CHAPTER 16

OTHER CURTAILMENT OF TAX SHELTERS

Current rules limiting the deduction of investment interest are inadequate to curtail tax shelter abuses. This Chapter proposes a comprehensive limitation on the deduction of nonbusiness interest. In addition, the special exceptions to the at-risk limitations for certain leasing and real estate activities would be repealed, so that the at-risk rules would apply uniformly to all activities.

LIMIT INTEREST DEDUCTIONS

General Explanation

Chapter 16.01

Current Law

In general, interest paid or incurred on indebtedness is fully deductible from income. This general rule is subject to exceptions for interest on indebtedness incurred to generate certain tax-preferred income. Thus, for taxpayers other than certain financial institutions, no deduction is allowed for interest on indebtedness incurred to purchase or carry obligations which generate tax-exempt income. In addition, for noncorporate taxpayers, interest on debt incurred to acquire or carry investment property ("investment interest") is deductible only to the extent of the sum of (i) $10,000 ($5,000 for married persons filing separately), (ii) "net investment income," and (iii) certain deductions attributable to net-leased property. Amounts disallowed under this limitation for a taxable year are carried forward and treated as investment interest in the succeeding taxable year.

Interest on debt incurred to acquire or carry personal-use property or business property is ordinarily deductible currently, even if that property does not produce taxable income or is likely to appreciate substantially (resulting in deferred capital gains). (See Ch. 10.01 for a discussion of circumstances in which interest costs must be capitalized when incurred in connection with certain production or manufacturing activities.)

Reasons for Change

Clear reflection of income for tax purposes requires that the costs of generating income be matched with the income actually earned. If a current deduction is allowed for the cost of producing income that is exempt from tax or includible in income on a deferred basis, the current deduction will offset other taxable income and thus eliminate or defer tax. Such "tax arbitrage" occurs, for example, when an investor deducts interest on indebtedness incurred to acquire or carry assets that yield tax-exempt income such as personal-use property or assets held in an Individual Retirement Account. It also occurs, though with less predictability, where indebtedness is incurred to acquire or carry interests in business property that experiences real appreciation over time.

Current law permits taxpayers to deduct the interest costs of generating certain tax-exempt or tax-deferred income. Although interest incurred to acquire or carry tax-exempt bonds is nondeductible, interest incurred to produce analogous forms of tax-preferred income is deductible without limitation. Thus, "consumer interest," i.e., interest incurred to acquire personal assets, such as a car or vacation home, is fully deductible, even though such assets do not generate taxable income. Similarly, current law limits the deductibility of "investment interest," but interest incurred in a trade or business is fully deductible, even if the investor is not actively engaged in the management of the business and much of the return from the business is expected to be in the form of deferred capital gains. This current deductibility of interest is an important feature of real estate tax shelter investments structured as limited partnerships.

The unlimited deduction for consumer and "passive" business interest also undermines existing limitations on investment interest and interest incurred to acquire tax-exempt bonds. Since money is fungible, the identification required under current law of the purpose for which indebtedness is incurred is difficult at best. The general deductibility of all consumer and business interest complicates the task of determining whether debt was incurred for a nondeductible purpose.

Proposal

Interest subject to the current investment interest limitation would be expanded to include: (a) all interest not incurred in connection with a trade or business (other than interest on debt secured by the taxpayer's principal residence, to the extent such debt does not exceed the fair market value of the residence), (b) the taxpayer's share of all interest expense of S corporations (other than S corporations in which the taxpayer actively participates in management), and (c) the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. Interest on indebtedness incurred to carry or acquire business rental property used by the taxpayer for personal purposes for part of a taxable year would generally be treated as business interest (and thus not subject to limitation) in the same proportion that the number of days the property is rented at a fair rental bears to the number of days in the taxable year.

Interest subject to the limitation would be deductible only to the extent of the sum of (a) $5,000 ($2,500 in the case of a married person filing a separate return), and (b) the taxpayer's net investment income. In general, net investment income for this purpose would have the same meaning as under current law, except that it would include the taxpayer's share of all income of S corporations not managed by the taxpayer, and the taxpayer's distributive share of all income of limited partnerships in which the taxpayer is a limited partner. Any interest deduction disallowed for the taxable year under this limitation would be treated as investment interest expense for the succeeding taxable year.

In general, interest income and expense would be adjusted by application of the fractional exclusion rate (see Ch. 9.03) prior to application of the investment interest limitation. Suspended interest deductible in a succeeding taxable year would not be subject to further adjustment by the fractional exclusion rate. If interest subject to the limitation includes both itemized and nonitemized interest expense deductions, suspended interest would first reduce the current deduction for nonitemized interest expense to the extent thereof, and the current deduction for itemized interest expense to the extent of any excess. Suspended interest deductions subsequently allowed would first be treated as itemized interest expense, to the extent of suspended itemized interest deductions, and nonitemized interest expense to the extent of the excess.

Effective Date

The proposal would be effective for interest expense paid or incurred in taxable years beginning on or after January 1, 1986. The expanded limitation would be phased in so that for taxable years beginning before January 1, 1988, interest subject to limitation would be deductible to the extent of $10,000 plus net investment income.

Analysis

Because the expanded limitation on interest deductions would not apply to mortgage interest deductions on the taxpayer's principal residence nor to the first $5,000 of any additional interest expense, the vast majority of taxpayers would not be affected by the proposal. Interest expenses attributable to a trade or business in which the taxpayer actively participates also would not be subject to the limitation. Thus, sole proprietors, owner-operators of farms, general partners, and shareholder-managers of S corporations would continue to treat their business expenses in the same manner as under current law. However, taxpayers with substantial tax shelter interest expense would be prevented, in many cases, from using that interest expense to offset business and employment income.

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EXTEND AT-RISK LIMITATION TO ALL ACTIVITIES

General Explanation

Chapter 16.02

Current Law

In general, current law limits the loss a taxpayer may deduct from an investment to the amount the taxpayer has at-risk with respect to such investment. This "at-risk" limitation on deductible losses applies to individuals and to certain closely held corporations, and is applied on an "activity-by-activity" basis.

For purposes of the at-risk rules, a taxpayer is generally at-risk in an activity to the extent that the taxpayer has contributed money or property (to the extent of its basis) to the activity, or is personally liable to repay borrowed funds used in the activity. A taxpayer is not considered to be at-risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop loss or similar arrangements. Losses which are disallowed for a taxable year under the at-risk rules are carried forward indefinitely and are allowed in a succeeding taxable year to the extent that the taxpayer increases the amount at-risk in the activity giving rise to the losses.

The at-risk rules apply to all activities other than (1) real estate activities and (2) certain equipment leasing activities conducted by closely held corporations. Accordingly, an investor in real estate (or a closely held corporation engaging in certain equipment leasing activities) may deduct losses from the investment for tax purposes that exceed the investor's maximum possible economic loss from the investment.

Reasons for Change

The at-risk rules of current law reflect the fact that, as an economic matter, an investor cannot lose more than the amount that he or she has directly invested plus any additional amount for which the investor is liable. This principle is no less true for investments in real estate or equipment leasing than it is for the activities to which the current at-risk rules apply.

The exclusion of real estate and equipment leasing from the at-risk rules allows taxpayers investing in such activities to offset taxable income with tax losses that will never be matched by economic losses. The allowance of such noneconomic losses for tax purposes is a necessary basis for many tax shelter investments. Front-loaded tax losses that have no economic basis permit the investor to shelter other income from tax. The resulting deferral of tax liability guarantees a return to the investor that may make an otherwise noneconomic investment plausible. Tax-driven noneconomic investment activity diverts capital from more productive uses, causes overinvestment in the tax-preferred activities and thus distorts prices and capital costs throughout the economy.

Tax shelter activity also invites disrespect for the tax law. Whether legally justified or not, the use of tax shelters by high-income, well advised taxpayers is viewed with confusion and skepticism by taxpayers. These perceptions undermine the voluntary compliance that is crucial to the income tax system.

Proposal

The at-risk rules would be extended to all investment and business activities, including real estate and equipment leasing activities. The at-risk rules would continue to be applicable only to individuals and certain closely held corporations.

Effective Date

The proposal would be effective for losses attributable to property acquired after the date on which the proposal is introduced as legislation, unless acquired pursuant to a binding contract entered into prior to that date.

Analysis

Extending the at-risk rules to all activities would not inhibit the leveraged acquisition of properties expected to yield a market rate of return. The proposal, however, would require that investors in real estate and leasing activities evaluate the economic risk of loss associated with investments in those activities as well as their tax benefits and income potential. The proposal thus would leave real estate and equipment leasing investments subject to the same market discipline as currently applies to investments generally. The enhanced neutrality among investment alternatives would improve resource allocation and reduce overinvestment in these activities that are currently tax preferred. This, in turn, should lead to overall productivity gains.

It is possible that the laws of some States that preclude the use of recourse debt in connection with the acquisition of certain real estate could prevent certain investors in those States from receiving full tax benefits from leveraged real estate investments. It is anticipated that any such States would act quickly to permit business investments in real estate to employ recourse indebtedness.