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REALTY SHELTERS: NONRECOURSE FINANCING, TAX REFORM, AND PROFIT PURPOSE

by

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The Tax Reform Act of 1976 made sweeping changes in the area of tax shelters. Real estate tax shelters are the only ones to survive with any semblance of their former vitality. Two rules were introduced to prevent investors from claiming tax losses in excess of amounts they place "at risk," and neither rule considers a nonrecourse liability an amount "at risk." The first applies to four specific tax shelters, not including real estate, and the second is a catchall that applies to all partnerships other than real estate partnerships. Thus, it is only in the real estate area that the use of nonrecourse financing continues unchanged. The purpose of this Article is to explain the extent to which nonrecourse financing may be used to increase depreciable basis, trace the direction of congressional response to real estate tax shelters, and identify doctrines the Internal Revenue Service and the courts can be expected to apply to arrangements they find particularly abusive.

I. INTRODUCTION TO TAX SHELTER

The term "tax shelter" is usually used in one of two ways. One definition of a tax shelter is an investment through which an individual pays tax on a smaller amount than the amount of cash actually received. In this sense, a municipal bond is considered a tax shelter because no tax need be paid on its interest income. In an investment in depreciable real estate, a tax shelter in this broad sense exists in any year in which the depreciation deduction exceeds the amount of cash that is used to retire the principal on outstanding indebtedness. Stated differently, taxable income will be less than the net amount of cash generated by a real estate investment whenever the deduction for the noncash expense of depreciation exceeds the amount of money applied to repay principal on indebtedness, a cash expense for which there is no corresponding deduction. The essential point is that there is a gap between deductions that are available without current cash expenditures and actual cash expenditures that are not deductible.[1] For example, no matter what the other income and expense items in con-

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1. Thus, it would be more precise to say that there will be tax shelter in the broad sense

nection with a property, if depreciation is $100 and debt amortization is $80, taxable income will be $20 less than the net cash produced. If there is an overall cash loss, the tax loss will be $20 greater than the cash loss.

Investment advisors who specialize in real estate, however, are likely to respond that their clients who seek "tax shelter" are using the term in a more restrictive sense. High bracket investors in real estate often want more from their real estate investments than a flow of cash that is currently free from tax. They seek tax losses that can be passed through to them and used to offset, or "shelter," their income from other sources. Current cash flow, indeed, may be of little or no immediate interest. As shall be illustrated more fully below, it is extremely common for investments in depreciable real estate to produce a stream of cash flow that is currently sheltered from tax and, at the same time, generate tax losses that can be used by the investor to offset income from other sources. In effect, two different commodities are produced annually: cash benefits and tax benefits.

Tax shelter can perhaps best be demonstrated by deriving a year's tax consequences from that same year's cash consequences. The net cash flow for any year is, most basically, cash received minus cash spent. In rental properties, whether they are apartments, offices, or retailing concerns, net cash flow (NCF) consists of rent receipts (RR) minus real estate taxes (RT), maintenance expenses (ME), principal repaid on indebtedness (P), and interest paid on indebtedness (I). Consider, for example, the following statement of one year's net cash flow from Blackacre Apartments:

$$\begin{aligned} NCF &= RR - RT - ME - (P + I) \\ &= \$10{,}000 - 500 - 400 - (900 + 8{,}000) \\ &= \$200 \end{aligned}$$

The taxable income or loss of Blackacre Apartments for the year in question can be derived by making two adjustments to the net cash flow: add back in principal repayment (P) and subtract the appropriate depreciation deduction (D). The effect of these two adjustments is to convert the year's cash reality into that same year's tax reality. Principal repayment was subtracted in the computation of net cash flow because it is an actual cash expense. It must be added back to convert net cash flow into taxable income or loss because it is a nondeductible expense. Conversely, depreciation must be subtracted from net cash flow. Depreciation did not enter into the computation of net cash flow because it is a deduction available without a current cash expense. If the Blackacre Apartments' depreciation deduction for the year in question is $1,200, the taxable income or loss is computed as follows:

$$\begin{aligned} TI &= NCF + P - D \\ &= \$200 + 900 - 1{,}200 \\ &= (\$100) \end{aligned}$$

in any year in which the depreciation deduction, available without a cash outlay, exceeds the sum of the nondeductible cash outlays for debt amortization and capital improvement.

Thus, for the year in question, Blackacre Apartments has produced a positive cash flow of $200 and a tax loss of $100.

Stating taxable income or loss in terms of net cash flow makes it clear that tax shelter depends solely on the relationship between principal repayment and the depreciation deduction. If principal repayment equals depreciation, the two cancel each other out and taxable income, or loss, is the same amount as the amount of positive, or negative, net cash flow. In other words, the owner of Blackacre Apartments must pay tax on the same amount as the amount of dollars he actually receives. Whenever the depreciation deduction is greater than principal repayment, however, he will only be required to pay tax on a lesser amount than the amount of cash actually received. Indeed, in the above example, he not only is free from paying tax currently, he also has a tax loss. An investment in depreciable real estate is a tax shelter in this more narrow sense whenever the depreciation deduction is greater than the sum of net cash flow and principal repaid on indebtedness; when, after all the net cash flow and debt amortization[2] are "sheltered" from tax, tax losses remain.

II. The Collapse of Tax Shelter

The extent to which a particular investment achieves tax shelter usually changes constantly over time. Typically, tax shelter diminishes, disappears, and the reverse of tax shelter becomes the case: the investment becomes one in which the investor must pay tax on a greater amount than the amount of cash actually received. The reason for this collapse of tax shelter is that the two determinants of tax shelter, principal repayment and depreciation, generally change over time. Most typically, real estate is financed with level payment mortgages that are fully amortized at the end of a regular schedule of payments. In such mortgages early debt service payments consist almost entirely of interest. As time passes, a greater portion of each payment is attributable to the nondeductible expense of principal repayment. Further, if an accelerated method of computing depreciation is used, depreciation deductions will at the same time be getting smaller. Thus, as the life of the investment progresses, principal repayment (P) will be getting larger and depreciation (D) will be getting smaller. The tax shelter collapses when D is equal to P. Indeed, the situation deteriorates further as P becomes greater than D. Consider the above illustration of Blackacre Apartments in a year in which net cash flow is still $200. Assume, however, that the loan is much later in its life and that $8,000 of the $8,900 debt service payments for the year is attributable to principal repayment, and that only $900 is attributable to interest. Assume, further, that the depreciation deduction in this later year is only $700. Even though the cash flow remains at $200, the taxable income or loss is now computed as follows:

2. The term "debt amortization" is used herein to refer to the repayment of the outstanding principal on indebtedness. There are those who use the term more loosely to denote total debt service payments, that is, combined payments of principal plus interest.

$$\begin{aligned} TI &= NCF + \quad P \; - D \\ &= \$200 + 8{,}000 - 700 \\ &= \$7{,}500 \end{aligned}$$

Thus, although the basic cash reality remains the same, the tax reality has changed dramatically; in this subsequent year the owner of Blackacre Apartments must report ordinary income of $7,500 even though net cash flow is only $200.

III. NONRECOURSE FINANCING IN GENERAL

Real estate tax shelters would not be as popular as they are if investors were permitted to claim tax losses only up to the amount of their actual cash investments in an enterprise. Under the Internal Revenue Code, the amount of borrowed funds used to acquire depreciable real property is included in the property's depreciable cost, or basis, even if the borrower incurs no personal liability on the indebtedness and the only security for repayment is a mortgage of the property acquired. Stated differently, an investor may treat the entire price of depreciable real property as his depreciable investment in that property, even if the property is acquired entirely with borrowed funds, and even if the property acquisition loans are fully nonrecourse. The effect of this rule is that investors may claim depreciation deductions, or the tax losses that result,[3] in amounts far in excess of their actual cash investments. The three principal cases that support this rule that treats nonrecourse loans as if they were loans the borrower is personally obligated to repay are *Crane v. Commissioner*,[4] *Manuel D. Mayerson*,[5] and *Bolger v. Commissioner*.[6]

A. *Crane v. Commissioner*

Crane v. Commissioner[7] is the grand old Supreme Court case on nonrecourse liabilities. Mrs. Crane had inherited an apartment building subject to[8] a mortgage in the principal amount of $255,000, which also secured $7,000 of interest that was in arrears. Seven years later, Mrs. Crane sold the building for $2,500 cash to a purchaser who also took subject to the $255,000 mortgage. The issue before the Court was how to compute her gain on the sale.

The Internal Revenue Code at the time defined gain on sale as "the excess of the amount realized therefrom over the adjusted basis."[9] The question was whether Mrs. Crane's "amount realized" was simply the

3. See the discussion of partnership allocations at text accompanying notes 105-115 *infra*.
4. 331 U.S. 1 (1947).
5. 47 T.C. 340 (1966).
6. 59 T.C. 760 (1973). For an excellent discussion of this case, see Lurie, *Bolger's Building: The Tax Shelter that Wore No Clothes*, 28 TAX L. REV. 355 (1973).
7. 331 U.S. 1 (1947).
8. Throughout this Article the term "subject to a mortgage" is used to identify situations in which the owner of mortgaged property is free from personal liability on the indebtedness secured by the mortgage.
9. 331 U.S. at 5.

$2,500 cash she received, or whether it also included the $255,000 mortgage to which her vendee took subject.[10] The Code defined "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received."[11] Mrs. Crane conceded that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of her "amount realized" within the meaning of the Code. The Court stated that earlier cases had

> already repudiated the notion that there must be an actual receipt by the seller himself of 'money' or 'other property,' in their narrowest senses. It was thought . . . that the taxpayer was the 'beneficiary' of the payment in 'as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors.'[12]

Mrs. Crane, however, protested that the reasoning of the earlier cases did not apply to her situation. She was not a "real and substantial beneficiary" because (a) she had never been personally liable on the mortgage and (b) her vendee neither paid nor promised to pay the mortgage.

The Supreme Court rejected her argument in an opinion that emphasized that she received at least some cash from the sale:

> [A] mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and *for additional consideration*, realizes a benefit in the amount of the mortgage as well as the boot. . . . We are . . . concerned with the reality that an owner of property, *mortgaged at a figure less than that at which the property will sell*, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.[13]

Mrs. Crane had said that it was unrealistic to say that she was economically compelled to treat the mortgage as if she were personally liable on it. "[B]y all dictates of common sense," she argued, the apartment building was "a ruinous disaster."[14] As soon as she had inherited the property, she entered into an agreement under which she turned over all net receipts to the mortgagee. Not only was she not receiving any cash from the building, the mortgage was going even further into default. Over the seven-year period she owned the building, not only was no principal repaid on the mortgage, but also the interest in arrears had increased from $7,000 to $16,000. Nevertheless, said the Court, she had properly been claiming depreciation deductions computed on a tax basis that included the amount of the mortgage: "[t]he crux of this case, really, is whether the law permits her

10. The Court stated: "The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item." 331 U.S. at 4 n.6.

11. *Id.* at 5-6.

12. *Id.* at 13 (citing United States v. Hendler, 303 U.S. 564 (1938)).

13. *Id.* at 14 (emphasis added).

14. *Id.* at 15.

to exclude allowable deductions from consideration in computing gain."[15] In today's terms, *Crane* stands for the proposition that a taxpayer receives a constructive distribution of cash to the extent he is relieved of liability, even if the liability is nonrecourse as to him, and even if he is relieved of it only in the sense that he has transferred the property securing the liability to a nonassuming grantee. Stated differently, because you include a nonrecourse purchase money liability in your depreciable basis just as if it were with recourse, you must also treat the liability as if it were with recourse when you part with the property.

Recall that the Court's opinion was couched in terms of a transfer that had resulted in boot to the taxpayer. Would Mrs. Crane have avoided the constructive distribution of cash had she transferred the property without receiving boot, or if she had simply abandoned it? Widespread interest in this question became pointed in the early 1970's when many real properties were in default and mortgaged in excess of value. Many looked longingly at the Court's now famous footnote thirty-seven:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.[16]

Overwhelming opinion has been that this dictum is not reliable because *Crane* stands for the proposition that nonrecourse liability will be treated as with recourse liability for the purpose of taxing constructive distributions of cash. Nevertheless, just to be safe, the Internal Revenue Service in 1976 issued a Revenue Ruling that quoted and specifically repudiated footnote thirty-seven.[17]

B. *Manuel D. Mayerson: Standing Notes*

Crane represented a victory for the Internal Revenue Service insofar as it established that a taxpayer receives a constructive distribution of cash when he or she transfers property subject to a nonrecourse liability. *Manuel D. Mayerson*,[18] on the other hand, represents a victory for the tax shelter industry insofar as it indicates the extent to which a purchaser may claim that he has made a depreciable investment in real estate by incurring a nonrecourse liability. *Mayerson* involved a taxpayer who "purchased" an office building with a nonrecourse, standing note. A standing note is one in which the principal balance remains outstanding until some future time, until which time not even periodic repayment of principal occurs. Standing notes are frequently used in construction financing and in the financing of distress properties. A standing note is often desirable to its

15. *Id.*
16. *Id.* at 14 n.37.
17. Rev. Rul. 76-111, 1976-1 C.B. 214. *See also* Millar v. Commissioner, 67 T.C. 656 (1977), *aff'd*, No. 77-1926 (3d Cir. June 12, 1978); Rev. Rul. 74-40, 1974-1 C.B. 159.
18. 47 T.C. 340 (1966).

maker because it eliminates current payments for the nondeductible expense of amortization and, hence, maximizes tax shelter.

Mayerson "purchased" what had been an unprofitable office building for a minimal downpayment of $10,000 and a note to the vendor that:

(a) provided that no repayment of its face amount of principal, $322,500, need be made until the expiration of ninety-nine years;

(b) required monthly "interest" payments of $1,500;

(c) was fully nonrecourse as to the principal;

(d) was with recourse as to the monthly interest payments as they accrued; and

(e) provided for substantial discounts if paid in the next one ($275,000) or three ($298,000) years.

Five years after signing the note and taking possession, Mayerson negotiated a reduced repayment price of $200,000.

The Service argued that Mayerson was not entitled to claim depreciation deductions on the building prior to the time the reduced purchase price was negotiated and paid. It said that depreciation deductions are available to taxpayers who make "investments" in depreciable property, but that Mayerson's nonrecourse standing note did not constitute an "investment." The Service's position was that the benefit of the depreciation deduction, a deduction theoretically premised on the physical deterioration of the property, inures to the person who bears the economic burden of the deterioration. The economic burden of the depreciation was not transferred to Mayerson by the "sale," said the Service, because his note for the purchase price did not constitute an enforceable obligation to pay a sum certain. The Service focused on the fact that the note was nonrecourse, that no principal was due until the expiration of ninety-nine years, and that there were substantial discounts for early payment. The Service considered Mayerson not as an owner, but as a tenant under a lease with an option to purchase. Accordingly, the Service disallowed Mayerson's depreciation deductions. Following its lease analysis, the Service said that Mayerson's $10,000 cash "downpayment" was actually a payment for a favorable lease. It allowed this $10,000 lease premium payment to be amortized over the life of the lease, which it determined to be ninety-nine years. The Service's concern was quite understandable because Mayerson had a lesser liability under his purchase money note and mortgage than does the usual tenant under a lease with an option to purchase; Mayerson was only personally obligated to pay interest as it accrued, and he could stop interest from accruing at any time by reconveying to his grantor.

The Service lost, even though the Tax Court stoutly declared:

> It is well accepted . . . that depreciation is not predicated upon ownership of property but rather upon an investment in property. It therefore follows that the benefit of the depreciation deduction should inure to those who would suffer an economic loss caused by wear and exhaustion of the business property.[19]

19. *Id.* at 350 (citations omitted).

Without explaining how Mayerson undertook the economic burden of depreciation simply by signing the nonrecourse note, the Tax Court stated that *Crane* applies as fully to a taxpayer who acquires property by purchase as it does to a taxpayer who acquires property by inheritance.[20] It said that the nonrecourse nature of the note did not negate an "investment" by Mayerson, using language suggestive of a right to equal protection for nonrecourse borrowers:

> The element of the lack of personal liability has little real significance due to common business practices. As we have indicated in our findings it is not at all unusual in current mortgage financing of income-producing properties to limit liability to the property involved. *Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable* for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.[21]

The court concluded that, although the ninety-nine year term for maturity was unusually long, the standing feature did not destroy the status of the note as a genuine indebtedness. Nor did the discounts for early payment indicate that the amount of indebtedness was too indefinite to be included in depreciable basis. Accordingly, Mayerson had properly computed depreciation on a tax cost basis that included the full face amount of the note.[22]

A Warning about Mayerson. *Mayerson* should not be relied upon by taxpayers to "up" their bases by the use of artificially inflated purchase prices. *Mayerson* involved arm's length negotiations between parties who were strangers, and Mayerson immediately made substantial expenditures to make the office building profitable. The Service emphasized in its acquiescence in *Mayerson* that the case could not be relied upon "except in situations where it is clear that the property has been acquired at its fair market value in an arm's length transaction creating a bona fide purchase and a bona fide debt obligation."[23]

In *Marcus v. Commissioner*[24] the taxpayers were too greedy. They used nonrecourse notes with inflated purchase prices and maturities well in excess of the useful life of the assets. The Tax Court stated that it was difficult to conceive of a situation in which the taxpayers would continue to make payments "where the property in question no longer had any useful

20. The court specifically rejected the Service's argument "that the *Crane* case should not apply in a purchase situation since the basis in that [inheritance] case started with fair market value and not cost, as in the case of a purchase." *Id.* at 351.

21. *Id.* at 351-52 (emphasis added).

22. *Id.* at 352-54.

23. Rev. Rul. 69-77, 1969-1 C.B. 59. *See also* Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

24. 30 T.C.M. (CCH) 1263 (1971).

life and where they would incur no financial liability for failure to make such payments."[25] Hence, the court held the purchasers' "liability and the amount of the obligation incurred were contingent and not ascertainable" and "not determinative for purposes of establishing a basis for depreciation."[26]

C. *Bolger v. Commissioner: Tax Shelter in Extremis*

Bolger v. Commissioner[27] is perhaps the most stunning victory of the tax shelter industry. In *Bolger* the Service challenged ten different transactions put together by Bolger, a real estate professional. Although there were differences among the ten transactions, they followed the same basic pattern, and the Tax Court treated the case as one involving a class of transactions rather than considering each transaction separately.

The basic pattern was as follows. First, Bolger would form "a financing corporation" with an initial capitalization of $1,000. The shareholders of the corporation were the individual investors who ultimately would receive title to the building acquired. Bolger would then arrange to have the corporation purchase a building that a manufacturing or commercial concern, the user, desired to lease. In several of the transactions the seller was the user who would lease back the building. As described by the court:

> Then, within several days, and, more often, on the same day, all of the following transactions would take place: (1) The seller would convey the property to the financing corporation; (2) the financing corporation would enter into a lease with the user; and (3) the financing corporation would then sell its own negotiable interest-bearing corporate notes in an amount equal to the purchase price to an institutional lender (or lenders, as the case might be) pursuant to a note purchase agreement (as the document was usually called), which would provide that the notes be secured by a first mortgage (which sometimes took the form of a deed of trust), and by an assignment of the lease.[28]

The mortgage notes provided for payments to be made over a period equal to or less than the primary term of the lease to the user. The users were to pay their rent directly to the mortgagee in satisfaction of the financing corporation's secured notes. The mortgagee was to apply those rentals to the notes and pay any remainder over to the financing corporation. There was, however, little, if any, surplus to be paid over to the "owner," initially the financing corporation and ultimately its transferees, because the rental paid by the users was either equal to or just slightly above the debt service due the mortgagee.

As mentioned above, the basic lease term was always equal to or greater than the term of the mortgage notes, which all required constant payments roughly equal to the rental. In addition, the leases were all "net leases," that is, the rent which was paid by the user directly to the mortgagee was

25. *Id.* at 1273.
26. *Id.*
27. 59 T.C. 760 (1973).
28. *Id.* at 761-62.

"net" of all expenses; the lessee was responsible for all property taxes, maintenance and repair expenses, and insurance.[29] The lessee-user's interest was subordinated to the mortgage, and the lessees were liable for the rent even if the building were destroyed. In the event of such destruction, however, "the lessee had the right to purchase the property . . . for a price set in accordance with a schedule attached to the lease which approximated the amount required from the lessor to prepay the note. Refusal to accept the offer of purchase would result in the termination of the lease."[30] In addition to the basic lease term, which was typically from twenty-five to twenty-eight years, each user had a series of options to renew, at substantially reduced rental, for four or five five-year renewal periods.

As soon as the financing corporation closed the purchase, mortgage, and lease, it would convey the property to its shareholders for "one dollar and other valuable consideration," subject to the lease and mortgage, without any cash payment or promise thereof by the transferee. In each transaction, Bolger was either a 25% or a 100% transferee. The transfer was anticipated by the mortgage, which also required the financing corporation to remain in existence and to refrain from any activity other than in connection with owning and leasing the specific property in question.[31] Bolger and the other transferees were required by the mortgagee to sign an "Assumption Agreement," which was window dressing because it provided that the transferee would incur no personal liability in connection with the mortgage he was "assuming."

The Service disallowed Bolger's claim to depreciation deductions on the buildings. The Service did not challenge the transactions on the ground that they were, in substance, only secured loans to the long term lessees. Rather, it sought to establish that the depreciable interests were in the financing corporations and had not passed to Bolger and his fellow transferees. The Tax Court described the issues before it as follows:

> The two issues upon which resolution of [the question whether Bolger was entitled to claim depreciation deductions] depends are: (1) Should the corporations from which [Bolger] acquired his ownership interest in the properties be recognized as separate viable entities; and (2) if they should be so recognized, are they or [Bolger] entitled to an allowance for depreciation and for other related items.[32]

The court held that the financing corporations were separate taxable entities, both before and after they transferred their assets to their sharehold-

29. Throughout this Article the term "net lease" shall refer to a lease that is perfectly "net," that is, to one that requires the lessee to absorb all expenses. There are individuals who employ terms such as "double net lease" and "triple net lease" to refer to different degrees of "net-ness." The presence and meaning of such terms appear to depend on local custom.

30. *Id.* at 762. The lessee further agreed to indemnify the lessor from any liability from any occurrence on the property. The lessee could sublease or assign his interest, "providing the sublessee or assignee promised to comply with the terms of the mortgage or lease and further providing the lessee remain personally liable for the performance of all its obligations under the lease." *Id.* at 762-63.

31. *Id.* The loans were made through the financing corporations in part to avoid state law limitations on loans to individuals. *Id.* at 766.

32. *Id.* at 765-66.

ers. It also held, however, that the transfers effectively conveyed the depreciable interest in the properties to the shareholders. The Tax Court rejected the Service's assertion that

> [b]ecause of the long term leases and the commitments of the rentals to the payment of the mortgages . . . the conveyances by each corporation transferred only a reversionary interest in the buildings and that consequently [Bolger] did not acquire a present interest in the properties which may be depreciated for tax purposes.[33]

The court held that the corporations had conveyed their depreciable interests in the buildings to Bolger and the other shareholders, and then proceeded to determine the transferees' bases in those buildings. For example, in the case of the buildings transferred solely to Bolger, the issue was whether Bolger's basis was the one dollar consideration stated in the deeds or whether his basis also included the amount of purchase money financing subject to which Bolger took title. The court held that the unpaid balance of the mortgage was included in Bolger's basis, even though he never assumed any personal liability thereon. Quoting from *Mayerson*, the court explained that the effect of *Crane* is "to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be *assumed* that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability."[34]

The Service argued that it was unreasonable to assume that Bolger would pay off the mortgage because he had no significant interest to protect. His cash flow was either minimal or nonexistent, and the properties were mortgaged to the full extent of value. The court responded that the Service's argument overlooked the fact that Bolger would be building up an equity in the property as the rents paid by the users were applied to amortize the mortgage. The court reasoned that "[t]his increase in equity will benefit [Bolger] either by way of gain in the event of a sale or the creation of refinancing potential. Moreover, [Bolger] will seek to protect his interest in the property in order to retain the benefits of any appreciation in its fair value."[35] The opinion also emphasized that the rents were includable in Bolger's income even though they were assigned to the lender to service the debt. Noting that the normal owner applies rent to debt service, the court concluded that Bolger should not be treated less favorably simply because he was not personally liable for the amount of the mortgage, stating: "The combination of the benefits of accelerated depreciation and the *Crane* doctrine produces a bitter pill for [the Service] to swallow. We see no way of sugarcoating that pill, short of overruling *Crane v. Commissioner, supra*, which we are not at liberty to do."[36]

33. *Id.* at 768.
34. *Id.* at 770 (emphasis in original).
35. *Id.*
36. *Id.* at 771. *But see* Davis v. Commissioner, 66 T.C. 260 (1976).

IV. Limited Partnerships and Nonrecourse Loans

Regulations under the Code specify how the *Crane* rule operates in the case of limited partnerships. A brief word on partnership taxation should precede our discussion of those Regulations. Partnerships are tax reporting but not tax paying entities. Income is taxed directly to the individual partners with no taxation at the partnership level. Partnership tax losses, unlike corporate tax losses, are "passed through" to the individual partners and can be used by them to offset their income from other sources. Certain elections, however, are made at the partnership level that bind all the partners, such as the choice of method for computing depreciation.[37] The partnership computes and reports its various items of income, gain, loss, deduction, or credit, and the individual partners report their allocable shares.

Crane applies at both the level of the partnership and the level of the individual partner. At the partnership level, *Crane* permits the partnership to compute depreciation deductions on the basis of the full acquisition cost of partnership property, even if the property is acquired solely with funds borrowed on a nonrecourse basis. At the level of the individual partner, *Crane*, under certain conditions, permits a limited partner to claim tax losses in excess of the amount he invests in the partnership.

A partner may only claim partnership tax losses to the extent of his adjusted basis in his partnership interest.[38] A partner's initial basis in his partnership interest is the amount of money he contributes to the partnership, plus the adjusted basis of any property he contributes.[39] The Code, however, specifically provides that a partner shall be treated as having contributed additional money to the partnership to the extent he shares in partnership liabilities.[40] Under the Regulations, the members of a general partnership are automatically allocated a share of partnership liabilities in proportion to their share of partnership losses.[41] In the case of a limited partnership, the general rule is "a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the partnership agreement."[42] The Regulations, however, contain an exception on which the real estate limited partnership tax shelter is based:

> However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real

37. I.R.C. § 703(b).
38. Losses that are currently not deductible because basis is depleted are not permanently lost; in effect, they are placed in a suspense account and become deductible in later years to the extent of any subsequent increases in the partner's basis in his partnership interest. *Id.* § 704(d).
39. *Id.* § 722.
40. *Id.* § 752(a) provides: "Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership."
41. Treas. Reg. § 1.752-1(e) (1956).
42. *Id.*

> estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.[43]

The effect of this exception is that limited partners may deduct partnership tax losses in amounts far in excess of their actual cash investments in the partnership, provided there are nonrecourse liabilities they can use to "up" their bases.[44] For example, limited partner *L* contributes $100 to a limited partnership and receives a ten percent interest in partnership profits. At the time of the contribution, the partnership owns property that is subject to a mortgage in the amount of $1,000,000 on which none of the partners is personally liable. *L* shares in the partnership nonrecourse liability for basis purposes in accordance with his profit sharing ratio; that is, *L* is treated as having made an additional $100,000 contribution of cash to the partnership. Accordingly, *L*'s initial basis in his partnership interest is $100,100.

Even after years of popularity of the limited partnership form, what many limited partners fail to realize, or choose to ignore, is that there is a converse treatment of liabilities in later years. The Code treats a partner as having received a distribution of cash to the extent his share in partnership liabilities is decreased,[45] even if the liabilities are nonrecourse. Just as a limited partner is automatically allocated a share of the partnership's nonrecourse liabilities when he receives his interest in profits, he is automatically relieved of his share of partnership liabilities when he parts with his interest in profits. Thus, a limited partner who sells or abandons his partnership interest receives a constructive distribution of cash to the extent he is "relieved" of his share of nonrecourse liabilities.[46]

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43. *Id.* I.R.C. § 752(c) provides: "For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property."

44. This exception also permits partners to receive, without current taxation, cash distribution in excess of their actual cash or property investments in the partnership. Under *Id.* § 731(a)(1), a partner only recognizes gain on a distribution from his partnership to the extent that the distribution exceeds his adjusted basis in his partnership interest.

45. *Id.* § 752(b) provides: "Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership."

46. Rev. Rul. 74-40, 1974-1 C.B. 159, illustrates this point:

> Situation 3. Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.
>
> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

Id. at 160. The recapture provisions may require that part of the gain resulting from the constructive distribution of cash be taxed as ordinary income. *See* text accompanying notes 76-84 *infra*.

A. *Strict Requirements to "Up" a Limited Partner's Basis*

There are three basic ways in which the Service has narrowly confined the ability of a limited partner to "up" his basis by a share of partnership liabilities. First, it has strictly construed the general rule that a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution and the total contribution he is obligated to make under the partnership agreement. Second, it has required that the form, and not just the substance, of nonrecourse financing be strictly adhered to. Third, it has strictly construed the definition of what constitutes a partnership "liability" in which a limited partner might share.

Revenue Ruling 69-223[47] strictly construed the Regulation that contains the general rule that a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution and "the total contribution which he is obligated to make *under the limited partnership agreement*."[48] The Ruling involved a limited partnership in which *G* was the general partner and *L* the limited partner. The limited partnership agreement provided that *G* and *L* were to share partnership losses in the same percentage as they shared profits, ten percent for *G* and ninety percent for *L*, but that *L* [was] not liable for any losses or obligations of the partnership in excess of his initial capital contribution in the amount of 100x dollars."[49] The limited partnership agreement also provided that

> as between *G* and *L*, each partner is liable for all losses and obligations of the partnership in proportion to his respective capital and profits interest. The contract further provided that . . . if *G* should be required to pay more than his pro rata share of partnership liabilities, he is entitled to repayment from *L* for the excess amount so paid. However, these provisions . . . expressly state that they are not intended for the benefit of third party creditors, and that such creditors shall not obtain any rights thereunder.[50]

The limited partnership acquired real property and assumed an existing mortgage of $50x. The issue was whether *L*'s basis in his partnership interest was increased by a portion of the mortgage liability the partnership assumed. The Service ruled that it was not, quoting the following Regulation: "[A] limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement."[51] The Service ruled that the "total contribution which [the limited partner] is obligated to make under the partnership agreement" refers to "contributions which the limited partner is obligated to make to the *partnership*."[52] The Service stated:

> In this case, *L* is not obligated to make any further contributions to the limited partnership beyond his initial contribution of 100x dollars.

47. 1969-1 C.B. 184.
48. Treas. Reg. § 1.752-1(e) (1957) (emphasis added).
49. 1969-1 C.B. at 184.
50. *Id.*
51. Treas. Reg. § 1.752-1(e) (1957).
52. 1969-1 C.B. at 184.

> The provision in the limited partnership agreement that if *G* is required to pay more than his pro rata share of partnership liabilities, he is entitled to repayment from *L* for the excess amount so paid, is between the general and the limited partner in their individual capacities and is not an obligation of the limited partner to make a contribution to the *partnership*.[53]

The Service concluded that *L* was not entitled to increase his basis in his partnership interest by any part of the $50x mortgage liability, and that *G*'s basis was increased by the full amount.

This Ruling can be criticized on several grounds. First, *L*'s obligation to indemnify *G* fell within the literal terms of the Regulation because it was a payment *L* was required to make "under the limited partnership agreement." The Regulation contains no language that disqualifies an obligation that, although in the partnership agreement, is made by the partner "in his individual capacity." Second, to the extent the Ruling imposes a distinction between obligations incurred by a partner in his individual capacity as opposed to obligations incurred by a partner in his capacity as a member of the partnership, it imposes a distinction that is difficult, if not impossible, to make. Both for state law purposes[54] and federal income tax purposes[55] it has long been considered perplexing to try to distinguish between a partner acting in his individual capacity and a partner acting in his capacity as a partner. Finally, under the "at risk" rules of the Tax Reform Act of 1976, *L*'s promise to indemnify *G* would reduce *G*'s amount "at risk":

> [A] taxpayer's capital is not at risk in the business . . . to the extent he is protected against economic loss . . . by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer. Under this concept, an investor is not 'at risk' if he . . . is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person.[56]

Although the "at risk" rules do not apply to real estate, they do apply to non-real-estate partnerships, and it is hard to understand why a limited partner's promise to indemnify a general partner is sufficiently substantial to reduce the amount by which the general partner is "at risk," yet insufficiently substantial to increase the limited partner's basis in his partnership interest.

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53. *Id.* at 184-85.

54. J. STORY, LAW OF PARTNERSHIP 52 (2d ed. 1846) (emphasis in original):

> The distinction, as thus presented, does certainly wear the appearance of no small subtlety and refinement, and scarcely meets the mind in a clear and unambiguous form; for the question must still recur; when may a party properly be said to have 'an interest in the profits, *as profits*?' When also may it properly be said, that 'the interest in the profits is mutual,' and that 'each person has a specific interest in the profits, *as a principal trader*?'

55. In connection with I.R.C. § 707(a)'s treatment of transactions by a partner "other than in his capacity as a member" of the partnership, see Weidner, *Pratt and Deductions for Payments to Partners*, 12 REAL PROP. PROB. & TR. J. 811, 834 (1977); Cowan, *Compensating the Promoter-General Partner*, 22d WM. & MARY TAX CONF. 81, 83 n.6 (1977).

56. S. REP. NO. 938, 94th Cong., 2d Sess. 49 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3485.

The Service and the courts have also strictly construed the exception that permits limited partners to share in the nonrecourse liabilities of the partnership in accordance with their profit sharing ratios. *Curtis W. Kingbay*[57] illustrates that the *form* of nonrecourse financing, and not just the substance, should be strictly adhered to. In *Kingbay* the amount of partnership loss was clear. What was not clear was whether the limited partners were entitled to claim their distributive shares of that loss. The case involved the Regulation that states that limited partners only share in partnership liabilities for basis purposes if the liabilities are fully nonrecourse. Curtis W. Kingbay and his wife were the limited partners in a limited partnership in which the only general partner was Kingbay Properties, Inc., a corporation formed and wholly owned by Mr. Kingbay, and into which he paid its total capital of $1,000. The corporation signed the notes and mortgages to finance the purchase and construction of the partnership properties. The certificate of limited partnership reiterated the status of Mr. and Mrs. Kingbay as limited partners by providing that at no time should they be liable for any obligations or losses of the partnership beyond the amount of their respective contributions.

The Kingbays could only report their distributive share of tax losses if they could "up their basis" in their partnership interests by sharing in the partnership liabilities. The requirement that the liabilities be nonrecourse was the obstacle. They argued that, in economic reality, the loans *were* nonrecourse because they were taken out by their wholly owned, nominally capitalized, corporate general partner. The court rejected their argument:

> [The Kingbays] cite no case authority for their contention and under the facts here present we do not consider that the form in which the transactions were set up should be ignored. Kingbay Properties, Inc., was a corporation incorporated for business purposes. [The Kingbays'] contention amounts to disregarding the corporation as an entity separate from Curtis W. Kingbay. Only in unusual circumstances will a corporate entity be disregarded, particularly when it is the person who formed the corporation for a legitimate business purpose who seeks to have the corporate entity overlooked.[58]

Finally, the Service may prevent a limited partner from sharing in an alleged partnership "liability" for basis purposes by reclassifying the liability as a contribution to capital. In 1964, the Tax Court declared that debt versus equity distinctions, developed in the corporate context, would be applied to partnerships:

57. 46 T.C. 147 (1966).

58. *Id.* at 153-54. In Rev. Rul. 77-125, 1977-1 C.B. 130, the Service ruled that limited partners could not increase their bases in their partnership interests by any portion of a nonrecourse loan that had been taken out by their limited partnership. Repayment of the loan had been guaranteed by a corporation for which the limited partnership was acting as an independent contractor, and the limited partnership's liability under the loan was limited to the payments it received from the corporation. The Service ruled that the loan was a liability of the corporation rather than a liability of the partnership. The partnership's "only relation to the loan is its formal status as maker." *Id.* at 131.

> We . . . are concerned here with the question whether an advance by a partner to his partnership creates a valid debtor-creditor relationship. And, it is true . . . that the entire area of case law within which we are concerned has developed over transactions involving stockholders and their corporations. Although we have not been able to find . . . a case wherein a court has applied the aforementioned principles to a situation involving an advance by a partner to his partnership, we have likewise not been able to find . . . a case wherein a court has refused to apply these principles to a partnership transaction. Accordingly, we treat this case as one of first impression.[59]

On the basis of the facts involved, the court held that advances by a limited partner to his partnership constituted capital contributions and not loans.

In 1972, the Service issued two rulings that reclassified "loans" to partnerships as capital contributions. Although both rulings are in the oil and gas area, they are potentially of great significance in the real estate area. In Revenue Ruling 72-135[60] the limited partnership agreement provided that the general partner could make nonrecourse loans to the partnership, and also to limited partners for portions of their subscription in the limited partnership. The Service ruled:

> [A] nonrecourse 'loan' from the general partner to a limited partner or to the partnership is a contribution to the capital of the partnership by the general partner, rather than a loan, and accordingly, the amount thereof shall be added to the basis of the partnership interest of the general partner and not to the basis of the partnership interest of the limited partner.[61]

The Ruling contains no other facts that help explain the conclusion that the loans to the partnership, as well as the loans to the limited partners, were, as a matter of law, contributions to capital by the general partner.

Revenue Ruling 72-350[62] went one step further because it deemed a "loan" by someone who was not a partner to be a contribution to partnership capital. It involved taxpayer *B* who entered into an agreement to make a "loan" to an otherwise unrelated limited partnership. None of the partners had any personal liability to repay the "loan," which was "secured by the partnership's properties consisting of some unproven leases and some expensive but virtually unsalvageable oil and gas well installations." *B* had the right to convert the "loan" and receive in exchange a twenty-five percent interest in the partnership's profits. The Service ruled:

> [T]he so-called 'loan' is not a bona-fide debt but is, in reality, capital placed at the risk of the venture by *B*. Therefore, the funds advanced represents [*sic*] *B*'s equity interest in the venture and the amount of the advance constitutes the basis to *B* for such interest. Thus, the bases of the partnership interests of the other parties . . . are not affected.[63]

59. Joseph W. Hambuechen, 43 T.C. 90, 100 (1964).
60. 1972-1 C.B. 200.
61. *Id.* at 200.
62. 1972-2 C.B. 394.
63. *Id.* at 395.

This Ruling seems to embrace the conclusion that, for tax purposes, *B* became a partner as a matter of law.[64]

V. THE PATH OF TAX REFORM

Prior to the Tax Reform Act of 1976,[65] the primary focus of tax reform in the real estate area was on the depreciation deduction and the use of accelerated methods of computing depreciation. Owners of property used in a trade or business or held for the production of income are allowed annual depreciation deductions for the exhaustion, wear and tear of such property.[66] The straight line method of computing depreciation allocates equal deductions over each year of the estimated useful life of the property. Accelerated depreciation methods, however, allow the taxpayer much greater depreciation deductions in the earlier years of the property's useful life, and smaller deductions in later years. The use of accelerated depreciation deductions to shelter income from other sources was felt to be particularly offensive because the accelerated depreciation claimed often grossly exceeded the actual deterioration, if any, that had taken place.[67]

Prior to the Revenue Act of 1964,[68] a taxpayer "paid the piper" for the depreciation deductions taken only insofar as those deductions were subtracted from his basis in the property. Because gain on the sale of property is calculated as sale price less adjusted basis, the amount of gain is increased by the amount of the depreciation deductions taken. This, however, does not negate the benefit obtained by using the depreciation deduction to shelter ordinary income from other sources, because the gain is postponed until sale and is generally taxed at favorable capital gains rates. Thus, both tax deferral and tax conversion are achieved.

An example of the classic pre-1964 Act shelter illustrates the point. Assume that a taxpayer in the sixty percent bracket reported a depreciation deduction of $10,000. This resulted in a tax savings of $6,000 in the year of the deduction. The amount of the depreciation deduction that had been taken was subtracted from his basis in the property. Thus, when he sold the property, the gain he recognized was $10,000 greater than it would have been had there been no depreciation deduction taken. This gain, however, received capital gains treatment. In a year in which the maxi-

64. *See* Treas. Reg. § 1.761-1(a) (1972); Rev. Rul. 75-374, 1975-2 C.B. 261.

65. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 [hereinafter referred to as the "1976 Act"].

66. I.R.C. § 167(a). There are two basic types of depreciable property, § 1245 property and § 1250 property. Section 1245 property is depreciable tangible personal property and includes elevators and escalators. *Id.* § 1245(a)(3). Section 1250 property is depreciable real property, that is, buildings and their structural components, but not elevators and escalators. *Id.* § 1250(c). The distinction is important because each is subject to its own rules concerning the availability of accelerated depreciation methods and depreciation recapture.

67. Straight line depreciation often grossly overstates economic depreciation. For example, a classic study in this area concludes that, on average, the decline in the market value of apartment houses from 1951 to 1965 was negligible. TAUBMAN & RASCHE, TAX INCENTIVES 113-142 (1971).

68. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 [hereinafter referred to as the "1964 Act"].

mum tax on capital gains was twenty-five percent, the tax bill on the additional $10,000 gain was only $2,500. Thus, taxpayer, in effect, "bought" a $6,000 tax saving in the year in which he took his depreciation deduction, for only $2,500, which he did not have to pay until the sale of the property. The 1964 Act was the first legislation to require that part or all of the gain on the sale of property that had been depreciated at an accelerated rate be "recaptured," that is, taxed as ordinary income. It was not until the 1976 Act that Congress specifically focused on the inclusion of nonrecourse liabilities in depreciable basis.

A. *The Tax Reform Act of 1969*

The Tax Reform Act of 1969[69] was a continuation of the confinement of real estate tax shelters that began with the initial recapture provision in the 1964 Act. The basic thrust of the 1969 Act with regard to real estate tax shelters was threefold: (1) restrict the use of accelerated depreciation methods that permit taxpayers to take larger depreciation deductions in the earlier years of the property's useful life rather than spread them evenly over the useful life; (2) strengthen the 1964 Act provisions that treat some of the gain on sale as ordinary income when accelerated methods of computing depreciation have been used; and (3) include accelerated depreciation and one half of net capital gains in with certain other items of "preference" subject to a new ten percent tax.

Limitation on the Availability of Accelerated Depreciation Methods. The general rule of the 1969 Act with respect to depreciation of real property[70] is that *new* property may be depreciated only by the 150% declining balance or straight line methods,[71] and *used* property may be depreciated only by the straight line method.[72] The most important exceptions to this general rule apply to residential rental property and to rehabilitation expenditures on low income rental housing. Urban riots had left legislators more susceptible to incentives to develop and refurbish rental housing. With respect to new residential rental properties, all accelerated depreciation methods previously available remained available. Therefore, *new* residential rental properties may still be depreciated according to the very rapid 200% declining balance or sum-of-the-year-digits methods.[73] With respect to *used* residential rental property, only the straight line method is preserved, unless the property has a useful life of twenty years or more, in which case the 125% declining balance method is still available.[74] With

69. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 [hereinafter referred to as the "1969 Act"].
70. The 1969 Act did not place any limitations on the use of accelerated methods to depreciate new personal property, which can be depreciated even by use of the very rapid double declining balance or sum-of-the-years digits methods. Treas. Reg. § 1.167(b)-0(b) (1960).
71. I.R.C. § 167(j)(1)(B).
72. *Id.* § 167(j)(4).
73. *Id.* § 167(j)(2).
74. *Id.* § 167(j)(5).

respect to certain rehabilitation expenditures on low income rental housing, the taxpayer may elect to depreciate such expenditures by the straight line method over a sixty-month period.[75] Under prior law, such expenditures had to be capitalized and depreciated over the entire remaining useful life of the property.

Recapture of Ordinary Income. The 1969 Act strengthened the "recapture" provisions applied to real estate by the 1964 Act. The recapture rules reduce the tax shelter benefits of accelerated depreciation by treating some of the gain on the sale of property that has been depreciated at an accelerated rate as ordinary income. The amount of depreciation "recaptured" is determined by applying the appropriate "applicable percentage" to the amount of depreciation that has been taken in *excess* of the amount that would have been taken under the straight line method.[76] Separate rules are provided for determining the applicable percentages to be applied to pre-1970 and post-1969 "excess" depreciation. The applicable percentage imposed by the 1969 Act on pre-1970 excess depreciation is 100% less one percent for each month the property is held beyond twenty months. Thus, if the property is held for more than ten years, none of the pre-1970 excess depreciation will be recaptured.

Generally, the applicable percentage on post-1969 excess depreciation of real property is 100%. That is, all of the excess depreciation will be recaptured, regardless of the length of time the property is held.[77] The 1969 Act, however, applied more lenient recapture provisions to residential rental properties. With respect to such property, the applicable percentage was 100% less one percent for each month the property was held beyond 100 months. Thus, if a residential rental property were held for more than sixteen years and eight months there was no recapture. With respect to property financed under the National Housing Act or similar programs and subject to certain limitations on the rate of return and profit, the applicable percentage was the same as it would be for pre-1970 excess depreciation, such that there is no recapture if the property is held for more than ten years.

The Tax on Preferences. The 1969 Act imposed a new tax on items of "tax preference," certain deductions not used by most taxpayers, but used to great advantage by others.[78] The tax was ten percent of the excess of the year's preferences over the sum of $30,000 plus the taxpayer's regular federal tax. "Excess depreciation," the depreciation taken in excess of the amount of depreciation allowable under the straight line method, was made an item of tax preference subject to this tax. Consequently, al-

75. *Id.* § 167(k).
76. In contrast, in the case of depreciable *personal* property, *all* depreciation is recaptured, to the extent of gain, at ordinary income rates. *Id.* § 1245(a)(1).
77. The amount of depreciation recaptured is limited to the amount of gain. If, however, the real property, whether commercial or residential, is held 12 months or less, *all* depreciation, not merely excess depreciation, will be recaptured. *Id.* § 1250(b)(1).
78. *Id.* § 57(a).

though excess depreciation is not recaptured until the property is sold, it is taxed as a preference item each year accelerated depreciation is taken. Further, the minimum tax also applies not only to the accelerated depreciation as it is taken each year,[79] it also applies in the year of sale to one-half of the net capital gain for the year.[80]

B. *The Tax Reform Act of 1976*

From a real estate point of view, the 1976 Act may be more significant for what the Congress chose not to do to real estate, rather than for what it actually did. It chose, for example, not to subject real estate to the "at risk" limitation it applied to other tax shelters. Nevertheless, the 1976 Act did include several significant changes that restrict real estate tax shelters.

Strengthened Recapture Provisions. The 1976 Act left intact the 1969 Act rules that limit the availability of accelerated depreciation methods.[81] The 1976 Act, however, provides for greater depreciation recapture than did the 1969 Act. There is no change with respect to commercial properties; as under the 1969 Act, all excess depreciation will be recaptured.[82] The 1976 Act, however, extends this rule of 100% recapture to all residential rental housing other than assisted housing.[83] Congress learned that the preferred treatment it had given broadly to *all* residential rental housing would not necessarily result in the reconstruction of the inner cities or, indeed, in the construction of much low-income housing anywhere. Thus, the incentive was confined more narrowly to government assisted low and moderate income housing projects. In the case of assisted housing, the amount of excess depreciation subject to recapture is 100% less 1% for each

79. *Id.* § 57(a)(2).
80. *Id.* § 57(a)(9)(A).
81. Note that property may be depreciated under either the composite method or the component method. Under the composite method, a group of assets is lumped together and depreciated as a unit. For example, all the parts of a building can be depreciated by applying a single rate to the unit. The rate is essentially a weighted average. It is equal to the sum of the annual depreciation deductions allowable for each component, divided by the total cost of the components. The taxpayer may so calculate the composite rate if he is able to establish the useful life and cost of each component. As an alternative, the taxpayer may use the guideline composite life provided by the CLADR system to determine the composite rate. *See* Dailey & Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127, 131-32 (1977).

Component depreciation involves separate depreciation of each structural component. The effective useful life produced under the component method is generally shorter than the guideline composite life. *Id.* It will thus tend to produce larger deductions in the earlier years of ownership. Another substantial benefit of the component method is that there are no limitations placed on the use of accelerated depreciation methods on a component that might qualify as § 1245 property. For example, composite depreciation of a new commercial building, including its structural components, may be written off no faster than according to the 150% declining balance method. However, under component depreciation, components such as elevators and escalators, both § 1245 property, may be depreciated according to the 200% declining balance method. I.R.C. § 167(j)(1). *See* Tidwell, *Component Depreciation Can Be a "Cure" for Excess Depreciation*, 55 TAXES 116 (1977).
82. I.R.C. § 1250(a)(1)(B)(v).
83. *Id.* (with respect to depreciation attributable to periods after Dec. 31, 1975). The 1976 Act also provided that, when real property is disposed of by foreclosure, the holding period for purposes of determining the amount of depreciation recaptured terminates when the foreclosure proceedings begin. *Id.* § 1250(d)(10).

month the property is held after its first eight years and four months in service.[84]

Capitalization of Construction Period Items. The 1976 Act contains several provisions to prevent the real estate industry from currently deducting items of a capital nature. The most significant of these provisions is the completely new section 189. Prior to the 1976 Act, interest and taxes incurred during the construction period were deducted immediately rather than capitalized and written off over the life of the improvement. When fully phased in, section 189 will require construction period interest and taxes to be capitalized and written off on a straight line basis over a ten-year period.[85] The section applies to individuals, Subchapter S corporations, and personal holding companies. The first write-off year is that in which the expenses are paid or accrued, depending on the taxpayer's method of accounting; the second write-off year is the first year in which the property is placed in service; and each year thereafter is a write-off year until expiration.[86] Intervening construction period years are skipped; thus, the ten-year amortization period may not be consecutive.

The 1976 Act also made two changes to the partnership provisions to prevent partners from currently deducting capital outlays. First, it introduced a completely new section 709, which requires the capitalization of partnership organization and syndication fees, but permits them to be written off on a straight line basis over a five-year period.[87] Second, section 707(c), the provision that permits a partnership to claim a deduction for "guaranteed payments" it makes to its partners, was amended to emphasize that section 707(c) does not authorize partnerships to currently deduct items that would have to be capitalized had they been made to nonpartners.[88]

The Minimum Tax on Preferences. The minimum tax on preferences introduced by the 1969 Act proved to be an insignificant revenue raiser.[89]

84. *Id.* §§ 1250(a)(1)(B)(i)-(iv).

85. *Id.* § 189(b) contains separate transitional rules for nonresidential real estate, residential real estate, and government subsidized housing.

86. *Id.* § 189(c)(1).

87. *Id.* § 709(b)(1).

88. There were those in the industry who had argued that § 707(c) authorized current deductions for payments that would have to be capitalized if made to nonpartners. This contention was laid to rest in Cagle v. Commissioner, 63 T.C. 86 (1974). *See also* Rev. Rul. 75-214, 1975-1 C.B. 185. Thus, the 1976 Act's change to § 707(c) was merely a clarification. For a discussion of § 707(c), see Weidner, *supra* note 55.

89. S. REP. NO. 938, 94th Cong., 2d Sess. 109, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3544, states:

> The existing minimum tax on tax preferences was enacted in 1969 in order to ensure that high-income individuals and corporations pay at least a minimum rate of tax on their tax preferences, including both exclusions from taxable income and deferrals of tax liability into future years. The current minimum tax, however, has not achieved this goal. High-income individuals still are able to avoid paying income tax, and in 1974 the minimum tax on individuals raised only $130 million, a small fraction of tax-preferred income. Moreover, the existing minimum tax is largely a tax on only one type of preferred income—the excluded half of long-term capital gains, which constitutes about seven-eighths of the income in the minimum tax base.

In response, the 1976 Act included a general tightening of the minimum tax on preferences. The rate was increased from ten to fifteen percent and the exemption for tax preferences was reduced from $30,000 plus regular taxes paid, to the greater of $10,000 or one-half of regular taxes paid in the case of individuals. These changes in the minimum tax rules also affected the maximum tax rules on earned income because tax preference income reduces the amount that would otherwise qualify as earned income eligible for the fifty percent maximum rate.[90]

Prepaid Interest. The Code contains a broadly worded interest deduction, which provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."[91] In 1945, the Service ruled that it was permissible for taxpayers who computed their income using a cash method of accounting to deduct up to five years of prepaid interest in the year of payment.[92] Consequently, prepayments of interest in real estate transactions became as common as mortgages. In 1968, the Service revoked the earlier ruling "[i]n view of certain abuses."[93] It relied on its statutory authority to require a taxpayer to use a different method of accounting if the method he chooses for himself "does not clearly reflect income,"[94] and ruled that the prepayment of more than one year's interest by a cash method taxpayer "will be considered as materially distorting income."[95] Hence, the taxpayer making such a payment is required to report it on an accrual method of accounting, and postpone deduction until the year to which the interest is chargeable. The Ruling further declared that any prepayment for one year or less will be considered on a case-by-case basis to determine whether a material distortion of income has resulted.[96] The 1968 Ruling's dramatic change of position was controversial, particularly because of its automatic disqualification of all prepayments for more than a twelve-month period.

The 1976 Act put to rest any controversy about the 1968 Ruling by introducing section 461(g),[97] which eliminated deductions for prepaid inter-

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90. I.R.C. § 1348(b)(2)(B).
91. *Id.* § 163(a).
92. I.T. 3740, 1945 C.B. 109.
93. Rev. Rul. 68-643, 1968-2 C.B. 76, 77.
94. *Id.* (discussing I.R.C. § 446(b)).
95. 1968-2 C.B. at 77.
96. Rev. Rul. 77-304, 1977-35 I.R.B. 9, applies Rev. Rul. 68-643, 1968-2 C.B. 76, at the partnership level.
97. I.R.C. § 461(g) provides:

> (g) Prepaid Interest.—
>
> (1) In general.—If the taxable income of the taxpayer is computed under the cash receipts and disbursements method of accounting, interest paid by the taxpayer which, under regulations prescribed by the Secretary, is properly allocable to any period—
>
> (A) with respect to which the interest represents a charge for the use or forbearance of money, and
>
> (B) which is after the close of the taxable year in which paid, shall be charged to capital account and shall be treated as paid in the period to which so allocable.
>
> (2) Exception.—This subsection shall not apply to points paid in respect of any indebtedness incurred in connection with the purchase or improve-

est. The legislative history of the section makes clear that the material distortion of income principle is no longer to control the reporting of interest deductions; cash method taxpayers must simply report interest payments as would an accrual method taxpayer.[98] The legislative history also makes clear that previous law continues to control the definition of interest. Thus, the Service may continue to argue that payments denominated "interest" constitute something other than interest, such as a deposit, a portion of principal, or a payment for an option.[99] The Service can be expected to be particularly aggressive with respect to claims of "interest" deductions in wraparound mortgage situations.[100]

> ment of, and secured by, the principal residence of the taxpayer to the extent that, under regulations prescribed by the Secretary, such payment of points is an established business practice in the area in which such indebtedness is incurred, and the amount of such payment does not exceed the amount generally charged in such area.

98. S. REP. No. 938, 94th Cong., 2d Sess. 104, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3540, to accompany H.R. 10612, 94th Cong., 2d Sess. 104 (1976), provides:

> In determining whether an interest prepayment is properly allocable to one or more taxable years after the year of payment, the committee intends that the allocation be made to the period or periods in which the interest represents a cost of using the borrowed money in that period, regardless of whether allowing prepaid interest to be deducted when paid would materially distort the taxpayer's income in the year of payment (or the income of a partnership of which the taxpayer may be a member).
>
> . . . .
>
> [This rule] is intended to conform the tax deductibility of prepaid interest by cash method taxpayers to the rule which the committee understands to be proper under present law for interest prepayments by an accrual method taxpayer.

The 1976 Act also made certain changes to the limitation on deductions for interest incurred to purchase or carry "property held for investment," I.R.C. § 163(d), which was introduced by the Tax Reform Act of 1969. Real property subject to a net lease will be classified as "property held for investment" for this purpose if it falls within *id.* §§ 163(d)(4)(A)(i) or (ii). The 1976 Act limits the deduction for interest on investment indebtedness to $10,000 per year plus the taxpayer's net investment income. *Id.* § 163(d)(1).

99. S. REP. No. 938, 94th Cong., 2d Sess. 104 n.7, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3540 n.7, states:

> The committee does not intend to prevent the Treasury or the taxpayer from continuing (where appropriate) to characterize a purported 'interest' payment as not true interest in the particular circumstances. It may thus be appropriate in some cases to treat a payment denominated 'interest' as, in substance, additional purchase price of property, as a dividend, as payment for an option, etc.

100. See the discussion of Collins v. Commissioner, 54 T.C. 1656 (1970), at text accompanying notes 136-42 *infra*, in which the Tax Court recharacterized "interest" payments claimed under a wraparound mortgage as part of the purchase price. Congress was clearly hostile to the use of wraparound mortgages to accelerate interest deductions:

> A recent technique used to justify larger amounts of prepaid interest within the Service's present guidelines than can be obtained under conventional financing is the 'wraparound' mortgage (sometimes referred to as an all-inclusive deed of trust). Often, a . . . property which investors are purchasing is encumbered by an existing first mortgage. The investors execute to the seller a new purchase money obligation whose face amount includes both the unpaid balance of the first mortgage and the new financing supplied by the seller (which would ordinarily take the form of a second mortgage). The buyers agree to pay (and to prepay) interest on the face amount of the 'wraparound' note, while the seller agrees to continue paying the interest on the first mortgage out of the interest payments which he receives from the buyers. Since a wraparound mortgage usually bears a higher rate of interest than the first mortgage (and in some cases the additional prepaid interest which the buyers claim on the note is negotiated as a substitute for a larger down payment), this

Bonus Depreciation. Under section 179, when a partnership acquired tangible personal property with a useful life of six years or more,[101] it could elect to claim, in addition to regular depreciation, an extra depreciation allowance of twenty percent of the cost of such property up to $2,000 per partner.[102] Prior to the 1976 Act, the dollar limitation was applied to each partner, and not to the partnership as an entity. The 1976 Act applies the $2,000 limit on bonus depreciation[103] at both the partnership level and with respect to each partner.[104]

Partnership Allocations. A principal advantage of the partnership form is that it offers partners a great deal of flexibility to allocate among themselves the economic and tax consequences of their venture. In real estate partnerships, including limited partnerships, this flexibility has long been availed of, and pushed to its limit, to allocate particular deductions and overall partnership tax losses to the partners most in need of offsets against their income from other sources. In response, the 1976 Act completely rewrote the rules that govern partnership allocations.

The basic rules of partnership allocations can be stated simply. In general, partners are free to determine in their partnership agreement how the various economic and tax consequences of partnership operations will be allocated.[105] The partnership agreement includes any amendments made up until the deadline for filing the partnership return.[106] Prior to the Tax Reform Act of 1976, allocations in the partnership agreement were respected unless they were for the "principal purpose" of tax avoidance or evasion. Allocations that violated the principal purpose limitation were disregarded and reallocated according to the partners' ratio for sharing the "taxable income or loss of the partnership, as described in section 702(a)(9)."[107] The 1976 Act makes several changes to the rules governing

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> type of arrangement has been widely used to increase the amount of interest which can be prepaid in the initial year of a purchase of property and claimed as a deduction for one year's prepaid interest within the Service's present guidelines.

S. REP. No. 938, 94th Cong., 2d Sess. 102-03, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3538-39.

> In appropriate cases . . . the committee does not intend to prevent the Service from recharacterizing part or all of a buyer's (or borrower's) 'interest' payment on a wraparound mortgage as, in substance, an additional down payment of principal or as a nondeductible deposit of interest with a third party. See Rev. Rul. 75-99, 1975-1 C.B. 197.

S. REP. No. 938 at 105, n.9, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS at 3541 n.9.

101. I.R.C. § 179(d)(1)(C).

102. *Id.* § 179(a). In determining whether property qualifies for bonus depreciation, the distinction is between tangible personal property and real property, and not between § 1245 property and § 1250 property. In most cases, § 1245 property is tangible personal property, and § 1250 property is real property. There are, however, cases in which § 1245 property is not personal property, for example, elevators and escalators.

103. I.R.C. § 179(b).

104. *Id.* § 179(d)(8).

105. *Id.* § 704(a).

106. *Id.* § 761(c).

107. *Id.* § 704(b) (amended 1976) provided:

> (b) Distributive Share Determined by Income or Loss Ratio.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall

partnership allocations. Most basically, it removes the last two rules just quoted. It replaces the "principal purpose" limitation with the requirement that allocations have "substantial economic effect."[108] Further, allocations that lack substantial economic effect will now be reallocated according to each partner's "interest in the partnership (determined by taking into account all facts and circumstances)."[109]

It is not clear whether the 1976 Act made any change in substance by replacing the "principal purpose" limitation with the requirement that allocations must have "substantial economic effect."[110] There are two basic reasons for skepticism. First, it was generally assumed that the essential test for determining whether an allocation satisfied the principal purpose limitation was whether it had substantial economic effect. Second, the legislative history of the 1976 Act contains numerous references to existing law to determine what constitutes substantial economic effect.[111]

The fundamental purpose of the new section 704(b) is to make clear that bottom line allocations of taxable income or loss are subject to the same limitations as allocations of individual items. The new provision changes two features of section 704(b) that had in the past supported arguments that bottom line allocations could not be disregarded. First, the old principal purpose limitation, by its terms, applied to allocations of any "item." It had been argued that the partnership's bottom line was not subject to the principal purpose limitation because it was a "composite" rather than an "item." New section 704(b) makes it inescapable that the new substantial economic effect requirement applies to allocations of composites because it includes in every subsection the disjunctive parenthetical "(or item thereof)."[112] Second, it had been argued that it would be pointless for the

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be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

108. *Id.* §§ 704(a), (b).

109. The new I.R.C. § 704(b) provides as follows:

(b) Determination of Distributive Share.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

110. See Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. L. REV. 1 (1977), for a discussion of partnership allocations before and after the 1976 Act.

111. *See, e.g.*, S. REP. No. 938, 94th Cong., 2d Sess. 104 n.7, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3535-36, stating: "[T]he committee believes that allocations of special items and overall allocations should be restricted to those situations where the allocations have substantial economic effect, as presently interpreted by the regulations and case law."

112. I.R.C. § 704(b).

Service to disregard an allocation of taxable income or loss only to subject it to the reallocation mechanism of "taxable income or loss of the partnership, as described in section 702(a)(9)."[113] The new reallocation mechanism of "the partner's interest in the partnership (determined by taking into account all facts and circumstances)"[114] applies as easily to bottom line allocations as it does to allocations of individual items.

The 1976 Act also provided against retroactive allocations. The term "retroactive allocation" has been used in a broad sense to refer to ratios established to allocate items of income or loss previously accrued. A retroactive allocation in this broad sense is present if, for example, partners wait until the end of the year to decide how to divide the results of the year's operations. The term, however, is more commonly used in a much narrower sense to identify allocations to new partners of gain or loss that was incurred prior to their admission. The retroactivity that is at issue is not that of the partnership allocation provision itself. The issue is whether a new partner may share in tax consequences incurred prior to his admission. Thus, the retroactivity issue is present even if there is no amendment to the partnership agreement. For example, some partnership agreements allocate taxable income or loss in accordance with the partners' capital accounts at the close of the year. Although the allocation provision itself remains unchanged, its effect is to allocate preadmission gain or loss to partners admitted late in the year. The issue became extremely controversial because tax shelter partnerships frequently admitted limited partners at the end of the year and allocated losses to them as if they had been members for the entire year. The 1976 Act clearly limits a new partner to tax benefits for the portion of the year he was a member of the partnership.[115]

What the 1976 Act Did Not Do. Prior to the passage of the 1976 Act, Congress was acutely aware of the prevalence of limited partnerships to offer high bracket investors tax losses in amounts far in excess of their actual cash investments. It knew that such tax shelters existed in many different industries, including real estate, oil and gas, motion pictures, farming, and leasing. When the 1976 Act was before the House, it contained a proposal referred to as "LAL," the limitation on artificial ac-

113. *Id.* § 704(b) (amended 1976).
114. *Id.* § 704(b).
115. *Id.* § 706(c)(2)(B). The legislative history indicates that partners are to be given substantial leeway to compute the required proration:

> In determining the income, loss or special item allocable to an incoming partner, the partnership will either allocate on a daily basis or separate the partnership year into two (or more) segments and allocate income, loss or special items in each segment among the persons who were partners during that segment.

HOUSE COMMITTEE ON WAYS AND MEANS, SUMMARY OF THE CONFERENCE AGREEMENT ON THE TAX REFORM ACT OF 1976, H.R. 10612, 94th Cong., 2d Sess. 9 (1976). Partners are to have the same flexibility to compute proration that they have under the existing Regulations concerning the sale by a partner of his entire interest in the partnership. S. REP. No. 938, 94th Cong., 2d Sess. 98, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3534. *See* Treas. Reg. § 1.706-1(c)(2)(ii) (1957). *But see* Rodman v. Commissioner, 542 F.2d 845 (2d Cir. 1976).

counting losses. LAL provided that certain accelerated deductions could only be used to offset related income. The Senate, however, rejected LAL and instead introduced the "at risk" provisions that were ultimately enacted.

Although the 1976 Act did introduce the concept that the tax losses an investor may claim from certain activities should be limited to the amount he has "at risk" in those activities, real estate partnerships were exempted. Stated somewhat loosely, as to those activities covered by the new at risk rules, the 1976 Act repeals *Crane*. Two separate at risk provisions were inserted in the Code by the 1976 Act. Section 465[116] is entirely new and applies to only four specific types of tax shelters: motion picture films and video tapes; farming; equipment leasing; and oil and gas. Section 704(d)[117] was amended to include a catchall provision that applies broadly to all partnerships, but specifically exempts real estate partnerships.[118] Under each of these rules, the taxpayer is only considered to have placed amounts at risk in an activity to the extent of the amount of money he has contributed, plus the adjusted basis of any property he has contributed, plus the amount of any loans for the activity for which he is personally liable. A taxpayer will not be considered to be at risk with respect to nonrecourse financing, or with respect to other amounts protected against loss by guarantees, stop-loss agreements, or other similar arrangements. In addition to exempting real estate from the at risk limitations,[119] Congress also declined to amend the rules that permit limited partnerships, including limited partnerships that have no general partner other than a corporation, to be classified for tax purposes as partnerships rather

116. I.R.C. § 465.

117. *Id.* § 704(d).

118. H.R. 13511, 95th Cong., 2d Sess., § 201(b)(1) (1978), reported by the House Ways and Means Committee on August 4, 1978, would repeal the "at risk" rule in I.R.C. § 704(d), and § 201(a) would expand the "at risk" rule of I.R.C. § 465 to embrace all activities other than "the holding of real property." The House Ways and Means Committee Report explains the need for the change as follows:

> The at risk rules of present law impose a significant limitation on many types of tax shelters. However, the rules do not cover three types of situations where the use of tax shelters should be further restricted. First, except in case of the four types of activities specified in section 465, the at risk rules do not apply to direct investments. Second, the at risk rules do not apply to many types of closely held corporations which may use tax shelters. Third, the current at risk provisions fail to adequately deal with situations where a taxpayer receives distributions (or otherwise reduces his original at risk basis through debt guarantees, conversion of debt from recourse to nonrecourse, etc.) after having used his at risk basis to support losses in a prior year.
>
> Except for the four activities to which the specific at risk applies, neither of the at risk rules applies to direct investments (i.e., investments made directly, not through partnerships). Essentially, the committee believes that the lack of any application of the at risk principles to direct investments constitutes a major gap in the tax law in dealing with tax shelter abuses.
>
> Thus, the bill provides a revised at risk rule which would apply to all investments (direct or indirect) in all activities except real estate.

H. REP. NO. 1445, 95th Cong., 2d Sess. 68, to accompany H.R. 13511, Revenue Act of 1978.

119. S. REP. NO. 938, 94th Cong., 2d Sess. 109, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3545, provides:

> Many so-called tax shelter investments, however, do have economic merit, and elimination of the tax benefits for such investments could cause a signifi-

than as corporations.[120]

VI. The Service and the Courts

A. *The Requirement of Economic Purpose*

Independent of congressional "reform," the Service and the courts continue to strike out at arrangements they consider particularly abusive. The courts have at their disposal the principle that tax benefits can be derived from allegedly profit-oriented transactions only if those transactions represent "purposive economic activity," that is, if there exists a reasonable expectation of economic profit. It is important to understand the pervasiveness of this principle, which the Service has successfully used to invalidate particular details of transactions that, overall, have economic substance.

Gregory v. Helvering[121] is generally considered the classic Supreme Court statement that tax benefits will not be denied simply because they motivated a transaction. The *Gregory* Court, however, further held that the absence of a business purpose will result in the denial of the tax benefits of Code provisions premised on commercial transactions.[122] In addition to the commercial transaction provision cases, there is a further line of

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> cant decline in economic activity. This is especially true of two extremely risky industries—real estate and oil and gas drilling. In both of these industries, the committee concluded it would be undesirable to make tax changes that would cause major declines in investment.

Although oil and gas drilling ventures are subject to the "at risk" limitation of I.R.C. § 465, the limitation is not nearly as serious as it is to the other tax shelters covered. Nonrecourse financing has not been as critical in the oil and gas area as it has been in other areas.

120. Larson v. Commissioner, 66 T.C. 159 (1976), held that the Service is bound by the present classification regulations, which are extremely biased toward classifying as a partnership for tax purposes anything that is a general or a limited partnership under local law. *See also* Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975). The opinions in *Larson* repeatedly invited the Treasury Department to propose new regulations more evenly balanced between corporate and partnership classification. On January 5, 1977, the Treasury accepted the invitation by publishing proposed new regulations less biased toward partnership classification. Within hours of their publication, they were withdrawn. *Battle is Joined on I.R.S. Partnership-Corporation Ruling*, N.Y. Times, Jan. 7, 1977, at A 11, col. 3.

121. 293 U.S. 465 (1935). The taxpayer in *Gregory* wanted stock held by her corporation transferred to her without having the distribution taxed as a dividend. In an attempt to avail herself of the nonrecognition of gain provisions applicable to a corporate reorganization, she created a third corporation, transferred the shares to it, and immediately caused it to be dissolved and to distribute the shares to her. The Court said the transaction would not be disregarded simply because its ulterior purpose was to escape payment of a tax. The transaction was taxed as a dividend because the corporation created and immediately dissolved had "no business or corporate purpose" but was a "contrivance" set up "not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the [taxpayer]." *Id.* at 469.

122. For a collection and discussion of the cases, see Young, *The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969). In Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950), Judge Learned Hand stressed that *Gregory* is not to be confined to corporate reorganizations:

> It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial and industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.

cases that disallows interest deductions in a variety of tax avoidance schemes. These cases constitute the most striking example of the requirement of profit-making activity because the interest deduction is not premised on a commercial transaction.[123] The interest deduction is available for "all interest paid . . . on indebtedness,"[124] even if the loan is taken out for purely personal pleasure.

Knetsch v. United States[125] is the leading Supreme Court decision on the interest deduction. The case concerned an arrangement under which the taxpayer borrowed from an annuity company at 3-1/2% interest to purchase deferred annuity contracts that would yield 2-1/2%, then prepaid the interest.[126] The Court said that under *Gregory* it was irrelevant that the taxpayer entered the transaction only to secure interest deductions.[127] Nevertheless, it held that no indebtedness had been created for tax purposes because the transaction was a sham that offered the taxpayer "nothing of substance" beyond an interest deduction. The borrowing on the annuity policy rendered its net cash value negligible. *Knetsch* left unclear whether the reason the interest deductions were disallowed was that no genuine indebtedness had been created under local law, or whether the reason was that a genuine indebtedness under local law served no function other than to generate interest deductions.[128] In other words, the Court left unclear whether it considered the transaction a sham because the legal relationships purportedly created were found not to exist, or because those relationships existed for no other reason than tax avoidance.

In *Goldstein v. Commissioner*[129] the Second Circuit stated unequivocally

123. Some Code provisions specifically deny tax advantages to arrangements undertaken for particular motives or purposes. Other provisions, although not explicitly referring to motive or purpose, premise the availability of a tax advantage on activity of a particular character. Depreciation deductions, for example, are available only with respect to property used in a trade or business or held for the production of income. Finally, there are provisions that on their face allow tax advantage independent of motive, purpose, or character of transaction. The interest deduction is a prime example.

124. I.R.C. § 163(a).

125. 364 U.S. 361 (1960).

126. The transaction was far more complicated. The basic point is that there was no possibility of economic gain.

127. A variant on the scheme used in *Knetsch* was to involve a third party lender, usually a bank. In Weller v. Commissioner, 270 F.2d 294 (3d Cir. 1959), *cert. denied*, 364 U.S. 908 (1960), the taxpayer purchased an annual premium annuity policy and paid the first premium. Thereafter, he borrowed to increase the policy's cash or loan value, then borrowed the increase in value to pay off the loan taken out to create that value, and claimed interest deductions for payments made on the loans on the policy. The taxpayer borrowed at 4% to obtain a discount of less than 3% for prepayment, immediately recouping most of the alleged prepayments of interest by borrowing on the increase in cash surrender value created by the payments. The Third Circuit agreed with the Tax Court that the only purpose of the transactions was the creation of interest deductions, and emphasized that the mere fact that "there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of [section 163]." 270 F.2d at 298.

128. The latter seems to be the correct interpretation. *See* Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 1961 SUP. CT. REV. 135, 149. The incorporation of this vague standard into the interest deduction was resisted by the three dissenting Justices who protested that the majority had disallowed Knetsch's deduction "because the annuity device was devoid of commercial substance." 364 U.S. at 371 (Douglas, J., dissenting).

129. 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

that interest on an enforceable indebtedness is not deductible if it does not involve "purposive economic activity." In the year in which she won the Irish Sweepstakes, Mrs. Goldstein took out two loans to purchase short-term Treasury bills, which she pledged as collateral to secure the loans. She then prepaid the interest that would accrue on the loans should they remain outstanding until maturity. It was highly unlikely that the market for Treasury bills would fluctuate rapidly enough for Mrs. Goldstein to reasonably expect any economic profit from the transaction.

The Tax Court said the transactions were shams because they created no genuine indebtedness. The Second Circuit disagreed, finding that the "loan arrangements were . . . regular and, moreover, indistinguishable from any other legitimate loan transaction contracted for the purchase of Government securities."[130] Nevertheless, it disallowed the interest deductions, concluding that the transactions were structured "without any realistic expectation of economic profit and solely in order to secure a large interest deduction,"[131] and that tax consequences alone were insufficient to support an interest deduction. The court based its holding on the underlying purpose of the interest deduction, which it deemed to be a "Congressional policy of encouraging purposive activity to be financed through borrowing."[132] This policy would be frustrated if deductions were allowed "for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction."[133] Transactions should not be encouraged "that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress."[134] Because the court found "no prospect" of economic profit, the case does not specify the probability of eventual profit necessary to prevent a finding of nonpurposive activity. Cases since *Goldstein* have indicated that the purposive activity requirement is not satisfied by a profit that could not reasonably have been anticipated at the inception of the transaction.[135]

James A. Collins[136] is perhaps the most striking application of *Goldstein* to a real estate transaction. The case is significant because the Tax Court relied on *Goldstein* to invalidate one feature of a transaction that overall had as much economic substance as a real estate transaction could have. Mr. Collins won the Irish Sweepstakes in 1962. He was approached by a

130. *Id.* at 737.
131. *Id.* at 740.
132. *Id.* at 741.
133. *Id.* at 742.
134. *Id.* The Second Circuit admitted that the underlying purpose of the interest deduction "is difficult to articulate because this provision is extremely broad: there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable." *Id.* at 741.
135. In Estate of Frank Cohen, 29 T.C.M. (CCH) 1221 (1970), the "reasonable expectation of economic profit" requirement was applied to disallow interest deductions in a transaction that actually produced a profit potential. The court said that "the transaction per se was of sufficient substance to avert a finding of sham," *Id.* at 1227, but disallowed the deduction on the ground that the taxpayer "could not have *reasonably* expected the transaction to have an appreciable effect on his beneficial interest." *Id.* at 1228 (emphasis in original).
136. 54 T.C. 1656 (1970).

real estate broker who wanted to sell him income producing property. Collins signed a contract to purchase a one-year-old apartment building. The initial contract was signed by Collins on November 12, 1962, and contained the following terms:

(1) Purchase price: $168,000
(2) Downpayment: $63,000
(3) "Subject to" existing mortgage of $105,000 which:
  (a) bore interest at the rate of 7.2%;
  (b) required monthly debt service of $827;
  (c) had an approximate maturity of twenty years.
(4) Transaction must be closed by December 31, 1962.

After this initial contract was signed, its provisions were reworked by an attorney and an accountant, both working for Collins. The amended and final contract was signed by both buyer and seller and recorded on December 12, 1962. It provided as follows:

(1) Purchase price: $158,000
(2) Downpayment: $19,315
(3) Balance: Note in the amount of $139,485 which:
  (a) bore interest at the rate of 8.4% per annum, payable monthly;
  (b) required a minimum monthly amortization payment of $830;
  (c) approximate maturity: unstated, roughly fourteen years, based on $830 monthly amortization payments.
(4) Seller promises to make the debt service payments on the $105,000 first mortgage.
(5) Seller promises to deliver a deed to buyer when buyer pays off the note. However, buyer has a right to demand a deed sooner by assuming the first mortgage when the balance due under the note to the seller has been reduced to the balance due under the first mortgage.
(6) Buyer promises to prepay five years' interest on the note ($48,299) and seller gives a $4,000 discount for early payment. Therefore, buyer pays $44,299 prepaid interest.
(7) Transaction must be closed by December 31, 1962.

In short, although the final contract provided for a $10,000 smaller purchase price, it gave the seller the same total amount in cash at the closing as did the initial contract. Now, however, instead of the $63,000 cash payment being designated as "downpayment," most of it was designated as interest. Similarly, the annual payments the seller was to receive under the new contract were roughly the same as the debt service payments Collins would have made under the original contract, but which the seller would continue to make to the lender under the new contract. In sum, the dollar amount of Collins' payments, initial and subsequent, remained the same under the new contract; the only difference was that a much larger amount was denominated "interest."

The conversion of "purchase price" into "interest payments" was accomplished by what is often referred to as a wraparound note.[137] A wraparound note, or wraparound mortgage, is essentially a second mortgage that includes in its face amount the amount of the first mortgage. Wraparound notes are typically made at higher rates of interest than the senior mortgage. Thus, for example, consider a borrower who approaches a lender and requests a $100X loan and offers as security for repayment a second mortgage. The borrower tells the lender that the property is encumbered by a first mortgage loan in the amount of $300X that bears interest at the rate of seven percent.[138] The lender may respond with the suggestion that the borrower give the lender a note in the face amount of $400X, which bears interest on that face amount at the rate of eight percent. The lender will advance the borrower only the $100X difference between the face amount of the two notes, but will meet the debt service payments on the $300X, seven percent first mortgage. The lender, consequently, not only makes eight percent on the $100X actually advanced, but also makes money on the fact that it is charging eight percent on the face amount of the seven percent loan it undertook to service.[139] The type of note used in *Collins* required the seller to take more of his "profit" in the form of "interest" rather than in the form of increased sales price. Note that if this were upheld, the seller would be disadvantaged because part of what would have been his capital gain is converted to interest income, taxed at ordinary rates.

Collins arose at a time when it was black letter law that it was permissible for cash method taxpayers to deduct up to five years prepaid interest.[140] The issue was whether Collins could deduct the five years of "interest" he "prepaid." The court held he could not, stating the case was indistinguishable on principle from cases such as *Knetsch* and *Goldstein*. The court determined that the figures in the final contract "were completely arbitrary and fictitious" and explained:

> No true indebtedness was created by the December 12 contract. The installment debt and prepayment of interest provisions in the contract of December 12, 1962, were shams. They were completely devoid of economic substance. The certified public accountant merely juggled the figures that were contained in the earlier offer to buy and its acceptance until he arrived at the same result. He used

137. The term "wraparound" was nowhere used in the court's opinion. Beware legal research devices that boast.

138. The borrower may want to preserve the favorable interest rate on the first mortgage loan or avoid a prepayment penalty on the first mortgage loan, or the borrower may have no choice other than to keep the first mortgage loan outstanding.

139. The situation just described is the one presented in Rev. Rul. 75-99, 1975-1 C.B. 197, in which the wraparound lender was a real estate investment trust (REIT). The ruling, for purposes of the Code's REIT provisions, held that

> the indebtedness between the [REIT] and the borrower giving rise to an obligation to pay interest is not the total amount of the 'wraparound' loan. Although the borrower signs a note for 400X dollars, the [REIT] actually loans the borrower 100X dollars. Payments by the [REIT] on the senior obligation are considered to be made on behalf of the borrower from payments received from the borrower on the 400X dollar note.

Id. (citations omitted).

140. I.T. 3740, 1945 C.B. 109, *revoked by* Rev. Rul. 68-643, 1968-2 C.B. 76.

> other figures to one of which was affixed a label of 'prepaid interest,' but the amount of [Collins'] immediate payments to the sellers was the same. No genuine debt was created to support the so-called 'interest' prepayment.[141]

The court further stated that the fact that the seller reported the amount labeled interest as ordinary income "[was] not significant—especially since he had a large loss that year." It also rejected Collins' argument that because he actually entered into a profit-motivated transaction, the purchase of an apartment building, *Goldstein* was distinguishable. The court stated:

> The transaction we find to be a sham is not the acquisition of the apartment house but the prepayment of interest and the loan agreement. We accept the contention that the motivating factor in the purchase of the apartment house was economic gain. It is the terms used to support the deduction of prepaid interest (the loan agreement) which we consider to be a sham.[142]

B. *Code Section 183: Not For Profit Activities*

In 1974, many people in the real estate industry were shocked when they learned of the following statement in the Security and Exchange Commission's Guide 60 for the Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships:

> G. *Section 183*. The possible impact of this Code section on investors lacking a profit objective in investing in any tax shelter program which is expected to generate annual tax losses for tax purposes for a period of years should be discussed. The discussion should note that the section may apply to the partners of a partnership notwithstanding any profit objective the partnership itself may be deemed to have.[143]

The statement came as a surprise for two reasons. First, although it had been rumored that the Service was considering whether section 183 could be applied to tax shelters, no actual deployment had been officially announced. Second, section 183 seemed an unlikely choice of weapon.

Section 183, introduced by the Tax Reform Act of 1969, is known as the "hobby loss" provision because it was designed to prevent taxpayers from claiming losses from farming and other hobbies. As of 1970, no deductions attributable to any activity "not engaged in for profit" are allowed unless they are authorized by section 183.[144] It limits deductions attributable to activities not engaged in for profit to (1) items deductible without regard to whether the activity is engaged in for profit, such as interest and real estate taxes, and (2) items deductible if the activity were engaged in

141. 54 T.C. at 1663.
142. *Id.* at 1665.
143. Securities Act Release No. 5692, Securities Exchange Act Release No. 12224, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,405.
144. I.R.C. § 183(a) provides:

> In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

for profit, but only to the extent that gross income from the activity for the year exceeds the deductions in category (1).[145] The Regulations, for example, apply the provision to the owner of a beach house who occupies it for one of the three months of the recreational season, and rents it for the other two months.[146] Because the beach house is owned primarily for personal purposes, it is an activity "not engaged in for profit" within the meaning of section 183. The owner is allowed deductions for mortgage interest and real estate taxes without regard to whether owning the beach house is engaged in for profit. Allocation of these expenses between the two uses of the beach house, therefore, is unnecessary. Because no deductions are allowed for personal, living, and family expenses,[147] however, maintenance, utility expense, and depreciation must be allocated between the personal use and the rental use. Two-thirds of these expenses are attributed to the rental use, and are allowed only to the extent the gross income from the house exceeds the deductions available independent of profit purpose; that is, only to the extent gross income exceeds the deductions for real estate taxes and mortgage interest.[148]

Section 183 defines an "activity not engaged in for profit" as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 [trade or business expenses] or under paragraph (1) or (2) of section 212 [expenses for the production of income]."[149] A taxpayer will be presumed to engage in profit activity if a profit resulted in two or more of the five consecutive years ending with the current year.[150] The presumption, however, is rebuttable.[151] On the other hand, no negative inference is to be drawn from the fact that the taxpayer does not qualify for the presumption.[152] In determining whether an activity is engaged in for profit, all the facts are to be taken into account. It is not necessary that the taxpayer have a "reasonable expectation of profit,"[153] but "the facts must indicate that the taxpayer entered into the activity, or

145. *Id.* § 183(b) provides:

> In the case of an activity not engaged in for profit . . . there shall be allowed—
>
> (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

See also Treas. Reg. § 1.183-1(b) (1972).

146. The beach home is used only as an example. The 1976 Act introduced a new I.R.C. § 280A, which disallows certain expenses in connection with business use of a home and the rental of vacation homes.

147. I.R.C. § 262.

148. Treas. Reg. § 1.183-1(d)(3) (1972).

149. I.R.C. § 183(c).

150. *Id.* § 183(d).

151. *Id.* A taxpayer in the earliest years of an activity may postpone a determination whether the presumption applies until he has engaged in the activity for at least five taxable years (seven in the case of horses). *Id.* § 183(e).

152. Treas. Reg. § 1.183-1(c)(1) (1972).

153. *Id.* § 1.183-2(a).

continued the activity, with the objective of making a profit."[154] A "small chance of making a large profit" may be sufficient.[155]

The Regulations list expectation of appreciation in value as one of nine factors normally to be taken into account to determine whether an activity is engaged in for profit:

> The term 'profit' encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of the land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation.[156]

The holding of property for appreciation, however, may be deemed a separate activity from other activity in connection with the property.[157]

In *Jasionowski v. Commissioner*[158] the Tax Court attempted to explain the "somewhat enigmatic language of section 183"[159] and its contribution to existing law. It noted that section 183 builds upon sections 163 and 212, and that prior decisions under those sections are still relevant:

> Although section 183 has clearly placed a gloss on post-1969 judicial profit-motive inquiries, we think pre-1969 case law in this area remains relevant. We say this for two reasons. First, section 183(c) defines an 'activity not engaged in for profit' as an activity with respect to which deductions would not be allowable under section 162 or section 212(1) or (2). Thus, prior cases dealing with profit motive under these sections retain their vitality. Second, the so-called 'relevant factors' set forth in the regulations are themselves derived from prior case law . . . and, therefore, we think such prior law has a role to play in their application.[160]

What, then, is the contribution of section 183? The court answered:

154. *Id.*
155. *Id.*
156. Treas. Reg. § 1.183-2(b) (1972). The other eight factors are whether the activity is carried on in a businesslike manner, the expertise of the taxpayer or his advisors, the time and effort spent by the taxpayer on the activity, success in carrying on other activities, the taxpayer's history of income or losses with respect to the activity, the amount of any occasional profits earned, the presence of substantial income from other sources, and the presence of elements of personal pleasure or recreation.
157. *Id.* § 1.183-1(d)(1):

> Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. . . . If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

158. 66 T.C. 312 (1976).
159. *Id.* at 320.
160. *Id.* at 321-22.

> The legislative history surrounding section 183 indicates that one of the prime motivating factors behind its passage was Congress' desire to create an objective standard to determine whether a taxpayer was carrying on a business for the purpose of realizing a profit or instead was merely attempting to create and utilize losses to offset their income.[161]

The Tax Court did not seem to think that the congressional intent to provide "objective tests to determine subjective intentions" had been very successful. First, it noted that the nine separate factors in the Regulations are not very helpful in dealing with cases that do not involve farming or other hobbies. Second, the "test under section 183 is not whether the taxpayer's intention and expectation of profit is reasonable but rather whether such intention and expectation is bona fide."[162] *Jasionowski* is therefore some authority for the proposition that section 183 precludes the Service from relying on *Goldstein* to require a "reasonable" expectation of economic profit.

Jasionowski is also significant because it disallowed deductions under section 183 despite the presence of a long-term profit objective. The activity in question was a transaction between a doctor and a woman who had been a patient and a friend for twenty years. Her physical condition deteriorated to the point that she became unable to work. In 1965, when she was approximately fifty-five years old, she drew up a will in which she left her residence to the doctor. None of her relatives were still living, and she wanted to repay the doctor for his kindness. By 1968, because of her high medical bills, she could no longer meet the mortgage payments. In order to avoid foreclosure, she deeded the house to the doctor at a time when its fair market value was at least $24,000, subject to a mortgage of $7,700. Contemporaneously, the doctor leased the house back to her for a seven-year term under a lease that required her to pay all taxes, maintenance expenses, utility bills, and insurance premiums in connection with the property. The doctor was to pay the debt service on the mortgage. At the expiration of the seven-year term, she and the doctor were to renegotiate a new lease at terms agreeable to both, which would provide for a net annual rent of five percent on the value of the premises at that time after payment of taxes, utilities, and insurance.[163]

The court said it could not "impute a profit motive to petitioners when they voluntarily entered into a lease agreement under which, for a period of 7 consecutive years, they were bound to incur losses as distinguished from the usual 'start-up' situation where early losses are anticipated but where effort and imagination could turn the venture towards profit rather quickly."[164] The court said that the doctor's substantial income from his medical practice was additional evidence indicating the absence of a profit motive, as was the fact that he had other rental properties that were profit-

161. *Id.* at 321.
162. *Id.*
163. *Id.* at 315.
164. *Id.* at 322.

able. The court was unpersuaded by the argument that his primary intent was to earn lucrative rental income after the expiration of the lease and make capital gains on the eventual sale of the house, stating:

> First, we do not think that any profit motive [the doctor] may have harbored for the period following the lease's expiration can be substituted for [his] intentions during the actual term of the lease. Second, if the anticipation of eventually selling the house were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim.[165]

Accordingly, the doctor was held entitled to the deductions claimed for interest and taxes, but business expense and depreciation deductions were limited to the extent gross income exceeded the deductions for interest and taxes. Since there was no such excess, no business expense and depreciation deductions were allowed.

It is not clear how the Service will attempt to apply section 183 to real estate tax shelters. The only thing that does seem clear is that it has something in mind. Recall that section 183, by its terms, applies only to activities "engaged in by an individual or an electing small business corporation." Neither the statute nor the legislative history refers to the application of section 183 to partnerships. Nevertheless, in late 1977 the Service ruled that section 183 applies to the activities of partnerships.[166] Its rationale was that the taxable income of a partner is to be computed in the same manner as in the case of an individual. It further ruled that "the provisions of section 183 are applied at the partnership level and reflected in the partners distributive shares."[167] The ruling that section 183 applies at the partnership level is not necessarily inconsistent with the suggestion in Guide 60 that section 183 may be imposed at the level of the individual partner. The Service might choose to apply section 183 at both the partnership level and at the level of the individual partner. In the analogous application of the material distortion of income test to prepaid interest, the Service ruled that the test applies at the partnership level.[168] One of the most recent prepaid interest cases, however, declined to state whether a deduction that passes muster at the partnership level might also be examined for distortion at the level of the individual partner.[169]

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165. *Id.* at 323.
166. Rev. Rul. 77-320, 1977-36 I.R.B. 8.
167. *Id.*
168. Rev. Rul. 77-304, 1977-35 I.R.B. 9.
169. Resnik v. Commissioner, 66 T.C. 74 (1976), involved one of thirty cash method limited partnerships that were formed on December 31, 1969, and prepaid four years' and three months' interest on the same date with the capital contributions of the limited partners. Nothing else occurred. The court considered the problem at the partnership level and concluded:

> This is more than a distortion of income; it is 'a distortion of non-income.' . . .
>
> Having found the income of the partnership to be distorted by the prepaid interest deduction it is not necessary for us to see whether the income of petitioner-partner is distorted. We do not decide, whether, under different circumstances, the deduction of prepaid interest by a partnership may not materially distort the income of the partnership but, nevertheless, might dis-

C. *Code Section 446(b): Material Distortion of Income*

Taxpayers are generally free to compute taxable income or loss according to any method of accounting they see fit.[170] Section 446(b) contains the basic caveat that the Service may order the taxpayer to compute income in a different manner if the method the taxpayer chooses "does not clearly reflect income." As discussed above, it was this provision that the Service relied on to rule that cash method taxpayers could not deduct prepayments of interest. When current deduction of the cash payments created a "material distortion of income," taxpayers who otherwise reported according to a cash method were required to report the interest payments according to an accrual method.

Outside the prepaid interest area, the Service has made little use of section 446(b) to challenge real estate transactions, even in cases that appear to beg for its application. *Leslie Co. v. Commissioner*,[171] for example, involved a taxpayer who had set out to obtain a straight mortgage loan to finance the construction of a custom-made factory on a newly acquired site. The lender was an insurance company that insisted that the financing be provided in the form of a sale of the new building to the insurance company with a contemporaneous lease back of the building to the taxpayer. The sale price paid by the insurance company was substantially below the taxpayer's construction cost. On its own books, the taxpayer capitalized the loss and amortized it over the basic thirty-year term of the lease back. For tax purposes, however, the taxpayer claimed a deduction for a loss on the sale of a section 1231 asset.[172] Over the strenuous objection of several dissenting Tax Court judges, the deduction was upheld. The taxpayer was permitted to deduct one-quarter of the cost of its brand-new, custom-made factory in year one, and section 446(b) was not even mentioned.

Although section 446(b) has in the past had little impact in the real estate area, the prepaid interest saga indicates that the Service can change its mind and use section 446(b) more extensively in the future.[173] One recent decision has taken many practitioners by surprise and strongly suggests that the courts will be receptive to a more aggressive use of section 446(b).

> tort the partner's income necessitating an examination for distortion at the partner level.

Id. at 81-82.

170. I.R.C. §§ 446(a), (c).

171. 64 T.C. 247 (1975), *aff'd*, 539 F.2d 943 (3d Cir. 1976).

172. Section 1231 is trade or business property, the "best of both worlds" property for tax purposes. If it is sold at a gain, the gain is capital gain; if it is sold at a loss, the loss is ordinary loss.

173. In 1977, the Service used § 446(b) to challenge a motion picture tax shelter. A production-service limited partnership reported according to the cash method of accounting and deducted the expenditures it made to produce a film. The partnership's production contract with the owner of the film rights gave it a share in the film proceeds up to a fixed maximum. The Service ruled that "the deduction of expenditures in the year incurred which are the cost of acquiring the contract right to share in the film's proceeds in later years results in a substantial distortion of income. These expenses therefore are not currently deductible." Rev. Rul. 77-125, 1977-1 C.B. 130, 131. It required the partnership to write off its expenditures in accordance with an income forecast method of accounting.

Zaninovich v. Commissioner[174] involved a two-person farming partnership that used the cash method of accounting. In October of 1973, the partnership entered into a lease of farm land for a twenty-year period that was to begin December 1, 1973. Rent in the amount of $27,200 per lease year, December 1 through November 30, was payable each December 20. This twelve-month prepayment was in accord with normal farming practice in the area. Pursuant to the lease provision, on December 20, 1973, the partnership paid the rent for the lease year December 1, 1973, to November 30, 1974, and deducted the entire amount in the computation of its 1973 partnership income. The Service disallowed the portion of the deduction attributable to 1974, and the Tax Court upheld the disallowance.

Section 162 authorizes a deduction for ordinary and necessary trade or business expenses, including "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."[175] Although earlier cases had disallowed cash method taxpayers current deductions for prepaid rentals, the partnership sought to distinguish these cases on the ground that they involved prepayments for more than one year, or prepayments that were made prior to the commencement of the lease term. The Tax Court concluded that these were distinctions without differences:

> Regardless of the term, if payment secures possession and use of property for a significant portion of a taxable year other than the year in which payment is made, a deduction is allowed only for that portion of the payment attributable to the year of payment. The determinative factor is the period to which the payment is to apply; in this regard, the date of payment is immaterial.[176]

The court was also unpersuaded by the fact that lessors of farmland in the area insist on having twelve months of rent paid during the first month of a lease year. The court stated: "Such a consideration cannot convert a payment which is in the nature of a capital *expenditure* into an *expense* deductible under section 162(a)(3) . . . . Simply stated, the $27,200 paid as rent was not chicken feed, and we decline petitioners' invitation to treat it as such."[177]

VII. CONCLUSION

Congress has made a clear decision to permit investors in real estate to continue to claim tax losses in excess of amounts they have at risk by including nonrecourse financing in depreciable basis. It has also chosen to leave unchanged the present rules that permit limited partnerships, including limited partnerships in which a thinly capitalized corporation is the

174. 69 T.C. No. 47, 69 T.C. (CCH) 2252 (Jan. 25, 1978).
175. I.R.C. § 162(a)(3).
176. 69 T.C. (CCH) at 2254.
177. *Id.* at 2254-55. The court's "chicken feed" pun was a reference to the fact that the courts have been especially permissive in the area of deductions for prepaid feed expenses. *See generally* Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237 (1967). *But see* Clement v. United States, U.S. Ct. Cl. No. 131-75 (July 14, 1978).

only general partner, to be classified for tax purposes as partnerships rather than as corporations. The Carter administration has recommended to Congress that limited partnerships be classified as corporations for tax purposes if they have in excess of fifteen limited partners.[178] It is probably safe to say that the proposal has no serious chance of success in the Congress. Furthermore, no other legislation limiting real estate tax shelters appears imminent. In the absence of further action by Congress, the Service can, at a minimum, be expected to limit realty shelters to present decisions upholding them. It can be expected to give close scrutiny to the economic substance of transactions, and to particular features of transactions, and to use general principles opposing tax avoidance to disallow all practices that are not now specifically protected by existing authority.

178. President Carter's Tax Proposals, H.R. 12078, § 244 (introduced April 12, 1978).