[JOINT COMMITTEE PRINT]

BACKGROUND ON TAX SHELTERS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON

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PREPARED BY THE STAFF

OF THE

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CONTENTS

INTRODUCTION

The Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance has scheduled a hearing on June 24, 1983, on abusive tax shelters. This pamphlet, prepared in connection with that hearing, provides background information relative to tax shelters.

The first part of the pamphlet is an overview. This is followed by a description of elements of a tax-shelter investment (Part II), a summary of income tax provisions designed to limit tax shelters (Part III), a discussion of the time value of money (Part IV), and a description of specific areas of present law that provide the base for tax shelters (Part V).

I. OVERVIEW

Tax-shelter investments enable taxpayers to reduce their tax liabilities by use of tax benefits generated by the investments. There are three selling points that are common to most tax-shelter investments: (1) the ability to defer tax liability to a later year; (2) the opportunity to convert ordinary income to tax-favored income (such as capital gains); and (3) the use of borrowed funds to finance the investment (leverage). The elements of a tax-shelter investment are described in Part II.

Beginning in 1969, Congress has enacted a series of income tax laws that are designed to reduce the use of tax shelters. Part III contains brief summaries of tax-shelter legislative provisions contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act of 1982.

Certain aspects of present law continue to provide taxpayers with opportunities to obtain possibly unintended tax benefits, providing the basis for tax-shelter investments. For example, the benefits of deferring a tax liability are attributable, in large part, to the fact that present law does not take adequate account of the present value (or cost) of a future expense or receipt. The tax-law implications of the time value of money are discussed in Part IV.

Other identified abuses under present law include (1) the use of partnerships to achieve tax results not otherwise available, (2) the use of generally available deductions (*e.g.*, interest) to offset unrelated income, (3) the overvaluation of property that is used to generate tax deductions (*e.g.* charitable contributions), and (4) the organization of foreign corporations to avoid the application of U.S. tax rules. Part V describes tax-shelter operations that take advantage of loopholes in these areas of present law.

II. ELEMENTS OF A TAX-SHELTER INVESTMENT

In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings on other income, as well as the receipt of tax-favored (or, effectively, tax-exempt) income from the investment itself. Tax shelters are typically characterized as abusive if they are formed primarily to obtain tax benefits, without regard to the economic viability of the investment.

In some instances, tax shelters are used to take advantage of specific incentives, such as the accelerated cost recovery system, the deduction for intangible drilling costs, or the deduction for research and experimental expenses, which Congress has legislated. Other shelters use devices in the tax law to achieve tax savings which were never specifically intended by Congress, and some shelters attempt to inflate certain deductions, credits, etc. beyond the properly allowable amount.

Although tax-shelter investments take a variety of forms, there are several elements that are common to most tax shelters. The first of these is the "deferral" of tax liability to future years, resulting, in effect, in an interest-free loan from the Federal Government. The second element of a tax shelter is the "conversion" of ordinary income (subject to tax at a maximum rate of 50 percent) to tax-favored income (such as capital gains subject to tax at a maximum rate of 20 percent). Finally, many tax shelters permit a taxpayer to leverage his investment (*i.e.*, to use borrowed funds to pay deductible expenditures), thereby maximizing the tax benefit of deductibility. What follows is a general description of the elements of a tax shelter.[1]

Deferral

Deferral generally involves the acceleration of deductions, resulting in the reduction of a taxpayer's tax liability in the early years of an investment, instead of matching the deductions against the income that is eventually generated by the investment. Deferral also occurs when, for example, taxpayers funnel U.S. investments through a foreign corporation the earnings of which are not subject to current U.S. tax.

The effect of deferral is that the taxpayer grants himself an interest-free loan from the Federal Government, which loan is repayable when, and as, the tax-shelter investment either produces taxable income or is disposed of at a gain. For example, consider the case of a taxpayer who, at the end of year one, realizes that he or she requires a $1,000 loan for use in year two. If this taxpayer obtained a one-year loan when the prevailing rate of interest is 15

[1] The elements of a tax shelter investment are fully described in the pamphlet "Overview of Tax Shelters" (JCS-22-75), published in 1975 by the staff of the Joint Committee on Taxation.

percent (compounded annually), he or she would repay $1,150 at the end of year two. If, instead of obtaining a loan, the taxpayer were to invest in a tax shelter that generated a current deduction of $2,000 in year one, and the underlying investment were not expected to generate $2,000 of income until the following year, the taxpayer would have a $1,000 tax savings (at the 50-percent maximum rate of tax). In the latter case, at the end of year two, instead of repaying a lender $1,150, the taxpayer would incur a Federal income tax of $1,000 on the $2,000 of income generated by the investment. Obviously, the longer the deferral period, the greater the benefit obtained by the taxpayer. Alternatively, the taxpayer could invest the $2,000 of income in another tax shelter to provide a "rollover" or further deferral of the tax.

In some cases, deferral is obtained by the use of legislatively sanctioned tax benefits, such as, for example, the Accelerated Cost Recovery System (ACRS) or the expensing of intangible drilling costs. Other benefits associated with deferral reflect the tax law's treatment of the time value of money, and are discussed at length in Part IV below.

Conversion

The second aspect of most tax-shelter investments is the "conversion" of ordinary income to tax-favored income (such as capital gains or income that is otherwise subject to a reduced rate of tax). Conversion is achieved where, for example, a taxpayer takes an accelerated deduction against ordinary income, and the income that is eventually generated by the investment is taxed at the 20-percent capital gains rate. Also, if the taxpayer is in a lower tax bracket in the year when the investment generates income, he or she effectively "converts" the tax rate.

In the case of certain deductions (*e.g.*, depreciation deductions), as described in Part III below, Congress has dealt with conversion by requiring a portion of the gain on disposition of an investment to be treated as ordinary income (rather than capital gains). However, the current "recapture" rules apply only to prevent the conversion of some ordinary income to capital gains, and do not apply to all tax shelters.

Leverage

The use of borrowed money to fund a tax-shelter investment may result in an economic benefit, as well as a tax benefit. Generally, a taxpayer will borrow an amount of money that equals or exceeds his or her equity investment. From an economic viewpoint, to the extent that a taxpayer can use borrowed money to fund a tax-shelter investment, he or she can use his or her own money for other purposes (such as other investments), resulting in an increase in earnings if the investments are profitable. From a tax viewpoint, borrowed funds generally are treated in the same manner as a taxpayer's own money that he or she puts up as equity in the investment. Because a taxpayer is allowed deductions for expenditures paid with borrowed funds, the tax benefits of deductibility (*e.g.*, deferral) are maximized.

Because interest payments on indebtedness are themselves deductible, a debt-financed investment provides an additional tax advantage relative to an equity-financed investment. This is so because the deductibility of interest payments lowers the effective tax rate [2] on the income generated by the investment.

The benefits of leveraging a tax-shelter investment can be illustrated by a simple example. Assume that a 50-percent bracket taxpayer invests $10,000 of his or her own money, and borrows $90,000 to fund a $100,000 investment. If the investment generates a "tax loss" of $30,000 in the first year by reason of accelerated deductions, the taxpayer will save taxes of $15,000 on his or her investment of $10,000.

The significance of leverage increases where a taxpayer obtains a nonrecourse loan (i.e., where there is no personal liability to repay the loan). The benefits associated with the use of nonrecourse loans are discussed below in connection with the partnership rules.

Scope of tax shelter cases

Tax shelter cases require substantial resources of the Internal Revenue Service and the Tax Court. As of September 30, 1982, 284,828 returns with tax shelter issues were in the Internal Revenue Service examination process, an increase of 36,000 returns over the prior year. During 1982, 71,793 returns were closed after examination, with recommended tax and penalties totaling $954.2 million.[3]

On January 1, 1982, the Tax Court had 10,522 tax-shelter cases docketed. At the end of 1982, that number had increased to 15,693. During the 10-month period beginning March 1, 1982, 6,780 tax shelter cases were received by the Tax Court and 2,362 cases were disposed of.

According to a private register of tax shelters, taxpayers invested $8 billion in "tax-advantaged investments" (excluding IRAs and municipal bonds) in 1981 and $9 billion in 1982, and will invest an estimated $11 billion in 1983. According to a related newsletter, investments in public tax shelters (i.e., limited partnerships registered with the Securities and Exchange Commission) for the first quarter [4] of 1983 were 53 percent higher than they were one year ago. This increase appears partially attributable to the improvement in the oil and real estate markets, two major tax shelter areas.

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[2] The effective tax rate on income derived from an investment is the amount of tax paid per dollar of income earned. The concept of an "effective tax rate" is explained more fully in the pamphlet "Analysis of Proposals for Depreciation and Investment Tax Credit Revisions, Part I: Overview" (JCS-18-81), published in 1981 by the staff of the Joint Committee on Taxation.

[3] 1982 Annual Report, Commissioner and Chief Counsel, Internal Revenue Service, p. 11.

[4] The Stanger Register: Tax Shelter Profiles (Robert A. Stanger & Co.), Feb. 1983, pp. 1–9; The Stanger Report: A Guide to Tax Shelter Investing (Robert A. Stanger & Co.), April 1983, p. 2.

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III. SUMMARY OF INCOME TAX PROVISIONS DESIGNED TO LIMIT TAX SHELTERS

Beginning in 1969, Congress has enacted substantive and procedural income tax provisions that deal with tax-shelter investments. Following are brief summaries of the major changes contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981 (ERTA), and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Minimum tax

In 1969, a minimum tax was enacted which applied to both individuals and corporations. The original minimum tax was an "add-on" tax which applied to a taxpayer whose defined tax preferences exceeded his regular tax by more than $30,000. In 1976, the tax rate was increased from 10 percent to 15 percent and the exemption greatly reduced. Since that time, the individual minimum tax has been amended several times.

TEFRA repealed the individual "add-on" minimum tax and replaced it with an "alternative" minimum tax beginning in 1983. This tax requires all individuals to pay a tax of at least 20 percent on their "economic" income (i.e., taxable income plus tax preferences) in excess of an exemption level of $40,000 for married couples and $30,000 for single taxpayers. The corporate "add-on" minimum tax was retained.

Investment interest limitation

Prior to 1969, a taxpayer was able to reduce tax on income from the taxpayer's professional or other income-producing activities by voluntarily incurring interest deductions attributable to tax-shelter investments. The 1969 Act limited the deduction for interest paid or incurred by an individual (and other noncorporate taxpayers) on funds borrowed to purchase or carry an investment. Under the 1969 Act, the deduction for investment interest was limited to 50 percent of the interest in excess of the taxpayer's net investment income, long-term capital gains, plus $25,000. The 1976 Act further limited the deduction for investment interest to $10,000 per year plus the taxpayer's net investment income. Disallowed interest deductions are carried over and may be deducted in future years.

Investment tax credit: Noncorporate lessor limitation

The 1971 Act, which reinstated the investment credit, imposed limitations on the availability of the investment credit to individual (and other noncorporate) lessors. This provision was enacted to limit the extent to which individuals are able to utilize the tax benefits of leasing transactions (*i.e.*, the credit, depreciation deductions, and interest deductions) to shelter other income. Under present law, the investment credit is available to noncorporate lessors in only two situations: (1) if the leased property was manufactured or produced by the lessor, and (2) in the case of a short-term lease, where the lease term (including renewal options) is less than 50 percent of the useful life of the property, and for the first 12 months after the transfer of the property to the lessee, the sum of certain deductions allowable to the lessor with respect to the property exceeds 15 percent of the rental income produced by the property. The credit not usable by a noncorporate lessor may be passed through to a corporate lessee (sec. 48(d)).

At-risk rules

Loss limitation.—As part of an effort to limit abusive tax shelters, the 1976 Act enacted an at-risk limitation for deductions from an economic activity. The at-risk limitation is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in the activity. The limitation applies to all activities except the holding of real property.[5]

Under the at-risk rules, a taxpayer may deduct losses (including depreciation) from an activity only to the extent of his or her aggregate at-risk investment in the activity at the close of the taxable year. In general, the at-risk investment includes (1) cash and the adjusted basis of property contributed by the taxpayer to the activity, and (2) amounts borrowed for use in the activity for which the taxpayer has personal liability for repayment. This amount is generally increased by the taxpayer's share of net income from the activity and decreased by its share of losses. At-risk investment does not include the proceeds of nonrecourse loans. The at-risk amount also excludes (1) amounts borrowed from other participants in the activity, (2) amounts borrowed from related parties, and (3) amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements. However, the at-risk rules often will not apply, for example, where the taxpayer is personally liable on a note for the purchase of property, which is then leased to a credit-worthy lessee under a long-term lease.

The at-risk rules are applicable to individuals and certain closely held corporations.[6] An exception is provided for certain equipment leasing activities (not including the leasing of master sound recordings and other literary or artistic properties) engaged in by closely held corporations. In the case of partnerships or S corporations, the rules are applicable at the partner or shareholder level. Thus, a partner is considered at-risk with regard to a loan to the partnership only if the partner is personally liable for repayment.

Investment tax credit.—ERTA added a new at-risk limitation with respect to the investment tax credit (ITC). The limitation ap-

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[5] As enacted in 1976, the at-risk rules applied to four specific activities: (1) farming; (2) oil and natural gas exploration; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property. The Revenue Act of 1978 extended the at-risk rules to other activities.

[6] The Revenue Act of 1978, expanded the at-risk rules to cover closely held corporations. A corporation is subject to the at-risk rule if more than 50 percent in value of its outstanding stock is owned (directly or indirectly) by 5 or fewer individuals.

plies to the same activities, and to the same taxpayers, as the loss deduction at-risk rules.

Under the ITC at-risk rule, the basis of property for ITC purposes may not exceed the taxpayer's at risk investment in the property at the close of the taxable year. In general, the amount at risk for ITC purposes is determined on the same basis as under the loss deduction rules. However, an exception is provided for amounts borrowed from certain "qualified lenders" (including banks, savings institutions, and other commercial lenders) or from governmental authorities. A taxpayer is considered at risk with regard to these amounts if he or she has at least a 20 percent at-risk investment in the property (determined without regard to the exception).[7] The law also provides an exception for property used in connection with various alternative energy sources.

Farm operations

Farm operations are governed by special tax provisions, many of which confer tax benefits on farming activities. Under prior law, the special tax rules available to farmers were utilized by passive investors who were motivated, in large part, by a desire to use the special farming rules to shelter income from other sources. The 1976 Act contained several provisions designed to reduce the tax incentives for passive investors to invest in syndicated farming operations. In general, the 1976 Act limits the deductions of farming syndicates that serve as tax-shelter vehicles for passive investors.

The 1976 Act limits the deductibility of prepaid feed, etc. by a farm syndicate, requires the capitalization of the pre-production expenses of a farm syndicate in growing fruits or nuts and requires the use of the accrual method of accounting by farm corporations, other than certain small corporations and family corporations. The farm syndicate rules are intended to deny the farm tax benefits to persons who are not actually engaged in the business of farming.

Recapture rules

The recapture rules under present law prevent the conversion of ordinary income to capital gains, by requiring gain on a sale or disposition of certain property to be taxed as ordinary income (rather than capital gains), to the extent depreciation deductions were taken with respect to the property.

Real estate.—Among the tax benefits derived from a real estate tax shelter are accelerated depreciation deductions. The 1969 Act imposed more stringent recapture rules on real estate investments, requiring a larger portion of gain attributable to accelerated depreciation deductions to be taxes as ordinary income. However, under the 1969 Act, residential real property received favorable treatment. With limited exceptions, the 1976 Act provided for complete recapture of all depreciation in excess of straight-line depreciation, regardless of whether the property was residential real property. However, unlike personal property, only accelerated depreciation deductions are recaptured.

[7] In the case of partnerships and S corporations, the 20-percent test is applied at the partner or shareholder level.

Finally, under the Accelerated Cost Recovery System enacted by ERTA, all gain or disposition of nonresidential real property whose cost is recovered on an accelerated basis over the allowable 15-year period will be treated as ordinary income, to the extent of recovery allowances previously taken under the prescribed accelerated method. Thus, in the case of nonresidential property, taxpayers may either use straight-line recovery with no recapture, or accelerated recovery with recapture of all recovery deductions to the extent gain is recognized.

Intangible drilling and development costs.—Under present law, an investor in an oil and gas tax shelter can defer tax liability by deducting intangible drilling and development costs against ordinary income. The 1976 Act contained a recapture provision that prevents the conversion of the ordinary income against which such deductions are taken to capital gains. The amount subject to recapture is the amount deducted for intangible drilling and development costs, reduced by the amounts which would have been deductible had those costs been capitalized and deducted through cost depletion.

Production costs

The 1976 Act contained a provision that requires a taxpayer (other than a corporation that is not an S corporation or a personal holding company) to capitalize production costs of producing films, sound recordings, books, or similar property, and to deduct such costs over the life of the income stream generated by the production activity. This provision prevents a taxpayer from accelerating production costs, and, thereby, producing a mismatching of income and expenses attributable to the income.

Sports franchises: Player contracts

Under prior law, the purchaser of a sports franchise attempted to allocate a large portion of the purchase price to player contracts that could be depreciated. The amount allocated to player contracts usually represented a large portion of the purchase price, and could be depreciated over a short life. The depreciation deductions taken in the early years usually exceeded the income generated by the franchise and, thus, sheltered other income. On the other hand, upon a subsequent sale of the sports franchise, the seller attempted to allocate most of the sales price to other assets (such as good will) that were not depreciable and, therefore, not subject to recapture. Thus, a sports franchise tax shelter could be used to obtain conversion, as well as deferral.

Under the 1976 Act, on the disposition of a sports franchise (or the creation of a new franchise), the amount of consideration allocated to a player contract must not exceed the sum of the adjusted basis of the contract in the hands of the transferor and any gain recognized by the transferor on the transfer. On a sale or exchange of a franchise, there is a presumption that not more than 50 percent of the sales price is allocable to player contracts. Further, the 1976 Act provided special recapture rules for depreciation deductions taken with respect to player contracts.

Partnerships

The Tax Reform Act of 1976 contained numerous provisions relating to the taxation of partnerships and their partners.

Election to expense certain depreciable assets.—The Tax Reform Act of 1976 amended the provision relating to additional first-year depreciation (as subsequently amended by ERTA, an election to expense certain depreciable business assets) to require a limitation on the amount of the deduction to be applied to the partnership and to each partner.

Capitalization requirements.—The 1976 Act amended the rules governing guaranteed payments to a partner, (i.e., payments made by the partnership to a partner for services or for the use of capital that are determined without regard to partnership income), to require such payments to be capitalized if such payments to a party who is not a partner would have to be capitalized. The Act also required costs of organizing a partnership or promoting or selling interests when incurred by the partnership, to be capitalized, subject to an election to amortize organization fees over a period of 60 months or longer.

Allocation of income and loss.—The 1976 Act limits allocations of partnership income or loss to a partner to the portion allocable to the part of the taxable year during which he is a partner. Further, the 1976 Act amended the provisions relating to allocations of income and loss to provide that such allocations will be controlled by the partnership agreement, unless they do not have a substantial economic effect, in which case the allocation is to be made in accordance with the parners' interests in the partnership. Prior to the Act, the allocation provisions referred only to items of partnership income, loss, deduction or credit and it was unclear whether they applied to allocations of overall income or loss. Prior to the Act the allocation in the partnership agreement was not controlling only if the principal purpose of the allocation was evasion or avoidance of tax. The "substantial economic effect" test has been adopted under Treasury regulations in applying the principal purpose test of prior law.

At-risk provision.—The 1976 Act imposed limitations to disallow partnership losses attributable to nonrecourse liability except for investments in real property (other than mineral property). These restrictions were incorporated into the general at-risk rules of section 465 by the Revenue Act of 1978 and the special partnership restrictions were repealed.

Prepaid interest

Under the general rule of section 163(a), a taxpayer using the cash method of accounting can claim a deduction for interest paid within his taxable year. Prior to the 1976 Act, prepaid interest was used in many types of tax shelters to defer tax on ordinary income. In many cases, a deduction for prepaid interest was generated without adverse cash flow consequences by borrowing more than was needed and promptly repaying the excess as "prepaid interest." Under the 1976 Act, if a taxpayer uses the cash method of accounting, interest that is prepaid but that is properly allocable to a later taxable year must be deducted ratably over the period of the loan. This rule applies to all taxpayers (including individuals, corporations, estates, and trusts), and covers interest paid for personal, business, or investment purposes. Once prepaid interest has been allocated to the proper periods, such interest is then subject to other applicable limitations (*e.g.*, the limitations on the deduction of investment interest).

Construction-period interest and taxes

Under prior law, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions, even if there was no income from the property. The ability to take current deductions for construction-period interest and taxes permitted the deferral of tax on other income. Under the 1976 Act, a taxpayer (other than a corporation that is not an S corporation or a personal holding company) is required to capitalize construction-period interest and taxes attributable to the construction of real property (other than low-income housing). The capitalized expenditures are amortized over a 10-year period. TEFRA extended the scope of the capitalization rule for construction-period interest and taxes to require all corporations to capitalize construction-period interest and taxes attributable to the construction of nonresidential real property.

Straddles

Prior to ERTA, commodity straddles and straddle-related transactions were used to defer tax liability and to convert ordinary income or short-term capital gain into long-term capital gain. Straddles generally involved both the buying and selling of similar items, and then realizing the loss in one year and the gain in the subsequent year. The 1981 legislation adopted a number of provisions to deal with these issues.

Gains or losses on straddles.—Under ERTA, all commodity futures contracts are marked-to-market at year end and treated as if 60 percent of the capital gains and losses on them were long-term and 40 percent were short-term. Net losses under the mark-to-market rule may be carried back three years against mark-to-market gains. This treatment was extended by the Technical Corrections Act of 1982 to cover certain cash settlement contracts and foreign currency contracts traded in the interbank market.

In the case of straddles involving property other than futures that are marked-to-market, ERTA allows straddle losses only to the extent such losses exceed the unrecognized gains on offsetting positions. Disallowed losses are deferred. The wash sale and short sale principles of present law are extended to straddles by regulation. The loss deferral rule applies to actively traded personal property but not to such property as real estate, stock and short-term stock options. Hedging transactions are excepted from this provision.

Because short-term stock options are excepted from these rules, straddle transactions in these options have become widely used since the enactment of ERTA.

Interest and carrying charges.—Under ERTA interest and carrying charges for purchasing or carrying commodity investments are required to be added to the basis of the commodity if it is part of a straddle. Hedging transactions also are excepted from the capitalization rule.

Hedging exception.—ERTA excepts hedging transactions from the mark-to-market, loss deferral and capitalization rules. Syndicates are not entitled to the hedging exemption. A requirement that hedging transactions be entered into in the normal course of the taxpayer's trade or business prevents persons otherwise entitled to the hedging exemption from relying on that exemption in connection with transactions whose motivation is the deferral or avoidance of tax liability. Taxpayers are attempting to structure transactions to qualify losses not entered into in the normal course of business as ordinary losses.

Characterization of Treasury bills.—Prior to ERTA gain and loss on certain governmental obligations (including Treasury bills) issued at a discount and payable at a fixed maturity date less than one year from issue date were treated as ordinary income and loss. Under ERTA such obligations are defined as capital assets and the discount on these obligations as ordinary income.

Dealer identification of securities held for investment.—Prior to ERTA dealers were required to identify securities held as investments within 30 days of the date of acquisition. ERTA requires identification of securities by the close of business on the date of acquisition. Floor specialists are allowed seven business days to designate stock for which they are registered specialists.

Sale or exchange of capital assets.—Prior to ERTA for gain or loss to be capital gain or loss, it must have resulted from the sale or exchange of a capital asset. ERTA provides that taxable dispositions of capital assets which are commodity-related property are treated as sales or exchanges.

Original issue discount obligations

Prior to TEFRA, holders of corporate bonds issued at a discount were required to include the total discount in income on a straight-line basis over the life of the bond and corporate issuers were permitted to deduct discount on the same basis. As amended by TEFRA, the original issue discount rules require the income inclusion and deduction at a constant interest rate, i.e., at a compound rate which parallels the manner in which interest would accrue on interest-paying nondiscount bonds. The original issue discount rules were also extended by TEFRA to cover noncorporate obligations other than those issued by individuals.

Stripped-coupon bonds.—Prior to TEFRA, some taxpayers took the position that a disposition of the corpus without the coupons with respect to coupon-bearing bonds resulted in income deferral by allocating the entire cost of the bond to the stripped corpus, producing an artificial loss. The stripped coupons in the hands of a purchaser became capital assets which, if disposed of prior to redemption, could result in capital gain. Under TEFRA, upon a disposition which separates ownership of the bond and the detached coupons, the stripped corpus and detached coupons are treated as obligations issued by a corporation on the date of disposition and are subject to the periodic income inclusion applicable to original issue discount bonds. The basis of the bond is allocated to the components, i.e., the corpus and each coupon, in accordance with their relative fair market values on the date of disposition.

Reorganizations.—Prior to the Technical Corrections Act of 1982, the original issue discount rules did not apply to obligations issued in a corporate reorganization. New obligations issued in exchange for a corporation's outstanding obligations in a recapitalization could provide for the deferral until maturity of payments exceeding both the issue price and the fair market value of the old obligations. Some issuers claimed deductions for interest accruals prior to payment without regard to the limitations applicable to the newly issued obligations under original issue discount rules. There was no taxable income to cash basis holders until maturity unless they disposed of the bonds earlier. This treatment would result in a substantial mismatching of the holder's income and the deduction under the claimed treatment by the issuer. The original issue discount rules were amended by the Technical Corrections Act to remove the exception for recapitalizations and other tax-free reorganizations.

Audit provisions

In 1982, new audit procedures were enacted for partnerships and S corporations. These provisions are effective for taxable years beginning after 1982. Under these provisions, the tax treatment of partnership and S corporation income, deductions, credits, etc. will be determined administratively and judicially in a single proceeding at the entity level. Partners and shareholders generally must be notified of the proceedings and may participate. The partners and shareholders are bound by the determinations and may not contest the determinations in separate proceedings.

Because these proceedings were not effective for years beginning before 1983, there is no experience as to the effect on tax shelters.

Penalties

Overvaluation penalty.—ERTA provided a graduated addition to tax applicable to certain income tax "valuation overstatements." The addition to tax applies to the extent of any underpayment of income tax attributable to such an overstatement, in the case of a taxpayer who is an individual, a closely held corporation, or a personal service corporation.

If there is a valuation overstatement, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	The applicable percentage is—
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The penalty may be waived if the valuation had a reasonable basis and was made in good faith. The penalty is effective for returns filed after December 31, 1981.

Addition to negligence and fraud penalties.—Prior to ERTA, an addition to tax, or penalty, with respect to certain tax underpayments due to negligence or civil fraud, was imposed. That penalty for negligence was 5 percent of any underpayment that is due to negligent or intentional disregard for rules and regulations. The penalty for fraud was 50 percent of any underpayment due to fraud.

ERTA imposed a nondeductible addition to tax equal to 50 percent of the interest attributable to that portion of an underpayment which is attributable to negligent or intentional disregard for rules or regulations. TEFRA added a similar addition to tax in the case of fraud.

Substantial understatement.—Under TEFRA, a penalty of 10 percent is imposed on any substantial understatement of income tax. For this purpose, an understatement is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. A substantial understatement of income tax exists if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year, or $5,000 ($10,000 for corporations other than S corporations and personal holding companies).

The amount of the understatement will be reduced by the portion of the understatement that is attributable to (1) the treatment of any item for which there is or was substantial authority, or (2) any item for which there was adequate disclosure of the relevant facts on the return. In the case of a tax shelter, the reduction when there is substantial authority will apply only to the portion which the taxpayer reasonably believed was more likely than not to be the correct treatment. The disclosure defense is not available in a tax shelter case. A tax shelter is defined as a transaction for which evasion or avoidance of income tax is the principal purpose.

The Secretary may waive all or a part of the penalty on a showing by the taxpayer that there was a reasonable basis for the understatement and the taxpayer acted in good faith. This penalty is in addition to all other penalties provided by law.

The penalty is effective with respect to returns which have a due date after 1982.

Penalty for promoting abusive tax shelters, etc.— Under TEFRA, a new civil penalty was imposed on persons who organize or sell any interest in a partnership or other entity, investment, plan or arrangement, when, in connection with such organization or sale, the person makes or furnishes either (1) a statement, which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit said to be available by reason of participating in the investment, or (2) a gross valuation overstatement as to a matter material to the entity which is more than 200 percent of the correct value.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith. This penalty is in addition to all other penalties provided for by law.

This provision took effect September 4, 1982.

Action to enjoin promoters of abusive tax shelters.— TEFRA permits the United States to seek injunctive relief against any person engaging in conduct subject to the penalty for organizing or selling abusive tax shelters. Venue for these actions generally is the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the promoter penalty.

This provision took effect September 4, 1982.

The IRS has been successful in obtaining two injunctions restraining the seller from promoting illegal trust schemes under these provisions.[8] Two more civil suits have been instituted by the government to enjoin the selling of certain tax shelters involving the leasing of master plates for stamps and the sale of a trust scheme.

[8] *U.S.* v. *Hutchinson,* 83-1 USTC ¶ 9322 (S.D. Cal.) (Apr. 6, 1983); *U.S.* v. *Buttorff,* 83-1 USTC ¶ 9342 (N.D. Tex.) (Apr. 13, 1983).

IV. TIME VALUE OF MONEY

From an economic viewpoint, the present value of a future expense or receipt is less than the face amount thereof. The treatment of the timing of income and deductions attributable to original issue discount is one area in which the income tax laws deal with the time value of money. Another is section 483 which imputes interest in a deferred-payment sales contract that has an unstated interest element. However, in many cases, a taxpayer is not required to take the time value of money into account in computing taxable income. Thus, by use of an advantageous accounting method, contractual arrangement, or other device, a taxpayer can obtain the economic equivalent of an interest-free loan from the Federal Government simply by currently deducting the full amount of a payment to be made in the future.

Time value concept

The present value (or cost) of a receipt or expense deferred one year is equal to the amount that will grow, at the prevailing interest rate, in one year to the face amount of the receipt or expense. The more distant a future expense or receipt, the lower its present value. For example, at an interest rate of 10 percent (compounded annually), the present value of $1 deferred one year is 90.9¢ (*i.e.*, 90.9¢ invested at a 10-percent interest rate will grow to $1 in one year). If the receipt of $1 were deferred two years at a 10-percent interest rate, the present value of the receipt would be 82.6¢ (the amount required today that will grow to $1 by the end of two years).[9]

Significance of accounting method

Taxpayers generally compute taxable income and file Federal income tax returns on an annual basis. In computing taxable income, most taxpayers use either the cash method of accounting or the accrual method of accounting. A taxpayer's choice of accounting method can affect the timing of both income and deductions.

Cash method of accounting.—Under the cash method of accounting, receipts are included in income for the year when the income is actually or constructively received, and expenditures are deducted for the year in which they are actually paid.[10]

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[9] Conversely, for any annual rate of interest, the future amount that will be exchangeable for any present value can be computed: at 10-percent simple interest, $1 received today will be worth $1.10 at the end of one year.

[10] A cash-basis taxpayer may be required to use the accrual method of accounting with respect to certain items of income or deduction. For example, if a cash-basis taxpayer acquires an original issue discount bond (where the issue price is less than the redemption price) the taxpayer would be required to accrue the daily portions of original issue discount during the period the bond is held (sec. 1232A). Also, section 461(g) requires a cash-basis taxpayer who prepays interest to treat the interest as paid in the year (or years) to which it is properly allocable.

Many tax-shelter promoters tout the availability of deductions for prepaid expenses (paid with borrowed funds). Some tax-shelter offerings rely on *Zaninovich* v. *Commissioner*, 616 F.2d 429 (9th Cir. 1980), as authority for deducting prepaid expenses that do not result in the creation of an asset having a useful life of more than one year. *Zaninovich* was recently cited with approval as authority for deducting prepaid rent by the Supreme Court in *Hillsboro National Bank* v. *Commissioner*, U.S.—(Mar. 7, 1983).[11] The Supreme Court's citation of *Zaninovich* provides some support for the position that the "one-year" rule adopted therein may be relied upon.

Taxpayers may argue that the rationale of *Zaninovich* applies to other types of expenses, such as prepaid breeding fees. Thus, cash-basis taxpayers may retain the ability to shelter other income by prepaying expenses (other than interest subject to section 461(g)). To deal with this problem, consideration may be given to extending the rule of section 461(g) to prepayments of items other than interest.

Accrual method of accounting.—Under the accrual method of accounting, income is included, and expenditures are deductible, for the taxable year when all events have occurred which fix the right to receive such income or establish the liability to pay such expenditures, and the amount thereof can be determined with reasonable accuracy.[12] In general, an accrual-basis taxpayer can deduct the face amount of an accrued expense if the "all events" test is met.

The "all events" test may not require that the taxpayer have a current liability, or that the ultimate recipient be known, in order to deduct an expense.[13] Thus, except for the "at-risk" rules (discussed in part III), present law may be inadequate to prevent a taxpayer from deducting accrued expenses with respect to which the taxpayer has no current liability.

Apart from the vagaries of the "all events" test, the accrual rules overstate the true cost of future expenses by failing to take the time value of money into account. An accrual-basis taxpayer in the 50-percent bracket can obtain a tax savings with a present value of $1 by taking a $2 current deduction for an expense to be paid in the future, notwithstanding the fact that the present value (or cost) of the future payment is less than $2, and the present value of reduction in future tax liability is less than $1.[14]

A requirement that taxpayers take the time value of money into account in computing deductions for accrued but unpaid expenditures would raise several unresolved issues: (1) what the appropri-

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[11] Although the *Hillsboro* case turned on the application of the tax benefit rule, in reaching its decision, the Supreme Court determined that a rental paid 30 days in advance was properly deducted under *Zaninovich*.

[12] In certain circumstances, an accrual-basis taxpayer is prevented from taking a current deduction for accrued expenses that are not paid within a specified time. For example, if an accrual-basis taxpayer fails to pay an accrued expense within 2-1/2 months after the close of its taxable year, and the amount accrued is payable to a related person who uses the cash method, then section 267 would disallow a deduction for the expense.

[13] Thus, in *Ohio River Colleries Co.* v. *Commissioner*, 77 T.C. 1369 (1981), the Tax Court held that the accrual-basis taxpayer could deduct the reasonably estimated costs of its obligation to reclaim strip-mined land during the mining operation, even though reclamation had not started and the taxpayer had no present liability to perform the work. The Treasury department has testified that they believe the case was incorrectly decided.

[14] To illustrate this point, consider that the taxpayer in this example could set aside 90.9¢ today at a 10-percent interest rate, and earn the $1 required to pay the deferred tax liability by the end of one year.

ate discount rate should be (*e.g.*, the interest rate offered by the local savings bank or the prime rate available to the most credit-worthy commercial borrowers), (2) how often taxpayers should be required to compound interest (*e.g.*, section 6622 requires all interest payable under the internal revenue laws to be compounded on a daily basis, while the bond market normally calculates yields to maturity by compounding on a semi-annual basis), (3) whether taxpayers should be able to agree within a range of interest rates where valuation of property or services are at issue, and (4) how should accrued income be treated.

The accrual rules could be amended to provide that an expense is not currently deductible unless the recipient of the payment is known and the taxpayer has a present liability to make the payment. Another alternative would be to require taxpayers to report certain deferred payment transactions using the cash method of accounting.

Accelerated cost recovery

In general, income taxes are paid on the basis of net (or taxable) income. In computing net income, deductions are allowed for ordinary and necessary expenditures incurred in a trade or business or for the production of income. However, capital expenditures (i.e., expenditures for assets with useful lives extending substantially beyond the close of the year) are not deductible in the year the expenditure is made. Under present law, capital costs generally are recovered under the Accelerated Cost Recovery System (ACRS).

ACRS is a system for recovering capital costs using accelerated methods over predetermined recovery periods. Congress intended ACRS to serve as an investment stimulus; thus, ACRS does not reflect only the annual loss in value of property (i.e., the true measure of a taxpayer's economic cost). Rather, ACRS concentrates larger deductions in the earlier years of the property's use and, thus, accelerates the return of the taxpayer's investment in the asset.

Under ACRS, the acceleration of cost recovery allowances results in net cash flows (i.e., economic income less tax on that income) that are larger in the early years of the property's use. Thus, because the cash flows are received earlier rather than later, the present value of the net income generated by the property will be greater than if the taxpayer were required to measure the income from the property by reference to the economic decline in the value of the property.

Deferred-payment contracts

Transactions in which payment for the purchase of property, rents, or services is deferred afford taxpayers the opportunity to reduce the present value (or cost) of the tax liabilities of the parties thereto.

Deferred-payment sales.—Under section 453, all sales of property (other than dealer sales of personal property) in which at least one payment is to be received by the seller after the close of the taxable year of the transaction must be reported under the installment method, unless the seller elects not to have that method apply.[15] Under the installment method, a seller of property postpones recognition of gain until the receipt of payments from the purchaser, recognizing the gain ratably as payments are received. The purpose of section 453 is to make it easier for installment sellers to pay their taxes by deferring gain recognition until cash is received. However, in view of the time-value of money, one of the effects of section 453 is to reduce the effective tax burden on taxpayers who receive deferred payments.

By way of example, if a seller (in the 50-percent bracket) sold a building, with an adjusted basis of $20,000, for $100,000 in cash, assuming no depreciation recapture, it would realize $80,000 of capital gain and owe a current tax of $16,000. By contrast, if the taxpayer received a $20,000 downpayment and an $80,000 note, payable at the rate of $20,000 a year in each of the succeeding four years, the taxpayer's current tax liability would be only $3,200 (*i.e.*, the tax on 80 percent of the $20,000 actually received). Thereafter, the installment seller would pay a $3,200 tax in each of the four succeeding years. The present value of the future tax liability will be less than the tax due from a cash sale. While the installment seller defers the recognition of gain, the buyer is entitled to a cost basis of $100,000, regardless of whether the building is paid for with cash or with a note. ACRS deductions based on the $100,000 purchase price may be used by the buyer to reduce its tax liability.

Deferred rents.—Under the accrual rules, an accrual-basis lessee can maximize the benefits of rental deductions by entering into a lease that provides for deferred rentals. The Internal Revenue Service (IRS) has ruled that an accrual-basis lessee can deduct deferred rentals on a straight-line basis, so long as the "all events" test is met. Rev. Rul. 70-119, 1970-1 C.B. 120. In Rev. Rul. 70-119, a 21-year lease of improved real property called for an annual ground rent plus an amount equal to six percent of the cost to the lessor of buildings on the land. The lessee was permitted to withhold portions of the stipulated rentals during the first three years of the lease; the rentals withheld were payable, in all events, ratably during the remaining 18 years of the lease term. The IRS ruled that, under the accrual rules, the rentals withheld by the taxpayer each year were deductible in the year in which they were accrued but withheld. Thus, if an accrual-basis lessee amortizes the aggregate rental on a straight-line basis, notwithstanding the deferral of a portion of the rentals, the tax deductions in the early years will shield other income (which can be put to other use). Similar issues arise in the context of accruing deductions currently for deferred fees.

Accounting for interest

Section 163(a) provides that there "shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." For section 163(a) to apply, assuming that there is a valid indebtedness of the taxpayer, the item sought to be deducted must be "interest" (as distinguished from other expenses), and the item must be "paid or accrued" within the taxable year.

[15] Installment sales of dealer property may qualify for installment treatment under section 453A.

Interest" is commonly defined as the amount charged for the use or forbearance of money.[16] There are several income-tax provisions dealing with the treatment of items that serve as payments for the use of money but are not labeled as interest, or which are not structured as a percentage of the principal amount due, as well as the timing of deductions for such items. However, because the scope of the statutory provisions that address the treatment of unconventional items of "interest" is not comprehensive, taxpayers have sought to structure financing arrangements to generate interest deductions that do not reflect the economics of the arrangement. Many of these arrangements attempt to combine the acceleration of interest deductions to the borrower with deferral of its inclusion in income to the lender, who typically is on the cash method. Thus, these schemes often involve a mismatching of deductions to one taxpayer and offsetting income to another.

Original issue discount

Original issue discount (OID) arises when a borrower receives less from the lender than the amount to be repaid to the lender. The difference between the amount received by the borrower and the amount to be repaid (*i.e.*, the OID) is functionally equivalent to an increase in the stated rate of interest, and is intended to compensate the lender for the use of money.[17] Under present law, the issuer of an OID bond (other than a natural person) is allowed deductions for the OID over the life of the bond.[18] Conversely, the holder of the bond is required to include in income the daily portions of OID determined for each day of the taxable year the bond is held.[19] The statutory provisions for the treatment of OID do not apply to an obligation issued in exchange for property unless the obligation is part of a publicly funded issue or the property for which it is exchanged is publicly traded stock or securities. They also do not apply to obligations issued for consideration other than cash or property transfers, such as the performance of services or the use of property.

The rules for amortizing OID parallel the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds.[20] The OID is allocated over the life of the bond through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary thereof). The adjustment to the issue price for each bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment to the issue price for any bond period is the amount of the OID allocated to that bond period.

[16] *See Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552 (1932).
[17] *See United States* v. *Midland-Ross Corporation*, 381 U.S. 54 (1965) (a case that arose under the 1939 Code).
[18] Sec. 163(e).
[19] Sec. 1232A.
[20] Under pre-TEFRA law, OID was computed on a straight-line basis over the life of the bond. Thus, the issuer of an OID bond was allowed larger deductions in the early years of a bond's term relative to deductions allowed issuers of interest-bearing nondiscount bonds.

Computing interest on deferred-payment sales

Under section 483, if a deferred-payment sales contract does not provide for interest (or calls for an unrealistically low rate of interest), a portion of the deferred payments must be treated as interest income rather than as part of the selling price. The unstated (or imputed) interest element of deferred payments is deductible as interest by the purchaser. Section 483 applies only to payments that are due more than six months after the date of sale, under a contract, with a selling price of more than $3,000, that provides for the payment of one or more installments more than one year from the date of sale.

If interest is provided for in a deferred-payment sales contract, section 483 would not apply unless the rate provided is less than the rate fixed by the Treasury Department, currently 9 percent simple interest. In determining whether the contract contains unstated interest, the present value (at the test rate) of all payments under the contract is required to be computed. If the total payments due more than six months after the date of sale exceeds the sum of the present value of such payments (including the stated interest payments), then interest will be imputed at the rate set by the Treasury, currently 10 percent compounded semi-annually. Once the amount of imputed interest is determined, certain general rules of accounting for interest come into play, including the limitations for investment interest (sec. 163(d)), interest to purchase or carry tax-exempt income (sec. 265(2)), and prepaid interest (sec. 461(g)).

Accounting for interest on installment obligations

The general rule for accounting for interest deductions had been thought to be that the interest deduction can be computed on a straight-line basis, although a different method (such as the "Rule of 78's," described below) is permissible if the underlying contract so provides.[21] This pro rata spreading, in some cases, may result in larger deductions in the early years of an obligation's life than would result if interest were charged in the contract and payable (as is normally the case) on a declining balance. However, on June 6, 1983, the IRS published a revenue ruling that requires interest to be accounted for on the basis of an economic accrual method (with an exception for short-term consumer loan transactions). Rev. Rul. 83-84, 1983-23 I.R.B. 12.

Rule of 78's.—The "Rule of 78's" represents a formula for allocating interest over the term of a loan. The calculation of interest under this rule is illustrated by the following example: In the case of a 30-year loan, interest would be calculated by obtaining the sum of the years (*i.e.*, 1+2+3+4...and so on up to 30), or 465. The debtor would then accrue 30/465 (or 6.45 percent) of the interest in

[21] In *James Brothers Coal Co.*, 41 T.C. 917 (1964), *appeal dismissed per stipulation*, (6th Cir. 1964), the taxpayer borrowed $164,683.61 from a bank for a period of three years, under an arrangement whereby the borrower's obligation to repay the principal sum and interest thereon of $27,172.99 -computed at 5-1/2 percent per annum for the entire three-year period -were evidenced by a single promissory note for $191,856.60, payable in 36 equal monthly installments of $5,329.35 each. The taxpayer accrued and deducted interest using the sum-of-the-month digits method (a variation of the Rule of 78's). However, the Tax Court held that the interest was deemed to accrue in equal installments over the entire period of the loan. *Accord, Lyndell E. Lay* v. *Commissioner*, 69 T.C. 421 (1977).

the first year, 29/465 (or 6.24%) in the second year, and so on down to 1/465 in the 30th year.

In recent years, the Rule of 78's has been used in tax-shelter schemes to generate extremely large interest deductions. Under one scheme, individual cash-basis taxpayers formed an accrual-basis partnership to buy real property at a price of $30,000. The partnership made a downpayment of only $10,000 and gave a mortgage of $20,000 for the balance of the purchase price. The loan documents stated that the partnership would be required to pay an "add-on" finance charge (*i.e.*, included in the face amount of the note) as computed under the Rule of 78's in case the mortgage were prepaid. Over the 30-year term, the finance charge was $620,155 (an average annual percentage rate of 16.44 percent) on the $20,000 balance. However, the only payments required in the early years of the loan were three $10,000 interest payments in years two, three, and four, ending with a balloon payment of the principal and all unpaid interest at the end of the 30-year term. The promoters of this scheme took the position that the general tax accounting rules permitted the accrual-basis partnership to accrue interest under the Rule of 78's and to pass through the deductions to its cash-basis partners. If this scheme were successful, the cash-basis partners would deduct a total of $40,000 of interest for the first year of the investment, the equivalent of a 200-percent annual interest rate on the unpaid loan balance.

Effect of Revenue Ruling 83-84.—Consistent with the present-law rules for computing OID (secs. 1232A and 163(e)), generally accepted accounting rules, and sound economic conceptions, in Rev. Rul. 83-84 the IRS ruled that the amount of interest attributed to the use of money for a period between payments must be determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of a loan is the amount borrowed, plus interest earned, minus amounts paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made, and is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the indebtedness for a given period. The concept of the true cost of the amount borrowed is referred to as the economic accrual of interest. The concept of economic accrual of interest is applied in the statutory provisions dealing with OID.

Rev. Rul. 83-84 holds that, in the case of a discount obligation, no deduction for interest will be allowed for any year in excess of the amount of the economic accrual of interest. Thus, for a cash-basis taxpayer, any interest paid on a loan in excess of the amount of interest that has economically accrued is not deductible in the year of payment. Similarly, in the case of an accrual-method taxpayer, no deduction will be allowed to the extent that the taxpayer's liability is for interest that does not economically accrue in the current year. Because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner (such as the Rule of 78's) fails to reflect the true cost of borrowing. Thus, an accrual-basis taxpayer can no longer deduct any additional interest attributable to the Rule of 78's computation.

Exception for short-term consumer loan transactions.—In Rev. Proc. 83-40, 1983-23 I.R.B. 22, a companion document to Rev. Rul. 83-84, the IRS provided an administrative exception to the requirement of economic accrual. This exception will apply only to consumer loans, if there is a self-amortizing loan that requires level payments, at regular intervals at least annually, over a period not in excess of five years (with no balloon payment at the end of the loan term), and if the loan agreement provides that interest is earned in accordance with the Rule of 78's.

Possible areas for Congressional consideration

For deferred payment obligations reflecting both stated and unstated interest exchanged for property, whether or not of a kind that is publicly traded, consideration could be given to requirement that both parties use the cash method unless they elect to apply the OID rules to a stated value for the property. In such a case, the portion of the deferred payment to be treated as unstated interest could be determined in accordance with section 483. This treatment, including elective-application of the OID rules, could be applied to obligations issued by natural persons. It could also be extended to obligations issued in exchange for services or for the use of property.

The section 483 imputed interest rules are inapplicable so long as a contract calls for at least 9 percent simple interest. When interest rates are high taxpayers can still disguise interest as part of the selling price so long as the 483 test rate is provided for. Consideration could be given to re-examining these rules.

Finally, regardless of the correctness of the requirement of economic accrual, the new IRS ruling relating to the computation of deductible interest may be challenged by taxpayers. A statutory mandate for the economic accrual of interest could remove any ambiguity.

V. DESCRIPTION OF SPECIFIC AREAS OF PRESENT LAW THAT PROVIDE THE BASIS FOR TAX SHELTERS

This part describes specific areas of present law that provide taxpayers with opportunities to obtain apparently unintended tax benefits, providing the basis for tax-shelter investments. The present-law rules discussed involve: (1) the use of partnerships to achieve tax results not otherwise available; (2) the use of generally available deductions to convert ordinary income to tax-favored income; (3) the overvaluation of property that is used to generate tax deductions; and (4) the use of foreign corporations to avoid the application of U.S. tax rules.

A. The Use Of Partnerships As Tax-Shelter Vehicles

In general

The form of entity most commonly used to maximize tax benefits in a tax shelter investment is a partnership. A partnership does not incur income tax liability; rather individual partners are taxed currently on their share of partnership income and deduct currently their share of partnership losses to the extent of the basis of their partnership interests.

An investor's initial basis in his partnership interest includes the amount he invests and his share, if any, of partnership liabilities. Treasury regulations generally provide that partnership liabilities are allocated in accordance with the partnership ratio for sharing losses. In the case of a limited partner, this amount is limited to any contribution which he may be required to make under the partnership agreement in excess of his original investment. However, where no partner is personally liable for repayment, i.e., nonrecourse liabilities, liabilities are allocated to all partners, including limited partners, in accordance with the ratio for sharing profits.

The allocation of partnership overall income or loss, as well as items of partnership income, loss, deduction or credit is generally determined by the partnership agreement if the allocation has a substantial economic effect. Otherwise, allocations are made in accordance with the partners' interests determined by taking into account all facts and circumstances.

The limited partnership is generally preferred over the general partnership for tax shelter investments because the limited partners, generally passive investors, have limited liability for the debts of or claims against the partnership and because limited partnership interests can be readily marketed. Commencing with the Tax Reform Act of 1976, the limitation of the deduction of losses to amounts for which the taxpayer is personally at risk has diminished this advantage for most activities. However, real estate activities are excepted from the "at risk" limitations and real estate tax shelter investments in the form of limited partnership interests continue to provide deductions for losses attributable to nonrecourse liabilities.

Allocation of income and loss

The requirement that the allocation of partnership income and loss under the partnership agreement must have substantial economic effect has been interpreted to permit the agreement to govern the allocation of deductions only if the partner to whom the allocation is made is liable to restore the amount deducted in the event that the amount deducted corresponds to an economic loss sustained by the partnership.[22] For example, if a partnerhsip acquires property at a cost of $100, allocates partnership losses to partner A, incurs losses of $50 wholly attributable to cost recovery deductions, the property is thereafter disposed of for $50 and the partnership is liquidated, the allocation to partner A of the partnership losses will be allowed only if he is required, except to the extent he has other funds invested in the partnership, to restore to the partnership the $50 deducted. This interpretation of the substantial economic effect requirement has been incorporated in proposed regulations recently issued by the Treasury Department.[23]

Where losses are attributable to nonrecourse liability, their allocation to any partner is without substantial economic effect since, by definition, no partner is liable to restore the amount deducted in the event that it reflects a true diminution in value which is realized upon disposition of partnership property. Only the creditor providing the nonrecourse loan is at risk and the creditor sustains the economic loss in such case. However, the basis of partnership property includes both recourse and nonrecourse indebtedness to acquire the property. Basis reductions attributable to cost recovery deductions may result in taxable gain when the property is disposed of, whether by sale, foreclosure, or other disposition, because the indebtedness, to the extent not previously amortized, is treated as an amount realized when discharged upon such disposition. Reductions in the loan through loan amortization payments are treated as payments of cash to the partners and may also produce taxable gain if they exceed the basis of the partner for his interest in the partnership.

The proposed regulations would allow an allocation of deductions attributable to nonrecourse liability provided the partners to whom such allocation is made are charged with any taxable gain from amortization of the indebtedness or its discharge upon disposition of the property. Since any special allocation of nonrecourse liability is without economic effect, this gain-chargeback rule, in order to comply with the requirements of the statute, must be considered to satisfy the requirement that the allocation accords with the partners' interests in the partnership. However, it excludes from consideration other facts and circumstances, particularly facts bearing on the economic sharing of profits and losses aside from tax consequences, which would be required to be considered in determining

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[22] This interpretation of what constitutes a substantial economic effect is based largely on the analysis in *Stanley C. Orrisch* 55 T.C. 395 (1970), aff'd *per curiam* AFTR 2d 73-1069 (9th Cir., 1974).

[23] 48 *Fed. Reg.* 9671 *et seq.* (March 9, 1983).

whether allocations not attributable to nonrecourse liability satisfy the statutory standard. It is understood that the Treasury Department may reconsider that portion of the proposed regulations dealing with nonrecourse liability.[24]

Item allocations.—Allocations of particular items of income and deduction may be provided for in the partnership agreement, as well as the allocation of overall partnership income or loss. As long as such item allocations are reflected as adjustments in a partner's investment, i.e., his capital account in the partnership, and upon liquidation of the partnership proceeds are distributed in accordance with the partners' capital accounts, the allocation may satisfy the economic effect requirement as interpreted by case law and the proposed regulations. This requirement is largely mechanical and does not preclude a partnership with, for example, $100 of net income exclusive of cost recovery deductions and $100 of cost recovery deductions, from allocating the income to partner A and the cost recovery deductions to partner B although the partnership overall has no taxable income or loss, provided the economic effect of such allocations is substantial in relation to their tax effect. The result is an assignment of income and losses between partners not permitted elsewhere in the tax law.

It has been suggested that the partnership rules should be revised to permit allocations of only overall partnership income or loss. Alternatively, special allocations of items of income or deduction could be restricted to preclude the allowance of losses not economically sustained by the partnership.

Capitalization of organization and syndication fees.—Amounts expended to organize a partnership or promote the sale of partnership interests, subject to an election to amortize certain organizational expenses, are not deductible. Denial of the current deduction of such costs was made explicit in the partnership provisions of the Tax Reform Act of 1976. However, if the organizer or syndicator is also a general partner, allocation of partnership gross income to such person may produce the same result as a deduction to the other partners for organizational and syndication fees paid to such person. The capitalization requirement for other types of expense can be avoided as well by this technique. Generally, if amounts are paid or payable to a partner when he engages in a transaction with the partnership in a capacity other than as a member of the partnership or if guaranteed payments are made to a partner for services, such payments are required to be capitalized to the same

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[24] The application of the proposed regulations to nonrecourse liabilities has been criticized as offering a vehicle for the transfer of tax benefits similar to safe harbor leasing. Comments of the Commtitee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983) at pp. 32-38. It has also been suggested that a gain-chargeback provision will not satisfy the statutory requirements as applied to nonrecourse liability and that the allocation of tax benefits must be compared to economic benefits calculated without regard to tax benefits in order to determine the validity of the allocation. Krane and Sheffield, "*Beyond Orrisch: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved*". 60 *Taxes* 937 (1982); American Law Institute Federal Income Tax Project, Subchapter K, Tentative Draft No. 3, p. 115 *et seq.* (1979). On the other hand, it is contended that the proposed regulations insofar as they relate to the treatment of losses attributable to nonrecourse debt, are a valid and appropriate interpretation of present law. However, the proponents of this view also suggest that certain additional restrictions could be added to provide a safe-harbor rule for nonrecourse deductions. Memorandum dated May 24, 1983 from ad hoc committee of tax lawyers to the Assistant Secretary for Tax Policy on proposed regulations relating to nonrecourse liability dated May 24, 1983.

extent as comparable payments to a party who is not a partner. The payments described would be subject to the capitalization requirement only if they are guaranteed payments since the payee receives payment in his capacity as a partner. However, guaranteed payments are defined to include only those which are made without regard to partnership income. Where a partnership payment is based on partnership gross income, the partnership provisions have been construed to characterize the payment as a special allocation of partnership income. *Edward T. Pratt*, 64 T.C. 203 (1975), *aff'd*, 550 F. 2d 1023 (5th Cir., 1977). The effect is to avoid the requirement that certain expenses be capitalized by characterizing them as allocations of partnership gross income and thus excluding them from the income of the partners on whose behalf the expenses are incurred.

If the definition of guaranteed payments included only those determined with regard to partnership net income, payments which require only that the partnership have sufficient gross income could be characterized as guaranteed payments and made subject to the capitalization requirement. Another approach, which would eliminate the possibility that this technique could be employed with net income allocations, would be to amend section 707(a) to cover all organizations and syndication services performed by partners.

Like-kind exchange treatment of partnership interests.—Property held for productive use in a trade or business or for investment may be exchanged tax-free for property of like kind but this treatment does not apply if the property exchanged consists of inventory, stocks, securities, choses in action or other evidences of indebtedness or interest. It is unclear whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service has ruled that the exception for interests in financial enterprises applies to partnership interests and thus they do not qualify as like-kind property that may be exchanged tax-free. Rev. Rul. 78-135, 1978-1 C.B. 256. Court decisions have held that exchanges of partnership interests may qualify for tax-free treatment as like-kind property where the underlying assets of the partnerships are substantially similar in nature. *Estate of Rollin E. Meyer, Sr.* 58 T.C. 311 (1972); *Gulfstream Land and Development Co.* 71 T.C. 587 (1979). However, it was also held that an exchange of a general partnership interest for a limited partnership interest does not satisfy the like-kind requirement. *Estate of Meyer, supra, aff'd, per curiam* 503 F. 2d 566 (9th Cir., 1974).

Special considerations may apply in determining whether like-kind exchange treatment should be available to facilitate the exchange of partnership interests in tax shelter investments for interests in other partnerships. Under certain circumstances, taxation of the gain inherent in a partnership interest in a "burned out" tax shelter, i.e., one with substantial outstanding liability which has been reflected in prior tax losses without reducing the indebtedness, may be avoided if the interest may be exchanged tax-free for an interest in another partnership.

Retroactive allocations and tiered partnerships.—The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from deducting partnership expenses incurred prior to his entry into the partnership, so-called "retroactive allocations" of partnership losses. Some taxpayers take the position that, in applying this restriction, partnership income and losses are considered to pass through to partners until the close of the partnership's taxable year and that if an investor, rather than acquiring an interest in the operating partnership which sustained the loss, acquires an interest in a second partnership which in turn is a partner in the operating partnership, there is no retroactive allocation because the operating partnership's loss does not pass through to the second partnership until the close of the second partnership's taxable year, i.e., until after the investor has acquired his interest. The Internal Revenue Service has taken the position that losses are sustained by the second partnership in this case at the same time they are sustained by the operating partnership and that the limitation against retroactive allocations is equally applicable whether an investor acquires his interest in an operating partnership directly or through a second partnership. Rev. Rul. 77-311, 1977-2 C.B. 218.

The partnership provisions could be clarified to adopt expressly the Internal Revenue Service's interpretation.

B. Conversion of Ordinary Income to Tax-favored Income

Interest deduction

The availability of a deduction for interest under the general rule of section 163(a) has proved to be a fertile source for arrangements to convert ordinary income to tax-favored income.

Deferred-payment sales.—Notwithstanding Rev. Rul. 83-84, 1983-23 I.R.B. 22 (applying the concept of economic accrual of interest), transactions involving deferred-payment contracts continue to afford accrual-basis taxpayers the opportunity to claim huge current deductions for interest where the cash basis creditor defers the inclusion in income. For example, deferred payments sales can be used in tax-shelter schemes to generate deductions for accrued but unpaid interest.[25] In one scheme, an accrual-basis purchaser acquires non-depreciable property with a low value relative to the nominal amount of the deferred obligation (which could be nonrecourse), and claims deductions for the "discount" under the general rule for the deduction of interest (sec. 163(a)). In this case, no interest would be taxable to a cash-basis seller until payment. Thus, even though no deduction will be allowed for excess interest that does not economically accrue (under Rev. Rul. 83-84), the purchaser would be able to take current deductions for economically accrued amounts that are not includible in the seller's income. If the purchaser has received the property's full value, the obligation may never be paid. If all or some of the deferred obligation is later paid, the seller could also claim that the face amount of the obligation equalled the value of the property and no discount was present.

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[25] If nonpublicly traded property is acquired for a non-traded obligation that provides for deferred interest payments, or if the issuer of the deferred-payment obligation is an individual, the rules requiring the accrual of original issue discount would not apply. Further, the parties to the transaction could avoid the imputation of interest by providing for 9 percent simple interest.

The use of deferred-payment sales to generate excessive interest deductions could be prevented by one of several proposals. As already suggested (Part IV, Supra), both the seller and the purchaser could be required to use the cash method of accounting with respect to deferred payments, with section 483 determining the extent to which such payments are treated as interest. However, the parties could elect to agree to the value of the property (within an acceptable range of discount rates) and accrue OID under the general rules of sections 1232A and 163(e). Absent the election, no deductions for OID would be permitted. As indicated, this proposal could be applied to individual purchasers if the elective OID treatment were extended to obligations issued by individuals and further the proposal could apply to obligations issued for services or for the use of property.

Interest incurred on indebtedness borrowed to finance the purchase of market-discount bonds.—Market discount arises as the result of a decline in the value of an obligation after it has been issued (because, for example, of an increase in prevailing interest rates or a change in the issuer's credit rating). Under present law, upon maturity of a bond that was purchased at a market discount, the difference between the face amount of the bond and the price paid for the bond is taxable at the favorable capital gains rate (sec. 1232). When a taxpayer borrows the funds used to purchase a market-discount bond it can deduct the interest on the acquisition indebtedness against ordinary income, even though the income eventually generated by the financed investment is taxed as capital gains.

There are several options that would prevent the use of market-discount bonds to achieve deferral of tax liability and rate conversion. One option is to extend original-issue-discount treatment to market-discount bonds (*i.e.*, to require accrual of the daily portions of market discount during the period the bond is held). To simplify the computation of the amount of market discount to be included in income, taxpayers could be permitted to use a straight-line computation, rather than the constant -interest method. Since discount is the economic equivalent of interest, extension of the OID rules to cover market discount on bonds issued in the future may be appropriate, regardless of whether the acquisition of the bond is financed by interest bearing obligations. This rule currently applies to short-term Treasury bills. Inclusion of market discount over the life of the bond would be in accordance with the present law treatment of bond premium, which is amortized against the interest due on the bond, in order not to produce a capital loss on maturity of the bond. Alternatively, leveraged purchases of market discount bonds could be discouraged by requiring taxpayers to capitalize the interest on the amount borrowed to finance the purchase or on the debt collateralized with the bond.

Interest incurred by a corporation to finance the purchase or carrying of stock.—Under present law, a corporate shareholder generally can deduct 85 percent of dividends received from other corporations (sec. 243). Because the maximum rate of tax on corporate income is 46 percent, the maximum (effective) rate of tax on dividends received by a corporation is only 6.9 percent. Thus, when a corporation takes interest deductions against ordinary income, and the interest is attributable to indebtedness incurred to purchase stock, the corporation effectively converts ordinary income to tax-favored income.

A corporation that borrows to purchase stock is in a situation similar to that of a taxpayer who borrows to purchase a tax-exempt security. Under present law, for a taxpayer who borrows to purchase a tax-exempt security, a tracing concept is employed and no deduction is allowed for interest on indebtedness incurred or continued to carry the tax-exempt security (sec. 265(2)). A similar rule could be applied to a corporation that borrows to finance purchases of portfolio stock.

Transactions in mutual fund shares

Distributions by a regulated investment company (commonly called a mutual fund) from long-term capital gain may be treated as long-term capital gain to its shareholders (*i.e.*, the character of the capital gain is flowed through to the shareholders), regardless of whether a shareholder has held the mutual fund for over one year (the long-term capital gain holding period. After the distribution of a capital-gain dividend, the market value of a mutual fund's shares usually decreases by approximately the amount of the capital-gain dividend. Thus, absent an applicable statutory provision, a taxpayer could convert short-term gain to long-term gain by purchasing mutual fund shares just before a capital-gain dividend becomes payable, and then, immediately after the receipt of the dividend, selling the shares (realizing a short-term capital loss which is deductible against short-term capital gain).

Under a special rule, if mutual fund shares are sold at a loss after a capital-gain dividend date, and the shares were held for less than 31 days, then the loss is treated as a long-term capital loss to the extent of the capital-gain dividend on the shares (sec. 852(b)(4)). However, a taxpayer can avoid the application of this rule simply by holding mutual fund shares for 31 days or more. Thus, taxpayers retain the ability to engage in transactions in mutual fund shares as a device to achieve conversion.

In order to restrict a taxpayer's ability to use mutual fund shares in the manner described above, the applicable statute could be revised to permit short-term loss treatment only if the stock is held by the taxpayer at the close of the taxable year in which the capital-gain dividend is paid, or the taxpayer has held the shares for six months.

Mutual funds which accumulate earnings

Certain mutual funds, sometimes called tax-managed funds, rather than paying dividends currently, accumulate the dividend income derived from their portfolio stock. While such funds are taxable, they are eligible for the 85-percent dividend-received deduction, thus paying a corporate tax at a maximum rate of 6.9 percent (.15 x 46%) while increasing the fund net asset value. Shareholders who satisfy the 1-year long-term capital gain holding period before disposing of their stock in such a fund can realize the earnings from their investment at a maximum tax rate of 20 percent.

Present law imposes an accumulated earnings tax on corporations formed or availed of to avoid the tax on their shareholders by accumulating rather than distributing their earnings. The funds which accumulate earnings rely on the position, supported by some case law, that the accumulated earnings tax only applies to closely held corporations. The Internal Revenue Service has ruled to the contrary. Rev. Rul. 77-399, 1977-2 C.B. 200. Present law could be amended to provide explicitly for the application of the accumulated earnings tax to these funds.

Expenses for the production of income

Section 212 allows as a deduction all ordinary and necessary expenses paid or incurred for the management, conservation, or maintenance of property held for the production of income. Expenses are deductible under section 212, even if the related property produces no current income.[26]

Short sale of stock that is about to go ex dividend.—In a "short sale" of stock, the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property. Section 1233 contains several rules that operate to prevent the use of short sales to convert short-term capital gains to long-term capital gains. However, under present law it is still possible to use a short sale to convert ordinary income to short-term gains. This conversion permits a taxpayer to utilize capital losses that cannot be deducted against ordinary income except, to a limited extent, in the case of noncorporate taxpayers. It further may allow the taxpayer to convert the short-term capital gains to long-term capital gains by use of mutual fund transactions, described above.

The IRS has ruled that amounts paid with respect to cash dividends on stock borrowed to cover a short sale are allowable as deductions under section 212. Rev. Rul. 62-42, 1962-1 C.B. 133. Thus, a taxpayer can enter into a short sale of stock that is about to go *ex dividend*, and deduct the amount paid in lieu of dividends against ordinary income. After the dividend is paid (and, as a result, the market value of the stock has decreased), the taxpayer can close the short sale by purchasing identical shares (at the lower value), realizing a short-term capital gain. This transaction is particularly used where relatively large dividends are to be paid. This device could be prevented by requiring the seller to capitalize the payment made in-lieu-of-the-dividend to the lender.

C. Overvaluation of Property

Charitable contributions of precious gems, etc.

Present law (sec. 170) allows a deduction subject to certain limitations, for charitable contributions made within the taxable year. If a charitable contribution is made in property other than money, the amount of the contribution is generally the fair market value of the property at the time of the contribution.[27] Treasury regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller,

[26] *Herschel H. Hoopergarner*, 80 T.C. No. 26 (1983).

[27] See Treas. Reg. sec. 1.170A-1(c). Most other tax deductions are either limited to the basis of property (e.g., losses under sec. 165), or gain is recognized when appreciated property is used to pay a deductible expense.

neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[28]

In general, a taxpayer may not deduct that portion of fair market value which would not have qualified as long-term capital gain had the property been sold at the date of the contribution. Thus, a taxpayer must generally hold property for at least 1 year in order to deduct the full appreciated value of the property.[29]

Tax shelter opportunities.—Because the value of donated property is frequently subjective, charitable contributions may be an attractive form of tax shelter. This is particularly true for donations of artistic or literary property.[30] For example, assume that an individual purchases a work of art for $10,000, but is able to have the art appraised, a year or more later, at a value of $50,000. By donating the art to a museum, the individual may claim a $50,000 tax deduction. Assuming that the individual is in a 50 percent tax bracket, this deduction is worth $25,000, or 250 percent of the original purchase price.

One popular tax shelter[31] involves the purchase of precious gems for donation to a museum. In a typical transaction, an individual purchases gems from a promoter at a nominally "wholesale" price. The promoter represents that the gems, at the time of donation, will have an appraised value substantially in excess of the purchase price. In certain cases, the gems are subjected to chemical treatments which allegedly increase their value. After holding the gems for at least 1 year, the taxpayer donates them to a museum, claiming a deduction based on an expert appraisal of the value of the gems.[32] This value is frequently 5 or more times the price the individual actually paid for the gems. Thus, a 50-percent bracket taxpayer may receive a tax benefit 2 or 3 times the initial investment. Congress may wish to consider lengthening the holding period to obtain a fair market value deduction for contributions of property of this type.

Determination of fair market value.—To provide an attractive tax shelter, donated property (including precious gems) must be appraised at a value significantly in excess of the purchase price. The validity of these appraisals, in turn, depends, in part, upon the applicable definition of fair market value.

The courts have generally held that fair market value is the publicly available retail price in the relevant market.[33] For example,

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[28] For contributions of inventory-type property, fair market value is the price which the taxpayer would have received if he had sold the property in the ordinary course of business. Treas. Reg. sec. 1.170A-1(c)(2).

[29] Sec. 170(e)(1)(A).

[30] Under the Tax Reform Act of 1976, donations of artistic or literary property by the creator of the property are denied favorable tax treatment. However, the owners of such property (other than the creator and persons whose basis in the property is determined by reference to the creator's basis) may receive a deduction for the full value of the property.

[31] *See* Wash. Post, March 29, 1983, p. A-1; March 30, 1983, p. A-1; and April 15, 1983, p. A-1 (concerning donations to the Smithsonian Institution).

[32] In certain cases, the promoter has provided an appraisal as part of the original transaction. *See, e.g., Anselmo v. Commisioner*, 80 T.C. No. 46 (May 12, 1983).

[33] Treasury Regulations under the estate and gift taxes state that fair market value is the price of an item in the market in which that item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Treas. Reg. sec. 20.2031-1(b) (estate tax); sec. 25.2512-1 (gift tax). These regulations are not binding for charitable contribution cases. However, they appear to state the general rule applicable in those cases. *See Anselmo v. Commisioner*, 80 T.C. No. 46 (May 12, 1983).

in *Goldman v. Commissioner*, 388 F. 2d 476 (6th Cir. 1967), *aff'g* 46 T.C. 136 (1966), the court held that the value of donated books should be computed based on the price that an ultimate consumer would pay, rather than a dealer buying to resell. However, the courts have held that the determination of fair market value must be based on the facts of the particular case.

In Rev. Proc. 66-49, 1966-2 C.B. 1257, the Internal Revenue Service provided guidelines for appraisals of contributed property for charitable deduction purposes. The revenue procedure stated that all factors bearing on the value of donated property are relevant including, where pertinent, the cost or selling price of the item, sales of comparable properties, cost of reproduction, opinion evidence and appraisals. The revenue procedure stated further that appraisals and other opinion evidence will be given appropriate weight only when supported by facts having strong probative value.

Rev. Rul. 80-69, 1980-1 C.B. 55, stated that the best evidence of the fair market value of an assortment of gems was the price at which a taxpayer bought the gems from the tax shelter promoter. The ruling involved a taxpayer who purchased an assortment of gems from a promoter for a price of 500x dollars. The promoter asserted that the price was wholesale, although the promoter and other dealers engaged in numerous sales at similar prices with other individuals who were not dealers in gems. The taxpayer contributed the gems to a museum 13 months after purchase and claimed a charitable contributions deduction of 1500x dollars. According to the ruling, the best evidence of fair market value depends on actual transactions and not on an artificially calculated estimate of value.[34]

In *Anselmo v. Commissioner*, 80 T.C. No. 46 (May 12, 1983), the Tax Court held that the fair market value of unset gems was the price that would have been paid by a jewelry store to a wholesaler to obtain comparable items. The case involved a taxpayer who donated some 461 colored gems to the Smithsonian Institution approximately 9 months after purchasing them.[35] The taxpayer claimed a charitable contribution deduction in an amount ($80,680) more than 5 times the purchase price ($15,000). The appraised value of the gems was based on the retail prices charged by jewelry stores for jewelry containing similar gems. The taxpayer purchased the gems from a promoter which promised to obtain appraisals of 5 times the purchase price as part of the contract of sale.

The court held that the ultimate consumers of gems like those contributed were the jewelers who set the gems into finished items of jewelry. Accordingly, the effective retail market for the gems (as opposed to the finished jewelry) was the market for sale to the jewelers. Based on these holdings, the court determined the fair market value of the gems as $16,800 (approximately 10 percent more than the purchase price). The charitable contribution deduction in this case was claimed before the ERTA overvaluation penalty became effective.

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[34] In another 1980 ruling, the Service stated that the best evidence of the value of Bibles donated to charities was the price at which similar quantities of Bibles were actually sold in arm's length transactions. Rev. Rul. 80-233, 1980-2 C.B. 69.

[35] Under the then applicable rules, property held for 9 months qualified for long-term capital gains treatment.

Enforcement and administration.—The Internal Revenue Service has had success in *Anselmo*, and in several art donation cases,[36] in challenging charitable deductions. However, the effort to limit charitable deduction and other tax shelters presents problems of enforcement and administration. One of these problems arises from the volume of these cases. According to the Internal Revenue Service, 2,895 returns relating to charitable contribution deductions were under examination at the end of May, 1983.

A further problem arises in detecting excessive charitable deductions at the administrative level. The Art Advisory Panel of the Internal Revenue Service, composed of 12 outside art experts, has helped the Service to detect excessive valuations in the art donation area. In the last 8 years, the panel has recommended approximately $24 million in reductions out of $141 million of appraised contributions.[37] The Service has also initiated a special audit program to combat charitable contribution tax shelters. However, it is not possible to detect all or even most instances of excessive deductions. Because of the subjective nature of valuation, taxpayers may continue to play the "audit lottery" and claim excessive charitable deductions.

Nonrecourse seller-financed property

Another area in which the valuation of property can provide the basis for a tax shelter involves purchase-money nonrecourse loans to acquire depreciable property where the seller, or a party related to the seller, is the creditor.

The parties may try to inflate the purchase price, since a higher price benefits the purchaser by reason of larger tax deductions (for depreciation or accrued interest). Because the purchaser is not personally obligated to repay the loan, the higher price, in many situations, will not be detrimental to the buyer, since the property may be simply repossessed by the seller after the buyer has benefitted from the tax deferral.[38] The higher price may economically benefit the seller, but cannot be to its economic detriment and may not increase the seller's tax liability where the seller is not taxable or where it uses installment reporting and no payments are received.

If the nonrecourse indebtedness unreasonably exceeds the fair market value of the property acquired with the indebtedness, the courts have found that the "loan" is not a genuine debt and have denied depreciation and/or interest deductions to the "purchaser."[39] However, the taxpayer may take the position that the transaction is a purchase with bona fide nonrecourse debt. The IRS must then contest the valuation.

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[36] *See, e.g., Farber v. Commissioner*, 33 T.C.M. 673 (1974), *aff'd* 76-1 USTC par. 9118 (2d Cir. 1976) ($150,000 deduction reduced to $10,000); *Vander Hook v. Commissioner*, 36 T.C.M. 1394 (1977) ($12,000 deduction reduced to $1,200).

[37] N.Y. Times, May 2, 1983, p. D–1.

[38] The obligation discharged on the repossession will be an amount realized from disposing of the property regardless of its value and generally will result in taxable gain to the taxpayer, some of which may be recaptured as ordinary income. *Commissioner v. Tufts* 461 U.S.—(May 2, 1983). See partnership discussion infra.

[39] *See e.g., Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976), *affg*, 64 T.C. 752 (1975); *Odend'hal* v. *Commissioner*, 80 T.C. 588, 604 (1983); *Hager* v. *Commissioner*, 76 T.C. 759, 788 (1981); *Narver* v. *Commissioner*, 75 T.C. 53 (1980), *affd, per curiam* 670 F.2d 855 (9th Cir. 1982); *Beck* v. *Commissioner*, 74 T.C. 1534 (1980), *affd*, 678 F.2d 818 (9th Cir. 1982); *Oden* v. *Commissioner*, 80 T.C. 588 (1983).

The at-risk rules, which were first enacted in 1976, and expanded to apply to all activities other than real estate for taxable years beginning after 1978, reduce this problem for non-real-estate activities. (See Part III above.)

Investment tax credit pass-through

Under present law, a lessor of property eligible for the investment tax credit may elect to allow the lessee to claim the credit (sec. 48(d)). The lessee's credit is based on the fair market value of the property. In certain instances, lessors have acquired property at an inflated price using seller nonrecourse financing or seller recourse financing by a corporation with little net worth and then leased the property to an investor who claims the credit based on an inflated purchase price. It is uncertain whether the at-risk rules apply where the lessor is not a closely held corporation or is a thinly capitalized corporation with "recourse" debt and passes the credit through to an individual. Although the taxpayer may, in fact, not be entitled to the full investment credit claimed, the question of the value of the property may need to be litigated. Congress may desire to apply the at-risk rules specifically to the lessee in the case of certain "pass-through" leases.

D. The Use of Foreign Corporations

Under present law, taxpayers can defer (and thereby minimize) U.S. tax on earnings derived through a foreign corporation until the earnings are distributed as dividends or the taxpayer disposes of the shares in the corporation. The advantage of using a foreign corporation to defer U.S. tax is enhanced when the corporation is organized in a tax-haven country that imposes little or no tax on the corporation's earnings. In recent years, U.S. investment firms have organized foreign corporations not only as a means of deferring U.S. tax liability, but also to circumvent the application of recent tax reforms.

"Mark to market" rule applicable to commodity futures

The Economic Recovery Tax Act of 1981 (ERTA) contained a provision that effectively taxes net gains from regulated futures contracts at a 32-percent maximum rate (by treating gains and losses as 60-percent long-term and 40-percent short-term capital gains and losses). This treatment applies to positions open at the end of the taxable year as well as those closed during the year.

In one scheme, investors are offered stock in a foreign corporation that trades in commodities futures on U.S. exchanges through an offshore subsidiary. The corporations are insulated from U.S. taxation by incorporating offshore and, although potentially liable for tax on U.S. source accumulated earnings, seek to escape that tax through distributions from the subsidiary to the parent corporation in whose hands the earnings become nontaxable foreign-source dividends. The deal is structured so that the investors will not be subject to tax until they dispose of their stock and then, if the long-term capital gain holding period requirements are satisfied, will pay tax at a maximum capital gain tax rate of only 20 percent. If successful, this scheme results not only in deferral of tax, but in taxation of gain from futures trading at a maximum 20-percent rate, rather than the 32 percent rate that Congress prescribed in 1981 for taxpayers who engage in such futures trading directly. The plan is also intended to avoid the present law treatment of gain that results from the disposition of the stock of certain foreign investment companies. Under the foreign investment company rules, gain attributable to untaxed corporate earnings is taxed as ordinary income, but this ordinary income treatment is not applied to corporations trading in commodities.

The straddle rules

Under another provision of ERTA, the deduction of a taxpayer's losses from straddled investments is deferred to the extent that the taxpayer has unrecognized gains in offsetting positions.

Under one offering, U.S. investors may invest in stock in an offshore corporation that enters into forward contracts in U.S. Government guaranteed debt instruments, such as GNMA certificates. The U.S. investors enter into offsetting positions in their individual capacities. The offshore corporation does not pay U.S. tax on its gains and the U.S. investors are not required to defer the deduction of losses on their individually held positions notwithstanding unrealized gain in their stock. Direct investment in both legs of this type of straddle would result in deferral of the deduction of loss until the gain was recognized. Under the tax shelter investment the result is that losses are deducted and gain is deferred. This offering is a deliberate effort to exploit the exclusion of corporate stock from the restrictions of the 1981 straddles legislation.

H.R. 3096.—A bill (H.R. 3096) was introduced in the House this year by Congressman Stark in order to prevent certain abuses involving tax straddles and to prevent the avoidance of the accumulated earnings tax through the use of foreign corporations. Under the bill, a foreign corporation that engages primarily in trading in commodities or interests in commodities, and which is at least 50-percent owned (directly or indirectly) by U.S. persons, will be treated as a foreign investment company. Thus, on the disposition of shares in such a corporation, gain attributable to previously untaxed earnings will be treated as ordinary income subject to tax at regular tax rates of up to 50 percent (rather than the lower capital gains rate).

The bill contains a new source-of-income rule, applicable solely for purposes of the accumulated earnings tax. Under this provision, if more than 10 percent of a foreign corporation's earnings and profits is derived from U.S. sources (or is effectively connected with a U.S. trade or business), then any dividends distributed from such a corporation (directly or through one or more other entities) to a "U.S. owned foreign corporation" will be treated as from U.S. sources. For purposes of this provision, the term "U.S. owned foreign corporation" is defined as any foreign corporation 50 percent or more of the stock of which is owned (directly or indirectly) by U.S. persons. Under this provision, it will no longer be possible to avoid the accumulated earnings tax by interposing a holding company between U.S. shareholders and a foreign corporation that earns significant U.S.-source income.

The bill also would provide for a limited category of stock that will be treated as an offsetting position for purposes of the loss deferral rules of current law. Under this provision, "offsetting position stock" is included in the definition of property that is subject to the straddle rules. The term "offsetting position stock" is defined as any stock of a corporation formed or availed of to take positions in personal property that offset positions taken by such corporation's shareholders.

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