Current Issues and Developments Involving Sales or Exchanges of Real Estate: The Impact of Tax Reform 1986 on Real Estate Investments and Activities

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CURRENT ISSUES AND DEVELOPMENTS INVOLVING
SALES OR EXCHANGES OF REAL ESTATE:

THE IMPACT OF TAX REFORM 1986
ON
REAL ESTATE INVESTMENTS AND ACTIVITIES

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I. INTRODUCTION.

A. The Tax Reform Act of 1986 ("TRA 1986") is certainly the most far-reaching tax law enacted since 1954. It will have pervasive effects on all aspects of American business and investments, particularly including real estate.

B. In contradistinction, however, to a lot of soothsayers, it is the belief of the author of this outline that, while there will undoubtedly be a short-term, downward push on real estate values, in the not-too-distant future real estate business and investments will be far stronger as a result of TRA 1986.

C. Moreover, as Gramm-Rudman, the import/export disparity and defense and domestic needs create calls for additional dollars, it seems almost a certainty that income taxes will soon begin to rise, even while Congress and the Administration explore other sources of dollars, such as increased excise taxes and the value-added tax, which is in effect a form of national sales tax.

II. INDIVIDUAL TAX PROVISIONS.

A. Tax Rate Schedules.

1. There is a basic two-rate structure:

   a. 15%
   b. 28%

2. In order to ease the impact on the economy for 1987, there is a blend, as follows:

   a. **Taxable Income** | **Rate**
   $0 - $3,000 | 11%
   $3,000+ - $28,000 | 15%
   $28,000+ - $45,000 | 28%
   $45,000+ - $90,000 | 35%
   $90,000+ | 38-1/2%

   b. The above blend schedule assumes married taxpayers filing joint returns.

   c. There is no phase-out in 1987 of the lower rates on the personal exemption.

3. For 1988 and thereafter, the basic two-rate structure is brought into full effect, as follows:

   a. **Taxable Income** | **Rate**
   $0 - $29,750 | 15%
   $29,750+ | 28%
b. The above schedule assumes married taxpayers filing joint returns.

c. There is a 5% rate adjustment surcharge starting at $71,900. The rate adjustment is intended to "recapture" from taxpayers having taxable income of $71,900 to $149,250 (again, assuming married taxpayers filing joint returns) the "benefit" of the 15% tax bracket. [Above $149,250 of taxable income, there would be a 28% tax starting with the first dollar of taxable income.]

B. Standard Deduction Increase.

1. TRA 1986 replaces the present zero bracket amount with the standard deduction, effective for taxable years beginning in 1987.

2. The standard deduction amount for married individuals filing jointly (and surviving spouses) is $3,760 in 1987, increasing to $5,000 in 1988.

3. An additional standard deduction (of $600 for a married person, whether filing jointly or separately, or a surviving spouse, and of $750 for an unmarried person (other than a surviving spouse) or a head of household) has been provided for elderly or blind individuals, effective beginning in 1987.

4. Beginning in 1989, the increased standard deduction amounts are to be adjusted for inflation.

5. There will no longer be any general floor under total itemized deductions.

C. Personal Exemptions.

1. The personal exemption for each individual, the individual's spouse and each eligible dependent is increased from the present $1,080 to $1,900 for 1987, $1,950 for 1988 and $2,000 in 1989. The $2,000 personal exemption will be adjusted for inflation beginning in 1990.

2. The additional exemption for an elderly or blind individual is repealed, beginning in 1987. (As noted, an additional standard deduction amount is provided for such individuals.)

3. The benefit of the personal exemption is phased out in 1988 for taxpayers having taxable income exceeding specified levels.

   a. The income tax liability of such taxpayers is increased by 5% of taxable income within certain ranges.
b. This reduction in the exemption benefit starts at the taxable income level at which the benefit of the 15% tax rate is completely phased out. In the case of married individuals filing joint returns, the 1988 personal exemption phase-out begins at taxable income of $149,250.

c. The phase-out occurs over an income range of $10,920 in 1988 and is serial -- that is, the phase-out of the second personal exemption benefit on a joint return does not begin until the phase-out of the first is complete. In the case of a married couple filing jointly who have two children, the benefit of the four personal exemptions would phase out over an income range of $43,680 (4 x $10,920) and would be phased out completely at taxable income of $192,930 ($149,250 + $43,680).

4. Beginning in 1987, no personal exemption amount is allowable on the return of an individual eligible to be claimed as a dependent on another taxpayer's return (for example, on the return of a child eligible to be claimed on the parent's return).

   a. As under the present law zero bracket amount rule, TRA 1986 provides that the standard deduction may be used by a dependent individual only to offset such individual's earned income. However, this limitation also provides that the individual's standard deduction is limited to the greater of

      (1) the individual's earned income up to the basic standard deduction amount (in 1988, $3,000 for a single individual), or

      (2) $500 (to be adjusted for inflation starting in 1989).

   b. Additionally, such a dependent child must file a Federal tax return only if the child either

      (1) has gross income exceeding the standard deduction amount for such a dependent child (that is, the greater of earned income or $500), or

      (2) has unearned income exceeding $500.

D. Two-Earner Household.

1. Under present law, married individuals filing a joint return are allowed a deduction equal to 10% of the lesser of

   a. the earned income of the lower-earning spouse, or

   b. $30,000.
2. TRA 1986 repeals the two-earner deduction, effective for taxable years beginning after December 31, 1986.

E. Income Averaging.
   1. Currently, an eligible individual can elect to apply a lower marginal rate to that portion of the current year's taxable income that is more than 40% higher than the average of his taxable income for the prior three years.
   
   2. Income averaging is repealed for all taxpayers, effective for taxable years beginning after December 31, 1986.

F. Earned Income Credit (Children).
   1. Under present law, individuals with one or more children are allowed a refundable tax credit of 11% of the first $5,000 of earned income, for a maximum credit of $550. The maximum allowable credit is phased down if income exceeds $6,500 and is unavailable to individuals earning over $11,000. The credit is available only if the child resides with the taxpayer, who is
      a. a married individual filing jointly and entitled to a dependency exemption for a child; or
      b. a surviving spouse; or
      c. an unmarried head of household.
   
   2. Effective for taxable years beginning after December 31, 1986, the earned income credit is increased to 14% of the first $5,714 of earned income (with the income base, and the phase-out starting point, adjusted for inflation occurring after the 12-month period ending on August 31, 1984), for a maximum credit of $800. The credit amount is phased down where income exceeds $6,500 and is unavailable if income is over $13,500. The income phase-out levels are raised to the range of $9,000 to $17,000, effective for taxable years starting after December 31, 1987.

G. Deductions for Personal Expenditures.
   1. The itemized deduction for state and local sales taxes is repealed, effective for taxable years beginning after December 31, 1986.
   
   2. State, local or foreign taxes incurred in connection with the acquisition or disposition of property in a trade or business are treated, respectively, as part of the cost of the acquired property or as a reduction in the amount realized on the disposition.
      a. Excluded, however, from this capitalization rule are state, local and foreign real property taxes and state
and local personal property taxes, which (along with state and local income taxes) continue to be itemized deductions, subject, in the case of real property taxes, to the rules of Secs. 164, 189 and 266, I.R.C.

b. This capitalization rule applies to both business and investment (Sec. 212, I.R.C.) activities.

c. This rule is effective for taxable years beginning after December 31, 1986.

H. Employee Business Expenses, Investment Expenses and Miscellaneous Itemized Deductions.

1. Investment expenses include (pursuant to Sec. 212, I.R.C.) investment counsel and trust administration fees, subscriptions to investment advisory publications and attorney’s fees incurred in collecting income.

2. Other miscellaneous itemized deductions include tax counsel and assistance fees and appraisal fees paid to determine the amount of a casualty loss or charitable contribution. (Sec. 212(3), I.R.C.) Expenses related to hobbies are deductible to the extent of income from the hobby, and gambling losses are deductible to the extent of gambling gains.

3. Effective with respect to taxable years beginning after December 31, 1986, employee business expenses (including those, other than expenses reimbursed by the employer, that are presently and continue to be deductible above-the-line), investment expenses and miscellaneous itemized deductions will be deductible only as "itemized expenses" and, as such, only to the extent that, in the aggregate, they exceed 2% of adjusted gross income.

a. Itemized expenses subject to other rules (such as the 80% limit on business meals) are then subject to the 2% of adjusted gross income test.

b. The test will also apply with respect to indirect deductions through pass-through entities (including mutual funds) other than estates and trusts, cooperatives and REITs.

c. The two percent (2%) adjusted gross income test does not apply to certain deductions otherwise allowable, such as the estate tax in the case of income in respect of a decedent, certain costs of cooperative housing corporations, or gambling losses.

I. The Interest Deduction Limitations.

1. Personal (or Consumer) Interest.
a. No deduction is allowed for personal interest, such as interest on car loans or credit card balances.

b. Personal interest does not include interest paid or accrued on a debt incurred or continued in connection with the conduct of a trade or business (other than the performance of services as an employee) or in connection with an income-producing activity (under Sec. 212, I.R.C.).

c. Interest on tax deficiencies is treated as personal interest, with the exception of interest on installment payments of deferred estate taxes (under Secs. 6163 or 6166, I.R.C.).

2. Qualified Residence Interest.

a. Interest on debt secured by a security interest perfected under local law on the taxpayer's principal residence or a second residence is not treated as personal interest, subject to the following:

   (1) Unless incurred on or before August 16, 1986 and secured by the residence on August 16, 1986 (in which case the sole lid is the fair market value of the residence, presumably measured at the time the debt was incurred), the debt cannot exceed the purchase price of the residence plus the cost of home improvements, except that

   (2) Interest on such debt in excess of the purchase price of the residence plus the cost of improvements, up to the fair market value of the residence, is deductible if the debt is incurred for qualified educational expenses or qualified medical expenses (which expenses are, in turn, incurred within a reasonable time, before or after the debt is incurred).

b. A principal residence includes a condominium, cooperative unit or other residence (including a houseboat or house trailer) that would qualify for rollover of gain under Sec. 1034, I.R.C. if sold.

c. The fact that state homestead laws may restrict the rights of secured parties with respect to certain types of residential mortgages will not cause nondeductibility of interest so long as the lender's security interest is perfected.

d. The second residence, in the case of a joint return, includes a residence used by the taxpayer or his spouse and owned by either or both spouses.

e. If the taxpayer owns, in addition to the principal residence, more than one other residence, the taxpayer may designate each year which of the other residences is to be treated as the second residence.
f. The cost basis is determined without regard to depreciation or similar adjustments to basis. Accordingly, if the second residence is rented out and depreciated, the basis is not reduced for interest-determination purposes.

3. Investment Interest.

a. The deduction for investment interest under Sec. 163(d), I.R.C. is generally limited to net investment income.

b. Investment interest, under present law, means interest paid or accrued on debt incurred or continued to purchase or carry property held for investment, including property subject to a net lease.

c. Under TRA 1986, investment interest includes interest paid or accrued on a debt incurred, or continued, to purchase or carry a property held for investment and investment interest also includes such same interest with regard to a "limited business interest".

(1) The limited partner interest in a limited partnership is a limited business interest.

(2) Another form of limited business interest is an interest as a shareholder of an S corporation in the activities of which the taxpayer does not materially participate.

(3) Also treated as a limited business interest is an interest in any activity in which the taxpayer does not materially participate and the income or loss from which is trade or business income or loss, if that activity is not treated as a passive activity under the passive loss rule.

d. Investment interest does not include (i) interest from activities subject to the passive loss rules, including interest allocable to a rental real estate activity in which the taxpayer actively participates, or (ii) property subject to a net lease (which is treated as a passive activity under the passive loss rules), and for these purposes investment income does not include income from such activities. However, in calculating net investment income, passive losses that are allowed under the phase-in provision (allowing non-passive income to be offset by a percentage of passive losses) are subtracted from investment income.

4. Effective Date.

a. The new interest deduction limitations are effective for taxable years beginning after December 31, 1986, regardless of when the obligation was incurred, but subject to a
phase-in (which is separate as to the consumer interest limitation and the investment interest limitation) as follows:

(1) 1987 - 35% interest disallowance
(2) 1988 - 60% interest disallowance
(3) 1989 - 80% interest disallowance
(4) 1990 - 90% interest disallowance
(5) 1991 and thereafter - 100% interest disallowance.

b. In the case of investment interest, the entire present law allowance of $10,000 (for married individuals filing a joint return) is eliminated, and there is a full disallowance above $10,000, with the percentage disallowance applicable only up to $10,000.

c. During the period of the investment interest limitation phase-in, there is a carryforward for disallowed investment interest (as an offset only to net investment income), but no carryforward for disallowed personal interest. Furthermore, during such phase-in period, the amount of net investment income is reduced by the amount of passive activity losses that is allowed as a deduction solely by virtue of the passive loss phase-in (other than net losses from rental real estate in which the taxpayer actively participates).

J. Dividend Exclusion Repeal.

1. Currently, under I.R.C. Sec. 116(a), the first $100 of qualified dividends received by an individual shareholder ($200 by a married couple filing jointly) from domestic corporations is excluded from income.

2. TRA 1986 repeals the dividend exclusion for individuals, effective for taxable years beginning after December 31, 1986.

K. Tax on Wealth Transferred to Children.

1. Under present law, if income-producing assets are transferred to a minor child, income earned on those assets generally is taxed to the child at the child’s rate.

2. TRA 1986 substantially reduces the opportunities for tax savings through intra-family transfers of income producing property by taxing such income at the parent’s marginal rates. Regardless of the source of the assets, the net unearned income of a child under 14 years of age is taxed to the child at the top rate of the parents.
a. The child must be under 14 years of age and have at least one living parent at the close of the tax year.

b. Net unearned income means unearned income less the sum of $500 and the greater of:

   (1) the amount of allowable deductions which are directly connected with the production of the unearned income, or

   (2) $500 of the standard deduction or $500 of itemized deductions. (The $500 figures are to be adjusted for inflation beginning in 1988.)

c. The top rate of the parent is deemed to be the top rate applicable to the parent if the child’s unearned income were included in the parent’s taxable income.

d. Where there is more than one qualifying child with unearned income, each child’s share of the parent’s tax is pro-rated based on the ratio of such child’s net unearned income to the total net unearned income of the parent’s children under age 14.

e. In the case of divorced parents, it is the custodial parent’s taxable income which is taken into account when computing the tax on a child’s unearned income.

f. In the case of married parents who file separate returns, the income of the parent with the greater taxable income is taken into account.

3. The child’s earned income is taxed at the child’s rate.

4. Treasury is expected to issue regulations providing for the application of these provisions where

   a. either the child or the parent is subject to the alternative minimum tax for the year, and

   b. where the tax on capital gains of a trust is determined by reference to the income of the parent.

5. This provision is effective for taxable years beginning after the date of enactment.

III. COST RECOVERY, DEPRECIATION AND REGULAR INVESTMENT TAX CREDIT.

A. Cost Recovery and Depreciation.
1. New cost recovery classes are imposed, including particularly the following:

a. 7-year 200% class Includes single-purpose agricultural and horticultural structures.
   (switching to straight-line at a time to maximize depreciation allowance.)

b. 20-year 150% class Includes municipal sewers.
   (switching to straight-line at a time to maximize depreciation allowance.)

c. 27-1/2 year Straight-line Residential rental property, including manufactured homes and elevators and escalators.

 d. 31-1/2 year Straight-line Nonresidential real property, including elevators and escalators.

2. The following accounting conventions apply:

   a. With respect to other than residential rental property and nonresidential real property, there is both:

      (1) A half-year convention, under which all property placed in service or disposed of during a taxable year is treated as placed in service or disposed of at the midpoint of such year. Thus, a half year of depreciation is allowed for the first year property is placed in service, irrespective of when that occurs, and a half year of depreciation is allowed for the year in which the property is disposed of or retired from service.

      (2) A mid-quarter convention is applicable to all property if more than 40% of that property is placed in service during the last quarter of the taxable year.

   b. With respect to real property, the present mid-month convention continues to apply. (TRA 1986 extends the use of this convention to low income housing and to all residential rental property and nonresidential real property.) Thus, the depreciation allowance for the first year property is placed in service is based on the number of months the property was in service, and property placed in service at any time during a month is treated as having been placed in service in the middle
of the month. Property disposed of at any time during a month is treated as having been disposed of in the middle of the month.

3. Certain alternative depreciation methods which currently exist are continued (with or without modifications), including particularly:

a. Where real property is leased to or used by a tax-exempt entity (including a foreign person, unless more than 50% of the gross income derived from the property by such person is subject to U.S. tax), the reduction of ACRS deductions is retained. This includes increasing the recovery period (which, under Sec. 168(j), I.R.C., is 40 years) used for ACRS to not less than 125% of the lease term if that would be longer than the depreciation period otherwise applicable to the property.

b. Where real property is financed directly or indirectly by an obligation, the interest on which is exempt from tax under Sec. 103(a), I.R.C., the reduction of ACRS deductions is retained, but is broadened to include such reduction if all or any part of such property is so financed.

4. The cost of leasehold improvements will be recovered in the same manner as with other real property.

a. On lease termination, the lessee who does not retain the improvements will compute gain or loss by reference to the adjusted basis of the improvement at that time.

b. Sec. 178, I.R.C. will be relevant only in determining the amortization period for lease acquisition costs. Sec. 178, I.R.C. is revised to provide that the term of a lease is determined by including all renewal options, as well as any other period for which the parties reasonably expect the lease to be renewed.

5. Transferees receiving real property in a generally non-taxable situation (e.g., under Secs. 351, 361, 721 or 731 (except in the case of a partnership termination under Sec. 708(b)(1)(B)), I.R.C.) are treated as follows:

a. To the extent the basis of the property is not increased as a result of the transaction, the transferee "steps into the shoes" of the transferor, and is treated as the transferor was in computing the depreciation deduction.

b. Where the transferee's basis exceeds that of the transferor, the excess is depreciated by the transferee under TRA 1986 rules.

6. As to additions or improvements to property, the following applies:

a. The components method cannot be utilized.
b. The recovery period begins on the later to be placed in service of (i) the addition or improvement or (ii) the property with respect to which such addition or improvement is made.

c. The ACRS deduction for the addition or improvement is computed the same as it would be for the underlying property if such property were placed in service at the same time as such addition or improvement.

7. Recapture on the disposition of the asset is as follows:

a. As to tangible property (other than residential rental property and nonresidential real property), all gain on disposition is recaptured as ordinary income to the extent of previously-allowed depreciation deductions.

b. Because only straight-line methods can be used under TRA 1986, there is no recapture of previously-allowed depreciation deductions in the case of residential rental property and nonresidential real property.

8. Generally, the ACRS revisions apply to all property placed in service after December 31, 1986. Additionally, with regard to certain property placed in service after July 31, 1986, application of the modified ACRS can be irrevocably elected if such election is made on the first tax return for the year in which the property is placed in service. TRA 1986 provides transition rules, some of the key ones of which include:

   a. An exception will apply to the "binding contract" -- that is, property constructed, reconstructed or acquired pursuant to a written contract binding as of March 1, 1986, and at all times thereafter.

      (1) If a taxpayer transfers his rights in any such property under construction or such contract to another taxpayer, TRA 1986 does not apply to the property in the hands of the transferee, so long as the property was not placed in service by the transferee before the transfer by the transferor. (This same exception applies in the case of a deemed partnership termination under Sec. 708(b)(1)(B), I.R.C., which occurs because of sales or exchanges of partnership interests.)

      (2) A contract is considered binding only if it is enforceable under State law against the taxpayer, and does not limit damages to a specified amount. (A contractual provision limiting damages to not less than 5% of the total contract price is not treated as limiting damages.)

      (3) An option to acquire property is not treated as a binding contract; however, an irrevocable put
granted by the taxpayer is treated as binding because the grantor does not have the ability to unilaterally rescind the put.

b. Another exception applies to property constructed or reconstructed by the taxpayer if (i) the construction or reconstruction began by March 1, 1986 and (ii) the lesser of $1,000,000 or 5% of the cost of the property was incurred or committed by binding written contract by that date.

(1) A taxpayer who serves as the engineer and general contractor of a project is to be treated as constructing the property.

(2) Construction of the property is considered to begin when physical work of a significant nature starts:

B. Regular Investment Tax Credit.

1. The regular investment tax credit is repealed.

2. The repeal is effective for property placed in service after December 31, 1985. The basis of the property that qualifies for transition relief (under the same rules as noted immediately above, using December 31, 1985 rather than March 1, 1986) is reduced by the full amount of investment credits earned with respect to that property after application of a phased-in 35% reduction. This 35% reduction of the investment tax credit allowable for carryovers is fully effective for taxable years beginning on or after July 1, 1987 (with a partial reduction for taxable years that straddle July 1, 1987).

IV. CAPITAL GAINS AND LOSSES.

A. Individual Capital Gains.

1. The capital gains rate is conformed to the individual rate, by deleting the net capital gain deduction for individuals.

2. The change is effective for all taxable years beginning after December 31, 1986; however, notwithstanding the blended rates for individuals in 1987, the top long-term capital gains rate in 1987 is 28%.

3. Capital losses are allowed to the extent of capital gains plus $3,000 of other income.

4. The character of gain as capital or ordinary is not changed. Moreover, the whole structure stays in the Code (except that the alternative minimum tax is conformed by deleting the capital gains preference) so that, if necessary, the tax rate distinction may be reinstituted at a later time.
B. Corporate Capital Gains.

1. The alternative capital gains rate is conformed to the top corporate tax rate for ordinary income, which is 34% for more than $75,000 of corporate taxable income.

2. The 34% rate becomes effective for gain properly taken into account under the taxpayer’s method of accounting after December 31, 1986 without regard to whether the gain is pursuant to a written binding contract in effect at any earlier time.

3. Sec. 1231, I.R.C. is retained as to corporations to facilitate, if necessary, reinstatement of a rate differential at a later time.

V. ACCOUNTING PROVISIONS.

A. Use of the Cash Method of Accounting.

1. Tax shelters are prohibited from using the cash method of accounting, effective for taxable years beginning after December 31, 1986.

2. The term "tax shelter" is defined in Sec. 6661(b), I.R.C., as (i) a partnership or other entity, (ii) any investment plan or arrangement, or (iii) any other plan or arrangement, "if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." The term "tax shelter" is broadened under Sec. 461(i), I.R.C. (the caption of which is "Tax Shelters May Not Deduct Items Earlier Than When Economic Performance Occurs") to include

   a. any syndicate (which, under Sec. 1256(e)(3)(B), I.R.C. is defined as any partnership or other entity, other than a corporation which is not an S corporation, if more than 35% of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs), and

   b. any enterprise, other than a C corporation, if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale.

B. Installment Method of Reporting.

1. TRA 1986 will certainly have a significant adverse effect on installment sales.

   a. Generally, the installment method cannot be used for sales pursuant to a revolving credit plan. However,
such sales are treated as installment sales with respect to which all payments are received in the year of sale. This provision is effective for taxable years beginning after December 31, 1986. The spread period for taxpayers resulting from the change in accounting method is not to exceed 4 years. Where the adjustment is taken over the 4-year period, 15% is accounted for in the first taxable year, 25% in the second year and 30% in each of the remaining two taxable years.

b. Similarly, the installment method cannot be used for sales of stock or securities traded on an established securities market, or (to the extent provided in Treasury Regulations) for other property of a kind regularly traded on an established public market, except that such sales are treated as installment sales with respect to which all payments are received in the year of sale. This provision is effective as to sales occurring after December 31, 1986.

2. As to real property held for sale to customers in the ordinary course of a trade or business ("dealer property") and real property (other than farm property) used in the taxpayer's trade or business (Sec. 1231, I.R.C.) or held for the production of rental income (Sec. 1221, I.R.C.), provided that the selling price thereof exceeds $150,000, the following applies (effective for taxable years ending after December 31, 1986 with respect to property sales after February 28, 1986):

a. Installment obligations arising from the sale of the above (as well as from the sale of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan) after February 28, 1986 are "applicable installment obligations" ("AIOs").

   (1) The use of the installment method for such sales is limited based on the amount of outstanding debt of the taxpayer.

   (2) Generally, the limitation is applied by determining the amount of the taxpayer's "allocable installment indebtedness" ("AII") for a taxable year and treating such amount as a payment immediately before the close of the taxable year on AIOs of the taxpayer that arose in such taxable year and are outstanding at the end thereof.

   (3) AII for a taxable year is determined by

      (a) dividing the face amount of the AIOs outstanding at the end of the year by

      (i) the face amount of all installment obligations (that is, both AIOs and all other installment obligations), and
(ii) the adjusted basis of all other assets of the taxpayer,

(b) multiplying the resulting quotient by the taxpayer's average quarterly indebtedness, and

(c) subtracting any AII that is attributable to AIOs arising in previous years.

b. An exception is made to the quarterly basis calculation of indebtedness for taxpayers who have no AIOs arising from the installment sale of either personal property by a person who regularly sells such property on the installment method or real property held for sale in the ordinary course of a trade or business. These taxpayers must calculate indebtedness on an annual basis. Treasury may issue Regulations preventing the possible avoidance of the proportionate disallowance rule by use of this annual basis provision.

c. With respect to each taxable year subsequent to the year of the above computation, the following apply:

(1) The taxpayer is not required to recognize gain attributable to AIOs arising in a prior year to the extent that the payments on the AIOs do not exceed the amount of AII attributable to such AIOs.

(2) On the receipt of payments, the AII attributable to the AIO on which the payment is received is reduced by the amount of such payment.

(3) Payments on an AIO in excess of the AII attributable thereto are accounted for under the usual rules for applying the installment method.

d. Generally, AII for a specific AIO is not adjusted after its initial computation, except to reflect the receipt of payments on the installment obligation that do not result in the recognition of additional gain. Nonetheless, in order to assure the allocation of a proportionate share of a taxpayer's indebtedness to all AIOs, additional AII may be allocated to AIOs arising in prior years if the amount of AII for a particular taxable year exceeds the amount of AIOs arising in that year and outstanding at year end.

3. The above proportionate disallowance rule otherwise applicable to sales of dealer property will not apply to the sale of "timeshares" or unimproved land if the seller pays the IRS interest on the deferral of its tax liability. The interest rate is 100% of the applicable Federal rate applicable to the installment obligation received in the sale (without regard to the Sec. 1274(d)(2) three-month lookback rule).
a. The installment obligation cannot be guaranteed or insured by any third person other than an individual.

b. The development of the timeshare or unimproved land cannot be done by the seller of the land or any affiliate of the seller; however, a parcel of land is not considered improved or developed if it has been provided with the benefits of common infrastructure items such as roads and sewers.

c. In applying the "six-week" limitation on the eligibility of timeshare interests for the special rule, a timeshare right held by the spouse, children, grandchildren or parents of an individual shall be treated as held by that individual.

4. TRA 1986 provides that Treasury may issue Regulations (retroactive as to all transactions after the general effective date of the proportionate disallowance rule) disallowing use of the installment method in whole or in part for transactions avoiding the effect of the proportionate disallowance rule through the use of related parties, pass-through entities or intermediaries. Thus, the Regulations may treat any corporation, partnership or trust as related to its shareholders, partners or beneficiaries. Additionally, the assets of such related parties may be aggregated for purposes of the rule.

C. Capitalization of Construction Costs.

1. Under Sec. 189, I.R.C., construction-period interest and real estate taxes are currently capitalized and amortized over a 10-year period, with the exception of:

   a. such costs incurred with respect to low-income housing, which are deductible when paid or incurred (subject to other rules in the Code), and

   b. such costs which are capitalized under Sec. 266, I.R.C., and added to the basis of the property (enabling, for example, such costs to be factored into the base for the rehabilitation tax credit).

2. TRA 1986 requires all interest on debt to be capitalized, effective with respect to interest paid or incurred after December 31, 1986, if the debt is incurred or continued to finance the construction or production of long-lived personal property or real property, whether such property is held for sale to customers or is used by the taxpayer in a trade or business or activity for profit.

   a. Rules similar to those of Sec. 189, I.R.C. are to be applied in determining whether debt is incurred or continued to finance the production of property.
b. Interest expense that would have been avoided if production or construction expenditures had been used to repay debt of the taxpayer is treated as construction-period interest subject to capitalization.

c. Debt that can be specifically traced to production or construction expenditures must first be allocated to production or construction.

(1) If production or construction expenditures exceed the amount of this debt, interest on other debt of the taxpayer must be treated, to the extent of this excess, as production or construction period interest.

(2) The assumed interest rate on other debt treated as production or construction debt is the average of the rates on the taxpayer's outstanding debt.

d. To the extent income is not being reported under the percentage of completion method, the production of property under a long-term contract requires capitalization of interest costs.

e. The Treasury Department is to issue Regulations to prevent the avoidance of these rules through the use of related parties.

f. The interest capitalization rules are applied first at the level of a partnership (or other flow-through entity), and then at the level of the partners (or beneficiaries), to the extent that the partnership (or other entity) has insufficient debt to support the production or construction expenditures.

D. Contributions in Aid of Construction.

1. Utilities presently may treat as contributions to capital the value of any property, including money, which they receive to encourage them to provide services to, or for the benefit of, the person transferring the property. Sec. 118, I.R.C.

a. The basis of the property received or of property acquired with such contributions is zero. Secs. 118(b)(4) and 362(c), I.R.C.

b. No deductions or credits are allowed for, or by reason of, the expenditure which constitutes a contribution in aid of construction or any expenditure made with such money so contributed. Sec. 118(b)(4) and 362(c), I.R.C.

2. Effective with respect to contributions received after December 31, 1986, the utility must include in gross income the value of any such property, including money, so received.
E. Cancellation of Indebtedness of Solvent Taxpayers.

1. Under present law, a taxpayer need not include in gross income (under Sec. 61(a)(12), I.R.C.) discharge of indebtedness income when:

   a. the discharge occurs in a bankruptcy case arising under Title 11 of the U.S. Code;

   b. the taxpayer is insolvent both before and after the discharge; or

   c. the debt discharged is qualified business indebtedness under Sec. 108(a)(1), I.R.C.

   (1) "Qualified business indebtedness" is debt incurred or assumed by (a) a corporation or (b) an individual in connection with property used in the individual's trade or business, which the individual elects to have treated as such.

   (2) The amount of the discharge is applied, under Secs. 108(c)(1) and 1017, I.R.C., to reduce the basis of depreciable property of the taxpayer.

2. Effective with respect to cancellations of indebtedness occurring after December 31, 1986, income from such cancellations will have to be recognized unless the discharge occurs in a Title 11 case or the discharge occurs when the debtor is insolvent.

3. Present Sec. 108(e)(5), I.R.C., which treats any reduction of purchase-money debt of a solvent debtor as a purchase price adjustment, rather than as a discharge of indebtedness, remains in effect.

VI. ALTERNATIVE MINIMUM TAX.

A. Individual Minimum Tax.

1. Under TRA 1986, the individual alternative minimum tax (under Secs. 55, 57 and 58, I.R.C.) is retained, but increased from 20% to 21% for taxable years beginning after December 31, 1986.

2. The exemption amount (which is $40,000 for joint returns under present law) is reduced by 25 cents per dollar for alternative minimum taxable income in excess of $150,000 (for married couples filing joint returns).

3. Effective for taxable years beginning after December 31, 1986, modifications are made to the present adjusted
gross income basis for purposes of the alternative minimum tax ("AMT"), including the following:

a. Accelerated depreciation on all property placed in service after 1986, other than property under a transitional exception, is a preference to the extent that such accelerated depreciation is different from alternative depreciation.

(1) Alternative depreciation generally is straight-line depreciation over the ADR midpoint life of the property.

(2) Real estate alternative depreciation is 40 years. Accordingly, subject to the exemption amount, AMT would be imposed on the difference between 40 years and 27-1/2 years in the case of residential rental property, or 31-1/2 years in the case of nonresidential real property.

b. Use of the completed contract method of accounting for long-term contracts is treated as a preference for purposes of AMT by requiring application of the percentage of completion method to long-term contracts entered after March 1, 1986.

c. As to installment sales to which the proportionate disallowance of the installment method of reporting applies under TRA 1986, the installment method will not apply for AMT purposes. Thus, the taxpayer will be required, for AMT purposes, to recognize all gain with respect to the disposition in the taxable year in which the disposition occurs.

d. Tax-exempt interest on private activity bonds (other than Section 501(c)(3) bonds, as defined in Sec. 145, I.R.C.) issued after August 7, 1986 (with certain exceptions, as to which September 1, 1986 is the key date) will be a preference for AMT purposes.

e. Untaxed appreciation on charitable contributions of appreciated property will be a preference for AMT purposes, except as to carryovers of the deduction with respect to charitable contributions made before August 16, 1986.

f. The passive activity loss rule for regular tax purposes (applicable to all rental activities and other passive interests in trades or businesses), which is subject to a phase-in for regular tax purposes, is also applicable to the AMT, but without any phase-in whatsoever.

g. Investment interest will be defined the same for AMT purposes as for the regular tax (under Sec. 163(d), I.R.C.), and a carryforward will apply for AMT purposes to disallowed interest expenses.
(1) It will be clarified that limited business interests are included in the AMT calculation. Accordingly, items of income and deduction relating to such interests are considered in determining the amount of qualified investment income and qualified investment expenses, respectively, and interest deductions relating to such interests are treated as itemized deductions and subject to disallowance for purposes of the AMT.

(2) No minimum tax itemized deduction is allowed with respect to personal interest, even if the personal interest would be allowed if treated as investment income.

B. Corporate Minimum Tax.

1. Under TRA 1986, effective for taxable years beginning after December 31, 1986, an AMT, similar to the individual AMT, replaces the present add-on minimum tax.

2. The corporate AMT rate is 20%.

3. There is a $40,000 exemption, phased out at the rate of 25 cents per dollar for alternative minimum taxable income in excess of $150,000.

4. The items of tax preference include those items which are corporate preferences under present law (Secs. 56, 57 and 58, I.R.C.), as well as the items noted above as to individuals (other than the investment interest limitations).

5. In addition, the excess of pre-tax book income (that is, generally, the net income or loss set forth on a taxpayer's applicable financial statements, subject to certain adjustments to reflect consolidated tax returns, the effect of Federal and foreign income taxes, and for other purposes) over the alternative minimum taxable income (prior to this adjustment) becomes an AMT preference.

   a. For taxable years beginning after December 31, 1986 and before January 1, 1990, one-half of such excess is a preference.

   b. For taxable years beginning after December 31, 1989, pre-tax book income is replaced with earnings and profits, with certain adjustments.

VII. REAL ESTATE AND TAX SHELTER PROVISIONS.

A. At-Risk Rules.

1. Under present law, all losses from business and income-producing activities are subject to at-risk limitations under Sec. 465, I.R.C., other than certain corporate active
business activities and real estate activities (other than real
estate used in certain specified activities under Sec. 465(c)(1),
I.R.C.).

2. Real estate, which traditionally has been financed
in whole or in part with nonrecourse debt (in the case of real
estate held for investment or in a rental trade or business), has
included within its basis such nonrecourse debt for purposes of
calculating losses therefrom, subject to a number of Congression-
ally- or judicially-imposed rules, including:

   a. In the case of a partnership,

      (1) The nonrecourse debt available for
          losses cannot exceed the fair market value of the property (Sec.
          752(c), I.R.C.); and

      (2) Such nonrecourse debt is allocated in
          accordance with shares of profits, under Inc. Tax Reg. §1.752-
          1(e), and is subject to the allocation rules of Sec. 704(b),
          I.R.C. (the "substantial economic effect" test).

   b. In the case of all ownership vehicles (in-
      cluding partnerships),

      (1) Speculative or contingent liabilities
          are not includable in basis until paid;

      (2) Cost basis cannot exceed fair market
          value at the time of acquisition;

      (3) Sham liabilities are not includable in
          basis; and

      (4) Where the context shows that an acquisi-
          tion subject to a nonrecourse debt is in fact only an "option",
          there is no basis until that option is exercised.

3. Under TRA 1986, the at-risk rules are extended to
real estate activities, effective with respect to property placed
in service after December 31, 1986 and for losses attributable to
an interest in a pass-through entity acquired after December 31,
1986.

   a. There is an exception for "qualified non-
      recourse financing", which includes:

      (1) Financing secured by real property used
          in the activity and loaned, with respect to the real property
          (other than mineral property), by

          (a) a Federal, state or local govern-
              ment or instrumentality thereof, or
(b) another person or entity and guaranteed by a Federal, state or local government, or

(c) a "qualified person"

(2) A "qualified person"

(a) Includes any person actively and regularly engaged in the business of lending money, such as

(i) a bank,

(ii) savings and loan association,

(iii) credit union,

(iv) insurance company,

--- regulated under Federal, state or local law, or

(v) a pension trust

(b) Does not include

(i) any person from which the taxpayer acquired the property (or a person related to such person); or

(ii) any person related to the taxpayer unless

(A) the terms of the loan are commercially reasonable, and

(B) the terms of the loan are substantially similar to those of loans made to unrelated parties; or

(iii) any person (such as a promoter) who receives a fee with respect to the taxpayer’s investment in the property (or a person related to such person).

(3) Nonrecourse financing means financing with respect to which no person is personally liable, except to the extent provided in Regulations.

(a) Remember that the Regulations under Sec. 752, I.R.C., relating to sharing of recourse and nonrecourse liabilities by partners, are to be revised as a result of TRA 1984 to take account of true economic risk of loss.

(b) The Regulations are to focus on the circumstances under 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 as qualified nonrecourse financing.

b. Real estate ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture, provided that (as noted above):

(1) The lender is not the seller; or
(2) Where the lender is related to the venture
(a) The terms of the financing are commercially reasonable; and
(b) The terms of the financing are substantially similar to those of loans made to unrelated parties.

c. Significant limits on the concept of "commercial reasonableness" are imposed.

(1) The Conference Report states that it is likely that a loan which would be treated as a "below-market loan" under Sec. 7872(e), I.R.C., is not commercially reasonable.

(2) It also states that an interest rate would not be considered commercially reasonable if it were contingent.

(3) But a floating rate tied to a major commercial bank's prime rate, LIBOR, government securities rates or the applicable Federal rate would be acceptable even though not a fixed rate.

d. With respect to partnerships, partnership-level qualified nonrecourse financing may increase a partner's (including a limited partner's) amount at risk, determined in accordance with his share of the liability (under Sec. 752, I.R.C.), so long as the financing is qualified nonrecourse financing with respect to the partner as well as with respect to the partnership.

e. If property is transferred subject to a debt which was qualified nonrecourse financing in the hands of the original borrower, such debt may be considered in the same category as to the transferee, provided all the criteria for qualified nonrecourse financing are satisfied for that debt with respect to the transferee.
B. **Limitations on Passive Losses and Credits from Passive Activities.**

1. Under present law, subject to such overrides as the alternative minimum tax, the net investment interest limitation and the rules under Sec. 1231, I.R.C., there are no limitations on the ability of a taxpayer to use deductions or credits from one activity to offset income from other activities.

2. TRA 1986 makes a basic change in such ability to use losses or credits from one activity to offset income from other activities, turning upside-down and inside-out the layers of learning from the past many years.

3. Generally, TRA 1986 provides that losses from "passive activities", to the extent that they exceed income from all such activities (exclusive of "portfolio income"), may not offset other income of the taxpayer (such as salary, interest, dividends and active business income). Deductions from passive activities may be used to offset income from passive activities.

   a. Similarly, credits from passive activities are generally limited to the tax attributable to passive activity income.

   b. Disallowed losses and credits are carried forward and treated as deductions and credits from passive trade or business or profit-seeking (even though not trade or business, but considered investment, or Sec. 212, I.R.C.) activities (again, offsetable only against passive income) in the next taxable year(s).

   c. Any remaining suspended losses from an activity are allowed in full when the taxpayer disposes of his entire interest in the activity in a taxable transaction. Credits are not so allowed upon disposition.

4. As an overview, the following should be noted:

   a. Individuals, trusts, estates, personal service corporations (except where the owner-employees own, together, less than 10%, by value, of the corporation's stock) and closely held C corporations are subject to the passive loss limitations.

   b. Special application rules

      (1) Limit the use of passive activity losses to offsetting net active income, not including portfolio income, in the case of closely-held corporations;

      (2) Apply to rental activities (where primarily for the use of tangible property), which are passive activities under the provision; and
(3) Enable losses from working interests in oil and gas properties not to be limited by the provision.

c. The passive loss limitation is effective for interests in passive activities acquired after the date of enactment of TRA 1986, with a phase-in (applicable only to interests acquired on or before the date of enactment) over 5 years as follows:

(1) 1987 -- 35% disallowed as an offset to non-passive income
(2) 1988 -- 60% disallowed
(3) 1989 -- 80% disallowed
(4) 1990 -- 90% disallowed
(5) 1991 and thereafter -- 100% disallowed

5. Contrary to what might be expected, a "passive activity" is one which involves the conduct of a trade or business or is a profit-seeking activity (includes a net lease of real property), if the taxpayer does not "materially participate" in the activity.

a. A limited partner interest is treated as intrinsically passive (except as may be provided in Regulations).

(1) The intention is that it not be necessary to examine the facts and circumstances involving the limited partner.

(2) A share of partnership income or a guaranteed payment to a partner (including, here, a limited partner) attributable to the performance of personal services is not to be treated as passive.

(3) Portfolio income of a partnership is not treated as passive.

b. A passive activity includes any rental activity, whether or not the taxpayer materially participates.

(1) Operating a hotel or similar transient lodging, where substantial services are provided, is not a rental activity. (Accordingly, the hotel operation would be considered a trade or business, subjecting any owner who does not materially participate to the passive loss rules.)

(2) Activity as a dealer in real estate is not generally treated as a rental activity.
c. "Material participation" means that the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis.

(1) Again, a limited partner (who is generally precluded from participating in the partnership business if he is to retain limited liability status) cannot be considered a material participant.

(a) The presumption that a limited partner interest is passive applies even though the taxpayer owns the limited partner interest through a tiered entity.

(b) When a taxpayer owns both a general partner interest and a limited partner interest, lack of material participation is conclusively presumed as to the limited partner interest (thereby limiting the use of an allocable share of deductions and credits).

(c) On the other hand, the Treasury is empowered to issue regulations setting forth circumstances under which a limited partner interest will not be considered as a passive activity interest, in order to eliminate manipulation of the general rule that a limited partner interest is passive.

(2) Again, rental activities, including net leases of property, are passive activities whether or not the taxpayer materially participates.

(a) The rental activity may include the performance of incidental services (such as a laundry room in a rental apartment building).

(b) If a sufficient amount of services are rendered, they may rise to the level of a separate activity, or (as in the case of a hotel) the entire activity may not constitute a rental activity.

(3) Material participation of a taxpayer is determined on a year-by-year basis.

(4) Material participation takes into account the following factors:

(a) The individual’s involvement must relate to operations.

(b) Most likely the involvement in the activity will be the taxpayer’s principal business, although this is not conclusive.

(i) An individual may materially participate in more than one business activity, and
(ii) An individual who does not work or is retired might not materially participate in any business activities.

(c) There must be considered whether, and how regularly, the taxpayer is present at the place or places where the principal operations of the business activity are conducted.

(d) A merely formal and nominal participation in management, in the absence of a genuine exercise of independent discretion and judgment, does not constitute material participation.

(e) The fact that a taxpayer uses employees or contract services to perform daily functions in running the business does not prevent qualifying, but such services of others are not attributable to the taxpayer, who must still qualify based on his own services.

6. While rental real estate activities are treated as passive without regard to whether the taxpayer materially participates, there is a relief provision specifically targeted toward individuals in the "middle"-income brackets. This provision creates an "active participation" test, under which $25,000 of losses and credits may be utilized against other income.

   a. This relief is available only to individuals (including the estate of such an individual for 2 years following his or her death).

   b. The $25,000 allowance is applied by first netting income and loss from all of the taxpayer’s rental real estate activities in which he actively participates.

   c. The $25,000 is reduced, but not below zero, by 50% of the amount by which the taxpayer’s adjusted gross income exceeds $100,000, thus eliminating such amount entirely at $150,000 of adjusted gross income.

   d. The taxpayer (together with the taxpayer’s spouse, whether or not a joint return is filed) must own at least 10% (by value) of all interests in the activity.

   e. "Active participation" is a lesser standard than material participation. Active participation can be satisfied without regular, continuous and substantial involvement in operations, so long as the taxpayer participates in a significant and bona fide sense in such roles as the making of management decisions (such as approving new tenants, deciding on rental terms and approving capital or repair expenditures) or arranging for others to provide services (such as repairs or maintenance).
7. The scope of a particular "activity" has to be carefully examined.

   a. If two undertakings are part of the same activity, the taxpayer need only establish material participation with respect to the activity as a whole, whereas if they are separate activities, he must establish such participation separately for each.

   b. The determination of what is a separate activity is intended to be made in a realistic economic sense, with a focus on what undertakings constitute an integrated and interrelated economic unit, conducted in coordination with or reliance on each other, and constituting an appropriate unit for the measure of gain or loss.

   c. Generally, providing two or more substantially different products or services involves engaging in more than one activity (unless the activities, as indicated by normal commercial practices, are customarily or for business reasons provided together, for example the sections of a department store).

   d. The fact that two undertakings involve the same products or services does not establish that they are part of the same activity absent the requisite degree of economic interrelationship or integration.

   e. The fact that two undertakings are conducted by the same legal entity does not establish that they are part of the same activity; on the other hand, the fact that two undertakings are conducted by different entities does not establish that they are different activities.

8. With respect to the rehabilitation tax credit and low-income housing credit, there is a special allowance and phase-out against non-passive income (unrelated to the $25,000 rental real estate activity allowance and phase-out), regardless of whether the taxpayer actively participates in the activity generating the credits.

   a. The allowance for each is the tax on up to $25,000 of non-passive income.

   b. The phase-out is 50% of the adjusted gross income (disregarding passive losses) above $200,000 resulting in a total phase-out of the credit at $250,000 of adjusted gross income.

   c. As to the low-income housing credit only, the exception applies only to property placed in service before 1990, with the exception of property placed in service before 1991 as to which 10% or more of the total project costs are incurred before 1989.
VIII. COMPLIANCE AND PENALTIES.

A. Information Reporting on Real Estate Transactions.

1. Congress was concerned that a large number of real estate transactions that should be reported on tax returns are not being reported.

2. TRA 1986 requires that, effective with respect to closings on or after January 1, 1987, real estate transactions must be reported.
   a. Form 1099 will be the reporting mechanism.
   b. Reporting will be required whether or not Treasury has issued Regulations. Treasury is to provide guidance to taxpayers on accomplishing this information reporting before the provision's effective date.
   c. Penalties will apply for failure timely to report.

3. Responsibility for reporting the transaction is according to the following order:
   a. The title company, settlement attorney or other person responsible for closing the transaction. Treasury may issue uniform rules to determine which of the persons involved with the closing is the one with primary responsibility for the information reporting.
   b. If there is no person responsible for closing the transaction, the mortgage lender reports; provided that, if there is more than one, the primary mortgage lender does the reporting.
   c. The seller's real estate broker (including a representative or agent).
   d. The buyer's real estate broker (including a representative or agent).
   e. Any other person designated in Treasury Regulations.

B. Tax Shelters.

1. The tax shelter ratio computation used to determine whether a tax shelter must be registered (under Sec. 6111, I.R.C.) with the I.R.S. is conformed more closely to the new tax rate schedules.
2. Effective on the date of enactment of TRA 1986, penalties are increased for:

   a. Failure to register a tax shelter (under Sec. 6111, I.R.C.);

   b. Failure to report a tax shelter identification number (under Sec. 6707(b), I.R.C.); and

   c. Failure to maintain lists of tax shelter investors (under Secs. 6112 and 6708, I.R.C.)

3. Sham or fraudulent transactions are subject to the increased rate of interest (120%) on underpayments of tax attributable to tax-motivated transactions, under Sec. 6621(d), I.R.C., effective as to interest accruing after December 31, 1984.

C. Penalty for Substantial Underpayment of Tax Liability.

1. The penalty for substantial understatement of tax liability (under Sec. 6661, I.R.C.) is increased from 10% to 20% of the amount of underpayment of tax attributable to the understatement.

2. The increase is effective for returns the due date of which (determined without regard to extensions) is after December 31, 1986.

IX. THE REHABILITATION TAX CREDIT.

A. Under present law, the rehabilitation tax credit system operates generally as follows:

1. There is a three-tiered system (under Sec. 46(a)(2)(F), I.R.C.):

   a. 30-year buildings -- 15% credit

   b. 40-year buildings -- 20% credit

   c. certified historic structures -- 25% credit

2. A "certified historic structure" is (under Sec. 48(g)(3), I.R.C.) a building (and its structural components) which is (i) listed in the National Register or (ii) located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.

3. The credit applies to the basis of the property attributable to "qualified rehabilitation expenditures", which are amounts chargeable to capital account for real property subject to the applicable real property accelerated cost recovery
period (15, 18 or 19 years, as the case may be, depending on when the property is or was placed in service) and incurred in connection with the rehabilitation of a "qualified rehabilitated building".

4. A "qualified rehabilitated building" is any building (and its structural components) which

a. has been substantially rehabilitated [that is, during a 24-month (or, in the case of phased rehabilitations, a 60-month) period the qualified rehabilitation expenditures exceed the greater of (i) the adjusted basis of the building (and its structural components) or (ii) $5,000];

b. if other than a certified historic structure, was placed in service at some time at least 30 years before the beginning of the rehabilitation (whether in service or empty immediately before the rehabilitation was commenced); and

c. meets an external wall test, which is either

(1) that 75% or more of the existing external walls are retained in place as external walls in the rehabilitation process, or

(2) that 75% or more of the existing external walls are retained in place as internal or external walls, with at least 50% or more of such existing external walls retained in place as external walls, and with 75% or more of the existing internal structural framework of such building retained in place.

5. The adjusted basis of the building is reduced by 100% of the credit taken with respect to 30-year and 40-year buildings and 50% of the credit taken with respect to certified historic structures.

B. TRA 1986 makes several significant changes in the rehabilitation tax credit system, while leaving the rehabilitation of a certified historic structure as a tax-advantaged real estate investment.

1. Under TRA 1986, there will be a two-tiered system:

a. buildings (other than certified historic structures) placed in service before 1936 -- 10% credit

b. certified historic structures (whenever placed in service) -- 20% credit

2. The only external wall test retained is that noted under §A4c(2) above. This test does not apply to certified historic structures.
a. Unlike the situation that can occur under present law, a building that is completely gutted cannot [generally] qualify for the rehabilitation credit.

b. A building's internal structural framework includes, generally, all load-bearing internal walls and any other internal structural supports, including the columns, girder, beams, trusses, spandrels, and all other members that are essential to the stability of the building.

3. Even in the case of certified historic structures, the adjusted basis of the building is reduced by 100% of the credit taken.

4. As to the interface of the rehabilitation tax credit with the passive loss limitation rules, see discussion of the same above.

5. The TRA 1986 changes are applicable to property placed in service after December 31, 1986. Generally, a transitional rule provides that the rehabilitation credit modifications (as well as the ACRS changes) will not apply to property placed in service before January 1, 1994, if such property is placed in service as part of a rehabilitation which was completed pursuant to a written contract binding on March 1, 1986. However, even though the transitional rule may apply, if such property is placed in service after December 31, 1986, the applicable credit percentages are reduced from 25, 20 and 15 to 20, 13 and 10, respectively, and the 100% reduction of basis is required.

X. THE LOW-INCOME HOUSING TAX CREDIT.

A. Under present law, there is no low-income housing credit, although several other provisions relate to, and are intended to induce the construction, rehabilitation and ownership of, low- and moderate-income housing.

1. Tax-exempt bonds may be used to finance multifamily residential rental property if at least 20% (15% in targeted areas) of the housing units are occupied by individuals whose income does not exceed 80% of the area median income when they first occupy the units.

2. Low-income rental housing is subject to 15 year ACRS using the 200% declining balance method.

3. Certain qualifying expenditures (up to $20,000 per dwelling unit, or $40,000 in certain situations) for additions or improvements to low-income rental housing with a useful life of 5 years or more may, at the taxpayer's election, be amortized over 60 months.
4. Construction-period interest and taxes may be currently deducted, and need not be capitalized and amortized over 10 years.

B. TRA 1986 eliminates all of the above provisions benefiting low- and moderate-income housing other than the tax-exempt bond rules (which are impacted by several changes) and replaces them, effective for property placed in service after December 31, 1986, with tax credits for new construction of low-income housing, rehabilitation of low-income housing and certain costs of acquisition of existing housing to serve low-income individuals.

1. The credits are claimed annually for a period of 10 years.

2. The annual credit has a maximum rate for property placed in service in 1987 of

   a. 9% for new construction (70% present value credit),
   b. 9% for rehabilitation (70% present value credit), and
   c. 4% for the acquisition cost of existing housing (30% present value credit).

3. The credit applies only with respect to expenditures on the low-income units.

4. As to new construction or rehabilitation, the expenditures must exceed $2,000 per low-income unit.

5. The states issue the credits. Each state is permitted to issue low-income rental housing tax credits in an amount equal to $1.25 per resident of the state.

   a. At least 10% of the credit authority must be reserved for projects developed by certain non-profit organizations, one of the exempt purposes of which is the fostering of low-income housing.

   b. The credit authority is sufficient to cover about $14 per capita of new construction or rehabilitation expenditures (for property not receiving other Federal subsidiaries) and $42 per capita of acquisition cost.

6. As to the interface of the low-income tax credit with the passive loss limitation rules, see discussion of the same above.
XI. REAL ESTATE INVESTMENT TRUSTS.

A. The real estate investment trust ("REIT") is an entity which receives most of its income from passive real estate-related investments and receives conduit treatment for income distributed to its shareholders.

1. If the entity meets the tests for REIT status (which relate to organizational structure, source of income, nature of assets and distribution of income), the income distributed to its shareholders each year is taxed to them without being taxed at the REIT level; the REIT in turn is subject to corporate tax only on income it retains and on certain income from property that constitutes "foreclosure property".

2. The REIT focus is intended to be passive, and its income is intended to be passive income from passive real estate investments.

B. Under TRA 1986, the REIT, as compared with other real estate investment vehicles, has an enhanced "most-favored nation" status. It must be remembered, however, that the underlying assets and management remain the key to the person considering an investment as a REIT shareholder.

C. Effective for taxable years beginning after December 31, 1986, the following key changes are made by TRA 1986:

1. In the first year of REIT status, the REIT is relieved from the 100 shareholder requirement and the non-potential of personal holding company status (based on the share ownership) requirement, if the entity otherwise meets the applicable REIT requirements.

2. In the first year after a REIT receives new equity capital, income derived from stock or debt instruments (that is, interest, dividends or gains from the sale thereof) attributable to the temporary investment of the new equity capital is treated as qualifying income under the "75% income test" and the "95% income test". Any such stock or debt instruments so purchased are treated as "real estate assets" for purposes of the "75% asset test".

3. The REIT need no longer use an independent contractor for the performance of certain services in order to assure the status of income from the rental of property as "rents" from real property.

   a. Such services are those which would not constitute "unrelated business income" (under Sec. 512(b)(3), I.R.C.) by an otherwise tax-exempt organization.
b. **Caveat** - only services which are not considered rendered to the occupant of the property will qualify, under Treas. Reg. §1.512(b)-1(c)(5).

(1) Services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

(2) Maid service is considered rendered to the occupant; on the other hand, the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, and the collection of trash are not considered services rendered to the occupant.

4. Rents from real property will now include rents based on the net income of the tenant, so long as the rents are received from a tenant that receives substantially all of its income from the leased property (or, as to the parallel test for interest, the property that secures the loan) from the subleasing (or leasing) of substantially all such property, and the rent received by the tenant consists entirely of amounts that would be treated as rents from real property if received directly by the REIT.

5. The minimum amount the REIT is required to distribute each year is reduced by certain amounts the REIT is required to include in income in advance of receiving cash.

a. These include (i) amounts under rental agreements with deferred rents (under Sec. 467, I.R.C.) and (ii) original issue discount with respect to a loan to which Sec. 1274, I.R.C. applies.

b. The REIT must itself pay tax on amounts not so distributed.

XII. **REAL ESTATE MORTGAGE INVESTMENT COMPANY.**

A. TRA 1986 establishes a new vehicle -- the real estate mortgage investment company ("REMIC") -- for the issuance of multiple class mortgage-backed securities, with respect to taxable years beginning after December 31, 1986.

1. Any entity, including a corporation, association, partnership or trust, can elect REMIC treatment upon meeting specified requirements. A segregated pool of assets may also qualify as a REMIC.

2. Substantially all of the assets of the REMIC must consist of:

a. "Qualified mortgages", which are
(i) obligations (including participations or certificates of beneficial interest therein) principally secured directly or indirectly by an interest in real property and that are either transferred to the REMIC on or before "startup day" (which is any day that is on or before the first day on which REMIC interests are issued) or are purchased by the REMIC within three months of startup,

(ii) "qualified replacement mortgages" (which are "qualified mortgages" received in exchange for a defective qualified mortgage within 2 years of startup or in exchange for any other qualified mortgage within 3 months of startup), and

(iii) "regular interests" in another REMIC transferred to the REMIC on or before startup; or

b. "Permitted investments", which are

(i) "cash flow investments" -- that is, any temporary investment of amounts received under qualified mortgages before distribution to REMIC interest holders (these temporary investments are limited to those types that produce passive income in the nature of interest, such as the guaranteed investment contract),

(ii) "qualified reserve assets" -- that is, any intangible property held for investment as part of a "qualified reserve fund" to provide additional security for payments of both certain expenses and those due on regular interests in the REMIC, in case of delay or default on a qualified mortgage, and

(iii) "foreclosure properties", which would fall under Sec. 856(e), I.R.C. if acquired by a REIT and which cease to be foreclosure property one year after its acquisition by the REMIC.

3. All of the ownership interests in the REMIC must be either "regular interests" or "residential interests", or both.

a. A "regular interest" is one the terms of which are fixed on startup day, as follows:

(i) the holder is entitled to receive a specified principal (or similar) amount, and

(ii) interest (or similar) payments, if any, at or before maturity are based on a fixed or, to the extent provided in Regulations, a variable rate. A REMIC interest may qualify as a regular interest where the timing, but not amount, of principal or similar payments is contingent upon the extent of prepayments on qualified mortgages and income from permitted
investments. A REMIC interest may not qualify as solely a regular interest if the amount of interest is disproportionate to the specified principal amount.

b. A "residual interest" is any interest in the REMIC other than a regular interest, provided that:

(i) such residual interest is so designated by the REMIC and there is only one class of such interest, and

(ii) all distributions, if any, with respect to such interests are pro rata.

B. The transferor to a REMIC recognizes no gain or loss on the transfer of qualified mortgages or other property in exchange for regular interests or residual interests in the REMIC.

1. The adjusted bases of the regular or residual interests received by the transferor are equal to the aggregate bases of the property transferred.

2. The aggregate basis of the interests is allocated among the regular or residual interests received in proportion to their fair market values.

3. The basis of any property received by a REMIC in exchange for regular or residual interests is equal to the fair market value at transfer or at an earlier time provided by Regulations.

C. Generally, a REMIC is not a taxable entity for Federal income tax purposes. This pass-through status applies regardless of whether the REMIC otherwise would be treated as a corporation, partnership, trust or other entity.

1. However, a REMIC is subject to a tax equal to 100% of its net income from prohibited transactions. This net income is computed without taking into account any losses from such prohibited transactions, which include:

a. The disposition of any cash flow investment other than pursuant to a qualified liquidation;

b. The receipt of any income from assets other than assets permitted to be held by a REMIC;

c. The receipt of any compensation for services; and

d. The disposition of any qualified mortgage other than pursuant to

(i) the substitution of a qualified replacement mortgage for a defective qualified mortgage,
(ii) the bankruptcy or insolvency of the REMIC,

(iii) a disposition incident to the foreclosure or default of a mortgage,

(iv) a qualified liquidation, and

(v) a situation where such disposition is required to prevent default on a regular interest due to the default of one or more qualified mortgages.

2. Generally, holders of regular interests are taxed as if the regular interest were a debt instrument. The holder is required to account for income relating to such interest under the accrual method.

   a. A holder's basis in the regular interest is equal to the holder's cost therefor, but in the case of interests received in exchange for property, the basis is equal to the basis of the property exchanged.

   b. Gain on the disposition of a regular interest is treated as ordinary income to the extent of a portion, as defined in the Regulations, of unaccrued OID with respect to the interest.

3. At the end of each calendar quarter, the holder of a residual interest in a REMIC takes into account, as ordinary income or loss, the daily portion of the taxable income or net loss of the REMIC for each day during the holder's taxable year. The daily portion is determined by allocating to each day in a calendar quarter a ratable portion of the REMIC's taxable income or net loss for such quarter and allocating such amounts among the holders in proportion to their respective holdings on such day.

   a. REMIC distributions are not included in the gross income of the residual holder to the extent that they do not exceed the adjusted basis of the interest. To the extent that the adjusted basis of the interest is exceeded, the excess is treated as gain from the sale of the residual interest.

   b. The net loss of the REMIC that may be taken into account by the holder of a residual interest is limited to the adjusted basis of the interest at the close of the quarter or, if earlier, the time of disposition of the interest. Any loss disallowed because of this limitation may be carried over indefinitely but may be used only to offset income generated by the same REMIC.

   c. Where a residual interest is received in exchange for property, any excess of the issue price of the
residual interest over the basis of the interest held by the
transferor of the property immediately after transfer is amor-
tized and included in the residual holder’s income on a straight-
line basis over the REMIC’s expected life.

d. The wash sale rules (Sec. 1091, I.R.C.) apply
to dispositions of residual interests where the seller acquires,
during the period within 6 months before or after such sale or
disposition, any residual interest in any REMIC or any interest
in a “taxable mortgage pool” (to be discussed) that is comparable
to a residual interest.

e. In the case of certain thrift institutions, a
special exception is provided from the rule requiring that net
operating losses of a holder of residual interests may not offset
a portion of the net income of the REMIC taken into account.

D. If a REMIC adopts a plan of complete liquidation
and sells all of its non-cash assets within 90 days of the date
of the plan’s adoption, the REMIC recognizes no gain or loss on
the sale of its assets, provided, additionally, that the REMIC
distributes all of the sales proceeds plus its cash (other than
amounts retained to meet claims) to holders of regular and resid-
ual interests within that same 90-day period.

E. REMICs are the exclusive means of issuing mul-
tiple class real estate mortgage-backed securities without the
imposition of two levels of taxation. Thus, a “taxable mortgage
pool” (“TMP”) is treated as a taxable corporation that is not an
includable corporation for purposes of filing consolidated re-
turns.

1. A TMP is any entity other than a REMIC if:

   a. substantially all of the assets consist
      of debt obligations (or interests in debt obligations) and over
      50% of such obligations (or interests) consist of real estate
      mortgages;

   b. such entity is the obligor under debt
      obligations with 2 or more maturities; and

   c. under the terms of such debt obligations
      where the entity is the obligor, payment on such obligations
      bears a relationship to payments on the debt obligations, or
      interests therein, held by the entity.

2. Any portion of an entity meeting the defini-
tion of a TMP will be treated as such, and the provisions will
apply to any arrangement under which mortgages are segregated
from a debtor’s business activities (if any) for the benefit of
creditors whose loans are of varying maturities.
3. Upon meeting the applicable requirements, an entity that otherwise would be treated as a TMP may elect to be treated as a REIT.

4. TMP provisions do not apply to any entity in existence on December 31, 1991 unless there is a substantial transfer of cash or property to such entity (other than in payment of obligations held by the entity) after such date. However, for purposes of the wash sale rules, TMP provisions apply to any interest in any entity in existence after December 31, 1986.
RECENT CASES AND RULINGS

Section 163, I.R.C.

[1] Interest on Non-Recourse Wraparound Notes Not Deductible Where Transaction Structured Solely to Produce Large Interest Deductions Without Any Other Independent Business Purpose

In *Landry v. Comm'r.*, 86 T.C. ___, No. 76 (1986), the taxpayer was denied deductions claimed for interest allocated to him by a limited partnership in connection with the limited partnership's execution of a non-recourse wraparound note.

Taxpayer was a limited partner in *W* limited partnership formed for the purpose of constructing and managing an apartment project. *W* contracted with *J* for the construction of the project. The project was to be constructed in two phases, and *W* gave *J* a down payment in cash and executed wraparound notes in favor of *J* for the remainder of the purchase price. Because the wraparound notes did not have a stated interest rate, *W* was required to allocate part of its payments on such notes as interest expense.

The Tax Court found that, although *W* and *J* had entered into arms'-length negotiations to determine the total purchase price for construction of the project, the negotiation of the wraparound notes was not conducted at arms'-length; therefore, the amounts allocated by *W* to the payment of interest had no basis in economic reality.

After stating that a taxpayer will not be denied the benefit of a tax deduction merely because he made a bad bargain or did not structure the transaction in the most cost-efficient manner, the Tax Court held that, in light of the experience of *W*'s general partners and the interest rates that the partnership had negotiated in other agreements, the interest allocated by the partnership was clearly excessive. In addition, the Tax Court found that the wraparound notes were contrived solely to produce the largest interest deductions possible and served no other independent business purpose. Finally, the Tax Court found that, because there were other methods in which the transaction could have been arranged in which the partnership would have been required to pay no interest, the taxpayer was disallowed deductions for all of the interest claimed; therefore, the taxpayer was required to capitalize such amounts.

[2] Deduction for Interest "Prepayment" Denied Limited Partner Where Partnership's Prepayment of Interest to Lender Was in Amount Equal to 50% of Loan Principal

In Priv. Ltr. Rul 8633001 the Service ruled that a limited partnership's prepayment of interest on a note in an amount that equaled approximately 50% of the principal at the time of the
note's execution is not interest in substance and may not be accrued and deducted as interest.

E, the taxpayer, is a limited partnership that was formed by D, a corporation specializing in acquiring and managing investment real estate. E purchased a particular parcel of commercial real estate from D by making a $506 cash down-payment, executing a 30 year non-recourse wraparound note and mortgage in the amount of $2,379,504 and making an interest prepayment in the amount of $1,028,595. This was allocated over the first five years of the loan.

The Service denied the deductibility of this prepayment of interest on two alternative grounds. First, the Service ruled that the interest prepayment is not interest in substance due to the fact that it "is not commercially reasonable to expect a borrower to pay interest of nearly 50 percent of the principal at the time of execution of the note." The Service commented that it "is difficult to conceive of a payment this large representing a charge for the use or forbearance of money." Second, the Service ruled that, even if such prepayment was considered to be interest, the allocation distorts the limited partnership's income; therefore, this allocation does not clearly reflect income. Pursuant to Sec. 446, I.R.C., the Service is entitled to correct the taxpayer's method of accounting and disallow certain deductions in order to clearly reflect the income of the taxpayer. The Service analyzed the losses at issue and determined that, if the prepayment were interest, no deduction would be permitted in excess of amounts properly allocated using the economic accrual method of computing interest allocations. For more on the economic accrual method, see Rev. Rul. 83-84, 1983-1 C.B. 97, dealing with the Rule of 78's.

Section 465, I.R.C.


In Abramson v. Comm'r, 86 T.C. 360 (1986), the Tax Court held that limited partners of a partnership formed for the purpose of engaging in a motion picture production were at risk on an otherwise non-recourse promissory note where, as part of a transaction, each limited partner executed a "Guarantee Agreement" with the lender in which such limited partner agreed to pay to the lender the percentage of the note still outstanding in 10 years that was proportionate to his interest in the partnership.

The Tax Court reasoned that, because each limited partner was "directly and ultimately liable" for the partnership debt, the limited partners did not have the protection against economic loss that Congress had in mind when enacting the "at risk" rules. The Court distinguished Pritchett v. Comm'r, 85 T.C. 580 (1985). In Pritchett, the limited partners were not, as a technical
matter, directly liable to the lender on the partnership debt; rather, the general partners were personally liable to the lender on the recourse obligation, while the limited partners were only obligated to make additional contributions to the partnership if the partnership was not able to pay off the recourse note. The Tax Court held that, because the limited partners in Pritchett were not directly and ultimately liable to the lender, they were not "at risk" within the meaning of Sec. 465(b)(2), I.R.C. In Abramson, the Tax Court found that the limited partners were directly and ultimately liable to the lender, and so were "at risk".


In Priv. Ltr. Rul. 8636003 the Service held that a limited partner in a limited partnership formed to engage in oil and gas exploration and production was "at risk" within the meaning of Sec. 465, I.R.C. where each limited partner, as part of the contribution to obtain the partnership interest, executed an irrevocable Letter of Credit and an Assumption Agreement.

The Letters of Credit and Assumption Agreements were pledged by the partnership as security for a bank loan. The Letter of Credit reflected an irrevocable and unconditional promise to pay the lending bank or reimburse the partnership with respect to the loan payments.

The Service found that the limited partners were personally liable to repay their pro rata shares of the loan and that the lending bank could seek satisfaction directly from the limited partners. The Service held that the limited partners ultimately bore the economic risk associated with the repayment of the loan because the lender could bring a legal action to enforce the limited partners' promise to pay the loan pursuant to the Assumption Agreement and the Loan Agreement. Therefore, the limited partners were "at risk" within the meaning of Sec. 465, I.R.C. to the extent of the face amount of the Letter of Credit that was contributed to the partnership.

NOTE: The identical fact pattern contained in this ruling was presented for review in Priv. Ltr. Rul. 8404012. The Service there found it unnecessary to consider whether the limited partners were "at risk" pursuant to Sec. 465 because the Service held that, pursuant to Sec. 752, I.R.C., the limited partners did not have basis in their partnership interests as a result of their contribution of the Letters of Credit and Assumption Agreements. Accordingly, in Priv. Ltr. Rul. 8636003, the Service withdrew its ruling in Priv. Ltr. Rul 8404012 and placed the Sec. 752 basis issue under further review.
Taxpayer Not "At Risk" on Recourse Obligation Convertible to Non-Recourse Obligation Where Taxpayer "Effectively Immunized" from Loss During Recourse Period

In Porreca v. Comm'r, 86 T.C. 821 (1986), the Tax Court held the taxpayer was not "at risk" for purposes of Sec. 465, I.R.C. on a recourse note which was convertible to a non-recourse note after 5 years, where such note only required a nominal payment to avoid default during the time period in which the note was recourse.

Taxpayer purchased all rights to the distribution and sale of 6 episodes of 2 television programs. The promissory notes taxpayer signed in connection with the purchase were labeled "recourse" promissory notes and purported to make taxpayer personally liable thereon. During the initial 5-year term of the obligation, however, only nominal payments were required to be made to avoid default. At the end of the initial 5-year term, the promissory notes could be converted by taxpayer to non-recourse liabilities by the payment of $1,000 per note.

Sec. 465, among other things, provides that where an individual invests in motion picture films or television videotapes, any loss from such investment for a taxable year is deductible only to the extent that the taxpayer is "at risk" with respect to the activity at the close of the taxable year. In particular, Sec. 465(b)(4) provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements."

The Tax Court examined the legislative history behind Sec. 465 and concluded that the words "other similar arrangements" meant situations in which taxpayers are effectively immunized from any realistic possibility of suffering an economic loss even though the underlying transaction was not profitable. Accordingly, the Tax Court determined that the taxpayer was not "at risk" because he was effectively immunized from economic loss during the time period in which the notes were labeled "recourse". The Tax Court was particularly influenced by the facts that (i) the required payments during the first 5 years of the note were nominal; (ii) the taxpayer had the right to make up any delinquency in such nominal payments at the end of the 5-year period; and (iii) the taxpayer had the unilateral right to convert the promissory notes to non-recourse at the end of the 5-year period upon the payment of a nominal conversion fee.

For another recent case analyzing the "other similar arrangement" language of Sec. 465(b)(4), see Capek v. Comm'r, 86 T.C. 14 (1986).
Borrowed Amounts Not Considered “At Risk” with Respect to Activity if Lender Has 50% Net Profits Interest in Borrower’s Franchise

In Waddell v. Comm’r, 86 T.C. 848 (1986), the Tax Court held, among other things that the taxpayer was not “at risk” for amounts borrowed from a lender which had the right to at least 50% of the net profits in taxpayer’s borrowing entity.

Pursuant to Comp-U-Med’s offering circular, taxpayer applied for and purchased four franchises. Each franchise included the purchase of one of Comp-U-Med’s computerized electrocardiogram ("ECG") terminals. For each franchise and terminal, taxpayer paid $6,000 cash and executed a $25,000 promissory note. The notes were each for a 7-year term and labeled “recourse”; however, taxpayer’s only obligation during the initial 7-year term was to make a minimum payment of $1,500 per year, which was denominated as interest at the stated rate of 6% percent of the stated principal of $25,000. Any payments of principal prior to maturity would come only from Comp-U-Med’s right to 50% of the taxpayer’s net profits from each franchise. The notes could be renewed for an additional 7-year period if taxpayer had renewed the franchise. In addition, for the payment of $1,000 during the extended term, taxpayer could convert each note to non-recourse.

Comp-U-Med allocated $27,500 to the purchase price of each ECG terminal. Simultaneously with their application for the ECG franchise, taxpayers executed distribution agreements with independent medical equipment distributors for each of the terminals they were to acquire, and executed a management service contract with an independent firm.

The Tax Court held that the $25,000 note could not be recognized as true indebtedness for Federal income tax purposes because the likelihood that the note would be paid was too speculative according to its terms. The leading case in determining whether a non-recourse liability represents a genuine indebtedness for Federal income tax purposes is Estate of Franklin v. Comm’r, 544 F. 2d 1045 (9th Cir. 1976), aff’g on other grounds 64 T.C. 752 (1975). Under Estate of Franklin, the entire non-recourse debt is excludable from depreciable basis where the initial equity in the property fails to provide adequate security for the loan. The Estate of Franklin test should be satisfied if the borrower has a substantial initial equity even though later events indicate that there is very little, if any, likelihood that the note will be paid.

The Court indicated that adequate security at the inception of the transaction alone does not guarantee that the loans will be recognized for Federal income tax purposes. Rather, the proper focus in determining the likelihood of payment is “to look at the transaction based on the facts and circumstances at its inception — including reasonable revenue projections based on objective criteria and the value of the security at the time the
lender has a right to proceed against the security for payment—and determine whether it is likely that the note will be paid."

The Tax Court could not conclude at the outset of the transaction that payment of the note was likely, and so held that the note was too contingent to be recognized for Federal income tax purposes. Accordingly, the $1,500 minimum annual payment was not deductible as interest expense. The Tax Court found that the taxpayer paid $27,500 for each ECG terminal while the value was only $6,500, and, given the relevant market for Comp-U-Med franchises, no reasonable projection of revenue and expense could indicate that a Comp-U-Med franchise would generate enough cash so that the notes were likely to be paid.

Finally, the Tax Court applied the "at risk" rules to portions of the note which it considered to be genuine indebtedness. Under Sec. 465(b)(3)(A), I.R.C., a borrower is not considered "at risk" with respect to an activity if such amounts are borrowed from any person having an interest in such activity other than an interest as a creditor. The Court held that even the small amount of the original loans considered genuine did not put the taxpayer at risk because Comp-U-Med’s interest in taxpayer’s franchises was as a joint venturer (entitled to 50% of the net profits), rather than as a creditor.

[5] Ability to Transfer Property in Extinguishment for Note is Not At-Risk

In Rev. Rul. 85-113, 1985-2 C.B. 150, the service held that an investor is not at risk for a note that may be satisfied by transferring to the creditor property derived from an investment in mining activity, without any obligation that the investor pay the difference if the value of the property is less than the amount due on the note.

The taxpayer invested in the rights to mine units consisting of a specific number of cubic yards of ore which purportedly contained precious metals. Investor also signed a note with an affiliate of ore offering company to finance the cost of mining his unit. The note purports to make the investors personally liable for the payment of principal and interest on the note. The taxpayer, however, had the option to assign to the affiliate a right to 22 percent of the precious metals extracted from the taxpayer’s unit in full payment of the note.

The taxpayer did not have any income from the mining activity during 1983. On the taxpayer’s federal income tax return for 1983, the taxpayer claimed a deduction for mining development expenditures under Sec. 616(a) of the Code.

The taxpayer claims to be personally liable on the note to the affiliate. The taxpayer, however, had the option of completely satisfying all obligations on the note by transferring to the affiliate a right to 22 percent of the precious metals.
extracted from the taxpayer’s unit. Upon maturity of the note, if the value of this right is less than the balance due on the note, the taxpayer will have no obligation to pay the affiliate the difference. Under these circumstances, the note is essentially a nonrecourse obligation secured solely by a right to property derived from the activity. Thus, taxpayer is not at risk with respect to the funds borrowed from the affiliate and the taxpayer cannot claim a deduction under Sect. 465 for the money borrowed to develop the unit. Sect. 465(a)(1) of the Code provides that in the case of an individual engaged in an activity to which the Section applies any loss from the activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk for the activity at the close of the taxable year. In this case, taxpayer can only deduct the amount paid to the offering corporation for the mining rights.

Section 702, I.R.C.

Limited Partners Denied Deductions For Distributive Share of Partnership Losses Because Ownership of Property Had Not Transferred For Tax Purposes

In Smith, Jr. v. Comm’r, 50 TCM 1444 (1985), the Tax Court held that limited partners could not deduct their shares of losses from rental property because the general partner, and not the partnership, owned the building for Federal income tax purposes.

Georgetown University (“Georgetown”) had purchased an apartment building, renovated it into a dormitory and operated it at a loss for several years. Because it believed that the losses could adversely affect its fundraising efforts, Georgetown agreed to transfer the property to a limited partnership, of which it would be the sole general partner, in exchange for the partnership’s note. According to a formula by which Georgetown’s losses would be offset by interest payable on the partnership’s note to it and on its operating loans to the partnership, 80% of the partnership interests were allocated to the limited partners and 20% of the partnership interests were allocated to the general partner.

Under the partnership agreement, if the partnership could not make a cash payment, it would be treated as paid and then contributed by Georgetown to the capital of the partnership. If Georgetown decided to develop the property, the note and accrued interest would be contributed to the partnership, and Georgetown’s partnership interest would be increased to 51%. Georgetown managed the property, paid all its expenses, entered into leases as lessor, was registered as the legal owner and took legal action in its own name against tenants for lease violations. In addition, all licenses, insurance policies and tax returns for the property were in Georgetown’s name; the partnership’s existence was not disclosed.
The Tax Court held that, inasmuch as none of the benefits or burdens of ownership had transferred to the partnership, no sale had occurred; therefore, the limited partners of the partnership could not deduct their distributive share of losses from operation of the rental property pursuant to Sec. 702, I.R.C. The determination of whether the benefits and burdens of ownership have transferred is a factual one. The Tax Court stated that some of the factors to consider in making this determination are: (i) whether legal title passed; (ii) the manner in which the parties treated the transaction; (iii) whether the purchaser bears the risk of loss or damage to the property; (iv) whether and to what extent the purchaser has any control over the property; and (v) whether the purchaser acquired any equity in the property.

In the instant case, the partnership neither had record title nor made any decisions regarding the operation of the property. Georgetown dealt with all third parties as the owner; it did not disclose either the existence of the partnership or the nature of the partnership's interest in the property. As landlord and the party responsible for funding operating deficits, Georgetown bore the risks of loss or damage to the property. In addition, although it held only a minority interest in the partnership, Georgetown had veto power over all decisions concerning the property.

Finally, the Court found no business purpose for the partnership's existence. Georgetown did not transfer the property for its fair market value; rather, the property was transferred for an amount equal to Georgetown's then-existing investment. No payments were made on the notes or operating loans. The sole purpose of the transfer was to permit Georgetown to report loans rather than losses on its financial statements, although it continued to fund the losses.

Section 708, I.R.C.

[1] Section 754 Election Applies to Incoming Partner upon Sale of 50% Partnership Interest

In Rev. Rul. 86-73, 1986-20 I.R.B. 7, the Service ruled that a Section 754 election in effect upon the sale of a 50% interest in the partnership's capital and profits applies to the interest of the incoming partners for purposes of determining the adjusted basis upon the deemed distribution of partnership assets following a termination pursuant to Sec. 708(b)(1)(B), I.R.C.

A, a 50% partner of AB, a partnership, sold his interest to C. In the taxable year in which the sale occurred, AB had in effect an election under Sec. 754, I.R.C., and the fair market value of AB's property exceeded its adjusted basis. The issue decided was whether the Section 754 election applies to adjust the basis of partnership assets with respect to the incoming
partner before the constructive liquidation of the partnership
that occurs under Treas. Reg. §1.708-1(b)(1)(iv) or whether the
sale of the 50% interest to the incoming partner extinguishes the
Section 754 election before it can be applied.

The Service ruled that an existing Section 754 election
applies to the incoming partner with respect to the adjustment of
the partnership’s assets even though the partnership undergoes a
constructive liquidation. The Service supported its holding in
two ways. First, the Service looked to Secs. 732(b) and (c) and
743(b), I.R.C., and the Regulations thereunder, and determined
that the incoming purchaser is treated as a partner for purposes
of the deemed liquidation; therefore, a Section 754 election
ought to apply to the purchaser. Second, the Service cited the
legislative history of Sec. 743 for a specific example in which a
Section 754 election is applied to adjust the basis of partner-
ship assets when a 50% interest in a partnership is sold.

NOTE: Although the Section 754 election applies to the
interest of the incoming partner, if the new partnership wants a
Section 754 election to be in effect, it will have to file a new
election.

[2] No Termination Pursuant to Sec. 708(b) Where General
Partnership Converted to Limited Partnership

In Priv. Ltr. Rul. 8609021 the Service ruled that no termi-
nation had occurred for Federal income tax purposes upon the
conversion of a general partnership to a limited partnership.

X and Y were formed as general partnerships. A and B, two
individuals, each held a 49.5% interest and a corporation held a
1% interest in the capital and profits of both X and Y. The
partners entered into an agreement whereby X and Y will be con-
verted to limited partnerships. The corporation will be the
general partner and A and B will be the limited partners of X and
Y. Each partner will have the same capital and profits interest
in the limited partnerships as such partner had in each partner-
ship prior to the conversion.

The Service followed Rev. Rul. 84-52, 1984-1 C.B. 157, and
ruled that no termination had occurred because (i) the partner-
ship’s business would continue after the conversion and (ii)
under Treas. Reg. §1.708-1(b)(1)(ii), a transaction governed by
Sec. 721, I.R.C., as this transaction was, is not treated as a
sale or exchange for purposes of Sec. 708. Thus, because no sale
or exchange had occurred within the meaning of Sec. 708(b)(2), no
termination had occurred.
Section 752, I.R.C.

[1] Limited Partners Allowed to Increase Outside Bases Where Each Limited Partner Personally Guaranteed Share of Non-recourse Obligations

In Abramson v. Comm’r, 86 T.C. 360 (1986), the Tax Court held that, where limited partners personally guaranteed to pay their proportionate shares of an otherwise non-recourse obligation of the partnership, they were allowed to increase their bases by that amount. The taxpayers in Abramson were limited partners in a movie shelter. In connection with this activity, the partnership executed a non-recourse promissory note. As part of the transaction in which this note was executed, each limited partner executed a “Guarantee Agreement” with the lender in which he personally promised to pay to the lender the percentage of the note still outstanding in 10 years proportionate to his interest in the partnership.

In following the holding of Smith v. Comm’r, 84 T.C. 889 (1985), the Court stated that the test under Sec. 752, I.R.C. as to any increase of outside basis is whether the partner is “ultimately liable” for the debt. Thus, because the limited partners were the “equivalent of general partners to the extent of their pro rata guarantees”, the Court allowed the limited partners to increase their outside bases pursuant to Sec. 752.


In Priv. Ltr. Rul. 8636002 the Service withdrew its ruling in Priv. Ltr. Rul. 8404012. In the prior Ruling, the Service refused to permit limited partners to increase their outside bases, where, as part of their contributions to the partnership, the limited partners each executed an irrevocable Letter of Credit and an Assumption Agreement, both of which were pledged as security for a bank loan. In the prior Ruling, the Service found that the limited partners were personally liable to repay their pro rata shares of the loan, and that the lending bank could seek satisfaction directly from the limited partners; however, there the Service held that the obligation to make any additional contributions was too indefinite to permit the limited partners to increase their bases because the loan was not due for 4 years and might be paid by the partnership out of its income.

Possibly as a result of recent cases such as Smith v. Comm’r, 84 T.C. 889 (1985), and Abramson v. Comm’r, 86 T.C. 360 (1986) (discussed above), the Service has placed the issue decided in Priv. Ltr. Rul. 8404012 under review and, accordingly, has withdrawn its holding.
Section 1034

[1] Reinvestment of Coop Proceeds in Condominium

In Rev. Rul. 85-132, 1985-2 C.B. 182, the Service ruled that a tenant-stockholder in a housing corporation, as defined in Sec. 1034, will not recognize gain or loss upon the exchange of stock in a cooperative housing corporation for a condominium unit, subject to the limitations of Sec. 1034(a) and Treas. Reg. §1.1034-1.

The taxpayer was a tenant-stockholder in a cooperative housing corporation. The taxpayer and the other tenant-stockholder of the cooperative converted their equity interests from cooperative ownership to condominium ownership. Pursuant to the conversion plans the taxpayer surrendered all of his shares of stock in the cooperative and received legal title to the condominium unit that he occupied and an undivided interest in the common elements. The value of the condominium unit and A's undivided interest in the common elements exceeded the adjusted basis of A's stock in the cooperative.

Sec. 1034(a) of the Code provides that if property (the "old residence") used by the taxpayer as the taxpayer's principal residence is sold by the taxpayer and within the period beginning 2 years before the date of such sale and ending 2 years after such date, property (the "new residence") is purchased and used by the taxpayer as the taxpayer's principal residence, gain (if any) from such sale shall be recognized only to the extent that the taxpayer's adjusted sales price of the old residence exceeds the taxpayer's cost of purchasing the new residence.

Sec. 1034(f) of the Code provides, in part, that for purposes of Sec. 1034, references to property used by the taxpayer as the taxpayer's principal residence, and references to the residence of a taxpayer, shall include stock held by a tenant-stockholder in a cooperative housing corporation. Under Sect. 1034(f) of the Code, the cooperative stock is considered to be the taxpayer's principal residence for purposes of Sec. 1034(a) and an exchange of the taxpayer's residence for other property constituting a residence is considered to be a sale of a residence and a purchase of another residence under Sec. 1034(c) (1). Accordingly, based on the facts and circumstances presented, the exchange of the taxpayer's shares of stock in the cooperative for legal title to the condominium unit occupied by the taxpayer and an undivided interest in the common elements will qualify as a sale within the meaning of Sec. 1034(a), and no gain or loss will be recognized on such sale.

[2] Temporary Rental of Residence

In Bolaris v. Comm'r, 85-2 U.S.T.C. ¶9822 (9th Cir. 1985), the Court held that rental expense and depreciation deductions had been improperly denied to a homeowner who purchased a
replacement residence and temporarily rented his old residence to third parties while attempting to sell it.

The first issue examined by the Court was whether the Bolarises were entitled to delay recognition of gain on the sale of their home under Sec. 1034. On this point the Court held that the rental of the Bolarises' old home prior to its sale did not preclude the nonrecognition of gain realized on the sale of the old home.

The second issue addressed by the Court was whether the Bolarises should have been permitted deductions under Secs. 167 and 212 [Sec. 167 permits depreciation deductions for property held for the production of income. Sec. 212 permits deductions for insurance and miscellaneous maintenance expenses.]. The IRS argued that if the Bolarises were permitted both rental expense deductions and nonrecognition of gain would result in an improper "windfall" to the taxpayers. The Court held that since Congress had never drafted a code provision which sets forth that a residence which qualifies for nonrecognition of gain cannot also be held for production of income they could not imply one. The Court also held that the Bolarises were entitled to claim deductions under Secs. 167 and 212 because they had the requisite profit motive. In making this determination the Court applied a five factor test: (1) the length of time the house was occupied by the individual as his residence before placing it on the market for sale; (2) whether the individual permanently abandoned all further personal use of the house; (3) the character of the property; (4) offers to rent; and (5) offers to sell.