to the basic purpose of §469.

The second application of the SPA concept in Treas.Reg. §1.469-2T(f)(2) is draconian and represents an unwarranted extension of the Treasury's anti-abuse powers under section 469(l). Rather than responding to a specific area with significant potential for taxpayer abuse, the focus of Treas.Reg. §1.469-2T(f)(2), which employs a scatter-gun approach, seems to be simply to lessen the general likelihood that a taxpayer will have any passive income to apply against his passive losses. It is submitted that the Treasury's authority to create "heads we win, tails you lose" rules under §469(l) should be exercised solely with respect to clearly defined instances where there is an abuse such as (for example) in the area of abusive related party leases and the area of a general partner seeking to convert active income to passive by maintaining interests both as a general and limited partner in the same partnership. If material participation is to be the general standard for separating active from passive non-rental activities, then Treasury should be prepared to live by the same standard. See, the discussion of this re-characterization rule in the attached comments on that topic.

For the foregoing reasons, we urge the deletion or substantial amendment of Treas.Reg. §1.469-5T(a)(4) as well as its counterpart, Treas.Reg. §1.469-2T(f)(2).

4. <u>The 5-out-of-10 and Personal Service Activity Rules</u>. Treas.Reg. §1.469-5T(a)(5) and (6) add categories of material participation that are clearly designed to prevent taxpayers who in prior years have materially participated in an activity under one of the other definitions of material participation from intentionally downgrading their participation below the material participation level for the sole purpose of generating passive income.

The first of these anti-abuse categories provides that if a taxpayer has materially participated in an activity for any five taxable years (whether or not consecutive) during the ten taxable years immediately preceding the current year, he will automatically be deemed to have materially participated in the activity for the current year. Treas.Reg. §1.469-5T(a)(5). We believe this is a reasonable limitation upon taxpayers who might otherwise turn the material participation spigot on or off from year to year for the sole purpose of avoiding passive loss limitations. This subsection will only be invoked after the taxpayer has a five-year material participation record. Moreover, the test period, which consists of the ten consecutive years immediately preceding the year at issue means that the taint is not permanent and will eventually become inapplicable if the taxpayer consistently refrains from materially participating in the activity in the future. The rule may also provide salutary relief for the taxpayer who has a net loss from an activity and who, for health reasons or otherwise, is not able to qualify in the current year for material participation in an activity in which he has consistently materially participated in the past.

Although we support the 5-out-of-10 year rule, we believe that a change in this rule is necessary to prevent inequities in two situations. First, this rule should not apply to taxpayers who ceased to materially participate in activities prior to the enactment of §469. For example, assume that a taxpayer had materially participated (i.e., participated for more than 500 hours) in an activity during 1981 through 1985, but ceased to materially participate in that activity commencing in 1986. The taxpayer's change in status could not have been part of an attempt to "game" §469, since that provision was not yet contemplated. Nonetheless, under the Regulations, the taxpayer's income from the activity will be non-passive through 1989. We believe that it would be more appropriate to include a transition rule so that the 5-out-of-10 year rule would apply only to taxpayers who cease to materially participate in an activity during any year after 1986. In such situations, the change in status may have been undertaken for tax planning reasons, so that protection of the FISC is appropriate, whereas pre-1987 changes in status would not have been taken as a result of §469.

In addition, we believe that this rule should give rise to a rebuttable presumption rather than mandatory treatment.

For example, suppose that a taxpayer owned an interest in an S corporation for five years while he worked for the corporation. The taxpayer quits and sells his stock, but three years later he repurchases stock in the corporation solely for investment purposes. It seems wrong to treat the taxpayer as materially participating in the operations of the S corporation in the later years.

The presumption we would suggest would be a strong one, i.e., it would be presumed that the taxpayer materially participates in the activity during the test year. Nonetheless, the taxpayer can prove that the income from the activity in the later years is not related to the taxpayer's prior participation in the activity. To protect the Service from taxpayers who play the "audit lottery," this rule could be limited to taxpayers who "flag" the application of the special rule on their returns.

The second anti-abuse category is far more severe than the first. Under Treas.Reg. §1.469-5T(a)(6), if the taxpayer has an ownership interest in a personal service activity and if such taxpayer has materially participated in such activity for any three preceding taxable years, he will thereafter <u>forever</u> be deemed to materially participate in the activity (provided, of course, that he maintains his ownership interest in the activity). A "personal service activity" is defined in Treas.Reg. §1.469-5T(d) as an activity involving the performance of personal services in (1) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, or (2) any other business in which capital is not a material income producing factor.

Treasury presumably felt constrained to adopt a stricter rule for personal service activities because most such activities generate positive taxable income (unless the owners of such activity intentionally create a loss by paying compensation to themselves in excess of current revenues) and because most persons who have an ownership interest in the activity are required to render significant services. Treasury was apparently fearful that equity participants in such personal service activities who might have a need for passive income to offset passive losses would be tempted to manipulate their participation in the activity to generate passive income.

Despite these concerns, it is our belief that the three-year permanent taint rule of Treas.Reg. §1.469-5T(a)(6) represents an over-reaction on the part of Treasury, is unnecessary and may produce inequitable results. It is highly unlikely that members of a professional accounting or law firm, for example, would allow a member professional to reduce his services below 500 hours per year and still take a significant distributive share of the income (which could not be earned income, or it still would not be passive) just to accommodate his desires to generate passive income. Even if they were willing to do so for a brief period, the 5-out-of-10 rule of Treas.Reg. §1.469-5T(a)(5) should apply.

The potential for inequity is illustrated by A, an attorney who forms a partnership which owns and operates a series of store front law firms. The partnership initially consisted of a local operation but later expanded to a statewide and then a national business. Due to the growth of the business and the numerous office locations across the country, income from the business could reasonably be attributed not only to the performance of legal services but also to capital. Although A is an attorney and was initially engaged in the practice of law, his services on behalf of the business are now primarily managerial due to the ever-increasing size of the business. If A retires, ceases rendering any services on behalf of the partnership but is allowed to retain all or a portion of his partnership interest, why should he be treated any differently than another taxpayer ("B") who happens to retire from a partnership engaged in a non-personal service activity? Both A and B would (and should) be subject to the 5-out-of-10 rule of Treas.Reg. §1.469-5T(a)(5), but it is difficult to justify retaining the taint in perpetuity for A while allowing it to phase out for B.

Finally, we also question the necessity of expanding the definition of "personal services" in Treas.Reg. §1.469-5T(d) beyond the scope of Treas.Reg. §1.469-1T(g)(2) which contains the definition of a personal service corporation. These definitions are the same except that in defining a "personal service activity," Treas.Reg. §1.469-5(d)(B) adds "any other trade or business in which capital is not a material income producing factor." There seems to be little, if any, justification for applying a broader definition of personal services for material participation purposes than is employed in defining a personal service corporation under Treas.Reg. §469(j)(2) and Treas.Reg. §1.469-1T(g)(2). Indeed, the broad definition of a personal service activity is likely to spawn significant litigation as taxpayers battle the Service concerning whether or not capital was a material income producing factor in a variety of businesses. This possibility of litigation is heightened by the particularly harsh treatment for personal service activities under the perpetual taint rule.

Thus, we believe that there are two important flaws in this provision. First, a perpetual taint is unwarranted and inconsistent with the purposes of this provision. Second, the broad definition of a personal service activity is difficult to justify and will likely result in a tremendous amount of needless litigation. We believe that it would be more appropriate to simply apply the 5-out-of-10 year rule to all trades or businesses, without regard to the nature of the services being performed. This rule would prevent abuse but would not cause either litigation over what constitutes a personal service activity or the unjust results from a perpetual taint.

5. Limited Partners. Under Treas.Reg. §1.469-5T(e), rules are set forth for the treatment of limited partners for purposes of the material participation test. Although such rules are for the most part excellent, we believe that there are several flaws which will enable taxpayers to exploit unintended loopholes. Thus, we would advocate a tightening of these rules in certain respects.

a. Applicable material participation tests. Under Treas.Reg. §1.469-5T(e)(2), a limited partner is treated as materially participating in an activity only if the 500-hour rule (Treas.Reg. §1.469-5T(a)(1)), the 5-out-of-10 year rule (Treas.Reg. §1.469-5T(a)(5)) or the three-year personal service activity rule (Treas.Reg. §1.469-5T(a)(6)) are satisfied. It appears that this rule would leave open the possibility of abuse by a taxpayer who does everything in connection with an activity and works fewer than 100 hours in a taxable year in such activity.

For example, assume that a taxpayer runs a profitable business in his basement; the taxpayer spends 20 hours per month (5 hours every Saturday) in this business for the four-month season that it operates. If the taxpayer is the sole person involved in this activity, he will materially participate in the activity, so that income from the activity will be active. If the taxpayer were well advised, however, he would take a limited partnership interest, giving the general partnership interest in the partnership to his child. In that event, the taxpayer would be deemed _not_ to materially participate in the activity, so that his income therefrom would be passive.

With respect to taxpayers who exceed the 100-hour standard, all income from the activity would be active under Treas.Reg. §1.469-2T(f)(2). However, losses from the activity would always be passive unless the taxpayer participates for at least 500 hours in the activity. This heads-Treasury-wins, tails-taxpayer-loses result is unjustifiable, and is subject to the comments set forth above concerning SPAs. In any event, if the SPA rule were to remain, we believe that it would be appropriate to apply this rule (as well as the rule relating to persons who devote more than 100 hours and do the most in an activity) to limited partners as well, so that a limited partner would be able to materially participate in an activity if the limited partner otherwise satisfies the requirements of Treas.Reg. §1.469-5T(a).

b. _Definition of a limited partnership interest_. In the interests of simplicity, the regulations provide that a partnership interest will be treated as a limited partnership interest if it is so designated, without regard to the level of the taxpayer's involvement in the operations of the partnership. While we are the first to applaud simplicity, this rule is an invitation to abuse in light of the special rules which presume that limited partners do not satisfy the material participation test. We would not change this result, but perhaps it could be revised in the form of a presumption unless there were clear and convincing evidence that the taxpayer became a limited partner in order to avoid materially participating in an activity.

c. Limited partner holding general partner interest. The regulations address the problem of a person who holds both a limited and a general partnership interest, and we strongly support re-characterization in such situations. The regulations provide that a limited partnership interest will be re-characterized as not a limited partnership interest if the individual is a general partner at all times during the partnership's taxable year during which the individual owns such limited partnership interest. This rule could lead to abuse if, for example, a limited partner must also become a general partner during the succeeding taxable year but postpones the acquisition of the general partnership interest until January 2. Thus, in order to prevent such abuse, we believe that a limited partnership interest should not be treated as such during any portion of the taxable year in which the taxpayer also owns an interest as a general partner. This rule would encompass the provision set forth in the regulations, and would reduce the chances for abuse.

6. Definition of Participation. The regulations contain rules concerning the meaning of "participation." We believe that these rules are in need of amendment.

a. In general. The regulations provide that any work done by an individual in connection with an activity in which the individual owns an interest at the time the work is done shall be treated as participation. While this definition should be relatively easy to apply, since it includes all work, the definition does not follow the statutory guidelines which refer to participation in the operations of an activity. We believe that it would be advisable to utilize the statutory test which reflects Congress' intent. Moreover, a test for participation which focuses on operations could avoid the problem created under the participation as an investor rule.

b. Participation as an investor. The regulations provide in Treas.Reg. §1.469-5T(e)(2)(ii)(A) that work done by an individual in the capacity of an investor will not be treated as participation unless the individual is directly involved in day-to-day management or operations of the activity. We believe that it would be more appropriate to have a modified version of this special rule become the primary rule, i.e., only work done in connection with the management or operations of an activity should be counted for material participation purposes. Thus, no credit would be given to work done in the capacity of an investor except to the extent, if any, that such work is part of the management or operations of the activity.

There are a number of reasons for this proposal. First, the requirement that participation be in the management or operations of the activity is based squarely on §469 and the legislative history, which "count" only work done in operations for purposes of the material participation test. Second, the regulations only refer to a person who is "directly involved" in day-to-day management or operations, whatever that means. Rather than trying to determine the status of each individual in order to determine if he is "directly involved," we suggest that only work in management or operations be counted. Third, there does not appear to be any basis for segregating different types of participation for purposes of §469; either a person participates in the management or operations of an activity, or he doesn't. It seems very unlikely that an investor would devote sufficient time (without greater involvement in the operations of the activity) to satisfy the material participation test, so that there appears to be no need for this special rule.

c. Work not customarily done by owners. The regulations contain a special rule under which work not customarily done by owners is not treated as participation in an activity. This special rule is an attempt to limit the possibility of abuse where a taxpayer who does not materially participate in an activity arranges for his or her spouse to participate in such activity so as to generate active losses. In light of the minimum amount of abuse, if any, which will arise from this scenario, we think that a special rule is unnecessary. However, a need nevertheless exists for a broader rule under Treas.Reg. §1.469-5T(f)(2)(i). The definition of "participation" in Treas.Reg. §1.469-5T(f)(1) as any work done "without regard to the capacity in which the individual does such work" creates a potential for abuse by taxpayers. For example, assume that an accountant is a partner in a partnership engaged in an active trade or business which is not a rental activity. Assume further that the accountant's firm is retained to provide accounting services for the partnership and the accountant renders all such services including the preparation of the tax return, financial reports to partners and regulatory agencies, etc. Such services would constitute participation under the definition contained in the Regulations. Treas.Reg. §1.469-5T(f)(2)(i) would not deny characterization of such services as "participation" even though the services were not rendered by the accountant in his capacity as an owner because there was no intention to avoid the disallowance rules of §469. The legislative history of §469 clearly provides that services rendered by a taxpayer as an independent contractor rather than as an owner of an interest in the activity will not constitute participation. See, Sen.Rpt. 735. We recommend that Treas.Reg. §1.469-5T(f)(2)(i) be revised to comply with the legislative history which would ensure that services performed by a taxpayer in his capacity as an independent contractor rather than as an owner would not be deemed to constitute participation.

Revised: 9/23/8

EXHIBIT "B"

SECTION OF TAXATION

AMERICAN BAR ASSOCIATION

TASK FORCE ON PASSIVE ACTIVITY LOSSES

ISSUES RELATING TO SELF-CHARGED INTEREST RULE

The purpose of this paper is to identify certain issues arising under the self-charged interest rule which is discussed at pages II-146 and 147 of the Conference Committee Report and pages 233 and 234 of the Joint Committee on Taxation General Explanation of the Tax Reform Act of 1986 (the "Blue Book").

This paper has been principally prepared by Charles H. Egerton, Richard E. Levine, and Charles B. Temkin of the ABA Section of Taxation's Committee on Partnerships. The views expressed herein do not necessarily represent the position of the American Bar Association or of the Section of Taxation.

ISSUES

I. How Should the Self-Charged Interest Rule Apply to Multiple Loans?

The examples included in both the Conference Report and the Blue Book pertaining to loans to pass-through entities deal solely with a loan made by one partner to a partnership (or by one shareholder to an S corporation). The two examples contained in the Conference Report are designed to illustrate the principle that interest paid by a pass-through entity to a shareholder or partner in that entity is "self-charged" and should not be regarded as giving rise to both portfolio interest income and to passive interest expense. Both the Conference Report and the Blue Book also provide that the application of this rule should be limited to the taxpayer's allocable share of the interest expense determined without regard to any special allocation.

The application of this rule is determinable within the context of a loan by one partner to a partnership in which the interest paid on that loan is the only interest expense of the partnership. However, if loans are made by more than one partner in a partnership or if the partnership has interest expense attributable to third party loans, the application of the self-charged interest rule under the Conference Report or the Blue Book is not clear.

For example, assume that A and B who each own a 50% interest in the capital, profits and losses of the AB Partnership (which is engaged in a passive activity), each loan $1,000 to the AB Partnership on January 1, 1987, which loans are payable in full on December 31, 1987, together with interest at the rate of 10% per annum. Interest of $100 is paid by the Partnership to each of A and B on December 31, 1987, and the Partnership claims an interest deduction of $200, $100 of which is allocated to each of A and B under the terms of the partnership agreement. The self-charged interest rule could be interpreted to recharacterize each partner's interest income from portfolio to passive, and thereby permit netting, only to the extent of his allocable share of the interest <u>attributable to his loan</u>. If this were the case, only $50 of each partner's allocable share of the interest expense could be applied to offset the $100 of interest income paid to him by the partnership.

The application of the self-charged interest rule to the facts of the example set forth above could also be interpreted to allow each partner to recharacterize his interest income received from the partnership <u>to the full extent of his allocable share of partnership interest expense</u>, without regard to whether the interest is attributable to his loan to the partnership or to other partnership debts. Thus, the taxpayer in the example would be able to offset his entire $100 of interest income with his $100 allocable share of interest expense. It is submitted that this latter interpretation best carries out the intent of this self-charged interest principle. For example, if this result were compared with the result in the two examples contained in the Conference Committee Report involving a loan by one partner (or one shareholder) to a pass-through entity, the amount loaned by the taxpayer in all three examples would bear the same ratio as the taxpayer's interest in the pass-through entity bears to the total outstanding ownership interests (<u>i.e.</u>, 50%). On the other hand, if the application of the self-charged interest recharacterization rule were limited to the taxpayer's allocable share of interest paid with respect to his own debt only, these relationships would be artificially skewed. Thus, it is submitted that the <u>better approach would be to</u> permit netting to the extent of the taxpayer's allocable share of the <u>total</u> interest expense.

As an example of this concept, assume that A and B are each 50% partners in partnership AB which is engaged in a passive activity. A and B each borrow $1,000 from a bank and contribute the loan proceeds to partnership AB as a capital contribution. The partnership distributes $100 in cash to each A and B. Moreover, A and B's share of taxable income is also $100 each. A and B use the cash distribution to pay the interest owed by each of them under the bank loan.

In this situation, A and B would each receive a distributable share of passive income of $100. However, each would receive a deduction against such income of $100 by virtue of the interest paid to the bank. (Interest incurred in connection with a passive activity is treated as part of the passive activity computation). Thus, full netting would occur, and A and

B would not have income which could not be netted in full by the interest expense.

This factual situation is essentially equivalent to the situation described above in which A and B make a loan to partnership AB and receive interest income instead of the partnership distribution. The example illustrates that the self-charged interest should operate such that a partner may net his entire share of interest expense against the interest income received from the partnership.

The underlying purpose of the self-charged interest rule is to permit netting to the extent a taxpayer has made a loan to himself. Thus, the two partner loan scenario could be analyzed by viewing the partnership under the aggregate, as opposed to the entity, theory. The interest expense payable to a partner can be specifically traced to the loan made by such partner. If A and any other partners of the partnership AB make loans to the partnership, it would seem logical to permit a loaning partner to net the entire amount of interest received by him against the expense attributable to the interest payable to A. <u>In this regard, the apparent prohibition against special allocations of interest expense, as noted in the Blue Book, may be inadvisable.</u>

II. <u>How Should the Self-Charged Interest Rule Apply in the Situation of Loans from a Partnership to its Partners</u>?

It is not uncommon for partnerships to raise equity capital by requiring the limited partners to make capital contributions to the partnership in stages. These staged contributions may bear interest in those cases in which the obligations are evidenced by promissory notes. In certain situations, some but not all of the limited partners may pay their capital contributions in stages, with interest. The other limited partners would pay their capital contributions in one lump sum at inception.

In these situations, the limited partner-borrowers would pay interest to the partnership in connection with their notes, and the partnership would receive interest income. Such interest income would generally be allocable among all the partners in proportion to their respective interests in the partnership, not just the limited partner-borrowers. It is submitted that the self-charged interest rule should apply when a partnership has essentially made loans to its partners.

If the self-charged interest rule were not applicable, the limited partner electing to make staged contributions would be in a situation where he would have portfolio income to the extent of his share of the partnership's interest income from the partner loans but not an offsetting amount of interest expense. Such interest expense of the limited partner would be treated as being incurred in connection with the acquisition of an interest in a passive activity, and would be part of the passive activity computation. This result seems particularly inappropriate in that it would not be visited upon partners who evidence staged contributions with non-interest bearing notes, since it is not at all clear that interest would be imputed under IRC §§1274 or 7872.

Several solutions to this problem would be feasible. First, portfolio income could be defined as not including income from such loans to partners. If this were viewed as being too broad, the rule could be limited by applying only to loans made before some date (the enactment of the 1986 Tax Reform Act or the promulgation of the proposed regulations). It would not be appropriate for loans to partners not to generate portfolio income. Among other things such a rule would present an easy way to circumvent the statutory mandate that interest on working capital be treated as portfolio income. Alternatively, because it is typical for partners' notes to be pledged as security for purchase money or other third-party loans, much relief could be provided by a rule which treated the partnership interest expense associated with such debts as being directly allocable to the portfolio income from the partners' notes. Finally, a self-charged interest rule could provide that where interest income is generally from loans which finance capital contributions, a partner's share of such interest income would be treated as portfolio income only to the extent it exceeds interest expense he incurs in financing his own capital contribution.

III. Should the Self-Charged Interest Rule Apply to Loans from Related Parties?

Assume that X Corporation and Y Corporation, both of which are "S Corporations," are equally owned by individuals A and B. Y Corporation is a 50% partner in Partnership Z (which is engaged in a passive activity). Assume that on January 1, 1987, X Corporation (which is not a partner in Partnership Z) makes a loan of $1,000 to Partnership Z and receives an interest payment of $100 on December 31, 1987. Should the self-charged interest principles be applied to recharacterize the interest income received by X Corporation? The same question could be raised if A and B (rather than X Corporation) were to make the loan to the partnership. It is submitted that a failure to extend the self-charged interest rule to loans by related parties in the example set forth above would be inequitable and would not fulfill the principles of the self-charged interest rule as set forth in the Conference Report and the Blue Book.

If the regulations implementing the self-charged interest rules do not incorporate some form of related party rules, a trap for the unwary will be created. Taxpayers with competent advice will carefully structure their loans to take advantage of the rule, but the uniformed, who are not aware of the importance of following the prescribed format for their loans, may fail to qualify. Therefore, it is submitted that a failure to extend the self-charged interest rules to loans by related parties would be inequitable. Thus, the income received by X Corporation (and thereby passed through to A and B) should be netted against the passive loss allocable to A and B through Y Corporation.

If the self-charged interest rule is to be extended to loans by related parties, then the question must also be raised as to the appropriate definition of a "related party." Since the self-charged interest rule only applies to loans to pass-through entities, it appears that the appropriate definition of "related parties" would be as set forth in §§707(b) and 267. Although some minimal degree of relationship should perhaps be required to avoid administrative problems in implementation, excessively stringent requirements are not warranted since the self-charged interest rules will only apply to the extent of the lending party's indirect percentage interest in the borrower, and the potential for abuse is, therefore, minimal.

IV. How is the Prohibition Against Special Allocations to be Applied within the context of the Self-Charged Interest Rule?

The recharacterization of portfolio interest income to passive interest income under the self-charged interest rule is to be limited to the taxpayer's allocable share of interest expense to the extent not increased by any special allocation. This rule was necessary in order to prevent abuses that might occur if the partners in a partnership have the discretion to allocate all of the interest expense to a partner who has made a loan to the partnership and received substantial interest payments with respect to that loan to the partnership. The example contained in the Conference Report pertains to a loan by a partner who has a 40% interest in a partnership and who receives $100 of interest income with respect to such loan. The Conference Report explains that the $100 of interest income received by the partner could be netted to the extent of the $40 of interest expense allocable to the partner under the partnership agreement. Thus, a special allocation of the remaining $60 to the lender/partner would not be effective to recharacterize the entire $100 of interest income as passive.

The limitation on special allocations is a necessary backstop to prevent abuses under the self-charged interest rule. However, assume that a general partner in a limited partnership holds a 20% interest in all partnership items, but the partnership agreement provides that the general partner's allocable share is to be escalated to 50% after the limited partners have recovered all of their contributions. If the general partner receives interest income with respect to a loan made by him to the limited partnership in a year in which the escalation of his interest in partnership items becomes effective, it is submitted that this should not be viewed as a "special allocation" within the meaning of the Conference Report. It is suggested that a clarification is necessary to ensure that a separate allocation of all items of income, deduction and loss (i.e., a "bottom line allocation") which complies with the requirements of Treas. Reg. §1.704-1(b) should not be regard as a "special allocation" for the purposes of the self-charged interest rule.

V. Should the Self-Charged Interest Rule Be Applied to Items other than Interest?

The Conference Report provides as follows:

> "Such regulations may also, to the extent appropriate, identify other situations in which netting of the kind described above is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest. Such netting should not, however, permit any passive deductions to offset non-passive income except to the extent of the taxpayer's allocable share of the specific payment at issue." (Page II-147)

What "other situations" would warrant similar treatment? For example, should a guaranteed payment made to a partner for services in managing an apartment complex owned and operated by the partnership receive netting treatment under the self-charged interest rule? Similarly, should a salary paid under the same circumstances to a shareholder of an S Corporation owning an apartment complex be subject to the self-charged interest rule? In other words, should the service partner or the employee-shareholder be entitled to offset his allocable share of the deduction attributable to the guaranteed payment (or the salary) against his "active income" from the guaranteed payment or salary? It is submitted that the extension of the self-charged interest rule to these situations would be consistent with the principles enunciated in the Conference Report.

Suppose instead of a deductible payment that the payment must be capitalized and added to the basis of an asset of the pass-through entity subject to ACRS. Should the taxpayer's allocable share of the additional ACRS deductions attributable to the capitalized item also be treated under this rule? Once again, this treatment appears to be consistent with the principles of the self-charged interest rule.

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If the regulations promulgated under §469(k) operate to recharacterize income from ground leases and certain related party leases from passive to portfolio, it would also be appropriate to permit the partner-lessor to offset the rent received by his allocable share of the deductions for such rental payments.

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