OVERVIEW OF TAX SHELTERS

PREPARED FOR THE USE OF THE COMMITTEE ON WAYS AND MEANS

By the staff of the Joint Committee on Internal Revenue Taxation

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OVERVIEW OF TAX SHELTERS

General

Over the last several years, there has been a great deal of concern about high income individuals who are able to eliminate or substantially reduce their tax liability through the use of various tax preferences. Congress reviewed this problem in 1969, and the Tax Reform Act of that year contained many provisions to deal with these preferences, either directly or indirectly. Also, the Congress enacted a minimum tax which was intended to cover those situations where Congress believed a tax preference should be allowed, to serve as an incentive for particular kinds of investment, but also believed that it was not desirable to allow taxpayers to cumulate those preferences to such an extent that the taxpayer might escape tax altogether.

Since 1969, however, there has been a substantial growth in the promotion of investments which are advertised as "tax shelters." Although these take a great variety of forms, in general, they all allow taxpayers to offset certain "artificial losses" (that is, noneconomic losses but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the taxpayer's other income, usually from his regular business or professional activity. A major purpose of these investments for most taxpayers is to reduce the tax liability on their regular income.

There are several elements that make up a tax shelter investment (though not all of these elements are found in all shelters). The first is the "deferral" concept where deductions are accelerated in order to reduce the tax liability of an individual in the early years of the transaction instead of matching the deductions against the income which is eventually generated from the investment. This deferral of tax liability from earlier years to future years, in effect, results in an interest-free loan by the Federal Government, repayable when, and as, the investment either produces net taxable income, is sold or is otherwise disposed of.

The second element of a tax shelter is "leverage" whereby a taxpayer maximizes his tax benefits, as well as his economic situation, by using borrowed funds in his investments to pay the expenses for which accelerated deductions are received. The individual's position is enhanced when the borrowing is on a nonrecourse basis, which means that he is not personally liable to repay the loan, but his personal investment risk is limited to his equity investment. Limited partnerships generally are used in tax shelter investments so that the taxpayer can invest as a limited partner with no liability other than the amount of equity that he has advanced from his own funds.

In addition, a third tax shelter element for many investments is "conversion" of ordinary income to capital gains at the time of a subsequent sale or other disposition of the asset. Conversion occurs when the
portion of the gain which reflects the accelerated deductions taken against ordinary income is taxed as capital gains. (Also, if the taxpayer is in a lower income tax bracket in the later years, he effectively "converts" the tax rate too.)

The following discussion deals generally with tax shelter investments as an overview to the whole area. The analysis of each activity (such as, real estate, farming, oil and gas, equipment leasing, movies, etc.) will be dealt with more specifically in subsequent pamphlets. This discussion will cover the elements of a tax shelter and the entities used for such investments, highlight the revisions in the Tax Reform Act of 1969 which related to tax shelters, briefly describe the economic problems involved, and describe several alternative approaches that the committee may want to consider to deal with tax shelters (which also will be discussed more specifically in the subsequent pamphlets).

**Elements of a tax shelter investment**

**Deferral**

Deferral commonly arises in situations where taxpayers make investments in activities or businesses which use the cash basis method of accounting and are permitted to take certain deductions (such as cattle feed or vineyard development costs) for tax writeoffs in the first year and the other early years of the shelter investment before the investment produces any income. Deferral also occurs where taxpayers are permitted to accelerate certain deductions (such as depreciation) to the early years of an investment transaction.

The "bunching" of deductions in the first years, rather than ratably over the life of the property, is used to offset (shelter) an individual's other income. The excess accelerated deductions result in losses used against his other investment and earned income and may significantly reduce the individual's tax liability. However, the taxes that are reduced in the earlier years may be shifted to later years when the investment begins to generate income, and many of the offsetting deductions have been used up. Taxpayers in this situation have found it advantageous to invest in another tax shelter to provide a "rollover" or further deferral of the taxes.

The net effect of deferral is that the taxpayer grants himself an interest-free loan from the Federal Government during the period of the tax deferral. Over a period of years, this "loan" can be worth a substantial amount of money. For example, if a taxpayer has $100,000 of accelerated deductions and invests the tax savings in 7% tax-exempt bonds (with interest compounded annually) his money will double in less than 11 years. In other words, deferral can be worth as much as total tax forgiveness after a period of time.

In addition, in many cases, especially where leverage is used, as discussed below, a tax shelter investment also results in a taxpayer completely recovering his investment (and in some cases more) by the acceleration of the deductions. This is often the case for taxpayers in the 50-percent or higher tax brackets. Thus, not only does the Federal Government provide an interest-free loan, but in a sense the Government provides the risk capital to high bracket taxpayers to enter into these investments.
It is important to note that this deferral treatment benefits those in the higher brackets proportionately more than it benefits those in the lower brackets. For example, for each $100 deduction, a taxpayer in the 70-percent bracket will save $70 by taking that deduction against his income. On the other hand, a taxpayer in the 20-percent bracket will save only $20 when that $100 deduction is used to offset his income. This is particularly important in a tax shelter investment because of the various risks that are involved. In other words, the interest free loan for the upper income taxpayer is $70; the interest free loan for the lower bracket taxpayer is considerably less.

It should be noted that the tax benefits from deferral are greater in some tax shelters than in others simply because the deferral is for a longer period than for other investments; that is, taxes are deferred over a longer period of time. In the case of the shorter deferrals it is possible for an individual to rollover his investment; that is, to make another tax shelter investment to provide new accelerated deductions and thus defer tax liability further into the future.

Effect of progressive rate structure.—One of the risks in a tax shelter is that the investment may result in a true economic loss where the taxpayer may lose his entire investment. If this were the case (not taking into account the use of borrowed money, as discussed below), a taxpayer in the 70-percent bracket would lose only $30 of his own money; whereas, a taxpayer in the 20-percent bracket would lose $80. Therefore, the high bracket taxpayer would be willing to make riskier investments because his potential net loss (that is, the tax benefit less any economic loss) is less. In effect, the Federal Government finances more of the investments, and takes more of the risks, for a high bracket taxpayer than a low bracket taxpayer.

It should be noted that in the case of a taxpayer with only "earned income" subject to a maximum tax rate of 50 percent, tax shelter deductions reduce income at the 50 percent and lower rates. However, when the tax shelter investment is disposed of at other than capital gains rates, gains may be taxed as high as 70 percent, since they will be investment income and thus not eligible for the 50 percent maximum rate on earned income.

Leverage

The second element of a tax shelter investment is "leverage," which is the use of borrowed money by an individual in the investment. Generally, an individual will borrow money (or money will be borrowed on his behalf) which will equal or exceed his equity investment. There are two benefits in the use of borrowed funds, the first being an economic benefit and the second being a tax benefit. From an economic standpoint, the more that an individual can use borrowed money for an investment the more he can use his own money for other purposes (including other investments) and the more he can make on an investment which is profitable. From a tax standpoint, borrowed funds are treated in the same manner as a taxpayer's own funds that he has put up as equity in the investment. Since a taxpayer is allowed deductions not only with respect to his equity but also on the borrowed funds, he can maximize deferral by incurring deductible expenditures which exceed his equity investment.
A simple illustration of the use of leveraging in tax shelter investments is as follows. Assume the investment requires $100,000 of capital. If an individual invests $10,000 of his own money and is able to borrow $90,000 to meet the $100,000 requirement, for tax purposes he is treated as having $100,000 in the investment. This means that if there are accelerated deductions of $20,000 in the first year, the individual, if he is in the 70-percent bracket, would be reducing his tax liability by $14,000. In this case, the tax deduction in the initial year ($20,000) would be $10,000 more than the equity capital invested and his tax savings would be $4,000 more than the amount originally invested ($10,000). This individual would be financing his investment completely with what can be referred to in effect as an interest-free loan from the Federal Government. In this example above, a taxpayer in the 50-percent bracket would recover his entire investment in the initial year; that is, if he invests $10,000 of his own money and is allowed to deduct $20,000, he receives back by way of reduction of his tax liability the $10,000 he invested. This is the reason why most tax shelter investments are advertised for taxpayers in the 50-percent bracket and above.

A taxpayer in the 20-percent bracket who invests the same $10,000, as in the above example, would only receive back $4,000 from the same $20,000 tax write-off in the first year and, therefore, he is still out of pocket $6,000 in the first year. Not only is the low bracket taxpayer less likely to have the funds to invest in these investments but the Federal Government does not provide him the same subsidy as it does for the high bracket individual.

As can be seen from this example, in the initial years, the risks to a high bracket taxpayer are rather minimal because in the normal tax shelter investment, he would recover the entire amount of his own investment in the year it is made through tax deductions. It should be noted, however, that even if the investment fails, there is usually some recovery (and sometimes substantial recovery) of previous written-off income. In other words, where the investor would be liable for tax on the constructive income he is required to recognize when the shelter terminates. This is often referred to as the "phantom gain"; where there is gain for tax purposes, even though the investment does not generate economic income or positive cash flow. In other words, the taxpayer is required to repay his interest free loan from the Government, at least to the extent of any nonrecourse borrowings which he was previously able to deduct. (Sometimes this repayment must be made in full, and sometimes only in part, if there is a "conversion" feature to the shelter, as discussed below.)

The use of leverage has increased significance when an investor is not even liable on the borrowed money, which is often the case in tax shelter investments. This is what is referred to as "nonrecourse financing." Where a partnership (usually a limited partnership) is being used as the investment vehicle, a loan may be made to the partnership so the partnership assets are subject to liability but the investors are not personally liable for the loan. However, under partnership tax regulations, the limited partner investor is entitled to increase his basis in his investment by the amount which is treated as his proportionate share of the liability (even though in fact he has no such liability).

(A partner may deduct partnership losses to the extent of his basis.)
Thus, the investor is able to take tax write-offs on account of the accelerated deductions not only for the money he invested (on which he is at risk) but, more significantly, also on his share of the nonrecourse loans (on which he is not at risk). This is one of the most important aspects of tax shelter investments. (Nonrecourse loans are discussed below in connection with limited partnerships.)

Conversion of ordinary income into capital gains

A third aspect which is present in some tax shelter investments is referred to as "conversion," which is the process of converting ordinary income deductions into capital gains.

When a taxpayer depreciates an asset, he takes a deduction against his ordinary income (and thus reduces taxable ordinary income) for depreciation. If the asset is a capital asset when it is sold and the proceeds exceed basis, there is a taxable gain. However, even though the previous reduction in basis (depreciation) reduced ordinary income, this gain may be taxed as capital gain. When the gain is a capital gain, the effect of the sale is to convert ordinary income, that is the income which was reduced by the previous accelerated deductions at the marginal bracket of the taxpayer, to capital gains taxed at the preferential capital gains rates.

In several cases, Congress has dealt with this situation by requiring a portion of the gain on a sale or other disposition to be treated as ordinary income rather than capital gains, to the extent of accelerated depreciation deductions (and in the case of personal property, to the extent of all depreciation). This is what is referred to as "recapture." The taxes on the ordinary income that have been deferred through the taking of accelerated deductions in earlier years are recaptured at the time the property is disposed of. Although there are several recapture rules in present law today, the recapture rules do not apply to all tax shelter investments. (In addition, the "recapture" applies only to prevent the conversion of ordinary income to capital gains; it does not apply to the deferral factor.)

Use of Limited Partnerships

The form of entity most commonly chosen to maximize tax benefits in a tax shelter investment has been the limited partnership, which, upon meeting certain requirements, is subject to the partnership rules of the Internal Revenue Code. In general, a partnership is not considered a separate entity for tax purposes; rather the individual partners are taxed currently on their share of the partnership gains and can deduct partnership losses to the extent of the basis of their partnership interest.

When an investor enters a partnership, his basis in the partnership generally includes the amount he invested and his share, if any, of the partnership liabilities. In this regard, the income tax rules...
tions (Regs. § 1.752-1(e)) provide that a limited partner may include in the basis of his partnership interest his share of the nonrecourse loans to the partnership even though he is not personally liable on the debt. (Such loans usually are secured only by the partnership property.) Nonrecourse financing facilitates the use of limited partnership for tax shelter investments because the investor is able to limit his liability to the amount he has actually invested but use nonrecourse loans obtained by the partnership to substantially increase his basis and thus increase his tax deductions.

More specifically, these general principles apply to limited partnerships in tax shelter investments:

1. The limited partnership is not a taxpaying entity, but instead is a tax conduit, the partners reporting their distributive shares of partnership income or loss.
2. Subject to the restriction that its purpose not be to avoid or evade tax, a limited partnership agreement may provide for the manner in which the partnership's items of income, gain, loss, deduction or credit will be allocated among the partners.
3. The amount of losses which a partner may deduct for a particular year is limited to the amount of the adjusted basis of his partnership interest as of the end of the year. At the inception of a partnership, the adjusted basis of the partner's partnership interest equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities. In the case of a limited partnership, a limited partner's share of the partnership liabilities is his pro rata share (the same proportion in which he shares profits) of all liabilities with respect to which there is no personal liability ("nonrecourse liability"). This rule, where a limited partner's adjusted basis in his partnership interest is increased by a pro rata amount of nonrecourse liability, is one of the cornerstones of tax shelter investments, allowing the investor, in many cases, to currently deduct amounts in excess of his actual investment.

The limited partnership is generally preferred over the general partnership because the limited partners, who are passive investors in most cases, have limited liability for the debts of or claims against the partnership.

Corporations

The corporate form of doing business generally does not lend itself to tax shelter investments by individuals since the corporation is the taxpaying entity and, therefore, the tax incidents of its operation remain at the corporate level and do not pass through to its shareholders. The one exception to this treatment is for Subchapter S corporations. To a great extent, the tax incidents of a Subchapter S corporation's operations pass through to its shareholders. However, there are certain tax limitations applicable to the Subchapter S corporation which are not imposed upon a limited partnership under the partnership provisions.

As previously noted, one of the principal tax shelter benefits obtained under the partnership tax provisions is that the adjusted basis of an individual partner in his partnership interest not only includes his cash investment but also a pro rata share of any nonrecourse
liability of the partnership. By contrast, the adjusted basis of the shareholders of a Subchapter S corporation in their stock includes their investment in the stock and any loans they may have made to the corporation, but, most significantly, does not include any portion of the corporation's liabilities. In both cases, that of the Subchapter S corporation shareholder and the limited partner, it is the adjusted basis in partnership interest or stock, as the case may be, which serves as the upper limit on the amount of loss that may be deducted by the shareholder (partner) in a given year. Thus, in comparison to the limited partner, the Subchapter S corporation shareholder is severely limited in terms of the amount of losses, and therefore tax shelter, available.

Other limitations which apply only to Subchapter S corporations are: (1) A Subchapter S corporation may not have more than ten shareholders; (2) Trusts may not be shareholders of a Subchapter S corporation; (3) A Subchapter S corporation may not have two or more classes of stock; (4) No more than 20 percent of a Subchapter S corporation's gross receipts may be derived from passive investment income, which includes, among other things, certain types of rental income; (5) No provision may be made for special allocation of losses and other items to the shareholders, these items being allocated strictly in proportion to stock ownership.

Summary of Major Tax Shelter Investments and Their Related Tax Deductions

This part of the overview discussion presents a list of the business activities which investors often enter chiefly for tax benefits from special kinds of deductions. This part also sets forth the principal deductions which are relied on for "tax shelter" in each industry. The main characteristics of these deductions is that they are all accelerated in some manner, providing for the deferral of taxes. In each of these shelters leverage can be an important factor which can magnify the deductions which are indicated.

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<th>Key shelter-producing deductions or other benefit</th>
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<td>ments, FHA-subsidized hous-</td>
<td>b. Construction period taxes.</td>
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<td>ing, office buildings, shopping centers.</td>
<td>c. Accelerated depreciation.</td>
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<td>2. Land</td>
<td>a. Current expensing of taxes, interest and certain other land development costs.</td>
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<td>b. Capital gain on sale.</td>
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*Many of the deductions listed are available only to taxpayers who report on the cash method of accounting, and thus can deduct expenses when and as they pay them and are not required to use inventories in their business operations.*
Specialized investment area  Key shelter-producing deductions or other benefit

3. Rehabilitation of low-income rental housing.
   a. 60-month depreciation.
   b. Capital gain on sale.

B. Farming

1. Cattle feeding.
   a. Feed costs (including prepaid feed costs).
   b. Other direct costs of fattening the animals.

2. Cattle breeding (also breeding other kinds of livestock such as horses, mink, hogs, etc.)
   a. Feed and other raising expenses (including breeding fees).
   b. Accelerated depreciation of purchased animals.
   c. Additional first year depreciation.
   d. Investment credit (except on horses.)
   e. Capital gain on sale.

3. Raising certain vegetables Expensing of growing costs.
   or plants.

4. Shell eggs.
   b. Raising costs (including feed).

5. Agricultural crops, vineyards, fruit orchards, Christmas trees.\(^1\)
   a. Development and raising costs.
   b. Accelerated depreciation on underlying grove (after crop matures).
   c. Investment credit.
   d. Capital gains on sale.

6. Thoroughbred horse racing.
   a. Maintenance costs.
   b. Stud fees.
   c. Capital gain on sale.

C. Oil and gas drilling

   a. Intangible drilling costs.
   b. Capital gain on sale.
Specialized investment area | Key shelter-producing deductions or other benefit
---|---
D. Equipment leases (e.g., computers, airplanes, ocean-going vessels, railroad cars, CATV systems, etc.)  
   a. Accelerated depreciation or 5-year amortization.  
   b. First-year "bonus" depreciation.  
   c. Investment credit (corporate lessors only).

E. Motion pictures  
   1. Purchase of completed picture.  
      a. Accelerated depreciation.  
      b. Investment credit.  
   2. Production of a picture.  
      Expensing of production costs.

F. Professional sports franchises  
   a. Rapid depreciation of player contracts.  
   b. Payroll and other operating costs.  
   c. Capital gains.

G. Deductions available generally  
   a. Interest on borrowed funds used to finance costs of acquiring the investment and to pay some of the deductible expenses.  
   b. Real estate, sales and use taxes.  
   c. Various prepaid expense items.  
   d. Miscellaneous commissions, fees for professional services, etc.

The Tax Reform Act of 1969 was a substantive and comprehensive reform of the income tax laws generally and dealt either directly or indirectly with a number of the provisions involving tax shelter investments. Although many tax preferences were dealt with directly by the 1969 Act, in most cases these were not eliminated but only reduced in certain respects. Certain tax preference provisions were not affected at all by the 1969 Act because it was believed inappropriate to make any change in those areas at that time. However, since 1969 (and especially in the early 1970's), as indicated below (in the section on Economic Effects and Background of Tax Shelters and their Public Syndication), tax preferences have been packaged and promoted in tax shelter investments to an increasingly significant extent.

A brief summary of the 1969 revisions and reforms relating to tax shelter investments follows:

Real estate

In the case of real estate, the 1969 Act substantially limited real estate depreciation allowances. The 200-percent declining balance method and other accelerated forms of depreciation were restricted to new residential housing. Other new real estate was restricted to the 150-percent declining balance method. Used properties acquired in the future were limited to straight line depreciation, except for used residential housing which was made eligible for allowances at 125 percent of the straight line method where the property still has a useful life of more than 20 years. In addition, stricter recapture rules were imposed, particularly for nonresidential property, so that a larger proportion of gain on the sale of property (which resulted from accelerated depreciation allowances taken previously) is taxed as ordinary income.

Farm operations

In the case of farm operations, the 1969 Act made a series of changes. Taxpayers deducting farm losses against their non-farm income generally must treat capital gains arising on the subsequent sale of farm assets as ordinary income. For individuals, this recapture rule applies only to losses over $25,000 and only if nonfarm income is over $50,000. The Act also provided for the recapture of depreciation on the sale of livestock and a more effective treatment of hobby losses. The holding period for capital gain treatment with respect to cattle and horses was extended, provision was made for the recapture of soil and water conservation or land-clearing expenditures on the sale of farm land held less than 10 years, and the costs of developing citrus groves were required to be capitalized.
Natural resources

In the case of natural resources, the Act made several significant revisions, the main one being the reduction of the percentage depletion allowances. The percentage depletion rate for oil and gas wells was reduced from 27 1/2 percent of gross income to 22 percent. (The depletion rate was also cut to 22 percent for minerals eligible for a 25 percent rate under prior law and to 14 percent for most minerals eligible for a 15 percent rate under prior law).

Carved-out and other production payments (including ABC transactions) were treated as if the payments were loans by the owner of the payment to the owner of the mineral property. This prevented the use of carve-outs to increase percentage depletion payments and foreign tax credits. It also eliminated the possibility of purchasing mineral property with money which was not treated as taxable income to the buyer. Finally, recapture rules were applied to mining exploration expenditures not subject to recapture under prior law and the foreign tax credit was disallowed to the extent foreign taxes were attributable to the deduction allowed against U.S. tax for percentage depletion.

Capital gains and losses

The 1969 Act eliminated the alternative tax on long-term capital gains for individual taxpayers to the extent they have capital gains of more than $50,000. Long-term capital gains up to the first $50,000 received by individuals continues to qualify for the 25-percent alternative capital gains tax rate. The maximum tax rate on that part of long-term capital gains above $50,000 was increased (over a 3-year period) to 35 percent (one-half of the 70-percent top tax rate applicable to ordinary income). The alternative tax rate on corporate long-term capital gains income was increased (over a 2-year period) from 25 percent to 30 percent.

Interest deduction

The 1969 Act limited the deduction for interest paid or incurred by a taxpayer (other than a corporation) on funds borrowed for investment purposes to 50 percent of the interest in excess of the taxpayer's net investment income, his long-term capital gains and $25,000. The disallowed interest, however, may be carried over to subsequent years. (This provision had a 2-year delay in effective date.)

Minimum tax

To supplement the specific remedial provisions of the Act in curtailing tax preferences, a minimum tax was enacted which applies to both individuals and corporations. It is computed by (1) totaling the amount of tax preferences received by the taxpayer (from the cate-

1 In addition, the Act required net long-term capital losses (in excess of net short-term capital gains) of individuals to be reduced by 50 percent before they affect ordinary income.) The limitation on the deduction of these losses against ordinary income was retained at $1,000. Where separate returns were filed, the deduction of capital losses against ordinary income was limited to $500 for each spouse.) Ordinary income tax treatment instead of capital gains treatment was provided for (1) gains from the sale of memorandums and letters by a person whose efforts created them (or for whom they were produced). (2) transfers of franchises, trademarks, and trade names where the transferor retains significant rights, powers, or continuing interests, and (3) contingent payments received under franchise, trademark, or tradename transfer agreements. (In addition, corporations were allowed a three-year loss carryback for net capital losses.)
gories of tax preferences specified in the Act), (2) subtracting from this total a $30,000 exemption and the amount of the taxpayer's regular Federal income tax for the year (plus any carryovers from prior years), and (3) applying a 10-percent tax rate to the remainder.

**Maximum tax on earned income**

The 1969 Act provided that the maximum marginal tax rate applicable to an individual's earned income is to be 50 percent. It was concluded that the higher rates of tax (that is, the top marginal rate of 70 percent), was inappropriate in the case of earned income.

In addition, the 50-percent limit on the tax rate applicable to earned income was adopted as a means of reducing the pressures for the use of tax avoidance devices. As a result, for purposes of the maximum tax provision, earned income eligible for the 50-percent top rate is reduced by tax preferences in excess of $30,000.

**Economic Effects and Background of Tax Shelters and Their Public Syndication**

Tax shelters are not a new form of investment, nor were they created by the public syndicators of interests in real estate and other limited partnerships. The advantage of owning an apartment building, for example, both for current income and for accelerated depreciation, has long been familiar to doctors, lawyers, and other high-income professionals and businessmen. Real estate syndicates of individuals have been formed for many years, usually involving a builder and a small group of individuals who personally know each other. However, the widespread public sales of shares in investments in real estate, farming, oil drilling, motion pictures and the like (many of which involve registering the offering with the Securities and Exchange Commission and selling it like a stock interest) has been a phenomenon of recent years, reflecting efforts by promoters to pass through tax shelter benefits to passive outside investors.

This form of mass merchandising, which has received much publicity in recent years, is basically a reflection rather than a cause of tax shelter benefits in present law. Some critics of tax shelters believe, however, that the public syndication of specialized investments to absentee owners has created a preoccupation with tax benefits (rather than with the economic merits and risks of the project) to the neglect of future tax liabilities.

Some of those who share this view argue that the tax provisions which Congress intended as incentives work well so long as they are not carried to extremes, but when an investment is made chiefly to intensify "tax writeoffs," the tax rules become distorted and cease to work as they were intended.

Other critics of tax shelters argue that historically, it has never been completely clear that Congress specifically focused on attracting private capital into particular industries when the rules which support many present tax shelters were originally enacted.Accelerated depreci-
ciation on real estate, for example, was introduced in 1954 as part of a focus on accelerating the depreciation of business equipment rather than on the rate of depreciation of commercial real estate. In farming, use of the cash method originated in administrative rulings in the 1920's, obviously before raising outside capital from high income professionals was being considered. The principles of leveraging which justify deductions of more than an investor's own equity dollars originated in a Supreme Court decision. It also seems doubtful that Congress ever addressed itself to the "packaging" and bunching of as many deductible items as possible into the initial year of an investment.

Increase in public offerings.—Several factors contributed to the high level of syndicated offerings of public limited partnerships in the two or three years immediately following the Tax Reform Act of 1969. Even though that Act was aimed at reducing the pressure for tax shelters (through provisions summarized earlier), sophisticated promoters and their tax advisers capitalized on the advantage to high-bracket taxpayers of deferring the payment of taxes, which accelerated deductions make possible, and which was not basically touched by the 1969 Act's emphasis on "recapturing" deductions previously allowed. Even the 50 percent ceiling tax rate on earned income did not prove as big a deterrent to tax shelters as was expected, partly because the rules interrelated with the minimum tax on tax preferences and caused some earned income to be ineligible for the 50 percent rate. The desire to defer taxes also appealed to many persons who could have qualified for the 50 percent rate, either because they believed that when the deferral period ended they would be in a less-than-50 percent bracket, or because they planned to "reshelter" the deferred income by entering into a new investment when necessary in the future.

Other observers have traced the rise of real estate limited partnerships (for example) to a decline in stock market values during the latter half of the 1960's. From this perspective, the low downside risk which real estate apparently offered, along with the prospect of appreciation and future profit in an expanding (and inflationary) economy, made real estate and other similar nonstock investments an attractive alternative. The adverse impact of high tax rates on a taxpayer's real income during a period of inflation also made the accelerated tax deductions which are available in several specialized investment areas, including real estate, look like an effective way for taxpayers to reduce their current tax liabilities. The inflation of the early 1970's also pushed many taxpayers in high middle-income brackets and therefore into tax rates formerly imposed only on the wealthiest taxpayers. (A married couple filing a joint return becomes subject to a Federal income tax rate of 50 percent on taxable income in excess of $44,000. For a single person, the 50-percent rate applies to taxable income over $22,000.)

In these circumstances, promoters saw opportunities to attract a wide range of taxpayers into investment areas where a large part of the investment costs were subject to special deductions (such as intangible drilling expenses in the case of oil, crop raising costs in the

2 Crane v. Commissioner, 331 U.S. 1 (1947).
case of farming, and accelerated depreciation in the case of real estate and other depreciable property). An ideal format also appeared to be available through which investors across the entire country could be sold interests in an apartment house, a vineyard, an oil well, an equipment lease, or a motion picture, and could directly share in the “tax losses” generated by the property, while remaining passive investors. The vehicle which proved able to serve these needs was the limited partnership, in which the promoter or his agent usually served as the corporate general partner and in which the investors became limited partners.

Although the tax law had long permitted individuals who invest with borrowed funds to claim depreciation and other deductions as though the borrowed funds were their own equity, the promoters of many syndicated shelters exaggerated the debt-equity ratios which were used. The point was reached that enough deductions could be created with borrowed funds so that an investor could, in effect, “recover” all of his own equity out of tax savings on his other income, sometimes in the very year in which he first invested in the “deal.” Many optimistic investors saw in this an opportunity through tax provisions to make an economic profit with little or none of their own money at risk in the property. (In many cases an over-optimistic outlook caused neglect of the potential tax liabilities which present law would impose if the project turned out to be unsuccessful, such as if the investors’ underlying mortgage were defaulted and the property foreclosed upon.)

Another factor contributing to the success of public sales of “tax losses” was the aggressive approach of many promoters in structuring the deals so that the investors could claim the maximum number of deductions, in the largest amounts, at the earliest possible dates. As a result, many syndicated shelters contained one or more of the following features: maximum use of borrowed money; maximum prepayments of interest and other financing costs, and of supplies, such as animal feed; maximum expense deductions for fees to brokers, promoters, lawyers and accountants; extreme allocations of the purchase price of a shelter property between depreciable and nondepreciable assets; extreme (and sometimes unrealistic) allocations of deductions under partnership agreements to speed the rapid write-off items through to the limited partners; going to the limits of the rules which permit the partnership to be taxed as a partnership and not as a corporation; and attempts to reduce or deflect the tax liability due after the shelter benefits have been received by the investors.

Adverse factors.—Beginning in about 1973, several factors began to reveal many of the questionable practices followed by public syndicates and to throw them into loan foreclosures, tax audits, and (in some cases, promoters diverted a large portion of the investors' equity funds to themselves through excessive markups when they resold a parcel of land to the limited partnership, or when they contracted with the partnership to do the construction of a rental building on the land. Real estate commissions and management fees, also paid to the promoters, were often tied to the purchase price of the properties. This resulted in these funds being spent before the projects were completed, so that the investors had to use larger amounts of borrowed funds than they might otherwise have used.)
some cases) scandal, and to decrease the general attractiveness of new investments in many traditional shelter industries. Table 1 shows the trend since the Tax Reform Act of 1969 in the number and volume of publicly syndicated tax shelter offering registered with the National Association of Securities Dealers.

The trend indicates that publicly syndicated tax sheltering offerings since the 1969 Act increased from 1970 through 1972 but began to decrease in 1973 and then started to drop off sharply in 1974 and 1975. It should also be noted, however, that public syndications registered with the National Association of Securities Dealers make up only a very small number of the actual tax shelter investments. There are many more private syndications (or public syndications) which are not required to be registered.

*One indicator of the current state of the tax shelter industry is the number of conferences currently being devoted to the tax consequences of mortgage foreclosures, and other problems of the "aging, failing or fraudulent" shelter. One recent professional meeting discussed such topics as: "Real Estate Tax Shelters—A Towering Inferno in the Midst of an Earthquake"; "Paradise Lost and the New Leveraged Leasing Guidelines"; "Grundstake to Homestake—Offering Protection in Tax Shelters"; and "Is There Life After Death in Tax Shelters?".
TABLE 1.—TREND IN PUBLICLY SYNDICATED TAX SHELTER OFFERINGS SINCE THE TAX REFORM ACT OF 1969

The following data shows partnership offerings registered with the National Association of Securities Dealers. The figures include offerings made in interstate and intrastate transactions, but only those made through securities dealers who are members of NASD. The figures do include some private placements but not offerings made through securities dealers who are not members of NASD. The figures show the total dollar amount offered to the public but not the amount actually sold.

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<td></td>
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<td>Number</td>
<td>Dollars</td>
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<td>783</td>
<td>4,777,314,699</td>
<td>528</td>
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<td>Cattle feeding and breeding</td>
<td>13</td>
<td>26,764,000</td>
<td>244,636,000</td>
<td>12</td>
<td>243,512,170</td>
<td>296</td>
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<tr>
<td>Miscellaneous</td>
<td>13</td>
<td>26,336,260</td>
<td>29,915,620</td>
<td>12</td>
<td>243,512,170</td>
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<td>Total</td>
<td>145</td>
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<td>1,568,405,895</td>
<td>507</td>
<td>2,181,679,794</td>
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*Includes equipment leasing (computers, tank cars, aircraft, cable TV, etc.), mining, theatrical, and motion picture productions, community funds, race tracks, auto racing and restaurant investments. Does not include equipment leasing by banks.

Source: National Association of Securities Dealers, Inc.
The recent decline in the nation's economy and the mixture of inflation and recession have affected many of the tax shelter investments, real estate in particular. For tax-oriented syndicates, the combination of inflation, recession and inherently weak economic value has often been fatal. Because of inflation and high interest rates, many real estate construction ventures had cost overruns which owners found difficult to finance. Because of recession, owners of rental properties struggled with high vacancy rates and inability to increase rents to meet rising operating costs. The energy crisis was an additional factor that contributed to the failure of many resort-area condominiums. In cattle feeding, increased feed costs and falling cattle prices caused many investors to suffer losses of their equity, and banks which had made nonrecourse loans to investors in cattle feeding deals suffered losses when the market value of the cattle fell below the amount of the investors' equity.

In addition, the fees involved in syndicating tax shelters and in managing them for their absentee owners are typically quite large in relation to the capital invested. In certain extreme cases that have been noted, these costs exceeded the capital invested by the partners. In more typical cases, these syndication costs amount to 15-25 percent of invested capital. While all methods of raising capital for businesses involve some cost, those costs related to syndicating a tax shelter are exceptionally high.

These external problems combined with several factors which existed in many public syndicates and others which resulted from a preoccupation with tax losses. Some promoters operated several different syndicates at the same time and others got their profits out early by reselling property to the syndicate at inflated prices (or paying themselves fees unrelated to the success of the project). For their part, investors who were primarily concerned with creating and bunching tax deductions, including expenses arising from financing costs, were often willing to pay more for a property than if they had bought it for cash. A desire to recover all the equity through first-year tax losses also encouraged investors to reduce their down payments and to borrow a larger proportion of their total investment costs. This, in turn, required higher mortgage payments, and reduced the margin for error in the project's revenue and expense projections. For example, what might be a break-even point of 75 percent occupancy in many rental buildings became 90 percent for tax-oriented investors, but the occupancy rates, in many projects, fell far below this level in recent years. An inherent tendency of tax-motivated investors (particularly those in syndicated shelters) to create deductible expenses, and thus, in many cases, not to stress operating economies, also

Outright frauds have occurred in the operation of some public syndicates. Last year an investigation by the Securities and Exchange Commission disclosed an alleged $125 million swindle of more than 2,000 investors in syndicated oil drilling programs of Home-Stake Production Co. The company attracted large numbers of investors over a 10-year period by the prospect of large initial tax loss deductions from exploratory drilling programs in California, Oklahoma, Kansas, and Venezuela. In fact, according to the SEC, drilling activities were nonexistent and investors' funds were diverted for the personal benefit of the promoters. Many investors in Home-Stake's ventures were wealthy entertainers, doctors, lawyers, and businessmen. Reportedly, some investors in Home-Stake are now arguing that if their original tax loss deductions can be disallowed by the Internal Revenue Service, they are entitled to theft loss deductions in the year when the alleged fraud was discovered.

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proved fatal in a declining market. The overall result has been an increasing number of loan defaults and foreclosures on real estate partnerships.

Decline in new shelters.—Other factors have contributed to a decline in the number of new tax shelter offerings. These include a shortage of investor funds because of the recession; restrictive audit policies and ruling guidelines by the Internal Revenue Service; increased disclosure requirements by the SEC and by State securities laws; and a decreased supply of loan funds. High interest rates also attracted investors to Treasury notes, corporate bonds and other conventional investments.

Nevertheless, despite the adverse factors which have curtailed the public sale of tax shelters, many observers believe that these factors have not destroyed the basic advantages of tax shelter investment. Many abuses at the extremes have been eliminated or curtailed. But many private groups of investors continue to be formed, and the basic provisions of present law which give rise to accelerated deductions, tax losses and leveraging continue to be available whenever high-income taxpayers find it advantageous to use them.

The ineffectiveness of tax shelters as a form of subsidy is best illustrated in the case of low-income housing. Under the Housing and Urban Development Act of 1968, a low-income housing program (section 236) was set up in such a way that the owners of the building had virtually no economic incentive to manage the building profitably. The law intended that profits were to come almost entirely from special tax benefits. As a result, the owners have incentives to invest in low-income housing, since the tax benefits are proportional to capital investment, but little incentive to manage the projects efficiently and to maintain them. Studies show that costs of section 236 housing are far in excess of the costs of similar housing built without benefit of the subsidies.

Tax equity.—Finally, the existence of tax shelters has become a focal point for disenchantment with the fairness of the Federal tax system. When the great majority of taxpayers perceive that a few wealthy taxpayers escape tax almost completely in return for making investments which may not even be sensible from an economic standpoint, it becomes hard to convince them that the tax system is truly fair and progressive. The resulting disrespect for the law and reduced compliance therewith may entail a hidden revenue loss which is far in excess of the loss measured by the deductions claimed by those who participate in the shelters.

Current Positions of the Internal Revenue Service With Regard to Tax Shelter Investments

Over the last several years, the Internal Revenue Service has taken an active role in reviewing various aspects of tax shelter investments. This involves a review of past, as well as present, positions with respect to arrangements which are packaged in the form of tax shelter investments to determine whether they meet the requirements to allow the special tax benefits.
A summary of the various rulings published by the IRS in the general area of tax shelter investments appears below.

**Advance Rulings for Partnership Tax Treatment**

In recent years the Service has issued Revenue Procedures setting forth certain conditions that must be met before the Service will issue a favorable ruling that a limited partnership will be treated as a partnership for Federal tax purposes.

The Service has been concerned with the bona fides of the financial responsibility assumed and level of participation in the limited partnership operations by the general partner. Thus, in Rev. Proc. 72-13, 1972-1 C.B. 735, certain net worth requirements were set forth with respect to a corporation serving as the sole general partner of a limited partnership before the IRS would issue a favorable ruling. In Rev. Proc. 74-17, 1974-1 C.B. 438, the requirement for advance ruling was established that the general partner or partners, during the existence of the partnership, should have at least a one percent interest in each material item of partnership income, gain, loss, deduction, or credit.

The Service has not been unmindful of the extensive use of leveraging in tax-shelter limited partnerships, thus giving rise to another advance ruling requirement found in Rev. Proc. 74-17 that for the first two years of operation of a limited partnership, the partners may not claim aggregate deductions which exceed the amount of equity capital invested in the limited partnership. This requirement has the effect of precluding the use of nonrecourse liability included in the partners' adjusted bases to absorb losses incurred during the first two years of operation.

**Nonrecourse Loans**

In many situations, so-called "nonrecourse loans" bear a striking resemblance to, and in substance are, equity contributions to the limited partnership. In 1972, the Service issued two Revenue Rulings pertaining to certain alleged to be nonrecourse loans. While both rulings dealt with and had particular application to limited partnerships engaged in gas and oil exploration, they are susceptible to a much broader application.

In Rev. Rul. 72-135, 1972-1 C.B. 200, the Service ruled that an alleged nonrecourse loan from the general partner to a limited partner, or from the general partner to the partnership, would be treated as a contribution to the capital of the partnership by the general partner, and not as a loan, thereby precluding an increase in the bases of the limited partners' partnership interests with respect to any portion of such loans. In Rev. Rul. 72-350, 1972-2 C.B. 394, the Service ruled that a nonrecourse loan by a nonpartner to the limited partnership, which was secured by a highly speculative and relatively low value property of the partnership, and which was convertible into an equity interest in the partnership's profits, did not constitute a bona fide loan, but was, in reality, an equity contribution to the partnership.

In recently issued Rev. Proc. 74-17, the Service stated that it would not issue an advance ruling granting partnership status to a limited partnership where a creditor had made a nonrecourse loan to the partnership and could acquire at any time, as a result of such loan,
a direct or indirect interest, other than as a secured creditor, in any profits, capital or property of the partnership.

Prepaid Interest

In 1968, the Service issued Rev. Rul. 68-643, 1968-2 C.B. 76, which, using distortion of income as its main criterion, in effect, restricted prepayment of interest to the taxable year succeeding the year of prepayment. Moreover, the Service cautioned that even with respect to those prepayments for the year succeeding the year of prepayment (i.e., for a period not more than 12 months beyond payment), material distortions of income could result in a disallowance of all or part of such prepayment. Recently, the position taken by the Service has been sustained, for the most part, in two cases, Sandor, 62 T.C. 469 (1974), (prepayment of five years' interest), and Burch, 63 T.C. 866, (1975), (prepayment on one year's interest).

Prepaid Feed Deduction

One of the major tax shelter deductions in the farming area has derived from prepayments at the end of the year for livestock feed to be consumed in a following taxable year. Concerned with the possible resulting distortion of income and whether such prepayments have a bona fide business purpose, the Service issued Rev. Rul. 75-152, 1975-17 I.R.B. 15. This ruling requires that (for a current year's deduction to be available) the prepayment be for the purchase of feed, rather than a mere deposit; that it be for a business purpose and not merely for tax avoidance; and that the deduction in the year of prepayment not result in a material distortion of income.

Syndication and Organization Fees

Until recently, it had been common practice for limited partnerships to deduct the payments made to the general partner for the services he rendered in connection with the syndication and organization of the limited partnership. In recently issued Rev. Rul. 75-214, 1975-23 I.R.B. 9, the Service ruled that such payments to general partners for services rendered in organizing and syndicating a partnership constituted capital expenditures which were not currently deductible.

Equipment Leasing

The tax shelter expectations of the parties to a lease of personal property which, in most cases, is leveraged ¹ are dependent upon the transaction being treated as a lease and not as some form of sale of the property involved. In the mid-1960's, the Service issued a number of rulings, and recently issued Revenue Procedure 75-21 (I.R.B. 1975-15) setting forth the criteria to distinguish between what is a bona fide lease and a sale of property. Under these Rulings and Revenue Procedure, the Service will closely scrutinize the terms of the lease agreement in question and, if the economic substance is such that it

¹ A "leveraged lease", recently having become a very popular financing and tax shelter device, typically involves three parties: the lessor, the lessee and the lender. It may be defined as a net lease of property for a substantial part of the useful life of such property, where a substantial part of the purchase price of such property is obtained through borrowings or other long-term financing, and where the rents paid by the lessee are at least sufficient to amortize the lessor's borrowings. It is the substantial borrowing of the lessor, which typically is on a nonrecourse basis, which adds the "leverage" aspect to what otherwise might be described as a "straight lease" transaction. The lender does take a security interest in the leased property as, as a matter of practice, looks to the credit worthiness of the lessee before making the loan.
more closely resembles a sale of property, as opposed to a lease, lease
treatment, and the resulting tax advantages flowing therefrom, will
not be accorded the parties to transaction. One of the main require-
ments to be met for the lessor to be treated as such, is that he maintains
a minimal and unconditional investment in the property in question.

Intangible drilling and development costs
One of the basic tax shelter deductions in the oil and gas area is
that for intangible drilling costs which, essentially, consists of
amounts paid for labor, fuel, repairs, hauling, and supplies, etc. which
occur in connection with the drilling of wells for the production of
oil or gas.

The Service has ruled, in Rev. Rul. 68-139, 1968-1 C.B. 311, that
a limited partnership may earmark a limited partner's contribution
to expenditures for intangible drilling costs, thereby allowing the
allocation of the entire deduction to the limited partners (if the prin-
cipal purpose of such allocation is not the avoidance of Federal taxes).

In another ruling in this area, Rev. Rul. 71-252, 1971-1 C.B. 146,
the Service has ruled that a deduction may be claimed for intangible
drilling costs in the year paid, even though the drilling was performed
during the following year, so long as such payments are required to
be made under the drilling contract in question.7

Current Positions of the Securities and Exchange Commission
With Regard to Tax Shelter Investments

The Securities and Exchange Commission has also taken an active
role over the last several years in reviewing various aspects of tax
shelter investments. Under the full disclosure requirements of the
Securities Act of 1933 and the Securities Exchange Act of 1934, any
material risks of adverse tax consequences must be fairly disclosed to
prospective investors. Mindful that certain tax shelter benefits some-
times constitute a substantial investment inducement and that certain
issues of Federal tax law relating to tax shelters are as yet unsettled,
the Securities and Exchange Commission ("SEC") requires certain
disclosures regarding various aspects of tax shelters which may involve
material risks of adverse tax consequences. Although only public of-
ferrings of securities must be registered with the SEC, the anti-fraud
provisions of Federal securities laws apply to private and intrastate
as well as public offerings. Consequently, while SEC disclosure re-
quirements and policies have direct application only to public offer-
ings, they also have indirect application to intrastate and private
offerings.

Qualification for partnership tax treatment
In tax shelters, it is of critical importance that a limited partner-
ship be treated as a partnership for tax purposes in order that the tax
benefits generated by the partnership pass through to, and may be
used by, the limited partners. In many instances, a limited partner-
ship may not apply for an advance ruling that it has partnership tax
status, but, instead, obtains an opinion of counsel to this effect. In
these cases, the SEC requires a disclosure that no advance ruling was

obtained, that the opinion of counsel is not binding on the IRS, and that, in the event of the reclassification of the limited partnership as an association taxable as a corporation, investors would lose the pass-through of tax benefits.

Nonrecourse loans

Generally, the SEC suggests appropriate risk disclosures as to the possible applicability of Rev. Ruls. 72-135 1972-1 C.B. 300 and 72-350 1972-2 C.B. 394 in which the Service held that certain "nonrecourse loans" were, in substance, equity contributions to the oil and gas exploration limited partnership involved. (See Internal Revenue Service—Nonrecourse Loans, above). Less emphasis is placed on such disclosures in real estate partnerships than in exploratory oil and gas drilling partnerships.

Prepaid interest

With respect to a real estate limited partnership which deducts a large interest prepayment in its first year of operation and which has little or no income in such year, the SEC suggests a disclosure to the effect that the IRS may disallow the prepayment on the ground that it constitutes a distortion of the partnership’s income and that the deduction for such prepayment may be allocated over the term of the loan.

Prepaid feed deduction

In cattle-feeding partnership registration statements, the SEC requires a cover-page disclosure to the effect that there is a substantial risk that the IRS will disallow a deduction, and thus reduce or eliminate contemplated tax benefits, for payments for cattle feed which will be consumed in a taxable year following that of payment.

Intangible drilling and development costs

Currently, the SEC does not require extensive risk disclosures with respect to prepayments of intangible drilling costs.

Management fees

Many limited partnerships make rather sizable payments of what is referred to as “management fees” to general partners of the partnership. These fees, which often are deducted in the year of payment by the partnership, many times relate to services in organizing the partnership and services that will be rendered in taxable years following the year of payment. As to the deductibility of these fees, the SEC suggests risk disclosures to the effect that they will not be deductible if they constitute a capital expenditure or if they represent unreasonable compensation.

Partnership allocations

While section 704 of the Internal Revenue Code provides the flexibility for allocating among partners various partnership items of income, deductions and credits, these allocations may be disregarded if their principal purpose is the avoidance or evasion of income taxes. With respect to these special allocations, including retroactive allocations to new partners, the SEC requires an opinion of counsel that they do not have tax avoidance as their principal purpose and/or a disclosure to the effect that the special allocation may be disregarded upon an IRS audit of the partnership’s returns.
Alternative Approaches for Reform

There are a number of alternative approaches that the committee could consider to deal directly or indirectly with tax shelter investments. If the committee believes that certain incentives are no longer desirable or that the tax benefits from the preferences are greater than they need be, the committee could revise the provisions directly; that is, the particular provisions could be eliminated or the preference cut back to some extent.

On the other hand, if the committee believes that certain incentives should be continued but that the tax benefit involved should not be available to be used to offset income unrelated to that particular activity, then the committee could consider limiting the tax write-offs to the income from that particular activity, thus, not allowing excess deductions to be used to shelter other income. (This is the approach that the Administration made in its limitation on artificial loss (LAL) proposal in its tax reform presentation to the committee on April 30, 1973, and essentially reproposed in its testimony before the committee on July 8, 1975.) In addition, the committee could consider the question of leverage (that is, limiting deductions to amounts of risk).

A third approach to deal with tax shelter investments could be considered if the committee decided against either of the first two approaches; that is, if the committee believes that there is a desired objective for continuing the tax incentives and that revising the provision directly (or applying an LAL approach on their availability) would unduly restrict their purpose, then the committee could consider dealing indirectly with the preferences. This is the approach that the Congress took in 1969 when it enacted a minimum tax to make sure that taxpayers paid at least some tax on those specified tax preferences that the committee believed were appropriate to continue for the desired economic or social purpose. Thus, the committee could review and revise the present minimum tax, as well as make it more generally applicable to all tax-shelter investments, or to cover those preferences that the committee does not deal with directly.

Later pamphlets will deal more specifically with each investment type and cover the various direct or indirect alternatives the committee may want to consider with respect to each one.

1 Retroactive allocations to new partners essentially involve the allocation to a new partner of deductions that were incurred on income that was realized prior to the time of the entrance of the new partner into the partnership.