I. Introduction

The past few years have brought a continued economic slowdown. For many of our clients, the downturn in the economy has resulted in tax losses. The only good thing about seeing a loss in part of a client’s business is that the losses can be used to offset other taxable income for the year - usually.

The Internal Revenue Code places many limitations on the use of losses to offset income. The most important rules - the passive loss rules and the at-risk rules - were designed to defeat abusive tax shelters. Other loss limitation rules, especially those relating to partnerships and S corporations, are inherent in the structure of taxation of those entities. In any case, when using a business loss to offset other income or gain for the year on a return, practitioners must be aware of all these rules.

Generally speaking, CPA’s have a solid grasp on the implications of the loss limitation rules. The purpose of this paper is to highlight several of the most common pitfalls in loss limitations rules - the provisions of the Code and the regulations that seem designed to trip up even the most careful practitioner. It will also point out some good - and several bad - planning strategies to minimize the impact of these rules.

II. Sneaky Sections of the Passive Loss Rules

The Section 469 passive loss rules generally operate by separating income and loss into two separate categories - passive and nonpassive (this paper will generally refer to "nonpassive" items as "active" for ease of reference). The dividing line is generally whether the taxpayer "materially participates" in the activities generating the income or loss, although some activities (notably rental activities) are passive whether or not the taxpayer materially participates.

Passive loss, of course, can only be used to shelter passive income. Active losses can be used to offset any kind of income, including passive income. But some parts of the passive loss rules act to "recharacterize" income and loss - in other words, even if it looks like passive income, walks like passive income, and talks like passive income, it may well be active income. These rules generally cause taxpayers to have less passive income from their profitable passive activities, making it more likely that passive tax losses from other activities will be disallowed.
A. "NOPAs" - Nonshelterable Passive Activities

The most commonly encountered recharacterization rules are found in Regulation § 1.469-2T(f) - the dreaded "NOPAs" or "nonshelterable passive activities". As with most elements of the passive loss rules, the NOPA rules were put in place to counter common tax shelter abuses.

Activities that are NOPAs get the worst of both worlds - losses from these activities are always passive, while gains from these activities are always active. Therefore, when the activity shows a tax loss, it cannot be used to offset the taxpayer’s other active income. When the activity shows taxable income, the income cannot be used to absorb other passive losses. The end result is a classic regulatory whipsaw. At least disallowed passive losses from a NOPA can be carried forward into future tax years and taken against taxable income from the same NOPA in those years (even though that income, for all other purposes, is active and cannot be used to absorb passive losses from other passive activities or NOPAs). There are six varieties of NOPAs.

1. "SIPPAs" - Significant Participation Passive Activities

Before you can determine whether a taxpayer has any "significant participation passive activity", or "SIPPA", problems, you must determine whether a taxpayer has any "significant participation activities", or "SPAs". SPAs are defined in Regulation § 1.469-5T(c). SPAs are activities meeting the following test: (a) trade or business activities, (b) that are not rental activities, (c) in which the taxpayer participates for more than 100 hours, but (d) in which the taxpayer does not materially participate. Generally speaking, a taxpayer is deemed to materially participate in all of her SPA’s if she devotes at least 500 hours to all her SPAs in the aggregate (Regulation § 1.469-5T(a)(4)). If she does, her SPAs are all nonpassive activities, and any losses or income generated are not passive.

The SIPPA trap arises if a taxpayer (a) has SPAs (businesses in which he participates for more than 100 hours), but (b) does not participate for more than 500 hours in all his SPAs in the aggregate. If this is the case, the SPAs are SIPPAs, and are therefore NOPAs (as if this wasn’t confusing enough).

EXAMPLE 1A. Paula works 60 hours in her restaurant, 150 hours in her dry cleaning business, 150 hours in her carpet cleaning business, and 150 hours in her laundromat. The dry cleaners, carpet cleaners, and laundromat are all SPAs, because she worked more than 100 hours in each of them. The restaurant is not an SPA. Aggregating the three SPAs, we see Paula only worked 450 hours. Therefore, the three SPAs are SIPPAs, and are therefore NOPAs. The hours worked in the restaurant are irrelevant - all income or loss from this activity will be passive.

EXAMPLE 1B. Now assume Paula works 100 hours in her restaurant. This makes the restaurant an SPA, but now she has worked for 550 hours in all her SPAs combined. Therefore, all four businesses are not SIPPAs, and so none of them are...
NOPAs. Paula is deemed to materially participate in each business, so all income and loss is active.

EXAMPLE 1C. The SIPPA rules also apply when there is just one SPA. Now assume Paula has a "day job" and owns an interest in a restaurant where she works for 120 hours in the year. The interest in the restaurant is a SIPPAs. All losses will be passive, but any income will be recharacterized as active.

If a taxpayer runs afoul of the SIPPAs trap, all of the income and loss from all SPAs is aggregated. If the SPAs yield net income or gain, then such net income is considered active income. This income is then allocated among the SPAs that produced income, and a proportional amount of the income from each profitable SPA is recharacterized as active income. Of course, because the taxpayer did not meet the material participation test for all of her SPAs in the aggregate, all losses from SPAs are passive losses, and cannot be offset other active income.

EXAMPLE 2. Paraphrasing the example in Regulation § 1.469-2T(f)(iii), assume that Susan owns an interest in three businesses - a dry-cleaning business, a laundromat, and a carpet-cleaning business. She works at the dry-cleaning establishment for 230 hours, at the laundromat for 160 hours, and cleans carpets for 105 hours, in 2002. Because she works more than 100 hours in each, but not more than 500 hours, all three businesses are SPAs. She has no other SPAs. The trap has closed: Susan has worked for less than 500 hours in all of her SPAs combined (495, to be exact), and therefore each SPA becomes a SIPPAs. Her CPA, incensed that Susan went on vacation instead of working for a mere 5 more hours at any of the businesses, must now aggregate all the income and deductions for these SIPPAs businesses.

<table>
<thead>
<tr>
<th></th>
<th>Dry-Cleaning</th>
<th>Laundromat</th>
<th>Carpets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$600</td>
<td>$700</td>
<td>$900</td>
<td>$2,200</td>
</tr>
<tr>
<td>Deductions</td>
<td>(200)</td>
<td>(1,000)</td>
<td>(300)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Net Passive Income</td>
<td>$400</td>
<td>(300)</td>
<td>600</td>
<td></td>
</tr>
</tbody>
</table>

After aggregating the income and deductions, it appears that Susan’s passive gross income items for all her SPAs exceed her aggregate SPA deductions by $700. The $700 of passive gross income is now recharacterized as active income, and allocated among the profitable activities. The income-producing activities yielded $1,000 of income; the recharacterized income is $700.

Under the regulations, Susan’s CPA now divides recharacterized income by the income produced by the profitable activities - 700/1,000 = .7. Now, the income from each activity is multiplied by this fraction to arrive at the portion of income from each profitable passive activity that must be recharacterized as active income.
Doing the calculation for the dry-cleaning business, the CPA arrives at 400 x .7 = 280, and for the carpet cleaners, 600 x .7 = 420. Therefore, $280 of the dry-cleaning income is active income, while $120 remains passive, and $420 of the carpet cleaning income becomes active income, while $180 remains passive. The $300 dollar loss from the laundromat is unaffected - it remains passive. Susan will still have $300 of passive income (from the dry-cleaning and carpet cleaning businesses) to absorb the $300 passive loss from the laundromat. However, no passive income from any of her SPAs will be available to absorb passive losses from other sources.

Now assume that, in addition to these businesses, Susan has an interest in an apartment building (a per se passive rental activity) which generates a $700 tax loss for 2002. If the SIPPAs recharacterization rules didn’t apply to her other businesses, Susan would have enough passive income (from the dry-cleaning and carpet businesses) to absorb all her passive losses (from the apartment building and the laundromat). Because of the recharacterization rules under the SIPPAs regulations, however, Susan has only enough passive income to offset her laundromat losses, and must either find other passive income to absorb the apartment building tax losses or carry them forward to a future year.

The point of the SIPPAs rules is not to disallow passive SIPPAs losses. Instead, they are designed to greatly reduce the amount of passive income from SIPPAs that is available to absorb passive losses from other sources.

What could Susan have done to keep herself out of the SIPPAs trap? If she had consulted her CPA in December of 2002, he could have advised her to work a few more hours in one of her SPAs so she has more than 500 aggregate SPA hours. This would make all of the SPAs active businesses, so that the losses from the laundromat become active instead of passive losses. Of course, this doesn’t help the apartment complex tax losses much.

A better solution would be for Susan to cut back on her hours at the carpet cleaning business. If Susan works less than 100 hours in the carpet cleaning business, the carpet cleaning business is no longer an SPA. Therefore, all the carpet cleaning income would be passive income, which could then be used to absorb most of the apartment complex passive tax loss.

If an activity is not only a SIPPAs, but is also an activity involving the rental of nondepreciable property or equity-financed lending (discussed below), then the total amount of recharacterized income from the activity is limited to the greatest of the amounts recharacterized under any of the three rules. This is designed to prevent duplication.

Any client who has multiple business interests is exposed to the SIPPAs rules. A taxpayer’s tax practitioner will have to reexamine her client’s participation levels for all these activities every year to make sure they don’t run afoul of the NOPAs rules (or at least don’t cause much harm if they do).
Also, from a compliance standpoint, CPAs should impress on their clients the importance of keeping reliable contemporaneous records of the time they devote to their businesses. Not only will they greatly assist the CPA to represent the client effectively in tax planning and return preparation, the records will be invaluable when the IRS auditor arrives. Note that the courts have consistently thrown out self-justifying "records" of participation hours prepared years after the events have taken place!

2. Rentals of Nondepreciable Property

Under the passive loss rules, all income and loss produced by "rental" activities is per se passive. If a taxpayer owns an interest in a "rental activity," and less than 30% of the total unadjusted basis of all the assets held for rent is depreciable, the activity is a NOPA. All net income from the rental activity is recharacterized as active income, but if the activity produces losses, net income remains passive. The rules regarding rentals of nondepreciable property are found in Regulation § 1.469-2T(f)(3).

"Unadjusted basis", for this purpose, is defined as basis as adjusted by Section 1016, but without regard to any Section 1016 adjustment that decreases basis. Section 1016 is the comprehensive Internal Revenue Code section providing for adjustments to basis of property for depreciation, amortization, wear and tear, distributions with respect to stock and partnership interests, and so forth.

Before a practitioner can determine whether an activity is subject to this NOPA rule, she must first determine whether or not the activity is a "rental" activity. There are several regulatory exceptions to the definition of "rental activities", found in Regulation § 1.469-1T(e)(3).

The regulatory example, in Regulation § 1.469-2T(f)(3) describes one potential recharacterization situation a practitioner might encounter under this rule.

EXAMPLE 3. Assume Jeffrey purchases land in 1990 for $300,000 and builds a building for $100,000. He then leases the property to tenants, and the activity does not fit under any of the exceptions to the definition of a rental activity. In 2002, he sells the property for $600,000, recognizing gain on the transaction. Remember, for purposes of this test, depreciation is disregarded - only unadjusted basis is considered. The land is not depreciable, but the building is. However, the unadjusted basis of the depreciable property (the building) is less than 30% of the unadjusted basis of the property as a whole - 100,000/400,000 = 25%. Therefore, all of the gain from the sale of this passive, rental property is active gain.

Another obvious example is the common land lease transaction - the lease of raw land to another party, which then builds a building on the lot.
EXAMPLE 4. The same facts as above, except now a lessee, not Jeffrey, builds a building on Jeffrey’s $300,000 lot for $1,000,000. During the term of the initial land lease, Jeffrey is leasing only the land, a nondepreciable asset. None of the unadjusted basis of the assets rented is depreciable, so the 30% threshold is not met, and all rental income from the land is recharacterized as active income. At the end of the lease, Jeffrey will own the building, but will have no basis in it. If Jeffrey sells the land, all gain will be active gain.

This rule can obviously have serious consequences. Consider, for example, if Jeffrey has $200,000 of passive rental losses from another property for the tax year of the sale of the property in the example. He will not be able to use this loss against the gain from the sale of his rental land. Therefore, when a client sells a piece of rental property, if any portion of the property is nondepreciable the tax practitioners must examine the unadjusted basis to spot the NOPA issue, as well as the adjusted basis they look at to determine how much gain or loss will be recognized.

3. Equity-financed Lending Activities

Under Regulation § 1.469-2T(f)(3), an "equity-financed lending activity" is a trade or business of lending money, in which "the average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year." The regulation includes an anti-avoidance rule, which states that liabilities incurred principally for the purpose of increasing the relevant percentage are disregarded.

If a taxpayer does not materially participate in such an activity, her losses will be passive losses. However, under the NOPA rules, income equal to the lesser of the equity-financed interest income from the activity or the net passive income from the activity for the year will be recharacterized as active income.

The basic purpose of this rule is to insure that a taxpayer will not be able to transform portfolio income (which is not usually considered passive income) into passive income by investing it in a lending activity in which the taxpayer does not materially participate. The idea behind the 80% threshold is to provide a safe harbor - if the lending activity is sufficiently risky, the taxpayer should be allowed the benefit of his investment in the activity and get passive income. If, however, the lending activity is a "sure thing", the taxpayer’s investment should be treated as portfolio income - an active type of income.

There are several definitions that are necessary for an understanding of this type of NOPA. These definitions are set forth clearly in Regulation § 1.469-2T(f)(4).

The most important steps in the analysis of this species of NOPA will be (1) determine whether or not the lending activity is "equity-financed," (2) determine how much "equity-financed income" is passed through to the taxpayer from the activity, and (3) determine the taxpayer’s net
passive income from the activity. Given the anti-avoidance section of the regulation, it seems that there will be little opportunity to avoid the application of this section by restructuring debt. However, a practitioner may be able to adjust the percentages slightly by changing the method of calculating average balances of liabilities and assets - the regulation allows taxpayers to compute such balances on a daily, monthly, or quarterly basis, in the taxpayer’s discretion.

Similarly, there is no anti-avoidance rule with respect to interest-bearing assets. This may enable the taxpayer to sell off assets at the end of the tax year, and then calculate the percentages on a quarterly basis, to produce the desired result. This, of course, has the effect of increasing risk and reassuring the IRS that the taxpayer’s invested money is actually being invested in a real enterprise, rather than being deposited in a secure, portfolio-like environment.

4. Property Rented Incidental to Development Activity.

A. Rationale for the rule. This NOPA rule prevents real estate developers from producing passive income from their development-related activities. In the absence of this rule, developers could purchase property, develop it as part of a development trade or business, and then rent it for a short period before selling it for a gain. If allowed, this would create artificial passive gain from value added to property by the active services of the taxpayer. This would allow, for example, a developer to use her gain from constructing and selling a new office building to absorb her otherwise passive tax losses from her apartment buildings held for rent.

B. General effect of the rule. The rules for this species of NOPA are found in Regulation § 1.469-2(f)(5). This rule is likely to apply whenever a client buys property, improves it, rents it for awhile, and then sells it, and tries to report the gain as passive income. A taxpayer is vulnerable to this rule if the taxpayer (1) owns an interest in rental property, and (2) participates for more than 100 hours in an activity which makes improvements (or performs "enhancement services") to the rental property. If the taxpayer is vulnerable, the taxpayer cannot report gain from the rental property as passive in the year of disposition unless the property is rented or held for rent for 12 months before sale.

EXAMPLE 5. George and Stanley are members of Office, LLC. George owns 80%, Stanley owns 20%. Office, LLC purchases a run-down building containing ten office suites on January 1, 2001. At the time of the purchase, the suites are leased or held for lease by tenants, so the activity is undeniably a rental activity. Office, LLC now hires some contractors to spruce up the building. George and Stanley participate for more than 100 hours in the renovations by meeting with the architect, supervising workers, and so forth. By September 1, 2001, the work is done and Office, LLC begins selling the office suites as condominiums. During the sales period, the suites are rented to tenants. The LLC must hold each suite for rent for 12 months before selling it. If the LLC sells any suite before holding it for rent for 12 months, that suite is a NOPA.
The rule is applied on an item-by-item basis, so each item of rental property can be a separate NOPA. If there is net gain from the activity in the year of disposition, the portion of that gain that arises from NOPA items is treated as active. This NOPA rule only applies in the year of disposition of the item of rental property.

C. Start of the 12-month rental period. Because the taxpayer must hold the property for rent for 12 months before selling it to avoid the application of this rule, it is important to note that there are special rules for when this 12 month period "commences." The 12 month rental period begins (1) when the taxpayer owns an interest in the property, (2) all of the property is rented, held out for rent, or held "in a state of readiness for rental," and (3) no construction or renovation work is left to be done on the property. Significant services related to lease-up can still be performed after the date of "commencement".

EXAMPLE 6. Assume the same facts as above. Renovations are complete on office suite A on September 1, 2001. Renovations continue on office suite B until December 1, 2001. If Office, LLC sells both suites on November 1, 2002, suite B will be a NOPA, but suite A will not.

D. Enhancement. Property has been "enhanced" by the taxpayer if the taxpayer materially or significantly participates in a business, in any tax year, which has conducted services related to the construction, renovation, or lease-up of the property - in other words, if the taxpayer works for more than 100 hours in such an activity. However, if the property was more than 50% leased on the date when the taxpayer acquires an interest, the taxpayer’s services in leasing the property are not considered "enhancement services".

EXAMPLE 7. Assume the same facts as above. Stanley materially participates in the work. George, on the other hand, takes a completely hands-off approach to the renovations. He spends exactly 30 minutes approving the renovation plans before going to Antigua to wait out the stressful construction period (George is allergic to dust). Applying the rules, only Stanley has materially or significantly participated in a business which has performed services related to the renovation of the property. When office suites A and B are sold on November 1, 2002, office suite B is a NOPA, but only with respect to net income passed through to Stanley. Net income and loss passed through to George from either suite remain passive.

EXAMPLE 8. Assume the same facts as above, except Office, LLC hires Stanley's Development, Inc., which is owned by Stanley, to do the renovation work in 2001. Stanley is semi-retired, but still attends board meetings and so forth for more than 100 hours relating to general corporate business. With respect to the renovations to the Office, LLC buildings, Stanley merely approves his foreman's plans and then goes to Antigua with George. Nonetheless, Stanley has still participated for more than 100 hours in the business providing enhancement services. Office Suite B is still a NOPA with respect to Stanley.
There may be an additional trap for the unwary here. A taxpayer has "enhanced" disposition property if she performed development services for that disposition property, "or any other item of property if the basis of the [disposition property] is determined in whole or in part by reference to the basis of such other item of property." Regulation § 1.469-2(f)(5)(i)(C). Translation: if a taxpayer performs enhancement services on Property 1, then trades Property 1 in a 1031 exchange for Property 2, then sells Property 2 (assume the sale doesn’t disqualify the 1031 exchange), the taxpayer is deemed to have performed enhancement services on Property 2. Therefore, Property 2 may be deemed a NOPA and any net income or gain in the year of disposition will be recharacterized - even though the taxpayer never lifted a hammer anywhere near Property 2.

To avoid this exchange trap, CPAs must check the history of not only the property sold by their clients, but also the history of any properties that preceded the disposition property through tax-deferred transactions. Unless the property received in the exchange is held for rent for at least 12 months after the exchange, it may be subject to the NOPA rules. While most commentators agree that the IRS should "tack" the rental period of the previous property, there is no authority for this position as of yet.

EXAMPLE 9. Assume the same facts as above, except that after renovations are complete, Office, LLC holds the building for rent for 11 months. Office, LLC then swaps the building in a 1031 exchange for another office building (Building 2). Building 2 is brand new, needs no renovations, and is completely leased up. Office, LLC holds Building 2 for rental for another 11 months, and then sells it (assume there is no 1031 exchange problem). Building 2 is a NOPA with respect to Stanley, the developer. Why? First, the original building was a NOPA as to Stanley - a rental property on which Stanley performed "enhancement services," and which was held for rental for less than 12 months after the enhancement services were complete. Second, Building 2 was a rental property owned by Stanley and which was held for rental for less than 12 months after Stanley acquired an interest in the building. The basis of Building 2 was determined by reference to that of the original building, because it was received in a 1031 exchange for the original building. Therefore, Stanley’s enhancement services are attributed to Building 2 - even though it has been 22 months since those services were completed, and they were performed on a wholly different property! Any net loss from the rental and sale of the building for the tax year of disposition is passive, but any net gain will be recharacterized as active gain!

E. Date of Disposition Trap. Remember that to avoid the NOPA rule, taxpayers must hold their property for rent for 12 months prior to the date of disposition. There is another important pitfall here (within a NOPA rule already replete with traps for the unwary). The "date of disposition", for purpose of the 12-month rental rule, is the date on which a binding contract for sale or option to sell is executed.
EXAMPLE 10. Assume the same facts as in Example 8 above, except that Office, LLC purchased the run-down office building in January 2000, and it was already full of tenants. Stanley's Development, Inc. immediately begins renovation services, which are completed on August 1, 2000. George and Stanley each participate for more than 100 hours in providing the renovation services. Office, LLC continues collecting rent from the tenants, but enters into a binding contract to sell Suites A and B on July 1, 2001. The closing date is February 2, 2002, and Office, LLC collects rent from the tenants of Suites A and B through January.

The result - the gain from the sale of the suites, and the rental profit for the January rent, is recharacterized as active income for tax year 2002. Even though Office, LLC collected rent on the suites for two years and a month, it only held the suites for rent for purposes of the NOPA rule for 11 months - from August 1, 2000 (the date of completion of his renovation services), through July 1, 2001 (the date the LLC entered into a binding contract to sell the suites).

If the partners' CPA was savvy (and if George and Stanley remembered to ask her for advice before signing the contract), she could have avoided this recharacterization rule by telling George and Stanley not to sign the binding contract until August 2, 2001.

The NOPA rule on rentals incidental to development activities is very tricky. Practitioners must be on their toes to help their developer clients plan their transactions with this rule in mind.

5. Property Rented to a Nonpassive Activity of the Taxpayer

Under Regulation § 1.469-2(f)(6), income is recharacterized as active income for tax year 2002. Even though Office, LLC collected rent on the suites for two years and a month, it only held the suites for rent for purposes of the NOPA rule for 11 months - from August 1, 2000 (the date of completion of his renovation services), through July 1, 2001 (the date the LLC entered into a binding contract to sell the suites).

EXAMPLE 11. Betty Trucker owns a trucking business which hauls watermelons to Oregon in which she materially participates, Trucker’s Trucking, Inc. For insurance purposes in 2001, she forms Trucker’s Trucking Truck Leasing, LLC, and transfers all of the trucks used in her business to the LLC. The LLC leases most of the trucks back to Trucker’s Trucking, Inc., but leases four trucks to an unrelated
business, Shaker’s Movers, Inc. Assume that all income from the rental of the trucks would normally be passive. However, because Betty materially participates in Trucker’s Trucking, Inc., all rental income arising from rentals to Trucker’s Trucking, Inc. is recharacterized as active income. Two trucks were rented to Trucker’s Trucking, Inc. only for the months of January and February, and to Shaker’s Movers, Inc. for the balance of the year. Nonetheless, all the income from the rentals of those trucks is recharacterized. Only the two trucks which were rented to Shaker’s Movers, Inc. for the entire year produce passive income.

While a taxpayer’s material participation in an activity is always attributed to his or her spouse, there is no part of this regulation which affects rentals by any relative other than the spouse of the taxpayer to a business in which the taxpayer materially participates (of course, general tax principles on sham transactions will still apply).

EXAMPLE 12. On January 1, 2002, Betty transfers all of her LLC membership interests in a bona fide sale to her daughter, Jane Trucker. The LLC conducts identical operations in 2002. Jane does not materially participate in Trucker’s Trucking, Inc. in 2002. Jane’s income from the LLC is not recharacterized under the NOPA rules, because Betty’s material participation in Trucker’s Trucking, Inc. is not attributed to Jane.

This rule, of course, was created to prevent taxpayers from creating passive income by spinning off portions of their active businesses into rental activities.

6. Royalties Received by a Pass-through Entity.

Royalties on various types of intellectual property, and the losses from businesses that held the rights to such royalties, are an old and notorious tax shelter. In the good old days of tax shelters, promoters sold interests in companies which owned film negatives, collectibles of various descriptions, master music recordings, and other property. The passive loss rules put paid to those items by making all losses from such activities passive, and the income portfolio income.

However, the IRS recognized that some persons and entities actually are engaged in the business of creating such intellectual property. Thus, if a developer entity incurs certain types of costs or provides certain services in creating the intellectual property, the income will qualify as active income under Regulation § 1.469-2T(c)(3)(iii)(b). In turn, if an owner of such an entity does not materially participate in the business of the entity in any given tax year, the royalties income or loss from the developer entity will be passive income or loss as to that taxpayer.

This creates a potential "reverse" tax shelter. A promoter could have an entity make the proper expenditures and provide the proper services to develop some intellectual property, and then sell equity interests in the entity to investors who need passive income to absorb their passive losses. The IRS, of course, saw this coming, and promulgated Regulation § 1.469-2T(f)(7).
Under the regulation, passive income from a pass-through entity which licenses intangible property is recharacterized as active income, unless the pass-through entity makes certain bona fide expenditures after the taxpayer acquires his interest in the entity. Under the regulation, either (a) expenditures for developing and marketing the intangible property must exceed 50% of the gross royalties from the item of property for the taxable year; or (b) the taxpayer’s share of the development or marketing expenditures reasonably incurred by the development entity, for all taxable years of the entity in which he owned his interest, must exceed 25% of the fair market value of the taxpayer’s interest in the item of property, measured as of the time the taxpayer acquired his interest in the entity.

This test must be applied on an item-by-item basis within each pass-through licensing entity to determine the effects on the owners.

B. Recharacterization of Gain or Loss from Dispositions of Items of Property

Generally speaking, gain or loss on a disposition of property is passive if the property was used or held in a passive activity during the year of the disposition. Similarly, if the property was used or held in a nonpassive activity, the gain or loss will be considered active. The loss or gain from the disposition will be allocated to the activity that held the property when it was sold.

However, there are four major exceptions to this simple rule. These rules may result in either recharacterizing nonpassive income as passive, or in a reallocation of the gain or loss from the disposition to a different activity than the selling entity. This reallocation may result in recharacterization of gain or loss, depending on the nature of the businesses involved. These rules require taxpayers and their advisors to be very careful when transferring property between different activities of the same taxpayer, and require careful examination whenever there is a disposition that produces passive gain.

1. Property Used in More than One Activity.

Under Regulation § 1.469-2T(c)(2)(ii), if an item was used or held for use in more than one activity during the twelve months prior to the disposition, the amount realized and the adjusted basis of the property must be allocated among all the activities in which the property was used "on a basis that reasonably reflects the use of such interest in property during such 12-month period." The regulation provides several examples of what a "reasonable" basis would be. Commentators suggest that an allocation based on the number of days in which the property was used in each activity would almost always be reasonable.

EXAMPLE 13. Carla Computer runs a computer repair business in which she materially participates. She also has interests in several rental activities which are per se passive. For the first three months of 1999, she used a computer to run her accounting software for the repair business. She then transferred the computer to one
of her rental businesses. For the balance of the year, the computer was rented to an accounting firm. At the end of the year, Carla sells the computer for $8,000. Carla allocates 1/4 of the income to her repair business, and 3/4 to the rental business. This is a reasonable allocation under the regulations.

The regulation provides an exception - the gain or loss may all be allocated to one activity, if the property was "predominantly" used in that activity, and if the taxpayer’s interest in the property does not exceed the lesser of $10,000 or 10% of the sum of the fair market values of all property used in the predominant activity immediately before the disposition.

EXAMPLE 14. Assume that the fair market value of all of the property used in Carla’s computer rental business was $500,000. The computer is worth less than $10,000, and less than 10% of the total value of all property. Carla allocates all of the income to the passive rental activity. This is reasonable under the regulations.

2. Disposition of Substantially Appreciated Property Formerly Used in Nonpassive Activity.

Regulation § 1.469-2(c)(2)(iii) may require the recharacterization of passive gain from the disposition of an interest in property owned by a passive activity if the property is "substantially appreciated". The passive gain will be recharacterized as active gain unless the property was used in a passive activity (not necessarily the one which eventually sold the property) for either (a) 20% of the entire period during which the taxpayer held an interest in the property, or (b) 24 consecutive months prior to the disposition. This section is coordinated with the allocation rules of Regulation § 1.469-2T(c)(2)(ii), explained above. Therefore, the "substantially appreciated" rule only applies if the allocation rules allow some portion of the disposition gain to be treated as passive gain.

An interest in property is "substantially appreciated" if its fair market value exceeds 120% of the taxpayer’s adjusted basis in the interest. Therefore, whenever a taxpayer sells a property held by a passive activity at a substantial profit over adjusted basis, practitioners must check to be sure the property has been held by passive activities for the requisite period of time. This rule is especially likely to apply when property is held in businesses in which the taxpayer’s participation level is inconsistent.

EXAMPLE 15. Assume that Carla sells the computer in the example above for $8,000; her adjusted basis was $2,000. The computer was "substantially appreciated" (probably because the basis was greatly reduced by depreciation, while the computer held its value). She allocates all of the income to the passive activity, as above. Because this allocation has produced passive gain, Regulation § 1.469-2(c)(2)(iii) comes into play. Clearly, Carla did not use the computer in a passive activity for 24 consecutive months prior to disposition. Unless the nine months of passive use represents 20% of the entire period for which Carla owned the computer, all the passive gain will be recharacterized as active gain.
EXAMPLE 16. Now assume that the computer was held in the computer repair activity for three years prior to disposition. In Years 1 and 2, Carla materially participated in the business. In Year 3, however, Carla did not materially participate in the business, and it is a passive activity as to Carla in Year 3. Applying the NOPA rule, there is a disposition from a passive activity, and the asset used to be held by a nonpassive activity. The 24-month exception doesn't apply, but the computer was held in the passive business for more than 20% of the total ownership period. The income is not recharacterized.

3. Property Held for Sale to Customers - Sale Incidental to Another Activity.

Regulation § 1.469-2(c)(v) acts to reallocate gain from dispositions of property held in "dealing" activities to "nondealing" activities that previously held the property. The intent of the regulation is to prevent taxpayers from avoiding the passive loss rules by transferring items of property they intend to dispose of at a loss from a passive to a nonpassive activity just before the sale. If taxpayers were allowed to do this, the passive loss rules on dispositions could be entirely avoided by the simple expedient of shifting assets into operating entities before they were sold.

The regulation operates by "tainting" certain properties. Property is "tainted" if it is (a) held by the taxpayer through an activity that holds the property primarily for sale (a "dealing" activity); (b) the taxpayer owns other activities that do not involve holding property for sale ("nondealing" activities); (c) the property was used or held in those activities for more than 80% of the time the taxpayer owned an interest in the property; and (d) the taxpayer did not acquire the property for the primary purpose of selling it in the ordinary course of business.

When the taxpayer disposes of her interest in "tainted" property, the gain or loss from the disposition is not allocated to the "dealing" activity. Rather, it is reallocated to the last "nondealing" activity in which the property was held. If the last "nondealing" use was a passive activity of the taxpayer, the gain or loss will be recharacterized as passive. Clearly, the IRS is primarily concerned that the "nondealing" use will be a per se passive activity, primarily a rental activity.

There are two rebuttable presumptions that operate in favor of the taxpayer in Regulation § 1.469-2(c)(v)(A)(I)(ii). If the taxpayer meets one of the presumptions, the taxpayer will be presumed to have acquired the property with the primary purpose to sell it, or a "dealing purpose" in Regulation-talk. The taxpayer is presumed to have a dealing purpose if (a) the period during which the interest in property was used in nondealing activities does not exceed the lesser of 24 months or 20 percent of the Section 168 recovery period for the property; or (b) the interest in property was simultaneously offered for sale to customers and used in a nondealing activity of the taxpayer for more than 25 percent of the period during which the interest in property was used in nondealing activities of the taxpayer.

If the taxpayer cannot meet either of the rebuttable presumptions, the taxpayer can still prevail by demonstrating intent to sell by all relevant facts and circumstances. Similarly, the IRS
must resort to facts and circumstances to rebut the presumptions if the taxpayer does meet them. Clearly, most taxpayers and practitioners will be more comfortable if they can rely on one of the presumptions and make the IRS rely on facts and circumstances.

The regulations note that "an interest in property is not considered to be offered for sale to customers solely because a lessee of the property has been granted an option to purchase the property."

EXAMPLE 17. Joe Landlord acquires a residential apartment building on January 1, 1993, and uses the building in a rental activity. In January 1986, Joe converts the apartments into condominium units. After the conversion, Joe holds the condominium units for sale to customers in the ordinary course of a trade or business of dealing in condominium units. Assume that Joe materially participates in the dealing activity. In addition, Joe continues to rent the units until they are sold. The units are first held for sale on January 1, 1996, and the last unit is sold on December 31, 1996. To avoid recharacterization, Joe must prove that the condominiums are not "tainted."

Joe is holding the condominiums for sale, and clearly owns another activity which is a nondealing activity. In this case, the apartments were used in Joe’s rental activity for the entire period during which they were held by Joe. Thus, the apartments were used in a nondealing activity for more than 80 percent of Joe's holding period in the property, and the marketing of the property falls within the first three parts of the "taint" test.

Joe must now avoid the taint by proving that he acquired the property with the intent to sell the apartments in the ordinary course of business. Unfortunately, Joe can’t meet either of the rebuttable presumptions. The apartments were used in nondealing activities for more than 24 months, so the first of the rebuttable presumptions described above does not apply. In addition, the apartments were offered for sale to customers for up to 12 months (depending on the month in which the apartment was sold) during the period in which the apartments were used in a nondealing activity. At the most, Joe’s period of using the apartments for both dealing and nondealing activities was 25% - 12 months of simultaneous rentals and sales, divided by a total 48 month holding period. Thus, no apartment was offered for sale to customers during more than 25% of the period in which it was used in nondealing activities, and the second rebuttable presumption does not apply.

Because neither of the rebuttable presumptions applies in this case, Joe is now in the position of relying on the "facts and circumstances" test. There is nothing in the facts to indicate that when he bought the apartments in 1993, he intended to convert them into condominiums. Joe probably does not have a dealing purpose.
Since Joe can’t prove that he had a dealing purpose, all the requirements for "tainted" property are met, and any gain or loss from the sale of the condominiums gets reallocated to the nondealing activity. All gain or loss from the sale of the condominiums is treated as passive activity gross income or loss.

4. Dispositions of Property Rented Incidental to Development Activity

The NOPA rules under Regulation § 1.469-2(f)(5), relating to property rented incidental to a development activity, also act to recharacterize gain from dispositions of property. These rules are explained more thoroughly above. Keep in mind that if the property disposed of falls within the NOPA rule, any rental income for the taxable year of the disposition is recharacterized as active income, in addition to the gain on the disposition. Unlike some of the other disposition rules, loss is not recharacterized under this rule.

C. Determination of Passive Gain or Loss from Dispositions of Equity Interests

Regulation § 1.469-2T(e)(3) governs the treatment of a disposition of an interest in a pass-through entity. When a taxpayer sells or otherwise disposes of an ownership interest in a pass-through entity, all gain or loss on the disposition is tested under the passive loss rules. Testing is not necessary when a taxpayer disposes of C corporation stock, as C corporations are subject to the passive loss rules at the entity level. The gain or loss must be allocated among the activities operated by the pass-through entity.

1. Allocation of Gain or Loss Among Activities

Generally speaking, net gain on a disposition of a pass-through interest is allocated among all activities which produced a gain, while net loss is allocated among all loss producing activities. When there is a net loss, activities which produced a gain are ignored for allocation purposes, and when there is a net gain, loss activities are ignored. However, in the rare situation when a taxpayer disposition of an ownership interest produces a net gain, but all activities of the entity show a book loss, or the converse, then all gain or loss is allocated among all activities in accordance with their fair market values. After allocating the gain or loss to all activities of the entity, the passive loss rules are applied to each activity to determine what portion of the taxpayer’s gain or loss on the overall disposition will be treated as passive gain or loss.

EXAMPLE 18. Juanita Salesman owns 50% of the stock of an S corporation, J-B Sales, Inc. J-B Sales has two "activities" within the meaning of the passive loss rules - one is a car dealership, and the other is land adjacent to the dealership which is rented out as parking space on a monthly basis. Assume the parking lot is a per se passive activity. Juanita materially participates in the car dealership. Juanita’s adjusted basis in her stock is $500. In 2000, Juanita sells her stock for $1,000.
Applying the regulations on dispositions, Juanita’s CPA must examine the activities conducted by the S corporation and allocate the $500 gain among them. The corporation’s adjusted basis in the dealership is $500, and the dealership has a fair market value of $300. The corporation’s adjusted basis in the parking lot is $1,000, and it has a fair market value of $1,700. Since Juanita recognized a gain on the sale, the loss activity is ignored. All of Juanita’s gain is allocated to the parking lot, a separate passive activity. All of Juanita’s gain on her sale of her interest in J-B Sales, Inc. is passive income.

A big trap to watch out for - distributions in excess of basis are "dispositions" subject to this recharacterization rule! This rule applies to any "disposition" of an ownership interest in a pass-through entity. Under Sections 731(a) and 1368(b)(2), a distribution by a partnership to a partner or by an S corporation to a shareholder, respectively, in excess of the owner’s adjusted basis in his ownership interest is treated as gain from the sale or exchange of the interest - in other words, as a disposition subject to this regulation.

EXAMPLE 19. Same facts as above, except that Juanita Salesman does not sell her interest in her S corporation. Instead, she receives a distribution from the corporation of $600 (her adjusted basis in his stock is only $500). The distribution is entirely due to profits of the car dealership. Nonetheless, Juanita’s $100 of distribution in excess of adjusted basis is passive income - it is allocated under the disposition rules only to the parking lot because the dealership is a loss activity.

The regulations do provide a planning opportunity; they allow the entity to make an election regarding the valuation date of the activities. The entity may choose to value its component activities as of (1) the beginning of the taxable year of the entity in which the disposition occurs or (2) the date of the disposition. However, Regulation § 1.469-2T(e)(3)(ii)(D) places certain limits on this flexibility.

The regulation requires the entity to value its activities as of the date immediately preceding the disposition if any of the following occur between the beginning of the tax year of the disposition and the disposition date: (1) the entity disposes of more than 10% of its interest (by value as of the beginning of such taxable year) in any activity; (2) more than 10% of the property (by value as of the beginning of such taxable year) used in any activity of the entity is disposed of; or (3) the disposing shareholder or partner contributes substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the pass-through entity as of the beginning of such taxable year. "Substantially appreciated property" is property with a fair market value in excess of 120% of its adjusted basis, while "substantially depreciated property" has an adjusted basis in excess of 120% of its fair market value.
2. NOPA Rules and Dispositions of Ownership Interests

Just when you thought it was safe to go back into the tax code, the NOPA rules rear their ugly heads again. Under certain circumstances, closely analogous to the NOPA rules, passive gain from dispositions of partnership or S corporation interests may be recharacterized as active gain. These rules are basically extensions of the NOPA rules discussed above. To apply these rules, practitioners must first allocate the gain from the disposition of an ownership interest as described above. Then, each passive gain-producing activity must be tested to determine if falls into one of the recharacterization rules.

To perform the test, the practitioner must first determine how much gain would be recognized if the entity had sold all of the property used in each of the activities which are passive as to the taxpayer disposing of his interest. Next, the practitioner determines how much of the gain from each passive activity would be recharacterized under five specific recharacterization rules if the entity had sold such property (for ease of reference, "theoretical recharacterized gain"). If the theoretical recharacterized amount exceeds 10% of the taxpayer’s gain from the disposition of the ownership interest that is allocable to that particular activity, then an amount of the gain allocated to the activity equal to the theoretical recharacterized gain will be recharacterized as active gain. If the theoretical recharacterized gain does not exceed 10% of the total gain allocable to the activity, then none of the allocated gain will be recharacterized.

The five specific recharacterization rules are:

1. the rules on working interests in oil or gas properties (Regulation § 1.469-2(c)(6)(ii));
2. the substantially appreciated property rule (Regulation § 1.469-2(c)(2)(iii) and II.B.2., above);
3. the NOPA rules for property rented incidental to development activities (Regulation § 1.469-2(f)(5) and II.A.4., above);
4. the NOPA rules for property rented to an activity in which the taxpayer materially participates (Regulation § 1.469-2(f)(6) and II.A.5., above);
5. the NOPA rules relating to interests in pass-through entities with royalties income (Regulation § 1.469-2T(f)(7) and II.A.6., above).

EXAMPLE 20. Let’s go way back to our friends George and Stanley, who bought a run-down office building, renovated it, and sold some of the office suites as condos. Assume all the facts set forth in Example 7, above, are true, except instead of entering into a binding contract to sell two office suites, George and Stanley enter into a binding contract to sell their entire membership interest in Office, LLC. As you will remember, at the time of the sale, the suites are being used in a rental activity. Also assume the following: George and Stanley’s basis in their LLC interests are $500, and they are selling for $2,000; the LLC’s adjusted basis in the office building is $200; and the fair market value of the office building is now $700. Therefore, $500 of George and Stanley’s $1,500 gain on the sale of their LLC membership interests is allocable to the office building.
Applying the rules above, the partners' CPA tests the transaction as if the LLC had sold all of the property used in the office building activity, and applies the "property rented incidental to a development activity" rule. All of Stanley's gain from the theoretical property sale must be recharacterized as active income under this rule. Therefore, 100% of the gain from the sale of Stanley's membership interest that is allocable to the office building activity would be recharacterized in a theoretical property sale. Because 100% is greater than 10%, all of this theoretical recharacterized gain is now actually recharacterized. George's share of the sales proceeds is unaffected.

III. The Section 465 At-Risk Rules - Frequently Overlooked Issues

The "at-risk" loss limitation rules are found in § 465 of the Code. Section 465(a) states that a taxpayer’s deductions from any activity in which the taxpayer owns an interest are limited to the amount for which a taxpayer is "at risk" with respect to that activity. It also specifies which taxpayers are subject to the at-risk rules, and provides that disallowed losses are carried forward.

Section 465(b) contains the rules for determining the amounts for which taxpayers are "at risk." It includes definitions related to qualified nonrecourse financing. Section 465 (c) contains the aggregation rules. Section 465 (c) also contains the rules excluding certain qualified C corporation active businesses and the business of equipment leasing from the application of the at-risk rules, under certain circumstances. Section 465(d) defines the losses that are limited by § 465(a). Section 465(e) provides for recapture when amounts at risk are less than zero.

All individuals, trusts and estates are subject to the at risk rules, although the problem rarely arises with respect to trusts and estates. Closely-held C corporations are also subject to the rules; if five or fewer people own 50% or more of the stock, a C corporation is "closely-held." Full attribution rules apply. Partnerships and S corporations are not subject to the at-risk rules but the rules are applied to partnership or S corporation items at the partner or shareholder level.

Note that there are five "enumerated" at risk activities. The five enumerated activities are any investment in: a film or video tape, an item of §1245 property that is leased or held for leasing, a farm, an oil or gas property, or a geothermal property. The five enumerated activities are still treated differently for some purposes under the rules, however, so if your clients are engaged in any of these activities, be aware that some special rules apply.

The key issue for every taxpayer and practitioner is determining what amounts are "at risk" with respect to each of a taxpayer’s activities. Generally, § 465(b) defines amounts which are at risk. There are four basic ways for a taxpayer to be considered "at risk" with respect to an activity. The taxpayer can always contribute cash or other property or the taxpayer can (1) be personally liable or pledge property as security for debt of the activity, (2) lend money to the activity, or (3) have the activity borrow money in the form of qualified nonrecourse financing. While each of these methods raises its own set of problems, contributions of cash or other property are generally straightforward.
The other three methods of being "at risk", however, each have a few commonly encountered traps and pitfalls.

As a threshold matter, remember that the amount at risk with respect to the taxpayer is tested anew at the end of every tax year. That means that there are some real opportunities for planning under the at risk rules, if practitioners have the opportunity to examine their clients’ situations before year end. With good planning, practitioners can maximize the amount at risk by the end of the tax year, even if the taxpayer’s situation doesn’t look good in November.

1. Borrowed Money for Which Taxpayer is Liable.

If a taxpayer borrows money and then contributes it or uses it in an activity, he is at risk if he is sufficiently personally liable for repayment.

To be personally liable, the taxpayer must not have any right of indemnification or contribution from any other person. In other words, the taxpayer must be the person who is ultimately responsible for repaying the obligation. Furthermore, the taxpayer's obligation to pay cannot be a contingent obligation. *Melvin v. Commissioner*, 88 T.C. 63 (1987), aff'd 894 F.2d 1072 (9th Cir. 1990). These concepts are largely the domain of case law.

There are two important things to remember here: (1) never assume that money borrowed by the taxpayer and contributed to the shareholder’s C or S corporation, LLC, or partnership is at risk without reading all the relevant loan documents and partnership agreements, and (2) never assume that just because the amount of the loan was at risk last year, it is still at risk this year.

**EXAMPLE 21.** Matt owns a 50% interest in Clean Carwashes, Inc. To capitalize the business when it started up in 2000, Matt personally borrowed $50,000 and contributed it to the corporation in exchange for his stock. At year end of 2000, Matt’s CPA knew that Matt was personally liable for the debt, and used it as an at risk amount which absorbed $20,000 in losses. In 2001, therefore, Matt has $30,000 at risk (under § 465(b)(5), at risk amounts are reduced by deductions allowed). In July of 2001, Clean Carwashes, Inc. issues new stock to Allison. Again, Matt is still at risk at the end of 2001, and his CPA deducts $5,000 more in losses. In 2002, Matt has $25,000 at risk. But in May 2002, Matt wants to tie Allison into the business, so they enter into shareholder agreement. Pursuant to some boilerplate language in this agreement, Allison agrees to indemnify Matt for up to 50% of his losses if the bank ever attempts to collect on the debt. At year end 2002, therefore, Matt is at risk for only $12,500. If Matt’s CPA doesn’t read the shareholder agreement, he will not know that Matt has reduced his amount at risk.

If a taxpayer pledges property to secure a loan, she is personally liable to the extent of the fair market value of her interest in the property. However, there is a pitfall here - under Section
465(b)(1)(2)(B), pledged property cannot be property used in the activity for which the taxpayer is seeking at-risk treatment.

EXAMPLE 22. Assume Allison contributed a garage to the business in exchange for her stock. She now personally borrows $50,000 and contributes it to the capital of the business. The bank demands that the loan be secured by the garage. Allison is not at risk for the amount of the loan, because the property is used in the activity for which the taxpayer is seeking at-risk treatment. Now assume that instead of pledging the garage, Allison takes out a $50,000 home equity line. This is a loan secured by property not used in the business, and Allison is at risk.

Not all money borrowed by an owner of an activity and contributed to the business is at risk. Under § 465(b)(3), amounts borrowed from persons who "have an interest" in the activity will not be considered at risk for that activity. However, this rule only applies to the five enumerated at-risk activities mentioned earlier.

Persons "have an interest" if they own equity in the company for tax law purposes. A lender has an interest if they are related to any person who has an interest under the § 267(b) and § 707(b) attribution rules, or under the § 52 "business under common control" rules.

EXAMPLE 23. Assume that instead of a carwash, Allison and Matt are partners in a horse farm (farms are one of the five "enumerated activities"). Now assume that Allison is the horse farmer, while Matt is the capital partner. The farm needs a new barn, but has no money. Matt doesn’t want to increase his capital investment in the farm, so he agrees to loan Allison the money to buy the barn. Allison is not considered at risk for the amount she borrows from Matt, even though she is personally liable and contributed the money to the farm partnership.

2. Qualified Nonrecourse Financing.

Generally speaking, a loan from a third party to an activity is not considered an amount at risk with respect to the owners of the activity unless they are personally liable to repay that debt. However, a third party loan to a business that engages in the activity of holding real property may be included in the at-risk amount for the owners of the business, even if they are not personally liable for repayment, if it is "qualified nonrecourse financing". To be "qualified nonrecourse financing" for purposes of this at-risk inclusion, a loan must meet four requirements, set forth in § 465(b)(6).

(a) The money must be borrowed by the taxpayer with respect to the activity of holding real property.

(b) The funds must be borrowed by the taxpayer from a qualified person or from any Federal, State, or local government or instrumentality thereof.
(c) Subject to certain exceptions, no person (person includes legal entities) may be personally liable for repayment. However, the personal liability of a partnership is generally disregarded, if only partnerships are personally liable, if the partnerships own only real property that secures the loan, and the lender cannot proceed against the personal assets of the partners.

(d) The debt cannot be "convertible debt".

A complete discussion of the ins and outs of qualified nonrecourse financing is beyond the scope of this paper. However, there are two major potential traps for practitioners to watch out for in qualified nonrecourse financing.

A. Incidental property trap. Generally, to be qualified, financing must be secured only by real property that is used in the activity of holding real property. However, Regulation § 1.465-27(b)(2)(i) allows financing that is secured by "incidental" property to be included in the qualified at-risk amount.

"Incidental property" is personal property held in the activity as an "incident" to the holding of real property. For example, a taxpayer may own an interest in an LLC that owns an apartment complex, which is a real property activity. The same entity may own a truck, some golf carts, office furniture, and computers that are used for maintenance, marketing and administrative activities. These items of personal property are "incidental" to the activity of holding real property.

If the loan is secured by property that is not real property nor incidental to real property, however, the entire amount of the nonrecourse financing may be disqualified. This occurs if the non-incidental property exceeds 10% of the aggregate fair market value of all property securing the financing. For example, marketable securities also owned by the apartment complex LLC above are not incidental to the activity of holding real property.

The trap in this section comes in the use of the de minimis 10% rule. If qualified nonrecourse financing is secured by a small amount of non-incidental property, at the end of each year practitioners must check to make sure that the value of that property has not increased relative to the total value of all the property securing the loan. This can happen because the non-incidental property has appreciated, or because other property has been sold, declined in value, or released from the security agreement.

EXAMPLE 24. Jay and Kay each own 50% of Apartments, LLC. In 1998, Apartments, LLC borrows $1,500,000 to buy real estate with a fair market value of $1,500,000. Apartments, LLC uses the money to buy an apartment complex and all of the assets used in its operation. The loan is secured by the real estate and all personal property associated therewith. The bank also demands a security interest in Worldcom stock owned by the LLC with a fair market value of $100,000, as reflected by its share price on a national securities exchange. Assume that any personal liability for the debt by the LLC is disregarded. One of the members of the...
LLC, Jay, has personally guaranteed the debt, but only up to the first $200,000 of loss. In preparing the 1998 return:

(i) The amount guaranteed by Jay is not qualified nonrecourse financing, but the remaining $1,300,000 is.
(ii) The amount of the debt secured by non-incidental property (the Worldcom stock) is less than 10% of the total value of the property securing the loan.

The assets incidental to the operation of the apartment complex (truck, golf cart, computers) are disregarded and don’t affect the analysis. For 1998, assuming the other qualifications are met, $1,300,000 of the loan is qualified nonrecourse financing and is at risk as to the LLC and its members, Jay and Kay.

In 1999, the value of Worldcom stock soars. At the end of the year, the stock securing the loan is worth $400,000. Suddenly, the loan is secured by personal property worth more than 10% of the total fair market value of the property securing the loan. Unless the CPA spots the issue and convinces the bank to release enough stock to get below 10% before year-end, the loan will not be "at risk" for 1999, because it will no longer be qualified nonrecourse financing.

**B. No personal liability trap.** The other major trap in the qualified nonrecourse financing area is the personal liability issue. If any person is personally liable for the debt, the loan is no longer qualified. If a person is liable only for a portion of the debt, the remainder may still be qualified. The point here is that practitioners must check at the end of every year to make sure that nobody is personally liable for the debt.

EXAMPLE 25. Same facts as above, but fast forward to 2002. The "greater than 10% problem" has been solved by the catastrophic bankruptcy of Worldcom, as the stock is now essentially worthless. However, the bank now gets nervous that its collateral is deteriorating. It demands that Jay personally guarantee the entire amount of the note. If Jay does, the note will no longer be qualified nonrecourse financing, and will no longer be "at risk" as to Kay. Furthermore, because Jay has the right to reimbursement by the LLC, and doesn’t bear the ultimate liability on the note, Jay is no longer at risk, either.

Partnerships may be allowed to be personally liable for debt under certain circumstances without disqualifying the financing. The test for these "disregarded partnerships" is set forth in Regulation § 1.469-27.

### 3. Lending Money to the Activity, and Guaranteeing Activity Debt.

Owners can be at risk for amounts that they personally loan to the activity (as opposed to contributions to capital). In most situations commonly encountered by practitioners, these loans will
be made by a shareholder or partner to her S corporation or partnership. There are several potential traps in the at risk rules with respect to such loans.

Shareholders and partners also regularly guarantee the debt of their corporations and partnerships. The business owners certainly feel that they are "at risk" on these guarantees, but whether they are under the tax laws is a whole different subject.

As a threshold matter, remember that amounts are never at risk if the taxpayer is protected from loss by any side agreement, right of contribution, stop-loss agreement, and so forth, under Section 465(b)(4). Such arrangements may not be immediately obvious - you may have to carefully quiz your client to make sure there are none of them out there.

A. Partnerships.

1. Loans to the Partnership. If a partner lends money to her general partnership, she is at risk only to the extent of her pro rata share of the debt. If she waives her rights to enforce the debt against the general partners, she will be at risk for the entire amount of the debt. Note that, in the case of an LLC, the lending member usually has no right of contribution against the other members, and so the lending member should be at risk and receive basis for the entire amount of the debt. However, this state law rule can be changed by the LLC operating agreement. Furthermore, if other partners guarantee or otherwise agree to contribute to repaying the lending partner, this also reduces the amount of the loan included in the lending partner's at-risk amount. Such guarantees mean that the lending partner is no longer "at risk" solely with respect to the success or failure of the activities of the partnership.

The potential trap here is often set for us by our clients. Before assuming a member is at risk for the full amount of money loaned to an LLC or partnership, practitioners must read the operating agreement or partnership agreement, and look for any outside guarantees, stop-loss agreements, or other indemnification-type agreements.

EXAMPLE 26. Sammy and Cliff are equal partners in a general partnership which owns a nightclub. Sammy loans the nightclub $50,000 to install a new music system. Under state law, both general partners are equally liable for partnership debt. Therefore, Sammy is at risk only for $25,000 of the debt. Because this is a general partnership, Cliff is at risk for his half of the debt as well. If, in the promissory note documenting the loan, Sammy agrees that he may seek recourse only against the partnership assets, and in an agreement between the partners Sammy waives all rights of indemnification or contribution by Cliff, Sammy is at risk for all $50,000.

EXAMPLE 27. Now assume that Sammy and Cliff own 50% interests in Nightclub, LLC, which owns the nightclub property. Sammy makes the same loan to the LLC. Under state law, creditors of the LLC may only proceed against the assets of the LLC.
In this situation, Cliff is not at risk for any portion of the debt. Sammy is at risk for the entire amount.

EXAMPLE 28. Same facts as above. The loan was made to Nightclub, LLC in 1999. In 2000, Sammy and Cliff admit a new partner, Normie. They have their lawyer draft a new operating agreement. It contains a provision which states that all three members agree to be personally liable for their proportional share of the "Sammy Note". Now, Sammy is no longer at risk for the full amount of the note - he is at risk only for 1/3 of the outstanding amount. Normie and Cliff probably have a state law right to be reimbursed by the LLC if the guarantee is enforced. Therefore, they are not at risk for the amounts they guaranteed.

The upshot is that before reporting deductions against amounts at risk with respect to a pass-through activity, practitioners must make sure no new agreements have been entered into in the past year. Practitioners must always read the governing documents for partnerships and S corporations very carefully - a boilerplate provision meant to protect one party or another (not necessarily the practitioner’s client) may mean that a loan amount is not fully at risk.

2. Guarantees of Partnership Debt. A guarantor of partnership debt is not generally "at risk" for that debt for tax purposes, because in most cases the guarantor, if forced to make good on the guarantee, will have the right to force other partners to contribute or to force the partnership, as primary obligor, to indemnify his losses. As with other aspects of the at-risk rules, a guarantor of partnership is only at risk for the amount of the debt for which he is ultimately liable. Melvin v. Commissioner, 88 TC 63 (1987), Abramson vs. Commissioner, 86 TC 360 (1986), Prop. Regs. § 1.465-6(b), 1.465-24(a)(2).

What this means, again, is that a tax return preparer must carefully examine all the relevant documents before assuming a guaranteed amount is at risk. In most cases, the loan documents, partnership agreement, or state law provide that a guarantor of partnership debt has a right of contribution from other partners, indemnification from the partnership, or some other liability-limiting rights. For a partner to be at risk for guaranteed partnership debt, all the debt must be structured very carefully from the outset.

EXAMPLE 29. Jenny, Sarah, and Zoe are members of Hardcore Hockey Equipment, LLC. The LLC borrows $100,000 from a bank. The bank requires all three members to personally guarantee the debt. The three members structure a joint guarantee agreement, which provides that each of them is individually liable for repaying the entire amount of the debt if the LLC doesn’t pay. The agreement releases the LLC from any obligation to indemnify them if they have to make good on the debt, and they agree that they have no right of contribution against any of the other members. Under these circumstances, each of the members is at risk for the full amount of the debt. Abramson v. Commissioner, 86 T.C. 360 (1986).
EXAMPLE 30. Assume the same facts as above, except Jenny, Sarah, and Zoe leave out one step. They waived all their rights to contribution from each other, but neglected to waive their rights, provided by the LLC statute in the state, to be reimbursed by the LLC for paying LLC obligations. In this situation, the members are not at risk for any portion of the LLC debt. *Bjerke v. U.S.*, 677 F. Supp. 633 (D.N.D. 1987).

It is very difficult for a partner to be at risk for guarantying partnership debt. The very complex debt structure entered into in the *Abramson* case, as illustrated above, accomplishes the goal, but in most cases this will be a case of the at-risk tail wagging the business deal dog. Most practitioners would rather find another way to create at-risk amounts rather than allow their clients to execute an agreement signing away all their legal protections and accepting absolute liability on business debt.

3. Partnership Basis vs. At-Risk Amount. A potential trap for the unwary is the fact that partnership basis and at-risk amounts, while conceptually similar, are not identical. If a practitioner relies on one of these amounts when taking deductions on the return, without considering the other, she and her client could be in for a rude surprise from Uncle Sam. There are three major traps that may cause a partner's at-risk amount to be substantially less than his partnership basis:

(1) While partnership basis takes nonrecourse debt to third parties into account, the amount at risk includes only "qualified nonrecourse financing".

(2) Partnership basis can be increased by debt owed to related parties. Related party debt cannot be "at risk" if the partnership is engaged in one of the five activities listed in § 465(c)(2)(A) (farms, oil and gas properties, geothermal activities, films or videos, and leased § 1245 property).

(3) If there is any type of stop-loss arrangement, guarantee, or other arrangement or agreement, the amounts of the partner's money protected thereby is not "at risk," although it may well be included in partnership basis.

B. S Corporations.

1. Loans to the S Corporation. Under state law, a creditor of a corporation may only proceed against the assets of the corporation, not its shareholders. Therefore, a loan from a shareholder to an S corporation is only at risk if the lending shareholder is the sole shareholder of the corporation. If there is more than one shareholder, however, the shareholder loan to the S corporation is not an amount at risk, because the corporation is the party ultimately at risk for the repayment, not any of the shareholders. However, if a shareholder personally borrows money and then lends it or contributes it to his S corporation (a "back-to-back loan"), the shareholder is at risk for the amount borrowed, absent any indemnification or stop-loss agreement.

2. Guarantees of S Corporation Debt. There is very little available authority on whether personal guarantees of S corporation debt place the guarantor "at risk." The courts have determined
that such guarantees do not increase the basis of S corporation stock. However, if the guarantor bears the ultimate risk of loss for the guaranteed amount (i.e., there are no rights of contribution or reimbursement from the corporation or other shareholders) the guarantor should be able to treat some portion of the guaranteed amount as "at risk." In the absence of some authority, however, this may be an aggressive return position. Of course, if the shareholder does not have sufficient basis in her S corporation stock to absorb the loss, the question of whether the guarantee provides an amount at risk is academic, at least for that tax year.

IV. S Corporation Basis Limitations on Recognition of Losses

A. Introduction

Most CPAs are already familiar with the basic mechanics of S corporation basis adjustments; therefore, this paper will not restate the basic ordering and basis adjustment rules. Instead, we will focus on what to do if a client’s basis in her S corporation stock is insufficient to absorb the losses for the year.

There are several ways to create basis in S corporation stock. Not all of them are appropriate for each client, and there are a few pitfalls in this area of which practitioners should be aware. Generally speaking, the important thing to remember in creating S corporation basis is that the courts and the IRS have clearly decided that there is no such thing as a free lunch. Shareholders will not receive basis without making some kind of economic contribution to their S corporations.

When dealing with pass-through losses from an S corporation, practitioners must keep in mind that the first limitation on recognition of losses is the S corporation basis limitation. If there is sufficient basis to deduct a loss, the practitioner then determines if the shareholder is at risk under the § 465 rules; finally, if the shareholder is sufficiently "at risk" to deduct the loss, the § 469 passive loss rules are applied to determine whether the shareholder is materially participating in the activity, or if some exception applies.

B. Basis in S Corporation Indebtedness to Shareholders

There are two basic ways for shareholders to increase their basis in their S corporations - contributing money or lending money to the corporation. The shareholder’s initial basis in a loan to an S corporation is the face amount of the loan. Basis in the debt decreases as payments of principal are made, and S corporation losses can be deducted against the note basis. If note basis is decreased by S corporation operating losses which are passed through to the shareholder, net S corporation income for subsequent taxable years replenishes the note basis before increasing stock basis.

The usual ordering rules apply - in other words, basis is first increased for income, then decreased for distributions, then decreased for deductions. Any net income remaining after the decreases in basis for distributions and deductions will be added back to the basis in the note until
the basis has been replaced, and then to the shareholder’s stock basis. Therefore, even if a shareholder has little or no basis in her stock or her notes to the S corporation, distributions may still be made tax free.

EXAMPLE 31. Coolers, Inc., an S corporation, is wholly owned by Beatrice. Beatrice’s has a basis of $0 in her Coolers, Inc. stock. In addition, Beatrice has made one loan to Coolers, Inc., and has deducted losses against the note basis, so that the note also has a basis of $0. During the tax year, Coolers, Inc. incurs $60,000 in income items and $30,000 in deduction items, for a net income of $30,000, and makes a $28,000 distribution to Beatrice. Therefore, the net of income, deduction and distribution items is $2,000. Under Regulation § 1.1367-2(c)(1), $28,000 of the basis increase is allocated to stock basis. Stock basis is then offset by the $28,000 distribution. The remaining $2,000 in basis increase is allocated to the debt.

Despite the taxpayer favorable ordering rules (effective for post-1996 tax years), S corporation shareholders whose corporations have continued tax losses may face a situation in which they have insufficient basis in either their stock or their notes to deduct losses. Furthermore, if an S corporation repays a note in which the shareholder has basis less than the outstanding principal amount, the shareholder must recognize gain on the note. Again, in this situation the ordering rules are favorable to the taxpayer, because for each taxable year basis in stock and notes is increased for income items before the repayment of the note is considered.

C. Creating Basis in S Corporation Stock and Indebtedness

1. Direct Contributions and Loans. The two most obvious ways for an S corporation shareholder to create basis in stock is for the shareholder to contribute more money to the capital of the corporation or to directly loan money to the corporation and take back a promissory note. Basis is adjusted upwards for these amounts under § 1366(d)(1). When tax practitioners perform projections in November and December, they can assess whether or not their clients have sufficient S corporation basis to absorb the projected tax losses. If the projections indicate insufficient basis, taxpayers who have sufficient liquid funds can contribute or loan money to increase their basis. Remember, however, that unless a lending shareholder is the sole shareholder of an S corp or the loan is a "back-to-back" loan, he will not be "at risk" for loans to the S corporation.

2. "Back-to-Back" Loans. One of the best ways to create S corporation basis and "at risk" amounts without a current cash expenditure by the shareholder is to perform a "back-to-back" loan. In this situation, the shareholder borrows money from a third party and then loans the money to her S corporation. The shareholder will have basis in her stock to the extent of the outstanding principal amount of the loan. As long as the shareholder remains personally liable on the debt to the third party, she will also be "at risk."

Compare this result to that obtained by having the corporation borrow money directly. In most closely-held businesses, the lender will require the shareholders to personally guarantee the
loans in any case. It is clear, however, that until an S corporation shareholder actually pays money to the lender pursuant to a guarantee, the guarantee creates no basis in the S corporation and is not an amount at risk under the § 465 rules.

Therefore, if an S corporation is planning to borrow money for expansion, operating capital, or for other reasons, the tax advisors for the shareholders should carefully consider whether a back-to-back loan is more appropriate. If the shareholders must personally guarantee the planned indebtedness in any case, the practical effect of having the shareholders borrow the funds directly is much the same and creates a much better tax result.

That being said, the IRS and the courts will not allow taxpayers to be too "creative" in structuring loans for the purpose of creating basis. The three key rules in the context of shareholder loans to S corporations are (1) for a shareholder to claim increased basis, there must be an "actual economic outlay" by the shareholder; (2) corporate indebtedness purporting to increase basis must run directly to the shareholder (indebtedness of an S corporation to a passthrough entity which is closely related to the shareholder does not satisfy this requirement); and (3) taxpayers are bound by the form of the transaction they have chosen and may not recast it in hindsight for tax advantage.

Careful readers will note that rule number 1 basically says that substance will control, while rule number 3 says that form will control. Two cases on S corporation basis issued earlier this year demonstrate that the government has the option of using either the form or the substance of a transaction against the taxpayer, at its discretion. Furthermore, one of the cases indicates that when using back-to-back loans, the taxpayer may be required to borrow the money that he intends to lend to his S corporation from a third-party lender, not an entity controlled by the taxpayer.

In Thomas v. Commissioner, T.C. Memo 2002-108, 83 T.C.M. 1576 (April 30, 2002), the tax court found that the taxpayer was bound by the form of the transactions he had chosen, and ignored the taxpayer’s arguments that the substance of the transactions increased his basis in an S corporation. In Thomas, several persons and entities, including the taxpayer’s brother, several S corporations, and one C corporation, advanced and loaned funds back and forth between several of the corporations. The taxpayer-shareholder claimed losses arising from operations of the S corporations, which the IRS challenged on the basis that the taxpayer had insufficient basis to deduct the losses.

The transfers of funds between the entities were documented in a variety of ways, but the court found that there was no credible evidence to establish that any of the loans or transfers were made directly from the taxpayer to the S corporation. The court held that in order for a shareholder to get increased basis for amounts loaned or contributed to an S corporation from other entities, the shareholder must prove (1) that the shareholder made the "actual economic outlay," and (2) that the other entities were merely agents assisting the shareholder to loan or contribute the money.

The Thomas case presents a very common situation. A taxpayer owns interests in two or more entities. He wants to create basis in one of them, but his available cash is tied up in the other.
Therefore, the taxpayer needs to get cash out of one entity and into the other, but perform the transaction so that he can prove that he made the actual economic outlay. Let’s look at two examples from *Thomas* demonstrating how the taxpayer did this wrong.

**EXAMPLE 32.** In one particular example from the case, Company X wrote a $200,000 check to the taxpayer. The taxpayer deposited the check in the account of Company Y, a C corporation. Company Y then wrote a check to Company Z for $200,000. The court refused to recognize Company Y as the taxpayer’s agent in transferring the money to Company Z, stating that the taxpayer "can offer no reasonable explanation why we should not respect the form of this transaction" and "petitioners selected the form of the funds flow and are bound by the form they selected."

In this situation, the taxpayer was unable to prove that he made the actual economic outlay of $200,000 to Company Z. The Tax Court was apparently unable to get past the fact that the taxpayer deposited the check from Company X in the account of Company Y. Clearly, if the taxpayer had simply cashed the check and then contributed the money to Company Z, there would be no question that the taxpayer made the actual economic outlay and was entitled to additional basis.

Perhaps the taxpayer really needed Company Y to hold onto the money for a few days or hours to cover an immediate cashflow situation. If so, the taxpayer should have produced some evidence that the money held by Company Y and then forwarded to Company Z belonged to the taxpayer, and Company Y was merely a depository or conduit. For example, the taxpayer could have had Company Y execute a corporate resolution to that effect. It might also have helped if Company Z had executed a promissory note to the taxpayer, thus demonstrating that the money came from the taxpayer, not from Company Y. This might have helped to support the argument that Company Y merely advanced the taxpayer’s funds as his agent.

**EXAMPLE 33.** In another example, the taxpayer’s brother wrote a $100,000 check to Company Z. On the same day, Company T reimbursed the brother, and Company Z executed a promissory note for $100,000 to the taxpayer. The brother testified that he considered the reimbursement from Company T as coming from the taxpayer. Nonetheless, the court stated that the taxpayer had not proven that the payment was an economic outlay by the taxpayer or a direct debt from Company Z to the taxpayer.

In this example, the taxpayer had no proof (other than his brother’s testimony) that the reimbursement from Company T to his brother actually came from the taxpayer. He already has a promissory note from Company Z showing that an obligation runs from Company Z to him. Now he must prove that he made the actual economic outlay for that obligation.
There are two ways that the taxpayer could have structured this transfer to give himself a better chance of getting basis in Company Z. First, he could have simply left Company T out of the deal and reimbursed his brother himself. This would support the argument that his brother was merely his agent in making the loan to Company Z. Second, if Company T is a necessary party, the taxpayer must produce some evidence that the money that came from Company T to the brother actually came from the taxpayer. For example, he could execute a promissory note to Company T. Then he could argue that, in substance, he performed a back-to-back loan by borrowing money from Company T and loaning it to Company Z.

The lesson of Thomas is that it is difficult for inter-company loans and advances to give rise to basis for a taxpayer. Such transactions must be documented very carefully.

In any case, the Tax Court is clearly suspicious of these types of transactions. If a taxpayer seeks to create basis through back-to-back loans, a far better approach is to borrow the funds directly from an independent lender, and then loan them directly to the S corporation. This point is even more clearly demonstrated by the Oren case.

In the other 2002 case, Oren v. Commissioner, T.C. Memo 2002-172, 84 T. C.M. 50 (July 19, 2002), the tax court agreed with the IRS and looked through the form of the transaction to its substance, rather than allowing the taxpayer’s form to control. In Oren, the intercompany loans were perfectly circular, and were undertaken at the advice of the taxpayer’s tax advisors for the express purpose of increasing basis in two different S corporations. The S corporations, which owned large fleets of tractor-trailers, had significant depreciation deductions which would be deferred because of the taxpayer’s low basis in the S corporation stock.

The taxpayer, for example, loaned $5,000,000 to Company A, which loaned $5,000,000 to Company B, which loaned $5,000,000 to the taxpayer. The money was transferred between the parties by wire transfer, and proper demand promissory notes were contemporaneously executed. Interest was apparently paid on the notes, and generally all or most of the proper formalities were followed. Furthermore, the loan documents for the credit facility under which all of the taxpayer’s entities operated specified that no distributions or loans could be made from the companies to the taxpayer unless the taxpayer contributed or loaned an equal amount of money to another of the companies (this language was apparently inserted into the loan documents in contemplation of the circular transactions). Several identical circular transactions involving millions of dollars were carried out.

The court dismissed the taxpayer’s arguments that the loans were bona fide, and that the taxpayer’s "personal economic wealth was changed significantly as a result of the loan transactions since he was personally indebted to [Company B] for repayment of the loan proceeds." The taxpayer also argued that "economic outlay" was only necessary in the context of shareholder guarantees of corporate debt, not in direct loan situations. The court disagreed, stating that the taxpayer failed to show that the deductions were "based on some transaction which when fully consummated left the
taxpayer poorer in a material sense" (quoting Perry v. Commissioner, 54 T.C. 1293, 1296 (1970).

It is difficult to see what further "formalities" the taxpayer in Oren could have followed to shore up his argument that there was an actual economic outlay of cash. The court, while discussing the case in terms of the economic outlay doctrine, was clearly disturbed by the circular structure of the transaction. The Tax Court could have reached the same result by analyzing the deal on sham transaction principles. Based on Oren, practitioners cannot advise their clients to undertake such circular transactions.

The Oren court also called into question the validity of the entire concept of back-to-back loans using controlled entities, and held as a matter of law that in back-to-back loan situations, "a third-party lender is generally required". In back-to-back loan situations where the taxpayer is the controlling shareholder of the entity that loans the money to the taxpayer, the court stated that the taxpayer "must overcome 'a heavy burden' and demonstrate that the loans [are] bona fide and [have] 'economic impact'" (quoting Bergman v. U.S., 174 F.3d 928 (8th Cir. 1999)). The Oren court found that there was no realistic possibility of the notes ever being enforced against the taxpayer.


Another option for creating basis is appropriate when an S corporation is already indebted to a third party, with attendant shareholder guarantees. If the shareholders’ tax advisors see that they will have insufficient basis in the corporate stock to absorb losses for the tax year, the shareholders may be able to convince the bank to release the corporation from the indebtedness and make the loans to the shareholders personally. This must be done very carefully, however; form is as important as substance in this transaction.

Gilday v. Commissioner, 43 T.C.M. 1295 (1982) provides a blueprint for this type of transaction. First, the shareholders arrange to borrow money from the corporate lender on terms similar to the corporate debt. The shareholders lend the borrowed funds to the S corporation on the same terms (a back-to-back loan). The corporation then uses the funds to pay off the corporate debt to the lender. This technique creates a direct indebtedness between the corporation and the shareholders.

The shareholder must remain personally liable on the loan so that there is a potential economic risk of loss for the shareholder. If the loan to the shareholders is nonrecourse and is secured by corporate assets or the shareholder's stock, the transaction will not give rise to basis, nor will the loan amounts be considered amounts at risk. However, in one private letter ruling, the IRS allowed shareholders to increase their S corporation basis by the amount of a substituted loan, even though the loan was still collateralized by corporate assets. The shareholders borrowed money from the bank holding debt of their corporation, then loaned the money to their corporation. The S corporation used the funds to pay off its bank debt. The loan from the bank to the shareholders would be secured by the shareholders' stock and the corporate assets.
The ruling stated that this back-to-back loan would increase basis, and would also be an amount at risk. The shareholders were at risk because they were personally liable on the loan under § 465(b)(2)(A). Practitioners relying on this private letter ruling should proceed with caution, and follow the form outlined in the ruling carefully.

4. Shareholder Payments on Corporate Debt. Another option for creating basis where corporate debt is secured by shareholder guarantees is for the shareholders to simply make payments on the debt to the third party lender. Once a taxpayer has made an actual economic outlay on a guaranteed debt, the taxpayer is deemed to have basis in the S corporation and to be at risk under the § 465 rules. Payments on guaranteed debt generally place the guarantor in the shoes of the lender, creating a direct obligation from the corporation to the shareholder. If "emergency basis" is needed, this type of transaction can be accomplished and documented more quickly than a complete overhaul of the corporate debt structure.

EXAMPLE 34. Fred is the majority owner of an S corporation, Fred’s Deadhead Memorabilia, Inc. Fred’s basis in the stock is $0. In tax year 1999, the corporation has $100 in operating losses to be passed through to Fred. It is indebted to a bank, and $200 of payments on the debt are due in 1999. Fred has guaranteed the loan. If the corporation makes the payments, Fred will be unable to deduct any losses from the corporation for 1999. If, instead, Fred pays the bank, his basis in the stock will increase to $200. It will then be decreased by the $100 operating loss, which he will be able to deduct against other income. At the end of the year, Fred will have $100 in basis in his stock, due to the debt the corporation owes him because he paid the bank, and a $100 deductible loss.

V. Basis Limitations on Partnership Losses

A. Introduction.

Just as with S corporations, the primary limitation on owner-level deductions of passed-through partnership losses is the basis of the partner in his partnership interest (often referred to as "outside basis"). When a partner seeks to deduct partnership losses, she (or, more often, her CPA) must determine whether or not she has sufficient basis in her partnership interest to absorb the loss. If so, the loss can be deducted, subject to the application of the at risk and passive loss rules, as explained above.

A partner’s basis in her partnership interest is calculated and tracked separately from the basis of the partnership in its property (often referred to as "inside basis"). It must also be maintained separately from the partners’ capital accounts, which track the partners’ economic interest in the partnership. Thus, in partnership taxation, practitioners must in essence keep two sets of books - one for tax, and the other for economics. Of course, no paper discussing partnership tax would be complete without the obligatory reference to the "third set of books - the one your clients don’t tell you about!"
Now that joke is out of the way, let us consider the sections of the tax code that must be considered in calculating outside basis. Under § 722, the basis of the partnership interest is the amount of cash and the adjusted basis of property contributed to the partnership in exchange for a partnership interest. Generally speaking, under § 721, this is a tax-free transaction, unless the contributing partner has debt in excess of his basis in the contributed property, and the partnership assumes the debt upon contribution. If this is the case, the new partner’s basis in his partnership interest will be zero because it is reduced by the amount of debt assumed by the partnership, and the partner will recognize gain from the deemed distribution of cash in reduction of debt in excess of basis.

Interests acquired by gift, from a decedent, or by purchase from a partner, the general basis rules of §§ 1011 through 1016 apply. Gifted partnership interests have a carryover basis, inherited interests have a stepped-up, fair market value basis, and purchases interests have a basis equal to the purchase price.

Outside basis is adjusted after acquisition by items passed through to the partner from partnership operations, under § 705. The partner’s basis in his partnership interest is increased by the partner’s distributive share for the taxable year of taxable income of the partnership, tax exempt income of the partnership, and certain depletion items. A partner’s outside basis is decreased, but not below zero, by the partner’s distributive share of losses of the partnership. Basis is also decreased by items that cannot be deducted by the partnership in computing taxable income, and by items not chargeable to the capital account.

Section 732 provides that a partner’s basis in the partnership is decreased, but not below zero, by distributions of cash and other property.

Finally, and most importantly for purposes of this paper, a partner’s basis in the partnership is increased or decreased based on a partner’s share of any increase or decrease of partnership liabilities pursuant to § 752. Exactly how this is done is the subject of numerous regulations.

Because partnership basis is the primary limiting factor on deductibility of partnership losses, tax planners will often be faced with situations in which their clients have insufficient basis in their partnerships to absorb all their losses. Thus, as with S corporations, it is often necessary to find a way to increase partners’ basis in their partnership interests. Of course, the simple expedient of contributing more capital to the partnership will always increase basis.

In S corporations, the treatment of corporate liabilities is relatively straightforward - shareholders get no basis with respect to corporate liabilities except when they loan money to the corporation or make an economic outlay in payment of corporate debt. In partnership taxation, however, the effect of partnership liabilities on partners’ outside basis is very different. Partnership debt is generally a tax planner’s most effective tool in creating basis.
B. Effect of Liabilities on Outside Basis.

Section 752 treats any increase in a partner’s share of partnership liabilities as a contribution of cash to the partnership, and treats any decrease in a partner’s share of partnership liabilities as a distribution of cash to the partner. Because of §§ 722 and 732, these deemed contributions and distributions result in adjustments to the partner’s basis in his partnership interest by an amount equal to the deemed contribution or distribution - increases in liabilities increase basis, and decreases decrease basis. Section 752(c) provides that nonrecourse liabilities shall, to the extent of the fair market value of the encumbered partnership property, be considered as a liability of the partnership.

As clients approach the end of a tax year with losses which may be limited by partnership basis, practitioners must carefully examine the activities of partnerships during the year to determine if any changes in partnership liabilities have adversely affected outside basis. The types of transactions that can result in a decrease in basis and unexpected limitation on the deductibility of pass-through losses include the distribution of encumbered property by a partnership to a partner; the refinance of recourse debt with nonrecourse debt, or vice versa; changes in the ownership of the partnership; reduction in or payment of principal on debt (including cancellation of indebtedness); and the sale or disposition of encumbered property.

EXAMPLE 35. At year end of 2001, Alice and Barbara are equal partners in Sleepy Hollow, LLC. The LLC owns a factory, which is encumbered by bank debt in the amount of $600. At year end 2001, Alice and Barbara each have a basis of $500 in their LLC interests - $300 from their share of partnership liabilities, and $200 representing their initial contribution of property. In July 2002, Alice and Barbara admit a new partner, Carl, who contributes $200 to the LLC. They execute a new partnership agreement which provides that each of them is equally responsible for their pro rata share of the debt of the LLC. When the Sleepy Hollow CPA begins tax planning for year end 2002, he will find that Alice and Barbara have each been relieved of $100 of partnership indebtedness (due to Carl’s assumption of $200 of indebtedness). Therefore, each of Alice and Barbara now have a basis of $400 in their partnership interests. If the factory has losses to be passed through to Alice and Barbara, the CPA must test the losses to see if they are limited by the partners’ basis.

C. Calculating a Partner’s Share of Liabilities.

The calculation of a partner’s outside basis depends heavily on the partner’s share of partnership liabilities. In turn, the calculation of a partner’s share of liabilities depends on the character of each particular debt or liability. Different rules apply depending on whether the debt is recourse or nonrecourse with respect to one or more of the partners.

Absent any special allocations, if a partnership debt is "recourse," only those partners who are economically at risk for the debt (i.e., have guaranteed or pledged non-partnership property to secure the debt) share in the debt for purposes of calculating basis. On the other hand, if the debt
is "nonrecourse," (i.e., the lender can only proceed against the assets of the partnership to satisfy the debt), all partners will share in the debt ratably in accordance with their percentage interests in the partnership.

1. Recourse Debt. A debt or liability is recourse to the extent that at least one partner bears the "economic risk of loss" if the loan is not repaid. To determine economic risk of loss, the regulations adopt a hypothetical worst case scenario called a "constructive no value liquidation" (more conventionally known as the "atomic bomb test") under which it is presumed that:

(i) all liabilities become due in full;

(ii) all the assets of the partnership (including cash) have a value of zero;

(iii) the partnership disposes of all its assets in a fully taxable transaction for no consideration;

(iv) all income, gain and loss is allocated to the partners; and

(v) the partnership is liquidated.

Under the atomic bomb test, a partner bears the economic risk of loss with respect to a partnership liability (and therefore, the liability is recourse) if the partner would be obligated, upon the constructive liquidation in part (v) of the atomic bomb scenario, to make a payment to any person or a contribution to the partnership. The question of when such a payment is required is generally a facts and circumstances test. All of the partners’ statutory and contractual obligations are taken into account. These include:

(i) Contractual obligations such as guarantees, indemnifications, reimbursement agreements and other obligations which make any partner directly liable for the payment of the partnership debt, whether to creditors or other partners or to the partnership.

(ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account (a "deficit restoration obligation", or DRO) upon liquidation of the partnership.

(iii) Any obligation imposed by state law (i.e., the right of a partner who makes payments on a debt to be subrogated or to demand contribution from other partners).

There are several considerations that affect whether or not a partner bears the economic risk of loss for a partnership obligation. For example, a partner who pledges assets, other than a direct or indirect interest in the partnership, to secure the payment of a partnership liability is considered
to bear the economic risk of loss for the loss to the extent of the fair market value of the property pledged.

A partner will not bear the "economic risk of loss" to the extent a partner (or a related person) is entitled to receive "reimbursement." The right to reimbursement must be an obligation of another partner. The obligation for reimbursement can be created contractually, or can be created under state law (i.e., the right of a partner who makes payments on a debt to be subrogated or to demand contribution from other partners).

A partner also bears the economic risk of loss to the extent that a person related to the partner bears such risk. Under Regulations § 1.752-4(b), a "person related to a partner" has the same meaning as contained in Section 267(b) and Section 707(b)(1) with two exceptions:

1. A person is "related" to a partner if the person is an entity in which the partner owns an 80% (as opposed to a 50%) interest, if the partner and the related person are entities in which the same person owns an 80% (as opposed to a 50%) interest.

2. Siblings are not considered related.

2. Nonrecourse Debt. If, after the application of the atomic bomb test, no partner or related person bears the economic risk of loss for a partnership liability, the liability is "nonrecourse." If a partner bears liability for a portion, then the debt is split into two liabilities, recourse and nonrecourse. Nonrecourse partnership liabilities are allocated to the partners under § 704(b) and § 704(c).

First, under § 704(b), the adjusted basis of partnership property securing a nonrecourse debt is subtracted from the amount of the debt. If this amount is positive, it is allocated to the partners’ outside basis as § 704(b) minimum gain.

Second, if any partner contributed property subject to a nonrecourse loan in excess of the partner’s basis in the property, the partner’s adjusted basis on the date of contribution is subtracted from the amount of the nonrecourse debt on the property. If positive, that amount must be allocated to the contributing partner’s basis as § 704(c) minimum gain.

Finally, if there is any basis from the debt left over after these allocations, it is allocated ratably among the partners by their interests in the profits of the partnership.

3. Loans by Partners to their Partnerships. One of the biggest differences between the calculation of S corporation basis and partnership basis is the treatment of money loaned to the partnership by a partner. As explained above, loans made by shareholders to their S corporations generally result in an increase in the shareholder’s basis to the extent of the face amount of the loan.
In contrast, when a partner or related person makes a loan to a partnership, the treatment of the loan will differ depending on whether it is recourse or nonrecourse. If no partner bears the economic risk of loss for the note - i.e. it would be characterized as nonrecourse if made to the partnership by an unrelated person - then the loan is categorized as a recourse loan as to the lending partner or related person only. Therefore, the lending partner or the partner related to the lender is deemed to bear all of the economic risk of loss with respect to the loan. Therefore, only the lending partner’s basis will be increased by the amount of the loan.

On the other hand, if any partner other than the lending partner bears the economic risk of loss for all or part of the loan - i.e., the loan would be treated as a recourse loan if made by an unrelated third party lender - then the loan must be further tested to determine which partners bear the economic risk of loss for the loan, by applying the atomic bomb test. The partners who bear the economic risk of loss will receive basis adjustments. This may or may not include the lending partner.

There is a de minimis exception to the application of this rule under Regulation § 1.752-2(c). If the loan qualifies under the de minimis rule, a loan made by a partner will not be deemed to be recourse only to the lending partner, even though no other partner bears the economic risk of loss. To qualify, a loan must:

(i) be made by a person who is a partner or related person, but whose share of partnership income, gain, loss, deduction or credit is 10% or less; and

(ii) be "qualified nonrecourse financing" under the passive loss rules, but this test is applied without regard to the type of activity being financed (therefore, the partnership need not be engaged in real estate activities).

If the loan qualifies, it will be deemed a nonrecourse loan as to all partners, and the rules relating to the allocation of nonrecourse loans will be followed.

4. Contributions and Distributions of Encumbered Property. When a partner contributes property subject to debt to her partnership, the partnership is deemed to assume the debt to the extent the debt does not exceed the fair market value of the property, under Regulation § 1.752-1(e). Breaking this transaction down, we see that upon contribution, the partner’s outside basis is first increased by the adjusted basis of the contributed property. Because the partner is allocated his distributive share of the debt assumed by the partnership (assuming it is nonrecourse), the contributing partner’s outside basis is then increased by that amount after application of the nonrecourse rules. Finally, the resulting basis is decreased by the excess of the assumed debt over the partner’s distributive share. A mirror image process is followed when property subject to a liability is distributed to a partner. Regulation § 1.752-1(f) provides the authority for netting the simultaneous debt assumption and debt relief.
D. Timing of Determination of Basis.

Generally, partners’ outside basis in their partnership interests is determined as of the end of each tax year. This gives rise to some tax planning opportunities, similar to those available under the S corporation and at risk rules. Partners with low basis can loan or contribute money to their partnerships, or engage in back-to-back loans similar to those described in the S corporation section above.

However, if, during the tax year, a partnership interest is sold or exchanged, or if a partner’s interest in the partnership is liquidated, the partner involved must redetermine his adjusted basis as of the time of the sale, exchange, or liquidation.

E. Techniques for Increasing Basis.

The same basic techniques used to increase S corporation basis are also used to increase a partner’s basis in her partnership interest. These include contributions of property or cash to the partnership, loans to the partnership, back-to-back loans, payments of partnership debt, or substitution of direct partner debt for partnership debt. Because of the differences in the basis treatment between S corporation and partnership liabilities, however, the effect of any transaction involving partnership debt may be significantly different from similar S corporation transactions.

EXAMPLE 36. Sally’s basis in her partnership interest is $0. Her partnership will generate losses this year, and $500 of those losses will be passed through to Sally. Sally would like to take those losses in the current tax year, instead of delaying them into another tax year. The partnership is indebted to the bank for $1,000. Assume that the debt is recourse - all the partners have an economic risk of loss under the atomic bomb test. Sally’s economic risk with respect to the debt is $200, but all of her basis resulting from the debt has been absorbed by prior year losses. Sally would like to pay $500 on the debt. She assumes, based on her experience with S corporations, that this will give her $500 in basis. However, this may not be the case. Sally pays her $500. She is now deemed to have made a loan to the partnership, and steps into the shoes of the bank. However, the loan is a recourse loan, such that all of the partners have an economic risk of loss. Therefore, Sally receives basis only to the extent that she bears an economic risk of loss for the debt. Her proportional share of the debt is $100. Therefore, she can still only deduct $100 of the pass-through losses, while $400 will be deferred to a future tax year.

EXAMPLE 37. Sammy is Sally’s partner. His basis in his partnership interest is $0, and he expects $500 to be passed through to him as well. He is better advised than Sally, so he makes a $500 loan to the partnership. Now assume that the partnership is an LLC. The loan is nonrecourse - under state law, LLC members are not responsible for the debts of the LLC, the operating agreement says nothing to contradict or change this result, and Sammy is careful to structure the loan documents
so that his only recourse is against partnership assets. Therefore, only Sammy bears the economic risk of loss for this loan, and his basis in increased by $500, enabling him to take the pass-through losses in the current tax year. It doesn’t matter whether Sammy took the money out of his 401(k) or borrowed it from an independent third party (i.e., a back-to-back loan).

A further distinction between partnership and S corporation debt is the treatment of partner loans to the partnership. While S corporation shareholders may increase their basis by loaning money to the corporation, the debt is not an amount at risk unless the lender is the sole shareholder or the loan is a back-to-back loan. In contrast, partner loans to partnerships both create basis and amounts at risk, as described above, without the necessity for back-to-back loans.

**F. Potential Partnership Loss Limitation Pitfalls**

As in the S corporation context, partnership loss limitation traps are usually set for practitioners by their clients. Traps are set when changes are made to the debt or ownership structure of a partnership or LLC without consideration of the tax consequences, and the partnership CPA doesn’t discover the problem until after the close of the tax year. Tax practitioners must be very careful to delve into the history of their partnership clients every year, especially when they know changes have taken place. It is critical to read the partnership agreement and the debt documents to determine their effect on the amount of basis that partners can claim from partnership liabilities.