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Passive Activity Provisions--A Tax Policy Blooper

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THE PASSIVE ACTIVITY PROVISIONS — A TAX POLICY BLOOPER

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I. INTRODUCTION

Since 1969,[1] Congress has made spasmodic legislative attempts to grapple with the highly publicized and invidious problem stemming from investments by wealthy taxpayers in "tax shelters"—substantial reduction of the investor's taxable income below real economic income.[2] The Tax Reform Act of 1986[3] contained the most ambitious of these attempts in its addition of new Internal Revenue Code ("the Code") section 469. This section restricts the use of losses and credits from so-called "passive activities."[4]

This article demonstrates that the expansive and indirect approach of this new provision not only fails in many cases to curb tax sheltering, but also creates a whole new class of grievous inequities. The article will first describe tax sheltering. It will then describe the operation of new Code section 469 and recently-issued regulations[5] that interpret this section. Lastly, the article will discuss the inequities, anomalies, complexities, and inefficiencies created by this provision.

1. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

2. For purposes of this article, the term "her" shall mean her or his and the term "his" shall mean her or his. The term "she" shall mean she or he and the term "he" shall mean she or he.

3. Pub. L. No. 99-514, 100 Stat. 2085.

4. I.R.C. § 469(a)(1) (1988). Except as otherwise noted, all citations are to the Internal Revenue Code as amended through October, 1988.

5. Temp. Reg. §§ 1.469-1T, -2T, -3T, -5T, -11T, 53 Fed. Reg. 5686-5732 (1988). This article is not intended to be an exhaustive explanation of the passive activity Code and Regulation provisions. Its main purpose is to explore some pivotal issues regarding the merit of the Passive Activity provisions. While not entirely successful, every effort was made to spare the reader from an overly detailed discussion of the technicalities of the Passive Activity provisions.

II. Overview of Tax Shelters

In order to have a tax shelter, there must be some device by which taxable income is understated in reference to economic income. The device could take the form of an exclusion from taxable income of an item of economic income (e.g., tax-exempt interest). The most common device, however, is a tax deduction that exceeds the actual economic expense involved.

The typical tax shelter involves ownership of property that is subject to depreciation or amortization at accelerated rates. The types of tax shelters using depreciable property are far ranging; they include racehorses, railroad cars, movies, oil and gas wells, and buildings (both commercial and residential). Real estate tax shelters, which derive substantial depreciation deductions on buildings, have been the most popular of all tax shelters. In the initial years of ownership of tax shelter property, accelerated rates give rise to deductions that exceed actual economic depreciation occurring in the value of the property. To the extent that the tax deduction exceeds the actual economic expense, the deduction is often described as "artificial."

Another common ingredient in the tax shelter recipe is the interest deduction, which is allowed with respect to the payment of interest on substantial amounts of indebtedness incurred to purchase or construct the depreciable property of the tax shelter. Unlike depreciation, the amount of deduction for interest does correspond to the economic outlay involved; thus, no artificial deduction arises out of the interest deduction. Nonetheless, it is the combination of large amounts of artificial and interest deductions that frequently represents the heart and soul of tax shelters.

The following illustration of tax sheltering applies 1982 law, shortly after the enactment of the most generous depreciation rules our country has ever witnessed.[6] Assume that in January, 1982, Taxpayer used $100,000 of his own funds and $900,000 of borrowed funds to acquire a residential rental apartment building ("the building"). During 1982, Taxpayer derived rental income of $150,000 from the building; he also paid $110,000 of interest on the $900,000 loan. Although the building only actually lost $10,000 in value during 1982, the Code allowed Taxpayer to deduct $120,000 of depreciation. Consequently, for 1982, Taxpayer reported a loss of $80,000 from the building ($150,000 rent less $110,000 interest and $120,000 depreciation) and deducted this loss against his income from various other sources. If not for the

6. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172.

artificial deduction of $110,000 ($120,000 depreciation deduction less $10,000 true economic loss in value), Taxpayer would have had $30,000 of income to report from the building ($150,000 rent less $110,000 interest and $10,000 depreciation). Instead, he was able to use the $110,000 artificial deduction to preclude taxation of not only the $30,000 building income, but also $80,000 of his other income. Not a bad deal.

III. EXPLANATION OF THE PASSIVE ACTIVITY PROVISIONS

A. *Overview*

New Code section 469 ("the Passive Activity provisions") restricts the amounts of "passive activity loss" and "passive activity credit" that are allowed to certain taxpayers.[7] Essentially, a "passive activity loss" for a particular year is the excess of deductions from all of the taxpayer's "passive activities" over gross income from these activities.[8] A taxpayer who is subject to the Passive Activity provisions may not deduct a "passive activity loss" against either nonpassive income (e.g., salary) or "portfolio income" (e.g., interest and dividends).[9] "Passive activity credits" are allowable only to the extent of the income tax attributable to taxpayer's "passive activities."[10] Consequently, a taxpayer who is subject to the Passive Activity provisions may not offset a "passive activity credit" against tax liability attributable to either nonpassive or portfolio income.

Disallowed "passive activity losses" are carried forward to the taxpayer's next taxable year and are allowable in that year to the extent of the amount, if any, of net income that the taxpayer derives from "passive activities."[11] Disallowed "passive activity credits" are also carried forward to the taxpayer's next taxable year and are allowable in that year to the extent of the amount, if any, of income tax attributable to net income that the taxpayer derives from "passive activities."[12] The carryforward process continues indefinitely.[13] However, in the year that the taxpayer disposes of his entire interest in the "passive activity," he may offset the carryover losses (but not the carryover credits) attributable to that activity against nonpassive and portfolio income.[14]

7. I.R.C. § 469(a).
8. *Id.* § 469(d)(1); Temp. Reg. § 1.469-2T(b)(1), 53 Fed. Reg. 5686, 5711 (1988).
9. I.R.C. §§ 469(a)(1)(A), (e)(1), (e)(3).
10. *Id.* § 469(d)(2).
11. *Id.* § 469(b).
12. *Id.*
13. *Id.*
14. *Id.* § 469(g).

B. *Taxpayers Subject to Passive Activity Provisions*

Individuals, estates, trusts, and certain corporations are subject to the Passive Activity provisions.[15] Losses and credits that individuals, estates, and trusts derive either directly from sole proprietorships or indirectly from flow-through entities, such as partnerships and S Corporations, are subject to the Passive Activity provisions.[16] "Closely-held C Corporations" and "Personal Service Corporations" engaging in "passive activities" also are subject to the Passive Activity provisions.[17]

Essentially, a "Closely-held C Corporation" is any corporation that has not elected Subchapter S treatment and which, at any time during the second half of its taxable year, is more than 50 percent owned by five or fewer individuals.[18] An election under Subchapter S by a qualifying corporation[19] eliminates that corporation as a taxable entity; instead, the electing corporation's income, deductions, and credits "flow through" to its shareholders.[20]

Essentially, a "Personal Service Corporation" is a corporation that is more than 10 percent owned by its "employee owners" and which derives most of its income from the rendition of personal services by the "employee-owners" for third parties.[21] An "employee-owner" is an employee who owns any of the corporation's stock.[22] Examples of Personal Service Corporations are professional corporations formed by doctors, lawyers, accountants, architects, and other professionals.

C. *Passive Activity*

A passive activity loss or credit arises in an "activity" that, in relation to a particular taxpayer, is considered "passive." Essentially, an "activity" is an undertaking, or a group of economically interrelated undertakings, that constitutes a trade or business.[23] The focal point

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15. *Id.* § 469(a)(2).
16. *Id.* § 469(a)(2)(A).
17. *Id.* §§ 469(a)(2)(B)-(C).
18. *Id.* §§ 465(a)(1)(B), 469(j)(1), 542(a)(2).
19. In order to qualify for Subchapter S treatment, the corporation must be a domestic corporation that does not have: (i) more than 35 shareholders, (ii) a shareholder who is other than an individual, estate, or certain type of trust, (iii) a nonresident alien shareholder, and (iv) more than one class of stock. *Id.* § 1361(b)(1).
20. *Id.* § 1366(a).
21. *Id.* §§ 269A(b)(1), 469(j)(2).
22. *Id.* §§ 269A(b)(2), 469(j)(2).
23. S. REP. No. 313, 99th Cong., 2d Sess. 713, 739 (1986), *reprinted in* 1986 C.B. 713, 739 [hereinafter SENATE REPORT].

in determining whether a particular activity is "passive" is the degree of the taxpayer's involvement in that activity.[24] The activity itself may be the hub of frenetic enterprise, but if the taxpayer in question is not a "material participant" in the activity, the activity is considered "passive" vis-à-vis that taxpayer.[25] Thus, a given activity may be passive with respect to one taxpayer who is not a "material participant," but nonpassive with respect to another taxpayer who is a "material participant."

The determination of whether a group of undertakings constitutes either a single activity (because they are economically interrelated) or several activities is crucial. If the undertakings comprise a single activity, then the taxpayer need only establish material participation with respect to that activity. If, on the other hand, each undertaking represents a separate activity, then the taxpayer has the more difficult task of establishing material participation with respect to each of the activities.[26]

D. *Material Participation*

The sole issue in characterizing an activity as "passive" with respect to a particular taxpayer is whether that taxpayer "materially participates" in the activity.[27] The regulations provide the general rule, subject to two exceptions, that all work performed by an individual with respect to an activity in which he owns an interest is considered as "participation" in that activity.[28] However, if the taxpayer performs work that is not customarily performed by an owner, and the principal purpose for the performance is to avoid disallowance under the Passive Activity provisions of a loss or credit, then the work will be disregarded.[29] Moreover, work performed by an individual in his capacity as an investor in the activity will be disregarded.[30] Although participation of any of an individual taxpayer's agents or employees will not be attributed to the taxpayer,[31] participation of the taxpayer's spouse in the activity will be attributed to the taxpayer.[32]

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24. I.R.C. § 469(c)(1)(B).
25. *Id.*
26. *See* SENATE REPORT, *supra* note 23.
27. I.R.C. § 469(j)(1)(B).
28. Temp. Reg. § 1.469-5T(f)(1), 53 Fed. Reg. 5686, 5727 (1988).
29. *Id.* § 1.469-5T(f)(2)(i), 53 Fed. Reg. at 5727-28.
30. *Id.* § 1.469-5T(f)(2)(ii)(A), 53 Fed. Reg. at 5728.
31. *See* SENATE REPORT, *supra* note 23, at 735.
32. I.R.C. § 469(h)(5).

The Code states that a taxpayer materially participates in an activity if he is involved in the activity's operations on a regular, continuous, and substantial basis.[33] There are no precise statutory definitions of what is meant by "regular, continuous, and substantial" involvement in the operations of an activity. While the Senate Finance Committee Report ("the Committee Report") provides general guidance,[34] the recently issued regulations provide a series of specific alternative definitions of the term "material participation." Under the regulations, a taxpayer will be considered a material participant in a particular activity on meeting a "facts and circumstances" test or one of the following six quantitative tests:

(1) the taxpayer participates more than 500 hours during the taxable year of the activity;[35]

(2) the taxpayer's participation represents substantially all participation in the activity for the year;[36]

(3) the taxpayer participates in the activity for more than 100 hours during the taxable year of the activity and no other individual's hours of participation exceed that of the taxpayer;[37]

(4) the taxpayer participates in more than one "significant participation activity" (an activity with respect to which the taxpayer, who has failed the other material participation tests, participates for more than 100 hours during the taxable year[38]) and the aggregate amount of participation therein exceeds 500 hours;[39]

(5) the taxpayer materially participated in the activity for any five of the ten taxable years immediately preceding the current taxable year;[40] or

(6) the activity is a "personal service activity" and the taxpayer materially participated in the activity for any three taxable years preceding the current taxable year.[41] A "personal service activity" is an activity that principally involves the performance of personal services in such fields as health, law, accounting, and the performing arts, and any other trade or business in which capital is not a material income-producing factor.[42]

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33. *Id.* § 469(h)(1).
34. *See* SENATE REPORT, *supra* note 23, at 732-35.
35. Temp. Reg. § 1.469-5T(a)(1), 53 Fed. Reg. 5686, 5725 (1988).
36. *Id.* § 1.469-5T(a)(2), 53 Fed. Reg. at 5725-26.
37. *Id.* § 1.469-5T(a)(3), 53 Fed. Reg. at 5726.
38. *Id.* §§ 1.469-5T(c)(1)-(2), 53 Fed. Reg. at 5726.
39. *Id.* § 1.469-5T(a)(4), 53 Fed. Reg. at 5726.
40. *Id.* § 1.469-5T(a)(5), 53 Fed. Reg. at 5726.
41. *Id.* § 1.469-5T(a)(6), 53 Fed. Reg. at 5726.
42. *Id.* § 1.469-5T(d), 53 Fed. Reg. at 5726.

Under the regulations, based on the facts and circumstances involved, a taxpayer may be considered a material participant in a particular activity.[43] The regulations do not specify the facts and circumstances that will be reviewed under this test. Presumably, some or all of the facts and circumstances alluded to in the Committee Report will be taken into account. Among the facts and circumstances referred to in the Committee Report are the frequency of the taxpayer's presence at the location of the principal business operations of the activity, the frequency of involvement in management decisions that are crucial to conducting the business operations of the activity, and the taxpayer's level of knowledge and experience regarding the particular field of the activity's business.[44]

Future regulations will specify the general principles to be followed in applying the facts and circumstances test.[45] The current regulations do provide, however, that certain services will not be considered under this test. The taxpayer's management services will not be considered if either a paid manager (other than the taxpayer) participates in the activity or if another individual's management services exceed that of the taxpayer.[46] Moreover, the regulations restrict application of the facts and circumstances test to only those taxpayers whose participation in the activity exceeds 100 hours.[47]

1. Special Material Participation Determination Rules for Closely-Held C and Personal Service Corporations

For taxpayers other than Closely-held C Corporations and Personal Service Corporations (i.e., sole proprietorships, partnerships, and S Corporations), the determination of material participation is made separately with respect to each owner's, partner's, or S Corporation shareholder's involvement in the particular operations of the activity. In the case of Closely-held C Corporations and Personal Service Corporations, each corporation must meet the material participation test itself.[48] A Closely-held C Corporation or Personal Service Corporation will meet the material participation standard with respect to a particular activity it conducts if one or more of its shareholders who holds more than 50 percent of the corporation's stock materially participates in that activity.[49]

43. *Id.* § 1.469-5T(a)(7), 53 Fed. Reg. at 5726.
44. *See* SENATE REPORT, *supra* note 23, at 733-34.
45. Temp. Reg. § 1.469-5T(b)(1), 53 Fed. Reg. 5686, 5726 (1988).
46. *Id.* § 1.469-5T(b)(2)(ii), 53 Fed. Reg. at 5726.
47. *Id.* § 1.469-5T(b)(2)(iii), 53 Fed. Reg. at 5726.
48. I.R.C. § 469(h)(4).
49. *Id.* § 469(h)(4)(A).

An alternate material participation test exists for a Closely-held C Corporation, which is not a Personal Service Corporation. One of these corporations will be a material participant in a particular activity it conducts if: (1) the corporation has at least one full-time employee who is primarily and actively involved in providing management-level services with respect to the activity; (2) the corporation has at least three full-time non-owner employees whose services are directly related to the conduct of the activity's business; and (3) certain of the business and employee retirement expense deductions of the activity exceed 15 percent of the gross income derived from the activity.[50] This alternate participation test can be met without personal involvement in the activity by any of the Closely-held C Corporation's shareholders.

2. Special Rules for Limited Partners, Rental Activities, and Oil and Gas Working Interests

For various reasons, Congress determined that application of the material participation standard to certain situations would be inappropriate. One of these situations involves the most typical form of tax shelter activities: limited partnerships. Because legal restrictions preclude a limited partner from being significantly involved in a partnership's business activities, Congress concluded that it was unnecessary to examine the facts and circumstances on a case-by-case basis to determine whether a particular limited partner meets the material participation standard.[51] Congress decided to generally treat all activities as passive vis-à-vis the limited partners owning interests therein.[52] Consequently, any loss that a taxpayer incurs in the capacity of limited partner can only offset income that the taxpayer derives from other passive activities.

Because limited partner status taints a partnership activity as passive vis-à-vis the limited partner, some taxpayers may seek this status with respect to those partnerships that are generating income in excess of deductions. If classified as passive, the taxpayer could use this net income (income less deductions) to absorb the losses derived from other passive activities. In other words, the automatic treatment of an activity as passive vis-à-vis its limited partners could have a double-edged sword effect. Although the taxpayer is disadvantaged with respect to the losses from these activities, he benefits with respect to net income from these activities.

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50. *Id.* §§ 465(c)(7)(C), 469(h)(4)(B).
51. *See* SENATE REPORT, *supra* note 23, at 731.
52. I.R.C. § 469(h)(2).

Congress was concerned about those taxpayers who would strive to have income treated as passive so that it could absorb losses from other passive activities. Therefore, Congress authorized the Treasury to promulgate regulations that, in appropriate cases, treat a limited partner's share of income from a limited partnership as nonpassive income.[53] The regulations provide a number of exceptions to the general rule that an activity is treated as passive with respect to limited partners.

Under one of these exceptions, an activity will not be characterized as passive with respect to a limited partner whose participation in the activity during the taxable year exceeds 500 hours.[54] If the limited partner's participation for the current year does not exceed 500 hours, then the taxpayer may be subject to nonpassive treatment if he materially participated in the activity for any five of the immediately preceding ten years.[55] In the case of a personal service activity, the taxpayer may be subject to nonpassive treatment if he materially participated for any three preceding taxable years.[56] The regulations also provide that an activity will not be automatically treated as passive regarding a limited partner who also serves as a general partner in the partnership.[57]

a. Special Rules for Rental Activities

Congress also decided that it would be inappropriate to apply the material participation standard to "rental activities."[58] Income derived from a "rental activity" is primarily attributable to the use of capital, without any significant personal involvement of the owner of the rental property. Thus, Congress provided that all "rental activities" would be treated as passive, regardless of the actual involvement of the owner in the activity.[59]

Essentially, a "rental activity" is an activity that derives gross income from receipt of payments made principally for the use of tangible property.[60] The regulations specify six situations that will not be treated as rental activities. First, an activity will not be considered

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53. *Id.* § 469(l)(3).
54. Temp. Reg. §§ 1.469-5T(a)(1), (e)(2), 53 Fed. Reg. 5686, 5725-26 (1988).
55. *Id.* §§ 1.469-5T(a)(5), (e)(2), 53 Fed. Reg. at 5726.
56. *Id.* §§ 1.469-5T(a)(6), (e)(2), 53 Fed. Reg. at 5726.
57. *Id.* § 1.469-5T(e)(3)(ii), 53 Fed. Reg. at 5726.
58. *See* SENATE REPORT, *supra* note 23, at 718.
59. *Id.*
60. I.R.C. § 469(j)(8); Temp. Reg. § 1.469-1T(e)(3)(i), 53 Fed. Reg. 5686, 5702 (1988).

a rental activity if, on the average, the period that each customer uses the property does not exceed seven days.[61]

Second, an activity will not be considered a rental activity if "significant personal services" are rendered to the customers and, on average, each customer's use of the property of the activity, although exceeding seven days, does not exceed thirty days.[62] Personal services only include services rendered by individuals.[63] The determination of the significance of the personal services is based on the surrounding facts and circumstances. These circumstances include the frequency of services, type and amount of labor required to render the services, and the value of the services in relation to the amount charged for use of the property.[64] In making the significant personal service determination, certain services are not taken into account: services needed to facilitate lawful use of the property, services related either to construction of improvements or to repairs that extend the useful life of the property, and, with respect to improved real property, the types of services usually rendered in connection with long-term rentals of high grade commercial and residential property (such as janitorial services).[65]

Third, if on the average, property is used by each customer for more than thirty days, the activity will not be treated as a rental activity if "extraordinary personal services" are rendered to the customers.[66] Essentially, personal services performed by individuals are considered "extraordinary" when the customer's use of the property is merely incidental to the services provided.[67] Thus, a patient boarding at a hospital is incidental to the individual personal services provided by the medical staff of the hospital.[68]

Fourth, an activity will not be treated as a rental activity when the customer's use of the property is merely incidental to the conduct of certain nonrental activities of the taxpayer.[69] The nonrental activities that trigger this exception are holding property for invest-

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61. Temp. Reg. § 1.469-1T(e)(3)(ii)(A), 53 Fed. Reg. at 5702.
62. *Id.* § 1.469-1T(e)(3)(ii)(B), 53 Fed. Reg. at 5702.
63. *Id.* § 1.469-1T(e)(3)(iv)(A), 53 Fed. Reg. at 5702.
64. *Id.*
65. *Id.* § 1.469-1T(e)(3)(iv)(B), 53 Fed. Reg. at 5702.
66. *Id.* § 1.469-1T(e)(3)(ii)(C), 53 Fed. Reg. at 5702.
67. *Id.* § 1.469-1T(e)(3)(v), 53 Fed. Reg. at 5702.
68. *Id.*
69. *Id.* § 1.469-1T(e)(3)(ii)(D), 53 Fed. Reg. at 5702.

ment,[70] using property in a trade or business,[71] holding property for sale to customers,[72] and renting lodging for the convenience of the employer.[73]

Fifth, the provision of property for the use of customers will not be considered a rental activity if "the taxpayer customarily makes the property available during defined business hours for the nonexclusive use by various customers."[74] For example, the operation of a golf course would not be considered a rental activity.[75]

The sixth and last of the regulations' exclusions from rental activity treatment concerns partners and S Corporation shareholders who, in their capacities as owners, provide property to these conduit organizations. If the partnership or S Corporation uses the contributed property in a nonrental activity, no part of the partner's or S Corporation shareholder's share of the income of the conduit organization will be treated as rental income.[76]

While rental activities are subject to automatic passive activity treatment, individual taxpayers involved in real estate rentals are sometimes entitled to a partial exemption from this treatment. A qualifying individual is entitled to offset against his nonpassive and portfolio income up to $25,000 of the aggregate of both the passive activity losses and the "deduction equivalent" of a passive activity credit that is attributable to that individual's rental real estate activities.[77] The "deduction equivalent" of a passive activity credit is the hypothetical amount of deduction that would reduce regular tax liabil-

70. *Id.* § 1.469-1T(e)(3)(vi)(B), 53 Fed. Reg. at 5703. The customer's use of property is considered merely incidental to the conduct of an investment activity when, during the taxable year, the gross rental income derived from the property is less than 2% of its unadjusted basis (or, if lower, fair market value) and the principal purpose of holding the property is for investment. *Id.*

71. *Id.* § 1.469-1T(e)(3)(vi)(C), 53 Fed. Reg. at 5703. The customer's use of property will be considered merely incidental to the conduct of a trade or business if, during the taxable year, the gross rental income derived from the property is less than 2% of its unadjusted basis (or, if lower, fair market value) and the property was used predominantly in a trade or business that year (or during two of the five immediately preceding taxable years). *Id.*

72. *Id.* § 1.469-1T(e)(3)(vi)(D), 53 Fed. Reg. at 5703. The customer's use of property during the taxable year in which the property is sold will be considered merely incidental to an activity of dealing in such property if, at the time of the sale, the property was held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. *Id.*

73. *Id.* § 1.469-1T(e)(3)(vi)(E), 53 Fed. Reg. at 5703.

74. *Id.* § 1.469-1T(e)(3)(ii)(E), 53 Fed. Reg. at 5702.

75. *Id.* § 1.469-1T(e)(3)(viii), ex.(10), 53 Fed. Reg. at 5704.

76. *Id.* § 1.469-1T(e)(3)(vii), 53 Fed. Reg. at 5703.

77. I.R.C. §§ 469(i)(1)-(2).

ity by the same amount as that of the passive activity credit.[78] For example, the deduction equivalent of a $280 passive activity credit for a taxpayer whose highest marginal tax bracket is 28 percent would be $1,000 ($280/.28) because a hypothetical $1,000 deduction would reduce his regular tax liability by $280 ($1,000 x .28), the same amount as the passive activity credit.

The purpose of the $25,000 exemption is to provide relief to individuals with moderate incomes who own rental real estate to assure their financial security.[79] Consequently, the $25,000 exemption is phased out for individuals whose adjusted gross incomes exceed $100,000; the phaseout is fifty cents per dollar of adjusted gross income in excess of $100,000, with total phaseout occurring at $150,000.[80]

In order to qualify for the $25,000 rental real estate exemption, the taxpayer must be an individual who "actively participates" in the rental real estate activity.[81] "Active participation" entails both a minimum 10 percent ownership in the rental real estate activity as well as a certain degree of involvement in the activity.[82] The degree of involvement required to satisfy the active participation standard is less than that necessary to satisfy the material participation standard. Instead of regular, continuous, and substantial involvement, the taxpayer need only participate in making management decisions such as approving new tenants, determining rental terms, and approving capital and repair expenditures.[83]

b. Special Rules for Oil and Gas Working Interests

Congress also decided that the material participation test should not apply to certain investors owning "working interests in oil and gas property." The decision to exempt these oil and gas property investors was based on the worldwide oil price collapse and the resulting hardship currently suffered by the oil and gas industry.[84] In this instance, Congress concluded that financial risk was a more relevant standard than material participation.[85] Consequently, the lawmakers

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78. *Id.* § 469(j)(5).

79. *See* SENATE REPORT, *supra* note 23, at 736.

80. I.R.C. § 469(i)(3)(A). A special phaseout applies with respect to the low-income housing and rehabilitation credits. In these cases, the phaseout is fifty cents per dollar of adjusted gross income in excess of $200,000, with total phaseout occurring at $250,000. *Id.* § 469(i)(3)(B).

81. *Id.* § 469(i)(1).

82. *Id.* § 469(i)(6); *see* SENATE REPORT, *supra* note 23, at 737.

83. *See* SENATE REPORT, *supra* note 23, at 737.

84. *Id.* at 717.

85. *Id.* at 717-18.

restricted the exemption from the material participation standard to those investors who were subject to unlimited financial risk with respect to their proportionate interests in the oil and gas activities.[86]

c. Special Rules for Activity of Trading Personal Property

Generally, a taxpayer is subject to passive treatment with respect to the income and deductions of any business activity in which she is a nonmaterial participant. The Treasury Department was concerned about those taxpayers who were deriving income from trading stocks, bonds, and other securities for their own account. If these taxpayers were successful in asserting that they were nonmaterial participants with respect to a business of trading securities, then the income from this activity would be passive and, therefore, available to absorb losses from other passive activities. The regulations resolve this potential problem by providing that any activity of trading stocks, bonds, and other securities on behalf of the owners of the activity will not be considered a passive activity.[87]

E. *Determination of Passive Activity Losses*

As previously explained, the "passive activity loss" is not currently deductible. Instead, the taxpayer must carry the loss over to the succeeding year for application against the amount, if any, of net income derived from all passive activities.[88] A taxpayer's "passive activity loss" for a particular taxable year represents the amount by which deductions from the taxpayer's passive activities exceed the gross income derived from these activities.[89] For example, if a taxpayer had interests in two passive activities and, with respect to these activities, the aggregate deductions exceeded the aggregate gross income by $20,000, then the taxpayer would have a passive activity loss of $20,000.

As a general rule, taxpayers are not required to separately account for each item of deduction and credit disallowed under the Passive Activity provisions.[90] However, separate accounting will be required if the identification of an item of deduction or credit could affect the taxpayer's tax liability.[91] Thus, if one of the deductions comprising a

86. I.R.C. § 469(c)(3)(A).
87. *Id.* § 1092(d)(1); Temp. Reg. §§ 1.469-1T(e)(6)(i), (ii), 53 Fed. Reg. 5686, 5705 (1988).
88. I.R.C. §§ 469(a)(1), (b).
89. *Id.* § 469(d)(1); Temp. Reg. § 1.469-2T(b)(1), 53 Fed. Reg. 5686, 5711 (1988).
90. Temp. Reg. § 1.469-1T(f)(2)(iii), 53 Fed. Reg. at 5706.
91. *Id.*

passive activity loss were a capital loss, the taxpayer would be required to account separately for that deduction, as well as any deduction or credit subject to special limitations.

Certain types of investment income derived outside the conduct of a trade or business ("portfolio income") are not taken into account in determining the passive activity loss.[92] "Portfolio income" is gross income from interest, dividends, annuities, and royalties, as well as any gain resulting from the disposition either of property that gave rise to portfolio income or other property held for investment.[93] Portfolio income also includes any income or loss attributable to investment of working capital.[94] However, as a general rule, gain resulting from the disposition of an interest in a passive activity is not considered portfolio income.[95]

In addition to portfolio income, passive activity gross income does not include amounts paid to an individual as compensation for services ("earned income").[96] Earned income also includes taxable distributions from pensions and other retirement plans.[97]

Certain deductions are not taken into account in determining the passive activity loss. Among the excluded deductions are those for expenses (other than interest) that are directly allocable to portfolio income.[98] Thus, fees paid in connection with collection of portfolio income would, along with portfolio income, be excluded from the passive activity loss determination. Also excluded are deductions for losses recognized on the disposition either of property that gave rise to portfolio income or other property held for investment.[99]

Interest expense that is "properly allocable" to portfolio income is not taken into account in determining the passive activity loss.[100] A special set of new and elaborate regulations relate to proper allocation of interest expense between portfolio income and other activities.[101] Generally, allocation of interest follows allocation of the debt with respect to which the interest is incurred.[102] Debt is allocated according to the use of the proceeds of the loan that gave rise to the debt.[103]

92. I.R.C. § 469(e)(1)(A)(i)(I).
93. *Id.* §§ 469(e)(1)(A)(i)(I), (A)(ii).
94. *Id.* § 469(e)(1)(B).
95. *Id.* § 469(e)(1)(A)(ii).
96. *Id.* §§ 469(e)(3), 911(d)(2)(A).
97. Temp. Reg. §§ 1.469-2T(c)(4)(i)(C)-(D), 53 Fed. Reg. 5686, 5714-15 (1988).
98. I.R.C. § 469(e)(1)(A)(i)(II).
99. *Id.* § 469(e)(1)(A)(ii).
100. *Id.* § 469(e)(1)(A)(i)(III).
101. Temp. Reg. § 1.469-2T(d)(3)(i), 53 Fed. Reg. at 5716; Temp. Reg. § 1.163-8T, 52 Fed. Reg. 24,999 (1987).
102. Temp. Reg. § 1.163-8T(a)(3), 52 Fed. Reg. at 24,999.
103. *Id.*

For example, interest paid with respect to a debt attributable to the purchase of stock, on which dividends are collected, would be allocated to portfolio income. On the other hand, if the debt were attributable to the purchase of property used in the trade or business of a passive activity, then the interest would be allocable to the passive activity.

F. *Publicly Traded Partnerships*

As previously discussed, a limited partner's share of partnership income, as well as loss, is generally characterized as passive.[104] As a consequence of this general rule, taxpayers in need of passive income to absorb passive losses would be encouraged to make investments as limited partners in partnerships that usually generate income (excess of gross income over deductions). Just such an investment vehicle is the master limited partnership or "publicly traded partnership."[105]

In 1987, Congress amended the Passive Activity provisions to preclude the use of income derived from a "publicly traded partnership" to absorb losses from all other passive activities (including those conducted by other publicly traded partnerships).[106] A "publicly traded partnership" is a partnership whose interests are either traded on an established securities market or readily tradable on a secondary market.[107] A partner's share of a publicly traded partnership's loss (excess of deductions over gross income) is disallowed as a deduction.[108] The disallowed loss is carried over to the subsequent year and will then be deductible to the extent of the partner's share of the amount, if any, of the publicly traded partnership's income.[109] This new provision is applied separately with respect to each interest in a publicly traded partnership.[110]

G. *Recharacterization of Passive Income*

Section 469(l)(3) authorizes the Treasury Department to prescribe regulations that, in effect, recharacterize what otherwise would be passive income as either nonpassive or portfolio income. This grant of authority represents Congress's recognition that certain taxpayers would attempt to structure transactions in such a way as to maximize

104. I.R.C. § 469(h)(2).
105. *See* Adler, *Master Limited Partnerships*, 40 U. FLA. L. REV. 755 (1988).
106. I.R.C. § 469(k)(1).
107. *Id.* § 469(k)(2).
108. *Id.* §§ 469(a)(1), (k)(1).
109. *Id.* §§ 469(k)(1), (b).
110. *Id.* § 469(k)(1).

the amount of passive income that would then be available to absorb passive activity losses.[111] In the absence of these regulations, taxpayers would be tempted to decrease their participation below the level of material participation. Moreover, they would be encouraged to replace portfolio investments with investments in businesses that have many of the characteristics of traditional portfolio investments.[112]

1. Net Income From Significant Participation Passive Activities

Under one of the recharacterization rules of the regulations, gross income equal to the taxpayer's "net passive income"[113] from "significant participation passive activities" will be treated as nonpassive income.[114] A "significant participation passive activity" is an activity with respect to which the taxpayer has failed all of the material participation tests, but has participated for more than 100 hours during the taxable year.[115] For example, if a taxpayer was involved in three significant participation passive activities with aggregate gross income of $25,000 and aggregate deductions of $15,000, then $10,000 ($25,000 - $15,000) of the gross income would be recharacterized as nonpassive income.[116]

2. Gain From Sale of Rental Property Developed by the Taxpayer

As previously explained, rental activities are treated as passive activities.[117] Moreover, gain or loss on disposition of a rental activity property is characterized as passive.[118] The Treasury was concerned about passive characterization of gain on the disposition of rental property when the gain is attributable, in substantial part, to the taxpayer's development of the property rather than any appreciation in value taking place during the rental period.[119] Consequently, if, for the year

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111. *See* SENATE REPORT, *supra* note 23, at 730.

112. 53 Fed. Reg. 5686, 5693 (1988).

113. "Net passive income" is the excess of passive activity gross income over passive activity deductions. Temp. Reg. § 1.469-2T(f)(9)(i), 53 Fed. Reg. 5686, 5724 (1988).

114. *Id.* § 1.469-2T(f)(2)(i), 53 Fed. Reg. at 5721.

115. *Id.* §§ 1.469-2T(f)(2)(ii), 1.469-5T(c)(2), 53 Fed. Reg. at 5721, 5726.

116. The amount of gross income treated as passive income is attributed on a pro rata basis only to those significant participation passive activities that themselves reflected net passive income. *Id.* § 1.469-2T(f)(2)(i), 53 Fed. Reg. at 5721. Thus, in the example, if two of the significant participation activities reflected net passive incomes of $9,600 ("Activity 1") and $2,400 ("Activity 2"), while the third reflected a loss of $2,000, then the $10,000 of recharacterized gross income would be attributed 80% ($9,600/$12,000) to Activity 1 and 20% ($2,400/$12,000) to Activity 2.

117. I.R.C. § 469(c)(2).

118. *Id.* § 469(e)(1)(A)(ii).

119. 53 Fed. Reg. 5686, 5693 (1988).

that gain was recognized on a disposition of rental activity property, three conditions are met, then an amount of gross rental income equal to the "net rental activity income"[120] will be treated as nonpassive income.[121] The three conditions are:
(1) recognized gain exists from the disposition of rental activity property;
(2) the taxpayer materially or significantly participated in a trade or business during any taxable year in which he performed services for the purpose of enhancing the value of the property; and
(3) a binding sale contract was entered into less than 24 months after the property was rented.[122]

As an example of the application of this regulation, assume that Taxpayer materially or significantly participated in the construction of an apartment building that was initially rented in 1988 and then sold in 1989 at a gain of $125,000. Also assume that for 1989, the rental activity had rental income, other than disposition gains, of $50,000 and deductions of $75,000. Under these circumstances, gross income equal to the net rental activity income for 1989, $100,000 (gross income of $175,000 [$50,000 + $125,000] less deductions of $75,000), will be treated as nonpassive income.

3. Self-Rented Property

If a taxpayer, who is a material participant in a particular activity, rents property to, and for use in, that activity, then an amount of the taxpayer's gross income equal to the net rental income derived from the rental of the property will be recharacterized as nonpassive income.[123]

4. Rental of Nondepreciable Property

If less than 30 percent of the unadjusted basis (essentially, original cost) of the property used in a rental activity during the taxable year is depreciable, then an amount of gross income from that activity equal to its net passive income will be recharacterized as portfolio income.[124]

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120. "Net rental activity income" is the excess of gross rental activity income, including gains on dispositions of rental property, over rental activity deductions. Temp. Reg. § 1.469-2T(f)(9)(iv), 53 Fed. Reg. 5686, 5724 (1988).

121. *Id.* § 1.469-2T(f)(5)(i), 53 Fed. Reg. at 5723.

122. *Id.*

123. *Id.* § 1.469-2T(f)(6), 53 Fed. Reg. at 5723.

124. *Id.* § 1.469-2T(f)(3), 53 Fed. Reg. at 5721.

5. Net Interest Income From Equity-Financed Lending Activity

Ordinarily, interest income derived from loans made in the course of the business of lending money is not portfolio income.[125] The income or loss from these businesses is characterized as either nonpassive or passive, depending on the material or nonmaterial participation of the taxpayer involved. With respect to an "equity-financed lending activity," however, an amount of gross income equal to the taxpayer's "equity financed interest income" will be recharacterized as portfolio income.[126]

Essentially, an "equity-financed lending activity" is an activity engaged in the business of lending money, the average liabilities of which do not exceed 80 percent of the average balance of its interest-bearing assets.[127] Put in a less exact way, it is a lending activity that derives 20 percent or more of its capital from equity contributions. Generally, a taxpayer's "equity-financed interest income" equals the taxpayer's net interest income (essentially, interest income less expenses allocable to the interest income) from the activity multiplied by the activity's ratio of equity to interest-bearing assets.[128] Assume that Taxpayer is a 50 percent partner and a nonmaterial participant in a partnership in the business of lending money. Assume further that for 1989, the partnership has net interest income of $200,000 and a ratio of equity to interest-bearing assets of 25 percent. In this instance, Taxpayer will have an amount of gross income from the partnership recharacterized as portfolio income equal to 25 percent of his 50 percent share of the net interest income, or $25,000.

6. Licensing of Intangible Property by Passthrough Entities

In its attempt to separate out those situations where income closely resembles portfolio income, the Treasury focused on those taxpayers owning interests in a passthrough entity that derives income from licensing intangible property. Under the regulations, portfolio income treatment is accorded to those taxpayers who acquire their interests in the passthrough entity subsequent to the time that the entity created the intangible property, performed substantial services, or incurred substantial costs concerning the development or marketing

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125. *See* I.R.C. § 469(e)(1)(A)(i)(I).

126. Temp. Reg. § 1.469-2T(f)(4)(i), 53 Fed. Reg. at 5722. However, if the amount of the taxpayer's net passive income from the activity is less than the amount of equity-financed interest income, it will be treated as portfolio income. *Id.*

127. *Id.* § 1.469-2T(f)(4)(ii)(A), 53 Fed. Reg. at 5722.

128. *Id.* § 1.469-2T(f)(4)(iii), 53 Fed. Reg. at 5722.

of the property.[129] In this instance, an amount of gross income equal to the taxpayer's net passive income derived from licensing the intangible property is treated as portfolio income.[130]

7. Recharacterization of Disposition Gain

As a general rule, gain recognized on the disposition of either property used in an activity, or of an ownership interest in an activity conducted by a passthrough entity, is characterized as passive if the activity was a passive activity for the taxable year of the disposition.[131] In cases involving the disposition of property used in a passive activity, application of the general rule is conditioned on the property having been used in the activity for the twelve-month period preceding the disposition.[132] In the event that the property had not been used in the passive activity for the preceding twelve month period, the regulations require the taxpayer to make a reasonable allocation of the recognized gain among the activities in which the property was used during that period.[133] For example, if during the twelve-month period, the property was used for nine months in a nonpassive activity and three months in a passive activity, three-fourths (9/12) of the gain would be nonpassive and one-fourth (3/12) of the gain would be passive.[134]

The general rule will also not apply to certain dispositions of "substantially appreciated property," property with a fair market value that is more than 120 percent of its adjusted basis.[135] The gain from disposition of substantially appreciated property will be treated as nonpassive if the use of the property in the passive activity was for neither 20 percent of the taxpayer's holding period in the property nor the twenty-four month period preceding the date of disposition.[136] Assume that property, originally acquired at a cost of $100,000 and used for ten years in a nonpassive activity owned by the taxpayer, is

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129. *Id.* § 1.469-2T(f)(7)(i), 53 Fed. Reg. at 5723.

130. *Id.*

131. *Id.* § 1.469-2T(c)(2)(i)(A), 53 Fed. Reg. at 5711.

132. *See id.* § 1.469-2T(c)(2)(ii), 53 Fed. Reg. at 5712.

133. *Id.*

134. A de minimis exception is provided when, at the time of disposition, the value of the property does not exceed the lesser of $10,000 or 10% of the value of all the property used in the activity. *Id.* In these instances, the entire gain realized can be allocated to the activity in which the property was predominantly used during the preceding 12-month period. *Id.* Thus, if, in the example, the property had a fair market value of $9,000, then the entire gain realized on its disposition could be allocated to the nonpassive activity.

135. *Id.* §§ 1.469-2T(c)(2)(iii)(A), (C), 53 Fed. Reg. at 5712.

136. *Id.* § 1.469-2T(c)(2)(iii)(A), 53 Fed. Reg. at 5712.

transferred to and used by a passive activity owned by the taxpayer for a twenty-two month period and then sold for $150,000. Because the property is substantially appreciated property, and neither holding period requirement is met, the $50,000 gain will be treated as nonpassive.

In the event that a taxpayer recognizes a gain or loss from the disposition of an interest in a conduit entity (partnership or S Corporation) that conducts both passive and nonpassive activities, the character of the gain or loss (passive versus nonpassive) is to be determined through a proration among the gains and losses that would result if the entity had sold its activities as of the applicable valuation date.[137] Assume that Taxpayer recognized a gain of $90,000 on the sale of his interest in a partnership that conducts both a passive activity and a nonpassive activity. A hypothetical sale of both activities as of the applicable valuation date results in gains allocable to the Taxpayer in the amount of $25,000 from the passive activity and $50,000 from the nonpassive activity. Because one-third ($25,000/$75,000) of the hypothetical gain is attributable to the passive activity, one-third of the actual $90,000 gain, or $30,000, is characterized as passive. Because two-thirds ($50,000/$75,000) of the hypothetical gain is attributable to the nonpassive activity, two-thirds of the actual $90,000 gain, or $60,000, is characterized as nonpassive.

8. Former Investment Property Held Primarily for Sale

Any income or gain of a taxpayer with respect to property held primarily for sale to customers will be treated as portfolio income or gain if he previously held the property as an investment.[138]

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137. *Id.* § 1.469-2T(e)(3)(ii)(A), 53 Fed. Reg. at 5718-19. The applicable valuation date is the beginning of the entity's taxable year or the date of disposition of the taxpayer's interest, whichever the entity selects. *Id.* § 1.469-2T(e)(3)(ii)(D)(1)(i), 53 Fed. Reg. at 5719.

However, the applicable valuation date is the date immediately preceding the date of the disposition if, after the beginning of the taxable year in which the disposition occurs, any one of the following events takes place: (i) the conduit entity disposes of more than 10% of its interest in any activity; (ii) more than 10% (in value) of the property used in any activity of the conduit entity is disposed of; or (iii) the taxpayer holding an interest in the conduit entity contributes either "substantially appreciated property" (fair market value exceeds 120% of adjusted basis) or substantially depreciated property (adjusted basis exceeds 120% of fair market value), which exceeds 10% of the total fair market value of the taxpayer's interest in the conduit entity as of the beginning of the taxable year. *Id.* § 1.469-2T(e)(3)(ii)(D)(1)(ii), 53 Fed. Reg. at 5719.

138. *Id.* § 1.469-2T(c)(3)(iii)(A), 53 Fed. Reg. at 5713.

H. *Special Offset Rule for Closely-Held C Corporations*

For unspecified reasons, Congress exempted Closely-held C Corporations from the general rule that precludes the offset of passive losses against nonpassive income. Thus, unlike other taxpayers subject to the Passive Activity provisions, a Closely-held C Corporation is entitled to offset its passive losses against its nonpassive income, excluding portfolio income.[139] Furthermore, any passive activity credits of this corporation may offset the income tax liability attributable to its nonpassive income.[140] In other words, the only restriction of the Passive Activity provisions pertaining to a Closely-held C Corporation is that its passive activity losses and credits may not offset its portfolio income.

I. *Determination and Treatment of Passive Activity Credit*

Congress determined that a taxpayer should be allowed to use various tax credits arising out of passive activities only to the extent of the amount of the income tax liability (before application of tax credits) that is attributable to these passive activities.[141] The taxpayer may carry the amount of disallowed passive activity credits over to the subsequent taxable year.[142] The amount of income tax liability (before application of tax credits) attributable to a taxpayer's passive activities is dependent on the amount of net passive income (the excess of gross income from passive activities over deductions from these activities). The amount of income tax liability that results from the addition of the taxpayer's net passive income to his other taxable income represents the income tax liability attributable to passive activities.[143]

To illustrate the computation of the passive activity credit, assume that in 1988, Taxpayer has $5,000 of gross income, $15,000 of deductions, and a $4,000 credit from Passive Activity No. 1; $35,000 of

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139. I.R.C. § 469(e)(2). Closely-held C Corporations that are also Personal Service Corporations are not eligible for this treatment. *Id.*

140. *Id.* § 469(e)(2)(A).

141. *Id.* §§ 469(a)(1)(B), (d)(2). The credits subject to the Passive Activity provisions are: (i) the general business tax credits (described in I.R.C. § 38(b)(1)-(5)); (ii) the Puerto Rico and Possession tax credit (described in I.R.C. §§ 27(b) & 936); (iii) the rare disease drug testing expense tax credit (described in I.R.C. § 28(b)); and (iv) the nonconventional source fuel tax credit (described in I.R.C. § 29). Temp. Reg. § 1.469-3T(b)(1)(i)(B), 53 Fed. Reg. 5686, 5724 (1988).

142. I.R.C. § 469(b).

143. Temp. Reg. § 1.469-3T(d)(1), 53 Fed. Reg. at 5725.

gross income, $10,000 of deductions, and a $3,000 credit from Passive Activity No. 2; and $70,000 of taxable income from nonpassive activities. The income tax liability (assuming a joint return) determined solely with reference to Taxpayer's $70,000 of nonpassive taxable income is $15,732.50. When the $15,000 of net passive income ($40,000 of gross income less $25,000 of deductions) is added to the $70,000 of nonpassive taxable income, the income tax liability increases by $4,200 to $19,932.50. The $4,200 of income tax liability attributable to the net passive income serves as the upper limit on the amount of credits currently allowable. In this instance therefore, $4,200 of the $7,000 of credits will be allowed in 1988 and the remaining $2,800 of credits will be carried over to 1989. The $2,800 of credits carried to 1989 will be added to all credits arising out of passive activities during that year and the sum total of credits will be subject to the process just described. The carryover can continue indefinitely.

J. *Former Passive Activities*

The status of an activity as passive can change from year to year. For example, a general partner who did not materially participate in the partnership's activity in 1988 may do so in 1989. In that case, the passive nature of the activity in 1988 would cease in 1989. As another example, a corporation that met the requirements of being either a Closely-held C Corporation or a Personal Service Corporation in one year may not meet those requirements the next year.

Absent a special rule, the change in status from passive to nonpassive could result in inequitable treatment. Any carryover losses or credits arising when the activity was passive would not be allowed to offset any nonpassive income now generated by the activity. Congress concluded that it would be unfair to treat these losses and credits less favorably than they would have been treated had the activity remained passive.[144] Consequently, it devised special rules for treatment of these losses and credits of "former passive activities." The taxpayer must first apply the carryover passive activity losses against the net income (other than portfolio income and related deductions) of that activity and then against the net passive income of all the taxpayer's passive activities.[145] Any carryover passive activity credits are first applied against the income tax liability attributable to the net income of the activity (determined after the offset of any carryover losses). The

144. *See* SENATE REPORT, *supra* note 23, at 727 n.15.

145. I.R.C. §§ 469(f)(1)(A), (C).

taxpayer may then apply any remaining credits against the income tax liability attributable to the amount of net passive income from all passive activities.[146]

If a corporation was once either a Closely-held C Corporation or Personal Service Corporation, the Code subjects carryover passive activities losses and credits to the same treatment in the current year as if the corporation had not changed its former status.[147] Thus, in the case of the former Closely-held C Corporation, the entity may apply any carryover loss against the net income of the former passive activities, as well as any net income of other (non-portfolio) activities of the corporation.[148] A former Personal Service Corporation may apply any carryover loss against any net income of former passive activities.[149]

K. *Dispositions of Interests in Passive Activities*

If insufficient passive activity income exists to absorb both carryover and current passive activity losses, then some amount of passive activity losses may remain suspended indefinitely. Congress decided that because the taxpayer could accurately determine gain or loss on a taxable disposition of the entire interest in the passive activity, this event would be an appropriate time to allow the taxpayer to offset the suspended losses against nonpassive and portfolio income.[150] A disposition of only part of a taxpayer's interest in a passive activity will not trigger the full deduction of the suspended losses.[151] However, the taxpayer may deduct these losses to the extent of any gain recognized on such a disposition.[152]

Congress was concerned that some taxpayers with suspended losses would attempt to trigger the deduction of these losses by selling their interests in the passive activities to a related party, e.g., a family member or an entity under the taxpayer's control. Consequently, it devised an exception to the taxable disposition trigger rule under which taxable dispositions to related parties would not bring about the deduction of suspended losses.[153] While a related party would then

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146. *Id.* §§ 469(f)(1)(B), (C).
147. *Id.* § 469(f)(2).
148. *Id.* §§ 469(f)(2), (e)(2)(A).
149. *Id.* §§ 469(f)(2), (d)(1).
150. *See* SENATE REPORT, *supra* note 23, at 725.
151. *See* I.R.C. § 469(g)(1).
152. *See id.* §§ 469(d)(1), (e)(1)(A)(ii).
153. *Id.* § 469(g)(1)(B).

own an interest in the passive activity, the suspended loss would nonetheless remain with the transferor-taxpayer. If the related party makes a taxable disposition to an unrelated party of the entire interest in the passive activity, the transferor-taxpayer can then deduct any of the remaining suspended losses.[154]

Transfers by reason of death also trigger the deduction of suspended passive activity losses. The executor may deduct suspended losses of a decedent on the decedent's final return, but only to the extent that these losses exceed the so-called "basis step-up" that occurs at death regarding the interest held in the passive activity.[155] The Code requires that the basis in any property owned at the time of a taxpayer's death be restated to equal the amount of the particular property's fair market value.[156] If, at the time of death, the fair market value of the property exceeds its pre-death basis, that excess will represent a step-up from the amount of the pre-death basis. For example, assume that at death, Taxpayer had a $10,000 basis in an interest in a passive activity with respect to which there was a $5,000 suspended loss. If at the time of death, the interest in the passive activity had a fair market value of $12,000, there would be a $2,000 step-up in basis ($12,000 fair market value less $10,000 pre-death basis). Consequently, only $3,000 of the suspended loss ($5,000 suspended loss less $2,000 step-up in basis) would be deductible on the decedent's final return against the decedent's passive, nonpassive, and portfolio income. The remaining $2,000 of suspended loss (equal to the amount of step-up in basis) is eliminated at the time of death.[157]

The gift of an interest in a passive activity is not a disposition that gives rise to the deduction of suspended losses.[158] Unlike sales to related parties, suspended losses do not remain with the transferor-taxpayer. Subject to one limitation, the donee of the passive activity interest is allowed to add the amount of suspended losses to the basis of the interest.[159] Therefore, on the donee's taxable disposition of the passive activity interest, gain that would otherwise be recognized will be reduced (or the loss otherwise recognizable will be increased) by the amount of the suspended loss that was added to the basis. One potentially significant qualification to this rule is that, for purposes of determining loss on a subsequent taxable disposition, the basis in the

154. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-143 (1986).
155. I.R.C. § 469(g)(2).
156. *Id.* § 1014(a)(1).
157. *Id.* § 469(g)(2)(B).
158. *Id.* § 469(j)(6).
159. *Id.* § 469(j)(6)(A).

passive activity interest cannot exceed the fair market value of the interest at the time of the gift.[160] For example, assume Taxpayer has $60,000 of suspended losses from a passive activity. Taxpayer gives the passive activity interest to a child at a time when the interest has a basis of $30,000 and fair market value of $80,000. In this instance, for purposes of determining loss on a subsequent taxable disposition, the $30,000 basis transferred by Taxpayer to the donee[161] would not be increased by the full $60,000 of suspended losses. Doing so would put the basis at an amount, $90,000, that exceeds the fair market value, $80,000.[162] The donee's basis would increase only to $80,000 and the potential use of $10,000 of suspended losses (to increase loss) on the donee's ultimate taxable disposition of the passive activity interest would be eliminated.

Because of their nontaxable nature, a number of dispositions of passive activity interests do not trigger deduction of suspended losses.[163] Notable examples of these nontaxable dispositions include exchanges of the passive activity interest for an ownership interest either in other similar property or in another business entity such as a partnership, C Corporation, or S Corporation. Thus, a taxpayer might exchange his apartment house (which, as a rental activity, is a passive activity) for another apartment house. Another taxpayer might exchange a passive activity interest for stock in a C Corporation or for a partnership interest in a partnership. These nontaxable dispositions will not trigger deduction of suspended losses.[164] Instead, the suspended losses will remain in the hands of the exchanging taxpayer until the ultimate disposition of property received in the exchange (i.e., similar property, stock in either a C or S Corporation, or a partnership interest).[165] At that time, the exchanging taxpayer may deduct the suspended losses.[166]

Unlike carryover passive activity losses, carryover passive activity credits do not become allowable on the taxable disposition of the activ-

160. *See* SENATE REPORT, *supra* note 23, at 726 n.12.

161. I.R.C. § 1015(a).

162. However, for purposes of determining gain on a subsequent taxable disposition, the fair market value limitation does not apply. *Id.* Consequently, for these purposes, the basis would be $90,000.

163. *See* SENATE REPORT, *supra* note 23, at 726-27.

164. *Id.*

165. *Id.* at 727. In those instances when the passive activity has been transferred to a conduit entity (partnership or S Corporation), any income of such activity that is passed through to the taxpayer (as partner or shareholder) may be used to absorb the suspended losses.

166. *Id.*

ity giving rise to the credit.[167] These credits become allowable only to the extent of the income tax liability attributable to the amount of net passive income that the taxpayer derives from all his current passive activities.[168] Consequently, in the absence of either ownership of any passive activity (other than the one disposed of) or net passive income, the carryover passive activity credit may remain suspended indefinitely. The Code provides some relief with respect to carryover credits that initially gave rise to a basis reduction in property[169] held by the passive activity. On the taxable disposition of the passive activity, including the reduced-basis property, the taxpayer may elect to increase the basis of the property by the amount of the carryover credit.[170] The increased basis of the transferred property either reduces gain or increases loss otherwise recognizable on the taxable disposition of such property.

L. *Phase-in of Passive Activity Provisions*

The Tax Reform Act of 1986 phased in the application of the Passive Activity provisions with respect to "pre-enactment interests."[171] For 1987, the Code disallows 35 percent of the passive activity losses and passive activity credits attributable to pre-enactment interests.[172] The percentages of disallowance for 1988, 1989, and 1990 are sixty, eighty, and ninety, respectively.[173] Thus, while complete disallowance begins in 1987 for "post-enactment interests" (interests acquired after October 22, 1986), it does not begin until 1991 for pre-enactment interests.[174]

M. *Interaction of Passive Activity Provisions With Other Code Provisions*

The Passive Activity provisions form part of a battery of Code provisions governing deductibility of various expenses. As a general rule, all other relevant Code provisions are to be applied prior to

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167. *See* I.R.C. § 469(g)(1).

168. *Id.* 469(d)(2); Temp. Reg. § 1.469-3T(d), 53 Fed. Reg. 5686, 5725 (1988).

169. For example, a tax credit allowed with respect to certain "energy property" (defined under I.R.C. § 48(1)(2)) gives rise to a basis reduction in such property equal to 50% of the amount of the credit. I.R.C. § 48(q)(1).

170. *Id.* § 469(j)(9).

171. *Id.* §§ 469(m)(1) & (2). Pre-enactment interests are interests in passive activities that were held on the date of enactment of the Tax Reform Act of 1986, October 22, 1986. *Id.* § 469(m)(3)(B)(i).

172. *Id.* § 469(m)(2).

173. *Id.*

174. *See id.* § 469(m)(1).

application of the Passive Activity provisions.[175] Thus, for example, a salary expenditure would first be subjected to the ordinary and necessary business requirements of Code section 162 before any loss that it comprised was tested under the Passive Activity provisions. One major exception to this general rule is that certain interest expenditures arising in relation to a passive activity that otherwise would be subject to certain investment interest limitations (Code section 163(d)) will only be subject to the Passive Activity provisions.[176] Another major exception to the general rule applies to capital losses. With respect to any capital loss incurred in relation to a passive activity, Code section 1211(b), which restricts the deduction of the excess of capital losses over capital gains to $3,000, is applied after the Passive Activity provisions.[177]

In contrast to losses, credits from passive activities are initially subject to the Passive Activity provisions.[178] Credits allowable under the Passive Activity provisions are combined with all other nonpassive activity credits and then subjected to the other pertinent credit limitation provisions.[179]

The Passive Activity provisions represent one of Congress's many attempts to have wealthier taxpayers pay tax on amounts of taxable income bearing some reasonable relationship to economic income. The most elaborate attempt is embodied in the "Alternative Minimum Taxable Income provisions."[180] With respect to individual taxpayers, the Code specifies a "tentative minimum tax" by applying a 21 percent tax rate to the excess of the taxpayer's "alternative minimum taxable income" ("AMTI") over the "exemption amount" ($30,000 for a single individual and $40,000 for a joint return).[181] To the extent that the tentative minimum tax exceeds the tax normally determined without regard to the Alternative Minimum Taxable Income provisions ("the regular tax"), the taxpayer incurs additional tax liability.[182] Very generally, the determination of AMTI involves making certain prescribed upward and downward adjustments to taxable income and adding to

175. Temp. Reg. § 1.469-1T(d)(1), 53 Fed. Reg. 5686, 5701 (1988).

176. I.R.C. § 163(d)(3)(B)(ii).

177. Temp. Reg. § 1.469-1T(d)(2), 53 Fed. Reg. at 5701.

178. STAFF OF THE JOINT COMMITTEE ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 209, 224 (P-H May 11, 1987).

179. *Id.*

180. I.R.C. §§ 55-59.

181. *Id.* § 55(b).

182. *Id.* §§ 55(a), (c).

this the amount of the taxpayer's "items of tax preference."[183] One of the main adjustments made to taxable income involves recomputation of depreciation on certain business properties of the individual. In most cases, the amount of depreciation allowed for regular tax purposes greatly exceeds the amount allowed for AMTI purposes.[184] This excess represents an upward adjustment to taxable income.[185]

As previously stated, the determination of AMTI involves making various adjustments to taxable income. The determination of taxable income involves application of all loss deduction limitations, including the Passive Activity provisions. Thus, for purposes of the alternative minimum tax, to the extent that any alternative minimum tax adjustments to taxable income affect the amount of loss incurred in the taxpayer's passive activities, the taxpayer must again apply the Passive Activity provisions.[186] Assume that, because of a $2,000 upward adjustment, a $10,000 loss from a passive activity was reduced to $8,000 for alternative minimum tax purposes. While the passive loss carryover for regular tax purposes would be $10,000, the passive loss carryover for alternative minimum tax purposes would be $8,000.

As previously discussed, the disallowance of losses otherwise occurring under the Passive Activity provisions with respect to "pre-enactment interests" is phased-in from 1987 through 1990. Thus, a taxpayer with a $100,000 loss in 1987 from a pre-enactment passive activity would only have $35,000 disallowed for purposes of determining the taxpayer's regular tax liability. However, for unspecified reasons, Congress decided that the Passive Activity disallowance phase-in should not apply in determining taxable income for purposes of the alternative minimum tax.[187] Consequently, in the above example, there would be a complete $100,000 disallowance of the pre-enactment passive activity loss. The disallowance results in alternative minimum taxable income that is at least $65,000 greater than the amount of taxable income used to determine regular tax liability.

IV. Policy Analysis of Passive Activity Provisions

It should be kept in mind what the essence of the "tax shelter problem" was before the enactment of the Tax Reform Act. Relatively wealthy taxpayers substantially reduced their income tax liabilities by

183. *Id.* § 55(b)(2).
184. *Id.* §§ 56(a)(1)(A), 168(g)(2)(A).
185. *Id.*
186. *Id.* §§ 58(b)(1)-(2).
187. *Id.* § 58(b)(3).

availing themselves of artificial tax deductions. An obvious aspect of the tax shelter pattern was the ability of wealthy taxpayers to deduct a loss from a tax shelter activity against income the taxpayers derived from other activities and portfolio investments. In most instances, wealthy taxpayers had little or nothing to do with the conduct of the business of the tax shelter activity, whereas they were quite involved in the conduct of business of one or more activities producing substantial amounts of income.

If tax policy concepts such as "horizontal equity" and "efficiency" can be set aside, a seemingly practical and expedient way of thwarting the typical tax shelter investor is to somehow prevent the deduction of losses from activities in which the taxpayer is not active against both portfolio income and income from activities in which the taxpayer is active. Essentially, Congress adopted this approach. Whether this approach can withstand any decent tax policy analysis is one matter. But, from the practical standpoint of substantially curtailing the deductions from the typical tax shelter investment, its beauty cannot be denied. Prosperous doctors, lawyers, and candlestick makers can no longer offset limited partnership real estate and other tax shelter losses against their primary source of income. This is not to say that Congress did not offer a tax policy rationale for the enactment of the Passive Activity provisions. It did. But, as will be demonstrated, little of this rationale makes any sense on close analysis.

A. *Artificial Deductions*

Because artificial deductions were the main cog in the tax shelter machine, perhaps the first question to ask is whether the Passive Activity provisions eliminated these deductions. Assume that taxpayers Active, a material participant, and Inactive, a nonmaterial participant, are equal partners in the AI Partnership, the only deduction of which is depreciation. In 1989, the AI Partnership has no income and a depreciation deduction of $100,000. In fact during 1989, there was no real loss in the value of the partnership's depreciable property. Consequently for 1989, all $100,000 of the depreciation deduction is artificial ($100,000 tax depreciation less zero economic depreciation). Under these facts, Active, a material participant, is entitled to offset a 50 percent share of the loss, $50,000 (50 percent of $100,000 of deductions less zero income), against other nonpassive and portfolio income. On the other hand, Inactive, a nonmaterial participant, is not allowed to deduct a $50,000 share of loss against other nonpassive and portfolio income. Inactive could deduct all or part of the share of loss against income from other passive activities. However, assume, as will often be the case, that Inactive is not involved in any other passive activities.

Quite obviously, material participants such as Active may still use artificial deductions to reduce income tax liabilities. Without reference to previous legislative history, the Committee Report states that Congress is now finally implementing its original intention of restricting the use of tax preferences such as artificial deductions to taxpayers who are active in the businesses involved.[188] Implicit in this is the policy that those taxpayers who are actively involved in their businesses need a special subsidy to encourage them to commence or continue these businesses. The inactive owners, on the other hand, who are merely providing capital, but withholding their time, do not deserve this encouragement.

All too frequently, Congress has seen fit to spur the economy by providing a special tax preference that would increase the investment of capital in various industries. For example, one of the main objectives of the Economic Recovery Tax Act of 1981 ("ERTA") was to stimulate "capital formation."[189] ERTA substantially increased depreciation rates that would be employed in the initial years of ownership of depreciable property.[190] Nothing in ERTA supports the assertion of the Committee Report that this (or any other) very generous tax incentive was intended to benefit only those taxpayers actively involved in the businesses acquiring depreciable property. The main concern of this and other ERTA provisions was to attract capital needed to replace worn-out plants and equipment.[191] The source of the capital was irrelevant.

Do the Passive Activity provisions completely deprive the nonmaterial participant of the use of artificial deductions? In the AI Partnership example, the partnership had no income and Inactive did not have any income from any other passive activities. Assume, alternatively, that the AI Partnership had $100,000 of income. In that instance, the full $100,000 of depreciation, all of it being artificial, could be offset against AI Partnership income. Consequently, nonmaterial participants, as well as material participants, can still use artificial deductions to the extent of income from the activity in which the artificial deductions arose. The argument can be made that in these instances it is appropriate to allow the nonmaterial participant to use artificial deductions because neither nonpassive nor portfolio income is being sheltered. However, but for the allowance of the artificial deduction, the nonmaterial participant, as well as the material participant, would

188. *See* SENATE REPORT, *supra* note 23, at 715.

189. STAFF OF THE JOINT COMMITTEE ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 18-19 (1981).

190. *Id.*

191. *Id.*

have significantly greater income tax liability. Should the source of income (here, a passive activity) somehow validate an artificial deduction? What logical connection is there between income that was not earned by the sweat of a taxpayer's brow and allowing that taxpayer to deduct a fictitious loss? Does the loss become less fictitious as the amount of passive income increases?

Changing the facts again of the AI Partnership example, assume that, while Inactive does have a $50,000 loss from the partnership's passive activity, he also has $50,000 of income from another passive activity. Inactive can offset the $50,000 loss from the AI Partnership passive activity against the $50,000 of income from the other passive activity. This is yet another instance of a nonmaterial participant using artificial deductions. The only connection between these two activities is the lack of Inactive's material participation. Thus, Congress is rewarding Inactive for failing to materially participate in the other activity by allowing him to use otherwise nondeductible artificial deductions.

In summary, while the Passive Activity provisions have substantially restricted artificial deductions in some situations (the nonmaterial participant with little or no passive income), they are alive and well in other situations.

B. *Real Economic Losses*

Assume that General and Limited are 50 percent partners (General, the general partner, and Limited, the limited partner) in a grocery store business. In the current year, the partnership incurs a loss of $60,000, entirely attributable to cash outlays for bona fide business expenses. General and Limited each have taxable and economic income of $100,000 from other activities in which they are material participants. They have no deductions other than those taken into account in determining loss from the grocery store business and the taxable income from other activities.

Because partnership activities are considered passive vis-à-vis all of a partnership's limited partners, the Code treats Limited's $30,000 share of the partnership's loss as a nondeductible passive loss. On the other hand, General, who is a material participant in the grocery store business, may deduct his $30,000 share of the partnership loss against the $100,000 of income derived from other activities. Here, the material and nonmaterial participants have each incurred a real economic loss of $30,000, but only the material participant is allowed to deduct that loss. This illustrates how Congress cast its new anti-tax shelter net far too wide — for the net not only captures some artificial deductions, but also captures real economic losses.

Until the enactment of the Passive Activity provisions, little or no disagreement arose as to the appropriateness of allowing a deduction for actual economic losses incurred in the conduct of a business. One could speculate that Congress did not intend to cast the net as wide as it did. Perhaps it only meant to strike at the heart of tax shelters, the artificial deduction. However, Congress expressed concern about preventing the reduction of tax liability regarding a taxpayer's primary source of "positive income."[192] One could also reasonably surmise that Congress consciously decided to disallow both the artificial and real losses of these nonmaterial participants. The question then becomes whether there is some reasonable basis to provide totally disparate treatment for the real economic losses of material and nonmaterial participants.

The Committee Report states that the overriding purpose of the Passive Activity provisions was to eliminate or curb the expansion of tax shelters so that tax liability would bear a fair relationship to ability to pay.[193] The closer the correspondence is between a person's taxable income and his true economic income, the closer the correspondence is between income tax liability and ability to pay tax.

Further examination of the preceding grocery store business example is helpful in determining whether the Passive Activity provisions achieve some reasonable correspondence between taxable and true economic incomes. In the example, both General and Limited have economic incomes of $70,000 ($100,000 - $30,000). General's taxable income is also $70,000 ($100,000 - $30,000). However, the Passive Activity provisions disallow the deduction by Limited of his $30,000 share of the grocery store business loss. Consequently, Limited's taxable income is $100,000 ($100,000 - 0) notwithstanding that his economic income is only $70,000. Quite clearly, vis-à-vis the nonmaterial participant, the Passive Activity provisions create disparity between taxable income and economic income. This disparity arises to the extent that the disallowed passive activity loss is attributable to a true economic loss. In this context, the Passive Activity provisions cause tax liability to bear a distorted and unfair relationship to ability to pay.

Comparing Limited's income tax liability situation with that of General, one finds two taxpayers with identical economic incomes and identical abilities to pay. Yet one taxpayer pays considerably more

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192. *See* SENATE REPORT, *supra* note 23, at 716.
193. *Id.* at 713-14.

income tax ($8,400, an approximate increase of 43 percent[194]) than the other. On its face, this disparate treatment is unfair and contrary to the well established tax policy principle of "horizontal equity" that similarly situated taxpayers should receive similar treatment under income tax laws.

Until the Tax Reform Act, an individual's income tax liability was based primarily on the amount of net income, regardless of the sources of income and deduction items that comprised net income.[195] In contrast to net income taxation, the so-called "schedular approach" of taxation involves separate taxation of different sources of income. Under this approach, tax would be imposed on $100 of income from one source notwithstanding that the taxpayer had incurred $100 of loss from another source. To the extent that schedular taxation disallows the offset of real economic loss from one source against income from another source, distortion occurs in the measure of ability to pay taxes. When only certain taxpayers suffer distortions in the measurement of the ability to pay taxes, horizontal inequity results. The grocery store business example discussed above clearly illustrates how the schedular approach of the Passive Activity provisions can cause horizontal inequity.

The Committee Report discusses at great length the reasons for the disparate treatment of the nonmaterial participant. One of the main reasons is to encourage nonmaterial participants to make more economically motivated investments:

> There are several reasons why it is appropriate to examine the materiality of a taxpayer's participation in an activity in determining the extent to which such taxpayer should be permitted to use tax benefits from the activity. A taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value.

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194. Assuming a 28% tax rate, General pays $19,600 ($70,000 x .28), whereas Limited pays $28,000 ($100,000 x .28).

195. The few notable exceptions to this source-blind method of taxation are the investment interest limitation of I.R.C. § 163(d) (the deduction of certain interest expenses limited to the amount of the related investment income), the capital loss limitation of I.R.C. § 1211 (the deduction of capital losses limited to the amount of capital gains (plus $3,000 in case of individuals)), and the limitations of I.R.C. §§ 265(a)(1) & (2) (the disallowance of the deduction of interest and other expenses related to the purchase and holding of tax-exempt bonds).

> A material participation standard identifies an important distinction between different types of taxpayer activities. In general, the more passive investor is seeking a return on capital invested, including returns in the form of reductions in the taxes owed on unrelated income, rather than an ongoing source of livelihood. A material participation standard reduces the importance, for such investors, of the tax-reduction features of an investment, and thus increases the importance of the economic features in an investor's decision about where to invest his funds.[196]

Undoubtedly, many wealthy investors, material and nonmaterial participants alike, have focused too much attention on potential tax benefits to be derived from an investment. The prospect of deducting illusory losses is quite appealing. Conversely, most of these investors did not relish the thought of losing the hard dollars they were going to invest. Consequently, many investors, although quite interested in the potential tax benefits, did pay some attention to the economic aspects of the investment. However, because of the de-emphasis of tax benefits, the Passive Activity provisions will certainly enhance the importance of the economic features of an investment. Another more perverse reason for the increased attention to economic soundness will be the taxpayers' new quest to find passive activities generating passive income that will absorb their otherwise nondeductible losses derived from other passive activities.

Notwithstanding a keener eye to economics, many nonmaterial participants are still going to lose money on their investments. Notwithstanding that these taxpayers will have done what Congress has encouraged them to do, they will, for the first time, be denied a current deduction of actual economic losses. The nonmaterial participant investor is receiving a draconian message here: "your investments had better be successful; for, if they are not, your losses, however real, will not be currently deductible." Encouragement of sound economic investing is, at best, an incidental and salutory effect of the Passive Activity provisions, and it hardly can be considered as one of the main justifications for a radical rule that has such illogical and harsh consequences.

Another part of the congressional rationale for the disparate treatment of the nonmaterial participant also lies in the realm of economics:

196. *See* SENATE REPORT, *supra* note 23, at 716.

> In some cases, the availability of tax preferences to non-participating investors has even harmed the industries that the preferences were intended to benefit. For example, in the case of farming, credits and favorable deductions have often encouraged investments by wealthy individuals whose principal or only interest in farming is to receive an investment return, largely in the form of tax benefits to offset tax on positive sources of income. Because such investors may not need a positive cash return from farming in order to profit from their investments, they have a substantial competitive advantage in relation to active farmers, who commonly are not in a position to use excess tax benefits to shelter unrelated income. This has significantly contributed to the serious economic difficulties presently being experienced by many active farmers.
>
> The availability of tax benefits to shelter positive sources of income also has harmed the economy generally by providing a non-economic return on capital for certain investments. This has encouraged a flow of capital away from activities that may provide a higher pre-tax economic return, thus retarding the growth of the sectors of the economy with the greatest potential for expansion.[197]

It is certainly commendable for Congress to try to stem unfair competition arising from selective endowment of tax preferences such as artificial deductions. But, it must be kept in mind that the Passive Activity provisions also eliminate the nonmaterial participant's ability to currently deduct real economic losses. The fact remains that business ventures that are running at a loss, or are likely to do so, are the ones that are in the greatest need for infusion of new capital. Now, instead of an incentive to invest in these ventures, there is a tremendous disincentive because losses of hard dollars will not be currently deductible.

Congress seemingly has forgotten or ignored some of the economic facts of life. Many people with requisite skills and ideas relating to the conduct of a new business do not necessarily have adequate capital to both commence and maintain a business during its early years. Consequently, businesses must obtain outside capital, mostly in the form of equity. Many new businesses operate at a loss during the early years. These losses are no longer currently deductible by nonmaterial participants. This type of investor will now seek out the more

197. *Id.* at 715-16.

established business with a proven track record for generating profits. These profits will represent passive income that, in turn, will absorb passive losses from other activities.

Thus, while Congress was striking out against businesses like large farming syndicates, which were not necessarily operated on a sound economic basis, it also hammered all potential new bona fide business ventures. Here, Congress threw out many babies with the bath water. Many would agree that the tax preferences such as artificial deductions should not influence the flow of capital to a particular industry or section of the economy. On the other hand, virtually everyone would agree that it is at least as injudicious to influence the flow of capital *away* from new and needy businesses through a punitive rule denying deduction of real economic losses.

It is both implicit and explicit throughout the Committee Report that the disparate treatment of material and nonmaterial participants will result in a more accurate measurement of income.[198] The Committee Report implies that the deduction of losses from passive activities against nonpassive income causes "undermeasurement . . . of income."[199] The grocery store example demonstrates that deduction of a passive activity loss would not have caused undermeasurement of income. Instead, disallowance of that loss deduction caused an overmeasurement of income. In fact, the ability to deduct passive losses against nonpassive income has nothing to do with the undermeasurement of income. Quite simply, undermeasurement of income results when any taxpayer, active or passive, is able to reduce taxable income, regardless of the source of that income, with an artificial deduction. To the extent that the passive loss rule prevents a taxpayer from using an artificial deduction, it also prevents undermeasurement of income. However, as previously illustrated, in many cases, this new

198. Moreover, the committee believes that restricting the use of losses from business activities in which the taxpayer does not materially participate against other sources of positive income (such as salary and portfolio income), addresses a fundamental aspect of the tax shelter problem. As discussed above, instances in which the tax system applies simple rules at the expense of economic accuracy encourage the structuring of transactions to take advantage of the situations in which such rules give rise to undermeasurement or deferral of income. Such transactions commonly are marketed to investors who do not intend to participate in the transactions as devices for sheltering unrelated sources of positive income (e.g., salary and portfolio income). Accordingly, by creating a bar against the use of losses from business activities in which the taxpayer does not materially participate to offset positive income sources such as salary and portfolio income, the committee believes that it is possible to reduce significantly the tax shelter problem. *Id.* at 716-17.

199. *Id.*

rule does not preclude artificial deductions and, all too often, it causes overmeasurement of income by denying the deduction of real economic losses.

Few would contest that the nontaxation of unrealized appreciation gives rise to distortions in the annual attempt to accurately measure income or loss. The Committee Report would have us believe that this is a problem peculiar to determining losses of nonmaterial participants and that these taxpayers should be allowed to deduct their losses only on disposition of their ownership interests in the passive activity.[200] The longstanding and deeply entrenched income tax principle of nontaxation of unrealized appreciation applies to all business and income producing activities, regardless of the level of involvement of the owners in these activities. Thus, nontaxation of unrealized appreciation causes distortion in measuring income or loss of all activities, whether they are passive or nonpassive.

The two Joint Committee on Taxation staff attorneys who wrote the Committee Report have authored a thoughtful article defending the Passive Activity provisions.[201] They argue that deductions of losses from activities that are rife with unrealized appreciation substantially detracts from an accurate measurement of net income.[202] In contrast to these activities, they allude to other activities such as wage earning, in which little or no unrealized appreciation is involved and where, consequently, the income is more susceptible to accurate measurement.[203] They contend that the Passive Activity provisions improve determination of net income by precluding the offset of unreliably measured losses from unrealized appreciation activities against reliably measured income from activities such as wage earning.[204]

The authors call attention to other Code provisions that, like the Passive Activity provisions, have employed the schedular approach in

200. Further, in the case of a nonparticipating investor in a business activity, the committee believes that it is appropriate to treat losses of the activity as not realized by the investor prior to disposition of his interest in the activity. The effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that may occur, especially when debt financing is used heavily. Only when a taxpayer disposes of his interest in an activity is it possible to determine whether a loss was sustained over the entire time that he held the interest. *Id.*

201. Rock & Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 VA. TAX REV. 1 (1987).

202. *Id.* at 28-30.

203. *Id.* at 39, 46.

204. *Id.* at 39, 42-46.

order to improve measurement of net income. Principal among these provisions is the limitation on deduction of "investment interest."[205] Under this limitation, a taxpayer may not deduct interest attributable to indebtedness incurred to purchase "property held for investment" to the extent that the interest exceeds "net investment income" (investment income less non-interest expenses directly connected to the production of investment income).[206] Essentially, "property held for investment" is property that yields income such as interest, dividends, and royalties or is held for ultimate realization of anticipated appreciation.[207] In this situation, were it not for the investment interest limitation, the gap in measurement of net income stemming from the realization requirement would widen if taxpayers with interest expenses attributable to investment property with untaxed unrealized appreciation were allowed to offset income from non-investment activities.

Assuming, for the sake of argument, that the approach taken by the investment interest limitation does mitigate the distortion in measurement of net income brought about by the realization requirement,[208] the question remains whether this provision can serve as a justification for the Passive Activity provisions. It should first be observed that the investment interest limitation only applies if the taxpayer actually holds investment property. In contrast, the Passive Activity provisions do not involve an examination of the activity's property to determine whether unrealized appreciation is likely to exist.

The authors contend that a strong connection exists between nonmaterial participation and the presence of unrealized appreciation.[209] However, nowhere in the article do they substantiate this connection. Their best attempt in this regard is as follows:

> For many activities that are characterized by little personal involvement or provision of services, the profit from the venture may come primarily from capital, not from labor.

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205. I.R.C. § 163(d). Other notable provisions that employ the schedular approach are I.R.C. §§ 265(a)(1)-(2) & 1211. *See supra* note 195.

206. I.R.C. §§ 163(d)(1), (4)(A).

207. *Id.* §§ 163(d)(5), 469(e)(1).

208. Arguably, many properties, such as bonds, that, for purposes of this provision, are considered "held for investment," are not held primarily for appreciation. To this extent, the provision is over-inclusive.

209. Rock & Shaviro, *supra* note 201, at 45.

> Thus, *when such an activity gives rise to current tax losses rather than income, and yet the activity continues to be engaged in, there is particular reason for suspecting that the taxpayer is relying on capital appreciation to produce an ultimate profit.*[210]

The reasoning here is highly questionable. The authors seem to assert that the only reason a nonmaterial participant would continue owning an interest in an activity that is reporting "current tax losses" is to ultimately profit from the realization of capital appreciation. One should first observe that the authors are implicitly equating "current tax losses" with real economic losses. For, if, notwithstanding reported tax losses, these activities were experiencing real economic income (excess of economic income over economic outlays), the operative part of the authors' premise would disappear. The very nature of a tax shelter is the use of artificial deductions that, in many cases, have the probable effect of converting real economic income into tax losses. Therefore, it is suggested that many taxpayers invest in a tax shelter activity, not only to benefit from tax losses, but also to share in the real economic income the activity will generate from its inception.

Even with respect to those activities experiencing real economic losses, does it really make sense that the *only* reason a person would stay invested is to ultimately profit by realizing capital appreciation? Seemingly, an equally valid, if not better, reason to continue on as an owner in such an activity would be the expectation that the business operations of the activity would eventually become profitable. The problem is that the material participation standard has little or nothing to do with separating capital appreciation situations from others. In one of many moments of forthrightness, the authors admit that "the material participation standard might not be especially direct" in identifying capital appreciation situations. They also admit that an ownership of capital assets test might be more appropriate.[211]

The authors contend that the real strength of the material participation standard lies in its identification of situations that do not involve capital appreciation.[212] In this regard, they point to compensation income as the main example of how the material participation standard isolates a non-capital appreciation situation in which income can be reliably determined.[213] They provide no other examples of pure non-

210. *Id.* (emphasis added).
211. *Id.* at 45-46.
212. *Id.* at 46.
213. *Id.*

capital appreciation situations because no others exist. First, note that the material participation standard is not needed in order to categorize wage earnings as nonpassive. Regardless of a taxpayer's status (material or nonmaterial participant), the Code treats all "earned income" (i.e., compensation paid for services) as nonpassive income.[214] It is with respect to activity owners, who are not necessarily being paid wages, that the material participation standard serves its main purpose. Although it may identify the more involved owner, this standard provides no further assurance that the activity does not have capital appreciation property. How could it? The material participation of an owner of an activity has no bearing on whether that activity owns capital appreciation property. Thus, outside of the wage earner, for whom the material participation standard is unnecessary, this standard has as much chance of separating out the non-capital appreciation situation as a blindfolded person has in attempting to pin the tail on the donkey!

Another major distinction between the Passive Activity provisions and the investment interest limitation lies in the scope of deductions to which they relate. The investment interest limitation is narrowly focused on leveraged financing of investment property. Congress believed that it was inappropriate for a taxpayer to have an unlimited deduction of interest on indebtedness incurred to purchase property that could give rise to unrealized and untaxed appreciation.[215] The investment interest limitation only limits deduction of one specified and identifiable expense, interest incurred with respect to an investment. Consequently, all other investment related expenses, even if they exceed investment income (and regardless of the unrealized appreciation in the property of the activity), are deductible. Thus, Congress only felt justified in limiting deduction of expenses that bore a direct relation to property that could give rise to unrealized appreciation.

In contrast to the approach of the investment interest limitation, the Passive Activity provisions limit deduction of all expenses notwithstanding that these expenses may be totally unrelated to the purchase or holding of a passive activity's capital appreciation property. Thus, just as in the tax shelter context, where they fail to distinguish between artificial deductions and real economic losses, the Passive Activity provisions fail to discriminate between those expenses

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214. I.R.C. § 469(e)(3).

215. STAFF OF THE JOINT COMMITTEE ON TAXATION, 91ST CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 104-05 (1970).

that are and are not causally connected to ownership of capital appreciation property.

Perhaps the most specious justification for disallowing the nonmaterial participant's current deduction of passive losses lies in the attempt to analogize this taxpayer with a C Corporation shareholder:

> The relationship to an activity of an investor who does not materially participate may be little different from the relationship of a shareholder to a corporation. So long as the investor retains an interest in the activity, any reduction in the value of such interest not only may be difficult to measure accurately, but has not been realized by the investor to a greater extent than in the context of a C Corporation. In the case of a C Corporation, losses and expenses borne by the corporation, and any decline in the value of the corporation's stock, do not give rise to the recognition of any loss on the part of shareholders prior to disposition of their stock.[216]

Our income tax laws consider the C Corporation and its shareholders separate taxpaying entities. Because of this separateness, the C Corporation shareholder is treated as lacking any interest in properties held by the corporation. Instead, the shareholder is considered as having invested solely in the corporation's stock. Consequently, recognized gains or losses of the C Corporation do not constitute recognizable gains or losses of the corporation's shareholders. In order to recognize gain or loss, the shareholder must await the taxable disposition of his sole investment, the corporation's stock. Therefore, it is not lack of participation that precludes the shareholder's deduction of losses incurred by the C Corporation. It is simply a matter of an income tax rule that divorces the shareholder from underlying corporate activities.

Many shareholders are very actively involved in their C Corporations' business activities. Nonetheless, the separateness rule precludes deduction of any of the corporation's losses. The level of involvement of the corporation's shareholders is totally extraneous to the shareholders' inability to deduct these losses. Under Subchapter S, the Code relieves certain corporations and their shareholders from the rule of separateness.[217] The Code allocates a pro rata share of the corporation's gains and losses to an S Corporation shareholder notwithstanding the

216. *See* SENATE REPORT, *supra* note 23, at 717.

217. I.R.C. §§ 1363(a), 1366(a).

total lack of involvement by the shareholder in the corporation's business activities. Quite obviously, the level of involvement by a shareholder in a corporation's business activites has no bearing on whether the shareholder will (Subchapter S) or will not (C Corporations) share in the corporation's gains and losses. In summary, the separate entity treatment applicable to C Corporation shareholders is based on factors and rationales that are totally unrelated to the level of shareholder involvement. Consequently, with respect to the nonmaterial participant, separate entity treatment cannot serve as the basis for denying a current loss deduction.

C. *Insult to Injury*

Arbitrary rules are many times the consequence of an oversimplified approach to a complex and multifaceted problem. In some cases, the arbitrary rule is embodied in a succinct and unambiguous statute. In these instances, some redemption exists in that taxpayer and government have at least been provided with the benefit of a statute the application of which is both clear and unburdensome. Unfortunately, the Passive Activity provisions do not represent succinct and unambiguous drafting. To get some idea of the mind-boggling complexity of the Passive Activity provisions, one only has to thumb through the approximately seventy pages of regulations (in small print) interpreting these provisions.[218] Moreover, these seventy pages represent only the first of three sets of passive activity regulations![219]

Many times, burdensome statutes only apply to the wealthier taxpayer who, at least, can afford to hire the accountant and lawyer to grapple with various difficulties the statute poses. However, the Passive Activity provisions apply to a very broad range of taxpayers, many of whom will lack the ways or means to cope with these provisions. For example, any taxpayer who has invested even a dollar as a nonmaterial participant in an activity incurring losses will be subject to the Passive Activity provisions. Thus, Congress has enacted an arbitrary and complex income tax provision that unfairly impacts a very broad range of taxpayers.

D. *Other Anti-Tax Shelter Provisions*

Hopefully, at this point it has been established that the Passive Activity provisions do not represent an appropriate congressional re-

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218. 5 Fed. Taxes (P-H) ¶ 20,649.75 (1988).
219. 11 Fed. Taxes (P-H) ¶ 60,083 (1988).

sponse to the tax shelter problem. The question arises whether there was a need for another major anti-tax shelter provision. It is submitted that, in light of other measures taken by Congress in the Tax Reform Act, another major anti-tax shelter provision was not needed.

The Tax Reform Act of 1986 contained a number of revisions impacting directly or indirectly on tax sheltering. In this Act, Congress substantially lengthened the periods over which real property was depreciated.[220] Moreover, the Act eliminated all accelerated depreciation for most real property.[221] These two revisions strike right at the heart of the most popular tax shelter, the real estate tax shelter, by substantially reducing artificial deductions derived from these activities. Another significant revision was the repeal of the rather substantial 10 percent investment tax credit granted for virtually all purchases of business personal property.[222]

The Tax Reform Act of 1986 partially closed the major loophole in the "at risk provisions."[223] Essentially, the "at risk provisions" restrict a taxpayer's deduction of the share of loss from an activity to the amount of actual investment in the activity.[224] As a general rule, in determining the amount a taxpayer has invested in an activity, nonrecourse financing is not taken into account.[225] However, until the Tax Reform Act of 1986, an exception applied to nonrecourse financing provided to real estate activities. The at risk provisions took the taxpayer's "share" of this nonrecourse financing into account as part of his investment in the activity.[226] As a consequence of this exception, the real estate investor was able to substantially increase the amount of deduction of real estate activity losses.

The Tax Reform Act of 1986 eliminated the exception with respect to nonrecourse financing obtained by real estate activities from noninstitutional lenders.[227] In many cases, these noninstitutional lenders were affiliated in some way (e.g., the promoter) to the real estate activity and had sold real property to the activity. By overstating the selling price of the property and the nonrecourse financing, the real estate activity obtained greater depreciation deductions.[228] The elimi-

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220. Pub. L. No. 99-514, § 201(a), 100 Stat. 2085, 2121-23 (1986).
221. *Id.*
222. *Id.* at § 211, 100 Stat. at 2166-70.
223. I.R.C. § 465.
224. *Id.* §§ 465(a)(1), (b)(1)(A).
225. *Id.* §§ 465(b)(1)(B), (b)(2)(A), (b)(4).
226. *Id.* § 465(c)(3)(D) (as in effect prior to January 1, 1987).
227. Pub. L. No. 99-514, § 503, 100 Stat. 2085, 2243-44 (1986).
228. *See* SENATE REPORT, *supra* note 23, at 747-48.

nation of the exception by the Tax Reform Act for noninstitutional nonrecourse financing put a substantial damper on inflated nonrecourse financing and the corresponding inflated depreciation deductions once enjoyed by a number of real estate investors. Hopefully, one day Congress will resist the formidable real estate lobby and repeal the remaining unjustified exception for nonrecourse financing provided to real estate activities by institutional lenders, such as banks and insurance companies.

The Tax Reform Act of 1986 also contained revisions that strengthened the alternative minimum tax provisions. For example, the amount of depreciation now taken into account under these revised provisions with respect to all business personal property represents a substantial reduction (from 200 percent declining balance to 150 percent declining balance) of the amount taken into account in determining regular tax liability.[229] Moreover, the revised alternative minimum tax provisions lengthen the depreciation periods of virtually all business properties.[230] The Tax Reform Act of 1986 also added a new provision that precludes a "tax shelter"[231] from using the potentially manipulative cash receipts and disbursements method of accounting.[232]

Undoubtedly, the most significant anti-tax shelter revision of the Tax Reform Act lies in its substantial reduction of income tax rates. The highest rate of income tax has been reduced from 70 percent to 28 percent.[233] In other words, whereas an allowable dollar of deduction once reduced income tax liability by as much as seventy cents, that same deduction will now only reduce income tax liability by no more than twenty-eight cents. The potential tax savings resulting from a tax shelter (or any other) deduction has been reduced by 60 percent.[234] Corresponding to the substantial reduction in tax savings from tax

229. Pub. L. No. 99-514, § 701(a), 100 Stat. 2085, 2322 (1986).

230. *Id.*

231. Specially defined under I.R.C. §§ 448(d)(3), 461(i)(3) & (4), 464(c), 1256(e)(3)(B), and 6661(b)(2)(C)(ii).

232. Pub. L. No. 99-514, § 801(a), 100 Stat. 2085, 2345-47 (1986).

233. *Id.* at § 101(a), 100 Stat. at 2096-97. Under I.R.C. § 1(g), a 5% surtax is imposed at certain taxable income levels, thereby raising the highest marginal rate to 33%. I.R.C. § 1(g). When taxable income reaches a certain level (e.g., $71,900 for joint returns), the 5% surtax is imposed until there is a recovery of the additional tax that would have been imposed (i) had the taxpayer claimed no personal exemptions, and (ii) if the first bracket of taxable income had been subject to a tax rate of 28% instead of 15%. *Id.*

234. The 42 cents per dollar tax saving ($.70 less $.28) divided by the old 70 cents per dollar tax liability.

shelter deductions is the substantial reduction in incentive to obtain these deductions. Thus, while it was eliminating most, if not all, of the incentive for any rational person to further engage in tax sheltering, Congress nonetheless enacted an inequitable, ineffective, and complicated piece of anti-tax shelter machinery. The Passive Activity provisions should be repealed.

V. An Overall Limit on Artificial Deductions

Eventually, this country's overwhelming budget deficit will compel Congress to increase income tax rates, particularly at the higher income levels. Such a tax increase would likely rekindle that old lust among upper-level income taxpayers to engage in tax sheltering. At such time, hopefully, Congress will have repealed the Passive Activity provisions and, notwithstanding the alternative minimum tax and other anti-tax shelter provisions, might find it necessary to devise a new anti-tax shelter provision. It is suggested that Congress approach this task from the following perspective.

Rightly or wrongly, Congress has and will continue to enact tax provisions to induce capital investment. Many of these provisions will involve the creation or restructuring of an artificial deduction. It should be kept in mind that most investment capital comes from wealthy taxpayers. Thus, in order for these capital investment inducements to succeed, wealthy taxpayers should be allowed to claim the artificial deductions involved.

Having granted these tax benefits to the wealthy, Congress should not later contradict itself by claiming that it never intended this grant. It should not deny tax benefits to various taxpayers based on some criterion (e.g., material participation) having little bearing on the matter. On the other hand, Congress will not contradict itself if it says that no taxpayer should be allowed to make a pig of himself by amassing tremendous amounts of artificial deductions. It would not be unreasonable for Congress to construct an overall limitation on the use of artificial deductions.

Most importantly, Congress should recognize that, regardless of the activity from which it emanates, an artificial deduction has the same effect. Whether the artificial deduction is offset by income from the same activity or by income from another activity, taxable income, and therefore, tax liability, will be reduced. Consequently, no reason exists to adopt any quarantine type approach under which artificial deductions from a particular activity or kind of activity will only be allowed to offset income of one of these activities. As illustrated by the Passive Activity provisions, the quarantine-schedular type approach almost inevitably results in horizontal inequity and insufferable complexity.[235]

If a source-blind view is adopted, a very simple and equitable limitation can be devised. All of a taxpayer's artificial deductions — regardless of their source and whether they offset income from the same or another activity — would be aggregated and subjected to an overall annual limit, e.g., $25,000. The taxpayer could carry over disallowed amounts to the succeeding year and aggregate them with that year's current artificial deductions. Because the source of the artificial deduction would be irrelevant, disposition of the activity that gave rise to the deduction would not be of any consequence.

VI. CONCLUSION

With rationale that is at best tenuous, Congress has enacted a provision that fails to adequately deal with the direct source of the tax shelter problem, the artificial deduction. More devastatingly, Congress has illogically conditioned the deduction of a true economic loss of invested capital on the taxpayer's substantial involvement in the activity in which the loss was incurred. The degree of an investor's involvement in an activity has no bearing on whether he has actually incurred an economic loss. Therefore, it should have no bearing on whether any such loss should be deductible. This provision will cause a flow of capital away from the traditional tax shelter activity that in many cases is bereft of any significant economic merit. However, it will also cause a flow of capital away from bona fide new businesses and ongoing businesses that have yet to show any profits. Because

235. In 1975, the House of Representatives adopted rather elaborate "Limitation of Artificial Losses" rules. H.R. REP. NO. 658, 94th Cong., 1st Sess. 25-85 (1975). Under these "LAL" rules, certain artificial deductions, such as accelerated depreciation, prepaid feed expenses, and intangible drilling costs, would only be allowed against related income. *Id.* at 28. The limitation was applied separately to oil and gas wells, real estate, farm operations, equipment leasing, movies, and sports franchises. *Id.* at 28-85. With the exception of farm operations and real estate, the limit was applied on a property-by-property basis. *Id.* at 54-85. Thus, for example, the intangible drilling costs pertaining to a particular oil well could only be deducted against the income of that oil well. In the case of farm operations and real estate, the limit was applied on an aggregate basis. *Id.* at 28-54. Thus, for example, the accelerated depreciation on various real properties could be deducted against the income derived from all of these real properties. The Senate Finance Committee rejected the LAL rules because of the potential adverse economic impact and the extreme complexity resulting, in part, from the necessity of distinguishing between related and other income on a property-by-property basis. S. REP. NO. 938, 94th Cong., 2d Sess. 39 (1976).

passive losses can be offset against income from other passive activities, taxpayers with otherwise nondeductible passive losses will now have the incentive to refrain from becoming involved as a material participant in activities that are likely to generate income.

At great cost and frustration, a very broad range of taxpayers will have to grapple with the arbitrary and complex Passive Activity provisions. In too many of these cases, the taxpayer will not have had much concern for tax sheltering. The taxpayer's only mistake will be failing to meet the material participation standard.

In light of other significant anti-tax shelter provisions contained in the Tax Reform Act of 1986, particularly the substantial reduction of income tax rates, there should be little remaining incentive to engage in the tax sheltering that was the object of the Passive Activity restrictions.

The Passive Activity provisions should be repealed. If, because of an increase in tax rates or any other reason, many wealthy taxpayers should continue to engage in tax sheltering, Congress should seriously consider a more direct approach to the problem of limiting artificial deductions. One approach would be to put a dollar limit on the aggregate amount of artificial deductions from all of the taxpayer's activities.