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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9124

RIN 1545-BA69

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

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: These regulations finalize the rules 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. These regulations affect taxpayers subject to the at-risk limitations and provide them with guidance necessary to comply with the law.

DATES: Effective Date: These regulations are effective May 3, 2004.

Applicability Date: For dates of applicability, see §§1.465-8(e) and 1.465-20(d).

FOR FURTHER INFORMATION CONTACT: Tara P. Volungis or Christopher L. Trump, 202-622-3070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 to provide rules relating to the treatment, for purposes of the at-risk limitations under section 465 of the Internal Revenue Code (Code), of amounts borrowed from a person who has an interest in an activity other than that of a creditor. 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 certain activities under section 465 of the Code. On July 8, 2003, a notice of proposed rulemaking (REG-209377-89) amending §§1.465-8 and 1.465-20 of the proposed regulations was published in the Federal Register (68 FR 40583). No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations under §§1.465-8 and 1.465-20 are adopted by this Treasury decision.

Explanation of Provisions

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.

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. 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. Section 465(c)(3)(D) provides that this rule applies to new activities (activities that were not subject to section 465 before 1978) only to the extent provided in regulations.

These regulations apply the rule of section 465(b)(3) to new activities and provide rules for determining when a person has an interest in an activity other than that of a creditor. Additional rules are provided with respect to related persons, interests as a shareholder, and qualified nonrecourse financing.

Special Analyses

It has been determined that this Treasury decision 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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. Sections 1.465-8 and 1.465-20 are added to 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.

(2) Capital interest. For the purposes of this section a capital interest in an activity means an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity. The partners of a partnership and the

shareholders of an S corporation are considered to have capital interests in the activities conducted by the partnership or S corporation.

(3) Interest in net profits. For the purposes of this section it is not necessary for a person to have any incidents of ownership in the activity in order to have an interest in the net profits of the activity. For example, an employee or independent contractor any part of whose compensation is determined with reference to the net profits of the activity will be considered to have an interest in the net profits of the activity.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A, the owner of a herd of cattle sells the herd to partnership BCD. BCD pays A \$10,000 in cash and executes a note for \$30,000 payable to A. The three partners, B, C, and D, each assumes personal liability for repayment of the amount owed A. In addition, BCD enters into an agreement with A under which A is to take care of the cattle for BCD in return for compensation equal to 6 percent of BCD's net profits from the activity. Because A has an interest in the net profits of BCD's farming activity, A is considered to have an interest in the activity other than that of a creditor. Accordingly, amounts payable to A for use in that activity do not increase the partners' amount at risk even though the partners assume personal liability for repayment.

Example 2. Assume the same facts as in Example 1 except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 1 percent of the gross receipts from the activity. A does not have a capital interest in BCD. A's interest in the gross receipts is not

considered an interest in the net profits. Because B, C, and D assumed personal liability for the amounts payable to A, and A has neither a capital interest nor an interest in the net profits of the activity, A is not considered to have an interest in the activity other than that of a creditor with respect to the \$30,000 loan. Accordingly, B, C, and D are at risk for their share of the loan if the other provisions of section 465 are met.

Example 3. Assume the same facts as in Example 1 except that instead of receiving compensation equal to 6 percent of BCD's net profits from the activity, A instead receives compensation equal to 6 percent of the net profits from the activity or \$15,000, whichever is greater. A is considered to have an interest in the net profits from the activity and accordingly will be treated as a person with an interest in the activity other than that of a creditor.

(c) Nonrecourse loans secured by assets with a readily ascertainable fair market value--(1) General rule. This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which has a readily ascertainable fair market value. 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.

(2) Example. The provisions of this paragraph (c) may be illustrated by the following example:

Example. 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.

(d) Nonrecourse loans secured by assets without a readily ascertainable fair market value--(1) General rule.

This paragraph shall apply in the case of a nonrecourse loan for use in an activity where the loan is secured by property which does not have a readily ascertainable fair market value. 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. 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.

(2) Example. The provisions of this paragraph (d) may be illustrated by the following example:

Example. A is the promoter of an activity described in

section 465(c)(1). As the promoter, A organizes the activity and solicits potential investors. For these services A is paid a flat fee of \$130x. This fee is paid out of the amounts contributed by the investors to the activity. X, one of the investors in the activity, borrows money from A for use in the activity. X is not personally liable for repayment to A of the amount borrowed. As security for the loan, X pledges an asset which does not have a readily ascertainable fair market value. A is considered a person with an interest in the activity other than that of a creditor with respect to this loan because the asset pledged as security does not have a readily ascertainable fair market value, X is not personally liable for repayment of the loan, and A received financial gain from the activity. Accordingly, X's amount at risk in the activity is not increased despite the fact that property was pledged as security.

(e) Effective date. This section applies to amounts borrowed after May 3, 2004.

'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.

(c) Amounts protected against loss; cross reference. See §1.465-6 for rules relating to amounts protected against loss.

(d) Effective date. This section applies to amounts borrowed after May 3, 2004.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.