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THE AT-RISK RULES UNDER THE TAX REFORM ACT OF 1986: THE DOOR CLOSES ON TAX-MOTIVATED INVESTMENTS

Olivia S. Byrne†

I. INTRODUCTION

The Tax Reform Act of 19861 (the “TRA’86”) curtailed significant tax benefits previously available to real estate investors.2 One of the most important changes of the TRA’86 was the extension of the at-risk rules to real estate activity. The impact of the application of the at-risk rules to the activity of holding real property, however, is substantially diminished by a special provision for nonrecourse financing.3 With respect to the activity of holding real property, a taxpayer is deemed to be at risk for his share of any “qualified nonrecourse financing” secured by real property used in the activity.4 In the case of a partnership, a partner’s5 share of qualified nonrecourse financing is determined in accordance with that partner’s share of liabilities under section 752 of the Internal Revenue Code6 (the “Code”).

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5. Unless otherwise indicated, references to partner(s) include both general and limited partner(s).

6. I.R.C. § 752 (1982). General and limited partners share nonrecourse liabilities in accordance with their respective share of partnership profits. Treas. Reg. § 1.752-1(e) (1956). In contrast, general and limited partners share recourse liabilities according to the ratio partners share losses under the partnership agreement. Id. However, a limited partner’s share of recourse liabilities must not exceed the difference between his actual contribution credited by him to the partnership and the total contribution he is obligated to make under the partnership agreement. Id. The Regulation provides the following example:

G is a general partner and L is a limited partner in Partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L’s liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership
This article reviews the historical evolution of the at-risk rules, as well as the extension of their application to real estate financing under the TRA'86. Significant exceptions for qualified nonrecourse financing are examined in detail, as are the special rules for partners in partnerships that invest in real estate. Because regulations have not been promulgated concerning the application of the at-risk rules to real estate, this article discusses several as yet unresolved issues that should be considered in tax planning. Finally, various tax planning techniques are considered with the goal of assisting investors in formulating a cogent investment strategy.

II. EVOLUTION OF AT-RISK RULES

The at-risk rules, which have been in existence for over a decade, were designed to prevent a taxpayer from deducting losses in excess of his actual economic investment in the activity. Under these rules a taxpayer's deductible losses are limited to the amount he has at risk in the activity.

Prior to the Tax Reform Act of 1976 (the "TRA'76"), taxpayers could deduct tax losses in excess of the amount of their economic investment primarily through the use of nonrecourse financing. This practice promoted both economically unsound investments and unproductive interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount.

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7. The at-risk rules were first enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 202, 90 Stat. 1520, 1527-30 (hereinafter "TRA'76").
9. TRA'76, supra note 7.
10. Deductions such as depreciation and amortization have been generally allowable with respect to investment property to the extent of the taxpayer's basis in the property. That basis included various types of investment including nonrecourse loans for which the taxpayer was not held personally liable. As a result, the taxpayer could make an investment and take deductions in excess of the amount for which he was at-risk.
11. Nonrecourse financing is financing with respect to which no person is personally liable for repayment. See I.R.C. § 465(b)(6)(B) (West Supp. 1988); H.R. CONF. REP. No. 1515, 94th Cong., 2d Sess. 407, 411. When an investment was solicited for a tax shelter activity, it was common practice to promise the prospective investor substantial tax losses which could be used to decrease the tax on his income from other sources. The opportunity to deduct tax losses in excess of the amount of the taxpayer's economic investment had arisen under prior law primarily through the use of nonrecourse financing, not only by limited partnerships, but also by individuals and S corporations. The ability to deduct tax losses in excess of economic risk had also arisen through guarantees, stop-loss agreements, guaranteed repurchase agreements, and other devices used by partnerships, individuals and S corporations. See generally Klein, Lack of Profit Motive and Guaranteed Recourse Debt Sink Deductions for Tax Shelter, 13 J. REAL ESTATE TAXATION 371 (1986); Wolf, At-Risk as Applied to Partnerships: Recent Developments, 43 N.Y.U. INST. ON FED. TAX'N §§ 26.01, 26.02 (1985).
use of investment funds. Furthermore, individual investors were deferring tax on income from other sources through losses generated by tax sheltering activities. Congress, believing this result to be inequitable, formulated the at-risk rules to combat the exploitation of tax shelters.

Under the TRA’76, the amount of any loss deductible in connection with certain investment activities could not exceed the aggregate amount that the taxpayer was at risk in such activities as determined at the close of the taxable year. A taxpayer was considered to be “at risk” with respect to an activity to the extent of his cash contribution and the adjusted basis of other property contributed, as well as any amounts borrowed for use in the activity for which the taxpayer was personally liable for payment. A taxpayer’s at-risk amount also included amounts borrowed for use in the activity that were secured by property other than property used in the activity. A taxpayer was not considered to be at risk with respect to the proceeds from his share of any nonrecourse loan used to finance either the activity or the acquisition of the property used in the activity. The creditor usually had recourse only against certain specified assets, thus limiting the taxpayer’s economic risk in the transaction.

The at-risk limitations were initially applied to four specific activities: (1) farming; (2) exploring for, or exploiting oil and gas resources; (3) holding, producing or distributing motion picture films or videotapes; and (4) equipment leasing. These limitations applied to all taxpayers

16. Id. at 411-12.
17. Id. For example, if the taxpayer acting as sole proprietor (or partner or shareholder in an S corporation) used personally owned real estate to secure nonrecourse indebtedness, the proceeds from which were used in an equipment leasing activity, the proceeds would have been considered part of the taxpayer’s at-risk amount. In such a case, the portion of the proceeds which increased the taxpayer’s at-risk amount was limited by the fair market value of the property used as collateral (determined as of the date the property was pledged as security), less any prior or superior claims to which the collateral was subject. Under these rules, the taxpayer was not “at risk” to the extent he was protected against economic loss on all or part of his capital contribution by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he might suffer. Thus, the taxpayer was not “at risk” if he arranged to receive insurance or other compensation for an economic loss after the loss was sustained, or if he was entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person. See id.
18. S. REP. NO. 938, supra note 13, at 3484.
20. H.R. CONF. REP. NO. 1515, supra note 11, at 412. Generally, in the case of an activity engaged in by an individual, each motion picture film or videotape, item of
At-Risk Rules

(OTHER THAN CORPORATIONS THAT WERE NOT S CORPORATIONS OR PERSONAL HOLDING COMPANIES) INCLUDING INDIVIDUALS, SOLE PROPRIETORSHIPS, ESTATES, TRUSTS, SHAREHOLDERS IN S CORPORATIONS, AND PARTNERS IN A PARTNERSHIP CONDUCTING ANY OF THE FOUR ACTIVITIES DESCRIBED ABOVE. THE AT-RISK AMOUNTS WERE DETERMINED BY THE CIRCUMSTANCES AS THEY EXISTED AT THE END OF EACH TAX YEAR. ANY LOSSES NOT DEDUCTIBLE IN A CURRENT TAX YEAR WERE DEDUCTIBLE IN A SUBSEQUENT YEAR IN WHICH THE AT-RISK LIMITATION DID NOT PREVENT THE DEDUCTION.

Abuses continued after enactment of the TRA'76 because application of the at-risk rules was restricted to only the four specific types of activities. In the Revenue Act of 1978 (the "1978 Act"), Congress extended the application of the at-risk rules to all types of investments, except for real estate investment and equipment leasing by certain closely-held corporations. In addition, the scope of the at-risk rules

leased equipment, farm or oil and gas property is treated as a separate activity. In the case of a partnership, personal holding company, or S corporation, all the activities of the same type (such as all motion picture films and video tapes) are to be treated as one activity. Thus, when the partnership is engaged in only one type of activity the loss from that activity for any partner is that partner's loss from the partnership, and his at-risk amount is generally the amount of his cash or other contribution to the partnership, plus his share of any partnership indebtedness with respect to which the partner's liability is not limited.

22. Id. at 1124.
23. Id. Under the TRA'76, the amount of a taxpayer's loss in a particular year reduces that person's at-risk investment (but not below zero) as of the end of that year and in all succeeding years with respect to that activity. Thus, if a taxpayer has a loss in excess of his at-risk amount, the loss disallowed will not be allowed in a subsequent year unless the taxpayer increases his at-risk amount.
25. Id. at § 201(a), 92 Stat. at 2814-15. The exception for closely held corporations (i.e., where five or fewer individuals own 50% or more of the stock of the corporation) applied to the extent that they were actively engaged in leasing equipment which was I.R.C. § 1245 property. See Revenue Act of 1978, supra note 24, at § 201(a) (3)(D)(ii), 92 Stat. at 2815. A closely-held corporation was not considered to be actively engaged in equipment leasing unless 50% or more of its gross receipts for the taxable year were attributable to equipment leasing. See id. at § 201(a) (3)(D)(ii)(II), 92 Stat. at 2815. The Committee report states:

For purposes of this test, gross receipts are to include gross receipts from the sale or servicing of the same type of equipment leased by the corporation. For example, the gross receipts from the sale of computers would be included if the corporation also leased computers, notwithstanding that the computers involved had different functional capacities. The gross receipts from both the sale and lease of office equipment would be combined for purposes of this test, as would the gross receipts from the sale and lease of automobiles. "Equipment leasing" includes the leasing of such tangible personal property as computers, copiers, calculators, airplanes, automobiles, tractors, cranes, railroad cars and furniture. "Equipment leasing" does not include the leasing of master recordings and other similar contractual arrangements made with assets associated with literary, artistic or musical properties (such as books, lithographs or works of art, or musical tapes). "Equipment leasing" would also not include any lease ac-
was broadened to cover closely-held corporations in which five or fewer individuals owned more than 50% of the stock. This change was later determined to be unfair, and in 1984, the 1978 Act was revised to exclude certain "qualified" C corporations from the at-risk limitations.

The Technical Corrections Act of 1979 (the "1979 Act") further clarified the at-risk rules. The 1979 Act included new provisions requiring the recapture of previously allowed losses to the extent that the amount at risk was reduced below zero. This recapture income was treated as income from an activity subject to the at-risk rules; accordingly, recapture income was used to offset losses from an activity if the losses were incurred in the year in which the recapture occurred or were suspended losses treated as having been incurred in such year.

Prior to 1982, subchapter S corporations were subject to the at-risk limitations at both the corporate and shareholder levels. In 1982, the Subchapter S Revision Act removed subchapter S corporations from

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26. Revenue Act of 1978, supra note 24, at § 202, 92 Stat. at 2816. It was believed that § 465 of the Code should be extended to closely held corporations to prevent the avoidance of an accumulated earnings tax or the reduction in the overall tax liability of the corporation and its shareholders by generation of tax sheltered deductions in excess of economic outlays. See H.R. CONF. REP. NO. 1800, supra note 25, at 219-20. This rule provided an unfair economic advantage for corporations not subject to the at-risk rules. In 1984, Congress enacted § 465(c)(7) which excludes the active business of qualified C corporations from the at-risk rules for both investment tax credits and losses.


28. I.R.C. § 465(c)(7)(A) (West Supp. 1988). Qualified C corporations are defined as corporations that have more than 50% in value of their outstanding stock owned by not more than five individuals during the last half of the taxable year and that are not: (1) a personal holding company; (2) a foreign personal holding company; or (3) a personal service corporation that conducts a qualifying business. Id. §§ 465(a)(1)(B), (c)(7)(B) (West Supp. 1988); 542(a)(2) (1982 & West Supp. 1988). Further, the attribution rules of § 318 were used to determine whether five or fewer individuals owned 50% or more of the stock of the corporation. Id. § 465(c)(7)(E)(i) (West Supp. 1988).


30. Id. Prop. Treas. Reg. § 1.465-3(b), 44 Fed. Reg. 32237 (1979) provides the following example:

[If] a taxpayer's amount at risk in an activity is $100 and if $120 is distributed to the taxpayer from the activity (or if a $120 recourse loan is converted to nonrecourse), the taxpayer's amount at risk is reduced to negative $20. In that event, for the taxpayer to restore the amount the taxpayer is at risk in the activity to zero, the amount at risk must be increased by $20. Thus, in such a case if in the succeeding taxable year the taxpayer incurs a loss described in section 465(d) of $40, the amount at risk must be increased by $60 ($40 + $20) in order for the full $40 to be allowed under section 465.


the at-risk limitations of Code section 465(a)(1). Therefore, the at-risk rules apply only at the shareholder level for taxable years after 1982.\textsuperscript{33} This treatment is appropriate because subchapter S corporations are pass-through entities.

Prior to 1981, the at-risk rules did not apply to the investment tax credit. This situation was changed by the Economic Recovery Tax Act of 1981 ("ERTA")\textsuperscript{34} which adopted an investment tax credit at-risk rule. Under ERTA, the investment tax credit was permitted for "qualifying property" only to the extent the invested amounts in that property were "at-risk."\textsuperscript{35}

Contrary to the trend of previous legislation, the Tax Reform Act of 1984 (the "TRA'84") amended the investment tax credit at-risk rules in a manner favorable to taxpayers.\textsuperscript{36} For example, a taxpayer was automatically deemed at risk regarding qualifying assets to the extent of his "credit base" (the cost of property placed in service during that year).\textsuperscript{37} A significant exception was also provided for qualified commercial financing.\textsuperscript{38} The basis of property for purposes of determining the investment tax credit, however, was reduced by the amount of nonrecourse

\textsuperscript{33} Subchapter S corporations were removed from § 465(a)(1). An argument was made that subchapter S corporations were still subject to the at-risk rules if they were also personal holding companies. Section 465(a)(1)(B), however, was amended to apply only to C corporations. Therefore, after 1982, the at-risk rules did not apply to subchapter S corporations. \textit{See} August, \textit{Navigating the At-Risk Waters After the Tax Reform Act of 1984}, \textit{TAXES} 83, 85-86 n.10 (1985).

\textsuperscript{34} Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 211, 95 Stat. 172, 227-28 [hereinafter "ERTA"]. An investment tax credit is a direct offset against tax liability which equals a certain percentage of the cost of the qualifying depreciable property. \textit{See} G. ROBINSON, \textit{FEDERAL INCOME TAXATION OF REAL PROPERTY} \textit{\S}\textsuperscript{11, 12} (1979).

\textsuperscript{35} ERTA, \textit{supra} note 34, at 229. Amounts were not at risk if: (1) the taxpayer was protected against the loss of the invested amount; (2) the amount was borrowed and the taxpayer was not personally liable for the repayment of the debt; (3) the lender had an interest in the activity other than as a creditor; or (4) the lender and borrower were related parties. \textit{See id.}, reprinted in \textit{INTERNAL REVENUE ACTS, LEGISLATIVE HISTORY OF THE ECONOMIC RECOVERY TAX ACT OF 1981}, 1980-81, at 1470 (1982).


\textsuperscript{38} Qualified commercial financing is defined as: any financing with respect to any property if:

(I) such property is acquired by the taxpayer from a person who is not a related person, (II) the amount of nonrecourse financing with respect to such property does not exceed eighty percent of the credit base of such property, and (III) such financing is borrowed from a qualified person or represents a loan from any Federal, State or local government or instrumentality thereof, or is guaranteed by any Federal, State or local government.

\textit{Id.} § 46(c)(8)(D)(ii) (1982 & West Supp. 1988). The exception for qualified commercial financing is similar to the latter provided for real estate under the application of the at-risk rules pursuant to TRA'86. The exception is significant because it permits nonrecourse financing to a certain extent.
financing with respect to that property.\textsuperscript{39} In addition to these modifications, changes were also made to the rules governing the aggregation of activities, loans from related parties, and recapture income rules.\textsuperscript{40}

The historical evolution of the at-risk rules reflects a congressional intent to gradually broaden the scope of activities subject to their application. Significantly, real estate escaped the repeated revisions of these rules until the TRA '86. This omission was not because real estate investment was an activity in which no perceived abuses occurred. On the contrary, it was well known that many tax shelters were generating paper losses for limited partners with little or no economic investment in the activity. The ability of the real estate industry to avoid the at-risk rules may be attributed to the strength and power of that industry's lobbying efforts and Congress' apparent desire to protect the real estate industry.

III. THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986, reflecting a continuing trend on the part of Congress to expand the type of activities to which the at-risk rules apply, finally extended the at-risk rules to real estate.\textsuperscript{41} The first reason for this extension was to limit the opportunity for overvaluation of property which traditionally resulted in inflated deductions for taxpayers.\textsuperscript{42} Secondly, Congress hoped to prevent the transfer of tax benefits to taxpayers who had little or no equity in a given real estate activity.\textsuperscript{43} The TRA'86 applied the at-risk rules to the activity of holding real estate for property placed in service after December 31, 1986 and for losses attributable to an interest in a partnership, S corporation, or other pass-through entity acquired after December 31, 1986.\textsuperscript{44}

A. Qualified Nonrecourse Financing: An Important Exception

Under the TRA'86, a major exception to the at-risk rules exists for

\begin{itemize}
\item \textsuperscript{39} H.R. REP. NO. 432, 98th Cong., 2d Sess. 1510 (1984). Nonrecourse financing includes amounts with respect to which the taxpayer is protected against loss or guarantees, stock loss agreements, or other similar agreements. \textit{Id.}
\item \textsuperscript{40} See generally August, supra note 33.
\item \textsuperscript{41} Section 503(a) of TRA'86 repealed I.R.C. § 465(c)(3)(D) (1982) which excluded "the holding of real property (other than mineral property)" from § 465(a). Section 465(c)(3)(D) also excluded "personal property and services which were incidental to making real property available as living accommodations." See I.R.C. § 465(c)(3)(D) (1982) (repealed by 1986).
\item \textsuperscript{42} S. REP. NO. 313, 99th Cong., 2d Sess. 748 (1986).
\item \textsuperscript{43} \textit{Id.}
\item \textsuperscript{44} TRA'86, supra note 1, § 503(c)(1)-(2), 100 Stat. 2085, 2244 (TRA'86 repealed I.R.C. § 465(c)(3)(D) which excluded from the application of § 465(a) the holding of real property). \textit{See} I.R.C. § 465(a), (c)(3)(D) (1982) (repealed 1986). The date that the real property was purchased is not determinative; the partner or shareholder need only to have been admitted to the partnership or S corporation after December 31, 1986. The effective date may cause some new partners to be subject to the at-risk rules for a parcel of real estate held by the partnership prior to December 31, 1986, while ongoing partners are not.
\end{itemize}
qualified nonrecourse financing used in the activity of holding real estate.45 A taxpayer is still considered at-risk for certain third party nonrecourse financing secured by real property used in an activity, even though the taxpayer has no economic risk in the activity.46 The exception for nonrecourse debt is significant because major real estate projects, particularly rental trade or business properties, have traditionally been financed in whole or in part with nonrecourse debt.

"Qualified nonrecourse financing" is any financing: (1) which is borrowed by the taxpayer with respect to the activity of holding real property; (2) which is borrowed by the taxpayer from a qualified person or represents a loan by any federal, state or local government or instrumentality thereof, or is guaranteed by any federal, state or local government; (3) except to the extent provided in regulations, with respect to which no person is personally liable for repayment; and (4) which is not convertible debt.47

1. Activity of Holding Real Property

For purposes of qualified nonrecourse financing, the activity of holding real property includes the holding of personal property and the provision of services incidental to making real property available as living accommodations.48 Several questions concerning this part of the definition await resolution through the Regulations. Because financing for the activity of holding real property involves borrowed money, the Regulations need to include some provision to ensure proper tracing of the proceeds and should explain whether the proceeds can be distributed to the owner. Also unclear at present is the extent to which the activity must

45. I.R.C. § 465(b)(6) (West Supp. 1988). "Notwithstanding any other provision of this subsection, in the case of the activity of holding real property, a taxpayer shall be considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity." Id. The exception for qualified nonrecourse financing is similar to that for qualified commercial financing under the investment tax credit at-risk rules under prior law. For a definition of qualified commercial financing, see supra note 38.

46. Nonrecourse seller financing is not generally treated as an amount at risk because the installment sales rules remove the incentive for the seller to limit the nonrecourse mortgage to fair market value. Inflated mortgages enable a purchaser to deduct interest and depreciation which is not related to economic costs. See S. REP. No. 313, 99th Cong., 2d Sess. 748 (1986). In the case of third-party financing, however, the lender is more likely to limit the amount of his loan to fair market value, thus preventing artificial overvaluation of property (hence the exception for qualified nonrecourse financing). Id.

47. I.R.C. § 465(b)(6) (West Supp. 1988). The Treasury Department has been given regulating authority to provide circumstances for which guarantees, indemnitees, or personal liability of a person, other than the taxpayer, will not preclude financing from being classified as qualified nonrecourse financing. See H.R. REP. NO. 426, 99th Cong., 1st Sess. 294 (1985).

48. I.R.C. § 465(b)(6)(E) (West Supp. 1988). The activity of holding real property does not include the holding of mineral property. Id. The rule permitting incidental services does not apply to an activity concerning commercial or industrial real property. See McKee, supra note 3, ¶ 10-118 n.172.9.
be the actual "holding" of real property. Furthermore, whether a taxpayer can be involved in an activity consisting of holding real property only in substantial part, or whether the activity must consist exclusively of holding real property is also left unanswered. If a pre-TRA'86 activity, such as providing services and holding personal property as a mere incidence of making real property available for living accommodations, was not subject to the at-risk rules (by virtue of section 465(c)(3)(D) of prior law), the same activity will be treated as one of holding real property under the TRA'86.\textsuperscript{49}

Another unresolved issue concerns the extent to which a service component of an activity may exist without prejudicing the applicability of the qualified nonrecourse financing provisions. To the extent financing is allocable to activities constituting more than "incidental services," such financing does not constitute qualified nonrecourse financing.\textsuperscript{50} Taxpayers therefore must be careful in selecting investment activities with service components. It is unclear whether service-related activities, such as restaurants, hospitals, amusements parks, nursing homes and hotels would qualify. Until regulations are issued, taxpayers are best advised to invest in a facility whose primary function is property-related (such as an apartment or office building), rather than in a service-related facility (such as a restaurant or hospital).\textsuperscript{51} The benefit of this conservative investment strategy is the enhanced likelihood of the ability to use nonrecourse financing that qualifies under the new rule.

Another issue that arises from the activity of holding real estate is whether different real estate activities may be aggregated, or whether they must be treated as separate activities for purposes of section 465. Section 465(c)(2) provides that the at-risk rules are to be applied separately to five specific trade or business activities in which a taxpayer may be engaged.\textsuperscript{52} The activity of holding real estate is not one of the five enumerated activities in section 465(c)(2) requiring "separate activity" treatment.\textsuperscript{53} Activities which constitute a trade or business may be aggregated and treated as one activity only if: (1) the taxpayer actively participates in the management of such trade or business; or (2) for an organization that is a partnership or an S corporation, 65% or more of

\textsuperscript{51} Section 465(b)(6)(E) provides that to the extent an activity was not subject to the at-risk rules under former section 465(c)(3)(D), it will currently be treated as the activity of holding real property which includes the provision of services and the holding of personal property which is incidental to the activity of making real property available as living accommodations. It was intended, however, that under § 465(c)(3)(B) a hotel or motel was to be excluded under the at-risk rules. See H.R. Rep. No. 1445, 95th Cong., 2d Sess. 70 (1978); Priv. Ltr. Rul. 8-641-024 (July 1986).
\textsuperscript{52} I.R.C. § 465(c)(2) (1982 & West Supp. 1988). A taxpayer's activity with respect to each (1) film or videotape, (2) leased § 1245 property, (3) farm, (4) oil and gas property, or (5) geothermal property shall be treated as a separate activity.
\textsuperscript{53} See id.
the loss for the taxable year must be allocable to persons who actively participate in the management of a trade or business ("active participation test"). Since the activity of holding real estate is not listed as a separate activity, by implication it appears that real estate activities in a trade or business may be aggregated.

Therefore, in the case of a partnership, if a taxpayer is a general partner in several different partnerships that invest in real estate and that partner actively participates in the management of each of these partnerships, he should be able to aggregate the real estate activities of these different partnerships for purposes of the at-risk rules. The real estate activities of the different partnerships should all be treated as one tax activity for this particular partner. Similarly, if one partnership has several different real estate parcels, these parcels should constitute a single at-risk activity as long as the partnership is engaged in a trade or business.

2. Qualified Person

An additional criterion of qualified nonrecourse financing is that the financing must be from a "qualified person" or represent a government funded or guaranteed loan. The definition of qualified person includes any person who is actively and regularly engaged in the business of lending money and who is not (1) a related person with respect to the tax-

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54. Id. § 465(c)(3)(B) (1982). Section 465(c)(3) provides in pertinent part:

(B) AGGREGATION OF ACTIVITIES WHERE TAXPAYER ACTIVELY PARTICIPATES IN MANAGEMENT OF TRADE OR BUSINESS. — Except as provided in subparagraph (C), for purposes of this section, activities described in subparagraph (A) which constitute a trade or business shall be treated as one activity if —

. (i) the taxpayer actively participates in the management of such trade or business, or

(ii) such trade or business is carried on by a partnership or an S corporation and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business.

55. No regulations have been issued on this yet. See McKee, supra note 3, ¶ 10.11(1).


57. Id. The Senate Report provides that the at-risk aggregation rules of § 465(c)(3)(B) apply if "[i]t is intended that if a taxpayer actively participates in the management of several partnerships each engaged in the real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity with respect to that partner for purposes of the at-risk rules." S. REP. No. 313, 99th Cong., 2d Sess. 750 (1986). This "active participation requirement" is not the same as that used for passive loss activities. See I.R.C. § 469 (West Supp. 1988).

58. See McKee, supra note 3, ¶ 10.11(1). Real estate is not listed as a separate activity under § 465(c)(2). Section 465(c)(2)(B) provides for § 1245 properties held by a partnership or S corporation to be aggregated and treated as a single activity. Id.

payer; (2) a person from whom the taxpayer acquired the property (or related person to such person); or (3) a person who receives a fee with respect to the taxpayer's investment in the property (or related person to such person).\textsuperscript{60} As an example, a promoter for the taxpayer's investment in the property does not meet the definition of a qualified person. One problem caused by the above requirement is that the relationship between the parties is not always known. To take full advantage of qualified nonrecourse financing, prudent investors should ensure that the entity which extends financing complies with the definitional standard for a qualified person.

Qualified persons include such institutions as banks, savings and loan associations, credit unions, insurance companies regulated under federal, state or local law, or pension trusts.\textsuperscript{61} These are the types of institutions that are "regularly engaged in the business of lending." At the present time, however, the term "regularly engaged in the business of lending" is undefined, and it is not clear whether a newly created lending institution or partnership would be considered regularly engaged in the business of lending money with respect to its first loans. At issue is whether such a lending institution has been created to be involved solely or primarily in legitimate business ventures. Real estate joint ventures may obtain financing from an otherwise qualified lender which has an equity interest in the venture, provided the lender is not the seller or related to the seller.\textsuperscript{62}

The rationale for the "qualified person" requirement was provided by the Joint Committee on Taxation.\textsuperscript{63} According to the Joint Committee's Explanation, when third party commercial financing is secured solely by real property, the lender is much less likely to make loans that exceed the property's value or which cannot be serviced by the property.\textsuperscript{64} The Joint Committee reasoned that such financing would be repaid and that the purchaser, consequently, would have a real equity interest in the activity.\textsuperscript{65} Therefore, it was appropriate to treat such financing as an amount at risk. In contrast, nonrecourse financing by the seller or promoter of real property is not treated as an amount at risk under the TRA'86 because there may be little or no incentive to limit the

\textsuperscript{60} I.R.C. § 465(b)(6)(D) (West Supp. 1988) (a qualified person under § 465 is the same as that under § 46(c)(8)(D)(iv)). A "qualified person" under § 46(c)(8)(D)(iv) is a person who actively and regularly engages in the business of lending money and who is not (1) related to the taxpayer, (2) the seller (or relative of the seller) of the real property held in the activity, or (3) a person who receives a fee with respect to the taxpayer's investment in the real property held in the activity (or a person related to such fee recipient). Section 46(c)(8)(D)(iv) defines related person by reference to § 465(b)(3)(C).

\textsuperscript{61} S. REP. No. 313, 99th Cong., 2d Sess. 749 (1986).


\textsuperscript{63} Id.

\textsuperscript{64} Id.

\textsuperscript{65} Id.
amount of such financing to the value of the property. As a result, a “qualified person” may not be a seller or promoter of real property.

Congress was concerned about the opportunities for overvaluation of property resulting in inflated deductions when a related seller or promoter was involved in the financing. When there is less than arm’s length dealing between the lender and the borrower, there is an increased potential for overvaluing the property, as well as for transferred tax benefits attributable to amounts that resemble equity. Accordingly, under the TRA’86, financing from a related person is treated only as an amount at risk when loans are commercially reasonable and on substantially the same terms as loans involving unrelated persons.

When the financing is obtained from a related person, the question becomes whether the terms of the loan are commercially reasonable and on substantially the same terms as loans involving unrelated persons. The House Conference Report indicates that the terms of a non-recourse loan will be considered commercially reasonable when the financing is reflected by a written unconditional promise to pay on demand or at specified date(s) a sum or sums certain of money, and the interest rate approximates the reasonable market rate of interest. The interest rate may not be unreasonably low because, if it is, a portion of the principal may in fact represent interest, resulting in the stated principal amount exceeding the fair market value of the financed property. This prohibition stems from the intent of the TRA’86 to prevent a taxpayer from receiving financing for property with an inflated value. Therefore, an interest rate would not be commercially reasonable if it fell significantly below the market rate on comparable loans by qualified persons who are not related to the borrowers under those loans. Thus, so

66. Id.
67. Id.
69. The Senate amendment to the 1986 Act would have allowed the third party non-recourse debt exception for real estate losses notwithstanding the fact that the lender was related to the taxpayer and that the taxpayer acquired the property from a related party. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-134 (1986). The Conference agreement imposed the additional requirements of commercial reasonableness and terms indicative of a transaction between unrelated persons because the Conference Committee believed that under the Senate amendment the opportunities for overvaluation of property and for the transfer of tax benefits attributable to amounts that resemble equity were insufficiently limited in the case of nonrecourse financing from a related person. Id. at II-13.
70. A related person generally includes family members, fiduciaries, corporations and partnerships in which a person has a 10% or greater interest. I.R.C. § 465(b)(3)(C) (West Supp. 1988). See Melvin v. Commissioner, 88 T.C. 63, 70-71 (1987) (holding that for a loan to be “at-risk” under section 465(b)(2)(A) the terms of the loan must reflect an arm’s length transaction); Ockels v. Commissioner, 54 T.C.M. (CCH) 785, 799-800 (1987).
71. H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-135 (1986). The maturity of the obligation is also taken into consideration. Id.
72. Id.; cf. United States v. Anderson, 542 F.2d 516, 517 (9th Cir. 1976) ("[Reasonable rates and terms] require a buyer to refinance when he can obtain a loan from a
called "below market loans" are not commercially reasonable. The House Conference Report also provides that if the interest rate exceeds a reasonable market rate or is contingent on profits or gross receipts, the loan is not considered commercially reasonable. These types of loans may indicate a disguised equity interest in the financed property which may result in the stated principal amount exceeding the fair market value of the financed property. This position is consistent with the treatment of below market loans because both types of loans may misrepresent the fair market value of the property.

The Conferrees, however, did not intend to restrict the use of variable or floating interest rates, as long as interest is calculated with reference to a market interest index, such as the prime rate charged by a major commercial bank, the rate accruing on government securities (such as Treasury bills or notes), or the applicable federal rate (within the meaning of section 1274(d)). For instance, an interest rate floating at one point above the prime rate charged by a major commercial bank would not generally be considered contingent on profits or gross receipts. Thus, floating interest rates based on objective standards and variable interest rates calculated with respect to the market interest index are considered commercially reasonable. A blanket prohibition of contingent interest, however, is not necessarily justifiable.

By contrast, the House Bill would have applied more stringent limitations to financing received from related parties. The House version of "qualified nonrecourse financing" excluded financing received from any person related to the taxpayer. No exception was provided for financ-

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73. H.R. CONF. REP. NO. 841 at II-135 (1986); see supra note 69 (below market loans are defined in I.R.C. § 7872(e) (West Supp. 1988).
74. H.R. CONF. REP. NO. 841 at II-135 (1986) (if it significantly exceeds the market rate for comparable loans by unrelated parties).
75. Id.
76. Id.
77. Id.
78. Id.
79. A per se prohibition of contingent interest is overly broad because no exception has been provided for taxpayers who can demonstrate that similar interest arrangements are used by unrelated borrowers and lenders. See McKee, supra note 3, ¶ 10-118 n.172.7.
81. Id. The House version states: Nonrecourse financing by the seller of real property (or a person related to the seller) is not treated as an amount at risk under the bill, because there may be little or no incentive to limit the amount of such financing to the value of the property. In the case of arm's length third party commercial financing secured solely by the real property, however, the lender is much less likely to make loans which exceed the property's value or which cannot be serviced by the property; it is more likely that such financing will be repaid and that the purchaser consequently has or will have real equity in the activity.

Id. at 293.
ing that was on commercially reasonable terms. The more lenient Senate Bill provided that qualified non recourse financing included non recourse debt, notwithstanding the lender's relation to the taxpayer and the taxpayer's acquisition of the property from a related party. 82 In summary, the Conferees have adopted a compromise position because under the TRA'86 financing from qualified related persons is permitted, but only to the extent that loan terms are commercially reasonable and on substantially the same terms as loans involving unrelated persons. 83

Although commercially reasonable financing provided by qualified related parties is permitted, seller financing is prohibited. 84 This prohibition may create new problems in situations where loan obligations on distressed properties are being resolved. In many instances a bank or other lending institution acquires actual title to property being foreclosed before permitting sale to a new owner. Any resulting loan by the bank or lending institution on such a subsequent sale would be considered seller financing. It is important for taxpayers that the title not be transferred to the bank. The structure of such property transfers should ensure that title pass only between owners of the property because direct title passage from the bank to the buyer would preclude purchase money financing from banks who have foreclosed on real estate and are in the process of disposing of the property. 85

Significantly, government financing does not contain restrictions relating to qualified persons. Government financing includes monies borrowed from "any Federal, State, or local government or instrumentality thereof" or which are "guaranteed by any Federal, State, or local government." 86 Financing money, however, must still be borrowed for an activity of holding real property, and it cannot be personally guaranteed by any person; nor may financing consist of convertible debt. 87

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82. S. REP. No. 313, 99th Cong., 2d Sess. 749 (1986). When the lender is not the seller or related to the seller, the opportunities for overvaluation may be limited to the same degree as if the lender were an unrelated third party. In addition, as is normally the case with the at-risk rules, the financing actually had to be debt and not disguised equity. Id.

83. I.R.C. § 465(b)(6)(D)(ii) (West Supp. 1988). But cf. Prop. Treas. Reg. 1.465-1(b), 44 Fed. Reg. 32235, 32237 (1979) (regardless of form, there is no increase if the transaction is not consistent with normal commercial practices; therefore, the form should be irrelevant if the transaction is within normal commercial practices).

84. I.R.C. § 46(c)(8)(D)(iv) (1982 & West Supp. 1988). The seller of property is not considered to be a "qualified person." Id.

85. Tangentially, the restriction against seller financing also prevents the use of installment reporting when those sales involve seller financing. Other provisions in TRA '86 restrict the use of the installment sale treatment. See I.R.C. § 453(C) (1982) (the proportionate disallowance rules treat a portion of the deferred payment as having been received prior to actual payment). The alternative minimum tax provisions under TRA '86 treat deferred gain under the installment sale provisions as a tax preference. See I.R.C. §§ 55, 56(a)(6) (West Supp. 1988). Finally, interest on installment sales is treated as portfolio income under the new passive loss rules. Id. § 469 (West Supp. 1988).


87. Id. § 465(b)(6)(B)(i), (iii), (iv) (West Supp. 1988).
ently, an instrumentality of a local government may directly sponsor qualified nonrecourse financing, while monies provided by an instrumentality of a federal or state government must still be borrowed by the taxpayer from a qualified person. Future regulations should shed more light on which governmental entities need not meet the qualified person test.

3. Nonrecourse Financing and Nonconvertible Debt

A final requirement of nonrecourse financing is that the financing, in fact, be debt that is not convertible and for which no one is personally liable for repayment. Convertible debt is not treated as qualified nonrecourse financing because it represents a right to an equity interest. Generally, convertible debt is debt that is convertible into equity at the lender's option. No definition has been provided, however, as to what convertible debt means in the real estate context and several questions remain. For instance, if the lender has paid for an option, does this automatically cause the debt to be classified as convertible debt? What is the effect on this debt in light of the fact that the lender is related to the purchaser of the option, if a related party buys the option? Regulations should be promulgated which may describe the circumstances that cause debt to be convertible.

In conclusion, "qualified nonrecourse financing" provides a significant exception to the at-risk rules for real estate activity. Although many issues remain open, the general guidelines examined above should be followed as closely as possible. If a related party is involved in a transaction of uncertain taxable character, the terms of the note should be structured to be commercially reasonable. In any event, prudent tax planners should ensure that the activity involves the holding of real property, that the note is nonrecourse and nonconvertible, and that the financing is borrowed from a qualified person.

4. Partnerships

a. Qualified nonrecourse financing

i. amount at risk

Section 465(b)(6)(C) of the Code provides that "[i]n the case of a

88. Id.; see supra note 47 and accompanying text.
Under the House Bill, the Senate Amendment, and the Conference Agreement, convertible debt is not treated as qualified nonrecourse financing. The conferees believe that it is not appropriate to treat investors as at risk with respect to nonrecourse debt that is convertible and that consequently represents a right to an equity interest, because taxpayers are not intended to be treated as at risk for amounts representing others' rights to equity investments.

Id.
partnership, a partner's share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner's share of liabilities of such partnership . . . [within the meaning of section 752]."  

As a general proposition, under regulations promulgated under section 752, if none of the partners have any personal liability (with respect to financing of partnership property), then all the partners, including limited partners, share the liabilities in accordance with the manner in which they share profits under the partnership agreement.

Special rules apply when a general partner guarantees a nonrecourse partnership loan. In *Raphan v. United States*, the Court of Claims held that limited partners could increase their basis with respect to nonrecourse debts personally guaranteed by a general partner. The Internal Revenue Service had previously concluded that limited partners were not entitled to a step-up in their basis because under these circumstances the loan is treated as a recourse loan. In disagreement with the Court of Claims' ruling, Congress, in the 1984 Act, directed the Treasury Department to modify the regulations under section 752 of the Code to be consistent with the Service's position. Subsequently, the Court of Appeals for the Federal Circuit reversed the Court of Claims' holding in *Raphan* on this issue and concurred with the Service's position not to permit an increase of a limited partner's basis with respect to a nonrecourse loan by general partners.

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91. I.R.C. § 465(b)(6)(C) (West Supp. 1988). Under section 752, in the case of a general partnership, liabilities are allocated among partners so that all recourse liabilities are allocated in accordance with the ratios in which partners share partnership losses, and all nonrecourse liabilities are allocated pursuant to the ratios in which they share benefits. In the case of a limited partnership, all partners, general and limited, share nonrecourse liabilities in accordance with their respective interests in the partnership profits, but each limited partner's share of recourse liabilities is equal to the lesser of

1. the amount, if any, by which the total contribution that he is obligated to make to the partnership exceeds his actual contribution or
2. that portion of such liabilities which corresponds to his share of partnership losses.

Finally, all remaining partnership recourse liabilities are shared among the general partners in proportion to their respective interests in the partnership losses (i.e., if the general partner A has a 15% interest in losses and general partner B has a 5% interest in losses, three-quarters of unallocated recourse liabilities are allocated to A and one-quarter to B).


92. See example *supra* note 6.

93. 3 Cl. Ct. 457 (1984), rev'd, 759 F.2d 879 (Fed. Cir. 1985) (nonrecourse partnership loan personally guaranteed by a general partner is classified as a recourse loan for purposes of Treas. Reg. § 1.752-1(e) (1956)).


ii. Level of application for nonrecourse financing

To determine whether a given partnership’s borrowing meets the requirements of qualified nonrecourse financing, tests are applied at both the partner and the partnership levels. The partnership and each partner are treated as a borrower, and the “related person test,” discussed above, is applied at both levels. The rules for qualified nonrecourse financing are also applied on a partner by partner basis because individual partners would be subject to the at-risk rules, whereas corporate partners might escape the application of these rules. Furthermore, the total amount for which partners are treated as being at-risk is limited to the total amount of the qualified nonrecourse financing at the partnership level.

b. Special rules for certain types of obligations

i. guarantees by a partner

Special rules apply to partners in determining whether they may treat as amounts at risk under section 465 and as basis under section 752 amounts that they have guaranteed to the partnership. Under recently issued Treasury Regulation section 1.704-1(b)(4)(iv)(g), a nonrecourse loan guaranteed by only one partner will yield basis only to the partner who guarantees the loan. For example, if a limited partner guarantees a nonrecourse loan made to the partnership, but that loan does not constitute “qualified nonrecourse financing,” the deductions attributable to the loan must be allocated solely to that partner under section 704. He is also the only partner who receives basis for the loan under section 752. The guaranteeing partner does not, however, receive more basis than the value of the deductions allocable to him by regulations issued under section 704(b).

98. Id.
100. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, supra note 97, at 260.
101. Treas. Reg. § 1.704-1(b)(4)(iv)(g) (1986); see Treas. Reg. § 1.704-1(b)(5), examples (20)(vii), (20)(viii) (1986); see also Rev. Rul. 83-151, 1983-2 C.B. 105 (limited partner cannot increase basis when a general partner is personally liable on a loan and limited partner is not obligated to make additional contributions).
103. See Treas. Reg. § 1.704-1(b) (1986). The guarantor limited partner should have no rights of subrogation or reimbursement for monies paid under the guarantee to obtain basis under § 752. See Gefen v. Commissioner, 87 T.C. 1471 (1986) (limited partner guaranteed her pro rata share of the partnership’s recourse indebtedness without right of contribution for any amounts paid under the guarantee); Melvin v. Commissioner, 88 T.C. 63 (1987) (a partner is personally liable under § 752 if he or she has responsibility for the ultimate liability to repay a partnership obligation when a partnership’s assets are inadequate).
While this limited partner receives basis for purposes of section 704, and presumably for purposes of section 752, the deductions attributable to the nonrecourse loan are also subject to the at-risk rules since the exception for qualified nonrecourse financing is inapplicable.\textsuperscript{104} Proposed regulations under section 465 expressly provide that a partner would receive at-risk credit for the amount of a partnership note guaranteed against loss only after he repays the creditor and has "no remaining legal rights against the primary obligor."\textsuperscript{105} These proposed regulations would prevent the guarantor from increasing his amount at-risk when he guarantees a partnership note or partner against loss if the guarantor has rights of subrogation or indemnification from the partnership or other partners for the amount of his guarantee. The guarantor will receive credit toward his at-risk amount only when he has no rights to reimbursement.\textsuperscript{106} Therefore, in structuring guarantees of partnership losses it is important to the guarantors that the guarantee or partnership agreement provide that the guaranteeing partner has no legal rights of reimbursement from the primary obligor or any other protection from loss.

\textbf{ii. loans by a partner to the partnership}

Prior to the TRA'86, a general partner making a recourse loan to his partnership which invested solely in real estate obtained basis for himself, as well as for the other general partners.\textsuperscript{107} Because the at-risk rules did not apply to real estate, the amount at risk was not an issue. Each general partner received basis to the extent of his proportionate share of the loan.\textsuperscript{108}

\begin{itemize}
  \item \textsuperscript{104} See supra notes 47-48 and accompanying text. If, however, the loan in the above example constituted qualified nonrecourse financing the limited partner would not only be given basis under section 752, but also, under section 465(b)(6)(C), he would be allocated an at-risk amount equal to the qualified nonrecourse financing. I.R.C. § 465(b)(6)(C) (West Supp. 1988) (partner's share of qualified nonrecourse financing determined on the basis of partner's share of liabilities of such partnership in accordance with § 752).
  \item \textsuperscript{106} See Abramson v. Commissioner, 86 T.C. 360 (1986) (a limited partner is considered at risk for demands of capital contributions upon the partnership default if the creditors can demand the contributions and there are no contingencies that protect the limited partner from loss, i.e., no chance for reimbursement). Under the at-risk rules a partner will never increase his amount at risk as long as he is protected against loss through a right to contribution or otherwise. It is only when the guaranteeing partner has no legal rights against the obligor of the note that his amount at-risk is increased. \textit{Id.} at 375-78.
  \item \textsuperscript{107} Treas. Reg. § 1.752-1(e) (1956).
  \item \textsuperscript{108} \textit{Id.} Recourse liabilities are allocated to the general and limited partners according to the ratio the partners share losses pursuant to the partnership agreement. However, a limited partner's share of recourse liabilities must "not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement." \textit{Id.}
Under the at-risk rules a taxpayer does not increase his amount at risk for loans where the lender has an interest in the activity.\(^{109}\) Only the partner who makes a direct recourse loan to his partnership (real estate or otherwise) obtains at-risk credit for his proportionate share of the loan.\(^{110}\) The other partners in his partnership do not receive any increase in their at-risk amounts because the lender is not a third party creditor who does not have an interest in the partnership.\(^{111}\) For example, if there are four partners in the general partnership WXYZ and if W loans $80,000 through a recourse note to the partnership, W would receive a $20,000 increase in at-risk credit under Proposed Treasury Regulation section 1.465-7(a). This is his proportionate share of the loan. X, Y and Z would each receive a $20,000 increase in basis under section 1.752-1(e). However, X, Y and Z would not receive any increase in their amounts at risk for W's recourse loan to the partnership WXYZ because partner W has an interest in the partnership other than as a creditor.

The Code does not define who has an interest in the activity except to exclude an interest as a creditor.\(^{112}\) The proposed regulations provide that with respect to loans for which the borrower has personal liability, a person with an interest in the activity includes a lender who has a capital interest in the activity or an interest in the net profits of the activity.\(^{113}\) Partners are considered to have a capital interest in activities conducted by the partnership.\(^{114}\) Any partner who has an equitable interest in a partnership is considered to have an interest in the activity other than as a creditor. Accordingly, any loan a partner makes to the partnership

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110. The amount at risk in an activity of a partner who lends the partnership money for use in the activity shall be increased by the amount by which that partner's basis in the partnership is increased under Treas. Reg. § 1.752-1(e) due to the incurrence by the partnership of that liability. The amount at risk of any other partners shall not be increased as a result of the loan. Prop. Treas. Reg. § 1.465-7(a), 44 Fed. Reg. 32238 (1979). A taxpayer is at risk for amounts borrowed to the extent he is personally liable for the repayment of such amounts. If the loan is nonrecourse, deductions attributed to this loan may be taken only by the partner who made the loan. I.R.C. § 465(b)(2) (1982). In order for nonrecourse loans to increase a taxpayer's amount at risk according to § 465(b)(2), the taxpayer must have pledged property, other than property used in such activity, as security for such borrowed amounts to the extent of the net fair market value of the taxpayer's interest in the property. Id. § 465(b)(2)(B) (1982).
111. Prop. Treas. Reg. § 1.465-7(a), 44 Fed. Reg. 32238 (1979). Persons who have an interest in the net profits of the at-risk activity or in the capital of the at-risk activity will be considered as having an interest other than as a creditor. Id. § 1.465-8(b), 44 Fed. Reg. at 32239. Thus, a partner, because of his equitable interest in the partnership, is considered to have an interest in the activity other than as a creditor. Id. §§ 1.465-7(a), 1.465-8(b)(1), 44 Fed. Reg. at 32238; see also I.R.C. § 465(b)(3) (1982).
does not meet the requirements of section 465(b)(3), and the other partners do not receive at-risk credit for his loan.

For tax planning purposes, it is important to insure that a recourse loan from an unrelated person to the partnership does not have characteristics of an equity investment. Similarly, the recourse loan should not give the lender an interest in the net profits of the partnership if it is to meet the mandates of section 465(b)(3)(A).\textsuperscript{115}

Section 465(b)(3)(A) also applies to nonrecourse loans.\textsuperscript{116} In the case of a nonrecourse loan with a readily ascertainable fair market value, a lender with an interest in the activity other than as a creditor includes a lender who has either a capital interest in the activity or an interest in the net profits of the activity.\textsuperscript{117} To illustrate,

[assume] X is an investor in an activity described in section 465(c)(1). In order to raise money for the investment, X borrows money from A, the promoter (the person who brought X together with other taxpayers for the purpose of investing in the activity). The loan is secured by stock unrelated to the activity which is listed on a national securities exchange. X's stock has a readily ascertainable fair market value. A does not have a capital interest in the activity or an interest in its net profits. Accordingly, with respect to the loan secured by X's stock, A does not have an interest in the activity other than that of a creditor.\textsuperscript{118}

In the case of a nonrecourse loan secured by property without a readily ascertainable fair market value, the definition of a person with an "interest in the activity" is greatly expanded. It includes any lender that:

stands to receive financial gain (other than interest) from the activity or from the sale of interest in the activity. For the purposes of this section persons who stand to receive financial gain from the activity include persons who receive compensation for services rendered in connection with the organization or operation of the activity or for the sale of interests in the activity. Such a person will generally include the promoter of the activity who organizes the activity or solicits potential investors in the activity.\textsuperscript{119}

Thus, when borrowing from a promoter, a recourse loan should be used, or if this is not feasible, the nonrecourse loan should be secured by prop-

\textsuperscript{115} See Pritchett v. Commissioner, 85 T.C. 580 (1985), rev'd on other grounds, 827 F.2d 644 (9th Cir. 1987) (lender had an interest in 20% after gross sales proceeds of land leased to the partnership so the lender had an interest other than as a creditor).
\textsuperscript{117} Id. § 1.465-8(c)(1), (2).
\textsuperscript{118} Id.
\textsuperscript{119} Id. § 1.465-8(d)(1), 44 Fed. Reg. at 32239.
property with an ascertainable fair market value, such as stock traded on the New York Stock Exchange.

In deciding whether to make either a direct contribution or a loan to a partnership, a partner should note that a direct contribution permits the partner to receive a dollar for dollar credit for at-risk determination and for the section 752 basis rules, while a loan only increases the partner's amount at risk by his proportionate share of the loan. If the partner contributes property instead of cash to the partnership, his amount at risk is increased by the adjusted basis of the contributed property.\(^\text{120}\) To enable all the partners to benefit from the at-risk rules, a loan to the partnership by a third party creditor might be considered.

iii. cash calls and the *Pritchett* case

Special rules also exist for cash call agreements. Cash call agreements require that a limited partner be on call (for payment) for future contributions under a partnership agreement. Under proposed regulations pursuant to section 465, such a requirement for future contributions would not give a partner an increased amount at risk until the time at which the partner makes the actual contribution.\(^\text{121}\) Under recent case law, however, certain partnership cash call agreements may entitle partners to immediate at-risk credit.\(^\text{122}\) In order to increase an amount at risk, a partner must be personally liable to the creditor after any rights to contribution or subrogation are asserted.\(^\text{123}\)

In *Pritchett v. Commissioner*,\(^\text{124}\) a case likely to have substantial impact on real estate partnerships, the taxpayers were members of limited partnerships formed to conduct oil and gas operations.\(^\text{125}\) Each partner-

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124. 827 F.2d 644 (9th Cir. 1987), rev'd, 85 T.C. 580 (1985). The proposed regulations under I.R.C. section 465 were not discussed in this case. While the Tax Court reversed on the above issue, the case was remanded on another. The Commissioner had argued in the alternative that the taxpayer's deductions were barred by section 465(b)(3), which provides that "amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who . . . has an interest (other than an interest as a creditor) in the activity." *Pritchett*, 827 F.2d at 647. Any type of financial interest in the activity would constitute a prohibited other interest under § 465. See id. A lender is not considered a creditor if it has either a capital interest or an interest in the net profits of the activity. See Prop. Treas. Reg. § 1.465-8(b), 44 Fed. Reg. at 32239 (1979). Since the drilling company was to receive a 20% interest of the gross sales of oil and gas as the partnership achieved certain profit levels, the Tax Court could have found that the company had a substantial interest in the partnership. See *Pritchett*, 85 T.C. at 592 (Simpson, J., concurring) (1985), rev'd, 827 F.2d 644 (1987). The Ninth Circuit remanded the case for a factual determination as to whether the drilling company had such a prohibited interest in the partnership so as to preclude at-risk credit. *Pritchett*, 827 F.2d at 648.
ship entered into certain drilling and exploitation agreements with a drilling corporation. Each partnership gave the drilling corporation cash plus a recourse note. Each note had a maturity date of fifteen years and was secured by the partnerships' assets. The general partners were personally liable on the notes, and the partnership agreements held the limited partners personally liable for cash contributions if the notes were not paid off at maturity. The limited partners deducted from their taxable income a proportionate share of the partnership losses for the year.

The Tax Court found that the limited partners could not take such a deduction because, under the at-risk rules, they were not personally liable on the notes. Therefore, the limited partners were not at risk; the notes and cash call agreements were simply too contingent for the limited partners to be considered personally liable on them.

On appeal, the Ninth Circuit concluded that the liability of the limited partners under the cash call agreements and notes was not too contingent for the limited partners to receive at-risk credit because the liability of the limited partners was unavoidable. The limited partners were ultimately responsible for the debt. In reversing and remanding the case, the Ninth Circuit relied on Melvin v. Commissioner, in which the Tax Court had stated:

[T]he fact that the partnership or other partners remain in the "chain of liability" should not detract from the at-risk amount of the parties who do have the ultimate liability. The critical inquiry should be who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls.

Applying this rationale to the Pritchett case, the Ninth Circuit concluded that the limited partners, by virtue of their contractual obligations under the partnership agreements, had ultimate responsibility for the debt. The appeals court was not convinced that the cash call was too contingent even though the general partners had the right to make the

126. Id.
127. Id. at 583.
128. Id.
129. Id.
130. Id. at 584.
131. Id. at 588. The court did not address the issues concerning the fact that the person who extended credit had an equity interest in each of the partnerships. Id. at 585-86, 590.
132. Id. at 588. The court did not address the issues concerning the fact that the person who extended credit had an equity interest in each of the partnerships. Id. at 585-86, 590.
133. Pritchett, 827 F.2d at 647.
135. Id. at 75 (citing Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985)).
136. Pritchett, 827 F.2d at 647 (9th Cir. 1987); see also Bennion v. Commissioner, 88 T.C. 684, 695 (1987) (applying the Melvin standard to taxpayer's "Guarantee Agreement" and determining that the taxpayer was ultimately liable on a debt obligation even though the obligation flowed through others).
cash call but did not have an obligation to do so. Instead, the court found that the contracts made the call mandatory and "economic reality" dictated that the general partners would hold the limited partners to their liability. Furthermore, the fact that the obligation would not become due for several years in the future was of no significance to the allocation of a pro rata share of taxpayer's debt in the year in question.

As a result of the Pritchett case, partners who are not guarantors on a partnership note may be able to obtain additional basis and at-risk credit by becoming subject to a cash call agreement. Significantly, Pritchett helps eliminate the prior concern that a cash call based on an outstanding recourse liability would not give a partner additional amounts at risk because the partner was not currently liable under Proposed Treasury Regulation section 1.465-22(a). Although the case does not mention this regulation, it is clear that Pritchett provides that a partner may receive at-risk credit on a cash call agreement prior to the time that the partner must make actual contributions under the cash call.

IV. TAX PLANNING

It will be important in the future for all investors in real estate activities (whether an individual, shareholder or partner) to monitor continually their amounts at risk. Taxpayers will be able to deduct losses resulting from real estate activities as long as the amounts at-risk are greater than the net loss. If the net loss exceeds the amount at-risk the taxpayer will be limited in deducting losses to the at-risk amount. There

137. Pritchett, 827 F.2d at 647.
138. Id.
139. Id. The court relied on Taube v. Commissioner, 88 T.C. 464, 487 (1987) ("[D]ebt due years in future is nevertheless genuine indebtedness fully includable in basis.") and Melvin, 88 T.C. at 73 ("[D]ebt obligations of a partnership that are payable in later years generally are to be included in the at-risk amounts."). In Melvin, it was found that limited partners were at risk to the extent of their obligations to make additional contributions. The notes were pledged to secure a recourse indebtedness of the partnership. The notes did not increase the limited partners' at-risk amounts under § 465, but did increase the limited partners' basis to the extent of their share of the partnership's recourse liability. Id.

A taxpayer's amount at risk in an activity shall be increased by the amount of personal funds the taxpayer contributes to the activity. For this purpose a contribution by a partner to a partnership conducting only one activity is a contribution to the activity. However, a partner's amount at risk shall not be increased by the amount which the partner is required under the partnership agreement to contribute until such time as the contribution is actually made. Neither shall a partner's amount at risk be increased in the case of a note payable to the partnership for which a partner is personally liable until such time as the proceeds of the note are actually devoted to the activity.

is an indefinite carryover for any portion of the loss not used.\textsuperscript{141} If a distribution or any other event causes a negative at-risk amount, the amount below zero must be included in income for that year.

The objective of most tax planners will be to have the financing of real property qualify as qualified nonrecourse financing. If an amount is to be borrowed on a nonrecourse basis for the activity of holding real estate, it should be borrowed from a qualified person and not be convertible debt. If it is borrowed from a related person, it is important that the terms be commercially reasonable. In any event, however, the lender may not be the seller of the real estate.

The real estate activity financed should involve no more than an incidental amount of services. Otherwise, the financing will not meet the qualified nonrecourse financing test and the taxpayer will not obtain an at-risk credit. For a partnership, the financing must be qualified nonrecourse financing with respect to the partner, as well as to the partnership. It is often advisable for a partner to aggregate real estate activities for purposes of the at-risk rules. Therefore, a general partner should take part in management activities for each real estate activity.

A limited partner may attempt to obtain at-risk credit by cash call agreements under the partnership agreement. The cash call agreement should be carefully structured so that it is made at arm's length. Even if the cash call agreement is drafted correctly, the proposed regulations under section 465 still suggest that a partner should not get at-risk credit for a cash call or guarantee until the partner actually has to make a payment. These proposed regulations are yet to be reconciled with the Ninth Circuit decision in \textit{Pritchett}.

The at-risk rules also affect recourse loans made by partners to a partnership. A partner who makes a recourse loan to his partnership will not generate any at-risk credit on this loan for other partners in the partnership because he has an interest other than as a creditor in the partnership. Therefore, a cash contribution from that partner or a loan from an unrelated third party creditor might be better alternatives. Additionally, a guarantee by a limited partner of a nonrecourse obligation of the partnership will not provide that partner any at-risk credit until he has no rights against the original debtor.\textsuperscript{142} Therefore, the partner should ensure that he has no rights of subrogation or contribution and the guaranty should be required in the partnership agreement so that the partner may receive at-risk credit for the guaranty.\textsuperscript{143}

\section*{V. CONCLUSION}

Congress has been successful in eliminating most of the prior tax

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\textsuperscript{141} I.R.C. § 465(e)(1)(B) (1982 & West Supp. 1988). However, regulations have as yet not been issued to explain whether or not a suspense account is required to be set up for unused losses as is the rule used for unused passive losses.


\textsuperscript{143} Gefen v. Commissioner, 87 T.C. 1471, 1501-04 (1986).
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benefits of a real estate limited partnership tax shelter and in decreasing the amounts of most of the tax benefits available to real estate investments. Many investors, obviously, will dispose of their tax shelter investments, while others will look for ways to increase their amount at risk in the partnership or in the activity involving real estate. However, the significant exception for qualified nonrecourse financing will enable many investors to continue to enjoy taking deductions in excess of their cash investment in the activity. Careful tax planning will ensure that investment financing will qualify as qualified nonrecourse financing. This type of financing should enable taxpayers to enjoy deductions in excess of amounts actually at risk. At the same time, the congressional goal of limiting financing provided by unrelated third parties to the fair market value of the property which is subject to the loan will have been obtained.