

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 article discusses the use of partnerships as a means for individuals to shelter income from taxation and seeks evidence on the effects of TRA for 1987, the first year affected by the new law.

The first section of this article 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 conclusions.

TAX SHELTERS AND THE TAXATION OF PARTNERSHIP INCOME

A partnership is not a taxable entity. Each partnership files an information return (Form 1065) with the Internal Revenue Service (IRS), 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 corporations as well as the flow-through benefit of partnerships [3,4,5,6].

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 [7]. The Tax Reform Act of 1986 took several steps to reduce the attractiveness of tax shelters, including:

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- eliminating the preferential tax rate on net long-term 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 losses that individuals receive from most forms of flow-through businesses, they particularly concern partnerships. (The passive loss limitations do not apply to corporations or other taxable entities.) 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 from "portfolio income" such as interest and dividends [8]. (Exceptions were provided for certain partners for losses from oil and gas operations and from certain real estate 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 S Corporation in which the individual does not materially participate [9]; 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 were 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 was provided through phase-in rules, it was hypothesized that tax shelter partnerships were dealt a very serious, if not fatal, blow by these provisions [10]. 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 article, would be to examine tax return data for partnerships and partners for years before and after the enactment of TRA for evidence of the anticipated response.

EXAMINATION OF PARTNERSHIP DATA

Some of the significant trends in partnership data for 1981-1987 are presented in Figures A through C. In each figure, the data are presented by type of partnership (general or limited) and overall profit (i.e., gain or loss in "ordinary" income, with capital gains excluded) as well as in total.

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

After 1985, however, profits (or the lack thereof) provided the common factor for increasing or decreasing numbers. The 1985-86 decline occurred among gain partnerships, both general and limited,

Figure A.—Number of Partnerships by Type of Partnership and Gain or Loss Status, Income Years 1981–1987

[Number of partnerships are in thousands]

Income Year	All partnerships	Type of partnership			
		General		Limited	
		With gain	With loss	With gain	With loss
		(1)	(2)	(3)	(4)
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	1,648	769	617	96	166

Sources: See note following Figure C.

and the larger drop between 1986 and 1987 occurred only among loss partnerships, again for both general and limited. The decline in the number of loss partnerships for 1987 is consistent with the expected response to TRA.

The overall number of partners, as shown in Figure B, exhibited steady and uninterrupted growth throughout the entire period, even for years in which the number of partnerships dropped. The number of partners in limited partnerships grew much more rapidly and constantly than those in general partnerships, which can be attributed to the growth of tax shelters. The number of partners of gain general partnerships show a large decline for 1985, while the number of partners in loss general partnerships declined for 1987, as predicted.

Figure B.—Number of Partners by Type of Partnership and Gain or Loss Status, Income Years 1981–1987

[Number of partners are in thousands]

Income Year	All partnerships	Type of partnership			
		General		Limited	
		With gain	With loss	With gain	With loss
		(1)	(2)	(3)	(4)
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	16,963	3,185	2,255	6,054	5,469

Sources: See note following Figure C.

The overall profits (excluding capital gains) of partnerships are shown in Figure C. In total, partnerships had net losses in ordinary income throughout the entire period, peaking initially for 1982, a recession year, and again at \$17 billion for 1986, the last pre-Reform year. Net income for gain partnerships (both general and limited) grew every year between 1981 and 1987. Losses for both general and limited

loss partnerships also increased persistently through 1986, but then declined for 1987, dropping by \$4.6 billion. (The only exception came for 1983 when losses for loss general partnerships shrank a bit from the previous year, probably reflecting some recovery from the 1982 recession.) The pattern of changes in net income for 1987 is consistent with the expected response to TRA.

Figure C.—Partnership Gain or Loss in Ordinary Income by Type of Partnership and Gain or Loss Status, Income Years 1981–1987

[Money amounts are in billions of dollars]

Income Year	Total gain less loss	Type of partnership			
		General		Limited	
		With gain	With loss	With gain	With 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	-5.4	66.2	-43.4	21.5	-49.6

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

Looking at these figures together, it can be noted that despite the increasing losses of loss partnerships (both general and limited), the number of loss partnerships and the number of partners in them 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 profits while loss partnerships show the first reaction to TRA.

To understand better the changes for 1987 and their relation to Tax Reform, the data on net income are classified by industry in Figure D for 1985-87, the period "surrounding" TRA. Column 4 decomposes the \$12.0 billion improvement in net income (less deficit) between 1986 and 1987 by industrial division. That column shows a number of significant points:

- \$6.2 billion (or 52 percent) of the 1986-87 improvement came in the finance, insurance and real estate industrial division. This is not surprising in view of the large and growing losses in that industrial division before TRA.

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Figure D.—Partnership Net Income Less Deficit by Industrial Division and Selected Industry Groups, Income Years 1985–1987

[Money amounts are in billions of dollars]

Industrial division, group	All partnerships				General partnerships				Limited partnerships			
	1985	1986	1987	Change, 1986–87	1985	1986	1987	Change, 1986–87	1985	1986	1987	Change, 1986–87
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
All industries ¹	-8.9	-17.4	-5.4	12.0	18.0	18.1	22.7	4.6	-25.8	-35.5	-28.2	7.3
Agriculture, forestry, and 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 and gas.....	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	(²)	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, gas, and sanitary services.....	-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 and 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	-26.8	6.2	-3.0	-3.5	-0.6	2.9	-23.0	-29.5	-26.1	3.3
Real estate operators and lessors of buildings.....	-26.2	-32.8	-33.1	-0.3	-4.7	-6.1	-5.4	0.7	-21.5	-26.7	-27.8	-1.1
Subdividers and 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
Holding and investment companies, except investment clubs and common trust funds.....	0.6	1.1	4.0	2.9	0.8	1.1	1.7	0.5	-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	(³)

¹ Includes "Nature of business not allocable," not reported separately.² Positive net income (less deficit) less than \$0.05 billion.³ Negative net income (less deficit) less than \$0.05 billion.SOURCES: *Statistics of Income (SOI) Bulletin*, selected issues; *Statistics of Income—1978–82, Partnership Returns*; and unpublished data from Office of Tax Analysis and SOI partnership data files.

What is noteworthy, though, is that real estate operators and lessors of buildings (the source of most of the finance division's losses) contributed nothing to the 1986-87 decrease in losses. Indeed, net losses in real estate grew slightly, by \$0.3 billion. It is also noteworthy that, within real estate, 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 \$5.4 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 that real estate losses in limited partnerships grew by only \$1.0 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 in the Sun Belt States (in part due to over-building caused by the pre-TRA tax benefits).

- The largest part of the improvement in net income (less deficit) in the finance division came from holding and investment companies (other than investment clubs and common trust funds), where net income nearly quadrupled between 1986 and 1987 (from \$1.1 billion to \$4.0 billion). This \$2.9 billion increase accounted for 24 percent of partnerships' 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 for this industry is "portfolio income," in the form of interest and dividends, not useful for cushioning the effect of the passive loss limitations.
- About \$3 billion, or 25 percent, of the total partnership improvement from 1986 to 1987 came in agriculture, forestry, and fishing. Some of this can be attributed to TRA, but mainly it appears to result from a generally good year in farming [11,12].
- Oil and gas extraction in the mining division 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 D show a turnabout among oil and gas limited partnerships from a loss of \$0.3 billion for 1986 to a gain of \$2.3 billion for 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 partnerships responded to the tax shelter provisions of TRA in 1987, but not nearly as much as the \$12.0 billion improvement in net income would imply. Since the passive loss limitations apply only to losses flowing through to individuals, many corporations can still benefit from tax shelter partnerships. It is likely, therefore, that some of the market for tax shelters may have shifted to corporations. Nevertheless, as the phase-in of the passive loss limitations proceed and partnerships are able to restructure even their illiquid investments, it can be expected that partnership losses, the number of partnerships, and the number of investor/partners will continue to decline in those industries in which pre-TRA provisions were a large part of their attractiveness.

ANALYSIS OF INDIVIDUAL INCOME TAX RETURN DATA

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

Figure E presents time series data on total and net ordinary income and losses from partnerships as reported on individuals' income tax returns [13]. The increases in losses that persisted through 1986 were reversed abruptly for 1987, decreasing by \$17 billion. Combined with a growth of \$4 billion in total income, 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 partner-

Figure E.—Partnership Ordinary Income and Losses Reported on Individual Income Tax Returns, 1980–1987

[Money amounts are in billions of dollars]

Income year	Net loss ¹	Total income	Total loss
	(1)	(2)	(3)
1980	9.6	29.8	20.2
1981	-0.1	31.1	31.2
1982	-0.7	33.0	33.8
1983	-2.3	36.2	38.5
1984	-8.2	38.6	46.8
1985	-8.5	45.5	54.0
1986	-13.0	48.2	61.2
1987	8.2	52.0	43.8 ²

¹ Includes "expense deduction."

² Deductible loss after passive loss limitations.

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

ship passive losses [14]. 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 partnership net income as well. Separating the indirect response to TRA from the effect of other factors would require a behavioral model that is beyond the scope of this article.

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 [15]. This would tend to understate the gains and overstate the losses for 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.

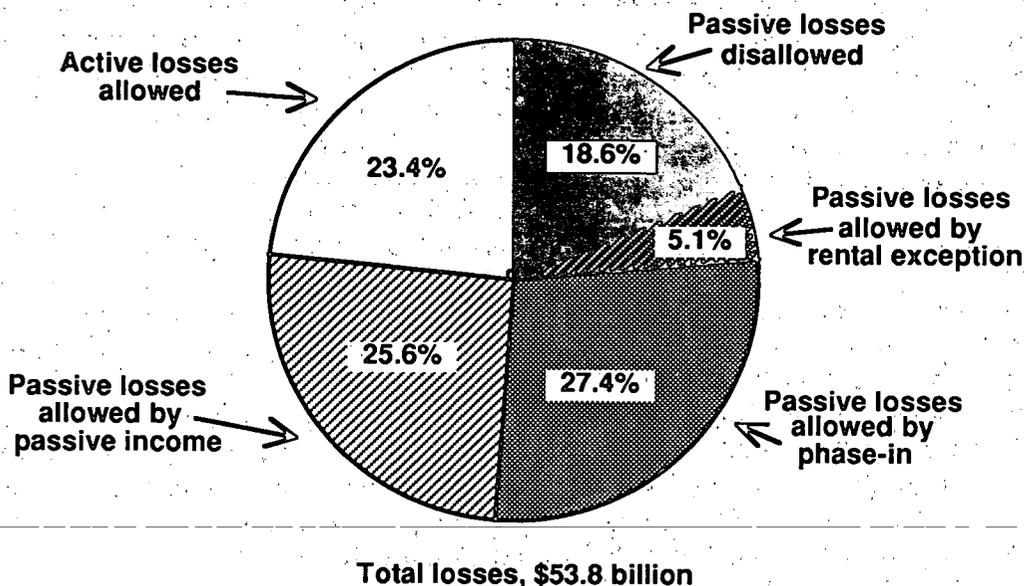
Figure F shows the relative magnitude of the different categories of partnership losses for 1987. This chart represents all partnership losses reflected on individual income tax returns for 1987 [16]. The slices of the pie show the type of loss -- active or passive -- and, if it was passive, whether it was disallowed, and, if allowed, why.

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

For the passive losses:

- 25.6 percent of total losses were passive but

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



offset by passive income;

- 27.4 percent of total losses were passive but were allowed because of the gradual phase-in of the limitations;
- 5.1 percent of total 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 were lower for 1987, does that mean that high-income individuals used 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 G helps address these questions with data from 1983 through 1987.

In Figure G, a measure of income is used that

ignores taxpayers' losses in determining whether or not they have high-incomes. The measure, total positive income, or TPI, looks only at positive sources of income, viewing people as high income if they have large amounts of "gross" income with no netting of losses [17,18]. Figure G 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 income tax burdens relative to TPI.

Figure G shows that, for high-income returns, partnership losses did indeed offset a smaller frac-

Figure G.—Partnership Losses as a Percentage of Total Positive Income (TPI) for Taxpayers with TPI Over \$250,000, by Percentage of Taxes to TPI, 1983–1987

Percentage of Tax/TPI	1983	1984	1985	1986	1987
	(1)	(2)	(3)	(4)	(5)
All high TPI returns.....	10.9	10.9	11.3	9.1	8.5
Less than 5 percent.....	36.2	42.1	45.9	47.7	35.9
5 percent under 10 percent.....	21.4	22.9	24.1	23.6	21.3
10 percent under 20 percent.....	9.1	7.8	7.0	5.3	11.0
20 percent or more.....	3.6	3.6	3.7	3.0	2.7

Source: Unpublished data from Office of Tax Analysis: Individual Income Tax Models.

tion of TPI after Tax Reform than before it [19]. This conclusion is particularly true for returns with the smallest fraction (less than 5 percent) of their TPI reportable as tax.

For returns with low tax burdens, partnership losses had been offsetting an increasing fraction of TPI before TRA, from 36 percent for 1983 to nearly 48 percent for 1986. For 1987, however, the trend was sharply reversed and deductible partnership losses offset no more of TPI than they did for 1983. As the period for phasing-in the passive loss provisions expires, this effect can be expected to grow.

SUMMARY AND CONCLUSIONS

The goal of this article was to see, based on the first returns filed under the 1986 Tax Reform Act (i.e., for Income Year 1987) whether the Act was achieving its intended effect on tax shelter partnerships. This article 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 for 1987, and perhaps by more than \$30 billion, if interest and dividends received by individual partners, which are now reported separately on the individual income tax return, 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 partnership losses in sheltering income from taxation shrank, particularly among those with low tax burdens.

On the partnership side, net income improved by \$12.0 billion for 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 than an absolute decrease in losses.) The declines for 1987 in the number of loss partnerships and the size of their losses in combina-

tion with increases in the number and profits 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, more evidence of responses to TRA are expected. 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 number 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.

NOTES AND REFERENCES

- [1] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (H.R. 3838, 99th Congress; Public Law 99-514), May 4, 1987.
- [2] U.S. Congress, Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.
- [3] Nelson, Susan, "Taxes Paid by High-Income Taxpayers and the Growth of Partnerships, 1983," *Statistics of Income Bulletin*, Fall 1985, Volume 5, Number 2.
- [4] Nelson, Susan, "Noncorporate Business Taxation: Before and After the Tax Reform Act of 1986," *OTA Paper 59*, U.S. Department of Treasury, Office of Tax Analysis, May 1988.
- [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] A "general" partnership was comprised entirely of "general" partners, i.e., partners each of

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which could be personally liable for the obligations of the partnership. A "limited" partnership is one in which the liability of one (or more) partners was generally limited to the amount the person had invested (the amount "at risk").

[7] See footnote 2.

[8] See footnote 5.

[9] An S Corporation was generally a small corporation, with no more than 35 shareholders (primarily individuals), electing to be taxed at the shareholder level.

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

[11] An example of an industry affected by TRA is beef cattle except feedlots, which had benefited from treating most income as capital gains and deducting most expenses from ordinary income. This industry switched from a net loss of \$0.3 billion for 1986 to a net gain of \$0.7 billion for 1987.

[12] According to the Department of Agriculture, net income of farm operators from farming rose from \$37.5 billion for 1986 to \$46.3 billion for 1987. See *Economic Indicators of the Farm Sector: National Financial Summary*, annual, U.S. Department of Agriculture, Economic Research Service.

[13] Net (ordinary) income or loss on individuals' returns (Figure E) frequently differs from the comparable figures for partnerships (Figures C and D) because not all partners are individuals and because of the income reporting requirements on individual income tax returns, as described below.

"Total income" as reported in Schedule E, *Supplemental Income Schedule, Individual Income Tax Return*, Form 1040, is the sum of positive net income from gain partnerships, including separately treated items reported on Schedule K-1, *Partner's Share of Income, Credits, Deductions, Etc.*, such as guaranteed payments to partners. "Total loss" is the sum

of net losses from partnerships adjusted for guaranteed payments to partners and for other separately-treated items.

Partnership totals based on Schedule E, Form 1040, differ from those on the Form 1065 partnership return income statement for reasons such as the following:

(a) the amounts shown on Form 1040 are after the "at risk" and (for 1987) the "passive loss" limitations imposed on partners (the "at risk" limitation restricts the allowable losses limited partners can deduct to the amounts they invested);

(b) guaranteed payments to partners and certain other separately-treated items (except capital gains) are handled differently in computing net income, by the partnership and by the partners on Form 1040 (for instance, in the case of guaranteed payments, they are deducted by the partnership in computing partnership net income on Form 1065, but are included as income by partners in computing partnership net income on Form 1040); and

(c) partners other than individuals share in partnership income (or loss).

[14] Estimate made by Susan Nelson.

[15] In general, starting with 1987 partnership "portfolio income" was reported on the individual income tax return schedules according to the type of portfolio income and thus was not reported as income from partnerships. Previously, total partnership portfolio income was combined under income from partnerships.

[16] Because of how passive losses are reported on the individual income 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 according to the reason for their being allowed were estimated by Susan Nelson from returns with more than one type of passive loss.

[17] Total Positive Income (TPI) measures "gross" income reported on individual income tax returns before losses. Specifically, it sums all positive amounts of income on the Form 1040 return and accompanying schedules, before losses or exclusions (such as the 60 percent exclusion of long-term capital gains allowed before 1987) or deductions which reduce adjusted gross income (such for contributions to individual retirement arrangements, or Keogh retirement plans).

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

[19] For all high-income returns, Figure G shows partnership losses covering notably less TPI for both 1986 and 1987 than before. The drop for 1986 is due less to a reduction in partnership losses than it is to a jump in TPI as taxpayers realized their capital gains before the Tax Reform Act ended the partial exclusion of long-term capital gains from adjusted gross income.