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Secs. 465 and 714(d): Invest at Your Own Risk

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Secs. 465 and 704(d): invest at your own risk

In fiscal years 1977 and 1978, the Joint Committee on Taxation estimates revenue gains of $417 million and $395 million, respectively, from the tax shelter changes made by the '76 Act. In comparison, the child care credit will result in revenue losses of $384 million and $368 million. Thus, the actual revenue loss from tax shelters is relatively small. But, although tax shelters are a small ticket revenue item, they were a major concern to Congress in 1976 due to the element of inequity (i.e., sheltering of high bracket income) to taxpayers in general. In addition, Congress seemed to be genuinely concerned with investment market dislocations and unsound or unproductive use of investment funds.

Thus, to curb one of the principal elements of tax shelter abuse—leverage—Congress adopted the "at risk" rule (new Sec. 465), and a similar but broader limitation on deductible losses of partners (amended Sec. 704(d)).

1 Joint Committee on Taxation, Summary of the Tax Reform Act of 1976, 109 (CCH Special 14).
2 Id.
4 Id., at 109. Congress chose this approach over the House Limitation on Artificial Accounting Losses ("LAL") approach on the theory that the combination of the "at risk" rule and the minimum and maximum tax provisions would curb tax shelter abuse, while avoiding the adverse economic impact that would have resulted from the House bill. Id. at 110. Translated into English, this explains the otherwise curious exception from the at risk provisions and amended Sec. 704(d) for real estate investments. See 122 Cong. Rec. S 10108 (Daily Ed. June 22, 1976) (Senator Bentsen).

"At risk" rule: limitation of leverage

The "at risk" rule, in effect, constitutes a limited legislative reversal of the Crane rule. Under Crane, nonrecourse (and recourse) indebtedness is generally included in an investor's adjusted basis in business or productive property and also is included in his amount realized upon a subsequent sale. Thus, write-offs against liabilities generate a no-cash gain, or "phantom income," upon a disposition of the property. In addition, in many cases, a taxpayer could deduct losses in excess of the amount he was actually "at risk" in an activity.

The Senate Finance Committee chose to use an "at risk" limitation, under which a taxpayer's losses are limited to the sum of his equity contributions and borrowed amounts on which he is personally liable in selected tax shelter activities, as the primary alternative to the LAL provisions of the House Bill. The committee report states that

7 Tax Shelters, Analysis Prepared by the Staff of Joint Committee on Taxation, 84 (CCH Special Ed. 17, 1976).
8 See note 3, at 47.
the Senate Finance Committee believed that the "at risk" rule dealt more directly with abuses in tax shelters.9

Taxpayers and activities covered

New Sec. 465 applies the "at risk" limitation to all categories of taxpayers except taxable corporations which are not personal holding companies.10 While the category of taxpayers is quite broad, including partnerships,11 the tax shelter activities to which Sec. 465 applies are quite narrow:

- Holding, producing, or distributing motion picture films or video tapes;
- Farming (except timber operations);
- Leasing any Sec. 1245 property—this is primarily aimed at equipment leasing tax shelters; or
- Exploring for, or exploiting, oil and gas resources.12

The Senate Finance Committee Report does not discuss why these particular activities were singled out or why the list is so narrow. However, it is clear from the floor debate that the Senate thought real estate ventures differed from other tax shelter activities.13

Mechanics of disallowance

Suspense account. Sec. 465(a) provides that any loss from an "at risk" activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk at the close of the tax year. Any disallowed loss goes into a "suspense account" to be carried forward indefinitely and treated as a deduction allocable to the activity in the next succeeding tax year. The term "loss" is defined as the excess of deductions allowable for the tax year, determined without regard to Sec. 465 and allocable to an "at risk" activity, over the income received or accrued by the taxpayer during the taxable year from the activity.14 As a consequence of the carryforward provision, if a taxpayer's amount "at risk" increases in later years he will be able to obtain the benefit of previously suspended losses to the extent that such increases in his amount at risk exceed his losses in later years.15 Presumably, this "suspense account" is personal to the taxpayer. Thus, if an individual taxpayer dies prior to full utilization of carryforward losses, the suspense account would be extinguished just as previously taxed income under Secs. 1373(b) and 1375(d) is.

Partnership rule for retained profits. The Senate Finance Committee Report provides a special rule for partnerships, analogous to the partners' basis provisions, under which a partner is treated "at risk" to the extent that his basis in the partnership is increased by his share of partnership income.16 As a corollary, if the partnership does not "retain" the income (generally the retention would consist of taxable income which was used for nondeductible partnership expenses such as amortization of loan principal), and makes actual distributions of the income to a partner in the tax year, the distribution reduces the partner's amount "at risk," just as a distribution reduces a partner's basis under Sec. 705.17 There is no clear indication that the latter rule would apply in the absence of partnership income to create a negative "at risk" amount; i.e., where the taxpayer's amount at risk has been fully offset by losses, cash flow distributions apparently do not generate a negative "at risk" amount to absorb subsequent retained partnership income before a positive "at risk" amount arises.20 Rather, the distribution-reduction rule appears merely the necessary mechanical corollary of the basis and "at risk" increase for a partner's distributive share of partnership income—if the partnership, instead of retaining the income, makes actual distributions of the income to a partner in the taxable year, the amount distributed reduces the partner's amount at risk.21 Where retained partnership income increases a partner's amount "at risk," such increase must be reduced by "personal," i.e., "at risk," noncourse indebtedness included in his basis.22 This could arise in the case of a noncourse partnership liability guaranteed by a limited partner.

Although the Senate Finance Committee did not address the question, a similar increase in amount at risk for retained income (used to pay non-deductible expenditures) should apply in non-partnership contexts.

Tracing concept. There is a final element in the mechanics of applying the "at risk" rule: a tracing concept is adopted under which, as to activities that were begun in tax years beginning before Jan. 1, 1976 (and are not exempted by various transitional rules),23 amounts deducted in such tax years generally reduce first the portion of the taxpayer's basis which is attributable to amounts not "at risk."24 Conversely, withdrawals made in

9 Id.
10 Sec. 465(a).
11 See note 3, at 48.
12 Sec. 465(c)(1).
14 Sec. 465(d).
15 Id.; Sec. 465(b)(5); and note 3, at 48.
16 See Sec. 705(a)(1).
17 See note 3, at 50.
18 Id., at 51.
19 Sec. 705(a)(2).
20 In the corresponding partnership basis provisions, a negative basis cannot arise, see Sec. 705(a)(2); M. Fal­koff, 82 TC 200 (1974). Rather, cash flow distributions in excess of basis where there are no unrealized receivables give rise to a capital gain under Sec. 731(a).
21 See note 3, at 51 (emphasis supplied).
22 Id., at 50.
23 76 Act Section 204(c)(2) and (3).
taxable years beginning before Jan. 1, 1976, will be treated as reducing the amount which the taxpayer is "at risk."\textsuperscript{25}

**Amount at risk**

Once one has determined the taxpayers and the activities to which Sec. 465 applies, the critical factor is the amount deemed to be "at risk." Under Sec. 465(b)(1), a taxpayer is considered "at risk" for an activity with respect to (A) the amount of money and the adjusted basis of the property contributed by him to the activity, and (B) "borrowed amounts" as to such activity.

**Property contributions.** The term "adjusted basis of other property contributed by the taxpayer to the activity" appears relatively simple, even deceptively so. But the situation in which a taxpayer dies (and his suspended losses disappear) poses substantial problems. It could be argued that the decedent's transferee contributed no property to the activity and, therefore, no amounts are considered at risk from property contributed by the deceased taxpayer. This obviously unjust result is not likely to be adopted. Therefore, the decedent's transferee should be deemed to have contributed his inherited interest in the property to the activity. But what about any increase in adjusted basis in the transferee resulting from the "fresh start" rule of new Sec. 1023? If the transferee is deemed to have contributed the property to the activity, then any increase in his adjusted basis from payment of estate taxes, etc., under Sec. 1023 also would increase his amount considered at risk. Even assuming that this approach is adopted in the regulations, substantial technical problems arise in applying it to the partnership area. In the case of transfer of a partnership interest, the general rule under Sec. 743(a) is that the transferee's "outside" adjusted basis in his partnership interest does not affect the partnership's "inside" adjusted basis in its assets. Yet it is the partnership assets, not the partnership interest, that must be considered contributed to the activity. Therefore, if the transferee-partner is to have any amount attributable to his purchase price or inherited basis (under Secs. 742 and 1023) considered at risk in the partnership activity, his share of the partnership's inside adjusted basis (presumably with Sec. 743(b) inside basis adjustments under a Sec. 754 election) will have to be considered to have been contributed to the partnership. Alternatively, upon every such transfer, in an analogy to Regs. Sec. 1.708-1(b)(1)(iv), the old partnership will have to be deemed to have terminated and distributed all of its assets to the remaining old partners and the new transferee partner who then contributes all of such assets to the new partnership (and thus to the partnership activity).

**Borrowed amounts.** Sec. 465(b)(2) defines the term "borrowed amounts" as amounts with respect to which the taxpayer is personally liable for repayment or has pledged property, other than property used in the activity, as security for the borrowed amount, to the extent of the net fair market value of his interest in the property. The taxpayer is not considered "at risk" as to the proceeds of his share of any nonrecourse loan he used to finance the activity or the acquisition of property used in the activity. In addition, if the taxpayer borrows money to contribute to the activity and the lender's sole recourse is either against the taxpayer's interest in the activity or property used in the activity, the amount of the proceeds of such borrowing are considered amounts financed on a nonrecourse basis and not an increase of his amount at risk.\textsuperscript{26}

The Senate Finance Committee Report uses in this context the language "the lender's recourse is either the taxpayer's interest in the activity or property used in the activity,"\textsuperscript{27} while Sec. 465(b)(2)(B) speaks only of a pledge of property, other than property used in the activity. Arguably, under the latter provision, a shareholder in a subchap. S corporation could secure a loan with a pledge of his stock interest in the corporation and then lend or contribute the proceeds of the loan to the subchap. S corporation and increase his amount "at risk." Possibly, such a case comes within the umbrella prohibition of Sec. 465(b)(4) as to "amounts protected against loss through nonrecourse financing . . . or other similar arrangements" (discussed below).

Another interesting and apparently unintended anomaly arises in the case of subchap. S corporations. Assume a shareholder lends amounts to a subchap. S corporation which uses the proceeds to purchase property for a Sec. 465 activity. If the limitation of Sec. 465(a) applies at both the corporate and the shareholder level, and it appears that it does, there is an unexpected result. Although the shareholder has both basis and is "at risk," the corporation is not "at risk" since the amounts were borrowed from a related party (Sec. 465(b)(3)). The taxpayer's and the Service's classic roles in the debt vs. equity imbroglio are reversed.

**Cross-collateralizations.** Sec. 465(b)(2) provides that no property will be taken into account as security, i.e., pledged property at risk, if it is directly or indirectly financed by indebtedness secured by property used in the activity. The purpose of this provision is to prevent the taxpayer from increasing his "at risk" amount by cross-collateralizing property used in the activity with other property not used in the activity.\textsuperscript{28}

\textsuperscript{25} Id.
\textsuperscript{26} Id., at 49.
\textsuperscript{27} Id.
\textsuperscript{28} Id., at 50.
**Stop-loss guarantees and reimbursements.** In certain tax shelter areas, particularly livestock feeding operations, promoters commonly provided investors with guarantees or reimbursement of investment against any loss sustained above, say, a stated dollar amount per head.\(^{29}\) Indeed, a wide variety of protections against ultimate loss had grown up in this area through stop-loss orders, guarantees, guaranteed repurchase agreements, etc. Accordingly, Sec. 465(b)(4) states that a taxpayer will not be considered "at risk" as to "amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar agreements." The Senate Finance Committee explains to some degree the scope of this provision. Indeed, the provision is so broad that the Committee thought it necessary to carve out specifically in its report circumstances under which "at risk" portions of equity would be available.\(^{30}\) For example, with stop-loss orders an investor will be considered "at risk" to the extent of the portion of his capital against which he is not entitled to reimbursement. And, where there is a guaranteed repurchase agreement, the taxpayer will be considered "at risk" as to the portion of his equity investment over and above the guaranteed repurchase price. Similar provisions apply to a limited partner's exposure to loss in excess of an indemnity from a general partner. Where a taxpayer separately obtains insurance to compensate himself for any payments which he is personally liable to make, he is "at risk" only to the extent of the uninsured portion of his personal liability, but he can include in the amount "at risk" premiums paid from personal assets for the insurance. Indeed, the Senate Finance Committee Report is careful to state that casualty insurance or insurance protecting the taxpayer against tort liability will not make the taxpayer "not at risk" solely because of such insurance protection.\(^{31}\) Also, government price support programs, in the absence of agreements limiting the taxpayer's cost, do not reduce the amount in which he is "at risk."\(^{32}\)

The above rules assume that a loss-protection guarantee, repurchase agreement, or insurance policy will be fully honored and that the amounts due thereunder will be fully paid to the taxpayer. The possibility that the party making the guarantee to the taxpayer, or that a partnership which agrees to repurchase a partner's interest at an agreed price, will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until the time when the taxpayer becomes unconditionally entitled to payment and, at that time, demonstrates that he cannot recover under the agreement.\(^{33}\)

**Borrowings from related party.** Amounts borrowed from any person with an interest (other than as a creditor) in the activity or who is related to the taxpayer (under Sec. 267(b)) are not considered "at risk."\(^{34}\) Presumably, the rationale is that in such circumstances the lender would not proceed against the taxpayer upon a default.

**Substituted collateral.** "Borrowed amounts" under Sec. 465(b)(2) include borrowings to the extent of pledged property (not used in the activity) to the extent of the value of the taxpayer's interest in the property. However, it appears that such fair market value is fixed at the date of the pledge,\(^{35}\) so that subsequent appreciation would not increase the amount at risk. The legislative history does not clearly state whether it would be possible to substitute new collateral equal in value to the appreciated property and then determine fair market value at the time the substituted collateral is pledged. Since the pledged property rule looks to fair market value and not adjusted basis (as is the case with property contributed to the activity\(^ {36}\), as a policy matter, substitution of collateral should be permitted to utilize the subsequent appreciation; but this may not be allowed by the regulations. There is no indication that any "recapture" rule would apply here. On the other hand, once allowed losses had reduced the amount at risk attributable to pledged property to zero, a taxpayer should not be able to get a "fresh start" by substituting collateral of only equivalent value.

**Annual accounting and economic reality.** Sec. 465(a) states that, as a general rule, a loss from a Sec. 465 activity is allowed only to the extent the taxpayer is "at risk . . . for such activity at the close of the taxable year." Thus, where a taxpayer is personally liable on a loan when initially made, but the loan provides for-release upon the occurrence of certain later events (e.g., a farm activity reaching the productive stage), the taxpayer is considered at risk during the period of personal liability but not thereafter.\(^ {37}\) An unanswered question is whether the risk of actual personal payment of the liability during this period must be real. For example, assume that the liability is personal until the cross-over, at which point it becomes nonrecourse, but until it becomes nonrecourse the loan calls for interest-only payments. Is it too much to provide also for no acceleration of principal in the event of default?\(^ {38}\) Consider a less extreme example

\(^{29}\) Id., at 46 and 49.

\(^{30}\) Id., at 49-50.

\(^{31}\) Id., at 50-51.

\(^{32}\) See note 24.

\(^{33}\) See note 3, at 50, fn. 6.

\(^{34}\) Sec. 465(b)(3).

\(^{35}\) See note 3, at 50.

\(^{36}\) Sec. 465(b)(1)(A). The adjusted basis rule, the probability that substitute property used in the activity would be acquired in a tax-free exchange under Sec. 1031, and the certainty that a carryover basis rule would apply in such case generally rule out any substitution of property to increase basis.

\(^{37}\) See note 3, at 48, fn. 1.

ple of a personal guarantee of the last 20% of a 100% secured liability with an exculpation clause.

Separate activity. Sec. 465(c)(2) treats each film or videotape, leased property, farm, or oil and gas investment as a separate activity. In contrast, an interest in a partnership (or subchap. S corporation) is treated as a single activity to the extent that the entity is engaged in any of the above activities. The reason for the distinction in the form of investment may be that most tax shelter investments by outsiders (as contrasted with the activities of those engaged in the particular business) were conducted through the medium of a partnership or syndicate and Congress wished to discourage only the outsiders. In any event the non-partnership separate activity rule may severely erode the rule that a pledge of property used in a Sec. 465 activity does not give rise to amounts at risk. For example, if taxpayer X used $100,000 of his own funds to purchase rental equipment, and then borrowed $80,000, pledging the rental equipment as security, for the purchase of similar rental equipment, using it in a separate activity, he would be "at risk" for $180,000, although he stood to lose only $100,000 of his own funds.

Another result of the separate activity rule is that income from a "turned-around" activity can be used to increase the amount at risk in a similar activity.

Example. Y, an individual oil and gas operator, invests $100,000 in Property A and $100,000 in Property B. In year one, he incurs $100,000 of intangible drilling costs (IDC) as to Property A. In year two, Property A produces $50,000 of income before statutory depletion. In year two, Y incurs $150,000 of IDC with respect to Property B. As an individual operator, each property is a separate activity as to Y. In year two, Property A has not produced a net loss and, thus, Sec. 465 is inapplicable. Consequently, statutory depletion can be taken as to Property A, and, at the same time, the $50,000 can be contributed to Property B in year two, thereby increasing the amount at risk there.

In a partnership, however, in year one, the partners deduct $100,000 IDC and therefore have $100,000 "at risk" at the close of year one as to properties A and B. In year two, the partnership incurs $150,000 of IDC and therefore has nothing "at risk" at the close of year two. Accordingly, a loss equal to the statutory depletion as to Property A will be suspended. The question of the character of the suspended deduction (IDC vs. percentage depletion) is discussed below.

"At risk" and basis

Basis not affected. The "at risk" provisions do not apply for other purposes, such as determination of basis. For example, a partner's basis in his interest in the partnership would generally be unaffected by the "at risk" limitation.41 Instead, the "at risk" limitation constitutes an overriding provision that would disallow losses which in a partnership context would otherwise be deductible: "... for purposes of determining how much, if any, of his partnership loss a partner may deduct in any year, this provision of the committee amendment overrides the existing partnership rules of Section 704(d) and related provisions, including [the basis determining] regulations section 1.752-1(e)."42

Partnerships. The difference between the partnership basis provisions and Sec. 465 cannot be overemphasized. For example, it appears that although a limited partner guaranteeing or assuming a recourse partnership liability would be at risk under Sec. 465,43 he would not, according to the Service's position,44 have such a recourse liability included in his basis under Sec. 752 for purposes of the Sec. 704(d) partnership loss deduction limitation. Query, whether a limited partner who guarantees a partnership liability retains his status as a limited partner as to creditors of the partnership.45

Another example in which a partner could have a partnership liability considered an amount "at risk," but not included in his basis in his partnership interest, arises where a promoter purchases a business asset with his own personal liability note and then as a general partner contributes the asset to the partnership subject to the existing liability. It appears that for purposes of Sec. 465 the general partner has personal liability as to his interest in the partnership, but the other partners do not have personal liability on the note and, thus, would not be "at risk" with respect to the partnership liability.46 It is possible, in some circumstances, that for partnership basis purposes the liability would be treated as nonrecourse and thus "shared" by the limited partners as well as the general partners in the ratio in which they share partnership profits.47

The fact that the "at risk" limitation does not affect basis has many other consequences. For example, it appears that for all purposes other than deduction of losses, a limited partner would be able to share in nonrecourse liabilities in determining his basis. Thus, if there were refinancing and distribution of cash proceeds to partners (assuming that there was no Sec. 751(c) "hot asset"), distributee-partners, limited or general, would be taxed under Sec. 731(a) only to the extent that the

41 Id., at 48-49.
42 Id.
43 Id., at 49, fn. 5.
45 See 1A Collier, Bankruptcy ¶ 5.39 (14th ed. 1974).
46 See note 38, at 110.
distributions were in excess of their basis, including nonrecourse liabilities, under Sec. 752.

Subchap. S. Inconsistency between basis and amounts "at risk" also appears in the context of shareholders in subchap. S corporations. Under Sec. 1374(c)(2), a shareholder's portion of his subchap. S corporation's net operating loss is limited to the adjusted basis of his stock and any indebtedness of the corporation to him. For this purpose, no form of indirect borrowing by the shareholder, be it guaranty, surety, accommodation, or otherwise, gives rise to indebtedness of the corporation to the shareholder, and hence basis, unless and until the shareholder pays all or part of the obligation.48

"Phantom income." The interface between basis and the amount "at risk" could produce unexpected results, or "phantom income" with a vengeance. Assume a limited partner in an equipment leasing shelter makes in year one a capital contribution of $20,000 and his share of nonrecourse partnership liabilities is $80,000. In year one, his distributive share of partnership loss is $40,000. His amount "at risk" is only $20,000 although his basis is $100,000. Consequently, only $20,000 of the loss is allowed although under Sec. 705 his basis arguably is reduced to $60,000. Upon a sale of his partnership interest in year two for $1,000, his gain by virtue of Sec. 752(d) and Crane49 is $21,000.

The problem arises as follows: Sec. 705(a)(2) provides that the adjusted basis of a partner's interest in a partnership is decreased, but not below zero, by the sum of his distributive share of partnership losses for the taxable year and prior taxable years. Neither this provision nor the regulations provide that such distributive share of losses is limited to the amount of losses allowable. The reason, of course, is obvious. Under the pre-'76 Act interplay between Secs. 704(d) and 705, a partner's distributive share of partnership loss was allowed only to the extent of his adjusted basis, and under Sec. 705 his adjusted basis could not be decreased below zero by his share of partnership losses. With Sec. 465 and the amendments to Sec. 704(d) (discussed below), under which a partner's distributive share of partnership losses in certain partnership activities are suspended, Sec. 704(d), as amended, has come out of alignment with Sec. 705. Consequently, a partner's distributive share of losses could reduce his basis in his partnership interest (but, of course, not below zero) although he could not deduct such losses due to the "at risk" rule. Yet the full amount of his share of the liability would, under Sec. 752(c), be included in the amount realized upon a subsequent disposition of his partnership interest. Since there appears to be no provision for increasing a partner's amounts considered "at risk" for gain realized upon the sale of his partnership interest (as contrasted with retained partnership income), the suspended losses would not offset the "phantom income" arising from those selfsame losses. Nor does it appear that the taxpayer could successfully argue that because he received no "tax benefit" from the suspended losses, his basis should not be reduced by such losses that generate "phantom income."50 Although the phantom income has the practical effect of a "recovery" of an item previously expensed,51 it is not actually this but arises from Crane. In any event, the tax benefit rule is more properly viewed as an adjunct to the annual accounting principle; a deduction should be taken based upon facts in the tax year of the expenditure and a correlative adjustment (restoration to income) made in the subsequent year when facts manifest that the deduction should not have been taken,52 unless the prior deduction generated no tax benefit.

Potential partnership recapture and "at risk"

A problem apparently not considered at all by the drafters of Sec. 465 is that it is theoretically possible for a shelter partnership to have substantial potential Sec. 1245 or Sec. 1250 recapture53 at the partnership level which was never deducted by a partner due to the "at risk" limitations. Yet when such partner disposes of his partnership interest, or receives certain disproportionate distributions, he may have substantial ordinary income under Sec. 751(a) or (b) even though he never enjoyed the deductions. This could occur even if the entire transaction does not itself result in any economic gain at the partner level.54 Again, the

48 M. T. Radnor, 50 TC 762, 771 (1968).
49 See Frank A. Logan, 51 TC 482 (1958).

52 See Est. of D. B. Munter, 63 TC 663, 678 (1975) (Tannenwald, J., concurring).
53 Potential partnership depreciation recapture constitutes an "unrealized receivable" as defined in Sec. 751(c).
54 See Regs. Sec. 1.751-1. These provisions can create Sec. 751 ordinary income where there is no economic gain on the entire transaction (i.e., where taxpayer's aggregate basis equals his aggregate amount realized) if there is potential partnership recapture. This is because the entire transaction is split into two components, the Sec. 751 component and the capital or Sec. 741 component. The total amount realized is allocated between the two components. Regs. Sec. 1.751-1(a)(2). However, basis is not prorated between the two components; rather the partner takes over the partnership basis in the Sec. 751(c) assets as if the partnership had distributed the asset to him immediately prior to the taxable transaction. Regs. Sec. 1.751-1(a)(2). Potential partnership recapture has a zero basis to the part-

THE TAX ADVISER, MARCH, 1977

137
tax benefit doctrine would not apply. Nor would the taxpayer's amount deemed at risk be increased by the "recapture" or "Hot Asset" gain so as to absorb the suspended losses.

"At risk" and the minimum tax

Still unclear is the effect on a taxpayer's minimum tax liability of the suspension of a deduction under Sec. 465 which, in effect, generates a tax preference item, e.g., accelerated depreciation. Arguably, the suspended deduction does not constitute a tax preference item unless and until it is allowed. The definition of a tax preference item which could be so suspended, speaks of the deduction "allowable for the taxable year."55 Sec. 465(a) states that any loss from specified activities is "allowed" only to the extent at risk. Assuming arguendo that a deduction suspended under Sec. 465 does not constitute a deduction allowable for the taxable year in which incurred, the question arises as to the applicability of the new tax benefit rule of Sec. 58(h). This subsection provides that the IRS must prescribe regulations under which items of tax preference will be "properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax . . . for any taxable years." It appears that Congress was contemplating the situation in which items of tax preference alone eliminate all taxable income, thereby resulting in the loss of other itemized deductions, which cannot be carried forward or back.56 Were a suspended deduction held to constitute an item of tax preference in the year in which incurred, it would not be possible in that year to determine whether the taxpayer would ever realize a tax benefit from the tax treatment. If the taxpayer's amount considered at risk were to increase subsequently so that the suspended deduction could be used, then the taxpayer would obtain a tax benefit. Conversely, were the suspended deduction never taken, the taxpayer would never have a tax benefit. In such circumstances, there are two radically different approaches that the regulations could take:
- Hold the transaction open and treat the suspended deduction as an item of tax preference in the first taxable year in which an actual suspended loss is taken; or
- Treat the suspended deduction as giving rise to an item of tax preference in the year in which the deduction is incurred, and in the subsequent year in which it becomes clear that the taxpayer will never have any tax benefit from the suspended deduction, grant an offsetting deduction from his items of tax preference in that year.

Obviously, the first alternative is more equitable, but it is to be hoped that the Service avoids the entire imbroglio by treating a suspended deduction as one that is not "allowable" for purposes of the definition of items of tax preference until it is actually used by the taxpayer.

Character of suspended deduction. Assuming that the item of tax preference attributable to a suspended deduction is "suspended" as well, the technical question whether a suspended deduction retains its character (i.e., will give rise to an item of tax preference in the year allowed), must be answered. The House Committee Report indicates that a suspended deduction retains its character. Under the House Bill, the risk limitation was applied before the limitation on artificial accounting losses ("LAL"). Where a deduction was suspended and later allowed as a deduction because a taxpayer's risk investment increased at the end of a subsequent year, the committee report pointed out that the LAL restrictions might apply in the subsequent year.57 By analogy, the same results should apply to an item of tax preference. However, this approach gives rise to a host of further problems. For example, in the year in which the expenditure was incurred, the taxpayer might not have had sufficient tax preference items to trigger the minimum tax, but when the deduction is allowed due to an increase in amounts considered at risk, other items of tax preference may generate minimum tax. The converse of such a rule offers tax planning potentialities. If a taxpayer sees, near the end of a year, that he will generate less in tax preference items in such year than he may have in future years, he could increase his amounts at risk (e.g., by guaranteeing a loan for a fixed period of time), thereby triggering the suspended deduction and the tax preference in a year in which he would have no minimum tax. Similarly, a taxpayer might attempt to trigger tax preference items in a year in which he had little or no earned income.

Accelerated depreciation. A more serious problem concerns items of tax preference arising from accelerated depreciation. Sec. 57(a)(2) and (3) define the item of tax preference as the amount by which the depreciation deduction allowable for the taxable year exceeds the deduction which would have been allowable for such year had the taxpayer depreciated the property under the straight line method for each taxable year over its useful life. Assume that in year one, taxpayer A takes double declining-balance depreciation on a Sec. 1245 asset with a useful life of ten years. The de-

55 See, e.g., Sec. 57(a)(2), (a)(3), (a)(8), and (a)(11).
56 See note 38, at 132.
57 Id., at 109.
preciation deduction is suspended because A has no amount at risk. In the year ten, A increases his amount considered at risk and takes the suspended deduction. Literally, the suspended depreciation deduction is twice the amount of the depreciation which would have been allowed in year ten had A depreciated the property under the straight line method for each taxable year. Actually, however, the taxpayer has not received any tax benefit from the "acceleration" of depreciation because the depreciation deduction has not been taken earlier than it would have been taken under the straight line method. However, this situation may not fall within the ambit of Sec. 58(h) (tax benefit rule). Yet, such "accelerated" depreciation should be treated as generating a tax preference item in the year it is deducted (the year that the taxpayer's amount at risk increases) only to the extent that the aggregate of all depreciation deductions actually allowed through the tax year exceed the aggregate straight line depreciation deductions that would have been allowed if the taxpayer had invested sufficient amounts "at risk."

Allocation. Where the taxpayer has some amount at risk and there are both deductions that generate tax preference items and other deductions that do not, the question arises as to allocation. The House Committee Report provides that a loss which is not allowable under Sec. 465 will be allocated to the various deductions which, but for Sec. 465, would be allowable to the business. "Such allocation is to be made in accordance with the regulations, but generally according to an appropriate pro rata method."58 Thus, where depreciation is involved, presumably a pro rata portion of the suspended deduction would be accelerated depreciation. Similarly, in the above partnership, IDC, and statutory depletion example, the two expenses would have been prorated in the disallowance.

Effective date

The effective dates of Sec. 465 are quite complex because, while generally the "at risk" provision applies as to losses attributable to amounts paid or incurred for taxable years beginning after Dec. 31, 1975, there are extensive transitional rules for movies and videotapes and for equipment leases59 which will not be discussed here.

Partnership "at risk" rule

In the Senate floor debate on the Tax Reform Bill of 1976, the liberal block twice attempted to revive the House LAL approach. They lost both times. They then waited until the main body of the Senate Finance Committee tax shelter reform provisions, including the "at risk" provisions, had been passed. Then Senators Haskell and Kennedy proposed an amendment to Sec. 752 under which a limited partner's "share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership, and the total contribution which he is obligated to make under the partnership agreement." This basis rule would have applied generally to partnerships formed after June 30, 1976, except in the case of a low income housing partnership, in which case it would have applied to one formed after Dec. 31, 1981. The effect of the amendment would have been to apply the "recourse rule" of Regs. Sec. 1.752-1(e) to nonrecourse liabilities with respect to limited partners. The sponsoring Senators relied heavily on the fact that they were simply applying the "at risk" rule of Sec. 465 in a broader context.60

The Conference Report states that the partnership "at risk" rule "generally follows the Senate amendment." However, close examination shows substantial differences.

Technically, the final provision, '76 Act Section 213(e), amends Sec. 704(d), which provides that a partner's distributed share of partnership loss is allowed only to the extent of the adjusted basis of his interest, by adding that for purposes of Sec. 704(d), "the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability." (Emphasis supplied.)

Activities and partners affected

Amended Sec. 704(d), by the terms, does not apply to any activity to which Sec. 465 applies nor does it "apply to any partnership the principal activity of which is investing in real property (other than mineral property)." Thus, new Sec. 704(d) applies to loss deductions of both general and limited partnerships and to both limited and general partners, unlike the Senate floor amendment. Consequently, in a partnership to which this provision applies, a general partner will not be able to take losses against his share, under the Sec. 752 regulations, of nonrecourse partnership liabilities.

Operating rules

The Conference Report states that it is intended that in determining whether a partner has personal liability as to any partnership liabilities, rules similar to those of Sec. 465 will apply. "Thus, for example, guarantees and similar arrangements will be taken into account in determining whether there is personal liability."61 Since the Conference Re-

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58 Id.
59 See '76 Act Section 204(c) for effective dates; see also, note 1, at 5.
61 See note 24, at 423.
port makes reference to Sec. 465, query whether the related party rules of Sec. 465(b)(3)(B) are incorporated to situations within the ambit of Sec. 704(d). However, because the amendment to Sec. 704(d) refers only to inclusion of partnership liabilities in basis for purposes of the allowance of a partner's distributive share of partnership losses, the parallel with Sec. 465 cannot be exact. For instance, it appears that a partner in a partnership engaged in a non-Sec. 465 activity could borrow from a third party, secure the loan solely by a pledge of his partnership interest and contribute the proceeds of the loan to the partnership and thus increase basis for purposes of Sec. 704(d). Conversely, if all the partners borrow outside and pledge their interests on a nonrecourse basis, this would probably be deemed a nonrecourse partnership liability. This might be described as an application of the "too piggy rule."

It has been suggested that the language of amended Sec. 704(d) ("adjusted basis . . . shall not include any portion of any partnership liability with respect to which the partner has no personal liability . . . ") has a clear existing meaning under which "if any partnership undertook a debt obligation, regardless of the existence of a guarantee or an indemnification and regardless of the source from which the monies might be borrowed, the statute [Sec. 704(d)] would consider that there is a personal liability under the state law applicable to partnerships and partners."62 Support for this view arises from the fact that the nonrecourse financing exception of Sec. 465(b)(4) overrides "borrowed amounts" under Sec. 465(b)(2)(A) as to which a taxpayer is "personally liable." But if the meaning of personal liability is to be found under state law, then limited partners will be able to include only the portion of any partnership liability equal to their unpaid capital contribution, for that is the extent of a limited partner's personal liability in any jurisdiction that has adopted the Uniform Limited Partnership Act. In short, the above argument (which is the easiest reading of the statute, albeit in conflict with the Conference Report) brings us full circle back to the Haskell-Kennedy amendment, which would have generally applied the "recourse liability" rule of Regs. Sec. 1.752-1(e) to limited partners.

**Sec. 704(d) and basis**

As we have seen, the Sec. 465 "at risk" rules, in determining whether a partner has a personal liability, may differ considerably from the Sec. 752 rules as to how a partner shares in partnership liability. The identical problem arises in Sec. 704(d). Thus, it is apparent that in many instances, such as a limited partner sharing in nonrecourse partnership liabilities, a partner may have basis under Sec. 752 and yet not have the basis for purposes of deducting losses under Sec. 704.

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rental real estate. Of course, the literal language of the Report would apply as well to raw land. Query whether under the literal language of Sec. 704(d)—"principal activity of which is investing in real property"—most real estate tax shelters as to which the partnership carries on a trade or business would come within the exception?67 A potentially more serious problem is that of a tier-partnership where arguably only the bottom tier partnership principally involves real estate.68 Unfortunately, Temporary Regs. Sec. 7.704-1(d)(3) uses the term "investing in real property" rather than "involving real property" in describing this exception.

Effective date

Amended Sec. 704(d) applies to liabilities incurred after Dec. 31, 1976.

Conclusion

The Senate Finance Committee amendment deleted LAL for two principal reasons: its complexity and its adverse economic impact. It seems to us that the Secs. 465 and 704(d) provisions are at least as complex as the LAL provisions and correct few, if any, of the administrative and compliance difficulties of LAL perceived by the Senate Finance Committee. Moreover, the amendments introduce statutory conflicts which will not be easily reconcilable with existing subchapter K (partnership) provisions. A better solution might have been to adopt LAL with exceptions for real estate and oil and gas.

One would expect that the drafters of the regulations will overlook the gaps in the statute, Congress will return to this area and make some technical amendments, or the courts will fashion an analogue to the tax benefit rule where appropriate. Otherwise, tax consequences clearly not contemplated by Congress will result.

In the meantime, in this area taxpayers invest and their advisers proceed at their own risk.}

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