

Notice of Proposed Rulemaking

At-Risk Limitations; Interest Other Than That of a Creditor

REG-209377-89

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the treatment, for purposes of the at-risk limitations, of amounts borrowed from a person who has an interest in an activity other than that of a creditor or from a person related to a person (other than the borrower) with such an interest. Proposed regulations published in 1979 provide that amounts borrowed from a person who has an interest in an activity other than that of a creditor do not increase the amount at risk in certain enumerated activities. These proposed regulations extend this rule to all activities subject to the at-risk limitations. In addition, the rule is conformed to the current statutory language providing for its application to amounts borrowed from persons related to a person (other than the borrower) with an interest other than that of a creditor. These proposed regulations affect taxpayers subject to the at-risk limitations and provide them with guidance necessary to comply with the law.

DATES: Written or electronic comments and requests for a public hearing must be received no later than October 6, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-209377-89), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-209377-89), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at: www.irs.gov/reg.

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations, Tara P. Volungis or Christopher L. Trump, 202-622-3080; concerning submissions and requests for a public hearing, Sonya Cruse, 202-622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document proposes amendments to 26 CFR part 1 to provide additional rules under section 465 of the Internal Revenue Code of 1986 (Code), as amended. Section 465 was added to the Code by section 204 of the Tax Reform Act of 1976 (Public Law 94-455, 90 Stat. 1531). Section 465 limits the deductibility of losses to a taxpayer's economic investment (the amount at risk) in the activity at the close of a taxable year. A taxpayer is generally considered at risk in an activity to the extent of cash and the adjusted basis of property contributed by the taxpayer to the activity. In general, a taxpayer's amount at risk also includes any amounts borrowed for use in the activity if the taxpayer is personally liable for repayment or if property other than property used in the activity is pledged as security.

As originally enacted, section 465 applied to certain enumerated activities described in section 465(c)(1) (old activities). Subsequent amendments made by section 201 of the Revenue Act of 1978 (Public Law 95-600, 92 Stat. 2814) extended the at-risk rules to other activities described in section 465(c)(3)(A) (new activities).

On June 5, 1979, the IRS published in the **Federal Register** (44 FR 32235) proposed regulations (LR-166-76) relating to the treatment of investments in old activities under section 465 of the Code (the previously proposed regulations). Section 1.465-8 of the previously proposed regulations provides that amounts borrowed by a taxpayer for use in an old activity do not increase the taxpayer's amount at risk if the lender has an interest in the activity other than that of a creditor. Section 1.465-20 of the previously proposed regulations provides rules for the treatment of amounts borrowed from certain persons and amounts protected against loss. This document proposes to amend §§1.465-8

and 1.465-20 of the previously proposed regulations.

Explanation of Provisions

I. Application of Section 465(b)(3) to New Activities

Under section 465(b)(3), amounts borrowed for use in an activity will not increase the borrower's amount at risk in the activity if the lender has an interest other than that of a creditor in the activity (a disqualifying interest) or if the lender is related to a person (other than the borrower) who has a disqualifying interest in the activity. The rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity.

Section 465(c)(3)(D) provides that section 465(b)(3) will apply to new activities only to the extent provided in regulations prescribed by the Secretary. The Tax Court in *Alexander v. Commissioner*, 95 T.C. 467 (1990), held that, until regulations are issued, section 465(b)(3) cannot be applied to a new activity. These proposed regulations will apply section 465(b)(3) to the new activities described in section 465(c)(3)(A).

II. Related Persons

As originally enacted, section 465(b)(3) also applied to any borrowing from persons related to the taxpayer under section 267(b). Section 432(c) of the Deficit Reduction Act of 1984 (Public Law 98-369, 98 Stat. 814) eliminated this rule but provided, instead, that a taxpayer's amount at risk is not increased by amounts borrowed from a person related to a person (other than the taxpayer) who has a disqualifying interest in the activity. These proposed regulations change §1.465-20 of the previously proposed regulations to reflect the amendment made by the Deficit Reduction Act of 1984.

III. Scope of §1.465-8

These proposed regulations modify the previously proposed regulations to reflect section 465(b)(3)(B)(ii), which provides that, for purposes of determining a corporation's amount at risk, an interest as a

shareholder is not a disqualifying interest. Thus, amounts borrowed by a corporation from its shareholders may increase the corporation's amount at risk.

These proposed regulations also modify the previously proposed regulations to reflect section 465(b)(6)(A), which provides that "qualified nonrecourse financing," if borrowed for use in an activity of holding real property and secured by real property used in the activity, is not subject to the limitations of section 465(b)(3). In addition, these proposed regulations expand the exception to include financing that, if it were nonrecourse, would be financing described in section 465(b)(6)(B). This expansion of the exception ensures that recourse financing is treated no worse than qualified nonrecourse financing.

Proposed Effective Date

The new rules in these regulations are proposed to be applicable to amounts borrowed after the rules are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request

comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Tara P. Volungis and Christopher L. Trump of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from Treasury and the IRS participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1, which was proposed at 44 FR 32235 (June 5, 1979), is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.465–8 also issued under 26 U.S.C. 465. * * *

Section 1.465–20 also issued under 26 U.S.C. 465. * * *

Par. 2. Section 1.465–8, as proposed at 44 FR 32238 (June 5, 1979), is amended as follows:

1. Paragraphs (a) and (b)(1) are revised.

2. The last sentence of paragraph (c)(1) is revised.

3. The second sentence of paragraph (d)(1) is revised.

4. Paragraph (e) is added.

The revisions and additions read as follows:

§1.465–8 General rules; interest other than that of a creditor.

(a) *In general*—(1) *Amounts borrowed.* This section applies to amounts borrowed for use in an activity described in section 465(c)(1) or (c)(3)(A). Amounts borrowed

with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor or is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor. This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity. For additional rules relating to the treatment of amounts borrowed from these persons, see §1.465–20.

(2) *Certain borrowed amounts excepted.* (i) For purposes of determining a corporation's amount at risk, an interest in the corporation as a shareholder is not an interest in any activity of the corporation. Thus, amounts borrowed by a corporation from a shareholder may increase the corporation's amount at risk.

(ii) For purposes of determining a taxpayer's amount at risk in an activity of holding real property, paragraph (a)(1) of this section does not apply to financing that is secured by real property used in the activity and is either—

(A) Qualified nonrecourse financing described in section 465(b)(6)(B); or

(B) Financing that, if it were nonrecourse, would be financing described in section 465(b)(6)(B).

(b) *Loans for which the borrower is personally liable for repayment*—(1) *General rule.* If a borrower is personally liable for the repayment of a loan for use in an activity, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

* * * * *

(c) * * *

(1) * * * In the case of such a loan a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.

* * * * *

(d) * * *

(1) * * * In the case of such a loan a person shall be considered a person with an interest in the activity other than that of a creditor if the person stands to receive financial gain (other than interest) from the

activity or from the sale of interests in the activity. * * *

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(e) *Effective date.* This section applies to amounts borrowed after the date this section is published as a final regulation in the **Federal Register**.

Par. 3. Section 1.465–20, as proposed at 44 FR 32241 (June 5, 1979), is amended as follows:

1. Paragraphs (a) and (b) are revised.
2. Paragraph (d) is added.

The revisions and additions read as follows:

§1.465–20 Treatment of amounts borrowed from certain persons and amounts protected against loss.

(a) *General rule.* The following amounts are treated in the same manner as borrowed amounts for which the taxpayer has no personal liability and for which no security is pledged—

(1) Amounts that do not increase the taxpayer's amount at risk because they are borrowed from a person who has an interest in the activity other than that of a creditor or from a person who is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor; and

(2) Amounts (whether or not borrowed) that are protected against loss.

(b) *Interest other than that of a creditor; cross reference.* See §1.465–8 for additional rules relating to amounts borrowed from a person who has an interest in the activity other than that of a creditor or is related to a person (other than the taxpayer) who has an interest in the activity other than that of a creditor.

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(d) *Effective date.* This section applies to amounts borrowed after the date this section is published as a final regulation in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.