NON-REAL ESTATE TAX SHELTERS

by

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I have been asked to speak today on the general subject matter of tax shelters, exclusive of real estate tax shelters. When I agreed to speak on this subject, I realized that the subject matter itself could be as narrow or as all-encompassing as I wanted since no one has ever clearly defined a tax shelter. I am sure many if not all of you have had clients ask you, particularly toward the end of the year, to recommend a tax shelter for them, whatever “a tax shelter” may be. In the abstract, I suppose everyone would agree that the ideal tax shelter is a device which requires a minimum investment by the individual, eliminates all tax liability of that individual for that year, will eventually return the taxpayer’s total investment to him in addition to the tax shelter benefits, and will cause no additional tax liability at any time in the future. We would also all agree that this is what our clients expect us to find for them when they call us on December 15 and ask us to provide them with a tax shelter. Since the ideal shelter does not exist, and since there is no clear definition of a tax shelter any way, I have categorized tax shelters generally in terms of their ultimate consequences. Taking this approach, there are basically three types of shelters: (1) the deferral shelter, the major function of which is to shift income from the year in which the shelter interest is acquired to some future year when that interest is disposed of, or in which it produces an income flow in excess of deductible expenditures; (2) the tax avoidance shelter, whose major aim is the elimination of any present tax with either no recapture or minimum recapture in the future, a shelter which is generally non-existent, except perhaps to a limited degree in the real estate area; and, (3) investment-type shelters which tend to combine some degree of tax avoidance or tax deferral with an investment which, hopefully, will produce some future return on the investment.

The lawyer’s function is to determine which general category of tax shelter, or perhaps no shelter at all, is most appropriate for the particular client, and thereafter to review the tax shelter programs in that particular category which would be available for someone in the client’s financial and personal circumstances. In discussing such an investment with a client, especially when non-real estate tax shelters are being considered, it is probably wise to adopt a practice of telling the client that there are only three things that can be predicted with certainty about any tax shelter: first, that the shelter investment will, at best, merely defer income tax liability and will not eliminate it entirely; second, that, even with the best of intentions and with the most
detailed attention to both the form and the substance of the tax shelter, the tax consequences predicted by the promoters of the shelter may not survive an IRS review; and, third, that, at the end of the tax shelter, the taxpayer probably will not get his investment back. If, after such advice, the client is still willing to invest in a tax shelter, you must proceed with an analysis of the various types of available tax shelters.

Although new methods of sheltering income from tax are developed almost daily, ranging from pig farms to art, tax shelters can be classified within certain general categories:

1. The real estate tax shelters, which provide interest and depreciation deductions on a leveraged acquisition of real estate, sometimes with some form of government subsidy through tax exempt government bond financing or interest payment guarantees.

2. The equipment leasing tax shelters, which provide investment tax credit and accelerated depreciation, again on a leveraged purchase basis, generating deductions in excess of cash flow. Although the particular equipment to be leased can be infinite in variety, such as computers, barges, ocean-going vessels and boxcars, the basic shelter is the same. The investor or investors in the equipment contribute a minimum amount, for example, 10 percent of the purchase price of the equipment, and the balance of the purchase price is financed through pre-arranged borrowing, either through an independent third party or through a financing affiliate of the tax shelter promoter, with the loan structured so that the expected cash flow from the property will amortize the loan. The tax benefit will then result from investment tax credits on the full purchase price and depreciation deductions, again on the full purchase price, even though the investors have put up only 10 percent of that purchase price from their own funds. The depreciation, interest and other deductions on the tax shelter investment generally substantially exceed the rental or other income from the property and will produce excess deductions which can be claimed on each individual investor's personal income tax return as a loss from a trade or business or income producing activity.

3. Oil, gas, or other natural resource tax shelters, which provide some of the benefits of equipment leasing shelters, to the extent that the investment is in depreciable assets subject to the investment credit. However, these shelters also provide the benefits of depletion, intangible drilling costs, other deductible development expenses, prepaid drilling costs, and front-end management fees structured as guaranteed payments deductible under Section 707(a) or 707(c) of the Code, again on a borrowed or leveraged basis.
4. Timber tax shelters, which are a special form of natural resource tax shelter, providing the depletion allowance, and also the potential of capital gains on a certain portion of the investment on disposition of the property.

5. Farming tax shelters which include the familiar horse and cattle breeding and feeding operations as well as farming operations involving pigs, chickens, and mink, among others. Again, these shelters provide the usual depreciation and investment credit benefits to the extent tangible personal property is acquired as part of the investment, and also attempt to capitalize upon certain exclusively farm-oriented tax deductions. The breeder-type farm shelter attempts to capitalize on investment tax credits, depreciation and other operating expenses at the beginning of the shelter and to obtain capital gains on disposition of the livestock bred from the original herd purchased at the beginning of the shelter. The feeder-type shelter is usually formed near the end of a tax year for the purpose of entering into contracts to purchase feed in a leveraged transaction and thereby secure a prepaid feed expense deduction.

6. Artistic properties, which have become the subject of tax shelter investment promotions in recent years. The primary tax shelter aspect of artistic properties is the interest deduction available on a leveraged purchase of art work and the deductible expenditures for services such as appraisals, storage and security expenses rendered in connection with the holding of the property. Hopefully, these tax deductible expenditures will be converted into capital gains on the disposition of the art work without any recapture or characterization of the gain as ordinary income. A variation of this type of investment, not as common as it was once, is the investment in scotch whiskey futures, which caused the purchaser of the futures to incur certain storage costs during the aging process of the scotch whiskey, all of which costs were prepaid, using borrowed funds. The Service successfully took the position that the prepaid storage costs should be amortized over the storage period rather than deducted on the taxpayer's individual tax return in the year of payment.

7. Movie tax shelters, which are usually one of two types, the production shelter and the completed film purchase shelter. The production shelter involves formation of a production entity, usually a limited partnership, to produce a film, which, after production will be owned and marketed by others. Investor contributions to the production limited partnership are used, along with substantial other borrowed cash, to pay production costs. Since no income will be earned until the film is distributed, the production partnership will incur substantial operating losses
on the front end. For the completed film purchase shelter, the limited partnership purchases the completed film on a highly-leveraged basis and retains a distributor to handle the distribution function. Tax shelter benefits are provided through the investment tax credit and prepayment of management and distribution expenses. The same basic format is also used for television and master recording tax shelters.

8. The employee fringe benefit area, which is generally not thought of as a tax shelter, yet in an appropriate circumstances can offer some of the most effective tax shelter benefits currently available. For instance, whether a particular taxpayer is operating a business in a proprietorship, partnership or corporate form, the qualified fringe benefit area affords him an opportunity to make contributions to a tax-exempt trust which can invest the funds contributed on a tax-exempt basis. The contributions made by the taxpayer-employer to the fund will be tax deductible at the time of contribution although no tax will be paid by the employees ultimately receiving the benefits until they have actual receipt of benefit payments. Obviously, the fringe benefit area, generally, provides tax deferral as well as a limited amount of total tax exemption. This type of investment should be considered in any situation where a client, desiring to shelter dollars from a trade or business activity, has not availed himself of the available fringe benefits. Use of employee fringe benefits is, on the other hand, not free of substantial non-tax costs and can create substantial tax costs as well if careful planning and supervision is not assured.

It is not my intention today to attempt to cover exhaustively the whole area of tax shelters, nor is it my intention to consider in detail how to structure a tax shelter investment. Rather, I will discuss how best to protect the interests of a client who would like to invest in a tax shelter to ensure that, to the extent possible, the client gets what he paid for, understands what he gets and gets what he needs. This requires a review and analysis of the tax shelter prospectus or other selling brochure to discover hidden pitfalls and problems in the particular tax shelter investment.

However, before considering any particular tax shelter problems in detail, it seems appropriate to first consider the Internal Revenue Service’s current position on tax shelters. The current Internal Revenue Service tax shelter policy is very strongly anti-tax shelter. Sometime prior to the consideration by Congress of the 1976 Tax Reform Act, the Treasury Department made its position on tax shelters clear by strongly recommending the adoption of an anti-shelter device known as the “limitation on accounting losses” or “L.A.L.” system. While this suggestion was not substantially supported it paved the way for the
eventual “at risk” limitations imposed by the 1976 Tax Reform Act, which will be considered shortly. Independent of the “at risk” limitations, however, the Internal Revenue Service has given notice that it will conduct exhaustive audits of “abusive tax shelters” where the investment was structured to provide tax benefits but had no real substance other than the tax deduction. Pursuant to this announced policy, the Internal Revenue Service has added tax shelter audit guidelines to its Audit Manual which, among other things, set out six separate tests for determining whether an investment in a partnership should be subjected to a special examination on the grounds that it was a tax shelter investment without real substance. Without going into detail, it should be noted that each of these six tests is concerned with the pass-through of loss deductions and the creation of negative capital accounts without any recognition of income. These shelter guidelines are not exclusive, but rather are in addition to the usual considerations which the IRS has announced will trigger a tax audit of a normal partnership, whether or not designed as a tax shelter. Thus, any partnership which shows large net losses at the end of the year, has low gross income for the year, lacks any operating characteristics, was formed late in the tax year, has nominal contributions of assets in relation to the cost of the assets contributed, has improperly treated management fees and other payments to partners and other promoters of the partnership which create substantial first year deductions, has year-end negative capital accounts, or shows a reduction in capital assets of the partnership of 50 percent or more over a particular tax year will trigger an audit. In addition, the tax shelter audit guidelines have developed detailed tests, (keyed to specific types of shelters), to be applied by examining agents in uncovering the “abusive” tax shelters and disallowing what the Service considers to be the unjustifiable tax benefits claimed.

A continuing area of dispute between the Internal Revenue Service and any tax shelter formulated on a partnership basis is whether or not the entity will be characterized as a partnership or as an association, taxable as a corporation for income tax purposes. Treasury Regulations §301.7701-2 provides a list of corporate characteristics, the presence of a majority of which will cause a non-corporate entity for state law purposes to be treated as a corporation for tax purposes. These characteristics are the existence of associates, an objective to carry on business and divide the profits from the business, continuity of life of the entity despite the death of any one of the associates, centralization of management of the entity in one or a few associates, limited liability in the associates for debts of the entity, and free transferability of ownership interests in the entity. However, given the fact that several of these characteristics are common both to partnerships and to corporations, the Regulations provide that these
common characteristics will be ignored in determining whether or not a particular entity will be treated as a partnership or a corporation. The common characteristics to be ignored are the existence of associates and the existence of a profit objective. The remaining factors are relevant in determining partnership versus corporate existence for federal tax purposes. Despite the statement in the Regulations that, in determining whether an entity should be treated as a partnership or as a corporation, only these four factors should be considered, the IRS at one time attempted to argue that seven other factors should also be considered in determining whether a tax shelter partnership would be treated as a corporation to eliminate the tax shelter benefits. These seven factors were, first, the division of limited partnership interests into units or shares and the promotion and marketing of those interests in a manner similar to corporate securities; second, the grant of discretion to the managing partner to retain or to distribute profits according to his determination of the business needs; third, the limited partner's right to vote for the removal and election of a general partner and to vote on the sale of all or a substantial amount of the assets of the partnership; fourth, the use of certificates to represent limited partnership interests; fifth, the observance of corporate formalities and procedures in the operation of the partnership; sixth, a requirement that limited partners sign the partnership agreement; and seventh, the use of the limited partnership as a method of pooling investments while limiting liability of some of the investment participants. Since all or some of these seven characteristics are present in most limited partnership tax shelters, the application of these guidelines during the audit process resulted in the re-characterization of many limited partnerships as corporations. After one of these audits, an investor in a tax shelter filed a Tax Court petition contesting the IRS application of these seven factors and the Tax Court held in Larson, 66 T.C. 159, that the determination whether a partnership should be classified as a corporation must be limited to the four relevant factors set forth in Treasury Regulations §301.7701-2(a). The Tax Court pointed out that the other factors were either not significant in making this determination or were already implicit in the four factors set out in the Regulations, and were not worthy of separate consideration. In Revenue Ruling 79-106, the IRS acquiesced in the decision and in the Tax Court's appraisal of the seven factors. As a result of Larson and the acquiescence by the Internal Revenue Service in that decision, the partnership versus association issue in the tax shelter area should be less troublesome in the future.

In a series of Revenue Rulings in 1977, issued on October 31 and therefore called the "Halloween Massacre" rulings, the Service took a very strong anti-shelter posture designed to enforce its regulation of tax shelters generally in conjunction with the new "at risk" provisions
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adopted by the 1976 Tax Reform Act. Since these rulings, as modified by subsequent 1978 and 1979 rulings, are crucial to the analysis of any tax shelter, the important points of each should be summarized. Revenue Ruling 77-110 involved a limited partnership designed to purchase and exhibit a completed motion picture in the United States. The terms of the contract called for a 10 percent down payment by the limited partnership on the film. A non-negotiable, interest-bearing promissory note for the balance of the purchase price, requiring payment of all interest and principal as a single payment at the end of twenty years was also executed and delivered. Prepayment on the note was required to the extent of 50 percent of the net receipts from the exhibition of the film by the limited partnership. Neither the partnership nor any of the partners were personally liable for payment of the note and the sole recourse of the seller of the film in the event of default was to the film itself. The ruling concluded that the fair market value of the acquired film rights could not be shown to at least approximate the amount of the non-recourse obligation and, therefore, that the basis of the partnership in the acquired film rights could not include the non-recourse liability. This ruling represents a modification of the basic rule of the Crane case that the basis of acquired property includes any liabilities to which the property is subject at the time of a acquisition or which are assumed by the purchaser on the acquisition. In addition, since the obligation was contingent on future profits from the sale or rental of the film, the IRS also concluded that the indebtedness was not one with respect to which the interest paid or accrued on the note could be deducted. Therefore, the limited partnership could claim amortization of the film rights only on the basis of the 10 percent down payment and not on the basis of the full purchase price. All accrued interest deductions were also disallowed, thereby defeating all tax shelter benefits of the limited partnership. In Revenue Ruling 77-125, another limited partnership formed for the purpose of producing motion picture films lost anticipated tax shelter benefits. The limited partners contributed a fixed amount in exchange for the limited partnership interest. The amount of each of their contributions was then used as the initial payment on a contract with a third party to produce a film, under a contract calling for payment of that amount already collected initially, and an additional amount to be secured by a non-recourse loan from an unrelated financial institution. The partnership again had no liability on the non-recourse loan except to the extent of payments received under its contract with the producer of the film, and the producer guaranteed repayment of the loan. In the first year of the partnership, the partnership claimed a deduction for production expenditures in a total amount equal to the cash contributed by the partners and paid to the producer pursuant to the contract plus the amount of the
non-recourse loan also used for this purpose. The Service ruled that
the loan for which the partnership had no personal liability, and
which was guaranteed by the third party, was not in substance a liability
of the partnership. Since the indebtedness was not a liability of the
partnership, the expenditures made with the proceeds of that loan
would not constitute partnership expenditures and would not be de-
ductible. In addition, the basis of the limited partners in their interests
and their capital contributions would not include any portion of the
loan. As a result, the partners’ deductions for any losses incurred by
the partnership could not exceed their actual cash investment in the
partnership. The Service also ruled that the claimed deduction for the
expenses incurred in the first year of the partnership represented a
substantial distortion of income since the income resulting from the
contract would not be realized until future years. The interesting aspect
of this part of the ruling is that the Service applied the rule of Section
446(a) of the Internal Revenue Code, permitting the Internal Revenue
Service to compute a taxpayer’s taxable income under a method which
clearly reflects income if the taxpayer’s method does not clearly reflect
income, to Section 461(a) of the Code which provides that the
amount of any deduction otherwise allowed is to be taken for the
taxable year which is the proper tax year used in computing taxable
income under the method of accounting. Thus, the Service held that
the timing determination of Section 461 is subject to the distortion
of income standard of Section 446(b) and that reallocation of deduc-
tions can occur in circumstances where the Service determines that
a distortion of income would otherwise result.

In Revenue Ruling 77-395, an individual taxpayer entered into a
contract with the corporation under which the corporation would
file applications to lease federal lands for oil and gas development
purposes for a predetermined fee and would provide certain other
services to the taxpayer. For an additional fee, the corporation granted
the taxpayer an option to sell to the corporation a one-third interest
in any leases acquired as a result of the corporation’s services for an
agreed upon price, with a further understanding that if no leases were
acquired, the corporation would assign a lease to the taxpayer and
buy it back for a predetermined amount. The taxpayer sought to
deduct the fee paid to the corporation for the services provided. The
Service ruled that the entire transaction should be integrated and the
fee should be considered part of the leasehold acquisition cost which
must be capitalized by the taxpayer and amortized over the life of the
leasehold interest.

In Revenue Ruling 77-397, the Service held that the “at risk” pro-
visions of Section 465 applied to an individual who purchased a
master recording for a cash down payment and a non-recourse note
and thereafter granted the right to use and exploit the master record-
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ing for a limited period of time to a third party in exchange for royalties on the records sold. The Service ruled that leasing the master recording was the activity of leasing Section 1245 property and, therefore, under Section 465(c)(1)(C), the "at risk" provisions applied. Consequently, any losses resulting from the master recording activity for any given year would be allowed only to the extent of the aggregate amount "at risk" at the close of that tax year, which was the amount of the cash down payment made by the individual but no part of the non-recourse note. This treatment has since been confirmed in the proposed regulations under the "at risk" provisions.

In Revenue Ruling 77-398, an individual taxpayer purchased for fair market value, from an unrelated party, all of the rights in a motion picture film. The purchase agreement called for a 20 percent cash down payment and a recourse note with interest payable within ten years from the closing date of the purchase. The purchase agreement also provided that 50 percent of the gross receipts from the distribution of the film were required to be applied against the unpaid balance of the note, plus interest, and that, at the end of the ten year period, if the note was not fully paid off from gross receipts, a third party would be obligated to loan the individual taxpayer the unpaid balance of the note. The note for the unpaid balance would by its terms be renewable at the taxpayer's option from year to year until such time as the debt shall be fully paid from gross receipts derived from the film's distribution. The Ruling concluded, without discussion, that no amount due on the note by the taxpayer would be considered to be "at risk" and the taxpayer's deductions would be based only on the 20 percent cash down payment. Presumably, this conclusion was based upon the language in Section 465 that the agreement was an "other similar arrangement" protecting the taxpayer against any risk of loss.

In Revenue Ruling 77-400, the taxpayer, as lessee, entered into a contract for the disposal of timber with a third party, under the terms of which the lessor retained an economic interest in the timber for purposes of obtaining capital gains treatment on the cutting of the timber. The contract provided for royalty payments by the taxpayer for each unit of timber cut and also required payment of advance royalties at the beginning of each year of the two year contract, whether or not timber was cut. The advance royalty would be applied as payment for timber cut in a subsequent year. No timber was cut in the first year of the contract and the taxpayer claimed a deduction for the advance royalties required under the contract. The Service concluded that, since these advance royalties were not being paid with respect to mineral property, they would not be deductible in the year paid, but would be treated as part of the cost of timber and would become part of the taxpayer's depletiable basis in the timber.

In Revenue Ruling 77-401, the Service applied the "at risk" limi-
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tations to a non-tax shelter partnership. A cash basis general partnership was formed to engage in the road building business. The two partners contributed funds to the partnership, and the partnership used a portion of these funds as a cash down payment on certain road building equipment. The balance of the purchase price was evidenced by a non-recourse promissory note, the sole security for which was the machinery and equipment. The general partnership sustained a loss in its first taxable year and the partners sought to deduct that loss on their personal income tax returns. The Service ruled that, for purposes of determining deductibility of the partnership loss, the loan on the equipment would not be includable in the adjusted bases of their interests in the partnership under Section 704(d) of the Code and, therefore, would not support a loss deduction.

In Revenue Ruling 77-402, the Service effectively put an end to a means of avoiding the ordinary income recapture on the disposition of an exhausted tax shelter interest. An individual had created a grantor trust and, through the grantor trust, invested in a tax shelter. The tax shelter losses passed through to the taxpayer, as grantor of the trust, under the grantor trust rules of Subchapter J of the Code. When the adjusted basis of the partnership interest held by the trust had been reduced to zero, the taxpayer renounced the powers he had retained which had caused the trust to be a grantor trust, hoping that he would no longer be considered the owner of the trust and that the income generated by the tax shelter would be taxed to the trust or to its beneficiaries, who were in a lower tax bracket than he was. The Service ruled that under the grantor trust provisions, the taxpayer was considered the owner of the entire trust for tax purposes and, by renouncing the powers which had made the trust a grantor trust, he had, in effect, made a transfer or disposition of the partnership interest. Therefore, the Service ruled, the taxpayer would be considered to have transferred ownership of the partnership interest to the trust at the time he renounced the powers. Applying ordinary partnership rules, the Service then concluded that the taxpayer would be treated as having sold his partnership for an amount equal to the share of partnership liabilities reduced or eliminated on the disposition. Under Section 741 of the Code, any gain or loss resulting from this disposition would be taxed to the taxpayer, and would be characterized as ordinary income to the extent of the recapture of depreciation or other ordinary income recapture items attributable to his interest.

Finally, in Revenue Ruling 77-403, a partnership engaged in the business of managing rental property purchased newly constructed rental property from a real estate developer and, in the contract of purchase and sale, allocated the purchase price between the property itself and a covenant not to compete. Under the covenant, the developer agreed not to participate directly or indirectly in the con-
struction, purchase or management of competing property within a specified distance from the purchased building for a fixed period of time. However, the Ruling indicated that the developer had never managed rental property, had no intention of managing rental property and did not intend to construct, purchase or manage any rental property in that general area. Therefore, the Service ruled that whether payment for a covenant not to compete made in connection with a purchase of real property should be considered a part of the cost of the property or a part of the cost of a separate asset would depend upon whether the covenant has a separate demonstrable value. In the particular situation, the Ruling held that the covenant had no separate value, so, the payment allocated to the covenant must be added to the basis of the property and would not be subject to amortization over the period of the covenant, as the taxpayer had contended.

Three additional Rulings in 1978 have continued the strong anti-shelter bias for the IRS ruling position. In Revenue Ruling 78-28, a limited partnership formed to acquire screen plays and other motion picture and television rights was required to use the income forecast method of depreciation for the film rights and to spread the depreciation deductions over the expected future income stream. In applying this income forecast method, which requires the application of a fraction, the numerator of which is the income from the film for the tax year and the denominator of which is the estimated total income from the film during its useful life, that income must reflect the same gross income used in computing taxable income and does not include amounts due but not yet received by the end of a calendar year. In addition, the Ruling held that the denominator of the fraction could not be less than the amount of the non-recourse loan which was secured by the film rights.

Revenue Ruling 78-29 reaffirmed the previous holding in Revenue Ruling 77-110 that the liability created by a non-recourse, interest-bearing note given as part of the purchase price of an asset whose value cannot be shown to at least approximate the amount of the note, is not to be included in the property's basis for depreciation purposes and that no deduction is allowable for interest paid or accrued on the non-recourse note. In Revenue Ruling 79-255, 1979-35 I.R.B. p. 5, the Service applied this same general theory of Revenue Rulings 77-110 and 78-28, in which a depreciation deduction for property financed by non-recourse loans was disallowed, to the taxpayers’ claim of entitlement to an investment tax credit. In the Ruling, the Service determined that no investment tax credit would be allowed for property financed by a taxpayer through non-recourse borrowing.

Finally, in Revenue Ruling 78-30, the Service reapplied the holding of Revenue Ruling 77-125 to a cash basis taxpayer who paid the costs of dredging a developer's beachfront property with a combination
of his own funds and the proceeds of a non-recourse loan from a third party. The loan was to be repaid from a portion of the sales price of each lot until the loan was fully paid. The Service held that the loan from the third party, which was guaranteed by the developer, was in substance not a liability of the individual taxpayer since he had no liability with respect to the loan and all sales proceeds otherwise payable to him from sale of the lots would be assigned to the lender until the loan was repaid. Therefore, any expenditures from the loan proceeds would not be deductible costs incurred by the individual taxpayer. In addition, the portion of the dredging costs paid by the taxpayer with his own funds would not be permitted as a deduction in full in the year paid, even though the taxpayer was on the cash basis of reporting, because a deduction in the year of expenditure would result in a substantial distortion of income under Section 446(b) of the Code. Since no income from lot sales was received in the year of the expenditure, the taxpayer was allowed no deduction in that year.

With this background, we must now analyze the specific kinds of benefits that tax shelters can provide and some of the specific problem areas which can occur.

The proper form around which to structure a tax shelter through a corporation, a partnership, or a proprietorship, is fairly straightforward and depends primarily upon the application of the normal tax rules to these forms of investments. A note should be made about the partnership area, however, since as a result of the 1978 Tax Reform Act, the Code now specifically provides that any allocation of profits and losses of a partnership in a manner other than in proportion to the capital accounts of the partners will be recognized only if the allocation has "substantial economic effect" apart from tax consequences. Although this provision, (Section 704(b)(2) of the Code), reflects the Service's pre-amendment policy with respect to shelters, the clear statutory authority for this view will give added weight to the Service's reallocation of losses, deductions or credits if an allocation on a basis other than in proportion to capital interests has been attempted. Also, if tax shelter benefits in a partnership or proprietorship form of ownership depend upon the availability of the investment tax credit on leased property, Section 46(e)(3)(B) of the Code causes certain further restrictions. These restrictions, applicable when the lessor of property otherwise subject to the investment tax credit is not a corporation, require that the term of the lease, including renewal options, be less than 50 percent of the useful life of the property, and that the total trade or business deductions with respect to the property, other than rents and reimbursed amounts during the first twelve months after the property is transferred to the lessee, must exceed 15 percent of the gross rental income produced by the property. The purpose of these rules is to insure that the non-corporate lessor
is the true lessor of the property and that the lease term itself has economic substance and is not a pure tax shelter device merely designed to pass through an investment tax credit.

The most fundamental recent change which has occurred in the tax shelter area has been the adoption of the "at risk" provision, found in Section 465 of the Code, by the 1976 Tax Reform Act and the amendment of these rules by the Revenue Act of 1978. As a result of the 1978 amendments, the "at risk" rules extend to all activities engaged in by a taxpayer except for the holding of and investing in real property. All taxpayers, including partnerships, are included within the coverage of the "at risk" rules—the only exception is for non-closely held corporations. Closely-held corporations, defined as a corporation with respect to which five or fewer shareholders own directly or indirectly more than 50 percent in value of the outstanding stock during the last half of the corporation's taxable year (a definition which is determined by cross-reference to the personal holding company definition found in Section 542 of the Code), are now within the "at risk" provisions unless actively engaged in the leasing of Section 1245 property. A corporation is considered to be actively engaged in leasing such property if 50 percent or more of its gross receipts for a tax year are attributable to the leasing and selling of Section 1245 property.

The basic goal of the "at risk" provision is to limit current deductions for losses incurred in a tax shelter investment to the amounts for which the particular taxpayer has personal liability or personal risk of economic loss. Under Code Section 465, a taxpayer is considered to be "at risk" to the extent of the amount of cash and the adjusted basis of property contributed to the activity and the amount borrowed with respect to such activity, provided he is personally liable for repayment of the borrowed amount or has pledged property other than property used in the activity as security for the borrowed amount. Any amount borrowed by a taxpayer, even with full recourse, would not be considered to be "at risk" with respect to any investment activity if borrowed from a person who has an interest in the activity other than as a creditor, or who is related to the taxpayer within any of the definitions of Section 267(b) of the Code. Finally, Section 465 provides that if a taxpayer is protected against loss through non-recourse financing, guarantees, stop-loss agreements, or "other similar arrangements", he will not be considered to be "at risk" with respect to such protected amounts.

Another fundamental change in the 1978 amendments was designed to plug a loophole in Section 465 as it was in the 1976 Act. Under that Section as it originally read, a taxpayer could claim full deductions to the extent he was "at risk" in a given year, despite the fact that in a subsequent year his "at risk" amount would or could be reduced as,
for example, by converting a recourse liability into a non-recourse liability. Section 465(e), which was enacted in 1978, now requires the taxpayer to recognize, as income, the amount by which his “at risk” liability is less than zero at the end of any tax year up to a maximum recapture amount equal to all previously deducted losses from the tax shelter activity, reduced by any prior recapture. If this recapture provision applies in any year, the recaptured amount becomes, in effect, a suspended loss which would be deductible in a future year if the amount “at risk” is increased above zero.

Proposed Regulations were issued by the Internal Revenue Service on June 5, 1979 interpreting the “at risk” provisions of Section 465. Public hearings were held on these proposed regulations in September of this year but no further comment or action on these regulations has occurred. The Proposed Regulations state as a general rule that, in applying Section 465 and the Regulations, substance will prevail over form. Therefore, regardless of the form a transaction may take, the taxpayer’s “at risk” amount will not be increased if the transaction, as structured, is inconsistent with normal commercial practice or is in essence a device to avoid the consequences of Section 465. In Proposed Regulations Section 1.465-1(e), the position is taken that Section 465 applies only for the purpose of limiting losses in connection with an activity and that the Section and the Regulations do not apply for other purposes, such as for determining basis. It is not clear whether this provision reflects a retreat from the position the Service took in Revenue Ruling 77-110 and Revenue Ruling 78-29, which concluded that non-recourse financing could not be included in the basis of property for depreciation purposes in circumstances where it was not clear that the value of the property did not at least approximate the amount of the non-recourse liability.

Proposed Regulations Section 1.465-4 provides that, if a taxpayer engages in a “pattern of conduct” which is not within normal commercial practice or has the effect of avoiding Section 465, the taxpayer’s “at risk” amount may be adjusted to reflect more accurately the amount which is actually “at risk”. This Regulation then gives an example of such circumstances and factors to be considered which relate to the example; however, there is no indication that the broad language of the Regulation could not be applied beyond the specific type of situation indicated in the example. It is impossible to predict whether the Internal Revenue Service will attempt to apply this Proposed Regulation in a broad brush manner to disallow loss deduction from a tax shelter activity even in cases where the technical requirements of the “at risk” provision have been met. All that can be said presently is that the IRS has created for itself an open-ended standard that can be used if a more specific part of the “at risk” regulations would not apply to a given situation. Since these
proposed regulations have not been finally adopted it is impossible
to determine the overall effect their adoption will have on tax shelter
activity. At this point, it does appear, however, that the Service intends
to review tax shelters not only for technical compliance with the
statute, but also for substantive compliance. Therefore, many presently
promoted tax shelter investments will become subject to audit under
the “at risk” limitation provision and may ultimately lose the tax
benefits which have been heavily touted by the tax shelter promoters.

If a client has invested in a tax shelter he will at some time be
faced with the question of how best to dispose of the tax shelter invest-
ment. Unfortunately, the answer to his question is not an easy one,
since nearly every method of disposition results in adverse tax conse-
quences.

If sale or disposition is to occur during his life, as a practical matter
adverse tax can be expected. The depreciation recapture and invest-
ment credit recapture rules may cause substantial ordinary income tax
liability in the year of disposition which frequently will not be
matched by an equivalent amount of cash from the disposition. Typi-
cally, the depreciation deduction with respect to the activity will have
reduced the taxpayer’s basis in the shelter investment to such an extent
that the amount realized on his disposition, which, under the Crane
doctrine, includes any mortgages or other debts assumed or trans-
ferred on disposition, will be “phantom gain” because it will not
provide sufficient cash to pay the taxes generated by the disposition.
The IRS position is that the taxpayer has already realized the cash
flow during the period when the tax shelter interest has been producing
tax benefits. In order to postpone these adverse consequences, the
taxpayer can always refinance his tax shelter investment, particularly
if he holds the tax shelter in his name alone, since a refinancing is
not considered to be a disposition which triggers current gain or loss
for tax purposes.

An installment sale under Section 453, can reduce the adverse
disposition consequences because the gain required to be recognized
on the disposition can be spread over a period of years. However,
Section 453 provides that no more than 30 percent of the purchase
price may be received in the year of sale, and the amount received
in the year of sale will include the excess liabilities on the property
over the adjusted basis of the property. Since most tax shelter invest-
ments will have excess liabilities at the point of time at which a
taxpayer would normally be interested in disposing of the interest,
it is unlikely that Section 453 could be used successfully. Although
the real estate tax shelter investment vehicle may attempt to take
advantage of a wrap-around mortgage to avoid this result, it is unlikely
that this device, even if it is successful, would be available for non-
real estate shelters. Although there are indications that the IRS may
be reconsidering its position in a so-called “seller-to-pay” wrap-around mortgage transaction, the official position of the Service is still that use of a wrap-around mortgage will be treated as a sale of the underlying asset, causing full recognition of gain to the selling taxpayer. Nonetheless, for all intents and purposes, except for a prearranged non-arms’ length disposition, installment sale of a tax shelter interest is unlikely since there is little market for such interests.

A taxpayer could dispose of tax shelter property on a tax-free basis in a like-kind exchange under Section 1031, but no real benefit would be obtained from such an exchange unless the property for which he exchanges his tax shelter interest is property which the taxpayer plans to hold indefinitely. Also, although it is clear that a partnership can undertake a Section 1031 transcription at the partnership level, the application of the like-kind exchange rules to exchanges of partnership interests in a tax shelter is not so clear. In Estate of Meyer, the Tax Court held that an exchange of partnership interests in partnerships owning like-kind property would be considered a like-kind exchange to the extent that general partnership interests were exchanged for general partnership interests and limited partnership interests for other limited partnership interests. However, if the partnerships did not own like-kind property, this rule would not apply. It is not clear from the opinion or from any subsequent developments in this area whether the like-kind assets of the partnerships whose interests are to be exchanged must be the sole assets of each of the partnerships or whether such an exchange would be successful even if the partnership interest received has only one asset, of many, which is like-kind property with respect to the property exchanged. In any event, any attempt to exchange partnership interests will be attacked by the Service since, in Revenue Ruling 78-135, it made its position clear that partnership interests are equity interests which are specifically excluded from like-kind exchange treatment by the language of Section 1031(a).

A gift of the tax shelter interest to a family member or other individual can effectively shift the income generated after the transfer to the lower bracket taxpayer. However, since the donee will retain the donor’s basis in the tax shelter interest, increased by any gain recognized on the transfer and increased by any gift tax paid with respect to the transfer, the donee will recognize gain on any subsequent disposition of the asset, which gain will be subject to the ordinary income recapture rules to the same extent as if the disposition had been by the donor. A gift of a tax shelter interest may be a part sale—part gift if the property is subject to liabilities in excess of its adjusted basis so income will be recognized to the extent that the liabilities exceed basis. This income would be characterized as ordinary income to the extent that the normal recapture provisions would apply, and presumably would also constitute a disposition of the interest which could cause invest-
ment credit recapture. If the tax shelter investment is held in partnership form, a gift of the partnership interest will result in a reduction of the original partner’s proportionate share of partnership liabilities, and, to the extent that reduction exceeds his basis in the partnership interest (which again will very often be the case with a tax shelter) the partner will have income under Section 752(d) of the Code. If the tax shelter interest is contributed to a charity the adverse tax consequences would be even more serious, since not only will the taxpayer have the same basic tax consequences as if the gift had been made to an individual, but the gift can cause problems for the charity itself. For example, if the property is subject to liabilities, those liabilities will constitute acquisition indebtedness under Section 514(c) and the income generated on the property after its transfer would be considered unrelated business income of the charitable organization under Section 512. If the gift were to an individual and liabilities exceed basis, income will be recognized only to the extent of that excess, but if the gift is to a charity and liabilities exceed basis, under Revenue Ruling 75-194, the donor-taxpayer must first allocate his total basis in the interest between the gift portion and the sale portion, causing income to the extent of the excess of the liabilities over that portion of his basis which is allocated to the sale part of the transaction.

A transfer of the tax shelter interest to a corporation is a possible way to dispose of it, although if liabilities exceed basis, the provisions of Section 357(c) apply, causing the excess liabilities to be treated as gain from the sale of the interest, subject to the recapture rules. This problem may be avoided, however, if the taxpayer is in a position to transfer other property to the corporation at the same time, since Section 357(c) applies on an aggregate basis. Thus, if the aggregate basis of all properties transferred exceeds the aggregate liabilities to which all properties are subject, the excess liabilities on any one property will not cause recognition of gain and the transfer can be effected tax-free under Section 351. However, if a tax avoidance motive exists for the transfer to the corporation or if there is a lack of a business purpose for the transfer of the liabilities, then Section 357(b) could apply to cause recognition of income on the transfer.

If the taxpayer holds the tax shelter interest until death, then both his estate and the ultimate recipient of the tax shelter interest obtain a stepped-up basis in the interest equal to its date of death value under Section 1014(a). This result would, of course, be changed in the event that the carry-over basis rules of Section 1023, or some subsequently enacted modification or replacement provision, should become operative. It is clear, however, under Revenue Ruling 73-183, that the transfer of the interest on death will not cause recognition of the gain or recapture of any prior tax benefits. The new stepped-up basis
in the tax shelter interest may in fact recreate the tax shelter and provide additional depreciation deductions or other tax benefits. In most cases, however, even with the stepped-up basis, the tax shelter program will have been exhausted. Therefore, usually the stepped-up basis will only avoid the recapture of the prior tax benefits obtained by the decedent, at the cost of a possible estate tax liability based upon the estate tax value of the interest. However, it is not entirely clear how the "at risk" provisions will affect a tax shelter interest on the death of the original stockholder. Proposed Treasury Regulations Section 1.465-69 offers some guidance in this area by providing that if the decedent's amount "at risk" in a tax shelter activity after the close of the taxable year in which the decedent dies is greater than zero, then that amount is to be added to the successor's amount "at risk" in the activity. In addition, the Regulations provide that the successor's amount "at risk" is to be increased by the amount by which the successor's basis in the activity is increased under Section 1014 or 1023. Although the example provided in the Regulations deals with a basis adjustment under the carry-over basis rules, it seems clear from this proposed Regulation that the estate and the beneficiaries of the estate will have an "at risk" amount equal to the increase in the basis to the date of death fair market value. The difficulty with this Regulation is that it does not seem to tie in this "at risk" amount increase at death to the estate or the beneficiaries' actual "at risk" liability. If the Regulation is read literally, the successor in interest would have an "at risk" amount equal to the full basis of the property, regardless of the fact that there is no personal liability whatsoever in the tax shelter activity. This may represent an oversight in the Proposed Regulations.

For the past hour, I have attempted to focus on some of the kinds of problems with which you will have to deal when a client asks your advice on whether to invest in a particular tax shelter investment, or, having invested in a tax shelter, on how to dispose of the interest. My aim has been to point out some of the basic questions which you must ask to evaluate the particular investment and to list some of the problems you will have to keep in mind in determining how best to dispose of the interest. In analyzing any particular tax shelter investment, you must apply the general rules applicable to all tax shelters as well as the rules applicable to the specific kinds of deductions and credits which the tax shelter promotional materials claim will be avoidable to the investor. There is no substitute for careful and exhaustive research regarding the promised benefits and the unpublicized drawbacks. Hopefully, the client who asks you to review a tax shelter for him will understand that your review requires more than just a superficial reading of the tax shelter brochure.