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The Regulation of Tax Shelters and New Internal Revenue Code Section 469: A Complex and Unnecessary Addition to The War on Abusive Tax Shelters

ELIZABETH K. LEWICKI*

TAX SHELTERED INVESTMENTS

Until the Tax Reform Act of 1986,1 a taxpayer was generally free to use deductions or credits from one activity to offset income from other activities. Largely in response to high marginal tax rates, many high income taxpayers invested in transactions designed to generate tax losses that could be used to offset income from other sources. Such transactions came to be known as "tax shelters" because investors effectively "sheltered" unrelated income with their tax losses. Many tax shelter transactions have been conducted in the form of a limited partnership, which minimizes personal liability for the limited partners while passing the tax benefits of the activity through to all of the partners.2

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While some tax shelter transactions involve esoteric activities such as movies, art reproductions, or racehorses, the vast majority of such transactions involve activities which are quite useful to society. In 1985, for example, total sales of limited partnership interests in public syndications totaled about $11.5 billion. Real estate syndications, generally considered to be the least controversial of all tax shelters, accounted for seventy percent of the total. Oil and gas syndications, which have frequently been the beneficiary of Congressional support, accounted for almost sixteen percent of the total. Equipment leasing transactions accounted for almost 5% of the total while all other transactions comprised only about nine percent of publicly syndicated tax shelters.

The number of abusive tax shelter transactions has declined in recent years in response to various initiatives by Congress and the Service, which are described below. Private syndications are some-

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6. Sales of Syndicated Limited Partnership Interests (Billions of Dollars)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Public</th>
<th>Private</th>
<th>Real Estate</th>
<th>Public</th>
<th>Private</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>5,510</td>
<td>3,963</td>
<td>1,547</td>
<td>2.471</td>
<td>1,647</td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>8,347</td>
<td>7,360</td>
<td>987</td>
<td>4,475</td>
<td>3,933</td>
<td></td>
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<tr>
<td>1984</td>
<td>8,401</td>
<td>10,497</td>
<td>5,686</td>
<td>5,308</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>11,549</td>
<td>7,502</td>
<td>8,062</td>
<td>4,682</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>13,138</td>
<td>3,550</td>
<td>8,461</td>
<td>2,650</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Robert A. Stanger & Co., P.O. Box 7490, Shrewsbury, N.J. 07701.


8. See Stanger, supra note 6.

9. The definition of an "abusive" tax shelter varies with the eye of the beholder. An abusive tax shelter can range from a fraudulent or sham transaction, to a transaction that aggressively utilizes existing tax law in a novel fashion (with or without regard to the underlying economic substance of the transaction), to a transaction that utilizes conventional tax techniques in a manner that reduces taxable income without sacrificing economic gain.

10. Private syndications are those transactions which are not registered with the Securities
what more likely to lead to abuses of both investors and the Code because they are not as closely regulated as public syndications. Until the Deficit Reduction Act of 1984,11 private syndications represented a larger segment of the tax shelter market than public syndications. Beginning in 1984, however, sales of private tax shelter syndications declined from $10.5 billion in 1984, to $7.5 billion in 1985, and only $3.5 billion in 1986.12 Real estate syndications, which have little potential for abusing the Code, grew from a forty-three percent share of all syndications in 1982 to sixty-seven percent of the market in 1985 and 1986. Finally, while some purely fraudulent transactions continue to be marketed by unscrupulous promoters, these frauds are unlikely to be reduced without significant additional criminal prosecutions.

The syndicated limited partnership form of business is an important segment of the capital formation process in this country. In real estate, for example, some projects are small enough that an individual can contribute the entire equity required by a conventional lender as a condition to financing the project. Other projects

and Exchange Commission or with state regulatory authorities. See 15 U.S.C. §§ 77a-77aa (West 1981 & Supp. 1987). Instead, private syndications are marketed under one or more of the private offering exemptions in section 2(a) of the Securities Act of 1933; the intrastate exemption of section 3(a)(11) of the Securities Act of 1933; and limited offering exemptions under state securities laws (e.g., CAL. CORP. CODE. § 25102(f) (West Supp. 1987)). Since 1982 most private syndications have relied on the exemptions described in Rules 501 through 506 of the SEC's Regulation D. 17 C.F.R. §§ 230.501-230.506 (1986).


11. See infra notes 68-75 and accompanying text.

are large enough that major investors, such as insurance companies or pension plans, will contribute the necessary equity. Many financially viable projects, however, are too small for large institutional investors and too large for most individual investors.

Syndicated partnerships permit a small group of investors to pool their equity capital and undertake those projects which would otherwise fall in the gap between individual and institutional investments. Private syndicated real estate partnerships typically involve properties such as small to medium size apartment projects and shopping centers. While the overbuilding of such projects may occasionally create a temporary surplus in certain geographic areas, there almost certainly would be an undersupply of these properties if small syndicated partnerships did not exist.

Syndicated tax shelter entities are an important part of the economy for another reason. There are numerous activities that by their very nature involve a high degree of risk; nevertheless, Congress considers these activities to have sufficient social value to justify special tax incentives. For example, most research and development projects and virtually all alternative energy projects (e.g., solar energy, windmills) are extraordinarily risky and unlikely to be undertaken without special incentives. Congress has from time to time provided special tax incentives to stimulate these activities. Similarly, exploring for or developing oil and gas wells is a very risky activity for which Congress generally provides special incentives.

Many of these activities are so risky that few major corporations or conventional lenders will participate in them. Syndicated tax shelters once again have filled the investment void by permitting individuals who are willing to assume large risks to pool their

14. See, e.g., I.R.C. § 174 (West Supp. 1987) (election to expense qualified research and development costs). In addition to the regular 10% investment tax credit (repealed by the Tax Reform Act of 1986) (see infra note 79 and accompanying text) there have been a number of special alternative energy credits, including: a credit for solar wind or geothermal property of 10% from 1978 through 1979 and 15% from 1980 through 1983; a 15% credit for ocean thermal property from 1980 through 1988; a 10% for chlor-alkali electrolytic cells from 1980 through 1982; a 15% credit for other solar energy property for 1986 and a 12% credit for 1987; and a 15% credit for geothermal property in 1986 and 10% for 1987 through 1988. I.R.C. § 46(b) (West Supp. 1987).
15. WESTIN, supra note 13, at § 14.05.
capital and undertake the activities which Congress seeks to stim-
ulate. The tax incentives adopted by Congress, moreover, are an
important stimulus for these extraordinarily risky investments. Hence,
tax sheltered transactions contribute to the economy in ways not
only anticipated but affirmatively intended by Congress.

The common perception that people invest in tax shelters primarily
for the anticipated tax benefits appears to be overstated. For ex-
ample, an analysis of a typical real estate tax shelter in 1985
indicated that only about twenty percent of the anticipated total
yield was attributable to its tax benefits. The remainder of the
projected yield was attributable to profits from operations and gain
on the ultimate sale of the property.\(^\text{17}\) While the anticipated and
actual results of a variety of tax shelter transactions may vary
greatly, it seems likely that the tax benefits associated with such
transactions have been exaggerated by promoters and critics alike.

**CODE SECTION 469: ANOTHER CONGRESSIONAL EFFORT TO CURB
ABUSIVE TAX SHELTERS.**

Despite the social utility of most tax shelters, by 1986 "Congress
concluded that it had become increasingly clear that taxpayers were
losing faith in the Federal income tax system."\(^\text{18}\) According to
Congress, "extensive shelter activity contributes to public concerns
that the tax system is unfair, and to the belief that tax is paid only
by the naive and the unsophisticated."\(^\text{19}\) Congress blamed tax shel-
ters for a host of national problems, ranging from "diverting
investment capital from productive activities to those principally or
exclusively serving tax avoidance goals,"\(^\text{20}\) to "the serious economic
difficulties presently being experienced by many active farmers."\(^\text{21}\)
Although the perceived problems might have been addressed by
reducing or eliminating various tax preferences, Congress recognized
that there are many preferences which are socially or economically
beneficial.\(^\text{22}\)

\(^{17}\) Richman, *Techniques for Analyzing the Economics of Real Estate Investments*, 37
713.
\(^{20}\) Id.
\(^{21}\) Id.

Among the numerous tax preferences still available are the deduction for qualified residence
Congress determined, therefore, "that decisive action was needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that was a necessary precondition to a beneficial and widely desired reduction in rates."23 Congress' "decisive action" was the adoption of new Code section 469,24 which provides that certain taxpayers may not currently deduct losses and credits from passive activities in excess of income and gain from other passive activities.25 Passive activity losses ("PALs") are not deductible except to the extent of passive income and gains ("PIGs"). Transactions generating "PIGs" have suddenly become very attractive because they can still absorb passive activity losses. On the other hand, transactions generating "PALs" are not as attractive as they were before Code section 469 limited their deductibility.

Under Code section 469, an activity is passive with respect to a taxpayer who does not "materially participate in the activity."26 Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in succeeding years.27 Suspended losses, but not credits, are allowed in full when the taxpayer disposes of his entire interest in the activity to an unrelated party in a transaction in which all realized gain or loss is recognized.28

Through Code section 469 Congress is trying to curb the sheltering of "positive income" by tax losses from other activities.29 In its


28. I.R.C. § 469(g) (West Supp. 1987). For tax purposes the gain realized from the sale or other disposition of property is the excess of the amount realized (any money plus the fair market value of property received) over the adjusted basis of the property. I.R.C. §§ 1001(a), (b), 1011 (West 1982). All gain realized must also be recognized, for tax purposes, except to the extent provided in numerous Code provisions. I.R.C. § 1001(c) (West 1982).
29. The term "positive income" does not appear in Code section 469. However, "positive income" is used in the Senate Finance Committee report to refer to salary and portfolio income, and will be given this meaning throughout this article. Sen. Fin. Rep. No. 313, supra note 7, at 716.

"Portfolio income" is also not specifically defined in Code section 469. However, certain items which are intrinsically passive, i.e., arise from activities in which the taxpayer does not actively participate, are not to be treated as passive. These items generally include: interest,
simplest terms, Code section 469 disallows the deduction of losses and credits from passive activities against positive income, including salary and portfolio income. Code section 469 does not eliminate any tax preferences. It simply provides that taxpayers who are "passive" with respect to a particular activity may currently use such preferences only against income or gain derived from other "passive" activities.

Code section 469 is exceptionally complex and is riddled with various special rules. For example, a taxpayer's material participation is irrelevant in determining that working interests in oil and gas property are not passive. In contrast, any rental activity is passive unless the taxpayer qualifies for a maximum $25,000 offset by "actively participating" in the activity of rental real estate other than as a limited partner.

The mechanics of Code section 469 and various planning opportunities are discussed below. Before turning to that discussion, however, a review of Congressional efforts to curb tax shelter abuses demonstrates that the new complexities created by Code section 469 are unnecessary.

CONGRESS HAS ALREADY PROVIDED THE SERVICE WITH THE NECESSARY TOOLS TO COMBAT ABUSIVE TAX SHELTERS.

It was unnecessary for Congress to add Code section 469 to the arsenal of weapons available to the Internal Revenue Service (the
"Service") in its war against abusive tax shelters. The battle waged by Congress and the Service against abusive tax shelter transactions dates back at least to 1969, with the adoption of a number of rules designed to curb farm tax shelters.

Farming was an important early tax shelter because of special rules permitting farmers to deduct costs which other taxpayers were required to capitalize and excusing farmers from maintaining inventories. Thus, city slickers who invested in farms could use farm deductions to shelter non-farm income. The Tax Reform Act of 1969 struck a heavy blow against farm tax shelters by eliminating many of the tax advantages enjoyed by farming activities.

Also in 1969, Congress limited the deduction for interest incurred to buy or carry an investment, which made the use of borrowed funds to finance tax shelter investments less attractive. In addition, Congress adopted a ten percent minimum tax on certain items of tax preference. Consequently, taxpayers attempting to shelter their income were more likely to pay at least some tax on their positive income.

1976 Tax Reform Act

Congress attacked tax shelters again in 1976 with the adoption of a broad range of restrictive provisions. Code section 464 limited

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32. See, e.g., id. § 175 (West Supp. 1987) (authorizing deductions for soil and water conservation expenses); § 180 (West 1982) (authorizing deductions for fertilizer expenses); § 182 (authorizing deductions for expenses incurred in clearing land) (repealed by TRA of 1986, supra note 24, § 402(a), 100 Stat. 2085, 2221); and Reg. § 1.162-12 (authorizing deductions for costs connected with raising livestock).


34. I.R.C. § 163(d) (West 1982 and Supp. 1987) (enacted by the TRA of 1969, supra note 33, § 221, 83 Stat. 487, 574 (effective for tax years beginning after 1971)). Code section 163(d) has been amended a number of times to make it much more restrictive.

35. I.R.C. §§ 56-58 (West 1982) (enacted by the TRA of 1969, supra note 33, §§ 301(a), (c), 83 Stat. 487, 580). Code sections 56-58 were effectively repealed and replaced by the TRA of 1986. Id. §§ 56-58 (West Supp. 1987) (enacted by the TRA of 1986, supra note 24, § 701(a), 100 Stat. 2085, 2322-336). Congress has expanded the list of preference items, and the alternative minimum tax rate is now 20% for corporations and 21% for other taxpayers. I.R.C. § 55. Thus, even taxpayers investing in tax shelters are likely to pay income taxes at a significant rate.

the deduction by "farming syndicates" of many farming expenses.\textsuperscript{37} Congress also adopted Code section 465, which limited certain taxpayers' deductions for losses from an activity to the amount which the taxpayer actually had at risk in the activity.\textsuperscript{38}

Finally, in 1976 Congress adopted a number of additional provisions including, among others, increasing the minimum tax rate,\textsuperscript{39} curtailing partnership tax accounting,\textsuperscript{40} precluding a deduction for

\textsuperscript{37} I.R.C. § 464 (West 1982 and Supp. 1987) (enacted by the TRA of 1976, supra note 36, § 207(a), 90 Stat. 1520, 1536). Code section 464(c)(1) defined a "farming syndicate" as: a partnership or other enterprise engaged in farming if any interest in the enterprise has been offered for sale in an offering required to be registered with a federal or state agency regulating securities transactions; a partnership engaged in farming if more than 35% of the losses during any period are allocable to limited partners; and any other enterprise if more than 35% of the losses are allocated to persons with "limited risks." \textit{Id.} Amounts prepaid for farm supplies were made deductible only when actually used. \textit{Id.} § 464(a). Poultry costs generally had to be capitalized. \textit{Id.} § 464(b). Farming syndicates also were denied the pre-productive period election for groves, orchards, and vineyards in which fruit or nuts are grown. \textit{Id.} § 278(b).


The "at risk" rules contained in Code section 465 proved to be one of the most important restrictions on tax shelter transactions. Generally, Code section 465 limited a taxpayer's deduction for losses from an activity to the amount he has "at risk" in the activity. \textit{Id.} § 465(a). A taxpayer is "at risk" in an activity to the extent of his real investment in it, i.e., for cash and the adjusted basis of property contributed to the activity. \textit{Id.} § 465(b)(1)(A). A taxpayer is also at risk for borrowed amounts contributed to the activity for which he is personally liable for repayment or has pledged property other than property used in the activity. \textit{Id.} § 465(b)(1)(B), (2). The taxpayer must reduce his at risk amount for any losses which he is permitted to deduct under Code section 465. Prop. Treas. Reg. § 1.465-22(c)(2), 44 Fed. Reg. 32241 (1979).

As enacted by the Tax Reform Act of 1976, the at risk rules of Code section 465 and the partnership at risk rules of Code section 704(d) (repealed by the Revenue Act of 1978, Pub. L. No. 95-600, §§ 201(b)(1), 204(a), 92 Stat. 2763, 2816) applied to all activities except real estate if the investment was made directly or through a partnership. The rules applied to direct investments only in the following categories: movies, farming, leasing (except real property) and oil and gas.


\textsuperscript{39} \textit{Id.} §§ 56-58 (West 1982) (amended by the TRA of 1976, supra note 36, § 301, 90 Stat. 1520, 1549 (the minimum tax rate was increased from 10% to 15% under the TRA of 1976)).

\textsuperscript{40} \textit{Id.} § 709 (West 1982) (enacted by the TRA of 1976, supra note 36, § 213(b), 90 Stat. 1520, 1547) (denies deduction of partnership organization and syndication fees, but permits amortization of such expenses over a minimum of 60 months). \textit{Id.} §§ 704(a) (West 1982), 706(c)(2)(B) (West 1982 and Supp. 1987) (amended by the TRA of 1976, supra note 36, § 213(c), 90 Stat. 1520, 1549) (prohibited retroactive allocation of partnership income and loss). The TRA of 1976 also added the "substantial economic effect" test to the special allocation provision of Code section 704(b) (enacted by the TRA of 1976, supra note 36, § 213(d), 90 Stat. 1520, 1548).
prepaid interest by cash basis taxpayers,41 and requiring recapture as ordinary income of certain excess deductions on sale of property.42

1978-1981

In the years that followed, Congress continued to cut back the tax advantages of sheltered investment activities. In 1978, for example, Congress added the alternative minimum tax ("AMT") with rates ranging from ten percent to twenty-five percent, to the regular minimum tax.43 In 1981, Congress added the Code section 6659 penalty for valuation overstatements.44 That same year, Congress applied the at risk principles of Code section 465, with some changes, to the investment tax credit.45

TEFRA—1982

In 1982 Congress struck out at tax shelters by adopting a wide variety of provisions. Congress added Code section 6700 to impose a penalty on promoters of abusive tax shelters.46 This provision permits the Service to assert penalties against promoters whose activities verge on criminal acts without referring the case to the Department of Justice for prosecution, which is a long and cumbersome process.47

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43. Id. §§ 55-58 (West 1982) (§ 55 was enacted and §§ 56-58 were amended by the Revenue Act of 1978, supra note 38, § 421, 92 Stat. 2763, 2871-77).
Under Code section 6700, anyone who organized or sold an interest in a tax shelter and made a false or fraudulent statement or grossly overstated any value in connection with such activity is subject to a stiff penalty. In addition, Congress adopted a $1,000 penalty for anyone who aids or assists in preparing any return or document under the revenue laws if that document results in an understatement of tax liability.

Congress enhanced the deterrent effect of these penalties by making inapplicable the normal deficiency procedures. Normally, a taxpayer assessed additional taxes or a penalty may contest the assessment by suing in the Tax Court without paying the assessed tax or penalties. Instead, both the promoter and aider/abettor penalties can only be contested by a refund suit after payment of fifteen percent of the penalty. The Code section 6700 promoter penalty is potentially a staggering amount and the Code section 6701 aider/abettor penalty is easily incurred by anyone remotely connected with a tax shelter. The mechanism for contesting these penalties, furthermore, is unusually costly. Thus, these provisions

48. Code section 6700 applies to any person who:
(A) organizes (or assists in the organization of)
(i) a partnership or other entity,
(ii) any investment plan or arrangement, or
(iii) any other plan or arrangement, or
(B) participates in the sale of any interest in any entity or plan or arrangement referred to in subparagraph (A).
I.R.C. § 6700(a)(1).
49. The penalty under Code section 6700 was originally the greater of $1,000 or 10% of the gross income derived or to be derived from the activity. Id. § 6700(a). Code section 6700(a) was amended in 1984 to increase the penalty to the greater of $1,000 or 20% of the income derived from the activity. See infra note 71 and accompanying text. This penalty is in addition to any other penalties. Id. § 6700(c).

The courts disagree as to whether the penalty is to be assessed per sale or per year. In Waltman v. U.S., 618 F. Supp. 718 (M.D. Fla. 1985), the court held that the promoter could be assessed "the greater of $1,000 or 10% [now 20%] of gross income derived from each 'sale' of the prohibited interests." Id., at 720. In Spriggs v. U.S., No. CA 86-0703-R (E.D. Va. May 15, 1987), however, the court held that "the language of § 6700 clearly indicates that the $1,000 penalty is a minimum penalty that applies only when 10% (20% after July 18, 1984) of the income derived from the salesperson's overall sales activity in promoting abusive tax shelters for the year is less than $1,000." The Waltman decision results in astronomically higher penalties than the Spriggs decision. The Spriggs opinion is a better decision, but the issue is far from settled.

51. Id. § 6703(b) (West 1982 and Supp. 1987).
almost certainly have had the substantial deterrent effect Congress intended.

In 1982 Congress also authorized in junction actions against promoters of abusive tax shelters, i.e., anyone subject to the Code section 6700 or 6701 penalties. A promoter enjoined under Code section 7408 may be held liable for civil contempt under the sweeping authority granted to the courts by this provision. In addition to the spectre of the Code section 6700 and 6701 penalties, tax shelter promoters now face public humiliation from the Code section 7408 injunction.

Congress provided the Service with two other important tools in the war against abusive tax shelters in 1982. First, in response to the Service’s complaint that the process of auditing individual partners of syndicated partnerships was administratively burdensome, Congress authorized partnership level audit proceedings. Under the new procedures, all partnership items are audited at the partnership, rather than the partner, level. The procedure for partnership level audits enormously accelerates and streamlines Service investigation of potentially abusive tax shelters.

Secondly, Congress imposed a penalty on taxpayers for substantial understatements of tax. Code section 6661 originally provided an addition to tax of ten percent of the amount of any underpayment attributable to a substantial understatement of income tax. In effect, this is a “no-fault” penalty because there is no requirement


58. I.R.C. § 6661(a) (West Supp. 1987). The “substantial understatement of income tax” to which Code section 6661 applies is defined, for individuals, as an understatement which exceeds the greater of 10% of the tax due for the year or $5,000. Id. § 6661(b)(1)(A) (West Supp. 1987).
of knowledge or willfulness with respect to the underpayment. The understatement subject to penalty is reduced for an amount attributable to any item for which there is or was "substantial authority" for the taxpayer's treatment of the item. The penalty is also reduced for items adequately disclosed by the taxpayer, but only for items not attributable to a tax shelter. To avoid the

59. Id.

The term "substantial authority" is not defined in Code section 6661 nor is it defined anywhere else in the Code. The term "substantial authority" was adopted by Congress as a new standard and was intended to "be less stringent than a 'more likely than not' standard and more stringent than a 'reasonable basis' standard." Conference Agreement, Tax Equity and Fiscal Responsibility Act of 1982, Section 323(a). The Regulations under Code section 6661 include two lists of authorities, one each for authorities that may and may not be considered in the determination of whether the tax treatment of an item is supported by "substantial authority." Treas. Reg. § 1.6661-3(b)(2).

61. Under the Regulations, disclosure is adequate with respect to an item only if:
   (I) It is made on a properly completed Form 8275 or if it takes the form of a statement attached to the return that includes the following:
      (i) A caption identifying the statement as disclosure under section 6661.
      (ii) An identification of the item (or group of items) with respect to which disclosure is made.
      (iii) The amount of the item (or group of similar items).
      (iv) The facts affecting the tax treatment of the item (or group of similar items) that reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item (or items).

Treas. Reg. § 1.6661-4(b)(1). In lieu of setting forth all of the facts, a taxpayer may also "set forth a concise description of the legal issue presented by such facts." Treas. Reg. § 1.6661-4(b)(2). Either alternative requires the taxpayer to perform a task which has not previously been demanded. In effect, the Service is requiring taxpayers to provide it with a blueprint for any possible challenge to the taxpayer's return.

In addition, the requirement of Regulation § 1.6661-4(b)(1)(i) that the statement be labeled as disclosure under section 6661 effectively requires the taxpayer to raise a red flag alerting the Service to a possible controversy.

Finally, the disclosure is not adequate to protect the taxpayer from the Code section 6661 penalty unless it is made with sufficient particularity. Treas. Reg. § 1.6661-4(b)(3). The Regulation states as an example that "attachment to the return of an acquisition agreement generally will not constitute adequate disclosure of the issues involved in determining the basis of certain acquired assets." Id.


For purposes of Code section 6661, a "tax shelter" is defined as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. Id. § 6661(b)(2)(C)(ii).

The Regulations state that "(1) the principal purpose . . . is the avoidance or evasion of Federal income tax if that purpose exceeds any other purpose." Treas. Reg. § 1.6661-5(b)(1)(iii) (emphasis added). This description of a principal tax avoidance purpose appears at first blush to be reassuringly narrow. The Regulations go on to provide, however, as follows:

Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, nonrecourse financing, financing techniques which do not conform to standard
penalty for items attributable to a tax shelter, the taxpayer must both have substantial authority for his treatment of the item and reasonably have believed that his tax treatment of the item was more likely than not the proper treatment. Adoption of the Code section 6661 substantial understatement penalty was extremely important because it significantly increased the cost to taxpayers of investing in transactions which ultimately are challenged by the Service.

1983—The Service acts.

In 1983 the Service announced a new program to identify and investigate abusive tax shelters. The program includes the formation of special tax shelter committees in each district to collect and analyze information about potentially abusive tax shelters from a wide variety of sources. In a novel move, the Service began issuing pre-filing notices to taxpayers advising them of the Service’s intent to disallow tax shelter deductions. The Service also notifies the appropriate service center of the identity of taxpayers to whom pre-

commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

Id. (emphasis added). Some of the factors identified as characteristic of a tax shelter properly subject to the Code section 6661 penalty are unexceptional: overvalued assets and mischaracterization of the substance of the transaction. Other factors, however, are an essential part of normal business practice without regard to tax motives: assets with values subject to substantial uncertainty (oil and gas wells); nonrecourse financing (a prudent business technique in jurisdictions with anti-deficiency statutes); and nonconventional financing. The last sentence quoted from the Regulations also denies a transaction the safe harbor of reasonable economic substance.

The regulatory roller coaster continues in the next paragraph, as follows:

The principal purpose of an entity, plan or arrangement is not the avoidance or evasion of Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose.

Treas. Reg. § 1.6661-5(b)(2) (emphasis added). The Regulation continues with a list of protected credits and deductions, including, among others, the investment tax credit under Code section 38, accelerated cost recovery allowances under Code section 168, percentage depletion under Code sections 613 or 613A, and intangible drilling and development costs expensed under Code section 263(c). Thus, the Service in this section apparently provides at least a partial safe harbor for the enumerated tax items.

In any event, the issue of which transactions will fall within the Code section 6661 definition of a tax shelter is far from clear.

filing notices have been sent, and these taxpayers are automatically audited.67

DEFRA—1984

In 1984, Congress gave the Service many new procedural and substantive tools to wield against abusive tax shelters. First, it added provisions requiring promoters to register their tax shelters with the Service.68 In addition, Congress adopted a provision requiring organizers and sellers of potentially abusive tax shelters to keep lists

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Code section 6111(a) requires any "tax shelter organizer" to register the tax shelter with the Secretary of the Treasury. A "tax shelter organizer" is initially defined as "the person principally responsible for organizing the tax shelter." Id. § 6111(d)(1)(A). If the person principally responsible fails to register the tax shelter, however, then "any other person who participated in the organization of the tax shelter" must register it. Id. § 6111(d)(1)(B). If all of the organizers fail to register the tax shelter, then anyone who participated in the sale or management of the shelter must register it. Id. § 6111(d)(1)(C). As a result, a large number of people associated with any shelter are potentially responsible for registering it under Code section 6111.

For purposes of Code section 6111, a "tax shelter" is defined as any investment:

(A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor as of the close of any of the first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and

(B) which is—

(i) required to be registered under a Federal or State law regulating securities,

(ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or

(iii) a substantial investment.

Id. § 6111(c)(1). The "tax shelter ratio" is generally defined as the ratio of deductions and deduction-equivalent of credits represented to be available to the amount invested by the taxpayer. Id. §§ 6111(c)(2), (c)(3). A "substantial investment" is defined as an investment in which the aggregate offering exceeds $250,000 and there are expected to be 5 or more investors. Id. § 6111(c)(4). This is a very broad definition of what constitutes a "tax shelter."

Even transactions which are rarely, if ever, considered tax shelters fall within the scope of Code section 6111(c)(1). For example, a professional partnership which incurs expenses double the partners' capital contributions will fall within the tax shelter registration requirements. Certain transactions generally considered to be tax shelters, however, such as research and development syndications, are unlikely to fall within this definition.

The Code section 6111(c)(1) definition is also very different than the definition of a tax shelter for purposes of the Code section 6661 substantial understatement penalty. The inconsistent definitions of "tax shelter" makes compliance with these provisions even more difficult for taxpayers and their advisers.

For a discussion of the tax shelter registration procedures and other tax shelter compliance requirements added by DEFRA, see Martin, Coping With the Tax Shelter Registration and Compliance Requirements: New Law and Regs, 62 J. Tax’n 2 (1985) and Cash, Reporting and Recordkeeping Requirements for Real Estate Tax Shelters, 13 J. REAL ESTATE Tax’n 246 (1986).
of investors. Congress also imposed penalties for the failure to register a tax shelter or keep an investor list. The new compliance provisions added in 1984 permit the Service to identify in advance those transactions and taxpayers which it might characterize as abusive.

By 1984 these sweeping legislative changes had dramatically changed the Service's role in its war against abusive tax shelters. Before, the Service was relegated to a hit or miss identification of individual taxpayers long after they invested in potentially abusive tax shelters. Now, the Service receives and processes vast quantities of information about transactions in their earliest stages. Moreover, the Service can strike preemptively by enjoining promoters of potentially abusive tax shelters before they widely syndicate their transactions. Finally, the Service can notify investors that they will be audited if they report any questionable tax benefits. The Service is able, therefore, to prevent or deter abusive tax shelters before there is an adverse impact on public revenues.

Congress also made numerous other statutory changes in 1984 to discourage tax shelter investors. Some of these changes were intended to strengthen existing compliance provisions directed against tax shelters. Other provisions which significantly and adversely affected tax shelters included significant amendments to the partnership tax sections of the Code, accounting changes, changes directed at tax straddles, and tightening the at risk rules.

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A "potentially abusive tax shelter" is defined as a tax shelter required to be registered under Code section 6111 or determined in regulations to have a potential for tax avoidance or evasion. Id. § 6112(b).


71. Code section 6700(a) was amended to increase the penalty for promoting an abusive tax shelter to the greater of $1,000 or 20% of the gross income to be derived from the activity. I.R.C. § 6700(a) (West Supp. 1987), enacted by DEFRA, supra note 33, § 143, 98 Stat. 494, 682).

DEFRA section 144 added code section 6621(d) to increase the interest rate on substantial underpayments of tax attributable to tax motivated transactions to 120% of the rate otherwise in effect for tax underpayments. Id. § 6621(e) (West Supp. 1987) (amended and renumbered § 6621(c) by the TRA of 1986, supra note 24, §§ 1511(c)(1)(A) - (C), 100 Stat. 2085, 2744-46).

Code section 6601(e)(2) was amended to accelerate the time at which interest begins to run on tax underpayments attributable to valuation overstatements and substantial understatements of tax from the date of notice of an assessment to the due date for the return. Id. § 6601(e)(2) (West Supp. 1987) (amended by DEFRA, supra note 33, § 72, 98 Stat. 494, 696).

72. E.g. Congress added code section 706(d) to prohibit retroactive allocations of tax

The Tax Reform Act of 1986 also contains a number of provisions, other than new Code section 469, which will further dis-
courage tax shelters. For example, the at risk rules of Code section 465 have been extended to real estate. In addition, the relatively short periods in which property could be depreciated under the Accelerated Cost Recovery System of Code section 168 were significantly extended. Thus, the slower cost recovery now permitted by the Code will significantly reduce the volume of deductions generated by tax shelters. Furthermore, the ten percent regular investment tax credit, which was especially important for equipment leasing transactions, was repealed.

In 1986 Congress also increased the penalties related to the tax shelter registration and investor list requirements. Sham transactions, which might have been exempt from the increased rate of interest on underpayments of income tax for tax motivated transactions under Code section 6621(c), were explicitly made subject to Code section 6621(c). In addition, the Code section 6661 penalty

however, the taxpayer recognizes a loss in year one and a gain early in year two. The taxpayer might also convert short term gain to long term gain if the gain position was the long position. Until the anti-straddle provisions of DEFRA, the taxpayer could engage in similar transactions at the end of year two to perpetuate his tax benefits. For a discussion of the effect of DEFRA on tax straddles, see, e.g., BNA, Tax Management Portfolio #184(3d) (1987).

75. DEFRA sections 431 and 432 amended various parts of Code section 465 to make the at risk rules more restrictive. DEFRA, supra note 33, §§ 431-32, 98 Stat. 494, 805.
76. TRA of 1986, supra note 24, § 503, 100 Stat. 2085, 8125 (amending I.R.C. § 465(c)(3)(D)). The extension of the at risk rules to real estate is subject to an exception permitting “qualified nonrecourse financing” to be part of the taxpayer’s at risk amount. Qualified nonrecourse financing generally consists of nonrecourse debt obtained from an independent lender. I.R.C. § 465(b)(6)(B). Thus, the at risk rules really were not extended to real estate tax shelters financed by conventional, third-party nonrecourse debt.

77. Section 201 of the Tax Reform Act of 1986, supra note 24, 100 Stat. 2085, 2121-42, completely revised the Accelerated Cost Recovery System (ACRS). The 19 year recovery period for all real property has been replaced with a 27.5 year recovery period for residential real property and a 31.5 year period for nonresidential real property. I.R.C. § 168(e)(2) (West Supp. 1987). All real property, moreover, must be cost recovered using the straight line method. Id. § 168(b)(3). Personal property is re-classified into six classes, with recovery periods from 3 to 20 years. Id. § 168(e)(1).

79. TRA of 1986, supra note 24, § 211, 100 Stat. 2085, 2166-70 (generally repeals the Code section 46 regular investment tax credit.)

80. As noted above, tax shelters must be registered with the Service by the person who is principally responsible for organizing the transaction. I.R.C. § 6111(a)(1), (d)(1). Investor lists must also be maintained by any person who organizes, sells, or re-sells an interest in a “potentially abusive” tax shelter, i.e., one that must be registered under Code section 6111. I.R.C. § 6112. Penalties for failing to register a tax shelter or to maintain an investor list are contained in Code sections 6707 and 6708, respectively.

The Tax Reform Act of 1986 deleted the prior $10,000 maximum on the Code section 6707 penalty and increased the maximum penalty under Code section 6708 to $10,000 per year. TRA of 1986, supra note 24, §§ 1532(a), 1534(a), 100 Stat. 2085, 2750 (amending I.R.C. §§ 6707(a)(2), 6708(a), respectively).

81. TRA of 1986, supra note 24, § 1535(a), 100 Stat. 2085, 2750 (enacting I.R.C. § 6621(c)(3)(A)(v)).
for substantial understatements of tax was increased to 20%.82 Furthermore, real estate transactions must be reported to the Service, effective for transactions closing after 1986.83

The 1986 Tax Reform Act also further restricted accounting rules for many taxpayers, including tax shelters. For example, tax shelters may no longer use the cash method of accounting.84 Putting all tax shelters on the accrual method minimizes the possibility that they can mismatch income and tax benefits.

In addition, a partnership must adopt the calendar year as its taxable year if neither the principal partners nor a majority of the partners have the same taxable year.85 The only exception to the calendar year requirement requires a partnership to establish a business purpose for a different taxable year.86 However, the Conference Committee Report indicates that the Service is to apply even stricter standards to the use of a non-calendar taxable year than it

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82. Id. § 1504(a), 100 Stat. 2085, 2743 (amending I.R.C. § 6661(a)).

It is still not certain whether the current penalty is 20% or 25% of the amount of the underpayment attributable to the understatement. The uncertainty was generated by an odd series of events. Section 1504(a) of the Tax Reform Act of 1986 (supra note 24) amended Code section 6661(a) to raise the penalty to 20%, effective for returns due (without regard to extensions) after December 31, 1986. Subsequently, section 8002(c) of the Omnibus Budget Reconciliation Act of 1986 (Pub. L. No. 99-509, 100 Stat. 1874) repealed section 1504 of the Tax Reform Act of 1986 and section 8002(a) amended Code section 6661(a) to raise the penalty to 25%, effective for penalties assessed after October 21, 1986, the date of enactment of the Omnibus Budget Reconciliation Act of 1986.

President Reagan signed the Omnibus Budget Reconciliation Act of 1986 into law before he signed the Tax Reform Act of 1986. As a result, the repeal of section 1504(a) of the Tax Reform Act of 1986 arguably is not effective since it had not yet become law. Thus, the most recent "law" on the penalty and its effective date is the 20% rate of the Tax Reform Act.

The Service contends that the penalty rate is 25%, effective on penalties assessed after October 21, 1986. I.R.S. News Release IR-86-149, (Nov. 6, 1986). In addition, the Technical Corrections Act of 1987 provides that the increase in the substantial understatement penalty to 25% by the Omnibus Budget Reconciliation Act of 1986 is to take effect as if the Tax Reform Act of 1986 had been enacted the day before the date of enactment of the Omnibus Budget Reconciliation Act of 1986. See Joint Committee on Taxation Description of Technical Corrections Act of 1987, JCS 15-87 (June 15, 1987).

It is unlikely that the Technical Corrections Act will be enacted this year because both tax committees have full agendas that will keep them occupied until the end of the session. 35 Tax Notes 1040 (June 15, 1987). However, it is likely that a technical corrections bill will eventually be enacted and that the Code section 6661 penalty will be increased to 25%, perhaps retroactively and according to the Service view.

83. TRA of 1986, supra note 24, § 1521(a), 100 Stat. 2085, 2746 (adding I.R.C. § 6045(e)). Penalties are imposed under Code section 6721 for failure to timely report real estate transactions. Id. § 1501(a), 100 Stat. 2085, 2732 (adding I.R.C. § 6721).


85. TRA of 1986, supra note 24, § 806(a)(1), 100 Stat. 2085, ____ (amending I.R.C. § 706(b)(1)).

has done in the past. As a result, a tax shelter is effectively forced to use the calendar year unless it can satisfy the formidable requirements of establishing a business purpose. Thus, Congress appears to have finally eliminated the possibility that a tax shelter might manipulate the rules of tax accounting to improve tax benefits available to its investors.

It is evident that Congress provided the Service with a wide range of statutory provisions to combat abusive tax shelters even before Code section 469 was adopted. Despite these extensive legislative changes, the Service has not yet fully implemented all of the tax shelter weapons in its arsenal, nor have the full effects of these legislative changes yet been felt. Congress nevertheless adopted Code section 469 which, as shown in the remainder of this article, is deeply flawed and injects even more complexity into an already confusing area. In view of the extensive tools to control abusive tax shelters already provided in the Code, the adoption of Code section 469 was wholly unnecessary.

Code Section 469 Was Not Adequately Reviewed by Congress

Code section 469 bears the scars of the frantic pace at which the Senate Finance Committee bill, which became the Tax Reform Act

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87. Taxpayers who obtained permission to use a taxable year under the "25% test" of Treas. Rev. Proc. 83-25, 1983-1 C.B. 689, may continue to do so. The "25% test" is satisfied if 25% or more of the taxpayer's gross receipts are recognized in the last two months of the fiscal year and this requirement has been met for three consecutive 12-month periods. Id.

The Service had also permitted a partnership to select a taxable year other than the calendar year if it met the requirements of Treas. Rev. Proc. 74-33, 1974-2 C.B. 489. Partnerships which obtained permission pursuant to Rev. Proc. 74-33 to use a year-end that resulted in an income deferral of less than three months are not grandfathered. 1986 Conf. Comm. Rpt. [CCH ¶ 7806 at p. 1213]. These partnerships, and all others which seek to satisfy the business purpose test, must satisfy new tests to be prescribed. The conferees provided, furthermore, that:

1. the use of a particular year for regulatory or financial accounting purposes;
2. the hiring patterns of a particular business, e.g., the fact that a firm typically hires staff during certain times of the year; (3) the use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and (4) the fact that a particular business involves the use of price lists, model years, or other items that change on an annual basis ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met.

Id. (emphasis added). Presumably, any new regulations to be issued by the Service will be at least as restrictive as the excerpt above. It seems clear that Congress expects the Service to be quite stingy in granting approval for non-calendar taxable years.

88. The enumeration above of anti-tax shelter initiatives is not exhaustive. For example, the original issue discount rules of Code sections 483 and 1271 through 1286 are enormously important in restricting the tax benefits available to many tax shelters.
of 1986, was created and ultimately adopted. The earliest predeces-
sor of the Tax Reform Act of 1986 was the Bradley-Gebhardt bill,
introduced in early 1983, only a few months after TEFRA was
enacted.89 This bill was followed by a number of Congressional
proposals,90 as well as two proposals submitted by President Reagan
and formulated by the Treasury Department.91 These proposals
became known as Treasury I and II. Treasury I appeared in No-

Subsequently, Representative Dan Rostenkowski, Chairman of
the House Ways and Means Committee, caused his committee to
issue its own bill, H.R. 3838, in December 1985. H.R. 3838 was
approved by a controversial voice vote on the floor of the House
on December 17, 1985,92 but Congress adjourned before the Senate
took any action.

Senator Robert Packwood, Chairman of the Senate Finance Com-
mittee, issued proposals which have been referred to as Packwood
I in March 1986. By April 17, 1986, tax reform was declared
“dead” by Congressional leaders and the press.93 One week later,
Senator Packwood emerged from closed door meetings with mem-
bers of his committee with Packwood II, which was adopted by the
Senate Finance Committee on May 7. Packwood II was radically
different than any of the earlier proposals because it contained a
top marginal tax rate of only twenty-seven percent and eliminated
or reduced many popular tax benefits. New Code section 469 made
its first appearance in Packwood II.

After adoption by the Senate Finance Committee, Packwood II
was rushed through the Senate on June 24 and sent to a House-
Senate Conference Committee on July 17. After little progress was
made on reconciling the radically different House and Senate bills,
the Conference Committee authorized Representative Rostenkowski and Senator Packwood to meet personally and work out a compromise.  On August 16, “the Conference Committee voted to approve a tax reform package—described only in general principles in a 102-page summary—which had been worked out by [Representative] Rostenkowski and [Senator] Packwood that same day.” The sketchy nature of this outline is demonstrated by the fact that the ultimate Conference Committee bill was over nine hundred pages long.

The House approved the Conference Committee bill on September 25, and the Senate did the same on September 27. Although a Concurrent Resolution, correcting numerous drafting and other errors, was adopted by the House, it was not adopted by the Senate before Congress adjourned. Thus, the bill signed by President Reagan on October 22, 1986, contained over three hundred known errors.

The frenetic pace at which Packwood II, containing the first version of Code section 469, was considered obviously could not permit any real review or input from tax professionals. Moreover, the limited time available to the staff writers caused them to leave many critical issues, such as the definitions of an activity, material participation, and active participation, to regulations to be issued by the Secretary of the Treasury.

The Treasury, of course, has been inundated with huge numbers of regulation projects as a result of the Tax Reform Act of 1986 and its pre-existing backlog. Service officials have already indicated that the regulations required under Code section 469 will be issued piece-meal, and no real schedule for their issuance has been offered. Thus, taxpayers and their advisers are left with a hurriedly considered, lengthy and complex, but incomplete provision.

94. Id., at 14-15.
95. Id., at 15.
96. Id.

In an effort to mitigate the delay in issuing Regulations under the 1986 Tax Reform Act, the Service has eased the rules for obtaining a private letter ruling. Rev. Proc. 87-1, 1987-1 C.B. 47. It is no longer necessary to show that there is either a clear resolution of the issue or a business emergency. Id. § 3.04. Thus, for the issues identified, including those arising under Code section 469, a private letter ruling may be sought. Rev. Proc. 87-7, 1987-2 C.B.
There is some prospect that Code section 469 will be amended. Senator Lloyd Bentsen, new Chairman of the Senate Finance Committee, wrote to 140,000 members of the Texas real estate industry that the passive loss provisions are "unfair, retroactive tax treatment." The effect on the economy of the new passive loss provisions has not yet been fully felt. With respect to real estate, for example, any decrease in activity has probably been slight because projects planned long before Code section 469 surfaced in Packwood II are still being built. Also, the real estate industry is working off a surplus of units in many parts of the country. Finally, current relatively low interest rates tend to offset the negative effect of Code section 469 on the bottom line of a transaction.

Pressure to modify Code section 469 is likely to build when economic trends stop masking the effect of the new provision. For example, rising interest rates will make the effect of the passive loss provisions more visible. Similarly, pressure for change will accelerate when the supply of rental housing is absorbed and rents increase. A continuation of the current stagnation in the oil and gas industry will also militate in favor of a broader exemption for that industry. Finally, prospects for change are improved in any election year, such as 1988, when Congressional members are particularly in need of campaign funds from members of industries who will seek modification of provisions such as Code section 469.

There is little chance, however, that any changes will be made before 1988. First, the recently introduced Technical Corrections Act of 1987 does not contain substantive changes to Code section 469. Secondly, all four chief congressional tax counsels have indicated that their committees will not take up this issue until other major topics are concluded. Finally, the estimate of an increase...
in net revenues of almost $24 billion over the period 1987-1991 makes outright repeal of Code section 469 rather unlikely. Thus, tax professionals should plan to work with Code section 469 for some time.

**Mechanics of Code section 469: When PIGs are PALS but PALs are not.**

Passive activity losses ("PALs") from one activity are currently deductible only to the extent of passive income and gains ("PIGs") from other activities. Code section 469 applies to deductions both above and below the line, i.e., adjustments both to gross income and adjusted gross income. Passive activity credits are allowed against PIGs to the extent of their deduction equivalent. As a result, a taxpayer cannot use PALs to shelter positive income, such as salary and portfolio income.

The passive loss rules do not insure that a tax loss corresponds to an economic loss. The at risk rules, which apply before Code section 469 is applied, already require economic viability within each activity. The investment interest limits, however, do not apply

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102. 1986 Blue Book, supra note 7, at 1363.
105. Id. § 469(d)(2) (West Supp. 1987). The deduction equivalent of passive activity credits is the amount of deduction that yields the same tax reduction as a credit against tax liability. Id. § 469(e)(5) (West Supp. 1987).
106. Id. § 469(e)(1) (West Supp. 1987). See Lipton, supra note 103, at 804.

See note 29, above, for a discussion of the concept of "portfolio income." Working capital is also treated as a portfolio item and, as a result, income derived from the investment of working capital is not offset by losses from the passive activity. I.R.C. § 469(e)(1)(B) (West Supp. 1987). This result may be sensible to the extent that an activity includes investments in the nature of other portfolio items, such as securities. However, it makes little sense and introduces enormous additional complexities with respect to normal amounts of true working capital, e.g., a checking account containing the funds necessary to operate a business on a day-to-day basis.

This defect may have been caused by the fact that the legislative staff was apparently confused as to the concept of working capital. The example given in the Senate Committee Report relates to funds set aside by a limited partnership operating a shopping mall for the purpose of expanding the mall. Sen. Fin. Rep. No. 313, supra note 7, at 730; 1986 Blue Book, supra note 7, at 233. The funds set aside for expansion of the shopping center are not, however, part of normal working capital. Instead, such an account is for capital expansion which might properly be treated like other capital investments characterized as portfolio items. The result of this special rule is that a few capital expansion investments will be properly treated as portfolio items while the vast majority of working capital accounts will be improperly treated as portfolio items. The author extends her sympathies to the accountants who will attempt to properly account for working capital under Code section 469.

to the extent that Code section 469 applies to disallow loss deduc-
tions.\textsuperscript{108}

Code section 469 represents a move away from the traditional
model of a taxpayer as one economic unit. The new passive loss
rules treat some taxpayers as though they are a group of profit
centers. A taxpayer must separately account for activities depending
on whether the taxpayer is active or passive with respect to each
activity. Thus, each taxpayer potentially has an active and a passive
profit center. While the at risk rules insure economic viability within
each activity, Code section 469 requires economic viability within
each profit center because it prohibits the use of losses from the
passive profit center as an offset against profits from the active
profit center.\textsuperscript{109}

Within each profit center, the taxpayer must separately account
for each activity. Within each passive activity, the taxpayer must
separately account for portfolio items. As a result, either the tax-
payer or his accountant will spend much more time trying to
properly account for the taxpayer's activities.

\textit{Dispositions.}

The passive activity losses which cannot be used in the current
year are not necessarily lost. PALs disallowed under Code section
469 are suspended and may be carried forward indefinitely to offset
future passive income and gains from the same or other activities.\textsuperscript{110}
In addition, PALs are revived and offset passive and active income
when the taxpayer disposes of his entire interest in the passive
activity.\textsuperscript{111}

Although suspended deductions are generally delayed, rather than
lost, delaying PALs until the taxpayer disposes of the passive activity
results in economic distortion because of the time value of money,
including tax benefits. The legislative history attempts to justify this
result as follows:

(P)rior to a disposition of the taxpayer's interest, it is difficult to
determine whether there has actually been gain or loss with respect
to the activity. For example, allowable deductions may exceed

\textsuperscript{109} For a somewhat different attempt to interpret the effect of Code section 469, see
\textsuperscript{110} I.R.C. § 469(b) (West Supp. 1987).
\textsuperscript{111} \textit{Id.} § 469(g)(1) (West Supp. 1987). \textit{See} Lipton, \textit{supra} note 103, at 807.
actual economic costs, or may be exceeded by untaxed appreciation. Upon a taxable disposition, net appreciation or depreciation with respect to the activity can be finally ascertained.\textsuperscript{112}

While this is true without regard to the time value of money, it is accurate for all investments, not just passive activities. Thus, Code section 469 discriminates against tax shelters to the extent of the time cost of deferred deductions.

Credits suspended under Code section 469, however, are not triggered when the taxpayer disposes of the passive activity.\textsuperscript{113} Moreover, suspended deductions are not revived on disposition of the passive activity to a related party or in a non-recognition transaction, except to the extent gain is recognized (i.e., to the extent of "boot").\textsuperscript{114} On a disposition of the passive activity to a related party, the taxpayer’s PALs remain suspended until the related party disposes of the activity in a taxable transaction.\textsuperscript{115} In addition, any capital loss on a disposition of a passive activity is still subject to the capital loss limits of Code section 1211.\textsuperscript{116}

An installment sale will revive suspended PALs.\textsuperscript{117} Since an installment sale will trigger suspended PALs, one planning option involves an installment sale of a passive activity. IRS Notice 87-8 confirmed that temporary regulations to be issued will treat gains recognized from installment sales of passive activities, entered into after 1986, as passive income.\textsuperscript{118} Thus, taxpayers can use installment sales of PIGs to offset PALs from other investment activities. An extra benefit of this rule is that the recent amendments to the installment sale provisions, which may generate phantom payments,

\begin{enumerate}
\item "Since the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted, credits, which are not related to the measurement of such loss, are not specially allowable by reason of a disposition." Sen. Fin. Rep. No. 313, supra note 7, at 725; 1986 Blue Book, supra note 7, at 225.
\item I.R.C. § 469(g)(1)(B) (West Supp. 1987).
\item Id.
\item Id. § 469(g)(1)(C) (West Supp. 1987). As amended by the Tax Reform Act of 1986, Code section 1211 limits corporate capital loss deductions to the amount of the corporation’s capital gains. Id. § 1211(a). Other taxpayers are limited in their capital loss deductions to the lesser of $3,000 or the excess of their capital losses over capital gains. Id. § 1211(b).
\item Furthermore, "[t]he limitation on the deductibility of capital losses is applied before the determination of the amount of losses allowable upon the disposition under the passive loss rule." 1986 Blue Book, supra note 7, at 227-28.
\item I.R.C. § 469(g)(3) (West Supp. 1987). The suspended PALs are allowed in each year of the installment sale in the same ratio that the gain recognized in each year bears to the total gain on the sale. Id.; Sen. Fin. Rep. No. 313, supra note 7, at 726; 1986 Blue Book, supra note 7, at 226.
\item I.R.R. Notice 87-8, 1987-3 I.R.B. 11.
\end{enumerate}

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can be mitigated by the use of otherwise unuseable PALs. However, Notice 87-8 also stated that payments received after 1986 on the pre-1987 installment sale of an activity that is now characterized as passive will not be deemed passive. This apparently anomalous view has already been strongly criticized.

A taxpayer who disposes of his entire interest in a passive activity by gift or at death is no longer subject to Code section 469. An individual who disposes of his entire interest by gift, however,

119. TRA of 1986, supra note 24, § 811(a), 100 Stat. 2085, 2365 (adding I.R.C. § 453C). Code section 453 generally permits a taxpayer who sells property on an installment basis to report the deferred payments as they are received. I.R.C. § 453(a)-(o) (West 1982 and Supp. 1987). In the absence of Code section 453, a cash method seller includes the fair market value of the buyer's note as part of his amount realized in the year of sale. Warren Jones Co. v. Commissioner, 524 F.2d 788, 793-94 (9th Cir. 1975). An accrual method seller realizes the face amount of the note when the debt is created. Jones Lumber Co. v. Commissioner, 404 F.2d 764, 766 (6th Cir. 1968). Thus, Code section 453 provides a valuable benefit to taxpayers by deferring the realization of income from installment payments to the time when the payments are received.

A seller who disposes of his buyer's note, i.e., sells or gives it away, must immediately recognize the deferred gain inherent in the installment obligation. I.R.C. § 453B (West 1982 and Supp. 1987). It is also possible for a seller to extract the cash value of his buyer's note by pledging the note as collateral for a loan. In order to eliminate this perceived abuse of the installment sale rules, Congress in 1986 adopted the proportionate disallowance rules of new Code section 453C. TRA of 1986, supra note 24, § 811(a), 100 Stat. 2085, 2365. Under this section, a seller who receives an installment obligation as part of his sale proceeds and who also owes debts to others is deemed to have pledged his installment receivable as collateral for his own borrowings. The result is that gain otherwise allocable to future installments is accelerated, typically to the year of sale. In effect, the installment seller is viewed as pledging his installment receivable for his new or existing debts, thereby disposing of his installment receivable and receiving phantom payments triggering early gain.

The problem addressed by new Code section 453C was probably overstated by Congress. In any event, the new provision is terribly complex, does not fully deal with the perceived abuse, and will stifle many real estate and dealer property sales. Legislation has already been introduced to eliminate from the scope of Code section 453C installment sales of real estate by nondealers. H.R. 567, 100th Cong., 1st Sess. (1987). This change would leave only dealers in real estate and installment dealers in personal property subject to the new rules.


120. Two bipartisan groups of legislators, one from each house of Congress, wrote Treasury Secretary James A. Baker on June 2, 1987, advising him that the Service has misinterpreted Code section 469 in asserting this view. The letter from 24 members of the House Ways and Means Committee, comprising a majority of the committee, states that "a seller of a passive activity should be treated as having received passive income on the receipt of installment payments after 1986 regardless of when the sale actually occurred." Letter reported at 35 Tax Notes 1015 (June 8, 1987). Similarly, the letter from twelve members of the Senate Finance Committee, comprising a majority of that committee, states that the position of the Service in Notice 87-8 "regarding the characterization of gain from pre-1987 installment sales is contrary to both the language of the statute and the legislative history of section 469." Id.

The Technical Corrections Act of 1987 also rejects the Service's position on pre-1987 installment sales. See Joint Committee on Taxation, Description of Technical Corrections Act of 1987, JCS 15-87 (June 15, 1987).
cannot deduct his suspended losses. Instead, the donee’s basis is increased by the donor’s suspended PALs.\textsuperscript{121} The donor loses his suspended losses,\textsuperscript{122} but the corresponding increase in the donee’s basis will reduce the donee’s recognized gain on a subsequent gain disposition. Therefore, another planning option for taxpayers who do not need or cannot use their suspended PALs may be to gift an interest in the passive activity to someone who will benefit from its sale.\textsuperscript{123} However, the tax planner should remember that the donee’s basis for determining loss on a later disposition of the passive interest is limited to the fair market value of the interest at the time of the gift.\textsuperscript{124}

On the transfer of a passive activity at the taxpayer’s death, suspended PALs disappear to the extent that the donee’s basis in the property is increased under Code section 1014.\textsuperscript{125} Again, like gift transfers, the donee will ultimately benefit from the transferred PALs when his increased basis reduces recognized gain on a later sale. Any suspended losses that exceed the donee’s increase in basis are revived and generally may be deducted on the taxpayer’s final tax return.\textsuperscript{126}

\textit{Taxpayers subject to Code section 469.}

Taxpayers subject to Code section 469 include individuals, estates and trusts, personal service corporations,\textsuperscript{127} and certain closely held

\begin{enumerate}
\item \textsuperscript{121} I.R.C. § 469(j)(6) (West Supp. 1987).
\item \textsuperscript{122} I.R.C. § 469(j)(6)(B) (West Supp. 1987).
\item \textsuperscript{123} Lipton, \textit{supra} note 103, at 807. Lipton believes that Code section 469 favors gifts over transfers at death and, as a result, there will be more lifetime inter-generational transfers. \textit{Id.}
\item \textsuperscript{126} I.R.C. § 469(g)(2)(A) (West Supp. 1987).
\item \textsuperscript{127} Personal service corporations are generally defined by reference to Code section 269A (I.R.C. § 469(j)(2)), a provision which permits the Service to re-allocate tax items between a personal service corporation and its employee-owners if the corporation was formed or availed of to avoid or evade income tax. For purposes of Code section 469, however, the definition of a personal service corporation is much broader than the definition under Code section 269A. \textit{Compare} I.R.C. § 469(j)(2) (West Supp. 1987) \textit{with id.} § 269A(b) (West 1982 and Supp. 1987). A personal service corporation is defined as a corporation whose principal activity is the performance of personal services substantially performed by employee-owners. I.R.C. § 269A(b)(1) (West 1982 and Supp. 1987). For purposes of Code section 469, an employee owner is an employee who owns any stock in the corporation, and the employee is treated as owning a proportional share of the stock owned directly or indirectly for him by his family, a partnership, estate, trust, and any corporation in which he has any interest. \textit{Id.} §§ 469(j)(2) (West Supp. 1987), 269A(b) (West 1982 and Supp. 1987), 318 (West 1982 and Supp. 1987).
corporations. The Senate Finance Committee Report may provide a planning opportunity with respect to estates and trusts. An estate or trust, except a grantor trust, is treated as materially participating in an activity (i.e., not subject to the limits of Code section 469), "if an executor or fiduciary, in his capacity as such, is so participating." It may be possible to structure a transaction as a trust in which the trustee, but not the beneficiary, materially participates in the activity. If so, the beneficiary may benefit from losses in an activity as though he were active in it, even though he is actually passive. The discussion of this issue in the 1986 Blue Book is less favorable, but the Blue Book is probably not as authoritative as the Senate Finance Committee Report.

Several planning opportunities exist with respect to corporations. First, a special rule permits closely held corporations to use PALs against "net active income." "Net active income" is the corporation's taxable income other than from passive activities or portfolio items. Thus, taxpayers can shelter positive income from an 'active' activity with passive activity losses by combining both activities in a "closely held corporation." Such a plan can backfire, however, if gain is recognized from debt relief in excess of basis on contribution of the tax shelter property to the corporation. Another potential problem with this plan is that any additional income generated when the passive tax shelter activity crosses over (i.e., begins to generate taxable income rather than tax losses) will be subject to double taxation in the corporation. Should this occur,
the taxpayer might consider electing subchapter S status to minimize
the double taxation of income.

A variation on the first plan involves forming a group of affiliated
corporations, each holding a separate activity, with a collection of
both PALs and positive income activities. Using an affiliated group
of closely held corporations, rather than a single corporation in
which both types of activities are combined, may provide some
advantages. First, using a separate corporation for each activity
might simplify the complex accounting required with respect to
PALs. Secondly, the shareholders can individually select to invest
in those members of the affiliated group which contain the activities
best suited to their own investment portfolio. One significant dis-
advantage of this approach is the need to comply with the consol-
ided tax return requirements.135

Another planning option relating to corporations is to form a
corporation which, by falling just outside the definition of a “closely
held corporation,” is free of the loss limits of Code section 469.
Such a corporation has been called a “6/11” corporation because
it would be structured so that six or more people own at least fifty
percent of the stock and the corporation is owned by at least eleven
unrelated people, each of whom owns less than ten percent of the
corporation’s stock.136 Although this corporation could avoid Code
section 469, it would still be subject to the accumulated earnings
tax137 and minimum taxes.138 Another major drawback of this ap-
proach is that it requires eleven unrelated people to contribute
property to a corporation in which no one has control, in exchange
only for a combination of salary or dividends and possible stock
appreciation attributable to the tax-preferred equity growth in the
 corporation’s assets. The 6/11 corporation is unlikely to be widely
used because of these serious business disadvantages.

Activities subject to Code section 469.

The transactions subject to Code section 469 include any activity
involving the conduct of a trade or business in which the taxpayer

100. See Snyder & Gonick, Affiliated Corporate Groups For Real Estate Investments: The
Syndication Vehicle of the Future, 34 Tax Notes 291 (Oct. 20, 1986) (a thorough discussion of this
planning alternative). See also letter from Schuyler M. Moore to the Editor, 34 Tax Notes
136. See Brode, Structuring Real Estate Entities in View of the New Limitation on Loss
137. I.R.C. § 531 (West 1982).
does not materially participate.\textsuperscript{139} Although the legislative history
concedes that the definition of an “activity” is “one of the most
important determinations that must be made,”\textsuperscript{140} it is not defined
in Code section 469 and its definition is left to regulations yet to
be issued.\textsuperscript{141} The question, according to the Senate Finance
Committee Report, is “what undertakings consist of an integrated and
inter-related economic unit, conducted in coordination with or re-
liance upon each other, and constituting an appropriate unit for
the measurement of gain or loss.”\textsuperscript{142}

The Report continues with a number of examples indicating that
providing two or more substantially different products or services
involves more than one activity, but providing the same products
or services does not establish a single activity.\textsuperscript{143} Similarly, the fact
that various undertakings are conducted by the same entity does
not establish one activity, nor does the fact that two undertakings
are conducted by separate entities establish two activities.\textsuperscript{144}

Code section 469, therefore, disregards the entities which may be
used to structure transactions. One entity may have multiple activities
and one activity may be conducted by multiple entities. The
possible permutations of activities and entities can easily lead to an
astonishing number of activities, for each of which the taxpayer
must determine if he is materially participating, separately account
for passive and portfolio items, and decide whether he has disposed
of all or part of the activity.\textsuperscript{145}

The legislative history further indicates that the approach de-
veloped in the regulations under Code “section 183, relating to hobby
losses, involves issues similar to those arising with respect to passive
losses.”\textsuperscript{146} Thus, the regulations defining an “activity” can be
expected to focus on the “facts and circumstances” test applied to
Code section 183.\textsuperscript{147} The hobby loss regulations also presume that
a taxpayer’s characterization of what constitutes an activity will be

\begin{itemize}
  \item 139. Id. § 469(c)(1) (West Supp. 1987).
  \item 145. One writer calculated that a simple partnership formed to build and run four office
buildings, each with a cafeteria, parking garage, flower and gift shop, and day care center
would involve at least 32 separate activities. Lipton, supra note 103, at 801.
  \item 147. Treas. Reg. § 1.183-1(d)(1).
\end{itemize}
accepted unless it is unduly artificial. For purposes of Code section 469, however, "there is no presumption that the taxpayer's characterization is correct even absent such 'artificiality.'" 

Although Code section 469(c)(1)(A) by its terms applies to an activity involving any "trade or business," special rules apply to several industries. First, all rental activities are deemed to be passive. Secondly, research or experimentation within the meaning of Code section 174 is deemed a trade or business. Thirdly, investment activities which are allowed a deduction under Code section 212 are deemed to be a trade or business for Code section 469, even though they are not considered a trade or business for other purposes under the Code.

Fourthly, working interests in any oil and gas property are not subject to the passive loss rules so long as the taxpayer does not hold the interest through an entity which limits his liability. Thus, an oil and gas interest held through a limited partnership will be subject to the passive loss rules while the same interest held through a general partnership will be free of the Code section 469 loss limits. An obvious planning option is to convert an oil and gas limited partnership to a general partnership. Revenue Ruling 84-52 indicates that there generally are no adverse tax consequences in converting a limited to a general partnership. On the other hand, there is obviously substantially more risk involved in being a general partner, with unlimited liability for the partnerships's debts, even if some of the risks can be minimized through insurance.

Finally, the taxpayer's "qualified residence interest" is excluded from the computation of passive loss. "Qualified residence interest..."
est” includes interest paid on the taxpayer’s “qualified residence,” which in turn includes both the taxpayer’s primary residence and a second residence of the taxpayer’s choice.\textsuperscript{157} Thus, one more planning option is for a taxpayer to buy a second house and rent it out. Any tax losses from the rental house will not be subject to the passive loss rules.\textsuperscript{158}

\textit{A taxpayer is subject to the passive loss rules unless he “materially participates” in the activity.}

The definition of a passive activity for purposes of Code section 469 includes those activities “in which the taxpayer does not materially participate.”\textsuperscript{159} Although the meaning of material participation is critical to an analysis of the passive loss limits, its definition was also left to regulations that still have not been issued.\textsuperscript{160} According to the legislative history, a taxpayer will be deemed materially participating in an activity only if he is “involved in the operations of the activity on a regular, continuous, and substantial basis.”\textsuperscript{161} Although there is a lengthy discussion of material participation in the legislative history, the net effect of this requirement is that a taxpayer will generally be deemed to be materially participating in an activity only if he is employed full time in it.\textsuperscript{162} This strict rule may actually restrict the scope of Code section 469 because most investment income will be passive. Such passive investment income can, of course, be sheltered by passive losses.\textsuperscript{163}

Tax professionals reviewing the Senate Finance Committee Report promptly suggested that taxpayers could manipulate this extreme position by refraining from material participation in any new investment which is expected to be profitable.\textsuperscript{164} Any income derived from such a passive activity is a PIG which can be sheltered by

\begin{itemize}
\item \textsuperscript{157} \textit{Id.} \textsection 163(h)(3)(a), (5)(A) (West 1982 and Supp. 1987).
\item \textsuperscript{158} So long as the taxpayer uses the residence within the meaning of Code section 280A(d)(1), which requires the taxpayer to use a dwelling unit for personal purposes for the greater of 14 days or 10\% of the days for which it is rented out. \textit{Id.} \textsection 163(h)(5)(A)(i)(II) (West 1982 and Supp. 1987).
\item \textsuperscript{159} \textit{Id.} \textsection 469(c)(1)(B) (West Supp. 1987).
\item \textsuperscript{160} \textit{Id.} \textsection 469(h)(1) (West Supp. 1987).
\item \textsuperscript{162} Lipton, \textit{supra} note 103, at 803.
\item \textsuperscript{163} \textit{Id.} at 809.
\item \textsuperscript{164} \textit{Id.} at 813.
\end{itemize}
other PALs. This strategy was attacked by the "line of business" approach in the Conference Committee Report. Under the Conference view, a taxpayer who is materially participating in one activity in a particular line of business will be deemed to be materially participating in all other activities in that line of business. The income generated by the second activity within the same line of business would not be passive and, as a result, could not be sheltered by passive losses. On the other hand, the same fundamental approach might still be used to avoid Code section 469 if the taxpayer diversifies across various lines of business.

Another planning option generated by the stringent "material participation" standard would be for a taxpayer, who is employed full time in a particular line of business which is profitable, to invest in another activity in the same line of business which either is just starting up or is otherwise generating losses. The taxpayer can use the losses to shelter income from the profitable activities within the same line of business. Richard M. Lipton, the Chairman of the ABA Section of Taxation's Special Task Force on Passive Activity Losses, has suggested that the line of business test be made elective with the taxpayer subject to consent by the Secretary of the Treasury. Presumably, the Secretary would refuse consent where the taxpayer tries to use the line of business approach to avoid the passive loss limits.

An important rule under Code section 469 is that a limited partner is conclusively presumed not to be a material participant, except as set forth in regulations that have yet to be issued. This presumption is based on the premise that a limited partner cannot be active in a partnership's business and still preserve his limited liability under State laws. This presumption is incorrect, however, because the Revised Uniform Limited Partnership Act ("RULPA"), adopted in a majority of states, permits a limited partner to engage in acts which might well meet the "material participation" standard with-

166. See Lipton, supra note 103, at 813.
167. See id. at 812.
168. Letter from Richard M. Lipton to David Brockway, Joint Committee on Taxation Chief of Staff, dated November 25, 1986, reprinted in 34 Tax Notes 969 (Dec. 8, 1986).
out imposing general liability.\textsuperscript{171} For example, a limited partner can obtain a partnership interest solely in exchange for services and, presumably, the limited partner would need to provide substantial services to justify receiving the partnership interest solely for such services.\textsuperscript{173}

Furthermore, RULPA section 303(a) does not impose general liability on a limited partner unless his “participation in the control of a business is substantially the same as the exercise of the powers of a general partner.” Since a limited partner could be regularly and substantially involved in a passive activity without exercising the powers of a general partner, founding the presumption on State law is inappropriate. RULPA section 303(b) also provides a long safe harbor list for various management actions by a limited partner. Finally, no general liability is imposed on a limited partner, even if he exercises the powers of a general partner, except to a creditor who has actual knowledge of the limited partner’s participation in the control of the partnership.\textsuperscript{174}

While RULPA imposes general liability if the limited partner exercises too much control over the partnership, the material participation standard only requires a taxpayer to be busily working in an activity in order to avoid the passive loss limits. These concepts are very different, because a limited partner can be working full-time for a partnership, and thus be materially participating, without exercising any control. Congress either misapprehended State partnership law or simply intended to severely discourage the use of limited partnerships.

One planning option created by the conclusive presumption that a limited partner is not a material participant is to structure new income producing activities, other than portfolio items, as limited partnerships. The income generated by the limited partnership will be deemed passive to the limited partners, and thus can be sheltered by other PALs. This plan should be used with caution, and should not be used at all for existing activities, because Congress directed the Treasury to issue regulations to prevent taxpayers from using a

\textsuperscript{173} Even Congress recognized that a limited partner can be an employee, which indicates that the limited partner is a material participant, because it provided that earned income from a partnership cannot be sheltered by passive losses. I.R.C. § 469(e)(3) (West Supp. 1987).
\textsuperscript{174} RULPA, supra note 172, § 303(a).
limited partnership to convert active income to passive income.\textsuperscript{175}

Another option for a limited partnership engaged in activities other than rental activities is to convert to a general partnership. As mentioned above, the conversion from a limited to a general partnership generally has no adverse tax consequences, but the business risks are much greater.\textsuperscript{176} A conversion from a limited partnership to a general partnership, moreover, merely eliminates the conclusive presumption that a limited partner cannot be a material participant. The taxpayer must still independently satisfy the material participation standard.

\textit{All rental activities are passive, but middle income taxpayers get an exemption.}

Under Code section 469, the "term 'passive activity' includes any rental activity."\textsuperscript{177} As a result, rental real estate and all other rental activities are subject to the loss limits of Code section 469 even if the taxpayer materially participates in the rental activity.\textsuperscript{178} Examples of rental activity include renting apartments to tenants pursuant to leases, furnishing a boat under a bare boat charter, and leasing property under a net lease.\textsuperscript{179} In contrast, renting hotel rooms where significant services are provided is not a rental activity.\textsuperscript{180} Real estate construction is a separate activity from renting the constructed building, and each building is also a separate activity.\textsuperscript{181}

\textsuperscript{175} I.R.C. § 469(k)(3) (West Supp. 1987). Former Internal Revenue Service Chief Counsel Kenneth W. Gideon originally asserted that the Congressional directive authorizing the Treasury to recharacterize income as not passive, while loss from the same activity remains passive, was unconstitutional. Treasury's Authority to Determine Whether Income Is Passive Is Subject to Challenge, Gideon Warns, 34 Tax Notes 621 (Nov. 17, 1986). Recently, however, Gideon seemed to soften this position, predicting that the Treasury will likely refrain from adopting an extreme position on this issue. BNA, Accounting: Conference Told Tax Planning Opportunities Limited by 1986 Tax Act, Hampered (By) Lack of IRS Guidance, Daily Tax Report No. 198 at G-1 (June 8, 1987).

\textsuperscript{176} See supra text at notes 154-155.

\textsuperscript{177} I.R.C. § 469(c)(2) (West Supp. 1987) (emphasis added).

\textsuperscript{178} Id. § 469(c)(4) (West Supp. 1987).

The statute provides that "rental activity" includes "any activity where payments are principally for the use of tangible property." I.R.C. § 469(j)(8). The legislative history indicates, furthermore, that "prior law applicable in determining when an S corporation had passive rental income, as opposed to active business income, for purposes of continuing to qualify as an S corporation, provides a useful analogy." Sen. Fin. Rep. No. 313, supra note 7, at 741; 1986 Blue Book, supra note 7, at 248. This definition is still terribly vague. Lipton, supra note 103, at 804.


The presumption that all rental activities are passive falls especially hard on real estate. Congress did provide an important but limited exception for middle income taxpayers. The maximum annual exclusion for PALs attributable to rental real estate is $25,000, but only for such activities in which the taxpayer "actively participates." The "active participation" standard is less stringent than the material participation standard, and generally does not require as much personal involvement by the taxpayer. According to the legislative history:

The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

A limited partner, however, is conclusively presumed not to be an active participant. Furthermore, a taxpayer must own at least ten percent, by value, of all interests in an activity in order to be deemed an active participant. A major limitation for commercial lessors is that a lessor under a net lease is unlikely to qualify as an active participant. On the other hand, a taxpayer claiming the

182. See Lipton, supra note 103, at 810-11 (example illustrating that a taxpayer who manages rental real estate will be penalized over $37,000, on net income of $250,000, in comparison to a similarly situated taxpayer who operates a retail grocery store).
183. Sen. Fin. Rep. No. 313, supra note 7, at 736; 1986 Blue Book, supra note 7, at 243. The legislative history attempts to justify the middle income exception for rental real estate as follows:

A limited measure of relief ... [is] believed appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income.

Sen. Fin. Rep. No. 313, supra note 7, at 718; 1986 Blue Book, supra note 7, at 214. This justification, however, is not persuasive since the same could be said of virtually all taxpayers and their investments. Perhaps legislators were simply trying to ameliorate for a large class of taxpayers the otherwise draconian treatment of all rental activities as passive.
189. Id. § 469(i)(6)(A) (West Supp. 1987).
low income housing credit$^{191}$ or a rehabilitation investment credit$^{192}$ qualifies for the rental activity exemption without proving that he was an active participant in the passive rental activity.$^{193}$

The maximum rental activity exemption for active participants is phased out for adjusted gross income above $100,000, and is fully phased out for adjusted gross income over $150,000.$^{194}$ The exemption is phased out for PALs attributable to the low income housing credit and the rehabilitation investment credit beginning at $200,000 and ending at $250,000.$^{195}$

The fact that rental activities are presumed to be passive has stimulated the formation of master limited partnerships.$^{196}$ The function of these entities is to combine various assets or subpartnerships so that confirmed PALs, such as rental activities, can shelter passive income generators. An ideal PIG is a parking lot or any other trade or business with high cash flow and stable deductions.$^{197}$

The presumption that rental activities are passive has also resulted in renewed interest in creative financing techniques designed to transform passive activities generating tax losses into income generating activities. One widely touted technique is to use zero coupon mortgages, a variation on a negative amortization mortgage, in which the interest is added to the principal due at the back end of the installment obligation. The zero coupon mortgage is typically used for a second or subsequent lien on the property. Obviously, the value of the installment debt to the lender is substantially diminished by deferring the interest to the end of the payment period. The lender may be compensated for this decline in the value of the debt either by accelerated payments on the first lien, which improves the lender’s equity position, or by requiring participants

$^{191}$ I.R.C. § 42 (West 1982).
$^{192}$ Id. § 48(o) (West 1982).
$^{193}$ Id. § 469(i)(6)(B) (West Supp. 1987).
$^{196}$ Master limited partnerships are large, publicly registered partnerships whose units are traded on national securities exchanges. The recent proliferation of master limited partnerships is generating Congressional scrutiny and the possibility that large partnerships will be taxed as corporations, and thus lose the pass-through advantage of partnership taxation. See, e.g., Sleeping Dogs: Publicly Traded Limited Partnerships Come of Age, 35 Tax Notes 1254 (March 30, 1987).
$^{197}$ Also known in a previous incarnation as a "cash cow."
to invest much more equity into the transaction. In any event, these transactions assume that appreciation will permit the creative debt to be refinanced within about ten years.\textsuperscript{198} An obvious risk in this plan is the assumption that future appreciation in the property will permit conventional refinancing, thereby avoiding a later disposition of the property when the debt might exceed the property value.\textsuperscript{199}

\textit{Allocation of expenses.}

As discussed above, Code section 469 requires a taxpayer to separately account for passive and active activities. The taxpayer must also separately account for portfolio items within each activity. Finally, the taxpayer must properly allocate all income and expense items to the correct category. The time and effort required to properly account for even simple activities will be enormous.

Congress specifically directed the Secretary of the Treasury to issue regulations providing for allocation of interest expense among the relevant categories.\textsuperscript{200} The conferees anticipated that regulations governing interest allocation would be issued by December 31, 1986.\textsuperscript{201} Of course, these regulations have not yet been issued. Instead, the Service issued an Announcement indicating that temporary regulations will be issued requiring interest expense to be traced and allocated based on the use of the loan proceeds which generate the interest expense.\textsuperscript{202} Similarly, interest incurred to buy an interest in a partnership or an S corporation will be characterized depending on the active or passive nature of the taxpayer’s participation in the investment.\textsuperscript{203} There is no indication when regulations governing the allocation of other items may be issued.

\textit{Phase-in of passive loss limits.}

The passive loss limits of Code section 469 are phased in for pre-enactment interests, i.e., interests in passive activities generally

\begin{footnotes}
\footnote{198. The use of zero coupon mortgages is especially popular for a transaction which, with conventional financing, would have generated a taxable loss largely attributable to interest on the debt. The goal of this technique is to reduce the debt burden so that the transaction will, instead, become an income generator, i.e., a PIG.}
\footnote{199. A subsequent sale when the debt exceeds the value of the property is likely to result in taxable income in excess of sale proceeds and, possibly, the taxes due might even exceed the sale proceeds.}
\footnote{200. I.R.C. § 469(k)(4) (West Supp. 1987).}
\footnote{201. Conf. Com. Rpt., supra note 165, at II-146.}
\footnote{202. Announcement 87-4, 1987-1 C.B. 47.}
\footnote{203. Id.}
\end{footnotes}
acquired before October 22, 1986. Only 35% of the PALs generated by qualifying pre-enactment interests are disallowed in 1987, increasing in increments to 100% disallowance in 1991 and thereafter. Interests in passive activities acquired after October 22, 1986, are not eligible for the phase-in and are fully subject to the passive loss rules. The phase-in applies, furthermore, after adjustment under the $25,000 rental activity exception for middle income taxpayers. Finally, the phase-in of the passive loss limits is illusory for taxpayers subject to the alternative minimum tax, because there is no phase-in of the passive loss rules for purposes of the alternative minimum tax.

**Conclusion**

Tax sheltered investments are a useful part of capital formation because they fill the gap between individual and institutional investors. Tax shelters also attract investors willing to undertake risky projects which Congress wishes to stimulate, although tax benefits are not the primary source of return in most projects.

While some tax shelters might be abusive, the Service had a powerful array of weapons to use against abusive tax shelters even before Congress adopted Code section 469. The number and abusiveness of tax shelters has been declining in response to earlier Congressional and Service initiatives, and the Service has not yet fully implemented all of its statutory and regulatory tools.

Despite the Service's impressive array of tax shelter weapons, Congress pushed through the passive loss limitations of Code section 469 without adequate review. As a result, Code section 469 is an

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204. I.R.C. § 469(l) (West Supp. 1987). A “pre-enactment interest” is defined as “any interest in a passive activity held by a taxpayer on the date of the enactment of the Tax Reform Act of 1986, and at all times thereafter.” Id. § 469(1)(B)(l) (West Supp. 1987). The 1986 Tax Reform Act was enacted on October 22, 1986. Several special rules apply, including an exception deeming any interest acquired after the date of enactment a “pre-enactment interest” if it was acquired pursuant to a written binding contract in effect on October 22, 1986, and thereafter. Id. § 469(l)(3)(B)(ii) (West Supp. 1987). Finally, an interest held on the date of enactment does not qualify as a pre-enactment interest unless the activity was being conducted, property used in the activity was acquired pursuant to a contract in effect on August 16, 1986, or construction of property used in the activity began by August 16, 1986. Id. § 469(l)(3)(B)(iii) (West Supp. 1987).

205. The percentage of pre-enactment interest PALs disallowed in the intervening years is 60% in 1988, 80% in 1989, and 90% in 1990.


extraordinarily complex yet surprisingly incomplete provision. One consequence of the passive loss rules is that the taxpayer's choice of entity in which to conduct a transaction has become much more complex.208

The more significant effect of new Code section 469 is likely to be a widening gap between middle and upper middle income taxpayers, on the one hand, and wealthy taxpayers on the other hand. Middle and upper middle income taxpayers are likely to be priced out of the syndicated tax shelter market because of the increasing cost of planning investment portfolios and the large amount of capital required to acquire a properly balanced portfolio. Wealthy taxpayers, however, will simply pay more for tax planning advice to accomplish the same objectives they achieved before adoption of Code section 469.

There may be some benefit in weaning middle income taxpayers away from those tax shelters which involve more economic risk than is appropriate for their income group. Congress may be dismayed to discover, however, that the perception that “tax is paid only by the naive and unsophisticated,”209 will be even more common. Furthermore, the additional complexity, cost of compliance, and distaste for the revenue laws generated by Code section 469 is unlikely to be justified by the additional revenue raised.

Code section 469 is so flawed that efforts to amend it are virtually certain to complicate rather than simplify the problem. Finally, the Service should have more time to apply its other tools against abusive tax shelters before taxpayers are burdened with the task of complying with anything like the passive loss rules. Therefore, Code section 469 should be repealed and the concept of passive loss limits should be reserved for future use if it truly becomes necessary.

208. With respect to real estate, for example, a large developer primarily engaged in “rental activities” may use a blended interest closely held corporation, a 6/11 corporation, a regular corporation, or a real estate investment trust. A large dealer who has little rental activity may be happier with a general partnership. A taxpayer with small rental activities may use a sole proprietorship, an estate or trust, a general partnership, or an S corporation. Finally, promoters of syndicated tax shelter transactions may continue to use limited partnerships or may move into master limited partnerships. See Brode, supra note 136, at 301.

209. See supra note 19 and accompanying text.