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THE IMPACT OF THE TAX REFORM ACT OF 1986 ON PERSONAL INVESTMENTS

by

DAVID D. GREEN*

The Tax Reform Act of 1986 (Act)\(^1\) represents the culmination of a lengthy process to make the Internal Revenue Code (Code) both simple and fair. Although that goal has been achieved for a vast number of lower-income taxpayers, the resulting Code is anything but simple for investors in real estate and other tax-advantaged investments. The removal of various tax subsidies is causing both investors and tax planners to rethink long-standing investment strategies.

The investment decision-making process now focuses to an increased degree on economics, rather than on tax benefits. The reduction in tax rates forced the Congress to eliminate such tax preferences as the capital gain deduction and the investment tax credit, which in the past played a significant role in many taxpayers’ investment decisions, in the search to maintain revenue neutrality.

To achieve its goal, Congress also restricted deductions attributable to investment activities. In structuring these new restrictions, the Act segregates income into “baskets,” distinguishing among (1) earned income, such as salary and earnings from active trade or business activities; (2) portfolio income, for example, interest, dividends, certain royalties, and gains from the disposition of investment property; and (3) passive income, e.g., income from traditional tax shelter investments including rental real estate. Deductions attributable to one basket of income generally cannot be used to offset income in another basket.

This article focuses on the effect of the changes made by the Act to personal investments, including the loss of the capital gain deduction, the introduction of limitations on passive activity losses, modifications to investment credits, the extension to real estate of the at-risk rules and other changes affecting investments.

I. CAPITAL GAINS AND LOSSES

The Sixty-Seventh Congress first introduced the concept of a capital gain

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\(^1\)Pub. L. No. 99-514, 100 Stat. 2085 (1986) [hereinafter Act]. Section references are to the Internal Revenue Code of 1986 unless otherwise noted. As of this writing of this article, it is anticipated that the General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation and the Technical Corrections Act of 1987 will be released in the near future. These may modify the interpretations taken here.
deduction when it passed the Revenue Act of 1921, finding that "[u]nder the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby." Subsequent legislation modified the concept of special treatment for capital gains due to concern over the fairness of the system, and the effect of tax planning for capital gains on the fisc. The present-day concept of short-term and long-term gains and losses was introduced in 1938, although the requisite holding period has been modified frequently in response to a variety of factors. In coming full circle to the process started in 1921, the Senate, during consideration of the Tax Reform Act of 1986, found that "as a result of the bill's reduction of individual tax rates on such forms of capital income as business profits, interest, dividends, and short-term capital gains, the need to provide a reduced rate for net capital gains is eliminated." Act Section 301 repealed Code Section 1202 effective for tax years beginning after December 31, 1986. Prior to repeal, Section 1202 permitted individuals and other noncorporate taxpayers to deduct 60% of net capital gains from gross income.

Notwithstanding the repeal of the capital gain deduction, Congress retained the $3,000 limit on capital losses offsetting ordinary income of noncorporate taxpayers, but liberalized it to permit excess long-term losses to offset ordinary income on a dollar-for-dollar basis. In a move correlated to the

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2 S. REP. NO. 275, 67th Cong., 1st Sess. 1939-1 C.B. 181, 189 (1921). The "excessive" surtax at the time was 65%. The Revenue Act of 1921 lowered the maximum individual tax rate to 50%, and provided that the maximum rate of tax on capital gain property (held for a minimum period of two years) was to be 12 1/2% (an equivalent capital gain deduction of 75% for taxpayers in the highest bracket). However, if the taxpayer elected the use of this maximum 12 1/2% tax on capital gains, the tax on total net income could not be less than 12 1/2%. Thus, no relief was available to lower income taxpayers.

3 The Revenue Bill of 1934 addressed the concerns of the Congress that the then existing system (1) produced an unstable revenue flow, (2) allowed for avoidance of tax by the judicious sale of an asset either just prior or subsequent to the required holding period determination, (3) was inequitable for smaller taxpayers, and (4) interfered with normal business transactions. The Bill modified the required holding period and tied the calculation of the capital gain deduction to the length of the holding period, permitting a 70% deduction for property held more than 10 years and allowing no deduction for property held for less than a year. Various intermediate deduction percentages were allowed depending on the length of the holding period. The Bill also prohibited the deduction of capital losses in excess of gains. It is interesting to note that the Congress at this juncture was still toying with the idea of adopting the British system of allowing capital gains to go entirely untaxed. S. REP. NO. 588, 73d Cong., 2d Sess. 1939-1 C.B. 586, 594-95 (1934).


5 The most recent factor being congressional concern in 1984 that investors felt "locked-in" to investments by a desire to avoid the recognition of short-term gains and that this had an adverse impact on the efficiency of capital markets. STAFF OF JOINT Comm. ON TAXATION, 98TH Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Reform Act of 1984 1083 (Comm. Print 1984).


7 "Net capital gain" is defined by I.R.C. § 1222(11) as the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year. Thus, the capital gain deduction would be available only for a portion or all of a taxpayer's long-term capital gains.

8 I.R.C. § 1211(b).

9 Act § 301(a)(10). Prior to amendment, it took $2 in long-term losses to offset $1 of ordinary income.
demise of the capital gain deduction, Congress repealed the deduction as a tax preference for the individual alternative minimum tax.10

The changes made by the Act in the capital gains area ripple throughout the Code, affecting tax planning in a wide variety of areas, including investment strategies, retirement planning, executive compensation arrangements, charitable giving, Section 1244 stock, related party transactions, “tax shelters” and state and local income taxes.

A. Investment Strategies

When first considered, the repeal of the capital gains deduction seems to discourage investment, since there is no longer a “reward” for investing on a long-term basis in such “speculative” assets as corporate securities.11 In contrast, the reduction in ordinary tax rates benefits the frequent trader, who now can buy or sell without regard to the holding period of his investments. On balance, the effect of tax reform on investment strategies will more probably be felt in the value of the underlying security, as each company’s earnings are affected by reduced corporate rates, the loss of the investment credit, and other corporate tax changes.

B. Retirement Planning

Individuals with self-directed retirement accounts, such as individual retirement accounts (IRAs), Keogh plans, and, to a certain extent, 401(k) and other employer-sponsored thrift plans, were historically advised to seek income-producing assets to place within the tax-deferred “shelter” of these accounts, in preference to assets with a high prospect of generating capital gains. Long-term capital gains were of little value in retirement accounts, since the tax benefits of capital gains were lost due to the taxation as ordinary income of distributions from such accounts.12 Individuals were advised to hold lower or non-income producing assets capable of capital appreciation in their personal investment portfolios rather than retirement accounts, to take advantage of the capital gain deduction upon the subsequent sale. With this “barrier” removed, taxpayers now are free to make retirement plan investment decisions without reference to whether the expected gain from the investment will take the form of ordinary income or capital gain.13

10 Act § 701 (amending I.R.C. § 56(b)).
11 Following this theory to a logical conclusion, a massive sell off in securities should have occurred in December, 1986, as tax motivated investors sought to “lock-in” long-term capital gain rates on appreciated securities. Or, in response to falling tax rates on ordinary income, investors with unrealized short-term losses should have sold in December to benefit from netting losses against higher tax rates. That nothing remarkable happened is not so much attributable to the action (or inaction of) individual investors as it is to the power of institutional tax-exempt investors such as pension funds, who are not affected by the change in tax rates or the loss of the capital gain deduction.
12 See, e.g., I.R.C. § 408(d).
13 Note, however, that while the Act does not interfere with the investment decision-making process, it does restrict those who may take an income tax deduction for contributions to an IRA. Act § 1101 (adding new § 219(g)).
C. Executive Compensation Arrangements

The loss of the capital gain deduction affects both existing deferred compensation and incentive equity compensation arrangements. The loss of the deduction makes incentive stock options (ISOs) less attractive, as the maximum individual tax rate on long-term capital gains increases from 20% to as high as 33%. Because ISOs are less attractive from a tax rate standpoint, there may be increased demand for nonqualified stock options, stock appreciation rights and performance plans, all of which will benefit vis-a-vis ISOs due to the reduced tax rates on ordinary income.

D. Charitable Giving

Prior to the Act, many higher-bracket taxpayers donated appreciated securities to charitable organizations, thus obtaining a fair market value charitable deduction without recognition (or taxation) of the inherent long-term capital gain. Taxpayers desiring to donate securities with an unrealized loss were advised first to sell the securities and then donate the proceeds, in order to recognize the capital loss. This strategy is not changed by the Act. However, the donation of appreciated property will trigger an alternative minimum tax preference in the amount of the unrecognized long-term capital gain for contributions of appreciated property made after August 15, 1986. The loss of the capital gain deduction, in conjunction with lower tax rates, makes it less attractive solely from a tax standpoint to make charitable contributions.

E. Section 1244 Stock

Section 1244 allows a shareholder to obtain ordinary (rather than capital) loss treatment on the sale, exchange or worthlessness of certain "small business" stock. This provision retains its vitality after the Act because of the retention of the $3,000 capital loss limitation (versus the $100,000 annual loss limitation for taxpayers filing a joint return provided by Section 1244(b)(2)). Further, because the loss on the sale is treated as attributable to the taxpayer's trade or business, it may be taken into account in the computation of a net operating loss.

F. Related Party Transactions

With the merger of ordinary income and capital gain tax rates after 1987, the penalty provisions of Sections 1239 and 707(b)(2), relating to the conver-
sion to ordinary income of otherwise capital gain resulting from a sale of property to a related person, are effectively eliminated.

G. "Tax Shelters"

Notwithstanding the death knell sounded for many shelters due to the passive activity loss limitations discussed below, the loss of the capital gain deduction hurt as well. The goal of many shelters was to convert ordinary income to long-term capital gain. The repeal of the capital gain deduction forces investors to focus on underlying economic assumptions offered by an investment rather than returns generated solely by the Code.

H. State and Local Income Taxes

With the vast majority of states following the Federal Internal Revenue Code in some form or another, the loss of the capital gain deduction will cause state and local income taxes of investors to increase, due to the larger tax base. For states using federal adjusted gross income as a starting point in computing state taxable income, the tax on capital transactions will be 2-1/2 times that under prior law. Many state legislatures are currently wrestling with the decision of what to do with the unexpected revenue increase.

Although the Senate believed that the elimination of the capital gain deduction results in "a tremendous amount of simplification for many taxpayers since their tax will no longer depend upon the characterization of income as ordinary or capital gain," this appears to be more puffery than truth. The Congress retained the entire capital gain statutory structure "to facilitate reinstatement of a capital gains rate differential if there is a future tax increase." Thus, while the vast majority of taxpayers will benefit from reduced rates under the Act, the retention of the capital gain statutory structure inhibits the stated (but illusory) goal of simplification. Rather, it stands for the promise of future law modifications.

II. Passive Activities

Before the Act, many taxpayers successfully reduced their tax liabilities by purchasing interests in limited partnerships and other entities that were engaged in business operations producing tax losses and credits. Probably the most popular was real estate, due to depreciation deductions and significant leveraging opportunities. Equipment leasing was another popular shelter in-

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*The District of Columbia and 38 states are linked to the federal tax system — either by the use of federal concepts as their starting point (for example, adjusted gross income) or by basing state tax liability as a percentage of federal liability.

*A recent survey by the National Association of State Budget Officers indicates that 80% of the state revenue windfall produced by the Act would be returned to taxpayers based on gubernatorial proposals.

*S. Rep. No. 313, supra note 6, at 169.

vestment. A well-structured shelter investment produced a tax loss but did not actually require additional cash investment to cover the loss. Some shelters were even better, providing a real cash flow, but a loss for tax purposes. With these investments, taxpayers could shelter income from other sources, including salaries, interest, and dividends.

The Act's passive activity rules\(^2\) apply to individuals, trusts and estates, personal service corporations, and closely-held C corporations. They are the result of congressional concern over loss of taxpayer faith in the federal income tax system, as well as the need to find sources of revenue to help pay for individual rate reductions.\(^3\) They also reflect an attempt to repair a tax system that was perceived to divert capital from "productive" activities to tax avoidance schemes.

The new rules generally are effective for investments made after the date of enactment, October 22, 1986. A limited phase-in rule permits partial use of losses generated by pre-enactment investments.\(^4\)

These measures have already had a profound effect on investments, primarily in limited partnership activities.

A. Passive Activity Rules — Definition and Operation

If an activity is a "passive activity," losses may only be offset against income from other passive activities,\(^5\) and may not be used against other sources of income. Further, credits generated by passive activities may only offset the tax liability attributable to passive activities.\(^6\)

An activity is a "passive activity" if it involves the conduct of a trade or business in which the taxpayer does not materially participate.\(^7\) "Material" participation is defined as the involvement of the taxpayer in the operation of the activity on a basis which is regular, continuous, and substantial.\(^8\) In determining whether participation is material, all the relevant facts and circumstances are to be examined, including whether the activity is the taxpayer's principal business. In addition, the physical presence of the taxpayer

\(^2\)I.R.C. § 469 (as added by Act § 501).
\(^3\)S. Rep. No. 313, supra note 6, at 713-14.
\(^4\)The phase in does not apply, however, for purposes of the alternative minimum tax. Thus, taxpayers with significant pre-enactment losses may find themselves subject to the Alternative Minimum Tax (AMT) due to the complete disallowance of passive activity losses. I.R.C. § 58(b).
\(^5\)I.R.C. § 469(a)(1)(A).
\(^6\)Id. § 469(a)(1)(B).
\(^7\)Id. § 469(c)(1).
\(^8\)The Conference Report clarifies that management decisions can constitute "material" participation if the decision-making process is bona fide and (impliedly) on a full-time basis. H.R. Rep. No. 841, supra note 21, at II-148.
\(^9\)I.R.C. § 469(h)(1).
at the activity is also to be taken into consideration. The Code specifically provides that limited partners can never be treated as materially participating in an activity, thus they will always be subject to the passive activity rules.

Certain activities are specifically defined as either passive or nonpassive, without regard to material participation by the taxpayer. Rental activities are passive, while working interests in oil and gas property are not passive activities so long as the taxpayer's liability with respect to the working interest is not limited.

Once a determination has been made that an activity is passive, the components of income (or loss) must be analyzed, as certain items of income or loss are not taken into account. Portfolio income and compensation for personal services are excluded from the computation of income or loss from a passive activity.

Excess passive activity losses (passive activity losses in excess of passive activity income) are suspended, and may be carried forward indefinitely. The amount of the suspended loss is to be determined after the application of any

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38S. REP. No. 313, supra note 6, at 732-33.
39I.R.C. § 469(h)(2). For holders of both limited partnership interests and another type of interest (such as a general partnership interest), only the nonlimited partnership interest could qualify for material participation, based on all the relevant facts and circumstances. S. REP. No. 313, supra note 6, at 731.
40I.R.C. § 469(e)(4).
41I.R.C. § 469(e)(2). Rental activity is defined by § 469(j)(8) as an activity where payments are principally for the use of tangible property. Thus, where significant services are provided in connection with a rental of tangible property, the activity will not be considered a rental activity and thus not a passive activity. See, H.R. REP. No. 841, supra note 21, at 11-148 and S. REP. No. 313, supra note 6, at 742.
42I.R.C. § 469(c)(3)(A). If liability is limited, the activity will not be deemed a working interest for the purpose of the passive activity rules. The Senate Finance Committee Report defines a working interest as "an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property." S. REP. No. 313, supra note 6, at 744. Rights to overriding royalties, production payments and contract rights to extract oil and gas will generally be considered portfolio income because they do not bear the cost of development and operation. Id. Section 469(c)(3)(B) prevents taxpayers from converting working interests treated in a prior year as "nonpassive" into passive activities by placing them in a limited partnership or an S corporation.
43I.R.C. § 469(e)(1).
44Portfolio income includes interest, dividends, royalties and annuities not produced in the ordinary course of a trade or business as well as the gain or loss from the disposition of property that produces such interest, dividends, royalties and annuities. I.R.C. § 469(e)(1)(A)(i)(II) and (ii)(II). The investment return on working capital is to be treated as portfolio income. Id. § 469(e)(1)(A)(i)(II). Further, gain or loss from property held for investment (except an interest in a passive activity) is includible in portfolio income. Id. § 469(e)(1)(A)(ii)(II).
45Finally, expenses (other than interest) which are clearly and directly allocable to portfolio income, as well as interest expense which is properly allocable to investment income, shall be taken into account. Id. § 469(e)(1)(A)(ii)(III). The Secretary of the Treasury is directed to deal with expense allocation issues by regulations. Id. § 469(k)(2) and (4).
46Id. § 469(c)(3).
47The Senate Finance Committee Report indicates that the calculation of the suspension of losses is to be on a pro rata basis by taking the disallowed passive activity loss and multiplying by the ratio of the net loss from each individual activity to the total net losses from all passive activities. S. REP. No. 313, supra note 6, at 722.
at-risk or other limitation. Suspended losses will be allowed in full upon a taxable disposition of the passive activity. On the other hand, suspended credits are not automatically allowable upon a disposition, rather, because the passive activity rules are written to allow only economic losses from an activity, they simply disappear.

Because of the "material" participation concept, it is possible for activities to be passive in one year, and nonpassive in the next. Previously suspended passive activity losses and credits, while retaining their character, are allowed to offset the now nonpassive activity income, in the following order: first, income from the activity during the year; and second, the regular tax liability from the activity after taking into account the offset for previously suspended losses. Any remaining unused deduction or credit remains available to be offset against future income from the activity.

Closely-held C corporations are subject to a modified rule: passive activity losses may offset "net active income," but not portfolio income. "Net active income" is defined as the corporation's taxable income for the year, determined without regard to passive activities and portfolio income. Like the treatment afforded a former passive activity for an individual, a change in status of a closely-held C corporation or personal service corporation requires suspended losses to be applied as though the activity were still passive, i.e., for a closely-held C corporation, the losses will continue to be applied against all but portfolio income.

B. Rental Real Estate Activities Exception

Although rental activities are automatically passive, the Act allows

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40S. REP. No. 313, supra note 6, at 723. Note that the Conference Report specifically excludes interest deductions attributable to passive investments from the investment interest limitation. H.R. REP. No. 841, supra note 21, at II-140. Losses not allowed due to at-risk limitations will be subject to the passive activity rules in the year in which they become allowable under the at-risk rules. S. REP. No. 99-313, supra note 6, at 723. Losses that are suspended under the passive activity rules will nonetheless reduce both amounts at risk in the activity and basis. Id. at n. 9.
41I.R.C. § 469(g) requires that the taxpayer dispose of his entire interest in the activity. In a fully taxable transaction with an unrelated person, suspended losses will first be applied against any gain resulting from the sale of the activity, then against any net gain from other passive activities, and finally against other income. I.R.C. § 469(g)(1)(A). Special rules apply in the case of death, id. § 469(g)(2), installment sales, id. § 469(g)(3), and transfers by gift, id. § 469(g)(6).
42S. REP. No. 313, supra note 6, at 725.
43I.R.C. § 469(f)(1)(A) and (B).
44Id. § 469(f)(1)(C).
45Defined generally as 5 or fewer individuals owning, directly or indirectly, more than 50% of the stock. Id. § 469(f)(1)(B). Personal service corporations are excluded from this definition. Id. § 469(e)(2)(A).
46Id. § 469(e)(2).
47Id. § 469(e)(2)(B).
48Id. § 469(f).
49Id. § 469(c).
$25,000 of losses and loss-equivalent credits against other income under certain specified circumstances. 50 Individuals who actively participate in rental real estate activities are allowed to deduct losses up to $25,000 notwithstanding the general disallowance of passive losses. 51 The "active" participation standard requires that the taxpayer own at least a 10% interest in the activity, 52 and, although the level of participation is less stringent than material participation, the taxpayer must still participate in a significant and bona fide sense. 53

A special rule allows taxpayers a $25,000 deduction equivalent of rehabilitation and low income housing credits regardless of active participation, with a higher than otherwise allowable adjusted gross income threshold before commencement of the phaseout of the benefit of the credit. 54

C. Low-Income Housing

The Act provides a temporary reprieve from the passive activity rules for certain investors in "qualified" low-income housing projects. 55 The relief from the passive activity rules, however, is granted only at the cost of foregoing the low-income housing credit (discussed below). 56 For many investors, this "relief" provision may result in less benefit than could have been obtained from the credit.

By limiting passive activity losses to only offset passive activity income, Congress may have finally shut the door on tax shelters. Taxpayers subject to these limitations should begin to reconsider their investment strategy and shift investment dollars from portfolio assets to investments generating passive income. Limited partnership offerings are beginning to respond to this investor need. The rental real estate exception primarily benefits active owners of "small" rental properties. It also offers more protection to pre-existing rental

50 Id. § 469(i).
51 Id. § 469(i)(1) and (2). The $25,000 is phased out for taxpayers with adjusted gross income (computed without regard to IRA contribution deductions, taxable social security benefits, and any passive activity loss) in excess of $100,000. Id. § 469(i)(3). Married individuals filing separate returns are not allowed any deduction unless they have lived apart from their spouse at all times during the taxable year. Id. § 469(i)(5).
52 Id. § 469(i)(6)(A).
53 "The Senate Finance Committee Report indicates that management decisions (e.g., approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions) or arranging for others to provide services will satisfy the active participation standard. S. REP. No. 313, supra note 6, at 737-38.
54 For example, a taxpayer in the 28% bracket would receive a maximum credit of $7,000, the equivalent of a $25,000 deduction.
55 I.R.C. § 469(i)(3)(B) and (6)(B).
56 Relief from the passive activity rules is available beginning with the taxable year in which the investor made his initial investment in the low-income housing project and ending with the earliest of (1) the sixth taxable year after the year of initial investment, (2) the first taxable year after the year of the final investment, or (3) the taxable year preceding the first year in which the qualified status of the project is lost.
57 Act § 502. Act § 502(c) details the requirements for qualification of the housing project.
58 Act § 502(d)(3). In addition, the credit will be lost for the project if any investor in the project takes advantage of the relief provision. Id.
units than it serves as an incentive to enter the rental real estate market, particularly when examined in conjunction with the lengthened depreciable lives for both residential and nonresidential rental property.\textsuperscript{59} To the extent that these types of investments will now be viewed in terms only of economic return, Congress may well have achieved its dual goals of encouraging productive allocation of investments dollars and maintaining taxpayer faith in the tax system.

III. AT-RISK RULES

Prior to 1976, the only restriction on the amount of losses a taxpayer could claim from any investment activity was the limitation of cost or other basis.\textsuperscript{60}

The Tax Reform Act of 1976\textsuperscript{61} added Section 465 to the Code, which generally prohibits losses in excess of the taxpayer's amount "at risk" with respect to an activity.\textsuperscript{62} The amount "at risk" generally consists of cash and the adjusted basis of other property contributed to the activity, any amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for payment, and the net fair market value of personal assets securing nonrecourse borrowings.\textsuperscript{63} Although the original scope of Section 465 was limited to such activities as motion pictures, leasing, farming, and oil and gas, the at-risk rules were subsequently expanded to cover other activities, with an exception carved out for real estate.\textsuperscript{64} Because basis could be created for real estate with the stroke of a pen on a nonrecourse mortgage, Congress became concerned with the potential for abuse in overvaluing real property, thus inflating deductions for depreciation.\textsuperscript{65}

The Act repeals the exception for the activity of holding real estate from the application of the at-risk rules.\textsuperscript{66} At the same time, however, the Act lessens the impact by extending the definition of amounts at risk to include "qualified nonrecourse financing."\textsuperscript{67}

"Qualified nonrecourse financing" is defined as financing (1) which is borrowed by the taxpayer in connection with the holding of real property, (2)

\textsuperscript{59} Act § 201(a) amends I.R.C. § 168 to generally lengthen the recovery period used in calculating depreciation deductions.
\textsuperscript{60} See, e.g., I.R.C. § 704(d).
\textsuperscript{62} TRA '76 § 204(a).
\textsuperscript{63} I.R.C. § 465(b).
\textsuperscript{64} The Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978), extended the at-risk rules to all activities except real estate and certain equipment leasing activities engaged in by closely-held corporations. The extension of the at-risk rules to real estate activities came only 10 years and 18 days after the rules were first enacted to cover the limited tax-shelter abuses perceived by the Tax Reform Act of 1976.
\textsuperscript{66} Act § 503(a).
\textsuperscript{67} Id. § 503(b).
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which is borrowed from a "qualified person" or is a loan from any federal, state or local government or instrumentality, or is guaranteed by a federal, state or local government, (3) with respect to which no person is liable for repayment (i.e., is nonrecourse), and (4) which is not convertible debt. A "qualified person" is any person who is actively and regularly engaged in the business of lending money, and who is not (1) related to the taxpayer, (2) a person from whom the taxpayer acquired the property, or (3) a person receiving a fee with respect to the taxpayer's investment in the property.

A nonrecourse loan will still constitute an amount at risk when an otherwise qualified lender maintains an equity interest in the property if the nonrecourse loan is made on terms which are both commercially reasonable and substantially the same as loans involving an unrelated person. The Conference Report indicates that the commercially reasonable standard will be met if the financing is a written and unconditional promise to pay (either on demand or for a term) and the interest rate is reasonable (measured by market standards and the below-market loan standards of Section 7872). In addition, although the interest rate may not be contingent, a variable rate of interest is allowed if it is pegged to a market interest index such as a major bank's prime rate, a government securities rate, or the applicable federal rate.

The extension of the at-risk rules to real estate activities is generally effective for losses incurred after 1986 on property placed in service after 1986. The at-risk rules also apply to all losses of pass-through entities where the interest in the entity is purchased after 1986.

IV. CREDITS

Prior to the Act, individuals made many investments which generated tax credits, favored because of the dollar-for-dollar offset against tax liability. The Act modifies, repeals, and adds to these credit provisions.
A. Investment Credit

Since its inception in 1962 as a means of stimulating capital investment, the investment tax credit has been the subject of considerable debate. Its history has been stormy, with periods of suspension, termination and resurrection. The Act repeals the investment tax credit for property placed in service after December 31, 1985.

B. Low-Income Housing Credit

The Act establishes a new credit for investment in qualified low-income housing projects. The credit structure is unique in that available credits earned by an investment are claimed annually over a 10-year period. For buildings placed in service in 1987, new construction and rehabilitation expenditures funded without tax-exempt bonds or other federal subsidies will generally qualify for a 9% credit percentage. All other qualified expenditures are entitled to a 4% credit percentage.

A taxpayer's credit amount in any one taxable year is computed by applying the applicable credit percentage to the qualified expenditure base amount for the year in question. The qualified basis amount is determined by the proportion of eligible basis attributable to low-income rental units, and consists generally of the eligible cost of new construction or rehabilitation, or the cost of certain building acquisitions including their subsequent rehabilitation.

Residential rental projects qualify for the credit only if certain minimum set-aside requirements are met. Either 20% or more of the aggregate residential units in a project must be occupied by individuals at an income level of 50% or less of the area median income (the "20/50" test), or 40% or more of

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98 I.R.C. § 49 (added by Act § 211(a)). Similar to the repeal of the capital gain deduction, the existing investment tax credit statutory framework has been left in place, to await the credit's (inevitable) return.
99 Act § 252(a) (adding new I.R.C. § 42).
100 I.R.C. § 42(f)(1) defines the credit period as a period of 10 taxable years beginning with the taxable year in which the building is placed in service. At the election of the taxpayer, the succeeding taxable year may begin the credit period. The credit allowed in the first year of the credit period is prorated to reflect a partial year of qualification; disallowed credits due to this proration are allowed in year 11.
102 Id. § 42(b)(1)(B).
103 Id. § 42(a).
104 Id. § 42(c)(1). The proportion is the lesser of (1) the proportion of low-income units to all residential rental units, or (2) the proportion of floor space of the low-income units to the floor space of all residential rental units. H.R. REP. No. 841, supra note 21, at II-89.
105 I.R.C. § 42(d).
106 Id. § 42(g)(1). The owner must choose between the two tests at the time the project is placed in service. The set-aside requirements must be met within 12 months after the placed-in-service date, and then continuously met for a period of 15 years.
107 Id. § 42(g)(1)(A).
the aggregate residential rental units must be occupied by individuals at an income level of 60% or less of the area median income (the "40/60" test). All units in the project’s minimum set-aside must be suitable for occupancy, used on a nontransient basis, and meet a gross rent limitation. Hotels, dormitories, nursing homes, hospitals, lifecare facilities, and retirement homes do not qualify for the credit.

The Act provides for a state volume limitation that gives a state the authority to determine which projects within the state will be eligible in whole or in part for the credit.

If projects fail to comply with these rules for the required 15-year period, some or all of the credit will be recaptured with interest. The low-income housing credit is generally available for property placed in service after 1986 and before 1990.

C. Rehabilitation Tax Credit

The Act modifies the rehabilitation tax credit and reduces the maximum allowable percentage available for qualifying structures. The definition of a qualified rehabilitated building is modified to allow the nonhistoric credit to be claimed only on buildings placed in service before 1936. Further, an "internal structural framework" test is added to prevent taxpayers desiring to claim the credit from gutting and rebuilding the interiors of qualifying buildings. Finally, the depreciable basis of a certified historic structure must now be reduced by the full amount of the credit. The Act does not modify the prior-law requirement that the nonhistoric credit may be taken only if the building is used for nonresidential purposes. The changes to the rehabilitation tax credit

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8 H.R. REP. NO. 841, supra note 21, at 11-92. The gross rent including utilities (other than telephone) paid by families in minimum set-aside units may not exceed 30% of the qualifying income for tenants, based on family size. Id. at 11-94.
8 Id. at 11-95.
8 I.R.C. § 42(h).
8 Id. § 42(j)(1).
3 Act § 252(e), I.R.C. § 42(n).
4 Act § 251. I.R.C. § 46(b)(4) is amended to allow a 10% credit with respect to qualified expenditures incurred in connection with the rehabilitation of a nonhistoric structure and a 20% credit with respect to a certified historic structure. Prior law allowed either a 15% or 20% credit for nonhistoric structures (depending on building age) and a 25% credit for certified historic structures.
5 "Nonhistoric" in this context means "other than certified historic structure."
6 I.R.C. § 48(g)(1)(B). Prior law allowed the nonhistoric rehabilitation credit to be taken on buildings as little as 30 years old. This requirement alone substantially reduces the availability of the credit.
7 Id. § 48(g)(1)(A)(iii)(III). This test applies only to nonhistoric rehabilitations and requires that 75% or more of the existing structural framework of the building be retained in place.
8 Act § 251(c). Prior to amendment I.R.C. § 48(q)(3) required only a 50% basis adjustment for the credit on certified historic structures.
9 S. REP. NO. 313, supra note 6, at 754. The credit on certified historic structures continues to be available for residential or nonresidential buildings.
are generally effective for property placed in service after December 31, 1986, in taxable years ending after that date.

The low-income housing credit and rehabilitation tax credit are allowed a limited exemption from the otherwise applicable passive activity rules. The credit equivalent of $25,000 of earned or portfolio income may be offset by the credits (but not losses) generated by these projects. Investors contemplating using these credits should plan carefully to avoid partial loss of available credits due to the adjusted gross income phaseout limitations. In addition, because the passive activity limitations are applicable to these activities, the investments should be reviewed to determine whether unusable losses will be generated.

V. OTHER INVESTMENT CONSIDERATIONS

While the Act’s major impact on personal investments comes from its effect on capital gains, passive activities and tax credits, it also affects investments in other ways, such as its effect on investment vehicles and the imposition of restrictions on the deductibility of investment expenses.

The form or manner in which an investment is made has important implications in the tax law. Although the Act does not make substantive changes to the manner in which these investment vehicles operate, it nonetheless has an effect.

Limited partnerships traditionally offered investors opportunities to shelter other income from tax by utilizing losses and credits generated by the partnership’s activities. The limited partnership structure was particularly attractive because investors benefited from professional management by the general partner as well as the limited liability for unexpected losses or litigation. While the Act does not directly affect limited partnership offerings, it substantially modifies the type of limited partnership offerings that will be purchased by investors. The material participation standard prevents limited partners from benefiting from the pass-through of passive activity losses. Further, the Act phases out the benefit of such losses generated by pre-Act investments. Thus, an increased importance will be placed by investors on offerings which offer passive income as well as positive cash flow to offset against current or suspended passive activity losses.

Oil and gas investments are particularly hard hit by the Act. Most oil and gas investment by individuals is through the use of limited partnerships. While losses will be limited by the passive activity rules, taxpayers who attempt to

99 Although many times the form of the investment is chosen for other than tax reasons (concern for limited liability, desire for professional management), the structure chosen will have a tax impact. For example, investments made through a corporate structure may cause the corporation to incur the personal holding company tax. Partnership investments are subject to the special allocation rules of I.R.C. § 704(b) and the passive activity rules of the Act.
take advantage of the "working interest" exception to the rules will subject themselves to the liability avoided with a limited partnership format.

Although future limited partnership offerings will be economic offerings, difficult decisions must be made by investors who purchased yesterday's tax-oriented syndications. In many instances an investor has a negative basis, thus creating potential "phantom income" upon a disposition. Alternatives available to investors in this situation include (1) matching passive losses with passive income from new investments in today's "economic" deals, (2) holding the units (without benefit from the suspended losses) until the partnership terminates, or (3) finding a corporate purchaser who can offset the passive losses against active business income.

Under the Act, S corporations become a more attractive means of investing, although not because of the flow-through of losses, since S corporation shareholders are subject to the passive activity rules. Rather, S corporations are a more attractive means of investing in activities producing income. The Act sets the maximum tax rate for individuals below the highest corporate rate for the first time, thus encouraging individuals to avoid a corporate level tax and pay tax only at the lower individual rates. S corporations may also provide a valuable vehicle for creating passive income to offset against potentially unusable passive activity losses. Income of an S corporation will be passive if it relates to a trade or business and the shareholder does not materially participate in the activity, or if the activity relates to any rental activity.

Life insurance products were left virtually untouched by the Act, and cash value products have taken on a new lustre due to the deferred taxation on the build up of policy values. Although the repeal of the personal interest deduction adversely affects policy borrowings (in particular minimum deposit policies), products such as single premium life insurance have become more attractive compared to other investment alternatives. Nonetheless, care should be exercised before leaping into this new "tax shelter." First, the publicity already accorded these products makes them prime candidates for future tax law changes. Second, the financial stability of the insurance carrier is more important when a single premium policy is purchased than when purchasing term insurance.

The deduction for investment interest expense has been severely limited under the Act. The Act limits the deductibility of investment interest expense to the amount of the taxpayer's net investment income. The definition

\[10\] I.R.C. §§ 1361-79.

\[11\] A principal disadvantage of S corporations is the limitation on the number and type of shareholders. I.R.C. § 1361(b).

\[12\] I.R.C. § 469(c).

\[13\] Act § 511(a) (amending I.R.C. § 163(d)).

\[14\] I.R.C. § 163(d)(1). Any investment interest expense disallowed as a result of the limitation may be carried forward indefinitely. Id. § 163(d)(2).
of net investment income has been expanded to include any gain from the sale of investment property (other than investments in passive activities) and, as under prior law, interest, dividends, royalties, etc. In addition, the taxpayer’s allocable share of net portfolio income from a passive activity generally will be included in net investment income. Interest expense incurred in connection with a passive activity is generally not considered investment interest expense, but is presumably included with the passive activity income or loss and is subject to the passive activity limitations. The new investment interest expense rules are generally effective for tax years beginning after 1986. The disallowance of investment interest due solely to the loss of the prior-law $10,000 allowance is phased in over a five-year period.

Most investment expenses taken as miscellaneous itemized deductions are subject to a new 2% of adjusted gross income floor beginning after 1986. These expenses include investment counseling fees, IRA fees paid to a custodian, fees for safe deposit boxes used to hold investment property, and subscriptions for investment publications. In addition, the Treasury is authorized to issue regulations concerning the disallowance of an indirect deduction of these expenses through certain pass-through entities, such as mutual funds, partnerships and S corporations.

The installment sales rules for investment property have been modified by the Act. Under prior law, sales of securities could be reported under the installment method if at least one payment was received after the taxpayer’s year end. The Act prohibits installment sales treatment for sales of stock or securities which are traded on an established securities market for tax years beginning after 1986.

\[\text{http://ideaexchange.uakron.edu/akrontaxjournal/vol4/iss1/4}\]
Finally, the $100 dividend exclusion ($200 for married individuals filing a joint return) has been repealed.\textsuperscript{119} Although of insignificant benefit to most individuals, Congress felt that it tended to disproportionately benefit high-bracket taxpayers.\textsuperscript{120}

**CONCLUSION**

By focusing attention on the nontax aspects of investment alternatives, the Act forces investors to analyze and evaluate the economics of a proposed transaction, rather than the tax benefits to be derived. This process, while traumatic at first, should achieve Congress' goals of improving efficiency of the capital and investment markets.

This efficiency is achieved, however, at the cost of an increasingly complex tax code as well as a realization that the tax code cannot be used to influence all social policy in an efficient manner. Although the Act makes significant changes to underlying investment strategies, it also reduces the need to rely on tax-oriented investments. The lower tax rates in many instances compensate for the loss of long-standing tax preferences.

\textsuperscript{119} Act § 612(a).
\textsuperscript{120} H.R. Rep. No. 426, supra note 65, at 247.