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THE "LIMITATION ON ARTIFICIAL LOSSES" AND ITS IMPACT ON FILM AND REAL ESTATE TAX SHELTERS

ROBERT FEINSCHREIBER

The U.S. Congress is now actively considering legislation that would sharply curtail benefits from tax shelters. The technical and policy aspects are considered herein. In general, the proposed legislation is questionable from a policy standpoint, and is too harsh from a technical standpoint if the policy objectives of its proponents are to be accepted.

The LAL Concept

When a new business is established or a new investment made, expenditures typically exceed income during the startup phase. Present tax law reflects this economic reality by permitting current deductions for many of these expenditures. Congress is concerned that, in certain instances, the deductibility feature is abused by permitting losses from the venture to offset income from other sources. The use of losses from one venture to counterbalance unrelated income is termed a tax shelter, or using the parlance of the tax legislation, "an artificial loss." The Tax Reform Act of 1975¹ is designed to restrict the use of these losses.

The Limitation on Artificial Losses ("LAL") plan would delay the deduction of various expenditures that are now current deductions. The general scheme of the LAL proposal is that losses designated as artificial accounting losses will not be allowed as current deductions but will be placed in a suspense account until income is earned to match these expenditures or until the venture comes to an end. This analysis describes how LAL will operate if enacted.

A deduction which precedes the income it generates is termed an "accelerated deduction." When an item is treated as an accelerated deduction, its utilization in a particular year would depend upon the amount of related income. In somewhat more technical terms, accelerated deductions attributable to a class of LAL property are allowed only to the extent of net related income from that property class.² Consequently, determination of related income is of primary importance.

An artificial loss exists to the extent an accelerated deduction exceeds related income. For the purpose of this computation, related income is determined before taking into account any of the accelerated deductions. When accelerated deductions exceed related income, producing an artificial accounting loss, deduction of this balance is postponed

¹ See generally, Robert Feinschreiber, "1973 Tax Reform: The Administration's Proposals", 51 *Taxes* 389 (1973).

² Prop. Sec. 466(a)(1).

to a future year through a deferred loss account.³ The deferred amount could be utilized in later years to the extent related income exceeds accelerated deductions for those years.⁴

To illustrate, if accelerated deductions are \$100,000, but related income is \$20,000, only \$20,000 is deductible currently. The remaining \$80,000 is an artificial loss and would be put into a deferred loss account. If related income in the following year is \$60,000 and accelerated deductions in that year are \$50,000, \$10,000 from the deferred loss account could be utilized.

Application of LAL

Not all taxpayers will be subject to LAL.⁵ LAL is specifically applicable to individuals⁶ and to Subchapter S Corporations.⁷ LAL also applies to certain corporations engaged in farming,⁸ but not to other corporations. Where the partnership form is used, LAL will be applicable to the individual partners.⁹ The proposed statute does not contain specific rules for trusts and estates.

There are six types of LAL property. Property that does not come within one of these six categories will be outside the scope of LAL and exempt from its coverage. Moreover, application of LAL to each covered class will differ in three major aspects: the extent to which deductions are denoted as "accelerated deductions" and thus within the scope of LAL, the extent to which ventures within a class can be aggregated by a taxpayer so that income from one venture will enable losses from another to be deducted currently, and the effective date for the property class.

The six classes of LAL property¹⁰ are real property,¹¹ lease property,¹² farm property,¹³ film property,¹⁴ oil and gas property,¹⁵ and sports franchise property.¹⁶ In general, each property within the class is a separate property so that the losses of one cannot be deducted against the income of another. This general rule applies to lease property,¹⁷ film property,¹⁸ oil and gas property,¹⁹ and sports franchise

³ Prop. Sec. 466(b).

⁴ Prop. Sec. 466(c).

⁵ Prop. Sec. 466(a)(2).

⁶ Prop. Sec. 466(a)(2)(A).

⁷ Prop. Sec. 466(a)(2)(B).

⁸ Prop. Sec. 466(a)(2)(C).

⁹ Prop. Sec. 470(d)(4).

¹⁰ Prop. Sec. 467(a).

¹¹ Prop. Sec. 467(a)(1).

¹² Prop. Sec. 467(a)(2).

¹³ Prop. Sec. 467(a)(3).

¹⁴ Prop. Sec. 467(a)(4).

¹⁵ Prop. Sec. 467(a)(5).

¹⁶ Prop. Sec. 467(a)(6).

¹⁷ Prop. Sec. 467(c).

¹⁸ Prop. Sec. 467(e).

¹⁹ Prop. Sec. 467(f).

property.²⁰ More liberal rules apply to real property and to farm property. In the case of real property, all real property of a taxpayer can be aggregated as one class of property.²¹ Aggregation of farm property is permitted²² except where the property is held through a "farming syndicate"²³ which is a publicly offered limited partnership.²⁴

Policy Considerations

The proponents of Limitation on Artificial Losses proposal have articulated a number of policy considerations in support of their proposal. The proposal was advanced in April 1973 as part of the Nixon Administration's tax package, and was then called "limitation on artificial 'accounting' losses". The Administration viewed the matching of income and deductions as "fundamental to our federal income tax system" and sees LAL as a means of correcting mismatching which results under current law.

Many tax shelter opponents have argued that Congress should not decide the relative social merits of tax shelters but should attempt to foreclose all existing exemptions. On the other hand, it can be argued that tax shelters encourage investments with higher risks and lower economic yields than would otherwise prevail. Consequently, Congress should affirmatively decide whether or not it is in accord with national policy to provide tax subsidies in specific industries.²⁵

Film and Real Estate

This article emphasizes film and real estate tax shelters because they are both industries in which tax shelters are strong, and exist outside the framework of the large corporate oligopolies to a greater extent than do most other industries. Thus, they rely heavily on direct investment by individuals and provide individuals the opportunity to bypass the corporate establishment.

Different considerations apply to the purchase of an existing building or film than are relevant to production or construction of a new film or real estate project. However, these considerations are not wholly separate because the existence of a favorable climate for resale can be an important factor in the feasibility of a new venture. Nevertheless, it appears that initial incentives at the production or construction stage should be of primary importance because the greatest economic risks occur at this initial stage. Consequently, the policy considerations analyzed here are of primary importance to new films and buildings though they may apply to a lesser extent to existing films and buildings.

²⁰ Prop. Sec. 467(g).

²¹ Prop. Sec. 467(b).

²² Prop. Sec. 467(d)(1).

²³ Prop. Sec. 467(d)(2).

²⁴ Prop. Sec. 467(d)(3).

²⁵ See "Response" by Robert Feinschreiber, Vol. 4, No. 1, Tax Notes, p. 30 (1976).

How LAL Would Affect the Film Industry

LAL film property is one of the six classes of "LAL property". The proposed statutory definition of LAL film property is "any motion picture film or video tape created primarily for use as public entertainment and any right to produce, distribute, or display such a film or tape."²⁶ Each motion picture film or video tape would constitute a separate class of property.²⁷

Accelerated deductions with respect to film property would include two types of deductions: depreciation or amortization;²⁸ and amounts attributable to producing, distributing, or displaying public entertainment motion picture films or video tapes.²⁹

The disposition of any public entertainment film or video tape, or of production, distribution, or display rights to such public entertainment film or video tape will be treated as a disposition of an LAL class³⁰ so any balance in the deferred deduction account for that film or video tape will be allowed as a deduction if otherwise deductible.³¹ Also, entertainment films and video tapes will be deemed to be disposed of at the earlier of two specific dates, if not actually disposed of at an earlier date³² One of these two dates is based on income,³³ the other is the close of the seventh taxable year following the year in which the property is placed in service by the taxpayer.³⁴

The deemed disposition based on income is more complex and requires explanation. First, it is necessary to determine the taxable year in which 95 percent or more of the income forecast for the film, tape, or rights has been received or accrued.³⁵ The year of deemed disposition is presented by the following table:

<i>Year in which 95 percent of forecast income has been received or accrued</i>	<i>Year of deemed disposition</i>
1	3
2	3
3	4
4	5
5	6
6	7
8 or later	8

²⁶ Prop. Sec. 467(a)(4).

²⁷ Prop. Sec. 467(e).

²⁸ Prop. Sec. 468(d)(1).

²⁹ Prop. Sec. 468(d)(2).

³⁰ Prop. Sec. 469(b)(1).

³¹ Prop. Sec. 469(a).

³² Prop. Sec. 469(c)(2).

³³ Prop. Sec. 469(c)(2)(A).

³⁴ Prop. Sec. 469(c)(2)(B).

³⁵ Prop. Sec. 469(c)(2)(B).

The year in which the film or tape is placed in service is year 1. In more technical terms, the deemed distribution rule works as follows: The year of the deemed disposition is the year following the year in which 95 percent or more of the income forecast for such property is received or accrued,³⁶ unless this occurs after the seventh year following the year in which the property is placed in service,³⁷ or unless 95 percent or more of income forecast is received in the year in which the property is placed in service.³⁸ In the latter situation, another rule applies that prohibits the deemed disposition from taking place earlier than the close of the second year following the year in which the property was placed in service.³⁹ In that event, the deemed disposition will take place at the end of the second year following the year the property was placed in service, which is year 3.⁴⁰ Note that "placed in service" means placed in service by the taxpayer and that "year" means taxable year.⁴¹

Enactment of the LAL plan with respect to the film industry will have adverse consequences to the nation as a whole, not just to the film industry. These are seven results that would emanate from the changes in the tax law:

1. Shift tax shelter benefits away from American investors for the benefit of foreign investors.
2. Shift increasing amounts of film production outside the United States.
3. Increase unemployment in the U.S. film industry.
4. Weaken the American share of the worldwide film industry.
5. Cause increased economic concentration in the portion of the U.S. film industry that remains.
6. Weaken the U.S. balance of payments.
7. Diminish U.S. influence throughout the world and increase foreign influence in the United States.

It is now appropriate that we take the opportunity to examine each of these seven potential consequences to the film industry and the nation.

Shifting Tax Shelter Benefits

Enactment of LAL and restriction of deductions to the amount at risk will make film tax shelters less viable for Americans than these shelters have been in recent years. However, these tax changes will not affect foreign investment in foreign films and will not cause any

³⁶ Prop. Sec. 469(c)(2)(A).

³⁷ Prop. Sec. 469(c)(2)(B).

³⁸ Prop. Sec. 469(c)(2), flush language.

³⁹ Prop. Sec. 469(c)(2), flush language.

⁴⁰ Prop. Sec. 469(c)(2), flush language.

⁴¹ Prop. Sec. 469(c)(2)(A) and Prop. Sec. 469(c)(2)(B).

difficulty for the very limited amount of foreign investment in United States film ventures.

Many foreign countries provide substantial incentives for film production. These incentives include outright grants, tax shelter benefits, and numerous other preferences. Countries such as Italy, Canada, and Germany provide these benefits. In many cases, these foreign film incentives are substantially greater than the film incentives that prevail in the United States. Moreover, the enactment of LAL or the restriction on the deduction of losses will have no effect on these investments unless at some future date foreign countries copy the U.S. laws.

Consequently, film investment by foreigners will continue unabated while American film investment is handicapped.

Shift of Film Production

The proposed U.S. tax changes will cause film production by U.S. companies to be shifted outside the United States and will cause foreign film companies to profit at the expense of the U.S. film industry. The departure of many productions will result because much of the financing will come from outside the United States. Canada, Iran, and West Germany are frequently cited as countries where financing can be obtained. Financing, of course, can be tied to production so that production will also shift from the United States.

Employment

There is already substantial unemployment in the film industry but the shift of additional production outside the United States will cause additional unemployment in the film industry. According to a major article in *Variety*, "If Shelter Goes, Film Runaway Romps", 68 percent of the production cost of a typical feature film goes to payroll and suppliers.⁴² The most recent data for film unions and guilds shows the following unemployment data: 50 percent of the grips are unemployed, 51 percent of the makeup people are unemployed, 56 percent of the script supervisors are unemployed, 63 percent of the motion picture electricians are unemployed, 75 percent of the plasterers are unemployed, 85 percent of the members of the Screen Actors Guild are unemployed, and 90 percent of the members of the Screen Extras Guild are unemployed.⁴³

American Share of the Film Industry

The shift in production overseas will ultimately work to the disadvantage of American based film companies to the advantage of their foreign competitors.

⁴² *Variety*, November 26, 1975, p. 3, p. 25.

⁴³ *Variety*, November 26, 1975, p. 3.

Economic Concentration

A major portion of the U.S. film industry is controlled by large corporations. Some of these large corporations are part of still larger conglomerates. These large corporations tend to be well-financed and less dependent on tax shelter financing than are smaller companies and independent producers. In addition, the film companies that are part of conglomerates are able to rely on these conglomerates for sustenance during lean years. As a result, the elimination or sharp curtailment of film tax shelters will have a severe adverse effect on small film companies and independents, but no adverse effect on industry giants. As a result, the largest film companies will increase their share of the market at the expense of the other companies and independents.

Balance of Payments

The U.S. film industry is a major positive factor in the balance of payments, earning in the hundreds of millions of dollars every year for the United States. Weakening the U.S. film industry through the curtailment or elimination of film tax shelters will ultimately cause a diminution in international film earnings for the United States and will result in a net overflow of payments.

U.S. Influence

It should be remembered that U.S. films can help spread American culture and values throughout the world. To the extent that our nation seeks to be an exporter of "the American way" rather than an importer of foreign values, a strong film industry is important. The proposed tax changes would serve to defeat this objective.

How the Film Industry Views Tax Shelters

Variety reports that Columbia is the major film production-distribution company that has benefitted most from tax shelter financing.⁴⁴ On the other hand, Metro-Goldwyn-Mayer has not yet used tax shelter financing in film production and has no plans to do so, according to *Variety*.⁴⁵

The curtailment of tax shelter investment in the film industry can have a serious impact on the industry itself, according to David Begelman, President of Columbia Pictures. He was quoted in *Variety* as stating "there will be fewer pictures to be made, fewer films to exhibit and greater unemployment."⁴⁶ From a revenue standpoint, Mr. Begel-

⁴⁴ "Columbia Plan for Retaining Advantages from Tax Shelter While Curing Admitted Abuses", *Variety*, November 26, 1975, p. 3.

⁴⁵ "Metro Features, Using UA Sales, Has No Need for Tax Shelter", *Variety*, November 26, 1975, p. 3.

⁴⁶ "Begelman Hopeful That Tax 'Deferral' Will Escape the Axe", *Variety*, November 26, 1975, p. 24.

man asserted that the net effect of the proposed tax changes will cause the Internal Revenue Service to receive fewer dollars from the film industry, and that this decrease will more than offset present revenue losses from film tax shelters.⁴⁷

*How LAL Would Affect the Real Estate Industry*⁴⁸

LAL real property is defined as property which is or will be a capital asset under Section 1221, held for rental, or personal or other depreciable property as provided under Section 1245.⁴⁹ This definition includes existing property, as well as property to be constructed, or reconstructed.⁵⁰

The LAL proposal would treat many otherwise deductible costs incurred during the construction period as accelerated deductions.⁵¹ Because no income is generated during the construction period, the entire amount of these expenditures would constitute artificial accounting losses. It is uncertain whether costs incurred with respect to land, as well as those attributable to the building, are encompassed within this provision. Thus, interest charges on amounts borrowed for acquiring or carrying the property will be deferred.

A broad range of taxes constitute accelerated deductions, considering the nature of the tax and the type of taxing jurisdiction.⁵² Foreign, state, and local taxes are presumably encompassed within this provision. Taxes included within this rule for construction period costs are property taxes, use taxes, and income taxes.

The LAL provisions allow for special transition rules in certain instances. In general, construction begun before January 1, 1976, is not subject to artificial loss limitations.⁵³ In the case of residential property, if a site is selected and permanent financing obtained before January 1, 1977, construction period costs will be currently deductible if construction begins prior to January 1, 1978.⁵⁴ Also included under the transition rules is low-income housing. LAL accelerated deductions provisions do not apply to construction or rehabilitation projects where financing is obtained prior to January 1, 1979, and the construction period begins before January 1, 1981.⁵⁵

Enactment of the LAL proposal would have a severe and adverse impact on the real estate industry. While intended to limit tax shelter benefits, here are six considerations that indicate how the LAL scheme

⁴⁷ *Ibid.*

⁴⁸ See also, Robert Feinschreiber, "The New Tax Proposals: Lowering the Boom on Real Estate", Vol. 3, No. 3, Real Estate Review 18 (1973).

⁴⁹ Prop. Sec. 467(a).

⁵⁰ Prop. Sec. 470(a)(2).

⁵¹ Prop. Sec. 468(a)(1).

⁵² Prop. Sec. 468(a)(1)(B).

⁵³ Prop. Sec. 470(c)(1).

⁵⁴ Prop. Sec. 470(c)(2).

⁵⁵ Prop. Sec. 470(c)(3).

will work to the detriment of real estate and other aspects of the economy.

(1) Property taxes are much greater in urban centers than in rural areas at the outskirts of American cities. If property taxes during construction cease to be an immediate tax deduction, builders will be forced away from localities where property taxes are high. Thus, LAL would cause land to be removed from agricultural production while cities decay.

(2) The elimination of current deductions for construction period interest and taxes would increase the tax bill of America's builders. This additional cost would deter building, even though housing and industrial facilities are in short supply, or would be passed on to consumers as higher prices or higher rents.

(3) The construction industry is highly cyclical. Shutdowns and startups are expensive too. Current deductions for construction period interest and taxes lessens the builder's risk and therefore encourages construction in periods of relative inactivity.

(4) If construction period interest and taxes aren't currently deductible, there will be a temptation to shortcut the construction period, which may adversely affect the quality of construction.

(5) Denial of current deductions for construction period interest is especially burdensome now with financing costs near their all-time peak.

(6) To encourage real estate development, without abuse of real estate as a tax shelter, the investment credit should be extended to buildings. The use of tax shelters would be discouraged (because the investment credit depends on taxable income) while the tax discrimination against buildings would be lessened.

*Limiting Tax Shelter Benefits—A Proposal*⁵⁶

Tax shelters can be and often are abused. In some shelters, investors can wind up with a negative income tax to the extent that they invest in shelters. This happens because they save more in taxes than they invest in the shelter. Suppose a tax shelter provides three dollars of deductions for every dollar invested. An investor in the 50 percent bracket who puts \$10,000 in the shelter will get \$30,000 in deductions and save \$5,000 in taxes. Thus, the individual will have an extra \$5,000 because of the tax shelter.

When an investor makes an initial net profit by making an investment in a tax shelter, the investor has every incentive to maximize the writeoff ratio (the ratio of deductions to investment) and relatively little incentive to be concerned with the economic merits of the

⁵⁶ Robert Feinschreiber, "Limiting Tax Shelter Benefits: An Alternative to LAL", *Tax Notes*, Vol. III, No. 46, pp. 43-45. Reprinted by permission of Tax Analysts and Advocates. See also, *Tax Notes*, Vol. IV, No. 1, pp. 29-31.

investment. If tax shelters are to serve as an economic incentive, as their proponents claim, this abuse should be eliminated.

I propose that a limitation on tax shelter benefits be imposed so that no investor can get an initial tax benefit from the shelter that exceeds the investment. Thus, an investor in the 50 percent bracket who puts \$10,000 in the shelter should be limited to \$20,000 in deductions so the tax savings is no more than the \$10,000 investment ($\$20,000 \times 50\%$). On the other hand, a person in the 40 percent bracket who puts \$1,000 in the shelter should be allowed a deduction of \$2,500 so that this person saves \$1,000 in taxes ($\$2,500 \times 40\%$).

*Limitation on Net Tax Shelter Benefits
(as a percentage of investment)*

<i>Tax Bracket</i>	<i>Writeoff Ratio (Deductions ÷ Investment)</i>					
	1.5	2.0	2.5	3.0	3.5	5.0
20	30	40	50	60	70	100
30	45	60	75	90	100	100
40	60	80	100	100	100	100
50	75	100	100	100	100	100
60	90	100	100	100	100	100
70	100	100	100	100	100	100

Under the formula that I propose, the writeoff ratio (deductions ÷ investment) times the tax rate could not exceed 100 percent of the tax. Excess deductions should then be saved for later years.

This technique provides somewhat more favorable tax treatment for investors in lower tax brackets. The Limitations on Artificial Losses proposal now before the Ways and Means Committee does not, and this is a drawback to the LAL scheme.

In fact, the limit on net tax shelter benefits can be set below 100 percent. Moreover, the limit can vary with the interest of Congress in encouraging a particular type of activity. These are some hypothetical limits that reflect my view of what the priorities ought to be:

<i>Type of Investment</i>	<i>Limitation on Tax Shelter Benefits(%)</i>
Low income housing	100
Industrial buildings	98
Domestic film production	95
Commercial buildings	90
Purchase of foreign films	70

Thus, an investor in a commercial building who is in the 60 percent tax bracket would be limited to \$1.50 in deductions for every dollar invested ($60 \times 1.50 = 90$). An investor in the 30 percent tax bracket who makes the same investment would be limited to \$3 in deductions for every dollar invested ($30 \times 3 = 90$).

This approach is substantially different from LAL in that it does not look to the immediate income from the investment as the measure of the allowable deductions. LAL serves to penalize investments where the turnaround time for economic recoupment is long, such as a large construction project. The limitation on tax shelter benefits, as outlined here, will avoid this disadvantage.

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