TAX SHELTER INVESTMENTS: ANALYSIS OF 37 INDIVIDUAL INCOME TAX RETURNS, 24 PARTNERSHIP AND 3 SMALL BUSINESS CORPORATION RETURNS

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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I. GENERAL

Process of Selection of Tax Returns

This is an analysis of 24 partnership and 3 small business corporation returns together with tax returns of 37 investors associated with these returns. The returns were selected by the Internal Revenue Service for the staff to illustrate tax sheltering in the areas of real estate operations, cattle breeding and feeding operations, motion pictures and oil and gas drilling funds. This is not a statistical sample but rather, as indicated, is an attempt to use certain returns as examples of these various types of tax shelter activity. However, no attempt was made to select particularly extreme examples of any of these activities.

The Service first selected the partnership or small business corporation return and then selected the individual income tax returns of some of the investors in these businesses in order to trace the loss from the partnership or small business corporation to the individual income tax return in order to show the effect on individual income tax liability. The individual income tax returns, partnership and small business corporation returns analyzed in this study cover one of the years from 1971 through 1974.

It should be noted that the returns analyzed for purposes of this study have not necessarily been audited by the Internal Revenue Service. However, it is possible that some of these returns are presently being audited by the Service.

Section 7213 of the Internal Revenue Code provides for criminal penalties in the case of unauthorized disclosure of certain tax-related information.[1] For purposes of this analysis, the staff has rounded the dollar amounts; also, descriptive titles which are general in nature have been used in order to preclude disclosing information indentifying specific partneships, small business corporations or any individual whose return was used in this study. The Chief Counsel of the Internal Revenue Service has informed the staff that in his opinion the public use of the information in such a form as herein presented does not violate the provisions of section 7213.

Summary of Analysis

In this study, there were 24 partnership and 3 small business corporation returns analyzed. Associated with these returns were the individual income tax returns of 37 investors. Because the objective of this study was to trace a loss generated by a partnership or small business corporation to the individual income tax return of the investor, the staff was of the opinion that it was not necessary to associate all of the individual income tax returns with their corresponding partnerships or small business corporations and analyze them for purposes of this study. Thus, in most cases the individual income tax return of only one investor was analyzed. There were 6 real estate partnerships analyzed; the individual income tax returns for 8 partners were associated with these 6 partnerships. With respect to cattle feeding and breeding activity, 7 partnerships, 3 small business corporations and 13 individual income tax returns were analyzed. There were 8 partnership returns and 12 individual income tax returns analyzed which reflected sheltering activity in the film industry and 3 partnership returns and 4 individual income tax returns showing sheltering activity in drilling funds.

The total equity capital contributed to 21 partnerships and 3 small business corporations amounted to $10,442,000.[2] The gross income generated therefrom

[1] Section 6103(d) of the Internal Revenue Code provides in part that upon request from the Committee on Ways and Means the Treasury Department shall furnish such committee sitting in executive session any data of any character contained in or shown by any return.

[2] It was not possible to determine the capital contribution to 3 partnerships principally because the partnership returns analyzed were for years subsequent to the initial year of operation.

was $182,000. The total losses available to be claimed by all investors in these partnerships and small business corporations amounted to $16,297,000.

Real Estate

Of the six partnership returns analyzed reflecting shelter activity in the area of real estate, three of these partnerships (the ones for which capital contribution could be determined) had a total equity capital contribution of $375,000. Gross income generated by these three partnerships amounted to $119,000 and the loss passed through to the individual partners totaled $532,000. The net loss as a percent of equity capital contribution ranged from 95.6 percent to 383.0 percent. On the average, these three partnerships passed through to the investors a loss of $1.42 for each $1.00 invested. With respect to two of these three partnerships, the partners whose returns were examined claimed a deduction for an amount greater than their equity capital contribution.

Interest expense (generally during the construction period) and accelerated depreciation were the largest deductions. Taxes during the construction period also provided significant deduction potential to the investor. Interest expense incurred by some of these real estate partnerships which used leveraging on permanent financing also provided large interest deductions. The returns which the staff analyzed did not indicate, generally, any unusually large management and syndication fees, although these deductions were present in most of the partnerships.

Cattle Feeding and Breeding

In the area of cattle feeding and breeding, 7 partnerships and 3 small business corporations received a total equity capital contribution of $6,528,000. The gross income earned by these 10 investment activities was only $23,000 whereas the net loss generated was $9,619,000. The net loss passed through to all investors as a percent of initial equity capital contribution ranged from a low of 96.4 percent to a high of 238.3 percent. On the average, these 7 partnerships and 3 small business corporations, passed through to investors a loss of $1.47 for each $1.00 invested. An amount greater than the initial equity capital contribution was deducted by the investors in 8 of these 10 activities. In the remaining two, the investors deducted, on the average, 96.7 percent of their initial equity capital contribution.

The most significant expense deduction which was passed through to the investors in these cattle feeding and breeding operations was for the purchase of feed. The returns which were analyzed by the staff were the returns as filed. Management and syndication fees were not necessarily large but were present in these cattle sheltering activities. Most of these cattle shelters did not rely heavily upon leveraging, and therefore the deduction for interest expense generally was not large.

Motion Picture Films

There were 8 film partnerships which were analyzed. The total investment in these partnerships amounted to $1,470,000. Only one of the partnerships had any gross income, and it amounted to $16,000. The aggregate net loss of these 8 partnerships was $4,363,000. The loss passed through to the individual partners amounted to, on the average, $2.97 for each $1.00 of investment. The net loss as a percent of equity capital contribution ranged from a low of 175.0 percent to a high of 441.9 percent. In all of these partnerships, an amount greater than the equity capital contribution was claimed by the individual partners as deductions against other income reported for tax purposes.

The film partnerships which were analyzed can be classified into two categories: (1) those which own the film, and (2) those which are engaged only in distributing the film. The principal deduction available in the first category is depreciation expense. For purposes of computing depreciation, generally, the income forecast method was used. This method provides that the cost basis of the film is to be written off on the basis of a fraction, the numerator of which is income received in the taxable year and the denominator of which is the total income anticipated to be earned on the film.[3] The second category of film shelters flowed through to its investors a significant writeoff for the costs of distribution.

The first category of film shelters (ownership and distribution of films) relied heavily upon leveraging and used, probably, nonrecourse financing. The returns which the staff analyzed showed that the cost of the film was financed to the extent of 80 to 90 percent of its purchase price.

Drilling Funds

Three drilling fund partnerships were analyzed for this study. The partners' total investment was $2,069,000. One of the partnerships generated gross income of $24,000. The aggregate net loss of these three partnerships amounted to $1,783,000. The net loss as a percent of equity capital contribution for each of these three partnerships was 71.8 percent, 99.3 percent and 179.3 percent.

The principal deduction passing through to the investors in these partnerships was the deduction for intangible drilling costs. An additional expense which passed through, although generally not as significant, was the management and syndication fees.

Individual Investors in Above Tax Shelter Investments

With respect to the 37 individual income tax returns analyzed by the staff, 15 returns showed no income tax liability. Two of these 15 returns, however, reported a minimum tax of $1,000 each. In total, six returns reported a minimum tax liability, two reporting a minimum tax liability of $1,000 each, one return reporting a minimum tax liability of $19,000, two other returns reporting a minimum tax liability of $28,000 each, and one return reporting a minimum tax liability of $83,000.

For most of the individual tax returns, the staff has computed an estimate of "economic income." This is adjusted gross income plus the excluded part of long-term capital gains and excluded dividends; the estimate also does not take account of business, partnership or small business corporation losses for which the staff did not have the necessary information to determine the existence of "artificial" losses. When the individual's loss came from a business whose tax return the staff examined, the precise nature of the loss could be determined, but in other cases the staff had to make a judgment with respect to whether a loss was artificial. In addition, in cases where taxpayers had net capital losses, only the amount of the loss that was deductible against ordinary income was taken into account in economic income. The staff's estimate of economic income, therefore, is only a rough approximation.

In the analysis which follows, a synopsis of the partnership or small business corporation return is shown first, followed by a summary of the individual income tax return of the investor. A brief narrative highlighting each partnership or small business corporation return and the return of the individual investor is shown next. Cases numbered 1 through 6 are real estate shelters, 7 through 16 are cattle feeding and breeding shelters, 17 through 24 are film shelters and 25 through 27 are oil and gas drilling funds.

[3] The returns analyzed by the staff showed that depreciation expense was computed using a numerator which was either a projection of income or was a function of distribution possibilities, neither of which was clearly shown on the return.

II. REAL ESTATE

CASE NO. 1

Partnership Return

Type of business: Real estate.
Date of startup: December 28.

Capital contributed by partners	225,000
Liabilities of partnership	0
Income	0
Expenses	215,000
Interest	197,000
Depreciation	0
Real estate taxes	0
Management and syndication fees	0
Net loss	215,000
Net loss as a percent of capital contribution	95.6%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		427,000
Dividends and interest		4,000
Capital gains (100%)		0
Partnership profit and loss		−410,000
Real estate (3 shelters)	−385,000	
Farm	−25,000	
Other income		16,000
Economic income		448,000
Adjusted gross income		37,000
Itemized deductions		27,000
Taxable income		7,000
Income tax		1,200
Minimum tax		0
Tax credits		0
Total tax after credits		1,200
Tax as a percent of economic income		0.3%

Analysis

The real estate partnership commenced operations on December 28 and lost $215,000. Expenses consisted of $151,000 of interest on a construction loan (presumably prepaid interest), $25,000 of commitment fees, $21,000 of guaranteed financing fees, and $18,000 for advertising and startup rental costs. For each $1.00 invested in this partnership, the partners were able to deduct 95 cents in the first taxable year, which was only 3 days in length.

This individual had wages of $427,000. Almost all of his income was sheltered by investments in real estate and farm partnerships.

CASE NO. 2

Partnership Return

Type of business: Real estate.
Date of startup: April 30.

Capital contributed by partners	53,000
Liabilities of partnership	3,420,000
Income	118,000
Expenses	321,000
Interest	186,000
Depreciation	116,000
Real estate taxes	0
Management and syndication fees	0
Net loss	203,000
Net loss as a percent of capital contribution	383.0%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries	100,000
Dividends and interest	51,000
Capital gains (100%)	0
Partnership profit and loss: Real estate	−127,000
Farming income	97,000
Rental loss	−13,000
Other income	4,000
Economic income	252,000
Adjusted gross income	112,000
Itemized deductions	35,000
Taxable income	74,000
Income tax	30,000
Minimum tax	0
Tax credits	0
Total tax after credits	30,000
Tax as a percent of economic income	11.9%

Analysis

This partnership, which is building and operating a store, is highly leveraged. Partners contributed capital of $53,000 to finance assets of $3,280,000. In the first year, the partnership threw off a loss of $203,000, almost four times the investment by the partners. Deductions were for interest $186,000, amortization of the financing fee $19,000, and depreciation $116,000.

The executive who invested in this store had large salary, dividends and interest and also had sizable income from a farm. The farm income consisted of a profit on the sale of cattle and feed grain. This executive used the 50-percent maximum tax method to compute his income tax.

CASE NO. 3

Partnership Return

Type of business: Real estate.
Date: Second year of operation.

Capital contributed by partners	(1)
Liabilities of partnership	7,716,000
Income	1,157,000
Expenses	1,300,000
Interest	609,000
Depreciation	215,000
Real estate taxes	124,000
Management and syndication fees	42,000
Ground rent	44,000
Net loss	142,000
Net loss as a percent of capital contribution	(1)

[1] Not available.

Individual Income Tax Return

Occupation: Executive.

Wages and salaries	150,000
Dividends and interest	25,000
Capital gains (100%)	365,000
Partnership profit and loss (various)	−151,000
Rentals	−101,000
Other income	13,000
Economic income	632,000
Adjusted gross income	118,000
Itemized deductions	97,000
Taxable income	16,000
Income tax	3,000
Minimum tax	19,000
Tax credits	0
Total tax after credits	22,000
Tax as a percent of economic income	3.5%

Analysis

The partnership is building and managing a shopping center. In its second year of operation, there was a $30,000 payment to the general partner. Only about one-fourth of the interest and taxes deductions seem to relate to the construction period; the rest appears to relate to buildings in operation.

The investor in this shopping center was an executive who had a sizable income from salary, dividends and interest and capital gains. This executive had losses from various unidentified partnerships totaling $151,000, and a loss from a rental business of $101,000. There was a $19,000 minimum tax liability, primarily on the capital gain.

CASE NO. 4

Partnership Return

Type of business: Real estate.
Date of startup: Not available.

Capital contributed by partners		97,000
Liabilities of partnership		866,000
Income		1,000
Expenses		115,000
Interest		35,000
Depreciation		0
Real estate taxes		1,000
Management and syndication fees		25,000
Net loss		114,000
Net loss as a percent of capital contribution		117.5%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		86,000
Dividends and interest		2,000
Capital gains (100%)		4,000
Partnership profit and loss		−37,000
Real estate	−11,000	
Other partnerships	−26,000	
Other income		0
Economic income		92,000
Adjusted gross income		53,000
Itemized deductions		15,000
Taxable income		30,000
Income tax		8,000
Minimum tax		0
Tax credits		0
Total tax after credits		8,000
Tax as a percent of economic income		8.7%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries	101,000
Dividends and interest	4,000
Capital gains (100%)	0
Partnership profit and loss: Real estate	−13,000
Rental loss	−10,000
Other income	1,000
Economic income	106,000
Adjusted gross income	83,000
Itemized deductions	10,000
Taxable income	70,000
Income tax	27,000
Minimum tax	0
Tax credits	0
Total tax after credits	27,000
Tax as a percent of economic income	25.5%

Analysis

This real estate partnership, in its first year of operation, threw off $114,000 in losses to partners, who contributed only $97,000 in capital. Management fees were $25,000, more than one-quarter of equity capital. For each $1.00 invested, the partners claimed as deductions $1.17.

One investor in this tax shelter, a physician, used it to shelter $11,000 in income. He also had other partnership losses of $26,000, but it cannot be determined whether they too are tax shelters. Assuming they were artificial losses, his economic income was $92,000, on which he paid $8,0 0 in tax, or 8.7 percent.

A second investor used this and other real estate partnerships to shelter $13,000 of his economic income of $106,000, and he paid tax of $27,000 or 25.5 percent.

CASE NO. 5

Partnership Return

Type of business: Real estate.
Date: Third year of operation.

Capital contributed by partners	(1)
Liabilities of partnership	9,099,000
Income	579,000
Expenses	1,842,000
Interest	965,000
Depreciation	416,000
Real estate taxes	51,000
Management and syndication fees	13,000
Net loss	1,263,000
Net loss as a percent of capital contribution	(1)

[1] Not available.

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		39,000
Dividends and interest		19,000
Capital gains (100%)		7,000
Partnership profit and loss		−203,000
Real estate	13,000	
Real estate	−253,000	
Medical practice	27,000	
Other income (net operating loss deduction)		−88,000
Economic income		105,000
Adjusted gross income		−227,000
Itemized deductions		6,000
Taxable income		−234,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries		113,000
Dividends and interest		29,000
Capital gains (100%)		74,000
Partnership and Small Business Corporation profit and loss		−417,000
Real estate	−463,000	
Small Business Corporation	46,000	
Other income		0
Economic income		262,000
Adjusted gross income		−236,000
Itemized deductions		12,000
Taxable income		−253,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Analysis

This real estate partnership generated a large tax loss for its partners because of interest and depreciation. It appears that this business owns several buildings, some of which are completed and others of which are under construction. Thus, there is $579,000 of rental income, which is more than offset by depreciation deductions and the expenses of managing the building.

Both investors in this partnership avoided paying any incomes taxes at all. The physician had an economic income of approximately $105,000. The businessman had economic income of $262,000, all of which was sheltered by the real estate partnership.

CASE NO. 6

Partnership Return

Type of business: Real estate.
Date: Second year of operation.

Capital contributed by partners	[1]
Liabilities of partnership	1,968,000
Income	102,000
Expenses	303,000
Interest	121,000
Depreciation	104,000
Real estate taxes	0
Management and syndication fees	13,000
Net loss	201,000
Net loss as a percent of capital contribution	[1]

[1] Not available.

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries	62,000
Dividends and interest	4,000
Capital gains (100%)	1,000
Partnership profit and loss: Real estate	—14,000
Other income	3,000
Economic income	70,000
Adjusted gross income	57,000
Itemized deductions	7,000
Taxable income	47,000
Income tax	15,000
Minimum tax	0
Tax credits	0
Total tax after credits	15,000
Tax as a percent of economic income	21.4%

Analysis

This real estate partnership, in its second year of operation, owns a building which cost $1,551,000 and land costing $170,000. Total assets of $1,662,000 are offset by $1,968,000 of liabilities. In the first year of operation, the partners deducted $56,000 more than their investments. In the current year, the partners were able to deduct losses of $201,000. The principal deductions were for construction and financing fees $121,000 and depreciation $104,000.

The investor in this tax shelter had wages and salaries of $62,000 and additional income of $8,000. He used the real estate partnership to shelter $14,000 of income.

III. CATTLE FEEDING AND BREEDING

CASE NO. 7

Partnership Return

Type of business: Cattle.
Date of startup: December 27.

Capital contributed by partners		1,000,000
Liabilities of partnership		2,442,000
Income		0
Expenses		1,927,000
Interest		0
Depreciation		0
Management and syndication fees		0
Feed		1,900,000
Net loss		1,927,000
Net loss as a percent of capital contribution		192.7%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		116,000
Dividends and interest		5,000
Capital gains (100%)		747,000
Partnership profit and loss		−279,000
Drilling funds	−134,000	
Cattle feeding	−145,000	
Other income		14,000
Economic income		882,000
Adjusted gross income		229,000
Itemized deductions		93,000
Taxable income		133,000
Income tax		66,000
Minimum tax		28,000
Tax credits		0
Total tax after credits		94,000
Tax as a percent of economic income		11.0%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		106,000
Dividends and interest		2,000
Capital gains (100%)		747,000
Partnership profit and loss		−279,000
Drilling funds	−134,000	
Cattle feeding	−145,000	
Other income		11,000
Economic income		866,000
Adjusted gross income		214,000
Itemized deductions		95,000
Taxable income		117,000
Income tax		56,000
Minimum tax		28,000
Tax credits		
Total tax after credits		85,000
Tax as a percent of economic income		9.8%

Analysis

In its three business days of operation, this cattle feeding operation had losses of $1,927,000. Partners contributed $1,000,000, and the partnership borrowed $2,000,000. Expenses consisted of $1,900,000 in feed purchases, $20,000 in payments to partners (presumably to the general partner) and $7,000 of legal fees. In this case, the partnership did show cattle inventories of $442,000, which were offset by a liability for accounts payable. At year end, cattle had been purchased, but not paid for and $1,900,000 was expensed for feed. In the initial year of partnership operation the investors received a deduction of $1.93 for each $1.00 invested.

One investor in this tax shelter had wages and salaries of $116,000, dividends and interest of $5,000, capital gains of $747,000, and other income of $14,000. He sheltered $134,000 with the losses from two drilling funds and $145,000 with the loss from the cattle feeding partnership. Income tax was $56,000 and minimum tax was $28,000 on economic income of $882,000, or 11 percent.

The other investor had practically an identical tax situation—wages and salaries of $106,000, a capital gain of $747,000, dividends and interest of $2,000, and other income of $11,000. This income was sheltered by $134,000 in losses from drilling funds and $145,000 from cattle feeding losses. Income tax was $56,000 and minimum tax $28,000 on economic income of $866,000, or, 9.8 percent.

CASE NO. 8

Partnership Return

Type of buiness: Cattle.
Date of startup: July.

Capital contributed by partners	2,544,000
Liabilities of partnership	6,689,000
Income	23,000
Expenses	3,742,000
Interest	94,000
Depreciation	0
Management and syndication fees	51,000
Feed	3,373,000
Net loss	3,719,000
Net loss as a percent of capital contribution	146.2%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		60,000
Dividends and interest		5,000
Capital gains (100%)		1,806,000
Partnership profit and loss		−869,000
Drilling funds	−580,000	
Cattle feeding	−194,000	
Real estate	−65,000	
Other	−30,000	
Other income		4,000
Economic income		1,875,000
Adjusted gross income		103,000
Itemized deductions		51,000
Taxable income		49,000
Income tax		16,000
Minimum tax		83,000
Tax credits		0
Total tax after credits		99,000
Tax as a percent of economic income		5.3%

Analysis

The cattle feeding operation showed a loss of $3,722,000. The partnership received $2,800 in interest income. The partners contributed $2,544,000, and the partnership borrowed $6,689,000. Feed purchases were $3,373,000, and management fees were $51,000. Death losses totaled $224,000. For each $1.00 invested, $1.46 was deducted as an expense.

This individual had a salary of $60,000 and a capital gain of $1,806,000 from the sale of his business. He sheltered $580,000 through two drilling ventures, $194,000 through two cattle feeding operations and $65,000 through two real estate partnerships. Unidentified partnership losses totaled $30,000. The individual paid $16,000 in income tax and $83,000 in minimum tax.

CASE NO. 9

Partnership Return

Type of busness: Cattle.
Date of startup: December 30.

Capital contributed by partners	250,000
Liabilities of partnership	175,000
Income	0
Expenses	313,000
Interest	0
Depreciation	0
Management and syndication fees	1,000
Feed	312,000
Net loss	313,000
Net loss as a percent of capital contribution	125.2%

Individual Income Tax Return

Occupation: Lawyer.

Wages and salaries	5,000
Dividends and interest	0
Capital gains (100%)	48,000
Partnership profit and loss: Cattle	−132,000
Breeding and Racing—Horses	−5,000
Law practice	43,000
Small Business Corporation	−26,000
Other income	−3,000
Economic income	99,000
Adjusted gross income	−93,000
Itemized deductions	0
Taxable income	0
Income tax	0
Minimum tax	0
Tax credits	0
Total tax after credits	0
Tax as a percent of economic income	0

Analysis

The principal tax shelter was a cattle feeding operation. It started business in December and immediately purchased $312,000 of feed. The partners contributed $250,000 of capital and claimed losses of $313,000. As of December 31, the partnership had assets consisting of $31,000 in cash and $81,000 in cattle and feed, and it had debts of $175,000. For each $1.00 of investment, the partners deducted $1.25.

This individual received income of $43,000 from attorney's fees, $5,000 from wages, and $48,000 in capital gains. All of this income was sheltered by $132,000 in losses from cattle tax shelters, $5,000 in losses from horse racing and breeding operations, and $26,000 due to losses from Small Business Corporations involved in cattle operations. The individual had no income tax liability.

CASE NO. 10

Small Business Corporation Return

Type of business: Cattle.
Date of startup: December 19.

Capital contribution	110,000
Liabilities	420,000
Income	0
Expenses:	
Interest	0
Depreciation	0
Management and syndication fees	0
Feed	106,000
Net loss	106,000
Net loss as a percent of capital contribution	96.4%

Individual Income Tax Return

Occupation: Lawyer.

Wages and salaries		80,000
Dividends and interest		31,000
Capital gains (100%)		0
Partnership and Small Business Corporation profit and loss		−126,000
Cattle feed corporation	−106,000	
Partnerships	−20,000	
Other income		40,000
Economic income		151,000
Adjusted gross income		24,000
Itemized deductions		42,000
Taxable income		−23,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Analysis

This cattle feeding operation is a small business corporation, which began operations on December 19. Unlike partnership shelters, small business corporation shelters do not allow deductions in excess of investment, which here totaled $110,000 compared with losses of $106,000. The corporation's only expense was for feed.

The owner of the small business corporation is a lawyer who received wages of $80,000, dividends of $8,000, interest income of $23,000 and commissions of $35,000. This was sheltered by the $106,000 loss from the cattle feeding operation and $20,000 of losses from partnerships. The lawyer paid no income tax on an economic income of $151,000.

CASE NO. 11

Small Business Corporation Return

Type of business: Cattle.
Date of startup: December 7.

Capital contributed		100,000
Liabilities		516,000
Income		0
Expenses		97,000
Interest		0
Depreciation		0
Management and syndication fees		0
Feed		97,000
Net loss		97,000
Net loss as a percent of capital contribution		97.0%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		14,000
Dividends and interest		54,000
Capital gains (100%)		0
Small Business Corporation and Partnership profit and loss		−99,000
Cattle feeding	−97,000	
Farming	−2,000	
Miscellaneous		−1,000
Other income		2,000
Economic income		70,000
Adjusted gross income		−30,000
Itemized deductions		9,000
Taxable income		−41,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Analysis

In December, the taxpayer organized a cattle feeding operaton as a subchapter S corporation, investing $100,000. The business borrowed $516,000 and purchased $97,000 of feed. The loss in that year enabled the individual to shelter all income and generated a net operating loss of $20,000.

The taxpayer was able to write off 97 percent of his investment in the initial year of operation.

CASE NO. 12

Partnership Return

Type of business: Cattle.
Date of startup: December 21.

Capital contributed by partners	1,929,000
Liabilities of partnership	4,117,000
Income	0
Expenses	2,649,000
Interest	6,000
Depreciation	0
Management and syndication fees	0
Feed	2,640,000
Net loss	2,649,000
Net loss as a percent of capital contribution	137.3%

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries	4,000
Dividends and interest	6,000
Capital gains (100%)	3,000
Partnership profit and loss: Cattle feeding	−13,000
Oil and gas working interest	−8,000
Sole proprietorship	145,000
Other income	10,000
Economic income	168,000
Adjusted gross income	144,000
Itemized deductions	Standard deduction
Taxable income	139,000
Income tax	68,000
Minimum tax	0
Tax credits	0
Total tax after credits	68,000
Tax as a percent of economic income	40.5%

Analysis

The cattle feeding operation began business on December 21 and managed to lose $2,649,000 by year end. The partners contributed $1,929,000, and the partnership borrowed on a nonrecourse basis $4,117,000. Feed expense amounted to $2,640,000. For each $1.00 invested a partner would be entitled to claim $1.37 as a write-off.

This businessman had economic income of $168,000, mainly from a sole proprietorship. He sheltered $13,000 with a cattle feeding operation. He took the standard deduction. His tax liability was $68,000.

CASE NO. 13

Small Business Corporation Return

Type of business: Cattle.
Date of startup: December 21.

Capital contributed	150,000
Liabilities	431,000
Income	0
Expenses	225,000
Interest	16,000
Depreciation	0
Management and syndication fees	0
Feed	209,000
Net loss	225,000
Net loss as a percent of capital contribution	150.0%

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries	7,000
Dividends and interest	1,000
Capital gains (100%)	—1,000
Small Business Corporation and partnership profit and loss: Cattle feeding	−225,000
Business income	388,000
Other income	0
Economic income	396,000
Adjusted gross income	170,000
Itemized deductions	32,000
Taxable income	135,000
Income tax	47,000
Minimum tax	0
Tax credits	0
Total tax after credits	47,000
Tax as a percent of economic income	11.9%

Analysis

This cattle feeding operation is a small business corporation. It was in business for only nine days but incurred $16,000 in interest and $209,000 in feed expenses. It assets consist entirely of $75,000 in cash and $281,000 in cattle. The business is highly leveraged, with $150,000 in capital contributed by the shareholders and $431,000 in liabilities.

The owner of the corporation had $388,000 in income from his business and about $8,000 of other income. He deducted the entire $225,000 loss from the small business corporation.

CASE NO. 14

Partnership Return

Type of business: Cattle.
Date of startup: October.

Capital contributed by partners	326,000
Liabilities of partnership	1,000,000
Income	0
Expenses	365,000
Interest	4,000
Depreciation	0
Management and syndication fees	9,000
Feed	333,000
Net loss	365,000
Net loss as a percent of capital contribution	112.0%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries	0
Dividends and interest	0
Capital gains (100%)	0
Partnership profit and loss: Cattle	−17,000
Business income	68,000
Other income	0
Economic income	68,000
Adjusted gross income	49,000
Itemized deductions	7,000
Taxable income	37,000
Income tax	11,000
Minimum tax	0
Tax credits	0
Total tax after credits	11,000
Tax as a percent of economic income	16.2%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		0
Dividends and interest		0
Capital gains (100%)		0
Partnership profit and loss		45,000
Medical partnership	56,000	
Cattle	−11,000	
Other income		0
Economic income		56,000
Adjusted gross income		42,000
Itemized deductions		7,000
Taxable income		33,000
Income tax		9,000
Minimum tax		0
Tax credits		0
Total tax after credits		9,000
Tax as a percent of economic income		16.1%

Analysis

The partners contributed $326,000 in capital to this cattle feeding operation and deducted $365,000 in losses. Most of the expense was for feed. A write-off of $1.12 was claimed for each $1.00 invested.

The individual investors whose returns were analyzed are both physicians with about $60,000 in income, One sheltered $17,000 and the other sheltered $11,000. Their marginal tax brackets are only 42 percent and 45 percent, which is fairly low for tax sheltering. One of the partners claimed a $17,000 loss write-off for an investment of $15,000 while another partner claimed an $11,000 write-off for an investment of $10,000.

CASE NO. 15

Partnership Return

Type of business: Cattle.
Date of startup: July.

Capital contributed by partners		47,000
Liabilities of partnership		87,000
Income		0
Expenses		112,000
Interest		1,000
Depreciation		0
Management and syndication fees		20,000
Feed		82,000
Net loss		112,000
Net loss as a percent of capital contribution		238.3%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		35,000
Dividends and interest		0
Capital gains (100%)		0
Partnership profit and loss		13,000
Business	36,000	
Cattle feeding	−23,000	
Other income		−1,000
Economic income		71,000
Adjusted gross income		46,000
Itemized deductions		11,000
Taxable income		31,000
Income tax		8,000
Minimum tax		0
Tax credits		0
Total tax after credits		8,000
Tax as a percent of economic income		12.0%

Analysis

The partnership had a loss of $112,000. Partners contributed capital of only $47,000, and the partnership borrowed $87,000. Feed expenses were $82,000 and management fees were $20,000, almost half of capital contributed by the partners. An investment of $1.00 returned to the investor a $2.38 loss.

This doctor received wages of $35,000 and income from his practice of $36,000. He sheltered $23,000 with a cattle feeding partnership. His total tax of $8,000 amounted to 12 percent of his eocnomic income. For a $9,300 investment in the partnership, this doctor claimed a deduction of $22,700.

CASE NO. 16

Partnership Return

Type of business: Cattle.
Date of startup: July.

Capital contributed by partners	72,000
Liabilities of partnership	89,000
Income	0
Expenses	106,000
Interest	13,000
Depreciation	5,000
Management and syndication fees	27,000
Feed	59,000
Net loss	106,000
Net loss as a percent of capital contribution	147.2%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		52,000
Dividends and interest		0
Capital gains (100%)		−1,000
Partnership profit and loss		−27,000
Cattle feeding	−16,000	
Other partnerships	−11,000	
Other income		0
Economic income		52,000
Adjusted gross income		24,000
Itemized deductions		17,000
Taxable income		3,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		39,000
Dividends and interest		2,000
Capital gains (100%)		−1,000
Partnership profit and loss		−23,000
Cattle feeding	−16,000	
Real estate	−4,000	
Other	−3,000	
Business Income		30,000
Other income		−2,000
Economic income		71,000
Adjusted gross income		40,000
Itemized deductions		9,000
Taxable income		28,000
Income tax		7,000
Minimum tax		0
Tax credits		0
Total tax after credits		7,000
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Analysis

This cattle-feeding partnership showed a loss of $106,000. Partners contributed $72,000, and the partnership borrowed $89,000. Deductions included $59,000 for feed, $17,000 as ranch management fees and $10,000 as the general partner's management fee. The general parner did not claim any of the partnership's loss for the year. Out of the $72,000 of capital contributed, $27,000 went to management fees (37.5 percent). Approximately 147.2 percent of the investment was written off in the initial year of operation.

Both limited partners whose returns were analyzed are physicians. One had $52,000 in wages and salaries, but was carrying forward a short-term capital loss of $117,000. He had a $16,000 loss from cattle feeding and a $11,000 loss from some unspecified partnerships. One of the other partnerships, however, passed through a section 1231 gain of $25,000 against which the doctor could offset some of his capital loss carryforward.

The second physician has $39,000 of wage and salary income and $30,000 of income from his practice. He sheltered $16,000 with a cattle feeding operation and $4,000 with real estate. He, too, had a short-term capital loss carryforward, amounting to $10,000.

IV. MOTION PICTURE FILMS

CASE NO. 17

Partnership Return

Type of business: Motion picture distribution.
Date of startup: October.

Capital contributed by partners		124,000
Liabilities of partnership		650,000
Income		0
Expenses		548,000
Interest		0
Depreciation		548,000
Management and syndication fees		0
Net loss		548,000
Net loss as a percent of capital contribution		441.9%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		116,000
Dividends and interest		36,000
Capital gains (100%)		−1,000
Partnership profit and loss		−174,000
Movie partnership	−174,000	
Rental income		2,000
Other income		1,000
Economic income		155,000
Adjusted gross income		−20,000
Itemized deductions		12,000
Taxable income		−36,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Individual Income Tax Return

Occupation: Dentist.

Wages and salaries		148,000
Dividends and interest		8,000
Capital gains (100%)		—1,000
Partnership profit and loss		−178,000
Real estate partnership	−4,000	
Movie partnership	−174,000	
Other income		0
Economic income		156,000
Adjusted gross income		−22,000
Itemized deductions		13,000
Taxable income		−39,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Analysis

The partners contributed capital of $124,000 to this movie distribution business. In its second year, the partnership deducted $548,000 as depreciation on a film thereby incurring an equivalent loss. The loss in the first year amounted to $29,000 which also was depreciation expense. For the 2 taxable years of its existence, this partnership threw off $4.66 of losses for each investment of $1.

Two partners used their share of the partnership loss to avoid tax entirely. An executive with a salary of $116,000, $36,000 in dividends and interest, $2,000 in rental income, and $1,000 from other sources, for a total economic income of $155,000, claimed itemized deductions of $12,000 and a partnership loss of $174,000.

A dentist with an economic income of $156,000 consisting of $148,000 from his practice and $8,000 in dividends and interest. He claimed itemized deductions of $13,000. His $174,000 share of the partnership loss completely sheltered the rest of his income.

CASE NO. 18

Partnership Return

Type of business: Motion picture distribution.
Date of startup: July.

Capital contributed by partners		352,000
Liabilities of partnership		1,725,000
Income		0
Expenses		1,041,000
Interest		0
Depreciation		1,017,000
Management and syndication fees		24,000
Net loss		1,041,000
Net loss as a percent of capital contribution		295.7%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		135,000
Dividends and interest		2,000
Capital gains (100%)		1,000
Partnership profit and loss		−45,000
Movie partnership	−49,000	
Other partnership	4,000	
Other income		−2,000
Economic income		143,000
Adjusted gross income		91,000
Itemized deductions		21,000
Taxable income		68,000
Income tax		28,000
Minimum tax		0
Tax credits		4,000
Total tax after credits		24,000
Tax as a percent of economic income		16.8%

Individual Income Tax Return

Occupation: Broker.

Wages and salaries	0
Dividends and interests	22,000
Capital gains (100%)	107,000
Partnership profit and loss	−99,000
Small Business Corporation	41,000
Sole proprietorship	11,000
Other income	−1,000
Economic income	181,000
Adjusted gross income	28,000
Itemized deductions	58,000
Taxable income	−32,000
Income tax	0
Minimum tax	1,000
Tax credits	0
Total tax after credits	1,000
Tax as a percent of economic income	0.5%

Analysis

The members of this moton picture distribution partnership contributed $352,000 in capital. The partnership acquired two motion pictures at a combined cost of $1,941,000. Depreciation deductions amounted to $1,017,000 and management fees were $24,000. The partnership reported a net loss of $1,041,000.

In the initial taxable year, 295.7 percent of the partner's capital was claimed as deductions. In essence, the partners each claimed $2.96 as deductible expenses for each $1.00 of investment.

One of the partners, a physician, reported $135,000 in salary, $2,000 in dividends and interest, and $1,000 in capital gains. His share of the movie partnership loss amounted to $49,000 which sheltered a substantial part of his income. His income tax liability was $24,000, or 16.8 percent of his economic income of $143,000.

Another partner, a broker, had a tax liability of only $1,000, or .5 percent of his economic income of $181,000. The broker reported $22,000 in dividends and interest, $107,000 in capital gains, $11,000 in brokerage income and $41,000 from another business. His $99,000 share of the movie partnership's loss sheltered all of his income from the income tax. The minimum tax on his capital gains accounted for his entire $1,000 tax liability.

CASE NO. 19

Partnership Return

Type of business: Motion picture distribution.
Date of startup: December.

Capital contributed by partners	150,000
Liabilities of partnership	1,200,000
Income	0
Expenses	326,000
Interest	0
Depreciation	326,000
Management and syndication fees	0
Net loss	326,000
Net loss as a percent of capital contribution	217.3 %

Individual Income Tax Return

Occupation: Executive.

Wages and salaries		12,000
Dividends and interest		19,000
Capital gains (100%)		73,000
Partnership profit and loss		−24,000
Movie partnership	−31,000	
Other partnership	7,000	
Other income		0
Economic income		111,000
Adjusted gross income		43,000
Itemized deductions		7,000
Taxable income		33,000
Income tax		6,000
Minimum tax		0
Tax credits		3,000
Total tax after credits		3,000
Tax as a percent of economic income		2.7%

Analysis

The partners contributed $150,000 to this movie partnership and acquired a motion picture for $1,350,000 on December 18. The partnership has $1,200,000 in liabilities and claimed $326,000 of depreciation. Approximately 217 percent of the initial investment of $150,000 was claimed as a deductible expense in the first month of partnership operation.

This executive reported $12,000 in salary, $19,000 in dividends and interest, $7,000 from a business partnership and $73,000 in capital gains. He sheltered $31,000 with a movie partnership loss. He claimed itemized deductions of $7,000 against an adjusted gross income of $43,000. His $6,000 income tax liability was reduced by a $3,000 investment credit attributable to the same movie shelter. His total tax amounted to 2.7 percent of his economic income of $111,000.

CASE NO. 20

Partnership Return

Type of business: Movie distribution.
Date of startup: November.

Capital contributed by partners	84,000
Liabilities of partnership	63,000
Income	0
Expenses	147,000
Interest	0
Depreciation	0
Management and syndication fees	0
Distribution costs	147,000
Net loss	147,000
Net loss as a percent of capital contribution	175.0%

Individual Income Tax Return

Occupation: Physician

Wages and salaries	0
Dividends and interest	0
Capital gains (100%)	0
Partnership profit and loss: Movie partnership	−20,000
Sole proprietorship	39,000
Other income	0
Economic income	39,000
Adjusted gross income	19,000
Itemized deductions	7,000
Taxable income	6,000
Income tax	1,000
Minimum tax	0
Tax credits	1,000
Total tax after credits	0
Tax as a percent of economic income	0

Analysis

This partnership is in the business of distributing movies. The partners put up $84,000, and the partnership borrowed $63,000 on a nonrecourse basis. All expenses were for distribution costs and the partnership had no revenue. The partnership agreement was for the limited partners to claim all of the initial year's loss but only 40 percent of the next year's profit or loss (presumably profit). The general partner gets 60 percent of the second year's profit.

The physician who invested in this movie distribution partnership reported net income from his medical practice of $39,000. In view of this amount of income, it does not appear that this type of shelter activity should have been undertaken by him. Even without his $20,000 write-off from this partnership, his marginal bracket is only 32 percent.

CASE NO. 21

Partnership Return

Type of business: Film partnership.
Date of startup: July.

Capital contributed by partners		83,000
Liabilities of partnership		1,415,000
Income		16,000
Expenses		334,000
Interest		0
Depreciation		280,000
Management and syndication fees		32,000
Net loss		318,000
Net loss as a percent of capital contribution		383.1%

Individual Income Tax Return

Occupation: Physician.

Wages and salaries		0
Dividends and interest		2,000
Capital gains (100%)		0
Partnership profit and loss		−49,000
Real estate partnership	−1,000	
Movie partnership	−48,000	
Medical practice		57,000
Other income		0
Economic income		59,000
Adjusted gross income		10,000
Itemized deductions		11,000
Taxable income		−6,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Individual Income Tax Return

Occupation: Not available.

Wages and salaries		0
Dividends and interest		97,000
Capital gains (100%)		35,000
Partnership profit and loss		−151,000
Movie partnership	−192,000	
Other	41,000	
Other income		0
Economic income		182,000
Adjusted gross income		−27,000
Itemized deductions		48,000
Taxable income		−77,000
Income tax		0
Minimum tax		0
Tax credits		0
Total tax after credits		0
Tax as a percent of economic income		0

Analysis

The partners contributed $83,000 to the partnership which reported a net loss of $318,000. Depreciation amounted to $280,000, management fees totaled $32,000. Additional miscellaneous expenses brought total deductions against $16,000 in sales revenues to $334,000. Due to the use of leveraging, $3.83 of deductions were claimed for each $1.00 of investment.

Two partners in this film partnership avoided taxes entirely by sheltering their incomes with losses attributable almost entirely to depreciation deductions. A physician with an income of $57,000 from his practice and $2,000 in dividends and interest had itemized deductions of $11,000, a real estate loss of $1,000, and sheltered the rest of his income with a $48,000 loss from the movie partnership. Another partner sheltered his economic income of $182,000 to the extent of $151,000, the net loss from partnership investments which included a $192,000 loss from a leveraged movie shelter.

CASE NO. 22

Partnership Return

Type of business: Movie distribution.
Date of startup: November.

Capital contributed by partners	240,000
Liabilities of partnership	872,000
Income	0
Expenses	660,000
Interest	0
Depreciation	658,000
Management and syndication fees	0
Net loss	660,000
Net loss as a percent of capital contribution	275.0%

Individual Income Tax Return

Occupation: Professional.

Wages and salaries	62,000
Dividends and interest	3,000
Capital gains (100%)	21,000
Partnership profit and loss: Movie partnership	−27,000
Other income	0
Economic income	86,000
Adjusted gross income	45,000
Itemized deductions	13,000
Taxable income	29,000
Income tax	8,000
Minimum tax	0
Tax credits	1,000
Total tax after credits	7,000
Tax as a percent of economic income	8.1%

Analysis

This movie distributorship began operations in November and claimed $658,000 in depreciation on its film. Partners contributed $240,000 of capital, and the partnership borrowed $870,000. Thus, the partners got a deduction of $2.75 for each dollar invested. Depreciation was computed under the income forecast method.

The investor had $86,000 in economic income, largely from wages and capital gains. He sheltered $27,000 with the movie partnership, which also generated a $1,000 investment tax credit. His taxes after the credit totaled $7,000, or 8.1 percent of economic income.

CASE NO. 23

Partnership Return

Type of business: Film distribution partnership.
Date of startup: November.

Capital contributed by partners	268,000
Liabilities of partnership	1,260,000
Income	0
Expenses:	
Interest	0
Depreciation	1,017,000
Management and syndication fees	0
Net loss	1,077,000
Net loss as a percent of capital contribution	401.9%

Individual Income Tax Return

Occupation: Lawyer.

Wages and salaries	73,000
Dividends and interest	1,000
Capital gains (100%)	0
Partnership profit and loss: Movie partnership	—28,000
Other income	0
Economic income	74,000
Adjusted gross income	46,000
Itemized deductions	5,000
Taxable income	39,000
Income tax	12,000
Minimum tax	0
Tax credits	0
Total tax after credits	12,000
Tax as a percent of economic income	16.2%

Individual Income Tax Return

Occupation: Salesman.

Wages and salaries	32,000
Dividends and interest	2,000
Capital gains (100%)	0
Business profit and loss: Movie partnership	−54,000
Other income	2,000
Economic income	36,000
Adjusted gross income	−21,000
Itemized deductions	7,000
Taxable income	−30,000
Income tax	0
Minimum tax	0
Tax credits	0
Total tax after credits	0
Tax as a percent of economic income	0

Analysis

In its second year of operation, this film distribution partnership claimed a net loss of $1,077,000 based on depreciation of $1,076,000 ($1,000 of other expenses) on a movie purchased the prior year for $1,520,000. Partners had contributed $268,000 to the partnership. For each $1.00 of investment, the partners claimed a writeoff of $4.02.

One of the partners, a lawyer, had an economic income of $74,000 consisting of $73,000 in wages and salaries and $1,000 in dividends and interest. He claimed $5,000 in itemized deductions and a loss of $28,000 from the movie partnership. He paid $12,000 in tax on a taxable income of $39,000—or 16.2 percent of his economic income. Another partner, a salesman, had economic income of $36,000, consisting of $32,000 in wages and salaries, $2,000 in interest and dividends and $2,000 from other sources. He claimed $7,000 in itemized deductions and more than sheltered the rest of his income with a $54,000 loss from the movie partnership. As a result, he had no tax liability.

CASE NO. 24

Partnership Return

Type of business: Film leasing distribution.
Date of startup: April.

Capital contributed by partners	169,000
Liabilities of partnership	77,000
Income	0
Expenses	246,000
Interest	0
Depreciation	0
Management and syndication fees	0
Distribution costs	246,000
Net loss	246,000
Net loss as a percent of capital contribution	145.6%

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries	9,000
Dividends and interest	0
Capital gains (100%)	1,000
Partnership profit and loss: Movie partnerships	−44,000
Other income	0
Economic income	10,000
Adjusted gross income	−34,000
Itemized deductions	Standard deduction
Taxable income	0
Income tax	0
Minimum tax	0
Tax credits	0
Total tax after credits	0
Tax as a percent of economic income	0

Analysis

This film leasing partnership reported a loss of $246,000, attributed to distribution costs in its first year of operation. Capital contributions totaled $169,000. The partnership incurred a $77,000 liability on a nonrecourse note. In its first year of operation, 145.6 percent of initial investment was claimed as a deductible expense.

An individual partner sheltered his $10,000 economic income with $44,000 in losses from two partnerships. He contributed $27,500 to a film leasing venture and claimed a loss of $40,000.

V. DRILLING FUNDS

CASE NO. 25

Partnership Return

Type of business: Drilling.
Date of startup: December 28.

Capital contributed by partners	134,000
Liabilities of partnership	0
Income	0
Expenses:	
Interest	0
Depreciation or depletion	0
Management and syndication fees	13,000
Intangible drilling costs	120,000
Net loss	133,000
Net loss as a percent of capital contribution	99.3%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries	27,000
Dividends and interest	1,000
Capital gains (100%)	25,000
Partnership profit and loss: Drilling funds	−127,000
Farm income	43,000
Oil proprietorship	49,000
Other income	3,000
Economic income	182,000
Adjusted gross income	9,000
Itemized deductions	6,000
Taxable income	0
Income tax	0
Minimum tax	1,000
Tax credits	0
Total tax after credits	1,000
Tax as a percent of economic income	0.5%

Analysis

This partnership started business on December 28, and incurred $133,000 of losses, consisting of $120,000 of intangible drilling costs and $13,000 of management fees. The partnership was not leveraged. Two limited partners claimed the entire loss from the partnership which amounted to a 99-cent deduction for each $1.00 invested.

This individual had wages and salaries of $27,000, farm income of $43,000, capital gains of $25,000, and $83,000 of economic income from oil and gas extraction (percentage depletion deductions were $26,000 and intangible drilling deductions $8,000, so the taxable income from the oil and gas business was $49,000). On economic income of $182,000, he paid no income tax and only $1,000 of minimum tax.

CASE NO. 26

Partnership Return

Type of business: Drilling.
Date of startup: November.

Capital contributed by partners		200,000
Liabilities of partnership		207,000
Income		0
Expenses		404,000
Interest		0
Depreciation or depletion		0
Management and syndication fees		53,000
Intangible drilling costs		350,000
Net loss		404,000
Net loss as a percent of capital contribution		202.0%

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries		186,000
Dividends and interest		2,000
Capital gains (100%)		−1,000
Partnership and Small Business Corporation profit and loss		−158,000
Drilling funds	−331,000	
Small business corporation	173,000	
Business income		27,000
Other income		2,000
Economic income		390,000
Adjusted gross income		59,000
Itemized deductions		16,000
Taxable income		39,000
Income tax		11,000
Minimum tax		0
Tax credits		0
Total tax after credits		11,000
Tax as a percent of economic income		2.8%

Individual Income Tax Return

Occupation: Businessman.

Wages and salaries		124,000
Dividends and interest		5,000
Capital gains (100%)		0
Small Business Corporations and Partnership profit and loss		11,000
Small Business Corporation	211,000	
Drilling funds	−200,000	
Other income		4,000
Economic income		344,000
Adjusted gross income		144,000
Itemized deductions		61,000
Taxable income		81,000
Income tax		33,000
Minimum tax		0
Tax credits		0
Total tax after credits		33,000
Tax as a percent of economic income		9.6%

Analysis

This drilling fund began operating in November. The partners contributed $200,000 and the partnership borrowed $207,000 on a nonrecourse basis. Intangible drilling deductions were $350,000 and management fees were $53,000 (15 percent of the drilling costs and 27 percent of equity capital invested). The partners, then, could write off $2 for each $1 invested.

One partner had wages and salaries of $186,000, and income from three businesses totaling $20,000. Economic income was $390,000. However, his losses in two drilling partnerships were $331,000, so he was able to shelter 85 percent of his economic income while paying only $11,000 in income tax.

A second partner had wages and salaries of $124,000, dividends and interest of $5,000, income from two businesses of $211,000, and other income of $4,000; his economic income was $344,000. Losses from drilling partnerships, however, were $200,000. His income tax was only $33,000, less than 10 percent of economic income.

CASE NO. 27

Partnership Return

Type of business: Oil drilling.
Date of startup: May.

Capital contributed by partners	1,735,000
Liabilities of partnership	0
Income	24,000
Expenses	1,270,000
Interest	0
Depreciation or depletion	0
Management and syndication fees	130,000
Intangible drilling costs	1,069,000
Net loss	1,246,000
Net loss as a percent of capital contribution	71.8%

Individual Income Tax Return

Occupation: Executive.

Wages and salaries	30,000
Dividends and interest	0
Capital gains (100%)	0
Partnership profit and loss: Drilling funds	−18,000
Other income	1,000
Economic income	31,000
Adjusted gross income	13,000
Itemized deductions	6,000
Taxable income	6,000
Income tax	1,000
Minimum tax	0
Tax credits	0
Total tax after credits	1,000
Tax as a percent of economic income	3.2%

Analysis

This drilling fund is not leveraged. Depreciable assets are $38,000 and depletable assets $24,000, but the intangible drilling costs of the partnership were over $1 million. Management and syndication fees were $130,000, more than 10 percent of the money invested in drilling. Approximately 72 percent of the investment was written off in the initial year.

This individual had $30,000 in income and shelters $18,000 with a drilling fund. Together with $6,000 of itemized deductions, the drilling fund enabled the individual to reduce his income tax to $1,000.

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