

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As originally enacted, section 465 applied to certain enumerated activities described in section 465(c)(1) (old activities).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.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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: