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1989]

## Comments

### HOW SECTION 469 REDEFINES THE TAX SHELTER—AND HOW THE REGULATIONS REDEFINE SECTION 469

#### I. INTRODUCTION

The Tax Reform Act of 1986<sup>1</sup> was intended to restore simplicity, fairness and efficiency to the federal income tax laws.<sup>2</sup> These objectives were facilitated through broad reductions in income tax rates and an aggressive attack on tax shelters.<sup>3</sup> However, while the equitable impact of rate reduction has received mixed reviews,<sup>4</sup> a consensus has formed against the complex and sometimes inequitable passive loss provisions<sup>5</sup>

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1. Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended at I.R.C. §§ 1-9602 (1982 & Supp. V 1987)) (originally enacted as Act of Aug. 16, 1954, ch. 736, 68A Stat. 3) [hereinafter 1986 Act].

2. TAX REFORM ACT OF 1986—REPORT OF THE COMMITTEE ON FINANCE UNITED STATES SENATE TO ACCOMPANY H.R. 3838 TOGETHER WITH ADDITIONAL VIEWS, S. REP. NO. 313, 99th Cong., 2d Sess. 3 [hereinafter 1986 SENATE FINANCE COMMITTEE REPORT]. To substantiate the inequities of the current tax system the Senate Report cited a study conducted by the Department of the Treasury which found that of the taxpayers reporting in excess of \$250,000 of "total positive income" (defined as the sum of salary, dividends, interest and income from profitable business ventures), 11% paid federal income tax equal to 5% or less of "total positive income," and 21% paid federal income tax of 10% or less of this figure. *Id.* at 714. Other studies characterized tax shelters as vehicles used by the rich to substantially reduce their tax liabilities. *Id.* at 714 n.4 (citing JOINT COMMITTEE ON TAXATION, TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX (August 7, 1985)).

The 1986 Senate Finance Committee Report forwarded these studies as proof that the "progressive tax [system] was a fraud," allowing those who possessed investment income to effectively shelter themselves from paying their fair share. Doernberg & McChesney, Book Review, 62 N.Y.U. L. REV. 891, 916 (1987) (reviewing J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS AND THE UNLIKELY TRIUMPH OF TAX REFORM 10 (1987)). However, to characterize the pre-1986 Act as unprogressive contradicts previous Treasury studies showing taxpayers with the top 5% in taxable income as paying 38.5% of all individual income taxes paid, and the top 10% paying 51.8% of the bill. *Id.* (citing Tax Found., News Release, *Shouldering the Burden—Who Pays the Tax Bill?* 1 (July 24, 1987)). Could our system be too progressive; are the rich paying too much? Interestingly, the "rich," top 10% in taxable income, encompass taxpayers with adjusted gross incomes as low as \$47,000. *Id.* at 917.

3. 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 3.

4. For an affirmative view on rate reduction, see *id.* at 3-4 & 29-44. For an example of legislators' concerns over the equity of rate reduction, see 132 CONG. REC. S13919, S13921 (daily ed. Sept. 27, 1986) (statement of Sens. Sasser and Harkin).

5. See, e.g., Lipton, *More Fun and Games with PALS: The First Set of Section 469 Regulations*, 66 TAXES 235 (1988); see also Dees, Mezullo, Seely *et al.*, *Comments on*

(1163)

introduced to the Internal Revenue Code of 1986 (the "Code")<sup>6</sup> under section 469.<sup>7</sup>

Section 469 was drafted with the premise that an activity's tax benefits should be *currently* available only to those taxpayers whose participation went beyond funding investment capital.<sup>8</sup> While a simple concept, this was an innovative approach which necessitated the development of new concepts. Congress and the Internal Revenue Service (the "Service") were forced to develop these new concepts, the most prominent and troublesome being "material participation,"<sup>9</sup> "significant participation activity"<sup>10</sup> and the definition of an "activity."<sup>11</sup> It is these concepts, which are devoid of any previous regulatory or judicial construction, which provide the primary source for the statute's and regulation's most complex and questionable provisions.

This Comment will focus primarily on the Service's first installment of passive activity regulations concerning the statute's "material participation" prong. This Comment's objective is to provide a pragmatic view of questions presented by the statute and material participation regulations in order to supply a starting point for the identification of, and preparation for, passive activity loss issues. It will be demonstrated

*Passive Activity Loss Regulations*, 1988 A.B.A. SEC. ON TAX'N—PASSIVE LOSS TASK FORCE 3-4 [hereinafter PASSIVE LOSS TASK FORCE] (comments represent views held by individual members of Special Task Force on Passive Activity Losses and not those necessarily held by the American Bar Association or its Section of Taxation).

6. I.R.C. §§ 1-9602 (1982 & Supp. V 1987) (originally enacted as Act of Aug. 16, 1954, ch. 736, 68A Stat. 3).

7. I.R.C. § 469 (West Supp. 1989). For the legislative background of the 1986 Act, see 1986 Act, *supra* note 1, §§ 501-502; TAX REFORM ACT OF 1986—CONFERENCE REPORT TO ACCOMPANY H.R. 3838, H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess., II-134 through II-157 [hereinafter 1986 CONFERENCE REPORT]; 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 713-46.

8. 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 715.

9. Section 469 applies only to "passive activities." A passive activity is defined as "any activity . . . which involves the conduct of any trade or business" (a concept well defined by case law under I.R.C. § 162) and "in which the taxpayer does not materially participate." I.R.C. § 469(c)(1) (West Supp. 1989). The statute defines material participation as involvement which is "regular, . . . continuous, and . . . substantial." *Id.* § 469(h)(1).

10. For a discussion of "significant participation activity," see *infra* notes 103-16 and accompanying text.

11. The concepts of "material participation" and "activity" represent the two fundamental pillars upon which the passive activity rules were constructed. This Comment focuses on "material participation" as defined by the Service's first installment of proposed and temporary regulations under § 469. See Temp. Treas. Reg. §§ 1.469-1T to -3T, -5T, -11T, 53 Fed. Reg. 5686-5733 (1988). While the Service's recently issued second installment defining "activity," see Temp. Treas. Reg. § 1.469-4T, 54 Fed. Reg. 20,527-66 (1989), intertwines with its "material participation" counterpart, the two concepts are sufficiently autonomous to allow for separate analysis. Therefore, while "activity" issues impacting the "material participation" analysis will be identified, further analysis of the "activity" regulations is beyond the scope of this Comment.

that the most fertile planning opportunities present themselves as alternatives to questionable positions adopted by the regulations. However, as a prerequisite to the above analysis, this Comment will first outline section 469's statutory scheme, followed by a review of the Code's numerous other tax shelter provisions and an analysis of how section 469 integrates with these other provisions.

## II. THE SECTION 469 STATUTORY SCHEME

Section 469 suspends the recognition of a net passive activity loss incurred by any individual, estate, trust,<sup>12</sup> closely held corporation,<sup>13</sup> or any personal service corporation.<sup>14</sup> Section 469 "freezes" a taxpayer's net passive activity losses until released by a recognition event.<sup>15</sup> These frozen losses can be recognized in three ways. First, passive loss carryforwards can be applied against the respective activity's future active or passive (*i.e.*, non-portfolio, non-personal service) income.<sup>16</sup> Second, the carryforward can be utilized in any tax year in which the taxpayer has net positive passive income from all his passive activities.<sup>17</sup> Finally, the activity's passive loss carryforward is released, and may shelter any class of income, after the taxpayer has effected a disposition of his entire interest.<sup>18</sup>

Suspending net loss recognition until there has been a complete disposition of the taxpayer's entire interest in the passive activity codifies the congressional belief in the Code's inability to accurately measure real annual economic losses, particularly those attributable to unrealized appreciation.<sup>19</sup> While provisions such as the adjusted basis and recapture rules equalize prior years' distortions between taxable and economic income, the taxpayer still reaps a timing benefit from pre-disposition deductions.<sup>20</sup> To eliminate this timing benefit, section 469

12. The regulations exempt grantor trusts as described in I.R.C. § 671. Temp. Treas. Reg. § 1.469-1T(b)(2) (1988).

13. "The term 'closely held corporation' means a corporation that meets the stock ownership requirements of § 542(a)(2) (taking into account the modifications in § 465(a)(3)) for the taxable year and is not a personal service corporation for such year." *Id.* § 1.469-1T(g)(2)(ii).

14. "The term 'personal service corporation' means a corporation that is a personal service corporation for the taxable year (within the meaning of [Treas. Reg.] § 1.441-4T(d))." *Id.* § 1.469-1T(g)(2)(i). For the regulations' definition of personal service corporations, see *infra* note 143.

15. I.R.C. § 469(a)(1), (b) (West Supp. 1989).

16. *Id.* § 469(f)(1)(A).

17. *Id.* § 469(b).

18. *Id.* § 469(g)(1)(A).

19. STAFF OF THE JOINT COMM. ON TAX'N, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 213 (Joint Comm. Print 1987) [hereinafter 1986 BLUE BOOK].

20. The most common example of a tax benefit timing deduction is the depreciation deduction allowed on real property. For example, take the case of a \$100,000 building: assume a 28.5-year depreciable life, a constant marginal tax

synchronizes tax loss recognition with economic realizations by deferring recognition until there has been a disposition of the taxpayer's entire interest in the activity.<sup>21</sup>

Congress developed the "passive activity loss" (PAL)<sup>22</sup> concept as the means for implementing this statutory scheme. A PAL occurs when a taxpayer's total passive activity losses for the taxable year exceed his total passive activity income.<sup>23</sup> The calculation of passive activity income or loss (*i.e.*, the specific items of income or loss to be used in the calculation) incorporates section 469's guiding principle of segregating passive losses from all other classes of income.<sup>24</sup> Accordingly, the statute requires identification and exclusion of all other classes of income, namely personal service income<sup>25</sup> and portfolio income.<sup>26</sup> The statute's

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rate of 28% and a fair market value at the end of the depreciable life cycle of \$100,000. Depreciation is designed to approximate economic exhaustion. However, economic reality diverges from these tax assumptions when either the asset appreciates or fails to depreciate as rapidly as provided for by the tax depreciation schedules. While the recapture provisions close this gap in the year the asset is sold, they do not remove the timing benefits. For instance, in the above example, if the taxpayer sells the building in year 28 for \$100,000, the recapture provisions will force a gain of \$100,000 to be recognized. However, this recapture does not reflect the time value of money benefit the taxpayer received from the \$28,000 in deferred taxes generated by deductions in years 1 through 28. By matching passive loss recognition with the asset's year of disposition, Congress hoped to deprive tax shelter investors of this time value of money tax benefit.

21. 1986 BLUE BOOK, *supra* note 19, at 213.

22. PALs, as used herein, refer to both passive activity losses and passive activity credits, unless designated otherwise.

23. I.R.C. § 469(d) (West Supp. 1989).

24. Congress characterized the ability to offset positive income (*e.g.*, salary and portfolio income) with passive activity losses (*i.e.*, losses from business activities in which the taxpayer did not "materially participate") as fundamental to the tax shelter problem. 1986 BLUE BOOK, *supra* note 19, at 212.

25. The regulations state that "[p]assive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time." Temp. Treas. Reg. § 1.469-2T(c)(4)(i) (1988).

That regulation's application can be exemplified as follows: Assume Mr. A has a distributable net passive loss of \$10,000 from an S Corporation, and Mr. A rendered 400 hours of management consulting services to the S Corporation for which he was compensated \$20,000. None of the \$10,000 distributable net passive loss can offset the \$20,000 of compensation income. *See id.* § 1.469-2T(c)(4)(ii) (example).

26. I.R.C. § 469(e)(1) (West Supp. 1989). Portfolio income includes all items of gross income and expense not derived in the original course of a trade or business, attributable specifically to one of the following: (1) interest (including § 707(c) interest payments on partner's capital); (2) annuities; (3) royalties (including fees and other payments for the use of intangible property); (4) corporation dividends; (5) real estate investment trust (REIT) income (including dividends from any § 856 trust); (6) real estate mortgage investment conduit (REMIC) (§ 851) mutual fund income; (7) REMIC (§ 850D) income; (8) common trust fund (§ 584) income; (9) controlled foreign corporation (§ 957) income; (10) qualified electing fund (§ 1295(a)) income; (11) cooperative

emphasis on segregation favors those taxpayers who have activities which can be classified as passive activity income generators (PIGs).<sup>27</sup> However, since PIGs are now the most favored form of activity among taxpayers, the regulations attempt to narrow the classification as much as possible, principally through the use of dubious recharacterization schemes which effectively place the taxpayer in a no-win situation.<sup>28</sup>

Fundamental to the PAL concept is the definition of a "passive activity." A non-rental activity<sup>29</sup> obtains passive status if it involves the conduct of a trade or business and is an activity in which the taxpayer does not materially participate.<sup>30</sup> While the "trade or business" concept has been well defined by existing case law,<sup>31</sup> the regulations substantially narrow the term in order to limit attempts to fabricate passive activity income.<sup>32</sup> These regulations appear reasonable and have stirred

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(§ 1381(a)) income; (12) S Corporation (§ 1368(c)(2)) dividend income; (13) income attributable to dispositions of any of the aforementioned income-producing items; (14) income attributable to the disposition of property held for investment within the meaning of § 163(d). *Id.* § 469(c)(1), (e)(1); Temp. Treas. Reg. § 1.469-2T(c)(3)(i) (1988); see also Lipton & Evaul, I *Passive Activity Losses*, TAX TRANSACTIONS LIBRARY (CCH) ¶ 902 (1988).

27. Activities which create net positive "passive activity income" are known as passive income generators (PIGs). See, e.g., Rubin, *Sticking PIGs: Real Estate Under the Passive Loss Regulations*, 39 TAX NOTES 867 (1988).

28. See, e.g., *infra* notes 107-32 and accompanying text. The preamble to the *Comments on Passive Activity Loss Regulations* states that "although Congress decreed that passive income should be available to be offset by passive losses, the Regulations make a serious effort to eliminate passive income through recharacterization rules which rely on a 'heads Treasury wins, tails taxpayer loses' rational." PASSIVE LOSS TASK FORCE, *supra* note 5, at 11-12.

29. Rental activities are presumptively passive. See I.R.C. § 469(c)(2) (West Supp. 1989).

30. *Id.* § 469(c)(1)(A)-(B). While the statute, by its provisions, would not apply to an endeavor before such endeavor constituted a trade or business under § 162, the newly issued activity regulations have amended the material participation regulations to apply the provisions of § 469 to an endeavor conducted in *anticipation* of becoming a trade or business. Temp. Treas. Reg. § 1.469-4T(b)(2)(ii) (1989).

31. For a discussion of the case law concerning the definition of a trade or business, see Lipton & Evaul, *supra* note 26, ¶ 401.01.

32. Regarding trade or business income, the temporary regulations provide:

(ii) Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity

little debate.

By contrast, the introduction of an expanded material participation concept has caused considerable debate.<sup>33</sup> The concept's ambiguity is helped little by the statute's own definition of material participation as "involve[ment] in the operations of the activity on a . . . regular, . . . continuous and . . . substantial [basis]."<sup>34</sup> The concept is based on prior usage within sections 1402(a)<sup>35</sup> and 2032A.<sup>36</sup> However, the established

of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

Temp. Treas. Reg. § 1.469-2T(c)(3)(ii) (1988).

33. The debate caused by the statute is a function of the broad and ambiguous language utilized in its key provisions. The most prominent questions raised are: (1) What constitutes an "activity"? (*e.g.*, If a taxpayer operates three grocery stores, are they to be treated separately or integrated?); (2) What constitutes "material participation?" (*i.e.*, Did Congress intend a quantitative hours spent approach, or was the quality of the time spent to be the controlling element?); and (3) What are the guidelines for recharacterization? For a further discussion of these provisions and the issues they present, see *infra* sections IV & V.

34. I.R.C. § 469(h)(1) (West Supp. 1989).

35. Section 1402 imposes a tax on self-employment income (the counterpart to the Social Security tax withheld from an employee's income). In general, self-employment income consists of an individual's net earnings from a trade or business carried on either alone or in general partnership. Treas. Reg. § 1.1402(a)-1(a) (1988). Rentals from real estate and related personal property generally are excluded from self-employment income. However, rentals for land are classified as self-employment income if three conditions are met: (1) they are derived under a contract to produce agricultural or horticultural commodities; (2) the rental contract requires *material participation* of the owner or tenant in either production or management; and (3) there is actual *material participation* by the owner or tenant. *Id.* § 1.1402(a)-4(b)(1).

The § 1402 regulations provide that *periodic* (as opposed to *regular* under §§ 2032A and 469) physical or managerial involvement, and furnishing required capital, is all that is necessary to establish material participation. *Id.* § 1.1402(a)-4(b)(3). The regulations' leniency is dictated by a taxpayer's desire to avoid material participation classification in order to have the rental payments excluded from self-employment income. Therefore, the cross purposes of the material participation concepts under §§ 1402(a) and 469 diminish the use of analytical comparisons.

36. Section 2032A provides an alternative estate tax valuation for real property used in farming or other closely held businesses. I.R.C. § 2032A (West 1989). Among other requirements, § 2032A is only available where there was *material participation* and a qualified use of the farming or closely held business by the decedent or member of decedent's family for at least five out of the eight years prior to death (with a qualified use on the date of death). *Id.* § 2032A(b).

precedents under those provisions are not dispositive of material participation under section 469. Congress intended<sup>37</sup> the statute's regular, continuous and substantial involvement criteria to be interpreted as expanding the concept's usage within section 469 beyond its current interpretations under sections 1402(a) or 2032A.<sup>38</sup> This extension beyond established usages has raised interpretative questions as to how far, and in what manner, Congress intended to alter the term's current meaning. While the ultimate determination of congressional intent is for the courts, the statute's extensive delegation of interpretive authority to the Secretary of the Treasury<sup>39</sup> makes the regulations the current focus of attention.<sup>40</sup> The manner in which the Secretary has exercised this

The benefits of alternative valuation are contingent upon continued qualified use and *material participation* for at least 10 years. *Id.* § 2032A(c).

As compared with regulations under § 1402(a), the § 2032A regulations are much more restrictive in order to limit taxpayer access to material participation status. Therefore, in contrast to § 1402(a), the pro-taxpayer posture of § 2032A's material participation standard causes § 2032A to be a more appropriate model of the congressional intent for the standard under § 469. For a discussion of material participation, see *infra* notes 150-64 and accompanying text.

37. 1986 BLUE BOOK, *supra* note 19, at 237.

38. See 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 732; see also *infra* notes 150-64 and accompanying text.

39. Section 469(l) provides:

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations—

(1) which specify *what constitutes an activity, material participation, or active participation* for purposes of this section,

(2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),

(3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,

(4) which provide for the determination of the allocation of interest expense for purposes of this section, and

(5) which deal with changes in marital status and changes between joint returns and separate returns.

I.R.C. § 469(l) (West Supp. 1989) (emphasis added).

40. Regulations can be broadly categorized into two distinct classes: those which are "interpretative" and those which are "legislative." Westin, *Dubious Interpretative Rules for Construing Federal Taxing Statutes*, 17 WAKE FOREST L. REV. 1, 17 (1981) (citing Rogovin, *The Four R's: Regulations, Rulings, Reliance, and Retroactivity—A View From Within*, 43 TAXES 756 (1965)).

Absent a specific statutory directive, the Secretary nonetheless may issue rules and regulations for any Code provision pursuant to his general rule-making power under § 7805(a). Regulations issued pursuant to this power are termed interpretative. Although these interpretative regulations do not have the force of law, they are accorded some weight. *Id.* at 18.

Legislative regulations, on the other hand, are issued pursuant to the directive of a specific Code provision (e.g., § 469(l)). *Id.* at 17. As a consequence they are regarded as having the status of law, and therefore are presumed correct and seldom invalidated. *Id.* at 17 n.133 (quoting J. CHOMMIE, FEDERAL INCOME TAXATION 13 (2d ed. 1973)).



power will be the focus of upcoming sections.

### III. EXISTING TAX SHELTER PROVISIONS

A review of existing tax shelter provisions will provide an appreciation of the extent to which the passive loss provisions have extended the tax shelter concept. This historical backdrop will frame the tax shelter problem from a congressional viewpoint and supply a reference point from which the legislative intent for section 469 can be assessed.

Pre-1986 Act tax shelter provisions have two forms: quantitative and qualitative. The former relies upon a quantitative formula to cap a taxpayer's overall benefit from tax preference items,<sup>41</sup> while the latter generally tries to disallow tax benefits derived from improperly motivated investments.

#### A. Quantitative Provisions

##### 1. *The Alternative Minimum Tax (AMT)—Sections 55-59*

The AMT is a parallel system of income taxation designed to ensure that taxpayers who have claimed substantial tax preference deductions and credits pay at least a minimum level of tax.<sup>42</sup> To arrive at alternative minimum taxable income,<sup>43</sup> the AMT recalculates ordinary taxable income through an addback of deductions designated as tax preference items.<sup>44</sup> Tax shelter investors are generally sensitive to the AMT, in that most tax shelters are designed to generate substantial tax preference items.<sup>45</sup>

##### 2. *Limitation on Investment Interest—Section 163(d)*

Investment interest expense is defined as "any interest . . . which is paid or accrued on indebtedness incurred or continued to purchase or

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41. Tax preference items are deductions and credits which have been granted preferential treatment by the Code, generally created by Congress to benefit a specific class of taxpayer. [1989 Index] Stand. Fed. Tax Rep. (CCH) ¶ 300.09, at 8818; *see also* S. LEIMBERG, M. SATINSKY, J. IVERS, E. KRADER & A. PARKER, STANLEY & KILCULLEN'S FEDERAL INCOME TAX LAW 2-28 (1988) [hereinafter STANLEY & KILCULLEN].

42. [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 300.09, at 8818; *see also* STANLEY & KILCULLEN, *supra* note 41, at 2-27.

43. *See* I.R.C. § 56 (West Supp. 1989) (listing specific adjustments necessary for computing taxpayer's alternative minimum taxable income).

44. Tax preference items are detailed in I.R.C. § 57.

45. [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 300.03, at 8805.

carry property held for investment."<sup>46</sup> The frequent use of leverage<sup>47</sup> in tax shelters' capital structures has given the investment interest limitation rules a significant impact in this area.<sup>48</sup> A taxpayer's aggregate investment interest expense is deductible only to the extent of net investment income.<sup>49</sup> This provision parallels the passive loss rules in that it isolates a specific character of income or expense, and prevents investment interest deductions from sheltering any non-investment income.

### 3. *The At Risk Rules—Section 465*

Most tax shelters are designed around a leveraged capital structure. To the extent that a capital structure was leveraged with nonrecourse financing,<sup>50</sup> tax shelter investors, prior to enactment of section 465, could generate total deductions in excess of their actual economic exposure.<sup>51</sup> In response, Congress created the section 465 at risk rules to limit an investor's aggregate deductions from any specific activity to his personal liability in that activity. Its most fundamental premise, in this regard, is that a taxpayer is generally *not* at risk with respect to nonrecourse debt or indemnified liabilities.<sup>52</sup>

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46. I.R.C. § 163(d)(3)(A) (West Supp. 1989). Section 163(d)(5)(A) specifies that for purposes of the subsection (dealing with limitation on investment interest) the term "property held for investment" shall include

- (i) any property which produces income of a type described in section 469(e)(1), and
- (ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business—
  - (I) which is not a passive activity, and
  - (II) with respect to which the taxpayer does not materially participate.

*Id.* § 163(d)(5)(A). Section 469(e)(1) specifies interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business, as well as any gain or loss from the sale of such property or any property held for investment. *Id.* § 469(e)(1).

In very general terms, the investment interest rules provide that a taxpayer's allowable deduction cannot exceed his net investment income (§ 163(d)(1)), and that unused deductions are to be carried forward (§ 163(d)(2)).

47. "Leverage," in the business sense, is the intensification of an entity's return or loss on equity through use of debt. BLACK'S LAW DICTIONARY 816 (5th ed. 1979). For example, assume company "A" is capitalized with \$100 in stock, while company "B" has \$10 in stock and \$90 in bonds. If company "A" earned \$15, and company "B" earned \$5 (\$15 less \$10 in interest expense), company "A" would have a 15% return on equity while company "B" would have a 50% return on equity.

48. [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 300.09, at 8818.

49. I.R.C. § 163(d)(1) (West Supp. 1989).

50. Nonrecourse financing is a "[t]ype of security loan which bars the lender from action against the borrower if the security value falls below the amount required to repay the loan." BLACK'S LAW DICTIONARY 953 (5th ed. 1979).

51. [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 300.07, at 8814.

52. *Id.*; see also 1986 Act, *supra* note 1, § 503(a) (striking § 465(c)(3)(D)—

4. *Depreciation Recapture—Section 1245*

One of the cornerstones of tax shelters is the ability to depreciate assets at an accelerated rate,<sup>53</sup> while the property being depreciated enjoys real economic appreciation—the most common example being real estate.<sup>54</sup> The recapture provisions prevent a double benefit (*i.e.*, an ordinary deduction coupled with a subsequent capital gain) by recharacterizing as ordinary income that portion of any realized gain which is attributable to prior years' depreciation deductions.<sup>55</sup>

B. *Qualitative Provisions*

While the preceding quantitative limitations effectively limit a taxpayer's tax preference item benefit, they generally fail to distinguish between the classes of taxpayers receiving the benefit. For example, quantitative limitations fail to distinguish between the family farmer from Wisconsin and the gentleman farmer from Wall Street. They focus on very narrow and specific abuses of the tax system.

However, the 1986 Act shifted from rules governing specific tax preference item abuses to the broad-based material participation concept embodied in section 469. The intent was to restrict tax preference benefits to those whom Congress had intended, *i.e.*, those taxpayers with a "bona fide involvement in the activities to which the preferences related."<sup>56</sup>

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removing real estate's exemption from the at risk rules). However, while the 1986 Act removed real estate's blanket exemption from the at risk rules, it did supply some relief in the form of qualified nonrecourse financing under § 465(b)(6). If an activity acquires qualified nonrecourse financing within the scope of § 465(b)(6), the taxpayer is then considered at risk with respect to such amounts; however, any non-qualified nonrecourse liabilities will be subject to the at risk limitations. *See* I.R.C. § 465 (West 1988).

53. "Depreciation" is the write-off of the cost or other basis of an asset over its estimated useful life. BLACK'S LAW DICTIONARY 397 (5th ed. 1979). Accelerated depreciation methods yield larger deductions in an asset's earlier years (relative to a straight-line method), balanced by proportionately smaller deductions in the later years. Therefore, the estimated useful life and degree of acceleration will impact upon the attractiveness of an investment where the investor is concerned with maximizing tax preference items in the earlier years, as is the case with a tax shelter investor. The 1986 Act reduced depreciation benefits by extending recovery periods, although the effect was mitigated in some areas by allowing for a more rapid/accelerated write-off. 1986 BLUE BOOK, *supra* note 19, at 99-104. But the 1986 Act dealt a triple blow to depreciable real estate, the most popular form of tax shelter investment, by extending recovery periods (from 19 years to 27.5 and 31.5 years for residential and non-residential property, respectively), mandating the straight-line write-off method, and repealing real estate's exemption from the at risk rules. *Id.* at 102-03.

54. [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 300.09, at 8819.

55. Section 1245 requires recapture of all ordinary depreciation deductions, while § 1250, which covers realty, recaptures only the accelerated depreciation deducted in excess of that allowable using the straight-line method. I.R.C. §§ 1245, 1250 (West Supp. 1989).

56. 1986 BLUE BOOK, *supra* note 19, at 212 (emphasis in original).

The passive loss rules extend the tax shelter concept from entities designed to maximize tax preferences to any entity which shifted any deduction, *preferenced or ordinary*,<sup>57</sup> to any individual who was not a "material participant" in the activity.<sup>58</sup> This expanded view transcended existing quantitative provisions, as recognized by Congress in its distinction between the issues of a taxpayer's at risk limitation and his status as a material participant in an activity.<sup>59</sup> However, while section 469's material participant concept is far more expansive than any existing quantitative limitation, the pre-1986 Code was not without the quantitative tools necessary to effect a similar result—principally section 183.

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57. Section 469's legislative history characterizes the question of what constitutes a tax shelter "as closely related to the question of who Congress intends to benefit when it enacts *tax preferences*." *Id.* at 211 (emphasis added). The passive loss rules encompass any loss from an activity—whether preferred or ordinary in nature.

*The passive loss rule applies to all deductions that are from passive activities, including deductions allowed under sections 162, 163, 164 and 165. For example, deductions for State and local property taxes incurred with respect to passive activities are subject to limitation under the passive loss rule whether such deductions are claimed above-the-line or as itemized deductions under section 164.*

*Id.* at 218 (emphasis added).

58. *Id.* at 211.

59. *Id.* at 213. The distinction between at risk (§ 465) and material participation was described as follows:

The distinction that Congress determined should be drawn between activities on the basis of material participation was viewed as unrelated to the question of whether, and to what extent, the taxpayer was at risk with respect to the activities. In general, the fact that a taxpayer placed a particular amount at risk in an activity did not establish, prior to a disposition of the taxpayer's interest, that the amount invested, or any amount, had as yet been lost. *The fact that a taxpayer was potentially liable with respect to future expenses or losses of the activity likewise had no bearing on the question whether any amount had as yet been lost, or otherwise was an appropriate current deduction or credit.*

At risk standards, although important in determining the maximum amount that is subject to being lost, were viewed as not a sufficient basis for determining whether or when net losses from an activity should be deductible against other sources of income, or for determining whether an ultimate economic loss had been realized. Congress concluded that its goal of making tax preferences available principally to active participants in substantial businesses, rather than to investors seeking to shelter unrelated income, was best accomplished by examining material participation, as opposed to the financial stake provided by an investor to purchase tax shelter benefits.

*Id.* (emphasis added). An appended footnote stated:

The at risk rules of prior law, while important and useful in preventing overvaluation of assets, and in preventing the transfer of tax benefits to taxpayers with no real equity in an activity, were viewed as not addressing the adverse consequences arising specifically from such transfers to nonparticipating investors.

*Id.* at 213 n.7.

Section 183 disallows a net loss from any activity which was formed and operated without the requisite economic profit objective. That section relies upon a subjective analysis of the entity's<sup>60</sup> nontax economic profit motive, and it focuses scrutiny at the entity level for determining whether the entity was formed with an economic profit motive. Therefore, under section 183 a tax shelter is any entity formed with tax benefits as its primary purpose.

By 1986 the "activity engaged in for profit" standard, as used in both sections 165(c)(2) and 183, had developed into an effective weapon against tax shelters.<sup>61</sup> Where successfully applied, an activity's net losses and/or deductions are completely disallowed, a much harsher consequence than section 469's suspension.<sup>62</sup> Given the Service's success with section 183,<sup>63</sup> one wonders why Congress did not, as an alternative to section 469, codify the rationale of those cases which had expanded the reach of section 183.<sup>64</sup> The answer may lie in the funda-

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60. See I.R.C. § 183 (West Supp. 1989). Application of § 183's profit-motive criteria at the activity level served to diminish the impact the statute had when applied to each individual investor. See *Ronnen v. Commissioner*, 90 T.C. 74, 91 (1988) ("Essential [to the application of § 183] is a demonstration that [the entity] had an 'actual and honest objective of making a profit.'") (citation omitted). For an extensive discussion of the level at which profit motive is to be determined, see *Brannen v. Commissioner*, 78 T.C. 471, 501-05 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984).

61. See *Smith v. Commissioner*, 78 T.C. 350, 394-95 (1982) (finding "that the [taxpayers] lacked the requisite economic profit objective necessary to enable them to deduct their commodity tax straddle losses [under § 165(c)(2)'s transaction entered into for profit standard]"), *aff'd*, 820 F.2d 1220 (4th Cir. 1987); see also *Brannen*, 78 T.C. at 512-13 (tax court made controversial extension of § 183's "activities not engaged in for profit" test for a non-hobby activity—a movie distribution limited partnership). For expanded coverage of the developments under § 183 in the tax shelter area, see *Detailed Analysis*, Tax Mgmt. (BNA) No. 241-4th, at A-11 to A-13 (1989).

62. Section 469(b) provides an unlimited carryover for suspended passive losses. These losses have three possible means for release: first, they are available to offset the originating activity's future net active or passive income, but not investment income (§ 469(f)(1)(A)); second, they may offset the taxpayer's future aggregate net positive passive income (§ 469(f)(1)(C)); and finally, upon disposition of the taxpayer's entire interest in the respective activity, the passive loss is released and applied against any class of income (§ 469(g)). I.R.C. § 469 (West Supp. 1989).

63. For examples of the successful application of § 183 to tax shelters during 1986, see *Powell v. Commissioner*, 52 T.C.M. (CCH) 163 (1986) (marketing license for oscillating toothbrush did not involve profit objective); *Goldstein v. Commissioner*, 52 T.C.M. (CCH) 9 (1986) (disallowing loss from Amway distributorship where minimal amount of time devoted to enterprise by taxpayers was significant factor in court's decision); *Finoli v. Commissioner*, 86 T.C. 697 (1986) (holding limited partnership formed to acquire and exploit community antenna television (CATV) system lacked requisite profit objective under § 183). *But see Gefen v. Commissioner*, 87 T.C. 1471 (1986) (computer leasing enterprise found to be activity engaged in for profit).

64. As of 1986, a debate existed as to whether § 183 required a dominant economic (non-tax) profit motivation, or whether entering into the venture with merely a *bona fide* (as distinguished *reasonable*) profit objective was sufficient. See,

mental differences in approach taken by sections 183 and 469 to the tax shelter issue.<sup>65</sup>

Section 183's profit-motive criteria is applied against the activity's characteristics, and this single determination controls the activity's characterization for all investors. In contrast, section 469's taxpayer-level operation requires that a separate, and sometimes independent, analysis be made of each investor.<sup>66</sup> Therefore, it is possible, and quite likely, for an activity to be passive with respect to one investor and active with respect to another. The investor's relation to the activity is the sole cri-

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*e.g.*, Jaros v. Commissioner, 49 T.C.M. (CCH) 548 (1985); Lemmen v. Commissioner, 77 T.C. 1326, 1339-47 (1981); Hager v. Commissioner, 76 T.C. 759, 784-88 (1981); *see also* Johnson v. United States, 11 Cl. Ct. 17, 26 (1986).

In a recent interpretation of § 183, the Tax Court held that the entity need not have a reasonable expectation of profit, but must merely possess a *bona fide* profit objective. *Ronnen*, 90 T.C. at 92 (rejecting Service's tax shelter claim against S Corporation formed to purchase and market computer software within nursing home industry).

65. A codified standard requiring a dominant or primary economic profit motive would have attacked the primary deficiencies listed as the impetus for adoption of the material participation standard. Congress intended the material participation standard to ensure that an "investor [would] approach the activity with a significant non-tax economic profit motive, and . . . form a sound judgment as to whether the activity had genuine economic significance and value." 1986 BLUE BOOK, *supra* note 19, at 212. Specifically, Congress' intended target was "the more passive investor" who viewed tax benefits as the primary component of return on capital. *Id.* Moreover, Congress targeted not only tax-motivated investors, but also taxpayers whose involvement in an enterprise did *not* represent "an ongoing source of [their] livelihood." *Id.* The gentleman farmer was often singled out as a primary example of congressional motivation for the passive loss provisions:

In some cases, the availability of tax preferences to nonparticipating investors was viewed as harmful to the industries that the preferences were intended to benefit. *For example*, in the case of *farming*, credits and *favorable deductions often encouraged investments by wealthy individuals whose principal or only interest in farming was to receive an investment return, largely in the form of tax benefits to offset tax on positive sources of income.* Since such investors often did not need a positive cash return from farming in order to profit from their investments, they had a substantial competitive advantage in relation to active farmers, who commonly were not in a position to use excess tax benefits to shelter unrelated income. This significantly contributed to the serious economic difficulties being experienced by many active farmers.

*Id.* at 211-12 (emphasis added).

It is apparent that § 183, even in an expanded form, would not possess § 469's scope of application. This distinction stems from the functional difference in each section's implicit definition of a tax shelter. While § 183 defines a tax shelter as any activity entered into without a *bona fide* profit objective (or references to *bona fide* profit, see *supra* note 65), § 469 classifies a tax shelter as any passive vehicle which generates any tax benefits. *See* 1986 BLUE BOOK, *supra* note 19, at 212.

66. Under § 469 an activity may be composed of both material and non-material participants (by reason of its taxpayer-level analysis), whereas a characterization under § 183 effects a uniform result on all the activity's investors. *See* I.R.C. §§ 469, 183 (West Supp. 1989).

terion, rather than the characteristics possessed by the activity itself, so long as the activity constitutes a trade or business other than a rental activity. This taxpayer-level analysis serves to intensify section 469's impact upon tax-motivated investors. In contrast, section 183's impact was diminished when the profit-objective analysis was restricted to the entity level. An entity level analysis allows taxpayers without a profit objective to skirt section 183 on the coattails of profit-motivated investors.

Beyond these operational distinctions, the substantive nature of section 469's material participation requirement imposes a far heavier burden on the taxpayer than section 183's profit-motive criteria. As explained below, section 469 is an additional hurdle that the taxpayer must clear. Further, while the exact criteria used to determine material participation is under debate,<sup>67</sup> even the most relaxed interpretation of the three material participation criteria (regular, continuous and substantial) would impose a greater evidentiary burden than that required to demonstrate a non-tax profit motive.

These substantive and operational differences make section 469 a far more effective weapon against tax shelters than section 183. However, as discussed earlier, this improved weapon relies upon a far more expansive definition of a tax shelter.<sup>68</sup> Congress, in attempting to isolate bona fide participants in an activity, has created a statute with a potential application far beyond the rich individuals who invest in traditional tax shelters.<sup>69</sup> The passive loss rules attack not only the gentleman farmer for whom Congress expressed concern,<sup>70</sup> but also have

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67. For a discussion of material participation, see *infra* notes 150-64 and accompanying text.

68. For further discussion of the definition of tax shelter, see *supra* note 41 and accompanying text.

69. "Traditional" tax shelter industries include: motion picture production or distribution ventures; real estate (a very popular form of tax shelter prior to the 1986 Act's specific assault upon the unique benefits produced by real estate); farming ventures (also an extremely popular pre-1986 Act tax shelter vehicle—the Senate Finance Committee Report specifically attacks a check-a-box, cattle-feeding activity); coal tax shelters; shelters engaging in commodity options and futures activity; equipment leasing shelters; research and development shelters; and energy tax shelters. TAX SHELTERS—EXAMINATION HANDBOOK (I.R.S.) (1985), reprinted in [1989 Index] Stand. Fed. Tax Rep., *supra* note 41, ¶ 302, at 8836. Congress specifically exempted working interests in oil and gas properties from the passive activity rules. See I.R.C. § 469(c)(3)(A) (West Supp. 1989).

70. See Gen. Couns. Mem. 39,529 (July 16, 1986). That General Counsel Memorandum was interpreting pre-1986 Act law. The specific issue addressed was "[w]hether interest incurred to purchase S Corporation stock [was] investment interest subject to the investment interest deduction limitation, where under section 163(d) of the Code, the S Corporation held no investment assets and the purchasers were employees of the S Corporation actively involved in its management."

The Service concluded that there was no basis to distinguish between the acquisition of C Corporation stock and S Corporation stock. Finding no basis for differentiation, the Service fell back to the well-settled position that a business interest is a capital asset held for investment purposes, and therefore the

the potential to hinder numerous legitimate non-tax-orientated activities—section 469's most ominous impact lies in those areas never before perceived as tax shelters.

#### IV. INTEGRATION OF SECTION 469 WITH OTHER CODE PROVISIONS

While this Comment's primary focus is not section 469's integration with other code provisions, integration issues can be helpful in identifying the statute's scope, as well as raising questions of legislative intent.

##### A. *The Investment Interest Limitation Rules of Section 163*

The most significant impact of section 469, with respect to section 163, is its effect on the characterization of interest payments made on indebtedness incurred to acquire an interest in a pass-thru entity. Prior to the 1986-Act there was no distinction between interest payments related to acquisition indebtedness of an interest in a pass-thru entity, as opposed to an interest in sub-chapter "C" corporation.<sup>71</sup>

The addition of section 469 to the Code required modification to the definition of investment interest. Section 469(e)(1)(A) of the Code now requires that interest expense related to an activity's portfolio investments be segregated, and not taken into account, in determining the activity's trade or business income. Accordingly, since section 469(e)(1)(A) has already identified the portfolio (investment) related interest, section 163(d)(3)(B) of the Code was added to provide that the term "investment interest" shall not include any interest expense taken into account under section 469 in computing the trade or business income of an activity. The Service has stated that yet to be issued temporary regulations will provide generally that interest expense will be allocated in accordance with how the proceeds from the underlying indebtedness are utilized.<sup>72</sup> Indebtedness related to the acquisition of an interest in a pass-thru entity is no longer simply attributed to the equity interest. Interest expense related to the acquisition of a pass-thru entity will be deductible as a trade or business expense to the extent the underlying assets are utilized in a trade or business activity in which the taxpayer materially participates.

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interest related to such an asset would be investment interest subject to the investment interest limitation rules contained in section 163(d).

71. Section 469(1)(4) of the Code provides that the Secretary shall prescribe regulations which provide for the determination of the allocation of interest expense for purposes of section 469. While these regulations are still pending, the Service has announced that "the temporary regulations will provide that, for purposes of sections 163(d), 163(h), and 469 of the Code, interest expense (other than qualified residence interest) generally is allocated on the basis of the use of the proceeds of the underlying debt." 1987-3 I.R.B. 17.

72. See *id.*; see also Starr, *S-Corporations*, Tax Mgmt. (BNA) No. 60-7th, at A-47 to -48.



B. *Section 183*

As previously stated, section 469 imposes an additional hurdle to the section 183 profit-motive requirement. Thus, while a taxpayer's participation level is important, a material participant is not presumed to possess the requisite profit objective required by section 183.<sup>73</sup> Any net loss from an activity, whether currently allowable or suspended, will be completely disallowed unless the activity possessed the requisite non-tax economic profit objective. Section 469, therefore, does not preempt section 183, but is complementary thereto.

The most troublesome example of section 183's application to passive losses would be where the taxpayer accrues passive losses for several years, disposes of his entire interest, but is precluded from using those losses by reason of an audit determination that section 183 applied to the originating loss years (*i.e.*, due to the application of section 183, the loss carryforward would be disallowed because there was no valid loss for section 469 to disallow and carryforward).

C. *The Statute of Limitations*

An important question unanswered by the above example is how far back can an audit reach—is the taxpayer's exposure limited to the last three years, or is the validity of the entire loss carryforward subject to review?

Section 469(b) provides for an unlimited carryover of a disallowed passive loss. Where a taxpayer has an activity which is a consistent passive loss generator, these losses will remain suspended, absent passive activity income from some other source, until the disposal of the taxpayer's entire interest in the activity.<sup>74</sup> This unlimited carryforward causes the original loss year to remain open with respect to an activity's items of passive income and deductions.<sup>75</sup> That is, the original loss year is closed for purposes of a deficiency assessment; however, the Service could recompute carry-over items which are being carried forward to an open year (*i.e.*, a year on which the limitations period has not run).

While the effect of section 469(b)'s unlimited carryover provision on section 6501(a)'s three-year assessment period has yet to be officially addressed, the above conclusion can be supported by reference to interpretations of section 172<sup>76</sup> in analogous circumstances. In a recent revenue ruling the Service stated, "[i]n determining the amount of a net operating loss that may be carried from a closed year forward to an open

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73. See, *e.g.*, *Detailed Analysis*, *supra* note 61, at A-11 to A-13.

74. I.R.C. § 469(g)(1) (West Supp. 1989).

75. For example, the Service may challenge a passive loss carryforward claimed in the year of disposition (1995) on the grounds that in the original loss years (1987-1990) § 183 foreclosed any net deduction whatsoever.

76. Section 172 governs net operating loss (NOL) deductions. I.R.C. § 172 (West Supp. 1989).

year . . . all adjustments to taxable income, whether or not barred by the statute of limitations, will be [subject to review]."<sup>77</sup> In light of the taxpayer's burden of proof,<sup>78</sup> this potential unlimited review imposes a heavy record retention requirement on the taxpayer.

D. *The At Risk Rules (§ 465) and Basis Limitations on Losses of a Partner (§ 704(d)) or S Corporation Shareholder (§ 1366(d))*

When determining a taxpayer's passive losses under section 469, the at risk and basis limitation rules are calculated prior to any passive loss classification.<sup>79</sup> Therefore, a passive loss will reduce a taxpayer's basis and amount at risk in an activity, even if these otherwise permissible losses are suspended by the passive loss provisions.<sup>80</sup>

E. *Tiered Structure Integration*

Although this analysis of the interplay between section 469 and the Code's other tax shelter provisions is not yet complete, a graphic summary at this point will illustrate the previous discussion and highlight the subsequent material:

77. Rev. Rul. 81-88, 1981-1 C.B. 585, 587.

78. See I.R.C. § 7422(e) (West 1989).

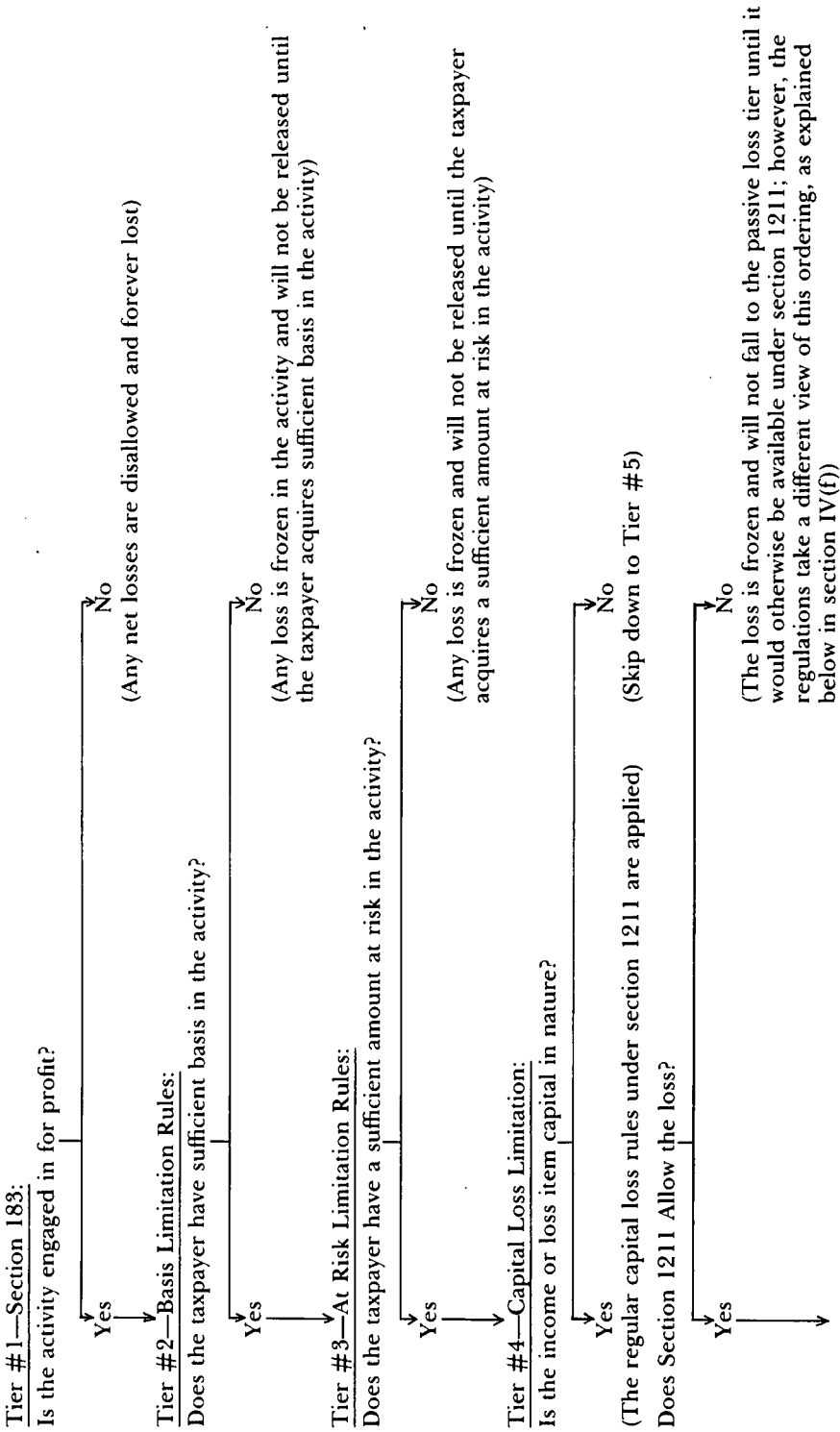
79. The legislative history specifically states:

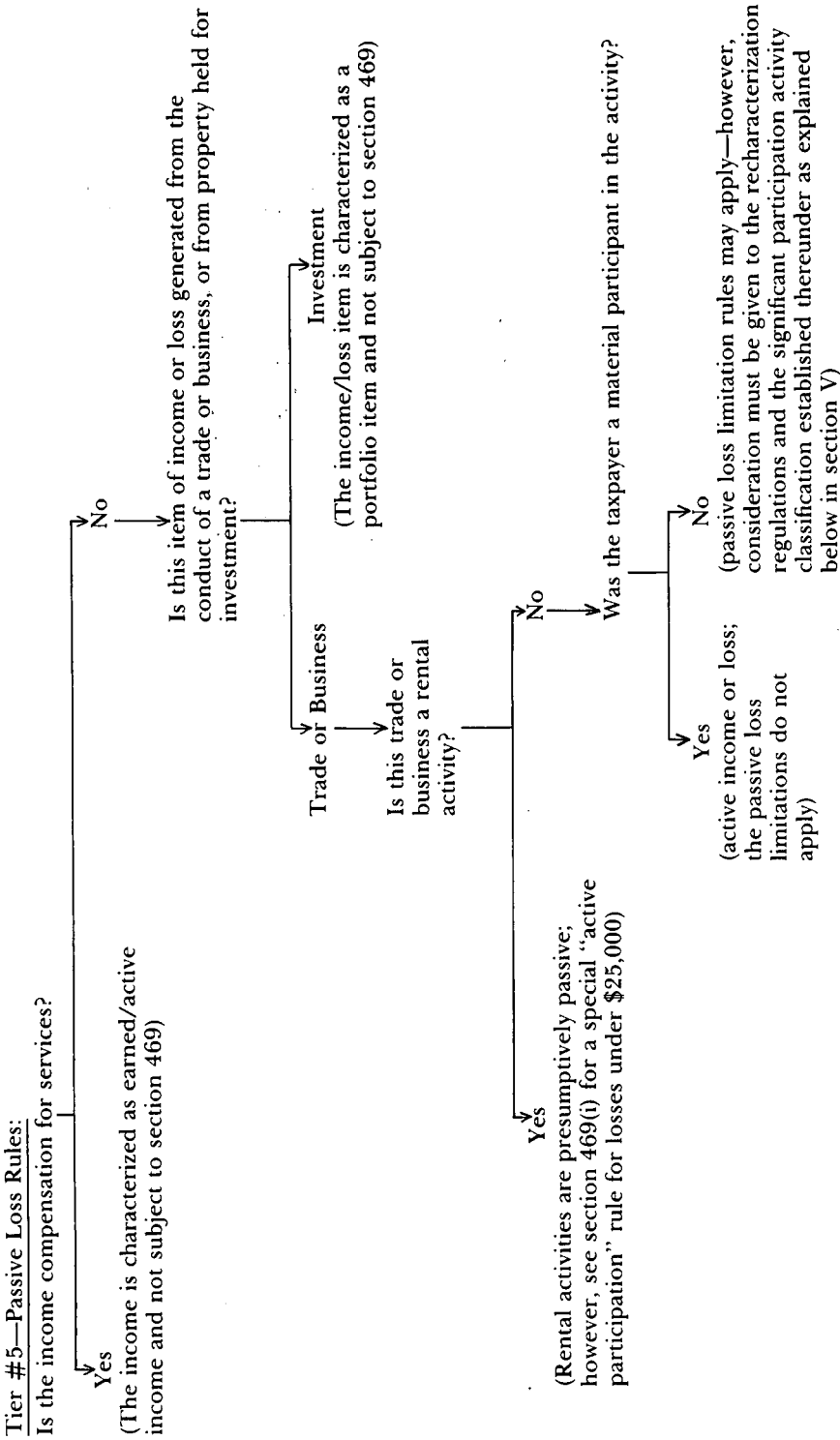
The determination of whether a loss is suspended under the passive loss rule is made after the application of the at-risk rules. A loss that would not be allowed for the year because the taxpayer is not at risk with respect to it is suspended under the at-risk provision, not the passive loss rule. Such amounts may become subject to the passive loss rule in subsequent years when they would be allowable under the at-risk rule. [An appended footnote stated:]

Amounts at risk are reduced even if deductions which would be allowed under the at-risk rules are suspended under the passive loss rule. Similarly, basis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule. However, if an amount at risk or basis has been reduced by a deduction not allowed under the passive loss rule, the amount at risk or basis is not again reduced when the deduction becomes allowable under the passive loss rule.

1986 BLUE BOOK, *supra* note 19, at 223 & n.17 (emphasis added).

80. *Id.* at 223.





The ordering of tiers four and five of the diagram is based upon the legislative history and the specific language of section 469(g)(1)(C) as enacted by the 1986 Act.<sup>81</sup> The regulations reverse tiers four and five and have the capital loss limitations applied after the passive loss limitations. The Service's position appears to have been incorporated by reference into changes made by the 1988 Act. However, neither the 1988 Act, nor its legislative history, indicates a specific intent to reverse the 1986 Act's ordering. The argument against the regulations is weakened by the 1988 Act's change to the statute.<sup>82</sup>

The Code's tiered structure provides a taxpayer with an opportunity to control when the loss falls to the passive loss level. Therefore, the loss item's character may be controlled to the extent a taxpayer can circumvent the recharacterization regulations<sup>83</sup> and change his status from passive to active, or vice versa.

For example, assume a taxpayer whose only passive activity is an investment as sole shareholder in an S Corporation. The S Corporation is expected to have a \$30,000 loss in the current year, and do no better than break-even in the future. Due to the prior years' losses, the taxpayer's basis in the stock of the S Corporation has been reduced to zero, and his debt basis stands at \$40,000, which is also the principal balance on such indebtedness. Under this capital structure, the \$30,000 current year loss would be allowed by the at risk and basis limitation rules, but suspended by section 469. Given an earnings forecast of no better than break-even, the suspended loss would not be utilized until the taxpayer disposed of his entire interest. The result would remain unchanged even if the taxpayer were successful in obtaining an active status in subsequent years. This is due to section 469(f)(1)(C), which provides that once a loss is tainted as passive it remains passive, irrespective of any subsequent change in the taxpayer's status.

However, the regulations, in combination with the at risk or basis limitation rules, provide a means to circumvent section 469(f)(1)(C). Treasury Regulation section 1.469-2T(d)(8) provides that passive or active characterization under section 469 does not occur until such time as the loss would have been otherwise deductible without regard to the

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81. 1986 BLUE BOOK, *supra* note 19, at 227-28. Section 469(g)(1)(C), as passed by the 1986 Act, read as follows: "In the case of any loss realized on the disposition of an interest in a passive activity, section 1211 shall be applied before subparagraph (A) is applied." 1986 Act, *supra* note 1, § 501 (amended 1988). Public Law Number 100-647, § 1005(a)(2)(B) amended § 469(9)(1)(C) of the Code to read as follows: "To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section."

82. For a further discussion of this issue, see *infra* notes 85-90 and accompanying text.

83. For a discussion of the recharacterization regulations, see *infra* notes 107-32 and accompanying text.

operation of sections 469, 613A(d) and 1211. Therefore, the taxpayer in the above example could utilize the \$30,000 loss, prior to the disposition of his entire interest, if he could trap the loss above the passive loss tier and release it in a year in which his status had turned active.

The trap-and-release could be effected through manipulation of the basis limitation rules. For example, in the above hypothetical the S Corporation could repay the \$40,000 loan prior to year end, reduce the taxpayer's debt basis to zero, and the loss would be suspended and carried forward indefinitely by operation of section 1366(d).<sup>84</sup> The taxpayer could release the suspended loss through a capital contribution in a year in which the taxpayer obtained active status. Treasury Regulation section 1.469-2T(d)(8) would require classification in the release year, which would allow the taxpayer to claim an active loss deduction in that year. However, practical limitations always must be considered. For instance, can the S Corporation afford to repay the loan? Where the S Corporation cannot afford to repay the loan, could the loan be replaced shortly after each year end's repayment without creating a sham transaction? Will the recharacterization regulations prevent the taxpayer from changing his status?

#### F. Capital Loss Limitation (§ 1211)

The legislative history to the 1986 Act specifically sets forth that "[t]he limitation on the deductibility of capital losses is applied *before* the determination of the amount of losses allowable upon the disposition under the passive loss rule."<sup>85</sup> However, the regulations appear to apply the passive loss provisions prior to the capital loss limitation calculation.<sup>86</sup>

84. This result is predicated on the shareholder having a basis in the indebtedness equal to the principal amount of such indebtedness. Note that if the shareholder's basis in the indebtedness had been reduced below its principal balance, then the S Corporation's repayment of the principal would cause the lender/shareholder to recognize income on such repayment equal to the repayment multiplied by a fraction—with the numerator being the basis reduction that has occurred on the indebtedness, and the denominator, the principal balance of such indebtedness. See Abramson & Eberhardt, *A Practical Approach to the Successful Capitalization of an S Corporation*, J. TAX'N OF S CORPORATIONS 16, 16-17 (Summer 1989). Therefore, if in the above example the indebtedness was repaid in the following year (*i.e.*, after the \$30,000 loss had reduced the shareholder's basis in the indebtedness to \$10,000), a \$10,000 repayment would cause the lender/shareholder to recognize \$7,500 income.

85. 1986 BLUE BOOK, *supra* note 19, at 227-28.

86. The temporary regulation reverses the statutory order of application as follows:

(2) A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 1211. The following example illustrates the application of this paragraph (d)(2):

*Example.* In 1987, an individual derives \$10,000 of ordinary income from passive activity X, no gains from the sale or exchange of

The difference between these two positions can be exemplified as follows. Assume an individual investor in a limited partnership, panicked by the crash of 1987, sells one-half of his interest for a \$20,000 capital loss. Despite realizing the loss, section 469(g) defers recognition until disposition of the "entire interest" in the activity. The remaining interest is sold in 1991 for a gain of \$3,000. The taxpayer has no other passive or capital transactions in 1991. Under Treasury Regulation section 1.469-1T(d)(2), the taxpayer would recognize a \$3,000 capital loss, with the remaining \$14,000<sup>87</sup> carried over under section 1212. The regulation's application of section 469 prior to section 1211 denies the taxpayer the benefit of section 1211(b)'s \$3,000 annual allowance for the intervening years, 1987 through 1990. Therefore, under the regulation's approach and assuming the taxpayer had no capital transactions in the subsequent years, the remaining \$14,000 would not be fully recognized until 1996 (*i.e.*, \$3,000 per year  $\times$  5 years).

In the alternative, if the capital loss provisions are applied prior to section 469, the capital loss to be recognized in 1991 should be computed with reference to what would have been allowed under section 1211 in the intervening years (*i.e.*, 1987-1990) without regard to section 469(g). Under the ordering described by the legislative history, the taxpayer would be entitled to a \$15,000 capital loss deduction in 1991, assuming no capital transactions in the intervening years. The deduction would be composed of the current (1991) year's \$3,000 section 1211(b) deduction, plus any section 1211(b) deduction which would have been allowed in each of the four intervening years without regard to section 469(g). Further, this amount would be increased by any capital gain recognized in the intervening years, and reduced to the extent the \$3,000 section 1211(b) deduction was otherwise utilized during those years.

Prior to the 1988 Act, section 469(g)(1)(C) referred to *realized* losses. The term *realized* refers to a transaction's economic conse-

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capital assets or assets used in a trade or business, \$12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of § 1.469-2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed \$10,000 of the \$12,000 passive activity deduction and has a \$2,000 passive activity loss for the taxable year. Since the \$10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed \$3,000 of the \$10,000 capital loss under section 1211 and has a \$7,000 capital loss carryover (within the meaning of section 1212(b)) to the succeeding taxable year.

Temp. Treas. Reg. § 1.469-1T(d)(2) (1988); *see also* *Passive Loss Rules*, Tax Mgmt. (BNA) No. 454, at A-43 (1988) (interpreting above regulation as requiring § 1211's capital loss limitation to be applied *after* application of passive loss provisions).

87. The \$20,000 loss reduced by the \$3,000 capital gain and \$3,000 § 1211(b) allowance.

quences.<sup>88</sup> *Recognized* refers to whether the realized transaction will be allowed to be reflected in the calculation of the taxpayer's taxable income.<sup>89</sup> The pre-1988 Act section 469(g)(1)(C)'s explicit reference to a *realized* loss, combined with its directive to apply section 1211 prior to section 469, gave substance to the position that the section 1211 limitation was to be calculated, and given effect, in the year of economic *realization*—with any allowable benefits passed down to the passive loss tier, which would suspend the loss until it could be recognized under section 469(g)(1).

As discussed above, the 1988 Act amended section 469(g)(1)(C), deleting its specific directive for the application of section 1211 prior to section 469. The 1988 Act change weakens the proposed alternative position to the regulation's integration of sections 1211 and 469. However, the alternative position still retains support from the 1986 Act's legislative history and the statute's overall purpose.<sup>90</sup>

While the above circumstances will not be faced by numerous taxpayers, it nonetheless should be an issue that will receive some attention in the near future since recognition of any loss in excess of \$3,000 will trigger an immediate inquiry by the Service. Any taxpayer adopting this alternative position to the regulations should anticipate a challenge and ensure that the potential benefit outweighs the expected costs of litigation. Further, given the lack of authority on this point, a taxpayer adopting this position would be well advised to disclose his position on his return to avoid any substantial understatement penalty.

## V. ISSUES OF STATUTORY CONSTRUCTION RAISED BY THE REGULATIONS

The preceding section discussed issues pertaining to section 469's integration with the Code's other tax shelter provisions. While relevant, those issues pale in significance to the impact made by the material participation and recharacterization regulations. The statute's broad delegation of power to the Secretary of the Treasury over these areas<sup>91</sup> allows the regulations<sup>92</sup> to redefine section 469's impact. How the Secretary has exercised this power will be this Comment's remaining focus.

88. See I.R.C. § 1001(a) (West 1988); see also BLACK'S LAW DICTIONARY 1137 (5th ed. 1979).

89. See BLACK'S LAW DICTIONARY 1143 (5th ed. 1979).

90. Section 469's purpose is to *defer* recognition of an activity's tax benefits until such time as the actual economic loss can be determined (*i.e.*, upon the taxpayer's disposition of his entire interest in the activity). However, the regulation's position defers recognition of a suspended passive capital loss well beyond the year of disposition. By contrast, the alternative position is consistent with the statute's intent. This approach accrues each year's unused capital loss limitation that would have been available to the taxpayer, but for section 469. 1986 BLUE BOOK, *supra* note 19, at 213.

91. See I.R.C. § 469(l)(1) (West Supp. 1989).

92. T.D. 8175, 53 Fed. Reg. 5686 (1988).



A. *Establishing Material Participation Under the Regulations*

The regulations have constructed seven alternatives by which a taxpayer may establish material participation status. The first six are mechanical tests which if met require the taxpayer to be treated as a material participant in an activity. The seventh is a catch-all facts-and-circumstances alternative. These criteria are:

(a) [A]n individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interest in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the 10 taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (b) of this section), and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all the facts and circumstances (taking into account rules and paragraph (b) of this section), the individual participates in the activity on a regular continuous and substantial basis during such years.<sup>93</sup>

The first three alternatives represent a pure quantitative measurement of material participation. The fourth test provides for what appears to be a quite favorable result, but one which is turned on its head by the recharacterization regulations. Finally, the Service provides a "facts-and-circumstances" test (the seventh alternative), which is

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93. Temp. Treas. Reg. § 1.469-5T(a) (1988).

designed as a backstop to the first four quantitative provisions. Together, these five alternatives comprise the material participation regulation's primary operational provisions. The remaining fifth and sixth alternatives are anti-abuse provisions, designed to thwart passive income characterization where historic participation in the activity does not warrant that classification.

In general, a regulation's primary function is to provide taxpayers with guidance on compliance with ambiguous statutory provisions. It is through these rules and standards that the Secretary exercises his interpretative powers. Therefore, an examination of the regulations in an application format provides the best context for illuminating specific interpretative positions of the Secretary.

### 1. *The More Than 500 Hours Test*

The over 500 hours criteria raises few questions other than interpretative issues over the quantitative approach and scope of activities to be included in participation.<sup>94</sup>

### 2. *The Substantially All Test*

The "substantially all activity required" alternative appears to be addressed to a one-man operation scenario. For example, an individual who devotes eighty hours a year running an automotive repair shop out of his garage, and who is the only individual engaged in that activity, will be deemed to have materially participated without regard to total time spent.<sup>95</sup>

Important to this example, as well as to the entire concept of material participation, is the fact that an agent's or employee's participation (other than a spouse)<sup>96</sup> cannot be attributed to the taxpayer.<sup>97</sup> Therefore, in the above example, if business picked up and the taxpayer increased his participation to ninety hours, and engaged his son to contribute forty additional hours, the taxpayer would not be deemed a material participant because the taxpayer's activity was not substantially all of the participation required (alternative two), and did not exceed 100 hours (the minimum hourly participation required under alternative three).<sup>98</sup> Query: Has the regular, continuous and substantial nature of

94. For a discussion of these issues, see *infra* notes 150-64 and accompanying text.

95. Lipton, *supra* note 5, at 241.

96. Section 469(h)(5) allows spouses' involvement in an activity to be aggregated for purposes of determining material participation. I.R.C. § 469(h)(5) (West Supp. 1989).

97. 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 735.

98. For further discussion of the issue, see PASSIVE LOSS TASK FORCE, *supra* note 5, at 63 example a. The example provides:

Sam sells automobiles. He decides to start a company converting mini-vans into campers. Initially, he spends his Sundays doing camper conversions, but later the demand outstrips his ability to convert vans

the father's activity changed?

### 3. *The Most Active Participant Test*

Alternatively, changing the taxpayer's participation in the above example to 150 hours illustrates compliance with the regulations' third alternative requiring that no one was a more active participant, and the taxpayer participated a minimum of 100 hours. This regulation's practical effect is to limit low hourly participation activities to one material participant.

For example, partners A and B operate a Sunday newspaper stand at a loss due to their having bid too high for the local church's concessions. Neither A's nor B's participation in the activity exceeds 500 hours, and this is the only activity in which either is engaged. In order for each partner to be a material participant (under alternative three), each partner must participate no more or no less than the other.<sup>99</sup> Therefore, if A missed two weeks of work because of illness, the regulations would deny him material participant status. The rule's inequity becomes obvious: Why does 45% participation lack materiality in the case of two otherwise equal partners, while 33% participation would have satisfied the requirement if A and B had hired an employee and split the workload evenly?

Where an activity requires less than 500 man-hours of participation, the regulations operate to allow only one material participant.<sup>100</sup> However, neither the language of the statute nor its legislative history implies that low hourly participation activities permit only one material participant. The statute gives no indication that its "regular . . . continuous, and . . . substantial" criteria are to be determined with regard to any other party's level of participation.<sup>101</sup> Further, "majority" or "most," as required by the regulations, are not synonymous with "substantial." "Substantial" should carry the same relative meaning to all activities, regardless of the total number of hours involved.

The regulations' third alternative should, therefore, be modified to recognize that an activity not requiring a substantial hourly commitment can, nevertheless, have more than one material participant. If the Service retains a quantitative test, it should shift its emphasis from an

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on Sundays. He brings his son into the business to work full-time. Sam continues to make all the major decisions and invests all of his own capital. The fact that Sam is only available to work on Sundays and an occasional evening and his son works more hours should not result in Sam having a passive activity.

*Id.*

99. See Temp. Treas. Reg. § 1.469-5T(k) example 3 (1988).

100. Alternative three will allow more than one material participant only where identical levels of participation are present. *Id.* As a planning matter this is not a viable option for an activity with two or more individuals who are in fact material participants.

101. I.R.C. § 469(h)(1) (West Supp. 1989).

hourly measurement to a stated minimum percentage participation relative to the activity's total required participation.<sup>102</sup> Further, as suggested by the above newspaper stand hypothetical, the regulations should adopt some relief measure for those whose participation levels are diminished by a temporary, but nonetheless lengthy, disability.

#### 4. *Significant Participation Activities*

The regulations' fourth route to establishing material participation introduces the non-statutory concept of a significant participation activity (SPA). An SPA is defined as a trade or business activity in which the taxpayer significantly participates, but does not materially participate.<sup>103</sup> Significant participation is activity exceeding 100 hours.<sup>104</sup> Where a taxpayer has multiple SPAs and his aggregate participation in all his SPAs exceeds 500 hours, the regulations deem him to be a material participant with respect to each SPA.<sup>105</sup>

The SPA regulations can be exemplified as follows. Recall A and B who ran the Sunday newspaper stand. A, due to illness, participated only 300 hours as compared to B's 375. Under the regulations' third alternative B was deemed to be the activity's only material participant. But, under the SPA regulations, A is a significant participant. Since A is not a material participant under any other rule, the activity is, therefore, a significant participation activity with respect to A.<sup>106</sup>

Where a taxpayer's total aggregate SPA participation exceeds 500 hours, the taxpayer will be deemed to have materially participated in all his SPAs. Therefore, if A also contributes 400 hours to his auto repair shop (which falls short of material participation because it is less than 500 hours, and the son's participation exceeds that contributed by the taxpayer), then the taxpayer's total SPA participation would exceed 500 hours (300 + 400 = 700 hours), and he would be deemed to be a material participant in both the newspaper stand and auto repair shop activities.

#### 5. *Recharacterization*

However, this sweet result can turn sour under the significant participation recharacterization (SPR) regulations.<sup>107</sup> The SPR regulations require that otherwise passive income be *recharacterized*, as active income, when the taxpayer's aggregate SPAs produce net positive income.

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102. For a discussion of this issue, see PASSIVE LOSS TASK FORCE, *supra* note 5, at 53. An example of such a provision would provide that any participant involved at a level of activity greater than or equal to 75% of that activity's most active participant shall be deemed a material participant in such activity.

103. Temp. Treas. Reg. § 1.469-5T(c)(1) (1988).

104. *Id.* § 1.469-5T(c)(2).

105. *Id.* § 1.469-5T(a)(4).

106. See Lipton & Eval, *supra* note 26, ¶ 505.44.

107. Temp. Treas. Reg. § 1.469-2T(f)(2) (1988).

These recharacterization rules can be exemplified as follows. In 1989, the initial year of operation, A has net passive income of \$5,000 from the newsstand and \$10,000 from the auto repair shop. A's total SPA participation was 350 hours (150 newsstand hours, and 200 repair shop hours); therefore, under the SPA regulations, A is not a material participant with respect to those activities. In addition, A has a passive rental loss of \$20,000 which does not qualify for the section 469(i) active participation exception. Absent the SPR regulations, A's net passive income would be zero because the net rental loss would shelter the passive income from the other two activities. However, under the SPR regulations, A's SPA passive income is recharacterized as active income due to the fact that his net SPA income was positive. Thus, none of the SPA income can be sheltered by the rental loss.<sup>108</sup>

The SPR regulations also have a detrimental effect upon the availability of a net operating loss carryback. For example, assume a taxpayer has only one SPA which generates \$1,000,000 of income in the first year. The recharacterization rules transform this otherwise passive income into active income. The following year, the same SPA suffers a \$500,000 passive loss which, because it is a net loss, is not subject to recharacterization. The activity's economic operating results are distorted by the SPR regulations because the change in the activity's year-to-year characterization appears to bar the benefit of section 172, which would allow the current year's loss to be matched against prior years' income.<sup>109</sup> Regardless of recharacterization, the \$500,000 passive activity loss will be available for use under the three alternatives described earlier.<sup>110</sup>

The SPA and SPR regulations represent a double-edged sword. In one respect the SPA regulations' leniency undermines section 469's statutory scheme. Evidence thereof is that support for this exception to the statute's material participation requirement cannot be found in either the statute or its legislative history.<sup>111</sup> Predictably, the SPA exception will apply disproportionately to wealthy taxpayers, who are cited as section 469's primary target.<sup>112</sup> This is because wealthy taxpayers are more likely to have multiple non-materially participating business ven-

108. See Lipton & Eval, *supra* note 26, ¶ 1004-13.

109. See PASSIVE LOSS TASK FORCE, *supra* note 5, at 108.

110. See I.R.C. § 469(f) (West Supp. 1989). This section allows an activity's suspended PALs to offset its future active income. This presumably encompasses income which is active by reason of recharacterization. Thus, a taxpayer's PAL-carryforward should be allowed to shelter the taxpayer's otherwise passive activity income which is subject to recharacterization in any given year.

111. Some members of the A.B.A. Section on Taxation specifically stated that "[i]n one respect, the SPA rules are far too lenient. The possibility that a taxpayer could participate 101 hours in each of five different trade or business activities and (without more) be deemed to materially participate in all of them appears totally incongruous with a rigorous 'regular continuous and substantial' standard." PASSIVE LOSS TASK FORCE, *supra* note 5, at 53.

112. 1986 BLUE BOOK, *supra* note 19, at 210.

tures which would fall within the aggregation rules set forth under the SPA regulations. The wealthy's propensity to fall within the SPA classification appears to have been an intended, as opposed to inadvertent, result. This is because the SPA regulations were not motivated by the statute, but are a tool contrived for the exclusive benefit of the SPR regulations.

Together, the SPA and SPR regulations operate to prohibit passive activity losses from sheltering passive activity income. However, the inter-activity sheltering of passive income with passive losses was specifically contemplated by Congress when it stated that "[l]osses and credits from a passive activity . . . may be applied against income for the taxable year from other passive activities or against income subsequently generated by any passive activity."<sup>113</sup> Further, the statute reflects this intent through section 469(d)(1), which defines passive activity loss as "the amount . . . by which—(A) the *aggregate* losses from *all* passive activities for the taxable year, exceed (B) the *aggregate* income from *all* passive activities for such year."<sup>114</sup>

The need for recharacterization authority to prevent manipulation was recognized by Congress, and the Secretary's regulations imply a reasonable presumption that contrived passive income generators pose the greatest threat to the statute's integrity. However, the SPA and SPR regulations' response to this threat casts a much too broad and indiscriminate net—one which goes far beyond congressional intent.

Congress intended the statute's anti-abuse authority to be targeted only against taxpayers acting with an intent to circumvent the rules.<sup>115</sup> This congressional limitation is expressed by the legislative history's example which designates as its target "activ[ies] . . . previous[ly] generating active business losses that the taxpayer *intentionally* seeks to treat as passive at a time when they generate net income with the *purpose* of circumventing the rule."<sup>116</sup> The SPR regulations exceed congressional intent by triggering recharacterization based on nothing more than positive aggregate SPA income.

#### 6. *An Abuse of Discretion?*

While regulations are often the subject of valid criticism, few are invalidated due to a presumption of correctness granted by most courts.<sup>117</sup> Despite their apparent overreaching, the SPR regulations are likely to be upheld given their legislative nature<sup>118</sup> and the statute's

113. *Id.* at 215.

114. I.R.C. § 469(d)(1) (West Supp. 1989) (emphasis added).

115. 1986 CONFERENCE REPORT, *supra* note 7, at II-147.

116. *Id.* (emphasis added).

117. See Westin, *supra* note 40, at 16; see also Wolfman, *Forward to Note—Supreme Court Decisions in Taxation: 1980 Term*, 35 TAX LAWYER 443 (1980).

118. "Legislative Regulations" are issued pursuant to a Code section's specific grant of authority to define a statutory term or provide a method of execut-

broad delegation of authority to the Secretary.

The Supreme Court, in *United States v. Vogel Fertilizer Co.*,<sup>119</sup> stated

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ing a statutory provision. See Westin, *supra* note 40, at 17; see also *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982).

119. 455 U.S. 16 (1982). The question presented in *Vogel* was quite simple. Under a graduated tax structure a corporation with \$200,000 of taxable income would have paid tax at a 46% marginal rate. But if the corporation were divided into 10 separate corporate taxpaying entities, then taxable income for each would be \$20,000, and the marginal rate would be reduced to 15%. To thwart this abuse of the graduated tax structure, Congress enacted § 1561(a), which forces corporations under common control (*i.e.*, "members of a controlled group") to file as a single tax paying entity. See I.R.C. § 1561(a) (West Supp. 1989). Under § 1563 a controlled group of corporations could exist in two forms: parent-subsidiary commonality (§ 1563(a)(1)); or a brother-sister commonality (§ 1563(a)(2)).

In *Vogel*, the Court interpreted the 80% prong of the brother-sister controlled group definition. *Vogel*, 455 U.S. at 18. Under § 1563(a)(2) a brother-sister controlled group exists "if five or fewer persons . . . [possess] (A) at least 80% of the total [voting power or total value of the corporation], and (B) more than 50% of the total combined voting power . . . or more than 50% of the total value of each corporation, taking into account the stock ownership of each such person *only to the extent such stock ownership is identical* with respect to each such corporation." I.R.C. § 1563(a)(2) (West Supp. 1989) (emphasis added).

The Treasury had interpreted § 1563(a)(2)(A)'s 80% requirement to mean that any of the five or fewer persons could satisfy the test by holding, *singly or in combination*, the requisite 80%. *Vogel*, 455 U.S. at 19. The taxpayer, however, took the position that only parties possessing an actual interest in each corporation would count towards the 80% threshold. *Id.* at 22-23. As demonstrated in a footnote, the practical difference between these two positions can be best illustrated by the following example:

Individuals	Corporations					Identical Ownership
	U	V	W	X	Y	
A	55%	51%	55%	55%	55%	51%
B	45%	49%	..	..	..	.... (45% in U & V)
C	..	..	45%	..	..	..
D	..	..	..	45%	..	..
E	..	..	..	..	45%	..

The parties would agree that the 50-percent identical-ownership requirement in Part (B) [§ 1563(a)(2)(B)] is met for all corporations by shareholder A's identical ownership of 51 percent of all of the corporations. The Commissioner would find the 80-percent requirement met as well, and would therefore define all five corporations as part of a controlled group, because various subgroups of the five or fewer shareholders can account for 80 percent of each corporation. *The Taxpayer's position is that only corporations U and V are part of a brother-sister controlled group, because they are the only two corporations in which precisely the same five or fewer persons account for 80 percent of the stock of the putative "brother-sister controlled" corporations.*

*Id.* at 23 n.7 (emphasis added).

In addressing these conflicting positions, the Court first resolved the

that deference to Treasury regulations will be accorded only where: (1) the regulation's position falls within a reasonable interpretation of the "four-corners" of the statute,<sup>120</sup> and (2) the interpretation chosen "harmonizes with the statute's 'origin and purpose.'" <sup>121</sup>

This analytical framework is nothing more than a reiteration of statutory construction's fundamental rules. More indicative of the Court's standard of review is the *Vogel* Court's statements that in order to be invalidated "the regulation [must be] fundamentally at odds with the manifest congressional design" of the statute;<sup>122</sup> and that legislative regulations will be accorded greater deference than interpretative regulations.<sup>123</sup>

*Vogel* invalidated an interpretative regulation, which had been accorded the lowest level of deference due to the specificity of the statutory language which the regulation purported to interpret.<sup>124</sup> However, despite ample evidence of congressional intent, the majority struggled

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threshold issue of the amount of deference owed to the Commissioner's interpretation. *Id.* at 24. The Court stated the well-settled policy that greater deference will be accorded to *legislative regulations*. *Id.* (regulations issued under the Commissioner's general authority to "prescribe all needful rules and regulations") (quoting I.R.C. § 7805(a)). The regulations under § 1563(a)(2) are interpretative. *Id.* The degree of deference granted regulations is proportional to the ambiguity of the statutory language the regulation purports to interpret. *Id.* The deference granted Treasury Regulation § 1.1563-1(a)(3) was circumscribed by the considerable specificity with which the statute defined the term "brother-sister controlled group."

Once the threshold issue of deference was resolved, the Court applied a two-prong harmonizing analysis, looking first to the regulation's harmony with statutory language, and secondly to the statute's origin and purpose. *Id.* at 25-26. First, the Court reviewed each alternative's position in light of the "four-corners" of the statute in order to determine if the statute was capable of more than one reasonable interpretation. *Id.* at 25. The Court concluded that each alternative was technically consistent with the statute's language and construction. *Id.* at 26. However, a regulation will not be sustained for mere technical consistency with the statute when it is "fundamentally at odds with the manifest congressional design." *Id.* at 26 (citing *United States v. Cartwright*, 411 U.S. 546, 557 (1973)).

The legislative history was then examined to determine whether the regulation harmonized with the statute's "origin and purpose." *Id.* (citing *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979)). The legislative history revealed that "[t]he intended targets of I.R.C. § 1563(a)(2) were groups of *interrelated* corporations characterized by *common* control and ownership." *Id.* at 27 (emphasis in original). The Court rejected the Commissioner's interpretation, having concluded that "it [was] not the *smallness* of the number of persons in each company that triggers § 1563; it is the *sameness* of that small number." *Id.* at 30 (quoting *T. L. Hunt, Inc. v. Commissioner*, 562 F.2d 532, 537 (8th Cir. 1977) (Webster, J., dissenting) (emphasis added)).

120. *Vogel*, 455 U.S. at 25.

121. *Id.* at 26 (quoting *National Muffler Dealers*, 440 U.S. at 477).

122. *Id.* (citing *Cartwright*, 411 U.S. at 557).

123. *Id.* at 24.

124. *Id.*



to invalidate this regulation which had been accorded a minimal level of deference.

In contrast to the regulation in *Vogel*, the SPR regulations are legislative in nature and, therefore, will be accorded a much higher level of deference. While different terminology is employed by the courts for review of legislative regulations, the difference amounts to mere semantics. The substantive analytical framework parallels the *Vogel* Court's traditional approach.<sup>125</sup> Hence, the level of deference granted is the only substantive distinction between the Court's approach to legislative, versus interpretative, regulations. In practice then, in order to invalidate legislative regulations one must sustain a burden of "greater weight" than when attempting to invalidate interpretative regulations.<sup>126</sup> This "burden of greater weight" has been characterized as requiring that the regulation either exceed the scope of the delegated power,<sup>127</sup> contradict the statute,<sup>128</sup> or be an unreasonable interpretation of the statute.<sup>129</sup>

Using the *Vogel* analysis, section 469 empowers the Secretary to recharacterize income (or gain) from passive to active, which is precisely the operation of the SPR regulations. Thus, the SPR regulations are technically consistent with the statute's language. However, the SPR regulations conflict with the express congressional intent to allow sheltering among passive activities and to target anti-abuse recharacterization authority only against those taxpayers whose participation has been manipulated "with the [intent] of circumventing the rule[s]."<sup>130</sup> Nonetheless, a court wishing to uphold the SPR regulations could expand upon the legislative history's parenthetical preface to the aforementioned recharacterization examples, which emphasize the Secretary's discretionary authority in this area.<sup>131</sup> The Service has in fact taken this position for justification of its recharacterization regulations.<sup>132</sup> While

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125. The Fifth Circuit has characterized the review of legislative regulations as a three-pronged analysis examining whether the regulation was: (1) within the statute's grant of authority; (2) issued pursuant to proper procedure; and (3) reasonable. *Kramertown Co. v. Commissioner*, 488 F.2d 728, 730 (5th Cir. 1974). The U.S. Claims Court characterized the test as determining whether the legislative regulation was "within the scope of authority vested in the Treasury by the enabling act." *Union Carbide Corp. v. United States*, 612 F.2d 558, 563 (Ct. Cl. 1979). However phrased, the analytical framework involved analysis of the statute, followed by a review of the consistency of the regulation with the congressional intent for that statute.

126. *Goldman v. Commissioner*, 497 F.2d 382, 383 (6th Cir.), *cert. denied*, 419 U.S. 1021 (1974).

127. *Panama Refining Co. v. Ryan*, 293 U.S. 388 (1935).

128. *M. E. Blatt Co. v. United States*, 305 U.S. 267 (1938).

129. *Joseph Weidenhoff, Inc.*, 32 T.C. 1222 (1959).

130. 1986 CONFERENCE REPORT, *supra* note 7, at II-147 (emphasis added).

131. *Id.*

132. Moriarty, *Real Estate, Timber, and Other Industries Call for De-Emphasis of Bright Line Passive Loss Rules*, 40 TAX NOTES 10, 11 (1988). Gregory Marich, at-

substantial criticisms of the SPR regulations exist, it is unlikely, given the deference accorded legislative regulations, that these criticisms would be so compelling as to satisfy the burden necessary to show the regulations as contradictory, unreasonable or exceeding the scope of the statute's delegated authority.

### B. *The Anti-Abuse Rules*

The regulations' fifth and sixth alternatives are designed to combat taxpayers' efforts to manipulate an activity's character by controlling any single year's participation in that activity. As with the SPR regulations, the anti-abuse rules' primary purpose is to prevent profitable material participation activities from being manipulated into passive income generators (PIGs). However, instead of flip-flopping an activity's characterization based solely on its profitability, these rules characterize the activity with reasonable presumptions based on historical experience.

#### 1. *The Five-Out-of-Ten Rule*

This rule provides that a taxpayer will be deemed to have materially participated in any activity for which he was a material participant for any five taxable years (whether or not consecutive) during the ten taxable years preceding the current year.<sup>133</sup> The regulation serves as a reasonable limitation against a taxpayer's year-to-year manipulation of participation status.<sup>134</sup> However, the following situations demonstrate the need for some modification.

One case is that of a material participant who retires from a non-personal service activity, but retains a financial interest. Suppose an owner of an S Corporation decides to retire and to turn the operations over to his son. If the owner retires at the end of 1989, the five-out-of-ten rule will treat him as a material participant through 1994. In effect, the rule recharacterizes the owner's status from passive to active for the initial five post-retirement years.

As stated earlier, the congressional intent for recharacterization was to thwart intentional manipulation of a taxpayer's participation status. To the extent a taxpayer controls participation in any one year, the five-out-of-ten rule's objective criteria contain a reasonable presumption of manipulative intent. However, the regulation works an inequity where imposed in circumstances void of any tax avoidance motivation, such as in the case of the retiree, or an employee/owner, who terminates his

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torney-advisor in Treasury's Office of Tax Legislative Counsel, responded to criticisms of the recharacterization rules by contending "that the legislative intent of § 469 [was] not merely to stop tax shelters, but to 'stop abuses relating to passive losses.'" *Id.*

133. Temp. Treas. Reg. § 1.469-5T(a)(5) (1988).

134. *Accord* PASSIVE LOSS TASK FORCE, *supra* note 5, at 56.

participation in order to pursue retirement or some other activity on a full-time basis.

To equitably modify the rule it is suggested that the Service provide for an election out of the regulation.<sup>135</sup> The election could be in the form of an agreement between the taxpayer and the Service that the taxpayer will not materially participate in the activity for the next five years, and that the taxpayer has an affirmative duty to inform the Service of any change in status during that period. Further, the statute of limitations could be extended for five years with respect to that activity.

Absent an election out, a retiring partner, or any partner who genuinely intends to terminate participation, could transform his interest from that of a general to a limited partner, and secure the shelter of section 469(h)(2), which presumes a limited partner as passive unless recharacterized by the regulations.<sup>136</sup>

However, the aggressive posture of the existing recharacterization regulations indicates that such a maneuver probably would be challenged. The Service would probably rely on the unqualified language of the statute. The taxpayer's counter-argument would focus on the examples for exercise of the Service's recharacterization power contained in the legislative history:

For example, regulations may provide that, in order to prevent avoidance of the passive loss rule, a limited partner's share of income from a limited partnership is treated as not from a passive activity. *Circumstances in which such treatment could be appropriate would include* a transfer by a corporation of an income-producing activity to a limited partnership with a distribution to shareholders of limited partnership interests. The regulations might also treat as not passive those activities that previously generated active business losses and that the taxpayer,

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135. Rather than an election out, various members of the ABA's Section of Taxation recommended that the mandatory treatment of the regulation be changed to a rebuttable presumption, thereby incorporating some equitable flexibility into the rule. *Id.* at 57. While both a rebuttable presumption and an election out strive to incorporate a measure of equitable flexibility into the rule, it is suggested that the election out better protects the Service's interests.

136. Section 469(h)(2) states: "*Except as provided in regulations*, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." I.R.C. § 469(h)(2) (West Supp. 1989) (emphasis added). As of the drafting of this article the recharacterization regulations under this provision had not yet been issued. See PASSIVE LOSS TASK FORCE, *supra* note 5, at 126.

One of a number of potential questions raised by such a transaction is whether it would trigger recognition or be eligible for like-kind exchange treatment under § 1031. A recent private letter ruling indicates that like-kind exchange treatment would be appropriate. Priv. Ltr. Rul. 8912023 (Mar. 24, 1989). Therein, the Service ruled that § 1031(a)(2)(D), which excludes partnership interests from like-kind exchange treatment, was limited to exchanges of interests in different partnerships.

*with the purpose* of circumventing the passive loss rule, intentionally seeks to treat as passive at a time when they generate net income. A further example of a situation where regulatory authority might appropriately be exercised is the case of related party leases or sub-leases, with respect to property used in a business activity, that have the effect of reducing active business income and creating passive income.<sup>137</sup>

These examples limit the appropriate circumstances for recharacterization to instances where the character of the activity was dictated by a completely tax-motivated change in the composition or structure of the activity, and not where a change was effected to better reflect a former participant's new legal and economic relationship to the activity. It is unclear whether this argument would be sufficient authority to allow the change over to a limited partnership interest to circumvent the five-out-of-ten recharacterization regulation.

## 2. *Retirement Payments Which Extend Beyond the Five-Year Recharacterization Window*

To this point it has been assumed that payments to a withdrawing owner were either lump-sum or did not extend beyond Treasury Regulation section 1.469-5T(c)(2)'s five-year recharacterization window. However, where payments extend beyond five years, two questions arise: (1) What are the payments' character after this five-year period? and (2) What happens to the activity's suspended PALs where the entire interest is disposed of under the installment method?

First, in the case of a non-personal service partnership, the regulations employ a look-back provision for any section 736(a)(2) and (b) payments—which are generally any payments classified as other than a distributive share under section 736(a)(1).<sup>138</sup> Therefore, regardless of when the payment is received, its characterization will be controlled by the partner's status as of the time the liquidation of such partner's interest commenced.

Second, where a taxpayer's entire interest is sold for a gain under the installment method, section 469(g)(3) provides for ratable recognition of any suspended PAL over the installment period.<sup>139</sup> Where the interest is sold for a loss, section 453 will not apply and, therefore, the entire suspended PAL can be recognized in the disposition year.<sup>140</sup>

Despite these limitations, there are means available to structure retirement payments as passive income generators. The above rules apply only to a closed transaction (*i.e.*, the look-back rules apply only when a

137. 1986 BLUE BOOK, *supra* note 19, at 234-35 (emphasis added).

138. Temp. Treas. Reg. § 1.469-2T(e)(2)(i)-(iii) (1988); *see also* Temp. Treas. Reg. § 1.469-2T(e)(2)(iii)(B).

139. Lipton & Evaul, *supra* note 26, ¶ 1302.04.

140. *Id.* ¶ 1302.05.

fixed payment structure is used). They are inapplicable to a transaction which utilizes section 736(a)(1) distributive share payments.<sup>141</sup>

Therefore, a withdrawing materially-participating partner who accepts a specified interest in the partnership's profits for a term of years can avoid recharacterization under the aforementioned regulation (although, absent successful conversion to a limited partnership interest, the term must extend beyond Treasury Regulation section 1.469-5T(c)(2)'s five-year taint before any passive income can be realized). Under Treasury Regulation section 1.736-1(b)(5)(ii), all payments under this format are first allocated towards payment for the fair market value of the partner's section 736(b) property, with subsequent payments classified as section 736(a)(1) payments. Therefore, in the ideal situation, payment for the section 736(b) property will be stretched over five years, with subsequent section 736(a) payments generating passive income. Of course, the risk of assuming a contingent payment obligation must be weighed against the retiring partner's need for passive activity income.<sup>142</sup>

### 3. *Participation In a Personal Service Activity for Any Three Years*

Where a taxpayer materially participated in a personal service activity<sup>143</sup> for *any* three preceding taxable years, whether or not consecutive, he is thereafter *forever* deemed a material participant in that activity.<sup>144</sup> This rule carries a similar presumption of manipulative intent to that found in the five-out-of-ten rule. However, the look-back period to *any* three years, combined with a *permanent* taint, magnifies this rule's departure from the congressional design of the statute's recharacterization authority. Neither the statute's specific provisions for the "[t]reatment of

141. Temp. Treas. Reg. § 1.469-2T(c)(4)(i) (1988).

142. Payments structured as a distributive share under § 736(a)(1) are not deductible by the partnership, while guaranteed payments under §§ 736(a)(2) and 707(c) are deductible. See I.R.C. §§ 707(c), 736 (West 1988).

143. The Treasury Regulations define a "personal service activity" as follows:

(d) An activity constitutes a personal service activity for purposes of paragraph (a)(6) [regarding material participation] of this section if such activity involves the performance of personal services in—

(A) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or counseling; or

(B) Any other trade or business in which capital is not a material income producing factor.

Temp. Treas. Reg. § 1.469-5T(d) (1988); see also PASSIVE LOSS TASK FORCE, *supra* note 5, at 58-59 (criticizing regulation's expanded definition of personal service activity as "likely to spawn significant litigation as taxpayers battle the Service concerning whether or not capital was a material income producing factor in a variety of businesses. This possibility of litigation is heightened by the particularly harsh treatment for personal service activities under the perpetual taint rule [of this regulation].").

144. Temp. Treas. Reg. § 1.469-5T(a)(6) (1988).

certain retired individuals,"<sup>145</sup> nor any of its references to personal service corporations<sup>146</sup> provides for any phase-out or permanent taint of material participation status. Congress demonstrated an ability to modify the material participation test for distinct categories of activities and taxpayers (*e.g.*, real estate,<sup>147</sup> limited partners,<sup>148</sup> and most pertinent to this point, redefining the statutory test for a personal service corporation).<sup>149</sup> It is, therefore, reasonable to infer congressional intent for uniform treatment of non-personal and personal service corporations, as well as limiting modification of the material participation test (*i.e.*, recharacterization) to intentional tax motivated manipulation. Whether this regulation goes so far as to be considered an abuse of discretion remains to be seen.

#### 4. *Quality v. Quantity—What is Material Participation?*

The regulations define a material participant in a strictly quantitative manner. While quantitative criteria provide administrative efficiencies,<sup>150</sup> this is a questionable interpretation of the congressional intent behind material participation. A rigid quantitative approach is contrary to the congressional intent expressed in the 1986 Senate Finance Committee's Report, which provides that "[t]he presence or absence of material participation generally is to be determined with reference to all the relevant facts and circumstances."<sup>151</sup> Section 469's material participation standard was patterned after the concept's usage within sections 1402(a)<sup>152</sup> and 2032A.<sup>153</sup> However, precedents under these sections were considered too lenient and, therefore, not intended to control the concept's interpretation with regard to the passive loss rules.<sup>154</sup>

However, while the example qualifying this caveat emphasized a stricter standard, it in no way rejected the analytical framework for the material participation concept developed by these precedents.<sup>155</sup> The

145. I.R.C. § 469(h)(3) (West Supp. 1989).

146. *Id.* § 469(h)(4), (j)(2).

147. *Id.* § 469(c)(2).

148. *Id.* § 469(h)(2).

149. *Id.* § 469(j)(2).

150. See Gunnar, *Current and Quotable: Gunnar Questions 'Quantitative' Approach to Material Participation*, 38 TAX NOTES 192 (1988).

151. 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 732.

152. For a further discussion of § 1402 and its regulations, see *supra* note 35.

153. For a discussion of § 2032A and its regulation, see *supra* note 36.

154. See 1986 BLUE BOOK, *supra* note 19, at 237.

155. The legislative history emphasizes:

[W]hether or not, under existing authorities interpreting § 1402(a) and § 2032A, it could be argued that the material participation requirement (for purposes of these sections) is in certain circumstances satisfied by periodic consultation with respect to management decisions, the standard under this provision is not satisfied thereby in the absence of regular, continuous, and substantial involvement in the operations.

regulation's rejection of the analytical framework developed by these precedents (which were guided by the regulations under sections 1402(a) and 2032A) reduces the legislative history's substantial references to these sections to a nullity. Further, a more perceptive interpretation of the legislative history points to the congressional intent to adopt the judicial and regulatory analytical framework developed under sections 1402(a) and 2032A. The parallel structure of section 469's legislative history to the section 2032A regulations also indicates this intent. The section 2032A regulations, which establish the material participation analytical framework, provide:

No single factor is determinative of the presence of material participation, *but physical work and participation in management decisions are the principal factors to be considered*. At a minimum, the decedent and/or a family member must *regularly* advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a *substantial* number of these decisions. Additionally, production activities . . . should be inspected *regularly* by the family participant . . . . With farms [or] hotels, . . . the operation of which constitutes a trade or business, the participating decedent or heirs maintaining his or her principal place of residence on the premises is a factor to consider in determining whether overall participation is material.<sup>156</sup>

The 1986 Senate Finance Committee Report emphasized similar, if not identical, factors as relevant to establishing material participation under section 469. The factors listed by the 1986 Senate Report were: the extent to which the taxpayer is present at the place or places where the principal operations of the activity are conducted; the proximity of the taxpayer's residence to the operations; and the actual participation in supervisory tasks and management decisions (*i.e.*, not merely ratification of another's recommendations).<sup>157</sup>

The case law and regulations under section 2032A have adopted a facts-and-circumstances approach, with temporal participation an important, but not dispositive, element in the analysis.<sup>158</sup> While these

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*Id.*

156. Treas. Reg. § 20.2032A-3(e)(2) (1980) (emphasis added).

157. 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 732-33.

158. *See, e.g.*, *Mangels v. United States*, 828 F.2d 1324, 1327 (8th Cir. 1987) (finding material participation where participation constituted: (1) daily attention to farm market reports; (2) quarterly physical inspections—averaging two hours per inspection; (3) monthly meetings with on-site manager—averaging one hour; (4) annual planning meetings—averaging 1½ to 2 hours; (5) annual post-harvest analysis—averaging four hours; (6) occasional long-term management decisions); *Estate of Sherrod v. Commissioner*, 774 F.2d 1057, 1060 (11th Cir. 1985) (finding material participation in timber farming business where “the

precedents demonstrate a far more qualitative than quantitative congressional design, the section 469 legislative history does recognize the temporal element of material participation.<sup>159</sup> While Congress contemplated a facts-and-circumstances approach, some objective criteria are necessary to promote administrative efficiency and provide taxpayers with certainty in their tax planning.<sup>160</sup> Regulations indicative of congressional intent would strike a balance between these two competing objectives. A balance between administrative efficiencies and congressional intent only can be achieved if the Service and the courts allow the facts-and-circumstances alternative to develop with a more qualitative emphasis.<sup>161</sup> However, the regulations' exclusion of management activ-

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decendent and his son had exercised management and control over the acreage by paying the taxes . . . , inspecting the timberland [on a regular basis], keeping in contact with the adjoining landowners, negotiating rental agreements, and deciding whether or not to retain or sell the property"), *cert. denied*, 419 U.S. 1021 (1986); *Estate of Ward v. Commissioner*, 89 T.C. 54, 57, 64-65 (1987) (finding material participation where decedent owned family farm, exercised independent management decisions, and supervised daily operations from her residence located on farm.).

These three cases represent a spectrum of participation. In *Estate of Ward*, the decedent resided on the farm and had a regular, continuous and substantial presence in the daily operations of the business. This level of participation is consistent with the intended use of material participation under § 469. However, *Mangels* represents the type of precedent which prompted Congress to expressly negate pre-existing legal standards under § 2032A. *Mangels* demonstrates that "an intermittent role in management [which], while relevant, does not establish material participation . . . ; [f]or example, the fact that one has responsibility for making significant management decisions with respect to an activity does not establish material participation even if one from time to time exercises such responsibility." 1986 SENATE FINANCE COMMITTEE REPORT, *supra* note 2, at 734.

159. For a discussion of § 469's legislative history, see Moriarty, *supra* note 132, at 11.

160. For a discussion of this issue, see Moriarty, *supra* note 132, at 11; see also Evaul & Lipton, *Current and Quotable: Evaul and Lipton Suggest 'Quantitative' Approach to Defining Participation*, 37 TAX NOTES 1276 (1987) (advocating quantitative approach).

161. Some of the ABA's Section of Taxation members state:

There is no easy solution to this conflict between the desire for an easy-to-administer quantitative test, particularly one which is consistent with the rigorous material participation standard in § 469(h)(1), and the need to provide relief in appropriate facts and circumstances. To resolve this conflict, we would suggest that the Regulations focus primarily upon a facts and circumstances test which applies to taxpayers who are involved in an activity for a minimal number of hours, while providing a "safe harbor" which may be elected by other taxpayers who participate for a sufficient period during the year. If the emphasis in the Regulations were placed on the facts and circumstances test in a manner which is consistent with the legislative history of § 469, the safe harbor could be a rigorous elective test which would apply only in situations in which the material participation test should be presumed to be satisfied.

PASSIVE LOSS TASK FORCE, *supra* note 5, at 47.



ities from accredited participation status eliminates the primary means of qualitative participation necessary to meet this objective.

5. *What Counts for Participation?*

a. Management Activities Within the Facts-and-Circumstances Alternative

The regulations, under the facts-and-circumstances alternative only, exclude management services from being credited towards participation unless: (1) the taxpayer was the activity's only participant who was compensated for management services, and (2) the taxpayer performs more hours of management services than any other participant.<sup>162</sup> The regulation is really an anti-abuse provision, designed to prevent manipulation of a taxpayer's status via the cloak of managerial responsibilities. The regulation accomplishes this objective by limiting accredited participation to those activities which have a single identifiable manager.

The need for protective measures against manipulation and abuse of management participation has direct and extensive support in the legislative history. A footnote in the legislative history specifically states:

Experience in applying existing legal standards confirms that a test based on participation in management is subject to manipulation and creates frequent factual disputes between the taxpayers and the Internal Revenue Service . . . . [W]hile the Internal Revenue Service may argue . . . that an investor is not truly participating in management, such argument may be difficult to sustain in the absence of reliable direct evidence regarding the investor's independence of judgment. *Congress expects that the material participation standard for purposes of the passive loss rules, in light of its focus on the taxpayer's role in the actual operations, will not be similarly subjected [sic] to manipulation and ambiguity.*<sup>163</sup>

The Service's regulation will certainly accomplish this objective. However, the Service's response to this congressional concern failed to recognize that Congress' remarks were made as a caveat (actually taking the form of the above quoted footnote) to its overall intent to generally treat "management functions . . . no differently than [the] rendering [of] other services or [the] performing [of] physical work with respect to the activity. However, a merely formal or nominal participation in management, in the absence of a genuine exercise of independence, discretion or judgment, does not constitute material participation."<sup>164</sup> Therefore, it is clear that Congress did not intend to exclude legitimate managerial functions. However, the regulations would apparently not credit participation of an individual whose sole function was as a participant of the

162. Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)(A), (B) (1988).

163. 1986 BLUE BOOK, *supra* note 19, at 239 n.31 (emphasis added).

164. *Id.* at 239.

Board of Directors of his S Corporation, unless he was that activity's only manager, or most active manager (two unlikely circumstances). And as shown below, the taxpayer would probably not receive credit for participation under the remaining alternatives unless his participation amounted to day-to-day involvement or went beyond what the regulations define as work done in the individual's capacity as an investor.

Therefore, the congressional direction to the Service was not to exclude management services from the material participation calculation, but rather to distinguish between genuine and contrived managerial positions. While the Service's position contradicts the congressional design for management services, a wholly facts-and-circumstances approach would be equally inconsistent given the concerns expressed by Congress. There is no easy resolution to the tension created by Congress' desire to include management activities, but yet avoid abuses and excessive litigation. However, the Service's approach is clearly weighted in favor of avoiding abuse, without any concern for its impact on legitimate managerial functions.

#### b. Limitations on What Counts for Participation in General

The first of two more general anti-abuse provisions covering all the alternatives is the regulation which excludes investor-orientated functions<sup>165</sup> from accredited participation status unless done in the context of an individual who is directly involved in the day-to-day management of operations of the activity.<sup>166</sup> While the facts-and-circumstances alternative allows management functions to be credited towards material participation only when there is a single identifiable manager, these overall participation regulations require day-to-day involvement. Why provide two different standards within the same section? Is one more lenient than the other? Can a taxpayer qualify under facts-and-circumstances with less than day-to-day involvement as long as he is the only participant performing management activities? Can investor-orientated functions qualify if the taxpayer is the only manager, but has less than

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165. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii) (1988) provides:

(A) Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day to day management or operations of the activity.

(B) For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(1) studying and reviewing financial statements or reports on operations of the activity;

(2) preparing or compiling summaries or analysis of the finances or operations of the activity for the individual's own use; and

(3) monitoring the finances or operations of the activity in a non-managerial capacity.

166. *Id.* § 1.469-5T(f)(2)(ii)(A).

day-to-day involvement? The answers, if any, are unclear, adding further complexity to an already confused area.

Of greater concern than the implications of these apparently conflicting criteria is the regulation's requirement of direct involvement in the day-to-day management or operations of the activity in order for any "investor-type" activities to be credited as participation.<sup>167</sup> Where a single operation is involved, determining day-to-day involvement is relatively simple. However, where the taxpayer is involved with multiple operations, characterization as either a single activity or multiple activities would presumably impact upon the taxpayer's ability to satisfy the day-to-day involvement criteria. Therefore, the first step in resolving such a problem would necessitate reference to the recently issued activity regulations.<sup>168</sup>

Failing the ability to demonstrate day-to-day involvement in the activity, the next step would be to structure the taxpayer's activities outside the regulation's definition of investor-type activity. The regulations define investor-type activity as either: (1) reviewing financial statements; (2) preparing financial summaries for the investor's own use; or (3) monitoring finances or operations in a non-managerial capacity.<sup>169</sup> The first example makes it clear that merely reviewing the numbers will not suffice as participation. However, the second example does leave an opening by way of its reference to the investor's own use. It is probable that preparation time could suffice if the investor had enough foresight to create an outside need for the information—for example, a lender who required monthly financial statements for monitoring conditions tied to its loan. This would presumably take the participation outside the scope of investor-type activity and, thereby, allow such participation to count without a corresponding day-to-day involvement by the taxpayer. However, this line of reasoning could fail as a sham if it were found that the reports were primarily for the taxpayer's use, or that the lender did not customarily require such information.

The regulations recharacterize any participation in an activity which is not of a type customarily done by an owner of such an activity or engaged in with a tax-avoidance purpose.<sup>170</sup> A prime example would be the sports franchise owner who sends his wife to work as a secretary for the ball club in order to secure material participation status. The wife's participation, which could otherwise be aggregated with the husband's, will be disallowed because owners do not customarily function as secretaries, and the participation was motivated by a tax-manipulation purpose. Here, the regulation's focus on intent conforms to the congressional design for recharacterization.

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167. *Id.*

168. *See* Temp. Treas. Reg. § 1.469-4T, 54 Fed. Reg. 20,527-66 (1989).

169. Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)(B)(1)-(3) (1988).

170. *Id.* § 1.469-5T(f)(2)(i)(A).

## VI. CONCLUSION

The two most elusive concepts of the passive activity rules are "material participation" and "activity." Together, these concepts can be expected to be the subject of many disputes and to engender substantial litigation before being honed into understandable concepts for taxpayers and their representatives.

The quantitative approach espoused in the regulations' definition of material participation, depending as it does on the number of hours worked at a particular activity, would seem to impose a substantial record-keeping burden on taxpayers. Evidently in response to concerns about the record-keeping burden expressed during the Senate floor debates,<sup>171</sup> the regulations<sup>172</sup> state that contemporaneous daily time records are not necessary if material participation can be established by other reasonable means. The regulations then go on to suggest that other reasonable means include such things as appointment books and calendars (records akin to contemporaneous daily time records). It is

171. See 132 CONG. REC. S7471 (daily ed. June 13, 1986). It states:

Mr. Andrews. Mr. President, in reading the committee report on the tax bill's passive loss section that the Senator from Nebraska and the Senator from New York had their recent colloquy on, I see a great deal of ambiguity on the definition of material participation that could raise havoc on the family farms of America.

Let me share with you, Mr. President, where my concern lies.

These characters in the Internal Revenue Service would not know a steer from a heifer. They have no idea of how an American farm works. *They are the ones who wanted us to start a log book on the use of the family farm pickup.*

Mr. President, that pickup on the average farm is used by our kids, by our uncles, by our cousins, by our hired men. You get into it and you run out into the field with some fuel for a swather. Someone else gets into it and runs to the elevator for a moisture test. Someone else gets into it and goes into town for repairs. *There is no way you can keep a log.*

We made the point. We made it here in this body. *Even though we passed legislation correcting it they interpreted it and they reinterpreted it and they misinterpreted it and we had to correct it yet again within the last month.*

Mr. President, in this passive loss section they have done it again.

*The regulations, as I pointed out earlier, that the IRS published in the matter of loss on the farm family pickup were totally contrary to the intent of Congress and, for this reason, tax counselors continue to advise their clients to keep contemporaneous auto record logs.*

*Id.* (emphasis added).

172. Temp. Treas. Reg. § 1.469-5T(f)(4) (1988) provides:

The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

difficult to surmise what type of evidence would suffice if it is not a time record or some other type of record from which time spent can be reconstructed. Until audits and cases commence, little will be known about what type of proof will be required. In some cases taxpayers may resort to the facts-and-circumstances test. However, if the quantitative tests are not met, the results are problematic.

This Comment has been designed to place the passive activity rules in perspective with other Code provisions and to provide a starting point from which passive activity loss issues can be identified and planned for, and from which alternative positions to the regulations can be explored. While any regulation will have some possible alternative positions, the passive loss regulations are particularly susceptible to valid criticisms due to numerous interpretations which embellish the statute well beyond its intended scope. However, despite numerous instances of overreaching, the task of challenging any legislative regulation is a formidable one. And, since the passive loss rules only defer rather than deny deductions, the inclination to challenge could be reduced.

The winds of change have taken a sharp turn with the adoption of the passive loss rules. Since the attractiveness of a tax shelter depends on the bunching of tax losses in the early years of operation, the passive loss rules will likely satisfy the desire of Congress to deter primarily tax-motivated transactions. At the same time, however, the passive loss rules will deny tax deductions for losses of businesses which were not designed and could never be classified as tax shelters. It is inevitable that unintended and unfair results will follow, and that changes will be necessary to deal with these problems.

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