The Passive Activity Loss Rules: Planning Considerations, Techniques, and a Foray Into Never-Never Land

*by Daniel S. Goldberg**

The passive loss limitation rules, complex in both concept and structure, are the subject of this article. The author explains these rules, suggests techniques that creative taxpayers could use to circumvent them, and criticizes the rules as being both conceptually flawed and administratively unworkable.

Introduction

The specter of the "tax shelter" as the principal evil in the tax system represents a major theme of the Tax Reform Act of 1986 (TRA '86). If only tax shelters could be eliminated, all taxpayers would pay their rightful share of tax. A correction in the tax system to eliminate tax shelters could be used to finance lower rates of tax for all taxpayers. Thus, the elimination of tax shelters was a principal objective of Congress.

Congress could have accomplished that objective simply by eliminating the so-called tax expenditures inherent in tax shelter activities and taxing those activities in accordance with their economics. In that event, depreciation rates would closely reflect actual economic depreciation of assets used in the activity, and tax subsidies for those activities would be eliminated. The result of that course of action would be both simplicity and fairness. Congress did not choose that course, however. Instead it chose parts of two alternative systems.

In 1986, Congress enacted the passive loss limitation rules, which, in essence, limit the use of losses from certain activities to offset income from other activities. In that way, Congress chose to penalize

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those activities that had generally yielded tax losses to investors, typically by reason of the tax subsidies inherent in those activities.

In order to restrain taxpayers who are able to work around the passive loss limitations, Congress retained, and in some respects fortified, the alternative minimum tax structure. That structure, in substance, ensures that all taxpayers will pay at least some tax on their incomes, even if their taxable income, after taking into account tax subsidy provisions under the general sections of the Internal Revenue Code, is a small or zero amount. Under the minimum tax structure, tax preferences are added back to taxable income to compute an alternative taxable income, upon which a flat rate of tax of 21 percent is then imposed. If the tax under the alternative minimum tax structure is greater than the regular tax, the alternative minimum tax is the amount payable by the taxpayer.

In spite of this very complex, multitiered structure, Congress has failed to achieve its objective. Instead, Congress should have gone back to basics and forced all taxpayers to compute their income for tax purposes in accordance with their economic income.

Passive Activity Loss Rules: Overview

Background

Prior to TRA '86, taxpayers had been able to use losses from "passive activities," such as limited partnership interests and real estate ("passive losses"), to offset income from an unrelated trade or business ("active income") and income from investments ("portfolio income"). While it is not readily apparent that there is any theoretical problem with viewing all kinds of losses alike, regardless of the nature of the activity in which they were generated, it was that opportunity that TRA '86 targeted as offensive. Congress's solution, in general, was to divide all losses into three "baskets," according to the type of activity in which the losses were generated. Losses from one of those baskets, the "passive loss basket," in general, may not be used to offset income from the other baskets.

Congress apparently was skeptical as to whether passive losses truly represented current economic losses. The general suspicion was that passive losses resulted largely from depreciation for tax or book purposes that may have borne little or no relationship to reduction in the property's value. Allowing passive losses to offset nonpassive income, it was believed, made it possible to create investments designed to produce tax losses without economic losses (i.e., tax shelters).

To correct the situation, Congress could have forced tax depreciation to track economic depreciation or disallowed depreciation on real estate altogether, likely the most egregious generator of tax losses without economic loss. Theoretically, if not practically, Congress could also have taxed unrealized appreciation on investments. This latter solution, however, would have raised insurmountable valuation and administrative problems.

Instead, Congress targeted real estate and certain other investments for special treatment, but only insofar as they are used for tax shelter purposes (i.e., to generate tax losses to offset other, unrelated, income). It is that attempt at precision targeting that will lead to many interpretative and administrative problems with the provision.

The Target Is "Passive Activities"

A passive activity is defined in Section 469(c) of the Code to include two kinds of activities. First, it includes any activity that involves the conduct of any *trade or business,* and in which the taxpayer does not *materially participate.* Second, the term specifically includes any *rental activity.*[1]

Trade or Business

The definition of trade or business should be determined with reference to other sections of the Code—principally Section 162—and judicial authority under those sections. However, trade or business is defined in Section 469 to include, specifically, research and experimentation activity[2] and, to the extent provided in the regulations, "any activity in connection with a trade or business"[3] and "any activity with respect to which expenses are allowable as a deduction under Section 212."[4]

Material Participation

A taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a regular, con-

[1] I.R.C. § 469(c)(2). All citations to sections are to sections of the Internal Revenue Code of 1986 unless otherwise indicated and all citations to regulations are to the Treasury regulations promulgated thereunder.

[2] I.R.C. § 469(c)(5).

[3] I.R.C. § 469(c)(6)(A).

[4] I.R.C. § 469(c)(6)(B).

tinuous, and substantial basis.[5] Although no further amplification of the term is provided in the statute, the legislative history does provide additional guidance. In order to materially participate, the taxpayer's involvement in the activity "must relate to operations." [6] The determination of whether a taxpayer materially participates in the conduct of the activity will be based on an analysis involving the weighing of several factors.

Factors indicating material participation of a taxpayer appear to include four principal items. First, material participation is indicated when the taxpayer's involvement in the activity is the taxpayer's principal business.[7] That factor is not conclusive, however.[8] Second, the taxpayer's presence with regularity at the place of business where the principal operations of the activity are conducted indicates material participation by the taxpayer.[9] A third factor is the actual performance by the taxpayer of management or other important services in connection with the activity, rather than mere formal or nominal participation in management decisions (such as "check a box" management in cattle-feeding operations). In that connection, the conference report acknowledges that this factor is difficult to verify. The report also makes clear that services normally provided by independent contractors, such as tax or other legal advice, are not considered material participation.[10] In addition, use of employees or agents to perform services will not be considered material participation by the taxpayer for whom the employees or agents are working. Fourth, material participation is indicated when the taxpayer does everything required to be done to conduct the activity. That factor indicates material participation even though the actual amount of work done by the taxpayer is low in comparison with other activities in which he is engaged.[11]

The statute also provides special rules for material participation covering certain closely held and personal service corporations.[12] Material participation in those cases is based, in general, on material participation in the activity of a shareholder or shareholders owning in the aggregate stock representing more than 50 percent (by value) of all of

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[5] I.R.C. § 469(h)(1).
[6] S. Rep. No. 313, 99th Cong., 2d Sess. 732 (1986).
[7] *Id.*
[8] *Id.*
[9] *Id.* at 733.
[10] See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-147 (1986).
[11] *Id.* at II-148.
[12] See I.R.C. § 469(c)(4).

the corporation's outstanding stock. Special rules are provided for certain retired individuals as well.[13]

Rental Activity

The statute provides that rental activities are always passive activities. Thus, any rental activity will be passive with respect to a taxpayer, even if the taxpayer materially participates.[14] "Rental activity" means "any activity where payments are principally for the use of tangible property." [15] Thus, the operation of a hotel or car rental business involving short-term leases are not rental activities, because, in the view of the tax writing committees, payments are principally for services and not for the use of property.

Special Rules

There is a special prophylactic rule in the statute for limited partnership interests. Those interests have been the traditional vehicle through which tax shelters have been syndicated and passive losses passed through to investors. Therefore, the statute provides that "no interest in a limited partnership as a limited partner shall be an activity treated as an interest with respect to which a taxpayer materially participates." [16] There is also a special exclusion for "working interests" in oil and gas properties from the definition of passive activity.[17] That provision is not a logical exception to the limited partnership rule, but rather was the result of a political compromise made during the legislative process.

Taxpayers to Whom the Rules Apply

The passive loss rules apply to three classes of taxpayers.[18] First, they apply to any individual, estate, or trust. Second, they apply to any closely held C corporation. That class of taxpayer includes a C corporation described in Section 465(a)(1)(B).[19] That means, in general, a C corporation in which 50 percent of its stock is held by five or fewer

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13 See I.R.C. § 469(c)(3).

14 I.R.C. § 469(c)(4).

15 I.R.C. § 469(j)(8).

16 I.R.C. § 469(h)(2). Exceptions to this rule may be provided in Treasury regulations in order to prevent circumvention of the passive loss rules, presumably in connection with an income-generating partnership. S. Rep. No. 313, note *supra*, at 731.

17 I.R.C. § 469(c)(3).

18 I.R.C. § 469(a)(2).

19 See I.R.C. § 469(j)(1).

individuals. Third, the rules apply to any personal service corporation. That class of taxpayer, in general, includes a corporation, the principal activity of which is the performance of personal services, and such services are performed by employee-owners.[20]

It is important to note the class of taxpayers to whom the passive loss rules do not apply. The excluded class consists of C corporations that are not specifically included in the coverage of the passive loss limitation rules.

Loss Disallowance Rule

While the greatest conceptual difficulty with the statute is determining what income and losses derive from passive activities, the greatest technical complexities appear to involve the understanding of how the passive loss rules work with respect to taxpayers to whom the rules clearly apply. The basic rule provided in the statute is that passive activity losses and passive activity credits for the taxable year are not allowed.[21] The term "passive activity losses" means the amount by which the aggregate losses from all passive activities exceeds the aggregate income from such activities.[22] It involves a netting process. The term "passive activity credit" means the sum of all allowable credits from passive activities over the taxpayer's tax liability "allocable to all passive activities." [23] Again, that term also involves a netting process, but one of somewhat greater computational complexity. Disallowed losses and credits are carried over indefinitely to future years. As such, they remain available to offset passive income in those future years.[24] Passive losses and credits, however, may not be carried back. Thus, timing of losses and gains could be very important to a taxpayer.

The general consequence of this framework is that passive losses cannot be used to offset certain types of income. That consequence represents the central goal which the rules were designed to accomplish. First, passive losses cannot be used to offset "net active income." Net active income, in general, is the taxpayer's taxable income for the taxable year without regard to income or loss from passive activities and "portfolio income." [25] Second, passive losses cannot be used to offset portfolio income. Portfolio income, although not a defined term in the

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20 See I.R.C. §§ 469(j)(2), 269(A)(6)(1), 269(A)(6)(2).
21 I.R.C. § 469(a).
22 I.R.C. § 469(d)(1).
23 I.R.C. § 469(d)(2).
24 I.R.C. § 469(b).
25 I.R.C. § 469(e)(2)(B).

statute, is income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business (or from working capital used in the business), and gain attributable to property producing such income and property held for investment.[26] For these purposes, the term "investment" excludes any interest in a passive activity.[27]

Exceptions

The general consequences described above are subject to several important exceptions. First, the statute contains a special rule for certain closely held C corporations that are not personal service corporations. Those corporations can use passive losses to offset active income, but they may not use passive losses to offset portfolio income.[28]

The statute also provides special rules for situations in which the activity ceases to be a passive activity.[29] Those "former passive activities," as they are referred to in the statute, are defined as "any activity which, with respect to the taxpayer, — (A) is not a passive activity for the taxable year, but (B) was a passive activity for any prior taxable year."

Current and suspended passive losses of former passive activities are not freed up completely. Rather, passive deductions and credits for the year when the activity ceases to be passive, as well as suspended passive deductions and credits, can be used to offset future income of any kind but from that activity only. More particularly, any unused deduction allocable to the activity can be used to offset income from the activity for the taxable year. Thereafter, any unused credit allocable to the activity can be used to offset that year's regular tax liability allocable to the activity for the taxable year. To the extent not used up, any remaining passive losses and credits will continue to be treated as passive. The consequence of this ordering is that passive losses from the activity that are carried forward after application of the foregoing rules can still offset future income (active or portfolio) from that activity but are generally not "freed up" for use against nonpassive income.

In contrast to the restricted use of passive losses from continuing activities, the statute provides for complete free-up of current and sus-

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26 S. Rep. No. 313, note 6 *supra*, at 728.

27 I.R.C. § 469(e)(1)(A).

28 I.R.C. § 469(e)(2). As explained above, C corporations that are not closely held are not subject to the passive loss rules at all.

29 I.R.C. § 469(f).

pended losses when the activity is finally disposed of. That free-up, however, occurs only on the disposition of the taxpayer's entire interest in the passive activity or former passive activity.[30] To fall within this special rule, the disposition transaction must be fully taxable.[31] If all gain or loss that is realized on a disposition is recognized, suspended losses and loss on the transaction are allowable as deductions against income. Partial recognition, such as a Section 351 exchange in which less than all realized gain is recognized, presumably is not covered. The free-up of losses occurs only after the losses have absorbed other passive income of the taxpayer. More particularly, the suspended losses can be used to offset income or gain from the passive activity for the taxable year (includng any gain recognized on the disposition). Any remaining losses can then be used to offset net income or gain for the taxable year from all passive activities. Thereafter, the remaining losses are completely freed up and can be used to offset any other income or gain of the taxpayer.[32] Thus, when the passive activity is disposed of, unused losses (after application of the general rule) become freed up for use against any nonpassive income or gain. The rationale for the free-up is consistent with the overall scheme of the passive loss rules. The rules are not designed to punish passive investors by disallowing losses forever. Rather, they are designed to prevent taxpayers from reporting early losses from activities, and reporting gains in later years, thereby taking advantage of the time value of money. The early losses did not demonstrably represent real economic losses while the activity was being conducted. At time of disposition, however, previous passive losses are demonstrably real economic losses and should be accounted for as such and allowed as deductions.

If the passive activity is disposed of in an installment sale, losses are freed up in a pro rata manner.[33] This provision allows suspended losses for each year of installment payments in the same ratio as gain recognized in each year bears to the total gain on the sale.

Special Circumstances

Disposition by death and by gift are treated as special circumstances.[34] In a disposition by death, suspended losses are allowed in the

[30] I.R.C. § 469(g).

[31] I.R.C. § 469(g)(1). The sale or other disposition, however, must be to an unrelated party. I.R.C. § 469(g)(1)(B).

[32] Note that there is an exception for a disposition involving a "related party." I.R.C. § 469(g)(1)(B).

[33] I.R.C. § 469(g)(3).

[34] I.R.C. § 469(g)(2).

decedent's final return only to the extent they exceed the basis step-up under Section 1014. In effect, the basis step-up "uses up" the suspended losses.[35] Disposition by gift of any interest in a passive activity causes suspended losses to be eliminated entirely, but the donee's basis is increased by the amount of such disallowed suspended losses.[36] In effect, the losses are reincarnated into the donee's basis to be realized by the donee in the ordinary course.

To deal with investment home or beach apartment situations, commonplace among voters, Congress also resorted to the special exception. It provided a special $25,000 loss allowance for real estate activities to individual taxpayers who "actively participate" in the activity.[37] "Active participation" is defined in a way that is different from "material participation." It requires a lesser connection with the activity.[38] It can be satisfied as long as the taxpayer participates in the making of managerial decisions, such as approving new tenants, repairs, or capital expenditures or arranging for others to provide services, such as repairs. The taxpayer must participate in those actions in a "significant and *bona fide* sense." [39]

Phase-in Provisions

The statute contains special effective dates and phase-in provisions. Generally, it is effective for years beginning after 1986, with exceptions for loss and credit carryovers and low-income housing. In addition, the rules will be phased in even for certain posteffective date losses. Passive losses from a "preenactment interest" will be disallowed in the transition years only as follows:

In Case of Taxable Years Beginning in	*The Applicable Percentage Is*
1987	35
1988	60
1989	80
1990	90

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35 S. Rep. No. 313, note 6 *supra*, at 725–727.

36 I.R.C. § 469(j)(6).

37 I.R.C. § 469(i). The allowable amount is restricted to $12,500 in the case of a married individual not filing a joint return. I.R.C. § 469(i)(5).

38 I.R.C. § 469(i)(6).

39 S. Rep. No. 313, note 6 *supra*, at 737. To restrict the use of this special exception, the statute provides that a limited partnership interest does not, and a net lease generally does not, qualify as an activity in which the taxpayer actively participates. I.R.C. § 469(i)(6)(C). See S. Rep. No. 313, note 6 *supra*, at 737. Furthermore, the spe-

A preenactment interest is defined, generally, as an interest held on the date of enactment (October 22, 1986) or acquired thereafter but pursuant to a written "binding contract" in effect on such date and at all times thereafter. Further, no "carryforward" of the disallowed portion of passive losses is allowed for use in a subsequent year's phase-in computation. TRA '86 also contains a special transitional rule for low-income housing.[40]

These phase-in rules interact with two other important changes enacted under TRA '86: the alternative minimum tax and the investment interest limitation on deductions.

Passive losses that are allowable under the phase-in rules constitute tax preference items for alternative minimum tax (AMT) purposes. Under appropriate circumstances, they may be rendered without tax benefit and, therefore, unusable to an investor.

The investment interest deduction limitation rules have also undergone significant changes in TRA '86. In general, they provide that in the case of a taxpayer other than a corporation, the amount allowed as a deduction for "investment interest" for any taxable year may not exceed the "investment income" of the taxpayer for the taxable year.[41]

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cial exception is subject to a phaseout for high-income taxpayers (generally, taxpayers with adjusted gross income in excess of $100,000). The phaseout reduces the allowable deduction by $1 for every $2 of a taxpayer's adjusted gross income in excess of $100,000. It is fully phased out at adjusted gross income of $150,000. Thus, an individual with adjusted gross income of $120,000, for example, is entitled to use only $15,000 of the special exception because the allowable amount is reduced by $10,000 (.50 x $20,000, the excess of the taxpayer's adjusted gross income over $100,000). See generally I.R.C. § 469(i)(3). The phaseout is also adjusted for married individuals filing separate returns. I.R.C. § 469(i)(5).

[40] TRA '86 § 502 (a noncodified provision), provides:

> (a) GENERAL RULE.—Any loss sustained by a qualified investor with respect to an interest in a qualified low-income housing project for any taxable year in the relief period shall not be treated as a loss from a passive activity for purposes of section 469 of the Internal Revenue Code of 1986.
>
> (b) RELIEF PERIOD.—For purposes of subsection (a), the term "relief period" means the period beginning with the taxable year in which the investor made his initial investment in the qualified low-income housing project and ending with whichever of the following is the earliest—
>
> (1) the 6th taxable year after the taxable year in which the investor made his initial investment,
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> (2) the 1st taxable year after the taxable year in which the investor is obligated to make his last investment, or
>
> (3) the taxable year preceding the 1st taxable year for which such project ceased to be a qualified low-income housing project.

Tax Reform Act of 1986, Pub. L. No. 99-514, § 502, (1986).

[41] I.R.C. § 163(d)(1). Disallowed investment interest, unlike disallowed personal

Investment interest includes all interest expense on indebtedness "incurred or continued to purchase or carry property held for investment."[42] Net investment income, which can be offset by investment interest, is the aggregate net income (income minus expenses) of all investment activities (including dividends, interest, royalties, and capital gains), determined without regard to interest expense attributable to activities.[43] However, in general it does not include income and expenses from passive activities.[44]

The investment interest rules are best understood by examining their overall purpose. They are generally designed to prevent taxpayers from deducting carrying costs of investments that are increasing in value, where such appreciation remains unrealized and therefore untaxed.

The interaction of the investment interest limitation rules with the passive loss rules illustrates how Congress can giveth with one hand and taketh away with the other. It fails to illustrate, however, how Congress can accomplish that with simplicity. In fact, it illustrates the exact opposite.

The passive loss rules phase in for preenactment investments over four years (1987, 65 percent; 1988, 40 percent; 1989, 20 percent; 1990, 10 percent).[45] The phase-in, however, has an important secondary effect on investment interest. Passive losses that are allowed by virtue of the phase-in reduce "net investment income."[46] The effect of that could be to cause some "investment interest expense" to be disallowed under Section 163(d). That secondary effect occurs even though interest expense from passive activities is treated under the passive loss limitation rules rather than the interest deduction limitation rules.

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interest, is not disallowed forever. Rather, it is carried over and treated as investment interest in the following year.

[42] I.R.C. § 163(d)(3)(A). In general, property held for investment includes traditional investments like purchasing and holding stocks and securities, raw land held for investment, and patents and copyrights producing royalty income.

Investment interest does not include interest on indebtedness incurred or continued in any trade or business activity. Further, it specifically does not include any "qualified residence interest" (I.R.C. § 163(d)(3)(B)(i)) or interest taken into account in an activity subject to the passive loss rules. (I.R.C. § 163(d)(3)(B)(ii).) The $10,000 floor has been eliminated and will be phased out through 1990. I.R.C. § 163(d)(6). Also, net leases are no longer covered because they are dealt with in the passive loss provisions.

[43] I.R.C. § 163(d)(4).

[44] I.R.C. § 163(d)(4)(D).

[45] I.R.C. § 469(1).

[46] I.R.C. § 163(d)(4)(E).

Problems With Administration of the Rules

Several interpretative issues are likely to arise in connection with the new passive loss rules. Many of these are simply not solvable in any satisfactory way because they require drawing significant distinctions where there are no significant differences.

Defining "Activity"

Among the most significant distinctions that needs to be drawn is whether a course of conduct represents a single integrated activity, or whether it represents one or more separate and distinct activities. The issue is significant because the taxpayer may materially participate in one of them and not in the other. If they were both regarded as a single activity, the taxpayer's material participation would be sufficient to avoid passive treatment of any of the losses generated by the activity.

Furthermore, one of the activities may be inherently passive, such as rental, while the other may be a trade or business in which the taxpayer materially participates, and therefore active. If the active one yields profits but the passive one yields losses, the passive losses cannot be used to offset the active profits. On the other hand, if they are both parts of a single integrated activity, the profits and losses can be netted to yield a single net profit or loss, either active or passive, as the case may be.

Characterization as an integrated activity or as separate and distinct activities is also significant at the time of disposition of one of the activities. Such a disposition may result in a freeing-up of suspended passive losses, if a separate activity is disposed of, or simply gain (passive or active, as the case may be) if it represents a partial disposition of only a portion of the activity.

The integration issue requires a definition, or at the very least, an understanding of the concept of "activity." The legislative history indicates that the scope of "an activity" is determined by asking the following question: What undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance on each other, and constituting an appropriate unit for the measurement of gain or loss?[47] Further, that determination should be made in a "realistic economic sense."[48] Factors such as centralized management of various parts of the activity are likely to be used to conclude that there is only a single activity.

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[47] S. Rep. No. 313, note 6, *supra*, at 789.
[48] *Id.*

Reference is also made in the committee reports to the similar inquiry that must be made under Section 183 dealing with hobby losses.[49] Regulations issued under that section look to "the degree of organizational and economic interrelationship in various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together . . . and the similarity of the various undertakings." [50] Unlike Section 183 situations, however, taxpayer characterizations in the "activity" area will not have the presumption of correctness.[51]

Moreover, conducting two undertakings in the same partnership or S corporation does not establish a single activity.[52] Rather, the scope of the pass-through entity should be disregarded. With respect to dispositions of one of several activities conducted by a limited partnership, it is not presumed, as was suggested in the Senate Finance Committee Report, that "a limited partnership interest includes no more than one activity." [53] Rather, disposition of a separate activity by a limited partnership may constitute a disposition that would free up suspended losses from that activity.[54]

The legislative history attempts to provide guidance in certain situations. Inherently passive activities, such as rental, cannot be treated as the same activity as one not receiving special passive treatment, such as providing services.[55] Furthermore, portfolio income, such as interest, from a passive activity will not be taken into account in determining passive income or losses.[58]

Allocation of Expenses

A second area of interpretative difficulty that will likely arise is the allocation of expense items, especially interest expense, between two closely related activities being conducted simultaneously by the taxpayer or some entity in which the taxpayer has an equity interest. That will be especially significant if one of the activities is active or portfolio and the other is passive. Treasury regulations, presumably, will provide rules, or at the least, usable guidelines, in this connection.

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[49] *Id.* at 739.
[50] Reg. § 1.183-1(d)(1).
[51] S. Rep. No. 313, note 6 *supra*, at 739 n. 29.
[52] See *id.* at 740.
[53] *Id.*
[54] See H.R. Conf. Rep. No. 841, note 10 *supra*, at II-145.
[55] See S. Rep. No. 313, note *supra*, at 741.
[56] *Id.* at 739.

With regard to interest, at least, the Treasury has issued temporary regulations adopting a tracing rule. Interest attributable to indebtedness, the proceeds of which are used in a passive activity or to purchase an interest in a passive activity, such as a limited partnership interest, will be regarded as passive and subject to the passive loss rules.[57] The Treasury, however, has specifically reserved sections of the regulations, to be issued at a later time, to deal with potential abuse situations and taxpayer attempts to manipulate the tracing rules to their advantage.[58]

We can anticipate a lengthy regulation project emerging from Treasury during the next several months. More important than the length of the anticipated regulation project will be the scope of the filling in of rules in the statute and attempts at administratively overruling the words of the statute under broad regulatory authority granted to the Treasury.[59] Before that possibility is explored, however, we must first understand taxpayers' likely planning responses to the new statute.

New Planning Considerations and Techniques

If we accept the rules of the statute as written, we could suggest a number of planning possibilities for creative taxpayers. Given the broad regulatory authority granted to the Treasury, we might expect Treasury to counter each taxpayer move with a rule preventing it. We will examine Treasury's ability to successfully accomplish that objective, both under statutory authority and as a practical matter. But first, we must understand the available planning techniques.

Macro: Structuring the Deal

Taxpayers will undoubtedly attempt to structure transactions around the passive loss rules. One avenue of structuring, particularly in real estate, involves decreasing losses and making the activity more economically profitable. That can be accomplished by reducing lever-

[57] Temp. Reg. § § 1.163-8T(a)(3), 1.163-8T(b)(4), 1.163-8T(c). The tracing rule, however, will not apply to interest on debt secured by the taxpayer's principal residence or second residence that constitutes "qualified indebtedness interest" within the meaning of I.R.C. § 163(h)(3), regardless of how the proceeds of the loan are used. That interest will be deductible under I.R.C. § 163(h)(3). Temp. Reg. § 1.163-8T(m)(3); see Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 218, 233 (1987).

[58] See Temp. Reg. § 1.163-8T(c)(7); Temp. Reg. Supplementary Information: Background.

[59] I.R.C. § 469(k), see p. 24 *infra*.

age. The effect on investors would be threefold. First, sheltered cash flow, that is, cash receipts without currently taxable income, would replace the "tax losses" that were generally available to offset other income and were traditionally a major beneficial by-product of real estate investments. That restructuring would likely result in the secondary effect of reducing the investor's expected economic yield or internal rate of return from the activity. That secondary effect would occur because the investor's return would become that of a part lender and part equity participant, and the investor's economic yield would be a weighted average of the two. Since equity participants typically expect a greater yield than lenders to compensate for the greater risk, injecting a lender's yield into the weighted average would typically reduce it. But, as a tertiary effect, reduced leverage will mean reduced economic risk that the investor will lose his investment.

A second avenue of structuring involves reconsideration of the allocation of tax items among investors. That will be especially fruitful in the context of a partnership because of the flexibility offered by that investment vehicle.

Planners could allocate losses or depreciation to those partners who can derive benefit from them. For example, loss allocations would continue to be attractive to limited partners with passive income from previous tax shelters, sometimes called in extreme cases "shelter junkies." In addition, C corporations that are neither closely held nor personal service corporations would also find loss allocations attractive. Those corporations are not subject to the passive loss rules. Even C corporations that are closely held but not personal service corporations might be candidates for loss allocations. Those corporations are not subject to the passive loss rules in offsetting active (nonportfolio) income. Presumably, investors from whom losses are reallocated under those new structuring techniques could be compensated by increased economic or cash flow returns.

This structuring might be effected through roll-ups into master limited partnerships (MLPs) in order to combine old partnerships that have passed the turnaround point and are yielding phantom income (taxable income in excess of cash flow), with new partnerships that are generating passive losses.

Micro: Affecting Character of Partnership Income

An alternative or additional technique to rearranging the mix of equity and debt in an activity, or to reallocating tax items among investors who provide capital to an activity, involves affecting the character of the income or losses generated by the activity. Under the new rules, all activities fall into one of three baskets and are either active, portfolio, or passive. The line between any two of them is not always clear. Therefore, taxpayers may formulate their activities in order to achieve the desired classification.

Convert Losses at Partnership Level

One potential technique involves generating losses from a passive activity that are not subject to the passive loss limitations. Consider a limited partner in a partnership that engages in an activity that generates income in the years of operation but on disposition generates a loss that is no greater than the aggregate of the income previously recognized in the activity. The income is deemed passive to a limited partner. The loss would also be deemed passive to a limited partner. That loss, however, would not be subject to disallowance under the passive loss rules because it results from the complete disposition of a passive activity. As such, it would be freed up for use against active or portfolio income. As long as the loss on disposition is not a capital loss,[60] such a technique could be successful. In effect, it converts passive losses from other passive activities into freed-up losses but does so at the cost of deferring those losses. Perhaps the resultant acceleration of income, if shelterable, would be a small price to pay for freed-up losses in future years.

A second potential technique, where flexibility permits, involves characterizing a passive activity as active in order to generate active rather than passive losses. Characterizing loss-generating activities as active instead of passive may be difficult to accomplish, especially with respect to those activities that are inherently passive under the statute. For example, rental activities are treated as inherently passive in the statute. If what might appear to be a rental activity could be transformed into a service activity, the income and losses therefrom would be regarded as active. Characterizing rental as the provision of services is particularly enticing where property used in the activity is high depreciation property.

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60 Capital losses are subject to the limitations of § 1211. In general, a noncorporate taxpayer may only offset in one year up to $3,000 of ordinary income with capital losses. Capital losses in excess of that amount, however, can be carried forward (but not back) indefinitely.

Rental activity generally is an activity the income from which consists of payments principally for the use of tangible (but not intangible) property. It should be contrasted with activities that use tangible property but which generate payments principally for the performance of substantial services.[61] The Senate Finance Committee Report refers to the S corporation rules for guidance as to what constitutes a passive activity for these purposes.[62] Under former Section 1372(e)(5) (as in effect prior to the Subchapter S Revision Act of 1982 renumbered as Section 1362(d)(3), which is still relevant in certain cases), the test for whether an activity should be characterized as services and not rental is whether significant services are performed in connection with furnishing property and whether the services are rendered primarily for the convenience of the occupants and are other than the type customarily rendered to occupiers of rental space.[63] Thus, income generated by hotels is not rent and therefore not passive, nor are payments for parking automobiles generally rent. The "nonrent standard" appears to be easier to satisfy with regard to personal property because of the degree of services that generally accompanies such rentals. Thus, daily or weekly leasing of automobiles does not generate rent because of the significant services involved in providing and repairing the automobiles. Of course, the taxpayer must materially participate in the activity in order for the loss to be other than passive with respect to that taxpayer.

A plan, in the real estate context, would be to perform sufficient services for the tenant to make the use of tangible property relatively less important than the overall service. In this connection, consider the following situation. Suppose the owner of a commercial office building, instead of renting offices to tenants, provided them copying, secretarial, and cleaning services, library facilities and services (including space, equipment, books, and a library staff), and conference rooms. Is it possible to provide enough of those services to overcome the passive nature of the activity (i.e., that the rental feature is of such overriding importance)? At first blush, it may appear that it is not. But, consider what a customer is paying for with regard to a hotel room in comparison to the cost of cleaning the room and other incidental services. Perhaps the distinction lies in the turnover rate and the rent-up activity required in a hotel. If the distinction lies in that, the foregoing situa-

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[61] See S. Rep. No. 313, note 6 *supra*, at 742.
[62] *Id.* at 741.
[63] See Reg. § 1.1372-4(b)(5)(vi).

tion would be unlikely to rise above passive as long as longer-term leases were involved and turnover was low. An alternative analysis, however, may be that these should be regarded as two separate activities: rental of office space and provision of secretarial, etc., services.[64]

The legal issue involved in distinguishing the provision of services from rental is essentially the same one dealt with in Section 7701(e)(1), enacted by Congress in the Deficit Reduction Act of 1984 (DEFRA). That section provides a six-factor text, originally intended to deal with investment credit and depreciation.[65] Those factors must be

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[64] See H.R. Conf. Rep. No. 841, note 10 *supra*, at II-148.

[65] The section was enacted to deal with the IRS's defeat in Xerox Corp. v. United States, 656 F.2d 659 (Ct. Cl. 1981) ("lessor" of equipment to tax-exempt entity allowed investment tax credit because lease was structured as a "service contract"). It lists among those relevant factors the following:

1. If the service recipient is in physical possession of the property, that circumstance indicates the existence of a lease rather than a service contract. In this connection, property on the recipient's premises or off the recipient's premises but operated by employees of the recipient are considered to be in the service recipient's physical possession. The DEFRA committee reports also provide, however, that property is not in the physical possession of the recipient merely because the property is located on land leased to the service provider by the recipient.

2. If the service recipient controls the property, that circumstance indicates a lease. The DEFRA Senate Finance Committee Report contains some explanation of this factor. It provides that the property should be considered in the recipient's control if the recipient has the contractual right to dictate the manner in which the property is operated, maintained, or approved. Control, however, is not established merely by reason of contractual provisions designed to enable the recipient to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

3. If the service recipient has a significant economic or possessory interest in the property, that circumstance indicates a lease. The DEFRA Senate Finance Committee Report explains that an economic or possessory interest in the property is shown by establishing that (a) the property's use is dedicated to the service recipient for a substantial portion of the useful life of the property; (b) the recipient shares in any depreciation or appreciation of the property or in savings in the property's operating costs; or (c) the recipient bears the risk of damage to or loss of the property.

4. If the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, that circumstance indicates a lease.

5. If the service provider does not use the property concurrently to provide significant service to entities unrelated to the service recipient, that circumstance indicates a lease. Concurrent use, on the other hand, would be indicative of a service contract.

6. If the total contract price does not substantially exceed the rental value of the property for the contract period, that circumstance indicates a lease. That is because the entire contract price would relate to compensation for the use of the provider's capital and no amount would relate to reimbursement for the provider's labor. If the total contract price substantially exceeded the rental value of the property, on the other hand, that circumstance would indicate a service contract because the price

weighed in each case in order to determine whether the arrangement is more properly characterized as a service contract or a lease. The DEFRA committee reports recognize that the test for determining whether a service contract should be treated as a lease is inherently factual. The presence or absence of any single factor may not be dispositive in a given case.[66]

We might also consider combining the active parts of a business with the passive parts so that the entire activity can be viewed as a single *integrated* active business. Taxpayers could put an otherwise passive activity into an active business so that passive losses can offset active income. In that manner, the taxpayer could end up with reduced net income to be taxed.

For example, a law firm could acquire fee ownership in the floor of the building in which it is located. Depreciation of the building portion could be used to offset law practice income.

The Senate Finance Committee, however, foresaw an abuse of this device and provided for the separate treatment of *unrelated* activities. The key word is "unrelated." If the remaining four floors of the building were owned by the law firm but rented to others, losses attributable to those floors would be passive. For the technique to work, therefore, ownership of the property must not be separated from those who use it.

As a final suggested technique in this category, planners might consider, in appropriate circumstances, adopting dealer status with respect to property that will ultimately be sold in the ordinary course of business. The objective would be to characterize early losses from the activity as merely the early stages of an active activity. As such, those losses would be active rather than passive.

Cooperative and condominium conversions may provide the most likely outlet for this technique. That is because interim rental losses,

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would include a substantial amount as compensation for the labor used in providing the service as well. In other words, a contract price equaling the rental value of the property indicates that the contract price was based principally on the provider's recovering the cost of the property. As a corollary to the foregoing proposition, if the contract provides separate charges for services, that circumstance is indicative of a lease of the property.

Furthermore, it is also possible that other types of arrangements may also be characterized as a lease as well. I.R.C. § 7701(e)(2). In that connection, the statute specifically mentions a partnership arrangement as susceptible of being treated as a lease instead of a partnership.

[66] To provide additional guidance to the taxpayers, the DEFRA committee reports provide a series of examples indicating how the factors should be weighed and applied in specific cases. It is likely that Treasury regulations issued under these provisions will be based on those examples.

in the absence of dealer status, will be passive. The questions raised by this planning idea are: When does dealer status begin, and are the rental and sale features a single integrated activity? The issue could also arise in connection with leases of equipment that are also available for sale to customers. Alternatively, the sale income may be classified as passive because it is integrated with the inherently passive activity of rental, even if the frequency of sales would cause the taxpayer to be classified as a dealer.

These examples of potential planning techniques illustrate an important problem with the passive loss rules. Conceptual definitional ambiguities are inherent in the line drawing attempted by the statute.

Convert Active Income Into Passive Income

Conversion of active income into passive income probably provides a somewhat greater opportunity for avoiding the detrimental impact of the passive loss rules. A taxpayer who can generate passive income instead of active income can use passive losses to offset that income. Passive income is shelterable in the traditional pre-TRA '86 manner. Conversion can take various forms and can be accomplished by a taxpayer himself but is most readily accomplished through use of the partnership vehicle.

First, at the investor level (or partnership level), a planner could seek to characterize an activity as a lease rather than as the provision of services because rental activity is inherently passive. The taxpayer would select an activity that can generate profits (i.e., one that uses no or low depreciation property). Evaluation of the potential success of this technique would involve the same considerations as we explored in the "lease vs. services" discussion. Under the factors of Section 7701, it would appear easier to characterize an activity using a significant amount of tangible property as rental than as services.

Second, a taxpayer willing to limit his participation in any activity may be well advised to have his equity participation in an inherently passive form, that of a limited partnership interest or S corporation stock. As long as such an investor does not materially participate in the entity's business (and a limited partner, for example, is presumed by statute not to do so) the investor's income and losses will be passive. Thus, partners and S corporation shareholders desiring passive income should invest as limited partners or inactive S corporation shareholders and be compensated for services performed for the partnership or corporation in ways other than as partners or shareholders entitled to distributive shares. Moreover, having a limited partner or shareholder who is working for the entity take compensation payments as small as possible under the circumstances might also be considered. This would minimize the taxpayer's active income and maximize his passive income.

Convert Portfolio Income Into Passive Income

Conversion of portfolio income into passive income is likely to be the major area of planning explored, and is just as likely to be the major area of future controversy, because it highlights the principal conceptual flaws of the passive loss rules. Those flaws may ultimately lead to the demise of the rules in their present form.

These observations may best be examined by first analyzing a series of examples illustrating planning techniques in this category. All of these examples have essential similarities. They all involve inherently passive activities that derive income principally from the use of capital of a type that either is not subject to an allowance for depreciation or is subject to depreciation in a relatively small amount. As such, they can generate passive income and, therefore, have been dubbed passive income generators or "PIGs."

First, an investor partnership can enter into a sale-leaseback without leverage. A sale-leaseback is essentially a financing device in which the property owner's economic return is calculated much like the economic yield of a bond. Thus, the predictable periodic, bondlike, income would be partially sheltered. Any excess of income over depreciation could be sheltered with passive losses from other activities. Although the passive income component will be offset to some extent by depreciation over twenty-seven and one-half (residential) or thirty-one and one-half (commercial) years, as the case may be, that depreciation as a result of TRA '86's lengthening of recovery periods will not likely result in net losses from the activity.

Under the clear words of the substantive provisions of the statute, income from a sale-leaseback net lease should be passive, rather than portfolio, because it results from the inherently passive activity of property rental. Indeed, the committee reports provide that a net lease is a passive activity. But those committee reports also suggest that if net leases are used in this manner to circumvent the passive loss rules, regulations may deal with this issue under the broad authority granted by

Congress to prescribe regulations to recharacterize income that would be characterized under the statute as passive as being nonpassive.[67]

Exercise of this regulatory power, even if validly authorized by Congress, creates a substantial dilemma for the Treasury. If the Treasury characterizes any net lease income as portfolio income, the impact of the passive loss rule will be much reduced, because a typical leveraged net lease transaction generates tax losses. Indeed, leveraged net lease transactions had been a standard method of generating tax shelter losses prior to TRA '86. On the other hand, if Treasury characterizes any net lease as passive, taxpayers will have a use for their passive losses. They can be used to shelter income from the rental of property subject to net leases, which are essentially substitutes for portfolio income-producing property. Taxpayers will simply have to redirect their capital into what economically are lending transactions structured around real property.

If Treasury chooses to leave characterization uncertain and relies instead on determination on a case-by-case basis, the tax law will be plunged into uncertainty and unpredictability. It has also been suggested that the Treasury might issue regulations to provide for net income to be portfolio but net losses to be passive. Indeed, the conference report suggests that as a possible alternative.[68] Would Treasury issue regulations to that effect?[69]

Any such regulations would run a high risk of being held invalid by a court as inconsistent with the statute, which makes rental activity inherently passive and income from that activity likewise passive. Moreover, if the regulatory authority granted under the statute is

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[67] I.R.C. § 469(k). Specifically, that subsection provides as follows:

> The Secretary shall prescribe such regulations as may be necessary or appropriate *to carry out provisions of this section*, including regulations—
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> (1) which specify what constitutes an activity, material participation or active participation for purposes of this section,
>
> (2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income),
>
> (3) *requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,*
>
> (4) which provide for the determination of the allocation of interest expense for purposes of this section, and
>
> (5) which deal with changes in marital status and changes between joint returns and separate returns. [Emphasis added.]

[68] H.R. Conf. Rep. No. 841, note 10 *supra*, at II-47.

[69] See I.R.C. §§ 469(k), 469(k)(3).

viewed as granting to the Treasury authority to issue regulations of this breadth, that statutory grant of authority could very well go beyond the scope of Congress's power under the U.S. Constitution to delegate regulatory authority. That is because Section 469(k) may be viewed as granting Treasury that authority without adequate standards set by Congress.

Congress has often granted Treasury legislative rulemaking authority. For example, in Section 385 of the Code, Treasury was authorized to promulgate regulations to determine the situations in which an interest in capital represents debt or equity. Congress granted that authority, however, by setting forth in the statute numerous factors to be used by Treasury in formulating its regulations.

The grant of authority in the passive loss statute, by contrast, contains no such enumeration of factors. Rather, it appears to empower the Treasury to use whatever standards it determines appropriate to accomplish the substantive objective of preventing potential abuse of the rules. Without setting forth any standards on which Treasury could rely, Congress has essentially left Treasury virtually on its own to legislate. While it is rare, indeed, for a statute to be declared unconstitutional on the grounds of an unconstitutional delegation of authority, it is by no means unheard of. Indeed, several decades ago, the Supreme Court struck down delegation statutes on these very grounds,[70] and even today, some commentators continue to believe that those grounds have vitality under appropriate circumstances.[71]

A court holding the regulations invalid on either of those grounds would not only adversely affect the administration of the passive loss rules, but could also adversely affect the authoritative status (real or perceived) of other unrelated regulations. Moreover, promulgation of broad regulations under the vague standards set forth in the statute and committee reports would likely be viewed as unprincipled and therefore could cause great discomfort to those in the Treasury Department and the IRS charged with the duty and responsibility of drafting and approving those regulations.

A second example involving similar characteristics and raising those legal and philosophical issues involves owning and operating a

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70 Panama Ref. Co. v. Ryan, 293 U.S. 388 (1935); A.L.A. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935). But see Yukas v. United States, 321 U.S. 414 (1944); Sunshine Anthracite Coal Corp. v. Atkins, 310 U.S. 381 (1940); United States v. Rock Royal Coops., 307 U.S. 533 (1939), which upheld delegation despite vague standards.

71 Young, "Some Reflections on Gramm-Rudman-Hollings," 45 Md. L. Rev. 1, 8–9 (1986). But see K. Davis, *Administrative Law Treatise* §§ 3:1–3:10 (2d ed. 1978).

parking lot. Again, that activity could yield income without offsetting depreciation deductions because the principal item of capital used is nondepreciable land. Regulations Section 1.1372-4(b)(5)(vi) would classify that activity as nonrental unless, possibly, the parking lot were a self-park lot, without an attendant.[72] However, the lease of a parking lot to a parking company for operation by the lessee should constitute rent to the lessor. Furthermore, a limited partnership interest in an "active" parking lot would generate passive income as well, because the taxpayer would not materially participate in the activity.

Owning ground leases represents a third example, and, in fact, one specifically raised during congressional staff consideration of the legislation. The conference report flatly suggests that Treasury regulations may call such income portfolio income.[73] And that result, though inconsistent with the substantive language of the statute, is not without sense, because it has significant portfolio characteristics. Like interest, its value depends on a stream of periodic (rental) payments, the creditworthiness of the obligor (lessee), and market interest rates. Ground leases, like net leases, are viewed as financing devices by all participants.

On the other hand, ground leases have significant passive characteristics. Technically, there is real estate involved. Also, there are real estate-type risks and rewards because ultimate profitability depends, in part, on residual value, even though that residual value could be so far into the future that the present value of any range of property values would be small.

The conference report suggestion seems contrary to the words of the statute, but Treasury's Section 469(k) authority to issue regulations in this area is very broad.[74] Regulations to that effect could very well be held invalid by a court as inconsistent with the language of the statute or on constitutional grounds.[75]

Income from operation of a mobile home park represents a fourth example of a potential source of passive income. If the services provided to renters of space in the park are only customary services, such as water, garbage removal, snow removal, lawn service, et al., the activity should be regarded as passive. Precedents under S corporation law would classify these as "passive" for purposes of that subchapter

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[72] See Tech. Adv. Mem. 8,133,027 (May 14, 1981); G.C.M. 38,696 (April 17, 1981), which concluded that fees for parking at a baseball stadium were not rent.

[73] H.R. Conf. Rep. No. 841, note 10 *supra*, at II-147.

[74] See I.R.C. § 469(k)(3).

[75] See text at note 70 *supra*.

of the Code[76] and the committee reports for the passive loss rules strongly suggest that they be interpreted consistently with those rules.

Fifth, "sandwich leases" that qualify as true leases should also be classified as passive, even though they may be viewed, economically, primarily as financing devices. Under a sandwich lease, an investor could pay money in advance for the rental of equipment such as computers. It would then rerent that equipment under leases requiring periodic rental payments. The investor would thereby generate net income equal to the rent received minus the amortized "prepaid rent" or rental cost paid to the original lessor. That net income would seem to be characterized as rent as long as the lease from the original owner is for a longer period than the sublease to the user and the equipment has a significant residual value after the sublease term. It would therefore appear to be passive.

Yet the rent is indistinguishable, economically, from interest. The investor's return is a function principally of the creditworthiness of the user and the time value of money. To a lesser extent, it also depends on the expected present value of the equipment leasehold interest at the termination of the sublease term. Under certain scenarios, that amount could be insignificant relative to the other determinants of yield.

The committee staffs understood this equality. Indeed, the conference report[77] suggests that Treasury regulations could classify these as portfolio activities. They would thereby generate portfolio income instead of the desired passive income.[78]

Finally, a limited partnership interest in any partnership engaged in rental activity would be a passive activity. In fact, several of the activities described above have traditionally been carried on in limited partnership form in order to facilitate the dispersion of tax shelter tax benefits to investors. It would be odd, at this point, for the government to classify those interests as nonpassive simply because they generate income.

Even more important, because of the amount of money that potentially could be involved, a limited partnership interest in any trade or business should also constitute a passive activity. Those limited partnership interests fit squarely within the statutory definition of passive activity because they involve an active trade or business in which the

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[76] Stover v. Comm'r, T.C. Memo. 1984-551.
[77] H.R. Conf. Rep. No. 841, note 10 *supra*, at II-147.
[78] See also I.R.C. § 469(k).

taxpayer, as a limited partner, does not materially participate. Those businesses can be run at a cash and taxable profit. That profit would constitute passive income to a limited partner and therefore could be offset or "sheltered" by passive losses.

Frighteningly to the Treasury, actual profit-making businesses conducted in limited partnership form could be syndicated as so-called MLPs and could contain a large number of investor limited partners. As long as the partnership avoids association classification,[79] income should pass through to the limited partners as passive income. MLPs, therefore, represent a significant threat to the revenues expected to be generated through the passive loss rules. As a by-product, they also represent a significant threat to the structure of the two-tier tax on corporations and shareholders. The proliferation of MLPs could significantly reduce tax revenues by allowing businesses to avoid the separate tax on income at the corporate level.[80]

In general, the active general partner of an MLP would be viewed as materially participating in the activity. In that event, that partner's income from the activity would not be passive. Suppose the active general partner also owns a limited partnership interest. Is any part of that partner's income passive? The Senate Finance Committee Report provides as follows:

> When a taxpayer possesses both a limited partnership interest and another type of interest, such as a general partnership interest, with respect to an activity, lack of material participation is conclusively presumed with respect to the limited partnership interest (thus limiting the use of deductions and credits allocable thereto). The presence of material participation for purposes of any other interests in the activity owned by the taxpayer is determined with reference to the relevant facts and circumstances.
>
> Under the bill, the Secretary of the Treasury is empowered to provide through regulations that limited partnership interests in certain circumstances will not be treated (other than through the application of the general facts and circumstances test regarding material participation) as interests in passive activities. It is intended that this grant of authority be used to prevent taxpayers from manipulating the rule that limited part-

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79 See Reg. § 301.7701-2.

80 We anticipate that Treasury will vent its unhappiness with respect to MLPs by reconsidering its regulations on association status. A limited partnership of this type, with a corporate general partner, is a good candidate for treatment as an association, taxable as a corporation, under revised regulations, if it contains a large number of limited partners.

nerships generally are passive, in attempting to evade the passive loss provision.[81]

The flexible rules contemplated by the committee reports would seem to be incapable of being written. Accordingly, one might speculate that Treasury in its regulations will either view all of a general partner's interests in a partnership as a single interest for passive loss rule purposes or strictly accept the form and view the limited partnership interest as a passive interest. The former approach is consistent with Treasury's position in determining a partner's basis in his interest, and one could speculate that it would be the position ultimately chosen by the Treasury in this context as well.

A related question, in this connection, arises with respect to the treatment of the general partner's spouse. If the spouse is a limited partner, will Treasury regulations attribute the general partner's material participation in the activity to the spouse? It appears likely that material participation of one spouse will be imputed to the other spouse in that Section 469(h)(5) specifically provides that in determining material participation of the taxpayer, the participation of the taxpayer's spouse "shall be taken into account." Definitive answers to those questions must await the regulations.

Consistency of Definition

Each of these planning alternatives involves altering the structure of an investment to cause income generated by the investment to be classified as passive rather than as portfolio. The Senate Finance Committee Report and conference report caution that "such attempts to subvert the purposes of the passive loss limitation rules in any manner," may be treated, under regulations to be written, as portfolio income.[82] Treasury officials, from time to time, have suggested that its regulations could provide that net losses from those activities are passive, but that net income would be portfolio.[83] The gratuitous statement in the committee reports may very well set forth a "guiding principle" for which rules cannot be written sensibly.

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[81] S. Rep. No. 313, note 6 *supra*, at 731.

[82] *Id.* at 730, 731–732; H.R. Conf. Rep. No. 841, note 10 *supra*, at II-147.

[83] Perhaps the regulations would select certain potentially abusive situations as appropriate items for rules. For example, the Finance Committee Report provides that a guaranteed cash return and portfolio income of a limited partnership are not considered passive. S. Rep. No. 313, note 6 *supra*, at 731 n.18.

The problem that is illustrated by these planning techniques lies not in taxpayer subversion but in the absence of sound theoretical justification for distinguishing among losses generated by different types of activities. The lack of justification is most acute in distinguishing between passive and portfolio activities, which are economically indistinguishable. Rent is the price for using another's property; interest is the price for using another's particular property (i.e., money). Both represent income from capital. Rules designed to draw distinctions between the two, when serious and substantial tax consequences flow from that distinction, will necessarily cause taxpayers to structure the form of their transactions to cause those transactions to fall on the desired side of the line. Substance-over-form challenges by the government will necessarily be unsatisfying because there are no substantive differences that are of sufficent or compelling importance to warrant different consequences.

Politically, however, Congress apparently felt constrained from allowing income from capital to be sheltered if income from services could not be sheltered. Indeed, that in essence was the original House of Representatives proposal.[84] Such a result, it was believed, was unfair to those nonwealthy taxpayers whose major source of income was from services. Therefore, Congress narrowed the definition of passive activity to exclude portfolio activities and thereby exclude the kinds of income from capital that generally resulted in taxable income.

The real problem regarding passive losses lies in tax depreciation exceeding economic depreciation. That divergence gives rise to book losses that do not represent economic losses. But Congress was unwilling to deal with that problem directly. Instead, Congress, in enacting the passive loss rules, treated the symptoms only. Such treatment is conceptually flawed because it departs from the basic principle that income is income, regardless of how it is derived, and that all such income should be treated alike. Also, as the discussion illustrates, the departure results in a substantial cost that inevitably will result from the creation of an artificial structure with inadequate theoretical underpinnings. Such a structure requires drawing lines in places where no theoretical differences lie.

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[84] H.R. 3838 as originally passed by the House of Representatives on December 17, 1985. That proposal, in contrast to the passive loss rules that were enacted, would have deemed excess passive losses to be items of tax preference and would have subjected them to an expanded alternative minimum tax. H.R. Rep. No. 426, 99th Cong., 1st Sess. 320 (1985).

The Assault on Tax Shelters: Has Congress Lost Its Way?

Under the passive loss rules, activities are divided into three baskets: active, portfolio, and passive. Passive losses cannot be used to offset either active or portfolio income.

Because Congress saw the tax shelter problem in terms of passive losses offsetting income that should be taxed, it defined the passive category broadly to make it as inclusive as possible. Thus, rental activities are inherently passive, as is income (other than portfolio) passed through to limited partners.

Depreciation lives, even though lengthened under TRA '86, are still generally shorter than economic useful lives. Indeed, much real estate does not depreciate at all in value. It follows that rental activities that do not entail an economic loss will still generate a tax loss, because the tax law allows the fiction of depreciation.

Conversely, activities that result in actual cash losses to an investor who does not materially participate are also regarded as passive and subject to the restrictions, even though they are demonstrably real. There can be no justification for denying those investors current deductions on account of those current economic losses. Yet the passive loss rules do just that.

The abuse of tax shelters is the allowance of deductions for tax losses where there has been no realization of economic loss. Yet, Congress was unwilling to attack the abuse head-on. Instead it chose to create an artificial and complex set of rules to prevent some taxpayers from taking egregious advantage of the divergence of tax from economics. As we have noted, the passive loss rules are conceptually flawed and administratively unworkable. The fault does not lie totally in the passive loss rules themselves but rather in the objectives that those rules are designed to accomplish. Indeed, other structures have been proposed and are even currently in place to achieve those goals. However, these other structures also fail to deal with the underlying problem of the divergence of tax from economics.

LAL

More than a decade ago, the Treasury Department proposed another system of precluding taxpayers from using losses from unrelated "tax shelter" activities to offset income.[85] That system was called the

[85] Administration's Proposal for Tax Reform Bill of 1973, at 94 (hereinafter LAL

"limitation on artificial losses" (LAL). It was aimed at the same abuse that the current passive loss limitation rules are aimed at, namely, that some taxpayers were able to reduce their taxable incomes by artificially accounting for losses which did not occur in economic terms. By preventing taxpayers from using losses in tax shelter activities to offset other income, the Treasury believed that abuses associated with tax shelters could be eliminated, while basic tax accounting methods and accelerated deductions designed to encourage certain kinds of activities could be preserved.

The abuses appeared to center on accelerated deductions allowed under the law. Losses resulting from those accelerated deductions were viewed as "artificial" and therefore disallowed under LAL.[86] Only excess losses, that is, deductions over income, that are generated as a result of accelerated deductions would have triggered the LAL provisions. To the extent that accelerated deductions merely offset income from the activity, they would have been allowed in full.[87]

The major difference between the LAL proposal of a decade ago and the current passive loss limitation rules is that the LAL proposal essentially drew a circle around a particular activity and disallowed certain losses to the extent they exceeded income from that particular activity. In contrast, the passive loss limitation rules draw a much wider circle. That circle encompasses all of the taxpayer's "passive activities." While the differences seem small in concept, they are sufficiently large to raise different conceptual issues.

LAL apparently would have required more cumbersome accounting, because each individual activity would have to be accounted for separately. Moreover, the definition of "activity" or "property" and the

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Proposal; see also H.R. 10612, 94th Cong., 1st Sess. § 101 (1975). The LAL proposal was incorporated in the House version of the Tax Reform Bill of 1976, but was ultimately rejected.

[86] In substance, LAL would have identified artificial accounting losses, regarded in general as "the amount by which (i) the accelerated deductions for the taxable year exceed, (ii) the associated net related income for the taxable year." See LAL Proposal, note 85 *supra*, at 94, for an explanation of the mechanics of the LAL proposal. For purposes of LAL, "net related income" was computed without regard to accelerated deductions.

[87] Similarly to the passive loss limitation rules enacted by Congress, LAL artificial accounting losses would be required to be deferred until the taxpayer realized "net related income," which would be income realized for the year from the property in excess of that year's accelerated deductions from the property. Deferred losses would be carried forward. See *Hearings on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6996-6999 (testimony of the Hon. George P. Schultz, Secretary of the Treasury, April 30, 1973).

determination of whether the taxpayer was engaged in a single activity or multiple activities would have been crucial for the application of the LAL rules.

At first blush, the passive loss limitation rules appear to avoid the first problem and relegate the second problem to minor importance. Such is not the case, however. Defining the scope of any activity could determine whether that activity is passive at all, and therefore whether the activity is even subject to the passive loss limitation rules. Furthermore, in order to compute the amount of passive losses that have been disallowed but that may be allowed in the future on the complete disposition of the activity, a taxpayer must keep track separately of the passive losses that are disallowed for each activity. While in some years that separate accounting will not directly affect the taxpayer's tax liability, it could ultimately be important in determining which activities that produced losses would generate freed-up passive losses on disposition at a gain smaller than the deferred passive losses from the activity.

Alternative Minimum Tax

Alternatively, Congress might have relied more heavily on the alternative minimum tax to ensure that every taxpayer will at least pay some tax, but that on a gross basis, the tax incentive provisions of the Code could continue to operate. In essence, the passive loss limitation rule phase-in does exactly that. To the extent that passive losses are allowed during the phase-in period, they constitute items of tax preference. As such, they are added back to adjusted gross income in determining alternative minimum taxable income. That latter concept ensures that every taxpayer will pay tax of at least 21 percent of the amount of some measure of income, that measure being alternative minimum taxable income.[88]

Alternative minimum taxable income, in general, consists of taxable income computed the regular way, with certain items of tax preference added. Items of tax preference include items of accelerated depreciation that are not covered under the passive loss rules because the taxpayer is not subject to those rules, as well as passive losses that are not disallowed under the passive loss phase-in rules.

In addition, and with respect to noncorporate taxpayers, while the regular computation of taxable income takes account of itemized de-

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88 See generally I.R.C. §§ 55–58.

ductions that are allowable to the taxpayer under the Code, the alternative minimum taxable income computation does not allow certain of those itemized deductions—most important, state income and real property taxes. Thus, the alternative minimum tax exists side by side with the regular tax and ensures that even a taxpayer who has been able to reduce his regular taxable income to a point that is perhaps close to zero, will nevertheless pay a tax at the rate of 21 percent on an alternative measure of taxable income. That alternative measure of income is one that does not take into account certain tax incentive deductions, itemized deductions, and personal exemptions.

Nevertheless, Congress was unwilling to rest the burden of correcting for tax shelter abuses entirely on the shoulders of the alternative minimum tax. Accordingly, with regard to those tax shelter abuses, the alternative minimum tax structure represents merely a backstop for those taxpayers who are subject to the passive loss limitation rules. As such, it represents a second layer of enormous complexity in this area of the revised Code—a revision that was loftily hailed by the Reagan Administration as a great simplification of the tax laws.

Closing Observations

The two alternative regimes as well as the passive loss rules represent a certain schizophrenia in U.S. tax policy. They represent damage control in a tax system unwilling to let go of tax incentive provisions. Moreover, and to a lesser extent, they provide an overlay to a system unsure of its position on a graduated income tax. Coexisting but inconsistent tax policy principles and objectives necessarily lead to conceptual haziness and a tax system of enormous complexity. To some extent, that would be the case with the minimum tax structure alone, and it is even more the case in combination with the passive loss rules.

Two secondary consequences appear to be inevitable not only from the choice that Congress made but also from either of the alternatives Congress might have chosen as its primary line of defense against tax shelters. First, tax incentives still inherent in certain kinds of "passive" investments, principally real estate, are now generally available only to profitable businesses. For example, a profit-making business can make full use of depreciation from fixed assets, including real estate, to offset its business income. In contrast, an unprofitable or start-up business that has no direct use for depreciation deductions, from a tax point of view, would generally be advised to lease rather than own depreciable property. Prior to tax reform, rental expense would reflect the tax benefits accruing to the owner of the property and would be lower than they would be absent those tax benefits. After TRA '86, however, unprofitable or start-up businesses will not even be able to take advantage of the tax benefits of ownership through lower rents that were typically available when the lessor could take full advantage of depreciation. Those businesses must now suffer a competitive disadvantage relative to established, profitable businesses.

Second, administration of the rules is likely to be extremely troublesome. Administration of the passive loss rules depends on being able to characterize all income and losses as active, portfolio, or passive. Taxpayer discretion in structuring transactions should permit a large degree of maneuvering. LAL would have required even more precise characterization. Only the minimum tax avoids these problems. In that sense, it is therefore administratively easier. However, it requires a "shadow" tax computation and a set of rules in addition to that of the regular tax. For taxpayers subject to the minimum tax regime, the dual structure makes planning indeed complex.

If Congress simply allowed tax consequences to follow economic consequences, none of those structures previously proposed or enacted to solve the "tax shelter" problem would be necessary because the problem would disappear. Tax simplification could actually be achieved.