[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

AUGUST 7, 1985

U.S. GOVERNMENT PRINTING OFFICE

50-668 O WASHINGTON : 1985 JCS-34-85

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INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to tax shelters, the minimum tax on corporations and individuals, and related proposals.

The pamphlet describes present law tax provisions and the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department report to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The first part of the pamphlet is an overview of tax shelters. The second part provides an economic analysis of tax shelters generally. The third part discusses interest deduction limitations; part four discusses the at-risk rules; part five discusses partnerships; part six discusses farm losses; and part seven discusses minimum tax proposals.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Tax Shelters and Minimum Tax* (JCS-34-85), August 7, 1985.

I. OVERVIEW OF TAX SHELTERS

A. The Nature 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 with respect to other income, as well as the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself. Generally, tax shelters are passive investments in the sense that the investor is not involved in actively managing a business. Tax shelters are typically characterized as abusive if they claim to give the investor larger tax benefits than may be warranted under present law, or if they are structured to take advantage of uncertainties in the law primarily to obtain tax benefits, without regard to the economic viability of the investment.

In some instances, tax shelters merely take advantage of specific incentives, such as the accelerated cost recovery system or the deduction for intangible drilling costs, which Congress has legislated. Other shelters use devices in the tax law to achieve tax savings which may never have been specifically intended by Congress. Still others inflate certain deductions, credits, etc. beyond the properly allowable amount.

B. The Elements of a Tax Shelter

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. A second frequent element of a tax shelter is the "conversion" of ordinary income (subject to tax at a maximum rate of 50 percent for individuals) 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 deductions. These elements of a tax shelter are described below.

Deferral

Deferral generally arises from the acceleration of deductions to reduce a taxpayer's tax liability in the early years of an investment while income is concentrated in the later years.

The effect of deferral is as if the taxpayer grants himself an interest-free loan from the Federal Government, which loan is repayable when the tax-shelter investment either produces taxable income or is disposed of at a gain. For example, if at the end of year one, a taxpayer wishes to have an additional $1,000 loan for use in year two, he can obtain a one-year bank loan. If the prevail-

ing rate of interest is 15 percent (compounded annually), he would repay $1,150 at the end of year two. If he is in the 50 percent bracket, the benefit of the interest deduction will reduce his after tax cost to $1,075. Alternatively, the taxpayer could invest in a tax shelter that deferred tax on $2,000 of income until the following year. The taxpayer then would have a $1,000 tax savings for year one (at the 50-percent maximum rate of tax), and at the end of year two, instead of repaying a lender $1,150 at an after tax cost of $1,075 (after deducting the $150 of interest payments), the taxpayer would incur a Federal income tax of $1,000 on the $2,000 of income generated by the investment. Thus, the taxpayer would have in effect borrowed $1,000 for the one-year period without an interest cost. The longer the deferral period, the greater the benefit obtained by the taxpayer. In addition, the taxpayer could invest in another tax shelter to provide a "rollover" or further deferral of the tax. A lengthy deferral of tax approaches an exemption.

In some cases, deferral of tax liability is obtained by the use of legislatively sanctioned tax provisions which accelerate deductions, such as, for example, the Accelerated Cost Recovery System (ACRS) or the expensing of intangible drilling costs. The tax law also permits the deferral of tax through the use of certain accounting methods, such as the installment method of reporting income. Certain benefits associated with this so-called time-value of money were limited by the Deficit Reduction Act of 1984.

Conversion of ordinary income

A second aspect of many 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 when, for example, a taxpayer takes an accelerated deduction from an investment against ordinary income and receives income on disposition of the investment that is taxed at the 20-percent maximum capital gains rate. Also, if the taxpayer is in a lower tax bracket in the year when the investment generates even ordinary income, he effectively "converts" the tax rate. Corporations may benefit from converting ordinary income or even capital gain income to dividend income eligible for the 85-percent dividends received deduction.

In the case of certain deductions (*e.g.*, depreciation deductions), as described in the forthcoming Capital Income pamphlet, Congress has dealt with conversion by means of "recapture rules" which require a portion of the gain on disposition of an investment to be treated as ordinary income (rather than capital gain). 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 equity investment. From an economic viewpoint, to the extent that a taxpayer can use borrowed money to fund a tax-shelter investment, he can use his own money for other purposes (such as

other investments), resulting in an increase in earnings if the investments are more profitable, after tax, than the after-tax cost of the borrowing. From a tax viewpoint, borrowed funds generally are treated in the same manner as a taxpayer's own money. Because a taxpayer is allowed deductions for expenditures paid with borrowed funds, the tax benefits of deductibility (*e.g.*, deferral) are maximized.

In addition, because interest payments on indebtedness are themselves deductible currently against ordinary income while the income attributable to the investment often is taxed only when realized or at reduced capital gains rates, a debt-financed investment provides an additional tax advantage relative to an equity-financed investment. The significance of leverage can increase where a taxpayer obtains a nonrecourse loan (i.e., when there is no personal liability to repay the loan). The benefits associated with the use of nonrecourse loans are discussed below.

To some extent, from an overall revenue point of view, the tax benefits to borrowers arising from interest deductions are offset by the tax paid on the lender's interest income. However, many lenders are tax-exempt, and taxable lenders tend to have lower marginal tax rates than do borrowers. As a result, debt financing tends to result in revenue losses to the Treasury.

C. Scope of Tax Shelters

According to an industry newsletter, taxpayers invested approximately $8.25 billion in "public program" tax-advantaged investments (i.e, limited partnerships registered with the Securities and Exchange Commission) in 1984, compared to $8.4 billion in 1983 and $5.5 billion in 1982.[2] These included approximately $3.9 billion in "shelter-oriented" investments (i.e., partnerships which pass through wholly or partially tax-free cash distributions and in some cases excess losses), including leveraged real estate, oil and gas drilling, equipment leasing, and miscellaneous categories. The remaining $4.4 billion was invested in "income-oriented" partnerships (generally, partnerships which pass through partially or wholly taxable income), including unleveraged real estate, mortgage loan partnerships, and oil and gas income funds which invest in producing properties. An additional $10.5 billion[3] is estimated to have been invested in "private placement" partnership investments in 1984 (generally involving fewer than 35 partners), nearly all of it in "shelter-oriented" investments.[4] According to the newsletter, real estate accounted for 69 percent of the public programs market in 1984, while oil and gas declined to approximately 19 percent (as compared to 36 percent in 1983). Real estate also accounted for the largest share of private placements.

The flourishing of tax shelters in recent years has affected the administration of the tax laws in at least three ways. First, the limited audit resources of the Internal Revenue Service have in-

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[2] Robert A. Stanger & Co., *The Stanger Review: Tax Shelter Sales*, December 1984. The terms "shelter-oriented" and "income-oriented" are the terms used in this newsletter.

[3] Testimony of Investment Partnership Association before the Committee on Ways and Means, July 30, 1985.

[4] The volume of private placements appears to have declined so far in 1985.

creasingly been diverted to focus on tax shelters. Second, the judicial process, particularly the Tax Court, has been burdened by a substantial increase in the number of pending cases. Third, the rise of the tax-shelter industry may have contributed to a deterioration in compliance by undermining taxpayer confidence in the fairness and effectiveness of the tax laws.

With respect to audit resources, resource constraints on the Internal Revenue Service have combined with growth in the number of taxpayers to reduce audit coverage from 2.11 percent of all individual income tax returns in 1979 to 1.27 percent in 1984.[5] In 1979, the Internal Revenue Service examined 1,844,986 individual income tax returns. By 1984, that number had declined to 1,215,927 returns, on which there were assessed approximately $4.38 billion in additional taxes and penalties. At the same time the number of staff positions assigned to examination increased slightly from 22,944 to 23,934. As of September 30, 1984, there were 331,395 tax shelter cases in audit, as compared with 182,731 in 1979 (the 1983 figure was 334,549). During 1984, an additional 114,323 tax shelter returns were closed after examination, with recommended taxes and penalties of $2.2 billion. Thus, tax shelter cases accounted for approximately one-half of recommended taxes and penalties.

The increasing number of tax shelter returns has also contributed to the rising backlog of cases in the Tax Court. At the end of 1979, the Tax Court had 27,910 cases pending on its docket. In 1981, three additional judges were appointed to the Tax Court and the interest rate on deficiencies was increased. Also, between 1979 and 1984, the Tax Court more than doubled the rate at which it disposed of cases, closing 34,451 cases in 1984,[6] as compared to 13,098 in 1979. Nonetheless, by the end of 1984, the backlog of docketed cases had risen to 63,932 cases. More than one-third of the Tax Court's current inventory consists of tax shelter cases, representing nearly $2 billion in asserted deficiencies.

Although the direct impact of tax shelters on the administrative and judicial process is substantial, their indirect impact may be more significant. A major concern is that the highly visible marketing of tax shelters, and the accompanying belief that the Internal Revenue Service cannot deal with those shelters which are abusive, may erode taxpayers' confidence in the fairness and effectiveness of the tax system. Likewise, to the extent tax shelters are legitimate under present law, it is possible that a highly visible market may tend to cause taxpayers to perceive the entire system as unfair. Sociological research supports the proposition that taxpayers are more likely to comply with the tax laws when they perceive the system to be fair and when the penalties for noncompliance are perceived as high and certain. Thus, compliance may decline if the widespread use of tax shelters deprives the tax system of its claim to fairness and retards the administrative and judicial processes so that penalties seem neither certain nor costly, in comparison with tax shelter benefits.

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[5] IRS and Tax Court figures are derived primarily from the 1984 Annual Report, Commissioner and Chief Counsel, Internal Revenue Service, pp. 12, 13-14, 42-45, 60-61, and 73. The numbers of returns examined does not necessarily reflect the "quality" of the returns selected from the viewpoint of assessing deficiencies.

[6] 40,514 cases were filed in the Tax Court in 1984.

II. ECONOMIC ANALYSIS

A. Overview

The increase in tax shelter activity has an immediate impact on tax revenue, particularly in the case of shelters where the tax write-offs are larger than the equity investment. This shifts the burden of the income tax to taxpayers that do not invest in tax shelters. Furthermore, the proliferation of tax shelter activity may decrease public confidence in the equity of the tax system. In addition, the organization and promotion of tax shelters diverts thousands of lawyers, accountants, and other professionals from other, possibly more productive, activities.

B. Limited Partnership Tax Shelters

Generally speaking, a tax shelter is any investment which results in a mismatch between deductions (or credits) and income, so that the deductions (or credits) "shelter" unrelated income from tax. For purposes of analysis it is useful to distinguish between tax shelter benefits that arise from tax incentives provided by Congress and those that result from the creative use of structural tax rules to accomplish results not intended by Congress. A so-called abusive tax shelter is structured to give the investor larger write-offs than may be warranted under current law or take advantage of uncertainties under the law. Abusive tax shelters may constitute illegal tax evasion and sometimes may involve fraud.

Increasingly, the limited partnership form of organization has been used to take advantage of tax shelters. Limited partnerships, like corporations, limit the liability of investors, but unlike corporations, are not subject to the corporate income tax. The income or loss of partnerships is flowed-through and taxed at the partner level. In 1983, partnerships (both limited and general) with net losses reported net losses of $62.9 billion, $2.6 billion more than the $60.3 billion of net income reported by partnerships with net income (see Table 1).[7] It is estimated that the deduction of net partnership losses reduced Federal income tax revenues by $7.4 billion in 1983, over 32 percent of the tax paid by individuals reporting net partnership loss.

In seven sectors, partnerships with net losses reported net losses of over $1.5 billion: farming; oil and gas extraction; security and

[7] These data overestimate tax shelter losses to the extent that net partnership losses are due to adverse economic circumstances as opposed to tax deductions. However, *net* partnership loss data underestimate tax deductions to the extent that losses from one partnership offset profits from another partnership in which the same taxpayer is a partner.

commodity dealers; holding and investment companies; real estate; hotel and lodging services; and business services (including leasing). Table 1 shows that over half of the $62.9 billion of business losses claimed by partners is attributable to two sectors: real estate ($25.4 billion) and oil and gas extraction ($9.5 billion).

Table 1.—Partnership Income and Loss, 1980 and 1983

Sector	With net income				Without net income			
	Number of partnerships (thousand)		Net income (billion dollars)		Number of partnerships (thousand)		Net loss (billion dollars)	
	1980	1983	1980	1983	1980	1983	1980	1983
All sectors	774	783	45.1	60.3	606	758	36.8	62.9
Farms	63	62	2.2	2.1	45	49	1.8	2.3
Oil and gas extraction	14	24	3.6	5.9	17	32	7.3	9.5
Security/commodity dealers	1	2	0.6	2.0	1	5	1.1	1.6
Holding/investment companies	92	72	5.8	5.3	69	55	6.9	4.2
Real estate	211	245	8.1	11.6	253	340	11.4	25.4
Hotel and lodging services	7	9	0.7	0.8	9	9	0.7	2.1
Leasing and business services	29	44	1.2	2.1	22	35	1.1	2.7

Source: Internal Revenue Service, Statistics of Income Branch.

The use of limited partnerships to flow through losses to investors has increased significantly in recent years. Over the three-year period 1980–1983, the number of partnerships reporting losses increased by 25 percent, while the number of partnerships with net income increased by only 1 percent. Over the same period, the amount of losses flowed through to investors in partnerships reporting losses increased by 71 percent, while the amount of income flowed through to investors in partnerships with net income increased by 34 percent. Thus, despite the economic recovery in 1983, the number of partnerships with losses increased 25 times faster than the number of partnerhips with net taxable income, and the amount of net loss increased twice as rapidly as the amount of net income reported by partners.

Limited partnerships serve a variety of legitimate business purposes and are an important source of investment capital in the economy. However, there is concern that limited partnerships are being used to market tax shelters to a rapidly growing number of taxpayers. In response to this concern, Congress enacted increased penalties for substantial underpayment of tax liability, new penalties for tax shelter promotions, and other compliance measures in the Tax Equity and Fiscal Responsibility Act of 1982. Additional provisions were added by the Deficit Reduction Act of 1984, including: tax shelter registration and reporting requirements; maintenance of investor lists by tax shelter promoters; increased penalties for promoting tax shelters; and an increased rate of interest on substantial underpayments attributable to tax-motivated transactions.

Net partnership losses are deducted primarily by higher income taxpayers. In 1983, it is estimated that 43.2 percent of taxpayers with over $200,000 of income reported net partnership loss, which reduced tax liability by an average of 12.1 percent in this income class (see Table 2). By contrast, only 0.6 percent of taxpayers with income between $10 and $20 thousand reported net partnership loss, and this loss reduced tax liability by an average of 0.3 percent in this income class. Thus, the deduction of partnership losses has tended to reduce the tax burden of upper income relative to lower income taxpayers.

Tax losses from forms of ownership other than partnerships also are used by high-income taxpayers to reduce tax liability on other income. Table 3 is similar to Table 2 except that it analyzes the effect of "passive" losses on tax liability. For the purpose of this table, passive losses include, in addition to losses from limited partnerships, losses from rental and royalty activities and from subchapter S corporations, since these activities or forms of ownership may also give rise to tax losses which are not real economic losses. Using this definition, many more taxpayers use tax losses to shelter other income than those tabulated in Table 2, although the use of losses, like partnership losses, increases with income levels. More than half of all taxpayers in the $200,000 and above income class have passive losses; these losses reduce the tax liability of these taxpayers by 15.7 percent.

Table 2.—Distribution of Net Partnership Loss, 1983

[Returns in thousands; tax amounts in millions of dollars]

Income class [1] (thousands)	Number of returns with and without loss	Number of returns with partnership loss	Tax liability before partnership loss	Tax reduction due to partnership loss	Percent of returns with partnership loss	Percent tax reduction
$10–$20	25,476	164	$31,747	$90	0.6	0.3
$20–$30	17,178	211	48,123	116	1.2	0.2
$30–$40	10,130	236	44,537	159	2.3	0.4
$40–$50	5,924	192	38,316	179	3.2	0.5
$50–$75	4,041	301	39,299	690	7.4	1.8
$75–$100	936	171	15,594	630	18.3	4.0
$100–$200	833	242	25,572	2,006	29.1	7.8
$200 and above	271	117	37,898	4,596	43.2	12.1

[1] The income concept used to place tax returns into income classes is: Adjusted gross income plus nontaxable unemployment compensation; contributions to individual retirement accounts; the deduction for two-earner married couples; the minimum tax preferences; and net losses, in excess of minimum tax preferences, from rental and royalty activities, subchapter S corporations and limited partnership interests.

Source: Joint Committee on Taxation.

Table 3.—Distribution of Net Passive Loss [1], 1983

[Returns in thousands; tax amounts in millions of dollars]

Income class [2] (thousands)	Number of returns with and without loss	Number of returns with passive loss	Tax liability before passive loss	Tax reduction due to passive loss	Percent of returns with passive loss	Percent tax reduction
$10–$20	25,476	713	$31,893	$236	2.8	0.7
$20–$30	17,178	1,087	48,614	607	6.3	1.2
$30–$40	10,130	923	45,154	776	9.1	1.7
$40–$50	5,924	662	38,875	738	11.1	1.9
$50–$75	4,041	827	40,327	1,718	20.5	4.3
$75–$100	936	302	16,116	1,153	32.3	7.2
$100–$200	833	365	26,401	2,834	43.8	10.7
$200 and above	271	152	39,488	6,186	56.1	15.7

[1] Net passive loss is defined as net losses from rental and royalty activities, subchapter S corporations, and limited partnership interests.

[2] The income concept used to place tax returns into income classes is: Adjusted gross income plus nontaxable unemployment compensation; contributions to individual retirement accounts; the deduction for two-earner married couples; the minimum tax preferences; and net losses, in excess of minimum tax preferences, from rental and royalty activities, subchapter S corporations; and limited partnership interests.

Source: Joint Committee on Taxation.

Partly as a result of the use of tax losses, a significant number of high-income taxpayers have relatively low tax rates. As shown in Table 4, 2.6 percent of taxpayers with incomes over $200,000 have no tax liability, 4.1 percent have tax rates (i.e., tax liability divided by income) between 0 and 5 percent, and 7.4 percent have tax rates between 5 and 10 percent. On the other hand, a substantial number of taxpayers in this income class have relatively high tax rates; one-third have a tax rate over 30 percent and another 24.0 percent have tax rates between 20 and 30 percent. It should be noted that besides tax losses, factors such as the capital gains deduction and itemized deductions contribute to the dispersion of tax rates among these taxpayers.

Table 4.—Percentage Distribution of Average Tax Rate for Tax Returns with Incomes of $200,000 and above, 1983

Tax rate (percent)	Percent distribution
0	2.6
0–5	4.1
5–10	7.4
10–15	11.8
15–20	17.0
20–30	24.0
Above 30	33.2
Total	100.0

Note: See footnote 1 in Table 3 for definition of income used for calculations shown in this table.

Results similar to these were found by the Treasury Department in a recent study.[8] Using an income measure which adds all business and investment tax losses to adjusted gross income, the study examines the effects of certain losses on the 1983 returns of taxpayers with income over $250,000. It finds that losses from partnerships, subchapter S corporations, rental and royalty activities, farms, and businesses offset 18.3 percent of the income of these taxpayers; the corresponding figure for middle-income taxpayers (with income between $30,000 and $75,000) is 4.4 percent. Of the high-income taxpayers, approximately 64 percent reported partnership losses. Largely as a result of tax losses, 11.4 percent of these taxpayers had tax liability less than 5 percent of income, 9.8 percent had a tax rate between 5 and 10 percent, and 32.0 percent had a tax rate between 10 and 20 percent.

C. The Market for Tax Shelters

To understand tax shelter activity it is useful to analyze the market for tax shelters. On the demand side of the market are taxpayers with substantial taxable income confronting high marginal

[8] Office of Tax Policy, Department of the Treasury, *Taxes Paid by High-Income Taxpayers and the Growth of Partnerships*, July 31, 1985.

tax rates. On the supply side of the market are users of tax-advantaged assets. The users of tax-shelter assets have an incentive to rent them from a tax shelter partnership, rather than own them, if they cannot take full advantage of tax deductions because they (1) lack sufficient unrelated income to shelter, or (2) have low marginal tax rates. Also on the supply side of the market are tax shelter promoters who organize and market limited partnerships interests in tax-shelter assets. The growth of tax shelter marketing is attributable to factors increasing both the supply and demand for tax shelters.

Supply factors

The supply of tax shelters is partly dependent on the ability of asset users to take advantage of the tax write-offs generated by their assets. The combination of the Accelerated Cost Recovery System (ACRS) and debt-financing, particularly in highly leveraged investments such as real estate, can generate tax deductions which are substantially larger than pre-tax income over the early years of the life of the property. It is interesting to note that debt-financing or ACRS alone will not, in general, cause the value of an investment's deductions to exceed the value of its pre-tax income in present value terms. However, in combination, tax deductions can greatly exceed pre-tax income. In these situations it is often difficult for asset users to absorb fully interest and depreciation deductions (and tax credits). This encourages asset users to lease from partnerships, the owners of which are better able to utilize tax write-offs (and credits).

Another factor that may explain the proliferation of tax shelters in recent years is the increasing complexity of the tax law, and the backlog of regulations, which appear to be providing more opportunity to take advantage of uncertainty in the tax laws.

Demand factors

The Economic Recovery Tax Act of 1981 (ERTA) reduced the top tax bracket on unearned income from 70 to 50 percent, a reduction of 29 percent, and reduced other tax rates by 23 percent, upon becoming fully effective in 1984. This change alone might have been expected to decrease the demand for tax shelters since the value of a $100 write-off to a top bracket taxpayer dropped from $70 to $50. ERTA also expanded eligibility for individual retirement accounts (IRAs) and increased the limitation on contributions to IRAs. Both of these changes would be expected to reduce demand for marketed tax shelters. In addition, the rapid growth in tax-exempt bond issues would tend to reduce this demand.

An increase in demand for marketed tax shelters could be attributable to a lagged response to the rapid increase in marginal tax rates which occurred prior to ERTA. Table 5 shows that from 1971 to 1981, the average tax bracket of individual taxpayers rose from 24.0 to 32.1 percent.

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Table 5.—Average Marginal Income Tax Rates, 1962–1982

Calendar year	Average marginal tax rate [1] (percent)
1962	24.9
1963	26.1
1964	22.7
1965	21.8
1966	22.2
1967	22.9
1968 [2]	27.0
1969 [2]	27.5
1970 [2]	24.5
1971	24.0
1972	24.4
1973	25.7
1974	26.2
1975	26.8
1976	27.8
1977	28.7
1979	29.6
1980	31.2
1981	32.1
1982 [3]	29.8

[1] Marginal tax rate (i.e., the rate applicable to the last dollar of income) for all returns, weighted by adjusted gross income.
[2] Includes surtax at 7.5% of individual income tax liabilities for calendar year 1968, 10% for calendar year 1969, and 2.5 percent for calendar year 1970.
[3] Data estimated for 1982.

Source: Joint Committee on Taxation.

It is likely that taxpayers do not immediately adjust their investment portfolios in response to an increase or decrease in their marginal tax rate. It takes time to compare and evaluate investment alternatives, and taxpayers may be cautious about investing in tax-oriented limited partnerships.

In conclusion, the recent growth in tax shelter marketing appears to be explained by the abundance of deductions and credits in the tax system as a result of ACRS and high real interest rates; and an increase in taxpayer interest in tax shelters as a lagged response to increasing marginal tax rates prior to 1982. Even as marginal rates decline, so long as significant effective marginal rate differentials are available (for example, due to the availability of accelerated deductions or preferential capital gains rates), taxpayers may continue to engage in tax shelter activity.

Approaches to reducing tax shelter marketing

The market for tax shelters can be reduced by policies which operate on the supply or the demand side of the market. One approach to reduce the supply of tax shelters would be to broaden the tax base and, thereby, reduce the excess deductions and credits

that encourage users of tax-advantaged assets to lease, rather than own, these assets. This strategy would require an examination of the tax incentives that Congress has enacted over the years. Broad base income tax proposals with lower and flatter tax rate schedules such as the Administration proposal, the Bradley-Gephardt bill, and the Kemp-Kasten bill would reduce these incentives. These proposals would reduce tax shelter activity on both the supply and demand sides of the market. On the supply side, base broadening reduces the amount of tax-shelter assets offering large deductions. On the demand side, tax rate reductions decrease the value of write-offs to taxpayers.

A second approach to reduce tax shelter activity would be to retain certain preferences in the tax Code, but limit the amount of incentives available. In view of the significant amount of tax shelter activity in real estate, leasing, and the oil and gas industry, incentives that might be reviewed include: accelerated depreciation; the investment credit; percentage depletion; expensing of intangible drilling costs. Percentage depletion, and expensing of intangible drilling costs, and certain other tax preferences could be reduced by extending the cutback in corporate preference items enacted in 1982 (section 291) to individuals. Alternatively, the scope of section 291 could be expanded to cover other preferences, or to have a more significant impact on certain of the preferences to which it applies.[9] This is the approach adopted in the Stark-Chafee bills (H.R. 1377 and S. 556).

A related approach would be to revise the present law minimum tax to reduce the extent to which any single taxpayer is able to utilize tax shelters. The present alternative minimum tax on individuals covers some, but not all, deductions and credits used in tax shelters, and was significantly expanded in 1982. It would be possible to modify the alternative minimum tax further so that it would more accurately reflects economic income. The Administration proposal and several congressional bills would revise the individual and corporate minimum taxes.

A third approach to reduce tax shelter deductions would be to add special anti-tax shelter provisions to the existing rules. The Administration proposal would extend to real estate the application of the at-risk provisions enacted in 1976. In general, the at-risk rules limit current tax deductions on an investment made by individual investors and certain closely held businesses to the investors' maximum economic loss (on an activity-by-activity basis). Terminating the exclusion of real estate investment from these rules could reduce the rapid growth of real estate tax shelters.

A related provision of the Administration proposal would extend the scope of the investment interest deduction limitation to include a taxpayer's share of the interest expense of partnerships in which the taxpayer is a limited partner. The unlimited deductibility of interest by limited partners is an important feature of many real estate tax shelters. The Administration proposal generally would limit an individual taxpayer's deduction of interest expense (other than interest on debt used in a trade or business or secured by the

[9] The preference cutback was generally increased from 15 to 20 percent by the Deficit Reduction Act of 1984.

taxpayer's principal residence) to the taxpayer's investment income (including partnership income) plus $5,000. For this purpose, a limited partner's share of interest deductions of a partnership would be treated as investment interest.

Finally, the viability of tax shelters could be limited by altering the rules applicable to vehicles, such as limited partnerships, which are used to market shelters.

D. Economic Effects of Tax Shelters

The proliferation of tax shelters has had an important impact on revenues and on the efficiency and equity of the income tax system. The growth of shelters feeds on itself: as the tax base is eroded, rates must be raised if revenues are to be maintained, which in turn increases the demand for tax shelters. This vicious circle threatens the integrity and fairness of the tax system as the tax burden falls increasingly on taxpayers who do not, or cannot, take advantage of tax shelters. The growth of tax shelters affects the fairness of the tax system in other important respects, including shifts in the ownership of certain assets from low-bracket to high-bracket taxpayers. For example, farms are being sold to limited partnerships who can pay more than others due to their superior ability to utilize tax write-offs or in some cases their willingness to take more aggressive positions on their tax returns. This may bid up the price of farmland and may encourage sole proprietors to abandon agriculture.

Even the tax shelters based on incentives can have important effects on tax equity. For example, the Accelerated Cost Recovery System (ACRS) increased the value of depreciation deductions on rental housing purchased after 1981. This contributed to a construction boom which has glutted the real estate market in several southwestern cities. Post-1981 investors (often limited partnerships) can afford to lower rents or sustain high vacancy rates because of the generous ACRS deductions. However, the income of pre-1981 investors in real estate, who rely on the old depreciation rules, may have been reduced as rents fell and vacancy rates increased in response to this oversupply. Thus, the effect of tax incentives for new investment can be to transfer wealth from existing investors to new investors.

The growth of tax shelters may have had an adverse impact on the efficiency as well as the fairness of the tax system. Tax shelter activity has significantly reduced the tax base over time, thus contributing both to higher deficits and the need for higher tax rates. In addition, tax shelter marketing absorbs the talents of thousands of highly skilled professionals who might otherwise be employed in activities that contribute to the growth of GNP rather than the redistribution of the tax burden. Finally, in the case of shelters based on tax incentives, there is evidence that the government has lower cost alternatives to the creation of tax shelters, such as targeted spending programs, for encouraging certain types of economic activity. Tax shelters tend to be inefficient incentive mechanisms as a result of the high organizational and management fees charged by the tax shelter promoters. Tax shelter incentives are also inefficient to the extent that they are targeted to investors taxed at less

than the top tax bracket. If investors in the 40-percent bracket are considered a market for a tax shelter, then the benefit passed through to the users of the assets are determined by the tax benefits of these marginal investors. In this case, high-income investors in the 50-percent bracket would receive a windfall, since the value of write-offs is 25 percent larger for these upper income investors. Thus, to the extent that these windfalls and organizational fees absorb the tax benefits of an incentive-type shelter, the tax system is an inefficient mechanism for increasing desirable economic activity.

III. INTEREST DEDUCTION LIMITATIONS

Present Law and Background

Present law imposes a limitation on the deductibility of investment interest (Code sec. 163(d)). In the case of a noncorporate taxpayer, deductions for interest on indebtedness incurred or continued to purchase or carry property held for investment is generally limited to $10,000 per year, plus the taxpayer's net investment income. Investment interest paid or accrued during the year which exceeds this limitation is not permanently disallowed, but rather is subject to an unlimited carryover and may be deducted in future years (subject to the applicable limitation) (sec. 163(d)(2)). Interest incurred to purchase or carry certain net lease property is treated as investment interest.

Income and interest of partnerships and S corporations generally retains its entity level character (as either investment or non-investment interest or income) in the hands of the partners and shareholders. The present law treatment of interest incurred to purchase or carry a partnership interest or S corporation stock is not entirely clear.[10]

Under present law, no limitation is imposed on the deductibility of either personal (consumer) interest, or of interest on funds borrowed in connection with the taxpayer's trade or business.

Investment income

Investment income under present law means income from interest, dividends, rents, royalties, short-term capital gains arising from the disposition of investment assets, and any amount of gain treated as ordinary income pursuant to the depreciation recapture provisions (secs. 1245, 1250, and 1254), but only if the income is not derived from the conduct of a trade or business (sec. 163(d)(3)(A)).

Investment expenses; straight-line depreciation and cost depletion

In determining net investment income, the investment expenses taken into account are real and personal property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income, and depletion, to the extent these expenses are directly connected with the production of investment income. For purposes of this determination, depreciation or depletion with respect to any property is taken into account on a straight-line basis over the useful life of the property or a cost basis, respectively.

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[10] Proposed Treasury Regulation sec. 1.57-2(b)(2)(i) under prior law implies that the interest would not be investment interest where the underlying assets are not investment assets. *Compare* Rev. Proc. 72-18, 1972-1 C.B. 740, Sec. 4.05 (relating to section 265 of the Code), and sec. 163(d)(7); *see* H.R. Rep. No. 97-760, 97th Cong., 2d Sess. at 476-477 (1982).

Minimum tax

For purposes of the individual alternative minimum tax, interest (other than interest on certain qualified housing) is deductible as an itemized deduction only to the extent of the taxpayer's net investment income. For this purpose, interest on indebtedness incurred to acquire or carry a limited partnership interest or stock in an S corporation (in the case of a stockholder who does not actively participate in corporate management) is treated as an itemized deduction. Also for this purpose, investment income includes net income (or loss) taken into account through a limited partnership interest or such S corporation stock.

Administration Proposal

Under the Administration proposal, investment interest subject to the limitation on deductibility would be expanded.[11] In addition to interest subject to the limitation under present law, investment interest would also include the taxpayer's share of all interest expense of S corporations (other than S corporations in which the taxpayer actively participates in management), and the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. It would also include all other interest not incurred in connection with a trade or business, except home mortgage interest on the taxpayer's principal residence (to the extent of its fair market value).

Interest on indebtedness incurred to carry or acquire business rental property used by the taxpayer for personal purposes for part of a taxable year would generally be treated as business interest (and thus not subject to limitation) in the same proportion that the number of days the property is rented at a fair rental bears to the number of days in the taxable year.

Interest subject to the limitation would be deductible only to the extent of the sum of (1) $5,000 ($2,500 in the case of a married person filing a separate return), and (2) the taxpayer's net investment income. In general, net investment income for this purpose would have the same meaning as under present law, except that it would include the taxpayer's share of all income of S corporations not managed by the taxpayer and the taxpayer's distributive share of all income of limited partnerships in which the taxpayer is a limited partner. Any interest deduction disallowed for the taxable year under this limitation would be treated as interest expense subject to the limitation for the succeeding taxable year. This rule would be phased in under two separate transitional rules over a 10-year period commencing in 1986.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill (S. 409, H.R. 800) would limit the deduction for nonbusiness interest for noncorporate taxpayers to the

[11] The Administration proposal and others as they relate to limitations on the itemized deduction for consumer interest are also discussed in a forthcoming pamphlet relating to Taxation of Individuals.

sum of housing interest (on a principal residence plus other dwellings used by the taxpayer or his family during the year) plus the amount of the taxpayer's net investment income, including net capital gains from investment property. No additional $5,000 amount would be allowed under the bill. The Bradley-Gephardt bill would limit—to the amount of net investment income—the deduction for interest incurred to purchase an interest in a limited partnership, an S corporation in whose management the taxpayer does not actively participate. These rules would become effective after 1986.

1984 Treasury Report

The 1984 Treasury report is similar to the Administration proposal except that it would take account of the indexing of interest, which was also proposed in the report.

Analysis

The present law limitation on the deductibility of investment interest attempts to prevent the mismeasurement of income by limiting differences in timing and character of deductions arising from interest on indebtedness and the income that is related to that indebtedness. Thus, the present law limitations on deducting investment interest are intended to prevent the current deduction of interest, which would be used to offset unrelated income (e.g., earned income and business income), where the income attributable to an asset purchased with the proceeds of the indebtedness is deferred and in many instances potentially converted to capital gains.

Definition of investment interest

The Administration proposal, as well as the Bradley-Gephardt bill, would change the present law definition of investment interest. Both would characterize an interest in an S corporation in whose management the taxpayer does not actively participate, as well as an interest in a limited partnership (in which limited partners usually cannot actively participate), as investments, the income from which is investment income. The Administration proposal also provides that interest expense of a limited partnership or S corporation is investment interest, in the hands of limited partners or shareholders who do not actively participate.

Both the proposal and the bill recognize that the status of a passive investor in a limited partnership or an S corporation may be more akin to that of a holder of corporate stock than to a taxpayer actively conducting a trade or business (under the passthrough or "aggregate" view of these entities), because of the investor's limited liability and lack of active participation in management. For example, limited partnership interests are generally treated as "securities" for purposes of federal and state securities laws.

To the extent that the dividing line between an investment activity and a business activity depends upon the status of the taxpayer as an active participant in the underlying trade or business, a more extreme approach would expand the definition of investment interest and investment income to all interest and income attributable to for-profit activities in which the taxpayer does not actively participate.

A similar approach would be to examine the taxpayer's material participation in any aspect of the activity. Material participation in an activity could be determined, for example, by analogy to present law rules determining when an activity of the taxpayer rises to the level that income from it would constitute net earnings from self-employment (sec. 1402 and accompanying regulations). Factors which could be taken into account might include whether the taxpayer is involved in the physical work of the activity and whether he makes managerial decisions substantially affecting the course of the activity.

A material participation standard for directly owned property, like a standard based on active participation in management, might demand a significantly higher level of taxpayer involvement in certain activities (e.g., a rental real estate project) for purposes of determining whether interest is subject to limitations than would present law.[12]

Broadening the scope of investment interest subject to a limitation could be viewed by some as unfair because interest represents an actual "out of pocket" cost of investment. In addition, expanding the limitation to a limited partner's share of interest incurred in the partnership business, as the Administration proposes, might be viewed by some as inconsistent with the "aggregate" theory of partnerships under which the character of items at the partnership level passes through to partners. Even if limited partners are considered akin to corporate shareholders for investment interest purposes, it could be argued that extending the limitation beyond limited partnership interests would require a factual inquiry into whether any particular taxpayer is merely a passive investor or actively or materially participates in an activity, thus potentially causing administrative and enforcement difficulties. On the other hand, the Administration and Bradley-Gephardt proposals to extend investment interest limitations to S corporation shareholders who do not actively participate in management recognize the similarity of such shareholders to limited partners and the possibility that S corporations might be used to circumvent limited partnership rules. The concept of active participation in management (and a concept of "material participation" in an activity) exist and must be applied for specified purposes under present law.[13]

Depreciation for purposes of investment income

Under present law, the computation of investment income measures depreciation using straight line depreciation over the useful life of the property. It is understood that the Administration pro-

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[12] Compare sec. 163(d)(4) (net lease provision) with Treasury Regulation sec. 1.1402(a)-4(a) and (b) (material participation for self-employment tax purposes) and Proposed Treasury Regulation 1.464-2(a)(3) (active participation in management).

[13] The concept of "active participation in management" applies to determine whether interest expense of a S corporation shareholder attributable to the acquisition of his stock is a preference item for purposes of the alternative minimum tax under present law (sec. 55(e)(8)). The concept also applies, for example, to limit the deductibility of losses of certain farming syndicates (sec. 464(c)); for purposes of aggregation rules under the at-risk provisions of present law (sec. 465(c)(3)); and to define "hedging transactions" for purposes of present law rules regarding the treatment of regulated futures contracts and certain other interests (sec. 1256(e)).

Concepts of "material participation" in an activity apply for certain estate tax purposes (sec. 2032A(e)(6)) and for purposes of determining whether a taxpayer has earnings from self-employment in certain circumstances (Treas. Reg. § 1.1402(a)-4).

posal would substitute RCRS[14] in measuring depreciation for this purpose. Thus, under both present law and the Administration proposal, any loss caused by the benefits of accelerated cost recovery is allowable in full without reducing investment income and accordingly without reducing the amount of investment interest allowable. This is intended to preserve the benefits of the accelerated recovery deductions in a debt financing situation. However, to the extent the passive investors take advantage of both the deductibility of interest in full plus the accelerated recovery deductions, which together may provide substantial mismeasurement of income,[15] it could be said that the availability of tax shelters will not be restrained by the proposal. On the other hand, since accelerated cost recovery tax incentives are intended to promote investment, whether or not debt-financed, a limitation on the interest deduction in such circumstances could be viewed as inhibiting debt-financed investment.

Interest allocable to business use of vacation home

Another issue relates to the treatment of interest on rental property used for part of the year by the taxpayer as a residence. In the interests of simplicity and consistency with present law, the allocation of interest between the business use and the personal use could be made in the same manner as presently provided under section 280A, relating to rental of vacation homes. Under that provision, the allocation of deductions attributable to rental use is made in accordance with the ratio of the rental days to the days of actual use during the year (see sec. 280A(e)). If interest were so allocated, the amount allocated to business use could be deductible to the extent of rental income, as under current law, with only the excess being subject to the nonbusiness interest limitations. Such an approach would tend to be more generous than the Administration proposal, but would avoid the administrative difficulty of allocating interest expense and other expenses under different formulas.

Scope of investment interest limitation

Expansion of the net interest limitation to interest deductions with respect to certain holdings that may be considered essentially passive would not limit the ability of taxpayers to use other deductions from such holdings against noninvestment income. An investment interest limitation expansion could, however, curtail the attraction of a tax shelter investment that furnishes a net tax saving attributable at the margin to the deductibility of interest, in the case of a taxpayer who does not have enough other investment income to absorb the interest limitation. Some have suggested extending the "passive investment" concept (at least in certain limited partnership cases and possibly other situations) to limit the deductibility of all losses from such activities to income from such activities. (See Part V, Section B, below.)

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[14] RCRS is the depreciation proposal set forth in the 1984 Treasury report and is intended to reflect economic (i.e., not accelerated) depreciation (as well as the effects of inflation).

[15] This result could tend to be more pronounced under the Administration proposal, which would index the basis of depreciable assets but would not require financing or interest deductions to be indexed.

IV. AT-RISK RULES

Present Law and Background

A loss limitation at-risk rule was first adopted by Congress in 1976, and later expanded in 1978, in order to limit the incentives for taxpayers to reduce their tax liability by investing in tax shelter activities in which they were not subject to real economic risk (Code sec. 465). An investment tax credit at-risk rule was adopted for similar reasons in 1981.[16]

The at-risk rules apply to individuals and to closely held corporations (sec. 465(a)(1)). They do not apply to the holding of real property (other than mineral property) and, in the case of closely held corporations, to certain equipment leasing activities or to certain active business activities (sec. 465(c)(3)(D), (c)(4), and (c)(7)). In the case of partnerships and S corporations, the rules apply at the partner or shareholder level. Thus, a partner is considered at risk with respect to a partnership loan from a third party to the extent the partner may be held personally liable for repayment of the loan.

In general, the at-risk rules limit a taxpayer's tax benefits (i.e. losses and credits) from an activity to those benefits attributable to funds which the taxpayer has personally invested in an activity (in the case of the loss limitation rule) or a property (in the case of the investment tax credit rule), including funds which the taxpayer borrowed to the extent he is personally liable to repay or has pledged other, non-financed, property (except property used in the activity) as security (sec. 465(b)).

Purposes of at-risk rules

The at-risk rules serve several purposes. In the case of property which is seller-financed (or financed by a party related to the seller), they serve to reduce the incentive for the parties to inflate the purchase price in order to give the purchaser additional tax deductions (e.g., for depreciation or accrued interest) or an inflated investment tax credit. In these situations, the buyer of overvalued property might otherwise be unconcerned about the higher price, since the property may simply be repossessed by the seller after the buyer has benefited from the inflated deductions or credits.

By limiting deductions and credits to the amount the taxpayer has at risk, the at-risk rules also prevent tax benefits from accruing to a purchaser who has no real equity in a property because the property's value is, or may become, less than the face amount of a nonrecourse loan on the property for which the taxpayer has no personal liability. In these situations, the purchaser could re-

[16] The Administration proposal would repeal the investment tax credit and with it the investment tax credit at-risk rule.

ceive tax benefits without bearing the economic burden of any corresponding decline in the property's value. Thus, to the extent the at-risk rules prevent the purchaser from taking current deductions and credits attributable to nonrecourse financing, they generally prevent him from deducting more than his maximum economic loss with respect to nonrecourse-financed property.

In addition, the at-risk rules may limit the extent to which taxpayers take deductions and yet may fail, upon disposition of leveraged property, to "recapture" prior deductions or credits taken with respect to the property. Failure to recapture prior tax benefits in the circumstance of a foreclosure, for example, is largely a compliance problem. To the extent the taxpayer was not initially at risk with respect to the property, however, the deductions or credits would not originally have been allowed.

Administration Proposal

The Administration proposal would extend the at-risk rules to real estate activities of individuals and closely held corporations, effective with respect to losses attributable to property acquired after December 31, 1985.[17]

Other Proposal

1984 Treasury Report

The 1984 Treasury report would extend the at-risk rules to all investment and business activities of individuals and closely held corporations, including equipment leasing activities of closely held corporations, as well as real estate activities, which are not subject to the at-risk rules under present law. This proposal would be effective for losses attributable to property acquired after the date the proposal is introduced as legislation, unless acquired under a binding contact previously entered into.

Analysis

In general

On the one hand, many of the reasons for applying the at-risk rules to non-real estate activities also apply to real estate activities: i.e., prevention of the deduction of tax losses in excess of maximum economic loss by persons with no real equity in the property, overvaluation concerns and compliance problems concerning avoidance of recapture of prior tax benefits. Real estate tax shelters at present offer an investor the ability currently to deduct tax losses in excess of his maximum risk of economic loss. The investor may be unconcerned about the economic soundness of the underlying investment, since, in any event, his economic losses are limited to his actual investment at the same time that he enjoys the benefits of

[17] The Administration proposal generally indexes the basis of depreciable property for inflation, thereby allowing more than one dollar of deduction for each dollar of investment. It is unclear how the at-risk rules are to apply to these additional deductions. This issue is discussed in a forthcoming pamphlet relating to Capital Income.

tax deferral and tax conversion with respect to amounts financed on a nonrecourse basis.[18]

On the other hand, the proponents of the real estate at-risk exception argue, as they successfully argued in 1976 and 1978, that, unlike other activities, in the real estate business nonrecourse financing is a traditional method of lending money and also appropriately permits owners to spread the risk of loss to a diversified third party lender in an arm's length negotiated transaction; to apply at-risk rules interferes with legitimate financing where the investors have real equity in the property financed. Proponents of this argument might distinguish nonrecourse loans made by third party unrelated lenders, where some real equity is likely to be present, from, for example, seller-financed nonrecourse loans where the possibility of overvaluation and the utilization of tax benefits by persons having little or no equity is more likely. At the least, bona fide third-party loans should not come within the at-risk rules, these persons argue, because lenders would tend not to make nonrecourse loans in excess of the present and expected value of the property, and would tend to require that borrowers have sufficient equity in the property as to make abandonment and default unlikely.

Applying the at-risk rules might not substantially change or inhibit certain real estate financing. For example, a lender and borrower might be willing to agree to similar real estate financing which is currently nonrecourse on a recourse basis (even if the borrower's other assets and income were insufficient to secure it), if the lender and borrower believed that the value of the financed real estate was sufficient collateral. Thus, one effect of applying the at-risk rules to real estate activities might be to give the borrower as well as the lender an additional incentive not to obtain financing in excess of the property's present and projected value, and at rates not in excess of the income likely to be generated by the property. For this reason, some argue, it would be especially appropriate to extend the at-risk rules to seller-financed real estate transactions.

Whether or not nonrecourse financing secured by real estate is less likely than other nonrecourse financing to exceed the value of the underlying property, overvaluation is not the only concern addressed by the at-risk rules. To the extent that, under present law, owners of real estate may take deductions and credits attributable to nonrecourse financing, proponents of the at-risk rules would argue that it is inappropriate that such owners may enjoy tax benefits unrelated to any real equity they may have in the property, in excess of their maximum risk of loss from the property. It could also be argued, however, that owners would be reluctant to proceed with potentially risky or expensive projects if personal liability were required to obtain the full benefit of the investment incen-

[18] Under present law, the difference between the depreciated basis of real property and the outstanding nonrecourse debt can be taxed as capital gain rather than ordinary income, providing a conversion benefit even if the project becomes worthless. Such opportunities to convert ordinary income to capital gain and to defer taxation would be limited under the Administration proposal to repeal capital gain treatment upon disposition of depreciable and depletable business property. This special treatment of gain on sale would be retained, however, for dispositions of land, under the Administration proposal.

tives in the tax law. Thus, because nonrecourse financing is an important component of real estate investments some argue, extending the at-risk rules to real estate could inhibit real estate development.

Aggregation of real estate activities

Another issue in the context of extending the at-risk rules to real estate is the extent to which aggregation or separation of real estate activities would be required. Aggregation of activities is important because, to the extent a taxpayer is permitted to aggregate his activities for purposes of the at-risk rules, he may offset (i.e., shelter) income from one such activity against losses from another. Opponents of extending the at-risk rules to real estate may suggest that separating one real estate activity from another, for purposes of the at-risk rules, creates serious enforcement and recordkeeping burdens, and could be subject to manipulation.

Under present law, aggregation of certain activities is permitted where the taxpayer actively participates in the management of activities which constitute trades or businesses, or, if the activity is carried on by a partnership or S corporation, 65 percent or more of the losses are allocated to persons who so actively participate (sec. 465(c)(3)(B)). The purpose of these rules is to permit aggregation only of the taxpayer's activities in which he is likely to be actually a participant, but not those where he is a passive investor. Similarly, appropriate aggregation rules for real estate activities, taking into account the taxpayer's active participation, the form of entity, and the allocation of losses from the activity, the duration and purpose of financing and the relation of the activity to sequential or physically adjacent real estate activities of the taxpayer could be devised.

Relevance of at-risk rules to widely held or affiliated corporations

Although the Administration proposal would not extend the at-risk rules to non-closely held corporations, many of the same concerns applicable to individuals taking losses where they are not at risk could apply in the corporate sector. For example, widely held corporations may engage in tax-favored activities to take advantage of tax benefits without necessarily having to be at risk. A corollary problem involves the use of losses of a subsidiary corporation by a parent corporation filing a consolidated return. Any losses in excess of the parent's basis in the stock and debt of its subsidiary represent a tax loss without necessarily representing a real economic loss to the parent.[19] Thus, some argue that in the interests of fairness all taxpayers, including widely held corporations, should be subject to the loss limitation at-risk rules, and that affiliated corporations filing consolidated returns should not be permitted to deduct losses in excess of their basis in their subsidiaries' stock and debt.

Those who favor extending the at-risk rules to all taxpayers assert that, when financing arrangements and transactions are de-

[19] Under the consolidated return regulations, such losses are recaptured as gain on disposition of the subsidiary. The gain is generally capital gain, unless the subsidiary has become worthless. Treas. Reg. sec. 1.1502-19.

termined on the basis of tax results rather than economic considerations, the tax law may cause misallocation of funds to the detriment of real economic productivity. Further, such transactions may in some cases permit taxpayers to utilize tax benefits without bearing the corresponding economic burdens. Thus, these persons might argue that potential market disruption resulting from extension of the at-risk rules, to the extent not stemmed by appropriate transitional rules, merely represents the reallocation of capital away from tax-motivated investments without marketable economic viability.

On the other hand, others would argue that extending the at-risk rules to all taxpayers and to consolidated groups would disrupt normal business financing techniques, and would also create uncertainty and have a chilling effect on pending and future transactions. These persons assert that it could curtail the intended benefits of tax incentives for capital investment to impose the at-risk rules upon all taxpayers, including widely held corporations.

V. PARTNERSHIPS

A. General Background

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 both the general provisions of the tax law applicable to partnerships, and certain provisions of the income tax regulations having particular application to limited partnerships. A limited partner is, in effect, a passive investor who is not personally liable for any more than his equity contribution to the partnership (plus his agreed future contributions), even though he may benefit by certain partnership provisions allowing him to deduct losses in excess of his currently paid-in contribution.

Under the partnership provisions of the Internal Revenue Code (secs. 701-771), a partnership is generally treated as an entity for accounting purposes and treated as a conduit for taxpaying purposes. It is an entity for purposes of calculating many particular items of income, deduction, and credit and taxable income exclusive of such separate items (sec. 703). It is also an entity for purposes of reporting information to the Internal Revenue Service (sec. 6031), and tax audits, similarly, are conducted at the partnership level (secs. 6221–6233).

Conduit tax treatment

A partnership is a conduit—i.e., it receives passthrough treatment—for purposes of income tax liability and payment. Each partner takes into income his own "distributive share" of the partnership's taxable income and the separately allocable items of income, deduction, and credit (sec. 702(a)). The liability for income tax payment is that of the partner, and not of the partnership (sec. 701).

On the profit side, this means that income is taxed at only one level: the partner's level (as distinguished from a corporation where, under present law, income is taxed at the corporate level and again taxed at the shareholder level when the earnings are distributed as dividends[20]). Also, this means that the partner is taxed on the partnership profits even though none of those profits may actually be distributed to the partner.

On the other side, this means that the partnership losses, deductions, and credits pass through to the partner and can be used to offset other income, thereby reducing the income tax liability of the partner. The amount of losses which a partner may deduct under these provisions for a particular year may not exceed the

[20] Electing small business corporations (S corporations) however, are taxed in a manner roughly similar to partnerships, but they are limited to no more than 35 shareholders and are subject to other restrictions not generally applicable to corporations.

amount of the adjusted basis of his partnership interest (sec. 704(d)), which, at the inception of the partnership, equals the sum of his capital contribution to the partnership plus his share, if any, of partnership liabilities.

Partnership liabilities

Treasury Regulations (sec. 1.752–1(e)) provide that a limited partner's share of partnership recourse liabilities is determined in accordance with his ratio for sharing losses, and may not exceed the difference between his actual contribution to the partnership and the total contribution which he is obligated to make. The rationale for this rule is that, to the extent he remains obligated to contribute to the partnership, a limited partner could be called upon to satisfy its recourse liabilities if the partnership is unable to do so; thus, he bears a risk of economic loss and to this extent he may include such liabilities in his basis in the same proportion as he would share in other partnership losses. With respect to partnership nonrecourse liabilities (for which there is not personal liability), the Treasury Regulations provide that a limited partner shares in them in the same proportion in which he shares profits. Because there is no personal liability for such nonrecourse obligations of the partnership and the limited partner could not generally be called upon to satisfy them, he normally experiences no personal economic risk of loss (though partnership assets may secure the debt), and includes a share of these liabilities according to the ratio for sharing partnership profits.

Allocations

A limited or general 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 (sec. 704). The allocation must have substantial economic effect; if it does not, or if the partnership agreement does not provide for allocations, partners' distributive shares of partnership items must be determined in accordance with the partners' interests in the partnership, determined by taking into account all facts and circumstances (sec. 704).

The Treasury Department issued proposed regulations in 1983 interpreting the meaning of "substantial economic effect." These proposed regulations would require as a general rule, among other things, that any partner with a deficit in his capital account[21] following liquidation (for example, due to his having taken deductions in excess of his share of partnership income and his capital contributions) must restore such deficit to the partnership, if an allocation scheme is to have substantial economic effect. Special provisions would apply to capital account deficits attributable to partnership nonrecourse liabilities (discussed in section D, Partnership Liabilities, below).

[21] A partner's capital account generally consists initially of his capital contribution, and is generally increased by his share of profits and reduced by his share of losses and distributions in accordance with the terms of the partnership agreement. A partner's basis for his partnership interest, by contrast, also includes the partner's share of partnership liabilities.

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B. Limited Partnerships as Tax Shelter Vehicles

Present Law and Background

As described in Part I (Overview of Tax Shelters), the growth of tax shelters over the past few years has been rapid despite the reduction in overall tax rates effected by the Economic Recovery Tax Act of 1981. This growth in tax shelters strains the administrative capabilities of the Internal Revenue Service and burdens the judicial system, particularly the Tax Court, which has experienced a substantial increase in pending tax shelter cases. Further, the increasing prevalence and general familiarity and acceptability of tax shelters may erode taxpayer confidence in the fairness of the tax system, and lead to the decline of voluntary compliance. Recent changes in the law have limited some opportunities for abuse, but tax shelters are still absorbing investment dollars. These changes, introduced in the Deficit Reduction Act of 1984 and the Tax Equity and Fiscal Responsibility Act of 1982, added substantial penalties for overvaluation and for promotion of abusive tax shelters, limited the ability of tax shelters to accelerate certain deductions, and imposed a requirement that certain tax shelters register with the Internal Revenue Service.

Marketability of limited partnerships

The continued attractiveness of limited partnerships as tax shelter vehicles depends on several factors. The marketability of tax shelter limited partnership interests is based on the limited liability available to investors combined with the passthrough to investors of writeoffs which can be large in relation to the amount of money the investor contributes in any given year. These results are obtained through a combination of deferral of income, conversion of ordinary income into capital gain, and the use of leverage to increase the ratio of writeoffs to amounts invested. Certain aspects of the conduit tax treatment of limited partnerships, particularly the inclusion of partnership liabilities in limited partners' tax bases for their interests and the allocability of partnership income and loss among the partners, make limited partnerships particularly suitable as tax shelter vehicles.

Other tax shelter vehicles

Other vehicles can be adapted for use as tax shelter vehicles, but do not have this combination of advantages. For example, a general partnership, in which all investors theoretically have personal liability for all the partnership's obligations, is also a passthrough entity and moreover could be utilized to increase the tax advantages of partnership liabilities to investors, but the investors, as general partners, would not have limited personal liability for partnership obligations (unless the obligations were themselves nonrecourse). Investors, especially those seeking tax deductions, may not be enthusiastic about having personal liability for all partnership debts. Thus, the limited liability aspect of limited partnerships is important. S corporations and multiple grantor trusts also offer some measure of conduit treatment combined with limited liability, but are subject to numerous other restrictions which make them

less attractive. For example, S corporations under present law may not have more than 35 shareholders, and liabilities of the S corporation are not included in the basis of the S shareholders' interests. Further, the various items of S corporation income and loss cannot be allocated among the shareholders by means of an agreement. Multiple grantor trusts, too, pose logistical problems which to some degree curtail their attractiveness as tax shelter vehicles. Thus, limited partnerships offer the best combination of passthrough and allocability of tax losses, combined with limited liability, of the aforementioned vehicles under current law.

Proposals

Types of proposals

Various types of proposals have been suggested which could have the effect of curtailing the marketing of limited partnership tax shelters. As discussed below, these include cutting back certain tax incentives which may give rise to net tax losses passed through to investors in entities such as limited partnerships. Others take a different approach, such as limiting or eliminating the loss passthrough feature altogether in certain circumstances. As discussed in section B, eliminating the passthrough feature of limited partnerships could also be accomplished by reclassifying them as nonpassthrough entities like corporations (which are subject to entity-level income tax). Other approaches (discussed in sections D and E) involve changing certain other partnership tax rules concerning partnership liabilities and partnership allocations.

Administration proposal

The Administration proposal would eliminate the investment tax credit and the present law ACRS accelerated depreciation scheme. The CCRS depreciation scheme would be substituted; it provides for less acceleration but would allow the basis of depreciable assets to be indexed for inflation.[22] Capital gain and ordinary loss treatment available under current law upon disposition of certain depreciable and depletable business property would also be curtailed; ordinary income or loss treatment would generally be substituted. The Administration proposal also imposes limits on deductibility of nonbusiness interest (except home mortgage interest) and provides that limited partners, and S corporation shareholders who do not actively participate in management, would be able to deduct interest expense of the limited partnership or S corporation only against their other investment income plus $5,000. In addition, the Administration proposal would extend the at-risk rules to real estate and would expand both the corporate and the individual minimum tax.[23]

American Law Institute (ALI)

Others have recommended a different approach to curtailing the marketing of tax shelters. The American Law Institute ("ALI") has

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[22] These proposals are discussed in a forthcoming pamphlet dealing with Capital Income.

[23] A number of minimum tax bills have also been introduced in Congress, as discussed below in Part VII.

recommended a limitation on the passthrough of net losses to limited partners under certain circumstances. This net loss limitation would apply in partnerships where the general partners hold less than a 40-percent interest in its tax attributes, and there are at least five partners (applying a lookthrough rule). Only limited partners who are individuals, S corporations or closely held corporations would be affected; net losses would be deferred and allowed against the affected partner's share of partnership income, or upon disposition of his interest.[24]

Other approaches

A variation on the ALI recommendation would be to apply a net loss limitation to limited investors under different circumstances. For example, limitations on certain farming prepayments and hedging loss deductions are imposed under present law where 35 percent or more of the interests in losses of the business entity are allocable to limited partners or limited entrepreneurs (secs. 464, 1256). (These rules are discussed below in section C, Partnership Classification.) A similar standard could be applied to trigger a loss passthrough limitation in the case of limited partners. Another approach would be to limit loss passthrough when a limited partnership contains special allocations of losses differing from the overall economic sharing of profits.[25]

In the case of limited partners, the nature of a limited partnership interest shields limited partners from personal liability for partnership obligations in excess of their contribution obligations and generally prevents them, as such, from participating actively in the partnership's business.[26] Thus, limited partners are not normally active participants in management or material participants[27] in partnership business or activity, but rather could be viewed as passive investors more closely resembling owners of corporate stock. Some take the view that such passive investors, especially those with limited liability, should not be entitled to passthrough of net losses under any circumstance.[28]

Under this view, net losses of any limited partnership would not pass through to limited partners on a current basis, but rather would be suspended until such time as the partnership has net profits sufficient to offset them, or until the limited partnership interest is disposed of (if earlier). Partnership tax credits would be limited to a limited partner's tax liability attributable to partnership income.

To prevent circumvention of a rule limiting the passthrough of losses to limited partners, a parallel net loss limitation could also be applied to investments in other passthrough entities, including S corporations, general partnerships, and multiple grantor trusts (and even to direct investments), where criteria triggering the loss

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[24] American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at pp. 445-447.
[25] See discussion of "flip-flops" in section E, *infra*.
[26] See Uniform Limited Partnership Act Section 7 (1916 version) or Section 303 (1976 version).
[27] See discussion of active participation in management and of material participation in Part III above, under Analysis.
[28] Cf. American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 441, noting that "[s]ome Consultants [to the Project] believe that an argument can be made for restricting the passthrough of tax benefits to every limited partner."

limitation are present (e.g., where the investor is not an active participant in management, or is not a material participant in the activity generating the losses.)

Analysis

Limiting tax incentives

The Administration proposal would eliminate the investment tax credit, expand the investment interest limitation, and extend the at-risk rules to real estate activities, and would curtail certain other tax benefits. It also contains both corporate and individual minimum tax provisions. Nevertheless, under the Administration proposal, some measure of acceleration in depreciation, and continued deductibility of interest in excess of investment income is retained.[30] The accelerated depreciation together with indexing is viewed as a spur to capital investment and an incentive to economic growth and productivity, despite its potential, like any tax incentive, to be used in the tax shelter context. Some opportunities for conversion would also be retained. For example, gain on the sale of land used in a trade or business (and not held for sale to customers) would generally remain eligible for capital gain treatment. Also, interest would be deductible without indexing even though assets financed by the debt would be eligible for indexing or capital gains treatment.[30a] Supporters of the Administration proposal argue that these rules would substantially curtail tax shelters, but others suggest that significant tax shelter opportunities would continue to exist.

Limiting conduit treatment of limited partnerships

Some would argue that a net loss limitation is an appropriate response to the continued availability of tax shelter investments. Proponents of this view suggest that it is inappropriate for limited partners who do not actively or materially participate in the trade or business of an enterprise, and are not personally liable for debts incurred in the partnership trade or business, to obtain tax treatment equivalent to direct ownership of the property used in the trade or business of the partnership. Instead, they argue, such investors have more attributes of corporate shareholders than of direct owners or active entrepreneurs. Some contend that current deduction of net losses should be limited when limited partners hold a particular percentage interest in partnership losses, and some contend that under any circumstances a limited partner should not be entitled to a current deduction for the entity's losses in excess of its income.

Those who believe that current net tax losses should not, as a rule, pass through to limited partners argue that limited partnerships are typically utilized as tax shelter vehicles, and thus such a net loss limitation rule would not be overly broad if directed at the marketing of tax shelters. They also point out that because of the

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[30] See Part III, Interest Deduction Limitations, above.

[30a] The Administration proposal would include certain interest expense in the corporate minimum tax base where the taxpayer claims accelerated depreciation. (See Part VII.)

similarity of limited partners to holders of corporate stock,[31] they should not be entitled to deduction of net losses until the partnership realizes profits, or until they dispose of their interests in a transaction where economic as well as tax gain or loss is actually realized (such as a sale). In addition, some proponents suggest that many of the tax investment incentives passed on to limited investors through limited partnerships were intended to benefit active businesses, not passive investors.

Those who believe that limited partners should not in all cases be denied passthrough of net losses argue that other factors, beyond similarity to corporate shareholders (i.e., passive investor status and limited liability), should also be considered. They suggest that certain undesirable results may be more likely to occur when an investment is marketed as a tax shelter (for example, aggressive exploitation of tax shelters by marketing promoters, audit difficulties, and public perceptions of widespread exploitation eroding confidence in the tax system). It is argued that circumstances such as the extent and timing of loss passthrough to limited partners should be examined, and that the likelihood that a limited partnership investment is marketed as a tax shelter is higher, for example, where a substantial part—e.g., more than 60 percent (as in the ALI recommendation) or more than 35 percent (as in secs. 464 and 1256)—of the tax losses are allocated to limited partners, or in some circumstances where limited partners are allocated a greater percentage of tax losses than of overall profit from the venture.

A proposal to limit the net losses of limited partners could evoke the criticism that such a rule would be unfair, too broad, or disruptive of business practices. Specifically, opponents may say that such a proposal is contrary to the "aggregate" or passthrough concept of partnerships and that such current tax treatment of limited partners and partnerships not only has remained in the law for over 30 years in relatively unchanged form, but was intended to, and successfully has, afforded flexibility to investors such that the tax treatment of their venture can parallel its economic substance. Superimposing a net loss limitation rule upon existing passthrough treatment for limited partners would not be appropriate, they assert, and, by cutting back on the flexibility now available to investors, could restrict capital formation and economic growth. These persons contend that equity investment in high-risk or other enterprises should be encouraged by allowing investors, including passive investors such as limited partners, to deduct net losses from the enterprise against their income from other sources, making the tax benefits part of their expected return.

On the other hand, some argue that it is appropriate to curtail the ready transferability of tax benefits and in addition that limit-

[31] Some have advocated that the corporate-level and shareholder-level taxes be integrated, eliminating double taxation of corporate income. See, e.g., Alvin Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harvard Law Rev.* 717 (1981). The Administration proposal would adopt an aspect of this approach by introducing a 10 percent dividends-paid deduction discussed in a forthcoming pamphlet relating to Taxation of Corporations). A net loss limitation rule is not necessarily contrary to a partial or limited integration approach to corporate income taxation, because a primary concern under that approach is double taxation of income, not passthrough of losses.

ing net tax losses passed through under the current system to passive investors such as limited partners can be directly targeted at currently marketed tax shelters. These persons assert that it is unfair for individuals with high incomes to be able to invest in tax shelters (as limited partners without active business involvement) to reduce or even eliminate their tax liability, while other taxpayers who do not invest in tax shelters, and who may have lower incomes, may be paying tax at a higher rate. In addition to this issue of unfairness, the tax subsidy given under current law to passive investments in passthrough entities is said to lead to investment choices undesirably responsive to tax factors. Those holding this view assert that if the expected return on an investment, due to tax savings, is sufficient that funds might be committed to it without serious consideration of the ultimate likelihood of economic profitability of the venture, then tax benefits may be functioning improperly and discourage, not encourage, the capital formation conducive to economic productivity and growth.

Opponents may make the argument that a net loss limitation rule would be redundant, because the at-risk rules already furnish a limitation on the deductibility of losses in excess of the amount for which an investor is at risk for any taxable year (except for real estate investments). Others might say the proposal would be redundant for a different reason: because current law already provides that a limited partnership will be reclassified—and taxed as—a corporation if it has more corporate than noncorporate characteristics. The alternative possibilities would not necessarily all apply in the same circumstances, however. The at-risk rules generally permit net loss deductions attributable to liabilities for which the investor is personally liable, thus permitting current deductions in excess of current income from the investment. A net loss limitation rule, on the other hand, generally would prevent deduction of such losses in excess of income either from the particular investment, or from all investments of the type subject to a net loss limitation. Partnership reclassification rules, discussed below, might be applied in circumstances where a net loss limitation rule would not be applied, and could have the added effect of imposing an entity-level tax.

Other extensions of net loss limitations

If a proposal like the ALI recommendation or any other approach to limit the passthrough of net losses of only limited partners were adopted, it might be circumvented through a shift of tax shelter investments to other, currently less attractive vehicles such as S corporations, for example.[32] Shareholders of S corporations have some similarity to limited partners, in that they have limited personal liability for corporate debt and need not materially participate in the trade or business of the corporation. Unlike limited partners, however, S corporation shareholders are not generally prevented by State law from so participating; other differences

[32] In making its recommendation regarding partnerships, the ALI Subchapter K Project states, "Because a Subchapter S corporation is frequently an acceptable vehicle for marketing tax-shelter losses, any restriction imposed on limited partnerships may not be fully effective unless parallel restrictions are imposed on the passthrough of losses by Subchapter S corporations." ALI, *Federal Income Tax Project—Subchapter K* (1984), at 444.

(such as a maximum of 35 shareholders, the one class of stock requirement, and the non-inclusion of corporate liabilities in a shareholder's basis for his stock)[33] distinguish S corporations from limited partnerships. Nevertheless, the passthrough of corporate losses to S corporation shareholders offers the same basic advantage as does the passthrough of limited partnership losses to limited partners. Similarly, other vehicles, although less desirable than limited partnerships under current law, could be used as tax shelter vehicles if a net loss limitation is placed upon limited partnerships. Even certain direct investments might be considered shelter vehicles, either because they are marketed like certain limited partnership interests [33a] or for other reasons.

Some would suggest imposing a net loss limitation on all losses from passive investments in passthrough entities where the investor has limited liability. Under this notion, S corporation shareholders who do not materially participate in the trade or business of the S corporation, and who by definition are shielded from personal liability for debts of the S corporation, would be subject to the net loss limitation rule just like limited partners. By contrast, such an investor who materially participates in the trade or business of the entity would not be subject to the loss limitation rule. The rationale for this treatment would be that an investor in a passthrough entity who materially participates in the business more closely resembles a direct owner or active entrepreneur than he resembles a typical corporate shareholder, even though he may enjoy limited liability.

Some would further broaden the net passive loss limitation to apply to all losses from activities in which the taxpayer does not materially participate or is not actively involved in management.[33b] Applying this approach, losses from all passive investments (whether owned directly or through or by an entity) could offset only income from all such investments, and could not offset income derived from personal services or from a trade or business in which the taxpayer materially participates. Another version would limit net passive losses (on an activity-by-activity basis) to income from the activity generating the losses.

Proponents of these types of rules contend that, if a taxpayer does not materially participate in the activity generating tax losses, he should not be permitted to deduct them on a current basis. Rather, they suggest, it would be more appropriate that losses be recognized upon the occurrence of an event which normally determines the recognition of gain or loss, such as a sale of his interest. These persons argue that recognition of tax losses, espe-

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[33] This would tend to limit the amount of corporate losses he could deduct. On the other hand, an S corporation shareholder is generally permitted to deduct corporate losses attributable to his loans to the corporation (sec. 1366(d)).

[33a] In discussing its particular proposal to limit loss passthrough in the case of certain limited partners, the ALI observes: "The need for continued Code improvements to limit tax-shelter abuses should, of course, be recognized. However, since the limitation of loss passthroughs to limited partners is an important step in that direction, it should be taken at this time even though there will remain some areas in which tax shelter losses continue to be exploited. These include, undoubtedly, activities carried on directly by individuals." ALI, *Federal Income Tax Project—Subchapter K* (1984) at 434. The ALI notes that "tax shelters are increasingly marketed to individual taxpayers," *Ibid.* at 442.

[33b] See discussion of active participation in management and of material participation in Part III above, under analysis.

cially losses arising from tax incentives such as accelerated cost recovery which do not necessarily correlate to concurrent economic losses, should not be allowed to investors who are not active participants in the activity generating them. Some proponents of these loss limitation extensions also draw an analogy to the limitation on net capital losses under present law. Noncorporate taxpayers may not, under present law, deduct net capital losses in excess of $3,000 per year (sec. 1211(b)). The limitation on the deduction of capital losses against ordinary income is based on the theory that an investor has a significant amount of discretion to determine when to realize investment losses, and may attempt to shelter ordinary income by realizing accrued capital losses without realizing accrued capital gains (i.e., by disposing of only investments that have declined in value while retaining investments that have appreciated in value). The limitation applies, however, even when a taxpayer has only investment losses and no unrealized capital gains, and even though those losses were not anticipated. It might be argued that investors who make passive investments in tax shelter vehicles expecting initial tax losses similarly are exercising discretion to shelter ordinary income from other sources.

On the other hand, a net passive loss limitation rule applicable to passthrough entities or to all activities in which a taxpayer did not materially participate could be criticized as overly broad if intended principally to limit the marketing of tax shelters, and difficult to administer. It could also be argued that such extensive net loss limitations are unfair, because an investor could experience actual economic loss, without accompanying tax deductions, if his investment became worthless before the activity generated any income. In such circumstances, it is argued, the investor would not be allowed to deduct any losses generated by the activity until he disposed of his interest in it, even if the deductions represented real economic decline in value.

Others might argue, as above, that allowing current deduction of net tax losses arising from investment incentives (such as accelerated depreciation) is appropriate to allow full use of the incentive. These persons might also argue that the resulting tax subsidy should be permitted, even to passive investors, to encourage investment.

C. Partnership Classification

Present Law and Background

Corporate resemblance

Whether a business entity is taxed as a partnership or as a corporation (and, thus whether losses can be passed through to the investors) depends upon which form of enterprise the entity more nearly resembles.[34] Treasury regulations list six major characteristics ordinarily found in a corporation. Two of these, namely associates, and an objective to carry on a business for joint profit, are shared by corporations and partnerships and are therefore irrelevant in determining the classification. With respect to the other

[34] Treasury regulations sec. 301.7701-2(a).

four, i.e., continuity of life, centralization of management, limited liability, and free transferability of interests, an entity generally will be classified as a corporation rather than a partnership only if it possesses at least three of these four characteristics. Thus, it is central to their function as conduits, and hence, as tax shelters, for limited partnerships to have fewer than three of the four corporate characteristics, thus enabling its partners to deduct tax shelter losses. Particularly as applied to limited partnerships, these characteristics (as developed in the regulations) have been criticized as unrealistic [35] in that a revision of the classification test that more realistically analyzes these factors and others would result in many entities now classified as partnerships being treated as corporations.

The Tax Court, in the case of *Larson* v. *Commissioner* (66 T.C. 159 (1976), acq. 1979-1 C.B. 1) applying the regulations, suggested that additional factors might be relevant in determining whether a limited partnership should be reclassified as a corporation. In 1977, the Treasury Department issued, and immediately withdrew, proposed regulations intended to make the test for reclassification more realistic, particularly as applied to limited partnerships. The proposed rules (42 *Fed. Reg.* 1038 (Jan. 5, 1977)) would have tightened the test with respect to the continuity of life and centralized management factors, and would generally have required the examination of additional factors if an entity had two of the four corporate characteristics. The proposed regulations were intended as a response to criticism that the existing regulations deviated from the "resemblance test" on which they were based, as articulated by the Supreme Court in *Morrissey* v. *Commissioner*, 296 U.S. 344 (1935). After the 1977 proposed regulations were withdrawn, the Internal Revenue Service subsequently indicated, in Rev. Rul. 79-106, 1979-1 C.B. 448, that it would follow the *Larson* application of the existing regulations, without examining additional factors. Thus, the issue under present law—whether the test for partnership status in the existing regulations is inappropriate, especially as applied to limited partnerships—remains unresolved.

Proposals

A number of alternatives have been proposed to the six-factor classification test in the current Treasury regulations. Most proposals have focused specifically on limited partnerships as the primary vehicle for tax shelters.

1984 Treasury Report

The 1984 Treasury report[36] would tax limited partnerships with more than 35 limited partners as corporations. A look-through rule would be applied to the owners of entities, such as corporations, holding limited partnership interests, in determining whether the 35-limited-partner threshold had been reached. The Treasury 35-

[35] Sexton and Osteen, *Classification as a Partnership or an Association Taxable as a Corporation*, 24 Tulane Tax Institute 95 (1975).
[36] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth* (November 1984).

limited-partner proposal is not included in the Administration proposal.

Publicly traded limited partnership proposals

Others have also suggested reclassifying partnerships as corporations for tax purposes, applying tests different from those of the present Treasury regulations. A 1983 Senate Finance Committee Staff Report[37] concerning recommendations for taxation of corporations, also included a recommendation that publicly traded limited partnerships be taxed as corporations. The final report prepared by the Senate Finance Committee Staff[38] contains no such recommendation because of the fact that at the time the final report was published, the 1984 Treasury report had recently published its broader 35-limited-partner proposal, and the Staff determined that it would not approach the issue in a piecemeal manner. The 1984 ALI Subchapter K Project (at 392) would tax any publicly traded limited partnership as a corporation.

Analysis

Treating publicly traded limited partnerships as corporations is intended to prevent conduit tax treatment for entities which tend to carry on active businesses and resemble publicly held corporations (which are not entitled to passthrough tax treatment). On the other hand, many non-publicly traded entities are not entitled to passthrough treatment under present law, while some tax shelter partnerships would be unaffected because they are not publicly traded. Thus, this notion could be criticized as simultaneously too broad and too narrow. Similarly, the 35-limited-partner proposal in the Treasury report has been criticized as easily circumvented, because a small group of very wealthy individuals, for example, could still invest in a limited partnership with less than 35 limited partners and the partnership could still pass through tax losses to them. Alternatively, multiple partnerships might be established to keep the investors in each one below 35.[39]

Loss allocation percentage

Some have argued that, instead of reclassifying as corporations those limited partnerships which are publicly traded, or which have more than 35 limited partners, tax shelter abuse would be better targeted by reclassifying any limited partnership as a corporation if, for example, more than 35 percent of the interests in partnership losses are held by limited partners. Such a rule would prevent the passthrough of net losses to passive investors (limited partners) and would subject net income to double taxation (once at the entity level, and again at the investor level when distributed). Proponents of such a reclassification rule assert that, in the case where a substantial portion of a partnership's investors, like most shareholders of publicly traded corporations, have limited liability

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[37] Senate Committee on Finance, Preliminary Report (October 1983).

[38] Senate Committee on Finance, The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff (May 1985) at 72.

[39] Keyser, "Publicly Traded Limited Partnerships: The Treasury Fights the Wrong War," *Tax Notes*, April 29, 1985.

and are not active participants in the entity's trade or business, they should be treated more like corporate shareholders for tax purposes. A similar rule, in cases where more than 35 percent of the losses during any period are allocable to limited partners, has been implemented to deny limited partners certain deductions for hedging losses and to defer limited partners' deductions for prepayments by farming syndicates until the materials which were prepaid are actually used. (See secs. 1256 and 464.) The purpose of the rule, as in place under current law, is to prevent limited entrepreneurs, who do not actively participate in a trade or business, from utilizing its losses as if they did so participate. This purpose would also be served by substituting this rule for the current Treasury regulations determining when a partnership is reclassified as a corporation. It could be argued, however, that such a standard would be overly broad as a reclassification standard because it would reclassify as a corporation an entity where a large percentage (up to 64 percent) of interests in losses were held by general partners.[40]

Regulated investment companies and real estate investment trusts

Others assert that limited partnerships should not, when reclassified, be taxed like corporations. Rather, they argue that all limited partnerships should be treated in a manner similar to RICs or REITs. Under this theory, net losses would not be passed through on a current basis to limited partners. Losses would be allowed only on the disposition of a partnership interest. However, there would be no double taxation of net income (i.e., at both the entity and the investor levels) provided a substantial portion of the partnership's income were distributed annually to investors. This type of treatment—no loss passthrough, but no double tax—would curtail the use of limited partnerships as tax shelter vehicles, without also spoiling their attractiveness to profitable businesses.[41] Further, proponents of this view argue, reclassification of limited partnerships as corporations puts too much pressure on the reclassification issue, because double taxation without loss passthrough is so very different from taxation as a partnership that attempts to circumvent the rule could be a serious problem. Thus, they say, reclassification should result in denial of loss passthrough to limited investors, but not double taxation.

Still others say that reclassification of tax-shelter limited partnerships as some other type of taxable entity does not directly address the problem. The simplest and most effective solution, they say, would be to deny a deduction for partnership net losses to limited partners; only to the extent of their share of partnership income subject to tax would limited partners be permitted to deduct partnership losses. Any remaining undeducted loss with respect to the partnership interest would be allowed at the time the partnership interest is disposed of. (Such alternatives are discussed further in section B., above.) This approach, unlike a reclassification approach, would not give rise to partnership level tax. The

[40] Others might suggest other standards for reclassification similar to those suggested for a limitation on net loss passthrough (see Section B, above).

[41] This approach would differ from a limitation on the passthrough of net losses, for example, because the entity would be subject to entity-level tax on net profits, except to the extent profits are distributed to investors.

result at the partner level, however, would be somewhat similar in both cases; net partnership losses would not be allowed on a current basis. Under a reclassification scheme, however, such losses would generally be suspended only in the form of entity-level NOL (net operating loss) carryforwards, and losses on disposition would generally reflect market value decline.

D. Partnership Liabilities

Present Law and Background

Commonly, the current equity contributions of limited partners do not adequately capitalize the operations of a limited partnership. The additional capital frequently is obtained by borrowing. The borrowing may be nonrecourse, using partnership property as security, without the limited partnership or its partners incurring any personal liability with respect to that borrowing. Partnership borrowings may also be made on a recourse basis. The loans obtained by the limited partnership provide "leverage"—in this context, that means that the loans may make it possible for a partner to deduct tax losses in excess of his paid-in equity contribution to the partnership.

Deductible losses limited to partner's basis

A limited partner may generally deduct from his personal income all the deductible items of the partnership which are allocated to him under the partnership agreement,[42] but not more than the amount of his basis for his interest in the partnership, which is reduced by the amount of the deductions previously taken. In addition, a limited partner in a partnership engaged in any activity other than the holding of real property may not deduct more than the amount with respect to which he is considered "at risk" for the activity. Amounts at risk generally include equity contributions and certain amounts borrowed on a recourse basis. See At-Risk Rules, above.

Determination of basis

In general, at the inception of the partnership, a limited partner's basis for his interest equals the sum of his capital contribution plus his share, if any, of partnership liabilities. His basis is generally increased by an increase in his share of liabilities and decreased by a decrease in his share of them, among other factors which affect his basis (sec. 752). A general partner's liability for his share of the partnership's liabilities is theoretically unlimited and so a general partner's basis in his partnership interest is increased by partnership liabilities in accordance with his ratio for sharing losses under the partnership agreement. Under the Treasury's income tax regulations (sec. 1.752-1(e)), a limited partner's share of partnership recourse liabilities is not to exceed the amount that

[42] Section 183 of the Code places limitations on the allowance of deductions to individuals arising from activities not engaged in for profit. In addition, a taxpayer is generally not entitled to the income tax benefits from a transaction entered into without a "business purpose," that is, without a reasonable expectation of an economic profit apart from tax benefits. In order to satisfy this business purpose requirement, the taxpayer must reasonably expect to derive some appreciable net economic (non-tax) benefit from the transaction.

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limited partner may be called upon to contribute under the partnership agreement. However, the Regulations provide, with respect to partnership nonrecourse liabilities, that "where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits." Through the use of this provision, a limited partner in a real estate partnership (who under current law is not subject to the at-risk rules) may obtain a substantial increase in his basis, and, thus, in the amount of losses he may deduct.

Inclusion of partnership liabilities in partner's basis

The passthrough of tax losses to limited partners to the full extent of their share of partnership nonrecourse liabilities, for which the limited partners could never be required to pay anything, is limited under present law by the at-risk rules (discussed in Part IV), except for real estate activities. Limited partners nevertheless may continue to be able to deduct losses attributable to partnership recourse liabilities to the extent of their obligation to contribute to the partnership (provided they are at risk to this extent).[43] Tax shelters frequently are structured so that a limited partner's obligation to pay in the full amount of his capital contribution to the partnership is deferred or contingent, while he expects to include in his basis his share of partnership recourse liabilities up to the amount of his yet unpaid capital contribution obligation.[44] To the extent he could be permitted to deduct losses attributable to this amount, he in effect accelerates deductions attributable to partnership recourse-debt-financed property to a year in advance of the year in which he actually pays a corresponding equity contribution.[45]

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[43] See ALI, *Federal Income Tax Project—Subchapter K* (1984), at 261, n. 7. Proposed Treasury Regulation sec. 1.465-22 provides that a partner's amount at risk is not increased by the amount he is required to contribute until the contribution is actually made. However, Proposed Regulation sec. 1.465-24 provides that "[w]hen a partnership incurs a liability in the conduct of an activity and under State law members of the partnership may be held personally liable for repayment of the liability, each partner's amount at risk is increased to the extent the partner is not protected against loss." The former provision is read by many tax advisors to stand for the fairly narrow point that, in the absense of a partnership liability, a mere promise to pay additional funds to the partnership at a later date does not increase the taxpayer's amount of risk. *See e.g.*, , Arthur Kalish and J. Rosen, "The Risky Business for Partnership Allocations," 38 Tax Lawyer 119, 140-141 (Fall 1984).

[44] Several recent Technical Advice Memoranda suggest that the Internal Revenue Service may contend in some circumstances that limited partners may not include in basis amounts attributable to partnership recourse liabilities if their obligation to contribute to the partnership is viewed as "contingent," for example, if the partnership may generate sufficient funds to pay the obligation without additional limited partner contributions. See, T.A.M. 8404012 (1983) T.A.M. 8421004 (January 25, 1984). Commentators and tax advisers have questioned the validity and rationale of such a position. See, Glenn L. Madere and R. Weitz, "Recent IRS rulings take a restrictive view of limited partnership basis rules," 61 Journal of Taxation 90 (August 1984), and Kalish and Rosen, supra note 43, at 132-134.

[45] Under present law, an allocation of losses to a partner must also have "substantial economic effect" if the losses are to be deductible (as further discussed in Section E, below).

Analysis

Some assert that partnership recourse liability should be included in a limited partner's basis to the extent he could be personally liable for such debt, but nonrecourse liability should not because partners are not generally personally liable for such debt.[46] Under this notion, a partner's basis would be increased by his share of partnership recourse liabilities, to the extent he could be required to satisfy them (in the case of a limited partner, to the extent of his contribution obligation). It has been argued that such an approach might place more significance on the distinction between recourse and nonrecourse debt than economic factors might warrant in particular cases.[47]

Others would prohibit the inclusion in a limited partner's basis for his partnership interest of any partnership-level obligation. Under this view, a limited partner would not be able to include any nonrecourse liability of the partnership in his own basis for his interest, nor would he be able to include recourse liabilities incurred by the partnership in his own basis, even in the amount of his unpaid obligation to contribute to the partnership. Thus, only the amount of money and the basis of property actually contributed would be included in a limited partner's initial basis for his interest. The rationale of this approach is that limited partners have an indirect relation to partnership-level liabilities. Further, because of their passive investor status and limited liability, limited partners are said to more closely resemble corporate shareholders, who may not include corporate debt in the basis of their stock, than they do direct owners of the leveraged property. This approach would thus treat limited partnerships a separate entities, rather than conduits, in determining the effect of partnership liabilities on a limited partner's basis. The effect of such a change would generally be to limit the deductions a limited partner could take from the limited partnership to the amount of his actual paid-in capital contribution (increased by his share of any undistributed partnership income and reduced by any actual distributions to him).

Permitting inclusion of partnership recourse liabilities in a limited partner's basis can be said to give the same tax advantages as does debt-financing of directly owned property.[48] This result is jus-

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[46] See James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary)*, 39 Tax Law Review 345, 398 (1984). It is noted that this approach would "place extraordinary stress on the distinction between recourse and nonrecourse debt." *Id* at 399. Thus, another approach would be to give partners (and S shareholders) basis for entity debt withut regard to personal liability, but it is also noted that such a rule would "perhaps facilitate tax shelters [and] . . . Congress may be reluctant to do anything that would facilitate tax shelters." *Id.* Current law provides that partners, but not S corporation shareholders, may include a share of entity debt in their basis for their interests. S corporation shareholders may include their basis in loans to the corporation in determinng the maximum amount of losses which may be deducted by the shareholder.

[47] The distinction between recourse and nonrecourse debt "sometimes has considerable economic significance, but sometimes it has very little. It means much, for example, if a speculative stock is acquired on 90% margin, but not so much if a well constructed building in a stable neighborhood is purchased with a 40% down payment." Eustice, supra note 46, at 399.

[48] The approach of eliminating partnership recourse debt, up to the amount of a limited partner's future contribution, from a limited partner's basis has been criticized as not appropriate, where the future contribution is paid in at the time the recourse debt comes due and is used to pay it, on the ground that the contribution obligation is "so much like a general partner's liability" that it should be included in basis. American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 262-263.

tified some argue, because limited partners, like direct owners, could be required to satisfy such liabilities (at least to the extent of their unpaid contribution obligations). The rule including a share of nonrecourse liabilities in a limited partner's basis for his interest (thereby permitting him to deduct greater partnership losses), has been similarly justified as an adaptation to the limited partnership situation of a principle based on the decision the United States Supreme Court in *Crane* v. *Commissioner*, 331 U.S. 1 (1947). Under this *Crane* approach, the basis of directly owned encumbered property generally includes the amount of the debt (including nonrecourse debt), for purposes of depreciation; when such property is disposed of, the amount realized includes the amount of the debt, for purposes of determining gain in the transaction. The recent case of *Tufts* v. *Comm'r*, 461 U.S. 300 (1983) treated the amount of the nonrecourse debt, even though in excess of the fair market value of the property, as an amount realized.

Some assert that changing the current rule to exclude all partnership liabilities from a limited partner's basis would not be unfair, if the current rule is excessively generous in a limited partnership context. While limited partners would be treated differently from direct owners and general partners, the difference in treatment can be justified, proponents suggest, because limited partners more closely resemble owners of corporate stock than direct owners of partnership property. They also argue that the *Crane* rule on which the current rule regarding nonrecourse liabilities is based would not be generally abrogated,[49] but would simply become inapplicable in the limited partnership context to which it was extended.[50]

Opponents of the change could further argue that, even though a limited partner would under the changed rule be prevented from currently deducting partnership losses attributable to partnership liabilities, he would nevertheless have to take into account his share of partnership income attributable to them.

Proponents would contend that this is not necessarily an unfair result if the losses which are disallowed due to noninclusion of partnership liabilities in a limited partner's basis are simply deferred and deducted against the limited partner's share of future income of the partnership, or when he actually pays his remaining contribution obligation.

Some may contend that changing the rule would be disruptive of legitimate business practices and would deter capital formation and economic growth. Others contend that a change in the law may more closely reflect economic reality, and encourage investment decisions motivated by economic rather than by tax factors.[51]

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[49] Indeed, some have argued that the *Crane* principle of inclusion of nonrecourse liabilities in basis should be eliminated. See *Tufts* v. *Comm'r*, 651 F.2d 1058 (5th Cir. 1981) at n. 9, reversed, 461 U.S. 300 (1983).

[50] Although the current rules regarding a limited partner's share of partnership liabilities included in his basis for his interest are stated in Treasury regulations, it has been suggested that legislative authority would be required to change them due to the Congressional reenactment of various sections of the Code since regulations were promulgated. See American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 259, n. 4.

[51] The 1984 American Law Institute Subchapter K project, at 262, suggests that a reason not to exclude partnership nonrecourse liabilities from a limited partner's basis is that "real estate

Continued

They may also suggest that appropriate transitional rules in implementing the change would tend to alleviate potential disruption.

Some argue that prohibiting limited partners from including partnership liabilities in their bases for their interests could overlap with the concept (discussed in Section B, above) of limiting deductibility of net losses for passive investors with limited personal liability, or with the at-risk rules (Part IV, above). If the aim of each rule is to limit the use of limited partnership (or other passive investment) losses as the means of tax sheltering, then several similar rules could be redundant. Their scope is not coterminous, however; the net loss limitation could be triggered in situations where the exclusion of partnership liabilities from basis would have no effect. The exclusion of all partnership liabilities from a limited partner's basis and, to a larger degree, the at-risk rules, arguably would permit more sheltering to continue than would the net loss limitation rule, and thus could be viewed as less of a change from current law. For example, the exclusion of liabilities rule would permit the deduction of net partnership losses up to the amount of the limited partner's actual paid-in contribution; the at-risk rules would permit loss deductions up to this amount plus the amount of liabilities for which the limited partner is at risk (i.e., generally, personally liable). The net loss limitation, by contrast, would not permit a limited partner to deduct losses up to the amount of his contribution, but rather would require them to be suspended and offset against future partnership income (or possibly against other passive investment income), or gain on disposition of his interest.

As another example, under the basis limitation rule discussed above, a limited partner could personally borrow an amount and invest the borrowed amount in a limited partnership. The entire borrowed amount would generally be included in his basis and, provided he is at risk, would permit him to deduct partnership net losses against his other income even if he were a passive investor not materially participating in the business of the partnership. Under the net loss limitation rule, however, no deduction for partnership net losses would be permitted on these facts: this rule would take into account not only the element of the investor's personal liability, but also such factors as his material participation in the partnership's business.

E. Partnership Allocations

Present Law and Background

Under the partnership provisions, a limited (or a general) partnership agreement may allocate any item of income, gain, loss, deduction, or credit among the partners in a manner that is disproportionate to the capital contributions of such partners (sec. 704(a), (b)(1)) or to the allocation of other partnership items. These ar-

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would be the industry principally affected," yet it has been excepted from any such rule and from the at-risk rules. This concern is addressed under "At-Risk Rules" above. The ALI would recommend that allocation of nonrecourse liabilities to limited partners be permitted only in accordance with their economic interests in the partnership, and in the absence of any provision in the partnership agreement, in accordance with current-year profit-sharing ratios. *Id.*, at 278.

rangements are sometimes referred to as "special allocations" and, with respect to any taxable year, may be made by amendment to the partnership agreement at any time up to the initial due date of the partnership tax return for that year (sec. 761(c)), except to the extent such allocations constitute retroactive allocations (sec. 706).

Special allocations of profits, losses, income items, and deductions may be used to combine investors with differing tax and investment objectives in a single partnership. As one example, the tax benefits and first return of cashflow may be given to a high income passive investor seeking tax deductions, while a large amount of potential for future income or appreciation may be given to a more active investor who is not seeking current tax deductions.

A special allocation will not be recognized unless it has "substantial economic effect" (sec. 704(b)). If a special allocation does not have substantial economic effect, it is disregarded and the partner's share is redetermined in accordance with the partner's interest in the partnership (determined by taking into account all the facts and circumstances) (sec. 704(b)). Under proposed Treasury regulations (48 Fed. Reg. 9671 et seq., (March 9, 1983)), in general, an allocation to a partner of a partnership item has economic effect if the allocation will actually affect (to the same extent) the dollar amount received by the partner. As a general matter, under the proposed regulations, most allocations would be considered to have economic effect if they meet three criteria: (1) the allocation is reflected in the partner's capital account; (2) liquidation proceeds are required to be distributed in accordance with partners' capital account balances; and (3) any partner with a deficit in his capital account following distribution of liquidation proceeds is required to restore the deficit to the partnership. Even if an allocation has economic effect, it will not be respected unless such economic effect is substantial in proportion to the tax effect under the proposed regulations.

While recognizing that the economic risk of loss attributable to nonrecourse financing is borne by the lender and not by any partner, 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[52] in connection with amortization of the indebtedness or arising due to the fact that present law (*Crane* v. *Comm'r,* 331. U.S. 1 (1947); *Tufts* v. *Comm'r,* 461 U.S. 300 (1983) requires a gain to be recognized for tax purposes in the amount of the difference between the outstanding nonrecourse debt and the adjusted basis upon disposition of the property.[53]

The proposed regulations also state for purposes of the substantial economic effect test that tax incentives such as accelerated depreciation are deemed to reflect economic reality. Accordingly, an investor who is allocated accelerated depreciation and is required to bear the risk that that depreciation reflects a real loss is deemed to be bearing the economic effect of the deduction.[54]

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[52] Amortization of debt is not generally a taxable event; however, taxable profits may produce the funds to pay down the debt.

[53] Proposed Treasury Regulation sec. 1.704-1(b)(4)(iv).

[54] Proposed Treasury Regulation sec. 1.704-1(b)(2)(iii)(c).

Analysis

Nonrecourse liabilities

The proposed regulations have been criticized as too generous, especially with regard to allocations of losses attributable to nonrecourse debt. Since any special allocation to a partner which is attributable to nonrecourse liability is without economic effect, such an allocation, in order to comply with the requirements of the statute, must be determined in accordance with the partners' interests in the partnership. Some suggest that an approach such as that of the proposed regulation, looking principally to whether the partner would be subject to tax on potential gain arising from foreclosure or disposition of the nonrecourse-financed property is not a sufficient standard under the statute for determining a partner's interest in a partnership. The proposed regulation, however, 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 whether allocations not attributable to nonrecourse liability satisfy the statutory standard.[54a]

It has been suggested that the validity of an allocation of partnership losses attributable to nonrecourse debt should be evaluated on the basis of the relative investment by the partners, and the economic sharing of cash from operations, proceeds from a sale of assets, and proceeds from a refinancing of assets. American Law Institute, *Federal Income Tax Project—Subchapter K* (1984), at 251. 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 Committee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983), at 32-38.

Others have contended, however, 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. It is contended that a direct owner of property could take deductions attributable to basis provided by nonrecourse debt (even though the lender bears the economic risk of loss) and would be charged with gain to the extent of the difference between the reduced basis and the outstanding debt on disposition of the property. Thus, it is argued, partners holding property through a partnership should be able to receive treatment, whether or not the partnership involves shifting allocations, so long as the partner who receives the deduction bears the gain-chargeback. It is also contended that some concerns about the extent of possible tax benefit transfers are based on unrealistic hypothetical cases. However, some proponents of this view also offer certain additional restrictions that might be added as a compromise to provide a safe-harbor rule for nonrecourse deductions. Memorandum from Ad Hoc Committee

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[54a] For example, an article written prior to the promulgation of the proposed regulation suggested that a gain-chargeback provision would 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 *Orrish*: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved," 60 *Taxes* 937 (1982).

of Tax Lawyers to the Assistant Secretary for Tax Policy on proposed regulations relating to nonrecourse liability dated May 24, 1983. It is understood that the Treasury Department may reconsider the treatment of nonrecourse liability when final regulations are issued.

Shifting allocations

The statutory "substantial economic effect" test has been interpreted to permit shifts in partnership allocations. Both courts [55] and the Internal Revenue Service [56] have taken the position that shifts in allocation ("flip-flops") are valid under section 704(b).

For example, in a typical flip-flop, often a large proportion of a newly formed partnership's initial losses and deductions (perhaps 99 percent) flow through to the limited partners. This allocation arrangement frequently remains in effect until the limited partners have recouped their initial investments, and perhaps some additional return, whereupon the allocation shifts so that losses (which are much smaller after the initial years) and profits and distributions (which may have increased if the partnership's business has obtained a firm footing) are allocated in greater proportion to the general partners (for example, up from one percent to 40 percent). This type of flip-flop can serve the purpose of giving limited investors an initial high-ratio writeoff, while keeping a substantial profits interest for the promoter.[56a]

It has been suggested that in many tax shelters, tax deductions, rather than capital recoupment or profit motive, are the reason for structuring shifting allocations in a partnership agreement. Thus, shifts in allocation could be treated as invalid *ab initio* (especially if, because of the initial loss allocation, a substantial part of a partner's expected return on investment is likely to be derived from tax savings rather than from ultimate economic profit in the venture). In such circumstances, an appropriate allocation could be redetermined on the basis of each partner's interest in the partnership, taking into account the partner's share of distributions, liquidation proceeds, and proceeds of refinancing partnership profits, as

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[55] See, e.g., *Hamilton v. U.S.*, 687 F.2d 408 (Cl. Ct. 1982), holding that allocation of partnership losses and income primarily to limited partners until "payout" (recoupment of their capital contributions), and thereafter a shift in allocation of these items primarily to general partners, did not constitute nonrecourse loans from the limited to the general partners, but rather both allocations were valid.

[56] Treas. Reg. sec. 1.704-1(b)(2), Example 5, and Prop. Treas. Reg. sec. 1.704-1(b)(5), Example 16(ii).

[56a] Flip-flops have also been designed to achieve other objectives. For example, leveraged buyout transactions have been structured so that a corporation with large net operating loss carryovers and a new corporation formed by buy-out investors enter into a partnership which acquires the assets of the target profitable corporation and incurs the debt for the acquisition. The profits of the partnership are allocated 90 percent to the loss corporation for a limited period of time (for example the period over which cash flow of the venture is expected to be used to pay down the debt incurred to acquire the assets). Thereafter, profits of the partnership are allocated 90 percent to the other corporation. The loss corporation is entitled to distributions with respect to its capital account build-up during the initial period, but over a very long period of time (e.g., 25 years), with a low amount of guaranteed payments in the nature of interest. The transaction is intended to utilize the loss corporation's loss carryovers to facilitate the amortization of the acquisition debt, and to avoid certain limitations on the use of loss carryforwards that might apply if the loss and the profit corporation otherwise combined.

well as the extent of his maximum risk of economic loss (regardless of tax losses).[57]

It has often been said that the provisions of subchapter K were crafted to afford partners flexibility in arranging their affairs. Thus, a proposal to invalidate shifting allocations *ab initio*, where a substantial part of an investors' return is likely to be derived from tax savings, might be criticized as inappropriately preventing partners from arranging the tax results of their agreement in a manner which reflects the true economic reality of the transaction. Thus, for example, if partners all agree that the price of a partnership interest comprised of receiving an allocation of 99 percent of partnership losses and profits until the initial contribution is recouped, followed by an allocation of 60 percent of partnership profits, is equal to 99 percent of the partnership's initial capital requirements, then this arrangement should be respected for tax purposes. It is also argued that if an investor's expectation of recouping his investment is speculative or contingent, and he may actually lose his money, the investment is in the nature of equity and tax losses, reflecting the possible economic loss of his investment, should be permitted to flow through to him under a shifting allocation arrangement.

Proponents of invalidating shifting allocations might argue that part of an investor's expected return from an investment with a high initial loss allocation to him may consist of the tax savings which the immediate tax sheltering affords. Thus, the "economics" of the investment are in part determined by its tax results. To the extent the partner is allocated an initial share of losses greater than his ultimate share of profits, it has been argued that the transaction resembles a small capital contribution and a larger loan by the partner to the partnership. (This resemblance might arguably increase if the investor realistically expected the venture to repay his initial investment.) Instead of interest, he initially receives tax savings. When the amount of the hypothetical loan has been recouped, he is left with a small equity participation in the form of a profit share. Thus, arguably, it is reasonable that the allocation of losses to him attributable to the sum he in effect loaned the partnership should be invalid, and allocations to him should be redetermined to reflect his interest in the partnership. Others contend that in the absence of a fixed obligation to repay the investment, the investor should not properly be viewed as a lender.

Some may contend that even if an investor's interest is in the nature of equity, the long-standing present law permitting special allocations of tax losses encourages the marketing of tax shelters and warrants reconsideration. Equity investors who do not seek special allocations of tax benefits would be unaffected by a change and could deduct losses in accordance with their interests.

Others could contend that invalidating certain shifting allocations is unwieldy and complex, and would virtually require a case-by-case analysis, especially in the case of different allocation ratios of different partnership items (such as depreciation, interest deductions, and the like). However, some might argue that such a rule

[57] This type of circumstance could also serve as the trigger for a net loss limitation to partners, rather than an allocation invalidation rule. See Section B above.

might be no more complex, unwieldy, or difficult than existing law (and proposed regulations) applicable to determining when an allocation has "substantial economic effect," and to redetermining an allocation in accordance with a partner's interest in the partnership.

VI. FARMING LOSSES

Present Law and Background

Farming is a capital intensive enterprise that often results in tax losses.[58] These losses arise partially from the greater than average use of generally available tax deductions and credits which persons engaged in farming, like all capital intensive enterprises, make. The losses also arise in part from special tax rules, generally accounting-related, that apply to farming. Farming deductions have been restricted in certain cases by special provisions designed to limit mismatching of income and deductions under certain circumstances.

Accounting-related provisions

Method of accounting

As a general rule, taxpayers for whom the production, purchase, or sale of goods is an income-producing factor must maintain inventory accounts and use the accrual method of accounting for purchases and sales. Persons engaged in the business of farming, however, generally may use the cash receipts and disbursements method of accounting. Under cash accounting rules, all costs, including the costs of acquiring or producing goods held for sale, are deducted in the year paid, even if that year is earlier than the year in which the goods are sold and the income from the sale is recognized for tax purposes. Under the accrual method, expenses and income generally are matched more closely than under the cash method as a result of such features as the requirements that inventory accounts be maintained and that all events giving rise to a liability occur before a deduction is claimed.

Subject to two principal exceptions, corporations (unlike proprietorships and partnerships) engaged in farming must use the accrual method of accounting (Code sec. 447). The first exception to the required use of the accrual method by farming corporations permits use of the cash method by S corporations and family-owned corporations (meaning at least 50 percent of the stock, in vote and value, is owned by members of the same family) (sec. 447(c)). The second exception permits corporations with gross receipts not exceeding $1 million for the prior taxable year to use the cash method of accounting (sec. 447(e)).

[58] Many of the specific tax rules discussed below will be analyzed in greater detail in forthcoming pamphlets on Capital Income and on Tax Accounting.

Special expensing and amortization provisions related to farming

Soil or water conservation expenditures.—Expenditures for soil or water conservation improvements may be deducted in the year paid or incurred rather than added to the basis of farmland (sec. 175). The amount claimed as a deduction under this expensing provision may not exceed 25 percent of the taxpayer's gross income from farming in any year.

Certain soil conditioning expenditures.—Certain expenditures for fertilizer and other soil conditioning that otherwise would be added to the basis of farmland may be deducted in the year paid or incurred (sec. 180).

Land clearing expenditures.—Taxpayers may deduct as a current expense amounts paid or incurred for the purpose of clearing land to make it suitable for farming (sec. 182). The maximum deduction in any year for land clearing expenses may not exceed the lesser of $5,000 or 25 percent of taxable income from farming.

Reforestation expenditures.—Taxpayers may elect to amortize certain reforestation expenditures over a seven-year period (sec. 194). The maximum amount of expenditures paid or incurred in any year for which amortization deductions may be elected is $10,000.

Payment of estimated taxes

In general, at least 80 percent of income tax liability must be paid in four quarterly installments (unless the tax is paid through withholding on wages). If at least two-thirds of an individual's income is derived from farming or fishing, the requirement of estimated tax payments is waived provided his income tax is paid in full, and the return filed, by March 1 of the following year (sec. 6654).

Treatment of commodity credit loans

The Commodity Credit Corporation makes nonrecourse loans to farmers with respect to crops for which the Federal Government operates price support programs.[59] Taxpayers may elect to treat amounts received pursuant to loans under these programs as income when received (i.e., as if they had sold the crops to the Government) (sec. 77). If this election is not made, income is recognized when the loan is repaid or when forgiveness of the indebtedness occurs (i.e., when the CCC takes title to the crop and the debt is cancelled). This provision permits farmers, to some extent, to choose the year in which income is recognized.

Treatment of certain gains and losses

Gain realized on the sale or other disposition of a capital asset is subject to tax at preferential rates. Although the term capital asset does not include property used in a taxpayer's trade or business that is of a character subject to depreciation (sec. 1221(2)), gain from the sale of such property may be treated as gain from the sale

[59] The nonrecourse nature of these loans in effect shifts from the producer to the Federal Government the risk of loss from these agricultural commodities (i.e., the excess of the Federally supported price over the market price plus carrying costs on the loans).

of a capital asset if gains on all sales of depreciable business property during a year exceed losses on such sales (sec. 1231). Gain from most farming property (e.g., tractors and barns) is eligible for the preferential tax treatment provided for capital gains on the same basis as other trade or business property. Cattle and horses held for draft, dairy, breeding, or sporting purposes are eligible for this treatment if the animals are held by the taxpayer for 24 months or more (sec. 1231(b)(3)). Other livestock held by a taxpayer for these purposes is eligible if held for 12 months or more.

Special farming rules also are provided qualifying certain farming property that may, in substance, constitute inventory property for capital gains treatment. For example, gain on timber produced as part of timber farming operations is taxed as gain on disposition of a capital asset even though the timber may be regarded as a crop (i.e., inventory) produced in the farming operation (sec. 1231(b)(2)).[60] Likewise, gain on the sale of unharvested crops is treated as capital gain if the crops are sold together with the underlying land (sec. 1231(b)(4)).

If losses from the sale or exchange of this specially treated property (i.e., property described in sec. 1231) exceed the gains from such sales or exchanges for the year, the net losses are treated as ordinary. Ordinary losses are deductible in full for tax purposes while deductions for capital losses are subject to limitations.

Restrictions on deductions in certain cases

Present law includes certain restrictions designed to prevent passive investors from using the special tax benefits generally available to farmers. Each of these limits modifies a result that otherwise obtains under the applicable method of accounting.

Restrictions on deductibility of prepaid expenses by farming syndicates and tax shelters

In the case of a farming syndicate, payments for feed, seed, fertilizer, or other similar farm supplies are not deductible until the taxable year in which such supplies actually are used, or otherwise are deductible under the taxpayer's applicable method of accounting, if that is later (sec. 464). The tax law defines a farming syndicate as a partnership, S corporation, or other noncorporate enterprise engaged in the business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.[61] This restriction also applies to any tax shelter, defined as an enterprise the principal purpose of which is the avoidance or evasion of Federal income tax.[62]

In addition to the restriction discussed above, certain taxpayers using the cash method of accounting are subject to the further restriction that no deduction may be claimed until economic performance occurs (sec. 461(i)).[63] In the case of the purchase of goods or

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[60] Income from the sale or other disposition of inventories generally is taxed at the rates applicable to ordinary income.

[61] A limited entrepreneur is a person (other than a limited partner) who does not participate actively in the management of the enterprise in which he holds an interest (sec. 464(e)).

[62] *See*, sec. 6661(b)(2)(C)(ii).

[63] This restriction is similar to a requirement, applicable to accrual method taxpayers, that economic performance occur before a deduction is permitted under that method of accounting.

services, economic performance generally occurs when the goods or services are received. For example, management fees in a cattle feeding operation may be deducted only as the services are rendered. Taxpayers subject to this restriction include (1) any enterprise (other than a corporation described in subchapter C of the Code) the offering for sale of interests in which must be registered under Federal or State securities law; (2) a syndicate;[64] and, (3) a tax shelter, as defined above.

Restrictions on deductions for preproductive-period expenses

Except in limited cases, farming (including timber farming) operations using the cash method of accounting generally may deduct preproductive-period expenses when such expenses are paid. For example, costs of feeding calves during the period before the calves develop into milk producing dairy cattle generally are deductible as the costs are paid. Accrual method taxpayers are required to capitalize such expenses by adding them to the basis of the preproductive-period asset.

The first limitation on this general allowance of deductions for preproductive-period expenses requires capitalization of these expenses in the case of citrus and almond groves (sec. 278(a)). Under this limitation, costs incurred before the fourth taxable year after the citrus or almond groves are planted must be capitalized. A second limitation applies to all fruit and nut orchards operated by farming syndicates (sec. 278(b)).[65] Under this rule, all expenditures incurred before the year in which the orchard first bears fruit or nuts in commercial quantities must be capitalized.

Other tax provisions

Cost recovery deductions

In general, the cost of farm equipment may be recovered under the Accelerated Cost Recovery System (ACRS) on the same basis as the cost of other equipment used in a trade or business (sec. 168). Most farm equipment (e.g., tractors and combines) is in the five year class and, like other five-year property, is eligible for a recovery method approximating the 150-percent declining balance method, changing to the straight-line method in the later cost recovery years.

Similarly, the cost of real property used in farming generally is recovered over an 18-year period, using a 175-percent declining balance method changing to straight-line deductions in later cost recovery years. An exception is made for single-purpose agricultural structures, however, with these structures being treated as five-year property (discussed above). Examples of the structures that qualify as single-purpose agricultural structures are chicken coops, greenhouses, and hog confinement facilities.

The election to expense up to $5,000 of the cost of depreciable property is available to farmers on the same basis as other taxpayers (sec. 179).

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[64] *See*, sec. 1256(e)(3)(B).

[65] *See*, the discussion of prepaid expenses, above, for the definition of farming syndicate.

Investment tax credit

Generally, investment in equipment used in the business of farming is eligible for an investment tax credit on the same basis as equipment used in other businesses (sec. 38). Specifically, the investment credit is allowed for certain reforestation expenditures (sec. 48(a)(1)(F)), for certain livestock (except horses) (sec. 48(a)(6)), and for investment in single-purpose agricultural structures (sec. 48(a)(1)(D)).

Tax-exempt financing

Interest on certain bonds issued by or on behalf of State or local governments is exempt from Federal income tax (sec. 103).[66] One of the types of bonds on which interest is tax-exempt is small-issue industrial development bonds the proceeds of which are used to make loans for the purchase of farmland by first-time farmers.[67] First-time farmers are persons (1) who have never owned an interest in substantial farmland in the operation of which they or members of their families materially participated, (2) who will be the principal users of the farmland financed with the bond proceeds, and (3) who will participate materially and substantially on the farm in the farming operation in which the land is used. Loans to first-time farmers made with the proceeds of these bonds may not exceed $250,000 per first-time farmer.

Subject to the general restrictions on the issuance of tax-exempt industrial development bonds, new farm equipment may be financed with the proceeds of these bonds (whether or not the equipment is for use by first-time farmers).

Administration Proposal

Accounting-related provisions

Method of accounting

The Administration proposal would limit the use of the cash method of accounting to trades or businesses (whether or not operated in corporate form) having annual gross receipts of less than $5 million. The adjustment in income resulting from a required change from cash to accrual method accounting would be spread over a period up to 6 years.

Special expensing and amortization provisions

The special provisions permitting certain expenditures for fertilizer, land clearing, and soil and water conservation improvements to be expensed would be repealed. The proposal also would repeal the provision permitting seven-year amortization of certain reforestation expenditures.

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[66] For a more complete discussion of the rules governing the tax treatment of State and local government bonds, *see*, Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985.

[67] A *de mimimis* amount of used farm equipment acquired in conjunction with farmland financed under this first-time farmer provision may be financed with the proceeds of these loans.

Treatment of certain gains and losses

The Administration proposal would repeal the present-law rule permitting preferential treatment as capital gain for gain on the sale or other disposition of property used in a trade or business, including depreciable property used in any business, livestock held for dairy, draft, breeding or sporting purposes, timber, and unharvested crops sold together with the underlying land (i.e., section 1231 property). Net gain on the sale of these assets would, therefore, generally be subject to tax upon disposition at ordinary income tax rates.

Treatment of preproductive-period expenses

The Administration proposal would require capitalization—as opposed to current deduction—of all preproductive-period expenses, including interest, incurred by any taxpayer in producing or raising plants or animals (except animals held for slaughter) that have a preproductive or development period of two years or longer. In the case of plants, the preproductive period would begin with the time the plant or seed was first planted or acquired by the taxpayer, and would end with the time that the plant became productive or was disposed of by the taxpayer. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the trees first bore fruit.

In the case of animals, the preproductive period would begin at the time of breeding or embryo implantation (or at the time the taxpayer first acquired the animal), and would end when the animal became productive or was disposed of by the taxpayer. An animal would be treated as productive when ready to perform its intended function (e.g., when ready to be bred or to produce marketable quantities of milk).

Other tax provisions

Cost recovery deductions

The Administration proposal would replace the present ACRS system with a new Capital Cost Recovery System (CCRS). In general, the CCRS system would require cost recovery deductions to be claimed using longer recovery periods and less accelerated cost recovery methods than under ACRS. For example, tractors that at present are five-year ACRS property would be six-year property depreciated at a 33 percent rate. Most other depreciable farm property would be depreciated over seven years using a 22 percent rate (equipment) or 28 years using a four-percent rate (barns).

Investment tax credit

The Administration proposal would repeal the investment tax credit. Among the farm-related expenditures no longer eligible for a credit would be those for farm equipment such as tractors and combines, for single purpose agricultural structures, for certain livestock, and for qualified reforestation expenditures.

Tax-exempt financing

The Administration proposal would repeal the tax-exemption for interest on all nongovernmental bonds, including industrial development bonds the proceeds of which are used to finance the purchase of land for first-time farmers or to purchase new farm equipment.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt) and H.R. 2222 and S. 1006 (Kemp-Kasten)

Accounting-related provisions

The Bradley-Gephardt (S. 409 and H.R. 800) and Kemp-Kasten (H.R. 2222 and S. 1006) bills would require all taxpayers having gross receipts over $1 million in the current or any prior taxable year to use the accrual method of accounting. Thus, the present exceptions for businesses conducted other than as corporations and for family-owned corporations having gross receipts over $1 million would be repealed. Farming syndicates would be required to use the accrual method regardless of the amount of their annual gross receipts.

The Bradley-Gephardt bill also would repeal the special amortization provision for certain reforestation expenditures. That proposal further would eliminate the special expensing provisions for certain soil and water conservation improvements, fertilizer and soil conditioning expenditures, and land clearing expenditures in the case of farming enterprises required to use the accrual method. The Kemp-Kasten bill would repeal the expensing provisions for certain soil and water conservation improvements and land clearing expenditures, and the amortization provision for certain reforestation expenditures.

Tax treatment of certain gains and losses

The Bradley-Gephardt bill would repeal the preferential tax treatment presently permitted for capital gains, including the application of that treatment to farm property such as timber, livestock, and certain unharvested crops. The Kemp-Kasten bill generally would permit taxpayers to elect annually between receiving capital gains treatment on gains realized during the year and treating the gains as ordinary income (after making an inflation adjustment).

Other tax provisions

Cost recovery deductions.—The Bradley-Gephardt bill would replace the present ACRS cost recovery system with a Simplified Cost Recovery System (SCRS). The Kemp-Kasten bill would replace the ACRS system with a Neutral Cost Recovery System (NCRS). Under both bills, cost recovery periods generally would be longer than those under ACRS. Both bills also would provide new cost recovery methods. The Bradley-Gephardt bill generally would prescribe deductions based on a 250 percent declining balance method. Cost recovery deductions would be computed using the straight-line

method under the Kemp-Kasten bill, but would be indexed based on the GNP deflator.

Investment credit.—Both the Bradley-Gephardt and Kemp-Kasten bills would repeal the investment credit, including the credit for single purpose agricultural structures, for certain livestock, and for certain reforestation expenditures.

Tax-exempt financing.—Both the Bradley-Gephardt and Kemp-Kasten bills would repeal the tax-exemption for interest on industrial development bonds, including such bonds the proceeds of which are used to finance purchase of farmland by first-time farmers or to finance new farm equipment.

S. 244 and H.R. 1120 (Abdnor-Hamilton)

The Abdnor-Hamilton bill (S. 244 and H.R. 1120) would restrict the deductions of any taxpayer from farming to the taxpayer's gross income from farming for the year, plus an amount equal to the national median family income for the previous year.[68] This restriction would apply only if the taxpayer's non-farm income exceeded his or her farm income in five of the preceding seven years. For 1983, the national median family income was $24,580.[69]

H.R. 2425 (Daub)

The Daub bill (H.R. 2425) would repeal or restrict the availability of several of the special tax benefits provided for farming under present law.[70] Specifically, the Daub bill would require a prorata reduction in the investment credit for farm property placed in service in a taxable year by a taxpayer, less than 50 percent of whose gross income for the year was attributable to the trade or business of farming. In addition, the Daub bill would repeal the investment credit for single purpose agricultural (but not horticultural) structures, and would repeal the election to expense certain expenditures for clearing land to make it suitable for use in farming.

The Daub bill also would add as a preference item subject to the present-law corporate and individual minimum taxes the farming losses of taxpayers not primarily engaged in farming. A taxpayer would be considered primarily engaged in farming only if more than 50 percent of the taxpayer's gross income for the year was attributable to the trade or business of farming. A farming business conducted by a partnership, trust, or S corporation would be treated as carried on by its partners, beneficiaries or shareholders in proportion to their respective interests.

Analysis

The central issue in developing tax rules for farming operations is how best to satisfy the need for administrable tax rules and ac-

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[68] A Sense of the Senate Resolution adopted as part of the Fiscal Year 1986 Budget Resolution expresses the Senate's approval of this purpose. S. Con. Res. 32, Amendment No. 56, *Cong. Rec.* S5465 (daily ed. May 7, 1985). This Sense of the Senate Resolution was agreed to in the House-Senate conference on S. Con. Res. 32 and passed by the House and Senate. No. 106 *Cong. Rec.* H 7149, S 10730 (daily ed. Aug. 1, 1985).

[69] U.S. Department of Commerce, Bureau of Census, *Money Income of Households, Families and Persons in the United States*, Series P-60, No. 146, p. 1.

[70] In addition to repealing several special farm tax incentives, the Daub bill would add several provisions relating to liquidation sales of insolvent taxpayers, and would provide a new soil and water conservation tax credit.

curate measurement of farm income without encouraging farm tax shelters. Farm tax shelters, like other tax shelters, may be viewed as misallocating capital, because investment choices are motivated by tax rather than economic factors. In the area of agriculture, tax shelters are said by some to have the additional undesirable effect of jeopardizing the continued existence of small, family-owned and operated farms.

Accounting-related issues

Most of the proposals before Congress seek to restrict farming-related tax shelters through repeal of, or imposition of new restrictions on, accounting-related provisions. For example, the repeal of the numerous special expensing and amortization provisions, the proposed new restrictions on availability of the cash method of accounting, and the treatment of preproductive period expenses all relate to the timing of income recognition—an accounting issue. Some people suggest that the most appropriate way to limit the appeal of farming as a tax shelter is to restrict the use of the cash method of accounting strictly to small businesses for which the complexity of the accrual method could be burdensome.

Proponents of restrictions on the use of cash accounting suggest that cash accounting promotes unwarranted manipulation of income for tax purposes, and that while cash accounting is simple and therefore appropriate for smaller farms, larger farming operations can handle the added complexity of the accrual method without being subjected to an undue burden. Some proponents suggest, however, that the Administration's $5 million gross receipts threshold is too high and that the proposed restriction is unlikely to affect many farming businesses. In support of a lower gross receipts limit, these persons point out that many businesses with gross receipts of less than $5 million presently have annual financial statements prepared using the accrual method for purposes such as credit approval. Further, these persons state that many businesses having less than $5 million in annual gross receipts are structured as groups of related corporations or reflect the use of other sophisticated financial (or estate) planning practices. These persons suggest that to the extent that a taxpayer engages in such sophisticated transactions, the taxpayer should not be allowed to take advantage of methods of accounting that sacrifice an accurate matching of income and expenses for the stated purpose of simplicity.

Opponents of additional restrictions on the availability of the cash method of accounting suggest that the narrow profit margins of many businesses, especially certain types of farming, make a gross receipts-based restriction inappropriate. These persons suggest that certain farming operations with large annual gross receipts may have relatively small profits and be financially unsophisticated. The opponents of additional restrictions further suggest that frequent and sometimes dramatic shifts in market conditions are the norm in agriculture and that the flexibility of cash accounting is essential to enable these businesses to survive.

Other tax provisions

Persons favoring other restrictions on farm tax benefits [71] suggest that the availability of special tax incentives for farming tends to attract tax shelter investors. These persons suggest that, to avoid this problem, consideration should be given to wider use of incentives outside the tax law—such as direct cash subsidies and liberal loan policies—to achieve results that otherwise might be attempted through tax expenditures. These proponents further suggest that removal of those tax incentives for farming which most benefit high-bracket investors will cause a shift of tax-motivated investments out of the agricultural sector. They suggest that removal of tax incentives also would have the beneficial effect of bringing the results of Federal tax rules regarding agriculture more into line with other Federal policies on agriculture—and thereby aiding in preservation of small family farms.

Opponents of repealing these tax incentives suggest that a sudden removal or restriction of tax benefits such as that included in the Administration Proposal and in certain Congressional proposals will cause all farmers, especially small farmers, to incur a sudden, increased tax burden that could exacerbate the current financial problems being experienced in the agricultural sector. These persons suggest further that the tax benefits accorded agriculture under present law reduce the prices of agricultural products to consumers, which they suggest is a socially desirable goal. Similarly, these persons suggest that repealing the special provisions encouraging certain specific activities (e.g., expensing of the costs of certain soil and water conservation improvements, will make such activities economically less attractive, a fact that could result in increased erosion of farmland and decreased food-producing capability in the United States.

[71] Among these proposed restrictions are proposals to repeal ACRS and the investment credit, to require capitalization of preproductive period expenses, to repeal the special capital gain treatment on the sale or other disposition of trade or business property, and to repeal special expensing and amortization provisions.

VII. MINIMUM TAX ON CORPORATIONS AND INDIVIDUALS

Present Law

Corporate minimum tax

Under present law, corporations pay a minimum tax on certain tax preferences. The tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences, to the extent that the aggregate amount of these preferences exceeds the greater of the regular income tax paid or $10,000.

Tax preference items

The tax preference items included in the base for the minimum tax for corporations are:

(1) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 18 years);

(2) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

(3) In the case of certain financial institutions, the excess of the bad debt deductions over the amount of those deductions computed on the basis of actual experience;

(4) Percentage depletion to the extent in excess of the adjusted basis of the property; and

(5) 18/46 of the corporation's net capital gain.[72]

For personal holding companies, accelerated depreciation on leased personal property, mining exploration and development costs, circulation expenditures, research and experimental expenditures, and excess intangible drilling costs are also preferences.

When a corporation has a regular tax net operating loss attributable to minimum tax preference items in excess of $10,000, no immediate add-on minimum tax liability is incurred with respect to those preference items. Minimum tax liability is incurred with respect to those preference items when the "preferential" portion of the net operating loss is used to offset regular taxable income, treating this portion as used only after nonpreferential net operating losses have been exhausted.

[72] Special rules applicable to capital gains from timber have the effect of (1) exempting $20,000 of such gains from minimum tax (in addition to the general exemption of $10,000), (2) lowering the rate of minimum tax on any remaining capital gains from timber from 15 to 10 percent, and (3) providing a carryover whereby regular taxes attributable to timber income can reduce the minimum tax due in subsequent years.

Cutback in certain preferences

In addition to imposing an add-on minimum tax, present law (sec. 291) imposes a cutback in the use of certain corporate tax preferences for regular tax purposes. Adjustments are made to the corporate minimum tax to prevent the combination of that tax and the cutback provision from unduly reducing the tax benefit from a preference.

The cutback applies to the following items as described below:

(1) *Depletion for coal and iron ore.*—The excess of percentage depletion otherwise allowable for iron ore and coal (including lignite) over the adjusted basis of the property is reduced by 15 percent. However, only 71.6 percent[73] of the excess of the allowable depletion allowances for these minerals over the adjusted basis of the property is treated as a corporate tax preference under the minimum tax (under sec. 57(a)(8) and sec. 57(b)).

(2) *Bad debt reserves.*—The bad debt reserve deduction (under sec. 585 or 593) is reduced by 20 percent of the amount by which the otherwise allowable deduction exceeds the amount which would have been allowable on the basis of actual experience. Only 59-5/6 percent of the excess of the allowable deduction over what would be allowable based on actual experience is treated as an item of tax preference under the minimum tax (under sec. 57(a)(7) and sec. 57(b)).

(3) *Tax-exempt interest.*—In the case of a financial institution, 20 percent of the otherwise allowable interest deduction allocable to debt incurred or continued to purchase tax-exempt obligations acquired after 1982 is disallowed.

(4) *FSC.*—A foreign sales corporation's (FSC) exempt foreign trade income is reduced by approximately 1/16 where there is a corporate shareholder.

(5) *Section 1250 property.*—The amount treated under the recapture rules as ordinary income on the sale or other disposition (including certain nonrecognition transactions) of section 1250 property (real estate) by a corporation is increased by 20 percent of the additional amount which would have been treated as ordinary income if the property were subject to recapture under section 1245 (the rule applicable to personal property). The minimum tax preference for the remaining 80 percent of the capital gain which would have been ordinary income under section 1245 is reduced by 40-1/6 percent (under sec. 57(a)(9)(b) and sec. 57(b)).

(6) *Pollution control facilities.*—Twenty percent of the basis of pollution control facilities to which an election under section 169 applies is treated as if the election did not apply. The minimum tax preference for the remaining property for which five-year amortization was elected is reduced by 40-1/6 percent (under sec. 57(a)(4) and sec. 57(b)).

(7) *Intangible drilling costs.*—In the case of an integrated oil company, 20 percent of the amount otherwise allowable as a deduction

[73] For a corporate taxpayer that is subject to the top regular tax corporate marginal rate of 46 percent and that is already on the minimum tax, the 71.6-percent figure has the effect of imposing the same marginal rate of tax (counting both regular and minimum taxes) as would apply if there were no preference cutback under section 291 but the full amount of the excess of percentage depletion over adjusted basis was an item of tax preference.

for intangible drilling costs under section 263(c) is capitalized to the oil, gas, or geothermal property and deducted ratably over a 36-month period beginning with the month the costs are paid or incurred.

(8) *Mineral exploration and development costs.*—Twenty percent of the amounts otherwise allowable as deductions under section 616 and 617 to a corporation are capitalized and treated as if they are used to acquire recovery property assigned to the five-year class. ACRS deductions are allowed beginning with the year the expenses are paid or incurred, and the investment tax credit is available in the year the expenses are paid or incurred.

Individual minimum tax

Under present law, individuals are subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the individual's regular tax owed.[74] The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of the exemption amount. However, the amount so determined is reduced by the foreign tax credit and the refundable credits.

Alternative minimum taxable income is generally equal to regular tax adjusted gross income, as increased by certain tax preferences and decreased by the alternative tax itemized deductions. The exemption amount, which is subtracted from alternative minimum taxable income before applying the 20 percent rate, is $40,000 for joint returns, $20,000 for married individuals filing separately, and $30,000 for single returns.

Tax preference items

The tax preference items that are added to the adjusted gross income basis for purposes of the alternative minimum tax on individuals are:

(1) Dividends excluded from gross income under section 116, which permits individuals to exclude dividends received in an amount not to exceed $100 ($200 for a joint return);

(2) For real property, the excess of accelerated over straight-line depreciation, applying the useful life or recovery period prescribed for regular tax purposes (in the case of property eligible for ACRS, 18 years);

(3) For leased personal property, the excess of accelerated depreciation over depreciation calculated under the straight-line method, with the latter being determined, in the case of property eligible for ACRS, by applying useful lives or recovery periods of five years for three-year property, eight years for five-year property, 15 years for 10-year property, and 22 years for 15-year public utility property;

(4) For certified pollution control facilities, the excess of 60-month amortization over the amount of depreciation otherwise allowable;

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[74] A taxpayer's regular tax means the taxes imposed by chapter 1 of the Code (other than the alternative minimum tax, the investment credit recapture tax (sec. 47), the taxes applicable in some instances for annuities (sec. 72(m)(5)(B) and 72(q)), lump sum distributions from qualified pension plans (sec. 402(e)), individual retirement accounts (sec. 408(f)), and certain trust distributions (sec. 667(b)), reduced by all nonrefundable credits including the foreign tax credit.

(5) For mining exploration and development costs (other than those relating to an oil or gas well) that are expensed, the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period;

(6) For circulation expenditures (relating to newspapers, magazines and other periodicals) that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a three-year period;

(7) For research and experimentation expenditures that are expensed, the excess of the deduction claimed over that allowable if the amounts had been capitalized and amortized ratably over a 10-year period;

(8) Percentage depletion to the extent in excess of the adjusted basis of the property;

(9) For net capital gains, the portion (i.e., 60 percent) deducted from gross income under section 1202, except that gain from the sale or exchange of the taxpayer's principal residence is not taken into account;

(10) For incentive stock options, the excess of the fair market value received through the exercise of an option over the exercise price; and

(11) For intangible drilling costs (relating to oil, gas, and geothermal properties) that are expensed, the amount by which the excess portion of the deduction (i.e., the excess of the deduction claimed over that allowable if the costs had been capitalized and amortized ratably over a 10-year period) exceeds the amount of net oil and gas income.

For certain of these preferences, individuals can elect for regular tax purposes to take a deduction ratably over 10 years (three years in the case of circulation expenditures) and thereby to avoid treatment of the item subject to the election as a minimum tax preference. The preferences, in addition to circulation expenditures, with respect to which such an election can be made are research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. In addition, the ACRS provisions themselves allow certain similar elections.[75] In general, a principal reason for making such an election is to preserve for later years the value of an otherwise preferential deduction which would not benefit the taxpayer in the year when the election is made, because the taxpayer would be subject to the alternative minimum tax.

Alternative tax itemized deductions

Certain of the itemized deductions allowable in calculating regular taxable income are allowable as well for purposes of calculating alternative minimum taxable income. The alternative tax itemized deductions are:

(1) Casualty or theft losses, and gambling losses to the extent not in excess of gambling gains;

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[75] Moreover, in the case of intangible drilling costs, a taxpayer (other than a limited partner or a passive subchapter S shareholder) may elect to forego the expense deduction and claim five-year ACRS and the investment tax credit instead. A taxpayer making this election would not be subject to the minimum tax on these items.

(2) Charitable deductions, to the extent allowable for regular tax purposes;

(3) Medical deductions, to the extent in excess of 10 percent of adjusted gross income;

(4) Qualified interest expenses, which are limited to (a) qualified housing interest (i.e., interest incurred to acquire, construct, or rehabilitate a primary residence or other qualified dwelling used by the taxpayer), plus (b) other interest expenses deducted by the taxpayer, but only to the extent not in excess of qualified net investment income for the year;[76] and

(5) Deductions for estate tax attributable to income in respect of a decedent.

Other regular tax itemized deductions, such as those for state and local taxes paid and for certain investment expenses, are not allowed for minimum tax purposes.

Credits and NOLs

In calculating minimum tax liability, no nonrefundable credits are allowed except for the foreign tax credit. The limitation on the foreign tax credit applying for regular tax purposes (which, in general, prevents use of the credit to offset a greater percentage of one's tax liability than the percentage of taxable income that is foreign source income) applies for minimum tax purposes as well, but is recalculated to reflect the percentage of minimum taxable income that comes from foreign sources. Credits that do not benefit the taxpayer because of the imposition of minimum tax liability can be carried back or forward to other taxable years.

Individuals with net operating losses are allowed to deduct such losses against alternative minimum taxable income. However, for years beginning after 1982 the losses are computed, for minimum tax purposes, by reducing the regular tax net operating losses by the amount of the items of tax preference.

Legislative History

A minimum tax, applying to both corporations and individuals, was first enacted in the Tax Reform Act of 1969. As enacted, the tax rate was 10 percent and the tax base was the amount by which certain tax preferences exceeded an exemption of $30,000 plus the taxpayer's regular income tax. This tax is generally referred to as an "add-on" minimum tax, since it is payable in addition to the regular income tax.

In 1976, the tax rate was increased to 15 percent. In addition, the exemption was reduced, though with different new rules, respectively, for individuals and corporations. For individuals, the exemption was reduced to the greater of $10,000 or one-half of regular taxes paid. For corporations, it was reduced to the greater of $10,000 or the full amount of regular taxes paid.

The Revenue Act of 1978 added an alternative minimum tax for individuals which was payable if it exceeded their regular tax. The

[76] Since this limitation applies only to itemized deductions for interest expenses, it generally has no effect on interest deductions that are claimed "above-the-line," such as business interest and interest attributable to the production of rents and royalties. Certain interest to carry limited partnership interests and S corporation stock is limited however.

tax base for this tax was generally the taxpayer's taxable income plus certain itemized deductions plus the capital gains deduction. The tax rate was graduated with a maximum rate of 25 percent on income over $100,000.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the add-on minimum tax for individuals was repealed and the present alternative minimum tax for individuals was adopted.

Number of Taxpayers Affected and Revenue Collected

235,600 individuals were subject to the minimum tax in 1983. $1.931 billion was collected from the individual minimum tax that year. In 1982, revenues from the corporate minimum tax were $478 million. 7,800 corporations were subject to that tax in 1982.

Administration Proposal

Corporate minimum tax

Effective in 1986, the minimum tax for corporations would be revised by replacing the "add-on" tax with an alternative minimum tax. It would apply at a rate of 20 percent, after subtraction of an exemption amount of $15,000, to the sum of (1) taxable income and (2) certain preferences to the extent that, in the aggregate, they exceed $10,000. As in the case of the present individual minimum tax, the foreign tax credit would be allowed against minimum tax liability, and minimum taxable income could be reduced through the use of net operating losses, as redetermined to exclude portions attributable to the use of preferences.

The following preferences would be added to taxable income in calculating minimum taxable income:

(1) for real property, leased personal property in the hands of a personal holding company, pollution control facilities, and depletable property, the preferences as measured under present law would apply to property placed in service before 1986;

(2) for real property or leased personal property placed in service in 1986 or thereafter, the excess of CCRS depreciation over that allowable using a system similar to that detailed in the 1984 Treasury Report;

(3) income that is untaxed due to the preferential rate applying to capital gains;[77]

(4) for exploration and development costs with respect to a mine or other natural deposit, the excess of the allowable deduction over that allowable if the costs had been amortized over a 10-year period;

(5) eight percent of the amount of intangible drilling costs relating to oil, gas, and geothermal properties other than dry holes. This percentage is derived by comparing the present tax treatment (expensing) to the present value of depreciation applying to Class 3 property under CCRS;

(6) for depletable property placed in service in 1986 or thereafter that still qualifies for percentage depletion under the Administra-

[77] The entire gain would be includible in the tax base without specially designating any portion of gain as a preference.

tion proposal, the excess of the deduction over that allowable using cost depletion;

(7) for charitable contributions of appreciated property, the excess of the allowable deduction over the donor's basis in the propert;

(8) 25 percent of the amount by which the taxpayer's interest expense exceeds its taxable interest income, to the extent not in excess of the amount by which the taxpayer's CCRS depreciation deductions for personal property exceed those allowable under a system similar to that detailed in the November 1984 Treasury Report;[78] and

(9) for personal holding companies, the excess of the deduction allowed for research and experimentation expenditures over that allowable if these expenditures were amortized over 10 years.

Individual minimum tax

Effective in 1986, the present law exemption amount and the computation of preference items would be revised. The new exemption amount would be $15,000 for joint returns, $7,500 for married taxpayers filing separately, $12,000 for heads of households, and $10,000 for single persons.

Preference items would be added to taxable income only to the extent that, in the aggregate, they exceeded $10,000 ($5,000 for married taxpayers filing separately). The preference items would be the same as those applying to corporations (including those applying only to personal holding companies), with the following differences:

(1) the capital gains preference would be defined as the amount of the net capital gain exclusion;

(2) the rule treating as a preference 25 percent of certain interest expenses, to the extent of certain depreciation on personal property, would not apply; and

(3) stock transferred pursuant to the exercise of an incentive stock option would be treated as a preference to the extent of the excess of the fair market value of the stock over its exercise price.

All itemized deductions that would be allowable for regular tax purposes would be allowable for minimum tax purposes as well, except that the deduction for non-business interest (other than home mortgage interest relating to a primary residence) in excess of net investment income would not be allowable.

Other Proposals

H.R. 2424 (Messrs. Schumer, Russo, and others)

This bill would establish alternative minimum taxes, for both individuals and corporations, levied at a rate, when fully phased in, of 25 percent. For individuals, the rate would be phased in at between $70,000 and $100,000 of alternative minimum taxable income, by starting at a rate of zero and then (until full phase-in at $100,000) increasing the rate applying to the taxpayer's entire income by 5/6 of one percent for each thousand dollars (or portion

[78] To avoid double-counting, this rule does not apply, in the case of a personal holding company, to leased personal property.

thereof) by which the taxpayer's alternative minimum taxable income exceeds $70,000. For corporations, full phase-in would be accomplished at $150,000 of alternative minimum taxable income, as accomplished by increasing the rate by 5/16 of one percent for every thousand dollars (or portion thereof) by which income exceeds $70,000.

Under the bill, individuals would be entitled to the alternative minimum tax itemized deductions allowed under present law, and to a further itemized deduction for State and local taxes paid. However, the allowance of itemized deductions would be phased out at between $100,000 and $150,000 of alternative minimum taxable income (as measured after allowing the above itemized deductions in full). For each $1,000 (or portion thereof) by which income exceeded $100,000, the amount of the itemized deductions would be reduced (but not below zero) by two percent. Taxpayers would be allowed to deduct net operating losses, as recalculated to eliminate tax preferences. The foreign tax credit would be allowed against minimum tax liability.

The bill would generally include the items under the Administration proposal, although with certain exceptions (e.g., untaxed appreciation on a charitable contribution would not be treated as a preference), and would also include (or make changes with respect to) such items as the following:

(1) accelerated elements of depreciation would be treated as a preference for all depreciable property, and measured in relation to the depreciation allowable under present law with respect to property leased by tax-exempt organizations (under sec. 168(g)(2)).[79]

(2) intangible drilling costs would be treated as a preference to the extent in excess of the deduction allowable under 10-year amortization, rather than to the extent of eight percent of such costs;

(3) all interest from newly issued tax-exempt securities would be treated as a preference;

(4) for individuals, the value of annual accrued pension benefits under qualified pension plans would be treated as a preference;

(5) for individuals, the fair market value of certain fringe benefits, including health and group-term life insurance, would be treated as a preference;

(6) excludable income earned abroad by United States citizens would be treated as a preference;

(7) the portion of social security benefits in excess of contributions that is presently excludable from income would be treated as a preference;

(8) research and experimentation expenditures would be treated as a preference for both corporations and individuals, and would be defined as the excess of expensing over five-year amortization;

(9) any installment sale gain which is deferred would be treated as a preference;

(10) excludable foreign sales corporation (FSC) income would be treated as a preference;

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[79] These depreciation rules were enacted by Congress in 1984, with the goal of providing a normative rule to prevent tax-exempt organizations from in effect "selling" the tax benefits of accelerated depreciation through lease arrangements with taxable third parties.

(11) use of the completed contract method of accounting for multi-year contracts would be treated as a preference; and

(12) for individuals, the net loss from all activities in which the individual did not materially participate in the management thereof would be treated as a preference.

In addition, the bill would treat as preferences several items that would be restricted or eliminated for regular tax purposes under the Administration proposal, including the special and small life insurance company deductions (sec. 806), untaxed inside buildup on life insurance contracts, and the deferral of certain shipping company income.

S. 956 (Senators Moynihan and Chafee)

This bill would establish alternative minimum taxes, for both individuals and corporations, levied at a rate of 15 percent to income above the applicable exemption amount. The applicable exemption amounts would be $50,000 for joint returns, $25,000 for married individuals filing separately, $40,000 for single taxpayers and heads of households, and $100,000 for corporations. The list of allowable alternative minimum tax itemized deductions for individuals would be expanded to include State and local taxes paid. Corporations would be entitled to deduct net operating losses (adjusted to eliminate preferences), and the foreign tax credit would be allowed.

The bill would generally include the items under the Administration proposal, although with certain exceptions (e.g., untaxed appreciation on charitable contributions would not be a preference), but would also include (or make changes with respect to) such items as the following:

(1) certain accelerated elements of depreciation would be treated as a preference for all depreciable property, and measured in relation to the depreciation allowable under the rules for calculating earnings and profits (under sec. 312(k));

(2) intangible drilling costs would be treated as a preference to the extent in excess of the deduction allowable under 10-year amortization, rather than to the extent of eight percent of such costs;

(3) research and experimentation expenditures would be treated as a preference for both corporations and individuals, and would be defined as the excess of expensing over five-year amortization;

(4) use of the completed contract method of accounting for multi-year contracts would be treated as a preference;

(5) interest deductions (other than qualified housing interest) would be denied to the extent of tax-exempt interest income;

(6) excludable FSC income would be treated as a preference; and

(7) individuals would be subject to an alternative minimum taxable income floor, under which deductions (e.g., for investment losses) would not be allowed to the extent that they would have the effect of reducing alternative minimum taxable income below the amount of (1) certain investment income, as from interests, dividends, and net capital gains from investments, plus (2) the greater of the taxpayer's earned income for the year, or his income from businesses which he controls, minus (3) the allowable alternative minimum tax itemized deductions.

In addition, the bill would treat as preferences certain items that would be restricted or eliminated for regular tax purposes under

the Administration proposal, including the special and small life insurance company deductions, certain rapid amortization provisions (e.g., for trademark and trade name, reforestation, and land clearing expenditures), and the deferral of certain shipping company income.[80]

S. 973 (Senators Bentsen, Danforth, and others)

This bill would establish a new alternative minimum tax for corporations. The tax would apply at a rate of 15 percent to alternative minimum taxable income in excess of $100,000. The foreign tax credit would be allowed. In addition, deductions would be allowed for net operating losses, as redetermined to eliminate items of preference.

The preferences under the bill would generally include the items applying to corporations under the Administration proposal, although with certain exceptions (e.g., untaxed appreciation on charitable contributions would not be treated as a preference), but would also include (or make changes with respect to) such items as the following:

(1) certain accelerated elements of depreciation would be treated as a preference for all depreciable property, and measured in relation to straight-line depreciation over useful lives similar to those used under the Moynihan-Chafee bill but shorter in certain instances;

(2) intangible drilling costs would be treated as a preference, but under the rules applying to its measurement for individuals and personal holding companies under present law (i.e., comparing expensing to ten-year amortization, reduced by the amount of net oil and gas income);

(3) research and experimentation expenditures would be treated as a preference, and would be defined as the excess of expensing over five-year amortization;

(4) use of the completed contract method of accounting for multiyear contracts would be treated as a preference;

(5) excludable FSC income would be treated as a preference; and

(6) a percentage of interest expenses deducted for regular tax purposes, equal to the percentage of the taxpayer's gross receipts derived from tax-exempt bonds, would be treated as a preference.

In addition, the bill would treat as preferences certain items that would be restricted or eliminated for regular tax purposes under the Administration proposal, including the special and small life insurance company deductions, certain rapid amortization provisions (e.g., for trademark and trade name expenditures), and the deferral of certain shipping company income.

Analysis

Overview of minimum tax issues

In considering the issues raised by the individual and corporate minimum taxes, it is useful to begin by summarizing the underly-

[80] Contrary to reports apparently disseminated in some newspaper articles, exempt income earned abroad by U.S. citizens or residents would not be treated as a preference under the Moynihan-Chafee bill.

ing purposes that minimum taxes generally are thought to serve. These purposes derive from the conflicting goals that underlie the structure of the income tax system as a whole.

The measurement of taxable income reflects two different and often conflicting goals. First, there is the goal of accurately measuring the economic income of taxpayers, so that taxpayers with the same amount of income will pay the same amount of tax and the tax system will not distort the market's allocation of economic resources. Second, there is the goal of using the tax code as a tool of economic or social policy, by providing incentives (or disincentives) for particular types of activity.

To the extent that the income tax system accurately measures and taxes the economic income of taxpayers, there is no need for a minimum tax. However, to the extent that the system is designed to provide incentives by allowing taxpayers engaged in certain favored activities to reduce their taxable income below their economic income (or to reduce their liabilities through tax credits), concern may arise, even among policymakers who favor the use of incentives, that some taxpayers do not pay even a minimally fair amount of tax.

Tax preferences that are provided as incentives can have the effect of enabling some taxpayers with substantial economic incomes to pay little or no tax. Although one could argue that this is wholly consistent with the policy that underlies providing incentives (i.e., these taxpayers are doing what Congress, in enacting the incentives, meant to encourage them to do), it is viewed by many as undesirable. First, many conclude that it is inherently unfair for affluent taxpayers to pay little or no tax (even if it is not unfair for these taxpayers to use preferences to reduce what their tax liabilities would be if based on economic income). Second, the fact that some affluent taxpayers pay little or no tax is viewed as harmful to the morale of other taxpayers, leading them to view the tax system as unfair and thereby undermining compliance.

With respect to the taxation of individuals, morale and compliance have been particularly harmed by the proliferation of tax shelters, whereby individuals with substantial economic incomes in effect purchase tax benefits that are not accompanied by significant economic burdens, and thereby may escape significant tax liability. While tax shelters may exploit some structural features of the tax system (e.g., the contrast between allowing depreciation, on the one hand, and not taxing unrealized appreciation, on the other), they are largely dependent upon the availability of tax preferences.

With respect to the taxation of corporations, controversy has arisen because of instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid dividends to shareholders. Most of the corporate tax preferences that make possible this tax avoidance involve deferral, rather than permanent avoidance, of tax liability with respect to economic income. Deferral can be seen as problematical in two respects. First, it reduces the effective rate of taxation, by functioning in effect as an interest-free loan from the Federal government in the amount of the tax liability that is deferred. Second, it adds to public perceptions of unfairness, to the extent that corporations

are reported to pay no tax in years when they have substantial income.

The minimum tax is designed to respond to the concerns arising from the fact that taxpayers with substantial incomes can use preferences to avoid significant tax liability. Its goal is to ensure that all taxpayers with substantial economic income pay at least some minimum amount of tax. To achieve this goal, it applies, at a rate that is lower than comparable regular tax rates, to income that escapes taxation under the regular tax system.

Since many tax preferences provide deferral rather than elimination of tax liability, the minimum tax serves in large part as a timing device. It limits deferral by requiring, in effect, a minimum "down payment" from high-income taxpayers. Requiring a "down payment" not only reduces the "interest-free loan" resulting from deferral, but addresses the public perception problem that arises when all liability is deferred.

To the extent that the minimum tax is a timing device limiting deferral, it is not meant to increase the total liability of taxpayers who are subject to it (except insofar as, under present value analysis, the extent of deferral itself has an impact on the effective tax rate). Thus, the minimum tax can be seen as requiring an adjustment device, whereby taxpayers receive in subsequent years the benefit of deferral preferences that have resulted in minimum tax liability. This device can take such forms as a credit against regular tax in the amount of minimum tax liability or a regular tax carryover for deductions that do not benefit the taxpayer as a result of the imposition of the minimum tax. In addition, to preserve the value of deferral preferences for taxpayers who are regularly on the minimum tax, taxpayers can be permitted (as under present law, with respect to certain preferences) to elect normative treatment for regular as well as minimum tax purposes.

Two further structural consequences for a minimum tax follow from its underlying purpose of preventing excessive tax avoidance by high-income taxpayers. First, a minimum tax is not meant to apply to, or have any effect on, most taxpayers. Theoretically, a minimum tax could be designed that would apply more frequently than the regular income tax. However, since a minimum tax is generally intended to prevent only relatively large instances of tax avoidance through the use of preferences, it is generally considered desirable to limit its potential applicability. Overly broad application would substantially increase the complexity of the tax system for many taxpayers, by requiring them to calculate tax liability (and engage in tax planning) under two separate tax systems. Thus, it is generally considered desirable to design the minimum tax system so that it will have little potential applicability either to taxpayers who are not in high income brackets, or to those in high brackets who make only moderate use of preferences.

Second, the base of income to which the minimum tax applies is meant to be relatively comprehensive, and to approach or equal economic income. The decision to disallow a tax preference for minimum tax purposes, by requiring that it be added to the minimum taxable income base, presumably implies, not that the preference is abusive or bad, but simply that it cannot be excluded from a mini-

mum tax base without enabling some affluent taxpayers to escape all significant tax liability.

With respect to corporations, the purpose of the minimum tax may suggest adopting an income base at least as broad as the base used for financial reporting purposes (e.g., for creditors and in annual reports to shareholders). Adverse effects on taxpayer morale and compliance may be expected when a corporation which reports substantial book income pays no tax. These effects may be particularly significant when a corporation that paid no tax pays significant dividends to shareholders. However, use of the financial reporting standards themselves for minimum tax purposes would be problematical, for two reasons. First, in some cases the standards used to calculate book income may differ, both between companies in different industries and even between different companies in the same industry. Second, by its nature financial reporting is meant to be conservative. In order to avoid presenting creditors or shareholders with an unduly favorable view of a company's performance, financial reporting is designed to err on the side of understatement, rather than overstatement, of income.[81] Thus, the definition of income used for financial reporting purposes may not be sufficiently broad to ensure that all taxpayers with substantial economic income will pay some tax.

Alternative versus add-on minimum tax

Originally, the minimum taxes for both individuals and corporations were structured as add-on taxes. That is, they applied to a minimum tax base consisting solely of preference items, and then reduced minimum tax liability by an amount bearing some relationship to the amount of regular tax due.

However, the minimum tax on individuals has since been restructured to be an alternative rather than an add-on tax. That is, it applies to a tax base that includes both the taxpayer's regular taxable income and the specified tax preferences. It provides an exemption amount that is determined independently of the amount of regular tax paid, and it applies only to the extent in excess of the regular tax.[82] Most recent proposals for revising the corporate minimum tax have suggested converting it as well into an alternative minimum tax that structurally resembles the minimum tax on individuals.

The fundamental difference between an alternative and an add-on minimum tax lies in the underlying purpose sought to be served. An alternative minimum tax seeks to ensure that all taxpayers with significant economic income will pay at least some minimum percentage of it to the Federal Government in taxes, even if they make substantial use of tax preferences. By contrast, an add-on minimum tax functions more like an excise tax on tax preferences; it reduces the value of these preferences (if in excess of the exemption amount), without directly considering economic income as a whole.

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[81] *See Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979).

[82] Technically speaking, the minimum tax on individuals is still an add-on tax in the sense that individuals who are subject to it are deemed to have paid the regular tax plus the excess portion of the alternative tax, rather than the entire minimum tax and no regular tax.

Exemption amounts

All versions of the minimum tax heretofore enacted, and most proposals for revising the individual or corporate minimum tax, provide an exemption amount below which income is not subject to the minimum tax. This amount is generally significantly greater than the zero bracket amount or personal exemptions under the regular tax, reflecting the different goals of policymakers in the two instances.

With respect to the regular tax, the aim is to ensure that all taxpayers with taxable incomes above whatever level is selected as the tax entry point have some tax liability. The regular tax is meant to apply to most individuals who have income. Thus, actual and proposed exemption amounts are generally set relatively low. By contrast, the minimum tax is expected and intended to have no direct impact on most taxpayers. A relatively high exemption amount helps to focus the effect of a minimum tax on the relatively affluent taxpayers, paying little regular tax, to whom it is meant to apply, while sparing other taxpayers from the burden of having to calculate whether they have any minimum tax liability.

Thus, in structuring a minimum tax, an increase in the proposed exemption amount can, for example, eliminate all minimum tax liability for a significant number of middle-income taxpayers, while having a relatively small percentage effect on the total tax liability of high-income taxpayers who are subject to the minimum tax. However, establishing an overly high exemption amount can result in overly narrow application of the minimum tax and in continued tax avoidance by some taxpayers with significant economic income. The proper level for the exemption amount depends in large part upon revenue goals and the number of taxpayers who are intended to be affected.

In general, present law and the various proposals provide an exemption amount that is stated in absolute dollar terms. However, since the exemption amount is intended primarily to prevent application of the minimum tax to taxpayers who do not have large economic incomes, rather than to reduce the liabilities of high-income taxpayers who pay little regular tax, some have suggested that the exemption amount should be phased out at high income levels. For example, under the Schumer-Russo bill, there is in effect an exemption amount of $70,000, since taxpayers with less than that amount of minimum taxable income are not subject to minimum tax. However, taxpayers with minimum taxable incomes in excess of $70,000 are subject to minimum tax with respect to their entire incomes (although the full rate of 25 percent is phased in gradually). One difficulty with eliminating the exemption amount is that elimination can result in the creation of effective marginal rates of minimum tax, in the phase-out range, that exceed the general minimum tax rate. Under the Schumer-Russo bill, the gradual phase-in of the full rate ameliorates, but does not eliminate, this problem.

Minimum tax rates

The determination of the rate at which the minimum tax should apply involves balancing two competing considerations. On the one hand, since the minimum tax generally is intended to apply only to

a minority of taxpayers (even in relatively high-income brackets), the rate must be set sufficiently below the relevant regular rates of tax to avoid over-broad application. On the other hand, setting the rate too low would permit taxpayers who are subject to the minimum tax to continue to avoid incurring significant tax liabilities. The rate of minimum tax also alters the top rate that can apply to capital gains, if the minimum tax rate exceeds the highest rate applying to capital gains under the regular tax. Thus, for example, under the Administration proposal, capital gains would be subject to minimum tax at a rate of 20 percent, as compared with a proposed top rate of 17.5 percent under the regular tax. Finally, for taxpayers potentially subject to the minimum tax, the rate differential between the regular and minimum taxes affects the marginal incentive to invest in tax preference assets.

The revenue effects of an alternative minimum tax are particularly sensitive to changes in the rate at which the minimum tax is applied. For example, increasing the rate by one-third would be expected to increase minimum tax revenues by more than one-third, since it would not only increase revenues from those already subject to minimum tax, but would also cause the minimum tax to apply to additional taxpayers.

In summary, the determination of the proper minimum tax rate involves considering (1) revenue goals, (2) the number of taxpayers intended to be affected, and (3) what percentage of economic income is viewed as the minimum amount that an affluent taxpayer should pay. Under enacted law and the various alternative minimum tax proposals, the rate of minimum tax has most commonly been 15, 20, or 25 percent.

Most minimum tax provisions and proposals have applied a single marginal rate without regard to income level, as opposed to using graduated rates. This may follow from the notion that the minimum percentage of income that an affluent taxpayer can pay without engaging in undue tax avoidance does not vary with income level. (On the other hand, it is generally agreed that no such minimum percentage should apply to taxpayers who are not affluent). However, it can be argued that, under general principles of progressivity, the rate of minimum tax should be graduated. Thus, for example, the Schumer-Russo bill phases in the full rate of 25 percent between the income ranges of $70,000 and $100,000 for individuals, and $70,000 and $150,000 for corporations.

The grounds for minimum tax rate progressivity may be particularly strong with respect to individuals (e.g., taxpayers in businesses that receive substantial tax preferences) who would be expected to incur minimum tax liability on a regular basis. These taxpayers would generally be unaffected by the progressivity of the regular tax system. Thus, if progressivity is considered generally desirable (and if the regular tax system applied graduation at income levels where liability for minimum tax was possible), it might be considered desirable to apply graduated rates for minimum tax purposes.

One possible approach that would result in retention of the progressivity of the regular tax system would be to set minimum rates at some fraction of the rates used in the regular tax system. For example, the alternative minimum tax rates could be set at one-half of the regular tax rates, using the same brackets. This would

effectively prevent taxpayers from using preferences to shelter more than one-half of their incomes from tax.

Determining what preferences should be subject to minimum tax

General considerations

The determination of what preferences should be subject to minimum tax raises several general issues. First, there is the question of what constitutes a preference. In principle, any provision that provides more favorable treatment for an item of income or of expense than is justified by the neutral application of objective economic and accounting principles is a preference. Typical examples of preferences include the following:

(1) permitting the value of an item or benefit received by a taxpayer, although theoretically constituting income, to be excluded in whole or in part (e.g., tax-exempt interest);

(2) permitting a deduction or credit for an item of personal consumption or living expense that, under general tax principles distinguishing between personal and business-motivated expenditures, would not be deductible (e.g., interest on consumer debt);

(3) permitting an item of business expense to be claimed as a tax credit rather than (or in addition to as) a deduction, without reducing its amount to reflect the greater value of a credit (e.g., the investment tax credit);

(4) permitting an item of business or investment expense that produces benefits over a multi-year period to be deducted at a faster rate than that dictated by its economic life (e.g., accelerated depreciation); and

(5) permitting the use of a method of accounting that "mismatches" income and offsetting deductions; i.e., permits deductions to be claimed prior to the recognition of related income (e.g., the completed contract method).

Although the definition of a preference is clear enough in theory, difficulty can arise in practice in determining whether the tax treatment of a particular item is "preferential," and how it would be treated under economically correct or normative principles. For example, people may disagree about the value of a non-cash item that theoretically constitutes income, about whether an expenditure serves business or personal purposes, or about the correct rate for writing off an expenditure that produces multi-year benefits.

Even to the extent that an item is agreed to constitute a preference, two additional issues arise in determining whether it should be treated as such for minimum tax purposes. First, there is the problem of administrative burden. In some cases, it may be argued that the burden of keeping records or making calculations under two different systems (i.e., regular tax and minimum tax) is too great to justify treating an item as a minimum tax preference. Any abuses regarding items for which this is true arguably should be addressed, if at all, by revising the rules for regular tax treatment. Second, to the extent that a preference is provided for reasons of social or economic policy, it can be argued that requiring normative treatment for minimum tax purposes would unduly reduce the incentive effect.

Specific issues

In applying these general considerations, a number of important issues arise with respect to the various preferences listed in the Administration and other proposals.

Depreciation

Accelerated depreciation is a preference for the same reason that, for example, permitting taxpayers to deduct amounts in excess of costs actually incurred would be a preference. When one invests in property that retains value after the end of the year, the cost of acquiring that property (to the extent that the property retains value) has no more been "spent" than money that is shifted from one bank account to another.[83] Under present law, depreciation deductions are accelerated (as an incentive to capital investment) in two respects: (1) acceleration *per se*, i.e., the allowance, during the early years of an asset's life, of a larger percentage of the total depreciation deductions for the asset than would follow from the use of straight-line depreciation, and (2) the application of a "useful life," during which the asset will be fully depreciated, which is substantially shorter than the actual useful life of the property. These features of accelerated depreciation are important in the structuring of many tax shelters, which permit investors to claim for tax purposes book losses substantially in excess of any real economic losses that have been suffered.

The present minimum tax addresses the preference resulting from accelerated depreciation, but in an incomplete manner. First, it does not apply to personal property (such as most machinery and equipment), except for leased personal property in the hands of an individual or personal holding company. Second, it addresses only one of the two elements of depreciation, requiring assets to be depreciated for minimum tax purposes on a straight-line rather than an accelerated basis, but without eliminating the acceleration resulting from using useful lives that are shorter than economic lives.

The Administration proposal would not fully address the incompleteness of the minimum tax with respect to the types of property covered. Like present law, it would not apply to personal property, other than leased personal property, held by an individual. For corporations, personal property similarly would not be treated like real property, although it would be subject to a new rule treating acceleration as a preference to the extent of 25 percent of certain interest expenses. This rule is designed to address "leveraging," i.e., using debt financing to claim large deductions for both depreciation and interest with respect to property in which one has invested little equity. The rule could be applied to individuals as well.[84] The Schumer-Russo, Moynihan-Chafee, and Bentsen-Dan-

[83] Of course, under accelerated depreciation the total dollar amount that is deducted over time, taking into account gains and losses on disposition of the asset, will be correct. However, acceleration nonetheless leads to an overstatement of the value of all deductions taken, applying present value analysis from the time that the asset is placed in service.

[84] The Administration's proposed limitations on interest deductions by individuals (i.e., for consumer and investment interest, an annual limit of $5,000 plus the amount of investment income for the year) would not wholly eliminate the leveraging problem with respect to individ-

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forth bills, in contrast to the Administration proposal, would apply to all types of depreciable property.

The Administration proposal to use a depreciation system similar to that outlined in the 1984 Treasury Report as the proper normative standard raises several issues. Arguably, taxpayers could be required to use book depreciation for minimum tax purposes. In addition, there is a presently existing depreciation system that could arguably be used to provide the normative standard. Section 168(g)(2) details the useful lives (derived from pre-1981 law) to be used for depreciation (on a straight-line basis) of property leased by tax-exempt organizations. Congress adopted this provision in 1984, based on the view that it accurately estimated useful lives, with the goal of preventing tax-exempt entities from in effect "selling" the tax benefits of accelerated depreciation through lease arrangements with taxable third parties. It is also the normative depreciation rule proposed in the Schumer-Russo minimum tax bill. Perhaps the principal difference between this system and the 1984 Treasury Report, other than the fact that they represent two different estimates of normative depreciation, is the fact that the Treasury plan would permit the basis of depreciable assets to be indexed to inflation. Some would argue that this increases the economic accuracy of the Treasury system, and that indexing is appropriate for minimum tax depreciation purposes if it is used for regular tax depreciation purposes. On the other hand, the use of indexing for minimum tax purposes may increase the system's complexity, and may be less appropriate to the extent that other indexing proposals from the 1984 Treasury Report (e.g., indexing interest payments to reflect the element of inflation) have been discarded.[85]

Other rapid amortization provisions

In general, issues similar to those raised by depreciation arise with respect to any provision that, for incentive reasons, permits amortization of capital expenditures at a rate more rapid than the economic rate. The Administration proposal would eliminate many such preferences for regular tax purposes. However, if Congress retains the incentives for regular tax purposes, they could be included as minimum tax preference items.

In the case of any preference that is retained for regular tax purposes, two issues arise with respect to the proper minimum tax treatment. First, there is the question of whether it should in fact be included in the minimum tax base. While inclusion is more con-

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uals. For example, no limitations would be placed on deductions of business interest by individuals, and even the proposed limitations would not be fully phased in until 1996. Moreover, to the extent that the proposal allows deductions for investment interest, it does not restrict leveraging (e.g., by reducing interest deductions to the extent of the accelerated depreciation). The minimum tax against leveraging accelerated depreciation on personal property could be applied by disregarding interest that is subject to the proposed limitations.

[85] Under the Administration proposal, corporations would use a depreciation system similar to that under the 1984 Treasury Report for earnings and profits and foreign investments, as well as minimum tax purposes. Earnings and profits are used to determine the source of a corporate distribution to shareholders—i.e., whether it was made out of retained earnings (and accordingly constitutes a dividend, taxable as ordinary income) or constituted a return of capital. Complexity would be decreased by permitting corporate taxpayers to use the same depreciation system for both earnings and profits and the minimum tax. However, it can be argued that, for earnings and profits purposes, just as for minimum tax purposes, there is no reason to adjust for inflation with respect to depreciable assets when no inflation adjustments are made in certain other respects, such as interest payments.

sistent with the purpose of the minimum tax to apply comprehensively to economic income, exempting a preference may be supported on the ground that it increases the incentive effect of the preference (albeit at the possible cost of permitting some taxpayers with substantial economic incomes to escape tax liability). One example of this issue is the question of the minimum tax treatment of research and experimentation expenditures (which can be expensed for regular tax purposes although in many cases they have a useful life of more than one year). Under present law, the expensing of these costs is treated as a preference for individuals and personal holding companies. The Schumer-Russo, Moynihan-Chafee, and Bentsen-Danforth minimum tax bills, but not the Administration proposal, would treat them as a preference for all corporations as well. Some have argued that research and experimentation expenditures should not be treated as a preference where they could be expensed for financial reporting purposes under applicable accounting principles, contending that current deductibility was not enacted primarily as an incentive provision but as an appropriate measure of economic income.[86] However, to the extent this approach could result in a significant reduction or elimination of tax in the case of expenditures with multi-year economic lives, it requires considering as well the balance between allowing the deduction, on the one hand, and applying the minimum tax to a comprehensive base, on the other.

Second, the decision to eliminate a preference involving rapid amortization requires determining what treatment would be normative. Again, disagreement has arisen on this issue with respect to the treatment of research and experimentation expenditures. For present minimum tax purposes, as well as under the Administration proposal, individuals and personal holding companies are required to amortize them over ten years. However, the Schumer-Russo, Moynihan-Chafee, and Bentsen-Danforth bills, while extending minimum tax treatment to apply to all corporations, would define the normative rule as amortization over only five years. If it is decided to treat these expenses as a tax preference, it would be necessary to examine the appropriate useful lives to use in establishing a normative rule.

Oil and gas tax preferences

Under both present law and the Administration proposal, percentage depletion of oil and gas wells is treated as a preference (for both individuals and corporations) under the minimum tax. The Administration proposal would change the definition of the preference with regard to wells placed in service in 1986 or thereafter.

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[86] *But see Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), where the Supreme Court stated that financial and tax accounting serve "vastly different objectives," with financial accounting being designed to err on the side of understatement, rather than overstatement, of income. The Court concluded that, in view of the "diversity, even contrariety, of objectives" served by the two systems, there is no "presumptive equivalency" between them as to the proper treatment of any particular item. 439 U.S. at 542-43. It has been suggested that the accounting rule requiring expensing of certain research and experimentation costs "institutionalizes the distortion of underestimation of a firm's assets and earnings" because of "conservative tendencies" of the accounting profession with respect to "describing current profits and assets in any situation of uncertainty" (Note, "The Tax Treatment of Research and Development Expenditures: A Comparison Between Financial Accounting Standards and Section 174 of the Internal Revenue Code," 10 Rutgers Computer & Technology L.J. 149, 157–58 (1984)).

For such wells, amounts in excess of the deduction allowable under cost depletion, rather than amounts in excess of the adjusted basis of the property, would be treated as a preference.[87]

This proposed rule is more consistent than the use of adjusted basis with the rules commonly used to measure other preferences, such as depreciation. Thus, for example, accelerated depreciation is treated as a preference to the extent that it exceeds depreciation as measured under some other system, rather than in relation to the basis of the property. However, in the case of percentage depletion, the difference between the two approaches in practice is relatively slight.

With respect to intangible drilling costs ("IDCs"), the Administration proposal would change the minimum tax rules under present law in three respects. First, it would require that the expensing of these costs be treated as a preference by all taxpayers. (Under present law, it is a preference only for individuals and personal holding companies). Second, the proposal would eliminate the so-called "income offset," under which the preferential portion of an IDC is included in minimum taxable income only to the extent that it exceeds net oil and gas income. This "income offset" rule limits the use of IDCs to shelter income from other businesses, but it does not prevent oil and gas operators from using IDCs to eliminate tax liability. Third, the Administration proposal would lower the amount of each IDC deduction on a productive well that is defined as a preference, from 90 percent under present law (i.e., the difference between expensing and amortization over 10 years) to eight percent. Thus, at the proposed minimum tax rate of 20 percent, taxpayers subject to the minimum tax would incur additional liability equaling no more than 1.6 percent of the amount of their expensed IDCs.

The Administration proposal to treat only eight percent of IDCs as a tax preference is founded on two decisions. First, instead of comparing expensing to a normative approach (such as the use of cost depletion for IDCs, as suggested in the 1984 Treasury report), the proposal would compare expensing to the treatment for Class 3 property under the Administration's proposed CCRS system of depreciation. This system of depreciation is itself avowedly preferential. Moreover, in making the comparison to the treatment of Class 3 property, the Administration proposal regarding IDCs does not account for the fact that other parts of the proposal require treating such depreciation as itself a minimum tax preference under certain circumstances (i.e., in the case of leased personal property in the hands of an individual or a personal holding company, and with respect to leveraging of accelerated depreciation deductions by corporations). It can be argued that the proposal would be more consistent if it both included 8 percent of IDCs in minimum taxable income and treated IDCs in effect as Class 3 personal property for purposes of measuring these other preferences for personal property.

Second, under the proposal expensing would be compared, not to the deduction that would be allowable for the same year under the

[87] In addition, the Administration proposal would significantly reduce the availability of percentage depletion, by permitting it only for stripper oil wells.

rules for CCRS Class 3 property, but to the present value of all deductions for CCRS Class 3 property over the life of an asset. This represents a departure from the rules for other preferences under present law, the Administration proposal, and other minimum tax proposals. For example, the Schumer-Russo and Moynihan-Chafee minimum tax bills would treat IDCs as a preference to the extent in excess of the deductions for the year under 10-year amortization. The Bentsen-Danforth minimum tax bill would likewise use this method, although it would retain the income offset rule of present law. One possible problem with the Administration proposal in this regard is that it does not account for instances where the taxpayer disposes of the property before the end of its useful life, and thus would not have been entitled to all future deductions if they were claimed on an annual basis. Thus, taxpayers may benefit in the year of minimum tax liability from the present value of deductions which they would never have taken under the CCRS Class 3 system.

Both of the decisions that underlie the proposed 8 percent rule appear to reflect a theory that is more in keeping with the rationale for an add-on minimum tax than with that for an alternative minimum tax. They attempt to measure the amount of the preference resulting from the expensing of IDCs (or, in any case, the amount by which the preference exceeds that for Class 3 property generally), and apply the minimum tax rate—in effect, like an excise tax—to this amount. By contrast, under the theory of an alternative minimum tax, one would expect the IDC preference to equal the full amount by which the regular tax deduction for the year exceeded the normative deduction for the year. Such a rule is necessary if taxpayers subject to the minimum tax are to be required to pay tax equalling at least some minimum percentage of economic income for the year.

Since the proposed eight percent rule is founded on concern about preserving the value of a deduction that merely defers, as opposed to exempting, the recognition of taxable income, there would arguably be no reason for the rule if broader rules were adopted addressing the issue for all deferral preferences. Thus, for example, if taxpayers were permitted to elect the use of normative deduction methods, and either to carry forward unused deductions or to claim a subsequent credit in the amount of alternative minimum tax liability, it arguably would be proper to include in minimum taxable income the percentage of IDCs reflecting the full difference between expensing and whatever is considered to be the normative first year's deduction for such costs.

A final oil and gas issue to be considered is the appropriate treatment for minimum tax purposes of costs related to dry holes on productive oil and gas properties. For regular tax purposes, the 1984 Treasury Report would have required that these expenses be recovered through cost depletion, on the ground that the success of a project is most accurately measured on a property-by-property, rather than a hole-by-hole, basis. Some have argued that expensing is the more appropriate treatment, and this view is reflected in the Administration proposal. However, if Congress views the 1984 Treasury proposal as economically more accurate, but decides on incentive grounds not to require its use for regular tax purposes, it

can require application of the dry hole rule solely for minimum tax purposes. Alternatively, Congress could require that dry holes be treated for minimum tax purposes consistently with their financial accounting treatment.[88]

Completed contract method of accounting

A taxpayer that is performing work under a multi-year contract and using the completed contract method of accounting can defer recognition of income until the contract is completed — even if the taxpayer receives progress payments during the life of the contract. Certain deductions for expenses incurred pursuant to the contract are also deferred until the completion of the contract, but other expenses (e.g., certain items classified as indirect costs) can be deducted in the years when they are incurred. Accordingly, the completed contract method is preferential in two respects. First, it permits the mismatching of income and related deductions, since certain deductions can be claimed in earlier years. Second, it defers recognition of any net gain until the contract is completed, whereas from an economic standpoint one might view a percentage of this gain as being realized during each year in which work is performed pursuant to the contract.

Among the industries that make significant use of the completed contract method are defense and construction. Use of the completed contract method has been viewed as a major factor in the recently publicized instances of low tax liabilities by large defense contractors. However, it has been argued that use of the completed contract method promotes certainty of result (since the taxpayer may not know the precise amount of profit on a contract until completion) and ameliorates cash flow problems experienced by some small companies in industries such as construction.

Under present law, use of the completed contract method is not permitted for purposes of calculating corporate earnings and profits. Instead, corporations are required to use the percentage of completion method (sec. 312(n)(7)). Under a recent bill, use of the completed contract method would be denied with respect to all multi-year contracts with the Federal government.[89] Taxpayers subject to this bill would be required to report as income the higher of the amounts derived by using the percentage of completion method and the cash method of accounting (i.e., recognition of progress payments received), respectively.

The Administration proposal does not provide for treatment of the completed contract method as a minimum tax preference. However, for regular tax purposes, the Administration proposal addresses one of the two elements that renders the use of the method preferential, i.e., the mismatching of income and deductions. Under the proposal, certain of the items that presently can be deducted during the life of the contract would not be be deductible by a taxpayer using the completed contract method until the contract was completed.

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[88] The chief difference between the tax and financial accounting rules for dry holes is that, for financial accounting purposes, costs of drilling certain exploratory wells that show the presence of reserves are subject to cost depletion rather than to expensing.

[89] H.R. 2214 (Mr. Stark).

Under the Schumer-Russo, Moynihan-Chafee, and Bentsen-Danforth minimum tax bills, use of the completed contract method would be treated as a preference to the extent that it is more favorable than use of the percentage of completion method. Enactment of the Administration proposal regarding the regular tax treatment of completed contract accounting would not render these proposals redundant, in view of the lesser scope of the Administration proposal, i.e., the fact that it neither denies all deductions incurred during the life of a multi-year contract, nor affects the deferral of recognition for net gain realized, or progress payments received, during the life of a multi-year contract.

Installment method of accounting

A taxpayer that makes an installment sale of property (i.e., a sale in which a portion of the payment is to be received after the year of the sale) is allowed to defer recognition of gain in accordance with the payment schedule. For each year during the period of payment, only a percentage of net gain, derived from the percentage of total payments made in that year, is treated as income.

The installment method is designed to address possible cash flow problems that some taxpayers might encounter if required to recognize gain in full during the year of an installment sale. In an economic sense, however, the installment method is a preference, since, to the extent that tax is deferred, the seller has in effect received an interest-free loan from the government.

While the Administration proposal does not treat the installment method of accounting as a tax preference, it restricts use of the method for regular tax purposes. Under the proposal, gain would be recognized on installment obligations that were pledged to secure loans. The Schumer-Russo bill would treat as a preference all gain deferred on sales through use of the installment method (under sec. 453).

Tax-exempt bonds

Under the Schumer-Russo bill, all interest on newly issued tax-exempt securities would be includible in minimum taxable income. The Administration proposal contains no comparable rule, although it would deny tax-exempt status for private purpose bonds (e.g., industrial development bonds) generally. The Moynihan-Chafee and Bentsen-Danforth bills would deny certain deductions for interest expenses related to purchasing or carrying tax-exempt obligations.

The determination of whether tax-exempt interest should be includible in income for minimum tax purposes raises a number of issues. To begin with, such interest is agreed to constitute income in an economic sense. In addition, the goal of requiring that all individuals with significant economic income pay some tax cannot be fully accomplished if the interest is excludable for minimum tax purposes. It is believed that some wealthy individuals derive a substantial portion of their income in the form of tax-exempt interest.

On the other hand, arguments can be made against including tax-exempt interest in minimum taxable income. Some argue that taxing such interest would unconstitutionally burden the States, although the Supreme Court has rejected this argument in the con-

text of whether it is constitutional to tax the salaries of State employees.[90] In addition, imposing minimum tax liability might burden the States by reducing demand for tax-exempt obligations (and possibly requiring them to increase the rate of interest paid). It can be argued that any such effect would be particularly significant in light of other proposals advanced by the Administration that may burden State and local governments (e.g., repealing the deductibility of certain State and local taxes).

Pensions and fringe benefits

The Schumer-Russo bill proposes certain rules for increasing minimum taxable income with respect to certain pensions and fringe benefits that receive tax-favored treatment under the regular tax system. These items generally constitute income in an economic sense, and thus would have to be included in any truly comprehensive base. However, taxing them raises a number of issues. First, as a policy matter, some argue that the preferred tax treatment accorded to pensions and fringe benefits should be subjected to no restrictions other than those applying for regular tax purposes. Second, taxation can involve a number of administrative and valuation problems. For example, certain pension benefits received by employees may accrue over several years without vesting (i.e., becoming nonforfeitable by the employee). Taxing such benefits before they vest may result in individuals being taxed with respect to income that they never receive. Taxing the benefits when they vest can result in "bunching" several years' accrued benefits in a single year.[91] With respect to fringe benefits, valuation difficulties can arise—for example, in measuring the health insurance premiums attributable to employees with different degrees of coverage when they are insured under a group health plan for which the employer pays a single premium.

Foreign tax preferences

Certain Congressional bills would eliminate, for minimum tax purposes, two preferences in the foreign area that are unaffected by the Administration proposal. First, under the Schumer-Russo bill, the exclusion for up to $80,000 of income earned abroad by a U.S. citizen would be denied in calculating minimum taxable income. Second, the Schumer-Russo, Moynihan-Chafee, and Bentsen-Danforth bills would treat as a preference the exclusion for a portion of the export income of an eligible foreign sales corporation (FSC).

A third foreign tax preference that could arguably be addressed through the minimum tax is the deferral of recognition for certain income earned by controlled foreign corporations ("CFCs"). In general, this preference permits U.S. parent corporations to defer tax on income earned by foreign subsidiaries until the income is brought home to the United States.

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[90] *Graves* v. *New York ex rel. O'Keefe*, 306 U.S. 466 (1939); *Helvering* v. *Gerhardt*, 304 U.S. 405 (1938). *See also South Carolina* v. *Regan*, 104 S.Ct. 1107 (1984); *Garcia* v. *San Antonio Metropolitan Transit Authority*, 53 U.S.L.W. 4135 (1985), for relevant constitutional discussion.

[91] In addition, in some cases it may be difficult to determine when vesting occurs.

A further foreign tax issue under the minimum tax concerns the treatment of the foreign tax credit. Under both present law and the various proposals, the foreign tax credit is generally allowed against minimum tax liability, subject to limitations that prevent its use to offset U.S. tax liability on U.S. source income. Under this rule, some U.S. persons with significant foreign incomes can be expected to pay no U.S. tax, because their foreign tax credits offset all liability. It can be argued that all high-income taxpayers who are subject to U.S. taxing jurisdiction should be required to pay some U.S. tax, even if they have substantial foreign tax liabilities. This would suggest further limiting the availability of the foreign tax credit for minimum tax purposes. On the other hand, it can be argued that taxpayers who incur sufficient foreign tax liabilities to avoid imposition of the minimum tax are not engaging in tax avoidance, and should not be subjected to further liability.

A further foreign tax credit issue relates to the Administration proposal, under the regular tax system, to calculate the credit on a per-country rather than an aggregated basis. The proposal is designed to prevent the use of credits from a high-tax country to offset income from a low-tax country. Whether or not this proposal is adopted for regular tax purposes, consideration could be given to adopting it for minimum tax purposes, or to requiring taxpayers to calculate minimum tax foreign tax credits on both an aggregated and a per-country basis and to use the method that yields a lower credit.

Investment losses

For both regular and minimum tax purposes, suggestions have been made to disallow the use of certain investment losses as a deduction against unrelated income. For example, in 1973 the Nixon Administration proposed a rule establishing limitations on artificial losses (LAL), under which certain preferential deductions would have been allowed only against net related income. The Schumer-Russo minimum tax bill would disallow the deduction by individuals of net losses on all activities in which the individual is not an active participant. The Moynihan-Chafee bill would establish an income floor for individuals, under which, in general, certain deductions (e.g., for investment losses) could not be claimed against the taxpayer's primary source of income (i.e., earned income or income from controlled businesses).

A rule preventing the use of investment losses to offset unrelated income (e.g., salary) can apply either to the losses in their entirety, or only to the preferential portion thereof (e.g., accelerated deductions). The arguments in favor of these two types of rules differ. Disallowing investment losses only to the extent of preferences (i.e., preferences that have not been generally denied for minimum tax purposes) serves to discourage the use of tax shelters. But the proposal to disallow nonpreferential losses on investments is founded on a broader concern, arising from the ability of many taxpayers to control the timing of events leading to the recognition of gain or loss on investments, or to benefit from rules that provide favorable timing (e.g., recognition of deductions before offsetting income). Since taxpayers may be able in many cases to claim net losses on investments without actually realizing net losses in an economic

sense, it is argued that the recognition of loss on an investment should be deferred, except to the extent of recognized gain (either from the same investment or from investments generally) until the taxpayer terminates his or her interest in the investment from which the loss arose.[92] Under present law, deductions for net capital losses are limited due to similar concerns.[93]

Preferences that the Administration proposal would eliminate or restrict for regular tax purposes

A number of other preferences that would be eliminated for regular tax purposes under the Administration proposal could be considered for treatment as minimum tax preferences if the Administration proposal is not fully adopted. Examples of preferences that are eliminated for regular tax purposes under the Administration proposal, and would be treated as minimum tax preferences under various bills, include the special and small life insurance company deductions (whereby a percentage of life insurance company income, in many cases 20 percent, is exempt from taxation), various rapid amortization provisions (e.g., the rules for trademark and tradename, reforestation, and land clearing expenditures), and the deferral of certain shipping company income. Consideration could also be given to other items that would be eliminated under the Administration proposal, and that can be seen either as preferences or as structural adjustments, such as income averaging and the deduction for two-earner married couples.

Application of preferences to personal holding companies

Under both present law and the Administration proposal, certain tax preferences applying to individuals apply as well to personal holding companies, but not to other corporations. These preferences include accelerated depreciation on leased personal property (under both the proposal and present law), research and experimentation expenditures (under both), and intangible drilling costs (under present law). The ground relied upon for not applying these preferences to most corporations is concern about lessening the incentive effect of the preferences. However, personal holding companies are required to recognize the preferences, due to concern that individuals would otherwise incorporate as a means of escaping minimum tax liability.

If the decision is made to treat certain items as preferences only for individuals, but to limit the use of incorporation as a means of escaping minimum tax liability, consideration could be given to selecting a group other than personal holding companies. In general, corporations may be taxed as personal holding companies if they are closely held and derive more than 60 percent of their income from such sources as dividends, rents, royalties, and personal service contracts. For minimum tax purposes, this definition may be viewed as overly broad under some circumstances, since a company

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[92] *See* Part III.A. of this pamphlet, *supra*, for a more detailed discussion of the issues raised by investment losses.

[93] Under section 1211, corporations can claim capital losses only to the extent of capital gains, and individuals can claim capital losses only to the extent of capital gains plus $3,000. Disallowed losses can be carried forward (as well as carried back, in the case of a corporation) to other taxable years.

in the start-up phase of an active business may qualify as a personal holding company until it begins to generate significant business receipts. Limiting corporate preferences to personal holding companies can also, under certain circumstances, be viewed as overly narrow. Since a company conducting an active business generally will not be treated as a personal holding company, the personal holding company rule does not eliminate the disparity between the minimum tax treatment of individuals who conduct their businesses, respectively, as sole proprietors and in corporate form. Thus, it may be thought desirable to treat minimum tax items as preferences for a different group of corporations, such as closely held companies or personal service corporations.

Use of earnings and profits to define minimum taxable income

One possible approach to defining minimum taxable income for corporations would be to use, with appropriate modifications, the rules for measuring annual earnings and profits. Under present law, corporations must determine the amount of their annual earnings and profits in order to determine whether distributions to shareholders constitute dividends (taxable as ordinary income) or returns of capital. Distributions are treated as dividends only to the extent that they are made out of earnings and profits.

The earnings and profits rules are generally designed to provide an economically accurate measurement of annual corporate income. Thus, they generally include items that, for policy reasons, are excludable from taxable income. While the determination of earnings and profits is generally made by following the timing rules that apply for regular tax purposes, section 312 provides a number of exceptions by prescribing more normative timing rules under certain circumstances (e.g., depreciation, and the use of the completed contract and installment methods of accounting).

Use of earnings and profits to define corporate minimum taxable income would have the advantage of applying a comprehensive rule as to which there is existing authority, instead of requiring Congress to make numerous item-by-item determinations regarding applicability of the minimum tax. In addition, since corporations are required under present law to keep track of their earnings and profits, use of this standard might lessen the burden of calculating minimum tax liability. However, since there has been relatively little litigation regarding the definition of earnings and profits, Congress might wish to clarify the rules applying to their calculation.

If earnings and profits were to be used for minimum tax purposes, various modifications to the standard might be necessary. For example, in instances where the timing rules for calculating earnings and profits follow those in the regular income tax, adjustments might be thought desirable to remove undue acceleration of deductions or deferral of income recognition. In addition, some changes might be considered desirable for policy reasons. For example, in calculating earnings and profits, taxpayers are permitted to deduct items (such as bribes, as well as charitable contributions in excess of the applicable ceilings) that are considered inappropriate as regular tax deductions. The policy reasons for denying de-

ductions for these items under the regular tax would presumably apply to the minimum tax as well.

Treatment of dividends

Whether or not earnings and profits is used as the standard for measuring corporate minimum taxable income, a question arises as to the minimum tax consequences of the payment and receipt of dividends. In measuring earnings and profits, dividends paid are generally deductible, since they reduce the amount of corporate earnings and profits that remain undistributed, and dividends received are includable in earnings and profits. For minimum tax purposes, however, the rationale for any deduction or exclusion with respect to dividends may not apply, since a minimum tax is designed to determine the amount of income that has been earned during the year.

Since the minimum tax is meant to apply to a broad base approaching or equalling economic income, it can be argued that no minimum tax deduction should be allowed for dividends paid, and that dividends received should be includable. Similarly, dividends paid are not deductible, and dividends received must be included, in determining book income as reported for financial reporting purposes. With respect to dividends paid, this argument is particularly strong to the extent that no dividends paid deduction is allowed for regular tax purposes. However, it would apply even if such a deduction were allowed (e.g., under the Administration proposal to allow a deduction, for regular tax purposes, equal to 10 percent of the amount of dividends paid). Arguably, denying a dividends paid deduction for minimum tax purposes could encourage corporations that make sufficient use of preferences to be subject to the minimum tax to act in accordance with the goal of many preferences—i.e., to increase investment instead of distributing funds to shareholders.

A further issue concerning dividends relates to the public perceptions of unfairness that may arise when a corporation pays dividends to shareholders in a year when it pays no tax. In view of the morale and compliance purposes served by the minimum tax, it can be argued that some tax liability should be imposed whenever a corporation pays substantial dividends. For example, the amount of dividends paid could be used as a floor on corporate minimum taxable income. In opposition to such a rule, it could be argued that a corporation which pays tax in one year, and then distributes those earnings in the next year, should not incur additional liability in the second year with respect to distributions of income that has already been taxed. However, any such problem could be addressed by maintaining multi-year accounts of the amount of minimum taxable income reported, and treating distributions in excess of such accounts as an income floor.

Interaction of corporate minimum tax preferences with preference cutback under section 291

Under present law, certain items relating to corporations are treated as preferences for purposes of both the minimum tax and the percentage cutback on corporate tax preferences that applies for regular tax purposes. The items that are treated as preferences

for both of the above purposes are: (1) percentage depletion for coal and iron ore, (2) for financial institutions, additions to bad debt reserves, to the extent in excess of the deduction allowable under the experience method, (3) capital gain on the sale or other disposition of real estate that would have been treated as ordinary income for regular tax purposes if the recapture rules for personal property (sec. 1245) rather than for real property (sec. 1250) had applied, and (4) excess amortization claimed with respect to pollution control facilities.

Although these items are treated as preferences for purposes of both the corporate minimum tax and section 291, there is no overlap between the application of the two provisions in practice. In effect, each of the above preferences is divided arithmetically into two portions: the part (either 15 or 20 percent) that is added back to regular taxable income under section 291, and the part (reduced by a percentage to exclude the first part) that is treated as a preference for minimum tax purposes.

Congress structured present law to avoid any overlap between the application of the add-on minimum tax and section 291 in order to avoid having an overly adverse impact on corporate taxpayers that use the above preferences. However, allowing the two sections to overlap under an alternative minimum tax would not lead to "double-counting" or over-measurement of any taxpayer's income. For each of the relevant provisions, the minimum tax treats as a preference only the difference between (1) the normative treatment of an item and (2) its treatment by the taxpayer in calculating its regular taxable income. Section 291, by increasing the amount relating to an item that is taken into account for regular tax purposes, automatically has the effect of reducing the amount of the preference for purposes of an alternative minimum tax.

Accordingly, it can be argued that the fact that an item is treated as a preference under section 291 should not give rise to a reduction in the percentage of it that is treated as a preference for minimum tax purposes. To the extent that treatment as a minimum tax preference item is reduced to reflect the application of section 291, some taxpayers (despite the possible effect of section 291 in increasing their regular tax liabilities) may continue to pay tax on their economic income at a lower rate than that which would result from application of the minimum tax rate to a comprehensive income base.

Itemized deductions for individuals

Under present law, individuals are allowed itemized deductions for minimum tax purposes only with respect to casualty losses, gambling losses (to the extent of gambling gains), charitable contributions, medical expenses, interest on a home mortgage, plus other interest to the extent of investment income, and certain items relating to estate taxes. However, the Administration proposal would allow nearly all itemized deductions to be taken against minimum taxable income.[94] In addition, the Administration proposal would

[94] For both regular and minimum tax purposes, the Administration proposal would generally reduce the itemized deductions available for regular tax purposes—for example, by denying the deduction for State and local taxes paid and limiting miscellaneous deductions.

treat untaxed appreciation with respect to charitable contributions as a preference. For individuals, this would generally have the same effect as limiting minimum tax charitable deductions for contributions of appreciated property to the basis of the property.

The Schumer-Russo and Moynihan-Chafee minimum tax bills would allow itemized deductions for State and local taxes paid, as well as for all items presently allowed. In addition, the Schumer-Russo bill would phase out itemized deductions at between $100,000 and $150,000 of minimum taxable income, with the result of denying all itemized deductions to taxpayers with minimum taxable incomes in excess of $150,000.[95]

The question of whether itemized deductions should be allowed for minimum tax purposes raises several types of issues. The reasons for allowing various itemized deductions differ; thus, the same result is not necessarily appropriate for all.

For example, the deductions for home mortgage interest and charitable contributions are generally viewed as incentives for certain activities. Thus, one could argue that allowing these deductions is inconsistent with the purpose of the minimum tax to apply to a comprehensive and incentive-free base. On the other hand, it can be argued that denying these deductions would unduly limit their incentive effect. In addition, depending on how other features of the minimum tax, such as the rate and exemption amount, are structured, denying these deductions for minimum tax purposes could have the effect of broadening the tax's applicability to middle income taxpayers who might not be intended to be subject to it.

The Administration proposal to treat as a preference the deduction of untaxed appreciation with respect to charitable donations of property raises additional issues relating to the purposes of the minimum tax and of the charitable deduction. For regular tax purposes (under both present law and the Administration proposal), taxpayers are permitted to deduct the full market value of appreciated capital-gain property donated to public charities, even though the appreciation has not been taxed, as an incentive to charitable giving. In practice, this rule may provide significant benefits (in the form of increased donations) to charitable organizations such as museums and universities. It also tends to benefit upper-income taxpayers.

Advocates of allowing charitable deductions, for both regular and minimum tax purposes, with respect to untaxed appreciation assert that its tax cost and possible regressivity are outweighed by its value as an incentive for making charitable contributions. Thus, the universities point out that appreciated property comprises about half of gifts over $5,000 to higher education, and museum groups argue that contributions of art from collectors would diminish unless full deductibility is allowed.

On the other hand, advocates of treating untaxed appreciation as a minimum tax preference respond that its allowance is inconsistent with the goal of the minimum tax to apply to a relatively comprehensive income base. They argue that there is a fundamental difference between the allowance of the charitable deduction *per se*

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[95] See p. 68, *supra*.

which permits the taxpayer to avoid taxation with respect to income that has been used to make a contribution to charity, and the deduction for untaxed appreciation which permits the taxpayer to deduct an amount that has not been included in income. The latter can be used to offset other income of the taxpayer (i.e., income that has *not* been donated to a charity). In addition, the deduction benefits individuals who possess appreciated property in comparison to other individuals, and yet there may be no reason to treat donations by these individuals more favorably.

Certain other itemized deductions, such as those for investment expenses, certain employee business expenses, and gambling losses to the extent of gambling gains, are associated with the accurate measurement of income. Thus, to the extent that these deductions are not overstated or improper (e.g., by permitting deductions for expenses that serve personal as well as income-producing purposes), there are grounds for arguing that they should be allowed under the minimum tax.

Similar arguments can be made with respect to itemized deductions (i.e., medical expenses and casualty losses) that are allowable for regular tax purposes only when they exceed specified percentages of adjusted gross income. Although these items generally reflect personal expenditures, they are often involuntary, and incurring them in sufficient amount to receive an itemized deduction arguably suggests that the taxpayer has undergone sufficient hardship to reduce his disposable income in a significant sense.

The merits of allowing State and local taxes to be deducted for minimum tax purposes depend upon one's view of the reasons for allowing this deduction in general. Under the present alternative minimum tax for individuals, the deduction is not allowed. Moreover, since the minimum tax is intended to apply to a base that is broader than taxable income, the minimum tax deduction for State and local taxes presumably would not be allowed if it was repealed for regular tax purposes. However, even if the deduction is retained for regular tax purposes, the arguments regarded its extension to the minimum tax would be influenced by the reasons relied upon for retaining it.

If the State and local tax deduction is retained on the ground that it is an important incentive for State and local government expenditures, one could argue that allowing it would be contrary to the purpose of the minimum tax. On the other hand, if it is retained on the ground that it is an expense of earning income, one could argue that it should be allowed for minimum tax purposes. The latter argument may have more application to State and local income taxes than to other taxes (i.e., on real and personal property and sales) which may be viewed as costs of consumption rather than costs of earning income.

Treatment for subsequent years of preferences that defer recognition of taxable income

Since the alternative minimum tax functions in large part as a "down payment" limiting the deferral of tax liability with respect to substantial economic income, a question arises as to the proper treatment in subsequent years of deferral preferences that are denied. If no subsequent adjustment is allowed, some taxpayers

may incur a form of "double taxation," in that the same item is taxed (or not recognized as a deduction) twice, first for minimum tax purposes and then, in a subsequent year, for regular tax purposes.

In some circumstances, taxpayers subject to this form of double taxation may nonetheless incur a lesser tax burden than would result from being taxed once, without deferral of income or acceleration of deductions, under the regular tax system. In the year when recognition of taxable income is deferred for regular tax purposes, the minimum tax is imposed at a significantly lower rate than would apply under the regular tax system. This tax saving may, in some cases, be greater than the present value of the regular tax liability that the taxpayer may incur in the future.[96]

For other taxpayers, however, the interplay between regular tax and minimum tax recognition of the same item in different years may result in receiving less favorable tax treatment than would result from applying economically neutral rules for regular tax purposes. Moreover, even if this does not happen, it can be argued that the purpose of the alternative minimum tax—i.e., requiring a down payment on ultimate tax liability, to the extent that it applies to deferral preferences—mandates allowing a subsequent offset for the denial of a deferral preference. Thus, some argue that it is desirable to provide some mechanism for limiting regular tax liability with respect to items that have caused the taxpayer to incur minimum tax liability. Two different types of mechanisms may be necessary: an election to use normative methods for regular tax purposes, and a system whereby the disallowance of preferences in one year may give rise to a reduction in regular tax liability in the next year. The latter system can take the form either of a carryover for unused deductions or of a credit against regular tax in the amount of minimum tax liability.

(1) *Election to apply normative treatment for regular tax purposes*—Under present law, in the taxable year when expenses giving rise to certain accelerated deductions are incurred, the taxpayer can elect, for regular tax purposes, to use a method under which the deductions are claimed over a longer period than would follow from use of the preference. The election enables the taxpayer to avoid treatment of the deduction as a preference for minimum tax purposes, and thus to preserve it for a subsequent year. Since, under the election, the deduction is claimed at what is considered a normative rate, it is allowable subsequently whether or not the taxpayer is subject to the minimum tax.

Advocates of this system note that it has several advantages. It is relatively simple to apply, it encourages taxpayers to use normative methods of reporting income, and it causes them to remain more frequently on the regular tax system, thereby lessening any complexity or distortions that may result from switching between the regular and minimum tax systems in different years. On the other hand, critics of this system note that it requires taxpayers, in the year that an expense is incurred, to make sophisticated and speculative estimates regarding their likely tax liabilities over a

[96] The future regular tax liability may also be reduced or avoided if the taxpayer is in a lower bracket, or reports a loss, in that year.

period of years. Taxpayers can end up failing to minimize their tax liabilities to the extent allowable, if their estimates prove incorrect. However, this problem can be addressed by adopting a more flexible election system, whereby taxpayers can switch between the normative and accelerated methods in different taxable years (although such a system might be complicated to apply).

One of the principal advantages of an election system is that it can preserve the value of deductions for taxpayers who are consistently on the minimum tax system. As discussed below, deduction carryforwards and credit carryovers would apply against regular tax liability, and thus might not benefit a taxpayer that was regularly subject to minimum tax liability. However, if the taxpayer elected to take deductions under a normative system, the deductions would not be treated as preferences in the first place. Accordingly, an election system could be adopted in addition, rather than as an alternative, to either of the systems discussed below.

(2) *Carryover of preferences to subsequent taxable years*—A further method that can be used to prevent taxpayers from losing the value of accelerated deductions (i.e., when they do not elect to normative treatment) is to permit them to carry such deductions over to subsequent taxable years (for regular tax purposes) to the extent effectively disallowed by application of the minimum tax. Under this rule, for example, a taxpayer who used ACRS and was subject to alternative minimum tax would be permitted to carry forward ACRS deductions in sufficient amount to increase his regular taxable income so that his regular tax liability would equal his minimum tax liability. The deductions so carried forward would then be allowed in the next taxable year in which they did not have the effect of reducing the taxpayer's regular tax liability to less than his minimum tax liability.

If this method is used, an issue arises as to the proper treatment of nonrefundable incentive credits (e.g., the investment tax credit) that are allowed for regular tax purposes. This issue is relevant, even if such credits are repealed for regular tax purposes, to the extent that taxpayers have carryforwards for such credits that accrued prior to repeal.

Under present law, carryovers are allowed for credits that do not benefit the taxpayer due to the effect of the minimum tax. Thus, even though credits permanently reduce tax liability, instead of merely deferring it, some argue that carryovers should continue to be permitted for credits that provide no benefit due to the minimum tax. Any such carryover would presumably be subject to any limitations applying to credit carryovers in other contexts (e.g., excess credits that are denied for regular tax purposes).[97]

(3) *Regular tax credit in the amount of minimum tax liability.*—A third method would be to allow taxpayers a credit against regular tax liability in subsequent years, in the amount of minimum tax liability. This system was proposed by the Administration in

[97] When Congress repealed the investment tax credit in 1969, it provided that no more than 20 percent of credits accrued but unused prior to repeal could be used in any one year. This limitation was based in part on the view that, if not for the repeal of the credit, many taxpayers subject to carryforwards would not have been to able to use all extra credits in the next year in any case (i.e., if they approached or exceeded applicable limitations on an annual basis).

1982, in connection with a proposal to enact a corporate alternative minimum tax (replacing the present add-on minimum tax).

To the extent that the premise for reducing subsequent years' liability by use of a credit when a taxpayer pays minimum tax (i.e., avoidance of double taxation) is that the purpose of the minimum tax is to accelerate payment, the credit could be structured so as to apply only with respect to minimum tax liability incurred through the denial of deferral preferences. On the other hand, if the credit is viewed as an averaging device between regular tax years and minimum tax years, the credit could be allowed for the entire minimum tax liability. Finally, to the extent that minimum tax liability was incurred due to the reduction of regular tax liability by incentive credits such as the investment tax credit, it might be thought desirable to retain any limitations generally applying to carryovers of such credits.

Transitional rules

Enactment of a new or expanded minimum tax would raise transitional issues regarding the treatment of items relating to transactions occurring before the effective date of the tax. For example, if accelerated depreciation and tax-exempt interest were treated as preferences, decisions would have to be made regarding the treatment of property placed in service, and bonds issued, prior to the effective date.

Imposing minimum tax with respect to an item relating to a transaction that occurred before the effective date of a new minimum tax can be criticized as unfair, on the ground that the change was not and could not have been foreseen by the taxpayer at the time of the transaction. For example, a taxpayer's decision to invest in personal property (which presently is not, in most cases, subject to minimum tax), or to purchase a tax-exempt obligation, is presumably influenced by the assessment of expected tax consequences.

In general, the various minimum tax proposals avoid this problem by recognizing new preferences only in the case of transactions occurring after the effective date of the tax. For example, the Administration bill applies new rules to depreciable property only in the case of property placed in service after 1985, and the Schumer-Russo bill treats tax-exempt interest as a preference only with respect to obligations issued after 1985.

A further transitional issue relates to the treatment of net operating losses incurred before the effective date of a new alternative minimum tax. Under both present law and various minimum tax proposals, taxpayers are allowed to deduct net operating losses in determining minimum taxable income. The rules for this deduction generally resemble those applying to the treatment of net operating losses for regular tax purposes. However, under both present law and various proposals, net operating losses incurred after the effective date of a particular minimum tax are recalculated to exclude the "preference" portion; in other words, they are determined using the same rules as those applicable to measuring minimum taxable income for the current year.

With respect to the treatment of net operating losses for years prior to the effective date of a new minimum tax, the relevant

ssues are more complicated. On the one hand, substantial difficul-
y might arise from requiring taxpayers to recalculate such net op-
erating losses in order to eliminate the preference portion thereof.
On the other hand, if such net operating losses were allowed in full
against minimum taxable income, taxpayers who have accumulat-
ed large net operating losses (despite earning substantial economic
income) through the use of preferences might continue to avoid
minimum tax liability for several years. This might seriously un-
dermine the effectiveness of tax reform in raising taxpayer morale
and compliance, i.e., convincing the public that henceforth all tax-
payers with substantial economic income will be required to pay
some tax.

One way of addressing this problem would be to deny pre-effec-
tive date net operating losses altogether. This would avoid the al-
owance of prior years' preferences without imposing on taxpayers
the administrative burden of reexamining past years' tax returns.
However, it could be viewed as unfair because it would impose li-
ability on taxpayers who became profitable, upon the effective date
of the new minimum tax, after suffering real economic losses in
prior years. On the other hand, one could argue that, under a fun-
damentally new type of tax (e.g., an alternative minimum tax re-
placing the present add-on tax for corporations), it is not unfair to
begin anew in the allowance of prior years' losses.

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