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TAX SHELTERING OF INCOME: PASSIVE LOSSES UNDER THE TAX REFORM ACT OF 1986

by

NINA J. CRIMM* AND RYAN R. BRENNEMAN**

“. . . tax shelters would be effectively eliminated. This proposed remedy gets rid of the bathwater, but saves the baby.”¹

INTRODUCTION

It is abundantly clear to those in the press and on Capitol Hill that the provisions of the new Tax Reform Act of 1986² will constitute the death knell for tax shelters. The text of the *Congressional Record* and pages of business, financial journals and newspapers for months prior to the Act's enactment were filled with commentary as to this doomsday effect. However, a prudent reviewer of the actual tax-sheltering provisions of the Act would be far less certain in his estimation of their overall and lasting effect. Even though the so-called elimination of tax shelters has been hailed in many circles as a “victory,” one might want to question first, whether the Tax Reform Act of 1986 will achieve total elimination of tax shelters, and, if so, whether pursuant to public policy the Act will produce an irrefutably desirable end.

I. BACKGROUND

The Tax Reform Act recently passed by Congress and signed into law by the President reflects several factors, some related and some independent. One must consider, first of all, the strong opposition in political circles to tax sheltering. The general sentiment expressed in congressional commentary and debate on the subject of tax shelters over the recent summer months was decidedly in favor, at least on the record, of their total elimination. In particular, the focus of certain legislators seemed to be on the perceived growth in partnership “passive losses” relative to “positive income.” As a corollary of that position, in recent years partnership investment has tended to be weighted too heavily on the side of tax considerations, such as tax credits and accelerated deductions, rather than of economic ones. In the Senate debate on the subject, Senator Patrick Moynihan cited a Treasury study completed in 1965 which indicated that aggregate partnership income was nine times greater than partnership losses. He claimed that by 1982 losses from partner-

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¹Statement of Senator Patrick Leahy (D-Vt.) (June 18, 1986).

²Pub. L. No. 99-514, 100 Stat. 2085 (1986).

ships (the “favored vehicle for generating passive losses”) exceeded gains, and twenty times more so than in the previous year.³ Moynihan himself probably best summed up overall congressional sentiment vis-a-vis tax shelters: “Under the present system, it is both highly profitable and increasingly common for the high income taxpayers — and more recently even the moderate income taxpayers — to use passive losses as a deduction against positive income, and so to avoid tax.”⁴

Increased evidence of both non-economic investment and lost tax dollars has been important in the conceptual landscape of tax sheltering. Many commentators have criticized the spectre of investors seeking out investments more for tax (*i.e.*, avoidance) reasons than for economic (*i.e.*, profit) ones. Stories of “exotic” shelter arrangements, “bucket shops,” and investment advisors going to prison for “trafficking” in sham tax shelters have all been conjured up in the debate in order to focus on the negative side of sheltering. Some have even gone so far as to call tax sheltering a formula for civic decadence and national decay. A “responsible” member of the New York financial community even predicted that tax shelters possessed the power to “zero out” the revenue system.⁵ While one might want to question the motives of such doom-sayers, one cannot ignore more factually based assertions, such as that annual tax revenues will drop several billion dollars. Senator Moynihan believes the figure to be \$10 billion.⁶

The debate over tax shelters, some would say, fortuitously coincided with an overall tax reform bandwagon that carried as part of its baggage multiple and independent objectives. One of these stated objectives was tax simplification. By nature, most Internal Revenue Code (Code) provisions that previously have formed the statutory core for tax sheltering have been complex. Arguably, by curtailing or eliminating such provisions the Code will become simpler by at least some degree. Another stated objective of tax reform was that of rate reduction. If marginal tax rates on the whole were reduced, then it would follow that both the necessity and the incentive to avoid taxes would be lessened. Finally, critics from all circles called for fair treatment amongst taxpayers. These critics had been supporting a “minimum tax,” so that ordinary taxpayers would no longer read of billionaires or mega-conglomerates suffering lower or no overall liability. They believed that blunting the previously sharp effect of tax shelters would pave a path to implementing a minimum tax since taxpayers would no longer would taxpayers be able to “zero out” their taxable income. All of these factors led to a clarion call to end, once and for all, provisions that have created opportunities to shelter taxable income. Now that the call has been transformed from mere discussion to new law, it is time to assess

³132 CONG. REC. S6730 (daily ed. June 4, 1986) (statement of Sen. Moynihan).

⁴*Id.*

⁵*Id.*

⁶*Id.*

whether indeed tax shelters are dead, or whether taxpayers are just seeing a form of new wine in old bottles.

The Tax Reform Act of 1986 addressed tax sheltering in numerous ways. First of all, the Act eliminated investment tax credits and severely curtailed the real property portion of the Accelerated Cost Recovery System (ACRS), which was enacted as recently as 1981. Secondly, the Act posited the passive loss and at-risk provisions as a means of further curtailing the ability of real property deductions to shelter taxpayer income. Finally, the Act established new credits for low income housing expenditures and reformulated credits for certain rehabilitation expenditures.

II. INVESTMENT TAX CREDIT (ITC)/ACCELERATED COST RECOVERY SYSTEM (ACRS)

Regular investment tax credits, codified in 1981 as Section 46(a)(1), were repealed outright for property placed into service after December 31, 1985 by Tax Reform Act Section 211(a).⁷ In its place, the Act creates new Code Section 49, which allows forms of tax credits to continue to be available for:

- a) property, covered via Section 38 by certain transition rules, which had either been constructed, reconstructed, or acquired under a written contract binding by December 31, 1985, and placed into service (depending on property type) no later than January 1, 1991;
- b) certain qualified progress expenditures for periods prior to January 1, 1986; and,
- c) portions of the adjusted basis of qualified timber treated as section 38 property under Section 48(a)(1)(F).

The reduction in overall investment tax credits is compensated for by the new, lower tax rates.

Other investment tax credit provisions of the Act further serve to underscore the legislative impulse to curtail tax shelters. For example, while the provisions preserve unexpired ITC carryovers (as of December 31, 1985) and entitle the holder to use them in subsequent taxable years, the carryovers are reduced by 35%.⁸ Next, the provisions reduce the regular ITC and require a full basis reduction for Section 38 transition property (other than qualified timber property). Finally, the provisions raise the tax liability limitation rule. The conference committee reports state clearly that the above basis adjustment rule applies even to the post-1985 property eligible for depreciation under modified ACRS.⁹

Tax Reform Act Section 201(a) amended Code Section 168 to channel

⁷Pub. L. No. 99-514, § 211(a), 100 Stat. 2085, 2166 (1986) (codified at I.R.C. § 49 (1986)).

⁸I.R.C. § 49(c)(1), (2) (1986).

⁹H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 63 (1986).

ACRS away from favoritism for real property.¹⁰ The new system, effective for tax years beginning in 1987, in most other respects, retains the original ACRS framework. The 3-, 5-, 10- and 15-year property classes are retained while two new classes — 7- and 20-year property — are introduced.¹¹ However, real estate interests — both residential and non-residential — do not fare well under the Act. Both of these forms of real estate now must be depreciated using the straight-line method.¹² In addition, the recovery period for real estate property is extended from 19 years for both residential and non-residential property to 27½ years and 31½ years, respectively.¹³ Clearly, real estate takes a beating here. Such “special” treatment, legislators argue, is no doubt warranted by recent abuses in real estate shelters.

The result of this special attention, however, is a great amount of complication and ambiguity for real estate owners. Now, real estate owning taxpayers will have three sets of depreciation rules for their property. First, the old “useful life” system, which applies to property placed into service prior to 1981 (and ACRS), as well as to property covered by the original anti-churning rules. Second, the original ACRS framework, which applies to assets placed into service after 1980 and before 1987 (as well as property covered by the transition rules of the Act and a new set of anti-churning rules). Third, and finally, the new ACRS framework, which applies to all property placed into service after December 31, 1986. And if that is not complicated enough, then it should not be overlooked that taxpayers placing real property into service between July 1, 1986 and December 31, 1986 have a choice between old ACRS and new ACRS. The question arises whether such complexity is really necessary and whether something more in the spirit of “simplification” could not have been devised.

On its face, the Act’s attack on tax credits and accelerated depreciation on real property appears to be faithful to the reform creed of “elimination” — or at least “curtailment” — of certain avenues of tax sheltering. It seems, however, that Congress was more generous in other areas.

III. PASSIVE LOSS PROVISION

Whether Section 501 of the Tax Reform Act (hereinafter referred to as Section 469 of the Internal Revenue Code of 1986) effectively will further help eliminate tax shelters depends upon the degree to which its language is imperious to attack. The statute provides a general rule which limits the loss deduction and credits from passive activities to income from passive activities.¹⁴ Ac-

¹⁰Pub. L. No. 99-514, § 201(a), 100 Stat. 2085, 2121-36 (1986).

¹¹I.R.C. § 168(a)(2), (c) (1986).

¹²I.R.C. § 168(b)(3) (1986).

¹³I.R.C. § 168(c) (1986).

¹⁴Taxpayers with interests in passive activities acquired prior to January 1, 1987, are entitled to a more lenient phase-in rule so that part of their passive losses from such activities may offset non-passive income.

cordingly, a taxpayer subject to Section 469 may not use losses¹⁵ from passive activities to offset active income, such as salary and wages, or portfolio income, such as interest, dividends, royalties and the gain on the sale of investments other than investments in a trade or business.¹⁶ However, the statutory language exempts from this stricture specified taxpayers. These include C corporations not defined as closely-held and listed activities such as working interests in oil and gas activities in which the taxpayer's form of ownership is not limited in liability.¹⁷ These exemptions suggest that other breaths of life may be hiding within the statute's depths for tax shelters. To this end, let's examine the provision.

A. General Rule of Section 469(a) and (b)

As previously stated, the general rule of Section 469(a) disallows for any taxable year a taxpayer aggregates losses from all passive activities.¹⁸ Similarly, credits from all passive activities are disallowed if they exceed the regular tax liability of the taxpayer for the taxable year that is attributable to all passive activities.¹⁹ Disallowed losses and credits are not forfeited by the taxpayer. Rather, Section 469(b) provides that the disallowed amounts may be suspended and carried forward (not back) indefinitely. Such suspended passive losses may be applied against a taxpayer's passive income available in a subsequent taxable year.²⁰

Nonforfeitability is carried one step further by the relief provision of Section 469(g). If a taxpayer has suspended losses remaining at the time that he disposes of his entire interest in the passive activity through a fully taxable transaction, such suspended losses, while retaining their character as passive losses, may be used by the taxpayer to offset income from any source, *i.e.*, active, portfolio or passive.²¹ Congress reasoned that this disposition rule finally

I.R.C. § 469 (l) (1986). This five year phase-in provision decreases a taxpayer's ability to use 100% of such net passive losses and credits to offset active income in 1986 to 65% in 1987, 40% in 1988, 20% in 1989, 10% in 1990 and 0% in 1991. Thus, the phase-in rule in certain instances temporarily reduces the forcefulness of the restrictive impact of § 469(a).

¹⁵Deductions from passive activities include deductions per I.R.C. §§ 162, 163, 164 and 165 (1986). Disallowance of excess investment interest expense per I.R.C. § 163(d) preempts the passive loss disallowance rule of § 469.

¹⁶In calculating portfolio income, expenses and interest allocable to the investments are taken into account. Thus portfolio income is actually net portfolio income.

¹⁷I.R.C. § 469(c)(3)(A) (1986).

¹⁸See *supra* note 14 and accompanying text.

¹⁹I.R.C. § 469(a)(1)(B), (d)(2) (1986).

²⁰I.R.C. § 469(b) (1986).

²¹Although the passive losses theoretically retain their character, in practical terms this generally may have little ultimate impact. When the taxpayer disposes of his entire passive activity interest in a taxable transaction, the suspended passive losses may be utilized to offset income from other sources. In this way, I.R.C. § 469(a) and (b) are little more than timing provisions, not dissimilar to § 83, and ultimately may allow de facto conversion of passive losses into non-passive losses.

S. REP. NO. 313, 99th Cong., 2d Sess. 713, 724 (1986) clearly states that a gift of all or part of a taxpayer's interest in passive activities does not trigger allowance of the previously disallowed passive losses. Moreover, a mere change in form of ownership does not trigger the allowance. See also H.R. CONF. REP. NO. 841, *supra*

makes possible the measurement of the taxpayer's ultimate economic gain or loss from the passive activity; prior to this time, loss deductions might exceed actual economic, non-paper expenses or may be exceeded by unrealized appreciation.²² However, the statute excepts from deductibility such a disposition if it occurs between related parties as described in Section 267(c) or Section 707(b)(1).²³ In that event, the disposition will be considered a sham transaction and the loss deduction will be disallowed until such a time that the interest is acquired in a taxable transaction by an unrelated party.²⁴ Finally, Congress believed that since credits are not related to the measurement of passive losses, they should not be allowed upon a taxpayer's disposition of his entire interest in the passive activity.

B. Covered Taxpayers

Taxpayers subject to the restrictions of Section 469 include any individual, estate, trust, certain personal service corporations, and certain "closely-held C corporations."²⁵ A covered "closely-held C corporation" is defined in Section 469(j)(1) as similar to a closely-held C corporation for purposes

note 9, at 141. This means that exchanges of interests in passive activities, *e.g.*, the exchange of a limited partnership interest where the partnership is involved in one rental activity for a general partnership interest or a limited partnership interest for a C corporation interest, will not frustrate the restrictions of § 469. However, Congress did not address the question of whether the taxpayer must have disposed of his entire directly and indirectly owned interest, *i.e.*, one that he constructively owned pursuant to such attribution rules as §§ 267(c) and 707(b). One can only assume that Congress intended such coverage. As the Senate Report further explains a mere change in ownership also includes situations where a taxpayer shifts his level of participation in the trade or business activity from passive to material during a taxable year or from one year to the next. S. REP. NO. 313, 99th Cong., 2d Sess. 725 (1986). This means that if a naive taxpayer desires to change his participation level and trigger the allowance of previously disallowed passive losses, he might plan to dispose of his entire interest in a taxable transaction and then subsequently to reacquire an interest in the trade or business in which he will materially participate. However, the Service likely would consider this a step transaction and disallow the taxpayer's claim of deductibility or previously suspended passive losses.

When a limited partnership disposes of one separable passive activity and retains others, according to the Senate Finance Committee, the conduit theory does not apply to allow partners to act as if they have disposed of their entire *partnership* interests for purposes of triggering loss allowance of previously suspended passive losses. *Id.* H.R. CONF. REP., *supra* note 9, at 145, eliminated this Senate Finance Committee restriction. Pursuant to the Conference Report, disposition of a partner's entire interest in one of two separable passive activities will trigger suspended losses from that one activity and allow the partner to offset not only passive income from other passive activities but also to offset his active and portfolio income. So, the partnership as a separate legal entity is pierced and thus is disregarded for purposes of § 469.

Finally, one might wonder whether the suspension of losses until a taxpayer finally disposes of his entire interest might cause a distortion or mismatching of losses and income. If so, this would conflict with the very intent of Congress that there be a better matching than under current law. If a taxpayer were to dispose of a partial interest, the passive losses attributable to that partial interest would not become deductible until later disposition of the taxpayer's remaining interest. To avoid distortion of real economic income, at the time of the original partial disposition, assuming that the income and gain is measurable, the gain should be immediately offset by the losses attributable to that interest portion.

²²S. REP. NO. 313, *supra* note 21, at 725.

²³I.R.C. § 469(g)(1)(B) (1986).

²⁴Pursuant to I.R.C. §§ 707(b)(1) and 267 (1986), the unrelated party will be entitled to offset his income from any source by the taxpayer originally holding the interest in the passive activity. In this way, the original interest holder is punished through denial of the loss deduction and unearned reward is shifted ultimately to the unrelated party.

²⁵I.R.C. § 469(a)(2) (1986).

of the Section 465 at-risk rules.²⁶ The definition generally includes any C corporation more than 50% of whose stock is owned directly or indirectly by five or fewer individuals. The closely-held C corporation definition clearly includes partners who fall within any of the above categories. The definition excludes S corporations, C corporations 50% or less of whose stock is owned by five or fewer individuals, and also C corporations more than 50% of whose stock is owned directly or indirectly by more than five individuals.²⁷ These exclusions leave room for individuals to establish corporations outside the reaches of Section 469.

C. Passive Activity Definition

Section 469(c) defines passive activity to include: (1) trade or business activity in which the taxpayer does not materially participate; and (2) rental activity. The concept of trade or business activity for purposes of this statute is not equivalent exclusively to the trade or business definition applicable to Section 162. Rather, this trade or business activity also includes activities entered into for the production of income within the meaning of Section 212.²⁸ Thus, if a taxpayer is involved in production of income or trade or business activity in which he materially participates, he is not subject to the strictures of Section 469(a).

Rental activities, where payments are primarily for the use of tangible personal and real property, automatically will be considered a passive activity.²⁹ This appears to have a rather broad reach, but Congress narrows its scope in several aspects. Activities that immediately precede the rental activity, that are conducted by the same persons or take place in the same location, or that are associated with, but do not actually involve, renting tangible personal or real property are deemed not to be part of the actual rental activity. In other words, such activities are categorized independently as separate activities. For example, the construction of an apartment or office building is considered a separate activity from the leasing of the apartments or office space. Only the latter activity will be treated as rental activity.

The narrowing of the scope of rental activity is also clear from a general rule involving location of rental property. A rental activity is defined with respect to rental property at one site. This rule means that each separate building in which space is leased will be considered a separate activity.

Finally, the narrowness of the rental activity definition is apparent in the rule that it excludes situations where substantial services (not merely incidental services) are also provided. For example, hotels and condo-hotels which

²⁶I.R.C. § 465(c)(7)(B) (1986).

²⁷I.R.C. § 465(a)(1)(B) (1986).

²⁸I.R.C. § 469(c)(6) (1986).

²⁹I.R.C. § 469(c)(2), (j)(8) (1986).

provide food, laundry, maid and other services to guests will not be rental activity. Likewise, nursing homes that provide patient care, food and laundry services, etc. will not be rental activity. Car rental businesses which rent, clean, maintain and repair cars for lessee used similarly will not be rental activity.³⁰

The definition of a passive activity is not bounded by, nor dependent upon, legal entity status; legal entity status is disregarded for purposes of determining and distinguishing among activities.³¹ Therefore, any partnership or closely-held C corporation can be engaged in numerous passive activities. For example, one such partnership or closely-held C corporation might invest in mortgages, construct buildings, rent apartments, and invest in a clothing discount outlet. The Code considers such a partnership or corporation to be involved in four separate passive activities; the legal status of the partnership or corporation is totally disregarded.

D. Material Participation Results in Non-Passive Activity Treatment

Material participation of a taxpayer in a trade or business activity is statutorily excluded from the definition of passive activity.³² Thus, where the taxpayer materially participates in a trade or business activity, he escapes the passive activity deductibility limitation of Section 469(a). Section 469(h) defines a taxpayer's material participation in a passive activity to include his own or his spouse's "regular, continuous and substantial" involvement in operations throughout the year.³³ This standard is subjective and only supplies a general yardstick by which a taxpayer may be guided.³⁴ The subjectivity of the standard is observable in numerous respects. For instance, it is underscored by the language of the Senate Finance Committee Report which indicates that material participation of a taxpayer with a general partnership interest depends on facts and circumstances.³⁵ It may be difficult to assure a taxpayer that he indeed is materially participating in a passive activity and would thus not be subject to the Section 469(a) deductibility limitations.

However, looking at the legislative intent of Section 469, a taxpayer is most likely to satisfy the material participation requirement if the involvement is in one's full-time, principal business, or in an activity having significant non-

³⁰I.R.C. § 469(j)(2) (1986); see generally S. REP. NO. 313, *supra* note 21, at 720-21.

³¹I.R.C. § 469(a)(2) (1986); see generally S. REP. NO. 313, *supra* note 21, at 721-22.

³²I.R.C. § 469(c)(1)(B) (1986).

³³S. REP. NO. 313, *supra* note 21, at 728. The Report explains that regardless of whether the taxpayer and his spouse file jointly, the spouse's participation will be attributed to the taxpayer. The Report does not explain whether "throughout" the taxable year means that divorce during the year would interrupt the attribution; presumably it would.

³⁴Subjectivity is particularly apparent in light of the fact that the Senate Finance Committee Report indicates that the material participation standard is not controlled or affected by similar preexisting legal standards applicable to other statutes of the Internal Revenue Code. *Id.* at 732.

³⁵*Id.* at 729. One might wonder whether and to what extent state law impacts the determination that the material participation standard is satisfied by a general partner since under state law it is the general partners that have the authority to become substantially involved in partnership managerial matters.

tax, genuine economic motives and value.³⁶ In fact, a taxpayer will be treated as materially participating in each separate activity within a single line of the business in which he spends most of his time in operations or in management. Thus, a taxpayer may be deemed to materially participate in a particular activity even if he spends relatively little time and energy in it. The purpose of this single "line of business" rule is to reduce a taxpayer's opportunities for creating and pairing passive income and losses within a business. This rule stipulates that the taxpayer's activities in a single "line of business" will be treated as non-passive in nature. In essence, the rule automatically converts losses from otherwise passive activity into losses from non-passive activities. We must observe that while the Conference Committee Report discussed this "line of business" rule and its consequences, the Report does not define "line of business." This is yet another instance of a Section 469 rule open to subjective interpretation.

It appears that in practical terms, satisfaction of the material participation standard will be rather limited. As above discussed, general partners can meet the standard under certain circumstances. By contrast, limited partners and investors in a master limited partnership are presumed to not materially participate in an activity *unless provided to the contrary by Treasury regulations*.³⁷ Although this rule provides opportunity for flexibility, the flexibility remains entirely in the hands of the Treasury Department. Thus, until such time as the Treasury writes the regulations, the presumption that such taxpayers cannot materially participate in an activity is irrefutable and conclusive. Furthermore, this exclusion presumably applies regardless of whether such a taxpayer is the direct or indirect owner of such a limited partnership interest. By comparison, a closely-held C corporation and a personal holding company, as entities, necessarily will be treated as materially participating in an activity if one or more shareholders having more than a 50% stock interest materially participate or if such corporations meet the Section 465(c)(7)(C) terms.³⁸ Thus, the material participation standard will be applicable primarily to general partners and to closely-held C corporations. This indicates the breadth of the reaches of Section 469(a).

IV. ACTIVE PARTICIPATION IN RENTAL ACTIVITIES — SECTION 469(i) RELIEF TO SECTION 469(a)

The Code provides a measure of relief to the harsh rule of Section 469(a)

³⁶See generally S. REP. NO. 313, *supra* note 21, at 732.

³⁷This rule is consistent with the state law concept that responsibility for management decisions is vested exclusively in general partners. This conclusive presumption applies even when the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement, e.g., the taxpayer actually owns a general partnership interest but the partnership itself owns a limited partnership interest in another limited partnership. See S. REP. NO. 313, *supra* note 21, at 729. However, the Report does not indicate that the conclusive presumption applies where the taxpayer is attributed a limited partnership interest from a related individual.

Dealers whose primary activity is real estate are not subject to the rental activities rules of § 469. *Id.* at 720.

³⁸I.R.C. § 465(c)(7)(C) (1986).

in Section 469(i). The relief measure applies only to a taxpayer who is a natural person (*i.e.*, an individual) and who actively participates in the rental activities of real estate property; by definition, taxpayers who are not individuals (*i.e.*, trusts, estates and corporations) are excluded from the Section 469(i) benefit. Moreover, for non-real estate rentals (*i.e.*, machinery), the road-block to relief is virtually absolute.

Section 469(i) generally provides that the passive losses from the active participation in rental real estate activities are utilized first to offset passive income from such activities. If this netting results in excess (net) passive loss from rental activities, the excess is applied against income from other passive activities.³⁹ Only after the double netting process does the taxpayer become entitled under Section 469(i) to offset \$25,000 of income from other sources in the taxable year.⁴⁰ A deduction equivalent applies to similarly offset income by passive credits.

The additional \$25,000 offset is phased out ratably when the taxpayer has adjusted gross income (computed without reference to passive losses) between \$100,000 and \$150,000.⁴¹ It is clear from this phase-out rule that if a taxpayer has adjusted gross income of at least \$150,000, he will not be entitled to the \$25,000 Section 469(i) relief.⁴² Many studies have indicated that the vast majority of individuals investing in real estate have adjusted gross income in excess of \$150,000. This factor alone necessitates that the Section 469(i) benefit will apply to a limited group of taxpayers.

Congress included several further statutory caveats to entitlement to the Section 469(i) relief. First, an individual with less than a 10% interest in the real estate rental activity at any time during the taxable year will never be considered to actively participate in it. Therefore, an individual with up to a 9.99% general partnership interest in a partnership that rents apartment buildings will be entitled only to offset his passive losses from such activity with passive income. Conversely, this means that such an individual with adjusted gross income of less than \$150,000, who has a 10% or more interest, if actively involved in the rental activity, will be entitled to the Section 469(i) relief. Second, regardless of the amount of interest held, a limited partner with an interest in a partnership involved in real estate rental activity is conclusively considered not to actively participate in the rental activity.⁴³ The limited partner will be restricted by the general rule of Section 469(a); he may only offset

³⁹I.R.C. § 469(i)(1) (1986).

⁴⁰I.R.C. § 469(i)(2) (1986).

⁴¹The phase out applicable to a taxpayer's adjusted gross income is raised (between \$200,000 and \$250,000) if the passive credits are related to rehabilitated or low income housing.

⁴²I.R.C. § 469(i)(b)(A) (1986).

⁴³See *supra* note 35 for similar reasoning.

his passive income by passive losses and credits. This prevents purely passive and paper expenses from offsetting positive income.⁴⁴

The standard required to satisfy the Section 469(i) active participation condition is not as stringent as that required to satisfy the material participation requirement. The former requirement "can be satisfied without regular, continuous and substantial involvement in operations, so long as the taxpayer participates, *i.e.*, in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense."⁴⁵ This more generous standard again is subjective, yet it carves out an area for a few particular taxpayers to effectively participate in sheltering positive income (albeit a limited amount). One might question whether this congressional generosity is entirely consistent with the pure legislative intent to avoid the sheltering of positive income by paper losses, to prevent the distorting and mismatching of losses from passive activity against unrealized appreciation of real economic gain, and to encourage "excessively" high leveraged investments.

Another area of legislative generosity under the passive loss provisions is through the exceptions granted to oil and gas "working interests." Section 469(c)(3)(A) provides that ownership of an oil and gas working interest is not regarded as a passive activity if the taxpayer owns the interest directly or through an entity that does not limit taxpayer liability (*i.e.*, limited partnership, S Corporation interest).⁴⁶ The lesser standard of "active participation" established by the rental real estate activity category applies also to oil and gas interests, rather than the more stringent "material participation" standard.⁴⁷ The Senate Finance Committee Report accompanying the legislation generally indicated that "working interests" would be deferred as an interest directly burdened with the cost of developing and operating the property.⁴⁸ Thus, contract rights to extract or share in the oil and gas, or a mere profits interest from the extraction, without evidence of an actual share in operating or liability

⁴⁴The Conference Committee calls for the Treasury to clarify the definition of that income which is to be treated as portfolio income rather than as passive activity income. H.R. CONF. REP. NO. 841, *supra* note 9, at 146.

⁴⁵S. REP. NO. 313, *supra* note 21, at 737.

⁴⁶I.R.C. § 469(c)(3)(A) (1986). While Senate commentary concentrated in part on the minimum working requirements required to establish a "working interest," overall congressional interest seemed especially pointed where a working interest concerned liability limitation. Toward this end, working interest characteristics would also include a proportionate share of tort liability "and some responsibility to share in further costs with respect to property in the event that a decision is made to spend more than amounts already contributed." Further testimony indicates, however, that if a taxpayer is entitled to decline or does decline to make additional contributions under a buyout, nonparticipation, or similar arrangements, he may still possess a working interest. Additionally, the fact that a taxpayer carries an insurance policy against potential tort liability related to the oil and gas interest does not contradict his ability to possess a working interest.

⁴⁷The \$25,000 deduction ceiling which applies to rental real estate activities does not apply to oil and gas "working interests," so that losses are allowable in full. *Id.*

⁴⁸I.R.C. § 469(c)(3)(A) (1986). *See generally*, S. REP. NO. 313, *supra* note 21, at 744-45.

costs, would not be considered "working interests."⁴⁹ Finally, a "working interest" in oil and gas property cannot be converted into "passive activity" after achieving profitability.⁵⁰

Again, when one considers the clear original intent of Congress to eliminate tax shelters, one questions this additional instance of legislative generosity. The question arises particularly amidst a seeming absence of overall purpose or focus by the authors of tax shelter reform.

V. AT RISK RULES

Congress originally enacted the at-risk rules as part of the Tax Reform Act of 1976.⁵¹ Through its presence Congress intended to combat a perceived increase in tax sheltering. The provision specifically attempted to limit the deductibility of losses by certain taxpayers involved in five listed activities to the amount for which the taxpayer was economically responsible ("at-risk").⁵² The statute specifically excluded real estate activities from its reaches and thus treated it as a sacred cow.⁵³ While one can only speculate as to congressional motives for exclusion of real estate activities from the 1976 statute, at any rate such exclusion must be seen as explicit, active tax shelter policy.

Recently, however, the Joint Tax Committee expressed its belief that real estate activities should no longer remain an untouchable sacred cow. In Section 503(a) of the Tax Reform Act of 1986 (Section 465 of the Code) Congress extended the at-risk rules to include real estate. The stated reason for the extension of the provision was to limit opportunities to overvalue property (resulting in inflated tax deductions) *and* to prevent the transfer of tax benefits arising from real estate activities to taxpayers with little or no equity in the property. To this end a taxpayer will in general be considered at-risk with respect to borrowed amounts if two conditions are met.⁵⁴ The first of these conditions is that the taxpayer is personally liable for repayment of the debt. The second condition is that the lender of the debt may have no interest in the activity other than as a creditor (*i.e.*, if a partner makes the loan then the amount is not considered at-risk), except to the extent provided in the Treasury regulations. The fact that at-risk rules are extended to real property means that a taxpayer's deduction for losses from real property are limited, *except* with respect

⁴⁹S. REP. No. 313, *supra* note 21, at 744.

⁵⁰I.R.C. § 469(c)(3)(B) (1986).

⁵¹Pub. L. No. 94-455, 90 Stat. 1520, 1531-33 (1976).

⁵²I.R.C. § 465(c)(1). This provision does include exploring for, or exploiting, oil and gas resources. So while certain working interests in oil and gas are excepted from the restrictions of § 469(a), the deduction of losses may be limited by § 465.

⁵³I.R.C. § 465(c)(3)(D) (1985), *amended* by Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

⁵⁴I.R.C. § 465(b)(3)(B) (1986).

to qualified non-recourse financing,⁵⁵ to the sum of 1) the amount of money paid, 2) the adjusted basis of property contributed, and 3) amounts borrowed where the taxpayer is personally liable or has pledged his other property as security.

The newly revised at-risk statute creates exceptions and exclusions from these conditions. For example, qualified nonrecourse financing when provided by organizations in the business of lending will be considered amounts at-risk to those engaged in rental real estate activities. So, this important part of the earlier at-risk provisions remains nearly untouched. Also, the Act allows the continuation of the current at-risk aggregation rules,⁵⁶ which are intended to aggregate the interests of several partnerships into one activity if the taxpayer "actively participates." Finally, a loss or interest deduction disallowed by the at-risk rules for a taxable year will be temporarily suspended by those rules rather than by the more restrictive passive loss provisions.⁵⁷ These exceptions and exclusions clearly carve out areas where some individual taxpayers might actively participate in real estate activities and continue to shelter some portion of the losses from that activity against positive income.

VI. CREDITS FOR LOW INCOME HOUSING AND REHABILITATION EXPENDITURES

Another area of congressional generosity emerges under the provisions of the Act granting direct tax credits for low-income housing and rehabilitation expenditures. Again, with overall congressional motives vis-a-vis tax shelter reform is less than clear; one can only speculate as to congressional intent in erecting yet another barrier to real estate tax shelter "elimination."

Act Section 252 adds a wholly new Code Section 42 that establishes certain tax credits for low-income housing placed into service after 1986 and before 1990. These credits supercede existing tax incentives for low-income housing such as preferential depreciation, five-year amortization or rehabilitation expenditures, and special treatment of construction period interest and taxes. The tax credits offered by the Act amount to 9% each year over a ten-year period for new construction and/or rehabilitation expenditures,⁵⁸ with the

⁵⁵"Qualified" non-recourse financing includes financing which is borrowed a) by the taxpayer with respect to the activity of holding real property, b) by the taxpayer from a qualified lender or from any government instrumentality, c) without personal liability for repayment, and d) which is not convertible debt. For clarification purposes, a "qualified" lender is a) a third-party lender, b) unrelated to the taxpayer, c) not a seller of the property, or d) one who is paid a fee with respect to the taxpayer's investment in the property. Also, a nonrecourse note from a "related" party will be respected if it is commercially reasonable and on substantially the same terms as loans involving unrelated persons. Also, one should note that neither the Tax Reform Act of 1986 nor congressional committee reports define convertible debt. Generally speaking, convertible debt is an arrangement whereby a lender may at some future time convert his interest as a lender into an equity interest in the property.

⁵⁶I.R.C. § 465(c)(3)(B) (1986).

⁵⁷This means that the at-risk rules, if applicable, will operate separately from the passive loss provisions. Conceivably, one might have losses suspended concurrently under both provisions. The treatment of losses is unclear when a partner's "at-risk" and partnership bases are increased.

⁵⁸I.R.C. § 42(b) (1986).

condition that the expenditure must amount to at least \$2,000 per unit to be rented.⁵⁹ In aggregate present value terms, the credit amounts to 70% of incurred costs.⁶⁰ There is even a credit of 4% per year if the project is financed with tax exempt credit or if the taxpayer is only acquiring existing housing and plans no rehabilitation.⁶¹

Clearly, the reasons for enacting those credits were not meant to further curtail tax credits for investments in real property. Rather, it appears that Congress saw a shortage in low-income housing, and saw credit as a means of stimulating investment in such housing. Prior to 1986, other incentives existed for low-income housing. These incentives included:

- a) tax-exempt multi-family rental housing bonds;
- b) 15-year ACRS deduction for such housing using a 200% declining balance method;
- c) five-year amortization for certain rehabilitation expenditures; and,
- d) special deductions for construction period interest and taxes.

Congress expanded on these incentives in the 1986 Act, feeling that prior incentives were not operating in a sufficiently coordinated manner, resulting in tax subsidies unrelated to the number of low-income individuals served. Also, and pursuant to these beliefs, Congress felt that existing sheltering methods did not guarantee that affordable housing would be provided to those that needed it the most.⁶² Therefore, Congress established these new shelter credits purportedly to better serve society's needs.⁶³ This may be true — certainly it is interesting. However, these credits, far from curtailing pre-1987 modes of tax sheltering, actually go a long way toward institutionalizing them.⁶⁴

Likewise, credits for rehabilitation expenditures, far from being eliminated, remain virtually unscathed by the Act. The new law replaces a three-tier rehabilitation credit structure with a similar two-tier credit. Under prior law, if the building were 30 years or older, the credit would be 15%; 40 years or older, 20%; and, if a certified historic building, 25%. The new credits are similar: 10% for all buildings placed into service prior to 1936, 20% for certified historic structures. These credits fared very well under the new law,

⁵⁹I.R.C. § 42(e) (1986).

⁶⁰I.R.C. § 42(b) (1986).

⁶¹I.R.C. § 42(b)(1)(B) (1986).

⁶²S. REP. NO. 313, *supra* note 21, at 758.

⁶³*Id.* at 759.

⁶⁴It should be noted here that the low-income housing credits work in tandem with both the new passive loss *and* at-risk provisions. Under the passive loss provisions, the credit (but not the loss) is treated as arising from rental real estate activities in which the taxpayer actively participates. Credits can be used to offset tax on up to \$25,000 of non-passive income, subject to phase-out when taxpayer reaches \$200,000 to \$250,000 of adjusted gross income. H.R. CONF. REP. NO. 841, *supra* note 9, at II-103. Credits claimed, however, do not reduce the basis of the building. Also, the credits are subject to the at-risk limitation similar to the investment credit at-risk limitation. *Id.* at II-98-99. However, the effect of this, due to the exception carried out for non-recourse financing by the Act is virtually nil.

particularly in light of the dramatic lowering of the overall tax rates.

VII. OBSERVATIONS AND ANALYSIS

As stated in the beginning, the objective of tax shelter reform as embodied in the debate leading up to passage of the Tax Reform Act was not merely to change the focus or scope of sheltering, but to eliminate it altogether. The Act went some way toward doing just that. Investment tax credits and accelerated cost recovery are now completely eradicated. These were extraordinarily important tenets of recent tax shelter schemes, and provided a philosophical core to the existence of tax shelters to stimulate overall business investment. Now that this core has vanished, pursuant to revised tax shelter objectives, one stands ready to discern the focus of the new provisions. The motives of Congress in eliminating some types of sheltering schemes and erecting others, however, have not been systematically articulated. From this standpoint one may wonder why the authors of the Act went so far toward erecting simplified terms in other parts of the new code provisions, only to establish the passive loss provisions, surely one of the more complicated and vague elements of the Act. Finally, pursuant to the new provisions, one is entitled to question whether the new provisions do curtail sheltering as much as claimed, or whether they merely provide a smoke screen for a changed, though still vigorous, tax shelter climate. This is particularly the case in reviewing the passive loss and at-risk provisions of the Act.

Clearly, comment on revised Section 465 and on new Section 469 must inevitably focus on the question of whether the statutes truly signal a demise in the tax shelter industry, or merely a reorientation. When one looks at the actual language of the provisions, one is stuck by the glaring exceptions to the stated objective of tax shelter rigor mortis. For example, take the passive loss restrictions. They appear impressive at first glance, but then one encounters exceptions for oil and gas exploration and, with limits, for rental real estate property. Moreover, though some tax deductions are denied on a yearly basis, they are allowed in full upon a taxpayer's disposition of his entire interest in the passive activity. Looking at the bottom line, this is merely a timing difference rather than a true substantive change. The glaring at-risk exception for nonrecourse lending in the area of rental real estate activities is unavoidable. In fact, the vast majority of current real estate tax shelters is based upon such financing.⁶⁵ What is striking about these exceptions is their focus: these elements of tax sheltering that were excepted are exactly the types of strategies which legislators had long cited as overall tax shelter reasons for

⁶⁵For example, in 1983, of the 109,491 limited partnerships involved in real estate activities, 54.9% of their total debt was non-recourse liability. DEPT. OF TREASURY, INTERNAL REVENUE SERV. 5, STATISTICS OF INCOME BULLETIN 4, at 73 (1986). Many tax commentators have consistently and effectively challenged the legitimacy of tax deductions based on partnership basis established by non-recourse debt. The bottom-line of such challenges is that it cannot be realistically considered an amount "at-risk." Yet it remains a viable vehicle for tax deductions.

elimination. If this appears contradictory, it is not surprising. In most circles, "elimination" means just that. Apparently, the same is not true in some tax circles. Toward this end, one might wonder whether the intended goal of these provisions, as designed, will accomplish their highly touted objectives.

In assessing the impact of the Act's tax shelter provisions, one should examine the extent to which they complement/conflict with other existing Code and Treasury Regulation provisions. Only recently, new regulations in the partnership special allocation arena were finalized.⁶⁶ In certain areas, the new tax shelter provisions openly contradict the special allocation regulations. For example, while the special loss allocation regulations allow early partnership deductions (*i.e.*, greater than \$25,000 for any individual partner) to be taken so long as the special loss allocation has "special economic effect," provisions in the Tax Reform Act would specifically deny the effect of such an allocation. Also, it appears as though a partnership could specially allocate passive income to certain partners under the special allocation regulations in order that they might take larger passive loss deductions. The provisions additionally would seem to allow situations where a partnership could specially allocate passive losses to a corporate general partner since corporations are able to use passive losses against other forms of income. Moreover, consider the provision in the special allocation regulations for revaluing partnership property; one might want to question whether paper revaluations of partnership property (both upward and downward) will enable partners to circumvent deduction limitations and thereby subvert the passive loss restrictions. Finally, in the at-risk area, the generous exceptions would limit only the taxpayer who is considered a related person lender; but this party's leverage is already limited by Sections 267 and 707.

Observers might also question the impact of Sections 42, 46, 48, 465 and 469 on individual partners as well as on the federal government's overall tax revenues. A cursory glance at recent government statistics of partnership income reveals startling observations, particularly in light of common perceptions regarding the nature of tax sheltering. For all the talk of sharp rises in real estate tax shelter deductions in recent years, there is another side to this view. Although net partnership deficits in the real estate area in the aggregate grew by about 70% between 1978 and 1982, during that same period, the total number of individual partners in real estate partnerships rose by over 60%.⁶⁷ Then, assuming no special allocations, the net deficit *per partner* actually grew only marginally in that "boom" period, not "astoundingly" as intimated by many who supported the elimination of real estate shelters. One also should consider that during 1981 alone, among real estate partnerships composed of operators and lessors (the vast majority of real estate partnerships), net deficits

⁶⁶Treas. Reg. § 1.704-1(b) (1986).

⁶⁷DEPT. OF TREASURY, INTERNAL REVENUE SERV., STATISTICS OF INCOME SOURCE BOOK — PARTNERSHIP RETURNS, 1978-1982, at 1 (1985) [hereinafter SOURCE BOOK — PARTNERSHIP RETURNS, 1978-1982].

rose by 72%; yet partnership total deductions, including credits and depreciation, actually fell by 52%.⁶⁸ The spectre causing so much concern, then, should not have been rising tax deductions but rather a precipitous decline in these real estate partnerships' gross receipts. This hardly appears to be attributable primarily to vigorous tax avoidance; rather it might be explained as resulting from a glut in rental real estate properties. In truth, the common perception of the sharp increases in real estate tax shelter deductions does not appear to be supported totally by the publicly available statistics.⁶⁹ To base sweeping tax reform exclusively on this common perception seems inappropriate.

Information compiled by the Internal Revenue Service from a large sample of partnership income tax returns further indicates that the new Section 469(i) \$25,000 net deduction limit per partner involved in rental real estate activity might not detrimentally affect the majority of partners involved in such partnerships. For instance, in 1984 the average dollar figure for net deductions per partner involved in *all* real estate partnership activities (assuming no special allocations) was only \$4,100.⁷⁰ Again, this figure includes losses and credits. Even if one were to look at *gross* partnership deductions in this category, which does not take into account gross receipts, each partner only averaged \$14,600 in deductions. Clearly this amount is well below the \$25,000 limit of Section 469(i).⁷¹ Certainly it is true that some individual partners claimed deductions in excess of the \$14,600 and the \$25,000 figures. But, these individuals surely must constitute a very small minority in the aggregate of all rental real estate partners subject to Section 469. It is unlikely that denying these relatively few individuals excess deductions will result in a *major* tax impact: millions of partners times \$25,000 is still a lot of tax revenue lost.

Oil and gas partnerships, which many consider to be profit-making endeavors, in reality have the capacity to provide a more aggressive form of tax sheltering than real estate. At a basic level, most income recognition from oil and gas partnerships is deferred until far in the future, whereas rental real estate income (*i.e.*, rents) generally is recognized immediately and continuously. However, for both types of partnerships, expenses incurred are deductible immediately.⁷² In theory, this points toward greater tax sheltering possibilities in oil and gas than for rental real estate. Indeed, gross deductions from oil and gas partnerships in 1982 amounted to \$7.727 billion, which, assuming no

⁶⁸See *id.* at 16, 22, 57, 63, 90, 96, 98, 124, 135, 140, 182, and 187.

⁶⁹*Id.* at 3.

⁷⁰DEPT. OF TREASURY, INTERNAL REVENUE SERV., 6 STATISTICS OF INCOME BULLETIN 1, at 48 (1986). Additionally, according to figures in the SOURCE BOOK — PARTNERSHIP RETURNS, 1978-1982, *supra* note 67 *passim*, if one were not to account for possible special allocations, between the period of 1978 and 1982, inclusive, the sampled partnerships involved in operating and leasing buildings, show the average partner's total annual deductions to not exceed \$25,000 in any year.

⁷¹*Id.*

⁷²Generally, real estate and oil and gas exploration activities are subject to the I.R.C. § 465 at-risk rules.

special allocations, constituted just over \$5,100 per oil and gas partner.⁷³ This deduction figure is higher per partner than the \$4,100 per partner deduction for all rental real estate activities. What is more, net oil and gas partnership deficits, as a percentage of total gross deductions, are much higher than those in real estate. Greater gross revenues in the rental real estate sector serve to offset more total deductions than in oil and gas partnerships. The flow-through effect of this comparison actually makes oil and gas partnerships a more exaggerated form of a traditional tax shelter (*i.e.*, high deductions, low revenue) than rental real estate activities.

The past strength in rental real estate is probably more reflective of the ease in accessibility to invest in real estate as compared to oil and gas exploration. In the future, individual suppliers of partnership capital may demand easier access to oil and gas investment opportunities. It is highly likely that as limits are placed on partnership deductions from rental real estate activity, more "investment" dollars will seek greater tax sheltering and flow into oil and gas exploration. Of course, from a public policy standpoint, this may be exactly what Congress wants — more oil drilling and less dependence on foreign oil. However, from a tax standpoint, it makes ridiculous the position both that tax shelters are on the wane and that tax revenues will thereby substantially rise as a result. To the contrary, the likely result is that oil and gas partnership investments will rise, in some instances dramatically, as will their net deductions. One is entitled to question whether the potentially increased utilization of oil and gas exploration partnerships as a tax sheltering device is more desirable than the continuation of the pre-Tax Reform Act investments in real estate. After all, only the location of invested funds (and consequently the device giving rise to deductions) would change. This inquiry is buttressed further by the irony that even as Congress believes it is providing an atmosphere for more economically (*i.e.*, profit) motivated investment, the practical implication of the statutes is that partnership investment probably will rise but for the "wrong" reasons. Again, tax avoidance considerations will rule partnership investment, both in oil and gas exploration *and* in rental real estate activities. It is only the investment mix between these two categories that may be altered.

Even if Sections 465 and 469 accomplish their touted goal, potential tax planning benefits remain. When one considers that suspended passive losses can be carried forward indefinitely until the entire partnership or S Corporation interest is disposed of, then it is clear that such losses are not wasted at all. Their utility is merely deferred to a time that the taxpayer perhaps can be more advantaged by the deduction. So, the sections are really timing mechanisms for tax recognition purposes. When one accounts for the latent opportunity for special allocations and the revaluation of partnership property and capital ac-

⁷³SOURCE BOOK — PARTNERSHIP RETURNS, 1978-1982, *supra* note 67, at 179. This cited \$7.727 billion of total deductible expenses for oil and gas partnerships is substantially below the aggregate amount of deductions claimed by partners of real estate partnerships.

counts, then one must conclude that there remains considerable latitude for tax planning. Finally, a glance at marketed strategies such as master limited partnerships (MLP) is illustrative of planning devices that effectively would undercut the extreme bite of the passive loss restrictions.⁷⁴ The MLPs are marketed as entities which engage numerous separate passive activities. MLPs offer many advantages to its investors. For example, the investors may rely upon the MLP managers to maintain the income and loss records required on each passive activity. Additionally, investors can rely upon the MLP managers to select and pair passive activities which likely will produce gains with those that likely will produce losses. In that way, the burden of tax planning can be shifted to some degree from each individual investor to the MLP managers.

Other investment choices by a taxpayer might enable him to blunt the sharp claws of Section 469. For example, if a taxpayer desired to purchase mortgages, he or she might consider instead to indirectly invest in the mortgages by buying a partnership interest in a partnership in the business of real estate financing. In this way, the mortgage interest income received by the taxpayer would be converted from what would have been portfolio income (from a direct investment) to passive income (indirect investment through the partnership intermediary). By increasing passive income, the taxpayer would be in a position to offset more passive losses from other investments. Another taxpayer might choose to invest capital as a shareholder in a small corporation that falls outside the most restrictive reaches of section 469(a). The return on that taxpayer's capital investment will reflect the corporation's entitlement to offset active business income by its passive losses. Yet another investor might decide to invest in an S corporation. That we saw the availability of such strategies before the general effective date of the Tax Reform Act of 1986 confirms that tax sheltering, as an industry, is far from dead.

As if the prospect of uncertain tax and revenue effects were not enough, one should consider the likelihood of a substantial number of legal challenges to Sections 465 and 469. Such challenges are probable in order to clarify (or circumvent) some of the definitional nuances of the passive loss provisions. For example, the Act and committee reports do not go very far in defining the boundaries of a separate activity nor the breadth of a single "line of business." With the possibility for partnership aggregation, multi-tiering, and brokering of interests, taxpayers are likely to challenge the Commissioner's potentially restrictive interpretations. Also, the notion of "material participation" seems certain to engender controversy and challenge, particularly in cases where an individual taxpayer is involved in many different activities. The outcomes of

⁷⁴In December, 1986, Deputy Secretary of Treasury Dennis Ross indicated that the Treasury Department realizes the potential tax uses and abuses that a master limited partnership can accomplish. He stated that it is unlikely that the Treasury Department will write regulations that will define a master limited partnership in terms of an association taxable as a corporation. However, he stated that Congress may take legislative steps to curtail the potential for abusive use of such partnerships.

such courtroom challenges (which, by the way, are by no means limited to the examples cited here), like the tax and revenue effects discussed above, are at best uncertain.

CONCLUSION

While many politicians and news commentators have hailed Sections 501 and 503 of the Tax Reform Act of 1986 as victoriously eliminating tax sheltering, we wonder whether the future will bring the realization of total success in the endeavor. There remain many pulpits upon which to criticize the overall focus and thrust of the government's "attack" on tax sheltering. The Act did not accomplish what it set out to do vis-a-vis tax shelters. First, the tax shelter provisions of the Act are inconsistent with their stated objectives. Elimination of shelters was not uniformly accomplished. Moreover, substantial opportunities for channeling losses and obtaining credits remain. The passive loss and ACRS provisions fly in the face of a primary reform goal of "simplicity." At any rate, it is clear that these new statutes independently and in conjunction with existing statutes provide a framework from which there exist bounded opportunities to shelter positive income by passive losses, to distort and mismatch passive losses against unrealized appreciation or real economic gain, and to engage in certain highly leveraged real estate investments. The presentation of such opportunities conflicts with the intent to destroy tax sheltering. If past history is a good indicator, such opportunities will be seized. A possible outcome may be some curtailment, but certainly not elimination, of tax sheltering. If this prediction is realized, Congress has merely replaced the vintaged, but familiar, wine in old bottles with new, but untasted, wine.