

Don't Let Capital Accounts Go Negative

By Calvin H. Johnson

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A negative capital account is a partnership tax concept describing the situation in which adjusted basis in partnership assets is less than the outstanding debt of the partnership. When the capital account is negative, the partnership is a tax shelter, worth more after tax than in the absence of tax. The shelter subsidy distorts the use of capital and induces investment into projects that are not justified by their real pretax economic merits. The term "negative capital account" is now used only in the partnership tax context, but the underlying concept of adjusted basis below debt applies to assets owned by a single corporation or individual.

This proposal would prohibit deductions that would reduce a taxpayer's capital account below zero. Subsidies resulting in negative tax should be given only when justified by the federal budget process. Real business activity that does not depend on the negative tax would be unaffected by the proposal.

Deductions suspended by the tax limitation would be allowed when the capital account is posi-

tive by enough to allow the deduction because the debt is paid off or income or contributions come into the activity. The adjusted basis side of the capital account would include all assets that could be reached by the liability.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop proposals to raise revenue. The Shelf Project is intended to raise revenue without a VAT or a rate hike in ways that will improve the fairness, efficiency, and rationality of the tax system. Now is the time for congressional staff work to be done to prevent the impending revenue crisis. An overview of the Shelf Project is found in "How to Raise \$1 Trillion Without a VAT or a Rate Hike," *Tax Notes*, July 5, 2010, p. 101, *Doc 2010-13081*, or *2010 TNT 129-4*. Congress adopted its first Shelf Project in March 2010. New section 871(1), enacted in the Hiring Incentives to Restore Employment Act, is based on the Shelf Project proposal by Reuven S. Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

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The proposal would prevent negative capital accounts as a remedy to prevent tax shelters. It would suspend deductions that would otherwise result in the taxpayer's adjusted basis being lower than the outstanding debt. When capital accounts are negative, the transaction is a tax shelter in which tax is negative, that is, tax increases the pretax return. Limiting deductions to prevent negative capital accounts will prevent negative taxes. A negative capital account, strictly speaking, is only a partnership account describing a situation when a partner's adjusted basis in his interest in the partnership is less than his share of partnership liabilities. The proposal would also apply to assets owned

by a single corporation or an individual, by suspending deductions that would otherwise drop adjusted basis in assets to an amount less than the debt outstanding.

The negative taxes that increase pretax returns are subsidies that warp investments away from their pretax values. The government is facing an impending revenue crisis. Before increasing tax rates on economic transactions that now produce tax, government revenue would be met better by ending the revenue-absorbing negative tax transactions. The proposal affects only tax shelter transactions when tax increases the internal rate of return

(IRR) from the investment, and it has no effect on ordinary business transactions that are not tax shelters.

Negative capital accounts require that a partnership is a tax shelter because debt and the interest deduction are inconsistent with favorable depreciation and with expensing of the debt-financed investments. Our treatment of debt, allowing both an interest deduction and also deductible basis arising from the borrowed principal, is consistent only with a pure income tax. In a pure income tax, investments would be deducted only as the investment is lost. In a pure income tax in which the tax accounting described the economic income from the investment, the taxpayer's adjusted basis would never be allowed to drop below the remaining net present value of the investment. Under the existing federal income tax, however, investments are often expensed or allowed depreciation deductions that exceed economic losses. Adjusted basis drops below the remaining value of the investment. The expensing or generous depreciation deductions mean that the tax system reduces the pretax IRR by less than the statutory tax rate. When a low (IRR-reducing) effective tax rate is allowed for investing and interest deductions are also allowed for the borrowing to fund the investment, the combination creates tax shelters — meaning that tax increases the pretax value of the activity. The proposal would allow the low IRR-reducing effective tax rates when the taxpayer has equity, determined under the regular rules of tax accounting, but when capital accounts go negative, the tax-account equity is gone, and the situation is entirely that of debt-financing and tax shelters. The proposal would end the tax shelters.

The negative capital proposal would prevent adjusted basis below debt not just for partnerships but also for corporations and individuals. The rules would apply not just to specific assets but also to enterprises as a whole, without regard to whether the costs are deducted as depreciation or expenses. The assets whose basis would count in determining whether the capital account is negative would generally be all of the assets the creditors can reach for payment. But no future income, or other values without basis would be considered. Losses would be suspended pending repayment of more of the loan, or contributions of more basis by the taxpayer. The suspension of losses could occur even when a large range of assets are at risk to secure repayment, but the basis of those assets would be considered in calculating the capital account.

An administrative rule, however, would deny use of basis from assets not committed to the partnership or other entity for partners with less than a 5 percent interest, on the grounds that it is unlikely that the creditors are looking to partner

assets because of the difficulties of collection. Application of the proposal to consolidated returns would end the negative basis in excess loss accounts on the grounds that the negative basis means that basis has been overrecovered. Taxpayers paying tax at statutory rates of less than 30 percent (ignoring the deductions at issue) would not be subject to the rules because sheltering is a more modest problem in low tax brackets.

The rule would reduce cancellation of indebtedness income cases. Cancellation of indebtedness income arises, in general, not because there is an economic gain at the time of the cancellation, but because the debt-financed deductions have gone too far and need to be reversed into income.

The proposed remedy goes to the heart of the leveraged tax shelters that Congress has repeatedly tried to curtail. The “at-risk” remedy of section 465 is focused primarily on the inflated liabilities that occur inevitably when a seller sells property for a liability to the seller that cannot be enforced except by reseizure of the property. The proposed remedy attacks the tax sheltering that arises from bona fide cash borrowing from unrelated creditors as well as the inflated liabilities from two-party nonrecourse debt. The “passive activity” remedy of section 469 prevents outsiders from getting access to shelters, while allowing the negative-tax subsidies from the mismatch of debt and rapid write-offs to those who materially participate in the activity. The proposed remedy would stop sheltering even for the insiders who materially participate in the debt-financed shelter. The remedy would go to the heart of the tax shelters, that is, the fundamental inconsistency between tax treatment of investment that is more generous than allowed in a pure income tax, and treatment of debt that is consistent only with a pure income tax.

A. Current Law

1. Partnership negative capital accounts. A partner's capital account is the partner's share of partnership equity, when assets are stated at their tax-accounting adjusted basis. The balance sheet lists the assets of the partnership on the debit (left hand) side, and the claims on those assets on the credit (right hand) side. Under double-entry accounting, the debits and credits must equal each other: Claims must exactly cover all the assets, but nothing more. On the credit or claims side, debt is listed first and is paid first. Whatever remains is by definition partnership equity. A partner's capital account is a single partner's share of partnership equity.

Assume for example a simple partnership ABC with three equal partners, which has \$1,000 in cash, \$1,000 in land, and \$500 in equipment. The cash arose from partnership income, not yet distributed.

The partnership owes the bank \$700 on the mortgage that arose to buy the land. The partnership equity is thus \$1,800:

Balance Sheet of ABC Partnership			
Assets		Liabilities and Equity (Claims on Assets)	
Cash	\$1,000	Bank debt	\$700
Land	\$1,000	Partnership equity	\$1,800
Equipment	\$500		
Sums	\$2,500		\$2,500

Each partner has a one-third interest in the partnership so that each partner has a claim against the partnership for one-third of total partnership equity, and one-third of \$1,800 is \$600.

Under the tax accounting that defines partnership capital accounts, the assets of the partnership are stated at the partnership's adjusted basis for its assets. Under double-entry bookkeeping, partnership equity must therefore equal the total adjusted basis of partnership assets reduced by its liabilities. A positive capital account means the partner's share of adjusted basis exceeds the partner's share of liabilities. Partner capital accounts would represent the amount the partner would get if the partnership liquidated by selling all of its assets at exactly their adjusted basis and distributing the cash. It is understood that it is highly unlikely that the sale price of partnership assets will exactly equal adjusted basis: Going concerns, for example, tend to have future income that will make the partnership's value higher than its adjusted basis in all assets. The partner's capital account, however, will not, and by definition, cannot reflect any values of assets or the partnership as a whole that is different from the tax adjusted basis.

For example, assume the land held by partnership ABC is now worth \$40,000, and the partnership will have a steady perpetual income of \$10,000 a year, so that at a 10 percent discount rate, the partnership is worth \$100,000 as a whole. Assume that the partnership is about to receive \$60,000 earnings in cash and that the equipment is really worth \$2,000, but its basis has been reduced to \$500 by incentive depreciation that allowed deduction of costs that had not yet expired. None of those facts are relevant to the calculation of the adjusted basis of partnership assets and hence necessarily have no impact on partnership equity or any partner's capital accounts. Capital accounts are not about valuation, but about balancing the books.

Capital account is a bit of misnomer because an important part of a partner's capital account will typically be the partner's share of the year's income or receivables that have not yet been distributed. Partner capital accounts include all booked but

undistributed income. The capital account is based on the balance sheet, however, and reflects income only because the asset entry from the income is included on the balance sheet. Capital account, moreover, does not now imply anything about a partner's share of partnership income from investment of capital. A partner with a capital account equal to 1 percent of partnership capital might be entitled to 99.9 percent of the cash from investment of partnership capital. A partner's capital account is a capital account just because it is a balance sheet account, rather than part of the income statement.

A negative capital account means that the liabilities of the partnership asset exceed the adjusted basis of the partnership assets. Assume, for example, partnership DEF borrowed \$100 to develop a valuable software product. The costs of the software would be expensed,¹ would have zero basis, and would be stated at zero on the assets or debit side of a tax accounting balance sheet. Assume DEF also purchased a building by the typical constant periodic payment mortgage. For a 30-year constant payment mortgage, the debt declines very slowly in early years, at a rate slower than pro rata straight-line reduction of the debt. For tax, by contrast, a residential building is depreciated straight-line over 27½ years.² After 10 years, a building purchased with \$100 debt bearing 5 percent interest will have \$63.64 basis, but \$81.01 outstanding mortgage.³ DEF partnership has both the software development and the 10-year-old apartment building:

Balance Sheet of DEF Partnership			
Assets		Liabilities and Equity (Claims on Assets)	
Software	\$0	Software development loan	\$100
Apartment building	\$64	Building mortgage	\$81
Sums	\$64	Partnership equity	(\$117)
			\$64

Partnership DEF has negative partnership equity of \$117, which is the excess of its debt over the

¹Rev. Proc. 69-21, 1969-2 C.B. 303, reaffirmed by Rev. Proc. 2000-50, 2000-2 C.B. 601, section 5, *Doc 2000-31079*, 2000 TNT 233-11. Calvin H. Johnson, "Capitalize Costs of Software Development," *Tax Notes*, Aug. 10, 2009, p. 603, *Doc 2009-15569*, 2009 TNT 151-9, criticizes the expensing of software development costs.

²Section 168(b)(3)(B) and (c).

³17.5 yr./27.5 yr. * 100 = \$63.64. The remaining mortgage would be \$81 because the present value of the 20 remaining yearly payments of \$6.51 on a 30-year 5 percent mortgage would be \$81.06.

adjusted basis of its assets. The negative partnership equity is a forced conclusion because balance sheets must have debits equal to credits, and liabilities exceed adjusted basis of the partnership's assets. Each one-third partner would have a negative capital account of one-third of \$117, or \$39.

If a positive capital account represents a claim by partners against the partnership on liquidation, the negative capital account in some sense represents a claim by the partnership against partners. If DEF is a general partnership, the partners *might* each be called on to pay \$39 on liquidation with a sale equal to adjusted basis to pay off the creditors. If the partnership is a limited partnership or limited liability company taxed as a partnership, the partners cannot be called on to contribute to the partnership, and it will be the creditors who lose the \$117 total negative equity. Or at least the creditors must await future income that has not yet been booked or rely on values not reflected in the adjusted basis of the assets.

In truth, negative capital accounts commonly have no meaningful economic impact. Negative capital accounts are not interest bearing, so under time value of money principles, the \$117 obligation does not have a present value of \$117. Allocation of partnership income from capital has nothing to do with the relative value of partner capital accounts, and partners with negative capital accounts can continue to receive a share of cash from capital investments of the partnership. Negative capital accounts are respected if the partner is obligated to pay tax when the obligation of the negative capital account disappears, but the tax can be at capital gains rates of 15 percent and can be a long way away. No one negotiating the deal who is not the tax lawyer pays much attention to them. Negative capital accounts, like positive capital accounts, have nothing to do with valuation: They are about balancing the balance sheet.

Creditors, however, tend to protect themselves, and they do not willingly go into positions in which the assets of the debtor are insufficient to cover the liability. Even in a general partnership in which the creditor can chase partners for the \$117, it is often hard work to find dispersed partners. It is the self-protection of creditors that led us to the conclusion that a debtor has no economic gain by borrowing: The obligation to repay the debt with adequate interest is enforced by creditors and prevents the cash in hand by borrowing from being considered economic gain. So too, the self-protection by creditors implies a plausible reason for the negative capital accounts: The assets have a value as collateral or will generate future income sufficient to cover the \$117 deficit, but the adjusted basis of DEF's assets is \$117 below the value of the assets.

Partnership DEF has plausibly been allowed to expense investments that have not been lost and to depreciate property at a rate faster than economic decline. In any event, negative capital accounts do not usually represent \$117 the partners expect to pay into the partnership, nor any insecurity about the payment of the partnership debts. Negative capital accounts simply identify that the partner's share of adjusted basis of partnership assets is lower than his share of partnership level debt, as required by double-entry bookkeeping.

While the term "negative capital account," in ordinary usage, applies to a partnership account, there is no impediment to applying the same concepts when there is a single owner, whether an individual or a corporation. A corporation can have an adjusted basis in its assets that is smaller than its outstanding liabilities. Individual investors do not ordinarily keep balance sheets, but in concept, an individual can have liabilities that exceed adjusted basis in assets. If the liability is nonrecourse liability, the negative capital account means simply that the assets that the creditor can reach to satisfy the liability have an adjusted basis of less than the debt outstanding.

2. Excess loss accounts. The corporate consolidated return regulations create a "negative basis" account for subsidiary stock called the excess loss account (ELA).⁴ The ELA negative basis arises because losses deducted by the consolidated group exceed the parent corporation's basis in the subsidiary stock. Losses in excess of basis happen because the subsidiary pays for deductible or depreciable costs with subsidiary debt, and the deductions occur before the debt is repaid.⁵

The negative basis ELA becomes additional gain when the subsidiary stock is sold or becomes worthless. For example, if a parent corporation invested \$10 in a new subsidiary within the consolidated group, the subsidiary borrowed \$40, and lost \$45, the losses would be deductible on the consolidated tax return, and the \$45 losses would reduce the parent's basis in the subsidiary from \$10 to negative \$35. If the subsidiary stock were sold to a buyer which is not a member of the consolidated group for \$2, the parent would have a \$37 gain.⁶ The \$37 gain is not by reason of receipt of \$37 or economic gain at the time, but rather because \$35 of

⁴Reg. section 1.1502-19(a)(2).

⁵Negative bases of the excess loss account also arise because the liabilities on contributed property exceed the parent's basis. *Id.* Section 357(c), which normally requires recognition of gain to prevent negative basis when a shareholder contributes property subject to debt in excess of basis, does not apply to contributions to a consolidated subsidiary.

⁶Reg. section 1.1502-19(g), Example 1.

the loss was not paid for. For tax to reflect the total transaction, the \$35 losses must be reversed into income at least by the termination of the ownership of the subsidiary. The \$35 gain, for instance, is recognized if the subsidiary ceases to be a member of the consolidated group, for instance if 20 percent of the stock of the subsidiary becomes owned by employees or other holders outside the group.

An ELA is different from a negative capital account only because debt of a partnership ordinarily passes through to partners and becomes part of their basis. Debt of the subsidiary is not part of a parent corporation's basis. Without that difference, an ELA negative basis is synonymous with negative partnership equity and negative capital accounts. If the subsidiary described above had been an equally owned partnership of two corporations, for example, the partnership would have had a negative partnership equity of \$35. The proposal, by disallowing deductions that would reduce basis below debt, also would prevent negative basis ELAs when applied to corporations.

The ELA system is avoidable, however, because the negative basis is purged and disappears if the subsidiary merges or liquidates into the parent. In the event of tax-free liquidation or merger, the parent takes over the basis the subsidiary had in its assets as its own, and the parent's basis of subsidiary stock disappears without any recognition of the \$35 negative basis.⁷ The negative basis that disappears in a liquidation or merger still represents basis allowances that exceed the taxpayers' cost, but the excess losses are never recovered. The proposal would prevent deductions that lead to the negative basis ELA in the first place.

3. Other shelter remedies. Congress has attempted to limit the negative tax from leveraged shelters in several ways since 1976. Two important overrides that suspend shelter deductions arising from debt-financed investments are the "at risk" rules of section 465, and the "passive activity" rules of section 469. The at-risk rules of section 465 restrict the deduction of losses from an investment to the amount for which the taxpayer is at risk regarding the property. Depreciation deductions are computed from basis that includes nonrecourse liability which is not at-risk, but deductions are suspended once basis from at-risk sources is fully recovered, until the taxpayer increases amounts at risk by paying off the debt or receiving more income from the transaction.

The abuses that were the target of the at-risk rules were the deductions arising from inflated two-party nonrecourse liability owed to the seller

⁷Sections 332 and 334(b).

who provided both the debt and the property.⁸ The at-risk rules do not limit depreciation from debt for which the taxpayer was personally liable, debt adequately secured by unrelated property, and qualified nonrecourse liability borrowed from an unrelated party, on the ground that those liabilities are unlikely to be inflated.

For this proposal, by contrast, no borrowing, whether or not at risk or vulnerable to inflation, would increase the ceiling for deductions because borrowing would not increase the capital account above the negative range.

The passive activity loss limitations of section 469 were adopted as a part of the 1986 Tax Reform Act to limit tax shelters so that the act could cut maximum tax rates for the richest taxpayers and also not change the distribution of the burden of taxes.⁹ The limitations are based on a skeptical assessment that deductions created by ordinary tax accounting from a basis that includes debt does not represent true losses. Under the passive activity rules, losses from an activity in which the taxpayer does not materially participate are suspended and may not shelter income from salary, portfolio investments, and regular business, until the taxpayer terminates the activity. At termination, debts need to be paid, so that the losses surviving to that time will represent real losses of cash rather than deductions from creditor money or promises to pay. Material participation is defined to require time equal to a quarter of a year of full-time work during the tax year. The material participation rules allow insiders who do spend the requisite time to get access to shelter deductions and protect the insiders from outsider competition.

Both the at-risk rules and the passive activity limitations are best understood as limiting artificial accounting losses that arise from the mismatch of debt and generous deduction of investment, as explained below. The proposal here bears a resemblance to both the at-risk rules and the passive activity loss provisions in that it allows deductions to be computed from a basis that includes debt, but then suspends the deductions so as to prevent artificial losses. The proposal attacks not just two-party nonrecourse debt likely to be inflated, but also

⁸For a discussion of the economics of the two-party nonrecourse liabilities that lead inevitably to inflation of the debt, see Johnson, "The Front End of the Crane Rule," *Tax Notes*, Apr. 30, 1990, p. 593.

⁹For a defense of the passive activity limitations, see Johnson, "Why Have Anti-Tax Shelter Legislation?" 67 *Tex. L. Rev.* 591 (1989).

Table 1. Equivalence of Exempt Yield and Expensing		
	(1) No Tax On Profits	(2) Expensing of Investment (Soft Money Investing)
1. Income	\$100	\$100
2. Tax on income	(\$33.33)	no tax
3. Investable (row 1 - row 2)	\$66.67	\$100
4. Growth (row 3 triples)	\$200	\$300
5. Taxable amount	no tax	\$300
6. Tax on profit	no tax	(\$100)
7. End result	\$200	\$200

the mismatch with reasonable debt from third parties. The proposal also has no protection allowing sheltering by insiders who materially participate in the transactions.

B. The Reasons for Change

Tax shelters are transactions in which the application of tax increases the pretax return from the transaction. Tax shelters arise because the tax treatment of debt under current law is inconsistent with generous tax treatment of investments that the debt finances. Borrowed or owed amounts are included in basis and interest is deductible immediately. Investments are commonly expensed under current law or depreciated under schedules that are faster and give deductions earlier than would be allowed by real economic losses. When the normal income tax treatment of debt is combined with generous treatment of debt-financed investment, the combination leads to a negative tax. The tax system then acts as a subsidy, making possible investments that would not be undertaken in a tax-free world that depended on the real demand or real economic value.

1. Expensed investments. First, look at the mismatch between expensed investments and interest deductions.¹⁰ The ability to deduct an investment immediately is ordinarily as good as getting an exemption from tax for the subsequent profit. Table 1, above, illustrates the point, assuming an investment that can be expensed when made,¹¹ an underlying investment that will triple over some unspecified period of time, and a tax rate of one-third of income. Column 1 represents an investment

made with after-tax money which is tax exempt as to the return. Column 2 represents “soft money investing,” in which the input is deducted or excluded and the return is taxed.

Ordinarily in an income tax, the profits from the tripling in column 1 of Table 1 would be subject to an income tax, but not as assumed here, when the profits are tax exempt. Column 2, which gave not an exemption for the profits, but rather an immediate deduction for the investment when made, gave a final result that was equivalent to the exemption for profits.

The equivalence of profit-exemption and soft money investing holds true for any (constant) tax rate and any multiple of growth.¹² The results of Table 1 can be generalized by algebra, assuming compound growth,¹³ or simple growth,¹⁴ or an annuity giving its return in constant payments

¹²The equivalence breaks down, however, if the taxpayer decides to fund upfront tax (row 2) not by reducing this investment but from other sources, and breaks down when tax rates upfront and on liquidation (rows 2 and 6) are not the same. Sometimes the break in equivalence favors the soft money investment, as when rates go down or the upfront tax is financed at a cost less than the IRR from the investment itself. When rates go up or the investment is worse than costs of financing the upfront tax, exemption is better.

¹³Assuming the triple growth is the result of compound growth, the algebraic description of profit exemption of column (1), is $\$100 * (1-t) * (1+R)^n * (1-0)$, where t is the tax rate and $(1+R)^n$ is the compound growth at rate R for period n . The $\$100$ is a unit of income. The $(1-0)$ term at the end just says there is no tax on distributions. The soft money investing of the regular IRA, column (2), is $\$100 * (1-0) * (1+R)^n * (1-t)$, using the same notation. Profit exemption (1) must equal soft money investing privilege (2):

$$(1) \$100 * (1-t) * (1+R)^n * (1-0) =$$

$$(2) \$100 * (1-0) * (1+R)^n * (1-t)$$

because of the “commutative law of multiplication,” which says that it does not matter here whether you put the reduction by tax “(1-t)” near the front of the expression or its end. If tax rate t is not constant, or if the taxpayer does not vary investment (line 3) by tax (line 2).

¹⁴The tripling in Table 1 could be a single period tripling of simple interest, R . The equivalence of profit exemption and soft money investment terminal value would be expressed as $\$100 * (1-t) * (1+R) = \$100 * (1+R) * (1-t)$.

¹⁰This section is based on Johnson, “Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation,” 61 *Tex. L. Rev.* 1013 (1983).

¹¹Investments that can be expensed include intangible investments, not capable of being sold except as embedded in the business as a whole, or without a property right protection. Reg. section 1.263(a)-4(b)(3). For historical reasons, computer software development is expensed. (Rev. Proc. 69-21, 1969-2 C.B. 303, reaffirmed by Rev. Proc. 2000-50, 2000-2 C.B. 601, section 5.) Johnson, *supra* note 1, criticizes the allowance of expensing of software development costs.

Table 2. Debt Financed Investment					
	Capital	Return at 5%	Taxable Income	Tax Savings at 35%	After-Tax Cash
Investment	(\$100m)	\$5m	\$0	\$0	
	Borrowed	Interest at 5%			
Debt	\$100m	(\$5m)	(\$5m)	\$1.75m	\$1.75m
			(\$5m)		
Net Cash	\$0	\$0		\$1.75m	\$1.75m

Table 3. Break Even From Lousy Return					
	(1) Capital	(2) Pretax Annual Cash Return at 3.25%	(3) Taxable Income	(4) Tax Savings (Tax) at 35%	(5) After-Tax Cash
Investment	(\$100m)	\$3.25m	\$0	\$0	\$3.25
	Borrowed	Interest at 5%			
Borrowing	\$100	(\$5m)	(\$5m)	\$1.75m	(\$3.25)
			(\$5m)		
Net Cash	\$0	(\$1.75)		\$1.75m	\$0

annually.¹⁵ The equivalence of profits exemption, as in Roth IRAs, and input exemption, as in regular IRAs and other qualified plans, is commonly called the Cary Brown thesis in honor of the economist who first saw it, surprisingly late in the history of the income tax.¹⁶

If income is exempt from tax, or its equivalent, and interest is deductible, the investor will get a tax deduction in which no money is lost by financing the investment with debt. If the tax deduction can be used to shelter some unrelated income (taxed in Table 2 at 35 percent), the tax savings will add cash value to a transaction that is just a break-even transaction in the absence of tax. Table 2 has an expensable investment with 5 percent return financed with debt bearing 5 percent interest payable in every period.

Table 2 says an investment that breaks even in absence of tax, because the investment both makes 5 percent and costs 5 percent to make, will produce positive cash from the deduction of the interest,

equal to the tax rate times the interest. The positive cash is a gain purely from tax, from the inconsistency of the debt and the expensing. The results of Table 2 can be generalized with algebra.¹⁷

When tax shelters like that in Table 2 are available, the investor can tolerate returns from the investment that are inferior to the given fair market value interest:

The cost of capital arising from an international market for capital was assumed to be 5 percent, but the expensed investment is justified if it makes only 5 percent * (1-T) or 3.25 percent. The transaction loses money as determined by the pretax real demand for the investment's products, but the value of the tax shelter (column 5), makes up the loss and allows the taxpayer to cover the interest cost. The results of Table 3 can be generalized by algebra.¹⁸

2. Rapid depreciation is inconsistent with debt. The inconsistency between debt and our treatment of investment extends beyond expensed investments to include property depreciated faster than the property truly declines. When adjusted basis

¹⁵The standard formula for present value of an annuity is $\$100 = A * [1 - (1+i)^{-n}] / i$, where A is the cash flow received in each period. The terminal value would be $A * [(1+i)^n - 1] / i$ (reached from the annuity formula by multiplying it by compound interest of $(1+i)^n$). If the \$100 income used for the investment is reduced by tax t to $\$100 * (1-t)$, then it will produce only $A * (1-t)$ in every period. If the $A * (1-t)$ bears no further tax by reason of income exemption then $A * (1-t)$ will be the periodic payment even after tax, and $A * (1-t) * [(1+i)^n - 1] / i$ will be the terminal value of the payments. If the \$100 income is invested in full without reduction by upfront tax, but A is taxed in every period, the after-tax annual amount will again be $A * (1-t)$. In either case the terminal value of the annuity will be $A * (1-t) * [(1+i)^n - 1] / i$.

¹⁶Cary Brown, "Business-Income Taxation and Investment Incentives," in *Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson* 300 (1948).

¹⁷If a pretax borrowing of \$100 allows an investment of $\$100 / (1-t)$ because of expensing, the return at rate R is $\$100 / (1-t) * R$. Interest at rate I is incurred only on \$100 borrowed to justify the $\$100 / (1-t)$, and so the net return is reduced by interest to $\$100 / (1-t) * R - \$100 * I$, which net is taxed to give an after yield of $[\$100 / (1-t) * R - \$100 * I] * (1-t)$ or $\$100 * R - \$100 * I * (1-t)$ or $\$100 * R - \$100 * I + \$100 * I * t$. When I and R are equal (here at 5 percent), the net result is $\$100 * I * t$, which is the value of the interest deduction.

¹⁸As explained *supra* note 17, if a pretax borrowing of \$100 allows an investment of $\$100 / (1-t)$ because of expensing, the after-tax return will be $\$100 * R - \$100 * I * (1-t)$. The equation will equal zero net when $R = I * (1-t)$.

Table 4A. Equipment With Rapid Depreciation Has Only 11 Percent Effective Tax Rate

Year	0	1	2	3	4	5
1. Pretax cash	(\$100)	\$23.10	\$23.10	\$23.10	\$23.10	\$23.10
2. NPV	\$100	\$81.90	\$62.90	\$42.95	\$22	\$0
3. Real loss		\$18.10	\$19	\$19.95	\$20.95	\$22
4. Bonus and 200% declining depreciation	\$50	\$25	\$12.50	\$6.25	\$6.25	
5. Adjusted basis	\$50	\$25	\$12.50	\$6.25	\$0	
6. ½ year shift	\$62.50	\$18.75	\$9.38	\$6.25	\$3.13	\$0
7. Taxable income	(\$62.50)	\$4.35	\$13.72	\$16.85	\$19.97	\$23.10
8. Tax at 35%	\$21.88	(\$1.52)	(\$4.80)	(\$5.90)	(\$6.99)	(\$8.08)
9. After-tax cash	(\$78.13)	\$21.58	\$18.29	\$17.20	\$16.11	\$15.01
10. PV at found discount rate	(\$78.13)	\$20.66	\$16.77	\$15.09	\$13.53	\$12.08
11. Found IRR after tax	4.45%	Sum PV:	(\$0)			
12: Eff tax from 5%		11%				

drops below the value of the property, the effective (IRR-reducing) tax rate is lower than the statutory tax rate. When the low effective tax rate investments are debt financed, the interest deduction turns the transaction into a shelter, better after tax than before tax. The point of this section is much the same as the logic for expensed investments, except that the spreadsheets for debt-financed investments in rapidly depreciated property allow another language and model to convey the point.

The following Table 4A illustrates the point with an investment in depreciable property that benefits from a hypothetical rapid depreciation schedule, which is close to current law and allows an adjusted basis to drop below the bank account balance equivalent to the investment.¹⁹ Assume \$100 investment in equipment that in the absence of tax will produce a 5 percent annual return and constant payment flows over the next five years, which means \$23.10 per year (row 1).²⁰ The investment declines economically as the net value of future cash flows declines (row 2), and the investor’s real economic loss (row 3) is slower than straight-line depreciation of \$25 per year. The equipment is depreciated under a rapid depreciation method, composed here of a four-year tax life²¹: bonus depreciation, that is, half the investment is de-

ducted immediately,²² the rest is deducted under the logic of double declining depreciation (row 4),²³ and depreciation deductions are all shifted six months early under a half year convention (row 6).²⁴ Taxable income in row 7 is the assumed \$23.10 revenue of row 1 less the depreciation deductions of row 6. Tax savings (row 8) or tax cost is computed on the assumption of 35 percent tax rates, and for tax savings that means the net tax loss is used against unrelated income. When the tax savings or cost are added to or subtracted from pretax cash, it results in the after-tax cash of row 9. To compute IRR from the after-tax cash, it is necessary to find a discount rate that will reduce the net present value of costs and returns in row 9 to zero, which will identify the interest rate on a bank account that is exactly like the after-tax cash.²⁵ Row 10 computes the net present value of row 9 after tax cash flows at the found discount rate that will make the sum of row 10 equal to zero, identifying the IRR. The IRR discount needs to be found by trial or error, or by a computer program (here Excel’s Goal Seek program) that works through trial and error. The found rate is 4.45 percent. When an investment starts at 5 percent pretax, as assumed here, and ends at 4.45 percent, that is like an 11 percent tax rate, because an 11 percent tax on 5 percent interest annually would reduce the interest return to 4.45 percent.²⁶

¹⁹The major departure from current law is that I created a four-year tax life, not available under current section 168, to give as many years as would fit the presentation to the width of a page.

²⁰Under the standard formula for the present value of a constant payment annuity, $\$100 = A * [1 - (1.05)^{-5}] / .05$, and A equal to \$23.10 satisfies the equation.

²¹There is in fact no four-year tax life, but only a three- or a five-year life for equipment. Section 168(e)(1). But property commonly has a shorter tax life than economic life, and a four-year tax life makes for a table that fills the page.

²²Section 168(k)(4).

²³Section 168(b)(1). Double-declining depreciation requires finding a declining balance percent of twice one over the tax life, then applying that percent to the ever-smaller adjusted basis (row 5).

²⁴Section 168(d)(1).

²⁵Present value, e.g., for year 4, rows 9 and 10, is $\$16.11 / (1 + d)^4$. With the found d of 4.45 percent, the present value is \$13.53.

²⁶The formula for effective (IRR reducing) tax rate is $(\text{Pretax IRR} - \text{Posttax IRR}) / \text{Pretax IRR} = (5 \text{ percent} - 4.45 \text{ percent}) / 5$

(Footnote continued on next page.)

Year	0	1	2	3	4	5
1. Pretax cash	(\$100)	\$23.10	\$23.10	\$23.10	\$23.10	\$23.10
2. Borrowing	\$100	(\$23.10)	(\$23.10)	(\$23.10)	(\$23.10)	(\$23.10)
3. Net cash	\$0	\$0	\$0	\$0	\$0	\$0
4. Interest on loan at 5%		\$5	\$4.10	\$3.15	\$2.15	\$1.10
5. Reduce balance (row 2 - row 4)		\$18.10	\$19.00	\$19.95	\$20.95	\$22
6. Loan balance	\$100	\$81.90	\$62.90	\$42.95	\$22.00	(\$0)
7. Depreciation with half year	\$62.50	\$18.75	\$9.38	\$6.25	\$3.13	\$0
8. Adjusted basis	\$37.50	\$18.75				
9. Negative capital account	(\$62.50)	(\$63.15)				
10. Taxable income (row 1 - rows 4 and 7)	(\$62.50)	(\$0.65)	\$9.63	\$13.70	\$17.83	\$22
11. Tax at 35% or row 10	\$21.88	\$0.23	(\$3.37)	(\$4.80)	(\$6.24)	(\$7.70)
12. After-tax cash	\$21.88	\$0.23	(\$3.37)	(\$4.80)	(\$6.24)	(\$7.70)
13. Present value at 5% * (1 - 35%)	\$21.88	\$0.22	(\$3.16)	(\$4.36)	(\$5.49)	(\$6.56)
14. Sum of PV (row 12)	\$2.53					

Now assume, in Table 4B following, that the entire investment is financed by borrowing at the same 5 percent interest rate that was used for the investment returns. The investment in year 0 is funded by borrowing and the constant payments on the loan absorb all the cash from the investment (row 2), so the net cash is zero in every period (row 3). Interest, which is deductible, is computed as 5 percent of the loan balance (rows 4-6). Payments (row 2) that are not interest (row 4) reduce the loan balance (row 6) and the new loan balance times 5 percent determines interest for the next period. Depreciation (row 7) is the same and uses the same logic as in row 6 of Table 4A, because borrowed cash is included in depreciable basis. Taxable income (row 10) is the revenue of row 1, less deductions now for both depreciation (row 7) and interest (row 4). It is assumed here that losses (negative taxable income) will be used against unrelated taxable income and produce positive-value tax savings at 35 percent of the loss. Row 11 tax is negative 35 percent of taxable income (row 10). The transaction produces zero net taxable income over the life of the transaction (assuming there is no capital gain sale), but the tax savings occur early, when the present value is higher. Under the assumptions of Table 4B, the tax savings are worth \$2.13 per \$100

percent, here 11 percent. The logic is that (Pretax - Posttax) identifies how much tax reduces the return, and the reduction is conventionally stated as a percentage of pretax return.

investment, from an investment that is a wash zero cash flow transaction in absence of tax.

The transaction in Table 4B has a negative capital account and would be affected by this proposal even if the owner of the equipment is not a partnership. Negative capital account is the excess of debt outstanding over adjusted basis (row 9). The rapid depreciation from debt creates a negative capital account that reaches \$63 after the first year (and contracts to zero by the time the outstanding debt disappears). The negative capital account means that the tax rate is negative, and that the value of a break-even transaction (as shown by row 3) will be a positive subsidy (rows 12 and 13). Disallowing the depreciation deductions that produce the negative capital account would prevent the tax shelter and the subsidy. Without a negative capital account, the tax on the transaction could not drop into the negative range.

The economic damage from the negative capital accounts arises because the subsidy allows the taxpayer to go into inferior investments such as that shown in Table 4C. Table 4C has the same logic as Table 4B, except that the annual constant payments on the investment (row 1) drop to found amount of \$22.19 per year. The tax shelter cash flows have a net present value of zero (rows 12 and 13) at a discount rate of 5 percent less tax on the 5 percent. With a drop in receipts to \$22.19 per year, the investor must pay 90 cents every year to make the

payments on the debt (line 2 and 3), but the value of the shelter deductions exactly offsets the cost of the extra payments.

The \$22.19 in row 1 represents a return of only 3.57 percent per year.²⁷ That is not as big a drop as expensing would allow. Under expensing as shown in Table 3, the taxpayer could break even with a return of 5 percent * (1-T), or 3.25 percent. Still, the investment consumes capital that has an annual value of 5 percent to other bidders in order to make an inferior investment. The tax treatment has allowed investments that give returns of 3.57 percent, which is 29 percent below the market value cost of the capital. The treatment has caused the waste of 29 percent of the cost of capital. The value from the use of the \$100 resources would be improved by ending the subsidy.

3. Creditor tax does not remedy. Sometimes the creditor pays tax on interest, and the creditor tax could offset the value of the tax shelter given to the debtor in the shelters of tables 1-4. If the recipient of the debt also bears tax at rate T, and must pay the tax when the debtor pays it, the tax on the other side of the transaction will be $\$100 * I * T$, which is an exact offset to the amount of the negative tax or subsidy for an expensed investment.

Tax on the creditor, however, does not remedy the subsidy from the mismatch of debt and generous depreciation or expensing. Taxpayers arrange themselves into clientele under which high-bracket taxpayers take the interest deduction and tax-exempt or low-effective-tax-rate entities receive the interest income.²⁸ Thus tax exemption is given, for example, to pension funds, charitable endowments, and to the internal buildup on life insurance policies. The marginal creditor who sets the interest rate is apparently a near-zero or low-rate institution: The reaction of interest rates to inflation, for instance, is such that interest comes to cover inflation, but not any tax on inflation.²⁹ Municipal bond interest, which is tax exempt, gives such a small discount from prevailing taxable interest rates, so as to indicate the taxable interest does not in fact bear much tax.³⁰

²⁷Under the standard formula for the present value of an annuity, $\$100 = \$2.19 * (1 - (1+i)^{-n})/i$, with i equal to 3.75 percent and n of 5 years.

²⁸Myron Scholes et al., *Taxes and Business Strategy* 130-132 (3d ed. 2005) (discussion of clientele effect).

²⁹Johnson, *supra* note 10, at 1041-1048 (discussing effect of creditor tax on the shelter).

³⁰Johnson, "A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax," 56 *SMU L. Rev.* 13 (2003), found effective tax rates on taxable interest to be less than 10 percent by looking at the small discount on competing tax-exempt bonds.

The creditors' tax can have an effect on borrower's behavior, moreover, only through interest rates charged. Creditors cannot price discriminate according to the tax character of the use of funds by their debtors. Therefore, even if interest rates rise in part because of the artificial demand generated by tax shelters — investments that would never be undertaken in the absence of tax — the tax subsidy equal in value to the now-higher interest deduction would continue to give the tax shelter transactions an advantage over other investments with real demand. Indeed, since the subsidy is measured by the level of interest, a rise in interest to account for creditor tax on interest would make both the subsidy and the distortion worse.

4. Go after shelters first. The subsidies in the mismatch of debt and investment are an attractive source of revenue. The subsidies distort the flow of capital into investments that can meet the going interest rates on their real pretax economic merits. We waste capital because of the tax shelters that give real returns that cannot carry their real pretax cost of capital. Shelters are also unfair when the revenue from the shelter does not drop to break even because it frees up consumption in high-brackets that would otherwise bear a 35 percent tax. Attacking the subsidies will make the tax system fairer and more efficient.

Of course differential tax rates on competing investments distort capital even if one of the competitors bears a low rate but is not negative. Still zero tax is an important line. As a matter of principle, subsidies by reason of tax less than zero should be paid in cash as government spending and subject to the slings and arrows of the budget process. The subsidy inherent in negative capital accounts is a stealth subsidy that is not known to the public at large. Stealth subsidies are not legitimated by a budget process nor by fair and open political discussion by a fully informed public.

There is an impending crisis in the coming need to raise revenue to 168 percent of current levels: We are now spending 24.6 percent of GDP and raising revenue equal to only 14.6 percent of gross domestic revenue for a deficit of 10 percent of GDP, or \$1.47 trillion.³¹ Auerbach and Gale estimate that there is a permanent gap of \$1.3 trillion per year.³² Raising the revenue by general rate increases will harm the economy. Increases in tax rates create deadweight losses, above the revenue collected, by the square of

³¹Office of Management and Budget, *Midsession Review, Fiscal Year 2010*, at 5, available at <http://www.budget.gov>.

³²See Alan J. Auerbach and William G. Gale, "The Economic Crisis and the Fiscal Crisis: 2009 and Beyond," *Tax Notes*, Oct. 5, 2009, p. 101, *Doc 2009-20422*, or *2009 TNT 190-10*.

Year	0	1	2	3	4	5
1. Pretax cash with drop to 3.75%	(\$100)	\$22.19	\$22.19	\$22.19	\$22.19	\$22.19
2. Borrowing at 5%	\$100	(\$23.10)	(\$23.10)	(\$23.10)	(\$23.10)	(\$23.10)
3. Net cash	\$0.00	(\$0.90)	(\$0.90)	(\$0.90)	(\$0.90)	(\$0.90)
4. Interest at 5% of prior row 6		\$5	\$4.14	\$3.24	\$2.29	\$1.29
5. Reduce balance (rows 2 - 4)		\$17.19	\$18.05	\$18.96	\$19.90	\$20.90
6. Loan balance	\$100	\$82.81	\$64.75	\$45.80	\$25.90	\$5
7. Bonus deprec and DDB off row 8	\$50	\$25	\$12.50	\$6.25	\$6.25	
8. Adj basis for DDB	\$50	\$25	\$12.50	\$6.25	\$0	
9. ½-year depreciation shift	\$62.50	\$18.75	\$9.38	\$6.25	\$3.13	
10. Adjusted basis	\$37.50	\$18.75				
11. Negative capital account	(\$62.50)	(\$79.36)				
12. Taxable income	(\$62.50)	(\$1.56)	\$8.68	\$12.71	\$16.78	\$20.90
13. Tax at 35% of row 12	\$21.88	\$0.55	(\$3.04)	(\$4.45)	(\$5.87)	(\$7.31)
14. After-tax cash	\$21.88	(\$0.36)	(\$3.94)	(\$5.35)	(\$6.78)	(\$8.22)
15. PV at 5% * (1-T)	\$21.88	(\$0.35)	(\$3.70)	(\$4.86)	(\$5.96)	(\$7)
16. Sum of row 15	\$0					

the rate increase.³³ Raising revenue by going after the tax shelters inherent in negative capital accounts will improve efficiency, not undermine it.

C. Explanation of the Proposal

The proposal would disallow tax deductions that would generate a “negative capital account,” that is, that would reduce the taxpayer’s adjusted basis in assets subject to debt to an amount lower than the taxpayer’s outstanding indebtedness. Negative capital account is a concept from partnership taxation, but the proposal would apply the negative capital account concept when a single individual or corporation owns the property and prevent the negative capital accounts even for a one-taxpayer owner who is not in a partnership. Partners, corporations, and individuals would not be allowed to have deductions that would make adjusted basis on assets drop below the outstanding debt which can reach those assets.

The deductions disallowed by the limitation would be held in a suspense account. The deductions would be allowed when and if basis is increased or the debt is paid off enough to allow the deductions without leading to a negative capital

account. Basis is increased, for instance, by taxed but undistributed income or by additional contributions to the activity, and the debt is reduced by payment. Allowing deductions of positive capital accounts but not negative capital accounts would mean that the taxpayer will recover all cash lost, but will not deduct losses based on unpaid debt or other people’s money.

Debt counted in determining whether the capital account is negative would include all debt of the taxpayer and affiliated entity, whether the debt was incurred for cash or in the purchase of assets.

The assets whose basis could be counted in the determination of whether the capital account was positive or negative would depend on the reach of the liability. For nonrecourse liability, only the asset that was the collateral for the liability could be counted in the adjusted basis. If the investment is held in an entity with limited liability, only the adjusted basis of assets within the entity could be counted. Only the adjusted basis, not the fair market value, of assets reachable by the liability would count. Assets that could not be reached by operation of law by reason of an exemption in bankruptcy would not be included in the calculation of capital accounts. For example, if the taxpayer’s state has a homestead exemption that prevents creditors from reaching the taxpayer’s primary residence, the

³³See, e.g., Joseph Stiglitz, *Economics of the Public Sector* 376 (1986).

basis in the primary residence would not be included in calculating adjusted basis component of the negative capital account.³⁴ Future income, unrealized appreciation, and intangible assets with no basis would not increase the adjusted basis component. Receivables would increase the adjusted basis component only for accrual method taxpayers who have included the receivables in income.

The proposal would limit deductions categorized as current expenses as well as deductions from depreciation because there is no meaningful distinction between the two. Many intangible investments are treated by the tax law as if they were ordinary business expenses.³⁵ A start-up company often expects operating losses in early years that are just the cost of future profit, and are thus investments in the future just like more tangible investments. A company as a whole is an investment, not unlike a separate and distinct salable asset, even if the costs are treated as expenses. Lenders need to be as diligent about ensuring that debtors have enough value to cover the debt repayments, whether the tax deductions arise from depreciation or expenses. Expense deductions, including deductions for payables by accrual method taxpayers, will reduce basis on the adjusted basis side of the negative capital account determination just as depreciation does.

The prohibition of negative capital accounts prevents tax rates of less than zero, but the proposed limitation allows tax rates to drop very low, even to zero on an equity-funded fraction of an investment. Actual debt would continue to be included in basis and would generate usable deductions. Assume for example equipment in which half the cost is deducted immediately. The deduction of half of basis drops the IRR-reducing effective tax rate from a statutory tax rate of 35 percent to a real economic tax of half that, 17½ percent.³⁶ A taxpayer who funded half of the cost with debt and half with equity would be entitled to deduct all the equity immediately, which is tantamount to a zero IRR-reducing effective tax rate. The borrowing thus caused the full deduction of all equity. Still, the

limitation prevents the effective tax rate on the transaction as a whole from dropping below zero, and preventing tax shelters is a worthwhile limitation.

The zero tax rate line is a very meaningful line, so that no indulgence would be allowed for deductions that reduce adjusted basis below the debt by just a little bit. Middle-income taxpayers are unlikely to keep balance sheets, however, and are unlikely to have significant shelters, and the shelters are less valuable in the middle-income tax brackets of 15 percent and below. Accordingly, the proposals would not apply unless the taxpayer has an adjusted gross income (ignoring the deductions at issue) of greater than \$200,000, which is roughly the point at which the tax rates rise above 30 percent.³⁷

There would be a need for authority for anti-abuse regulations to cover the cases in which outside assets are nominally collateral for the liability but seizure by the creditor is difficult. It is recommended that only assets disclosed to and *clearly* reachable by the creditors would be counted in the adjusted basis side of the capital account. Thus transfers to spouse or children would reduce the adjusted basis of the capital account even if the transfers are voidable by creditors. Secretly held assets not known to most creditors would not be included in the calculation. Thus, for example, assets held in a Swiss or Cayman Islands bank account would not count in determining the adjusted basis side of the capital account. Assets held in jurisdictions without a treaty covering enforcement of debt would not be included. Asset protection trusts would be presumed to be outside the reach of the liability, if they create meaningful procedural barriers to creditor collection, even if the assets within the trust might be reachable by protracted litigation. As a rule of administrative convenience, a partner or shareholder who holds less than 5 percent of the assets of the entity would be able to use the basis of unrelated assets on the presumption that the creditor is unlikely to chase small-percentage owners, even if there is a general partnership or no explicit limitation on owner liability. If the taxpayer does not know adjusted basis for all the assets that might be reached to satisfy an outstanding liability, the proposal will have an in terrorem effect to discourage negative-tax shelters even beyond its strict accounting logic.

Basis would be reduced not only by deductions of basis but also by distributions, transfers, or

³⁴It would be a simplification of the proposal to exclude basis in a primary residence from the adjusted basis component of the negative capital account in all cases. The rule would impose the same rule for jurisdictions with and without a homestead exemption.

³⁵See, e.g., reg. section 1.263(a)-4, allowing expensing of investment costs with future value unless the costs create a property right that can be sold apart from the business as a whole.

³⁶Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289, *Doc 2008-24799*, 2008 *TNT* 242-46, shows that the effective tax rate is equal to the ratio of adjusted basis to value times the statutory tax rate.

³⁷A phasing in of the rules might well start with AGI exceeding \$1 million and reduce the exemption to \$200,000 over time.

consumption of the assets that were counted on the adjusted basis side of the capital account. A distribution or transfer or a consumption or distribution of assets that brought the capital account below zero by year-end would create taxable income to reverse prior deductions into income and increase the capital account to zero. The order of a deduction versus distribution or transfer should not count, so that the taxpayer should face the same effective limitation if the deduction comes first as when the deduction was tried after the transfer or distribution.

The capital account would be measured at year-end only. Contributions of cash or property with a basis at year-end would thus increase the adjusted basis perhaps by enough to allow a deduction. But if the property is withdrawn before the tax return is prepared or is contemplated to be withdrawn for

two years in a row before amounts contributed are in fact withdrawn, then the withdrawals would not just be income in the year of withdrawal, but rather the deductions for the prior year would not be allowed.

The proposal resembles the passive activity loss limitations in suspending loss deductions because they are artificial accounting losses, but preserving the deductions for future use. Decisions under the passive activity loss limitations would thus be valid precedents for the proposed no-negative capital accounts limitations. The no-negative capital account proposal, however, would not allow insiders who materially participate to get access to the negative tax associated with negative capital accounts, so that definitions, for example, of "material participation" would have no bearing on the negative capital account limitation.