Volume 5 | Number 3 Article 7

9-1-1973

Limitation on Artificial Accounting Losses (LAL): Another Assault on the Tax Shelter.

Jeffrey Clarke Anderson

LIMITATION ON ARTIFICIAL ACCOUNTING LOSSES (LAL): ANOTHER ASSAULT ON THE TAX SHELTER

JEFFREY CLARKE ANDERSON

Tax shelter investments have come under fire again. This time the assault is from the President's Proposal for Tax Change as delivered before the House Ways and Means Committee on April 30, 1973.[1] The renewed offensive against tax shelters came as no surprise since the very nature of the tax shelter concept invites such attacks: Tax sheltered investments are almost exclusively utilized by individuals in the high tax brackets for the purpose of buying capital assets with income which would otherwise be paid in taxes.[2] In the early, developmental years of his investment, the investor intends to utilize the deductions and exclusions generated by the investment to offset his non-related taxable income.[3] As the investment matures, the investor desires a substantial tax free return of income, and finally a profitable sale price to be taxed at long term capital gains rates.[4] In general, the investor's desired result is an outright reduction in taxes, an increase in ordinary income, and a conversion of this ordinary income into capital gains.[5] It is no wonder that to most taxpayers, tax shelters appear to serve no purpose other than to provide "loopholes"[6] by which the wealthy can achieve these profitable results. For these reasons Congress is frequently placed under considerable pressure to further regulate the use of tax shelters.[7] Congress shows little reluctance to modify,[8] restrict,[9] or completely

1. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change (May 3, 1973); 24 CCH FED. TAX REP., Tax Reform Bill of 1973 (May 2, 1973).

2. Rossbach, *To Buy or Not To Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs,* 110 TRUSTS & ESTATES 906 (1971). Generally, those taxpayers in the 50 percent or higher tax brackets are the primary investors in tax shelters. While the rise of leverage and other factors may make a tax sheltered investment attractive to individuals in lower tax brackets, the numerous pitfalls should still make them think twice before entering into such an investment. Calkins & Updegraft, *Tax Shelters,* 26 TAX LAW. 493, 494 (1973). For an interesting discussion on potential tax-sheltering schemes for lower income taxpayers, see Bittker, *Tax Shelters for the Poor?,* 51 TAXES 68 (1973).

3. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 7 (May 3, 1973).

4. Rossbach, *To Buy or Not To Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs,* 110 TRUSTS & ESTATES 906 (1971).

5. *Id.* at 906.

6. There is a specific distinction between a tax shelter, a tax gimmick and a tax loophole. A tax shelter is a specific tax preference provided by Congress, and a tax gimmick is a unique application of that tax preference in a way Congress did not anticipate. Both are distinguished from a tax loophole, which is an unforeseen and unintended shelter. *Tax Shelter for the Individual: A Panel Discussion,* N.Y.U. 28TH INST. ON FED. TAX. 1009, 1009-10 (1970).

7. Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act,* 49 TAXES 450 (1971).

eliminate[10] the investment devices which have been exploited, but has refused so far to eliminate the tax shelter concept altogether.[11] This is because tax-sheltered investments, properly regulated, serve as an incentive to investors to channel their capital into highly speculative projects which require large capital outlays and little prospect for profit.[12] These passive investments stimulate the growth of the nation's economy by providing goods and services at lower costs, and by creating additional jobs. Indirectly, tax sheltered investments lower the cost of living for everyone by sharing the expense of providing such items as food and fuel with the government rather than passing the expense on to the consumer.[13] The tax shelter also serves as a subsidy to encourage private investment in projects of public concern.[14] But the Administration is mobilizing again to resume its attack on tax shelters, and this time the spearhead of the assault is a proposal designated the Limitation on Artificial Accounting Losses (LAL).[15]

THE NATURE OF THE ATTACK

The very essence of the current tax shelter concept is the counter-balanc-

8. INT. REV. CODE OF 1954, § 613(b)(1). The 1969 Tax Reform Act reduced the percentage depletion allowance in oil and gas investments from 27.5 percent to 22 percent. In addition, the excess percentage depletion over the tax basis in the property was subjected to a minimum tax as a tax preference item. INT. REV. CODE OF 1954, § 1231(b)(3).

9. INT. REV. CODE OF 1954, § 1231(b)(3). The 1969 Act placed a limitation on the livestock sale proceeds that qualified for capital gains treatment. The holding period required was increased from 12 to 24 months for cattle and horses. INT. REV. CODE OF 1954, § 1231(b)(3).

10. INT. REV. CODE OF 1954, § 278 (citrus groves). "Unfortunately, Congress became very much concerned with overproduction and, as a result, wiped out the tax shelter provided by citrus." Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 456 (1971).

11. The 1969 Tax Reform Act was the last major assault on the tax shelter concept. While the Act virtually eliminated some forms of investments from the tax shelter market (such as citrus orchards), it left most other popular tax-oriented investments almost unrestricted (such as oil and gas, and real estate).

12. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 7-8 (May 3, 1973). For example, in 1970 the success ratio between wildcat strikes and dry holes was approximately 1:10. Calkins and Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 503 (1973); Rossbach, *To Buy or Not to Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971). The chance of discovering a "significant field with reserves of around 1 million barrels of crude oil is about 1:50. *Id.* at 907.

13. The benefits derived from passive investments by the general public are usually considered to be substantial. For an interesting treatise by an author with an opposing view as to the need for providing passive investors with tax incentives, see P. STERN, THE RAPE OF THE TAXPAYER (1973).

14. *Eg.*, INT. REV. CODE OF 1954, § 167(k). To encourage the construction and rehabilitation of existing low income housing, the 1969 Act allowed amortization of the housing over a 60-month period (at the election of the taxpayer), and no allowance need be created for salvage value. INT. REV. CODE OF 1954, § 167(k).

15. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change (May 3, 1973).

ing of current taxable income with accelerated future deductions.[16] Under the present tax accounting rules, the taxpayer may shelter all or part of his profits from taxation by making an investment which allows a portion of his invested capital to be deducted from current nonrelated income. Since the investment is financed with capital previously marked for taxation, the investor is in effect investing the government's tax dollars rather than his own money.[17] The degree to which the accelerated investment expenses[18] offset current taxable income is the extent to which the taxpayer has suffered an "artificial accounting loss."[19] The proposal considers an artificial accounting loss to be "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."[20] The loss is "artificial" because it exists primarily on paper and is not an immediate "out-of-pocket" expense to the taxpayer.[21]

The Limitation on Artificial Accounting Losses proposal is designed to eliminate tax shelters by restricting the use of its most attractive feature—deferred taxation.[22] The proposal advocates matching income with the expense incurred in earning it. Artificial accounting losses will neither be permanently disallowed nor capitalized. These losses will be suspended and carried forward to be deducted in full from income produced by the investment (or related investments) in a future year.[23] In theory the proposal is designed to achieve two objectives: (1) Greater taxation equity will be realized since high bracket taxpayers will be prevented from escaping taxation by parlaying tax deductions and exclusions,[24] and (2) the incentive to venture capital into "high risk" investments will be preserved since

16. *Id.* at 95.

17. *Id.* at 95.

18. "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." *Id.* at 96-97.

19. *Id.* at 95.

20. *Id.* at 96.

21. As explained in 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change (May 3, 1973):

> Under the present tax accounting rules, in a taxable year in which the taxpayer has already received substantial income in excess of that year's deductions, he can avoid paying tax on all or part of that income by making an investment prior to the end of the year, which will produce income in succeeding taxable years, but which will in the current year produce only deductions in the form of an artificial "loss."

Id. at 95.

22. *Id.* at 94-95.

23. *Id.* at 94.

24. *Id.* at 9. The proposal acknowledges that the great majority of high income taxpayers pay their fair share of taxes each year. "In 1971 persons with adjusted gross incomes above $200,000 paid an average federal individual income tax of $182,000. Further, the wealthy as a group are paying more tax now than they were before the enactment of the Tax Reform Act of 1969." *Id.* at 7.

the proposal will still permit a taxpayer to deduct his investment expenses from the investment's profits.[25]

To achieve its first objective, the drafters of LAL noted the distinction between inside (active) investments and outside (passive) investments,[26] and directed LAL's restrictions primarily at the latter.[27] LAL will no longer allow an investor to project his future deductions into the current taxable year for the purpose of offsetting nonrelated income.[28] Investment expenses which bear little or no relation to the investor's primary source of income will not be permitted to shelter these unrelated profits, but will be temporarily suspended and placed in a specially created deferred loss account.[29] Only when the investment itself, or other related enterprises, produces an income may the deductions for expenses be removed from the deferred loss account and applied against the taxpayer's income. Should the deferred loss account be greater than the income produced by the investment during the taxable year, the remainder will be again suspended and carried forward to be used to offset future income.[30] If the taxpayer never realizes income from the investments, the deductions preserved in the deferred loss account cannot be realized. For the outsider whose primary investment motivation is often the production of a tax loss, the pitfall that LAL will create is obvious—the investment must make a profit. LAL's segregated investment concept will force the outsider to venture his capital intelligently since he faces the distinct possibility of losing his entire investment without realizing a dollar's reduction in tax.

In an attempt to achieve its second objective of retaining the existing investment incentives, LAL will have restrictions on its own applicability.

25. *Id.* at 11.

26. *Id.* at 11. At this point it is necessary to distinguish between the "inside" and the "outside" investor since the degree to which each is affected by LAL is significantly different. For those individuals who are regularly and profitably engaged in the business activity in which they subsequently invest (insiders), LAL will have little effect on their investment practices. Any accelerated expense generated by the new investment will be fully deductible from current related income. Since a majority of an "inside" investor's capital will probably be derived from activities related to the new investment, deductible expenses produced by the investment may be used to "shelter" a proportionate amount of current income. Deferred taxation is preserved as long as the insider confines his investments to activites related to his profitable enterprises. *Id.* at 94.

27. In making this delineation the drafters of LAL, 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change (May 3, 1973) stated: "LAL will normally affect neither the ordinary farmer, the professional oilman, nor the ordinary real estate developer [insiders], but rather the outsider who buys into those industries in search of tax losses." *Id.* at 94. *See also* Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 737-38 (1973).

28. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 11-12 (May 3, 1973).

29. *Id.* at 97. *See also* 7 CCH 1973 STAND. FED. TAX REP., REWRITE BULLETINS ¶ 8164, at 75,328.

30. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 94 (May 3, 1973).

LAL will not replace any existing tax accounting or accelerated deduction provision.[31] None of the existing tax shelters will be eliminated per se. Instead, LAL will exist as a separate provision restricting the tax avoidance incentive of such shelters to the activity for which they were created.[32] As previously stated, LAL proposes a general limitation only in terms of the deduction of the artificial accounting losses, and restricts it to use in offsetting income related to the particular investment.[33] A further restriction upon LAL will be that its application is limited to the individual taxpayer.[34]

While the application of LAL will be limited to investments by individual taxpayers, there will be no limitation as to the type of investment the individual taxpayer invests in.[35] Initially, however, the proposal identifies only four areas of concern: (1) Real estate, (2) personal property under net lease, (3) oil and gas investments, and (4) farming operations.[36] To best determine the probable impact of LAL on the individual investor, it is necessary to examine each of these areas in detail.

ATTACK ON THE REAL ESTATE SHELTER

Real estate has long been an attractive investment for the high bracket taxpayer with a desire for a long term tax shelter in that it generates both tax deductions and tax free income over a long period of time.[37] These

31. *Id.* at 96.

32. 7 CCH 1973 STAND. TAX REP., REWRITE BULLETINS ¶ 8164.

33. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 96 (May 3, 1973).

34. *Id.* at 94. Corporations, with the exception of Subchapter S corporations, will be exempt from LAL.

> Income (other than net related income and accelerated deductions subject to LAL) required to be included in a shareholder's gross income will continue as under present law to be characterized as dividend income. In addition, a subchapter S corporation will determine its net related income (in excess of the accelerated deductions) or its artificial accounting loss (accelerated deductions in excess of net related income) and will report to each shareholder his ratable share. A shareholder of a Subchapter S corporation will be entitled to treat his ratable share of the LAL item as though he directly owned a comparable interest in the property similar to the manner described for a partner.

Id. at 104.

35. The proposal contains a provision which allows for expansion of the measure to cover additional tax shelters not specifically referred to: "The Artificial Accounting loss to which LAL will apply is 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." *Id.* at 96 (emphasis added). *See also* 7 CCH 1973 STAND. FED. TAX REP., REWRITE BULLETINS ¶ 8164, at 75,326.

36. 7 CCH 1973 STAND. FED. TAX REP., REWRITE BULLETINS ¶ 8164, at 75,326.

37. Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 453 (1971). A long term tax shelter offers the investor all the tax benefits of a "pure" shelter in that its primary product is a deduction which runs over an extended period of time and the additional benefit of cash-flow distributions which the investor receives tax free so long as they do not exceed his losses. Both the pure and the long term tax shelter are distinguished from a one-shot shelter which is designed to provide the investor with substantial tax deductions only in the first year and substantial in-

features, coupled with the promise of capital gains treatment upon disposition of the property,[38] make real estate extremely popular with those investors possessing both a large amount of unearned income and a significant marketable net worth.[39] The tax-sheltering aspects of the real estate investment are primarily found in pre-opening construction costs,[40] leverage,[41] and depreciation.[42]

The pre-opening costs attributable to a real estate investment may be deducted from the investor's ordinary income during the year such expenses are incurred under sections 62, 162, 164 (other than under 164(a)(3), (5)), and 212.[43] These costs include interest;[44] state and local taxes;[45] management, brokerage, and legal fees; insurance; advertising;[46] and transfer and recording fees.[47] Many investors have further increased the deductions allowable to pre-opening costs by use of the so-called "soft dollar" purchase in which a portion of the purchase price goes for deductible ex-

---

come in the years thereafter. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 502 (1973).

38. INT. REV. CODE OF 1954, § 1221. *See also* Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 453 (1971).

39. Taxpayers who are interested in long term investments such as real estate, but who possess neither large amounts of unearned income nor a significant marketable net worth (i.e. business executives, doctors, lawyers) should carefully examine the tax consequences of such investments for the entire duration. Normally, such an examination will reveal a substantial tax liability arising in the latter years of the investment. In order to have the cash necessary to pay these future taxes, the investor is usually required to set aside funds annually in a "payback sinking fund," and this, in turn, reduces the benefits of the investment. Such long term investments are much more attractive to the 70 percent bracket taxpayer possessing ample amounts of credit and vulnerable to disallowance of excess investment income. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 501 (1973).

40. Expenses generally referred to as "pre-opening costs" are found in Sections 162-64 and 212 of the Internal Revenue Code of 1954.

41. *See* Crane v. Commissioner, 331 U.S. 1, 11 (1947).

42. INT. REV. CODE OF 1954, § 167. *See also* Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 505 (1973); Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 759 (1973).

43. INT. REV. CODE OF 1954, §§ 62; 162; 164(a)(1), (2), (4); 212. Recently, however, the Service has placed some limitations on the deductibility of certain pre-opening costs. For example, prepaid interest expenses will be disallowed if it serves no economic purpose other than providing a deduction for the taxpayer. Goldstein v. Commissioner, 364 F.2d 734, 741-42 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967). In 1968, Revenue Ruling 68-643 set out guidelines for determining the deductibility of prepaid interest. If interest is prepaid more than 12 months beyond the end of the current year, it will be disallowed as a material distortion of income. Interest prepaid less than 12 months in advance is not granted absolute immunity. The Service reserves the right to disallow it if it does not represent a true reflection of the taxpayer's income. Rev. Rul. 643, 1968-2 CUM. BULL. 76, 77.

44. INT. REV. CODE OF 1954, § 163; Treas. Reg. § 1.163-1(b) (1973). *See also Tax Shelter for the Individual: A Panel Discussion*, N.Y.U. 28TH INST. ON FED. TAX. 1009, 1029 (1970).

45. INT. REV. CODE OF 1954, § 164; Treas. Reg. § 1.164-1(a)(1) (1973).

46. INT. REV. CODE OF 1954, § 162(a)(1); Treas. Reg. § 1.162-1(a) (1973).

47. Treas. Reg., § 1.162-1(a).

penditures.[48] These may take the form of interest payments, wrap-around mortgages,[49] management fees, or rent-up expenses.[50]

A second tax-sheltering element inherent in the real estate investment is leverage.[51] Leveraging, sanctioned by the Supreme Court's decision in *Crane v. Commissioner*,[52] is a concept whereby the investor finances the majority of his investment with a nonrecourse mortgage. Since this mortgage many be computed into the investor's basis in the property even though he is not personally liable for the debt, the taxpayer has effectively increased his allowable deductions without a proportionate increase in his marketable net worth.[53] The investor's basis has been increased and he is allowed to deduct his investment losses and expenses to the extent of his basis in the investment.[54] In the case of a highly leveraged shelter, it is possible for the high bracket taxpayer to recover significantly more than his actual cash investment through tax savings during the first several years of the shelter.[55]

The third element contributing to the tax-sheltering effects of a real estate investment is depreciation; specifically, accelerated depreciation of the im-

---

48. Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 761 (1973).

49. A wrap-around mortgage is a second mortgage for an amount which includes the unpaid balance of the first mortgage plus an additional sum advanced by the lender. The wrap-around mortgagee agrees with the mortgagor-owned as to the owner's periodic payments of principal and interest on the senior mortgage, but he does not assume any liability on it. This enables the investor to make large interest payments during the early years of the construction and deduct the same from his taxable income. Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 762 (1973). For an in depth discussion of investment financing techniques, see Nad, *Financing Techniques and Problems: Wrap Around Mortgages, Unusable Interest Deductions, and Interest Subsidy*, N.Y.U. 29TH INST. ON FED. TAX. 1107 (1971).

50. Where the seller guarantees a minimum occupancy percentage, expenses in advertising and promoting the project may be made part of the purchase price. Such promotional expenses usually accrue during the "rent-up" period. Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 762 n.105 (1973).

51. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 506-07 (1973).

52. 331 U.S. 1 (1947).

53. *Id.* at 11. *Crane* has been incorporated into Section 1012 of the Internal Revenue Code of 1954. *See also* Parker v. Delaney, 186 F.2d 455, 458 (1st Cir. 1950); Mayerson v. Commissioner, 47 T.C. 340, 352 (1966).

54. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 507 (1973). The principle remains the same for the investors who utilize the popular limited partnership arrangement as their real estate investment vehicle, so long as none of the partners is personally liable for the nonrecourse debt and the basic rules of the subchapter K (sections 701-708 of the Code) are observed. *See* INT. REV. CODE OF 1954, § 752; INT. REV. CODE OF 1954, §§ 721-22; Treas. Reg. § 1.752-1(e) (1973); Treas. Reg. § 1.721-1(b)(1) (1973).

55. INT. REV. CODE OF 1954, § 1012 (if the property is sold), § 1015 (if inter vivos gift). Deductions in excess of the investor's cash or credit in the investment are computed into the investor's basis in the property and taxed accordingly at some future date. Should the investor die, however, before he disposes of the investment, his heirs are allowed to "step up" the basis to the current market value of the property at the time of the investor's death or 6 months thereafter. INT. REV. CODE OF 1954, § 1014.

provements.[56] Though the 1969 Tax Reform Act decreased the maximum rate of depreciation allowable in certain types of investments,[57] accelerated depreciation is still the principal item of the long term tax shelter.[58] The 1969 Act still allows the investor to use the double-declining balance (200 percent) method or the sum-of-the-digits method to compute his accelerated depreciation if the investment involves new residential property[59] (which includes apartments but excludes transient housing such as motels).[60] Depreciation of new commercial realty was reduced by the 1969 Act to a maximum rate of 150 percent of the declining balance.[61] An investment in used residential realty was limited to a maximum rate of depreciation not exceeding 125 percent of the declining balance,[62] and used commercial realty was restricted to straight-line depreciation.[63]

While the attractiveness of accelerated depreciation can not be denied, its overall effectiveness may be greatly diminished, if not completely defeated, by the depreciation recapture requirements which arise upon disposition of the investment. Upon sale, the investor in residential rental realty is required to recapture 100 percent of all accelerated depreciation in excess of straight-line depreciation less one percent for every month the property is held over 100 months.[64] Thus, after 16 years and 8 months no recapture of accelerated depreciation is required. Low income housing investments require shorter holding periods before the investor can avoid recapture; 100 percent of excess depreciation less one percent for each month held after only 20 months with no recapture required after 10 years.[65] All other realty (and depreciable personalty) must recapture 100 percent of the excess depreciation upon sale of the property regardless of the length

56. INT. REV. CODE OF 1954 §§ 167(b)(2) to (4); Treas. Reg. §§ 1.167(b)-2(c) (1973) (sum-of-the-years-digits method).

57. The 1969 Act reduced the maximum rate of depreciation on new nonresidential property from the double declining balance method (200 percent) to a maximum rate of 150 percent. INT. REV. CODE OF 1954, § 167(j)(1). Used nonresidential property can be depreciated only by the straight-line method. INT. REV. CODE OF 1954, § 167(j)(4).

58. Under certain circumstances, however, immediate deductions of accelerated depreciation have been disallowed. In Stanley C. Orrisch, 55 T.C. 395 (1970), the Tax Court held that where the primary purpose of a depreciation deduction was to enable a member of a limited partnership to completely avoid income taxation, such a deduction was expressly disallowed by Internal Revenue Code, section 704(b). *Id.* at 401. *See also* Jean V. Kresser, 54 T.C. 1621 (1970).

59. INT. REV. CODE OF 1954, § 167(j)(2).

60. Treas. Reg. § 1.167(j)-3(b)(1)(i) (1973). *See also* Treas. Reg. § 1.167(k)-3(c)(2) (1973).

61. INT. REV. CODE OF 1954, § 167(j)(1)(B); Treas. Reg. § 1.167(j)-2(b)(2) (1973).

62. INT. REV. CODE OF 1954, § 167(j)(5)(B); Treas. Reg. § 1.167(j)-6 (1973).

63. INT. REV. CODE OF 1954, § 167(j)(4)(A).

64. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(iii).

65. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(iii). *See also* Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 506 (1973).

of time such property was held.[66] The taxpayer who is seeking a long term shelter and is primarily interested in maximizing his deductions in the first several years of his investment will probably seek an investment in new residential property since the availability of accelerated depreciation is almost exclusively restricted to new property, and the effects of depreciation recapture can be minimized.[67]

The use of real estate as a tax shelter may be in its 11th hour in that Congressional passage of the LAL proposal will virtually eliminate real estate as an income-sheltering device for the outside investor. LAL will not allow a taxpayer's nonrelated income to be offset by his artificial accounting losses attributable to pre-opening constructions costs[68] or the excess of accelerated depreciation, over straight-line depreciation.[69] By eliminating losses attributable to pre-opening construction costs, LAL will also eliminate the use of leveraging in real estate purchases since there will be few investors desiring to pay the usual high interest rates inherent in the nonrecourse mortgage if they can not at the same time deduct these increased costs from their taxable income.

The proposal will further destroy the real estate tax shelter by specifying what classes of income will be considered related for the purpose of segregating it into a separate deferred loss account.[70] Residential real estate

66. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(v).

67. If a residence or office building has previously been occupied by even one tenant, it no longer qualifies for accelerated depreciation as a new building. INT. REV. CODE OF 1954, § 167(j)(2)(A)(ii); Treas. Reg. § 1.167(j)-1(a)(2)(ii) (1973). The limited partnership, as an investment vehicle in a real estate venture, faces some rather unique problems when it attempts to take advantage of certain accelerated depreciation provisions. *See* INT. REV. CODE OF 1954, § 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(1)(ii) (1973). For a complete study of these problems see Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 760 (1973). While the real estate investment presently ranks as one of the more popular forms of tax shelters, it offers the potential investor no guarantee of success. The careless investor too often discovers to his dismay that his investment has been transformed from a tax shelter into a tax trap. In such cases it is of little comfort that the investment saved $5,000 in taxes while losing $10,000 in the process. By giving careful consideration to the investment vehicle and anticipating the eventual tax effects of the future disposition of the property, however, a taxpayer in a high bracket can currently expect to realize substantial benefits from his real estate investment. Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 767 (1973).

68. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 99 (May 3, 1973). The pre-opening costs specifically referred to were deductible investment interest (section 163), state and local taxes (section 164), and costs deductible under sections 162, 212, and 62 of the Internal Revenue Code of 1954.

69. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 99 (May 3, 1973). *See also* INT. REV. CODE OF 1954, § 167.

70. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 101 (May 3, 1973). The deferred loss account will contain a record of all artificial losses attributed to each class of related income. In the case of residential real estate and oil and gas, a single account may contain any number of related investments. Artificial losses in the account will be used to offset related income each year until such losses are exhausted. *Id.* at 101.

will include both rental housing as set out in section 167(j)(2)(B) and housing held primarily for sale.[71] Losses from either of these investments may be used to defer income produced by the other. For example, a taxpayer with investments in both an apartment complex and a low income housing project will be allowed to deduct the expenses generated by one from the income produced by the other. This treatment is not afforded the investment in commercial property.[72] In commercial realty investment, each individual building will be treated as a separate investment for the purpose of establishing related income[73] except where more than one building is managed and operated as a single unit, and all buildings in the unit are located in a single tract of land.[74] Under these circumstances, the proposal will consider the interest expenses attributable to all buildings to be related for purposes of deductibility. Based upon this proposed treatment of commercial realty, it is difficult to see how a taxpayer who is in the regular business of developing commercial real estate will not be affected by the proposal. LAL effectively classifies all investors in commercial realty as "outsiders" since it requires that each commercial building "stand or fall" on its own.[75]

To illustrate the potential effects of LAL on the real estate investor consider this situation: Mr. Jones,[76] an unincorporated commercial real estate developer, earns $100,000 from his endeavors in 1974. In December of that year he invests in the construction of an urban shopping center which is scheduled for completion and leasing in early 1976. Before the end of 1974, however, Mr. Jones spends $48,000 on pre-opening construction costs. This expense is not a "paper loss" but an actual out-of-pocket cash expense which must be paid before the end of the year. Under present tax accounting rules, Mr. Jones is able to absorb this investment expense by offsetting it against his total business earnings for the year.[77] Mr. Jones subsequently reports $52,000 taxable income ($100,000 business earnings minus $48,000 pre-opening investment expenses) and pays $14,060 in tax.[78] Of course the sheltered $48,000 has not escaped taxation since the deduction will be computed into Mr. Jones' basis in the investment and taxed upon the property's disposition.[79] Under LAL, however, Mr. Jones must report the full $100,000

71. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 99 (May 3, 1973).
72. *Id.* at 99.
73. *Id.* at 99.
74. *Id.* at 99.
75. The proposal, however, alleges that "[i]n general, the Limitation on Artificial Accounting Losses will not affect those taxpayers who are regularly and profitably engaged in the business activity involved." *Id.* at 11.
76. For the purpose of this example, Mr. Jones is married and without any children. He has no other investments, and no unearned income from other sources.
77. INT. REV. CODE OF 1954, §§ 162-64, 212.
78. INT. REV. CODE OF 1954, Tax Rate Table, at v (1971).
79. INT. REV. CODE OF 1954, §§ 1012, 1015. If Mr. Jones dies before the prop-

as taxable income and pay the resulting $50,000 in tax.[80] LAL specifically classifies "pre-opening construction costs" as artificial losses which would limit their deductibility to the amount of any present related income.[81] The fact that Mr. Jones derives all his income from commercial real estate investments is immaterial since the proposal would restrict the class of related income in this situation to "only the rental income (and sales income if held primarily for sale) from the particular property to which the accelerated deductions are attributable."[82] The pre-opening investment expenses would be segregated into a separate deferred loss account to be applied against any future income.[83] Under the limitations of LAL, Mr. Jones' inability to defer taxation on the portion of his income expended on pre-opening investment expenses makes such a venture economically impracticable.

ELIMINATION OF THE NET LEASE

Prior to the 1969 Tax Reform Act, few tax shelters could match the dollar-for-dollar tax deductions generated by equipment-leasing programs. A carefully structured program could allow the taxpayer to recover up to 70 percent of his initial investment in tax deductions during the first year alone.[84] These substantial tax benefits usually resulted from the investor's portion of the investment credit,[85] interest deductions,[86] depreciation,[87] and conversion of sale proceeds into capital gain income.[88] The popularity of equipment-leasing as a tax shelter declined sharply, however, with the passage of the 1969 Tax Reform Act.

Although the general effect of the 1969 Tax Reform Act only slightly reduced the attractiveness of other deduction oriented investments, it virtually destroyed equipment-leasing tax shelters.[89] In addition to the general

erty is disposed of, his heirs will be allowed to take a step-up in basis in the property. The step-up will be computed to be the fair market value of the property at the time o the decedent's death or 6 months thereafter, at the election of the heirs. Should this be the case, the difference in the decedent's basis and the heir's basis in the property escapes taxation. INT. REV. CODE OF 1954, § 1014.

80. INT. REV. CODE OF 1954, § 1348. There is a maximum tax rate of 50 percent on all *earned* income.

81. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98-99 (May 3, 1973).

82. *Id.* at 99.

83. *Id.* at 98-99.

84. Goldstein, *Equipment Leasing After the 1969 Act*, N.Y.U. 29TH INST. ON FED. TAX. 1589, 1604 (1971).

85. INT. REV. CODE OF 1954, §§ 46(d)(3), 48(d). The 1969 Tax Reform Act repealed the investment credit, effective April 18, 1969, however, it was reinstated by the Revenue Act of 1971. INT. REV. CODE OF 1954, § 48(h).

86. INT. REV. CODE OF 1954, § 163.

87. INT. REV. CODE OF 1954, § 1250.

88. INT. REV. CODE OF 1954, § 1202.

89. Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 458-59 (1971). *See generally* Goldstein, *Equipment Leasing After the 1969 Act*, N.Y.U. 29TH INST. ON FED. TAX. 1589 (1971).

provisions of a maximum tax on all earned income[90] and a minimum tax on items designated as tax preferences,[91] the 1969 Act specifically attacked equipment-leasing shelters by disallowing investment interest deductions,[92] repealing the 7 percent investment credit,[93] and classifying all accelerated depreciation in excess of straight-line depreciation as a tax preference item.[94] The investor in equipment-leasing programs was left with accelerated depreciation as his sole tax sheltering device, and even this technique had the uniquely undesirable after effect of total recapture upon sale of the equipment at the end of the lease.[95]

In determining the scope of the 1969 Act's restrictions, however, its drafters drew a significant distinction between personal property which was leased and that property which was *net leased.* Today, this distinction is still of great importance to the potential investor in equipment-leasing programs. Equipment is considered to be held under a net lease if the sum of the investor's business expenses with regard to the lease total less than 15 percent of the annual rental it produces.[96] The equipment is also considered to be net leased if the lessor is either guaranteed a specific return on the lease, or is insured in some manner against loss on the transaction.[97] What this net lease distinction does, in effect, is to distinguish between those taxpayers who are involved in equipment-leasing as a full-time business and those who are involved only as passive investors in such ventures. Those persons who are actively and profitably engaged in equipment-leasing businesses usually have substantial profits and administrative expenses which are in excess of 15 percent of the business's annual income. In such cases the property is not considered to be net leased and the lessor can enjoy virtually all the tax benefits he did before the passage of the 1969 Act.[98] On the other hand, the speculative investor who is seeking neither involvement nor profits is denied the use of the many previously available tax-sheltering devices. The employment of such a distinction allows the individual whose full-time occupation is equipment leasing to compete on relatively equal footing with the well-financed outsider. In theory, the net lease distinction

90. INT. REV. CODE OF 1954, § 1348.
91. INT. REV. CODE OF 1954, § 56. This minimum tax applies to all tax preference items found in section 57.
92. INT. REV. CODE OF 1954, § 163(d)(4).
93. INT. REV. CODE OF 1954, § 48(h).
94. INT. REV. CODE OF 1954, § 57(a)(3).
95. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(v).
96. INT. REV. CODE OF 1954, § 1245.
97. INT. REV. CODE OF 1954, § 57(c)(1)(B).
98. The lessor may claim the 7 percent tax credit on the cost of the new equipment, INT. REV. CODE OF 1954, §§ 38, 46(a)(1), 48(d)(4)(D); deduct *all* his interest expenses from even a highly leveraged purchase, INT. REV. CODE OF 1954, § 163(d)(4)(A); and not compute the excess accelerated depreciation over straight-line depreciation into his taxable income as a tax preference item, INT. REV. CODE OF 1954, § 57(a)(3).

eliminated equipment-leasing investments from the tax shelter market. Apparently, however, the drafters of LAL have not arrived at the same conclusion.

The drafters of LAL, like those of the 1969 Tax Reform Act, apparently still consider equipment-leasing programs to be extremely attractive vehicles for tax manipulation.[99] As a result of this belief, LAL's primary thrust is again directed at equipment-leasing programs involving a net lease.[100] This net lease distinction provides an extremely effective guideline for segregating the professional lessors from the passive investors, or in other words, separating the inside business investments from the tax shelters. By observing this net lease distinction and applying the proposal's restrictions and limitations to only those investment programs which fall into a net lease classification,[101] the drafters of LAL intend to achieve greater taxation equity while at the same time preserving a measure of investment incentive.[102]

To achieve the proposal's objectives, LAL's application to investments involving a net lease will be twofold: First, LAL will apply to any artificial loss attributable to accelerated depreciation under section 167 (or amortization under section 184) in excess of straight-line depreciation;[103] and second, the proposal will restrict the class of related income to include only the annual rent produced by each particular piece of property.[104] Under LAL, this excess accelerated depreciation will no longer be available to shelter the taxpayer's nonrelated income. Instead, these artificial losses will be suspended in the deferred loss account until the particular lease begins to produce a profit.[105] When the LAL restrictions are added to those previously placed on equipment-leasing investments by the 1969 Tax Reform Act, equipment leasing will be less attractive to *all* potential investors irrespective of any tax considerations. Is this exploitation of investment incentive in equipment leasing such a widespread problem that it warrants the probable consequences of such overkill?

The drafters of LAL have greatly over-rated equipment-leasing as an attractive investment for tax purposes. In the wake of the 1969 Tax Reform Act, there is little left of the equipment-leasing tax shelter to attract many tax manipulators. If Congress passes LAL as proposed, the restrictions aimed at discouraging exploitation of tax deductions by passive investors could go so far in that respect that they would discourage active investment as well. Consider the following situation: Mr. Jones is contemplating

99. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98 (May 3, 1973).
100. *Id.* at 98.
101. *Id.* at 98.
102. *Id.* at 2.
103. *Id.* at 98.
104. *Id.* at 98.
105. *Id.* at 98.

an active investment in the aircraft leasing business. Seeking information about such a venture, Mr. Jones approaches his attorney. Mr. Jones is first informed that if he is required to finance the purchase of the airplanes, he will not be allowed a tax deduction for his investment interest payments,[106] since most aircraft leasing arrangements fall into the net lease classification under section 57c. For the same reason, Mr. Jones' investment will not qualify for the 7 percent investment credit.[107] Mr. Jones is also informed that although he may still depreciate his equipment by the double-declining balance method,[108] he will not be allowed to realize annual tax deductions greater than the investment's annual income.[109] When Mr. Jones inquires as to whether these deductions may be used to shelter income produced by his other leasing operations, he is informed that each particular investment is considered a class unto itself, and that the incomes are not classified as "related" for tax purposes.[110] The attorney also points out that any accelerated depreciation Mr. Jones does realize which is in excess of an amount computed by the straight-line method will be subject to an additional 10 percent tax as a tax preference item.[111] Mr. Jones is not discouraged enough at this point, so the attorney continues by emphasizing the ever-increasing tax liability of the investment after it reaches its cross-over point, and the need for establishing a payback sinking fund[112] well in advance of that time.[113] Mr. Jones's attorney also draws attention to the provision requiring recapture of 100 percent of all previously taken depreciation when the planes are finally sold at the end of the lease.[114] In concluding, the attorney informs Mr. Jones that while he will be denied these numerous tax advantages, his established competition will be allowed to realize the immediate tax benefits from their similar inside business investments.[115] Even

106. INT. REV. CODE OF 1954, § 163(d)(4)(A).

107. INT. REV. CODE OF 1954, §§ 38, 46(a)(1), 48(d)(4)(D).

108. INT. REV. CODE OF 1954, § 167(b)(2).

109. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 97 (May 3, 1973).

110. *Id.* at 98.

111. INT. REV. CODE OF 1954, §§ 56(a), 57(a)(3).

112. A payback sinking fund is an account created to cover the investor's increasing tax liability after the investment reaches its cross-over point, and the taxable income of the investor begins to exceed the available cash flow of the venture. This increase in taxable income results from the investments ever-decreasing interest costs and declining depreciation deductions. Goldstein, *Equipment Leasing After the 1969 Act*, N.Y.U. 29TH INST. ON FED. TAX. 1589, 1622 (1971). *See also*, Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 510 (1973).

113. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 508 (1973); Goldstein, *Equipment Leasing After the 1969 Act*, N.Y.U. 29TH INST. ON FED. TAX. 1589, 1622 (1971).

114. INT. REV. CODE OF 1954, § 1245.

115. Persons in the equipment-leasing business will undoubtedly have business expenses which exceed 15 percent of their gross annual income, and can thus avoid net leasing their equipment by utilizing open-ended contracts. By avoiding net lease treatment, the taxpayer is able to utilize all the tax sheltering devices previously available to him before either the 1969 Tax Reform Act or LAL's proposed effective date.

though Mr. Jones was not motivated to seek this investment by tax considerations alone, in view of the information he has received, he could hardly be expected to go through with the venture, unless he has a great deal of income. Thus, LAL's primary effect will not be the removal of equipment-leasing operations from the tax shelter market as its proponents claim, since this was previously accomplished by the 1969 Tax Reform Act. The proposal's primary effect will be to completely discourage outside investment in equipment-leasing programs by all except the most wealthy individuals. While the need for retaining the incentive for passive investment in the area of aviation may be debatable, the need for this incentive in such areas as medicine, pollution control, railroads, agriculture, and coal mine safety equipment is not.[116]

HANDS OFF TREATMENT FOR THE OIL AND GAS TAX SHELTER

Perhaps the oldest and most publicized tax shelter is an investment in oil and gas exploration. Were it not for this investment's numerous tax advantages, it is unlikely that many investors outside of the petroleum industry would finance such highly speculative ventures:[117] The ratio of dry holes to successful drilling programs is greater than 19 to 1.[118] Congress, however, has always recognized the need to increase outside investments in oil and gas exploration and has attempted to encourage these investments by providing them with ample tax benefits.[119] These investment incentives take

Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 511 (1973); 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98 (May 2, 1973).

116. In the fields of both medicine and agriculture (to name just two), many of the more expensive pieces of equipment are leased rather than purchased. Being able to lease expensive equipment increases the item's availability to persons of middle and lower incomes. For example, in the medical field such equipment as the following is usually leased: diagnostic computers, heart-lung machines, and artificial kidneys; in agriculture: harvesting combines and crop-dusting aircraft. Other areas in which leasing is economically preferable to purchasing is in those areas where technical obsolescence is of critical importance, such as in the areas of computers, CATV equipment, and nuclear fuel. For a complete discussion of the most promising areas for equipment leasing *see* Goldstein, *Equipment Leasing After the 1969 Act*, N.Y.U. 29TH INST. ON FED. TAX. 1589, 1629 (1971).

117. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897, 913 (1973). "In no event should an investment in oil and gas be considered by one who is not in a very high income tax bracket, probably at least 50% (per cent). The economic risks are too great for the investment to be considered by anyone else." *Id.* at 909. *See also* Rossbach, *To Buy or Not To Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 933 (1971).

118. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897, 907 (1973). Others place the success rate as "high" as 1 out of every 10 wells. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 503 (1973); Rossbach, *To Buy or Not To Buy: A Trust Officer's View of Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971).

119. In 1913, when the federal income tax laws were enacted, Congress allowed the

the form of tax deductions for prepaid intangible drilling and development expenses,[120] deductions for the interest payments on highly leveraged purchases,[121] investment credits,[122] accelerated depreciation,[123] percentage or cost depletion allowances,[124] and dry hole deductions.[125] Of all these tax benefits, the investor's intangible drilling expenses generally produce his most substantial tax deductions.

Intangible drilling and development costs are considered to be all the investor's expenses "incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas."[126] These costs include such items as wages, fuel and construction expenses.[127] The ability to deduct these costs when they are paid rather than when they accrue enables the investor to realize a return of up to 90 percent of his investment in tax deductions during the first year of the venture.[128] It is hardly surpris-

oilman a 5 percent depletion allowance. In 1926 the allowance was raised to 27.5 percent. Rossbach, *To Buy or Not To Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971).

120. INT. REV. CODE OF 1954, § 263(c).

121. INT. REV. CODE OF 1954, § 162.

122. INT. REV. CODE OF 1954, § 38.

123. INT. REV. CODE OF 1954, §§ 167(b)(2), (3), (4). New equipment may be depreciated at a maximum rate of 200 percent. INT. REV. CODE OF 1954, § 167(b)(2). Used equipment may be depreciated at a maximum rate of only 150 percent. INT. REV. CODE OF 1954, § 167(j)(1)(B).

124. INT. REV. CODE OF 1954, § 611.

125. If the drilling program is abandoned as a dry hole, the nonrecoverable costs which have been capitalized may be deducted in the year the well is abandoned. Treas. Reg. § 1.612-4(b)(4) (1973). *See also* Belridge Oil Co., 11 BTA 127, 137 (1928). This rule also applies to wells that had produced oil and gas, but are dry holes when they are abandoned. United Oil Co., 25 BTA 101, 108 (1932).

126. Treas. Reg. § 1.612-4(a) (1973).

127. *Id.* § 1.612-4(a)(1), (2), (3) (1973). The only initial expenses the investor must classify as *tangible* costs are the lease expense and the cost of the drilling equipment which is considered to be permanent and possessing a salvage value. INT. REV. CODE OF 1954, § 167(f); Treas. Reg. § 1.167(a)-11(b)(2)(ii) (1973). The prudent investor can even avoid these expenses if he leases rather than purchases his drilling equipment, in which case the rent will be considered just another intangible drilling expense, Rossbach, *To Buy or Not to Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971).

128. Rossbach, *To Buy or Not to Buy: A Trust Officer's View of Tax-Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971). The investment must be carefully structured to avoid having the prepaid costs considered nothing more than a voluntary advance deposit. In Revenue Ruling 71-579, the Internal Revenue Service established the current criteria for deducting prepaid intangible drilling costs—they must occur as a contractual obligation before they will be considered deductible in the year they are paid. Rev. Rul. 579, 1971-2 CUM. BULL. 225. Without the legal obligation to pay in the first year, it is irrelevant that the contractor begins drilling during that year; the obligation to pay arises only after the work is complete. Rev. Rul. 579, 1971-2 CUM. BULL. 225. The most popular form of oil and gas investment is the joint venture since it allows the participants to allocate the intangible drilling costs to those involved who can best utilize them. An investor could so structure his investment that all the intangibles were chargeable to him, and thus he would be able to deduct 100 percent of his investment in the first year regardless of

ing then that LAL classified intangible drilling costs as artificial losses.[129] What is unusual is the conservative treatment LAL affords these losses in view of its application in other investment areas.

LAL will limit the deductibility of intangible drilling costs to the amount of any net related income produced during the year.[130] Any intangible drilling costs remaining after all related income has been offset will be placed in a deferred loss account and suspended until the next year.[131] The proposal's classification of related income, however, will be deemed to include "mineral income from *all* oil and gas properties and will not be confined to the property to which the deductions are attributable."[132] This provision is particularly significant since it allows the investor to utilize income from his successful wells to finance his search for additional oil and reserves. The proposal's treatment of intangible drilling costs has a further attractive aspect in that LAL's classification of these costs as artificial losses applies only to the investor's successful wells.[133] If the drilling project is abandoned as a dry hole, LAL will still allow any losses attributable to the project to be deducted in full from any category of income in the year the drilling is abandoned.[134] This deduction even applies to some of those expenses that would be nonrecoverable on successful wells.[135]

The intangible drilling cost deduction is only one of many tax-sheltering devices available to the investor. Strangely enough, it is the only device classified as an artificial loss by LAL.[136] Tax deductions which are attributable to such devices as accelerated depreciation, or the percentage depletion allowance will still be fully deductible from the investor's nonrelated income after LAL's passage. This application to the oil and gas tax shelter reflects the current Congressional policy of retaining the incentives for oil and gas exploration.[137]

---

whether or not the well subsequently produced oil. Recently, however, the Court of Appeals for the Second Circuit affirmed the limitations the Tax Court previously placed on this technique in Charles M. Bernuth, 470 F.2d 710 (2d Cir. 1972), *aff'g* 57 T.C. 225 (1971). In *Bernuth*, the court held that the taxpayer had the burden of proof to establish that the amount allocated to drilling costs under a "turnkey" contract was reasonable in relation to the fair market value of such costs. Charles M. Bernuth, 470 F.2d 710, 714 (2d Cir. 1972).

129. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98 (May 3, 1973).

130. *Id.* at 98.

131. *Id.* at 98.

132. *Id.* at 98 (emphasis added).

133. *Id.* at 98.

134. *Id.* at 98.

135. Treas. Reg. § 1.612-4(b)(4) (1973).

136. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 97-98 (May 3, 1973).

137. Even in 1969 when the public was screaming for tax reform, oil and gas investments fared relatively well under the 1969 Tax Reform Act, suffering only two minor limitations on its tax-sheltering devices. The percentage depletion allowance was reduced from 27.5 percent to 22 percent, and any percentage depletion in excess of

Although the proposal's overall effects on oil and gas investments will be minimal, the extent of LAL's application in each instance will primarily depend on the success of the particular drilling operation. For example, the proposal will have little effect on the oil and gas investor whose drilling program fails to find oil. LAL has retained the dry hole deduction so this investor will still be able to deduct the entire cost of his venture.[138] LAL will also have little effect on the one investor in 50 whose operation locates a new oil field of significant size.[139] In such instances the investment is usually so profitable that it more than compensates for any increase in the investor's taxes, and produces so much related income that LAL's restrictions are never applicable.[140] Unfortunately, LAL's most significant effect will be on the oil and gas investor who drills in proven areas, or who strikes oil but not in a commercially profitable quantity. Without this present ability to deduct his intangible drilling expenses from his nonrelated income, the investor may find it extremely difficult to maintain these low-producing wells. Even when the operation's expenses begin to exceed its profits, it may still be economically impractical for the investor to get out of his investment, since so long as the well produces oil, the investor can not abandon it and recover his losses through the dry hole deduction.[141] In such instances, the investor will also be reluctant to sell his operation (even if he could find a buyer) so long as he believes there is a chance of salvaging at least a portion of his deferred loss account.[142] In other words, LAL's most significant effect on oil and gas investments will be its tendency to discourage investors from developing lower-producing and second-recovery fields. With the need for oil and gas increasing daily, and few sizable fields in North America left undiscovered or unleased, it seems only logical that the drafters of LAL redirect their efforts toward providing incentives for developing lower-producing wells and second-recovery fields rather than insuring that a few wealthy individuals pay their fair share of taxes.

---

the investor's basis in the property was made a tax preference item. INT. REV. CODE OF 1954, §§ 613(b)(1), 57(a)(8).

138. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98 (May 3, 1973).

139. Rossbach, *To Buy or Not to Buy: A Trust Officer's View of Tax Sheltered Oil and Gas Drilling Programs*, 110 TRUSTS & ESTATES 906, 907 (1971).

140. Since LAL will only affect current tax accounting procedures when investment losses exceed related investment gains, as long as the investment produces a net profit, LAL's limitations will not apply. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 94 (May 3, 1973).

141. Treas. Reg. § 1.612-4(b)(4) (1973).

142. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 102 (May 3, 1973). Actually the deferred loss account will not be completely lost to the taxpayer, but will be capitalized.

> In a taxable year in which there is a sale or other disposition of the property the proceeds of which do not constitute related income under the general definition, if there is a net balance in the corresponding Deferred Loss Account, the portion attributable to the property sold or disposed of will in general be subtracted from the Deferred Loss Account and added to the adjusted basis of the property.

Id. at 102.

While LAL's drafters should be commended for their conservative treatment of oil and gas investments in light of the proposal's application in other investment areas, it should be pointed out that this treatment is not conducive to achieving the proposal's own objectives of increased taxation equity. More equitable taxation cannot be achieved by limiting tax shelter investments to one area. This approach still allows those individuals who desire to completely avoid taxation to channel their taxable income into deductible investments. If the proposal is to achieve any measurable increase in taxation equity, its application must be uniformly restrictive. LAL should restrict the use of oil and gas investments by tax manipulators to the same degree it restricts the use of other tax shelters. Expanding LAL's application, however, to those tax-sheltering devices which are currently beyond the proposal's scope is not recommended since such action would probably result in fewer investments by passive investors in petroleum exploration. This resulting loss of investment capital would almost certainly aggravate the nation's already acute fuel shortage problem.

LIMITING LAL'S APPLICATION TO THE GENTLEMAN FARMER

Although the terms "farming" and "ranching" have been defined by the IRS to include a range of activities too numerous to mention,[143] investors in these activities usually have a number of common traits: First, these investors take no part in the management of the operation, since the entire investment is usually handled through a management firm;[144] secondly, the investor is not dependent upon the operation for his livelihood, since typically he has a great deal of nonrelated income;[145] and finally, the size of the investor's operation usually increases annually irrespective of its profits.[146] These investors (commonly referred to as "gentlemen farmers" or "Wallstreet ranchers")[147] are the specific persons to whom LAL's restrictions are directed.[148]

The investor's primary tax benefits in farming investments are his accelerated deductions for prepaid feed costs.[149] This technique allows the in-

143. Such farming or livestock operations range from racehorse ranches to fox farms. INT. REV. CODE OF 1954, § 1251(e)(4)(a); *see* Cedarburg Fox Farms, Inc. v. United States, 283 F.2d 711 (7th Cir. 1960); Rev. Rul. 588, 1957-2 CUM. BULL. 305.

144. Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450, 456 (1971). This firm locates and purchases the cattle, hires persons to attend the cattle, purchases the feed, and manages the operation's bookkeeping.

145. Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493, 494 (1973); Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897 (1973).

146. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897, 910 (1973).

147. P. STERN, THE RAPE OF THE TAXPAYER 188-89 (1973).

148. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 8-9, 100-01 (May 3, 1973).

149. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS.

vestor to reduce his taxes in the first year, and fatten his livestock for nothing during the second. Of course, if the investor's operation is to be carried into a third year, the tax advantages resulting from prepaid feed costs may be lost. The benefits of accelerating a deduction into the third year are offset by the loss of those deductions which were accelerated into the second year.[150] The only way an investor can continually receive tax benefits from prepaid feeding expenses is to continually expand his farming operation.[151] LAL's applicability to prepaid feeding costs is based on this rate of expansion.

LAL will classify prepaid feed deductions as artificial losses if they either accompany a significant expansion in the level of farming operations, or if they exceed a 20 percent increase in the previous year's feed expenditures.[152] If the accelerated deductions exceed these limits set by the proposal and are subsequently disallowed, the investor will have the burden of proving to the Commissioner or the Tax Court that such expenses are ordinary in his course of business and are not artificial losses.[153] By utilizing this approach rather than arbitrarily classifying prepaid feed costs as artificial losses, the drafters of LAL intend to restrict the proposal's application primarily to passive investors. The drafters allege that one reason most farmers will not be affected by the proposal's restrictions is that they do not increase the level of their farming operations annually.[154] The reasoning behind this belief is that the farmer's operation is neither profitable enough alone to sustain the expense, nor is it funded by a large amount of nonrelated capital as is the case with the passive investor.[155]

LAW. 897, 912 (1973). Prepaid feed costs are deductible by the investor during the year they are paid regardless of the fact that the feed will not be used until the following year. In recent years, however, this technique has come under close scrutiny from the Internal Revenue Service. The Tax Court recently held in Russel Mann, 41 P-H Tax Ct. Mem. 847 (1972), that prepayment for feed is deductible in the year it is paid only so long as it is not considered a returnable deposit. The dealer must record the payment as a nonrefundable purchase, and the prepayment must be considered an ordinary and necessary business expense. *Id.* at 847. Several earlier court decisions also denied prepaid feed deductions where it was established that the taxpayer had no legal obligation to tender the balance of the purchase price or to accept the grain upon its delivery. In Shippy v. Commissioner, 308 F.2d 743, 747 (8th Cir. 1962), payment was made on December 28, 1957, to the owner of a grain elevator as an advance deposit to cover future purchases of grain. The Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision denying the taxpayer an immediate deduction for the expense on the grounds that the asset obtained extended mainly beyond the close of the taxable year, and it was not ordinary and appropriate in the course of business. *Id.* at 747; *accord,* Lillie v. Commissioner, 45 T.C. 54, 63 (1965), *aff'd per curiam,* 370 F.2d 562 (9th Cir. 1966); Gold-Pak Meat Co., 40 P-H Tax Ct. Mem. 337 (1971). *But see* Gaddis v. United States, 330 F. Supp. 741, 752 (S.D. Miss. 1971).

150. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 100 (May 3, 1973).
151. *Id.* at 100.
152. *Id.* at 100.
153. *Id.* at 100.
154. *Id.* at 100.
155. *Id.* at 100.

LAL goes one step further in attempting to limit its application to investors by its classification of related income. The proposal defines related income as "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). . . ."[156] This classification takes advantage of the distinction that passive investors, unlike full-time farmers, usually take no part in the management of their farming operations.[157] The passive investor's artificial losses will be immediately deductible only to the extent of any income produced by the particular investment.[158] The farmer, on the other hand, may deduct his investment expenditures (if he has any) from his net annual income.[159] In theory, the farmer's tax deductions will be retained while the investor's deductions are reduced.

It is readily evident that LAL's restrictions were intended to eliminate the farming tax shelter without eliminating the farmer's tax benefits. In attempting to limit these restrictions to nonfarmers, the drafters designed into the proposal a fatal defect; the scope of LAL's application is too narrow. So long as the investor limits the expansion rate of his farming enterprises to a reasonable annual increase, and restricts his accelerated deductions to an increase of less than 20 percent of his deductions in the previous year, the investor will be unaffected by LAL. If the investor is really intent on parlaying his tax deductions, he can even avoid these limitations on the operation's annual increase by periodically investing in a completely new farming enterprise (which he can later merge with his older operations). In other words, the proposal will have little effect on the tax manipulator who will continue to avoid taxation by investing his tax dollars in farming operations just beyond the reach of LAL's restrictions.

Expanding LAL's application to include *all* farming investments will not provide a solution for the problem either. While such an expansion would undoubtedly come closer to eliminating the farming tax shelter, if that is a desirable goal, the most effective means of accomplishing it would be to repeal the provisions which authorize its tax deductions. Neither action is economically desirable. The marginal increase in taxation equity which would be achieved by eliminating the farming tax shelter would not be worth the disproportionate loss of investment capital. In the end, the taxpayers themselves would literally be purchasing a more equitable taxation

156. *Id.* at 100.
157. Cunnane, *Tax Sheltered Investment After the 1969 Tax Reform Act*, 49 TAXES 450, 456 (1971); Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897, 909 (1973).
154. *Id.* at 100.
155. *Id.* at 100.
156. *Id.* at 100.
158. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 94 (May 3, 1973).
159. *Id.* at 11, at 100.

scheme with a rise in the cost of living. For example, one of the most economical methods for fattening cattle is the commercial feedlot.[160] These feedlots are financed by passive investors, and tread a fine line between profit and loss.[161] The tax deductions which are produced by prepaid feed expenses allow the investor to reduce his risk of loss by sharing both his hazards and profits with the feedlot operator.[162] The feedlot operator primarily offers his services and experience to the venture and depends primarily on the various investors for the required operating capital.[163] By eliminating the tax sheltering aspects of the investment, the investor's risks would increase to a point where the venture would no longer be economically feasible.[164] At this point the price of beef would either go up, or the quantity of beef would go down. In effect, the consumer would be financing the elimination of farm and livestock tax shelters at the grocery store.

A Tactical Victory: A Strategic Loss

Although few causes are nobler than tax reform, it is extremely doubtful that LAL will succeed in reaching this goal. To do so, the proposal will have to achieve a number of intermediate objectives. First, LAL's restrictions on artificial losses must adequately eliminate the incentive for tax-sheltered investments. If this is accomplished, the elimination of these tax shelters must then result in the subsequent elimination of tax manipulation.[165] If the proposal is also successful in this respect, the resulting increase in taxation equity must then be determined to be worth the loss of a greatly disproportionate amount of investment incentive. Since these objectives are sequentially interrelated, LAL's inability to achieve any one will result in the proposal's failure to achieve beneficial tax reform.

160. *Cattle Feeding—and Lassoed Investors*, 93 DUN'S REV. 33 (Sept. 1971).

161. *Id.* at 33.

162. Pircher, *Tax Sheltered Investments: What, Who, When and Which?*, 25 BUS. LAW. 897, 912 (1973). Recently, however, some courts have placed qualifications on the deductibility of prepaid feed expenses for the passive investor. Russel Mann, 41 P-H Tax Ct. Mem. 847 (1972).

163. *Cattle Feeding—and Lassoed Investors*, 98 DUN'S REV. 33 (Sept. 1971).

164. Feeder cattle operations generally do not allow the investor such popular tax advantages as depreciation on the cattle or capital gains treatment of the sale proceeds. The only tax sheltering item the investor possesses is his ability to shift taxable income from one year to the next by paying for his feed in advance. Even this technique has come under attack. In Russel Mann, 41 P-H Tax Ct. Mem. 847 (1972), the Tax Court denied the taxpayer the right to deduct his prepaid feed expenses in the year he paid them on the grounds that since no feed was set aside by the seller, the money paid by the taxpayer was in the nature of a deposit and not a purchase. *Id.* at 847. For an excellent discussion on the problems involved in prepaying feed bills, see Pinney & Olsen, *Farmers' Prepaid Feed Expenses*, 25 TAX LAW. 537 (1972).

165. The proposal refers to tax manipulation in the context of high income taxpayers who are preoccupied with "parlaying tax deductions and exclusions" to avoid paying taxes. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 9 (May 3, 1973).

The proposal's restrictions on the immediate deductibility of artificial losses will discourage tax shelter investments by all investors except those fatally bent on tax manipulation (who are, ironically, the very persons the proposal is designed to control).[166] Tax manipulators will continue to shelter their investments, irrespective of LAL, by employing any of a number of devices to avoid LAL's restrictive provisions. One such device could be the routing of all transactions through some form of corporation,[167] since even professional corporations are beyond the scope of LAL's restrictions.[168] Another investment technique could be avoiding those tax shelters marked for regulation by LAL, and investing in only those programs free of its restrictions[169] (such as timber,[170] qualified pension and profit sharing plans,[171] qualified stock options,[172] and municipal bonds).[173]

Proponents of LAL will undoubtedly argue that expanding LAL's application will effectively control tax manipulation. Actually, such an expansion would create more problems than it would solve. For example, the application of LAL to corporate investments would require a tremendous increase in the auditing staff of the Internal Revenue Service in order to adequately police this expanded application. Expanding LAL to include corporations would also cause incorporators to adopt extremely vague or all-inclusive purpose clauses in an attempt to anticipate all future corporate investments. Corporations would also engage in fewer speculative investments under this expanded coverage, since those that exist only to make money are generally more cautious investors than are individuals.[174] The

166. *Id.* at 8.

167. The drafters of LAL decided to exempt corporations from the proposal's restrictive provisions for two reasons: (1) Since corporations are taxed at a designated rate, regardless of their capital base or the size of their operations, there is no real incentive toward tax manipulation through the use of tax shelter investments, and (2) LAL's restrictions could not be effectively administered to a corporation since it is usually involved in so many diversified activities. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 13 (May 3, 1973). However, Subchapter S corporations are specifically included under LAL. The Subchapter S corporation will be required to determine its net income or artificial accounting loss and report to each shareholder his ratable share. The shareholder must then treat this amount as if it were a partnership interest. If the share is an artificial loss, he will be required to suspend it until he has some future related income from which it may be deducted. *Id.* at 104.

168. *Id.* at 94. *See also* INT. REV. CODE OF 1954, § 401.

169. 7 CCH 1973 STAND. FED. TAX. REP., REWRITE BULLETINS ¶ 8164, at 75,326.

170. *Tax Shelters for the Individual: A Panel Discussion,* N.Y.U. 28TH INST. ON FED. TAX. 1009, 1016 (1970).

171. INT. REV. CODE OF 1954, § 401.

172. INT. REV. CODE OF 1954, § 422.

173. INT. REV. CODE OF 1954, § 75(b).

174. While it is true that few, if any, corporations are created for the express purpose of losing money, many corporations are created not to make money but to provide its owners with an effective means of retaining money earned from other sources. For example, a professional corporation is usually organized to enable a taxpayer the advantages of qualified pension and profit sharing plans and qualified stock options. A business corporation, on the other hand, is established solely for the purpose of

drafters would face an equal number of problems in attempting to expand LAL's coverage to other investment areas, since LAL's restrictions are not readily applicable to such tax shelters as qualified pension, profit sharing, and stock option plans.

In addition to its failure to prevent tax manipulation, the passage of LAL will produce several other undesirable effects. The proposal will have a tendency to produce business monopolies by restricting tax incentives to those investments entered into by profitable insiders.[175] Those persons already actively engaged in a business will have a definite advantage over those just entering the business since they will be able to realize immediate tax benefits from their inside investments.[176] This advantage will allow the insider to raise prices on necessary goods or equipment and have substantially higher business expenses resulting in a competitive increase in the operating costs of all businessmen. Because of LAL's restrictions, the new businessman will be unable to realize any benefits from his investment during the first several years of its operation, and he will thus need to possess a great deal of investment capital to enable him to compete with his established competitors and pay taxes on his invested capital at the same time. If the business competition is severe, the investor could find himself having to carry his investment much longer than he had planned in an attempt to realize a gain or at least salvage a portion of his ventured capital. This is another undesirable effect of LAL; it will operate to freeze people within given professions by making it too expensive for them to get out. For instance, an investor with a deferred loss account totalling more than $100,000 would find it extremely difficult to abandon a losing operation, even though he could not afford to keep it, if there was any possibility that the operation could begin to make a profit in the future (which would then come to the investor tax-free).

Finally, LAL will be inequitable in its own application. The proposal

---

carrying on a profitable enterprise. Professional corporations are not, however, always the fail-safe tax savings devices they are generally believed to be. For further discussions on the advantages and disadvantages of the professional corporation see Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965); and Note, *Professional Corporations: Tax Considerations of Incorporating a Law Firm*, 48 NOTRE DAME LAW. 671 (1973).

175. For example, equipment lessors who are actively engaged in equipment leasing operations can avoid net lease treatment and thus can avoid LAL's restrictions. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98 (May 3, 1973). This is also true in other tax shelters. *Id.* at 97-98 (oil and gas exploration), 99 (residential real estate), 100 (livestock investments).

176. The insider is allowed to deduct his investment expenses in total during the year they are incurred since LAL classifies them as related to the income produced by the business. This enables the insider to invest proportionately more money in his business than his newly-arrived competition. The competitor must pay tax on all the income he invests in his new business and is not allowed the immediate deductions that the established business receives under Section 162 of the 1954 Internal Revenue Code.

is inconsistent in its treatment of inside investors. In some investment areas, such as equipment leasing and cattle breeding, the insider will enjoy virtually all the tax benefits he enjoyed before LAL.[177] On the other hand, inside investors in commercial real estate are subjected to the same restrictions as will be applied to outsiders.[178] The proposal gives no reason for this inconsistent treatment.

While the proposal's restrictions will undoubtedly reduce the number of tax shelter investments, it will not eliminate them. Tax shelters must be completely eliminated if tax manipulation is going to be prevented. Taxation equity can be achieved in no other way. For this reason, LAL may achieve a tactical victory, but it will be a costly one and in the end it will result in a strategic loss.

Conclusion

Limiting artificial accounting losses (LAL) is one of two proposals designed to meet the increased public demand for tax reform.[197] The LAL proposal is intended to increase taxation equity while at the same time retain the current investment incentives. The drafters of LAL intend to achieve these goals by restricting the deductibility of investment losses in any one year to the amount of the investor's related income. This is intended to discourage deduction-motivated investors from seeking investments that only produce losses which could be used to shelter the taxpayer's nonrelated income and project him into a lower tax bracket. LAL will not be successful in deterring such investment techniques even though it will have a significant impact on tax shelter investments. As with the 1969 Tax Reform Act, LAL's effects on various investment areas will be inconsistent. Although they will be less attractive under the LAL restrictions, mineral and real estate investments will remain reasonably popular tax shelters even with the loss of some measure of investment flexibility. Other investments such as livestock operations and equipment leasing will be completely removed from the tax shelter market for most investors.[180] While tax manipulators will not be unaffected by LAL's restrictions, they will not be completely frustrated by them either, no matter where they decide to invest. Those taxpayers who desire to reduce their taxes or to defer taxation indefinitely will either avoid investments regulated by LAL (and channel their

177. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 98, 100 (May 3, 1973).
178. *Id.* at 99.
179. In addition the LAL proposal, the Administration advocates the passage of a new minimum taxable income provision. This proposal is designed to prevent the combination of exclusions and itemized deductions from offsetting more than one-half of a taxpayer's income. *Id.* at 10.
180. *Id.* at 100.

capital into such unregulated tax shelter investments as municipal bonds);[181] or they will pass their investments through some corporate form which is not subject to the restrictive provisions of the proposal.[182] The wealthy taxpayer who is currently avoiding taxation will continue to do so under the LAL restrictions if he so desires. LAL's disallowance of deferred taxation will greatly affect the average investor, however, tempering his desire to enter into speculative ventures by making them even riskier investments. This particular aspect of LAL could hardly come at a less opportune time since the need for capital from passive investors in such areas as low income housing, pollution control facilities, railroads, oil and gas, and beef is increasing every day. Even if the proposal could insure that every taxpayer will pay his fair share of taxes, the price LAL is asking would still be too high. LAL's proposed attack on the tax shelter should be discontinued before it produces too many innocent casualties.

181. LAL proposes no limitations on investments in municipal bonds which are extremely attractive tax shelters. The interest from such bonds is received by the investor entirely tax-free. INT. REV. CODE OF 1954, § 75(b).

182. 21 P-H FED. TAXES REP. BULL., Proposals for Tax Change 94 (May 3, 1973).