Tax Shelter Limitations

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TAX SHELTER LIMITATIONS

By

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I. PASSIVE LOSSES

A. Overview

1. After 1986, subject to certain phase in rules, passive activity losses ("PALs") may not be deducted from portfolio income, such as interest, dividends, royalties, etc., investment gains, or "active" business income, salaries, etc. and passive activity credits (PACs") will be disallowed. Subject to a few exceptions, PALs may only be used by individuals, estates, trusts, certain closely-held corporations and certain personal service corporation to offset profits from passive income until the taxpayer disposes of his interest in the activity.

B. Taxpayers Subject to the PAL Rules

1. The PAL rules generally apply to:

a. Individuals (effectively including all businesses conducted through general and limited partnerships and S corporations), estates and trusts.

b. Closely-held C corporations (widely-held C corporations are not subject to the PAL rules.)

c. Personal service corporations. IRC § 469(a)(2).

2. Closely-held C corporations are subject to the PAL rules if they are subject to the at-risk limitations. The general rule is that if a C corporation has 5 or fewer shareholders who own more than fifty percent (50%) of the stock, it will be subject to special PAL rules which differ from those applicable to other taxpayers. IRC §§ 469(j) and 465(a)(1)(B).
a. Under the special rule applicable to closely-held corporations, passive losses (and credits, in a deduction equivalent sense) offset net active income but not portfolio income. IRC § 469(e)(2).

3. Personal service corporations include those corporations the principal activity of which is the performance of personal services by any employee-owners, provided that such employee-owners own at least ten percent (10%), by value, of the corporation's stock.

4. The Conference Committee Report ("CCR") provides that if a personal service or closely held corporation's status changes previously suspended PALs will not be triggered by the change in status, but are allowed against income from that activity. PALs or (deduction equivalent) credits arising after a corporation ceases to be a personal service corporation or closely held C corporation will be allowed. CCR, 139-140.

5. The PAL rules apply to affiliated groups filing consolidated returns. CCR, 140.

C. "Passive Activity" Defined

1. Section 469(c) states that the term "passive activity" means any activity which involves the conduct of any trade or business and in which the taxpayer does not materially participate." According to the Senate Finance Committee Report ("SFC Report") an activity is the "undertakings which 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 a gain or loss." Obviously, this is a facts and circumstances determination.

a. To the extent provided in regulations, trade or business includes activities in connection with a trade or business" (See IRC § 174 re R & D expenditures) and "any activity with respect to which expenses are allowable as a deduction under IRC § 212." IRC § 469(c)(6).

b. Research and experimentation activity is explicitly included in "trade or busi-
ness" for purposes of this definition. IRC § 469(c)(5).

c. A working interest in oil and gas property is never a passive activity if the taxpayer holds it directly or through an entity which does not limit the taxpayer's liability. Once a loss is sustained with respect to such interest, any subsequent income will not be passive activity income. IRC § 469(c)(3).

2. Under the SFC Report, providing two or more substantially different products or services generally results in two or more activities. However, the appliance and clothing sections of a department store are treated as one activity.

3. Common management is not enough to make separate types of undertakings a single activity.

4. While each real estate project (a project can include an integrated group of buildings) will generally be treated as a separate activity, the construction and development phase is a separate activity from the leasing phase. To the extent separate rental buildings are not integrated parts of a project, each building should be a separate activity.

5. One must ask whether an activity is separate from a related activity incidental to the latter. For example, a laundry in an apartment building would generally be incidental to, and therefore part of, a rental activity, but this depends upon the amount of services provided. If a sufficient amount of services are rendered, a separate activity may be created, or the entire activity may not constitute a rental activity under the provisions (e.g. hotel). CCR, 148.

6. When a particular undertaking receives different treatment under the PAL rules, it will not be treated as the same activity which does not receive such treatment (rental activity not part of working interest in oil and gas).
D. **Other Definitions and Rules**

1. The PAL is the amount by which aggregate losses from passive activities exceed aggregate income from passive activities for the taxable year. IRC § 469(a) and (b). Thus, "passive activity loss" is the net loss from all passive activities. Passive activity loss is determined without taking **portfolio income** and its associated expenses into account.

   a. **Portfolio income** includes gross income from interest, dividends (including those received from REITs, RICs, and REMICs), annuities, or royalties not derived in the ordinary course of a trade or business. IRC § 469(e)(1)(A)(I) and CCR, 146.

   i. The "ordinary course of business" exception applies to all categories of portfolio income. See the Senate Report (page 729) which states interest received by a bank, gains on securities recognized by a brokerage firm, and interest charged on accounts receivable are not portfolio income.

   ii. Dividends must be reduced by the dividends received deduction. IRC § 469(e)(1)(4).

   b. Portfolio income is reduced by expenses (other than interest) clearly and directly allocable to such gross income and by interest properly allocable to such income. IRC § 469(e)(1)(A)(III).

   c. Gain from property producing dividends, interest, etc. or property held for investment constitute portfolio income. Interests in passive activities are not treated as held for investment for this purpose. IRC § 469(e)(1)(A).

   d. Income, gain and loss on investments of working capital are excluded from the passive loss computation. IRC § 469(e)(1)(B). Thus, such amounts are taken into account in computing portfolio income.
2. While the statutory language is not altered, the CCR states that a payment of interest from a passive entity to the holder of an interest in that entity (self-charged interest) should not result in portfolio interest which can not be offset against the passive loss arising from the same payment. Such offset relief is limited to the taxpayer's "allocable share" of the interest expense to the extent not increased by any special allocation. CCR, 146.

a. All investors in a limited partnership should contribute their equity in the same manner (cash or loans).

3. Earned income is not taken into account in computing income or loss from a passive activity. IRC § 469(e)(3). This provision is the statutory basis for denying a general partner who actively participates in a limited partnership any netting of compensation (through guaranteed payments, for example) against any loss he may sustain as a limited partner in the same partnership. Senate Report, 731.

4. The passive activity credit ("PAC") is the excess of: (i) the sum of the following credits from all passive activities allowable for the taxable year: investment credit; targeted jobs credit; alcohol fuels credit; employee stock ownership credit; orphan drug credit; nonconventional fuels credit; and the increasing research credit, over (ii) the regular tax liability of the taxpayer for the taxable year allocable to all passive activities. IRC § 469(c)(4).

a. IRC § 469(j)(3) states that regular tax liability is defined as in IRC § 26(b). However, no definition of regular tax liability is there provided other than to contrast the regular tax liability with tentative minimum tax liability.

5. The Code effectively imposes an ordering rule in which passive activity losses (including carryover losses) are allowed before any passive activity credit.

E. Material Participation. An activity is a passive activity if the taxpayer does not materially par-
ticipate in such activity. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis. IRC § 469(h)(1). Material participation by one spouse satisfies the rule for the other spouse. IRC § 465(h)(6).

1. Neither the statute nor the Committee Reports specifically define what constitutes "regular, continuous and substantial" involvement in an activity. However, the CCR explicitly adopts the Senate Report discussions. CCR, 147. The SFC Report provides the following general propositions and examples:

   a. The material participation standard is based on IRC § 1402(a) (relating to self-employment tax) and IRC § 2032A (relating to valuation of farm property for purposes of the estate tax) modified for purposes of the passive activity rule. Prior precedents under these sections are not controlling, however. Thus "periodic consultation" might satisfy those rules but will not satisfy the material participation rule. Senate Report, 732.

   b. The Senate Report recognized that a taxpayer could be materially participating in no activity (e.g., a retiree) or more than one (e.g., a farmer who moonlights at a gasoline station). Senate Report, 733.

   c. While the Senate Report states that management functions were treated no differently than rendering other services or performing physical work, it did stress that "merely formal and nominal" participation in management was insufficient. Senate Report, 734.

   d. A taxpayer is most likely to have materially participated in an activity where involvement in the activity is the taxpayer's principal business. Working as an employee or operating your own drug store would be treated as materially participating in that business (look to whether, and how regularly, the individual is present at the business).
e. Regular contact, standing alone, is not sufficient, however, for material participation. For example, a taxpayer who invested in a horse breeding activity which he visited regularly would not satisfy the regular, continuous and substantial test unless he was involved in the operations of the activity, for example, by hiring and from time to time supervising those responsible for taking decisions (and not merely ratifying decisions) regarding the purchase, sale and breeding of horses.

f. An investor in a barge that transports grain would be treated as materially participating if he traveled with the barge and performed substantial services with respect to transporting the grain. Alternatively, the investor could be involved on a regular basis in finding new customers and negotiating terms with such customers.

2. The CCR provides that "an individual who works full-time in a line of business consisting of one or more business activities generally is likely to be materially participating in those activities (except to the extent provided otherwise in the case of rental activities), even if the individual's role is in management rather than operations." CCR, 147-148. This provision was apparently intended to address the problem which arises when a single individual manages several activities. Because his time is divided among such activities, his participation in each separate activity might not otherwise rise to the level of regular, continuous and substantial activity.

a. The limitation of this rule to situations involving a "line of business" may cause individuals who are involved in the management of several different lines of business to fail to satisfy the material participation test. For example, in the case of "real estate developer," it is unclear whether the following are part of the real estate "line of business": construction, development, operating apartments, operating commercial office, operating hotels, operating nursing homes, brokerage, finance, and management.
b. The failure of the Conferees to define a "line of business" is a noticeable gap in the statute and Conference Report.

c. Legal entities are disregarded in determining activities.

   i. A single entity could be involved in numerous activities. Query whether a partnership, for example, will need to file separate K-1's for each activity.

   ii. The material participation and rental activity tests are applied on an activity-by-activity basis.

3. The material participation test may apply to an entity (e.g., an estate, trust, closely-held corporation or personal service corporation). A closely-held corporation is treated as materially participating if (a) one or more shareholders holding stock representing more than fifty percent (50%) (by value) of the outstanding stock of the corporation materially participate in the activity, or (b) the requirements of Section 465(c)(7) (determined without regard to clause (iv), involving businesses with certain full-time, non-owner employees are satisfied. IRC § 469(h)(4)(A).

4. In the case of an estate or trust, material participation is determined on the basis of the executor or fiduciary in his capacity as such. (Query: why no reference to beneficiary?)

5. Except as provided in regulations, no interest in a limited partnership as a limited partner is treated as an interest with respect to an activity in which the taxpayer materially participates. IRC § 469(h)(2). This rule applies even if the individual also has an interest in the partnership as a general partner. However, Regulations are to address situations in which limited partnership interests will not be treated as passive activities. This is intended to be an "anti-abuse" provision aimed at situations in which an individual is attempting to convert "active" income into income from a passive activity which could be sheltered by PALs.
6. Note that a taxpayer may be deemed to be materially participating in an activity, if he does everything that is required to be done to conduct the activity, even though the amount of such work is low in comparison to other activities. CCR, 148.

F. Rental Activity Exception

1. A rental activity is an activity "where payments are principally for the use of tangible property." IRC § 469(j)(2)(8). Rental activities are passive without regard to the taxpayer's material participation. IRC § 469(c)(2) and (4).

   a. A net lease of property is a rental activity. CCR, 138. However, the Conferees state that it might be appropriate to treat ground rents involving little expense as portfolio income or as not otherwise arising from a passive activity by regulation. CCR, 147. The Conferees intend that this authority be exercised to protect the underlying purpose of the passive loss rules, i.e., preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities.

   b. The Senate Report states that prior law applicable in determining when an S corporation had passive rental income or active business income provides a useful analogy. Senate Report, 741. Short-period rentals with heavy turnover of users may not be "rental activity" where substantial services are performed. Thus, for example, operation of a hotel, car rental agency or nursing home would not be a rental activity.

2. If any natural person actively participates in a rental real estate activity, up to $25,000 per year in losses attributable to such activities may be deductible, notwithstanding the general rule. IRC § 469(i). The "natural person" language was apparently added to prevent the use of trusts and the abuse that might arise as a result. See CCR, 142. Are losses from S corporations also precluded?
a. The $25,000 allowance is reduced by 50% of the taxpayer's adjusted gross income in excess of $100,000. Thus the allowance is fully phased out at $150,000 AGI. For low income housing and rehabilitation credits, the phase out occurs beginning at $200,000 in adjusted gross income. IRC § 469(i)(3). For this purpose, AGI is computed by excluding taxable social security income, IRA deductions, and passive losses. IRC § 469(i)(3)(D).

b. Married persons filing separate returns receive one-half the $25,000, $100,000 and $200,000 amounts set forth above if they are living apart. IRC § 469(i). The Conference Report states that the $25,000 is reduced to zero if married taxpayers live together during any part of the year and file separate returns (this was added to avoid complexity and abuse). CCR, 142, IRC § 469(h)(5)(B).

c. An estate is considered to actively participate for two years after the date of death in activities in which the decedent actively participated before death. However, this amount is apparently reduced to zero if there is a surviving spouse. IRC § 469(i)(4). This seems anomalous, since the allowance should follow the property. Again, the "allowable" rather than "allowed" language may be significant.

3. Active participation is something less than material participation, according to the Senate Report, in that it need not be regular, continuous and substantial. If must, however, be participatory as opposed to primarily passive. Thus a taxpayer does not actively participate in an undivided interest in an apartment building completely managed by others merely by holding such an interest. In contrast, performance of the minimal functions associated with renting a former residence probably will meet the active participation standard. The existence of non-tax-motivation for the investment may be significant for this purpose. Senate Report, 737-8.

a. Limited partners are not active participants. IRC § 469(i)(6)(C).
b. Spousal "active participation" is attributed to the other spouse. IRC § 469(i)(6)(D).

c. The taxpayer must have a 10% interest (by value) in the activity to be an active participant. IRC § 469(i)(6)(A).

d. Generally, no participation is required for low income housing or rehabilitation credits. IRC § 469(i)(6)(B) (but see also Section 501(c) of the Act relating to possible phase out after 1989).

G. Determination of Income or Loss

1. A taxpayer must allocate the portfolio income and related expense from a passive activity in order to determine the income or loss from such activity. In this regard, any income, gain or loss attributable to an investment or working capital will be treated as portfolio income, gain or loss. IRC § 469(e)(1)(B).

2. As a legal entity or person may be engaged in more than one activity, it will often be necessary to allocate expenses (particularly interest and overhead) between activities. The Conferees have instructed the IRS to prepare regulations by December 31, 1986 addressing the methods of allocating interest expense. Moreover, such regulations should not be inconsistent with other Code provisions which allocate interest (e.g., an interest deduction that is disallowed under IRC § 265 or capitalized under IRC § 291 should not be allowed, capitalized or suspended under another provision.) CCR, 146.

3. Interest deductions attributable to passive activities are subject to the PAL rules and not the investment interest limitation. However, any PAL allowed by virtue of the phase-in provision of the PAL rule will reduce net investment income for purposes of the investment interest limitation. IRC § 163(d)(3)(B). For example, an individual has $21,000 in interest and dividend income and $8,000 in investment interest expense in 1987 and owns real estate (and does not actively participate therein) which generates the following items in 1987:
In 1987, 35% of the passive loss would be disallowed. The taxpayer would only be able to utilize $19,500 of the tax loss against his active basket income in 1987. To compute the ceiling against which investment interest would be deductible, the investment income of the taxpayer of $21,000 would be reduced by the passive loss allowed in 1987 of $19,500.00. The ceiling would be $1,500.00. Thus the taxpayer would have excess interest expense in 1987 of $6,500.00. Under the transitional rule, 65% ($4,225) would be allowable in 1987 and the balance of $2,225 in excess interest expense would be disallowed and carried forward to subsequent years. Accordingly, the total amount of interest deductible in 1987 would be $5,725.

H. Treatment of PALs

1. Losses from a passive activity generally are deductible only against income from that activity or another passive activity. Suspended PALs can be carried forward (but not back) to be utilized against income from passive activities in subsequent years. IRC § 469(b).

2. The passive activity loss that is disallowed for any taxpayer year 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 such year. IRC § 469(c)(1).

3. PACs are similarly limited. A PAC is the amount by which the sum of the credits from all passive activities is allowable for the taxable year exceeds the taxpayer's regular tax liability for the taxable year allocable to all passive activities in which the taxpayer has an interest. IRC § 469(d)(2).

4. A loss that would not be allowed for the year because the taxpayer is not at risk with
respect to such loss is suspended under the at-risk provisions, not the PAL rules.

5. PALs retain their character when they are suspended and carried forward. Thus, suspended PALs could be either capital or ordinary, depending upon the manner in which the losses arose.

6. PALs which are carried forward can be utilized to offset passive activity income in subsequent years and in all events, will be recognized when the taxpayer disposes of his interest in the activity which gave rise to the PAL.

7. If an activity ceases to be a passive activity (e.g., because the taxpayer begins to materially participate in such activity), any PALs relating to that activity can be utilized to offset income from such activity (and only such activity). IRC § 469(f). Any remaining PALs retain their character as PALs.

8. As noted, if the taxpayer subject to the PAL rule was a closely-held C corporation, a change in status (e.g., the C corporation ceases to be closely held) will not alter the characterization of PALs. Such PALs shall be applied as if the taxpayer continued to be a closely-held C corporation.

I. Disposition of Passive Activities

1. The suspended PALs allocable to an activity (but not suspended PACs) may be utilized by a taxpayer when the taxpayer disposes of his entire interest in the activity in a transaction in which all gain or loss is recognized in the following order:

a. To offset income or gain from the passive activity for the taxable year (including any gain recognized upon the disposition).

b. To offset net income or gain for the taxable year from any other passive activities.

c. To offset any other income or gain. IRC § 469(g)(1).
2. Gain recognized in IRC §§ 351, 751 or 1031 exchanges does not trigger all losses but is considered gain from a passive activity. Senate Report, 726-27. Presumably, at least as favorable a rule should apply to a partial disposition (sale of an undivided interest). Query: whether the regulations will permit pro rata allowance of losses in such cases.

3. The allowance of losses on the disposition of a taxpayer's entire interest in a passive activity does not apply if the transferee is related to the taxpayer within the meaning of IRC §§ 267(b) or 707(b)(1). In such event, suspended losses are deductible in the taxable year in which such interest is acquired in a qualifying transaction by a non-related person. IRC § 469(g)(1)(B).

4. The limitations of Section 1211 (capital loss limitation) are applied before the PALs can be utilized to offset any income, including income or gain from the passive activity during such taxable year. IRC § 469(g)(1)(C).

5. An abandonment of an interest in an activity which is a fully taxable event under the law in effect before the enactment of the Act (e.g., abandonment under IRC § 165(a) or worthlessness of security under IRC § 165(g)(1) is a qualifying disposition. CCR, 143.

6. If an interest in an activity is transferred by reason of the death of a taxpayer, PALs may be utilized only to the extent such losses exceed the basis of the property in the hands of the transferee over its adjusted basis immediately before the death of the taxpayer. IRC § 469(g)(2). The effect of this rule is to eliminate losses in an amount equal to the "step up" in the basis of assets at death.

7. In the case of an installment sale of an entire interest in an activity, PALs are allowed in the same ratio to all losses as the ratio of the gain recognized on the sale bears to the gross profit. IRC § 469(g)(3).

8. In the case of a disposition by gift, the basis of the interest immediately before the transfer is increased by the amount of PALs allocable to such interest and such PALs are not allowable as a deduction. IRC § 469(j)(6).
9. Consistent with the disregard of legal entities, the Conferees changed the provision in the Senate amendment under which a taxpayer had to dispose of his entire interest in a limited partnership in order to utilize any previously-suspended PALs. Such PALs can be used as long as the taxpayer disposes of his entire interest in any activity. CCR, 145.

10. A change in the nature of an activity is not treated as a disposition. For example, no disposition occurs when a real estate construction activity becomes a rental activity upon the completion of construction. CCR, 145.

11. A problem will arise if a taxpayer has interests in several activities, some of which resulted in gains and others which resulted in losses. It will be necessary to determine which losses from which passive activities were utilized currently to offset passive activity income, and which losses were carried forward. This determination will be made pursuant to regulations to be issued.

12. For purposes of determining gain or loss from a disposition of any property, the transferor may elect to increase the basis of such property immediately before the transfer by an amount equal to the portion of any unused credit which reduced the basis of such property. IRC § 469(j)(9). The purpose of this provision is to permit the taxpayer to recognize economic gain or loss, taking into account the full cost of property for which no credit was allowed. This rule is appropriate as PACs are not allowable upon the disposition of an interest in a passive activity.

J. Phase-In Rules and Effective Date

1. IRC § 469 is generally effective for taxable years beginning after December 31, 1986.

2. Interests in passive activities acquired by a taxpayer on or before the date of enactment, are eligible for a phase-in rule whereby only a portion of the PAL is allowed. IRC § 469(1). The percentage of the PAL which is disallowed under this rule is as follows:
<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>Percentage Disallowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>35%</td>
</tr>
<tr>
<td>1988</td>
<td>60%</td>
</tr>
<tr>
<td>1989</td>
<td>80%</td>
</tr>
<tr>
<td>1990</td>
<td>90%</td>
</tr>
<tr>
<td>Thereafter</td>
<td>100%</td>
</tr>
</tbody>
</table>

However, PALs allowed against active income in years 1987-90 will be a tax preference subject to the 21% tax rate under the Alternative Minimum Tax calculation. As a result, the effective percentage disallowed may be in excess of that stated above. E.g., if the entire amount allowed in 1987 is subject to the AMT, the effective percentage disallowed will be roughly 70%, not 35%.

3. Any interest acquired after the date of enactment pursuant to a written binding contract in effect on such date, and at all times thereafter, shall be treated as held on such date. IRC § 469(1)(3)(B).

   a. A contingent contract will not be treated as nonbinding if the contingencies are beyond the control of the taxpayer.

   b. The activity must also have commenced prior to the date of enactment, unless its subject to the binding contract exception or construction began on or before August 16, 1986. IRC § 469(e)(3)(B).

4. In applying the phase-in rule, the suspended PAL from a prior year is not considered in determining the amount of the PAL against which the phase-in percentage is applied. IRC § 469(e)(1)(B). The applicable percentages are of current year losses only.

5. Any interests in passive activities acquired after the date of enactment are not eligible for this phase-in rule.

6. A liberal transitional rule is included for low-income housing. Under this provision, any tax loss sustained by a "qualified investor" with respect to an interest in a "qualified low-income housing project" during the "relief period" shall be exempt from the passive loss
rule. The use of this relief provision by any investor of a partnership precludes the availability of the low-income housing credit created under the 1986 Act. Act § 502.

a. A "qualified investor" is defined as a natural person who holds, directly or indirectly, an interest in a qualified low-income housing project, provided that the investor is required to make 50 percent or more of his requisite capital contributions after December 31, 1986 and the investor held such interest on December 31, 1986.

b. A "qualified low-income housing project" must meet each of the following requirements:

i. The project is of the type that would be subject to ordinary income recapture upon disposition as described in IRC § 1250(a)(1)(B) provided the operator of the project so certifies to the Treasury;

ii. The project is constructed or acquired pursuant to a binding contract entered into on or before August 16, 1986; and

iii. The project is placed in service before January 1, 1989.

c. The "relief period" commences no earlier than 1987 and ends upon the earliest to occur of (a) the 6th taxable year after the year of the initial investment, (b) the 1st taxable year after the taxable year in which the last installment is paid, or (c) the last taxable year in which the project is a qualified low-income housing project.

K. Problem Areas and Planning

1. If an owner of rental property is paid a management fee, such fee constitutes "active" income. However, if the owner adjusts his rent to include the management fee, the income would effectively be treated as income from a passive activity which could be sheltered.
2. If a taxpayer has $100,000 of portfolio income and $100,000 PAL from rental activity he should consider "offsetting" the portfolio income by the PAL by selling his portfolio and paying down indebtedness secured by the rental property.

3. Leases between related parties where the lessee is an active business should be carefully reviewed. Incentive exists for the reduction of salary and the increase of rents. The Secretary is instructed by the Conferees that regulations may be appropriate in this area, with respect to leases that have the effect of reducing active business income and creating passive losses. CCR, 147. If the lessor's loss is deemed to be a passive loss, consideration should be given to contributing the property to the lessee corporation, particularly if it is an S corporation.

4. Contrast the "three basket" concept of Congress with the results arising from an extreme exercise of the regulatory authority granted under IRC § 469(k)(3) - the so called "heads-I-win, tails-you-lose" approach. The mechanism is simple - a passive activity becomes "other than a passive activity" when it begins to generate positive income.

   a. The Conference Report states that exercise of such regulatory authority may be appropriate to "prevent the sheltering of positive income sources through tax losses derived from passive business activities (emphasis added)." Examples of such abuses include "ground rents that produce income without significant expenses, related party leases which decrease active income and create passive income, and activities which generate active business losses which the taxpayer intentionally seeks to treat as passive when they generate income." CCR, 147.

   b. Query: what "positive" income Treasury will seek to protect, "the crown jewels" of the income tax system or something more?

5. Tax advisors will still look for passive losses to offset income from burnt-out
shelters. A great deal of time and effort will also be expended to find creative ways to categorize income as passive. Taxpayers with PALs will be looking to new investments that generate passive income. Paired investments will become common place in the investment world.

II. INVESTMENT INTEREST

A. Limitation

1. The deduction for investment interest is limited to the amount of net investment income. IRC § 163(d)(1).

2. The $10,000 exclusion has been repealed.

3. Disallowed interest is carried forward indefinitely and treated as investment interest in succeeding years. IRC § 163(d)(2).

B. Definitions

1. Investment interest includes interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Thus all interest other than consumer interest and mortgage interest on debt not incurred in a trade or business is included. Examples include interest allocable to portfolio income under the passive loss rules and interest attributable to an activity in which taxpayer does not materially participate which is not considered a passive activity. Since neither kind of interest is subject to the passive loss rules, they are subject to the section 163(d) limitations. IRC § 163(d)(3)(A) and (5)(A).

   a. The Regulations will probably, in the case of individuals, generally require that interest expense will be traced to the asset or activity which is purchased or carried on by incurring or continuing the underlying indebtedness. CCR, 146, (in the case of other taxpayers allocations on the basis of assets may apply in some cases).

2. Net investment income is the excess of investment income over investment expenses. The
current definition of investment income as income from property held for investment is expanded to include gain attributable to the disposition of property held for investment and portfolio income under the passive loss rules. IRC § 163(d)(4).

3. Generally any interest and income subject to the passive loss rules is not subject to section 163(d). IRC § 163(d)(3)(B)(ii) and (4)(D).

C. Allowance of Investment Interest Deduction

1. The deduction for investment interest will be limited to the excess of net investment income over interest expense.

2. The disposition of property held for investment results in investment income. (Many dispositions will trigger suspended deductions).

D. Special Rules

1. Property subject to a net lease is not treated as investment property because it is treated as a passive activity under the passive loss rule. CCR, 154.

2. The investment interest limitation is not intended to disallow a deduction for interest expense which is required to be disallowed under IRC § 265 or capitalized (e.g., construction period interest under IRC § 263A). CCR, 154.

E. Effective Date and Phase-In

1. The new rules apply to interest paid or incurred after 1986 regardless of when the debt was incurred.

2. The new limitations on investment interest are phased in between 1987 and 1990. During those years the taxpayer is entitled to deduct a portion of the disallowed interest. The phase-in rules only apply to interest that would have been allowed under prior law which is generally $10,000. The percentages of otherwise disallowed interest which is allowable are:
Any amount of interest disallowed during the phase-in period can only be deducted in a subsequent year if the taxpayer has net investment income in excess of investment interest. IRC § 163(d)(6).

a. Example: In 1987 T has investment interest of $40,000 which exceeds investment income. She is entitled to deduct 65% of the portion which would have been allowed under prior law. Under prior law $10,000 would have been deductible; therefore $6,500 is deductible in 1987. IRC § 163(d)(6).

3. As noted, to the extent passive losses are allowed as a deduction during the phase-in period, they are subtracted from the net investment income. Section 163(d)(4)(E).

III. AT-RISK PROVISIONS

A. Law as to Items Other than Real Estate Unchanged

1. The law in effect before and after the enactment of the Act limits losses from business and income-producing activities other than real estate to the amount at risk. These rules are applicable to individuals and certain closely-held corporations.

2. The amount at risk is generally the sum of: (i) the taxpayer's cash contributions to the activity; (ii) the adjusted basis of other property contributed to the activity; and (iii) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability or has pledged property not used in the activity. Such amount is generally increased (or decreased) each year by the taxpayer's share of income (or losses and withdrawals) from the activity.

3. The investment tax credit at-risk rules limit the credit base of property used in an activ-
ity that is subject to the loss limitation at-risk rules, and generally provide that nonrecourse debt is treated as an amount at-risk for investment credit purposes where: (i) it is borrowed from an unrelated commercial lender, or represents a loan from or is guaranteed by certain governmental entities, (ii) the property is acquired from an unrelated person, (iii) the lender is unrelated to the seller, (iv) the lender or a related person does not receive a fee with respect to the taxpayer's investment in the property, (v) debt is not convertible, and (vi) the nonrecourse debt does not exceed 80% of the credit base of the property. CCR, 134.

B. Extension of At-Risk Provisions to Real Property

1. The Act extends the at-risk rules to include the holding of real property as an activity subject to the at-risk rules. Act § 503(a).

2. An exception to the previous at-risk rules was added for "qualified nonrecourse financing." The taxpayer is treated as being at-risk with respect to this financing.

3. Qualified nonrecourse financing.

a. Use of funds: The financing must be borrowed in connection with the activity of holding real property. IRC § 465(b)(6)(B)(i). (Includes the holding of personal property and providing of services that are incidental to the use of the real property). Query: how does one establish the purpose of borrowing (tracing)? What is the result if the proceeds are distributed to the owner? Can debt be split between two or more purposes?

i. The activity of holding real property includes the provision of services incidental to making real property available as living accommodations; but not where services are significant such as hotels, nursing homes, hospitals, vacation parks, amusement parks, and car washes. See, IRC § 465(b)(6)(E).
ii. The activity of holding real property does not include the holding of mineral property.

b. Nature of lender: The lender must be one of the following types -

i. The lender may be a federal, state, or local government (or instrumentality of one of these) or a qualified person. Real estate joint ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture, provided that the terms of financing are commercially reasonable and substantially similar to loans made to unrelated parties. IRC § 465(b)(6)(B)(ii).

ii. May be a person related to the taxpayer if the terms of the loan are commercially reasonable and are substantially the same terms as loans involving unrelated parties. CCR, 135.

iii. Seller financing cannot qualify.

iv. The loan may be guaranteed by a federal, state, or local government.

c. The financing must be nonrecourse.

i. This means financing with respect to which no person is personally liable, except to the extent otherwise provided in regulations. What is the result if the financing is recourse, but recourse is limited to the assets of a partnership? Recourse in part and nonrecourse in part? Cash flow, completion or performance guarantees?

ii. The Senate Report indicates that regulations should set forth circumstances in which guarantees, indemnities, or personal liability (or the like) of a person other than the taxpayer will not cause the financing to be treated as other
than qualified nonrecourse financing. Presumably, the regulations will be prospective.

d. The indebtedness is not convertible debt. What if the lender or an affiliate separately pays for an option? What if there is an option to cause the property to be contributed to a joint venture or if the lender has equity favored rights (participation in cash flow, etc.)?

e. The indebtedness must constitute bona fide debt and cannot constitute disguised equity.

4. Qualified person.

a. The loan may be borrowed from a qualified person, as defined in IRC § 46(c)(8)(D)(iv). Qualified person means any person which: (i) is actively and regularly engaged in the business of lending money (such as a bank, savings and loan association, credit union, regulated insurance company, or pension trust) and (ii) which is not:

i. a related person to the taxpayer (such as family members, fiduciaries, and corporations or partnerships in which a person has at least a 10% interest). IRC § 46(c)(8)(D)(iv)(I). This determination should be made both at the partnership and partner level.

A. Note that a related person is permitted as the creditor if the financing from the related person is on commercially reasonable terms and on substantially the same terms as loans involving unrelated persons.

B. Financing is commercially reasonable if the financing is a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money, and the interest rate is a reasonable
market rate of interest (taking into account the maturity of the obligation). Generally, an interest rate is not considered commercially reasonable if it is significantly below the market rate on comparable loans by unrelated qualified persons to borrowers under the comparable loans. Generally, an interest rate would not be considered commercially reasonable if it significantly exceeds the market rate on comparable loans by unrelated qualified persons. An interest rate would not be considered commercially reasonable if it were contingent. However, contingent interest may be commercially reasonable where it is calculated with respect to a market interest index such as the prime rate charged by a major commercial bank, LIBOR, the rate on government securities (e.g., Treasury bills or notes), or the applicable Federal rate. The terms of financing would not be considered reasonable if the term of the loan exceeds the useful life of the property or if the right to foreclosure or collection is limited (except to the extent provided under state law).

ii. A person from whom the taxpayer acquired the property or a person related to the person from whom the taxpayer acquired the property. IRC § 46(c)(8)(D)(iv)(II).

iii. A person who receives a fee (e.g., a promoter) with respect to the taxpayer's investment in the property or a related person to a person who receives a fee with respect to the taxpayer's investment in the property. IRC § 46(c)(8)(D)(iv)(III).
5. Real estate partnerships.
   a. A real estate joint venture is permitted to obtain financing from an otherwise qualified lender who has an equity interest in the venture, provided that the lender is not the seller or related to the seller.
   
   b. Partnership nonrecourse financing may increase a partner's at-risk amount, determined in accordance with his share of the liabilities incurred in connection with such financing (within the meaning of IRC § 752). IRC § 465(b)(6)(C). The partnership is treated as a taxpayer for purposes of determining whether a share of partnership indebtedness is qualified nonrecourse financing with respect to a partner.
   
   c. The related person test is applied both at the partnership and the partner level.

6. Where property is taken subject to a nonrecourse debt which constituted qualified nonrecourse financing in the hands of the original borrower, the debt is qualified nonrecourse financing as to the original borrower's transferee, provided that all criteria for qualified nonrecourse financing are satisfied for that debt with respect to the transferee. So long as the debt constitutes qualified nonrecourse financing with respect to each transferee or new partner, this rule also will apply to subsequent transfers of the property taken subject to the debt, admission of new partners to a partnership, and a sale of a partnership interest.

C. Effective Date of Act Provisions

1. This provision is effective with respect to losses incurred after December 31, 1986, with respect to property acquired by the taxpayer after December 31, 1986. It also applies to partnership interests and S corporation stock acquired after December 31, 1986. If the pass-thru entity interest is acquired after December 31, 1986, the at-risk rules apply regardless of when the property is placed in
service. Act § 503(c).