1977

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ATTACKING SHELTERS THROUGH THE MINI-MAXI TAX: A SKETCHBOOK OF TAX PREFERENCE CONCEPTS

by

PATRICIA ANN METZER*

* This article does not reflect the views of the Department of the Treasury or of the Internal Revenue Service. The examples discussed do not necessarily bear any relationship to reality, having been developed to illustrate a particular point.

The Setting

It all started back in 1969, when the new Republican Administration provided Congress with two separate proposals for what developed into the minimum tax. These were the days of the frontiersmen, when a substantial number of high-income individuals legitimately paid little or no Federal income tax. There were a variety of reasons. In some cases, taxpayers were able to permanently exclude certain items (such as tax-exempt interest) from income. In other cases, taxpayers were able to claim a current deduction for noncash outlays (such as percentage depletion exceeding a taxpayer's cost). In still other cases, income was deferred through the use of accelerated deductions (such as accelerated depreciation).

The House version of the Tax Reform Act of 1969 followed the second set of proposals introduced by Treasury in 1969, by placing a limitation on the use of tax preferences and by requiring taxpayers to allocate certain of their itemized deductions between taxable income and various preferences, with the latter deductions being disallowed. Congress wanted to close down the frontier. The House Ways and Means Committee stated that “no one should be permitted to avoid his fair share of the tax burden—to shift his tax load to the backs of other taxpayers.” The Senate agreed, but took a different approach, which was ultimately adopted by the Conference Committee. In addition to launching a direct attack upon preferences, the Senate decided upon what we now know as the minimum tax. This was viewed as a more effective and considerably simpler way to impose a tax on preference items. Euphemistically, what emerged was a cross between a sheep and a cow. The minimum tax became an additional rather than an alternative tax, but the alternative nature of the House version was

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1. U.S. TREASURY DEPT., TAX REFORM STUDIES AND PROPOSALS, pts. 1 and 2, 13-15, 94-95, 132-52 (Feb. 5, 1969) (suggesting a minimum individual income tax and the allocation of deductions between taxable income and various preferences); U.S. TREASURY DEPT., TAX REFORM PROPOSALS, Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means, 91st Cong., 1st Sess. 5050-51, 5060-78, 5280-86 (April 22, 1969) (proposing a limit on tax preferences (LTP) and the allocation of deductions).
3. Id. at 78.
recognized by allowing taxpayers to reduce their preferences by $30,000 plus their regular tax liability before applying the minimum tax rate.\(^5\)

Time marched on. By 1973, it was apparent that the 1969 minimum tax provisions were not really living up to expectations. That year, the Treasury suggested an alternative tax on minimum taxable income (MTI) and a limitation on the deductibility of artificial accounting losses (LAL).\(^6\) Nothing happened until 1975, when the House accepted LAL in a variety of tax shelter areas and tightened the minimum tax provisions for individuals by adding new preferences, reducing the preference offset, and increasing the rate of tax.\(^7\) When the Tax Reform Act of 1975 reached the Senate, however, it reacted differently to the clearly perceived abuses. The Finance Committee expressed concern over the fact that high-income individuals were still able to avoid paying any income tax, but suggested that the House approach was unnecessarily complex and indiscriminate, in that it would have interfered with economically meritorious investments.\(^8\) The Senate approach generally prevailed in conference.\(^9\) Thus, the Tax Reform Act of 1976 expanded the minimum tax for both individual and corporate taxpayers and dealt with tax shelters through a variety of new at risk, recapture, capitalization and partnership provisions.

Modifications were also made in those provisions dealing with the maximum tax on earned (now, personal service) income. The minimum tax and the maximum tax have always complimented one another. Back in 1969, when shelters were in their heyday, the House Ways and Means Committee observed that reducing rates was one of the best ways to discourage tax shelter activity. It was then that the maximum tax was born. The Committee was confident that reducing the marginal rate on earned income to 50 percent would direct taxpayer efforts toward those activities which were economically justified on a before-tax basis.\(^10\) Thus, the Tax Reform Act of 1969 went into conference


\(^7\) See H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 28-85, 130-32 (1975). There were also a variety of other tax shelter provisions, such as an at risk limitation for intangible drilling costs. Id. at 85-130.


with a maximum tax provision approved by the House (although absent from the Senate version of the bill). The conferees adopted the 50 percent limitation, but with one modification which tied the two complimentary minimum and maximum tax provisions together on a formal basis. The earned income eligible for the special rate was to be reduced by tax preferences in excess of $30,000.11

By 1976, however, it had become apparent that the maximum tax provisions (like the minimum tax) were not working as well as expected. The Senate Finance Committee attributed this to a number of factors, including the availability of the $30,000 exemption. Ultimately, the Senate decided to eliminate the exemption, add its new minimum tax items to the preference offset, and extend the maximum tax to pensions, annuities, and deferred compensation. The Conference Committee agreed, although the additional preferences were those added to the minimum tax by the conferees.12 The result has been a particularly strong deterrent to the use of tax shelters.

Timber: Taxing Preference Income

Timber affords the best insight into how the minimum tax computations work, because the provisions which affect timber reflect a little bit of the old and a little bit of the new. Take, for example, the individual entrepreneur who raises timber. When the timber is cut, the taxpayer can elect to treat the difference between fair market value and basis as gain or loss from a sale or exchange. Or, when he disposes of the timber under any contract which reserves for him an economic interest in the timber, the same treatment will automatically apply. In either case, the statute generally converts the gain into a capital item,13 thereby bringing into play the minimum tax provision under which the untaxed portion of a net capital gain is an item of tax preference (number nine on the list of 11).

The individual timber entrepreneur gets no special tax relief. He will have to compute his minimum tax liability just like any other individual taxpayer. The rate is now 15 percent. The exemption is now the greater of $10,000 or 50 percent of the taxpayer's regular tax liability, determined by excluding any penalty taxes on early distributions from an individual retirement account or, in the case of an owner-employee, from a Keogh plan and by excluding the separate tax on a lump sum retirement plan distribution. The regular tax carryover provisions have been repealed.

Timber corporations, on the other hand, are the sole remaining relic

13 INT. REV. CODE of 1954, §§ 631(a) and (b), 1231(b) (2). Gains on the sale of timber may also be covered under section 1231(b) (1).
of the past—the good old days when the minimum tax provisions were really little more than a paper buffalo roaming the tax shelter frontier. For timber corporations, the capital gains preference attributable to timber income will continue to be subject to tax at the old rate of 10 percent. The old exemption of $30,000 plus the corporation's full regular tax liability, determined by excluding any personal holding company and accumulated earnings tax, also remains in effect, while other (less fortunate) corporations now qualify for an exemption of only $10,000 or, if greater, their regular tax. Timber corporations can also take advantage of the regular tax carryover provisions (otherwise repealed), so that timber related regular taxes that are not applied against preferences in the current year can be carried forward for a period of seven years to offset that part of the minimum tax base attributable to timber gains. The result will be significant complexity as taxpayers struggle to determine how much of their corporate income tax is (and, for past years, was) attributable to timber income. The restriction is also somewhat anomalous, in that there is no limitation on a taxpayer's ability to use that portion of its current tax liability attributable to nontimber sources to offset its current timber tax preference income. Instead, there is a special formula which, in effect, allows the taxpayer to use its regular taxes attributable to nontimber sources to offset current timber tax preference income, at the expense of a reduction in the regular tax deduction available to offset other preference items.15

The Fruit or Nut Tree Joint Venture: Tax Benefit, Partnerships and Small Business Corporations

Preferences, by implicit definition, are supposed to produce a tax benefit, and, if they do not, there should presumably be no minimum tax. By way of illustration, assume that the Almorange Joint Venture


15 For timber corporations, the entire regular tax deduction (not just that attributable to timber gains) must be reduced by one-third or, if less, the so-called preference reduction for timber which in effect restores for timber gains the old 10 percent minimum tax rate and $30,000 exemption. In unusual circumstances, however, a timber corporation will be able to claim both the old $30,000 exemption with respect to its timber gains and the new $10,000 amount with respect to all of its tax preference items. This could occur when the corporation's credits reduce its tax liability below $10,000. See INT. REV. CODE of 1954, §§ 56(d), 56(e), 57(a) (1) (9) (C), and 57(e).

Conceptually, the special timber provisions do not work quite right because Congress chose to integrate them within the new 15 percent tax rate, $10,000 minimum exemption structure. Far more complexity, however, would have resulted by requiring taxpayers to separately determine their preference tax on timber gains under a different set of statutory rules.
(a partnership) is set up to invest in almond and orange groves. There are four general partners, two individuals and two personal holding companies, which put up very small amounts of cash. The partnership borrows heavily from the bank on a nonrecourse basis, goes out and buys a number of citrus and almond groves, and leases them to a third party in order to avoid having to cope with the day-to-day operational problems. Several years later, the trees start to produce. At that time, the investment credit and accelerated depreciation under the 200 percent declining balance method become available. But the partners will be able to claim a current deduction for their share of partnership losses only to the extent that they are at risk. Also, any accelerated depreciation attributable to the acquired citrus and almond groves will constitute an item of tax preference (as item number three on the list of 11).

The Almorange Joint Venture faces two separate levels of tax benefit concern under the minimum tax. First, what about accelerated depreciation which, although allowable, must be deferred because an investor does not have enough at risk? The House Ways and Means Committee focused upon this problem in the context of LAL, by providing that any deduction deferred under LAL was not to be considered an item of tax preference. The problem was buried, however, as the Tax Reform Act of 1976 made its way through Congress and the innovative solution to tax shelters shifted away from LAL to at risk. Literally, a deferred but allowable item of tax preference must be included in the minimum tax base right away. New section 58(h) does give the Treasury authority to write regulations under which preferences can be adjusted "where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax... for any taxable years." But, although addressed to the problem of tax benefit, this language would not appear to be particularly helpful in the at risk case, where it is impossible to conclude that deferred deductions will

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16 See Rev. Rul. 65-104, 1965-1 CUM. BULL. 28; JOINT COMMITTEE GENERAL EXPLANATION 41 n. 4 (1976). However, the individual partners will not be able to claim the investment credit by reason of section 46(e), which limits the availability of the credit in the case of noncorporate lessors. For purposes of section 46(e), personal holding companies are viewed as corporations.

17 The at risk provisions apply to individuals and personal holding companies engaged in the leasing of section 1245 property through a partnership. INT. REV. CODE of 1954, § 465(a) and (c) (1) (C); see JOINT COMMITTEE GENERAL EXPLANATION 36 n.2. The minimum tax provisions apply to accelerated depreciation claimed by individuals and personal holding companies on items of section 1245 property subject to a lease. INT. REV. CODE of 1954, §§ 57(a) (3) and 58(i). Both statutory provisions refer to section 1245 property as defined in section 1245(a) (3). Section 1245 property thus includes tangible property (other than personal property) used as an integral part of production, defined by regulation to encompass the cultivation of orchards. Treas. Reg. § 1.1245-3(c) (1) (1) and (2) (1965) and Treas. Reg. § 1.48-1(d) (2) (1964).

never produce a tax reduction. The Joint Committee's General Ex-
planation of the Tax Reform Act of 1976, however, does indicate
that preference items giving rise to losses which are suspended under
the at risk provisions are not to give rise to a tax benefit until the year
in which a suspended deduction is allowed.

Section 58(h) is really directed at the traditional tax benefit problem
which was of concern to Treasury when it developed the proposed
regulations under the minimum tax sections back in 1970. It is this
problem, of course, that is of second level concern to investors in the
Almorange Joint Venture. Assume that individual Partner A is able to
deduct $30,000 as his allocable share of the sole partnership deduction
which for him includes a tax preference in the amount of $20,000.
However, A, for the same taxable year, is also able to claim a deduc-
tion for home mortgage interest and gifts to charity of $20,000. His
gross income totals $40,000 (including $30,000 from the partnership).
Because A’s deductions ($50,000) exceed his gross income ($40,000),
no regular tax will be due, and, by operation of section 172, the unused
deduction of $10,000 will not be available as a net operating loss
carryover or carryback. This, then, brings us to the question of tax
benefit. Stated quite simply, should the unused deduction be viewed as
accelerated depreciation, thereby reducing the item of tax preference
for the current year from $20,000 to $10,000? The proposed regula-
tions say “yes”, through the application of a recomputed income
device. The problem becomes somewhat more complicated when there is a
current net operating loss and long-term capital gain. Assume, this
time, that Partner A has gross ordinary income of $70,000 from non-
business sources, a long-term capital gain of $10,000, and nonprefer-
ence business deductions from the partnership (the Almorange Limited
Partnership decides to claim only straight-line depreciation) of $90,000.
A will have no taxable income, with gross income of $80,000, a section
1202 deduction of $5,000, and business deductions of $90,000. On
the other hand, the section 1202 deduction represents an item of tax
preference, ostensibly subject to the minimum tax. At this point, how-
ever, the proposed regulations step in and say “no”, the theory being
that the deduction will cause A to lose $5,000 of his net operating loss
carryover or carryback, so that there cannot possibly be a tax benefit.

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19 Joint Committee General Explanation 107 n. 1.
20 Proposed Treas. Reg. § 1.57-4(b) (1) (i), (c), and (e), Ex. (1), 35 Fed.
21 Proposed Treas. Reg. § 1.57-4(b) (1) (ii), (c), and (e), Exs. (2) and (3),
19765-66 (1970). This provision was adopted pursuant to statutory language re-
quiring the Treasury to prescribe regulations setting forth the extent of the capital
gains preference for corporations which do not use the alternative tax.
The loss occurs because a net operating loss must be computed without regard to the section 1202 deduction, thereby reducing A's carryover or carryback to the difference between $90,000 of deductions and gross income of $80,000.

Having reached this level of complexity, let us make life more difficult first by assuming that the income items were received in 1978, while the business deductions became available in 1977 (thereby producing a 1977 net operating loss of $90,000), and then by assuming that the same events occurred in reverse order. If the tax benefit concept is to make any sense at all, it arguably should not make any difference whether the net operating loss being applied in a particular year got there as the result of a carryforward or a carryback—in either case, the section 172 modifications will cause A to lose $5,000 of his net operating loss. Thus, in case one, A should not have to pay a minimum tax for 1978 (assuming neither taxable income nor net operating losses during the carryback period), while in case two (assuming no taxable income during the balance of the carryback period), he should be able to recover the minimum tax he incurred in 1977, before he was able to apply the net operating loss carryback, even though there was some limited deferral because of his ability to use the section 1202 deduction right away. The proposed regulations come out the same way.22

One further example of the mismatching of net operating losses from other years and current income and deduction items is useful. Let us return to something akin to the first example, this time in which A has a depreciation deduction of $30,000 (including a preference of $20,000), gross income of $40,000, and other nonbusiness deductions of $10,000, bringing his taxable income down to exactly zero. However, he also has a net operating loss carryover of $20,000, all attributable to nonpreference items. As a result, should his current preference escape the minimum tax under tax benefit concepts, at least for the time being? It may be quite logical to say "yes", but then some vehicle would have to be developed in order to make certain that the net operating loss carryover disappeared or became an item of tax preference in subsequent years, so that it could not do double duty later on. Expiring net operating losses do, of course, disappear, so that a special rule could be constructed for them. The proposed regulations, however, decide against any special tax benefit provisions under the circumstances, by keeping carryovers (and carrybacks) out of the recomputed income device.23

22 Proposed Treas. Reg. § 1.57-4(b) (2) and (e), Ex. (4), 35 Fed. Reg. 19770-71 (1970). Although the example deals only with carryovers, the language of the regulations is broad enough to cover carrybacks.

23 Proposed Treas. Reg. § 1.57-4(c), 35 Fed. Reg. 19770 (1970). Recomputed income or loss is to be computed without regard to the net operating loss deduction.
What has happened to the tax benefit concept as articulated in the proposed regulations? Back in 1975, the House Ways and Means Committee expressed concern over the fact that there were cases in which a person derived no tax benefit from an item of tax preference and, yet, could still be subject to the minimum tax. The Committee recognized that the Service, through regulations, had dealt with the problem, but decided that it would be appropriate to adopt a specific statutory provision, which is present section 58(h). In doing so, the Committee made two points, which were subsequently endorsed by the Senate Finance Committee. Neither Committee intended to make any judgment about the authority of the Treasury to issue the proposed tax benefit regulations under then existing law. Also, a tax benefit was to include tax deferral, even if only for one year. Thus, most of the concepts which appear in the proposed regulations could be retained for the future and probably will be. Two significant questions, however, arise with respect to the availability of a minimum tax refund when a carryback gets applied against the taxpayer’s section 1202 deduction for the carryback year, and with respect to the use of net operating loss carryovers and carrybacks in determining recomputed income. Both problems will have to be reexamined in light of current law.

And so, we return briefly to the Almorange Joint Venture in order to determine how the minimum tax provisions work mechanically in the context of a partnership. Partnerships are one of seven conduit entities—i.e., partnerships, estates, trusts, electing small business corporations, common trust funds, regulated investment companies and real estate investment trusts—which are discussed separately under the proposed minimum tax regulations. A partnership, as such, is not subject to the minimum tax and has no items of tax preference. Instead, each partner, in computing his own items of tax preference, must pick up his share of partnership income and deductions which are labelled by statute as preferences. The approach differs from that taken in the case of an electing small business corporation, where items of tax preference are computed at the corporate level as if the minimum tax applied to the corporation. Then, all of these items, except certain capital gains, are apportioned among shareholders on a pro rata basis, per a per diem of ownership formula set forth in the statute, with a further prorating to determine each shareholder’s portion of each item of tax preference. The approach raises some interesting tax benefit questions when the corporation incurs a net loss equal to or greater than its preference deductions.


The Oil Company: Net Operating Losses, Oil Preferences and Regular Corporations

Net operating losses raise special problems under the minimum tax. For purposes of illustration, let us take the Ace Diversified Mining Company which drills for oil and gas, mines coal, and manufactures widgets. Ace happens to qualify as an independent producer of domestic crude oil and domestic natural gas, so that when it makes a profit it can claim percentage depletion not only as the result of its coal mining operations but also in connection with its oil and gas drilling activities. For 1977, Ace claims a depletion deduction of $400,000, which constitutes an item of tax preference. As it turns out, Ace also incurs routine operating expenses of a nonpreference nature in a substantial aggregate amount. Together, these deductions exceed Ace's gross income by $300,000, so that it has a net operating loss of $300,000 available for use in subsequent taxable years. Under these circumstances, should Ace currently have to pay a minimum tax on its item of tax preference, at least some portion of which, one might argue, produces no immediate tax benefit? We are, of course, back to tax benefit concepts, with one significant difference. From the inception of the minimum tax provisions, special rules (which, in fact, support the broader tax benefit concept) have been available for those taxpayers who incur a net operating loss which may be carried over to subsequent taxable years. Although Congress might have said that preference deductions should be stacked (or used up) first, or that in all cases preferences should immediately be subject to a minimum tax, it did not. Instead, the statute assumes that when there is a net operating loss, the loss will include preferences in excess of the minimum exemption (now $10,000), so that the tax on these preferences will be deferred until the loss is actually used, if ever. At that time, a minimum tax will be imposed at the rate in effect when the preference arose. Thus, in 1977 Ace will have to compute a current tax on that portion of its item of tax preference deemed not to have become part of its net operating loss ($100,000), and the tax on the remaining $300,000 ($45,000) will be deferred.

The statutory stacking rules which apply in subsequent taxable years during the carryover period are consistent with this approach. That portion of a net operating loss attributable to nonpreference items will be used up first, thus further delaying the imposition of a minimum tax. It may even be that the carryover period will expire before the tainted portion of a net operating loss can be deducted, the result being

20 See INT. REV. CODE of 1954, § 613A.
27 INT. REV. CODE of 1954, § 56(b). If the loss can immediately be carried back and deducted in a prior taxable year, there will be immediate use, so that the net operating loss deferral provisions do not apply.
a permanent forgiveness of the initially deferred tax. Viewed in a somewhat different fashion, as suggested by the Senate Finance Committee in 1969, the expiring net operating loss then becomes available to reduce the deferred minimum tax base.

Interesting things occur, however, when the net operating loss carryover has to be reduced under section 172. Here, the proposed regulations state that the tainted portion must be used up first. Thus, assume that Ace is a sole proprietorship doing business as the Ace Diversified Mining Company. In 1977 it incurs a net operating loss of $500,000, which Ace (the individual) carries over to 1978. Of this amount, $200,000 is tainted, carrying with it a potential minimum tax of $30,000. In 1978, the proprietorship cuts down substantially on its activities and receives gross (ordinary) income of only $300,000. Ace (the individual) also recognizes a long-term capital gain of $100,000. Current deductions (of a nonpreference nature) total $100,000. Thus, Ace has taxable income for 1978 of $250,000 before taking into account the net operating loss carryover and his personal exemption. The carryover reduces taxable income to zero, and, because the nontainted portion of the carryover is used up first, there would at first appear to be no minimum tax. However, this is not the case. In computing the carryover to 1979, Ace's net operating loss must be reduced by the section 1202 deduction of $50,000. According to the proposed regulations, this $50,000 amount must be taken from the tainted portion of the carryover, even though a nonpreference amount remains. Applying the tax benefit principles established later in the regulations, the regulations conclude that Ace will thereby incur a minimum tax of $7,500—15 percent of the section 1202 deduction. Any other result would make no sense. The problem, however, is that the regulations reach the right result for what would appear to be the wrong reason. The tax benefit results not from the fact that the taxpayer is able to use his section 1202 deduction, but rather from the fact that a deferred preference is being used in lieu of the section 1202 deduction to produce a current tax benefit. Thus, although the regulations come out the other way, there should be a minimum tax where, as the result of the section 172 recomputation, a deferred preference is being used in lieu of a taxpayer's Western Hemisphere trade corporation deduction to produce a current tax benefit. Generally, if the regulations can be criticized, it is because they require the section 172 modification to come first from that portion of a net operating loss carryover attributable to deferred preferences.

Before leaving the Ace Diversified Mining Company, it would be

31 See Proposed Treas. Reg. §§ 1.56-2(c) (1) and (e), Ex. (4), 1.57-4(b) (2), 35 Fed. Reg. 19759-60, 19770 (1970).
interesting to focus on the two major preferences available to those in the oil and gas production business—excess depletion (item number eight on the list of 11) and intangible drilling costs (item number 11). The depletion preference has been around since 1969 and for those in the oil and gas industry, it became markedly less significant in 1975, when Congress made percentage depletion available on only a limited basis to small independent producers. The specific item of tax preference is the amount by which allowable percentage depletion exceeds the adjusted basis of the underlying property, determined on a property-by-property basis. The concept of allowable depletion has been a source of concern to those in the petroleum industry, who have argued that the amount of the preference should be limited to the depletion deduction actually claimed. In view of the specific statutory language, however, it is difficult to justify the conclusion unless some support can be drawn from the new tax benefit provisions.

The intangible drilling cost preference is a recent addition. It was rejected by Congress back in 1969 and reappeared in the House version of the Tax Reform Act of 1976. The proposal went through several stages, with the Conference Committee ultimately agreeing that noncorporate taxpayers should be required to report as an item of tax preference the difference between their intangible drilling and development costs allowable currently and the amount that they could have deducted had these costs been capitalized and deducted either over the life of the underlying well as cost depletion or ratably over 10 years, at the taxpayer's election. The preference is not to apply to nonproductive wells or to taxpayers who choose to capitalize their intangible drilling costs. And the Tax Reduction and Simplification Act of 1977 has reduced the effectiveness of the preference for taxable

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83 The depletion preference was developed by the Senate Finance Committee in 1969; it was also one of the nontaxed items to which personal deductions would have been allocated under the House provisions of the 1969 Act. S. REP. NO. 91-552, 91st Cong., 1st Sess. 114-15 (1969); H.R. REP. NO. 91-413, pt. 1, 91st Cong., 1st Sess. 82 (1969).
85 See H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 302 (1969). The Senate Finance Committee adopted as an item of tax preference the deduction for intangible drilling costs (other than those incurred in drilling a nonproductive well). However, these costs were to be treated as a part of the recoverable cost in determining the depletion preference. S. REP. NO. 91-552, 91st Cong., 1st Sess. 114-14 (1969).
87 The Conference Report defines a nonproductive well and tells taxpayers what to do when it is not possible to determine until after the end of the taxable year whether a well is, in fact, nonproductive. H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 426 (1976).
years beginning in 1977. For one year only, the preference must be computed by reducing the amount determined under the permanent rules by the taxpayer’s net income from all of its oil and gas properties. Even then, there are bound to be complaints that a taxpayer is being penalized twice. Certainly when he goes to sell the property before the useful life is up, it will have a lower basis for purposes of determining gain than if intangible drilling costs had been capitalized. Thus, there will be a larger gain and, if the new section 1254 recapture provisions did not apply, a larger accompanying item of tax preference. However, it is not correct to conclude that the taxpayer is thereby being penalized twice, because the two preferences are quite different.

Having said all of this, let us return once more to the Ace Diversified Mining Company, which we will assume is a corporation for purposes of considering two mechanical problems faced solely by corporations under the minimum tax provisions. In 1978, Ace finds itself with an accumulated earnings problem, and incurs a minimum tax liability of $10,000. Can it deduct this tax in computing its accumulated taxable income? The answer would appear to be “yes”, because the minimum tax is an income rather than an excise tax. If, of course, it were an excise tax, a far more significant deduction for taxes would be available in determining the corporation’s regular income tax liability under Chapter

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89 As a result of the recapture provisions in section 1254, there will be no additional capital gain just because the taxpayer’s basis was never increased to reflect his intangible drilling and development costs. Take, for example, a case in which W (who is not an independent producer and, thus, uses cost depletion) acquires oil and gas property for $1,000x; incurs intangible drilling and development costs of $100x, which he deducts currently; and sells the property for $2,000x after half of the estimated production units have been extracted. Had the intangible drilling costs been capitalized, W’s basis at the time of sale would have been $550x, producing capital gain of $1,450x and a preference of $725x. Because W deducted his intangible drilling and development costs, however, he will have a gain of $1,500x, $50x of which section 1254 will convert into ordinary income, leaving capital gain of $1,450x and a preference of $725x. Thus, the capital gain preference remains the same, regardless of how W decides to handle his intangible drilling and development costs. On the other hand, these costs are currently subject to the minimum tax, even though they represent deferral rather than a permanent escape from tax. The Senate Finance Committee recognized this problem in 1969, but rejected basis adjustments on grounds of complexity. More significantly, the Committee added that “the fact of differing tax for an extended period of time is itself a tax preference for which the . . . tax is a moderate charge.” S. REP. NO. 91-552, 91st Cong., 1st Sess. 117 (1969).
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1, thereby producing circular computations under the basic minimum tax.\footnote{\textit{See Rev. Rul. 77-396, 1977 INT. REV. BULL. NO. 44, at 6. Legislative history indicates that the minimum tax is an income tax covered under section 275. The House Committee Report on the Tax Reform Act of 1975, for example, states that: “Under present law, an additional income tax is imposed on an individual’s or corporation’s tax preferences.” H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 130 (1975).}}

One year later, in 1979, Ace becomes a member of the ABC parent-subsidiary affiliated group, which chooses not to file consolidated returns. By statute, the group is limited to one $10,000 minimum tax exemption. Thus, because two out of its three members (including Ace) incur items of tax preference during the year, it sets about determining how to allocate the $10,000 amount. The statute presently allows the group to adopt the most advantageous apportionment scheme, although in default, the exemption must be divided equally among component members of the group.\footnote{\textit{INT. REV. CODE of 1954, § 58(b); see Proposed Treas. Reg. § 58-1(c), 35 Fed. Reg. 19772-74 (1970).}} Under the Technical Corrections Bill of 1977, however, the exemption would have to be apportioned among each member of the group in proportion to its regular tax deduction.\footnote{H.R. 6715, § 2(b) (2), 95th Cong., 1st Sess. 99 (1977); \textit{see H.R. REP. NO. 95-700, 95th Cong., 1st Sess. 9-10 (1977).}} Otherwise, the group would be able to allocate the $10,000 amount to relatively low tax-paying members of the group so that together they could obtain an exemption in excess of that available to a single corporation (which was untrue under pre-1977 law when the minimum tax exemption was $30,000 plus a corporation’s regular tax).

\textit{Foreign Source Income: The Nature of the Preference}

The treatment of foreign source preferences brings us once again back to the concept of tax benefit. This time, the statute specifically states that items of tax preference (putting aside for the moment items number six and nine dealing with stock options and capital gains) attributable to sources within any foreign country or United States possession must be taken into account under the minimum tax to the extent that they reduce the regular tax imposed by the United States on income derived from sources within the United States.\footnote{\textit{INT. REV. CODE of 1954, § 58(g) (1). Proposed Treas. Reg. § 1.58-7(b) (1), 35 Fed. Reg. 19777 (1970), deals with the determination of what preferences are attributable to sources within any foreign country or United States possession.}} The proposed regulations construct an apportionment scheme. Thus, foreign source preferences will reduce the regular tax on United States source income to the extent of the smallest of three amounts—foreign source preferences, foreign source deductions in excess of foreign source gross
income, or United States source taxable income.\textsuperscript{44} The approach is not unlike that taken on the domestic side when the taxpayer incurs a net operating loss for the year, in that the preference items are stacked last. But the consequences are quite different. The net operating loss approach results in deferral or forgiveness of the minimum tax. The stacking of foreign preference items last, however, maximizes the minimum tax impact by filling up the difference between foreign source deductions and foreign source gross income first with foreign preference items. This is consistent with the statutory mandate that preference items must be used before nonpreference items in computing a taxpayer's Chapter 1 tax.

When the taxpayer with both domestic and foreign source income incurs an overall net operating loss, the simple apportionment scheme in the proposed regulations turns into what some might characterize as a three-legged monster. The problem will arise when United States source taxable income is not large enough to currently absorb all of the foreign preferences which have been apportioned to the taxpayer's foreign source net operating loss. Under the proposed regulations, these unused amounts must be held in suspense until they offset the taxpayer's United States source income in subsequent or earlier taxable years. If they never do, of course, they will never be converted into actual items of tax preference. Thus, the problems of apportionment start all over again. The regulations tell taxpayers how to allocate their deductions from other years so that they can determine the extent to which unused foreign source preferences produce a tax benefit by reducing United States source taxable income in the year to which they are carried. There are four principles: deductions attributable to United States source income offset taxable income from United States sources before any remaining portion of the net operating loss; then deductions attributable to foreign sources offset taxable foreign source income; within this latter group, nonsuspense preferences must be used up first; and finally, suspense preferences offset United States source taxable income before other foreign deductions.\textsuperscript{45} In this fashion, the conversion of suspense preferences into actual preferences is maximized. But the process does not stop at that point. Having identified the preference, the taxpayer must determine the extent to which it can be used. When there is a net operating loss carryforward, the full amount of the converted preferences may not always be useful on an immediate basis, because in computing a taxpayer's current tax liability under normal

\textsuperscript{44} Proposed Treas. Reg. § 1.58-7(c) (1) (i), 35 Fed. Reg. 19779 (1970), dealing with a taxpayer on the overall foreign tax credit limitation. Different rules apply to taxpayers using the per country foreign tax credit limitation, which has generally been repealed. For taxpayers claiming a foreign tax deduction, the apportionment scheme developed for those on the overall foreign tax credit limitation will presumably apply. See S. REP. NO. 91-552, 91st Cong., 1st Sess. 115 (1969).

net operating loss procedures, nonpreference deductions must always be used up first before taking into account preference items. Any unused amounts can then be carried forward for use in subsequent taxable years, but now as full fledged preferences.\textsuperscript{46}

In the foreign preference world, capital gain items and stock options afford somewhat of an oasis, not on any substantive basis, but because the principles prescribed by statute are conceptually easier to understand. A foreign source preference will not be taken into account if, under the laws of the governing foreign jurisdiction, preferential treatment is not accorded gain from the sale or exchange of capital assets (in the case of preference number nine) or transfers of shares of stock pursuant to stock options (in the case of preference number six).\textsuperscript{47} There are two major issues. What is meant by the term "preferential treatment", and is the capital gain or stock option item of tax preference really attributable to sources outside the United States? The second question, of course, must be answered first, because only a foreign source preference has any chance of escaping the minimum tax. As a result of demonstrated abuse, the proposed regulations now state that when "the sales transaction is arranged in a particular manner for the primary purpose of tax avoidance, all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment, will be considered, and the sale will be treated as having been consummated at the place where the substance of the sale occurred."\textsuperscript{48} The Treasury has also taken a broad approach to the problem of preferential treatment, having rejected their initial view (one which was of particular delight to Bahamian tax shelter enthusiasts)\textsuperscript{49} that failure to tax income of any nature does not afford preferential treatment. Now, deferral, lower effective rates, or no significant amount of tax will be deemed to have bestowed a preference. Then there is the catch-all, which provides that income is accorded preferential treatment if the laws of the foreign country by any other method provide tax treatment for the particular item of income more beneficial than the tax treatment otherwise accorded income by that country.\textsuperscript{50} Thus, the two major issues under the foreign capital

\textsuperscript{47} INT. REV. CODE of 1954, § 58(g) (2).
\textsuperscript{49} See Wall Street Journal, June 2, 1971, at 1, col. 5.
\textsuperscript{50} Proposed Treas. Reg. § 1.58-8(c), 36 Fed. Reg. 12024-25 (1971). Treasury initially took the position that income, in order to be accorded preferential treatment, had to be treated more beneficially for tax purposes than other items of income. Proposed Treas. Reg. § 1.58-8(b), 35 Fed. Reg. 19784 (1970). New regulations were proposed on June 24, 1971, but Congress was still concerned. Thus, in the Revenue Act of 1971, section 58(g) (2) was amended, effective for taxable years beginning after December 31, 1969, to provide that preferential treatment will be accorded an item if the foreign country or United States possession imposes no significant amount of tax with respect to that item. See H.R.
gain and stock option provisions have been resolved in a manner designed to minimize abuse.

**Equipment Leasing: Net Leases and the Grantor Trust**

Equipment leasing has always been a star in the tax shelter field, and so we have two items of tax preference of particular interest to equipment leasing fans—accelerated depreciation on leased section 1245 property (item number three on the list of 11) and the amortization of railroad rolling stock (item number five). The old leased property preference, in effect before the Tax Reform Act of 1976, was relatively narrow in scope. It applied only to property subject to a "net lease", a term which Congress took pains to define essentially by focusing on the extent of the taxpayer's risk. We now have a broader leased property rule (applicable, as in the past, only to individual taxpayers, including subchapter S corporations and personal holding companies) under which the preference is the amount by which the allowable depreciation exceeds the deduction which would have been allowable had the taxpayer depreciated his property under the straight-line method for each year of its useful life during which he holds the property. There are a number of interesting nuances expressed in the proposed regulations. The preference must be determined on a property-by-property basis, so that when the straight-line depreciation exceeds accelerated depreciation with respect to a particular piece of equipment, the excess cannot be used to offset the preference attributable to another item. On the other hand, two or more items may be viewed as a single item (as is true in the case of the section 1250 property preference, item number two on the list of 11) where the periods for which depreciation is claimed begin on the same date, and the same method, rate and estimated useful life have been used continually for purposes of taking depreciation.

Special rules also determine the allowable and straight-line elements of the tax preference computation. Straight-line depreciation is to be computed by using the same useful life and salvage value that the taxpayer used for the first year in which he depreciated the property unless, of course, one or the other or both were not used under the method of depreciation chosen by the taxpayer or an artificial period became the useful life. Then the useful life and/or salvage value which would have been proper had depreciation actually been determined under the straight-line method will be determined by taking into account the

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52 Proposed Treas. Reg. § 1.57-1(c) and (b) (2) and (4), 35 Fed. Reg. 19761-63 (1970).
same facts and circumstances (presumably including the availability of an asset guideline period) that would have been taken into account by the taxpayer had he used that method throughout the period the property was held. Both straight-line and allowable depreciation include first-year bonus depreciation, so that these additional amounts will not be subject to the minimum tax. Similarly, allowable depreciation will not include any amount allowable for the year during which the underlying property is sold, to the extent that the deduction is recaptured as ordinary income. Then, the need for a minimum tax disappears, for there ceases to be deferral.

The preference for railroad rolling stock (which applies to all taxpayers) is computed in quite a different way, although conceptually the leased property and railroad rolling stock preferences are the same. If a taxpayer has elected to amortize the cost of a boxcar, for example, over a period of five years, the difference between the allowable deduction and the depreciation deduction which would otherwise have been allowable for the particular taxable year will constitute an item of tax preference. Again, the computations are to be made on a property-by-property basis, but in determining what constitutes a separate unit, the proposed regulations this time look to the rules developed for certified pollution control facilities (preference number four on the list of 11). There is also a difference in the offset. In the case of railroad rolling stock, it is depreciation otherwise allowable under any of the available methods and, where relevant, the additional first-year amount.53

We have, then, a minimum tax structure aimed at equipment leasing deals. But how effective has it been? One obvious problem is the fact that the leased property provisions do not apply to regular corporations. Thus banks, for example, can go around participating in equipment leasing transactions without being at all concerned about the minimum tax. They can even participate through grantor trusts which enable them to insulate themselves from direct liability should anything go wrong. The proposed regulations kindly point out that where accelerated depreciation on section 1245 property subject to a lease is apportioned from a conduit entity (such as a grantor trust) to a regular corporation, the amount so apportioned will not be treated as an item of tax preference.54 This is quite apart from the fact that the new at risk provisions do not apply to regular corporations and that if two regular corporations decide to engage in equipment leasing through a partnership, the partnership at risk provisions will not apply.55 Clearly, banks and other corporations which engage in equipment leasing are the fair-haired boys.

53 Proposed Treas. Reg. § 1.57-1(e) and (d) (2) and (4), 35 Fed. Reg. 19763-64 (1970). In general, rapid amortization for railroad rolling stock under section 184 is available with respect to qualified property placed in service after 1968 and before 1976.
55 See JOINT COMMITTEE EXPLANATION 97.
The traditional equipment leasing shelters set up as limited partnerships do not fare so well. For them, there is no way out of the minimum tax or the at risk provisions unless by some miracle the underlying contractual commitment to the user does not involve a lease.56

Charitable Trusts: Excess Itemized Deductions and the Exemption

Jonathan Tree is really a very generous person. In fact, he fathers four charitable trusts: Trust A, set up in 1966, under which all of the interests are set aside for Xavier University; Trust B, also set up in 1966, under which he reserves for himself the life income interest, with remainder to Xavier Prep; Trust C, a charitable remainder annuity trust established in 1977, under which Jonathan is to receive an annual annuity of $5,000, with remainder to the United Fund; and Trust D, a charitable annuity trust also established in 1977, under which the Peach Blossom Community Church is to receive a guaranteed annual annuity of $20,000, with remainder to Jonathan's daughter upon the death of his wife. Up until 1976, the 1966 trusts did not really have to pay any attention to the minimum tax, because their investments were limited to stocks, bonds and government securities. In a very accommodating move, the Service made it clear that where capital gains were set aside for charity and the charitable set aside deduction continued to be available under section 642(c), the section 1202 deduction taken into account in computing trust taxable income would not be viewed as an item of tax preference because there could be no real enjoyment of the preference given the fact that without it, the capital gains would still have been fully exempt from tax.57

Then along came the Tax Reform Act of 1976, with a new preference called excess itemized deductions. The basic concept is quite simple. Congress was concerned about the fact that a number of individuals with high adjusted gross incomes were paying no tax. Thus, in order to make it possible to impose some tax on itemized deductions, Congress developed an item of tax preference (number one on the list of 11) for the amount by which a taxpayer's total deductions (after excluding certain excepted amounts) exceed 60 percent of his adjusted gross income.58 Exceptions were provided for those deductions allowable in

56 The term "lease" is defined in the proposed regulations. Proposed Treas. Reg. § 1.57-3(d), 35 Fed. Reg. 19769 (1970). Also, the Internal Revenue Service has recently taken an expansive approach to the problem in a revenue ruling which holds that an individual who buys a master record and licenses it to a record producer, who will manufacture records for sale and pay him a royalty for each one sold, is "leasing" property in a transaction subject to the at risk provisions of section 465. Rev. Rul. 77-397, 1977 INT. REV. BULL. NO. 44, at 7.


58 See H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 131 (1975) (referring to itemized deductions in excess of 70 percent of adjusted gross income); S. REP.
arriving at adjusted gross income, the standard deduction, personal exemptions, medical expenses and casualty losses. It was all quite logical in the context of a human taxpayer. The preference, however, was also to apply to other individual taxpayers, including estates and trusts. For this latter group, Congress developed a special set of rules, so that certain additional items such as administration expenses and mandatory income distributions to beneficiaries would be viewed as deductions allowable in arriving at adjusted gross income.

These new provisions really left the trustees of Jonathan's 1966 trusts up a tree. Nowhere did Congress discuss how to handle the charitable deduction available to trusts under section 642(c). Was it possible that a charitable deduction would produce an item of tax preference even where all interests were set aside for charity? If so, how would Trust A, for example, compute its minimum tax exposure? Suppose that the trust had gross income (from interest and dividends) of $20,000, a $20,000 charitable set-aside, administration expenses of $2,000 (payable out of corpus), and a personal exemption of $100. Presumably, the trust was supposed to apply 60 percent to $18,000 (income of $20,000 less the administration expenses) and deduct the result ($10,800) from $18,000 (the charitable deduction), to arrive at preference income of $7,200. But even this simple calculation was not clear. What was the trust to do about its personal exemption; as in the case of a human taxpayer, would it not be appropriate to reduce the potential preference by this amount, even though there was no specific statutory authorization? What about the concept of tax benefit? Was it proper to assume, as the figures do, that the trust used up its good deductions first in computing taxable income? Also, when Congress provided that administration expenses were to be treated as a deduction allowable in arriving at adjusted gross income, did it mean to say that the 60 percent figure was to be applied to actual adjusted gross income unreduced by administration expenses? This nice guy approach would reduce the preference as previously computed by $1,200.

Trusts were not the only people with problems under the new excess itemized deductions preference, which soon after enactment (as a result of the zero bracket amount changes made by the Tax Reduction and Simplification Act of 1977) was relabeled a preference for "adjusted itemized deductions." How, for example, were subchapter S corporations and personal holding companies (both viewed as individual taxpayers for purposes of the minimum tax) to compute adjusted gross income, which for them was an alien concept?

The Technical Corrections Bill of 1977 as passed by the House


50 Pub. L. No. 95-30, § 101(d) (5) (A) and (B), 91 Stat. 133, amending INT. REV. CODE of 1954, § 57(a) (1) and (b).
would solve many of these problems. The preference for adjusted item-
ized deductions would clearly not apply to subchapter S corporations
and personal holding companies. An estate or trust would not be
required to treat its personal exemption as a tainted itemized deduction
(viewed by the House Committee Report as simply a clarifying amend-
ment). Also, the charitable deduction would not be viewed as an
itemized deduction under four circumstances—in the case of an estate,
where there is no real opportunity for tax planning; in the case of a
wholly charitable trust, where imposing the minimum tax as the result
of a gift to charity would simply harm the charitable beneficiaries; in
the case of a pooled income fund, where the same thing would occur;
and, finally, in the case of deductions attributable to pre-1976 transfers
in trust, made before the grantor had reason to know that charitable
trusts afforded an opportunity to avoid the minimum tax on adjusted
itemized deductions at the human taxpayer level. The 1977 Bill does
not deal specifically with charitable remainder trusts because they are
generally exempt from both the income and minimum tax.

Let us return, then, to Jonathan's Tree's 1966 trusts and the two
that he was daring enough to set up in 1977. If the 1977 Bill changes
take effect, Trust A will not have to worry about the adjusted (or
excess) itemized deductions preference, in part because it is wholly
charitable. Trust B will be safe because it was created long before the
adjusted itemized deductions preference was conceived—unless, of
course, additional property is transferred to the trust after 1975). Also,
newly established Trust C will be safe because charitable remainder
annuity trusts are normally tax exempt. This leaves Trust D, the only
problem child. Were it not, Jonathan Tree could use this and similarly
created trusts to avoid the minimum tax. The possibilities are fasci-
nating to behold. Jonathan, of course, is a very charitable man, so that
it is quite likely that on his own he will want to give more than 60
percent of his adjusted gross income to charity each year, thereby
triggering the adjusted itemized deductions preference, offset by only
a single minimum tax exemption. Why, then, not avoid the entire prob-
lem by making charitable gifts through a charitable lead trust such as
Trust D? To close this way around the adjusted itemized deductions
preference, the statute now applies the preference to charitable lead
trusts; deliberately, the 1977 Bill would make no change.

But what real impact will the preference have on Trust D, assuming
gross income of $20,000 (all of which is paid to the Peach Blossom
Community Church), administration expenses of $2,000, and a $100
personal exemption? The exact amount of the adjusted itemized deduc-
tions preference will be $7,100, based on two significant conclusions—

60 See H.R. REP. NO. 95-700, 95th Cong., 1st Sess. 9 (1977). See also JOINT
COMMITTEE EXPLANATION 108.
60 percent is to be applied to adjusted gross income less administration expenses and, in fact, the trust receives a tax benefit from the charitable contribution of only $17,900 ($20,000 less administration expenses and the personal exemption), thus reducing the charitable deduction for purposes of the preference to $17,900. We then come to the more interesting question: Will the trust be able to use the full $10,000 minimum exemption, thereby reducing its minimum tax liability to zero, or should the Peach Blossom Community Church be responsible for paying the minimum tax, after taking into account its own $10,000 minimum exemption? The statute indicates that a trust must apportion its items of tax preference between the trust and its beneficiaries, on the basis of trust income allocable to each. Here, of course, the Peach Blossom Community Church receives all trust income. Is it possible that the church thereby becomes the lucky recipient of a tax preference? The answer is probably “no”, because the church is not the recipient of trust distributable net income; instead it receives only a charitable gift. This approach would leave the preference at the trust level, presumably with the benefit of a full $10,000 minimum exemption, in that the statute requires a trust to give up part (or all) of its exemption only when preference items are allocated to beneficiaries. Trust D may, therefore, not be such a bad idea after all. In fact, it might even make sense to set up a number of separate trusts modeled after Trust D, in order to receive the benefit of multiple $10,000 minimum exemptions. However, there will always be the problem of substance over form.

Transfers of Appreciated Property in Trust: Computing the Minimum Tax

Trusts have always been a useful tax planning tool. Before the Tax Reform Act of 1976, one popular number was the peddler's second pocket. The setting was classic. The peddler was just about to sell some of his appreciated securities, when he suddenly realized that the resulting income tax liability would be enormous, in fact around 50 percent of the resulting gain (due in part to the reduction in his personal service income subject to the maximum tax). How could he cut back on this amount and still direct the destiny of the proceeds? The obvious answer was a trust, funded with the appreciated property. Upon receiving the

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63 Section 2(b) (3) of the Technical Corrections Bill of 1977 might be read so that administration expenses would be included as part of adjusted gross income to which 60 percent must be applied, but would be excluded (as a deduction “allowable in arriving at adjusted gross income”) in determining the extent to which itemized deductions exceed the floor. Such an interpretation is difficult to support.


65 INT. REV. CODE of 1954, § 58(c) (2).
property, the trust could sell it and pay a tax at significantly lower rates.66

Gone, however, are the good old days. Now, whenever appreciated property is sold at a gain within two years after it is transferred in trust, the trust will be taxed on the unrealized gain at the time of the transfer in trust as though it had been recognized by the grantor—at his top marginal rate. There may also be a minimum tax.67 In this context, there are some interesting computational problems. Suppose, for example, that Trust E (an accumulation trust) realizes a long-term capital gain of $50,000 upon the sale of nondepreciable property that it received from the grantor and held for a period of one year, during which there were no further price fluctuations. The gain will produce $25,000 of tax preference income, which will have to be included among the grantor's items of tax preference in order to determine the resulting minimum tax at the trust level. Only the grantor's minimum exemption of $10,000 will be available to offset the amount subject to tax. But then, what happens to the minimum exemption available to the trust? Trust E is required to accumulate income, so that normally the exemption would not disappear. However, the trust can distribute principal, and in fact decides to do so in the year during which the sale occurs, by distributing the gain to beneficiary Jones. Does the trust thereby lose all or some portion of its $10,000 amount? If the trust also has another capital gains preference of $25,000 and no other net income for the year, the answer may be that half of its exemption will disappear, on the theory that half of the items of tax preference end up in the hands of Jones. On close analysis, however, does this make any sense? Perhaps, for purposes of allocating the minimum exemption, items of tax preference taxed at the grantor's rates should not be viewed as preferences in the hands of the trust.68

Let us switch, now, to the grantor who, for computational purposes only, will have to include the long-term capital gain of $50,000 in his regular income tax base. Without this amount, the grantor has taxable income of zero, a net operating loss carried over from the prior taxable year of $50,000 (all attributable to nonpreference items), and no current items of tax preference. Will the $50,000 carryover reduce the long-term capital gain coming from the trust to zero, so that the grantor will have neither "reconstructed" taxable income (after the section 1202 deduction) nor "reconstructed" items of tax preference? The answer should be no, because even if the $50,000 carryover is applied against the gain, it will have continuing vitality in subsequent taxable years of the grantor (assuming that the carryforward period has not expired), given the fact that the gain never really becomes a part of the grantor's

67 INT. REV. CODE of 1954, § 644; see S. REP. NO. 94-938, 94th Cong., 2d Sess. 172-74 (1976); JOINT COMMITTEE EXPLANATION 162-64.
income tax base—it is merely assumed to be part of his income for purposes of determining the tax payable by the trust. The Technical Corrections Bill of 1977 confirms this result.69

Postscript

The future approach to tax shelters is uncertain. Should Congress attack them directly by eliminating preference items such as accelerated depreciation; should the minimum tax be expanded to pick up additional items, such as rapid amortization for historic structures, or modified to become an alternative tax; or should a greater effort be made to match income and deductions, both from the point of view of timing and the uses to which income items are put? The analysis will continue, but at present it is certain that the tax shelter world has been dealt a serious blow, in part by the current mini-maxi tax.

In Memoriam

LAURENCE NEAL WOODWORTH*

For all of its infinite and tedious complexity, the federal tax code maintains a sense of decency and reason. It has a coherent architecture. You might wonder how that happens since, notoriously, every major tax bill is finally enacted in an atmosphere of extreme confusion, haste, passion and anxiety. For the past 15 years one leading reason for the tax system's integrity was the vigilance of Laurence Neal Woodworth, who died this week. He had joined the Carter administration earlier this year as Assistant Secretary of the Treasury for tax policy, but previously he had been the staff director of the Joint Committee on Taxation.

A tax system is a nation's definition of social equity—its answer to the great question of what's fair. In taxation, the large philosophic issues never lie far behind the niggling legalistic details. The role of the congressional staff experts on taxation is not a comfortable one. The tax committees are generally led by tough and strong-willed men; stakes run high, and no bills are more fiercely lobbied. Under weak leadership, the Joint Committee's staff would have been ground to powder long ago between its two masters in the House and Senate. Under Mr. Woodworth, it built a monumental reputation for impartial and authoritative judgment. When, for example, Congress needed an unimpeachable expert for the ugly job of auditing Mr. Nixon's tax returns, it turned automatically to Mr. Woodworth.

To work effectively, the congressional system requires enormous talent and industry among its staffs. Those qualities are very unevenly distributed through the labyrinths of the congressional offices. But the staff of the Joint Committee on Taxation has become an acknowledged model. Mr. Woodworth always left the political decisions to the politicians, and never tried to undercut them with technical obfuscation. But he worked long into the nights after the committee meetings to ensure that the politicians understood the consequences of their votes. Even the most flamboyant of senators was unlikely to press an idea in the face of Mr. Woodworth's warning that it wouldn't work. His death now is a double misfortune to the Carter administration. He was the key figure in the drafting of the President's tax-revision bills. But he was also the administration's principal ambassador to Congress on this delicate subject, and he had earned a degree of trust and respect there that no other person at the Treasury enjoys.

He was a remarkable example of a certain style of public servant—one who is rarely a noted public figure, but who acquires a profound influence through sheer intellectual force and honesty. His subject was one that touches all of us every day. It is an American custom to complain about the tax system's vices while taking its virtues for granted. They are not accidental, but were written into law by a small number of people—among whom Mr. Woodworth was eminent—who labored with learning and skill in pursuit of the just balance between public and private interests.