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Richard M. Leder

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TAX SHELTER REFORM

RICHARD M. LEDER

Introduction

Background

In its consideration of H.R. 10612, the House Ways and Means Committee identified six general types of activities as "tax shelters":

1. Real estate;
2. Oil and gas exploration;
3. Various farming activities, including the feeding and/or breeding of livestock;
4. Equipment leasing;
5. Motion picture films, both the so called "purchase in the can" transactions and production company transactions; and

To deal with these alleged tax shelter abuses, the House introduced the concept of "LAL" (limitation on artificial losses). In essence, under LAL, the deductions primarily responsible for generating the tax shelter deferral, such as prepaid feed expenses, intangible drilling costs, and construction period expenses in the case of real estate, were to be allowed only against related income from the particular activity (which included other similar activities in certain instances). Thus, the LAL provisions were quite onerous insofar as the activities they specifically covered. LAL was augmented in the House Bill by, among other things, a limited "at risk" provision, but LAL was by far the central theme.

The Senate rejected LAL for two principal reasons. The first was "its extreme complexity." The more important reason, however, was the very serious impact LAL would have had on the real estate and oil and gas industries.

Tax Reform Act

The Tax Reform Act of 1976 deals directly with each of the six specified tax shelters, but in a less onerous way generally. The manner in which the Act attacks shelters is broader, however, in many respects, and operates to curtail the benefits of some arguably tax shelter activities not dealt with under the House Bill.

The central provisions under the Act in the attack on tax shelters are the so-called "at risk" provisions. The primary "at risk" provision

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1 Section 207 of the House Bill would have added an "at risk" limitation covering all taxpayers (including corporations), but which would have been applicable only to motion picture films, the raising of livestock and certain crops.
3 P.L. 94-455. The Tax Reform Act is hereinafter cited as the "Act".
applies to four of the six shelters designated by the House, real estate and sport franchises being the exclusions. The Act deals with real estate primarily by requiring the capitalization of certain construction period expenses, and by a slight tightening of the recapture rules; it deals with sports franchises by limiting the amount of purchase price allocable to player contracts, and by tightening the Section 1245 recapture provisions applicable to the sale of player contracts.

In the farming and motion picture areas, in addition to the "at risk" limitation, there are capitalization requirements with respect to the expenses generating the "deferral" benefit. Intangible drilling costs ("IDC") were spared this type of treatment.

With respect to oil and gas exploration, the principal change was to include excess intangibles as an item of tax preference for minimum tax purposes. In general, the minimum tax provisions have been tightened through an increase in rate, reduction in exemption and the addition of two new tax preferences for individuals (in addition to IDC).

There is also a new provision requiring the recapture of intangible drilling and development costs on the sale of oil and gas properties.

These are the changes that we will be exploring, primarily from the standpoint of noncorporate taxpayers, with the principal focus on the "at risk" provisions.

There are a number of other provisions of the Act which are also important with respect to certain types of tax shelter transactions. These are outside the scope of this paper, but should be briefly noted. They are:

1. Tightening of the investment interest limitation;
2. Requiring prepaid interest to be deducted by a cash basis taxpayer on essentially the accrual basis;
3. Requiring the accrual method of accounting for most corporations engaged in farming and partnerships engaged in farming with corporate partners; and
4. Various changes affecting partnerships:
   (i) Capitalization of guaranteed payments for capital services;
   (ii) Amortization of partnership organization expenses over 5 years;
   (iii) Capitalization of partnership syndication expenses;
   (iv) Bar of retroactive allocations to incoming partners; and
   (v) New rules as to special allocations.

Nature of a Tax Shelter

The vices seen by Congress in tax shelter activities generally are essentially three in number. The first is the deferral benefit, i.e., where deductions are "bunched" in one or more early years of the activity, rather than used against the income generated by the activity in subsequent periods. The resulting losses are used against unrelated income. The effect is tantamount to an interest-free loan from
the Government to the investor. Prime examples of this include accelerated depreciation; prepaid interest;\(^4\) construction period interest in the case of real property; the cost of feed and other development period expenses in the case of livestock and other farming ventures; intangible drilling costs, which can be prepaid and deducted by a cash basis taxpayer;\(^5\) and advance royalties paid in connection with coal mining.\(^6\) However, in the latter case, the Internal Revenue Service has recently changed its view and will not permit the immediate deduction of advance royalties in future coal transactions.\(^7\)

The second major tax attribute of a typical tax shelter investment is the use of nonrecourse financing to permit investors to deduct losses far in excess of the amount they could ever lose in the transaction.

The third basic attribute, which is not applicable to all shelters, is the "conversion" benefit, \(i.e.,\) the recovery of the ultimate income from the activity on a preferred tax basis, often as long-term capital gain. While a number of recapture provisions are applicable to the gain recognized on disposition,\(^8\) there has been nevertheless a substantial ability to convert the income into capital gain with respect to real estate, oil and gas ventures, sports enterprises and farming ventures.

Moreover, future gain (including recapture) could have been avoided by reason of the death of the investor.

In the case of oil and gas and mining activities, future income could be recovered subject to percentage depletion allowances which would produce a better overall effective rate of tax than would otherwise have been applicable to the income sheltered by the deductions from the activity in the early years.

Investment tax credits were obtainable in some shelter transactions, such as the movie purchase transactions, equipment leasing (limited to "operating leases" as described in Section 46(e)(3)(B) of the Code in the case of individuals) and certain livestock investments.

These, then, were the principal abuses that Congress set out to curtail through the tax shelter reform provisions of the Act.

\(^4\) IRS position was that interest could be prepaid for up to 12 months beyond taxable year if no material distortion of income results. Rev. Rul. 68-643, 1968-2 C.B. 76. Prepaid interest deductions were particularly valuable in transactions involving net equipment leases since it would be paid prior to the year in which rental income was first realized, thereby avoiding the investment interest limitations. See Code Section 163(d)(1)(B).


\(^6\) Treas. Regs. §1.612-3(b); Rev. Rul. 74-214, 1974-1 C.B. 148; Rev. Rul. 70-20, 1970-1 C.B. 144.

\(^7\) See IRS Information Release 1687 (October 29, 1976) proposing amendment to Treas. Reg. 1.612-3(b) and suspending Rev. Rul. 74-214 and Rev. Rul. 70-20.

\(^8\) See, \(e.g.,\) Section 1245 with respect to gain on the sale of most intangible personal property; Section 1250 with respect to gain on the sale of real property and Section 1251 with respect to gain from assets used in a farming business. Act Section 206 has amended Section 1251, however, to limit recapture to Excess Deductions Accounts maintained before December 31, 1975.
Provisions Specifically Affecting Real Estate

Real estate has been spared from the "at risk" limitations. The principal attack on the real estate shelter is through the required capitalization of construction period interest and taxes. The depreciation recapture provisions have also been tightened to a small degree. One change outside the tax shelter reform provisions, the elimination of the step-up in basis of property on death, may prove to have as significant an adverse effect on certain real property investments as the measures taken in the name of tax shelter reform.

Capitalization of Construction Period Items

The Act introduces new Section 189 into the Code. It is applicable to individuals, Subchapter S corporations and personal holding companies. When fully phased in, Section 189 will require construction period interest and taxes to be capitalized and amortized on a straight-line basis over a 10-year period.

The first amortization year is the year during the construction period when the expenses are paid or accrued (depending on the taxpayer's method of accounting); the second write-off year is the first year in which the property is placed in service, and then each year thereafter would be an amortization year until expiration. Intervening construction period years are skipped. Thus, the 10-year amortization period may not be consecutive.

Transitional Rules

Important transitional rules, particularly insofar as residential housing is concerned, are provided. First, the new rules do not affect low income housing at all until taxable years beginning in 1982. This will give the Government sufficient time to work out alternative bases for government assisted housing programs to go forward. Other residential property is not affected until 1978. Commercial real property becomes subject to Section 189 in 1976, but only if construction begins after December 31, 1975.

Phase-In

The full impact of the new provision will take seven years to be felt from the time the rules first become applicable to a particular class of property. In the case of an expenditure incurred in the first applicable year (e.g., 1978 for nonassisted housing), a 4-year amortization period would be applicable, if incurred the next year a 5-year amortization period and so forth until the 7th year, when the full 10-year period takes effect. The amortization is normally straight-line (i.e., 25% a year 20% a year, etc.) except that in the case of expenditures during 1976 with respect to the construction of commercial real property, 50% would be allowable in 1976 and 16 2/3% would be allowable in each of the first three years in which the property is placed into service.
Taxpayer may still choose, if he so elects, to capitalize construction period items pursuant to Code Section 266.

**Non-Business or Investment Property**

The new construction period expense rules are applicable to property to be held in either a business or investment capacity. There would be no prohibition against deduction in full of taxes and interest during the period of construction of a personal residence. Thus, it may be prudent in certain cases where a dual purpose could possibly exist, e.g., holding a vacation home for personal or investment use, to demonstrate an intention during the construction period to use the home for personal use rather than for investment. There are no recapture rules; thus if the intention to hold for personal use is later converted into an intention to hold for investment, presumably there would be no effect on the deductibility of interest and taxes during construction.

**Disposition of Property**

Upon the disposition of property with an unamortized balance of construction period expenses, a proportionate amount of amortization is allowed as a deduction for the year of disposition. If depreciable property is involved, the proportionate amount will be based on any applicable depreciation convention. Any remaining balance at the time of the disposition is simply added to basis for purposes of computing gain or loss in the case of a taxable disposition. Thus, if there would otherwise have been capital gain on the disposition, the unamortized portion of the construction deductions would offset capital gain. On the other hand, if Section 1250 would otherwise have applied to all of the gain on disposition, the effect would be the same as an ordinary deduction at the time of disposition.

Where the disposition is an exchange to which substituted basis rules are applicable to the transferor, e.g., transfers under Code Sections 351, 721 or 1031, in lieu of adding the unamortized balance to basis, the transferor continues to amortize it over the original amortization period as if the property had not been disposed of by him. The legislative history of Section 189 indicates that the same rule would apply to gifts, notwithstanding the absence of any property received by the transferor.9

 Totally unanswered is what happens to the unamortized balance upon death. Several possibilities exist: The decedent might be permitted to claim the unamortized balance in the year of death; his estate and/or heirs might continue to amortize the balance over the original amortization period; the unamortized balance could be added to basis; or it could be totally lost. The last possibility seems totally unjustified. Additional basis also seems to go beyond the congressional purpose. It is assumed, therefore, that the regulations will per-

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9 See Joint Explanatory Statement of the Committee of Conference (hereinafter cited as the “Conference Report”) at p.409.
mit the balance of the deductions to be taken either in the decedent's final tax return, or by the estate and/or the heirs over the original period. It is possible that as under LAL, the estate will succeed to the amortization schedule, but on further transfer, the heirs' basis will be adjusted.\(^\text{10}\)

**Partnership Activity**

In the case of a real estate venture conducted in partnership form, it seems clear that Section 189 is to operate on a partner-by-partner basis, rather than at the partnership level. Otherwise, the congressional purpose of applying the new rules to individuals, Subchapter S corporations and personal holding companies, but not to regular corporate taxpayers, would not be served. Thus, if an individual partner sells his partnership interest, the unamortized balance of construction period deductions attributable to that partner should be added to the basis of his partnership interest, and the successor partner would not have any interest in the construction period items. It would seem that the partnership should reflect in its own basis the amount of such un-amortized construction period deductions added to the basis of any partner's interest. The benefit of that special basis adjustment at the partnership level should flow to the new partner (as contrasted with, say, corporate partners that have not had any deferral of construction period items). Any adjustments required by a Section 743 election, if applicable, should then be applied from that point.

**Interrelationship With Other Provisions**

Some interesting questions arise as to the priority of application of Section 189 and other provisions providing for a disallowance or limitation of deductions. For example, construction period interest may be prepaid by a taxpayer, resulting in a disallowance of the deduction under Section 461(g). Section 189(e)(1) defines “construction period interest” to mean all interest attributable to the construction period of real property “to the extent such interest . . . would be allowable as a deduction under this chapter for the taxable year in which paid or accrued (determined without regard to this section).” Under new Section 461(g), a cash basis taxpayer is required to deduct prepaid interest not when paid but over the life of the loan. A question arises as to whether interest attributable to post-construction periods, but prepaid during the construction period, would be subject to Section 189. A question also arises as to whether construction period interest prepaid by a taxpayer meets the definition of construction period interest since it is not (reading literally) “allowable as a deduction . . . for the taxable year in which paid . . . .”

The proper priority rule appears to be to first subject the payment to the rules of Section 461(g), before applying Section 189. Section

\(^{10}\) See House Bill, Prop. Sec. 469(d) and (e).
189 would then be applied to prepaid interest for the periods in which the interest is treated under Section 461(g) as paid. This would mean that prepaid construction period interest would always be subject to the limitations of Section 189 for the year in which treated as paid under Section 461(g), and post-construction period interest which is prepaid during the construction period would not fall under Section 189.

On the other hand, the rules should be different in the case of the interplay between the investment interest limitations of Section 163(d) and the application of Section 189. There it seems more appropriate to first apply the rules of Section 189.

Construction Period

For purposes of Section 189, the “construction period” is that period beginning on the date on which construction of the building or other improvement begins, and ending on the date on which the item of property is ready to be placed in service. A wide choice exists as to when construction begins between the expansive rules in the collapsible corporation area, which seem inappropriate here, and rules to the effect that construction begins upon the commencement of actual physical work at the building site. See Treas. Reg. §§1.44-2(a) and 1.167(j)-4(a)(2).

Allocation Problems

Clarification is also required as to the portion of interest and taxes on real property which would be subject to capitalization under Section 189. For example, assume that construction of an addition to an existing building is commenced. Clearly, all of the taxes on such property and the interest attributable to the full mortgage on the property should not be subject to Section 189. Somewhat less obvious cases can also arise. For example, assume that interest and taxes have been incurred on unimproved land. Construction then commences on such property. Are only the incremental increases in the amounts of interest and taxes subject to Section 189, or are the entire amounts of such items now subject to Section 189? It is difficult to see any distinction here from the case of the addition to the building.

Recapture Of Depreciation On Real Property

The provisions of Section 1250 applicable to residential real property have been tightened somewhat. No change has occurred with respect to commercial property. All additional depreciation (i.e., the excess of depreciation allowed over the depreciation that would have been allowable under the straight-line method) on commercial property was previously subject to recapture.

In the case of residential housing other than assisted housing, the rules will be the same as in the case of commercial property with re-
spect to depreciation attributable to periods after December 31, 1975. With respect to assisted housing, the amount of post-December 31, 1975 depreciation deductions that will be subject to recapture will now be phased out over the 100 month period commencing 8 1/3 years (rather than 20 months) after the property has been placed in service.

**Foreclosures**

An amendment to Section 1250 designed to avoid stalling tactics to minimize recapture provides that a transfer pursuant to foreclosure shall be deemed to occur at the commencement of the foreclosure proceedings for purposes of determining the amount of depreciation recapture. This provision does not appear to be limited to transfers pursuant to foreclosures alone, and leaves to regulations the development of rules for comparable dispositions following a default on indebtedness, such as a deed in lieu of foreclosure.

The key aspect of Section 1250 that enables depreciation deductions to be converted into long term capital gain on disposition, to wit: that after the property is held for 12 months, only the excess of accelerated over straight-line depreciation is subject to recapture, remains unchanged.

**Carryover Basis**

Pursuant to new Code Section 1023, the basis of property, including real property, acquired from a decedent dying after December 31, 1976 will be the same as that which is in the hands of the decedent immediately prior to his death, subject to certain adjustments. There is a transitional rule with respect to property owned on December 31, 1976 which permits pre-January 1, 1977 depreciation deductions attributable to the decedent's holding period to be added to the basis of the transferee.

As a result of the carryover basis rule, it will no longer be possible to avoid ultimate recognition of gain where the real property is transferred at death.

**At Risk Provisions**

The central approach for dealing with tax shelters other than real estate are the so called “at risk” provisions, which are designed to reduce the leveraging benefit of shelters by limiting a taxpayer's tax losses from an activity to those amounts (including his actual investment) for which he is actually taking a risk. The primary provision is new Section 465, which operates to limit losses for any year to the aggregate amount “at risk” at the end of the year. These rules are applicable in the case of an individual, a Subchapter S corporation or a personal holding company (but not other corporations, including controlled foreign corporations and foreign personal holding companies which might, arguably, be susceptible of the same type of reasoning for inclusion).
Section 465 is applicable to four of the tax shelters designated by the House:

1. The holding, producing or distributing of motion picture films or video tapes;

2. Farming, which is broadly defined to include all types and stages of agricultural and horticultural production, the raising of and the caring for animals, and the production of nut and fruit trees (but not other trees);

3. Equipment leasing; and

4. Exploration for, or exploitation of, oil and gas resources.

**Partnership At Risk**

The second “at risk” provision is introduced by an amendment to Section 704(d), which operates generally to limit the deduction of losses by a partner to the amount of his adjusted basis for his partnership interest. The amendment to Section 704(d) provides, solely for purposes of determining the allowable portion of a partner’s distributive share of partnership loss, that a partner’s basis “shall not include any portions of any partnership liability with respect to which the partner has no personal liability.” The partnership at risk provision is applicable to all partners, general as well as limited, corporate as well as individual. However, the amendment does not apply to real property (other than mineral property) nor to any activity “to the extent that Section 465 . . . applies.”

The “to the extent that Section 465 applies” language of Section 704(d) has caused considerable concern as to whether corporate partners could engage in activities to which Section 465 was applicable in the case of individuals, such as equipment leasing, without the partnership at risk provision applying to them. This concern has been dealt with by Temporary Regulations under Section 704(d). These regulations make it clear that two corporate partners can engage in an equipment leasing transaction, and the new Section 704(d) at risk provision will not be applicable. The “to the extent” clause in Section 704(d) was only intended to distinguish between activities of the type specified in Section 465 and other type activities (other than real estate) which would be subject to the limitations of Section 704(d).

It appears, ironically, that a corporation can engage in any of the designated shelter activities described in Section 465, itself or through a partnership, without being subject to any “at risk” limitation, but that it cannot engage in any non-Section 465 activity (other than real property) through a partnership without being subject to the “at risk” limitations of Section 704(d).

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12 See Treasury Decision 7445 (December 14, 1976). This confirms a statement contained in the Summary of the Act prepared by the Staff of the Joint Committee on Internal Revenue Taxation (hereinafter “Staff Summary”) re Section 213 (e) of the Act.
Determination of Amount “At Risk”

A technical analysis of amounts considered to be “at risk” requires a determination of two preliminary questions:

1. What constitutes an activity?
2. At what level does the “at risk” provision apply (where the activity is conducted through a partnership or Subchapter S corporation)?

As to the first question the statute is clear. Under Section 465(c)(2) each film, or video tape, item of equipment, farm or oil and gas property is treated as a separate activity. Where a partnership or Subchapter S corporation conducts two or more activities of the same type, the activities shall be combined as a single activity.

It should also be clear that the “at risk” rules are to be applied at the level of the partner or stockholder, and not at the partnership or Subchapter S corporation level. This is stated clearly in the Staff Summary, negating a possible contrary implication contained in a footnote in the Conference Report.

If a partnership is engaged in the conduct of one activity, say, an equipment leasing venture, and has on hand marketable securities and/or cash not needed in the business (even if used to secure non-recourse indebtedness), the leasing activity would not include such amounts of cash or marketable securities. These concepts are important to keep in mind in examining the statutory definitions of “at risk” investments.

The amount at risk at the end of any year consists of:

1. The amount of money contributed to the activity by the taxpayer;
2. The adjusted basis of other property contributed to the activity by the taxpayer (the actual fair market value of property contributed to the activity by the taxpayer is irrelevant, assuming, presumably, that the contribution is not a sham);
3. Amounts borrowed with respect to the activity on which the taxpayer has personal liability for repayment; and
4. The net fair market value of property not used in the activity pledged by the taxpayer to secure amounts borrowed with respect to the activity.

Related Parties

Amounts borrowed from another party with an interest in the activity other than as a creditor, or from a related person described in section 267(b) (which includes family members and controlled corporations) for reasons that defy understanding, are not considered to be “at risk”, even if the taxpayer is personally liable for repayment.

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13 See Staff Summary, re Section 204 of the Act.
Pledged Property

Where property not used in the activity is pledged by the taxpayer to secure amounts borrowed with respect to the activity, the amount taken into account as being “at risk” is the net fair market value of the property at the time of the pledge of the property. Any subsequent value fluctuations are ignored. Thus, if property that has been pledged goes down in value, it will not reduce the “at risk” amount; if the property in pledge goes up in value, the taxpayer will not be given any additional “at risk” basis. In such case, substitution of new collateral with approximately the same market value should be considered to increase the “at risk” investment. All prior (or superior) liens on the property at the time of pledge are to be offset against the fair market value of the property for purposes of determining the net fair market value of the property at the time of pledge.

Exception for Nonrecourse Financing, Stop-Losses, etc.

Section 465(b)(4) provides that a taxpayer is not considered “at risk” with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. This provision appears to override all other provisions of Section 465 in determining amounts “at risk.” Thus, if taxpayer has received a stop loss guarantee as to amounts contributed to the activity from his own funds, as well as to amounts borrowed with respect to the activity, the amounts guaranteed against would not be viewed to be “at risk.”

The Senate Report gives examples of arrangements that will result in taxpayer being considered not “at risk.” Such examples include (1) the feeding of livestock where investors are given stop loss guarantees against losses sustained on the sales of the livestock (above a stated dollar amount per head), (2) livestock breeding investments where a limited partner is given a “put” to the partnership of his partnership interest at a stated minimum dollar amount, (3) insurance to compensate a taxpayer for any payments he might have to make on a mortgage, and (4) an indemnification of a limited partner by a general partner as to any payments that will have to be made on partnership indebtedness.

None of these examples are particularly troublesome. What about, however, a so called “hell or high water” rental payment clause in a lease or other normal business provisions which are designed to reduce one’s risk?

Some comfort can be derived from the Senate Report. It states that normal buy-sell agreements between partners would not prevent a taxpayer from being “at risk,” and that normal casualty insurance

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14 Property cannot, however, be treated as security if it is directly or indirectly financed by indebtedness secured by property used in the activity.
or tort liability insurance will not have any negative affect on the "at risk" amount. The Conference Report goes on to provide that in applying the "at risk" provision to farming operations, the existence of a target price program or other governmental price support program would not by itself cause the taxpayer not to be "at risk." It is hoped that parallel reasoning will be applied in the case of "hell or high water" clauses and other normal business arrangements.

**Determination Of At Risk Amounts In Subsequent Years**

Any loss disallowed under Section 465 would be carried to the following year and treated as a deduction with respect to the same activity in that year (and must then run the gamut of Section 465 again). For purposes of determining the "at risk" investment in subsequent years, Section 465(b)(5) merely provides that the "at risk" investment shall be reduced by that portion of any loss with respect to the activity which has been allowed as a deduction for prior years. The Senate Report sheds some light on the question of how the "at risk" amount is determined in future years, taking into account taxable income and cash flow generated by the activity. The Senate Report, however, limits its focus specifically to the partnership context.

The case of a partnership is illustrated by the example in the Appendix. In that case, A, an individual, invests in a partnership engaging in an equipment leasing transaction. A invests $100 for a 10% interest and the partnership obtains a $9,000 nonrecourse mortgage. A’s "at risk" investment each year is increased by his share of partnership taxable income, and decreased by distributions received by him from the partnership. It is assumed that taxable income and not economic income increases the "at risk" investment, since the statutory purpose would otherwise be largely frustrated.

Payments on the debt itself do not increase "at risk" investment. However, if the cash is not needed in the activity, and is not used to pay down the nonrecourse debt, such cash should be viewed to reduce the "at risk" investment.

There is one further assumption in the example which is not wholly free from doubt. The example assumes that distributions may reduce the "at risk" amount below zero. While there would be no recapture under Section 465 by reason of the "at risk" amount being lowered below zero, it is assumed that there would have to be a build up of positive "at risk" amounts to restore the negative balance to zero before additional losses can be claimed with respect to that activity. Thus, in year 2 of the example, in which A receives cash distributions of $25, and has taxable income for the year of $10, it is assumed that there would be a net recognition with respect to the activity of the full

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17 S. Rep. at page 50.
18 Conference Report at page 412.
$10 of taxable income for the year 2 (A having exhausted fully his "at risk" amount during the prior year). However, the Senate Report specifically says that losses will not reduce a taxpayer's "at risk" amount below zero,\textsuperscript{20} and one might argue that $10 of losses may be used in year 2 to offset the income.

The Senate Report upon which the foregoing example is based talks specifically of any activity conducted in partnership form.\textsuperscript{21} Presumably, the same rules are applicable in the case of Subchapter S corporations and personal holding companies. Moreover, it would appear that the same rules must be applicable to an activity conducted directly by the taxpayer to make sense of the statute. In such case, it may be difficult to establish when amounts have been committed to or withdrawn from an activity by the taxpayer. The regulations should spell these rules out in considerable detail. Clearly, where a taxpayer has paid expenses other than out of borrowed funds with respect to an activity, such amounts should be viewed as having been contributed to the activity by the taxpayer. If the activity produces positive cash flow, and the cash is not applied in payment of nonrecourse indebtedness related to the activity, taxpayer should be deemed to have withdrawn the funds from the activity, and to have thereby reduced his "at risk" amount. An exception to this probably should be made with respect to cash required for working capital purposes. A payment of recourse indebtedness will have the effect of reducing the taxpayer's "at risk" investment, since that indebtedness would have previously been counted as part of his "at risk" amount.

Planning Possibilities

As stated above, there are no recapture provisions under Section 465. Thus, if taxpayer can succeed in having sufficient "at risk" amounts until the end of the year in which he has claimed his front-end net losses, he can then reduce his "at risk" amount without adverse affect under Section 465.

It is clear from the Senate Report that recourse liability on indebtedness need not be permanent in order for that indebtedness to be counted as "at risk" at the end of any taxable year in which the personal liability exists.\textsuperscript{22}

The Senate Report reference, however, is to a situation in which the debt becomes nonrecourse upon the occurrence of certain later events, specifically when an orchard reaches a certain state of development. It is questionable whether such a rule would apply unless there is a true "at risk" situation existing during that period. There should also be some substance to the condition that triggers the fall off of personal liability. Moreover, the rule may be different if there

\textsuperscript{20} S. Rep. at page 48.

\textsuperscript{21} S. Rep. at page 50.

\textsuperscript{22} S. Rep. at page 48, footnote 1.
are not any significant debt service requirements during the period of recourse so as to cause any serious risk of foreclosure.

Infusions of cash immediately prior to year-end, and withdrawals after year-end will undoubtedly be ignored.

Where a taxpayer has an unconditional right to terminate personal liability, it is likely that he will not be considered "at risk."

If partnership indebtedness is subject to the personal liability of several partners, can all of such partners count 100% of the amount of the partnership debt as being "at risk"? If so, a little recourse can be pushed a long way. The probable answer is that Section 465(b)(4) would be applicable, and each partner's right of contribution from the other partners would be netted against the liability on the indebtedness for purposes of determining each partner's "at risk" amount.

If a taxpayer gives a "bottom end" guaranty, i.e., guarantees that a creditor will receive at least a portion, say, 20% of the face amount of the debt, taxpayer would appear to be "at risk" with respect to that proportion of the indebtedness. While one might argue that the taxpayer may not seriously be "at risk" in some cases, it would not seem relevant here.

It is questionable whether any benefit can be achieved through controlling cash flow at the end of each year. For example, assume positive cash flow is realized in year 1, is on hand and not needed in the activity on December 31, and is distributed to the partners on January 2 of year 2. The Senate Report speaks in terms of distributions made by the partnership as reducing "at risk" investment. If taken literally, the partnership may retain the cash on December 31 without reducing "at risk" amount, and distribute the cash out in January of year 2. If this is true, partners could also contribute cash during the year to increase the "at risk" amount at the end of the year, and take partnership withdrawals during the early part of the following year. True, sham transfers and withdrawals would presumably be attacked; but many activities have wide fluctuations in need from time to time and it could be difficult for the IRS to demonstrate the tax motive. It is suggested that the sensible rule is to make the retention of cash (or other assets) by a partnership irrelevant unless needed in the business for working capital or other purposes. Where not needed in the business, there should be a constructive withdrawal from the activity by each of the partners, thereby reducing each partner's "at risk" amount.

Where cash is on hand at the end of a year, it may be prudent, at least until clarifying regulations have been issued, to use such cash to make payment on nonrecourse debt.

**Partnership Activities**

Where similar activities are conducted through a partnership or Subchapter S corporation (there appears to be a statutory omission with regard to personal holding companies), all activities of the same
type are considered a single activity. The benefit in such cases is that losses from one transaction can be offset against the income from a second transaction without regard to the "at risk" limitation. This may be helpful with respect to partnerships with prior tax shelter investments, say, equipment leasing transactions, in which the "lines have crossed," and taxable income is being generated in excess of cash flow.

On the other hand, the aggregation within a partnership of several transactions as one activity can operate disadvantageously where property from one transaction is pledged with respect to a nonrecourse note related to the second transaction. If the two transactions were separate activities, the fair market value of the pledged property would be considered additional "at risk" investment with respect to the second transaction.

Technical Problems

The statute is silent with respect to what happens at the death of a taxpayer who has had losses deferred pursuant to Section 465. Presumably, these would be passed along to the estate and heirs as deductions in respect of a decedent at the time the "at risk" amounts are increased to absorb such deferred losses.

It is clear that other disallowance or limitation provisions are applied first, e.g., prepaid interest limitations and investment interest limitations would be applied first, and then Section 465 would be applied to the net tax loss remaining. However, it is not clear how the tax preference amount or amounts is computed where a portion of the disallowed losses under Section 465 consists of tax preference items.

Further, where losses are disallowed for more than one year and, say, tax preference items are included in the disallowed amounts for any year, and then a portion of the disallowed losses are allowed in a future year, how does one identify which year's losses are being allowed. LIFO? FIFO? The statute is silent on this question.

Scope of Provision

The "at risk" limitations are stated to be inapplicable for purposes other than the limitation of net losses from the designated activities. For example, basis computations would not be affected by the "at risk" limitations. Moreover, the Senate Report makes it clear that the computation of net income and taxable income for purposes of computing the limitations on the percentage depletion deduction would be made without regard to the Section 465 disallowance. If the property is sold when there are unused losses, the basis for determining gain from the sale will have been reduced by those losses, as well as those that have been allowed. However, so long as the recognition of that income produces additional "at risk" investment, as suggested

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23 S. Rep. at page 70.
herein, the unused losses can then be claimed to produce the correct result.

**Transitional Rules**

Section 465 is generally applicable to losses attributable to taxable years beginning in 1976 (subject to some transitional rules). A favorable presumption is applied with respect to losses sustained prior to 1976 in activities covered by Section 465. All such prior losses are deemed to first reduce basis other than “at risk” basis. However, pre-1976 distributions are deemed to reduce the “at risk” basis first.\(^{24}\)

**Amendment to Section 704(d)**

Section 704(d) excludes “investing in real estate” from the operation of the partnership “at risk” rule. However, the Staff Summary and the Conference Report\(^{25}\) make it clear that the exclusion applies in any case where the principal activity of the partnership involves real property.

The Conference Report states that it is the intention in determining whether a partner has personal liability with respect to a particular indebtedness that rules similar to those applicable under Section 465 are to be applicable.\(^{26}\) The precise meaning of this statement is unclear. For example, it is apparent that Congress intends that, in determining personal liability, protections against loss through guarantees, stop loss agreements and other similar arrangements be taken into account. However, there are such fundamental differences between the two sections that it is virtually impossible to apply the general rules of Section 465 to Section 704(d). The most significant difference between the two sections is that the limitations of Section 704(d) are only applicable with respect to partnership borrowings, and not to amounts contributed to the partnership by the partner, whether or not the funds for such contribution were borrowed by the partner on a nonrecourse basis. Presumably, if partnership property is pledged to secure loans to the partners, or if all the partners borrow funds pursuant to joint arrangements, the overall arrangements will be examined to determine whether the borrowings should be viewed as partnership obligations for purposes of Section 704(d).

Moreover, unlike Section 465, which operates for the most part on an activity-by-activity basis, there is nothing to prohibit the partners from keeping their overall Section 704(d) bases at sufficient levels to cover losses through contributions to the partnership, or permitting the partnership to retain assets not needed in the activity to which the nonrecourse indebtedness relates. This would appear to be true even if the nonrecourse lender cannot reach such assets to satisfy the indebtedness. The contribution of high basis low value assets would be

\(^{24}\) Conference Report at page 412.
\(^{25}\) Conference Report at page 423.
\(^{26}\) Conference Report at page 423.
best for such a program. It is true, of course, that limited partners may be unwilling in many cases to contribute assets that could be reached by general creditors. Excess assets kept in the partnership for this purpose can subsequently be withdrawn without tax effect since the non-recourse debt will provide basis for all purposes other than claiming losses.

The foregoing discussion also suggests strongly that it makes little sense to apply the Section 704(d) at risk provision to general partners, since their assets, whether within or outside the partnership are subject generally to the claims of general creditors of the partnership. Thus, they should find little problem in keeping their Section 704(d) basis up to necessary levels.

Presumably, a general partner's share of all recourse obligations of the partnership will be automatically included in his Section 704(d) basis. The same should be true with respect to limited partners to the extent of any future obligations to be contributed to the partnership, whether by reason of the partnership agreement or pursuant to the operation of law (e.g., when a limited partner has received cash distributions and becomes obligated to restore the amount of such distribution if necessary to pay partnership debts).

Although there is no specific statement of congressional intent as under Section 465 to the effect that the new Section 704(d) limitation on basis is applicable for any purposes other than limiting the amount of deductible loss, the statutory language clearly seems to be to the same effect. Thus, for example, if after losses have been claimed to the full extent of the "at risk" investment, the partners' "at risk" investment is reduced, there would be no constructive distribution to a partner by reason thereof. Similarly, if actual distributions are made, the nonrecourse partnership liabilities would be counted under the general rules of Section 752 as partnership basis for purposes of determining whether such distributions produced taxable income to the partner.

Some Technical Questions

There are some unclear technical questions as to the application of Section 704(d) that require resolution in the regulations. For example, does the statement in the Conference Report that rules similar to Section 465 are to be applied mean that related party recourse borrowings can result in the disallowance of basis? Similarly, would a corporate general partner organized for the special purpose of entering into the particular investment be considered to have personal liability for recourse liabilities of the partnership?

A question also arises as to whether the limitations of Section 704 (d) can be avoided by election "out" of partnership status under Section 761, where applicable.
Effective Date

The amendment to Section 704(d) is not effective until taxable years beginning in 1977. Thus, for tax shelter investments not falling within Section 465 that depend on nonrecourse leveraging, such shelters can go forward for 1976.

Minimum Tax

The rules with regard to minimum tax were generally tightened. The rate is increased from 10 to 15% and the exemption for tax preferences is reduced from $30,000 plus regular taxes paid to the greater of $10,000 or 1/2 of regular taxes paid (in the case of individuals). The important tax carryover in effect under the prior law has been eliminated.

New Preferences

In addition, new preferences have been added. The most significant of these is the excess of itemized deductions (other than medical expenses and casualty losses) over 60% of adjusted gross income. Taxpayers must now avoid the bunching of personal interest and tax deductions under this section. The provision can operate quite harshly. For example, it would appear that investment interest which has run the gamut of Section 163(d), and has survived by reason of the existence of an offsetting amount of investment income, could then get ensnared as a tax preference. The investment income would be included “above the line,” whereas the investment interest would be an itemized deduction. Thus, in effect, 40% of the investment interest (the amount of the interest, less 60% of the matching investment income) would become a tax preference item subject to the 15% tax, assuming that there was no cushion from other adjusted gross income.

A second new preference added by the Act is the excess of intangible drilling and development costs in connection with productive oil or gas wells, to the extent such deductions exceed the amount which would have been allowable for the taxable year under a straight-line method of recovery of the IDC. For all intents and purposes, this means that 90% of IDC costs incurred in connection with productive wells will constitute a tax preference. Perhaps this is softened by the fact that in drilling ventures there are generally some productive and some dry holes, and the IDC allocable to the dry holes does not result in a tax preference. However, note that there could be a “doubling up” of tax preferences here if taxpayer is also vulnerable with respect to the excess itemized deduction preference. The IDC with respect to the productive wells is a tax preference, and it will reduce adjusted gross income. This reduction, in turn, can trigger a second tax preference item in an amount up to 60% of the amount of the IDC deduction.

For corporations it is the greater of $10,000 or the full amount of taxes paid.
Thus, $1.00 of IDC can produce a $1.50 tax preference income subject to the minimum tax.

A third addition to the tax preference base is accelerated depreciation on leased personal property other than property subject to a net lease. Property subject to a net lease was subject to the minimum tax rules previously; now accelerated depreciation on all leased personal property is covered, whether subject to net or operating leases. It seems to be another irony growing out of this tax shelter legislation that transactions not particularly thought of as tax shelter activities have been more adversely affected than some acknowledged tax shelters. Thus, for example, a partnership that leases equipment, say, a vessel, pursuant to an operating lease, will generate tax preference income, and be subject to the new “at risk” provisions with respect to nonrecourse indebtedness.

**Effective Date**

The new preferences and all other changes in the minimum tax rules are applicable for 1976.

**Maximum Tax**

Changes in the minimum tax rules also impact the maximum tax rules of Section 1348. This is because tax preference income reduces the amount which would otherwise qualify as earned income for the 50% maximum rate. The $30,000 exemption for tax preference income previously applicable for purposes of Section 1348 will continue to be applicable for 1976, but not thereafter. However, the new items of tax preference income added by the Act will apply for purposes of the earned income rules under Section 1348 for 1976.

**Certain Limitations on Accelerated Deductions**

The Act serves to require capitalization of a number of other “deferral” type expenses.

**Farming Syndicates**

In the case of farming syndicates, new Section 464 would defer deductions for feed, seed, fertilizer and other similar farm supplies until the taxable year in which actually consumed. A farming syndicate is defined by Section 464 as a partnership, Subchapter S corporation or other enterprise engaged in the trade or business of farming if at any time (1) interests in the organization were offered for sale in certain registered offerings, or (2) 35% of the losses during any period are allocable to limited partners or other nonmanagement entrepreneurs. An agency relationship created by a management contract, such as is involved in many cattle feeding shelters, would be included as such
These provisions are not applicable until 1977 to a farming syndicate in existence on December 31, 1975, except where the syndicate had a change in membership during the year. This raises a question as to whether the death of one partner during 1976 could cause Section 464 to be applicable as of January 1, 1976.

**Movie Production Companies**

New Section 230 is intended to attack the movie production company format and similar production activities, and requires the capitalization and amortization, under essentially an income forecast method, of the production costs of a "film, sound recording, book or similar property." This rule would be applicable to individuals, Subchapter S corporations and personal holding companies.

**Recapture Of Intangible Drilling Costs**

New Section 1254 provides for the recapture of intangible drilling costs which have been deducted by the taxpayer under Section 263(c) with respect to oil and gas wells. Pursuant to Section 1254(a)(4), the recapture does not apply to the extent that the deduction for depletion under Section 611 would have been increased if such cost had been charged to capital account rather than deducted. Read literally, this means that if percentage depletion is elected by the taxpayer, this exclusionary rule will not be applicable (except perhaps to the extent that the cost depletion deduction would have been greater than the amount of the percentage depletion deduction in any year had the amount of the IDC been capitalized).

**Effective Date**

The new rules for recapture are applicable with respect to dispositions made after December 31, 1975 with respect to expenditures after December 31, 1975.

**Applicability**

The recapture rule is generally applicable to all taxpayers. A provision has been added authorizing the Commissioner to provide rules pursuant to which a Section 751 recapture concept can be applied to the sale of the stock of Subchapter S corporations. This appears to be a mechanical nightmare. Consider, for example, the fact that a Subchapter S corporation's status may be terminated either before or after the sale of stock by one of its stockholders, and presumably would be subject to the recapture rules itself upon ultimate disposition of the property. Unlike the case of a partnership, double tax problems are present.

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Sports Franchises

The Act deals with the "sports tax shelter" in two general ways, when there has been a "sale or exchange" of a sports franchise and a transfer of one or more player contracts incident to such sale or exchange. First, under new Section 1056, basis for each player contract in the hands of the transferee would be limited to the amount of transferor's basis for such contract plus the gain recognized to the transferor on the transfer of such contract. Second, under new Section 1245(a)(4), there would be substituted as the recomputed basis of player contracts transferred (in lieu of the normal rules), the greater of (i) the unreaptured depreciation (and abandonment loss deductions) taken with respect to the taxpayer's original roster or (ii) the depreciation deductions claimed with respect to the existing player contracts (less the amount of depreciation previously recaptured with respect to the original roster).

Basis Limitation - New Section 1056

The basis limitation rules of Section 1056 are intended generally to conform the allocation of purchase price by buyer and seller. The seller is to furnish the necessary information to the Secretary and to the buyer regarding the seller's basis for player contracts and the amount of gain recognized in connection with the sale of such player contracts. The seller's allocation will be binding on the transferee to the extent set out in regulations to be promulgated. There is also a rebuttable presumption that no more than 50% of the total price is allocable to the entire player roster. Transfers at death and exchanges described in Section 1031 are excluded from the applicability of the section. The section fails to cover, perhaps inadvertently, Section 334 (b)(2) transactions and Section 331 liquidations. This is because liquidations are generally not considered to be "sales or exchanges," as contrasted with other dispositions for purposes of the Code. See, e.g., Treas. Reg. §1.1245-1(c).

Special rules which appear to make little sense are also provided with respect to Section 337 transactions. There, an attempt is made to pass along basis to the transferee based on gain recognized by the stockholders of the selling corporation on the liquidation. Thus, it would appear that a transferee of the assets of a corporation conducting a sports enterprise would obtain a higher basis for player contracts in the case in which the stockholders of the transferor recognize substantial gain on the liquidation, than would be the case when the stockholders of the transferor had high basis, say, by reason of acquiring the stock on the death of a prior stockholder.

New Recapture Rules - Section 1245(a)(4)

New Section 1245(a)(4) was intended to increase the Section 1245 recapture on the sale or exchange of player contracts by requiring re-
capture upon sale of the franchise of not less than the amount of the net depreciation and abandonment deductions taken with respect to the original roster. Normal rules of Section 1245 would only recapture depreciation taken with respect to the contracts in existence at the time of sale. Those contracts typically have not had as large capitalizable costs subject to depreciation as the original roster. Moreover, abandonment losses are not adjustments of the type normally taken into account in determining recomputed basis under Section 1245. However, Section 1245(a)(4) largely fails (apparently) in achieving its intended purpose.

First, Section 334(b)(2) and other liquidation transfers appear to be exempt from application of the new recapture rules since there also must be a “sale or exchange” for those rules to be applicable. Moreover, the new recapture rules do not appear to apply to a sale by a partner of his interest in a partnership operating a sports franchise. An unrealized receivable does arise under Code Section 751 with regard to “potential Section 1245 income,” which is defined to mean the gain to which Section 1245 would apply if the items of Section 1245 property were sold by the partnership at fair market value. Treas. Reg. §1.751-1(c)(4)(i). However, the new recapture rules are only applicable if the franchise is sold or exchanged (in addition to player contracts), and the franchise itself, as contrasted with the player contracts, would not appear to be Section 1245 property. Thus, if only the player contracts were assumed to be sold for purposes of determining “potential Section 1245 income,” the new Section 1245(a)(4) rules would appear to be inapplicable.

Another important limitation on the applicability of the recapture rules is that they are only applicable in connection with the sale of contracts for players’ services in connection with the sale or exchange of a franchise. Thus, if one or more superstars are sold by a franchise for a significant sum of money, and there has not been any significant depreciation with respect to those particular player contracts, the new depreciation rules would not produce any significant recapture. After the disposition of one or more key players, a sale of the franchise in a later period may produce little or no gain applicable to player contracts to which the new recapture provisions can attach. Separate sales of players apart from sales of the franchise itself can totally frustrate the new recapture provisions.

_Aftermath of the Tax Reform Act - What is Left for Individuals?

Real Estate

Real estate investments appear to have survived relatively unscathed.

Government assisted residential housing appears to be totally unaffected, at least until 1982, when Section 189 first will be applicable to construction of such housing. By then, if the section becomes appli-
cable at all to low income housing, substitute programs will presumably have been worked out for continuing the construction of government assisted housing.

Insofar as other residential housing is concerned, there will be only a small immediate effect for 1976 and 1977 by reason of the tightening of the recapture rules. Construction programs will become subject to new Section 189 in 1978, but the full effect of that section will not be felt for some time.

In the case of commercial real property, the only immediate effect is with respect to construction programs, and for 1976, only to the extent of 50% of the construction period items.

Investments in real property other than construction ventures are largely unaffected, except in the case of residential housing where recapture has been tightened somewhat.

Real estate investments may be adversely affected also by the new "carryover" basis rule for transfers at death.

Oil and Gas

Oil and gas drilling ventures are affected in three basic ways, none of which seem overly fatal:

(a) The “at risk” limitations of Code Section 465 would be applicable. But nonrecourse financing has not been as critical in this area as in others.

(b) New Section 1254 provides for recapture of IDC. However, the capital gain “conversion” feature is not of prime concern here either. In lieu of early disposition, producing properties can be retained with percentage depletion serving to lower the effective cost of future income.

(c) IDC (in essence 90% thereof) will now be subject to inclusion in the tax preference income base. This is greatly minimized in the context of a normal drilling venture because it does not apply to dry holes. However, depletion is already subject to inclusion as a tax preference, and taking into account the overall tightening of the minimum tax rules, and the possible adverse effect under the maximum tax rules, an investment in oil and gas must be carefully considered. Moreover, one must be cautious because of a possible double “bite” of the preference provisions if the individual is, or will become, subject to the tax preference for excess itemized deductions. Here, each dollar of IDC can result in $1.50 of tax preference income.

Equipment Leasing and Motion Picture Ownership

These activities are severely affected insofar as individual investors are concerned because of their dependence on large amounts on non-recourse financing. There are some possibilities, however. For one thing, an existing partnership engaged in an equipment leasing trans-
action which is "reversing" can resharpen the "phantom" income through the use of a similar equipment leasing transaction. Moreover, there are possible uses of partial recourse techniques within Section 465, such as a "bottom end" guaranty, say, the last 50% of the principal (but not interest) of otherwise nonrecourse indebtedness which might, without substantially increasing the investor's true risk, provide sufficient leveraging to make the after-tax economics of the transaction attractive.

There are also various possibilities as to the use of temporary recourse techniques, i.e. when the taxpayer is "at risk" at the end of years in which the deductions exceed his actual investment, but on the happening of future, presumably significant, events the personal liability falls off.

Operating lease transactions, although made subject to possible minimum tax exposure and the "at risk" provision, will still be attractive in appropriate situations. These ventures can be structured to utilize investment credits and construction period write-offs as the primary tax benefits, and these benefits are not impaired.

**Cattle Feeding**

It seems clear that end-of-the-year cattle feeding shelters are eliminated, primarily because of Section 464. However, it would be possible to achieve a comparable result by entering into the transaction in mid-year. The cattle can be fully fed during the year, with the sale of the cattle deferred until the following year. There should be no difficulty with that transaction so long as one is willing to forego a stop loss guaranty for his investment and nonrecourse financing.

Other farming ventures (excluding trees other than fruit and nut trees) and movie production companies would seem to be severely limited by a combination of the "at risk" limitation of Section 465 plus the required capitalization of the early deductions that produced the "deferral" benefit. Cattle breeding ventures could go forward in the future if adequate devices to secure sufficient leveraging to claim write-offs can be designed.

**Sports Franchises**

As indicated, the provisions that deal with the so called "sports tax shelter" seem largely ineffectual.

**Other Possibilities**

In general, any activity not covered by Section 465 and not relying in any substantial way on a form of accelerated deduction that is required to be capitalized under the Act could go forward for the balance of 1976 without being affected since Section 704(d) is not applicable for 1976. Thus, for example, the purchase of a completed sound recording (as contrasted to the production of the recording) could sub-
stitute for a movie purchase. For future, years, these possibilities would continue to exist for one investor who could take the entire investment himself. A partnership activity would have to reckon with Section 704(d) after 1976. However, as indicated previously, the use of a partnership carrying on more than just the particular tax shelter activity (without subjecting the other assets to the claims of the non-recourse lender) could solve the Section 704(d) problem. Nonrecourse borrowings at the level of the individual partners may be possible in certain cases, against a pledge of their partnership interests (as contrasted with partnership property). Such borrowed amounts could then be contributed to the partnership without limitation under Section 704(d).

Coal Deals

Coal mining ventures that have been grandfathered in by the Revenue Service will continue to be doable during 1976 without regard to any "at risk" limitations. Beginning in 1977, Section 704(d) would be applicable. Coal ventures based on the use of minimum royalty payments to provide tax attractiveness will probably be seen in the future in respect to an otherwise solid mining property.
Appendix

At Risk Limitation - Partnership Context

Example

A, an individual, invests in a partnership which is engaged in an equipment leasing transaction. A invests $100 for a 10% interest and the partnership obtains a $9,000 nonrecourse mortgage, A's share of which is $900. A's share of partnership items is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Cash Income</td>
<td>$100</td>
<td>$250</td>
<td>$250</td>
<td>$250</td>
<td>$250</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$400</td>
<td>$240</td>
<td>$120</td>
<td>$120</td>
<td>$120</td>
</tr>
<tr>
<td>Taxable Income (Loss)</td>
<td>($300)</td>
<td>$10</td>
<td>$130</td>
<td>$130</td>
<td>$130</td>
</tr>
<tr>
<td>Debt Amortization</td>
<td>$0</td>
<td>$225</td>
<td>$225</td>
<td>$225</td>
<td>$225</td>
</tr>
</tbody>
</table>

A’s “at risk” investment is increased by taxable income and decreased by distributions. Payments on the debt itself are irrelevant under the Senate Report. Thus, A’s losses would appear as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income (Loss)</td>
<td>($300)</td>
<td>$10</td>
<td>$130</td>
<td>$130</td>
<td>$130</td>
</tr>
<tr>
<td>Loss Allowed</td>
<td>0</td>
<td>0(^1)</td>
<td>$90(^2)</td>
<td>$105</td>
<td>$105</td>
</tr>
<tr>
<td>Loss Deferred</td>
<td>$300</td>
<td>$300</td>
<td>$210</td>
<td>$105</td>
<td>0</td>
</tr>
<tr>
<td>Total Income (Net)</td>
<td>0</td>
<td>$10</td>
<td>$40</td>
<td>$25</td>
<td>$25</td>
</tr>
</tbody>
</table>

\(^1\) Distribution exceeds income creating negative “at risk” amount of $15.

\(^2\) Income first used to restore negative “at risk” amount to zero.