PARTNERSHIPS, PASSIVE LOSSES, AND TAX REFORM

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The Tax Reform Act of 1986 (TRA) contained provisions that could greatly reduce the tax shelter benefits of partnerships [1]. This paper discusses the use of partnerships as means for individuals to shelter income from taxation and offers evidence on the effects of TRA in 1987, the first year affected by tax reform.

The first section of this paper provides a brief background on the treatment of partnership income in the pre- and post-reform periods and on the elements that contribute to a tax shelter. The second section examines time series data on the income and deficits of partnerships, focusing on how 1987 compares with earlier years. Partnership income and losses as reported on tax returns of individual partners are analyzed in the third section, again focusing on the differences between 1987 and earlier years. The final section summarizes results and presents conclusions.

I. TAX SHELTERS AND THE TAXATION OF PARTNERSHIP INCOME

A partnership is not a taxable entity. Each partnership files with the Internal Revenue Service (IRS) an information return (Form 1065) which shows the partnership's taxable income or loss for the year and the allocation of that income or loss to the separate partners. Partners can be individuals, corporations, other partnerships or virtually any other legal entity. As partners calculate their annual tax liabilities, they include their distributive shares of income and deductions from the partnership along with income from other sources.

Tax shelters are generally defined as investments "in which a significant portion of the investor's return is derived from the realization of tax saving with respect to other income, as well as the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself" [2]. Tax shelters commonly involve one or more of the following advantages:

- Deferral of tax liability through the use of tax provisions or tax preferences that accelerate deductions. Deferral, in effect, produces an interest-free loan from the government to the taxpayer. Examples of such provisions are accelerated depreciation and expensing of intangible drilling costs.

- Conversion of ordinary income into capital gains or other forms of income subject to lower rates of tax.

- Leveraged purchasing which magnifies the other tax advantages.

Because of its nature as a "flow-through entity" and its flexibility in allocating income among partners, the partnership form provides an attractive structure for tax shelters. Individuals with substantial amounts of positive income from other sources, such as wages and salaries or self-employment earnings, could invest in partnerships and offset some (or even all) of that income with their distributive share of any tax losses from the partnership. If they invested in a "limited" partnership (as opposed to a "general" partnership), they could receive the limited liability benefit comparable to incorporation as well as the flow-through benefits of partnerships [3,4,5].

One of the main goals of the 1986 Tax Reform Act was to reduce the ability of individual taxpayers to offset income with losses from tax shelters, thereby lowering their tax liabilities [2]. The Tax Reform Act of 1986 took several steps to reduce the attractiveness of tax shelters, including:

- eliminating the preferential tax rate on capital gains;

- reducing the acceleration of depreciation deductions;

- lowering overall marginal tax rates; and

- imposing limitations on "passive losses."

While the passive loss limitations apply to most forms of flow-through business, they particularly concern partnerships. They mean that passive partners, those who do not "materially participate" in the business of the firm, which include most limited partners, can no longer use any temporary losses generated by the business to offset "active income" from sources such as wages and salaries, or "portfolio income", such as interest and dividends [5]. (Exceptions were provided for certain partners for losses from oil and gas operations and from certain rental activities.)

The basic mechanics of the pre- and post-reform taxation of partnership income at the individual level can be illustrated as follows, using categories introduced by TRA. Let

Y_A = "Active income" which includes wages, salaries, and other types of earned income;

Y_J = "Portfolio income" which includes interest, dividends, most capital gains, and other types of taxable investment income;

Y_K = "Passive income" which includes taxable income or loss generated by a business such as a limited partnership or small business corporation in which the individual does not materially participate; and

Y_T = The sum of active (Y_A), portfolio (Y_J), and passive (Y_K) income which corresponds to adjusted gross income prior to adjustments in both the pre- and post-tax reform periods.

Thus, $Y_T = Y_A + Y_J + Y_K$.

The differences in Y_T before and after tax reform are mainly in Y_J and Y_K.

- Before Tax Reform, portfolio income (Y_J) included only 40 percent of most long-term capital gains, whereas after TRA, 100 percent was included.

- Before Tax Reform, passive income (Y_K) could be positive or negative in the Y_T equation. After Tax Reform, it could not be negative. While this does not appear to be a significant change, the large passive losses (Y_K) that were previously used to offset active (Y_A) or portfolio (Y_J) income could now only be used to offset passive (Y_K) gains.

Although some relief has been provided through phase-in rules [6], it was hypothesized that tax shelter partnerships were dealt a very serious, if not fatal, blow by these provisions. Specifically, it would be expected that net losses would decline and net income would rise, and that loss partnerships, particularly limited ones, would become less attractive. One test of this hypothesis would compare actual data from 1987 with estimates of expected gains and losses based on a model of pre-TRA behavior. In the absence of a reliable model, an alternative approach, as reflected in this paper, would examine tax return data from before and after the enactment of TRA for evidence of the anticipated response. Section II looks at data from partnerships, and section III analyzes data from individual tax returns.

II. EXAMINATION OF PARTNERSHIP DATA

Some of the significant trends in partnership data for 1981-1987 are presented in Figures 1-3. In each figure, the data are presented by type of partnership (general or limited) and overall profitability (gain or loss on ordinary income) as well as in total.

Figure 1 shows the number of partnerships for these categories. The total number of partnerships grew quite steadily in the 1981-85 period, dropped slightly in 1986, then dropped substantially in 1987. The data for each of the four classes show where the changes occurred. All four types generally registered increases through 1985, with limited partnerships (both gain and loss) rising at a more rapid rate than general partnerships.

After 1985, however, profitability (or lack thereof) provided the common factor for increasing or decreasing numbers. The 1985-86 decline occurred among gain partnerships, both general and limited, and the larger drop between 1986 and 1987 came only among loss partnerships, again for both general and limited. The decline in the number of loss partnerships in 1987 is consistent with the expected response to TRA.

The overall number of partners, as shown in

Figure 1.-- Number of Partnerships by Type of Partnership and Profitability, 1981-1987

(Thousands of Partnerships)

Year	Total	General Gain	General Loss	Limited Gain	Limited Loss
1981	1,461	677	576	75	133
1982	1,514	707	581	87	139
1983	1,542	707	601	82	152
1984	1,644	750	636	101	157
1985	1,714	774	660	107	173
1986	1,703	766	663	92	181
1987	1,650	770	618	96	166

For data sources, see note following Figure 3.

Figure 2, exhibited substantial and uninterrupted growth throughout the entire period, even in years in which the number of partnerships dropped. The number of partners of limited partnerships grew much more rapidly and consistently than those of general partnerships, which we attribute to the growth of tax shelters. The number of partners of general gain partnerships show a large decline for 1985 while the number of partners in general loss partnerships declined for 1987, as predicted.

Figure 2.-- Number of Partners by Type of Partnership and Profitability, 1981-1987

(Thousands of Partners)

Year	Total	General Gain	General Loss	Limited Gain	Limited Loss
1981	9,095	2,883	2,036	1,628	2,548
1982	9,765	2,886	2,167	2,027	2,684
1983	10,589	2,939	2,216	2,488	2,947
1984	12,427	3,527	2,215	3,082	3,603
1985	13,245	2,990	2,340	3,680	4,234
1986	15,301	3,061	2,426	4,709	5,105
1987	17,201	3,415	2,263	6,054	5,469

For data sources, see note following Figure 3.

The overall profitability of partnerships is shown in Figure 3. (All figures exclude capital gains.) In total, partnerships had net losses on ordinary income throughout the entire period peaking initially in 1982, a recession year, and again at $17 billion in 1986, the last pre-reform year. Net income for gain partnerships (both general and limited) grew in every year between 1981 and 1987. Losses for both general and limited loss partnerships also increased persistently through 1986, but then retreated in 1987, dropping by $4.5 billion. (The only exception came in 1983 when losses for general loss partnerships shrank a bit from the previous year, probably reflecting some recovery

Figure 3.-- Partnership Gain or Loss in Ordinary Income by Type of Partnership and Profitability, 1981-1987

(Billions of dollars)

Year	Total	General Gain	General Loss	Limited Gain	Limited Loss
1981	- 2.7	42.8	-29.8	7.8	-23.5
1982	- 7.3	44.4	-34.2	9.2	-26.7
1983	- 2.6	48.6	-32.5	11.7	-30.4
1984	- 3.5	55.7	-36.6	14.0	-36.6
1985	- 8.9	60.5	-42.4	16.6	-43.5
1986	-17.4	63.5	-45.3	16.8	-52.3
1987	- 2.9	68.7	-43.4	21.5	-49.6

SOURCES FOR FIGURES 1-3: Internal Revenue Service, Statistics of Income (SOI) Bulletin selected issues; Internal Revenue Service, 1978-82 Partnership Returns; and unpublished data from Office of Tax Analysis and SOI tabulations of the SOI Partnership files. "Profitability" is defined as gain or loss in ordinary income. Zero is included with loss.

from the 1982 recession.) The pattern of changes in net income for 1987 is consistent with the expected response to TRA.

Looking at these figures together, it is interesting to note that despite the increasing losses of loss partnerships (both general and limited), the number of loss partnerships and number of their partners both increase through 1986. Such behavior is counter to conventional economic motives which would have predicted resources (firms and investors) expanding in profitable activities and declining where losses were incurred. The observed patterns are instead consistent with tax sheltering motives. For 1987, the pattern changes and the dual motives of partnership ownership (i.e., profit and loss seeking) are evident. Gain partnerships show increased profitability while loss partnerships show the first reaction to TRA.

To understand better the changes in 1987 and their relation to Tax Reform, the data on net income are broken down by industry in Figure 4 for 1985-87, the period "surrounding" TRA. Column 4 decomposes the $14.5 billion improvement in net income less deficit between 1986 and 1987 by industry. That column shows a number of interesting points:

- $8.7 billion (or 60 percent) of the 1986-87 improvement came in the Finance, Insurance, and Real Estate (FIRE) industrial division. This is not surprising in view of the large and growing losses in that industry before TRA. What is surprising, though, is that "real estate operators and lessors" (the source of most of FIRE's losses) contributed only $1.3 billion to the 1986-87 improvement. It is also noteworthy that, within the real estate

Figure 4.-- Partnership Net Income Less Deficit by Type of Partnership and Selected Industries, 1985-1987

(Billions of dollars)

Industry	All Partnerships 1985 (1)	All Partnerships 1986 (2)	All Partnerships 1987 (3)	All Partnerships Change 1986-87 (4)	General Partnerships 1985 (5)	General Partnerships 1986 (6)	General Partnerships 1987 (7)	General Partnerships Change 1986-87 (8)	Limited Partnerships 1985 (9)	Limited Partnerships 1986 (10)	Limited Partnerships 1987 (11)	Limited Partnerships Change 1986-87 (12)
All Industries[1]..........	-8.9	-17.4	-2.9	14.5	18.0	18.1	25.3	7.1	-25.8	-35.5	-28.2	7.3
Agriculture, Forestry, Fishing..................	-1.0	-0.9	2.0	3.0	-0.2	-0.1	2.3	2.4	-0.9	-0.8	-0.3	0.6
Mining....................	1.5	-3.5	-1.4	2.1	0.2	-3.0	-3.6	-0.7	2.4	-0.5	2.3	2.8
Oil & Gas Extraction.....	3.3	-2.7	-1.3	1.4	0.8	-2.3	-3.6	-1.2	2.5	-0.3	2.3	2.6
Construction..............	2.2	2.5	2.8	0.3	2.2	2.4	2.6	0.2	0.0	0.1	0.2	0.1
Manufacturing.............	-1.1	-0.5	0.8	1.3	-0.8	-0.2	0.6	0.8	-0.2	-0.3	0.2	0.5
Transportation, Communication, Electric, etc.....	-3.1	-3.0	-3.8	-0.8	-1.9	-1.6	-2.2	-0.6	-1.1	-1.4	-1.5	-0.1
Communication............	-1.7	-2.5	-3.2	-0.7	-0.9	-1.5	-1.9	-0.4	-0.8	-1.0	-1.3	-0.3
Wholesale & Retail Trade...	2.0	2.3	2.7	0.4	1.8	2.2	2.5	0.3	0.2	0.1	0.2	0.1
Finance, Insurance and Real Estate...........	-25.9	-33.0	-24.2	8.7	-3.0	-3.5	1.9	5.4	-23.0	-29.5	-26.1	3.3
Real Estate Operators and Lessors.............	-26.2	-32.8	-31.5	1.3	-4.7	-6.1	-3.7	2.4	-21.5	-26.7	-27.8	-1.1
Subdividers & Developers.	-2.7	-3.0	-2.0	1.0	-1.3	-0.5	-0.6	-0.1	-1.4	-2.5	-1.5	1.1
Other Holding and Investment Companies....	0.6	1.1	4.9	3.8	0.8	1.1	2.6	1.4	-0.1	-0.1	2.3	2.4
Services..................	16.5	18.6	18.1	-0.5	19.7	21.7	21.3	-0.4	-3.2	-3.2	-3.2	-0.0

SOURCES: Internal Revenue Service, Statistics of Income (SOI) Bulletin selected issues; Internal Revenue Service, 1978-82 Partnership Returns; and unpublished data from Office of Tax Analysis and SOI tabulations of SOI Partnership files.

[1]Includes "Nature of business not allocable", not reported separately.

sector, the net losses of limited partnerships continued to grow (from $26.7 billion to $27.8 billion) while they shrank (from $6.1 billion to $3.7 billion) for general partnerships. This occurred even though some partners in general partnerships, but not in limited partnerships, would qualify for the special $25,000 exemption from the passive loss limitations for losses from "active" real estate activities.

Does the experience in the real estate industry mean that TRA had little effect on real estate tax shelters? To the contrary, the fact real estate losses in limited partnerships grew by only $1 billion, or 4 percent, is a sharp reversal of the trend of the rest of the decade when losses grew by 30 percent per year. This reduction in losses is more remarkable because it came in the face of strong downturns that the real estate industry experienced in certain geographic areas, particularly the Sun Belt (in part due to overbuilding caused by the pre-TRA tax benefits).

- The largest part of FIRE's improvement in net income less deficit came from "other holding and investment companies," where net income more than quadrupled between 1986 and 1987 (going from $1.1 billion to $4.9 billion). This $3.8 billion increase accounted for 26 percent of the partnership sector's total improvement between 1986 and 1987. How much of this is a response to TRA is uncertain. On the one hand, some of the increase might be due to investors looking for "passive income" to offset their passive losses. On the other hand, most of the income reported in this industry is "portfolio income," in the form of interest and dividends, and not useful for cushioning the effect of the passive loss limitations.

- About $3 billion dollars, or 20 percent, of the total partnership improvement from 1986 to 1987 came in Agriculture, Forestry, and Fishing. Some of this can be attributed to TRA [7], but mainly it appears to result from a generally good year in farming [8].

- "Oil and gas extraction" in the mining industry contributed substantially to the improvement from 1986 to 1987. While the energy sector as a whole was recovering during this period from the sharp decline in oil prices in late 1985, the partnership figures suggest a strong response to TRA. "Oil and gas extraction" was one of the few industries granted major exceptions to the passive loss limitations. Basically, losses from most general partnerships in oil and gas could continue to shelter ordinary income from other sources, while losses from limited partnerships in oil and gas could not. The numbers in Figure 4 show a turnabout among limited oil and gas partnerships from a loss of $0.3 billion in 1986 to a gain of $2.3 billion in 1987. At the same time losses among general partnerships in oil and gas grew from $2.3 billion to $3.6 billion. Both of these changes are consistent with the incentives provided by TRA.

This discussion suggests that the partnership sector responded to the tax shelter provisions of TRA in 1987, but not nearly as much as the $14.5 billion improvement alone in net income would imply. As the phase-in of the passive loss limitations proceeds and partnerships are able to restructure even their illiquid investments, we expect that partnership losses, the number of partnerships, and the numbers of investor/partners will continue to decline in those industries in which pre-TRA provisions were a large part of their attractiveness.

III. ANALYSIS OF INDIVIDUAL INCOME TAX DATA

This section examines partnership data reported on individual returns to see if TRA appears to have reduced (1) the amount of partnership losses claimed by individuals, and (2) the use by high income taxpayers of partnership losses to lower their tax bills.

Figure 5 presents time series data on ordinary income and losses from partnerships as reported on individuals' income tax returns [9].

Figure 5.--Partnership Ordinary Income and Losses Reported on Individual Income Tax Returns, 1980-1987

(Billions of dollars)

Year	Total Income	Total Losses	Net *
1980	29.8	20.2	9.6
1981	31.1	31.2	-0.1
1982	33.0	33.8	-0.7
1983	36.2	38.5	-2.3
1984	38.6	46.8	-8.2
1985	45.5	54.0	-8.5
1986	48.2	61.2	-13.0
1987	52.0	43.8**	8.2

* Includes "expense deduction."
** Deductible loss after passive loss limitations.

SOURCES: Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1980-1986; unpublished data from Office of Tax Analysis, Individual Income Tax Model, 1987.

The increases in losses that persisted through 1986 reversed abruptly in 1987 with an improvement of $17 billion. Combined with income growth of $4 billion, partners' net income increased by $21 billion. The passive loss limitations are undoubtedly responsible for much of the reversal in losses. Directly, the limitations disallowed approximately $10 billion in passive partnership losses, according to our estimates. Indirectly, taxpayers would have responded to the limitations to some extent by diverting investment into other activities, further reducing reported partnership losses. Other provisions of TRA, such as the reduction in accelerated depreciation, would have reduced the tax losses associated with new investments. However, improvements in general economic conditions could have contributed to the change in net income as well. Separating the response to TRA from the effect of other factors would require a behavioral model that is beyond the scope of this paper.

A complication in interpreting these figures is that the 1987 partnership figures do not include "portfolio income" (interest, dividends, and royalties) earned by partnerships, while figures for earlier years do. This would tend to understate the gains and overstate the losses in 1987 relative to previous years. Based on the reporting of interest and dividends at the partnership level, income may be understated as much as 20 percent, while losses may be overstated only about 5 percent.

Figure 6 shows the relative magnitude of the different pieces of partnership losses in 1987. This chart represents all partnership losses reflected on individual income tax returns in 1987 [10]. The slices of the pie show the type of loss -- active or passive -- and, if it was passive, whether it was disallowed, and, if allowed, why.

- Of all partnership losses in 1987, 23.4 percent were active and not affected by the passive loss limitations.

For the passive losses:

- 25.6 percent of total losses were passive but offset by passive income;
- 27.4 percent of total losses were passive but permitted to be deducted by the gradual phase-in of the limitations;
- 5.1 percent of the losses were passive but benefited from the special treatment of certain rental losses; and
- 18.6 percent, or about $10 billion, were passive and disallowed.

If the partnership losses reported by all individual taxpayers are lower in 1987, does that mean that high income individuals are using them less to reduce their tax liability? How has the use of partnership losses to reduce tax liability for high income taxpayers changed with Tax Reform? Figure 7 helps address these questions with data from 1983 through 1987.

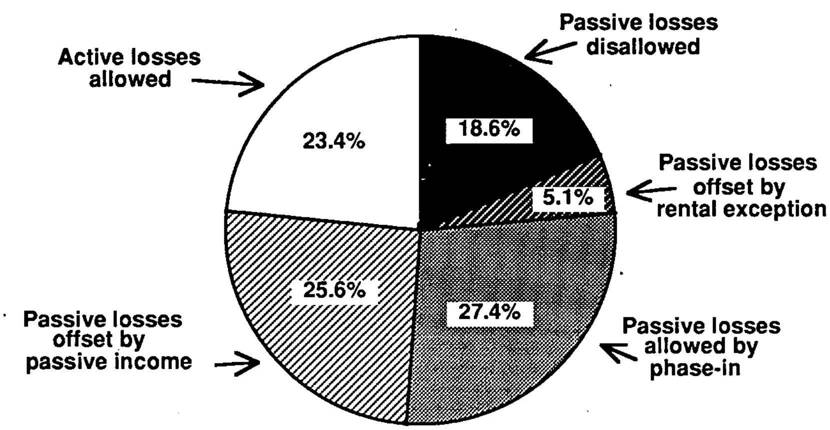
Figure 7 uses a measure of income that ignores taxpayers' losses in determining whether or not they have high incomes. The measure, total positive income, or TPI, looks only at positive pieces of income, viewing people as high income if they have large amounts of gross income with no netting of losses [11]. Figure 7 reports the fraction of TPI offset by partnership losses for returns with at least $250,000 of TPI. These high TPI returns are classified according to their tax burdens relative to TPI.

The figure shows that, for all high income returns, partnership losses did indeed offset a smaller fraction of TPI after Tax Reform than before it [12]. This conclusion is particularly true for returns paying the smallest fraction (less than 5 percent) of their TPI in tax.

For returns with low tax burdens, partnership losses had been offsetting an increasing fraction of TPI before TRA, from 36 percent in

Figure 6

Treatment of Partnership Losses on Individual Income Tax Returns, Income Year 1987



Total losses, $53.8 billion

1983 to nearly 48 percent in 1986. In 1987, however, the trend sharply reversed, and deductible partnership losses offset no more of TPI than in 1983. As the period for phasing-in the passive loss provisions expires, this effect can be expected to grow.

Figure 7 -- Partnership Losses as a Percentage of Total Positive Income (TPI) for Taxpayers with TPI Over $250,000, by Ratio of Taxes to TPI, 1983 - 1987

Ratio of Tax/TPT		1983	1984	1985	1986	1987
All High TPI Returns		10.9	10.9	11.3	9.1	8.5
	.05	36.2	42.1	45.9	47.7	35.9
.05	.10	21.4	22.9	24.1	23.6	21.3
.10	.20	9.1	7.8	7.0	5.3	11.0
	.20	3.6	3.6	3.7	3.0	2.7

High TPI = TPI in excess of $250.000 [13].

Source: Unpublished data from Office of Tax Analysis: Individual Income Tax Models from the Statistics of Income Division, Internal Revenue Service for relevant years.

IV. SUMMARY AND CONCLUSIONS

The goal of this paper was to see from the "early returns" (all 1987 returns) whether the 1986 Tax Reform Act was achieving its intended effect on tax shelter partnerships. The paper presents evidence suggesting that this has begun to happen, although there are instances where the anticipated effects were not as prominent as had been hypothesized. Nevertheless, TRA has had a definite impact on tax shelter partnerships.

At this point, the early effects of TRA are more evident among individual partners than among the partnerships themselves. Net income from partnerships reported on individual income tax returns increased by at least $21 billion in 1987, and perhaps more than $30 billion, if interest and dividends received by individual partners, which are now reported separately on the Form 1040, are taken into account. Approximately $10 billion of this came from losses directly disallowed by passive loss limitations. An undetermined amount of the remaining improvement represents an indirect response to TRA. Among high income taxpayers, the role of the partnership losses in sheltering income from taxation shrank, particularly among those with low tax burdens.

On the partnership side, net income improved by $14.5 billion in 1987. While some of this remains either unexplained or is attributable to factors other than TRA, the improvements in the mining and real estate industries, in particular, are consistent with a response to TRA. (In real estate, part of the response is simply slowing growth in losses among limited partnerships, rather that an absolute decrease in losses.) The declines for 1987 in the number of loss partnerships and the size of their losses in combination with increases in the number and profitability of gain partnerships are further signs of the effect of TRA.

Finding a larger response of TRA at the individual level than at the partnership level is consistent with expectations. The passive loss limitations affect the tax liabilities of individuals, giving them incentives to move out of tax shelters. Since corporate partners can still benefit from the tax advantages of tax shelter partnerships, many partnerships have less incentive to eliminate tax losses than do individual partners.

As tax return data for 1988 and later years become available, we expect to see more evidence of responses to TRA. The passage of time will provide increased liquidity to partnerships to restructure their portfolios and to individuals to sell or terminate investments that no longer provide immediate tax advantages. Additionally, the phase-in of the passive loss provisions will end. Partnership losses, the number of firms, and the numbers of investor/partners are likely to continue to decline in those industries in which pre-TRA tax provisions were a large part of their attractiveness.

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[5] Shapleigh, Colbert C., and Raley, Terry M., "The Effect of the Passive Loss Rule and Other Related Provisions of the Tax Reform Act," Journal of Partnership Taxation, Spring 1987.

[6] In 1987, 65 percent of passive losses from pre-TRA investments were allowed; in 1988, 40 percent; in 1989, 20 percent; in 1990, 10 percent; and none in 1991.

[7] "Beef cattle except feedlots," which had benefited from treating most income as

capital gains and deducting most expenses against ordinary income, went from a net loss of $0.3 billion in 1986 to a net gain of $0.7 billion in 1987.

[8] According to the Department of Agriculture, farm income rose from $37.5 billion in 1986 to $46.3 billion in 1987.

[9] Net income or loss on individuals' returns (Figure 5) frequently differs from the comparable figures for partnerships (Figures 3 and 4) because not all partnership income goes to individuals and because of income definitional differences.

[10] Because of the way passive losses are reported on the individual tax return, some of these figures had to be estimated for many returns. For partnership income, only active losses and total allowed passive losses are directly reported. Disallowed passive losses and the allocation of allowed passive losses among the reasons for being allowed were estimated for returns with more than one type of passive loss.

[11] See [3] for a similar use of the TPI concept.

[12] For all high income returns, the figure shows partnership losses covering notably less TPI in both 1986 and 1987 than before. The drop in 1986 relative to 1985 is due less to a reduction in partnership losses than it is to a jump in TPI as people realized their capital gains before the Tax Reform Act ended the partial exclusion.

[13] Total Positive Income (TPI) measures gross income reported on tax returns before losses. Specifically, it sums all the positive amounts of income on the Form 1040 and accompanying schedules, before losses or exclusions (such as the 60 percent exclusion for long-term capital gains) or deductions which reduce AGI (such as IRA or Keogh contributions).