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THE TAX BENEFITS OF LIABILITIES—THEIR RISE AND FALL

by
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LIABILITIES play a crucial role in determining the tax impact of an investment. Taxpayers may include purchase money liabilities in the basis of acquired property, thereby increasing the availability of depreciation and other tax benefits.[1] These tax advantages encourage taxpayers to maximize the use of debt, while the associated financial risks lead them to minimize their economic exposure.[2] In an effort to resolve these conflicting goals, taxpayers have used nonrecourse debt, as well as debt of dubious authenticity.[3] The courts and Congress have attempted to circumscribe these efforts. The "at risk rules" of section 465 of the Internal Revenue Code play a leading role in this regard.[4]

The basis rules, which measure the availability of deductions in the first instance, and the at risk rules, which may thereafter intervene to deny deductions, have caused confusion. Courts have made decisions under one set of rules when they should have used the other set.[5] The passive loss rules of the Tax Reform Act of 1986,[6] which generally limit the loss deductions from passive activities to income from passive activities, affect the prominence of the basis and at risk rules.[7] Prior to the taxable disposition of an investment

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1. Crane v. Commissioner, 331 U.S. 1, 11-12 (1947); *see also* United States v. Hendler, 303 U.S. 564, 567 (1938) (another corporation's assumption and payment of taxpayer's debt resulted in taxable gain to taxpayer).

2. *See* Franklin v. Commissioner, 544 F.2d 1045, 1046-47 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975); Bolger v. Commissioner, 59 T.C. 760, 766 (1973); Mayerson v. Commissioner, 47 T.C. 340, 348 (1966).

3. Franklin v. Commissioner, 544 F.2d 1045, 1047-48 (9th Cir. 1976) (limited partner not entitled to interest deduction or depreciation reduction for property it purchased and leased back and for which partner did not pay nor show as an investment), *cert. denied*, 385 U.S. 827 (1976).

4. I.R.C. § 465 (West Supp. 1987). The Internal Revenue Code will hereinafter be referred to as the Code.

5. *See infra* notes 170-95 and accompanying text for a discussion of Pritchett v. Commissioner, 85 T.C. 580 (1985), *rev'd*, 827 F.2d 644 (9th Cir. 1987).

6. I.R.C. § 469 (West Supp. 1987).

7. *Id.*; *see* Brode, *Structuring Real Estate Entities in View of the New Limitation on Loss Rules*, 65 J. TAX'N 290, 291 (1986) (overall effect of limitation on loss rules is to limit severely availability of losses or credits from tax shelter).

interest, the passive loss rules often will make the at risk and basis rules superfluous. Little need will exist to determine whether the at risk or basis provisions limit loss deductions when the passive loss rules prohibit them outright.

The at risk and basis rules, however, continue to be of the utmost importance. The passive loss rules only apply to passive activities,[8] leaving the at risk and basis provisions to impact loss deductions for undertakings in which the taxpayer may "materially participate."[9] Further, taxpayers may deduct passive losses from one passive activity from passive income from another passive activity. For example, participants in a highly leveraged real estate limited partnership may deduct passive losses from passive income attributable to a successful oil and gas limited partnership.[10] One must address the basis and at risk rules in order to ascertain the amount of passive losses that may be used to offset passive income.

This Article discusses liabilities in the context of the basis, at risk, and passive loss rules. Particular emphasis is given to the interplay between those rules, as well as to recent Tax Court cases that demonstrate that judges are not immune to the difficulties this area presents. The Article also provides a critique, particulary of the passive loss rules, and recommendations for reform.

I. BASIS

A. *The Basics of Basis*

Basis measures the taxpayer's investment: the cost of a property.[11] This measure is important because under our system of taxation the federal government generally taxes a taxpayer on gross income minus the costs associated with earning it.[12] Those costs might involve materials, such as legal pads in a law office, that are used promptly after acquisition. Alternatively, they might consist of property with an extended life, such as a word processor. The Internal Revenue Code usually permits an immediate deduction of the full cost of the materials since they are used currently.[13] It would not be appropriate to allow a current deduction of the cost of property with an extended life, such as the word processor. Users will only consume such property gradually, and the property will generate income for a period of years. In order to properly match income and expenses, therefore, a taxpayer should allocate the cost or basis of the property to annual income only to the extent its value declines.[14] The Internal Revenue Service accomplishes this match of declining property value with income, with dramatic

8. I.R.C. § 469(c)(1) (West Supp. 1987).
9. *Id.*; *see infra* notes 304-38 and accompanying text.
10. I.R.C. § 469(d)(1) (West Supp. 1987) (aggregate losses from passive activities must exceed aggregate gains from such activities.
11. *Id.* § 1012 (1982).
12. *Id.* § 63 (1987).
13. Treas. Reg. § 1.162-3 (1958).
14. United States v. Ludey, 274 U.S. 295, 303-04 (1927); B. BITTKER, FUNDAMENTALS OF FEDERAL INCOME TAXATION ¶ 10.1 (1983).

modifications, by the depreciation system. Since determining whether and the extent to which property has declined in value is impractical, the cost recovery system assumes that properties depreciate at various specified rates.[15]

Depreciation and various other income deductions associated with the property reduce basis.[16] Additional investments in the property can increase basis. As a result of these potential fluctuations, the concept of "adjusted basis" emerged. On the taxable disposition of property, taxpayers report gain or loss depending on the difference between the adjusted basis of the property and the amount realized on the sale.[17]

Obviously the calculation of basis is critical. Taxpayers typically want as a high a basis as possible, not only to increase the availability of current deductions, but also to limit the gain, or increase the loss, on a later taxable disposition. The basis includes the amount of the taxpayer's equity investment in the property.[18]

B. Liabilities

Liabilities constitute a more difficult problem when calculating basis. Arguably, one should not include liabilities in basis because they do not represent a taxpayer's current investment. At the time the taxpayer incurs the liabilities, it is not the taxpayer who is making the outlay, but the lender. The taxpayer may, in the case of recourse debt,[19] be obligated to make an investment in the future when the debt matures. The obligation is not a current one, however, and a question arises as to whether the taxpayer should be allowed basis before the investment occurs. In the case of nonrecourse debt that question becomes even more pertinent, since the taxpayer possesses no personal obligation to pay the debt at all. Instead the lender relies on the activity's future income or, if all else fails, the secured property itself to ensure payment of the debt. Why should a taxpayer receive basis for an investment he has not yet made and is not personally obligated to make? The issue is one of timing. When should the taxpayer's basis be credited: at the time the property is acquired or when the liability is paid and the investment is in fact made?[20]

From a purely theoretical standpoint, a cogent argument exists that basis should not be increased except to the extent the taxpayer actually pays the principal portion of the debt. Only with this requirement will the tax system insure that the investment will be made.[21] If taxpayers do not initially in-

15. I.R.C. §§ 167, 168 (West Supp. 1987).
16. *Id.* § 1016.
17. *Id.* § 1011 (1987).
18. *Id.* § 1012.
19. For a good description of recourse and nonrecourse loans, see Fielder, *Drilling Funds and Nonrecourse Loans—Some Tax Questions*, 24 INST. ON OIL & GAS TAX'N 527, 535-36 (1973).
20. For a detailed discussion of this topic, see Halpern, *Liabilities and Cost Basis: Some Fundamental Considerations*, 7 J. REAL EST. TAX'N 334, 336 (1980); Landis, *Liabilities and Purchase Price*, 27 TAX LAW. 67, 68 (1973).
21. Taxpayers have included liabilities in basis with surprisingly little discussion. Nothing

clude liabilities in basis, however, they must constantly adjust their basis as they make principal payments on the debt. Depreciation deductions would vary, potentially erratically, as basis varied. Abuse certainly would not be avoided. Taxpayers could accelerate, or retard, payment of debt, manipulating basis and associated deductions depending on their varying tax picture, which potentially could reduce the amount of overall taxes paid.

The tax system generally attempts to have tax consequences follow economic consequences.[22] Refusing to include liabilities in basis could violate this principle. Ordinarily only payments made toward the end of the loan period materially reduce the outstanding principal balance.[23] Further, quite frequently a property's expected life is close to the expected payout period on the loan.[24] Tying depreciation allowances to principal payments, therefore, could result in the bulk of the depreciation deductions being taken toward the end of a property's life. This result appears inconsistent with economic depreciation, the bulk of which typically occurs early in a property's life.[25]

Fundamental to the United States income tax system is a desire to match income and expenses.[26] As the assets the taxpayer acquired with the debt generate income, should not the taxpayer be permitted to deduct costs associated with that income that, in this context, represents the amount by which the property depreciates in value? The depreciation will be a function of the total cost of the property, part of which may have been paid with debt.[27] Any losses incurred are also a function of the total outlays, which include proceeds from loans. Based on these considerations and others, courts have always included purchase money recourse debt in basis.[28]

One does not significantly alter the analysis if nonrecourse debt is used.

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about this issue is contained in the legislative history to I.R.C. § 1012 (1982) or to its predecessor, I.R.C. § 202 of The Revenue Act of 1918.

22. B. BITTKER, *supra* note 14, ¶¶ 8.1-8.5; *see* I.R.C. § 162 (West Supp. 1987) (provides deductions for business expenses).

23. THORNDIKE ENCYCLOPEDIA OF BANKING AND FINANCIAL TABLES 5-1 table 5 (1983 Yearbook) (mortgage amortization schedules).

24. *See* Bolger v. Commissioner, 59 T.C. 760, 762-65 (1973); *see also infra* notes 36-55 (discusses *Bolger*). In *Bolger* the mortgage term equalled the lease term, which probably equalled the property's useful life. *See also* Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 TAX L. REV. 355, 370 (1973).

25. For an excellent discussion of depreciation methods and why an accelerated rate of depreciation may more accurately reflect income, see Kahn, *Accelerated Depreciation—Tax Expenditure or Proper Allowance for Measuring Net Income?*, 78 MICH. L. REV. 1, 30-43 (1979).

26. *See generally* I.R.C. § 63 (West Supp. 1987) (taxable income equals gross income less certain deductions).

27. *See* Kahn, *supra* note 14, at 25 (discussion of accelerated depreciation as proper deduction in determining net income).

28. *See* Crane v. Commissioner, 331 U.S. 1, 11 (1946) (property's basis equals amount paid for property; no decrease for mortgages on property); United States v. Hendler, 303 U.S. 564, 566 (1938) (discharge of debt by assumption of debt and obligation constituted income); Bolger v. Commissioner, 59 T.C. 760, 770 (1973) (amount of mortgages encumbering property included in basis). Some courts have included liabilities in basis even when not paid. *See* Amphitrite Corp. v. Commissioner, 16 T.C. 1140, 1143 (1951) (elimination of indebtedness did not authorize reduction in basis); Blackstone Theatre Co. v. Commissioner, 12 T.C. 801, 804-05 (1949) (taxpayer's basis prior to year of purchase of tax liens should include full amount of

Assuming the debt and purchase prices are bona fide, which is occasionally questionable, depreciation will continue to be a function of the property's cost, and the practical and conceptual issues remain the same. For these reasons, among others, the venerable *Crane v. Commissioner*[29] held that nonrecourse debt is included in basis, in the process causing it to be one of the most cited Supreme Court tax cases in history.[30] Including liabilities in basis does not result in a system that works perfectly, and abuses can arise. A host of judicial rules and Code provisions have been created to help stem the efforts of excessively creative taxpayers.[31]

C. *Boosting Basis*

Through the use of liabilities, taxpayers can generate basis levels far in excess of their equity investments.[32] The eventual need for repayment often offsets this potential benefit. From the taxpayer's, if not the government's, point of view, one would prefer to avoid that financial exposure while still obtaining the basis increase. The use of nonrecourse debt makes this avoidance of financial exposure possible. If the taxpayer's interest principally lies in tax benefits rather than economic benefits, an incentive exists to maximize basis by maximizing the use of nonrecourse debt, potentially in excess of a property's or activity's economic value.[33] Such efforts undermine the entire conceptual underpinning in permitting the inclusion of nonrecourse liabilities in basis. It is one thing to permit their inclusion when they are incurred on the assumption that the activity's income, or the collateral itself, will pay the underlying debt. It is quite another to allow one to add nonrecourse liabilities to basis when the prospect for their payment is highly questionable. Two cases highlight this concern.

1. Mayerson *and* Bolger

The facts in *Mayerson v. Commissioner*[34] strikingly demonstrate the advantages of nonrecourse debt. In *Mayerson* the taxpayer acquired depreciable property in exchange for $10,000 in cash and a $332,500 ninety-nine year, interest bearing, nonrecourse purchase money mortgage and mortgage note. The court, in a somewhat cryptic decision, found the debt obligation to be bona fide and held that the purchasers were entitled to include the debt

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such liens). For an alternative proposal, see Landis, *supra* note 20, at 84 (assumption of liabilities based on more conventional tax accounting rules would introduce degree of certainty.

29. 331 U.S. 1 (1947).

30. *Id.* at 11; *see* Halpern, *supra* note 20, at 337 n.12; Landis, *supra* note 20, at 67; Lurie, *supra* note 24, at 370.

31. *See infra* notes 66-196 and accompanying text.

32. Bolger v. Commissioner, 59 T.C. 760, 770 (1973) (taxpayer should include mortgage encumbering property in basis, regardless of whether taxpayer assumes personal liability for mortgage); Mayerson v. Commissioner, 47 T.C. 340, 352 (1966) (taxpayer should include purchase-money mortgage lien in basis).

33. *See* Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976) (absence of personal liability on debt reduces chance that genuine debt obligation arises and does not justify interest deduction).

34. 47 T.C. 340 (1966).

obligation in basis.[35]

The second case is the much celebrated case of *Bolger v. Commissioner*.[36] In *Bolger* the defendant created tax shelters to take advantage of the accelerated depreciation deductions available for real estate at the time the parties structured the transactions.[37] Bolger would form a financing corporation, capitalize it with $1,000, and have the corporation acquire a building.[38] The corporation normally would enter into a long-term, triple net lease of the building with a publicly held corporation. The corporation borrowed the funds for the purchases from institutional lenders, who took the building and the lease as security. The lessees made lease payments directly to the lenders. The leases, which were probably for terms equal to or in excess of the lives of the buildings,[39] obligated the lessee to make lease payments even if the buildings were destroyed, were coupled with an option to purchase, required the lessee to indemnify the lessor for any liability to third parties that might arise with regard to the building, and generally shifted responsibility for the building to the lessees. After purchase and lease of the building, the corporation would convey title to Bolger.[40] He would accept the property subject to, but without assuming any obligation on, the indebtedness. This scheme made the indebtedness, which was nominally recourse, effectively nonrecourse. Bolger was not liable for the debt, and the corporation did not posses any significant assets from which to pay it.[41] Bolger, as the purported owner of the building, included the liability in his basis. He took accelerated depreciation and interest deductions that, even after the inclusion in income of the rental fees, provided a large reduction in taxable income.

Bolger, at the outset, possessed no equity interest in the building and therefore no personal investment. The rental income received and debt payments made occurred over similar time frames and roughly offset one another, so little chance existed of Bolger receiving any net cash proceeds during the buildings' useful lives.[42] Consequently, the buildings would contain little value to Bolger at the end of the lease terms. Arguably there were no economic underpinnings to the transaction; it constituted a pure tax avoidance maneuver. Bolger probably never really intended to be the bona fide owner of the building. The court, nonetheless, held for the taxpayer.[43]

One commentator has cited the *Bolger* case as an example of misuse of the Code.[44] Ironically, the principal culprit was the Internal Revenue Service,

35. *Id.* at 353-55.

36. 59 T.C. 760 (1973); *see* Lurie, *supra* note 24, at 355.

37. I.R.C. § 167 (1963) (current version at I.R.C. § 167 (West Supp. 1987)), the applicable section at the time, allowed such deductions for real estate investments.

38. *See* Lurie, *supra* note 24, at 355, 356 (summarizes *Bolger* facts).

39. *Id.* at 370.

40. The manner in which the transfer was made is unclear.

41. Bolger capitalized the corporation with $1,000.

42. *See* Lurie, *supra* note 24, at 369-70.

43. Bolger v. Commissioner, 59 T.C. 760, 771 (1973).

44. *See* Lurie, *supra* note 24, at 358-60 (taxpayer should have investment in property and suffer economic loss with property's depreciation before being allowed depreciation deductions).

which defeated itself by stipulation. Given Bolger's lack of any current or future economic interest in the property and the other facts described above, the burden and benefits of ownership were with the lessees. They, not Bolger, effectively owned the property. Bolger and his corporations constituted little more than financing intermediaries. Other cases have held similar lessees to be the owners.[45] Unfortunately, the Internal Revenue Service neglected to argue this point. Incredibly, the Commissioner conceded the validity of the leases and did not argue that the lessees possessed the depreciable interest. Instead, the Internal Revenue Service conceded that Bolger's corporation did hold a depreciable interest, but maintained that the interest was not transferred to Bolger. The IRS creatively argued that Bolger only received a reversionary interest in the building and not a present interest subject to depreciation. The IRS premised its position on the long-term nature of the leases and mortgages and the fact that the parties consummated leases and mortgages before the buildings were transferred to Bolger.

The majority of the Tax Court decided the case in this context.[46] Focusing on the form of the transactions, the court held that the leases were transferred to the lenders solely as security and that each lease constituted "part and parcel of the ownership of the particular property the legal and beneficial ownership of which was vested at the outset in the appropriate corporation."[47] In addition, the court did not question that under the appropriate state law the corporations had made valid, present transfers to Bolger.[48] Accordingly, and somewhat summarily, the court rejected the IRS's view.[49] It further held that the indebtedness did not exceed the fair market value of the collateral and was not contingent.[50] Under *Crane*, therefore, the court found the debt includible in basis.[51]

The Internal Revenue Service belatedly argued that *Crane* should not apply since little likelihood existed of Bolger ever developing any equity interest in the property.[52] The court also rejected this argument, positing, somewhat fancifully, that equity would develop as the rents were paid, and that the taxpayer would also seek to protect his interest in order to obtain any benefits of appreciation.[53] If the leases were not for terms apparently approaching the useful lives of the building, it might have been possible for equity to develop and the potential for appreciation to exist. The long term nature of the leases made either event unlikely. The case, however, did not center around this issue. Had the IRS coupled this latter point with an argu-

45. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 576-84 (1978); Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 254-55 (1939); Sun Oil Co. v. Commissioner, 562 F.2d 258, 263-69 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); *see also* Rev. Proc. 75-21, 1975-1 C.B. 715, 715-16.

46. *Bolger*, 59 T.C. at 766-68.

47. *Id.* at 768.

48. *Id.*

49. *Id.* at 768-69.

50. *Id.* at 769.

51. *Id.* at 770.

52. *Id.* at 770-71.

53. *Id.*

ment that the lessees were the true owners, the court might have reached a different result. As it was, the court noted that "the combination of the benefits of accelerated depreciation and the *Crane* doctrine produces a bitter pill for respondent to swallow. We see no way of sugarcoating that pill, short of overruling *Crane v. Commissioner* . . . which we are not at liberty to do."[54]

Given the premises from which it began, the court's conclusions were probably inevitable. No authority exists to deny to an original purchaser depreciable basis in this context. Since the IRS acknowledged the validity of the leases, the only logical recipient of the depreciable basis became Bolger when the property was transferred to him. Courts should not interpret *Bolger* as authority, in following *Crane*, to permit taxpayers to manipulate the Tax Code and ignore the substance and economics of a transaction, but rather as a case in which curious stipulations led to a curious result. Indeed, *Bolger* has not unduly constrained the judicial system.[55]

D. The Counterattack

Fortified in part by *Mayerson* and *Bolger*, the shelter industry went to work in earnest. Promoters convinced often unwitting taxpayers that they could receive huge "tax write offs" with minimal investment.[56] *Crane* notwithstanding, the courts and the IRS responded with a variety of methods to thwart the efforts of taxpayers to excessively inflate basis with liabilities of often dubious authenticity.

1. Fair Market Value Requirement

One such response has required that the nonrecourse debt not exceed the property's fair market value. A seminal case in this regard is *Franklin v. Commissioner*.[57] In *Franklin* a California limited partnership, "Associates," purchased an Arizona motel for a purported purchase price of $1,224,000. The purchasers were to pay for the property over ten years. Associates paid the sellers, the Romneys, $75,000 in prepaid interest at the outset and gave them an interest bearing, nonrecourse promissory note for the amount of the

54. *Id.* at 771.

55. *See* Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976) (depreciation predicated on investment in property, not on ownership); Denver & Rio Grande W. R.R. Co. v. United States, 505 F.2d 1266, 1269-70 (Ct. Cl. 1974) (taxpayers cannot include in basis liabilities of highly contingent nature); Columbus & Greenville Ry. Co. v. Commissioner, 42 T.C. 834, 849 (1964) (since petitioner did not assume payment of mortgage, petitioner should not include mortgage in basis), *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, 839 (1963) (taxpayer may not increase basis for contingent liabilities), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964).

56. *See generally* Gibson Prods. Co. v. United States, 637 F.2d 1041, 1048 (5th Cir. 1981) (when parties agreed that lender might participate in venture and share in loan proceeds and borrower's debt was nonrecourse, parties did not create true loan); Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976) (although bona fide debt allows absence of personal liability, such debt is not bona fide if it is contingent on substantial appreciation of property directly before repayment); *Boom in Tax Shelters Artificially Lifts Prices of Much Real Estate*, Wall St. J., Dec. 27, 1983, at 1, col. 6.

57. 64 T.C. 752 (1975), *aff'd*, 544 F.2d 1045 (9th Cir. 1976).

purchase price. The bulk of the principal of the note became due as a balloon payment at the end of the ten-year term. Title was not to be transferred to the purchasers until they had paid the purchase price in full.[58] Associates subsequently leased the motel back to the Romneys by a lease that gave the Romneys all material rights of ownership.[59] The rental amount approximately equaled the payments due on the note, and the rental period was coterminus with the term of the note.

Since the debt was nonrecourse, and since the lease was structured so as to pay Associates' obligation on that debt, Associates' only exposure was the $75,000 it originally invested, which it maintained was deductible interest. Associates, however, claimed a depreciable basis of $1,224,000, the amount of the note.[60] The Tax Court, unburdened by the stipulations in *Bolger*, took a rather different approach. It concluded that, given the payment and lease terms, a sale had not even occurred because the sellers had not parted with the benefits and burdens of ownership.[61] It held that Associates had merely obtained an option to acquire the motel in the future.[62]

The Ninth Circuit, while also holding against the taxpayer, rejected the Tax Court's position, maintaining that it was possible, even under the exceptional circumstances of the case, for a bona fide sale to have taken place.[63] The appellate court emphasized that the cornerstone of the analysis was whether Associates had made an investment in the property.[64] To prove such an investment, it became necessary for Associates to show that the purchase price appeared approximately equal to the fair market value of the property.[65] Associates failed in this regard, and accordingly the court did not allow it to include any amount of the note in basis.[66] The court reasoned that:

> An acquisition such as that of Associates if at a price approximately equal to the fair market value of the property under ordinary circum-

58. The parties placed the warranty deed in an escrow account, along with a quit claim deed from Associates to the Romneys, both of which would be delivered to Associates on full payment of the purchase price, or to the Romneys on default.

59. The Romneys stood responsible for all the typical expenses of owning the motel property, including all utility costs, taxes, assessments, rents, charges, levies of "every name, nature and kind whatsoever," and payments on the first and second mortgages. They could also further encumber the property without the consent of Associates and could propose new capital improvements that Associates would be required to either build themselves or allow the Romneys to construct with compensating modification of the purchase price. *Franklin*, 544 F.2d at 1047.

60. At the time the case arose in 1968, Congress had not yet enacted the at risk rules of I.R.C. § 465. Congress enacted the first at risk rules to be effective for taxable years beginning after December 31, 1978. Revenue Act of 1978, Pub. L. No. 95-600, § 204(a), 92 Stat. 2763, 2817 (1978) (codified as amended at I.R.C. § 465 (West Supp. 1987)). Even if the rules had been in effect, the taxpayers might have fallen within the real estate exception. *See infra* notes 105-147.

61. *Franklin*, 64 T.C. at 761-62.

62. *Id.* at 761-71.

63. *Franklin*, 544 F.2d at 1047 (citing Hudspeth v. Commissioner, 509 F.2d 1224, 1227 (9th Cir. 1976)).

64. *Id.* at 1048-49.

65. *Id.*

66. *Id.*

> stances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.
>
> No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. . . .[T]he purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future . . . .[67]

Fresh from its victory in the Ninth Circuit, the Service issued a series of revenue rulings involving the film industry,[68] patents,[69] lithographic plates,[70] and domestic exhibition rights.[71] In each revenue ruling the taxpayers attempted to dramatically inflate basis with nonrecourse debt of a decidedly specious variety. Following *Franklin*'s lead, the Service denied a basis increase for the purported debt obligation given the taxpayer's inability to prove the property's fair market value.[72]

2. *Excessive Contingencies*

Regardless of a property's fair market value, courts also have refused to include liabilities in basis if they are so contingent that the likelihood of payment is seriously called into question. Courts have found liabilities excessively contingent when the liabilities involved: an obligation to repay an advance out of speculative revenues generated over a limited period;[73] uncertain liabilities that might arise out of a pending lawsuit;[74] a modified agreement to fulfill the undeterminable severance pay obligations of a predecessor company;[75] a note to be repaid solely from profits from the sale of ocean front properties, if and when created by a dredging operation;[76] and nonrecourse notes secured by a license for a computer assisted translation system and the speculative proceeds to be obtained from the system.[77]

The issue of the contingency of payments can also arise when the long term value of the collateral is too ephemeral to support the existence of non-

67. *Id.* at 1048. The court also denied the taxpayer a deduction for the prepaid interest because the debt did not have economic significance. Associates, therefore, had not secured "the use or forbearance of money." *Id.* at 1049 (quoting Norton v. Commissioner, 474 F.2d 608, 610 (9th Cir. 1973)).

68. Rev. Rul. 77-110, 1977-1 C.B. 58.

69. Rev. Rul. 78-29, 1978-1 C.B. 62.

70. Rev. Rul. 79-432, 1979-2 C.B. 289.

71. Rev. Rul. 80-42, 1980-1 C.B. 182.

72. Rev. Rul. 77-110, 1977-1 C.B. at 59; Rev. Rul. 78-29, 1978-1 C.B. at 62-63; Rev. Rul. 79-432, 1979-2 C.B. at 291-92; Rev. Rul. 80-42, 1980-1 C.B. at 183.

73. Denver & Rio Grande W. R.R. Co. v. United States, 505 F.2d 1266, 1269-70 (Ct. Cl. 1974).

74. Columbus & Greenville Ry. Co. v. Commissioner, 42 T.C. 834, 846-50 (1964), *aff'd per curiam*, 358 F.2d 294 (5th Cir.), *cert. denied*, 385 U.S. 827 (1966).

75. Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, 839-41 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964).

76. Graf v. Commissioner, 80 T.C. 944, 945-47 (1983).

77. Driggs v. Commissioner, 87 T.C. 759, 775-76 (1986).

recourse debt. This issue arises readily with oil and gas activities.[78] An oft cited case in this regard is *Gibson Products Co. v. United States*.[79] Gibson Products Company invested in the "McNiel Street" oil and gas limited partnership. McNeil Street in turn entered into a joint venture with another limited partnership. The joint venture acquired five oil and gas leases from Galaxy Oil Company (Galaxy). Galaxy agreed to drill exploratory wells on each of the five leases. The joint venture paid Galaxy approximately sixty percent of the drilling costs with a nonrecourse, interest bearing promissory note. The leases, the operating equipment, and eighty percent of the oil and gas to be produced secured the note. Galaxy also possessed an option to acquire a twenty percent joint venture interest in the wells. The joint venturers, pursuant to section 752 of the Code, included in their bases in the joint venture their shares of the nonrecourse note.[80] McNeil Street's share of the liability was in turn passed down to its partners, including Gibson Products Company. The partners included the liability in their bases in their partnership interests.[81] This additional basis permitted the partners to take substantial intangible drilling costs deductions.[82]

The court held that the nonrecourse note to Galaxy did not constitute a legitimate debt because the combined assets of both joint venturers were not sufficient to pay the note absent production from the oil and gas leases.[83]

> In a true lending transaction, the borrower normally possesses assets nearly equal or greater in value than the amount of indebtedness . . . [and] there exists the reasonable likelihood that the lender will be repaid in light of all reasonably foreseeable risks . . . [and] that the ability of the borrower will not be wholly or substantially contingent upon the success or failure of the business venture.[84]

The court acknowledged that the leases and drilling contracts initially possessed value and thus might have constituted legitimate collateral for the note.[85] The Court took the position, however, that the value of the drilling contracts and leases appeared too transitory to be considered proper security.[86] If drilling failed, not only the value of the drilling contracts, but the leases themselves might go to zero. An oil and gas property only has worth if oil and gas is present. In this regard the court insisted:

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78. *See* Fielder, *supra* note 19, at 527, 536-38, 556 (author questions whether ostensible loans that were only to be repaid if the borrower discovered oil and gas and achieved production really possessed enough characteristics of true loan to qualify as one).

79. 637 F.2d 1041 (5th Cir. 1981).

80. *Id.* at 1043-44; *see* I.R.C. § 752 (1982).

81. *See* I.R.C. § 752 (1982).

82. Section 263(c) provides an option by which taxpayers may elect to expense intangible drilling and development costs. *Id.* § 263(c) (West Supp. 1987). Section 704(d) limits a partner's loss deductions to his partnership interest basis. *Id.* § 704(d) (1982).

83. *Gibson Prods. Co.*, 637 F.2d at 1047; *cf.* Brountas v. Commissioner, 73 T.C. 491, 568-71 (1979) (nonrecourse notes constituted legitimate debt under § 636 and thus were fully includable in basis of partner's partnership interest, despite notes' contingent nature).

84. *Gibson Prods. Co.*, 637 F.2d at 1047 (quoting Fielder, *supra* note 19, at 534).

85. *Id.* at 1048.

86. *Id.* "It is self-evident that the enhancement value of an exploratory drilling contract will change when the well is completed, after which the value of [a lease interest in a] mineral property will either soar or plummet depending upon the results of the drilling." *Id.*

> In a true loan it is contemplated that the borrower will *maintain* assets equal or greater in value than the amount of the debt. [Cases upholding the existence of nonrecourse debt involved] . . . real and personal property of a durable nature which (1) possessed "an objectively ascertainable present value, at least equal to the amount of the indebtedness along with a reasonably predictable future value . . . reasonably certain to remain at least equal to the amount of the indebtedness and (2) was relatively immune to or which might be insured against sudden developments [that] might reduce the value of the property below the amount of unpaid indebtedness.[87]

The court pointed out that another characteristic of a loan is that it entitles a borrower to all the entrepreneurial rewards.[88] The court felt that Galaxy's right to a twenty percent share of profits conflicted with this principle.[89] Accordingly, the court held that the nonrecourse note did not possess enough of the characteristics of a true loan to be treated as one, and the putative debtors could not include the liability in basis.[90]

Gibson, therefore, adds the additional requirement that, in the case of nonrecourse debt, the collateral's value not be susceptible to quick evaporation. In emphasizing the transitory value of the partnership's assets, the court raises the question of whether it is possible for nonrecourse debt to be acceptable if the security consists of mineral interests. The value of the interest is usually almost wholly contingent on the existence of the mineral, assuming no associated surface rights exist. The possibility will always exist that the value of the interest would collapse if there were a failure to discover the mineral. Outside the mineral industry the problem is less likely to arise since the durability of the collateral's value is typically more substantial. As banks who made loans to farmers in the midwest and to real estate buyers in Colorado and Houston are now sadly aware, however, real estate values can collapse too.[91] Further, it seems inequitable to single out the mineral industry for adverse treatment. No congressional, or widespread judicial, support exists for such a position. When dealing with properties that have an inherently speculative value, the focus might be best moved away from considerations of the fair market value of the collateral to whether, given all the facts, it is likely the obligation will be paid. In the case of wildcat wells involved in *Gibson*, risk of nonpayment may well have been too great to permit the basis inclusion. *Dillingham v. United States*[92] demonstrates that this problem need not always exist. In *Dillingham* Basin Petroleum Corporation (Basin) was engaged in oil and gas exploration as well as contract drilling. In order to raise working capital, Basin offered limited partnership interests to third

87. *Id.* at 1048-49 (quoting Fielder, *supra* note 19, at 537) (emphasis in original).
88. *Id.* at 1048.
89. *Id.*
90. *Id.* at 1049.
91. *See* Belongia, *Factors Behind the Rise and Fall of Farmland Prices: A Preliminary Assessment*, 67 FEDERAL RESERVE BANK OF ST. LOUIS REV., Aug.-Sept. 1985, at 18; *see also* Hooper, *City Review, Houston*, NAT'L REAL ESTATE INV., June 1985, at 185 (discussing troubles in Houston, Texas); Wilkinson, *City Review, Denver*, NAT'L REAL ESTATE INV., Sept. 1986, at 115 (discussing troubles in Denver, Colorado).
92. 1981-2 U.S. Tax Cas. (CCH) ¶ 9601 (W.D. Okla. 1981).

parties in a large number of low risk, presumably developmental, prospects.[93] The limited partnership interests were financed in part by nonrecourse loans from Basin.[94] Revenues from successfully drilled wells effectively secured the loans just as they did in *Gibson*. The court nonetheless held that nonrecourse loans were bona fide and includable in basis.[95] Although it acknowledged that one might consider such loans contingent in some cases, the court concluded that the high percentage of low risk properties provided sufficient certainty that the loans would be repaid.[96] The court distinguished *Gibson* on the grounds that the properties in *Gibson*, and implicitly the potential for revenues, were "purely speculative."[97]

E. Shams

Of course, the rules for including liabilities in basis assume the debt is not a work of pure fiction. Circumstances may arise such that the alleged debt simply constitutes an artifice to create large tax benefits out of whole cloth. There may be no genuine intent to fulfill the obligation. The courts and the Service have understandably rejected the use of such nominal debt instruments.[98]

II. AT RISK RULES

A. General Principles

As discussed above, nonrecourse debt can inflate basis without personal exposure, and the incentive to use such debt has often proved irresistible. Taxpayers have structured transactions to yield a profitable return, not through their underlying economics, but rather through the tax benefits generated.[99] Taxpayers in a high tax bracket[100] potentially could earn a profit based on the depreciation deductions and investment tax credits alone.[101] Not all these efforts were ended successfully. The courts prevented excessive

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93. Developmental wells are drilled in areas with known production and therefore involve less risk. *See* J. LOWE, OIL AND GAS IN A NUTSHELL 295 (1983). Exploratory wells (such as those involved in *Gibson*) are drilled in areas without production, and involve greater risk. *Id.*

94. I.R.C. § 465 (West Supp. 1987) would now affect this method. *See infra* notes 105-147 and accompanying text.

95. *Dillingham*, 1981-2 U.S. Tax Cas. ¶ 9601. The transactions arose in 1971 and 1972 prior to the enactment of the at risk rules of section 465, which would have affected deductions. *See infra* notes 105-147 and accompanying text.

96. *Dillingham*, 1981-2 U.S. Tax Cas. ¶ 9601.

97. *Id.*

98. *See* Knetsch v. United States, 364 U.S. 361, 366 (1960) (transaction between taxpayer and insurance company did not create indebtedness); Beck v. Commissioner, 74 T.C. 1534, 1564 (1980) (parties never paid for property, but engaged in check swapping; since financial resources never required, purchase scheme and deduction illusory); Golsen v. Commissioner, 54 T.C. 742, 753 (1970) (purported loans lacked economic substance; "interest" payments merely insurance premiums).

99. Bolger v. Commissioner, 59 T.C. 760, 769 (1973).

100. Before 1982 taxpayers in a high tax bracket were taxed seventy percent of their taxable income. I.R.C. § 1 (1981) (current individual tax rates at I.R.C. § 1 (West Supp. 1987)).

101. *Id.*; Rose v. Commissioner, 88 T.C. 386, 405 (1987) (tax credits and deductions, not profit objective, motivated petitioners to acquire Picasso packages).

uses of nonrecourse debt.[102] Taxpayers, however, could still legitimately structure transactions so as to allow themselves substantial basis and associated tax benefits through the use of nonrecourse debt without risking financial exposure.[103] These transactions often conflicted with the principle that a taxpayer's basis in a property represents his investment.[104] Investment implies economic risk, or at least a concern for the economics and not just the tax aspects of a transaction.

Congress felt that the best remedy to this problem was not through the often ad hoc approach of the courts, but rather through the presumedly reliable and systematic approach of statute.[105] The result came in the form of the Tax Reform Act of 1976's enactment of the at risk rules of section 465.[106] The at risk rules disallow otherwise permissible deductions to the extent the taxpayer is not "at risk" on his investment.[107] In the case of debt the at risk rules require personal exposure, thereby usually orphaning nonrecourse liabilities.[108]

Initially the rules appeared far from prophylactic. They only applied to losses from movies, farming, leasing of personal property, and oil and gas activities.[109] The rules did not apply to corporations, other than personal holding companies and Subchapter S corporations.[110] In the case of partnerships they applied at the partner level.[111]

Congress apparently felt that the 1976 Act had not sufficiently suppressed the innovative instincts of tax shelter promoters. As a result, in the Revenue Act of 1978 Congress extended the application of section 465 to all types of investments, except equipment leasing by certain closely held corporations and investments in real estate.[112] Congress enlarged the risk rules to cover the investment tax credit produced by the Economic Recovery Tax Act of 1981.[113] The Tax Reform Act of 1984 made relatively taxpayer friendly changes.[114] The 1984 Act exempted active businesses of certain closely held

102. *See supra* notes 57-67, 79-90 and accompanying text.

103. Bolger v. Commissioner, 59 T.C. at 760; Mayerson v. Commissioner, 47 T.C. 340 (1966); Dillingham v. United States, 1981-2 U.S. Tax Cas. (CCH) ¶ 9601 (W.D. Okla. 1981).

104. *See supra* notes 11-18 and accompanying text.

105. I.R.C. § 465 (1977) (current version at I.R.C. § 465 (West Supp. 1987)); *see* SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1976, S. REP. No. 938, 94th Cong., 2d Sess. 46-47 (1976), *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 3439, 3482-83 (at risk rule will remedy abuses under *Crane*).

106. I.R.C. § 465(a) (1982 & West Supp. 1987); Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1520, 1531 (1976) (codified as amended at I.R.C. § 465 (West Supp. 1987)).

107. I.R.C. § 465(a) (1982 & West Supp. 1987).

108. *Id.* § 465(b).

109. *Id.* § 465(c).

110. *Id.* § 465(a)(1).

111. *Id.* § 465(c).

112. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (codified as amended in scattered sections of I.R.C.).

113. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of I.R.C.).

114. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of I.R.C.).

C corporations from the at risk rules.[115]

The exception for real estate survived all the amendments, based in part on the long standing use of nonrecourse debt in real property transactions. This exception and the availability of accelerated depreciation, which permits disproportionately large deductions in the early years of a property's life, caused the formation of many real estate tax shelters. The shelters were usually highly leveraged with nonrecourse debt.[116] Many office buildings in Denver and Houston stand vacant in tribute to these tax benefits.[117]

In response to these often overzealous tax shelter programs, Congress brought real estate's exalted status to an end in the full court press that constituted the Tax Reform Act of 1986.[118] The 1986 Act eliminated accelerated depreciation for real estate.[119] Taxpayers must now use straight line depreciation, which is a depreciation method that requires equal depreciation deductions over a fixed number of years.[120] The 1986 Act lengthened the depreciation terms to 27.5 years for residential real estate and 31.5 years for commercial real estate.[121] Previously the period ran 19 years for all depreciable real property.[122] The change of the depreciation method to straight line and the lengthening of the depreciation periods dramatically reduces the deductions available from real estate and, along with it, the interest in real estate tax shelters.[123] Congress, however, left no stone unturned. Congress also brought real estate within the ambit of the at risk rules, albeit with a statutory escape hatch.[124] This Article discusses this development in more detail below.

Deductions for losses from section 465 activities are limited to the tax-

115. The C corporation may not be a personal holding company, I.R.C. § 545 (West Supp. 1987), a foreign personal holding company, *id.* § 552(a), or a personal service company, *id.* § 269A. A corporation qualifies as a personal service corporation if its principal activity is the performance of personal services and an "employee-owner" performs those services. *Id.* § 269A(b)(1). Normally, an employee-owner is any employee who on any day during the tax year owns more than 10% of the outstanding stock of the personal service corporation. For purposes of the closely held C corporation exception to the at risk rules, however, that threshold decreases to 5%. *Id.* § 465(c)(7)(B)(iii). To qualify as a personal service company, five or fewer people must own one-half of the stock, by value. *Id.* § 542(a)(2).

116. *See Real-Estate Tax Shelters Booming, But Critics Move to Trim Benefits*, Wall St. J., July 5, 1983, at 25, col. 3.

117. *See supra* note 91 and accompanying text.

118. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of I.R.C.).

119. *Compare* I.R.C. § 168(b)(2), (c) (West Supp. 1987) *with id.* § 168(b)(3).

120. B. BITTKER, *supra* note 14, ¶ 10.8(1).

121. I.R.C. § 168(c) (West Supp. 1987).

122. *Id.* § 168(b)(2). The taxpayer, at its option, could lengthen the 19-year period up to 45 years and use straight line depreciation. *Id.* § 168(b)(3).

123. Commerical real property acquired on January 1, 1986, with $100,000 of depreciable basis receives depreciation deductions of $8,800 in the first year, $8,100 in the second year, and $7,300 in the third year, for a total of $24,200. *Id.* § 168(b)(2). If that same property is acquired on January 1, 1987, the depreciation deduction will amount to approximately $3,175 per year, for a total over the three years of $9,525, less than half the amount available under the prior system. *Id.* § 168(b)(3), (c).

124. *Id.* § 465(b)(6) (taxpayer at risk for his share of qualified nonrecourse financing secured by real property).

payer's "amount at risk."[125] A taxpayer is at risk in an activity to the extent of the amount of money and adjusted basis of property contributed to the activity.[126] More importantly, the amount at risk also includes sums borrowed for use in the activity on which the taxpayer is personally liable.[127] Even if the liability technically appears recourse, the Code will not consider a taxpayer at risk if he is in any way protected against loss through guarantees, stop losses, or similar devices.[128] Courts have often included the ability to convert a recourse note into a nonrecourse obligation as such a protection against risk.[129]

Although a direct exception to section 465 for real estate activities no longer exists, there is an indirect one. "Qualified nonrecourse financing" is included in the amount at risk.[130] Taxpayers, therefore, can still acquire real estate with nonrecourse debt without running afoul of the at risk rules. To constitute qualified nonrecourse financing the loan must be nonrecourse, and the taxpayer must borrow "with respect to the activity of holding real property."[131] A "qualified person," generally a governmental entity or a commercial lender not related to the taxpayer, must also make the loan, which may not be convertible.[132] While one can question whether real estate should receive preferential treatment, the use of excessive amounts of nonrecourse debt caused the concerns. The new rules should bring this abuse to a halt. The provisions require nonrecourse real estate loans to meet normal commercial standards. Commercial lenders generally will not make nonre-

125. *Id.* § 465(a).

126. *Id.* § 465(b)(1)(A). A contribution of encumbered property increases the amount at risk by the property's adjusted basis, if the taxpayer is personally liable on the debt, and by the adjusted basis less liabilities, if the taxpayer is not personally liable. If in the latter case, the liabilities exceed the basis, the amount at risk is reduced. Prop. Treas. Reg. § 1.465-2(a), 44 Fed. Reg. 32,237 (1979).

127. I.R.C. § 465(b)(2)(A) (West Supp. 1987).

128. *Id.* § 465(b)(4); *see also* Capek v. Commissioner, 86 T.C. 14, 49-54 (1986) (alleged loans protected through stop loss within meaning of I.R.C. § 465(b)(4) (West Supp. 1987); Rev. Rul. 85-113, 1985-2 C.B. 150, 150 (transfer of property derived from activity without additional exposure could satisfy recourse note); Rev. Rul. 83-133, 1983-2 C.B. 15, 16 (scheme identical to Rev. Rul. 85-113); Rev. Rul. 82-123, 1982-1 C.B. 82, 83 (no personal liability if Service finds tax benefits unavailable); Rev. Rul. 80-72, 1980-1 C.B. 110, 110-11 (taxpayer not at risk with respect to proceeds from sale of option); Rev. Rul. 78-413, 1978-2 C.B. 167, 167-68 (taxpayer protected from loss by offsetting liabilities).

129. Porreca v. Commissioner, 86 T.C. 821, 839-40 (1986) (since taxpayers could convert promissory note to nonrecourse liabilities, they were not at risk); Rev. Rul. 82-225, 1982-2 C.B. 100, 101 (purpose of provision allowing taxpayer to convert note from recourse to nonrecourse was to increase amount at risk); Rev. Rul. 81-283, 1981-2 C.B. 115, 116 (since purpose of option allowing investor to convert note into nonrecourse obligation was to increase investor's amount at risk and was not for business purposes, investors treated as at risk for amount paid before conversion); Prop. Treas. Reg. § 1.465-5, 44 Fed. Reg. 32,238 (1979) (liabilities that may convert from recourse to nonrecourse may still be at risk if primary motive is business and such transaction is consistent with normal commercial practice). In Gefen v. Commissioner, 87 T.C. 1471, 1501 n.24 (1986), the court noted, but did not rule on this issue.

130. I.R.C. § 465(b)(6) (West Supp. 1987).

131. *Id.* § 465(b)(6)(B)(1).

132. *Id.* §§ 465(c)(8)(D)(iv), 465(b)(6)(D). The loan also qualifies if a federal, state, or local governmental entity guarantees its. *Id.* § 465(b)(6)(B)(ii). The related party provision will not apply if the loan is commercially reasonable and is on substantially the same terms as loans involving unrelated persons. *Id.* § 465(b)(6)(D)(ii).

course loans in excess of amounts that can be paid from the expected income from the activity. In the future, therefore, nonrecourse real estate loans should be limited to reasonable amounts.

The taxpayer who contributes cash also will be at risk, notwithstanding that the taxpayer obtained the cash through a nonrecourse loan, provided the lender is unrelated to the taxpayer,[133] and provided further the collateral is not used in the activity.[134] This exception appears sensible, since from the perspective of the activity, only a contribution of cash is involved. The nonrecourse debt is between the taxpayer and an unrelated creditor. Except for qualified nonrecourse financing and this latter exception, nonrecourse debt will not increase the at risk amount.[135]

B. Loss Computations

One must recognize that the at risk provisions do not provide rules for the computation of deductions or losses.[136] A taxpayer will compute the depreciation and other available deductions from debt financed property by reference to his basis, which the taxpayer continues to compute by including both recourse and nonrecourse liabilities. Subsequently, one must make a determination as to whether the at risk rules deny any portion of the deduction.[137] Taxpayers, therefore, determine the extent to which losses are allowable under the basis rules. Section 465, inter alia, determines whether the losses are currently deductible. The taxpayer may carry forward losses that are not currently deductible due to the application of the at risk rules to a future year when there exists a sufficient amount at risk.[138]

Congress could have incorporated the at risk rules directly into the basis rules and simply have denied basis for unsuitable debt. This solution, however, would have created the computational problems discussed earlier.[139] Instead, Congress created accounts in which taxpayers could deposit disallowed deductions pending the development of a sufficient at risk amount.[140]

C. Recourse Debt

The indispensable requisite of the at risk rules, and the component that has resulted in the most litigation, is the provision permitting a taxpayer's share of recourse liabilities to increase his amount at risk. Tax shelters, which are typically organized as limited partnerships, live or die based on their ability to generate debts for which the partners will be considered to be personally liable.[141] The object often has been to create nominally recourse

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133. *Id.* § 465(b)(3)(A).
134. *Id.* § 465(b)(2)(B).
135. *Id.* § 465(b)(2).
136. *Id.* § 465(a).
137. Abramson v. Commissioner, 86 T.C. 360, 375 (1986); Pritchett v. Commissioner, 86 T.C. 580, 595 (1985) (Whitaker, J., dissenting), *rev'd*, 827 F.2d 644 (9th Cir. 1987).
138. I.R.C. § 465(a)(2) (West Supp. 1987).
139. *See supra* notes 20-28 and accompanying text.
140. I.R.C. § 465(a)(2) (West Supp. 1987).
141. Two principal means exist to accomplish the typical objective of a tax shelter, that is,

debt on which no payment is actually expected.[142] The proposed regulations under section 465 endeavor to limit the potential for this abuse. These regulations provide, for example, that if a partnership incurs recourse debt, that debt will only increase a partner's amount at risk if the partner is directly liable to the third party creditor on the partnership loan.[143] Those parties operate at an adequate distance from one another. Agreements between a partner and a partnership are not always at arm's length. Under the proposed regulations the amount at risk will not be increased if the partner is merely obligating himself to make contributions to the partnership in the future, whether it be under subscription agreements or under notes made to the partnership, until the contribution is actually made.[144] This regulation is defensible unless the partner's recourse obligation to the partnership is coupled to and triggered by the partnership's recourse obligation to a third party creditor. If properly transacted, the partner will, via the obligation to make contributions, be effectively liable on the third party debt. In such circumstances a court should consider the partner at risk for the amount of his obligation.[145] Neither the courts nor the Service have always agreed with this position, as is discussed in more detail below.[146]

Section 465 contains a rather curious exclusion from the amount at risk for sums borrowed from a person with an interest in the activity, or from someone related to a person other than the taxpayer, with an interest in the activity.[147] Presumably Congress added this provision to avoid fictitious

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to generate deductions in excess of an investor's equity investment. The first method creates deductions that require no cash outlays, for example, qualifying for the section 168 cost recovery reductions. I.R.C. § 168 (West Supp. 1987). Under the second method, often used in conjunction with the first, the tax shelter incurs liabilities and then expends the proceeds to generate deductions. While the taxpayer may have to repay recourse liabilities in a future year, the taxpayer obtains deductions often exceeding its equity investment in the tax shelter's first year. Intangible drilling costs incurred in drilling an oil and gas well exemplify a cash outlay that generates significant first year deductions. *Id.* § 263(c).

142. *See* Rose v. Commissioner, 88 T.C. 386, 415 (1987) (petitioners engaged in purchase and sale of Picasso packages for primary purpose of obtaining tax deductions and credits).

143. Prop. Treas. Reg. § 1.465-24(a)(2), 44 Fed. Reg. 32,242 (1979).

144. *Id.* § 1.465-22(a), 44 Fed. Reg. 32,241. The amount at risk is increased only when the contribution is made or an amount on the note is paid. *Id.* This proposal highlights the difficulty in applying the at risk rules to achieve their intended purpose. Section 465 provides for increases in the amount at risk to the extent of amounts borrowed with respect to the activity, if the taxpayer is personally liable thereon. I.R.C. § 465 (West Supp. 1987). The case of a recourse note contributed by a partner to a partnership arguably meets this requirement. On the other hand, the basis in the note or obligation under a subscription agreement would be zero. If the note is considered property contributed to the partnership, whether or not the relevant partners would be at risk is immaterial to the allowance of a loss deduction; the failure of the note to generate basis would bar a loss deduction. I.R.C. § 704(d) (1987).

145. *See infra* notes 153-196 and accompanying text.

146. *Id.*

147. I.R.C. § 465(b)(3) (West Supp. 1987). Except as provided in regulations, the House Report indicates that the regulations should exempt from the at risk provisions arm's length recourse loans by otherwise unrelated commercial lenders. H.R. REP. NO. 432, 98th Cong., 2d Sess., pt. 2, at 1510, *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 697, 1150; *see also* Waddell v. Commissioner, 86 T.C. 848, 915 (1986) (borrowed amounts, even if recourse, are not at risk in an activity if lender contains interest in activity other than as creditor); Jackson v. Commissioner, 86 T.C. 492, 530 (1986) (since investor owned 100% of stock of corporation, no part of his recourse debt could be considered at risk).

loans designed to artificially increase a partner's at risk amount. This approach appears unnecessarily encompassing. If loan proceeds are in fact to be used in the activity, with appropriate safeguards, such loans should qualify regardless of the source of the loans. No reason exists that a bona fide loan could not exist between parties with interests in the activity. While, for example, a general partner promoter might desire to increase his limited partner's tax benefits when his own money is at stake and used in the activity, he presumably will exercise prudence.

D. Brand *and* Smith

A series of relatively recent cases has gone far to define, and occasionally muddle, the scope of the at risk rules. In *Brand v. Commissioner*[148] the Tax Court considered whether limited partners were at risk for the portion of a partnership loan they guaranteed. The applicable state law allowed a guarantor reimbursement from the primary obligor for any amounts paid pursuant to the guarantee. This law protected the limited partners against loss since they could seek repayment from the general partner in the event they had to fulfill the guarantees. Accordingly, the Tax Court held that the limited partners were not at risk.[149]

The taxpayers were more successful in the somewhat convoluted case of *Smith v. Commissioner.*[150] The case actually concerned the basis calculations, but has proved relevant in the at risk context. Smith was a partner in a partnership that purchased a parcel of real estate and paid for it, in part, with a nonrecourse promissory note. Smith later contributed an assumption of liability agreement to the partnership, by which he assumed the partnership's liability on the nonrecourse note. Apparently the parties completed this transaction in connection with the departure of some partners and the entry of others, and also to permit Smith to withdraw certain funds from the partnership. Smith argued, and the court agreed, that his assumption of the nonrecourse liability permitted him to increase his basis in his partnership interest under section 752.[151] The decision is significant because the court focused on Smith's ultimate liability for the debt in reaching its conclusion.[152] If ultimate liability provides the cornerstone of the analysis in ascertaining basis, perhaps it can perform the same function in determining whether a taxpayer is at risk.

E. Pritchett

The Tax Court's analysis deteriorated in *Pritchett v. Commissioner.*[153] The Ninth Circuit subsequently reversed the Tax Court in *Pritchett.*[154] The

148. 81 T.C. 821 (1983).
149. *Id.* at 828.
150. 84 T.C. 889 (1985).
151. *Id.* at 905-08.
152. *Id.* at 908.
153. 85 T.C. 580 (1985), *rev'd*, 827 F.2d 644 (9th Cir. 1987).
154. *Pritchett*, 827 F.2d at 644.

lower court's ruling, however, raised important questions, and the author will review the Tax Court's opinion in detail prior to a discussion of the appellate court's decision. *Pritchett* involved five related limited partnerships organized to drill for oil and gas. Fairfield Drilling Corporation (Fairfield), assigned oil and gas leases to each partnership in exchange for the partnerships' agreement to pay Fairfield twenty percent of the gross sales proceeds of the oil and gas extracted from the leased land.[155] Concurrent with the lease assignments, each partnership executed agreements with Fairfield by which Fairfield agreed to drill and develop the properties on behalf of the partnership. The partnerships paid Fairfield with cash and fifteen-year recourse, noninterest bearing notes for these services. Only the general partners stood directly and personally liable on the notes. Each of the limited partnership agreements, however, provided that in the event the note to Fairfield was not paid in full at maturity, the limited partners would, upon the call by the general partners, be personally obligated, on a pro rata basis, to make additional capital contributions to the partnership to cover any deficiency.[156] The limited partners believed that they were obligated on the Fairfield notes to the extent of their obligations to make pro rata capital contributions. Accordingly, the limited partners argued that they stood personally liable for an amount borrowed with respect to the activity, as required by section 465, and therefore at risk.[157]

The Tax Court disagreed and refused to permit linkage between the notes and the limited partners' obligation to make additional capital contributions.[158] In the court's view section 465 required fixed liability to qualify under section 465, and the court considered the liability of the limited partners to be contingent since it only arose if the general partners made a call.[159] The taxpayers argued that their exposure was not contingent on the discretion of the general partners, because under the Uniform Limited Partnership Act a court can hold a limited partner liable to third parties for "the difference between the contribution as actually made" and "any unpaid contribution which he agreed . . . to make in the future *at the time and on the conditions stated in the certificate*."[160] Case law also permitted Fairfield to proceed directly against the limited partners.[161] The court responded that at

155. The agreement provided for the 20% payment to be made after the partnership had received a specific amount of net profits.

156. The case arose before the service proposed any regulations under I.R.C. § 465. Proposed Regulation § 1.465-22(a) provides that agreements to make contributions to a partnership do not increase the amount at risk. Prop. Treas. Reg. § 1.465-22(a), 44 Fed. Reg. 32,241 (1979). One may distinguish the regulations since the liability to a third party creditor triggers the obligation to make the contributions. Fairfield would have been able to enforce the limited partners' obligations to make contributions. *See infra* note 166 and accompanying text. Additionally, the regulations are proposed and therefore without legal effect.

157. *Pritchett*, 85 T.C. at 586; *see* I.R.C. § 465(b)(2) (West Supp. 1987).

158. *Pritchett*, 85 T.C. at 586-88.

159. *Id.*

160. *Id.* at 587 (emphasis in original) (citing CAL. CORP. CODE § 15517(1)(a)-(b) (West 1977); NEV. REV. STAT. § 88.180(1)(a)(b) (1979)).

161. *Id.* at 588-89. In support of their argument that limited partners may be directly liable to a creditor, the taxpayers cited Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir.

the end of the fifteen-year term of the note, the obligation to make the contribution might indeed become fixed.[162] For the tax years in question, however,

> [The] requirement [to make a contribution] was merely a contingency since it was not known in 1976 or 1977 (a) whether there would or would not be sufficient partnership revenues to satisfy the Fairfield note prior to or on maturity of the note, or in the event the Fairfield note was not satisfied in full on maturity, the amount of the capital contributions needed to cover the deficiency, or (b) if the general partners would in fact exercise their discretion to make the cash call if an unpaid balance on the Fairfield note were to exist on [the due date]. Hence, as of the close of the taxable year in issue, petitioners had no current ascertainable liability to their partnerships for future contributions.[163]

The court reasoned that even if one could view the limited partners as eventually possessing direct liability to Fairfield, "the 'at risk' inquiry . . . is an annual one," and no liability existed at the end of the taxable years in question.[164]

The majority opinion is misguided in a number of respects. First, the principal motivation for enactment of the at risk rules was to deny taxpayers deductions attributable to debts on which they are not personally liable.[165] The issue is not one of timing, as the court in *Pritchett* suggests, but rather one of ultimate exposure. The facts clearly established that the limited partners stood liable on their pro rata shares of the partnership's debt. Only the general partners' call would trigger the obligation to pay the liability, but in hanging its decision on that fragile peg the court prized form over substance. No legitimate question existed that the general partners would do anything other than require the limited partners to make their contributions should partnership income be insufficient to pay the note. The partnership agreements required the general partners to make the call. This situation constituted a business transaction, and few general partners would prefer to reach into their own pockets rather than those of their limited partners. Further, if the general partners had not made the cash call, Fairfield would have possessed the ability to proceed against the limited partners directly.[166] As the

1962); Linden v. Vogue Invs., Inc., 239 Cal. App. 2d 338, 48 Cal. Rptr. 633 (1966); Indiana Mortgage & Realty Investors v. Spira-Mart, 115 Mich. App. 141, 320 N.W.2d 320 (1982).

162. *Pritchett*, 85 T.C. at 588-89.

163. *Id.* at 588 (footnotes omitted).

164. *Id.* at 589. The court noted that "[t]he 'at risk' inquiry for purposes of section 465 is an annual one made on the basis of the facts existing at the end of each taxable year . . . ." *Id.* (citation omitted).

165. TAX REFORM ACT OF 1986, H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., pt. 2, at 134, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4222-24; S. REP. NO. 938, 94th Cong. 2d Sess., pt. 2, at 134, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4222-24; S. REP. NO. 938, 94th Cong., 2d Sess. 48 (1976), *reprinted in* 1976-3 C.B. 49, 86 [hereinafter Senate Report].

166. *See* Donroy, Ltd. v. United States, 301 F.2d 200, 205 (9th Cir. 1962) (although partnership statutes generally do not bind limited partners upon partnership obligation to third parties, general partner holds authority to conduct partnership business). The majority in *Pritchett* recognized that a plaintiff could name the limited partners in a lawsuit brought against the partnership debt when the limited partners are obligated to the partnership for unpaid contributions. *Pritchett*, 85 T.C. at 587.

court noted, the cash calls did not constitute amounts borrowed with respect to the activity.[167] The notes themselves, however, did represent amounts borrowed, and contrary to the holding of the majority, the limited partners effectively possessed liability with respect to them. For one to defend the decision, one would need to assume that the cash calls existed in a vacuum and were of no real import, an assumption that would not be valid.

The fact that the general partners required no calls for contribution from the limited partners for the years at issue is not determinative.[168] Section 465's annual determination is not one of actual payment, but rather one of personal exposure.[169] A partner is at risk with regard to a partnership indebtedness if the partner appears personally obligated for its repayment, regardless of when the partner must fulfil that personal obligation.[170] The limited partners in *Pritchett*, therefore, remained at risk to the extent of their liability for contributions. Under the reasoning adopted by the majority, however, the limited partners could not have been at risk until the year in which the call for contributions occurred.[171] If actual payment constituted the critical criterion for at risk analysis, no need for the discussion of liabilities in section 465 would exist. Once payment is made, the liability ends. Instead of enacting section 465, Congress could have simply excluded liabilities from basis altogether, but that did not represent Congress's intent.[172] The cornerstone of at risk analysis remains personal liability, and such personal liability existed in *Pritchett.*

The Tax Court looked to state law to buttress its position. The court noted that under the Uniform Limited Partnership Act a contributor's obligation runs to the partnership, instead of the creditor, and is limited to the conditions stated in the limited partnership certificate.[173] In *Pritchett,* the general partners' call for contribution constituted the condition.[174] The court's focus on state law is misplaced. Partners can be liable to third parties to the extent of their obligation to make contributions.[175] Further, courts have long held that federal law, not state law, controls tax issues.[176] Section 465 does not require the liability to run directly to the third-party creditor. As in *Smith,*[177] the court should have focused on ultimate liability, not on state procedural steps for enforcing the liability.

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167. *Pritchett,* 85 T.C. at 586.

168. *Id.* at 587-89.

169. I.R.C. § 465(a) (West Supp. 1987) (flush language); *see also* Senate Report, *supra* note 165, at 48, 1976-3 C.B. at 86.

170. *Cf.* Abramson v. Commissioner, 86 T.C. 360, 375-76 (1986) (since each partner's liability for partnership's debt ran directly to creditor, each partner presently stood at risk for his proportional share).

171. *Pritchett,* 85 T.C. at 592.

172. *See supra* note 165 and accompanying text.

173. *Pritchett,* 85 T.C. at 587-88.

174. *Id.* at 587.

175. Donroy, Ltd. v. United States, 301 F.2d 200, 205 (9th Cir. 1962).

176. *See generally* Helvering v. Stuart, 317 U.S. 154, 161 (1942) (since Congress designed federal revenue laws for national taxation scheme, these laws not subject to state laws unless specifically permitted by Code section).

177. *Pritchett,* 84 T.C. at 908.

If the limited partners were not at risk for their shares of the notes, no one was. Under section 465 a taxpayer is not at risk to the extent he is entitled to reimbursement for payment of a liability.[178] The general partners were entitled to reimbursement from the limited partners for any payment they might make on the notes in an amount equal to the contributions the limited partners were required to make. Since they therefore were protected them against loss, the general partners were not at risk on that respective amount of the debt.[179] If one accepts the court's reasoning, the limited partners were not at risk on that portion either, and the result amounts to a full recourse note, on most of which no party stood at risk.[180]

The majority opinion also emphasized that the obligation of the limited partners to make contributions would arise only upon the partnership's failure to generate sufficient revenues to pay the indebtedness.[181] Under this approach it would prove difficult, if not impossible, for a court to find anyone ever to be at risk. Typically, participants hope that revenues from an activity will pay any liabilities incurred. Personal exposure is always to some extent "contingent" on whether or not the activity is successful. Under the analysis of *Pritchett*, that contingency would prevent participants from being at risk. In addition, the *Pritchett* reasoning usually makes it pointless to include liabilities in basis, since attributable deductions would normally fail the at risk rules. A possibility almost always exists that the activity's revenues will pay the debt. Congress intended that the at risk rules suspend otherwise allowable deductions in certain limited circumstances,[182] not eliminate liabilities from the tax system. Focusing on the activity's potential for generating payment of debt does not represent a sound method of analyzing the applicability of the at risk rules.

Finally, the court failed to address the extent to which the limited partners could include the liabilities in their bases. The court should have addressed this issue before considering the at risk rules. As noted earlier, the Code limits the deductions that a partner initially may take by that partner's basis in the partnership.[183] If sufficient basis exists, the partner then turns to the at risk rules in order to ascertain whether they suspend otherwise allowable deductions.[184]

Before addressing this issue in the context of the *Pritchett* case, a brief return to a general discussion of basis is necessary. Section 752 treats a partner's share of partnership liabilities as a contribution of money by the partner to the partnerhip.[185] This treatment increases the partner's basis in the

178. Brand v. Commissioner, 81 T.C. 821, 828 (1983).
179. I.R.C. § 465(b)(4) (West Supp. 1987).
180. *Pritchett*, 85 T.C. at 584 n.7.
181. *Id.* at 588.
182. *See* Senate Report, *supra* note 165, at 48-49, 1976-3 C.B. at 86-87.
183. *See supra* notes 11-30 and accompanying text; *see also* I.R.C. § 704(d) (1982) (partner's share of partnership loss allowed only to extent of partner's adjusted basis in partnership).
184. *See* Senate Report, *supra* note 165, at 48, 1976-3 C.B. at 86.
185. I.R.C. § 752(a) (1982).

partnership interest.[186] The regulations determine a partner's share of recourse liabilities based on the ratio that determines how partners share losses.[187] A limited partner's share of recourse liabilities, however, cannot exceed the difference between contributions previously made and the contributions that the partnership agreement requires the limited partner to make in the future.[188] In the view of the regulations, therefore, limited partners share losses for recourse debt via their obligation to make contributions.[189] They need not possess a direct contractual obligation to the creditor in order to receive basis for their share of the recourse liabilities.[190] Partners are entitled also to the basis increase regardless of whether their contributions or the partnership revenues pay the liability.[191] Without question therefore, the limited partners in *Pritchett* would have been entitled to an appropriate basis increase if the partnership agreement automatically required them to make contributions to the partnership.

The only issue remaining in *Pritchett* is whether the need for the general partners to actually call on the limited partners for contribution so attenuates that obligation that a court should ignore its existence. The answer clearly is no. Partners typically do not make contributions until the general partners request such contribution. Further, the *Pritchett* court indirectly acknowledged that the general partners would make the call for contribution if partnership proceeds appeared insufficient to pay the debt.[192] To deny the basis increase simply because of a procedural step, which without doubt the general partners would have taken, prizes form over substance and serves no recognizable policy objective. Since the limited partners ultimately stood liable to the creditors, they should have received a basis increase.

Although the *Pritchett* court failed to address the basis issue, the court implied that it would have denied a basis increase: "[T]he cash call, as provided for in the certificates of limited partnership [was] not an unpaid contribution . . . .[193] As discussed above, an unpaid contribution must exist to enable the limited partners to include a share of the recourse liabilities in their partnership interest bases.[194] Under the court's reasoning, therefore, the limited partners could not include the liabilities in their bases. Given these circumstances, there probably existed no need for the court to address the at risk issues. At risk rules become relevant only when one crosses the basis threshold.[195] The lack of liabilities would have significantly reduced the limited partners' bases, and lack of basis alone would presumably have

186. *Id.* § 722 (West Supp. 1987).
187. Treas. Reg. § 1.752-1(e) (1956).
188. *Id.*
189. *Id.*
190. Proesel v. Commissioner, 77 T.C. 992, 1004 (1981).
191. *Id.*; Treas. Reg. § 1.752-1(e) (1956).
192. 85 T.C. at 583 n.5.
193. *Id.* at 588.
194. *See supra* notes 185-90 and accompanying text.
195. *See supra* notes 1-10 and accompanying text.

prohibited them from taking the losses.[196] Accordingly, given the court's reasoning, it should have analyzed the case under the basis rules, not the at risk rules. A proper analysis in both areas, however, should have resulted in a basis increase for the limited partners and a finding that they were at risk on the partnership debt.

The Ninth Circuit reversed the Tax Court's decision in *Pritchett,* often citing the Tax Court's post-*Pritchett* holding in support of its decision.[197] The appellate court acknowledged that the limited partners were not directly liable to Fairfield,[198] but rejected the Tax Court's contingency analysis, observing that under the partnership agreement the general partners were required to make the call for contributions, and the limited partners were required to make the contributions.[199] In this regard the court noted the Tax Court's decision in *Melvin v. Commissioner,*[200] discussed below,[201] which postdated *Pritchett* and in which the Tax Court held that a taxpayer stood at risk on a debt if the taxpayer bore the ultimate economic responsibility for the loan.[202] The Ninth Circuit stated:

> Applying the economic responsibility standard we have no reservation in concluding that taxpayers, by virtue of their contractual obligations, have ultimate responsibility for the debt. . . . Furthermore, we are not dissuaded by the Tax Court's reasoning that the debt is contingent because the general partners may elect to not make the cash calls. The contracts made the call mandatory and *"economic reality" dictates that the partners would do so.*[203]

Thus, unlike the Tax Court, the Ninth Circuit recognized that general partners would hardly pay the debt if they could obligate the limited partners to do so.

The Ninth Circuit also rejected the Tax Court's position that the liabilities were contingent because it was not known in the tax year at issue whether partnership revenues would be sufficient to satisfy the notes.[204] "If the notes required balloon payments upon maturity, the limited partners' obligation to contribute additional funds would be "certain." The acceleration of payments [via the use of partnership revenues] should not be a factor in the taxation analysis."[205] The Ninth Circuit also reminded the lower court that in *Melvin*[206] and in another post-*Pritchett* decision, *Abramson v. Commissioner,*[207] also discussed below,[208] the Tax Court had held that the taxpayers

196. I.R.C. § 704(d) (1982) (limits partner's distributive share of partnership loss to partner's adjusted basis).
197. Pritchett v. Commissioner, 827 F.2d 644, 646-47 (9th Cir. 1987).
198. *Id.* at 645 ("Only the general partners were personally liable under the notes.").
199. *Id.*
200. 88 T.C. 63 (1987).
201. *See infra* notes 243-50 and accompanying text.
202. *Pritchett,* 827 F.2d at 647 (citing Melvin v. Commissioner, 88 T.C. at 75).
203. *Id.* (emphasis added) (citations omitted).
204. *Id.*
205. *Id.*
206. Melvin v. Commissioner, 88 T.C. 63 (1987).
207. 86 T.C. 360 (1986).
208. *See infra* notes 219-42 and accompanying text.

were at risk notwithstanding that in those cases partnership revenues also might have paid the debt.[209]

Due to its contingency analysis, the Tax Court in *Pritchett* never resolved the question of whether Fairfield held a noncreditor interest in the partnership activity. If Fairfield held such an interest, section 465(b)(3)(B)(i) would have precluded a determination that the taxpayers are at risk. Funds borrowed from persons with noncreditor interests in the activity are excluded from the amount at risk.[210] The Ninth Circuit remanded the case for consideration of this issue.[211]

The Ninth Circuit issued its decision after this Article was submitted for publication. It was therefore gratifying to note that on appeal the Service asserted an argument that involved a discussion of the present values of the taxpayer's interest free obligations,[212] though not in the proper context. This Article presents a present value analysis below. Under section 465(b)(4) a taxpayer is not considered at risk with respect to amounts that are protected against loss by, inter alia, stop loss agreements, "or other similar arrangements."[213] The Commissioner argued that interest free notes were a "similar arrangement."[214] The Service's position is not supported in the statute or the legislative history. As the Ninth Circuit in *Pritchett*[215] and the Tax Court in *Melvin*[216] discussed, economic exposure is the critical determination under a section 465 analysis. The face amount of the notes represented that economic exposure, not their present value. The Service should have instead focused on the taxpayers' bases, where the emphasis is on economic investment, not economic risk. In this regard, as discussed below, the present value of the notes is indeed an important consideration.[217] The Ninth Circuit remanded this latter argument of the Service for consideration by the Tax Court as well, since the Service raised it for the first time on appeal.[218]

F. Abramson *and* Melvin

The Tax Court appeared to reverse its field in *Abramson v. Commissioner.*[219] In *Abramson* a limited partnership (Surhill), acquired the rights to a film possessing the provocative title of "Submission." Surhill paid the purchase price of $1,750,000 with $225,000 in cash and a nonrecourse promissory note in the amount of $1,525,000. Surhill secured this note with one-half of the revenues it received from the film's distribution. In an effort to come within the at risk rules, each partner also signed a guarantee agree-

209. *Pritchett*, 827 F.2d at 646-47.
210. I.R.C. § 465 (b)(3)(B)(i) (West Supp. 1987).
211. *Pritchett*, 827 F.2d at 648.
212. *Id.*
213. I.R.C. § 465(b)(4) (West Supp. 1987).
214. *Pritchett*, 827 F.2d at 647.
215. *Id.*
216. Melvin v. Commissioner, 88 T.C. 63, 75 (1987).
217. *See supra* notes 165-72 and accompanying text.
218. *Pritchett*, 827 F.2d at 648.
219. 86 T.C. 360 (1986).

ment, which provided that each limited and general partner would face personal liability for payment of a pro rata share of the note when it came due.[220] Although the note was nonrecourse, the lender still possessed recourse against the limited and general partners through the guarantee agreements.

The *Abramson* court initially noted that the transactions entered into did not reflect those of a "typical abusive tax shelter" and that the taxpayers had a "good-faith profit objective."[221] The court proceeded to an analysis of basis, a step the *Pritchett* court failed to pursue.[222] The court concluded that the guarantee agreements effected an assumption of partnership liabilities, increasing each limited partner's basis under sections 752 and 722.[223] The court referenced the ultimate liability focus of *Smith* in support of its holding.[224]

The *Abramson* court may have reached the right result in the basis analysis, but it utilized the wrong approach to obtain that result. According to the court, notwithstanding its liability discussion, the note in question was nonrecourse.[225] If so, whether the limited partners possessed liability to the lender was irrelevant for purposes of computing basis. Treasury Regulation section 1.752-1(e) provides that all partners, including limited partners, share nonrecourse liabilities in the same proportion as they share profits.[226] Personal exposure is not a factor.

On the other hand, personal exposure constitutes a factor in the case of recourse liabilities, which are shared in accordance with the partner's ratio for sharing losses.[227] Accordingly, the court should have only discussed the personal liability of the limited partners in its basis analysis if the liability

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220. The use of the term "guarantee" in this context is actually a misnomer. Guarantees usually give the guarantor a right of contribution against the debtor whose obligation is being guaranteed. Brand v. Commissioner, 81 T.C. 821, 828 (1983). The difficulty of finding an alternative title that would not take a paragraph to explain most likely is why the taxpayers used the term "guarantee." Abramson v. Commissioner, 86 T.C. 360, 366 n.10 (1986).

221. *Abramson*, 86 T.C. at 371-72.

222. *See supra* notes 183-196 and accompanying text.

223. *Abramson*, 86 T.C. at 374. The court noted that:

> The guarantee of an otherwise nonrecourse note places each guaranteeing partner in an economic position distinguishable from that of a general partner, with liability under a recourse note—except that the guaranteeing partner's liability is limited to the amount guaranteed. While recognizing that under State law there may be differences between the obligations of a general partner and those of a limited partner guarantor, such differences should not be controlling for Federal tax purposes . . . . In effect, the limited partners are the equivalent of general partners to the extent of their pro rata guarantees especially since, as to this obligation, the liability of the general partners is limited. Economic reality dictates that they be treated equally, and we so hold. Consequently, both general and limited partners will be entitled to include such liabilities in their basis to the extent of their pro rata guarantees.

Id.

224. *Id.*

225. *Id.* at 365.

226. Treas. Reg. § 1.752-1(e) (1987).

227. *See supra* text accompanying note 187 (limited partner's share of recourse liabilities cannot exceed future contributions that partnership agreement requires him to make). Treas. Reg. § 1.752-1(e) (1956).

was recourse. The court, however, specifically held that the liability was nonrecourse.[228] The court's difficulty with this area demonstrates the complexity of the Code and how even its most sophisticated handlers can experience difficulties.

The same end result does not necessarily occur. If the limited partner's exposure makes the note recourse, as Judge Swift suggested in his concurring opinion,[229] the regulation provides that the limited partners will receive basis to the extent of their obligation to make future contributions to the partnership.[230] The limited partners in *Abramson* apparently did not possess an obligation to make such contributions.[231] If the note were recourse, therefore, the limited partners would not have met the requirements of the regulation and could not have included any part of the loan in their partnership interest bases. Of course, this approach would also prize form over substance, since permitting partners to include nonrecourse liabilities in basis, but denying partners basis for recourse debt on which they have personal, unprotected liability promotes absurdity.

The anomaly just discussed exists because the Service has not updated the regulations promulgated under section 752 to take section 465 into account. The Service drafted the regulations before the enactment of section 465, and the regulations do not envision that the limited partners could stand directly liable to a creditor. The regulations assume, rather, that any agreement would only require that limited partners make additional contributions to the partnership. Consequently, the regulations provide that the limited partners share losses and accordingly receive basis increases attributable to recourse liabilities to that extent.[232] This assumption may have proved valid once. The current Code requires a different approach. While an obligation to make future contributions will permit a limited partner to include a share of liabilities in basis, it will not increase the amount at risk.[233] One way to meet the at risk rules is to make the limited partners liable directly to the lender on a pro rata share of the debt, hence the strategy used in *Abramson*. The Service should update the section 752 regulations to take section 465 into account and permit limited partners to increase their bases in their partnership interests if they own unprotected liability on partnership debt to partnership creditors. If the liability exists, any additional requirement that the limited partners make contributions to the partnership is not necessary. The limited partners sufficiently demonstrate their investment by the use of the funds in partnership activities and their financial exposure.

After drawing its somewhat questionable conclusions as to basis, the *Ab-*

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228. *Abramson*, 86 T.C. at 365.

229. *Id.* at 381.

230. Treas. Reg. § 1.752-1(e) (1956). This regulation states that, for purposes of computing basis, the limited partner's share of recourse liabilities cannot exceed the additional contributions that the partnership agreement obligates him to make. *Id.*

231. If this fact existed in this case, one would assume the court would have taken express notice.

232. Treas. Reg. § 1.752-1(e) (1956).

233. *See* Prop. Treas. Reg. § 1.465-22(a), 44 Fed. Reg. 32,241 (1979); *see also supra* note 144 and accompanying text (discusses limited partner's future contributions).

ramson court, in four short paragraphs, resolved the at risk issue.[234] The court emphasized that the critical concern questioned whether each limited partner possesed "personal liability for payment from his personal assets."[235] The court found the limited partners to be at risk, since "each partner agreed with the seller to be personally liable for a specific portion of the debt".[236] The court half-heartedly distinguished *Pritchett* on the grounds that the limited partners in *Pritchett* were not directly liable to the lender on the partnership obligation.[237]

To distinguish *Abramson* and *Pritchett* on the grounds that in the former the liability ran to the creditor and in the latter the liability ran to the general partners not only prizes form over substance, but also misconstrues the law. As previously noted, the section 752 regulations require that partners have an obligation to make contributions to the partnership in order to increase their basis in their partnership interests by their share in the partnership recourse debt.[238] Under the *Abramson* distinction, the basis and at risk rules could come into conflict. If the obligation runs solely to the partnership, the partner does not meet the at risk rules.[239] If the obligation runs directly and exclusively to the creditor, section 752 will not give the taxpayer basis. In either event, the taxpayer is denied consequent deductions because he either will possess insufficient basis or will have failed to satisfy the at risk rules.

Prudent taxpayers can solve this dilemma by making the limited partners liable to both the partnership and the creditor. Congress, however, did not intend sections 465 and 752 to become a procedural obstacle course for taxpayers. The Service should amend the section 752 regulations as discussed above. Courts should interpret section 465 in a manner consistent with the underlying intent of Congress, which is to ensure that adequate financial exposure exists before a taxpayer take deductions attributable to a liability. Such exposure existed in *Abramson*, and the court appropriately considered the taxpayers at risk. The financial exposure also existed in *Pritchett*, when the court should have considered the taxpayers at risk.

In the context of its discussion of *Pritchett*, the *Abramson* court noted, somewhat gratuitously, that the creditor in *Abramson* did not hold a partnership interest.[240] A taxpayer does not include indebtedness to creditors who have a partnership interest in the amount at risk.[241] The court may possibly have been implying that the creditor in *Pritchett* held such a prohibited interest, since the applicable contract entitled the creditor to twenty percent of gross sales.[242] If so, defensible grounds exist to support the Tax

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234. Abramson v. Commissioner, 86 T.C. 360, 375-76 (1986).
235. *Id.* at 375.
236. *Id.* at 375-76.
237. *Id.*
238. Treas. Reg. § 1.752-1(e) (1956).
239. Prop. Treas. Reg. § 1.465-22(a), 44 Fed. Reg. 32,241 (1979).
240. *Abramson*, 86 T.C. at 376.
241. I.R.C. § 465(b)(3)(A) (West Supp. 1987).
242. Pritchett v. Commissioner, 85 T.C. 580, 582 (1985), *rev'd*, 827 F.2d 644 (9th Cir. 1987). Judge Williams felt compelled to write a concurring opinion in *Abramson* that further

Court's holding in *Pritchett* that the limited partners were not at risk and for distinguishing *Pritchett* from *Abramson*. Unfortunately, the majority in *Pritchett* did not base its decision on the lender's interest. Further, the discussion of this issue in *Abramson* appears too casual for one to consider it a reformation of the Tax Court's conclusions in *Pritchett*.

The Tax Court followed the *Abramson* approach in the recent case of *Melvin v. Commissioner*.[243] In *Melvin* two brothers formed a general partnership (MEDICI), which in turn became a limited partner in a motion picture partnership (ACG). MEDICI contributed cash and a negotiable promissory note to ACG in exchange for its limited partnership interest. ACG then borrowed funds from a bank for a film purchase and gave the bank the MEDICI promissory note as partial security. The note did not entitle the brothers to reimbursement from the general partners, should they have had to pay the notes. The issue litigated concerned whether ACG's grant of a security interest in the note increased one of the brother's amount at risk.

The court held the taxpayer stood at risk to the extent of his pro rata share of the bank loan.[244] The critical fact was the taxpayer's unprotected liability on his note.[245] The court cited both *Smith* and *Abramson* in support of its conclusion.[246] The court also held, contrary to its position in *Pritchett*, that a taxpayer can be at risk notwithstanding the fact that the contributed

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distinguished *Pritchett*. *Abramson*, 86 T.C. at 382 (Williams J., concurring). After repeating the arguments of the majority, he took the position that even if one could treat the obligation in *Pritchett* as an amount borrowed with respect to the activity, the liability still would fail the § 465 test. *Id.* In his view the limited partners' obligation ran to someone with an interest in the activity, to wit, the general partners, which actually constituted the partnership itself. *Id.* If Judge Williams's position were correct, partners could never meet the at risk rules and simultaneously have basis. As mentioned above, the regulations require the limited partners to be obligated to the partnership. *See supra* note 187-91 and accompanying text. As to whether additional liability to the creditor directly would solve the problem, see *supra* notes 238-240 and accompanying text. Finally, the creditors in *Pritchett* most likely were third-party beneficiaries of the agreement or the limited partners, and hence the limited partners were exposed directly to the creditors as well, just as the limited partners were in *Abramson*. *See supra* note 161 and accompanying text.

243. 88 T.C. 63 (1987). The court also followed *Abramson* in Gefen v. Commissioner, 87 T.C. 1471 (1986). In *Gefen* a limited partnership borrowed funds to purchase computer equipment, which the partnership then leased to Exxon Corporation. Each limited partner guaranteed a portion of the debt without any entitlement to reimbursement. The lender could proceed directly against the limited partners or against the partnership. In the latter case each limited partner was obligated to contribute to the partnership the amount of the debt that he guaranteed. The court held that the pro rata share of the loan increased each limited partner's basis and that each limited partner was at risk as to that amount. *Id.* at 1499-1504. The court rejected the Service's argument that Exxon's strong credit rating meant that Exxon was unlikely to default on its lease obligations, thereby protecting the limited partners against loss and preventing them from being at risk. *Id.* at 1503. The court noted that the legislative history to § 465 did not require taxpayers to enter into transactions with poor credit risks. *Id.* A Lloyd's of London policy insuring the residual value of the computer equipment did not affect the court's analysis, since it did not pertain to the years in question. *Id.* The court made no reference to *Pritchett*. *Id.* at 1499-1504.

244. Melvin v. Commissioner, 88 T.C. 63, 70-73 (1987).

245. *Id.* at 75. The court noted that "[the at risk rules are met] if [the taxpayer] has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership's business and investments are not available for that purpose." *Id.* (citations omitted).

246. *Id.*

note was payable in future years.[247]

Although the court attempted to distinguish *Pritchett*, the analysis utilized applies to the limited partners in *Pritchett* as well as those in *Melvin*.[248] The *Pritchett* limited partners also had ultimate liability. In the worst case scenario, no partnership revenues would have existed, the general partners would have made the call for contributions, and the limited partners would have paid the debt. If ultimate liability is the focus, the obligations of the limited partners in *Pritchett* appeared as definite and fixed as the obligations in *Melvin*. The *Pritchett* court ignored the substance of the transaction, so prized in *Melvin*.

The *Melvin* court noted the "non-arm's-length nature of the underlying partnership loan" in *Pritchett*.[249] One can read this brief reference to imply that the loan was not genuine or perhaps that the creditor possessed an equity interest in the activity, which would prevent the taxpayer from including the liability in the amount at risk.[250] Again, if this interpretation constitutes the Tax Court's intent, a justification exists for the *Pritchett* decision. The *Pritchett* court, however, did not rely on either point to support its conclusion. Further, as in *Abramson*, the comments in *Melvin* in this regard are too brief for one to conclude that the Tax Court has revised the *Pritchett* holding.

A common denominator exists in the cases in which the Tax Court held that the taxpayer satisfied the at risk rules; the creditor had held obligations of the taxpayer. In *Abramson* the taxpayers and the creditor entered a guarantee agreement, and in *Melvin* the creditor held the taxpayer's note as collateral. In *Pritchett*, on the other hand, the creditor held no undertakings from the limited partners and principally stood as a third-party beneficiary of the limited partners' obligation to make capital contributions to the partnership. To make at risk determinations based on the directness of the nexus with the creditor, however, ignores the *Melvin* court's appropriate emphasis on ultimate liability, substance, and the irrelevance of other parties in the chain of liability who do not have actual exposure. As long as a taxpayer possesses unprotected liability on a debt, the Service and the courts should

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247. *Id.* at 76-77.

248. The *Melvin* court purportedly distinguished *Pritchett* because, in that case:

> The alleged recourse debt obligations of the limited partners to make additional cash contributions were not definite and fixed and were tainted by the non-arm's-length nature of the underlying partnership loan. In the instant case, the limited partners' obligations to make additional capital contributions to ACG were definite and fixed . . . .
>
> The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. . . . The scenario that controls is the worst-case scenario, not the best case. Furthermore, the fact that the partnership or other partners remain in the chain of liability should not detract from the at-risk amount of the parties who do have the ultimate liability. The critical inquiry should be who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls.

Id at 74-75 (footnotes and citations omitted).

249. *Id.* at 74.

250. I.R.C. § 465(b)(3) (West Supp. 1987); *see supra* notes 240-42 and accompanying text.

consider the taxpayer at risk, regardless of the path the creditor must follow to collect.

One can reasonably question whether *Pritchett* represents the Tax Court's true position. Only seven of the sixteen voting judges agreed with the majority holding.[251] Two concurred that the limited partners were not at risk on the completely independent grounds that the creditor held a prohibited equity interest.[252] Seven judges dissented.[253] Given a different fact pattern, the concurring and nonvoting judges might feasibly join forces with the dissenters, and a majority would exist for the opposite result.

G. The Service Backtracks

The *Abramson* and *Melvin* cases undermined the position the Service took in Technical Advice Memorandum 84-04-012.[254] The often noted Technical Advice Memorandum discussed a limited partnership involved in oil and gas exploration. Each limited partner contributed cash, a promissory note, and an irrevocable, transferable letter of credit to the partnership. Additionally, each limited partner executed an assumption agreement with the partnership by which the limited partners assumed and promised to pay a pro rata share of a partnership loan. The partnership pledged the letters of credit and assumption agreements to the creditor as security for the partnership loan.

From an objective view of the structure, the limited partners apparently had done more than enough to earn the entitlement of including their pro rata share of the loan in basis under section 752. The obligations of the limited partners ran both to the lender, by way of the letter of credit given as security, and to the partnership, via the assumption agreement.[255] The Service nonetheless concluded that the limited partners were not entitled to include any portion of the liability in basis.[256] Among the reasons for this startling conclusion was the fact that the partnership remained primarily liable on the debt.[257] According to the Service, in order to include a recourse liability in basis under section 752, the partners had to become the

251. Pritchett v. Commissioner, 85 T.C. 580, 585-91 (1985) (Judges Jacobs, Sterrett, Goffe, Chabot, Parker, Shields, and Clapp), *rev'd*, 827 F.2d 644 (9th Cir. 1987).

252. *Pritchett*, 85 T.C. at 591-93 (Judges Simpson and Swift). Judges Sterrett and Goffe, who voted with the majority, also concurred with Judge Simpson. *Id.* at 593.

253. *Id.* at 593-601 (Judges Whitaker, Nims, Korner, Cohen, Wright, Hamblen, and Wilbur).

254. Tech. Adv. Mem. 84-04-012 (Oct. 13, 1983); *see* Winston, *Basis and At-Risk Consequences of a Partner's Assumption of Partnership Debt*, 2 J. TAX'N INV. 15, 15 (1984) (T.A.M. 84-04-012 calls into question efficiency of partnership assumption arrangements); *see also* Schwidetzky, *Pool of Capital Doctrine: A Peace Proposal*, 61 TUL. L. REV. 519, 530-36 (1986) (discusses common law pool of capital doctrine in partnerships, whereby person may acquire nontaxable partnership interest by contributing services or property toward acquisition, development, and exploration of oil and gas); Hineman, *Basis Considerations in Assumption and Letter-of-Credit Arrangements*, 2 J. TAX'N INV. 42, 42 (1984) (IRS put damper on assumption arrangements with Tech. Adv. Mem. 84-04-012).

255. Tech. Adv. Mem. 84-04-012 (Oct. 13, 1983); *see also supra* notes 185-91, 234-41 and accompanying text (partner's basis increased for share of partnership's recourse liabilities).

256. Tech. Adv. Mem. 84-04-012 (Oct. 13, 1983).

257. *Id.*

primary obligors.[258] The Service also argued that any obligation of the limited partners to the partnership on the loan was too contingent, since the loan was not due until four years after its consummation.[259] One may have difficulty comprehending this latter position since the loan was due in all events and, therefore, in no way contingent. Apparently, the Service remained reluctant to give partners an increase in basis attributable to an obligation not payable for four years. Regardless of the validity of that concern the Service inappropriately created a contingency out of whole cloth. Further, contrary to the Service's position, case law generally has supported the inclusion of liabilities in the partnership interest bases, regardless of whether the partnership possesses primary liability.[260] This Article discusses the propriety of fully including liabilities in basis currently when they are not payable until a distant point in the future in more detail below.

The facts of the Technical Advice Memorandum were very similar to those of *Abramson* and *Melvin*, in which the court held that the partnership liability increased the limited partners' bases.[261] In an apparent response, the Service issued Technical Advice Memorandum 86-36-003,[262] which withdrew and placed "under review" the conclusions expressed in Technical Advice Memorandum 84-04-012 regarding basis.[263] The Service in Technical Advice Memorandum 86-36-003 then addressed the at risk issue raised by the Technical Advice Memorandum 84-04-012. Given the taxpayer's failure to obtain basis, no need to discuss at risk considerations originally existed.[264] With the potential for basis resurrected, the at risk issue became important. The Service essentially followed the reasoning of *Abramson*. Since the limited partners ultimately stood solely liable for their shares of the loan, the creditor could have brought a separate action against them for collection, and they therefore bore "the economic risk associated with the repayment of the [l]oan."[265] Accordingly, the Service considered each limited partner to be at risk for his share of the loan.[266] This emphasis on economic risk is both noteworthy and directly in conflict with the Service's position in *Pritchett*,[267] when the limited partners also bore the ultimate economic risk.

III. MEASURING LIABILITIES IN CURRENT DOLLARS

Although an abuse existed in *Pritchett* and may have existed in Technical Advice Memorandum 84-04-012, neither section 465 nor section 752 is designed to address such an abuse. Generally, section 752 allows a partner

258. *Id.*
259. *Id.*
260. *See* Proesel v. Commissioner, 77 T.C. 992, 1004 (1981) (citing relevant case law).
261. *See supra* note 223 and accompanying text.
262. Tech. Adv. Mem. 86-36-003 (Apr. 24, 1986) (issued before the *Melvin* decision, 88 T.C. 63 (1987)).
263. *Id.*
264. Tech. Adv. Mem. 84-04-012 (Oct. 13, 1983).
265. Tech. Adv. Mem. 86-38-003 (Apr. 24, 1986).
266. *Id.*
267. *See supra* notes 153-84 and accompanying text.

to increase the partnership interest basis by the pro rata share of the face amount of a partnership debt.[268] In *Pritchett* the note did not bear interest and was only due fifteen years after the date of its consummation. The current value of the note was approximately twenty-five percent of its face amount, assuming a ten percent present value rate. Accordingly, the limited partners were entitled to a one dollar basis step up, and potentially one dollar of associated deductions, while in effect assuming an obligation to pay in current dollars approxomately twenty five cents. This situation is obviously inappropriate and may have concerned the *Pritchett* court. The at risk rules, however, were not the ideal place for the court to tackle the problem, since these rules only consider financial exposure. The basis rules, on the other hand, look to the taxpayer's investment. If the face amount of the note did not properly reflect the taxpayer's investment, the court should have used the basis rules to effect the necessary adjustment.

A. Original Issue Discount and Imputed Interest Rules

The Code's new rules concerning original issue discount[269] and imputed interest[270] should remedy the abuse that existed in *Pritchett*. A detailed discussion of these rules is beyond the scope of this undertaking. In short, however, those provisions generally provide that if a loan charges a below market rate of interest, the parties convert the principal of the loan into interest in an amount sufficient to bring the interest rate up to market standards.[271] Subject to certain exceptions,[272] the debtor deducts the total interest, and the creditor then includes such interest in annual income as it accrues and not when it is paid, regardless of the debtor's and creditor's methods of accounting.[273] Converting principal into interest based on mar-

268. Abramson v. Commissioner, 86 T.C. 360, 373-75 (1986); Smith v. Commissioner, 84 T.C. 889, 906-08 (1985).

269. I.R.C. §§ 1271-1275 (West Supp. 1987).

270. *Id.* §§ 483, 7872 (1987). Prior to the enactment of these sections, courts generally did not impute interest. *See* Commissioner v. Brown, 380 U.S. 563, 576, 578 (1965) (sale of capital asset received capital gains treatment despite taxpayer's retained interest in income produced by asset); Montana Power Co. v. United States, 232 F.2d 541, 551 (3d Cir.) (asset-for-asset exchange pursuant to reorganizations tax-free unless fair market value of assets received greater than that of assets disposed), *cert. denied*, 352 U.S. 843 (1956). *But see* Dickman v. Commissioner, 465 U.S. 330, 340-42 (1984) (interest on gift-loan subject to tax).

271. I.R.C. §§ 483 (a)-(b), 1272, 1274(b), 7872(b) (West Supp. 1987). The interest rate is limited to 8% for certain transactions when the unstated principal amount does not exceed $2,800,000. *Id.* § 1274A. In addition, the § 1274A 9% limitation is compounded semi-annually. *Id.*; *see also id.* § 483(e) (interest rate shall not exceed 6% compounded semi-annually for certain sales or exchanges of land to related parties).

272. *Id.* § 1674(c) exempts certain transactions from its coverage, for example: certain sales for $1,000,000 or less, sales of principal residences, sales involving total payments of $250,000 or less, certain publicly traded property, certain sales of patents, and sales and exchanges within § 483(e), which deals with land transfers between related parties. These exemptions will fall within § 483, unless subject to the exemptions found in § 483(d). Section 483 does not require annual accruals, and thus a cash method taxpayer will not have income until he receives the payments. Section 483, however, will still reclassify a portion of the payment as interest. *See id.* § 483(a)-(b). Further, I.R.C. § 1274A(c) permits taxpayers on the cash method of accounting to recognize gain or take deductions when payments are made if the principal of the debt dues not exceed $2,000,000. *Id.* § 1274A(c).

273. *See id.* § 1272.

ket interest rates reduces the principal to its present value. The taxpayer should include that reduced principal in basis.[274] Liabilities therefore would increase basis not by their face amount, but by their present value.

These rules were not in effect at the time the parties structured the *Pritchett* transactions. Had they been, the parties would have reduced the principal of the loan to approximately twenty-five percent of the original face. If the limited partners had included this lesser amount in basis, a fair result would have been obtained. The seventy-five precent of the note no longer included in basis would have reduced deductions, which the Code limits to basis. Permitting the limited partners to then be at risk on the note would not have perpetuated any abuse because the problem's solution would have occurred at the basis level. This approach also avoids the necessity of denying the taxpayer's deductions by a tortured analysis of the at risk rules, which raises more questions than it answers.

The present value rules now contained in the Code reduce the likelihood that taxpayers will create *Pritchett*-type structures. Fairfield probably agreed to a noninterest bearing loan in *Pritchett* because such a loan permitted Fairfield to avoid the ordinary income otherwise incurred upon receipt of that interest.[275] Instead, Fairfield received only principal, which to the extent it exceeded the basis in the note might have constituted capital gain, taxable at favorable rates at the time the transactions occurred.[276] Now that the Code imputes interest and taxes capital gains at ordinary income rates,[277] the results will be quite different. A creditor will now obtain little or no benefit from the *Pritchett*-type structure. Under the general rule, the creditor recognizes interest income, while the debtor deducts such interest annually as the interest accrues regardless of the taxpayers' method of accounting.[278] Additionally, no benefit to receiving capital gains will normally exist. In fact, the creditor will be at a disadvantage if it accrues income annually, since the creditor will not receive cash with which to pay the tax on that income. Consequently, the creditor appears more likely to insist on appropriate interest with payments made currently.

One final question concerns whether the original issue discount and imputed interest rules apply in this context. Neither rule discusses the inclusion of liabilities in basis and, therefore, neither concludes that one may add only the recomputed principal to basis,[279] though that conclusion seems in-

274. Interest is a liability and can be passed on to partners under I.R.C. § 752, but only annually, as the liability arises. *See generally id.* §§ 165(a) (certain losses allowable as deductions), 165(b) (loss limit equals basis), 167(g) (depreciable basis rules), 704(d) (partner's loss limited to basis in partnership interest) (1982 & West Supp. 1987).

275. *Id.* § 61(a)(4).

276. *Id.* §§ 1201, 1202, 1221 (1977).

277. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2219 (1986); *see also* I.R.C. §§ 1274, 7872 (West Supp. 1987). Individual taxpayers may deduct up to $3,000 of net capital losses from ordinary income. I.R.C. §§ 1211(b), 1222(10) (West Supp. 1987).

278. One will obtain a different result if either § 483 or 1274A, both of which include interest in income only when the taxpayer's method of accounting would require it, applies. I.R.C. §§ 483, 1274A (West Supp. 1987).

279. *But see* Prop. Treas. Reg. § 1.1272-1(j), 51 Fed. Reg. 12,053 (1986) (one shall increase

escapable. Congress gave the Service the usual mega-delegation of authority to issue regulations,[280] authority that should be broad enough to limit basis to the recomputed principal. Even without those Code sections, however, the courts and the Service possess the authority to limit a basis increase due to a liability to the present value of that liability.[281] The basis rules focus on investment,[282] and one best measures investments in current dollars,[283] making that the appropriate measure for the amount of liabilities included in basis as well.

B. *Another Alternative*

One commentator, although recognizing that the present value methods discussed above represent an improvement, prefers a different solution, due to the following concerns.[284] In the case of a *Pritchett*-type structure, the Code now permits the debtor to take deductions for accrued but unpaid interest.[285] The debtor could invest and earn income from the funds that the debtor would have used to pay that interest. The tax savings from the interest deductions and from the expense or depreciation deductions attributable to the expenditure of the loan proceeds themselves can be invested and earn income.[286] Given certain assumptions, such as a longer term loan, fifty percent tax rate, and a ten percent pre-tax return, a debtor could possibly earn sufficient income prior to the time he must pay the liability to offset large amounts of the liability, and occasionally, the income could even exceed the liability.[287] As a result, the Code is giving deductions attributable to liabilities in excess of economic cost. Economic cost forms the cornerstone for deductions.[288] These "cost-free liabilities"[289] conflict with that principle. Assuming the situation involves an expense item, the proposed solution is to use financial discounting and treat a future liability as a current expenditure only in an amount that, if invested at current rates, would yield a sum, after tax, sufficient to pay the liability, with interest.[290] This solution would allow no additional deductions for interest in future years.[291] The proposed solution would have to make appropriate adjustments in the case of the acquisi-

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basis by amount of original issue discount in holder's gross income, and decrease it by amount of payment, other than qualified interest, from issuer to holder).

280. I.R.C. § 1275(d) (West Supp. 1987).

281. *See supra* notes 57-72 and accompanying text.

282. *See supra* notes 12-30 and accompanying text.

283. *See* Johnson, *Silk Purses From a Sow's Ear: Cost Free Liabilities under the Income Tax*, 3 AM. J. TAX POL'Y 231, 232-33 (1984) (Tax Reform Act of 1984 cuts back on traditional time blindness of tax law).

284. *Id.* at 242-58.

285. *See* I.R.C. §§ 1274, 7872 (West Supp. 1987) (interest rate determinations).

286. Johnson, *supra* note 283, at 231-42.

287. *Id.*

288. *See generally* I.R.C. § 162 (1987) (deductions allowed for all ordinary and necessary expenses incurred in carrying on trade or business); B. BITTKER, *supra* note 14, ¶ 10, at 10-1 (discusses cost recovery, depreciation, and amortization).

289. *See generally* Johnson, *supra* note 283, at 231-38 ("Cost-free liabilities are a litmus test of absurdity in a tax system.").

290. *Id.* at 239.

291. *Id.*

tion of depreciable assets, which unlike expense items generate deductions over time instead of only in the year of acquisition, but the focus would remain the same.[292]

One can raise several objections to this proposal. First, it does not adequately consider the role of the creditor, who will generally have to recognize income currently.[293] As a consequence, the creditor will in all probability insist on current payments, eliminating the availability of those funds for investment and much of the potential for cost free liabilities.[294] If the creditor does not require current payments, he will nonetheless possess current income and a current tax liability, which presumably he will attempt to neutralize with higher interest rates. Those higher rates will offset the relevant income earned by the debtor.

Second, the proposal is premised upon a post-tax yield. Given our graduated income tax structure those yields will vary from taxpayer to taxpayer. Unless some average is used, the proposed system will have to be applied on a case-by-case basis. The additional administrative burdens this necessity would cause would be substantial in a tax system already stumbling under the existing administrative load.[295] Each taxpayer would have to review his marginal tax rate before and after taking into account the benefits associated with a liability. The impact on the tax rate could vary if the taxpayer's income straddles the tax brackets.[296]

This approach also conflicts with the entire structure of the Code, which computes deductions on a pre-tax basis. Why stop with deductions arising from liabilities? Other non-cash deductions, for example depreciation, can create a similar impact. The proposal might require a complete restructuring of the tax system, potentially yielding few real benefits. The benefit of the present value system of the Code contained in the original issue discount and imputed interest rules, with its use of pre-tax values, is that it addresses the problem of under and/or unstated interest without violating the general premises of the tax system. The Tax Reform Act of 1986 also generally reduces the maximum marginal rates to twenty-eight percent for individuals and thirty-four percent for corporations.[297] This reduces the value of the debtor's tax deductions and the consequent tax savings. As a result fewer tax savings to invest will exist, which will reduce any return, and increase

292. *Id.* at 285-87.

293. Professor Johnson's argument contains greater merit if either § 483 or 1274A applies. Sections 483 and 1274A(c) do not require current inclusion for, respectively, certain property dispositions and certain loans with principal amounts up to $2,000,000, if the creditor uses the cash method of accounting. Instead, the creditor will only include income when the cash method of accounting requires it. The typical commercial lender uses the accrual method of accounting, however, requiring current inclusion. *See* I.R.C. §§ 483, 1274A(c) (West Supp. 1987).

294. The benefits of expense or depreciation deductions attributable to the expenditure of the loan proceeds would still exist, though the taxpayer's after tax interest costs would now partially offset them.

295. Professor Johnson acknowledges this difficulty. *See* Johnson, *supra* note 283, at 284-85.

296. *See* I.R.C. § 1 (West Supp. 1987) (sets tax rates of 15 and 28 percent).

297. *See id.* §§ 1(g)-(h), 11.

the amount of time required to offset meaningful portions of the liability, thereby reducing the extent of the problem.[298]

Finally, the proposal represents an indictment of accrual accounting, which always permits deductions without outlays.[299] One should recall that accrual accounting also requires the inclusion of income without receipt.[300] Furthermore, cash accounting can also lead to abuses.[301] Although a debate over accrual and cash accounting is thankfully beyond the scope of this Article, accrual accounting came into being to correct cash method of accounting distortions.[302] Nonetheless, the present value approach is complex and can eventually become a taxpayer's nightmare, as well as an accountant's dream. Taxpayers who fail to charge the proper interest rate will be able to obtain tax deductions for the computer they will need to purchase in order to calculate the alternative statutory interest.[303]

C. *A Modest Proposal*

A simpler solution would require that as a condition precedent to inclusion in basis, or to expense deduction, liabilities be incurred at prevailing interest rates. Requiring the interest rate to be correct at the outset would eliminate the need for complex recalculation. One argument against this approach would be its potential harshness. Failure to meet its requirements could result in bona fide liabilities receiving no tax benefits. Permitting the parties to retroactively amend the loan documents to change the interest rate appropriately can solve this dilemma. The deductions could then be allowed while the abuse is simultaneously avoided.

IV. PASSIVE LOSS RULES

Tax shelters provided a focal point for congressional deliberations during the drafting of the Tax Reform Act of 1986.[304] Congress viewed tax shelters as an egregious abuse of the Code mandating corrective action.[305] The premise appeared questionable since tax shelters only have a small effect on

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298. *See* Johnson, *supra* note 283, at 285.

299. Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1985); *see also* United States v. Anderson, 269 U.S. 422, 441-42 (1925) (permitted accrual basis taxpayer to deduct tax "reserve" on books, even though not yet assessed).

300. Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1985).

301. *See generally* Helvering v. Enright, 312 U.S. 636, 645 (1941) (permitted accrual for estimated receipts of deceased member of law firm for unfinished business); Zaninovich v. Commissioner, 69 T.C. 605, 606 (1978) (taxpayers took deduction on 1973 tax return for rental payments for use of land in 1974, and for which they actually paid in 1973); *see also* I.R.C. § 467 (West Supp. 1987) (taxpayer may use accrual method for certain rental agreements); B. BITTKER, *supra* note 14, ¶ 35.2(1), at 35-13 ("Tax theorists regard cash—basis accounting as less accurate than accrual accounting . . . .").

302. *See* Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 354 (1st Cir. 1970) (Commissioner may select type of accounting method that most properly reflects taxpayer's income); ELLIS & THACKER, INTERMEDIATE ACCOUNTING, ch. 10, at 300 (1980).

303. I.R.C. § 168(e)(3)(B)(iv) (West Supp. 1987).

304. SENATE FINANCE COMMITTEE REPORT ON H.R. 3838, S. REP. No. 313, 99th Cong., 2d Sess. 1 (1986), *reprinted in* CCH Special Report, May 29, 1986, at 713, [hereinafter Committee Report].

305. *Id.*

governmental revenues.[306] Congress, however, doubtlessly achieved the objective of bringing the tax shelter industry to its knees with the enactment of the passive loss rules of section 469.[307] The author will limit this discussion of section 469 to the basic aspects of the changes, their affect on liabilities, and why the passive loss rules represent an unnecessary and misdirected approach to a problem that other Code changes had already remedied.

A. The Basics

Section 469 puts the tax world into baskets. One is active and outside its ambit, the other is passive and victimized by the draconian approach of section 469.[308] Individuals, fiduciaries, partners, S corporation shareholders, certain personal service corporations, and closely held corporations are subject to the passive loss rules.[309] Section 469 requires these persons to place their gains and losses in one of the baskets. Generally, any activity other than a trade or business in which the taxpayer materially participates falls into the passive basket.[310] In order to materially participate, the taxpayer must be involved in the operations of the activity on a regular, continuous, and substantial basis.[311] The section deems all limited partnership participations and all rental activities to be passive activities.[312]

Subsection (a) of section 469 provides the muscle. This subsection states that taxpayers may only deduct aggregate passive activity losses from aggregate passive activity income. Taxpayers may not deduct passive activity losses from active income such as salary and wages. Taxpayers also may not deduct passive activity losses from portfolio income, which includes gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.[313] Wealthier taxpayers easily generate and regularly incur portfolio income and would probably still possess ample

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306. In 1986 the federal government collected approximately 790 billion dollars in total tax revenues. *See Facts and Figures on Government Finance*, 23 TAX FOUND., INC., at C-1 (1986). "Public Citizen," a Ralph Nader organization, projected that tax shelters would result in 24 billion dollars in lost revenue for 1986. *See* Wall St. J., Feb. 12, 1985, at 64, col. 4. This amount constitutes approximately 3.1% of revenues.

307. I.R.C. § 469 (West Supp. 1987); *see also* Brode, *supra* note 7, at 290 (new passive loss rules extremely broad and impact real estate developers and passive investors).

308. I.R.C. § 469(a) (West Supp. 1987); *see also* Tucker & Schwinger, *TRA 1986 Will Have a Pervasive Impact Upon Real Estate Transactions*, 66 J. TAX'N 130, 130 (1987) (after 1986 Tax Act, tax losses will become less important and cash flow will become more important in real estate); Brode, *supra* note 7, at 290 (new § 469 will cause real estate developers to restrict form of doing business).

309. I.R.C. § 469(a)(2) (West Supp. 1987); *see also* Committee Report, *supra* note 304, at 721-22 (passive loss rules apply to individuals as well as certain businesses to ensure that taxpayers do not circumvent rules).

310. I.R.C. §§ 469(c)(1)-(2) (West Supp. 1987). A taxpayer can be in the trade or business of being an employee. Noland v. Commissioner, 269 F.2d 108, 111 (4th Cir.), *cert. denied*, 361 U.S. 885 (1959). A trade or business also includes research and experimentation activities, as defined in § 174, and to the extent provided in regulations, any activity with respect to which expenses are allowable as a deduction under § 212. I.R.C. § 469(c)(5)-(6) (West Supp. 1987).

311. I.R.C. § 469(h)(1)(A)-(C) (West Supp. 1987).

312. *See id.* §§ 469(c)(2), (h)(2) (1987). *But see id.* § 469(i) (offset for rental real estate activities); Committee Report, *supra* note 304, at 719-21; Brode, *supra* note 7, at 290-95.

313. I.R.C. §§ 469(a), (d)-(e) (West Supp. 1987).

incentive to invest in tax shelters if the resulting losses could reduce that portfolio income, notwithstanding the fact the losses could not reduce active income.[314] This situation would have kept the taxshelter industry alive and well, contrary to Congress's intent.

The Code mercifully allows individuals to deduct up to $25,000 of excess passive losses attributable to rental real estate from their active income if the individuals actively participate in the rental activity.[315] The active participation standard requires less involvement than the material participation standard, but does require a meaningful involvement.[316] The taxpayer, for example, meets the active participation standard by making "management decisions or arranging for others to provide services . . . in a significant and *bona fide* sense."[317] The $25,000 deduction is reduced by fifty percent of the amount by which the taxpayer's adjusted gross income exceeds $100,000.[318] Thus, the deduction will be totally phased out for taxpayers with adjusted gross incomes of $150,000 or greater. This provision, therefore, will not benefit wealthier taxpayers.

A taxpayer may carry forward passive losses that he cannot use currently to future years that contain passive income.[319] When a taxpayer fully disposes of a passive interest in a taxable transaction, the taxpayer may deduct any associated, unused passive losses from active income to the extent there exists insufficient passive income to offset them.[320] The passive loss rules apply to passive losses occurring after January 1, 1987, even if the taxpayer made the original investment giving rise to the losses before that time.[321] The full impact of the provisions, however, is mercifully phased in over five years for investments made before August 16, 1986, which represents the date the Conference Committee reported on the tax reform act.[322] Revenue needs arising from a passionate attachment to a maximum individual rate of twenty-eight percent constituted the principal reason Congress applied section 469 retroactively.[323]

The practical effect of the passive loss rules is to bring the tax shelter era

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314. Committee Report, *supra* note 304, at 713-18, 722.

315. I.R.C. § 469(i) (West Supp. 1987).

316. *Id.* § 469(i)(6); *see also* Committee Report, *supra* note 304, at 719-21, 736-38. The Code will not consider an individual to actively participate if his interest in the real estate activity is less than 10% by value. I.R.C. § 469(i)(6)(A) (West Supp. 1987).

317. Committee Report, *supra* note 304, at 737. Relevant management decisions include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. *Id.* at 737-38. No active participation requirement exists for low income housing and rehabilitation credits. I.R.C. § 469(a)(i)(6)(B) (West Supp. 1987).

318. I.R.C. § 469(i)(3)(A) (West Supp. 1987). The phase out for low income housing and rehabilitation credits begins with adjusted gross incomes of $200,000 and, therefore, is completely phased out once the adjusted gross income equals or exceeds $250,000. *Id.* § 469(i)(3)(B).

319. *Id.* § 469(b).

320. *Id.* § 469(g).

321. *Id.* § 469(*l*).

322. *Id.* A taxpayer may deduct from nonpassive income the following percentages of passive losses arising from the lesser of such pre-enactment interests or overall annual passive losses: 1987 - 67%, 1988 - 40%, 1989 - 20%, and 1990 - 10%. *Id.*

323. Telephone interview with Minority Senate Finance Committee Staff (March 31, 1987).

to a close. Taxpayers generally participate in tax shelters in order to obtain losses that they may deduct from their income. Since the investment usually takes the form of a limited partnership interest, or the structure is such that the taxpayer cannot satisfy the material participation standard, those losses will be passive. Taxpayers' income is typically from wages, interest, dividends, and royalties, which is active or portfolio income. Under the new rules, taxpayers generally may not deduct the former from the latter, and therefore, a principal motivation for participation in tax shelters, at least as historically structured, will no longer exist. If tax shelters were inherently evil, one could justify section 469. They are not, and one cannot.

B. *Critique*

Unquestionably, some abuses continued in spite of the enactment of the at risk rules of section 465 and the judicial responses to the use of liabilities discussed earlier.[324] As noted, taxpayers could include the face amount of debt in basis notwithstanding its interest provisions or payment terms.[325] The imputed interest and the original issue discount rules, which denominate a portion of principal as interest when inadequate interest provisions are contained in the loan documents, however, should largely remedy this problem.[326] These rules should limit the basis inclusion to the present value of the debt and prevent the abuse presented in the *Pritchett* case.

Congress originally permitted very rapid accelerated depreciation deductions over time periods that bore no relationship to a property's useful life, particularly in the case of real estate.[327] As a consequence, taxpayers generated depreciation deductions in such large amounts that taxpayers were constructing buildings for the enjoyment of the tax consequences rather than for serious economic considerations.[328] The 1986 Act remedied the unfortunate situation, created by Congress itself, with the elongation of depreciation periods and the limitation on depreciation for real estate to straight line over twenty-seven and one-half years for residential property and thirty-one and one-half years for commercial property.[329]

The tax benefits of the erstwhile rapid depreciation schedules for real estate particularly became potent when coupled with the fact that the at risk rules did not apply to real estate.[330] Taxpayers could incur large amounts of nonrecourse debt, often of dubious legitimacy, with its concomitant basis increase. Taxpayers generated large depreciation deductions and investment

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324. *See supra* notes 66-196 and accompanying text.

325. *See supra* note 268 and accompanying text.

326. *See supra* notes 269-82 and accompanying text.

327. *See generally* I.R.C. § 168(b)(2) (1986) (permitted accelerated depreciation for real estate over 19 years).

328. *See* Bolger v. Commissioner, 59 T.C. 760, 861-62 (1973) (taxpayer formed corporations to purchase real estate on 10 different occasions between 1963-1966); *Boom in Tax Shelters Artificially Lifts Prices of Much Real Estate*, Wall St. J., Dec. 27, 1983, at 1, col. 6 (tax shelters may constitute one-half of commercial property sales, which results in 15-20% higher prices).

329. I.R.C. § 16(c) (West Supp. 1987).

330. *Id.* § 465(c)(3)(D).

tax credits, often with limited, if any, concern for the risk and economics, since no personal liability existed.[331] Congress remedied this part of the problem by subjecting real estate to the reach of at risk rules.[332] The one exception occurs when the nonrecourse loans meet normal commercial terms.[333] The debt incurred therefore should arise in reasonable amounts, thereby eliminating the abuse potential.[334]

The discussed changes help insure that tax consequences will follow economic realties and that taxpayers, when considering a proposed investment, will look at the economic returns as well as the tax benefits. The opportunity to increase basis with low interest, high principal debt, and generate accelerated depreciation deductions that bear no resemblance to economic depreciation will no longer exist. Further, incurring unrealistic amounts of nonrecourse debt in real estate settings will no longer serve any tax purposes.

C. *The Downside*

If Congress had stopped with the changes discussed above, few could have raised significant arguments with either the concerns or solutions. Unfortunately, Congress went further. The passive loss rules disallow legitimate losses from legitimate activities until those activities generate income, simply because the activities may, arbitrarily, be classified as passive.[335]

The passive loss rules neutralize the inclusion of liabilities in basis. A passive investor may incur debt for a passive activity, receive the associated basis increase, have genuine financial exposure, and be at risk, but the taxpayer may not take deductions attributable to expenditure of the loan proceeds except to the extent passive income is generated.[336] The Code no longer focuses on the genuineness of the liability and the associated investment. For reasons that have nothing to do with either, the passive loss rules simply are postponing certain deductions. Such rules are a far cry from the heralded desire to make the Code economically neutral. On the contrary, these rules encourage taxpayers to invest in activities that generate short-term income, and discourage them from investing in activities that incur short-term losses, except generally, to the extent that they materially participate. The rules will presumably foreclose entrepreneurs whose proposals will not generate early income from access to the large capital markets represented by passive investors. Further, since the typical business venture does not earn income until several years into the development cycle, the entrepreneur may not have the initial opportunity to receive the necessary investment to get started.[337] The new Code will not, therefore, just put an end to

331. *See supra* notes 327-29 and accompanying text.
332. I.R.C. § 465(c) (West Supp. 1987).
333. *See supra* notes 130-135 and accompanying text.
334. I.R.C. § 465(b)(6) (West Supp. 1987).
335. Pritchett v. Commissioner, 85 T.C. 580, 593 (1985) (Whitaker, J., dissenting), *rev'd,* 827 F.2d 644 (9th Cir. 1987).
336. I.R.C. § 469(d) (West Supp. 1987).
337. Fifty-seven percent of businesses fail within the first five years of organization. *See Failures by Age of Business by Industry,* BUSINESS FAILURE RECORD 17, 17 (1984).

abusive tax shelters, whose life expectancy was already shortened by the other tax changes discussed above, but put an end to many legitimate investments as well.

With these changes, the Code also moves away from an income tax system and toward something more akin to a consumption tax system, when consumption rather than income is taxed.[338] Now the Code will not allow many losses when they are incurred, but only later when income is earned, or the interest in the activity is sold. The focus appears not on the investment, but on the nature of the activity, not on the economics, but on the nature of the receipts. The problem that arises is that Congress only went part of the way down this path. Now a somewhat confused jumble of income and consumption tax provisions that may not work well together, and which may give rise to economic disincentives, exist. Unless Congress wishes to complete its journey to a consumption tax system, which appears unlikely, section 469 cannot be justified and should be repealed.

V. CONCLUSION

Congress has included liabilities in basis for reasons of policy and practicality. As is often the case, however, this step could not be taken alone, and a number of supplemental judicial, congressional, and regulatory reactions have arisen to deal with certain abuses. The focus of all such responses should be on the legitimacy of the taxpayer's investment, or in this context, on the genuineness of the liability and the taxpayer's economic exposure. With these two concerns allayed, tax consequences should follow economic consequences.

The courts appropriately insisted that any contingencies to which a liability is subject not be so great as to call into question its very existence.[339] Similarly, nonrecourse debt is purely metaphysical if the fair market value of the collateral does not equal or exceed the debt, for the debtor possesses no incentive to insure the viability of an economic activity the benefits of which will accrue to his creditor. Hence the reaction of the Tax Court in *Franklin*.

The potential for an excessive use of nonrecourse debt was so great that Congress decided to take it off the typical playing field with the at risk rules. Section 465 insists on genuine economic exposure. Unfortunately, in *Pritchett*, the Tax Court ignored the economic exposure analysis and refused to consider taxpayers at risk, notwithstanding the fact that the taxpayers had clearly met the letter and the spirit of section 465.[340] The court seemed more concerned with formalism than substance.[341] Other courts should reject the Tax Court's analysis in *Pritchett* and follow the reasoning of the

338. Aaron & Galper, *A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform*, OPTIONS FOR TAX REFORM 106, 106-07 (Brookings Inst. 1984).

339. *See supra* notes 73-97 and accompanying text.

340. *See* Pritchett v. Commissioner, 85 T.C. 580, 595-96 (1985) (Whitaker, J., dissenting) (majority's application of § 465 failed to recognize relationship between basis and at risk provisions), *rev'd*, 827 F.2d 644 (9th Cir. 1987).

341. *See Pritchett*, 85 T.C. at 598 (Whitaker, J., dissenting) (court's approach in *Pritchett* creates bad percent for genuine business transactions).

Ninth Circuit. The Tax Court should reconsider its position. The proper focus is that of *Abramson* and *Melvin*: whether the taxpayer possesses adequate exposure. Form should not control substance.

From its creation the Code has ignored something known by every sophomore business student; a dollar today is worth more than a dollar tomorrow. The refusal to adopt a present value test permitted liabilities with understated interest to overstate basis. Both the Service and the courts could have responded by insisting that basis represent a taxpayer's investment, which is best measured in current dollars. The Service and the courts unfortunately have not taken this position, which has lead to alternative responses such as the Tax Court's fanciful at risk analysis in *Pritchett*. Congress has, indirectly, remedied the omission with the defensible, if highly complex, imputed interest and original issue discount rules.[342] Although these rules deal with the problem, their complexity constitutes a major limitation on their utility. Perhaps a simpler solution, from the perspective of computing basis, would require adequate interest as a precondition to including a liability in basis, with appropriate provisions to safeguard equity.

Although the problems were never as great as many would have us believe, tax shelters have resulted in certain abuses. In a system where voluntary compliance is vital, the system's success requires assuring taxpayers that everyone is paying a fair share of taxes, including wealthy tax shelter investors. In section 469, however, Congress overreacted. Congress originally gave taxpayers overly generous investment tax credits and depreciation deductions, and then appeared surprised when taxpayers took advantage of them. Congress could have recognized that it had created the problem, and limited the solution to reducing the availability of those tax benefits. With section 469, however, Congress also excoriated all loss activities that have passive investors, regardless of their long-term value, economic benefits, or legitimacy. Equity gave way to the desperate search for revenues, and investments made before the enactment of section 469 became subject to its graceless approach.

The objective of an income tax system is to tax economic income. Creators and administrators of such a system must take precautionary steps to insure that tax deductions correspond to economic outlays. When provisions such as section 469 prohibit legitimate deductions, however, the system no longer achieves its objectives. The focus has shifted from raising adequate revenues through adequate tax rates, to maintaining arbitrarily selected tax rates and obtaining the lost revenue through the equally arbitrary disallowance of deductions for bona fide expenditures. This shift can only have the effect of limiting legitimate economic activities, in particular, those activities that produce early losses. The result of this approach could adversely impact the economy in general, and the perception of the fairness of the tax system in particular. Further, the adverse economic impact may reduce income and the associated taxes, potentially causing a revenue loss

342. I.R.C. §§ 483, 1271-1275, 7872 (West Supp. 1987).

greater than any revenue gains attributable to section 469. If Congress wanted more revenue it should have raised rates or equitably curbed deductions. Section 469's carte blanche disallowance of losses unfairly penalizes good-faith business activities. It should be recognized as a mistake and repealed.