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Use and Misuse of Tax Shelters: The Congress and Tax Reforms

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THE USE AND MISUSE OF TAX SHELTERS: THE CONGRESS AND TAX REFORMS

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When there is an income tax, the just man will pay more and the unjust less on the same amount of income.

Plato, *The Republic*, Book I, 343-d.

> Tax sheltering is the most misunderstood, and one of the most controversial, practices now fostered by our federal income tax system. If it does not become more widely and accurately understood, thousands of investors will learn to their sorrow that what is represented to them to be a tax shelter may in fact be a tax trap. If some of the rules governing it are not changed at once, tax sheltering will in five years lead to temptations to tax evasion so strong that it will further erode self-assessment morality and produce a tax scandal of major proportions.[1]

It was only nineteen years ago, in 1954, that the United States Congress recodified the tax laws.[2] Although the Internal Revenue Code introduced few major substantive changes, it was felt to be a significant tax reform measure. Five years later, in 1959, Wilbur Mills, the chairman of the House Ways and Means Committee, launched a wide-ranging analysis of the tax system with a view to its further reform. His thesis was that certain tax preferences enjoyed by limited economic groups were operating in unintended ways. It was hoped that if these preferences could be curtailed, the resulting additional revenue could be used to reduce tax rates generally. Thus, tax reform was deemed to be a matter of closing "tax loopholes" and balancing the overall system by reducing tax rates generally.

Five years later, in 1964, the Congress passed a second major revenue bill encompassing tax reforms.[3] The reforms failed to supply added revenue because rates were, of necessity, reduced to avoid a drag on the economic system.

The most extensive tax reforms ever enacted were passed by the United States Congress in 1969,[4] earning that year the title "the year of reform."[5] This reform was stimulated by a "taxpayers' revolt" over the fact that some very wealthy persons were paying no tax whatsoever. Unfortunately, the effectiveness of the 1969 reformation was diminished in 1971 by the reenactment of the investment credit,[6] the codification of the asset depreciation range system (which

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1 Calkins & Updegraft, *Tax Shelters*, 26 THE TAX LAWYER 493 (1973) [Hereinafter cited as *Shelters*].

2 INT. REV. CODE OF 1954.

3 Act of February 26, 1964, Pub. L. No. 83-272, 78 Stat. 19, *amending* INT. REV. CODE OF 1954.

4 Act of December 30, 1969, Pub. L. No. 91-172, 83 Stat. 487, *amending* INT. REV. CODE OF 1954.

5 Joy, *Farm Losses and Gains*, TAX SHELTERED INVESTMENTS 171 (1972) (Practicing Law Institute) [Hereinafter cited as *Farm Losses*].

6 INT. REV. CODE OF 1954, § 38.

accelerated depreciation deductions),[7] and the creation of the Domestic International Sales Corporation to encourage exports through tax deferral on export earnings.[8]

Again in 1973 the Congress faced the issue of tax reform, and it bids fair to become a perennial concern until such time as a meaningful reform measure becomes law. Past tax reforms have been clearly insufficient. One reason is that because of the intense pressure for preservation of some tax preferences and incentives, the Congress has legislated compromise and perforce partial solutions. Thus, reforms written into the Tax Code have invariably fallen far short of the kind of reform widely perceived by public interest groups and demanded by the general public and many members of Congress, including myself. Congress is evidencing an increasing awareness of this situation. Currently, there are a number of significant reform bills before the Congress.[9] The most comprehensive set of reforms is contained in a bill which I have introduced, and which has drawn the co-sponsorship of fifty-two Representatives:[10] The Tax Equity Act of 1973.[11]

Of necessity, general tax reform is more that the mere elimination of those provisions of the law which permit tax shelters. The elimination of tax shelters, however, is one of the major areas of tax reform. It is an area of crucial importance.[12] As the tax laws now exist, the use and misuse of tax sheltering devices act to encourage investments which distort the nation's economic health, rather than advance it, and which accentuate the growing sense of tax inequity welling up inside the average taxpayer, threatening the security of our self-assessment system. For these reasons the Congress, in approaching the subject of reforming our tax laws, has turned its attention to eliminating provisions of the law which foster or permit the abuses of tax sheltering.

I. The Nature and Effect of Tax Shelters

Tax shelter is not, as some tax critics have had occasion to claim, a synonym for "tax dodge."[13] A tax shelter is an investment primarily intended to produce

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7 INT. REV. CODE OF 1954, § 167.

8 INT. REV. CODE OF 1954, § 991 *et seq.*

9 By the end of the first session of the 93rd Congress, over eight hundred bills for tax reform will have been introduced in the Senate and House of Representatives.

10 My co-sponsors in this reformation of the nation's taxing structure are Ms. Abzug, Mr. Aspin, Mr. Badillo, Mr. Bolling, Mr. Brown of California, Mr. Brademas, Mrs. Chisholm, Mr. Clay, Mr. Conyers, Mr. Danielson, Mr. Dellums, Mr. Diggs, Mr. Dingell, Mr. Drinan, Mr. Dulski, Mr. Edwards of California, Mr. Eilberg, Mr. William Ford, Mr. Fraser, Mr. Gibbons, Mr. Harrington, Mr. Hawkins, Mr. Hechler of West Virginia, Mr. Helstoski, Mr. Kyros, Mr. Johnson of California, Mr. McFall, Mr. Madden, Mr. Meeds, Mr. Mitchell of Maryland, Mr. Moorhead of Pennsylvania, Mr. Moss, Mr. Nix, Mr. Obey, Mr. Pepper, Mr. Pike, Mr. Podell, Mr. Price of Illinois, Mr. Rangel, Mr. Rees, Mr. Reuss, Mr. Rodino, Mr. Rosenthal, Mr. Roybal, Mr. Stark, Mr. Stokes, Mr. Studds, Mr. Thompson of New Jersey, Mr. Tiernan, Mr. VanDeerlin, Mr. Waldie, Mr. Wilson of California, and Mr. Young of Georgia.

11 H.R. 1040, 93rd Cong., 1st Sess. (1973). The author regards the provisions of the Tax Equity Act of 1973 to be essential to valid tax reform; while that particular bill will not be passed in the current Congress its measures must be further considered.

12 Surrey, *Tax Incentives—Conceptual Criteria for Identification and Comparison with Direct Government Expenditures,* TAX INCENTIVES 9 (1972) (Tax Institute of America) [Hereinafter cited as *Tax Incentives*].

13 H. F. MILLIKIN, THE PRUDENT MAN 17 (1964) [Hereinafter cited as PRUDENT MAN].

deductions and losses which may be set-off against other income of the taxpayer, thereby giving that taxpayer a "tax profit," while not necessarily producing genuine profits. Shelters may be either tax incentives, "expenditures that have the effect of inducing certain activities or behavior in response to the monetary benefits afforded by the special tax provisions involved"[14] or abusive applications of tax rules which are otherwise sound and reasonable in their intent and ordinary application. In cases where the tax shelter is based on an incentive, its use fails to meet the basic tests of value:

> in order to justify the use of a particular tax incentive, the benefits which a tax incentive produces for society should exceed the cost of such incentives to the Treasury.[15]

In those instances where the tax shelter is predicated upon an abuse of an otherwise reasonable rule of tax law, a circumvention of the original legislative purpose is a virtual certainty. In either situation these abuses distort the economy, encourage a growing cynical attitude toward the taxing system,[16] prevent the sound administration and application of the tax laws, and undermine the philosophical underpinnings of our supposedly progressive tax policy.

The economic distortion caused by tax shelter abuses results from a combination of two of its by-products. One result occasioned by tax shelter misuse and abuse is that it leads the investor to make financial decisions based on tax advantage and the very weakness of the investment itself rather than on sound risk-return factors. This distortion, created by the failure of taxes to play a neutral role in financial decisions, weakens the economy. Secondly, prompted by the investor's attempt to gain unusually large deductions or losses in a given year, the flow of large amounts of capital into certain financial spheres, at a rate grossly disproportionate to the flow naturally required, creates abnormal and artificial price increases, impairing the profitability of ordinary business operations in these fields.

The national sense of tax inequity is grounded in the taxpayer's belief that he is "entitled to the privilege of paying as little as somebody else."[17] When a taxpayer at a lower or middle income bracket realizes that in 1967 more than one-hundred and fifty-five Americans with income over two-hundred thousand dollars paid no tax at all,[18] he will find little solace in the fact that this is a reduction from the eleven-hundred such non-taxpayers in 1964.[19] His feelings will be only that the taxing structure favors the rich and discriminates against the average wage earner. To the average wage earner it is not

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14 Chapman, *Panel Discussions on Tax Reform Before the Committee on Ways and Means, U.S. House of Representatives,* 93rd Cong., 1st Sess., at 21 (1973) [Hereinafter cited as Chapman].

15 U.S. DEP'T OF THE TREASURY, PROPOSALS FOR TAX CHANGE 11 (1973) [Hereinafter cited as PROPOSALS].

16 *Id.*

17 Eisenstein, *Some Second Thoughts on Tax Ideologies,* 23 N.Y.U. INST. ON FED. TAX 1 (1965).

18 *Hearings on the 1969 Economic Report of the President Before the Joint Economic Committee,* 91st Cong., 1st Sess., at 8-44 (1969).

19 Ginsburg, *Panel Discussions on Tax Reform Before the Committee on Ways and Means, U.S. House of Representatives,* 93rd Cong., 1st Sess., at 78 (1973) [Hereinafter cited as Ginsburg].

> *au courant* to devise a tax system that looks terribly stern with income tax rates of 90 per cent or more on the million-dollar-a-year men, and then to punch it so full of holes that even the fellow in the highest bracket can get away with an actual payment of no more than say 10 or 15 per cent of the income he earns.[20]

The ire of the average taxpayer is aroused—a typical human reaction going hand in hand with awareness that one is unfairly being made to "pay the piper." It should cause little surprise, therefore, that he thereafter expresses his discontent with the government by deciding all questions of tax liability in his favor and against the government and records his answer on his tax return. As one author puts it:

> When a taxpayer revolts he does not storm the office of the District Director, he adjusts his tax burden by assessing himself less.[21]

It is important, therefore, that current abuses of the tax shelter provisions of tax law be eliminated lest they "further erode the self-assessment morality and produce a tax scandal of major proportions."[22]

Another effect of the various tax shelter abuses is to confuse the application and administration of the tax laws. The complex nature of the tax structures, with Congress, the Department of the Treasury, and the Internal Revenue Service all acting simultaneously, though not always in concert, necessarily leads to this confusion. When attempts are made to correct abuses of tax shelters, the extensive nature of our tax laws increases the chance of contradiction. The resulting confusion is illustrated in the sad case of limited partnership taxation. As will be noted at greater length later, limited partnership provisions of the tax laws are among the most widely utilized in creating tax shelters. The Internal Revenue Service has tried to limit the availability of these special tax treatments to avoid the abuses which are currently in vogue in the financial community. In restricting the definition of "partnership," however, so that only ventures with substantial capital contributions by the general partners can qualify, conflicts have arisen. Many writers have stated that they feel there is now a severe conflict between the definitions of "corporation" and "partnership" under the tax laws.[23]

To further complicate the damage caused by tax shelter abuses, they contribute to a considerable revenue loss to the United States Treasury. The Tax Equity Act of 1973[24] deals with a large spectrum of "tax loopholes," aggregating some $20 billion annually in lost revenue. The tax shelters constitute only a part of the $20 billion. Nevertheless, the revenues lost because of them are particularly unfortunate since the tax savings redound to the benefit of a small number of taxpayers who are least in need of tax relief.

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20 PRUDENT MAN at 16-17.
21 Ginsburg at 99-100.
22 *Shelters* at 493.
23 Goldman, *Panel Discussions on Tax Reform Before the Committee on Ways and Means, U.S. House of Representatives,* 93rd Congress, 1st Session 134 (1973) [Hereinafter cited as Goldman].
24 H.R. 1040, 93rd Cong., 1st Sess. (1973).

I heartily endorse the four goals of tax reform announced by the Johnson Treasury:[25] 1) keeping tax burdens in line with the ability to pay taxes, 2) equity of tax burdens among similar taxpayers and between dissimilar taxpayers, 3) tax simplicity, and 4) neutrality of the tax system in economic decisions. Tax shelters violate every one of these principles. They shift tax burdens to the shoulders of those less able to pay. They are inequitable to taxpayers unable to take advantage of them. They introduce more complexity in the law than would otherwise be required. They cause investments of dubious economic validity that our economy could very well do without.

II. The Major Tax Shelters

The current tax laws have created many tax shelters for the large private or corporate investors and for the individual investor in a high tax bracket. There are three shelters, however, which have a particularly visible impact upon the national economy and the national tax sensitivities. Syndicated tax shelters, agrarian tax preferences, and oil, gas and mineral extraction preferences are prime illustrations of the manifest inequality that may flow from tax shelter abuses.[26] These three tax shelters and the laws that encourage them must be among the central targets in the current Congressional approach to tax reform.

A. *Shelter Syndicates: The Big Business of Tax Sheltering*

Recently a leading financial publication ran the following advertisement:

> WANTED: NEW YORK TAX SHELTER REPRESENTATION. Western land sales corporation requires aggressive marketing representative for unique secured real estate tax shelter investment. 300% deduction in year of investment plus extraordinary yield potential. . . .[27]

This advertisement illustrates dramatically the phenomenon of the syndicated tax shelters. These syndicates are organizations, almost universally in limited partnership form,[28] which promise their member-partners, in return for their investment, large tax losses and deductions along with some possibility of actual gains, not infrequently in the form of capital gains treatment. They offer investments in oil, apartments, low income housing, municipal bond funds, senior citizen homes, egg-laying hens, and for the more exotic tastes, pistachio or avocado groves or even underground movies.[29] They also share a common nucleus of tax advantages which the syndicate arranges to pass on to its member-partners.

In every instance the syndicated tax shelter must be organized to provide a

25 U.S. Dep't of the Treasury, Tax Reform Studies and Proposals (1969).

26 The financial impact of some of these tax shelters has been recently analyzed. The annual revenue gain from repeal of the percentage depletion tax shelter would be $950 million and the gains from eliminating farm deductions taken against nonfarm income would be $250 million. Tax Analysts and Advocates, May 14, 1973, at 3.

27 Wall Street Journal, January 30, 1972, at 1, col. 4.

28 Bullion, *Panel Discussions on Tax Reform Before the Committee on Ways and Means, U.S. House of Representatives*, 93rd Cong., 1st Sess., at 12 (1973) [Hereinafter cited as Bullion].

29 Goldman at 126-127.

substantial tax loss which will shelter the partners' outside income from taxation. The syndicates accomplish this extraordinary objective by using leverage to achieve a rate of deduction and loss greatly disproportionate to the actual dollar investment. Sometimes it is possible for the syndicate only to defer taxes from a given tax year to a subsequent year using accelerated depreciation to exact a "tax loan" from the government. Simultaneously, syndicates attempt to turn all eventual income to capital gains while maintaining ordinary loss treatment for losses. Leverage is obtained through the use of "nonrecourse loan financing" and the partnership format permits the syndicate to pass the related losses, credits, and deductions to its partners. The other deductions and losses required for the successful operation of the syndicate come from the specific fields of investment chosen by the organization, primarily oil, gas, minerals, cattle, farming and real estate. Consequently, there are two major directions tax reform may take as regards syndicated tax shelters. Reforms may eliminate the ability of the syndicate to pass losses to the partners, or they may strike at the specific areas of syndicated investment. In either case, it is necessary to examine how the syndicate functions as a tax shelter to appreciate fully the essential reforms required.

1. Limited Partnerships: The Flow-Through System

The current tax laws virtually compel syndicated shelters to take the legal form of a limited partnership in order to pass profits and, even more significantly, losses on to their partners. If a corporate form were used, the losses would be deductible only to the corporation itself. But, utilizing the provisions of current partnership tax law, credits, losses, and deductions may be passed on to the limited partners to shelter their outside income.[30]

Even though a partnership is an entity distinct from the individual partners, it is not under the tax law a taxable entity.[31] The tax law defines a partnership as including:

> a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on. . . .[32]

To be treated as a partnership under the tax law, the partnership must not be an "association," as defined in the law. An association is any organization which has two or more of the four general corporate characteristics: continuity of life, centralization of management, limited liability and free transferability of interest.[33] If an organization becomes classified as an association it may be subject to taxation as a corporation and lose its flow-through of tax losses. While the syndicates would usually qualify as an association, there is an exception in the regulations which permits any partnership which complies with a Uniform Partnership Act under State law to be classified as a partnership for tax purposes.[34]

30 INT. REV. CODE OF 1954, §§ 752, 704.
31 INT. REV. CODE OF 1954, § 701.
32 INT. REV. CODE OF 1954, § 7701(a)(2).
33 26 C.F.R. § 301.7701-2(a) (1972).
34 26 C.F.R. § 301.7701-1 (1972).

While this exception was recently qualified by a Technical Advice Memorandum which found a California limited partnership to be an association though organized in compliance with the California Limited Partnership Act, the qualification is not total since the partnership involved had all four of the general characteristics of a corporation.[35] It may be that unless this degree of corporate similarity is met, compliance with a Uniform Act will still except a partnership from association treatment. These provisions of the tax law allow the syndicated shelter to take the important advantages of gain and loss flow-through and, in effect, enable the syndicate to exist as a "profitable" enterprise.

The tax law also permits the partnership agreements to control totally the amount of gain and loss which flow through the syndicate. Regulations under the Internal Revenue Code of 1954 state that "[a] partner's share of any item or class of items of income, gain, loss, deduction or credit of the partnership shall be determined by the partnership agreement."[36] This is an important tax advantage for all syndicated tax shelters. The vast majority of syndication agreements provide that all deductions, losses, and credits will be distributed in relation to the contributions of the various limited partners, with significant exceptions such as depletion and depreciation deductions which are allocated in proportion to the income to which they are applicable.[37] This enables the general partner, who usually makes contribution of his managerial skills in the actual operation of the enterprise, rather than capital, to be granted a large percentage of the eventual income while giving the big tax losses to the outside investors who entered the enterprise for that express purpose. Therefore, the real estate developer and oil well drillers who, by virtue of their lower incomes, are unable to utilize fully the tax benefits provided for oil or real estate investments, can exchange those benefits for immediate capital. The operators make an effective current sale of the forthcoming tax benefits to high tax bracket individuals. In effect, the syndicate is the sale of the general partner's tax basis to the limited partners.

These tax "loopholes" of partnership form determine the structural format of a tax shelter syndicate. The partnership's ability to have losses flow-through to the individual partners is mandatory for the syndicate's existence. However, the ability of the syndicate to exist profitably is predicated largely upon its ability to use leverage. This is made possible by the application to partnerships of the *Crane* doctrine.

2. The *Crane* Doctrine: Leverage and the Non-Recourse Note

On January 11, 1932, Beulah Crane inherited an apartment building from her late husband. The building was encumbered by a mortgage in the amount of $255,000—secured only by the building and the land itself. Mrs. Crane operated the property for seven years but being unable to reduce her debt she sold the property in 1939 for $2500 cash and assumption of the mortgage.

35 *See* Livsey *Limited Partnerships: How Far Can IRS Go in Limiting Their Use in Tax Shelters?*, 39 JOURNAL OF TAXATION 123 (1973).
36 26 C.F.R. § 1.704-1(a) (1972).
37 Bullion at 15.

She reported the gain on the transaction as $2500, reasoning that she had inherited the equity of her late husband in the property. Mr. Crane's equity in the property, which was mortgaged for more than its actual value, must have been zero. Accordingly, Mrs. Crane argued that her gain was the $2500 she had received in cash. The Commissioner argued that the devise had been a compilation of rights and privileges that constituted the ownership of the property, and that the rights were worth $255,000 at the time of inheritance. The Commissioner reduced this figure by amounts deducted for depreciation taken over the last seven years and determined her basis at time of sale to be $178,-987.40. Since the mortgage had been assumed by the buyer and cash had also been paid, the sale price was calculated to include the value of the mortgage and the cash, and Mrs. Crane was assessed a deficiency predicated upon a gain on the sale of $24,031.45.[38] The Supreme Court agreed in *Crane v. Commissioner*:[39]

> Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.[40]

The result of the *Crane* decision was inclusion of the amount of a nonrecourse obligation on the basis of a depreciable asset. This is well illustrated in the situation of a syndicate investment in a large depreciable asset financed by a nonrecourse loan (a loan secured only by the purchased assets). If the asset costs one million dollars and has a twenty-year useful life for tax purposes, the syndicate may get up to one hundred thousand dollars depreciation deduction in the first year by using a declining balance depreciation method.[41] This deduction is taken with minimal investment of capital and gives a taxpayer in a fifty percent tax bracket an immediate gain on the transaction of fifty thousand dollars. This is the use of leverage offered by the application of the *Crane* doctrine to investment financing. It is especially valuable to syndicated partnerships because a partner is not permitted to deduct his share of the partnership losses in excess of his basis in the partnership interest.[42] For example:

> Assume partnership ABC buys a piece of real estate for $1 million, payable $50,000 cash and $950,000 by taking subject to a mortgage. Partner A invested $5,000 for a 10% interest in the partnership. The partnership incurs a taxable loss of $75,000, of which A's share is $7,500. The basis for A's interest in the partnership is $5,000, plus $95,000 (his share of partnership liabilities), or $100,000. A is therefore permitted to deduct the entire $7,500, and the basis for his partnership interest is reduced to $92,500.[43]

38 It is notable that the *Crane* doctrine, which has resulted in massive tax avoidances through the use of leverage by syndicated shelters, was first argued by the Commissioner of Internal Revenue rather than by a taxpayer. Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TEXAS L. REV. 525 (1972).

39 331 U.S. 1 (1947).

40 331 U.S. 1 at 10 (1947).

41 INT. REV. CODE OF 1954, § 167.

42 INT. REV. CODE OF 1954, § 752.

43 Kronovet, *Tax Shelter in Real Estate Investments*, PRACTISING LAW INSTITUTE, TAX SHELTERED INVESTMENTS 146 (1972).

Consequently, the leverage tool is passed from partnership to the partner, and a tax shelter is created.

It is certain, however, that tax shelter syndicates are built upon more tax advantages than simply the *Crane* doctrine and leverage though the advantage offered by non-recourse financing might well yield sufficient tax benefit to justify organizing a syndicate. These partnerships also utilize tax benefits afforded by the prepayment of expenses and interest, including the use of "points," first year bonus depreciation, accelerated depreciation, depletion allowances, investment credits and foreign tax credits. These tax treatments include both tax incentives and ordinary tax rules which in most common uses are fair, reasonable, and equitable but which, in the hands of a tax shelter syndicate, become grossly inequitable. In either case, the value of these tax treatments to the syndicates is not in their ordinary or intended use, but rather in their abuse and misuse. An area of palpable abuse is the misapplication of the prepaid expenses and fees provisions of the tax law. A hypothetical example illustrates the point:

> If a taxpayer invests in a citrus grove[44] he may follow either of two courses. If he is a serious farmer or grower he will make the necessary investments in tools, seed and young trees, and either take an immediate total expense deduction or take partial deductions in the years in which he actually benefits from the use of the asset. The tax losses will be spread over a number of years, in direct relationship to the years in which there are gains from the investment. If a syndicate enters the same field of endeavor, buying the same grove properties, it will make as many investments in tools, trees and seed for which it has capital. The syndicate will also make prepayments of its management fees and some prepayment of loan interest. All the deductions for these expenditures will be taken in the first year or two years in order to give large net losses to the investors.[45]

The net effect of this type of investment is to boost the price of the finished product to the consumer and to raise the prices of all assets used in production to other legitimate producers often with devastating impact. While all taxpayers clearly have a right to pay as little taxes as they are legally obligated to pay, the harmful effects of such financial gymnastics justify, if they do not compel, the immediate and effective reform of our tax laws. These shelters create extremes of economic distortion and correlative distortions in administration of the tax laws which cannot be tolerated.

Economic distortion caused by the activities of tax shelter groups is widespread. This distortion occurs in various economic areas, but the effects are always the same. Representative examples are seen in the 1969 land market

44 Citrus groves have been referred to as "a tax shelter of unusual charm." Irving Axelrad, *Tax Shelter for the Individual: A Panel Discussion*, 28 N.Y.U. INST. ON FED. TAX 1009, 1032 (1970). Mr. Axelrad continued to explain the appeal of the shelter:

> The reason that it has that charm, in addition to the tax benefits that I will speak of, is that if one buys his land in the right place, he can have a secondary purpose of hopefully selling it as industrial, commercial or residential property one day. *Id.* at 1032.

This "charm" may have lost some of its appeal by enactment of § 278 of the Internal Revenue Code of 1954 in 1971, which provides for the capitalization of most expenses in the first four years of developing a citrus grove.

45 This is required to achieve the return mentioned in the advertisement claims of syndicates, such as the one mentioned in note 24 *supra*.

depression of Southern California and the recent general increases in farm and agricultural prices, both attributable in large part to the entry of syndicates into real estate and agrarian enterprises, and both evidencing similar economic distortions.

Prior to 1969 a mass of real estate shelter syndicates entered the land market in Southern California. The usual tax abuses, particularly excessive use of prepaid interest and leverage financing, by the syndicates created skyrocketing inflation in land prices. In late 1968 the Internal Revenue Service issued Revenue Ruling 68-643,[46] cutting into the artificial demand and depressing the land prices almost as fast as the syndicated money had inflated them. Prices fell throughout Southern California and the number of mortgage foreclosures in-

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46 Rev. Rul. 68-643, 1968-2 CUM. BULL. 76:

> I.T. 3740 was based upon a transaction in which the taxpayer paid interest in advance for a period of five years. As to such transaction, I.T. 3740 holds that where a taxpayer keeps books of account and files Federal income tax returns on the cash receipts and disbursements method of accounting, interest paid in advance for a period of 5 years is deductible for the year in which paid, but where the accrual method of accounting is used in reporting income, interest is deductible for the year in which the liability to pay accrues irrespective of when payment is actually made.
>
> Section 163 of the Internal Revenue Code of 1954 provides, in general, that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> Section 446(a) of the Code provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) of the Code provides, in part, that if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.
>
> As to taxpayers employing the accrual method of accounting, consistent with the position stated in I.T. 3740, interest accrues ratably over the period of the loan and is allowable as a deduction ratably over this period, irrespective of when paid.
>
> In view of certain abuses which have arisen with respect to prepayment of interest by taxpayers using the cash receipts and disbursements method of accounting, the Service has reexamined its position in I.T. 3740. The Service now concludes that the deduction of prepaid interest in the year of payment by a taxpayer employing the cash receipts and disbursements method of accounting may not result in a clear reflection of income for the taxable year of payment. A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan. If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved.
>
> In view of the foregoing, I.T. 3740 is revoked. However, pursuant to the authority contained in section 7805(b) of the Code, this Revenue Ruling will be applied without retroactive effect to interest prepayments for periods not in excess of five years made prior to November 26, 1968 by taxpayers employing the cash receipts and disbursements method of accounting. This Revenue Ruling also will be applied without retroactive effect to an interest prepayment for a period not in excess of five years made on or after November 26, 1968, by a taxpayer employing cash receipts and disbursements method of accounting, pursuant to a legal obligation incurred prior to such date to make such prepayment.
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> * * * *

creased appreciably. In addition, one syndicate was placed in bankruptcy, losing its investors' assets; after Internal Revenue Service audits some syndicates were forced to pay large deficiencies because they had taken deductions to which they were unentitled.[47]

The adverse impact of using agrarian tax shelter syndicates was described by Treasury Secretary Shultz as follows:

> [T]here are those who invest in farms not for the purpose of efficiently producing food and fibre at a profit, but to produce an artificial tax "loss" which will shelter their nonfarm income from tax. These investors compete with full time farmers to bid up the prices of the necessary land, livestock, and equipment. Somewhat perversely, overreaction to existing tax laws may lead "hobby" farmers to be lavish and wasteful in their expenses. The result can be a competitive increase in the operating costs of all farmers.[48]

It may take years to complete the repair of the damage done by these tax syndicates. For some persons, principally homeowners in Southern California whose homes were lost as the result of foreclosures proximately caused by syndicate activity, the damage may never be repaired. Congress is not impotent to deal with these problems. The question which Congress should and must ask itself is how may the tax laws which permit these syndicates and their perpetual tax abuses be reformed. There is no single answer. The needed reform will take many shapes.

Treasury Secretary Shultz has proposed reforming this area of the tax law by "limit[ing] the use of some of the provisions that were intended as incentives."[49] Secretary Shultz proposes a systematic prohibition on "artificial accounting losses" to effectuate this plan. Within the scope of artificial accounting losses the Treasury Secretary includes:

> that portion of any loss, attributable to an activity or related activities, which would disappear if the taxpayer had no accelerated deductions in the current year. An accelerated deduction is a deduction which clearly relates to some future expected profit and has little or no relation to income reported in the current year.[50]

The Secretary would require deferral of such losses until a later tax year and their interim placement in a deferred loss account where they would remain until the next tax year in which they may be used. In addition, Secretary Shultz proposed a definite application of the "limited artificial accounting loss" (LAL) system to syndicates by passing the requirement of loss deferral to the partners.[51] The proposal would operate to prevent the application of losses from tax sheltering investments to other unrelated income. As he states, the effect on most syndicates would follow a pattern:

> The taxpayer has earnings in the amount of $100,000 in 1974. He also invests in an oil drilling fund to begin in the latter part of 1974. For that

47 Goldman at 133-34.
48 *Proposals* at 11-12.
49 *Id.* at 12.
50 *Id.* at 96-97.
51 *Id.* at 98.

> year, his share of the IDC [intangible drilling costs] expenses is $20,000. In 1974 he has no net related income since he is not principally and regularly engaged in the oil business and the fund has just begun drilling. Any oil income will be received in 1975 or thereafter. Under present law he has a $20,000 "loss" deduction against his earnings. Under the LAL [limited artificial accounting loss] proposal, he will have a $20,000 artificial accounting loss which will be added to the Deferred Loss Account to be deducted in the future against net related oil and gas income.[52]

These proposals would act to stifle most tax sheltering operations, but their complexity poses extensive auditing problems for the Internal Revenue Service and places added accounting burdens on any legitimate operations entering the areas of enterprise usually associated with syndicated shelters. Consequently, other proposals should be examined.

Another suggested reform comes from Kenneth Goldman, a Los Angeles attorney, who suggests a number of significant changes in both the specific areas of syndicate investment, particularly oil, cattle and land and two changes in the law applicable to the syndicate structures. Mr. Goldman suggests that the interest of a taxpayer in assets subject to nonrecourse security interests be limited to his equity in the item, effectively overruling the *Crane* doctrine, and enactment of the allocation of deductions proposition. The latter proposition would require that a taxpayer "divide proportionately his personal, 'below-the-line,' deductions between income included in the regular tax base and income excluded from the tax base through tax preferences."[53] As Goldman explains:

> For example, if an individual had $100,000 of dividend income, $50,000 of municipal bond tax-exempt interest income, and a personal interest expense of $30,000, it is logical to assume that the taxpayer paid one-third of his interest with dollars that were not included in the tax base; that is $50,000 out of a total real income of $150,000. Since the municipal bond interest was not included in the tax base in the first place, a taxpayer should not obtain a deduction for expenses paid from exempt income. Accordingly, two-thirds (100/150ths) of his interest deduction would be allowable against taxable income; but one-third (50/150ths), or $10,000, would not be deductible from taxable income since it was attributable to tax-exempt income. Naturally, a floor would be built in to avoid the necessity of allowing relatively small amounts of tax preferences; and the allocation of deductions would mesh very easily with the minimum tax and would not produce a double tax on the preferences.[54]

These proposals would also be effective in controlling the abuse of tax shelters. They have the additional advantage of being easily administered. However, since the allocation of deductions proposal would reduce only non-business deductions, there is merit in the simpler suggestion made in the Tax Equity Act of 1973.[55]

The Tax Equity Act of 1973, § 313, would eliminate the effectiveness and profitability of most tax shelter syndicates by altering the provisions of existing

52 *Id.*
53 Goldman at 138.
54 *Id.*
55 H.R. 1040, 93rd Cong., 1st Sess. (1973).

law[56] relating to limited partnerships. The proposed Act would limit a partner's distributive share of liabilities to the difference between his actual contribution and the contribution he is obligated to make under the partnership agreement.[57] This would limit the partner's deductions to the amount of his actual contribution to the partnership capital and would prevent the application of the *Crane* doctrine and non-recourse financing by limiting deductible losses to the partner's actual contribution, his equity in the partnership. The real test of this proposal's worth is that it strikes a balance between the national interests in promoting certain activities via tax preferences and the national interests in economic stability, administrative simplicity, and sense of tax equity—laudible goals which the activities of these syndicates have so severely taxed.[58] Some tax advantage will remain in investing in oil and gas or agrarian enterprises, but there will be no room for the current massive abuses which significantly distort the economy and fiscal administration and which invariably lead to a forboding sense of tax inequity. If tax shelter syndicates and their consequent evils are to be abated, it will be through adoption and stringent administration of a measure along the aforementioned lines.

B. *Agrarian Preferences: Incentive Abuse, Price Inflation and Tax Shelters*

Agrarian enterprises, including farming, cattle, timber and citrus and fruit groves, have historically been an area for legislative tax incentives and prefer-

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56 INT. REV. CODE OF 1954, § 752.

57 H.R. 1040, 93rd Cong., 1st Sess. (1973):

> Sec. 313. DEDUCTIBLE LOSSES OF LIMITED PARTNER CANNOT EXCEED INVESTMENT.
>
> (a) Section 752 (relating to treatment of partnership liabilities) is amended by adding at the end thereof the following new section:
>
> > '(e) LIMITED PARTNER. — In the case of a limited partner, his share of the partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the partnership agreement.'
>
> (b) The amendment made by this section shall apply to taxable years beginning after December 31, 1973.

58 Eisenstein states that he would deny the validity of the term "incentive" in taxation. His contention is that rather than incentives, the tax preferences are aimed at decreasing barriers. He has stated:

> If I may repeat the eloquent words of Guthrie, an income tax must be 'equal and uniform and not of selected individuals or classes.' Those who would detect a contradiction here are too troubled by discrepancies. As Emerson indicated, it is foolish to indulge in 'foolish consistency.' The demand for equality was a means to an end — the prevention of an income tax on the well-to-do. Since the effort had failed, the demand for equality gives way to a demand for exceptions. Income may be income, but one income is not the same as another.
>
> The exceptions vary, but they all have one thing in common. Each is designed to avert economic decay. True, certain taxpayers are the inevitable beneficiaries of the special exceptions, but the benefits which accrue to them are only incidental to the greatest good of the greatest number. [At 96.]

He concludes:

> The various dispensations are not granted in order to provide incentives, though the usual vocabulary employed in their defense may convey that impression. The objective, rather, is to remove barriers and deterrents to incentives that are already there. Anyone who understands the ideology should easily see the difference.

L. EISENSTEIN, THE IDEOLOGIES OF TAXATION 122 (1961).

ences.[59] While preferential tax treatments are predicated upon sound Congressional determinations of national interests and the public need for both heightened agricultural output and a sound farm economy, abuses of these preferences have completely distorted the impact of such tax benefits. Any public benefits have not only failed to counterbalance Treasury losses, but have been aggravated by inherent public injury. The most abused of these tax preferences are the treatments of cash accounting, early and prepaid expense deductions, and depreciation provisions. Reforms of our tax preferences to farms must pay special attention to these particular abuses.

The cash accounting provisions of our tax laws are a glowing example of how taxpayers, seeking always to pay as little as possible, utilize a reasoned, intelligent tax incentive in a manner Congress never intended. Congress and the Treasury have provided that if a farmer operates on a cash accounting system he may immediately deduct certain expenses from his gross income.[60]

> The historical and orthodox exposition of existing law is that a taxpayer engaged in farming who elects the cash receipts and disbursements method of accounting is not required to use inventories in the computation of taxable income and is entitled to expense many costs which taxpayers engaged in other business, even those using a cash method, would be required to capitalize as the cost of property.[61]

These expenses include "tools of short life or small cost," "the purchase of feed and other costs of raising livestock," and "seeds and young plants."[62] While this provision was enacted to relieve small farmers of the burdens of complex accounting systems, it is, in fact, used by large farming investment concerns (including many partnership syndicates) to achieve large losses in their early years of operation.[63] The irony of the situation is compounded when attention is called to the fact that these concerns invariably employ skilled and competent financial assistance for whom the accrual accounting method would not be the least bit burdensome.

If a farming enterprise operates on the cash basis it may, and it usually will, make an attempt to invest as much as possible in the first years of operation. The concern will use the resulting losses and deductions to offset its investors' nonfarm tax liability. Since such investors are rarely below the fifty percent tax bracket, a return of fifty percent is available for every dollar so invested even if no profit is made. As an example:

> [A] taxpayer may purchase ten acres of land and plant it with [olive] trees. The cost of the land and planting may be assumed to be $12,000. The . . . trees will not bear fruit until the seventh year, but during the development period, annual costs of perhaps $1,500 may be incurred for irrigation, cultivation, pruning, spraying, and other care of the trees. By the end of the

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59 With all due apologies to Mr. Eisenstein, the use of the terms "preference" and "incentive" is in such popularity that I feel obliged to maintain them for the sake of clear communication.

60 INT. REV. CODE OF 1954, § 162; 26 C.F.R. § 1.162-12 (1973).

61 *Farm Losses* at 169.

62 26 C.F.R. § 1.162.12 (1973).

63 *See generally* Davenport, *A Bountiful Tax Harvest,* 48 TEXAS L. REV. 1 (1969).

> sixth year, the taxpayer will have incurred 'cultural practices expenditures' of $9,000. These expenditures may be currently deducted against other income. To a taxpayer in the 70 percent bracket, the deductions over the years will have reduced his taxes on other income by $6,300. If the grove is sold early in the seventh year at an economic profit of 10 percent, the taxpayer will realize $23,100. His basis, however, will only be $12,000, and he must pay capital gains tax on the difference between his basis and the sales price, amounting to $2,775.
>
> The net economic profit is $2,100 [$23,100 sales price, less $21,000 of costs ($12,000 land and planting costs, plus $9,000 cultural practices expenditures)]. But the taxpayer also realizes an additional *tax profit.* The tax benefit from deduction of cultural practices expenditures was $6,300, and the tax cost of the sale was $2,775. The taxpayer thus has a *tax profit* (money paid to him by the Treasury's reducing taxes on other income) of $3,525. There is an overall profit of $5,625, consisting of an economic profit of $2,100 and a *tax profit* or subsidy of $3,525.[64]

The net result of this type of tax sheltering transaction is an obvious abuse of the legislative purpose of this particular preference. If there is to be reform in the field of tax shelter abuses, this kind of an arrangement must be included.

The effects of these practices further distort the economic realities of agricultural enterprises and threaten the national supply of much needed agricultural commodities. Illustrative is the case of one group of "hobby ranchers" who felt it would be to their tax benefit to invest in a herd of breeding cattle. A management company, Black Watch Farms, agreed to purchase and care for fifteen thousand head of breeder cattle, returning to the investors large tax losses and eventual capital gains. After dividing the herd among many smaller, independent farms and ranches, the management company ran into financial difficulties. The final outcome was that the management company left over five hundred investors with the fifteen-thousand head of cattle. One reported conversation between two of the "urban barons" proceeded:

> "You gonna keep the damn cows?"
> "Yeah."
> "Who's gonna take care of them?"
> "I'll find me some cowboys."
> "You think it's so easy to find cowboys?"[65]

The levity of this situation is lost when the adverse effects of this type of financial trickery are perceived. These incidents depress the supply of cattle, especially when breeding cattle, those most conducive to tax shelter investments, are involved. The depressed supply raises the price a consumer must pay for beef. Prices are further inflated, as Treasury Secretary Shultz states, by "lavish and wasteful" expenditures which force other cattle breeders to pay more for their supplies.[66] It is also disastrous for the small or medium investors who lose their investments, thereby further depressing the general cattle market.

There have been numerous proposals for reforming the tax laws relative

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64 *Id.* at 11-12.
65 Wall Street Journal, September 21, 1970, at 1, col. 4.
66 *Proposals* at 103-04.

to farming losses. Treasury Secretary Shultz's proposed limitation on artificial accounting losses[67] would have special application to farm losses and agrarian investment shelter concerns:

> The ordinary farmer will be unaffected by the LAL proposal. Most farmers will be outside the scope of the provision because (1) they have a profit, not a loss, from their farming operations, (2) they do not have non-farm income, or (3) they have not substantially increased the level of their farming operations during the year.
>
> The principal accelerated deductions in farming are deductions for prepaid feed or other expenses relative to crops or livestock which will not produce income until a future time. There are items which recur from year to year, and are often in the nature of inventories. Thus, the benefits of an accelerated deduction in the taxable year are typically offset by the loss of deductions which are accelerated into prior years. Since it is only the net *increase* in accelerated deductions which can create a loss distortion, the rule will be inapplicable unless there has been a major increase during the year in the level of operations or of investments of a type which would be capitalized or inventoried in a business other than farming. The fact that a taxpayer farms substantially the same acreage without a major change in the nature of his operation will ordinarily be accepted on audit as evidence that a loss, if it exists, is not an artificial loss.
>
> That will not suffice if there is an abnormally large and material expenditure in the nature of an accelerated deduction; but even then, in the case of inventory-type expenditures, up to a twenty percent variation from the prior year's expenditures of the same nature will be deemed normal, and greater variations may be justified by the facts and circumstances. If a loss should be suspended by the LAL proposal, it may, of course, be deducted against farming profits in subsequent years.
>
> In the case of farming, income from all farming units in which the taxpayer is personally engaged as a trade or business, (as distinguished from units in which he is a passive investor) will be treated as a single related class.[68]

Still, while the proposal put forth by the Secretary of the Treasury is sound and effective, it increases administrative expenses because of the auditing procedures involved and it imposes higher accounting duties upon the small farmer. This latter imposition is exactly what the original preference was intended to prevent. Therefore, it is incumbent upon any study of reform to examine other proposals.

Charles Davenport, of the University of California at Davis, has proposed a number of solutions to the problem. His "ideal solution" would be to insist on accrual accounting and full cost capitalization.[69] This solution is far from ideal, in a practical sense, since it ignores the burdens placed upon small, legitimate farmers as a result of technical accounting procedures. Recognizing this difficulty, Professor Davenport proposes an additional reform calling for new inventory methods of farm loss accounting. Davenport's suggestions call for an estimated inventory of all assets to be made and valued annually, and expenses allocated to incremental growth. This method, too, has numerous shortcomings

67 See text *supra* at n.48 *et seq.*
68 *Proposals* at 100.
69 Davenport, *supra* n.62, at 15.

conceded by Professor Davenport, including practical problems incident to both the inventory and valuation procedures. It also poses administrative problems for the Internal Revenue Service and for the small farmer. Professor Davenport, however, offers the following observation:

> Our existing farm laws permit taxpayers having income from other sources to invest in farm assets to a large extent at the expense of the public fisc. While it has been argued to be a deliberate subsidy to farmers, this seems doubtful on the record. It also seems implausible that Congress intended a subsidy that has little or no value to one having only the kind of income that it intended to benefit. The argument would mean that one hand giveth while the other taketh, by inducing unfair competition from the "tax farmer" who because he has sources of other income can subsist on little or no economic profit. Thus, even if Congress did intend the present scheme as a subsidy, it should be recast in a more rational form.[70]

Professor Davenport's conclusion is unassailable, and it is just this combination of tax reform and agricultural support policies that is incorporated into the farm tax provisions of the proposed Tax Equity Act of 1973.[71]

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70 *Id.* at 49.

71 H.R. 1040 § 307, 93rd Cong., 1st Sess. (1973):

SEC. 307. FARM LOSSES.

(a) Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding after section 279 the following new section:

'SEC. 280. LIMITATION ON DEDUCTIONS ATTRIBUTABLE TO FARMING.

'(a) GENERAL RULE — In the case of a taxpayer engaged in the business of farming (other than an individual whose nonfarm adjusted gross income, as defined in subsection (e)(1), does not exceed $20,000), the deductions attributable to such business which, but for this section, would be allowable under this chapter for the taxable year shall not exceed the sum of —

'(1) the gross income derived from the business of farming for such taxable year, and

'(2) in the case of an individual, the higher of (A) $10,000, or (B) the amount of the special deductions (as defined in subsection (e)(2)) for the taxable year, or

'(3) in the case of any other taxpayer, the amount of the special deductions for the taxable year.

For purposes of this subsection an individual does not include a trust.

'(b) MARRIED INDIVIDUALS — In the case of a husband and wife who file a separate return, the $20,000 and $10,000 amounts specified in subsection (a) shall be $10,000 and $5,000 respectively. The preceding sentence shall not apply if the spouse of the taxpayer does not have any income or deductions attributable to the business of farming for the taxable year.

'(c) EXCEPTIONS FOR TAXPAYERS USING CERTAIN ACCOUNTING METHODS —

'(1) IN GENERAL — Subsection (a) shall not apply to a taxpayer who elects to compute taxable income from farming (A) by using inventories, and (B) by charging in capital account all expenditures paid or incurred which are properly chargeable to capital account (including such expenditures which the taxpayer may, under this chapter or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account).

'(2) TIME, MANNER AND EFFECT OF ELECTION — An election under paragraph (1) for any taxable year shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year, and shall be made and filed in such manner as the Secretary or his delegate shall prescribe by regulations. Such election shall be binding on the taxpayer for such taxable year and for all subsequent taxable years and may not be revoked except with the consent of the Secretary or his delegate.

'(3) CHANGE OF METHODS OF ACCOUNTING, ETC. — If, in order to comply with the election made under paragraph (1), a taxpayer changes his method of accounting in computing taxable income from the business of farming, such change

The proposed Tax Equity Act of 1973 would eliminate the abuses of farm preferences by limiting an investor's ability to offset other gains from nonfarm sources with farm losses to $10,000 a year. The bill further provides for the disallowed expense deductions to be taken in the following available tax year. In an effort to reduce the burdens on genuine, full-time farmers this section would except all farm investors who earn less than $20,000 in nonfarm income in the tax year. This section of the proposed Act has the double blessing of sustaining the incentives to continued farm operation while severely restricting the possibility for abuse of those incentives. It would restore a positive result to the balancing of "the benefits which [the] tax incentive produces for society . . . [and] the cost of such incentive to the Treasury."[72] Furthermore, if additional impetus is required to build a stronger agrarian economy it should be financed through direct expenditures,[73] a method of incentive favored by many experts.[74]

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shall be treated as having been made with the consent of the Secretary or his delegate and for the purpose of section 481(a)(2) shall be treated as a change not initiated by the taxpayer.

'(d) CARRYOVER OF FARM OPERATING LOSSES — The amount not allowed as deductions by reason of subsection (a) for any taxable year shall be treated as a deduction attributable to the business of farming in the following taxable year.

'(e) DEFINITIONS AND SPECIAL RULES — For purposes of this section —

'(1) NONFARM ADJUSTED GROSS INCOME — The term "nonfarm adjusted gross income" means adjusted gross income computed without regard to income and deductions attributable to the business of farming.

'(2) SPECIAL DEDUCTIONS — The term "special deductions" means the deductions allowable under this chapter which are attributable to the business of farming and which are attributable to —

'(A) taxes,

'(B) interest,

'(C) losses arising from fire, storm or other casualty, or from abandonment or theft,

'(D) losses and expenses directly attributable to drought and

'(E) recognized losses from sales, exchanges, and in voluntary conversions.

'(3) INCOME AND DEDUCTIONS — The determination of whether any item of income is derived from the business of farming and whether any deduction is attributable to the business of farming shall be made under regulations prescribed by the Secretary or his delegate.

'(4) BUSINESS OF FARMING —

'(A) HORSE RACING — In the case of a taxpayer engaged in the raising of horses, the business of farming includes the racing of horses.

'(B) SEVERAL BUSINESSES OF FARMING — If a taxpayer is engaged in more than one business of farming, all such businesses shall be treated as one business.

'(C) RELATED INTEGRATED BUSINESS — If a taxpayer is engaged in the business of farming and is also engaged in one or more businesses which are directly related to his business of farming and are conducted on an integrated basis with his business of farming, the taxpayer may elect to treat all such businesses as a single business of farming. An election under this paragraph shall be made in such manner, at such time, and subject to such conditions as the Secretary or his delegate may prescribe by regulations.

'(5) PARTNERSHIPS — A business of farming carried on by the members of such partnership in proportion to their interest in such partnership.'

(b) Section 1241(b)(2)(A) (relating to additions to an excess deductions account for farm losses) is amended by adding at the end thereof the following sentence: 'No amount shall be added to the excess deductions account for any taxable year beginning after December 31, 1973.'

(c) The amendments made by this section shall apply to taxable years beginning after December 31, 1973.

72 Chapman at 21.

73 One possibility would be to utilize funds appropriated under § 32 of the Agricultural Adjustment Act of 1948, 7 U.S.C. § 612(c) (1970), which provides:

There is appropriated for each fiscal year beginning with the fiscal year ending

Such financing would retain the necessary neutrality of our tax laws in the selection of investments. It is this neutrality, along with a general sense of tax equity, that is guaranteed by the Tax Equity Act of 1973, and which would promote a healthy and sound agrarian economy and eliminate the impact of the present tax shelter abuses.

C. *Mineral, Oil and Gas Explorations: A Delicate Balance*

As stated above, all tax preferences and incentives should be evaluated by balancing benefits to the nation through increased participation in a particular area of endeavor with the detriment to the nation from lost revenues, economic and administrative distortion, and the increased taxpayer sense of inequity and injustice. At this time the balance in respect to mineral and petroleum development incentives is highly delicate. Whatever the resolution of inquiries into the existence of a genuine "energy crisis" or petroleum shortage, it cannot be denied that our national interests require the continued production of petroleum products and basic minerals to support our industrial society's efficient operation. It has been estimated that the national oil consumption in 1980 will be fifty percent greater than the current oil consumption level.[75] In addition, the United States balance of international trade is significantly affected by the amount of gas and oil we are forced to import because of domestic shortages. In 1972 the national importation of oil and petroleum was about seven billion dollars. It is estimated that this figure will rise to thirty-five billion dollars by 1985.[76] Therefore, in considering these reforms, a national interest in a favorable balance of international trade must also be taken into account. Balancing these interests against the harm caused by current abuse of the mineral, oil and gas incentives requires especially close study of the effects that removal of any of the incentives would have on the industries involved.

As with other forms of tax shelters, oil, gas and mineral extraction organizations aim at delivering to their investors large first- and second-year losses and later, if the explorations are successful, offsetting deductions and capital gains. The promotions almost invariably account on a cash basis, permitted and bene-

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> June 30, 1936 an amount equal to 30 per centum of the gross receipts from duties collected under the customs laws during the period January 1 to December 31, both inclusive, preceding the beginning of such fiscal year. Such sums . . . shall be used by the Secretary of Agriculture only to . . . (3) reestablish farmers' purchasing power by making payments in connection with the normal production of any agricultural commodity for domestic consumption. Determinations by the Secretary as to what constitutes diversion and what constitutes normal channels of trade and commerce and what constitutes normal production for domestic consumption shall be final.

This would enable Congress to utilize customs revenues already available to make the payments of subsidies for agrarian enterprises.

74 As one author states:

> What then, is the balance sheet regarding these two methods of government assistance, direct expenditures and tax incentives?
>
> I would conclude from the above observations that, as a generalization, the burden of proof rests heavily on the use of the tax incentive method. Hence, in any particular situation — certainly any new situation — the first approach is to explore the various direct expenditure alternatives.

Tax Incentives at 33.

75 Davis, *Oil Ventures,* PRACTISING LAW INSTITUTE, TAX SHELTERED INVESTMENTS 199 (1972).

76 FORBES MAGAZINE, January 1, 1973, at 107.

fitted by present tax law.[77] The current law permits the drilling or mining concern to deduct intangible drilling costs in the first year, costs which usually are paid by the investors to the drillers or mining engineers who perform the actual explorations and which would, if this were not a privileged operation, be capitalized over the life of the business. Since these expenses are usually financed with nonrecourse loans, there is a great deal of leverage obtained through the application of the *Crane* doctrine. Consequently, on a small initial capital investment a taxpaying investor may secure substantial first-year expense deductions. If the well or mine is "dry" the taxpayer will have minimized his loss on the operation since he will have received substantial profit in the form of tax benefits. If the well or mine is successful, there are other tax benefits to the taxpayer along with the substantial financial gains from the well or mine itself.

A wealthy taxpayer may find extensive deductions on a successful oil or mineral exploration by utilizing the tax procedures for percentage depletion.[78] As one author queries:

> Why are so many of our top millionaires in the oil business?
> The answer is simple and conclusive: Because of the depletion allowance.[79]

Percentage depletion, unlike the more realistic cost depletion allowances,[80] permits an investor to take a straight percentage of his gross income from the operation as a deduction for the depletion of a mine or well. In contrast, ordinary depreciation is based upon the capital investment or cost of a depreciable asset, rather than gross income from the asset. The cost of an asset bears a direct and genuine relationship to the depreciation or depletion losses on that asset. Gross income is a totally unrelated concept. The percentage of gross income available under percentage depletion varies with the object of the exploration: petroleum and most minerals qualify for a twenty-two percent depletion deduction; gold, silver, oil shale, and iron ore get a fifteen percent deduction; and other substances qualify for deductions from five to fourteen percent.[81] For example:

> Owners of oil wells, and even holders of oil property rights, are allowed to deduct every year [22] per cent—of gross income, not capital invested. If a well which cost $1 million produces $5 million worth of oil for ten years, the owner can deduct [$11,000,000] from income taxes, or almost fourteen times what he invested.
>
> Now, suppose an individual has an annual income of $10 million from oil properties. Thanks to the depletion allowance, he can pocket [$2,200,000] right off the bat, free and clear of all taxes. The remaining [$7,800,000] is theoretically subject to tax.[82]

While there is certainly justification for allowing a deduction for the depletion of natural resources upon the "proposition that natural resources are distinc-

77 26 C.F.R. § 1.612-4 (1973).
78 Int. Rev. Code of 1954, § 612.
79 Prudent Man at 78.
80 *Cf.* Int. Rev. Code of 1954, § 612.
81 Int. Rev. Code of 1954, § 613.
82 Prudent Man at 78-79.

tive in being physically depletable,"[83] there is an inherent and substantial inequity in the percentage depletion which permits a straight percentage based on an unrelated item to be taken for the life of the asset with no provisions for recapture of excessive depletion deductions. In effect, the mine or well can be depleted, for tax purposes, far beyond a mere one-hundred percent.[84] This allows even the most successful oil or mining concern to pass along substantial deductions to their members although it has recovered the entire depletion of its resource. This is the archetypal tax shelter about which one author said "[it is] our second most important national tax dodge,"[85] and about which another author said "[it is the] deduct[ion of] imaginary costs."[86] Former President Harry Truman summed it up: "I know of no loophole in the laws so inequitable as the excessive depletion exemptions now enjoyed by oil and mining interests."[87] This tax abuse has all the consequential evils which are attributed to tax shelters generally, and it is certainly the prime target for tax reform in the oil, gas and mineral areas.

In addition to the tax advantage available to investors in successful explorations, there is another benefit when the property of oil operators is sold. The tax law permits a maximum tax on such dispositions of thirty-three percent of the sales price.[88] This is especially meaningful to the successful oil venture, since it is then that there is a marked increase in the value of the qualified properties. A relatively inexpensive piece of realty upon which oil has been found has increased in value by the labors of the drillers and investors. The tax laws would normally treat the difference in value evidenced at sale as a gain on the value of the properties and it would be taxed at high rates. Instead, the gain is limited to thirty-three percent of the sales price. The necessity of such tax benefit after a successful oil exploration has been made would appear dubious at least and unacceptable by most objective standards. This too is a prime area for tax reform.

A final shelter device available to oil and mining explorations is the preferential treatment afforded such explorations when they occur in foreign lands. Under the law, a taxpayer drilling for oil or searching for minerals in a foreign country may deduct exploration and development costs against his domestic tax obligations, against income from both related and unrelated sources. If the venture is successful and the profits are taxed by the *lex situs,* a credit is allowed against taxes due in the United States.[89] The result is that the Treasury suffers revenue losses to a foreign treasury with no offsetting incremental domestic benefit. Moreover, if there is a loss of the properties through expropriation, the loss may be used as a deduction against domestic tax obligations. The nature of this advantage, like the two previously described, is to give special benefits to the successful oil explorations of persons who need them the least. This aspect

83 D. T. Smith, Federal Tax Reform 252 (1961).
84 Commissioner v. Elliott Petroleum Corp., 82 F.2d 193 (9th Cir. 1936); Louisiana Iron & Supply Co., Inc., 44 B.T.A. 1244 (1941); Second Carey Trust, 41 B.T.A. 800 (1940), *aff'd* 126 F.2d 526 (D.C. Cir. 1942).
85 Prudent Man at 19.
86 Eisenstein *supra* note 58, at 9.
87 The Nation, Feb. 26, 1955.
88 Int. Rev. Code of 1954, § 632.
89 Int. Rev. Code of 1954, § 901.

of the foreign drilling and mineral benefits is the most unreasonable since the profits from such successful ventures more than compensate for the risks involved.

As stated previously, the decisions incident to changing the tax laws relative to mining and drilling involve a delicate balance of competing national interests. Understandably, the views of reformers vary and the reasons for or against change are almost as numerous. One author, for example, would retain percentage depletion or remove it at a gradual pace merely because it is so long-standing,[90] a view which would stifle all tax reform if accepted generally. Treasury Secretary Shultz has stated that the national need for oil and gas far exceeds the harm done by these provisions and, along with maintaining the current benefits, he has proposed a five percent supplementary investment credit for oil and gas explorations.[91] While the Secretary has his supporters, many disagree with his position.

Opposing arguments are largely predicated upon the belief that oil, gas and mineral explorations, with their high return on investment for successful explorations, do not require the high incentives afforded them under the tax law. While there is a claimed success rate of only one-in-ten oil drillings, this statistic applies only to wildcat operations. Drilling success of the oil industry as a whole is about sixty percent.[92] It is also notable that ninety percent of the depletion allowance is taken by the major oil companies, rather than the wildcatters. There is also the pragmatic consideration that "substantial integrated companies have no choice but to drill for oil if they are to remain in business."[93]

The harm caused by the tax preferences granted the oil companies and mining concerns, the economic and administrative distortion and the increased taxpayer sense of inequity and injustice, is, therefore, far more significant in its broad impact than the impetus to drilling given the oil industry and the mining companies by these benefits. In recognition of these facts, two writers have proposed reform of the syndication aspects of oil, gas and mineral tax advantages.[94] These antisyndicate reforms would, according to these authors, include eliminating the effects of the *Crane* doctrine and limiting the use of loss deductions to income from like taxable sources, thereby preventing the use of the oil or mineral preferences as tax shelters. These two measures, while necessary and effective, are not sufficiently complete to bring real equality and neutrality to our tax systems. More curbs appear warranted and necessary if we are to avoid "a tax scandal of major proportions."[95]

The proposed Tax Equity Act of 1973[96] would act to eliminate all four of the major tax shelter devices of the oil, gas and mineral industries. It would repeal the percentage depletion provisions, permitting only the use of the more equitable "cost depletion" deductions, which are based on cost of the property and which can never exceed the actual value of the property being depleted.

90 D. T. SMITH, *supra* note 83, at 258.
91 *Proposals* at 49-53, 135-42.
92 L. EISENSTEIN, *supra* note 58, at 9.
93 *Id.* at 130.
94 McDanial, *Panel Discussion on Tax Reform Before the Committee on Ways and Means, U.S. House of Representatives,* 93rd Cong., 1st Sess., at 141-82 (1973); Goldman at 107-40.
95 *Shelters* at 493.
96 H.R. 1040, 93rd Cong., 1st Sess. (1973).

The Act would allow even more liberal cost and expense deductions to the oil concerns, maintaining an incentive for new drilling at the only time when the result of the exploration is unsure. The Act would not, however, allow the application of these deductions to other unrelated income unless the well or mine was "dry," whereupon the deductions could offset other income. The bill would also repeal the maximum tax on the sale of oil properties and it would completely except both foreign gains and losses from application to domestic income. The total effect of the bill would be to retain the early tax advantages and the incentives to drilling, in the form of deductions for "dry well" exploration expenses, but to remove the tax benefits upon the success of the venture since the profits of oil, gas and mineral exploration do not require added incentives. Even if more financial advantage becomes necessary to stimulate drilling or mining, direct and more equitable forms of incentive are still available. This is the delicate balance which must be struck between the competing national interests in energy and mineral production if tax equity and neutrality are to be finally obtained in this country. This continues to be true as the Congress considers a wide range of proposals for tax incentives in an attempt to solve the present energy crisis, either on a short-term or a long-term basis.

D. *Attendant Tax Reforms: The Shelters Cannot Stand Alone*

While this article is devoted to exposing the enormous inequity and danger extant in the unreformed tax shelter provisions, it is necessary also to reveal for analysis those other areas of injustice which act to support tax shelter abuses. The Tax Equity Act of 1973 includes numerous provisions aimed at curtailing "special tax treatments, such as a tax-free dividend income for certain controlled corporation dividends, the asset depreciation range system, the investment credit, excessive dividends received deductions, certain tax free reorganizations, and tax free treatment of state and local bonds. These, too, must be eliminated if tax shelter reform is to result in total tax equity. Probably the most important of the attendant tax inequities is the capital gains preference.

Capital gains treatment currently operates to tax gains from the sale of property at rates substantially lower than ordinary gain rates. One calculation has placed the revenue source possible from a comprehensive reform of this preferential tax treatment at $3.65 billion annually.[97] Such a reform is found in the proposed Tax Equity Act of 1973.

The proposed Tax Equity Act of 1973 would make seven major changes in the capital gains treatment. It would repeal the alternate tax on capital gains, recognize the impact of inflation upon a sale of assets held for one year or longer, limit the deduction of capital losses, grant limited capital loss carryback and carryover, redefine capital gains and losses, eliminate stepped-up basis at death, and alter the capital gains treatment on sale of certain patents. Perhaps the most significant of these changes are the first two: repeal of the alternative tax on capital gains and recognizing an inflationary economy's impact

97 TAX ANALYSTS AND ADVOCATES, May 14, 1973, at 3.

on the sale of assets held for a significant time. The former is most commendable in its simplicity, merely raising all capital gains to ordinary gains treatment, but the latter is commendable rather for its farsighted approach to long-term capital assets.

Under § 102 of the proposed Tax Equity Act of 1973, the impact of an inflationary economy is given realistic recognition. While capital gain income will be taxed as ordinary income under the amendments made by the bill, this section provides for a limited exemption from taxation depending on the length of time the property has been held before it is sold. The exemption is granted in deference to the fact that if an asset has been held a long time, the gain measured by dollars is attributable to some extent to the declining value of the dollar.

This section assumes an inflation rate of four percent, and provides, in effect, that in computing the gain on a sale of property, the taxpayer can add to the basis of the property four percent of the tax basis of the property (at the time of the sale) for each year the property was held after it was held for one year. More precisely, it is provided that the addition to the tax basis shall be one-third of one percent of the tax basis for each full month the property was held after it had been held for one year. Thus, if the property is held for less than thirteen full months, nothing is added to the tax basis in computing gain. If the property is sold after being held sixty-three full months, seventeen percent of the tax cost would be added to the basis in computing gain.

It is provided, however, that the maximum amount which can be added to the tax basis is sixty percent. This maximum does not come into play until the property has been held for more than sixteen years prior to sale. Under present law, an individual is taxed on only one-half of his capital gain if he holds the property for one day over six months.[98] Under the reforms of The Tax Equity Act of 1973 no one day can make a difference of more than one-third of one percent, and that percent is of the cost of the property, not the gain on the sale. This provision for not taxing the gain to the extent attributable to inflation applies not only to capital assets but also to property used in a trade or business, such as a plant, machinery, or other depreciable equipment. It does not apply to property held for sale to customers in the ordinary course of business.

These changes in capital gains taxation would also simplify the tax laws. Complicated provisions, such as those dealing with collapsible corporations and recapture of depreciation deductions on sale of property at a gain, become unnecessary deadwood when preferential treatment of capital gains is eliminated.

III. The State of Tax Reform

It is clear beyond all doubt that reform of our present tax laws is needed. They are inequitable and complex, and they violate the standard of neutrality which should characterize a fully fair and effective tax law. The tax shelter provisions of existing law permit extensive abuses which result in damaging

98 INT. REV. CODE OF 1954, § 1222.

economic and administrative distortion and foster the feeling of inequity in the average taxpayer. These results are further complicated by the effects of non-shelter tax inequities, such as the capital gains "loophole" mentioned earlier. Conditions such as these cannot be tolerated by our nation for many more years without serious adverse consequences.

Unless substantial tax reforms are immediately forthcoming, we will encourage economic blight—characterized by economic depression and inflation, foreclosures and bankruptcies, and agricultural and realty market collapses. Moreover, we court the risk of mass tax scandals involving the small taxpayers who, sensing the inequities of the system, will "revolt" against it by taking unqualified tax deductions and short-cuts on their returns. This is the bleak outlook facing the Congress in this and every future term until substantial and effective tax reforms are realized.

The first session of the Ninety-third Congress has seen the introduction of a large number of bills on the subject of tax reform. The proposed Tax Equity Act of 1973 is only one of these bills, but it is the most comprehensive. The fact that it has drawn the co-sponsorship of fifty-three members of the House of Representatives attests to the soundness of the bill and the widespread support that tax reform commands in the Congress. This particular bill will not be passed this Congress, but sooner or later its provisions, singly or in a comprehensive package, must be passed. The current level of congressional sympathy for and understanding of the need for reform will eventually produce results, if only out of absolute necessity. Such reforms will be strong, and they will be enforced with the vigor that comes from popular outrage. It is this climate of taxpayer outrage and economic necessity that spells the eventual demise of the current tax provisions which permit and encourage tax shelters.