Tax Shelters under the Tax Reform Act of 1976

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I. INTRODUCTION

WHILE THE TAX REFORM ACT OF 1976 (1976 Act) is a pervasive amendment of the Internal Revenue Code of 1954 (Code), one key feature is the assault upon tax shelters. Tax shelters assume a great variety of forms, but they are generally defined as devices whereby "taxpayers (are allowed) to offset certain artificial losses (that is noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from these investments, but also against the taxpayer's other income, usually from his regular business or professional activity." This article


2. STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., OVERVIEW OF TAX SHELTERS 1 (Comm. Print 1975).

In the course of considering changes in the tax law, a considerable amount of materials analyzing tax shelters was developed by the Staff of the Joint Committee on Internal Revenue Taxation. These materials constitute the single best statement of the tax law surrounding tax shelters assembled to date. For materials prepared for the House Committee on Ways and Means, see STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., COMMITTEE MEMBER SELECTIONS OF PROPOSALS FOR CONSIDERATION IN FIRST PHASE OF TAX REFORM (Comm. Print 1975); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: EQUIPMENT LEASING (Comm. Print 1975); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: OIL AND GAS DRILLING FUNDS (Comm. Print 1975); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: PROFESSIONAL SPORTS FRANCHISEES (Comm. Print 1975); STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 1ST SESS., TAX SHELTERS: USE OF LIMITED PARTNERSHIPS, ETC. (Comm. Print 1975). For materials prepared for the Senate Committee on Finance, see STAFF
proposes to describe the changes made by the 1976 Act in the law relating to tax shelters, including a discussion of the legislative history surrounding the adoption of these changes, and to analyze their probable effect.

One of the weaknesses of the present tax system is the slow response of legislation to problems that have already developed. Because taxpayers are ingenious, Congress seldom anticipates all of the maneuvers that will be contrived in the search for the investor's dollar. However, for several reasons discussed subsequently, the present congressional assault on tax shelters is legislation in an area which probably would have died of natural causes.

The Internal Revenue Service (IRS) has continually attempted to curb abuses in the tax system; with respect to tax shelters, this attack has been fierce. In August 1976, the IRS announced that it would put renewed emphasis upon its "Coordinated Tax Shelter Program" and increase its audit of returns that reflect deductions relating to oil and gas drilling, farm operations, real estate, and motion pictures. In May 1976, the IRS declared that it would be using new computer programming methods to scan tax returns reflecting investment in tax shelter areas. In the spring of 1976, the IRS instructed its agents to make a threefold attack on movie production tax shelters. Similarly, the IRS has indicated that it would suspend, but not settle, cases involving movie production shelters. Similar action was taken in July 1976 concerning prepaid fee cases. The IRS suspended issuance of rulings in situations involving the use of "leveraged leases" in August 1976. Furthermore, the IRS has continued to advance its theory that any recovery of a tax shelter deduction is subject to the "tax benefit" rule and has so advocated successfully. The IRS has attacked tax shelters directly, on the grounds that they are insubstantial or are lack-
ing in a profit motive, and has been successful with this line of reasoning as well.11

The Securities and Exchange Commission (SEC) has also become involved with tax shelters. In those cases where the interest in the tax shelter is deemed a "security" within the terms of the Securities Act of 193312 or the Securities Exchange Act of 1934,13 the SEC has required strict disclosure and technical compliance with these Acts.14 Of great concern to lawyers are direct attacks by the SEC upon the professionals involved in structuring tax shelters. The fear of being held to a strict "due diligence" standard15 has a tendency to make lawyers hesitant to approve a tax shelter; thus, the professionally approved tax shelter is often difficult to obtain. Finally, the fear of private antifraud litigation, whether under common law theories or under rule 10b-5,16 makes shelters less attractive to promoters, who may be found to have guaranteed the success of the venture.17

Taken together, it is quite possible that these various forces converging upon the devising and use of tax shelters would have, in due course, achieved the results now legislated. This conclusion is especially true in view of the recent recession, coupled with the maturing of many tax shelters which have not proven to be economically sound. Even those promoters who are willing to accept the risks are finding an ever-shrinking market for tax shelters. Today's investor realizes that it is economically more advantageous to retain thirty cents on the dollar after taxes than to risk losing the whole dollar in the event that tax loss deductions resulting from a tax shelter are not sustained upon IRS examination.

The congressional attack upon tax shelters may be viewed as a three-pronged approach, focusing upon 1) the shelter vehicle,18 2) the

11. Arnold L. Ginsberg, 35 TAX CT. MEM. DEC. (CCH) 860 (June 21, 1976) (taxpayer not entitled to a loss deduction for expenses incurred in breeding cattle, since taxpayer lacked the requisite profit motive).
18. See notes 22-109 and accompanying text infra.
shelter investment, \(^1\) and 3) the individual investor.\(^2\) As a framework for the following discussion, consider this typical example of a tax shelter:

The promoter locates a form of investment which has some, not necessarily substantial, promise of economic yield, and which, more importantly, generates tax deductions substantially in excess of income. As a vehicle for this investment, the promoter forms a limited partnership and sells interests in the partnership to individual investors. To maximize the tax losses to the investors, syndication fees are expensed, other charges are set up as "guaranteed" payments, the investors are given participations in the partnership from the first day of the taxable year even though they purchased interests at year-end, and all deductible tax losses are allocated to the investors. The partnership, usually with the promoter as the sole general partner or as one of the general partners in conjunction with a corporation, operates the investment to yield tax deductible losses, which, generally speaking, are sufficiently large to return the investor's capital in three to five years and provide a modest return thereafter. The return of capital and annual yield arise, of course, from the use of the investor's share of the partnership's tax losses as deductions against the income earned in other pursuits, e.g., practicing medicine.

Prompted in large measure by the apparent public concern for this alleged abuse, Congress became disenchanted by this form of investment and sought to curb any abuses by the threefold attack described in detail in the following pages.\(^3\)

II. THE TAX SHELTER VEHICLE: THE PARTNERSHIP

Because a corporation is a separate taxable entity which retains unto itself the losses which it generates,\(^4\) the partnership form is the most suitable vehicle in which to package tax shelter investments. Because the partnership is not itself a taxable entity,\(^5\) deductions pass directly through the partnership to the partners unchanged in char-

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19. *See* notes 110-337 and accompanying text infra.
21. *See* H.R. Rep. No. 658, 94th Cong., 1st Sess. 8-9 (1975); S. Rep. No. 938, 94th Cong., 2d Sess. 3 (1976). The House Ways and Means Committee asserted: [T]his bill will significantly reduce the abuses of tax shelters, while leaving the underlying tax incentives in place. It is essential that strong action be taken against all of the major tax shelter investments, otherwise, the bill will lead only to a redirection of shelter-seeking capital from shelters which are closed to the ones that are still left open.
22. *See* I.R.C. § 172(a).
acter,24 and while operating income or loss may be calculated at the partnership level,25 the result is reflected on the partners' individual returns.26 Trusts also have pass-through features,27 but trusts that operate businesses are generally characterized as operations taxable in the manner of corporations.28 To ensure limited liability for those investing in the shelters, the limited partnership form has usually been chosen, although the general partnership form is employed occasionally to avoid securities law complications.29 While not foreclosing the advantages of the partnership vehicle altogether, Congress made the pass-through features less vulnerable to manipulation by focusing upon certain characteristics of partnership taxation which it believed were being used to achieve unintended results.

A. Syndication Fees

The promoter, in organizing the partnership, incurs certain expenses which include legal, accounting, and recording fees; the time, effort, and expense expended in locating the shelter investment and tailoring it to the particular partnership; and, more importantly, the effort and expense of selling the partnership interests (units or shares). The promoter ordinarily desires payment or reimbursement for these expenses. Reimbursement might be obtained in several ways. First, with the approval of the limited partners, the promoter could recognize the expenses for what they are — organizational expenses. However, the IRS might then be tempted to capitalize the expenses.80 Also, reimbursement might be deferred for a short period by withdrawing these expenses in the form of an augmented or supplemented management fee, which would then be deducted as an ordinary expense incurred in operating the tax shelter.81 This approach, however, has several weaknesses. The management fee might be so large as to prompt the IRS to question whether it was ordinary and necessary and reasonable in amount. This questioning in turn might cause the IRS to investigate more closely and to discover the disguised payment of organizational fees; or, depending upon the nature of the tax shelter, the IRS might require part of the management fee to be capitalized as reflective, for example, of fees incurred in locating investment property.

24. See I.R.C. § 702(a) (1)-(7).
25. See id. § 703(a) (2) (E).
26. See id. § 702(a).
27. For example, a deduction is allowed at the trust level for distributable net income paid to the beneficiaries. Id. §§ 651(a), 661(a).
30. See I.R.C. § 263; note 35 and accompanying text infra.
31. See I.R.C. § 162(a).
Prior to the 1976 Act, the Internal Revenue Code itself seemed to offer the solution to this dilemma. Section 707(c) characterized certain payments made to a partner as "guaranteed payments," i.e., payments which would be made in all events regardless of the financial success or failure of the partnership's business. These payments appear to have been deductible in all events by the partnership, regardless of whether they would otherwise have been treated as capitalized expenditures. On the other hand, both the Tax Court and the IRS advocated that, in order to be deductible, any payment made by an individual or a partnership must be "ordinary and necessary" within the meaning of section 162 and must not be subject to capitalization under the rules described in section 263.

The version of the Tax Reform Act referred by the House Committee on Ways and Means (House Bill) solved the dispute by proposing new section 724, which provided that no deduction be allowed to the partnership or to any partner for any amounts paid or incurred to organize a partnership or an interest in the partnership. The House Bill also amended section 707(c) to clarify that in order for a guaranteed payment to be deductible by the partnership, it must meet the same tests under section 162(a) as if the payment had been made to a person who is not a member of the partnership. The report of the House Committee on Ways and Means (House Report) made it clear that

32. Section 707(c) formerly read:
[T]o the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expense).
Id. § 707(c). See also Treas. Reg. § 1.707-1(c) (1958). Section 707(c) was amended in Pub. L. No. 94-455, § 213(b) (3), 90 Stat. 1520 (1976). See notes 46 & 48 and accompanying text infra.

33. Jackson E. Cagle, Jr., 63 T.C. 86, 91 (1974) (management fee paid to a partner for conducting a feasibility study of a proposed facility, obtaining financing, and developing the complex held a capital expenditure rather than a section 162 "ordinary and necessary" expense).


35. See Kaster, Real Estate Limited Partnerships, 1973 N.Y.U. 31ST INST. ON FED. TAX 1799, 1810-13; Holdsworth, Partners' Drawings, 1962 N.Y.U. 20TH INST. ON FED. TAX 721, 731-34 (agreeing that section 707(c) payments are subject to section 162 requirements).


37. Id. Section 210(b)(1) read in part: "No deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership." Id.

38. Id. § 210(b)(3).
the normal rules relating to capital expenditures under section 263 must also be considered.\textsuperscript{39}

Although the House Bill's proposed section 724 appeared to solve the problem, it left the factual issue of determining which expenses were paid to organize the partnership or sell partnership units open to dispute. For example, tax advice dealing with the formation of the partnership may be charged separately from tax advice dealing with operations. A tax lawyer might reasonably place different prices on advice rendered depending upon the degree of complexity involved. The lawyer might regard tax advice concerning the formation of the partnership as routine while regarding tax advice concerning operations as more valuable and charge accordingly. Other devices, such as paying the promoter to guarantee the construction loan or to refrain from competition by starting a new venture nearby, may still result in deductions for what otherwise would be nondeductible syndication fees.

Secondly, the House Bill's version of section 724 failed to clarify when the partnership could recover these capital costs through write-offs or loss deductions, and the House Report was silent on this matter. Presumably, these expenses could be recovered only in the form of basis, perhaps only as a loss when the partnership dissolved.\textsuperscript{40} Nor did the House Bill deal with section 736(a) of the Code, which under certain circumstances treats payments by the partnership to a withdrawing or deceased partner as "guaranteed payment[s] described in section 707(c) if the amount thereof is determined without regard to the income of the partnership."\textsuperscript{41} Thus, under section 736, certain payments made to the withdrawing partner are regarded as nondeductible capital expenditures by the partnership and thus capital gain to that partner; other payments are treated as ordinary income to the withdrawing partner and qualify as deductions for the partnership. The House Report did contain a footnote concerning the impact of amended section 707 upon section 736(a): "[T]he committee's decision is not intended to affect adversely the deductibility to the partnership of a payment described in section 736(a) (2) to a retiring partner or to a deceased partner's successor in interest."\textsuperscript{42} The inadequacy of the conclusory footnote is evident.

The Senate's response to the organization expenses dispute, as contained in the version of the Tax Reform Act passed by the Senate

\textsuperscript{40} See S. Rep. No. 938, 94th Cong., 2d Sess. 94 n.8 (1976) [hereinafter cited as Senate Report].
\textsuperscript{41} I.R.C. § 736(a) (2).
\textsuperscript{42} House Report, supra note 39, at 121 n.5.
was the creation of a new section 709. The new section 709(a) reflected the House Bill language but added a subsection (b), permitting a sixty-month amortization of such organizational expenses. Subsection (b) defined organizational expenses as those expenses incidental to the creation of the partnership, chargeable to the capital account which would have been amortizable over the life of the partnership if it had had an ascertainable life.44 Selling expenses, however, were not amortizable. The Report of the Senate Finance Committee (Senate Report) described “selling expenses” as “capitalized syndication fees, i.e., the expenditures connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees, and printing costs.”45 Thus, the Senate Bill left unresolved the factual issue of whether these costs, expenses, and fees were organizational expenses or selling expenses.

The Senate Bill did not expressly recognize the problems of sections 707(c) and 736(a), but the Senate Report also contained a footnote expressing the Senate’s intention that the amendment to section 707(c) not adversely affect the deductibility to the partnership of a payment to a retiring partner or to a deceased partner as described in section 736(a)(2).46

The Conference Committee adopted the Senate approach in the new section 709, requiring the capitalization of organizational and selling expenses, but allowing partnership election to treat organizational expenses as amortizable over such period of not less than sixty months.47 Amortization commences with the month in which the partnership begins business. If the partnership is liquidated before the end of the sixty-month period, the unamortized balance may be deducted as a loss.48

43. H.R. 10612, 94th Cong., 1st Sess. § 210 [hereinafter cited as Senate Bill].
44. Id. § 210(b). Section 210 of the Senate Bill provided in pertinent part: Amounts paid or incurred to organize a partnership may, at the election of the partnership . . . be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership . . . , or if the partnership is liquidated before the end of such 60-month period, such deferred expenses . . . may be deducted to the extent provided in section 165.
45. Senate Report, supra note 40, at 94.
46. Id. at 94 n.7.
48. The requirement that all organizational and selling expenses be capitalized is effective for all partnership years beginning after December 31, 1975. Tax Reform Act of 1976, Pub. L. No. 94–455, § 213(f)(1), 90 Stat. 1520. However, the right to amortize organizational expenses initially applies to amounts paid or incurred in taxable years beginning after December 31, 1976. Id. § 213(f)(3). The report of the Conference Committee (Conference Report) stated: “The conferees intend that no in-
B. Retroactive Allocations

In order to attract investors, the shelter must yield the maximum of tax losses. Prior to the 1976 Act, this goal seemed to be served by the partnership tax rules relating to the retroactive allocation of tax losses. Average investors cannot be induced to part with their earnings until late in the calendar year, when the investors are satisfied that the accrued earnings are sufficiently high for the year to warrant a tax shelter. It is not unusual for an investor to seek admittance as a partner in a tax shelter venture on December 31. Since the investor could hardly benefit from an allocable share of the partnership loss prorated for one day, retroactive allocations have been common, wherein the investor is recognized as if he had been a partner for the full year, or at least for some mutually satisfactory period. The decision of Norman A. Rodman appeared to sanction such arrangements. While section 706(c)(2)(B) of the Code suggested that a new partner's share of the partnership's tax results for the year should be prorated on a daily basis, as is the case for losses of corporations electing subchapter S treatment (subchapter S corporations), this approach gave way to the law that developed under section 704. Such decisions indicated that

References should be drawn as to the deductibility (when paid) of partnership organizational and syndication fees paid or incurred in taxable years beginning before January 1, 1976," H.R. Rep. No. 1515, 94th Cong., 2d Sess. 421 [hereinafter cited as Conference Report]. Since the new section 709(a), which became effective for all partnership years beginning January 1, 1976, requires organizational and selling expenses to be capitalized, the import of this Conference Report language was unclear. There appeared to be a gap: 1976 calendar year organizational and selling expenses must be capitalized, while the right to amortize such types of expenses first began with those paid or incurred after December 31, 1976. As a practical matter, partnerships having such expenses in 1976 presumably had no choice but to deduct them. Otherwise, a partnership might have had two types of organizational expenses (selling expenses never being subject to amortization): one group paid or incurred in calendar year 1976 which are not subject to amortization, and another group, paid or incurred after December 31, 1976, which are subject to 60-month amortization.


50. I.R.C. § 706(c)(2)(B) formerly read:

The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced, but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year. Id. Section 706(c)(2)(B) was amended by Pub. L. No. 94-455, § 213(f)(1), 90 Stat. 1520 (1976). See notes 53-64 and accompanying text infra.

51. See I.R.C. § 1374(c).
the allocation of income or loss agreed upon by the partners and set forth in the partnership agreement would be respected. Retroactive allocations for which the partnership agreement provided were upheld, despite the fact that the IRS was aware of this problem.

The House of Representatives sought to avoid these retroactive allocations by proposing two technical amendments. First, the House Bill amended section 706(c)(2)(B) to read:

The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership, or with respect to a partner whose interest is reduced (by sale, exchange, or otherwise), but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his varying interests in the partnership during the taxable year.

Second, the Bill broadened the exception contained in section 704(a) to provide that the partnership agreement determined a partner's distributive share of income, gain, loss, deduction, or credit, except to the extent otherwise provided in the partnership subchapter (including the newly amended section 706). According to the House Report, these amendments were intended to result in a proration of tax benefits between the incoming partner and outgoing partner, thus preventing retroactive allocation.

Both the House Report and the Senate Report expressed disfavor with retroactive allocations when the consequence of allowing them is that "new partners investing in the partnership toward the close of the taxable year are allowed to deduct expenses which were incurred prior to their entry into the partnership." The term "incurred" may have been employed in a technical sense, meaning accrued or accruable; or it may have been employed in a general sense, meaning that an unpaid

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52. See, e.g., Wilson v. United States, 246 F. Supp. 613 (N.D. Cal. 1965) (taxpayers' refund denied since they were bound by the allocation in the partnership agreement for purposes of section 704).
54. House Bill, supra note 36, § 210(c)(1); see note 50 supra.
55. House Bill, supra note 36, § 210(d)(2) (emphasis added).
57. Senate Bill, supra note 43, § 210(c).
obligation has arisen because the partnership has already used time (interest), privilege (property tax), or an item of property. For example, real property taxes might be payable solely once a year, yet arguably, in a general sense, each day marks off 1/365 of the real property tax obligation. Careful tax shelter planning in the past kept all expenses in abeyance until after the admission of the partners and paid those expenses with the newly invested capital. Tax shelter partnerships, almost without exception, report on the cash method of accounting. Thus, the deduction for interest, taxes, and other expenses would in fact arise after the admission of the limited partners. The question remains whether the changes successfully foreclose this form of planning.

For a newly organized partnership which can sell its units quickly, the problem of prorating the tax benefits might be solved by holding the investors out of the partnership and admitting them as a group at the same time, probably at the end of the year. If all of the partnership interests are not conceived as remaining in one or more partners prior to the investors’ admission, there would be no outgoing partners whose interests require proration. However, the validity of this approach under partnership law is unclear. Would it be permissible for a promoter to organize a partnership taking a 1% general partnership interest himself, causing another party to take a 1% interest as limited partner, and leaving 98% hanging in limbo assigned to no one? Would the existing partners absorb the vacuum, giving the promoter 50% interest and the other party, the remaining 50% interest as limited partner? Neither the Uniform Partnership Act nor the Uniform Limited Partnership Act deals expressly with this problem. Presumably, however, a valid limited partnership can exist even though all of the percentage participations are not assigned.

Agency principles may be employed to attribute expenses incurred by the promoter to the investors, even though the investors have not yet joined the partnership. Those dealing in real estate are familiar with the use of closing documents to close the transaction upon behalf of a partnership yet to be formed. An analogous situation exists during the formation of a corporation, where the promoters incur expenses on behalf of the corporation to be formed. As a matter of substantive law, no one has difficulty with this concept. For example, the expenses may be paid by the corporation if the corporation ratifies the acts of the organizers.

59. See Treas. Reg. § 1.706-1(c) (2) (ii) (1956).
60. See Electric Supply Co. v. United States Fidelity & Guar. Co., 79 N.M. 722, 449 P.2d 324 (1969) (fact that there was an unallocated percentage of 40% unpaid setoff for various suppliers did not affect validity of the partnership itself but was merely a matter for adjustment between the partners).
Similarly, the law of agency recognizes that in certain circumstances the "principal" can ratify the actions of his "agent" even though the parties were strangers prior to the transaction. Perhaps a transaction can be structured with 98% of the partnership interests being held in limbo, whereby the promoter-general partner clearly discloses that all acts done, all expenses "incurred," and all obligations undertaken are not for his benefit, but for the benefit of the limited partners to be admitted. If this structuring is valid, the expenses incurred prior to formal admission of the investor partners would have been actually incurred on their behalf, assuming subsequent ratification. Since the expenses are incurred on behalf of the partners, it should be permissible to allocate them to the benefit of the limited partners. The IRS recognizes the agency concept although usually in the context of an established principal-agent relationship.

The Conference Bill adopted the House's approach and used the language of section 706 proposed in the Senate Bill version. The Conference Report summarized the resulting change in the law:

[1]ncome or losses will be allocable to a partner only for the portion of the year he is a member of a partnership. In determining the income, loss or special item allocable to an incoming partner, the partnership will either allocate on a daily basis or separate the partnership year into two (or more) segments and allocate income, loss or special items in each segment among the persons who were partners during that segment.

The broader applicability of the new approach, implicit in the additional language "whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise," causes some concern, particularly as to the meaning of "otherwise." However, the language from the Senate Report limits the potential significance of the words:

Correspondingly, the provision is to apply to the incoming partner so as to take into account his varying interests during the year. In addition, regulations are to apply the same alternative methods

63. While the American Bar Association Report of the Section of Taxation did not evidence the precise concerns dealt with by this author, it did suggest that the simple amendments proposed by the House to cut short retroactive allocations would not necessarily accomplish their goal. Section on Taxation, American Bar Association, Report on H.R. 10612, Tax Reform Act of 1975, at 60 (1976).
of computing allocations of income and loss to situations falling under section 706(c)(2)(B) as those now applicable to section 706(c)(2)(A) situations (sale or liquidation of an entire interest). These rules will permit a partnership to choose the easier method of prorating items according to the portion of the year for which a partner was a partner or the more precise method of an interim closing of books (as if the year had closed) which, in some instances, will be more advantageous where most of the deductible expenses were paid or incurred upon or subsequent to the entry of the new partners to the partnership.

Under the amended sections 704 and 706, suppose that the partnership operates with no activity until December 1, and from that point until December 31, the partnership pays all its expenses. The limited partner investors gain admittance into the partnership on December 2. Presumably, the partnership can close its books on an interim basis as of December 1, allocate such activity as existed prior to December 1 to the promoter-general partner, and allocate all expenses for the operating period of December 2 through December 31 to the promoter-partner and the limited partner investors. In substantial effect, a retroactive allocation has been accomplished under the new rule.

C. Special Allocations

Assuming the achievement of a full year's participation in the partnership's losses, the promoter's next step is to seek maximization of the amount deductible by the investor. To demonstrate the promoter's good faith, the partnership agreement often specifies a series of priorities, called special allocations, whereby the investors may be allocated all expenditures attributable to ordinary and necessary expenses (currently deductible expenses), or all first income or loss of the partnership until a designated "flip-flop" point. These special allocations make the units easier to sell because the promoter's junior partner status demonstrates his faith that the investment will ultimately pay out. Furthermore, most promoters involved in multiple shelters have not needed their full share of the shelter losses of any one partnership anyway.

The House Bill sought to frustrate these beneficial allocations by amending section 704 to provide a two-step rule. First, the partners

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66. Senate Report, supra note 40, at 98.
67. An example of a "flip-flop" point would be a situation where the investor partners have received a return of 90% of the capital which they invested in the form of cash flow. Until that point, the investors would enjoy 90% of the partnership losses. The promoter's participation after the flip-flop might be 50%. See [1976] 15 Tax Mgmt't (BNA) 5.
68. See House Bill, supra note 36, § 210(d).
would determine their shares of income or loss according to the partnership's "permanent" method of allocating taxable income, or if no such "permanent" method applies, according to the "partner's interest in the partnership (determined by taking into account all facts and circumstances)." The reference to "permanent" presumably denotes the percentage participations into which all partners settle after the "flip-flop" point is reached. However, the precise significance is not clear from the House's wording, especially in light of the alternative statement that the facts and circumstances will control absent a "permanent method." Among the applicable "facts and circumstances" is the fact that the investor partners put up all the hard dollars and want all the first cash flow until those hard dollars are recovered. Yet no indication of the validity of this position is manifest. Further, suppose the partnership agreement provides that the investors are to enjoy a 90% allocation until they recover their cash investment, say $100,000, and then the general partner is to enjoy 90% until he recovers $100,000. At that juncture, the allocation again shifts to the investors until they recover the next $100,000, so that the partners never settle back to 50-50 or other specified "permanent" percentages. A resort to the "facts and circumstances" suggests that the investors invested all the cash and perhaps should be entitled to a 99% interest in the partnership; any concession to the general partner actually constitutes payment to him by the limited partners and the partnership for services rendered, which payment would be deductible by the partnership as a management or service fee. Hence, the tax deduction returns to the limited partners, leaving them in the same position they would be in if the "flip-flop" were recognized.

However, the proposed second step of the House's version must also be considered. Under this rule, the "permanent" approach would not apply if the partnership agreement provides a special allocation and "the partner receiving the allocation can establish both that there is a business purpose for this allocation and that no significant avoidance or evasion of any tax imposed by this subtitle results from such allocation.

69. Id. The House Report regarded the relevant facts as including the interests of respective partners in cash flow and their rights to distribution of capital upon liquidation. House Report, supra note 39, at 127.

70. For example, permanent percentage participation may refer to 50-50 interests which come into play after the limited partners recover their capital via the 90% special allocation. See note 67 supra.

71. See Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974), aff'g 56 T.C. 530 (1971) (partnership interest received in exchange for services held to be income to the receiving taxpayer). For a critical response to the Tax Court's disposition, see Cowan, The Diamond Case, 27 Tax L. Rev. 161 (1972).
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These tests parallel the tests applicable under Treasury Regulation section 1.704-1(b)(2), but example (5) in that regulation has always been interpreted as sanctioning the special allocation under the hypothetical facts stated above. The key factor, well recognized in the tax shelter field and stated in the Senate Report, lies in whether "the partner receiving the allocation can demonstrate that it has 'substantial economic effect,' i.e., whether the allocation may actually affect the dollar amount of the partners' share of the total partnership income or loss independently of tax consequences." The Senate Bill simplified the language somewhat by abandoning the two-step approach, opting instead for a single criterion. Thus, the allocation would rest upon a determination made "in accordance with the partner's interests in the partnership (determined by taking into account all facts and circumstances) if the partnership agreement does not provide an allocation or the allocation "does not have substantial economic effect." Basically, the Senate relied upon the IRS to promulgate regulations defining the appropriate "facts and circumstances" in allocating income or loss.

72. House Report, supra note 39, at 126. An agreement may not go too far. See S. C. Orrisch, 55 T.C. 395 (1970), aff'd mem., 31 A.F.T.R.2d 1069 (9th Cir. 1973) (an agreement allocating the entire depreciation deduction on partnership property to one partner found to have been made to avoid taxes and was disallowed); notes 74 & 75 infra.

73. See, e.g., S. Rex Lewis, 65 T.C. 625 (1975). Example (5) sets forth the following situation:

G and H, each of whom is engaged as a sole proprietor in the business of developing and marketing electronic devices, enter into a partnership agreement to develop and market electronic devices. H contributes $2,500 cash and agrees to devote his fulltime services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.


74. See, e.g., Lee, The Partnership "Special Allocation": When Will It Be Upheld: Orrisch Analyzed, 43 J. Tax. 138 (1975); see note 73 supra.

75. Senate Report, supra note 40, at 100.

76. Senate Bill, supra note 43, § 210(d).

77. Id.

78. Senate Report, supra note 40, at 100.
It must be concluded that neither the Senate nor the House arrived at a satisfactory solution to the questions arising in this area. Special allocations still turn upon facts which no one yet has concluded are relevant in all circumstances. From a business point of view, it seems to make sense to distribute to the investors of the hard dollars the initial fruits of the investment and to postpone the benefit to the promoter-general partner until the sale of the key assets or liquidation of the partnership. In fact, this arrangement is preferable to a heavy front-end loading of the investment, permitting the promoter to make off with cash incident to an investment of an as yet unknown quality. While this legislation is aimed at tax shelter partnerships, its terms are broad enough to cover operating partnerships, such as law or other service partnerships that allocate profits at the end of the calendar year. For example, a two-member law partnership with a personal injury practice may allocate according to the 50% interest of each partner. However, at the end of 1977, partner A brings in a huge contingent fee and for that year receives 75% of the profit. Must this special allocation be justified? Another gray area is the manner in which the partnership should treat an investment tax credit, which is purely a tax creature with no semblance of economic reality, in view of the fact that an allocation must have economic substance.

The Conference Committee adopted the Senate version of section 704(b), allowing special allocations only upon a showing of "substantial economic effect." The new form of section 704(b) was effective for partnership taxable years beginning after December 31, 1975, meaning that the IRS has statutory authority to challenge any special allocations presently in effect.

However, the new section may be of some use. One possible side effect of the new special allocation rules is the abandonment of the old test of tax avoidance. Thus, under the change in the law, if "substantial economic effect" can be demonstrated, the fact that the allocation is tax motivated will no longer have relevance.

D. Partnership — At Risk

The Senate Bill rendered the retroactive allocation and the special allocation somewhat less important by limiting the deduction allowed

81. Treas. Reg. § 1.704-1(b)(2) (1956). The former test was as follows: "If the principal purpose of any provision in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the federal income tax, the provision shall be disregarded . . . ." Id.
to any partner to the amount of his investment that is "at risk." This change arose in the form of new section 752(e), which limited the share of the liabilities allocated to each limited partner to the difference between that partner's actual contribution to capital and the total contribution which the partner is obligated to make under the partnership agreement. This limit on each partner's allocation applied for "loss" purposes only and bore no relation to basis for computing income or gain. However, due to the new section, retroactive and special allocations would become less important only to the investor who is interested in long-term returns, for the investor who needs the deduction in the current year, assuming an investment sufficiently large to absorb the loss, retroactive and special allocations would continue to be important.

The Conference Bill version of the "at risk" provisions followed the Senate approach but pulled some of its "teeth." The Conference version amended section 704(d), which limited the amount of losses a partner can deduct to his adjusted basis, as follows: "For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability." While the language used in new section 704(d) does not coincide precisely with the "at risk" language contained in new section 465, the Conference Report stated that in determining whether a partner has personal liability under section 704(d), rules similar to the "at risk" rules of section 465 will apply. The "at risk" rules under section 465 operate with respect to amounts "including" money invested and amounts borrowed with personal liability. The word "including" connotes that the amounts described are illustrative, rather than exclusive. If this section 465 distinction also applies to section 704(d), a partner may be able to obtain basis for services contributed to a partnership in ex-

82. Senate Bill, supra note 43, § 210(e); see Conference Report, supra note 48, at 422.
83. Conference Report, supra note 48, at 422-23. It should be recalled that the great impetus toward creating tax shelters is the doctrine set forth by Crane. See Crane v. Commissioner, 331 U.S. 1 (1947) (taxpayer who acquired depreciable property subject to an unassumed mortgage and sold it subsequently so encumbered had a basis including the liability of the mortgage; the release of this liability constituted gain). In partnership terms, the Crane concept meant that nonrecourse liabilities were added to the limited partners' bases against which losses could be applied under section 704(d).
85. Id. § 213(e).
86. Id. § 204.
change for a partnership interest upon which he pays tax; the result is
the same as if the partnership had paid him a cash salary which he, in
turn, had contributed back to the partnership.

Most importantly, the new version of section 704(d) does not
apply with respect to any activity to which the section 465 "at risk"
rules apply; nor does it apply to any partnership whose principal
activity is investing in real property (other than mineral property).
Hence, section 704(d) applies with respect to partnerships engaged in
oil, gas, and hard mineral (i.e., coal) investments; but it probably does
not apply with respect to timber investments. According to the Con-
ference Report, "this provision would apply to liabilities incurred after
December 31, 1976."

By way of comparison, the general "at risk" rule set forth in new
section 465 applies to individuals including estates, trusts, and sub-
chapter S corporations, but does not apply to regular corporations
(those not electing small business corporation treatment). A partner-
ship of regular corporations which engage in activities described in
section 465(c) would not be subject to the "at risk" provisions of sec-
tion 465. Nevertheless, the "at risk" rule under new section 704(d)
applies to any type of partner — regular corporations included. Yet
section 704(d) states that the partnership "at risk" rule does not apply
"with respect to any activity to the extent that section 465 . . . applies."
Suppose a partnership composed of regular corporations engaged in
farming, which is a section 465 activity. Does this partnership escape
from the "at risk" rules of new section 704(d)? Technically, section
465 does not apply because regular corporations are involved; however,

89. Id. § 213(e).
90. The new section 704(d) uses the word 'investing'; however, it is suggested
that Congress did not intend that this word be interpreted narrowly. In fact, the Con-
ference Report used the phrase 'involves real estate' in its explanation. CONFERENCE
REPORT, supra note 48, at 423.
91. Is timber real estate? Hard minerals are expressly mentioned to avoid
doubt, but no such clarification exists with regard to timber. Although local law
might consider an attached chattel "real estate," tax law might regard it as personal
property for tax purposes. See I.R.C. § 1245.
92. CONFERENCE REPORT, supra note 48, at 423.
at I.R.C. § 465(a)).
94. Id. Amended section 465(c) lists such activities as follows:
This section applies to any taxpayer engaged in the activity of—
(A) holding, producing, or distributing motion picture films or video tapes,
(B) farming (as defined in section 474(e)),
(C) leasing any section 1245 property (as defined in section 1245(a)(3)), or
(D) exploring for, or exploiting, oil and gas resources,
as a trade or business or for the production of income.
Id.
at I.R.C. § 704(d)) (emphasis added).
the corporations through the partnership are involved in farming, which is an “activity” to which section 465 does in fact apply.

The general “at risk” concept, to be discussed more fully below, raises several other questions with respect to limited partnerships. For example, if partners cannot deduct losses in excess of their actual capital contributions, the general partner, without a special allocation of losses to the limited partners, may be blessed with deductions which he cannot use. In addition, “at risk” notions may encourage shelter partnerships to resort to the general partnership form rather than the limited partnership form. If the investors are “at risk” as general partners, there will hopefully be a greater tendency for the resulting partnerships to have financially strong and stable management partners in whom the investors can place reliance.

The irony of the new section 704(d) is that it appears to sanction boldface bailouts. The new section applies to basis for the purpose of absorbing partnership losses; however, it does not affect basis for computing gain or income. Hence, if toward the end of the year a partner needs “at risk” basis to absorb loss, presumably he can contribute cash to the partnership in order to obtain basis for loss purposes and distribute that same cash out to himself after the start of the new tax year. For example, suppose a taxpayer contributes $100 equity capital to the partnership and his share of nonrecourse debt is $900. For income purposes, the taxpayer has a basis in his partnership interest of $1,000. In year one, the taxpayer’s share of loss is $100. Under section 704(d) he absorbs his “at risk” basis; thus the taxpayer’s basis for income purposes is $900, while his “at risk” basis for loss purposes is zero. Suppose further that in year two, the taxpayer’s share of the loss is $100. Accordingly, if he contributes cash of $100 to the partnership (thereby raising his income basis to $1,000 and his “at risk” basis to $100), he will be able to enjoy his share of the loss. At that point, his “at risk” basis is reduced to zero, but his basis for income purposes is still $900. The partnership can thereupon distribute to the taxpayer his $100 cash against his $900 income basis and, under section 731(a), the distribution is tax-free. It is doubtful whether this result is intended.

Another significant aspect of new section 704 is its failure to deal with the problems of two-tier partnerships. The two-tier venture is structured so that investors own partnership A, which in turn owns an

96. See text accompanying notes 166–206 supra.
97. I.R.C. § 731(a)(1) provides in pertinent part that “in case of a distribution by a partnership to a partner ... gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner’s interest in the partnership immediately before the distribution.”
interest in partnership B. What happens if partnership A is “at risk” in B, but the investors are not “at risk” in A, or alternatively, if the partners are “at risk” in A, but A is not “at risk” in B? These questions remain unanswered.

Obviously, the avoidance of the general “at risk” rule of section 465 and the partnership “at risk” rule of section 704(d) lies in recourse financing, although unresolved issues exist here as well. Compare, for example, a loan made at prevailing interest rates where there is a present duty to pay an obligation or loan within a few months, with a loan made without interest which is not due for fifty years. In either case there is personal liability, but is it realistic to regard the fifty-year loan, without interest, as giving tax basis for loss purposes? A deferral of payment for such a length of time indicates that the obligation is not realistically an obligation. But if fifty years, without interest, seems too long, instances of twenty-five- or fifteen-year obligations with interest are less clear cut. The answer to this dilemma may be contained in the recently decided case of Estate of Franklin v. Commissioner.98

In that case, the Commissioner sought to disallow the taxpayer’s distributive share of interest and depreciation deductions reported by a limited partnership. The limited partnership had purchased property to be paid for over a period of ten years with a balloon payment at the end of the ten-year period to cover the balance.99 However, the purchase obligation was nonrecourse; the seller’s only remedy in the event of default would be the forfeiture of the partnership’s interest. Thus, the partnership had the power to walk away from the transaction in ten years and sustain only the loss of prepaid interest. The Ninth Circuit disallowed the interest deduction, noting that:

Prior to the date at which the balloon payment on the purchase price is required, and assuming no substantial increase in the fair market value of the property, the absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise. This is not enough to justify an interest deduction. To justify the deduction, the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price.100

98. 38 A.F.T.R.2d (P-H) ¶ 76-5343 (9th Cir. Nov. 1, 1976).
99. The sale was combined with a leaseback of the property to the sellers at a rental payment closely approximating the interest and principal payments. Thus, with the exception of the prepaid interest expense, no cash would pass between the parties until the balloon payment.
100. 38 A.F.T.R.2d (P-H) ¶ 76-5343, at 76-6167 (9th Cir. Nov. 1, 1976).
Although the reasoning of Franklin appears to resolve the issue in the case of a fifty-year obligation, it is less clear how the same reasoning might apply to a twenty-five- or fifteen-year obligation. Must each of these situations be tested by the "presently reasonable" test of Franklin?

Another unanswered question is whether there will be an allocation of tax attributes among activities under section 704(d), unlike section 465, since the Conference Report indicates that substantially the same rules will apply under both sections.101 Bearing in mind that the section 704(d) limits do not apply to activities subject to section 465, suppose that the partnership undertakes a section 465 activity (farming) with nonrecourse financing, but the farming activity is neutral in tax results, creating neither income nor losses. Assume further that the partnership, at the same time, enters upon a coal venture which triggers losses. Since section 704(d) does not apply, the partnership "at risk" rule will not eliminate or work against the taxpayer's basis for loss purposes in the farming activity. But, since the loss to be claimed by the individual partner is from the coal venture and not the section 465 activity, the fact that the section 465 activity is expressly exempted from section 704(d) limits is irrelevant. If the taxpayer has sufficient partnership basis in the coal venture the coal losses can be absorbed.

Several questions remain concerning which of the general "at risk" rules under section 465 can be applied to the partnership situation. For example, can a partner go to a bank, pledge his partnership interest for a loan, and then invest the cash in the partnership in order to create basis for losses? Will family attribution apply? Will borrowing from another limited partner be proscribed?

Finally, increased attempts will probably be made to utilize section 761, the election not to be taxed as a partnership. While it is doubtful whether the partners can use section 761 to elect out of new section 704(d), it would appear that the partnership as a whole could elect out of partnership tax treatment if the criteria102 of section 761 were satisfied. This possibility would tend to emasculate section 704(d), at least in those situations where section 761 applies.

102. See I.R.C. § 761(a). This section provides in part:
Under regulations the Secretary or his delegate may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of —
(1) for investment purposes only and not for the active conduct of a business, or
(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted,
if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

Id.
E. First Year Depreciation

Congress focused upon the allowance of additional first year depreciation under section 179. At the election of the taxpayer, section 179 allows an additional deduction of 20% of the cost of the property for the first year in which depreciation on the property is allowable. The maximum possible property cost is $10,000 ($20,000 on a joint income tax return) resulting in a maximum deduction for the first year of only $2,000 ($4,000 on a joint return), clearly a minimal amount. However, under prior law, this limitation operated at the individual level and not at the partnership level. Hence, prior to the 1976 Act, each one of 40 individual investors who contribute[d] $5,000 to an equipment leasing limited partnership which purchase[d] a $1 million executive aircraft [would have been] entitled to $4,000 of bonus depreciation if he filed a joint return. In this case, additional first-year depreciation [would have provided] total deductions to the partners of $160,000.

Both the House Bill and Senate Bill solved this problem by amending section 179(d) to contain a new paragraph (8) which specifies that the dollar limitation (the cost of $10,000, maximum to which section 179 can apply) applies with respect to both the partnership and to each partner of that partnership. Hence, if a taxpayer is a member of a partnership and also individually owns depreciable property, the drafters intended that the total amount of cost basis of property on which he can take additional first year depreciation be $10,000. These changes were incorporated into the Conference Bill as well.107

While the investment credit presents problems, the new limitation probably can be avoided by causing the partners, individually, to purchase the depreciable property and lease it to the partnership. Under the regulations, cotenancies are not regarded as “partnerships” unless the cotenants “actively carry on a trade, business, financial operation, or venture and divide the profits thereof.” The IRS might argue that such an arrangement is a sham, but such assertions probably would not prevail if the cotenants and the partners are not the same, as where the general partner and one or more of the limited partners were not also cotenants.

103. I.R.C. § 179(b).
104. HOUSE REPORT, supra note 39, at 119.
105. House Bill, supra note 36, § 210(a); Senate Bill, supra note 43, § 210(a).
106. SENATE REPORT, supra note 40, at 92.
III. LIMITATIONS ON TYPE OF SHELTER INVESTMENT

Having explored the limitations on the limited partnership as the investment vehicle, the next consideration is the consequences of the 1976 Act amendments concerning various tax shelter investments: Congress placed restrictions on the investment itself in the hands of the individual investors or the limited partnership in order to reduce or eliminate the amount of shelter derived.

A. Real Estate

Since real estate is the most popular form of tax shelter, any manipulation of depreciation or depreciation recapture has widespread implications. As one example, the House Bill extended the sixty-month depreciation deduction for rehabilitation expenditures incurred with respect to low income rental housing provided under 167(k), originally slated to expire January 1, 1976, until January 1, 1978.\(^\text{110}\) Under prior law, the maximum amount of rehabilitation expenditures paid or incurred by the taxpayer with respect to any dwelling unit in any low income rental housing could not exceed $15,000.\(^\text{111}\) The House would have extended the deduction for expenditures incurred after December 31, 1975,\(^\text{112}\) but the House Bill increased this limitation to $20,000.\(^\text{113}\)

The Senate adopted the House proposal\(^\text{114}\) but modified the affected class of families and individuals by providing that the eligible income limits be determined consistent with those established for the “Leased Housing Program under section 8 of the United States Housing Act of 1937.”\(^\text{115}\) It also provided a transition rule to ensure that expenditures incurred either pursuant to a binding contract entered into prior to January 1, 1978, or incident to rehabilitation begun prior to January 1, 1978, would be treated as incurred on or before January 1, 1978. The Senate would have made these amendments effective for expenditures incurred after December 31, 1975.\(^\text{116}\)

The Conference Bill adopted the Senate version of the amendment to section 167(k).\(^\text{117}\) This new provision applies to expenditures paid

\(^{110}\) House Bill, supra note 36, § 102(a).
\(^{111}\) I.R.C. § 167(k) (2) (A).
\(^{112}\) House Bill, supra note 36, § 102(b).
\(^{113}\) Id. § 102(c).
\(^{114}\) Senate Report, supra note 40, at 42.
\(^{115}\) Senate Bill, supra note 43, § 201(a). The Senate version extended the definition of low income rental housing to include “housing financed or assisted by direct loan or insured under Title V (sec. 515) of the Housing Act of 1949 (or housing financed or assisted by direct loan or insured under similar provisions of State or local laws).” Senate Report, supra note 40, at 42.
\(^{116}\) Senate Bill, supra note 43, § 201(d).
or incurred after December 31, 1975, and before January 1, 1978, and to expenditures made pursuant to a binding contract entered into before January 1, 1978.\(^{118}\)

This legislation has the effect of making tax shelters in low income housing the “only game in town.” Congress has continued to embrace the view that tax shelters represent a social evil, except to the extent they are used to accomplish what is regarded as a socially acceptable result. This new legislation will establish a premium on low income housing projects, and the investors will pay accordingly. One desired result of reform would have been the removal of the artificial supports to real estate to enable real estate to find its true value in the market place. ("True value" refers here to the real estates' economic worth as rental property.) Instead, Congress decided to continue this artificial support of low income housing, which may not be the most efficient way of supplying low income housing.\(^{119}\) As will be seen later in this discussion, Congress has also bestowed other advantages on low income housing.\(^{120}\)

Congressional treatment of other forms of rental housing contrasts sharply with the above approach. The House Bill amended section 1250 to require recapture of depreciation (that amount accelerated over straight-line) on all forms of housing, except for low income housing, after December 31, 1975.\(^{121}\) However, the House Bill retained the “applicable percentage” of recapture approach\(^{122}\) used in section 1250 prior to the amendment for all residential housing under the following circumstances: 1) the mortgage is insured under section 221(d)(3) or section 236 of the National Housing Act;\(^{123}\) 2) the dwelling unit is held for occupancy by families eligible to receive subsidies under section 8 of the United States Housing Act of 1937;\(^{124}\) or 3) the depreciation is in respect of rehabilitation expenditures allowable under section 167(k).\(^{125}\) The applicable percentage was fixed at 100% less one percentage point for each full month after 100 full months that the property was held. Thus, after 200 months (16\(\frac{2}{3}\) years) there will be no recapture. Also retained in the House proposal was the rule that

\(^{118}\) Id. § 203(b).


\(^{120}\) See text accompanying note 130 infra.

\(^{121}\) House Bill, \textit{supra} note 36, § 201(a).

\(^{122}\) Id.

\(^{123}\) Id. For the text of the National Housing Act, see 12 \textit{U.S.C.} §§ 1701-1750 (1970).


\(^{125}\) House Bill, \textit{supra} note 36, § 201(a).
all depreciation is recaptured if the property has not been held for more than twelve months.\textsuperscript{126} The House Bill provided that, on the disposition of real property by reason of foreclosure or similar proceedings, the monthly percentage reduction of the amount of accelerated depreciation subject to recapture terminates as of the date on which such proceedings are commenced.\textsuperscript{127} The taxpayer therefore does not gain the few added percentage points that would accumulate during the judicial proceedings or during the redemption period.

The Senate Report indicated that its version of depreciation recapture followed the House view, with the exception of two changes made by the Senate Finance Committee. First, a fourth category of low income housing was excluded from recapture,\textsuperscript{128} and second, depreciation recapture was set at 100\%, if the construction or rehabilitation of such housing was to begin after December 31, 1981.\textsuperscript{129} Under this second change by the Senate Finance Committee, the newly adopted depreciation recapture rule calling for 100\% of accelerated depreciation, applies even to low income housing if the construction of such housing is not commenced within the five-year grace period. While the language differs, the Senate Bill substantially adopted the Senate Finance Committee approach.\textsuperscript{130}

With regard to recapture, the conferees adopted the House version of the rule: in the case of residential real estate, recapture of all post-1975 depreciation in excess of straight-line depreciation is treated in the same manner as is presently required in the context of nonresidential real estate.\textsuperscript{131} In the case of low income housing, the new section calls for full recapture of post-1975 depreciation in excess of straight-line for the first 100 months (8\%) years and a phase-out of the amount recaptured during the second 100 months (up to 16\% years).\textsuperscript{132}

Thus, for real property held for any length of time, three possible recapture computations exist: 1) the rules applicable from January 1,
1964, through December 31, 1969 (100% less one percentage point for each full month after the property was held for twenty full months); 2) the rules applicable from January 1, 1970, through December 31, 1975 (100% less one percentage point over twenty months for certain low income housing, 100% less one percentage point over 100 months for other residential property); and 3) the post-December 31, 1975, rules (100% recapture except in the case of low income housing which is under the former residential housing rule).

Full recapture on accelerated depreciation does not necessarily render real estate shelters ineffectual; the change simply emphasizes the obvious fact that a real estate tax shelter is a rollover situation—a deferral of taxation from year to year. As a practical matter, most investors, even under the old rules, rarely expected to remain in a shelter for 16% years. Further, 100% recapture reinforces another conclusion long recognized: once having invested substantially in a shelter, the taxpayer is “hooked” and must enter upon the shelter “treadmill.” Thus, in order to avoid the recapture implications arising from the early disposition of one shelter, the taxpayer must purchase into another real estate venture, and so on, perhaps extricating the money only at death. Of course, most sophisticated operators do not use accelerated depreciation, relying instead upon the component method of straight-line depreciation, but with shorter useful lives.

The Conference Committee struck one additional blow to real property shelters in the form of a new section 189, requiring construction period interest and taxes to be capitalized in the year in which such items are paid or incurred and to be amortized over a ten-year period.133 This section covers professional home builders. The amortization deduction is allowable only in the year in which the amount is paid or accrued, and in the next taxable year or the taxable year in which the real property is placed into service or is ready to be sold. The new rule applies to individuals and subchapter S corporations. It is not clear whether it applies to partnerships. However, even if not applicable to the partnership entity itself, it surely applies at the individual partner level.134 Thus, while the partnership can claim a construction period interest deduction, this amount becomes frozen when passed out to the partners. The curious aspect of this provision is that under section 702(a), construction period interest is not an item of partnership tax attributes that must be specifically identified to the

134. But cf. I.R.C. § 703(a) (partnership income to be computed in same manner as an individual).
partners and which retains its identity and character in the partners' hands. Construction period interest seems to be an item in the catchall clause of section 702(a)(9), i.e., general partnership income or loss. If this statement is indeed accurate, the partners have no way of identifying the construction period interest that they must capitalize.

A transition rule applies in the case of amounts paid or accrued by the taxpayer in a taxable year beginning in 1976. The percentage allowable as a deduction for the taxable year beginning in 1976 is 50% and 16% for each amortization year thereafter.\(^\text{138}\)

Of course, the new rule is not operable where the taxpayer elects to capitalize interest and tax under section 266.\(^\text{136}\) Finally, the new provision does not relate to interest or taxes paid or incurred with respect to property that is not held for business or investment purposes, exemplified usually by the taxpayer's residence.\(^\text{137}\) Thus, constructing one's own residence remains one of the best shelters. In addition, home buyers should involve themselves in the process of building a house at a much earlier point in time. Instead of buying a finished home from the developer (or contractor), the taxpayer would be better served by obtaining the construction loan (thus obtaining a deduction for interest expense) and acting as general contractor with subcontractors (thus obtaining the sales tax deduction for materials purchased).

Since new section 189 is structured to be phased-in gradually, section 189 applies in the commercial property area only when the construction period began after December 31, 1975.\(^\text{138}\) Thus, if the construction commenced prior to January 1, 1976, the rule does not apply. In the case of residential property other than low income housing, the rule applies to construction period interest and taxes paid or accrued after December 31, 1977. As to low income housing, the rule applies after December 31, 1981.\(^\text{139}\)

With the exception of an amount allowed in the year paid under the transition rule, the amortization period begins the year in which the real property is ready to be placed into service or is ready to be offered for sale.\(^\text{140}\) But, only after seven years will the rule be fully operable. The amortization period is four years for items paid or accrued in the first year during which these rules apply.


\(^{136}\) Id.

\(^{137}\) Id.

\(^{138}\) Id. § 201(c).

\(^{139}\) Id.

\(^{140}\) Id. § 201(a).
tion period increases by one year for each succeeding year after the initial effective date until the amortization period reaches ten years.\textsuperscript{141} The Conference Report states that the "10-year period is fully phased-in for construction period interest and taxes paid or accrued in 1982, in the case of nonresidential real estate; 1984, in the case of residential real estate; and 1988, in the case of government subsidized housing."\textsuperscript{142}

If the property is sold, the unamortized balance of the construction period interest and taxes is added to the basis of the property, so that the deduction is "recaptured" in determining gain or loss on the sale.\textsuperscript{143} The ordinary deduction is converted into a capital transaction. If a like-kind or other tax-free form of exchange is involved, the amortization deduction is not lost; instead, the transferor may continue to deduct the capitalized items for the balance of the amortization period attributable to the items involved in respect of the property exchange. In this sense, the amortization deduction is personal to the taxpayer who incurs it.

In view of the question raised earlier as to whether section 189 applies at the partnership level,\textsuperscript{144} and since the deduction is a relatively individual thing adhering to the partnership entity in this instance, it is not clear who acquires the deduction if partners drop out or are added to the partnership after the capitalization of the interest expenses. Other problems might arise if regular corporations are partners, since corporations which have not made the subchapter S election are not subject to section 189.\textsuperscript{145} Thus, if there is construction period interest, presumably it must be capitalized as to individual partners, but is currently deductible by the corporate partners.

The key item of the new section 189(e)(2) is the definition of the term "construction period," defined to begin on the date when construction of the building begins and to end on the date on which the item of property is ready to be placed into service or to be sold.\textsuperscript{146} Congress probably directed this rule toward construction of buildings or similar improvements, rather than interest and taxes accrued in preparation for farming (\textit{e.g.}, installation of an orchard or vineyard). Nevertheless, several questions remain unanswered. For example, does the construction of an oil well or an irrigation project on a farm fall within the construction period? Reproduction costs in farming are covered al-

\textsuperscript{141} Conference Report, \textit{supra} note 48, at 409.
\textsuperscript{142} Id.
\textsuperscript{143} Id.
\textsuperscript{144} See note 134 and accompanying text \textit{supra}.
\textsuperscript{146} Id.
TAX SHELTERS

ready by new section 464\textsuperscript{147} and the new amendments to section 278.\textsuperscript{148} However, section 189 does refer to "the building or other improvement."\textsuperscript{149} Does this language include site plans, streets, and other preliminary improvements?\textsuperscript{150} In most situations, these points in time are blurred so that problems can be predicted. It is likely that pre-construction period interest (unless disallowed under other rules) will continue to be allowed as a deduction, as will taxes incurred upon land carried prior to the start of construction. Preconstruction period interest deductions, however, may be limited by the restrictions on investment interest, and may be subject to the minimum tax if treated as an itemized deduction.\textsuperscript{151}

Real estate developers are thus placed in a dilemma. Since the amortization deductions begin the later of the year of payment or accrual or the year in which the real property is ready to be placed in service or offered for sale, it is important to get the property into service as soon as possible in order to begin the amortization. On the other hand, investors brought in after the property is "used" (which occurs after first user) lose accelerated depreciation. Depending upon how the developer will handle the new anti-retroactive allocation rule, the developer might better serve the late arriving investors by delaying the amortization.

However, as with all tax planning, the amortization deduction can be used to serve the taxpayer. Since the capitalization rules take effect in different years, the syndicate may level out the deductions by combining the different types of real property in one shelter; \textit{i.e.}, nonresidential (starts 1976), residential other than low income housing (starts 1978), and low income housing (starts 1982). Furthermore, rollover type shelters may be used in early years while awaiting the commencement of amortization. Thus, cattle feeding (without prepayments) might shelter income one year with the amortization deduction to cover the proceeds of the sale of cattle when the amortization commences in the next year.

B. Farming

1. Accrual Accounting

The 1976 Act contains a number of provisions dealing with investments in farming. The House Bill provided for a new section 447,
which placed farming corporations on the accrual method of accounting and required the capitalization of preproductive expenses. Covered within the scope of the section were corporations engaged in farming and partnerships engaged in farming, if any partner were a corporation. The preproduction expenses proposed to be capitalized were those defined by new section 468(c)(1), the definitional subsection of the House Bill's provisions dealing with limitations on artificial losses (LAL), including any amount that is attributable to crop, animals, or trees during the preproductive period, except for taxes, interest, casualty losses, and amounts expended for the production of wheat, alfalfa, barley, oats, rye, sorghum, cotton, and livestock other than poultry. The preproductive period was defined as either the period before the disposition of the first crop (if the property has a useful life of more than one year or yields more than one crop), or, the period before the disposal of the property. However, the House Bill did except the small business and family corporation from the provisions of section 447. Neither the Senate Finance Committee nor the Senate adopted this approach.

The House view prevailed in the Conference Committee in the form of new section 447, applying to the taxable years beginning after December 31, 1976, of corporations engaged in farming and partnerships engaged in farming, with a corporation-partner. In those instances, the taxable income from farming must be computed on the accrual method of accounting, and preproduction expenses must be capitalized. A ten-year adjustment period is permitted upon the change to the accrual method beginning with the year in which the shift to the accrual method is required.

152. House Bill, supra note 36, § 204.
153. For a discussion of LAL, see text accompanying notes 327-37 infra.
155. Id.
156. Id. § 204(a). A small business corporation was defined as one that has made the subchapter S election. A family corporation is defined as a corporation in which members of the same family own 66⅔%. The family relationship was defined and attribution rules were made applicable. Id.
157. The Senate committee felt that, even with the exceptions provided by the House, too many farmers would be affected by the provision designed to limit artificial losses. The Senate believed that most farmers should be allowed to continue to use the cash method of accounting. The Senate committee also found that "LAL as applied to farming is too complex and requires too much recordkeeping for many farmers who might be subject to the provision." Senate Report, supra note 40, at 58.
160. Note that if the partnership involved has a corporate general partner which otherwise falls within the new section 447, that corporation must be put upon the accrual method of accounting and is subject to the new farm syndicate rules. See I.R.C. § 464. For a discussion of section 464, see text accompanying notes 235-37 infra.
However, much of the force of the House Bill was weakened. The new rules do not apply to nurseries or to the raising and harvesting of trees (timber) other than fruit and nut trees. Furthermore, subchapter S corporations and family corporations are excepted as they were under the House Bill. The family corporation category is defined somewhat more loosely, as one in which 50% of all stock is owned by members of the same family. The 50% ownership is determined by attribution, including stock attributed from siblings, ancestors, lineal descendants, partnerships, and trusts. Additionally, stock owned through the parent-subsidiary chain of corporations is used to determine family ownership.

The major new exception under the Conference Bill is the requirement that the corporation have gross receipts in excess of $1,000,000 for that taxable year in order to fall within the provisions of section 447. Once a corporation achieves that level of gross receipts, however, it must shift to the accrual method and capitalize preproduction expenses, even though its gross receipts later drop below $1,000,000.

The other exception is described as follows:

The conference agreement also adds special rules which provide that if a corporation (or its predecessors) has, for a 10-year period prior to the date of enactment, used an “annual” accrual method of accounting (in which preproductive period expenses are either deducted currently or charged to the current year’s crops), it may continue to use this method of accounting. Also, a taxpayer who has used, for a 10-year period, the static value method of accounting for the costs of deferred crops may change to the annual accrual method of accounting and be treated as if it had used such method of accounting for that 10-year period.

Accordingly, the force of this tax shelter weapon has been diminished sufficiently so as to make it an ineffective deterrent to most small farming tax shelters.

2. At Risk

The House Bill’s version of the “at risk” approach, proposed section 464, applied to films, livestock, and certain crops. The House’s suggested rule limited the amount of loss (excess of deductions over

162. See note 156 and accompanying text supra.
163. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 207(c), (e), 90 Stat. 1520 (codified at I.R.C. § 447(c), (e)).
165. House Bill, supra note 36, § 207(a) (1).
income attributable to the business) which could be claimed in any year to the "aggregate amount with respect to which the taxpayer is at risk in such business at the close of the taxable year." The House's new rule extended to the raising, feeding or otherwise caring for livestock (not including poultry) and to the raising and harvesting of wheat, alfalfa, barley, oats, rye, sorghum, or cotton. It applied to all taxpayers, corporations, partnerships, and individuals. However, to the extent that the loss was disallowed under new section 464, that loss amount could be carried forward and used when the taxpayer again obtained a risk position in the business. This rule, the unlimited carryover, also characterized the general approach for partnership losses under prior law.

The Senate drafted its own version of the "at risk" approach, covering areas other than farm losses, and it was this version that was adopted by the Conference Committee as new section 465. In general terms, section 465 indicates that the amount of any loss, otherwise deductible in connection with a specified list of activities, cannot exceed the aggregate amount for which the taxpayer is "at risk" with respect to each such activity at the close of the taxable year. Farming is included in the list of activities covered by the "at risk" rules, with each farm treated as a separate activity. In other words, individual taxpayers cannot use the income from one farm to offset the otherwise nondeductible expenses incurred on another farm. Although activities conducted by each partnership or small business corporation are also treated as separate, a partnership or a subchapter S corporation is permitted to aggregate related activities. For instance, all farms owned by a partnership are treated as one activity. All taxpayers including trusts and estates are covered by section 465, with the exception of those corporations not electing under subchapter S. Therefore, professional corporations having regular status are not covered by the new "at risk" approach.

166. Id.
167. Id.
169. House Bill, supra note 36, § 207(a) (1).
170. See I.R.C. § 704(d).
171. Senate Report, supra note 40, at 48.
173. The "loss" means the excess of deductions for the taxable year allocable to the activity in question, over the income derived in the same year from such activity. I.R.C. § 465(d).
174. See note 94 supra.
176. Id. § 465(c) (2) (C).
177. Id. § 465(a).
The following general rules apply to the "at risk" provisions of section 465:

1. The "at risk" limitation is applied on the basis of the facts existing at the end of each taxable year.178

2. Losses that are disallowed under section 465 may qualify as deductions in the following year with respect to the specific loss-incurring activity.179 Thus, if the taxpayer's amount "at risk" increases in a later year, he can take advantage of the deductions to the extent of the amount "at risk" in that later year. In effect, an unlimited carryover applies.

3. The "at risk" limitation applies regardless of which method of accounting is used by the taxpayer and the kind of expenses which contributed to the loss.180 However, the new limitation applies only to tax losses produced by expense deductions which are not disallowed by some other provision of the Code.181 Thus, if interest is disallowed as a current deduction under the new prepaid interest expense rule,182 such interest does not enter into the computation of the loss which is limited by new section 465. When the deferred interest expense becomes deductible, it becomes subject to the new limitation and, if not allowable, will be deferred as part of the overall loss until the taxpayer obtains an "at risk" position.

4. New section 465 limits only the deductibility of the loss without extending to other Code rules, such as computation of basis.183

The critical issue lies in determining the amounts for which the taxpayer is considered to be "at risk." In general, the taxpayer is "at risk" for the amount of money or other property (determined at the adjusted basis) which that person contributed to the activity plus amounts borrowed for use in the activity.184 However, borrowed money qualifies only to the extent that the taxpayer is personally liable on the loan or to the extent that the taxpayer "has pledged property, other than property used in the activity, as security for such loan ...."185

Further, with respect to loans, the money must be borrowed from a

178. Id.
179. Id. § 465(a), (b) (5).
180. SENATE REPORT, supra note 40, at 48.
181. Id. at 51.
182. See I.R.C. § 461(g).
183. SENATE REPORT, supra note 40, at 48.
184. I.R.C. § 465(b).
185. Id. Obviously, if the taxpayer has an asset having a $1 adjusted basis but a $100 net fair market value, the taxpayer gains by going to a bank and pledging the asset for a $100 loan, rather than contributing the asset to the partnership or using it in the activity.
disinterested third party. The lender cannot have any interest in the activity other than as creditor; nor may the lender be related to the taxpayer within the meaning of section 267(b). The taxpayer is not “at risk” with respect to amounts protected against loss through non-recourse financing, guarantees, stop-loss agreements, or other similar arrangements.

In summary, the taxpayer’s investment is not considered “at risk” in the following circumstances:

1. For the taxpayer’s share of any non-recourse loan used to finance the activity itself or the acquisition of property used in the activity.

2. For amounts borrowed to contribute to the activity, if the lender’s recourse is limited either to the taxpayer’s interest in the activity or to property used in the activity.

3. For amounts contributed as “equity” capital to the extent the taxpayer is protected against economic loss by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer.

4. For amounts covered by stop-loss arrangements, except to the extent the taxpayer is not entitled to reimbursement.

5. For any amount which is covered by a guaranteed repurchase price, as where the partnership agrees to repurchase the investor’s partnership interest at a stated dollar amount (the investor is “at risk” for the excess over the guaranteed repurchase price).

6. For any amount of mortgage liability which is insured against,

i.e., insurance to compensate the taxpayer for any payments which he

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186. Id. § 465 (b) (3). This section states:

[A]mounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who—

(A) has an interest (other than an interest as a creditor) in such activity, or

(B) has a relationship to the taxpayers specified within any one of the paragraphs of section 267 (b).

Id. I.R.C. § 465 (b) (1). Id.

187. I.R.C. § 267 (b) generally includes family-owned corporations and trusts.

188. Senate Report, supra note 40, at 49.

189. Id.

190. Id. However, the Senate Report notes that the normal buy-sell agreements between partners and presumably shareholders of a subchapter S corporation, which agreements are first effective at retirement or death, are not the arrangement[s] or agreement[s] intended to be banned by section 465. Id.

191. Id. For example, the usual arrangement in cattle-feeding operations requires the promoter or feed lot operator to reimburse the investor against any loss sustained upon sale of the cattle below a stated dollar amount per head.

192. Id.
must actually make under his personal liability to the mortgagee;\textsuperscript{193}

7. For any amount of indebtedness which is secured by property used in the activity; but if real property is pledged by the taxpayer to secure a loan for a leasing activity, the fair market value of that property, determined as of the date the property is pledged less prior encumbrances, is a risk amount;\textsuperscript{194}

8. For any amount of indebtedness secured by a cross-collateral arrangement; the taxpayer pledges real property to borrow in a leasing activity and, in turn, uses the leased personal property as collateral for funds borrowed to fund his farming activities.\textsuperscript{195}

Where the activity is conducted by a partnership, each partner is regarded as "at risk" to the extent that his basis in the partnership is increased by his share of partnership income.\textsuperscript{196} Apparently, this share of income is "at risk" even though the income is used by the partnership to reduce the partnership's nonrecourse indebtedness.\textsuperscript{197} If the taxpayer insures against personal liability on the loan, he has "at risk" any amount of premium which he had paid from his personal assets with respect to the insurance.\textsuperscript{198} But insurance protection against tort liability or casualty is not regarded as disqualifying the taxpayer from being "at risk" to the extent of such insurance coverage.\textsuperscript{199}

With regard to debt obligations, a taxpayer is regarded as "at risk" only so long as his personal liability is in effect. For example, if the taxpayer borrows money and must guarantee the loan personally until the orchard produces its first marketable crop, the taxpayer is "at risk" only until the loan becomes nonrecourse.\textsuperscript{200} The fact that the loss-protection guarantee, repurchase agreement, or insurance policy may not actually be an effective remedy does not change the fact that the amount so involved is not "at risk" unless and until the time the taxpayer becomes unconditionally entitled to payment and demonstrates that he cannot recover under the agreement.\textsuperscript{201} The only solace for the taxpayer is that, if part of the taxpayer's loss has been deferred under section 465, that portion of deferred loss carries over; it may be de-

\textsuperscript{193} Id. at 50.
\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{196} Id. \textit{But see} House Report, supra note 39, at 110 n.11 (observing that the basis of partner's interest also decreases at the same time).
\textsuperscript{197} Senate Report, supra note 40, at 50.
\textsuperscript{198} Id.
\textsuperscript{199} Id. at 48 n.1.
\textsuperscript{200} Id. at 48 n.1. For example, the loss protection or other similar agreement may not be effective because of the insolvency of the general partner.
\textsuperscript{201} Id. at 50 n.6.
ducted in the year that the taxpayer demonstrates an inability to recover, thus, in effect, converting the loss from a capital loss to an ordinary loss.

Equally troublesome, although it was not so viewed by Congress, is the notion that a taxpayer can be "at risk" for more than merely the money invested. For example, even though the loan is nonrecourse, if the shelter investment fails and the lender suffers a loss, the taxpayer will have substantial difficulty in obtaining another loan. Clearly, the taxpayer in this situation loses more than the investment.

Furthermore, the effect of joint and several liability upon "at risk" has interesting implications. Practically speaking, when both financially strong and weak partners become involved in a shelter, creditors look to and sue the "deep pocket." Thus, the wealthy partner often ends up paying off the creditors. In these situations, will the liability be prorated among the partners according to their percentage interests in the partnership, even though, in fact, the wealthy partner is carrying the project?

With respect to the application of "at risk" rules to farming, the Conference Report states:

In applying the at risk provision to farming operations, the conferees intend that the existence of a governmental target price program (such as provided by the Agriculture and Consumer Protection Act of 1973) or other governmental price support program with respect to a product grown by a taxpayer does not, in the absence of agreements limiting the taxpayer's costs, reduce the amount which such taxpayer is at risk.202

Since these rules are comprehensive and will no doubt be amplified by the IRS in the regulations, it is difficult to perceive at this stage what form of transaction will slip through the net. To the extent the investor believes himself entitled to some protection against loss, he will have to utilize the mechanism now prevalent, a piecemeal form of investment with deferral of the promoter's share until the venture proves reasonably successful. Thus, instead of investing the full amount initially, the taxpayer should make investments in stages: 15% when the land is acquired, another 15% when the land is prepared, 25% when the trees are planted, 10% during the next year, and the balance when the first marketable crop is harvested. The amount invested should be tied to that year's losses.

The intent of the last sentence of new section 465(b)(2), as set forth by the Senate Report, is to prevent taxpayers from increasing

their “at risk” amounts by cross-collateralizing property used in the activity with other property not used in the activity.\textsuperscript{203} Section 465 (b)(2) states: “No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).”\textsuperscript{204} The property described in paragraph (1) includes money and the adjusted basis of other property contributed to the activity.\textsuperscript{205} However, section 465 (b)(2), taken alone, would not appear to prevent all pyramiding shelters. For example, assume that tax shelter X has turned the corner and has cash flow. The taxpayer, who has now exhausted the deductions in shelter X, buys into a new shelter, Y. If the taxpayer contributed his or her interest in shelter X to shelter Y, no advantage would be obtained since the contribution is taken at its adjusted basis. Instead, the taxpayer takes the old shelter to a lender and borrows funds which are then invested in shelter Y. Thus, the assets or property of shelter X are not used as collateral; instead, the collateral is the taxpayer’s participation in the old shelter which amounts to something less than the underlying property since other partners have an interest in that partnership property as well. The issuance of regulations will be necessary to determine the viability of this approach. The new rule on “at risk” adopted by the Conference Committee applies to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975.\textsuperscript{206}

3. \textit{Excess Deduction Account}

Under prior section 1251, an individual taxpayer or a small business corporation, with an excess of $50,000 of non-farm adjusted gross income and farm-originated net losses in excess of $25,000 for the same year, established an excess deductions account (EDA).\textsuperscript{207} Later, when

\begin{itemize}
\item \textsuperscript{203} Senate Report, \textit{supra} note 40, at 50.
\item \textsuperscript{204} Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1520 (codified at I.R.C. § 465(b)(2)).
\item \textsuperscript{205} Id.
\item \textsuperscript{206} See Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(c), 90 Stat. 1520 (codified at I.R.C. § 465(c)). This section also states that “[f]or purposes of this subsection, any amount allowed or allowable for depreciation or amortization for any period shall be treated as an amount paid or incurred in such period.” Id.
\item The House version of the “at risk” limitation applied to all amounts paid or incurred after September 10, 1975, except for certain film situations. House Bill, \textit{supra} note 36, § 207(b). The Senate Bill applied to amounts paid or incurred in taxable years beginning after December 31, 1975. Senate Bill, \textit{supra} note 43, § 202(b). Thus, under the Senate version of section 465, deductions for the calendar year ended December 31, 1975, and for those fiscal years ending thereafter were preserved and the old rules applied.
\item \textsuperscript{207} I.R.C. § 1251(b).
\end{itemize}
the taxpayer sold “farm recapture property,” any gain realized was required to be treated as ordinary income to the extent of the balance in the taxpayer’s EDA.

In view of the comprehensive reform of farm shelters, both the House and the Senate provided for the prospective repeal of section 1251 by terminating additions to the EDA after December 31, 1975. The Conference Committee adopted this amendment effective for any taxable year beginning after December 31, 1975.

4. Farm Syndicates

The major thrust of House proposed section 447, which converted farm corporations to the accrual accounting method, was to force the capitalization of preproductive expenses. The Senate did not adopt this approach, adopting instead a more specific provision, section 464, designed to curtail farm shelter abuses, including those related to livestock and trees. In general, this provision permitted a deduction of farm expenses only when the items were consumed, limited the deduction of the expenses of purchased poultry over the poultry’s useful life, and required that start-up expenses for groves, orchards, and vineyards be capitalized. Section 464 applied the new rules only to farming syndicates. The definition of “farming syndicate” omitted regular corporations, but included partnerships, small business corporations, and any other form of enterprise engaged in the business of farming and to which either of the following criteria apply: 1) units have been offered for sale by public offering, or 2) more than 50% of the losses of the syndicate during any period are allocable to limited partners or “other investors with limited risk.” However, if the individual taxpayer had participated actively in the management of the farming operation for a period of not less than five years, his interest (or the interest held by members of his family) was not incorporated within the 50% loss group. Thus, it appears that an enterprise in which a private placement was made to investors participating in 50% or less of the losses would not have met the definition of a farming syndicate. Since the definition is phrased in terms of “losses” allocated to investors with limited risk, presumably the limited partners may enjoy any percentage of

208. “Farm recapture property” is a term of art, but generally it refers to the same category of assets as is referred to in section 1231, i.e., property used in the trade or business.

209. House Bill, supra note 36, § 203; Senate Bill, supra note 43, § 203.


211. House Bill, supra note 36, § 204.

212. Senate Bill, supra note 43, § 204(a) (1).

213. Id.

214. Id.
profit and capital assuming compliance with the new special allocation rules.\textsuperscript{215}

The class of investors who would comprise the 50\% loss group includes persons with "limited risk."\textsuperscript{216} For the purpose of proposed section 464, an investor with limited risk would be one who is not "at risk" with respect to the farming investment so as to deduct losses under new section 465.\textsuperscript{217} However, the definitions need not be identical, because the Senate Report indicates that the test of limited risk is determined under all facts and circumstances.\textsuperscript{218}

The Senate's definition of farming syndicate derived to some degree from the House definition used in its LAL provision.\textsuperscript{219} The House version, however, referred to the investors in the 50\% loss group as "passive" persons, on the theory that an active person could not be a "limited" partner and, hence, was not the type of investor sought to be captured under this provision.\textsuperscript{220} By contrast, the Senate focused upon whether the investor is a limited partner or has only "limited risk" in the venture; the investor's activities — whether the investor is passive or active — are irrelevant.\textsuperscript{221} The Senate provision also contains an exception which excludes from the 50\% loss group persons who have been active participants for a period of five years or more. This exception was intended to cover retirement situations. Frequently, a farmer-taxpayer, wishing to retire, turns the business over to his children and assumes a limited partner position. Since the taxpayer had been a bona fide farmer and not a tax shelter farmer, the Senate did not desire to disqualify this arrangement and make it into a farm syndicate for tax purposes.\textsuperscript{222}

Farming is defined by the Senate Bill as the cultivation of land; the raising or harvesting of any agricultural or horticultural commodity; the raising, shearing, feeding, caring for, training, and management of animals; and the cultivation of trees bearing fruit or nuts.\textsuperscript{223} The Senate Report gives the following examples of farming: raising of fish, bees, flowers, vegetables, as well as livestock.\textsuperscript{224} "Commodity" is not to be taken at its technical meaning; thus, a pursuit such as the raising of

\textsuperscript{215} The participations must not run afoul of the newly enacted special allocation rules under section 704. For discussion of these rules, see text accompanying notes 72-80 \textit{supra}.

\textsuperscript{216} Senate Bill, \textit{supra} note 43, § 204(a) (1).

\textsuperscript{217} For discussion of section 202 of the Senate Bill, see text accompanying notes 178-83 \textit{supra}.

\textsuperscript{218} \textit{SENATE REPORT}, \textit{supra} note 40, at 60.

\textsuperscript{219} \textit{See} House Bill, \textit{supra} note 36, § 101(a).

\textsuperscript{220} \textit{HOUSE REPORT}, \textit{supra} note 39, at 47.

\textsuperscript{221} \textit{SENATE REPORT}, \textit{supra} note 40, at 60.

\textsuperscript{222} \textit{Id.} at 59.

\textsuperscript{223} Senate Bill, \textit{supra} note 43, § 204(a) (1).

\textsuperscript{224} \textit{SENATE REPORT}, \textit{supra} note 40, at 61.
ornamental plants would be covered. However, Christmas tree farming or raising trees for timber are not covered.225 If a farming syndicate is involved, any amount paid for feed, seed, fertilizer, or other similar farm supplies is allowed as a deduction only in the taxable year in which such items are actually used or consumed.226 No definition of “used or consumed” is given, but presumably, a trade-off with other farmers; as where wheat is exchanged for oats, will be a “use” permitting a deduction in the year of the trade-off. However, this general rule of “deduct when used or consumed” does not apply to items which are on hand at the close of the taxable year because of casualty, disease or drought, or items which must be capitalized under section 278.227 Furthermore, if a farming syndicate purchases poultry for use in the trade or business (e.g., layer hens) the cost must be capitalized and deducted ratably over the lesser of twelve months or their useful life in the trade or business.228 On the other hand, the cost of poultry purchased for sale (e.g., frying chickens) is deductible only in the taxable year in which such poultry is sold.229

Finally, an amendment to section 278 was proposed in the Senate Bill, adding a new subsection (b) dealing with farm syndicates.230 The amendment has the following effect: any farming syndicate engaged in planting, cultivating, maintaining, or developing a grove, orchard, or vineyard in which nuts or fruit are grown, must capitalize and depreciate all ordinary expenses deductible but for this provision. These expenses must be attributable to that activity and incurred in a taxable year prior to the first taxable year in which such grove, orchard, or vineyard bears a crop or yields in commercial quantities. As to the treatment of the interest expense, such expense would probably be capitalized under this rule. However, if interest falls outside the scope of this rule, it probably also falls outside new section 189, requiring capitalization of construction period interest.231 New section 278(b) excepts expenses incurred which are attributable to the replanting of a grove, orchard, or vineyard which was lost or damaged by reason of freezing, disease, drought, pests, or other casualty.232 It is not clear whether nurseries — operations that do not raise trees for the crop, but to sell as seedlings — are covered under this provision.

226. Senate Bill, supra note 43, § 204(a) (1).
227. Id. For a discussion of section 278, see text accompanying notes 230-35 infra.
228. Senate Bill, supra note 43, § 204(a) (1).
229. Id.
230. Id. § 204(b) (1).
231. See text accompanying notes 133-34 supra.
232. Senate Bill, supra note 43, § 204(b) (1).
The rules provided by proposed section 278(b) supersede the general farm syndicate rules. For example, fertilizer that is used in cultivating an orchard is capitalized under new section 278(b) and it is not an expense under new section 464(a) when used. Subsection (a) required capitalization of all preproduction expenses “incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted.” Under new section 278(b), depreciation begins when commercial production begins whether three years or five years after the first planting.

The Conference Bill adopted the Senate’s proposals with regard to section 464 and the amendments to section 278. However, several changes were incorporated. First, while the Conference version applies to the same groups — all taxpayers or taxpayer entities except regular corporations — the 50% test was lowered. The rule applies to a partnership in farming if more than 35% of the losses during any period are allocable to limited partners or “limited entrepreneurs.” This 35% test is an annual determination. The amended rule utilizes a new concept: the “limited entrepreneur,” referring to a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of the enterprise. Thus, a general partner or a corporation as a general partner which does not participate in active management constitutes a “limited entrepreneur.” Individuals are included if a farm “enterprise” is established by agency relationships created by management contracts or trust and interests in subchapter S corporations.

The Conference Report is helpful on the concept of active management. Active participation is determined by such factors as living on the farm and managing it. An individual who does not operate the farm or has limited liability for farm losses is not an active participant.
As with the application of the “at risk” sections, it is too soon to speculate as to which arrangements will slip through newly proposed section 464, but one might reflect on this type of arrangement, which is similar to a single-shot rollover. A cattle-feeding shelter is structured to purchase feed which is then fed to its cattle and other cattle “leased” from other farms or syndicates, with provision that the leased cattle will be returned to the lessor after the close of the taxable year. The lessor will then pay a certain amount for the care and feeding of his cattle during the lease period. The feed would certainly be consumed and the expenses, deductible. The new section 464 applies to amounts paid or incurred in taxable years beginning after December 31, 1975. However, if the farming syndicate is in existence on December 31, 1975, and there is no change in its membership between December 31, 1975, and the end of the syndicate’s last taxable year beginning before January 1, 1977, the new rule applies to amounts paid or incurred in taxable years beginning after December 31, 1976. As for the amendments to section 278, the general rule applies to taxable years beginning after December 31, 1975. However, the rule does not apply where the trees or vines were planted or purchased for planting prior to December 31, 1975, or where there is a binding contract to purchase the trees or vines in effect on December 31, 1975.

C. Oil and Gas Shelters

Disenchanted with oil and gas shelters, the House launched a two-fold attack: 1) new section 1254, providing intangible deduction recapture, and 2) a proposed amendment to section 263, limiting the intangible deduction to the taxpayer’s investment “at risk”. This intangible deduction recapture provision, which was to function much the same as existing section 1245, was adopted by the Conference Com-

management pursuant to one of the first two exceptions set forth above), and the trade or business of the partnership or any other enterprise involves the further processing of the livestock raised in the trade or business with respect to which he is (actually or constructively) an active participant; or

(4) is a member of the family (within the meaning of section 267(c)(4)) of a grandparent of an individual who would be excepted under any of the first three cases listed above and his interest is attributable to the active participation of such individual.

Id. at 414-15.


240. Id.

241. Id. § 207(b) (3).

242. Id.

243. House Bill, supra note 36, §§ 202, 208. This proposal was in addition to the overall attack under LAL. For a discussion of the LAL attack, see text accompanying notes 327-37 infra.
Upon the disposition of "oil and gas property" new section 1254 requires ordinary income treatment to be given to the lesser of (a) the amount deducted for intangible drilling and development costs paid or incurred after December 31, 1975, but reduced by the amounts which would have been deductible had the intangibles been capitalized and deducted as cost depletion, or (b) the gain realized (in a nontaxable disposition, the fair market value of the property transferred). This rule applies separately to the intangible costs attributable to each oil and gas property, each "property" being defined in existing section 614 for depletion purposes. The rules apply to all taxpayers, including regular corporations. It is important to note, however, that on disposition of a portion of an oil or gas property, the entire amount of the recapture is allocable to such portion to the extent of the amount of gain to which section 1254 applies. If the taxpayer disposes of an individual interest, the recapture is allocated among the various interests. In the case of partnerships, this form of recapture receives treatment as an "unrealized receivable" under section 751, and a similar rule applies for the disposition of the stock of an electing small business corporation.

To the extent Treasury regulations allow the option of deducting intangible drilling costs instead of capitalizing them, such deduction will be allowed under the House Bill's amended section 263(c) only as to the amount for which the taxpayer is "at risk." But a carryover is permitted for unused deductions. Presumably, the House intended the "at risk" concept to parallel the House proposed section 464 dealing with films, livestock, and certain crops.

The Senate did not adopt the intangible recapture provision suggested by the House. However, the Senate did adopt its "at risk" provision, section 465, applicable to "exploring for, or exploiting, oil

245. "Oil and gas property" is defined as "any property (within the meaning of section 614) with respect to which any expenditures described in paragraph (1) (A) are properly chargeable." I.R.C. § 1254(a)(3).
248. Id.
250. House Bill, supra note 36, § 202(b).
252. House Bill, supra note 36, § 208(a).
and gas resources (but only if the taxpayer is entitled to claim a deduction under section 263(c) for such activity.) 255 Significantly, the limitations on depletion are to be computed without regard to the "at risk" provision. 256 The Senate version of "at risk" was much broader than the House version, which would have limited only the deduction of intangibles to the amount "at risk." Thus, under the House view, other deductions such as depreciation, operating costs, and the like were allowed in full. 257 The Senate version, which spoke in terms of the "loss" for the year, could disallow all other expenses as well as intangibles.

The Conference Committee determined to adopt the House version of intangibles recapture and the Senate's view on putting the "at risk" limitation on "exploring for, or exploiting, oil and gas resources, as a trade or business or for the production of income." 258

D. Films and Artistic Properties

While the House's major assault on tax shelters — LAL — dealt with films and motion pictures, 259 the House Bill restricted the tax advantages of these shelters by placing motion picture films under its limited version of "at risk." This proposed section applied to "producing, distributing, or displaying a motion picture film or video tape created primarily for public entertainment." 260 If the motion picture business is involved, the excess of the deductions attributable to that business over the income received during the year from such business "shall not exceed the aggregate amount with respect to which the taxpayer is at risk in such business at the close of the taxable year." 261

The House Bill also provided that the holding of a film or video tape for the production of income is to be treated as a trade or business. 262 The House Bill purported to include losses incurred in producing the film or tape, losses incurred in owning the completed picture or tape, thus including depreciation deductions 263 and incorporated a broad

255. Senate Bill, supra note 43, § 202(a). Each oil and gas property is to be treated as a separate activity if defined as a separate property under the depletion rules of section 614. Id.
256. Senate Report, supra note 40, at 70; see I.R.C. § 613(a), (d).
258. See Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 205(a), 204(a), 90 Stat. 1520 (codified at I.R.C. §§ 1254, 465(c) (1) (B)).
259. For a discussion of LAL, see text accompanying notes 327-37 infra.
260. House Bill, supra note 36, § 207(a). For a discussion of this section's effect on farming, see text accompanying notes 165-70 supra.
261. House Bill, supra note 36, § 207(a).
262. Id.
"grandfather" clause protecting films in production or committed to the taxpayer.\textsuperscript{264}

The Senate followed suit, including within its more comprehensive "at risk" rule "holding, producing or distributing motion picture films or video tapes" and treating each film or video tape as a separate activity.\textsuperscript{265} Under the new section 465(e) proposed by the Senate, the taxpayer involved in film production was permitted to elect out of the "at risk" provision. This provision permitted any portion of a production loan remaining unpaid on the earlier of (a) the last day of the sixtieth month ending after the date on which the film is first exhibited to the public, or (b) on the last day of the taxable year of the taxpayer in which he defaults on the loan, to be treated as taxable ordinary income for the taxable year in which such "last day" falls.\textsuperscript{266}

Two qualifications must be met in order to make the election. First, the taxpayer must have made a direct equity investment equal to not less than 25\% of the taxpayer's share of the film's total production costs: no more than 75\% of the film's financing can be nonrecourse debt. The 25\% investment must be held at that level during the entire sixty-month period after the first exhibition of the film to the public. Secondly, at least 80\% of the direct production costs of the film must have been expended in the United States.\textsuperscript{267} The taxpayer must elect not later than the due date for filing the return for the year in which the investment in the production is made, and such election is irrevocable.\textsuperscript{268} In effect, the election provided for a limited form of deferral of income recapture for production of films.

Although they applied the Senate version of "at risk" to films,\textsuperscript{269} the Conference Committee deleted the Senate provision that permitted the taxpayer investing in films to elect out of the "at risk" rules, adopting instead a more liberal transition rule.\textsuperscript{270} While the "at risk" rules in general apply to losses attributable to amounts paid or incurred in taxable years beginning after December 31, 1975, the Conference Report extended coverage to some films where the principal photography began before 1976.\textsuperscript{271}

\textsuperscript{264} House Bill, \textit{supra} note 36, § 207(b).
\textsuperscript{265} Senate Bill, \textit{supra} note 43, § 202(a).
\textsuperscript{266} Senate Bill, \textit{supra} note 43, § 202(a). A production loan is any loan obtained to defray the costs of producing the film, and with respect to which the taxpayer is not at risk.
\textsuperscript{267} \textit{Id}.
\textsuperscript{268} \textit{Id}.
\textsuperscript{269} \textit{SENATE REPORT, supra} note 40, at 77.
\textsuperscript{270} \textit{CONFERENCE REPORT, supra} note 48, at 412.
\textsuperscript{271} \textit{See} \textit{Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(c), 90 Stat. 1520 (codified at I.R.C. § 465).}

\textit{Id.} The Conference Report explained this section in detail:

With respect to motion picture activities, the conference also agreed that the at risk provision does not apply to a film purchase shelter if the principal photography
The Senate also proposed a new section 280, which generally re-
quired that the taxpayer capitalize his share of production costs and
deduct them over the life of the income stream generated from the
production activity.\textsuperscript{272} Regular corporations were not covered by this
rule.\textsuperscript{278} Included in the costs was the "amount attributable to the pro-
duction or distribution of a film, sound recording, book, or similar
property."\textsuperscript{274} The taxpayer was afforded the right to depreciate or
amortize such capitalized costs on the income forecast method.\textsuperscript{276} The
taxpayer would establish a ratio, the numerator of which was the income
received and the denominator of which was the total income which the
taxpayer may reasonably expect to receive from the film. Applying this
ratio to the capitalized costs determines that year's depreciation.\textsuperscript{278} If
the taxpayer satisfied the criteria for electing out of the "at risk" pro-
vision, he could include those costs financed through nonrecourse loans
in his basis for depreciation of his share of the production costs.\textsuperscript{277}

The Conference Committee adopted the Senate requirement as
to production costs but did not include distribution costs.\textsuperscript{278} Thus, so
called "negative pick-up" deals involving distribution of films continue
to be viable shelters if the "at risk" rule can be avoided by having the
distributor guarantee the box office receipts instead of the loan itself.
In summary, new section 280 requires individual taxpayers and sub-
chapter S corporations to capitalize the costs of producing motion pic-
ture films, books, records, and other similar artistic properties, but these
capitalized items may be recovered over the life of the income stream
generated from the production activity.\textsuperscript{279}

began before September 11, 1975, there was a binding written contract for the
purchase of the film on that date, and the taxpayer held his interest in the film
on that date. The at risk rule also does not apply to production costs, etc., if the
principal photography began before September 11, 1975, and the investor had
acquired his interest in the film before that date. In addition, the at risk provision
does not apply to a film produced in the United States if the principal photography
began before January 1, 1976, if certain commitments with respect to the film
had been made by September 10, 1975.

\textit{Conference Report, supra} note 48, at 412.

\textsuperscript{272} \textit{Senate Report, supra} note 40, at 77.
\textsuperscript{273} Senate Bill, \textit{supra} note 43, § 207(a).
\textsuperscript{274} \textit{Id.} The 1976 Act included a similar provision and also defined the terms
"Film" and "Sound Recording." Tax Reform Act of 1976, Pub. L. No. 94-455,
\textsuperscript{275} Senate Bill, \textit{supra} note 43, § 207(a).
\textsuperscript{276} \textit{Id.}
\textsuperscript{277} \textit{Senate Report, supra} note 40, at 78.
\textsuperscript{278} Tax Reform Act of 1976, Pub. L. No. 94-455, § 210(a), 90 Stat. 1520
(codified at I.R.C. § 280).
\textsuperscript{279} Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(c), 90 Stat. 1520.

While not strictly pertinent to this discussion, it should be noted that both the House
Bill (section 802) and the Senate Bill (section 803) contained provisions clarifying
the investment credit for films; the 1976 Act (section 804) contains similar pro-
E. Sports: Player Contracts

The House launched its attack on sports shelters on two fronts: limiting the amount of basis which could be allocated to such contracts and requiring ordinary income treatment of any gain attributable to the sale of such contracts. To accomplish these goals, several complex provisions were proposed. First, the House proposed to augment recapture by increasing the recomputed basis attributable on the player contract. Next, the House moved to make sure that depreciation on player contracts would be subject to the recapture rules of existing section 1245(a).

That section functions by treating as ordinary income, the lesser of either recomputed basis or gain realized upon disposal of personal property. In augmenting recomputed basis for player contracts, the House took an unusual step. Under the usual recapture rule, prior deductions incident to the particular asset disposed of are considered. The House proposed a new provision, section 1245(a)(4), which would have added to the usual recomputed basis what the House called “previously unrecaptured depreciation.” “Previously unrecaptured depreciation” is the excess of:

1. any depreciation claimed on any player contract held pursuant to the franchise (but claimed after December 31, 1975, and before the contract’s disposition), plus

2. any losses allowed on any player contract (e.g., by forfeiture of a contract) after December 31, 1975, and before the contract’s disposition,
any amounts treated as ordinary income by reason of this new section because of prior dispositions of player contracts held in connection with the franchise.285

This is an entirely new concept because the depreciation claimed with respect to contracts other than those being disposed of is brought into the recomputed basis used to determine the recapture incident to the contracts actually sold.

The second prong of the House attack involved the addition of a new section 1056. In effect, this new section stated that if player contracts are purchased in connection with the purchase of a sports enterprise, such contracts in the hands of the purchaser cannot have a basis greater than (a) the adjusted basis of such contract in the hands of the seller, plus (b) the amount of gain recognized by the seller on the sale of the contract.286 The House also provided that a presumption should exist that no more than 50% of the consideration paid in the sale of a sports enterprise is allocable to player contracts, unless otherwise shown to the satisfaction of the IRS.287 This presumption represents a revolutionary approach; the arm's-length bargaining of the parties, or at least the right of each party to put his best foot forward for tax purposes, is disregarded in favor of the IRS' mandated gain. The new basis provision does not apply to like-kind exchanges nor to contracts received from a decedent.288 Finally, the seller is required to supply the necessary information to compute basis to both the purchaser and the IRS.289

The Senate accepted the House proposed section 1056.290 However, the Senate modified the recapture rule. In so doing, it used the House mechanism of "previously unrecaptured depreciation" by applying it only when the sports franchise itself was sold, not when individual contracts were sold.291 The Senate also limited the recapture aspect to the larger of (a) depreciation and losses claimed with respect to player contracts which were initially acquired as a part of the original acquisition of the franchise, or (b) depreciation and losses claimed with respect to player contracts which were owned by the seller at the time of the sale of the franchise.292

285. Id.
286. Id. § 209(c) (1).
287. Id.
288. Id. However, like-kind exchanges may be the solution. See Braitman, Do Miller and Meyer Suggest A Solution for the "Crossover Point"?, 54 Taxes 168 (1976).
289. House Bill, supra note 36, § 209(c) (1).
290. Senate Bill, supra note 43, § 209(a) (1).
291. Id. § 209(b) (1).
292. Id.
Since the IRS was making some headway in the area of sports shelters, it is unclear why such drastic changes in the law were required. The essential unfairness of the special basis provision, section 1056, is illustrated by the fact that manipulating the basis to make large allocations to depreciable items takes place in virtually every enterprise which involves goodwill or other nondepreciable assets. For example, it seems clear that the covenant not to compete is a tax mechanism in most purchases. Typical of the maneuvering in this area is the purchase of broadcasting facilities, in which surprisingly large allocations to depreciable items are obtained by manipulating the allocations to the FCC license.

The Conference Committee generally adopted the Senate version of section 1056, except that the presumption provided in the House Bill, that not more than 50% of the agreed price of the franchise is allocable to the player contracts, was also retained. Thus, if a sports franchise is sold in a taxable transaction (tax-free exchanges and transfers by reason of death are excepted), the basis of player contracts in the hands of the purchaser is the total of the adjusted basis of such contract in the hands of the seller immediately before the transfer, plus the gain recognized to the seller on the transfer of the contract. Gain not technically recognized upon a twelve-month liquidation to the seller is added to the purchaser’s basis to the extent recognized by the seller’s shareholders. The House presumption operates unless the taxpayer can satisfy the Treasury that it is proper, under the facts, to allocate an amount in excess of 50%. New section 1056 is effective for sales after December 31, 1975, in taxable years ending after such date.

The Senate view of depreciation recapture also prevailed in the Conference Committee. Total recapture (“pool” recapture) of depreciation and losses taken on player contracts applies only in the case of the sale of the entire sports franchise unlike the House version, wherein it applied upon the sale of any one or more player contracts. Secondly, the amount subject to recapture on the sale of the entire franchise is limited to the greater of (a) total depreciation taken, plus losses

293. See, e.g., Laird v. United States, 391 F. Supp. 656 (N.D. Ga. 1975). In this case, the IRS convinced the court that the total price paid for a National Football League franchise should not be the basis for depreciation. Rather, the price had to be allocated among the elements purchased: to non-tax-deductible assets, e.g., television rights, the value of the franchise; and to tax deductible assets, e.g., the value of player contracts.

294. See, e.g., Kfox, Inc. v. United States, 510 F.2d 1365 (Ct. Cl. 1975).


296. See I.R.C. § 337.

297. See id. § 1056(d).

298. See CONFERENCE REPORT, supra note 48, at 420.
attributable to player contracts initially acquired as a part of the original acquisition of the franchise, or (b) the amount of depreciation or losses taken on those player contracts owned by the seller at the time of the sale of the franchise, but in any event, not in excess of gain attributable to the player contracts. The new amendments to section 1245 also apply to transfers of player contracts in connection with any sale of a franchise after December 31, 1975.

F. Interest

Two major provisions of the 1976 Act deal with the interest deduction: new section 461(g), which sets forth a new rule on prepaid interest, and new section 163(d), which limits the overall deduction of interest.

Under the new prepaid interest rule, taxpayers using the cash method of reporting income must treat interest which they pay and which is allocable to any later taxable year, as a capital expenditure to be deducted in the period in which the interest represents a true interest charge (use or forbearance of borrowed money). This rule could mean that prepaid interest is allocated over the life of the loan. The rule applies to all taxpayers, including regular corporations. Neither the House nor Senate intended to change the rules for a bona fide loan transaction, e.g., a level, constant payment. Congress did intend, however, that the new prepaid interest rule apply to "wraparound mortgages," and it intended that the rules apply regardless of whether there has been a material distortion of income. The prior law concerning discounting is unchanged; thus, the Treasury can regard discounted amounts as prepaid interest. Points which are charged as additional interest and not as service charges for the lender's services, are to be treated as prepaid interest paid over the term of the loan. The Committee reports indicate that the new rule applies to charges analogous to points, whether they are termed loan-processing fees or premium charges. If the points are charged for services, these amounts are not treated as interest and may qualify for immediate de-

300. Id.
301. See Senate Bill, supra note 43, § 205.

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duction as ordinary and necessary business expenses. Points paid in
respect of indebtedness incurred in purchasing or improving the prin-
cipal residence of the taxpayer are excepted.\textsuperscript{307} Thus, a vacation house
will fall under the new rule.

The new prepaid interest rule is to be applied to payments made
after December 31, 1975.\textsuperscript{308} However, the new rule exempts interest
payments made before January 1, 1977, pursuant to a binding contract
or loan agreement which existed on September 16, 1975.

The new legislation does put to rest one of the more vexing tax
issues — material distortion — although, in point of fact, the IRS
position on this issue has been successful recently.\textsuperscript{309} It does not resolve
another difficult question — the status of construction financing. For
example, the construction loan may run for two years. The new rule
may spread the interest over the two years even though, in practice,
construction interest is paid up front. It would not seem to authorize
the spreading of that interest expense over the life of the permanent
loan. Once again, the taxpayers must await the issuance of regulations
for clarification.

\textsuperscript{307} Senate Bill, \textit{supra} note 43, § 205(a); House Bill, \textit{supra} note 36, § 205(a).

\textsuperscript{308} See Senate Bill, \textit{supra} note 43, § 205(b); House Bill, \textit{supra} note 36, § 205(b).

\textsuperscript{309} “Material distortion” of income was never precisely defined; however, the
issue arose whenever the Commissioner determined that a taxpayer’s method of ac-
counting did not “clearly reflect income” and, therefore, should be rejected. \textit{See} I.R.C.
§ 446(b). Such a distortion was likely to be argued whenever “the amount of an
interest expense [was] substantially in excess of what might normally be expected
in an arm’s-length transaction structured without special regard to tax consequences.”

In 1968, Revenue Ruling 68-643 was promulgated to deal with interest pre-
In accordance with the ruling, interest prepayments for a period extending more
than 12 months beyond the end of the current taxable year were to be automatically
treated as “materially distorting income,” while those for a shorter period were to
be considered on a “case by case basis.” \textit{Id.} at 77. Factors to be weighed in deciding
if “material distortion” existed included size of income, amount of prepayment, and
reason for prepayment. \textit{Id.}

This “material distortion” test proved to be a rather successful weapon for
the Treasury in the courts. \textit{See} Sandor v. Commissioner, 536 F.2d 874 (9th Cir.
1976) (where prepaid interest represented 18% of the taxpayer’s taxable income, dis-
allowance of deduction held to be proper exercise of Commissioner’s discretion); Burck
v. Commissioner, 533 F.2d 768 (2d Cir. 1976) (plaintiff’s substantial capital gain for
the taxable year held not such a distortion of income as would justify distorting his
deductions by including prepaid interest to offset the taxable gain); Bernard Resnick,
66 T.C. 74 (1976) (limited partnership’s deduction of more than four years’ prepaid
interest disallowed on grounds that it materially distorted the income of the part-
nership); James V. Cole, 64 T.C. 1091 (1975) (prepaid interest equaling approximately
25% of the total principal amount due, and deducted in a high income year for plaintiff,
rejected as not clearly reflecting income). \textit{But see} S. Rex Lewis, 65 T.C. 625 (1975)
(deduction allowed where prepaid interest was for a period of less than one year
and did not offset an unusually large item of income, to the extent that it represented
payment in lieu of a penalty).
The House Bill also contained proposed section 163(d), limiting absolutely the amount of deductible interest. 310 Personal interest expense for all taxpayers other than regular corporations was limited to $12,000 per year ($6,000 for those married but filing separately). Interest on investment indebtedness was limited to the total of (a) the excess of $12,000 over the amount of the personal interest for the taxable year, plus (b) the amount of net investment income, 311 plus (c) the excess of certain deductions over net lease rental. 312 The Senate did not adopt this proposal.

The House limitation on investment interest was adopted with changes by the Conference Committee as new section 163(d). 313 An important distinction between the House and Conference Committee's versions is that the latter imposed no limitation on the deductibility of personal interest as with home mortgages. 314 Under the new section, any taxpayer other than a corporation 315 is limited to the amount of investment interest deductible to the total of $10,000 plus net investment income plus the excess of net lease expenses over rental income. In the case of a trust, the amount of investment interest allowable as a deduction is limited to the amount of net investment income. In all cases, an unlimited carryover applies. An additional amount of interest deduction up to $15,000 per year is permitted for interest paid in connection with indebtedness incurred by the taxpayer to acquire the stock in a corporation or a partnership interest, where the taxpayer, spouse, and children have or acquire at least 50% of the enterprise. 316

The interplay of the various interest limitations can be confusing. Assuming the existence of investment interest incurred during the construction period, it appears that new section 189 now requires the

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310. House Bill, supra note 36, § 206. This proposed section was designed to amend section 163 which authorized an investment interest deduction of up to an amount equal to the taxpayer's net investment income, long-term capital gain, and $25,000 plus one-half of any investment interest in excess of these amounts. The purpose of the House amendment was to restrict interest deductions on borrowed funds "where the loan proceeds are spent for items of a luxury nature." House Report, supra note 39, at 102. The Committee also expressed the hope that "a higher percentage of the benefit of this deduction [would] go, in the future, to lower- and middle-income taxpayers." Id.

311. Net investment income is defined as passive income, net short-term capital gains and recapture income, but only to the extent such items are derived from an investment and not a trade or business. I.R.C. § 163(d).

312. House Bill, supra note 36, § 206.


314. Id.

315. No exception is made for a subchapter S corporation for purposes of section 163(d).

316. Tax Reform Act of 1976, Pub. L. No. 94-455, § 209, 90 Stat. 1520 (codified at I.R.C. § 163(d)(7)). The amount which may be added to the $10,000 base is actually the lesser of $15,000 or the actual interest expense incurred to buy the family enterprise. See id.
capitalization of that interest. On the other hand, once the amortization of that capitalized interest commences, its deductibility will be limited by the new section 163(d). If it exceeds the investment interest limitation, the deduction will be disallowed. The same approach presumably applies for prepaid interest, even though capitalized. The fact that it is limited or covered by new section 461(g) does not assure its eventual deduction if the investment interest limitation applies.

Naturally, the thrust of these changes is to treat all interest expenses as if incurred in a trade or business. The changes are also important for minimum tax purposes. If the interest expense is treated as an itemized deduction, it might be picked up under the new preference for excess itemized deductions. As a business interest it will fall above the line in arriving at adjusted gross income. Special attention should also be paid to section 163(d)(4)(D) which provides: “For purposes of this subsection [limitation on investment interest], interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest.”

The transition rules, as described in the Conference Report, are significant. Because of the various effective dates under prior and present law, it is necessary for a taxpayer who has carryover investment interest to classify the interest according to the period in which it was incurred. Pre-1970 interest is not subject to a limitation; interest incurred before September 11, 1975, or pursuant to a binding contract in effect on that date is subject to prior section 163(d); and interest incurred after September 11, 1975 is subject to the new rules.

G. Equipment Leasing

Neither the House nor the Senate specifically addressed equipment leasing, aside from its inclusion within the Senate’s “at risk” section 465 provision. One of the activities to which the Senate version of

317. See text accompanying notes 338–50 infra.
318. Conference Report, supra note 48, at 418. The Conference Report provides the following illustration:

For example, assume a taxpayer has $30,000 of pre-1976 interest and $60,000 of post-1975 interest; also assume that the taxpayer has $45,000 of investment income. Under the conference agreement, one-third of the investment income ($15,000) is to be allocated to the pre-1976 interest, which would be fully deductible (the $25,000 allowance, plus the $15,000 if net investment income exceeds the $30,000 of pre-1976 interest, which is therefore fully deductible). Two-thirds of the net investment income ($30,000) is allocated to the post-1975 interest; this amount, added to the $10,000 allowance provided under the conference agreement, would result in a total deduction of $40,000 for the post-1975 interest. The remaining amount, ($20,000) could be carried forward.

Id.

319. Senate Bill, supra note 43, § 202 (codified at I.R.C. § 465(c)(1)(A)–(D)).
“at risk” is addressed is “leasing any section 1245 property (as defined in section 1245(a)(3)).” Under the Senate’s “at risk” provisions, where a “taxpayer may otherwise be entitled to deduct a loss in excess of his economic investment in an equipment leasing activity, the amount of the loss deduction is limited to the aggregate amount for which the taxpayer is ‘at risk’ in his trade or business activity at the close of the taxable year.” The usual “at risk” rules apply. If the leasing activity is conducted by an individual taxpayer, the “at risk” limitation applies separately to each separate property leased or held for leasing. However, where several properties comprise one operating unit under the same lease agreement and are neither separately financed nor are subject to different lease terms, such properties are considered to be one property for purposes of the “at risk” provisions. All leasing activities of a subchapter S corporation or partnership are treated as one activity, but this rule applies only with respect to the same activity. Thus, leasing cannot be combined with farming.

The Conference Committee did not change the above results. Although the general “at risk” rule is applicable to taxable years beginning after December 31, 1975, the Conferees agreed as to equipment leasing that the “at risk” rule would not apply to net leases under binding contracts finalized on or before December 31, 1975, or to operating leases under binding contracts finalized on or before April 30, 1976.

III. LIMITATION ON ARTIFICIAL LOSSES

The mainstay of the House’s assault on tax shelters was its proposal of a new section 466, establishing the “limitation on artificial losses” (LAL). Neither the Senate nor the Conference Committee adopted LAL, preferring instead the much simpler “at risk” provision. However, a short description of LAL is necessary in order to give a complete picture of the background behind the tax shelter reforms.

320. Senate Bill, supra note 40, § 202(c)(1)(C) (codified at I.R.C. § 465(c)(1)(C)).
321. Senate Report, supra note 40, at 85.
322. Id.
323. Id.
324. Id. at 86.
325. Conference Report, supra note 48, at 412. Equipment leasing is attacked only through the “at risk” approach.
327. House proposed section 466 read as follows:
[Accelerated deductions which are attributable to a class of LAL property and which (but for this section) would be allowable for the taxable year shall not
In very general terms, this extremely complex LAL section stated that certain “accelerated deductions” attributable to certain types of property could not be deducted in the taxable year in which paid or incurred, to the extent such deductions exceed the taxpayer’s “net related income” from such property. The deferred deductions were usable either when the taxpayer subsequently obtained net related income or when the taxpayer disposed of the property.

LAL property included 1) real property, held for sale or lease; 2) personal property held for lease; 3) farm property; 4) film property; 5) oil and gas property; and 6) sports franchise property. For each category, the rules relating to whether each property was to be treated by the taxpayer as separate or could be aggregated were different.

The LAL rules applied to individuals, subchapter S corporations, and partnerships. The accelerated deductions and net related income were to be allocated to the partners in the same manner as other items.

be allowed for such year to the extent that such deductions exceed the net related income for such year from such class of property.

Id.

In rejecting LAL, the Senate Finance Committee criticized it for contributing to the “trend toward greater complexity in the tax system” and for failing “to distinguish between actual abuses of tax shelters . . . and the situations where tax incentives provide important encouragement to economically worthwhile investments.”

SENATE REPORT, supra note 40, at 39.

During debates on the Senate floor, an amendment was offered by a group of senators to reinstate the House LAL language, with an exemption for residential real estate. 122 CONG. REC. S9688-71 (daily ed. June 17, 1976). This attempt was unsuccessful as, again, LAL was criticized for its complexity. In addition, it was argued that “LAL gives competitive advantage to individuals already in an industry” and it “discourages people from entering new ventures.” Id. at S9678-71 (remarks of Sen. Bentsen).

328. In the House Bill and Report, the term “accelerated deductions” refer to any noneconomic losses which are used under current tax laws to reduce tax liability on a taxpayer’s regular income. House Bill, supra note 36, § 101; HOUSE REPORT, supra note 39, at 25.

329. A taxpayer’s “net related income” is the gross income derived from the property minus the sum of regular or “ordinary” deductions attributable to the property. House Bill, supra note 36, § 101.

330. Id. The major elements comprising a tax shelter investment which this provision sought to neutralize were: deferral, leverage, conversion of ordinary income into capital gains, and use of the limited partnership. HOUSE REPORT, supra note 39, at 25-27.

331. Id.

332. Id. Naturally, the tax shelter investor would prefer to aggregate property in the event some properties might produce excess net related income which could be offset by deductions from non-income-producing properties. When property is treated separately, net related income cannot be “shared.” Farm property is considered one class of property unless the interest is in a farming syndicate, in which case each property “attributable to each activity on each farm begun during any taxable year is a separate class of property.” House Bill, supra note 36, § 101. With respect to film, oil and gas properties, and sports franchises, each item of property or franchise is a separate class. Id.
of partnership income or loss, with the individual partners being regarded as holding the property indirectly.\textsuperscript{333}

Using real estate as an illustration, the "accelerated deductions" included interest and real property taxes during the construction period (unless capitalized) and accelerated depreciation in excess of straight-line depreciation.\textsuperscript{334} These deductions, deferred under LAL, were to be reflected in a deferred deduction account.\textsuperscript{335} The deferred items became deductible only when they could be offset by net related income.\textsuperscript{336} If all the real estate in the class was sold, any balance remaining in the deferred deduction account was allowed as a deduction in that year. If only one or several items of real estate were sold, such part of the deferred deduction account which was allocable or attributable to the property sold was allowed as a deduction.\textsuperscript{337}

IV. LIMITATIONS ON THE INVESTOR

A. Minimum Tax

In addition to the specific remedial provisions designed to curtail tax preferences, the real crux of the anti-tax-shelter legislation lies in the minimum tax, because deductions, however narrowed, are still allowed under all of the other provisions and still reduce the tax payable by the taxpayer. The "at risk" provisions may deplete the shelter, yet shelter remains for those prepared to pay for it. The minimum tax provisions, however, place an absolute floor on the amount by which taxes payable may be reduced.

The following table compares existing law with the proposed changes made in the House and Senate.

\textsuperscript{333} Id.; House Report, supra note 39, at 33.
\textsuperscript{334} House Bill, supra note 36, § 104; House Report, supra note 39, at 33-34.
\textsuperscript{335} House Bill, supra note 36, § 101; House Report, supra note 39, at 34.
\textsuperscript{336} House Bill, supra note 36, § 101; House Report, supra note 39, at 34.
\textsuperscript{337} House Bill, supra note 39, § 101; House Report, supra note 39, at 35.
### Tax Shelters

<table>
<thead>
<tr>
<th>Item</th>
<th>Former Law</th>
<th>House</th>
<th>Senate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code Sections</td>
<td>I.R.C. §§ 56, 57 &amp; 58.</td>
<td>Division of § 56 into a new §§ 55 and 56.</td>
<td>Amends existing law</td>
</tr>
<tr>
<td>Tax is in addition to other taxes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Rate</td>
<td>10%</td>
<td>14%</td>
<td>15%</td>
</tr>
<tr>
<td>Base upon which tax applies</td>
<td>The total of tax preference in excess of $30,000 plus the total of (a) taxes for the year (excepting certain taxes), but less certain credits, and (b) the tax carryovers.</td>
<td>Divided into categories: Individuals and Corporations.</td>
<td>The total of tax preferences in excess of the greater of $10,000 or the liability for tax for the taxable year.</td>
</tr>
<tr>
<td>Exemption</td>
<td>$30,000</td>
<td>$20,000 (maximum).</td>
<td>$10,000</td>
</tr>
<tr>
<td>Phase out of Exemption?</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

**INDIVIDUALS:**
The excess by which the difference between total tax preferences and the exemption (if any) exceeds one-half of the tax liability for the year.

**CORPORATIONS:**
The total of tax preferences in excess of $30,000 plus the total of (a) taxes for the year (excepting certain taxes), but less certain credits, and (b) the tax carryover.

**INDIVIDUALS:**
- The exemption of $20,000 is reduced dollar for dollar for each dollar of preference for the taxable year over $20,000, this being eliminated at $40,000.

**CORPORATIONS:**
- No
<table>
<thead>
<tr>
<th>Item</th>
<th>Former Law</th>
<th>House</th>
<th>Senate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes added to Exemption?</td>
<td>Yes — taxes for the year other than those imposed by I.R.C. §§ 72(m)(5)(B), 402(e), 408(X), 531 &amp; 541 and less the credits allowed by I.R.C. §§ 33, 37, 38, 40, 41, 42, 44.</td>
<td><strong>INDIVIDUALS:</strong> Yes — one-half the regular taxes for the year other than those imposed by I.R.C. §§ 72(m)(5)(B), 402(e) and 408(f), and less the credits allowed by I.R.C. §§ 33, 37, 38, 40, 41, 42 [new], 44A [new] and 44B [new].</td>
<td>Yes — Same as former law.</td>
</tr>
<tr>
<td>Tax carryovers added to Exemption?</td>
<td>Yes — if in any taxable year the taxes for the year (other than I.R.C. §§ 72(m)(5)(B), etc.), reduced by the credits under I.R.C. § 33 and other provisions, exceed the total of tax preferences in excess of $30,000, the excess of taxes is a tax carryover to each of the seven taxable years following such year.</td>
<td><strong>INDIVIDUALS:</strong> No</td>
<td>No</td>
</tr>
<tr>
<td>Deferral of tax liability because of Net Operating Loss Carryovers (NOL)?</td>
<td>Yes — the minimum tax is not imposed on tax preferences that make up the NOL that is carried forward, but, instead, the minimum tax at 10% is imposed on those preferences when the NOL carryover reduces taxable income in the subsequent year.</td>
<td><strong>INDIVIDUALS:</strong> Yes — Same as former law, but rate is raised to 14%.</td>
<td>Yes — same as former law, but rate is raised to 15%.</td>
</tr>
<tr>
<td>Application of Preferences.</td>
<td>(1) Excess investment interest applies only to taxable years beginning before January 1, 1972. (2) Excess investment interest and accelerated depreciation on personal property</td>
<td><strong>CORPORATIONS:</strong> (1) Excess investment interest, accelerated depreciation on personal property subject to a net lease, excess itemized deductions [new] do not apply to corporations other than &quot;S&quot; corporations or per-</td>
<td></td>
</tr>
</tbody>
</table>

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subject to a net lease do not apply to corporations other than subchapter S corporations or personal holding companies.

(1) Excess investment interest (but only prior to January 1, 1972, and did not apply to corporations, other than subchapter S corporations, and personal holding companies).

(2) Construction period interest does not apply to interest paid or accrued before January 1, 1982, on indebtedness incurred on low income housing.

Tax Preferences

(1) Excess investment interest (but only prior to January 1, 1972, and did not apply to corporations, other than subchapter S corporations, and personal holding companies).

Same as former law.

Excess investment interest is retained as a preference. In the case of a limited partner, all partnerships in which he participates are aggregated, and the partnership losses to the extent attributable to investment interest expense, are treated as the partner's investment interest expense (netted, of course, against the partnership's net investment income). However, interest pre-January 1, 1976, is grandfathered under the old rule. The limitation on interest on investment indebtedness provided by I.R.C. § 163(d) is repealed for interest paid after December 31, 1976 (with transitional deduction allowed for previously disallowed interest deductions). "Investment interest expense" does not include interest incurred or continued to carry low income housing before December 31, 1981. "Investment expense" does not include interest to the extent...
<table>
<thead>
<tr>
<th>Item</th>
<th>Former Law</th>
<th>House</th>
<th>Senate</th>
</tr>
</thead>
<tbody>
<tr>
<td>(2) Accelerated depreciation on real property.</td>
<td>Same</td>
<td>Same</td>
<td></td>
</tr>
<tr>
<td>(3) Accelerated depreciation on personal property subject to net lease.</td>
<td>Same</td>
<td>Same, except that “net” is dropped and the preference applies to any kind of lease.</td>
<td></td>
</tr>
<tr>
<td>(4) Amortization of certified pollution control facilities.</td>
<td>Same</td>
<td>Same. Note the Senate Finance Committee would have eliminated this item as a preference to individuals.</td>
<td></td>
</tr>
<tr>
<td>(5) Amortization of railroad rolling stock.</td>
<td>Same</td>
<td>Same.</td>
<td></td>
</tr>
<tr>
<td>(6) Stock options.</td>
<td>Same</td>
<td>Same.</td>
<td></td>
</tr>
<tr>
<td>(7) Reserves for losses on bad debts of financial institutions.</td>
<td>Same</td>
<td>Same.</td>
<td></td>
</tr>
<tr>
<td>(8) Depletion.</td>
<td>Same</td>
<td>Same.</td>
<td></td>
</tr>
<tr>
<td>(9) Capital gains.</td>
<td>Same</td>
<td>Same.</td>
<td></td>
</tr>
<tr>
<td>(10) Amortization of on-the-job training and child care facilities.</td>
<td>Same</td>
<td>Same. Note the Senate Finance Committee would have eliminated this item as a preference to individuals.</td>
<td></td>
</tr>
<tr>
<td>(11) Excess itemized deductions. The excess of itemized deductions is the amount by which the total of such deductions for the year (other than deductions arriving at adjusted gross income, the standard deductions and personal exemptions) exceed 70% (but not over treated as a construction period interest preference.</td>
<td>Same</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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TAX SHELTERS

ITEM FORMER LAW HOUSE SENATE

100%) of the taxpayers adjusted gross income for the year. excess investment interest to the extent not treated as a deduction for the excess investment interest preference exceeds 60% (but not over 100%) of the taxpayer's adjusted gross income for the year.

(12) Construction period interest. Applies to each item of real property held for sale or rental. The preference is the amount of all interest incurred or continued to acquire, construct, or carry real property to the extent such interest is attributable to the construction period for such property and is not capitalized. The "construction period" begins on the date the property is ready to be placed in service or is ready to sell.

(13) Intangible drilling costs of development wells. This preference is the excess of intangible drilling costs for development wells over straight line recovery of intangibles (SLRI). SLRI means ratable amortization of intangible costs over 120 months beginning with first production. The taxpayer can elect to use, in lieu of SLRI, an acceptable method of cost depletion.

(13) Intangible drilling costs. This preference is the excess of intangible drilling costs for any well (except a non-productive well) over straight line recovery of intangibles but only to the extent there is an excess above the total net income attributable to such wells. "Net income" means gross income less any deductions (except the preference) allocable to such and the taxes imposed by § 57 on other preferences.
Many problems are presented by the new preferences specified in the Senate Bill, not the least of which is the construction period interest preference. According to the Senate Report, the "construction period begins with the date on which construction, reconstruction or erection of a building starts and ends when the building or other improvement is ready to be placed in service or to be held for sale." But, it is far from clear whether "construction begins" when the first nail is driven or when the plans are drawn. The IRS itself has had some difficulty with this concept, just recently having explained when a new factory is placed in service for depreciation purposes.

The Conferees in general opted for the Senate approach but eliminated two of the tax preferences proposed by the Senate: construction period interest and excess investment interest. In summary, the new minimum tax rules provide as follows:

1. The tax rate has been raised to 15% for both individuals and corporations.

2. The exemption has been fixed at the greater of $10,000, or one-half of regular tax liability for individuals; for corporations, the exemption is set at the greater of $10,000 or regular tax liability for the corporations. "Corporations" for this purpose do not include subchapter S corporations or personal holding companies. Hence, individuals, trusts, estates, subchapter S corporations, and personal holding companies are limited to one-half the regular tax liability for the year. The regular tax carryover is eliminated for both individuals and corporations.

3. Excess itemized deductions are added as a preference. The Conference Bill adopts the Senate version; thus, preferences consist of the excess of itemized deductions (other than for the standard deduction, deductions to gross income, personal exemptions, medical expenses, and casualty losses) in excess of 60% of the taxpayer's adjusted gross income for the year. This is an individual taxpayer preference. Note, again, that the emphasis is on treating all expenses as business expenses.

338. "The problem here is analogous to that of establishing when construction is completed under the collapsible corporation rule of section 341."

339. Rev. Rul. 76-238, 1976-1 C.B. 56. According to the ruling, "[a]n asset is considered to be placed in service when it is in a condition or state of readiness and availability." Id.


4. Intangible drilling costs are added as a preference, although inapplicable to corporations. The preference applies to those expenses in excess of the amount which could have been deducted had the intangibles been capitalized and deducted, either over the life of the well as cost depletion, or deducted ratably over ten years.\footnote{See Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1520 (codified at I.R.C. § 57(a)(11); CONFERENCE REPORT, supra note 48, at 426-27. The new section 1254 deals with the recapture of intangible drilling expenses and is not the same as the deduction.}

The preference does not apply to nonproductive wells. The Conference Report defines nonproductive wells as “those which are plugged and abandoned without having produced oil and gas in commercial quantities for any substantial period of time.”\footnote{CONFERENCE REPORT, supra note 48, at 426-27.}

Therefore, the classification of a well as nonproductive depends upon “the amount of oil produced in relation to the costs of drilling.”\footnote{Id. The Conference Report further stated: In some cases it may not be possible to determine whether a well is in fact nonproductive until after the close of the taxable year in question. In these cases, no preference is included in the minimum tax base with respect to any wells which are subsequently determined to be nonproductive. Thus, if a well is proved to be nonproductive after the end of the taxable year but before the tax return for the year in question is filed, that well can be treated as nonproductive on that return. If a well is not determined to be nonproductive by the time the return for the year in question is filed, the intangible expenses with respect to that well are to be subject to the minimum tax. However, the taxpayer may later file an amended return and claim a credit or refund for the amount of any minimum tax paid with respect to that well if the well subsequently proves to be nonproductive. Presumably, it is wise to keep the returns open for the year by extensions.}

5. Accelerated depreciation of leased personal property is also included as a new preference.\footnote{See Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1520 (codified at I.R.C. § 57(a)(3)); CONFERENCE REPORT, supra note 48, at 426.}

6. Companies in the timber industry are subjected to the minimum tax, but only upon special terms which have the effect of protecting timber income both from the increase in the minimum tax and the $20,000 reduction in tax preference items. In addition, timber is permitted to retain a regular tax carryover.\footnote{CONFERENCE REPORT, supra note 48, at 427-28. The text of the report dealing with the timber industry is as follows: These rules provide that the item of tax preference for timber gains is to be reduced by one-third and then further reduced by $20,000. Also, the deduction for regular taxes is to be reduced by the lesser of (a) one-third, or (b) the preference reduction described above. In effect, the adjustments compensate for the general minimum tax rate increases from 10 percent to 15 percent by scaling down the entire minimum tax base, as it relates to timber, by one-third and then subjecting that lower base to a 15-percent rate. This gives the same result as subjecting the normal tax base to a 10-percent rate. The reduction in timber preferences by $20,000 (two-thirds of $30,000), in effect, compensates timber for the loss of the $30,000 exemption. The agreement also retains a regular tax carryover for timber. Taxpayers will first have to determine how much of their corporate income tax is attributable}

Generally, the new prefer-
Enforce rules apply to items of tax preference for taxable years beginning after December 31, 1975. However, the effective date of these changes is delayed for two years.\footnote{350}

\section*{B. Maximum Tax}

Although the House did not propose any amendments to the maximum tax section 1348, the Senate did offer some significant changes in this area.\footnote{351} In addition to earned income,\footnote{352} the Senate Bill included pensions, annuities, and deferred compensation in "personal service income," which is the amount subject to the maxi-tax.\footnote{353} Lump-sum and penalty distributions were excluded from maximum tax considerations.\footnote{354} Further, in determining "personal service net income," "personal service income" must be reduced by any deductions allowed in

to timber income (including both gains from the cutting of timber and long-term gains from the sale of timber). This allocation is to be made under regulations prescribed by the Secretary of the Treasury. This allocation must be made for years prior to 1976 as well as future years, in order to determine how much of a corporation's existing regular tax carryover remains available for use in 1976 and subsequent years. The conferees do not intend that there be a carryover of regular taxes not attributable to timber income. To the extent that regular corporate income taxes attributable to timber exceed the items of tax preference in a taxable year, they may be carried forward for up to 7 additional years. The amount of the carryover that may be deducted in a subsequent year is limited to timber tax preferences in that year, reduced by the timber preference reduction described above, minus the regular tax deduction for the year (as reduced by the regular tax adjustment described above). This has the effect of permitting a carryforward of timber-related regular taxes that are not used in the current year and limiting the use of that carryforward to the part of the minimum tax base that is attributable to timber.

\textit{Id.}

\footnote{350} Conference Report, \textit{supra} note 48, at 428. The Conference Report further noted:

The conferees expect the Secretary of the Treasury to issue regulations dealing with how the minimum tax is to be computed for taxpayers who file consolidated returns with financial institutions. These will involve separating the minimum taxes of the corporations in the group for the years 1976 and 1977, and applying the new rules to preferences of corporations other than financial institutions and the old rules to financial institutions for these years.

In accordance with the Senate amendment, the general carryover of regular taxes is repealed effective for taxable years beginning after December 31, 1975.

\textit{Id.}

\footnote{351} Senate Bill, \textit{supra} note 43, § 302. The bill, as passed by the Senate, did not reflect all of the recommendations of the Senate Finance Committee. The Committee had proposed to extend the 50\% maximum tax rate to net investment income. \textit{Senate Report}, \textit{supra} note 40, at 116. Net investment income was defined as "investment income less any trade or business deductions (under section 62) properly allocable to investment income," and "the amount of net investment income eligible for the maximum rate [was] limited to the lesser of (a) $100,000 or (b) personal service net income." \textit{Id.}

\footnote{352} Earned income includes amounts within the meaning of sections 401(c)(2)(C) or 911(b).

\footnote{353} Senate Bill, \textit{supra} note 43, § 302; \textit{Senate Report}, \textit{supra} note 40, at 116.

computing adjusted gross income and the total of all items of tax preference for the year.\footnote{355}

Both the former rules, allowing an averaging of tax preference over five years and the flat $30,000 exemption, were eliminated by the Senate.\footnote{356} However, the most significant alteration was the reduction of income subject to the maxi-tax by the amount of applicable tax preference.\footnote{357}

The Conference Committee adopted the Senate version with some minor changes.\footnote{358} The items of importance in the new maximum tax section include (a) the elimination of the $30,000 exemption and the five year averaging provision, and (b) the inclusion of pensions and employee annuities as subject to the maxi-tax. Expressly excluded from maxi-tax coverage are: premature distributions,\footnote{359} lump sums subject to capital gain,\footnote{360} lump sums subject to averaging,\footnote{361} annuity distribution subject to capital gain,\footnote{362} certain Individual Retirement Account\footnote{363} distributions, premature redemption of retirement bonds,\footnote{364} and income due to late tender of retirement bonds. The new rules apply to taxable years beginning after December 31, 1976.\footnote{365}

Once again, the key provision in the Conference Committee version of section 1348 is the reduction in the earned income subject to the maxi-tax dollar for dollar for each item of tax preference.\footnote{366} There is no cushion as under the former law. The former rule that reduced eligible earned income by current year of tax preference in excess of $30,000 (or if greater, 1/5 of tax preferences for the past five years) has been repealed.\footnote{367}

V. Conclusion

The changes in the law under the Tax Reform Act of 1976 create new barriers to successful tax shelter investments. Nevertheless, the...
potential for tax shelter still exists for those willing to search carefully for the proper investment and investment vehicle. For example, regular corporations (those which have not made subchapter S election) are not subject to most of the rules limiting tax shelter deductions. Thus, although shelters have traditionally been regarded as individual investments, professional corporations may now offer substantial tax shelter opportunities, since a professional corporation which invested directly into the shelter could take advantage of the tax benefits available to a corporation.

There are several advantages of such an arrangement. First, the professional corporation would be able to borrow through nonrecourse financing and use that debt as basis. In this manner, the corporation would be able to derive maximum benefit from the leveraged tax shelter.

Second, the shelter would reduce or eliminate the professional corporation's taxable income for the year. Any excess loss could be carried over for seven years under section 172(b)(1)(B) as a net operating loss carryback or carryover. Furthermore, this elimination of the professional corporation's taxable income reduces the need for large salaries — salaries which might be taxed at 50% or higher to the professional.

On the other hand, lowering the salary paid to the professional reduces the base against which deductible, qualified plan contributions can be made. This suggests that the shelter should not be structured to eliminate all the professional corporation's income. Rather, a more conservative and less economically risky shelter is more appropriate.

If shelter deductions eliminate the need to pay large salaries in order to reduce or eliminate the professional corporation's taxable income, the problem which remains is how to pay out cash to the professional who needs it. One possibility is to pay capital gain dividends. If the corporation has no earnings and profits, capital dividends are applied against stock basis and, after the basis is consumed, the dividends receive capital gains treatment.

The question then arises of how the capital gain dividend helps the professional, since capital gains are subject to mini-tax and remove earned income from the maxi-tax rate of 50%. The key is moderation. While the effective rate on capital gains can approach 50%, the amount of capital gains dividend each year should be more modest. Thus, the capital gains dividend will be taxed at the lower 25% rate.

The use of a professional corporation as a vehicle for tax shelter investments may become viable following the 1976 Act. Nevertheless, such a vehicle is available to relatively few investors, and its widespread use is unlikely.
## APPENDIX I

<table>
<thead>
<tr>
<th>TAX BENEFIT</th>
<th>CONF. BILL</th>
<th>ACT SEC.</th>
<th>CODE SEC.</th>
<th>TAXPAYER*</th>
<th>LIMITATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction period interest — business and investment property</td>
<td>103</td>
<td>201</td>
<td>189</td>
<td>IND, SCORP, P, ET</td>
<td>Capitalized Commercial after 12/31/75; residential after 12/31/77 and low-income housing after 12/31/81.</td>
</tr>
<tr>
<td>Construction period taxes — business and investment property</td>
<td>103</td>
<td>201</td>
<td>189</td>
<td>IND, SCORP</td>
<td>Same</td>
</tr>
<tr>
<td>Depreciation</td>
<td>201</td>
<td>202</td>
<td>1250</td>
<td>IND, CORP, SCORP, P, ET</td>
<td>100% recapture of accelerated depreciation, applicable after 12/31/75 (rule on foreclosures, after 12/31/75). Low-income housing stays on 16% year schedule.</td>
</tr>
<tr>
<td>Rehabilitation depreciation.</td>
<td>201A</td>
<td>203</td>
<td>167(k)</td>
<td>IND, CORP, SCORP, P, ET</td>
<td>None — Benefit extended to 1/1/78, amount increases to $20,000 (after 12/31/75).</td>
</tr>
<tr>
<td>Losses (depreciation, operating expenses, attributable to films)</td>
<td>202</td>
<td>204</td>
<td>465</td>
<td>IND, SCORP, P, ET</td>
<td>Deductibility limited in investment at risk, effective date phased-in.</td>
</tr>
<tr>
<td>Losses (feed expense, depreciation, labor, operating expenses) attributable to farming, except timber</td>
<td>Same Same Same</td>
<td>IND, SCORP, P, ET</td>
<td>Same, after 12/31/75.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Losses (depreciation, operating expenses) attributable to leasing personal property</td>
<td>Same Same Same</td>
<td>Same</td>
<td>Same, effective date phased-in.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Losses (intangible deductions, depreciation, operating expenses, depletion) in exploring for or exploiting oil and gas</td>
<td>Same Same Same</td>
<td>Same</td>
<td>Same, after 12/31/75.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Individual — IND; regular corporation — CORP; electing small business corporation — SCORP; partnership — P; estates or trust — ET.
<table>
<thead>
<tr>
<th>TAX BENEFIT</th>
<th>CONF. BILL SEC.</th>
<th>ACT SEC.</th>
<th>CODE SEC.</th>
<th>TAXPAYER</th>
<th>LIMITATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible drilling expenses</td>
<td>202A 205</td>
<td>1254</td>
<td></td>
<td>IND, CORP, SCORP, P, ET</td>
<td>Recaptured (excess over cost depletion) after 12/31/75.</td>
</tr>
<tr>
<td>Prepaid feed or other related expenses.</td>
<td>204 207</td>
<td>464</td>
<td></td>
<td>SCORP, P or ET if publicly offered or if more than 35% of losses are allocated to limited partners.</td>
<td>Capitalized to some extent — deductible only when used or consumed, after 12/31/75 (subject to transition rule).</td>
</tr>
<tr>
<td>Expensing layer hens or fryers (or other poultry)</td>
<td>Same Same Same</td>
<td>Same</td>
<td></td>
<td>Same</td>
<td>Deductible over the lesser of twelve months or actual useful life, after 12/31/75 (subject to transition rule).</td>
</tr>
<tr>
<td>Expensing planting, cultivating, or developing fruit or nut trees</td>
<td>Same Same 278</td>
<td>Same</td>
<td></td>
<td>Same</td>
<td>Capitalized, but depreciable, after 12/31/75.</td>
</tr>
<tr>
<td>Preproduction expenses (except taxes, interest, casualty losses) for timber and nurseries</td>
<td>Same 207</td>
<td>447</td>
<td></td>
<td>CORP (with $1 million gross) or P (with CORP as partner).</td>
<td>Capitalized, income computed on accrual method of accounting to match expenses with crop income, after 12/31/76.</td>
</tr>
<tr>
<td>Prepaid interest</td>
<td>205 208</td>
<td>461</td>
<td></td>
<td>IND, CORP, SCORP, P, ET</td>
<td>Capitalized and amortized over life of loan, after 12/31/75 (with transition rule).</td>
</tr>
<tr>
<td>Investment interest</td>
<td>206 209</td>
<td>163(d)</td>
<td></td>
<td>IND, SCORP, P and Estate</td>
<td>Amount deductible limited to $10,000 (plus $15,000 for purchase of family business), plus net investment income (add expenses of equipment leasing over rental income), after 12/31/75 (with transition rule). Carryover allowed.</td>
</tr>
<tr>
<td>Same</td>
<td>Same Same Same</td>
<td>Same</td>
<td></td>
<td>Trust</td>
<td>Amount deductible limited to net investment income, after 12/31/75 (with transition rule). Carryover allowed.</td>
</tr>
<tr>
<td>Tax Benefit</td>
<td>Conf. Bill Sec.</td>
<td>Act Sec.</td>
<td>Code Sec.</td>
<td>Taxpayer</td>
<td>Limitation</td>
</tr>
<tr>
<td>------------</td>
<td>----------------</td>
<td>---------</td>
<td>----------</td>
<td>----------</td>
<td>------------</td>
</tr>
<tr>
<td>Production costs of films</td>
<td>208 210</td>
<td>280</td>
<td>IND, SCORP, P and ET</td>
<td>Capitalized and amortized on income forecast method, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Depreciation of player contracts</td>
<td>209 212</td>
<td>1056</td>
<td>IND, CORP, SCORP, P and ET</td>
<td>Basis of player contracts in hands of purchaser limited to seller's adjusted basis plus seller's gain on sale, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Depreciation of player contracts</td>
<td>209 212</td>
<td>1245(a)</td>
<td>IND, CORP, SCORP, P and ET</td>
<td>Amount of depreciation subject to recapture as increased, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>First year depreciation</td>
<td>210 213</td>
<td>179(d)</td>
<td>P</td>
<td>Amount limited to $4,000 at partnership and partner levels, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Expensing of startup and selling expenses</td>
<td>210 213</td>
<td>709</td>
<td>P</td>
<td>Capitalized and organization expenses amortized over 60 months, after 12/31/76.</td>
<td></td>
</tr>
<tr>
<td>Expense as guaranteed payments</td>
<td>210 213</td>
<td>707</td>
<td>P</td>
<td>Allowable only if ordinary and necessary and not capitalized, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Retroactive allocation of year's losses.</td>
<td>210 213</td>
<td>706</td>
<td>P</td>
<td>Prorated, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Special allocation of losses</td>
<td>210 213</td>
<td>704</td>
<td>P</td>
<td>Only if substantial economic effect, after 12/31/75.</td>
<td></td>
</tr>
<tr>
<td>Use of nonrecourse debt as basis to absorb losses</td>
<td>210 213</td>
<td>704</td>
<td>P</td>
<td>Basis limited to investment plus nonrecourse debt, after 12/31/75, but excludes real estate and any activity which is covered by the regular &quot;at risk&quot; rule after 12/31/76.</td>
<td></td>
</tr>
<tr>
<td>Uses of tax losses to reduce income</td>
<td>301 301</td>
<td>56</td>
<td>IND, CORP, SCORP, P and ET</td>
<td>Minimum tax at 15%, limited exemption of the greater of $10,000 or regular tax liability for cor-</td>
<td></td>
</tr>
<tr>
<td>TAX BENEFIT</td>
<td>CONF.</td>
<td>BILL</td>
<td>ACT</td>
<td>CODE</td>
<td>TAXPAYER</td>
</tr>
<tr>
<td>-----------------------------------------------------</td>
<td>-------</td>
<td>------</td>
<td>-----</td>
<td>------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Use of itemized deductions to reduce tax</td>
<td>301</td>
<td>301</td>
<td>57</td>
<td></td>
<td>IND, (P, ET)</td>
</tr>
<tr>
<td>Intangible drilling expenses</td>
<td>301</td>
<td>301</td>
<td>57</td>
<td></td>
<td>IND, P, ET</td>
</tr>
<tr>
<td>Accelerated depreciation on leased personal property.</td>
<td>301</td>
<td>301</td>
<td>57</td>
<td></td>
<td>IND, CORP, SCORP, P, ET</td>
</tr>
</tbody>
</table>
APPENDIX II

The following example illustrates the interplay between the minimum tax and maximum tax:

Taxpayer has $100,000 of professional fee income, $15,000 of unearned income (assume interest) and $12,000 of below-the-line deductions and exemptions. He has long-term capital gains of $100,000 (perhaps a pre-1969 lump sum distribution from a qualified plan). He is married and expects to file a joint return. He proposes to make a tax shelter investment which will produce a $60,000 write-off, the total amount of which constitutes a preference item.

**Regular Tax**

*Table A*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned Income (EI)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Unearned Income (UI)</td>
<td>$15,000</td>
</tr>
<tr>
<td>Capital Gains (CG)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: I.R.C. § 1202 Deduction</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Adjusted Gross Income (AGI)</td>
<td>$165,000</td>
</tr>
<tr>
<td>Deductions</td>
<td>$(12,000)</td>
</tr>
<tr>
<td>Taxable Income (TI)</td>
<td>$153,000</td>
</tr>
<tr>
<td>Regular Tax (I.R.C. § 1)</td>
<td>$ 78,960</td>
</tr>
</tbody>
</table>

**Alternative Tax**

*Table B*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>$153,000</td>
</tr>
<tr>
<td>Less: Net I.R.C. § 1201 Gain</td>
<td>$(50,000)</td>
</tr>
<tr>
<td>Ordinary Tax</td>
<td>$ 47,040</td>
</tr>
<tr>
<td>25% of $50,000</td>
<td>$ 12,500</td>
</tr>
<tr>
<td>(A) Tax on TI (Table A)</td>
<td>$ 78,960</td>
</tr>
<tr>
<td>(B) Tax on Ordinary Income + 50% of I.R.C. § 1201(d) gain</td>
<td>$ 62,700</td>
</tr>
<tr>
<td>Difference: (A) — (B)</td>
<td>$ 16,260</td>
</tr>
<tr>
<td>Tax for Year</td>
<td>$ 75,800</td>
</tr>
<tr>
<td>Alternative Tax Savings</td>
<td>$ 3,160</td>
</tr>
</tbody>
</table>

**Minimum Tax**

*Table C*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gains Preference</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Less: ½ of Regular Tax Liability</td>
<td>$(39,480)</td>
</tr>
<tr>
<td>Minimum Tax Base</td>
<td>$ 10,520</td>
</tr>
<tr>
<td>15% x $10,520 = Minimum Tax</td>
<td>$ 1,578</td>
</tr>
</tbody>
</table>
As can readily be seen, the minimum tax has virtually eliminated the alternative tax saving.

REGULAR TAXABLE INCOME WITH TAX SHELTER DEDUCTION

In view of the computation in Table B, this amount could be reduced slightly by the alternative tax.

MINIMUM TAX

The tax shelter investment which yielded a $60,000 deduction, but which might have cost the taxpayer $100,000 out-of-pocket cash, saved $22,971 in tax (compare Table D with Table G); the deduction was only approximately 38% tax efficient.
In long form, the capital gains preference knocked out any maximum tax savings. Obviously, the $60,000 shelter deduction would do the same.

To compare the result, consider that the taxpayer had $165,000 of earned income (i.e., assume no capital gains).

### MAXIMUM TAX  
**No CAPITAL GAINS**  
*(Table I)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>TI (Table A)</td>
<td>$153,000</td>
</tr>
<tr>
<td>Earned Net Income</td>
<td>165,000</td>
</tr>
<tr>
<td>AGI (Table A)</td>
<td>165,000</td>
</tr>
<tr>
<td>Tentative ETI (A)</td>
<td>153,000</td>
</tr>
<tr>
<td>Less: Tax Preferences (None)</td>
<td>0</td>
</tr>
<tr>
<td>ETI</td>
<td>$153,000</td>
</tr>
<tr>
<td>Tax on ETI through 50%</td>
<td>$18,060</td>
</tr>
<tr>
<td>Plus: 50% of ETI over 50% Bracket</td>
<td>50,500</td>
</tr>
<tr>
<td>Tax on Balance of Income</td>
<td>$78,960</td>
</tr>
<tr>
<td>Less: Tax on ETI</td>
<td>$78,960</td>
</tr>
<tr>
<td>Difference</td>
<td>0</td>
</tr>
<tr>
<td>I.R.C. § 1348 Tax</td>
<td>$68,560</td>
</tr>
</tbody>
</table>

The maximum tax saved this taxpayer approximately $10,000 (Table A or Table D less Table I). This might cause the taxpayer to consider whether capital gains are all that significant any more; the lump-sum capital gains distribution does not look as attractive at this point. Table D reflects that his total tax with capital gains is $77,378, whereas his tax if he had taken all earned income is only $68,560. However, as shown by Table G, with the shelter investment, the taxpayer’s tax is $54,407 or some $14,153 lower than the maximum tax on all earned income. The full application of the maximum tax makes the tax shelter deduction only 24% tax efficient. Thus, should the taxpayer spend, perhaps, up to $100,000 (to yield a $60,000 first year tax deduction) to reduce taxes by only 24%?
Nevertheless, this hypothetical taxpayer decides that he should aim for the lowest possible tax and makes the shelter investment. Assume that the taxpayer has $165,000 of earned income.

**Maximum Tax with Tax Shelter Deduction**

*(Table J)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>TI</td>
<td>$153,000</td>
</tr>
<tr>
<td>Earned Net Income</td>
<td>165,000</td>
</tr>
<tr>
<td>AGI</td>
<td>165,000</td>
</tr>
<tr>
<td>Tentative ETI</td>
<td>153,000</td>
</tr>
<tr>
<td>Less: Tax Preferences</td>
<td>(60,000)</td>
</tr>
<tr>
<td>ETI</td>
<td>$ 93,000</td>
</tr>
<tr>
<td>Tax on ETI through 50%</td>
<td>$ 18,060</td>
</tr>
<tr>
<td>Plus: 50% of ETI over 50% Bracket</td>
<td>20,500</td>
</tr>
<tr>
<td>Tax on Balance of Income</td>
<td></td>
</tr>
<tr>
<td>Regular Tax on TI</td>
<td>$ 40,980</td>
</tr>
<tr>
<td>Less: Tax on ETI</td>
<td>$ 40,980</td>
</tr>
<tr>
<td>Difference</td>
<td>0</td>
</tr>
<tr>
<td>I.R.C. § 1348 Tax</td>
<td>$ 38,560</td>
</tr>
</tbody>
</table>

The net effect of the preference is to reduce the efficiency of the maximum tax ($38,560 (Table J) over $40,980 (Table E)). However, the minimum tax must be considered.

**Minimum Tax**

*(Table K)*

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Preferences</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Less: 1/2 of Regular Tax Liability</td>
<td>(20,490)</td>
</tr>
<tr>
<td>Minimum Tax Base</td>
<td>$ 39,510</td>
</tr>
<tr>
<td>15% x $39,510</td>
<td>$  5,927</td>
</tr>
</tbody>
</table>

Thus, the total tax (Table J plus Table K) is $44,487, compared with the $68,560 (Table I) paid under the maximum tax without tax shelter deductions. The savings is $24,073 for a deduction which might have cost $100,000 (to yield a $60,000 deduction). This is a 24% return, assuming that the taxpayer recovers his $100,000 investment, but if it takes him ten years to get his money back, considering the taxes due upon quitting the shelter, the yield might only be 2% or less per year.

Finally, note the role of capital gains. If the taxpayer had a capital gain instead of all earned income (see Tables A, B, C, D, E, F, G), his total tax would have been $54,407 compared with $68,560 maximum tax on all earned income. In such a case, the tax shelter deduction saved only $14,153. Is it worth trading up to $100,000 in cash, or indeed, $60,000 in cash, for a $14,153 tax saving?