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TAX SHELTERS:
THE CONTINUING STRUGGLE

Daniel Q. Posin*

One of man's basic instincts is to seek shelter. In prehistoric times, this instinct was evinced in a desire for refuge from wind, snow, and rain.¹ But as civilization developed, the instinctive search for shelter came to include the drive to seek protection from the steeply progressive tax rates of the Internal Revenue Code.² Tax shelters have evolved, over the last several decades, as a sophisticated technique for attaining this protection. As such they have recently become a target of those who would "reform" the federal tax structure. The impetus for reform reached a climax in the Tax Reform Act of 1976 (the Act).³

The Act was a watershed in the field of tax shelters. It promulgated a number of detailed reforms which seemed to foreclose shelters in all areas except real estate. However, despite the Act's seemingly definitive treatment of tax shelters, there have been a surprising number of developments since its enactment. These developments demonstrate that the struggle to resolve how much and what kind of shelter is to be available is yet to be resolved. To provide a perspective on these problems, this article will discuss tax shelters prior to the Act, describe the changes effected by the Act, and focus in detail on recent problems.

TAX SHELTERS PRIOR TO THE TAX REFORM ACT OF 1976

Briefly stated, tax shelters worked in the following way prior to the Tax Reform Act of 1976:⁴ A typical tax shelter involved a

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2. See generally I.R.C. § 1.
limited partnership. Those seeking the shelter were the high-bracket limited partners. The general partner put the deal together and provided the managerial skill for the business. The limited partnership was an attractive vehicle because the "losses" generated in the business could be passed through to the limited partners. Moreover, it was generally true that, prior to the Act, any allocation of overall partnership loss would be upheld, so the bulk of the losses could be allocated to the high-income limited partners.

In employing the limited partnership form, two risks had to be circumvented. First, the Internal Revenue Service might classify the partnership as a corporation for tax purposes, resulting in loss of the pass-through of deductions. The Service set forth four characteristics to ascertain whether an entity would be classified as a partnership or a corporation: centralization of management, continuity of life, free transferability of interests, and limited liability. An entity which lacked two of these characteristics was considered a partnership. Under the regulations' definition of continuity of life and free transferability of interests, it was very likely the well-advised limited partnership would be found to lack those two characteristics and hence be found to be a limited partnership.

The second risk involved in using the partnership form was


that the limited partnership tax shelter might be disregarded by the Service if it deemed the transaction to be for the purpose of "tax avoidance." The tax avoidance or "sham transaction" doctrine stems from the venerable Gregory v. Helvering,11 Higgins v. Smith,12 and Commissioner v. Court Holding Co.13 cases, and is applied to this area in Revenue Procedure 74-17,14 which sets forth guidelines that must be met before the Service will issue a ruling that an entity will be treated as a limited partnership. The criteria that must be met for a favorable ruling are: (1) All the general partners must, in the aggregate, have at least a one percent interest in each material item of partnership income, gain, loss, deduction, or credit,15 (2) the aggregate deduction of the limited partners during the first two years of the partnership's operations cannot exceed the amount of the equity investment in the partnership,16 and (3) a creditor who makes a nonrecourse loan to the partnership may not acquire, as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership, other than as a secured creditor.17 The well-advised limited partnership could meet these criteria.

Once the limited partnership was set up, the next step was to establish the limited partners' bases in the partnership. The general rule is that a limited partner's basis in the partnership is the amount of money he pays plus the adjusted basis of the property he contributes to the limited partnership.18 A partner can deduct as a loss only an amount equal to the basis in his partnership share.19 Thus the arrangement does not appear particularly promising, since if a limited partner contributes $100,000 in cash and property to the partnership and loses it all, his maximum tax benefit (assuming he were in the seventy percent bracket and remained so even after the shelter deductions) would be $70,000—still a net loss of $30,000.

However, prior to the Tax Reform Act of 1976, it was possible to increase "artificially" the limited partner's basis by having the

15. Id. at 439.
16. Id.
17. Id.
partnership take out a nonrecourse loan, secured by the partnership property. Even though the limited partner was not personally liable on the loan, his basis was increased by a proportion of the loan equal to the proportion in which the partner shared in the profits of the partnership. This rule, based on *Crane v. Commissioner*, meant that, for example, if eighty or ninety percent of the partnership's capital were nonrecourse debt secured by partnership property purchased with the loan proceeds, a partner's basis in the partnership could be multiplied eight or nine times the amount he was actually risking in the partnership. Such heavily leveraged nonrecourse financing arrangements were common in the shelter field.

Given a limited partnership with the limited partners' bases greatly inflated over the amounts they actually risked in the venture, the stage was set for taking advantage of some large deductions. Tax-shelter limited partnerships before the Tax Reform Act of 1976 tended to be in those businesses which generated substantial deductions early in the life of the project. The typical fields were real estate, oil and gas, equipment leasing, movies, farming,
and sports franchises.\textsuperscript{27} The large early deductions generated by these projects would be passed through to the limited partners to offset their high salary or investment income earned from other sources.

A tax shelter is like marriage: getting in is fun but getting out can be painful. After a shelter has operated for a few years and the bulk of the deductions—whose major effect is early in the life of the project—has been exploited, it becomes attractive to get out. However, the accelerated depreciation deductions have dramatically reduced the basis of the property of the project, perhaps well below its fair market value. Hence the attractive “paper” losses these deductions generated are likely to be counterbalanced by unattractive “paper” gains when the property is eventually sold.\textsuperscript{28} Nevertheless the taxpayer will have benefited from the shelter in two ways: (1) He will have enjoyed tax deferral for some years; and (2) the early deductions will have been taken against ordinary income whereas the tax imposed on getting out may be only at capital gains rates.\textsuperscript{29}

This ordinary loss-capital gains dichotomy has long enraged tax reformers. Beginning in the early 1960’s, “recapture” provisions were introduced into the Code, causing some of the gain attributed to the taking of depreciation to be treated as ordinary gain. The treatment has varied somewhat over the years, but as matters stood just before enactment of the Tax Reform Act of 1976, all the gain on the sale of personal property attributable to the taking of depreciation was taxed at ordinary income rates,\textsuperscript{30} whereas the recapture on sales of real property was somewhat less stringent. On the sale of commercial real property, such as office buildings and industrial

\textsuperscript{27} The areas of farming and sports franchising provide, respectively, early deductions for feed costs to the cash method taxpayer and rapid amortization of player contracts. For further discussion of sports franchises, see note 57 infra.

\textsuperscript{28} If a partnership interest in a tax shelter is abandoned, that too will trigger gain. \textit{See} Millar v. Commissioner, No. 77-1926 (3d Cir. June 12, 1978); Fred H. Lenway & Co. v. Commissioner, [1978] 69 TAX CT. REP. (CCH) No. 50; text accompanying note 109 infra. Giving away the shelter property will be treated as a sale for the balance of the nonrecourse loan. Magnolia Dev. Corp., 29 T.C.M. (P-H) ¶ 60,177, at 1032 (1960); Treas. Reg. § 1.1011-2(a)(3) (1972).

\textsuperscript{29} The sale of such depreciable property would probably be governed by I.R.C. § 1231; hence if that provision’s “netting” process were positive, the transaction would be treated as a sale or exchange of a capital asset, pursuant to I.R.C. §§ 1231-1222.

\textsuperscript{30} I.R.C. § 1245.
plants, the gain recaptured was only the gain attributable to the excess of accelerated depreciation over straight line.\textsuperscript{31} On the sale of residential real property as well, only the excess of accelerated over straight line depreciation was recaptured; moreover the amount of recapture was reduced one percentage point for each full month the property was held beyond 100 months.\textsuperscript{32}

If the partner sells his limited partnership share before the partnership sells the partnership property, the recapture rules still bite. Since the partner will have enjoyed tax losses on the project, the basis in his partnership share will have been reduced \textit{pro tanto}.\textsuperscript{33} Thus, there will be a substantial gain on the sale of the partnership interest. While the sale of a partnership interest usually gives rise to a capital gain,\textsuperscript{34} to the extent that the gain is attributable to depreciation recapture, it will be ordinary.\textsuperscript{35}

Thus, tax shelters are sophisticated entities constructed by combining many different areas of the tax law. It is therefore not surprising that the attack instituted on them by the Act was sophisticated and was made on several different fronts.

\textbf{Changes in Tax Shelters Effectuated by the Tax Reform Act of 1976}

The Act attacked tax shelters on several levels. It tightened the screws on the use of the limited partnership, although it did not put that form out of reach of an otherwise viable tax shelter. After the Act, however, it is more difficult to allocate overall losses to the high-income limited partners in a manner disproportionate to their capital contributions to the partnership.\textsuperscript{36} Such an allocation must now have a "substantial economic effect."\textsuperscript{37} An allocation has a "substantial economic effect" if it affects the partners' share of the total partnership income or loss independently of tax consequences, for example, if it would affect the financial (as opposed to
accounts of the partnership and thus have an impact on the amounts the partners would receive on liquidation. Certain other changes in the treatment of partnerships were also effected.

The Act's most significant assault on tax shelters was the new so-called "at risk" rules. They attack the practice of "artificially" increasing the investor's basis by using nonrecourse debt. Under amended section 704(d), after January 1, 1976, for purposes of calculating a partner's distributive share of partnership losses, a partner's basis cannot include any part of a partnership debt for which the partner is not personally liable. Thus even if the partnership debt were with recourse, that is, if the general partner were liable on it, the limited partners' bases could not include the debt for the purpose of ascertaining their distributive shares of partnership losses. This limitation applies only for computing the distributive share of partnership loss. If the limited partner sells his share or makes a gift of it, or computes depreciation that does not give rise to a loss, the basis continues to include a part of partnership debt on which the partner is not personally liable.

On its face, the statute appears to allow a maneuver for avoiding the bite of the "at risk" rules. Partners could take deductions arising from depreciation and other sources, reducing their amounts at risk to zero. Then, the partnership could distribute cash to the partners. This distribution would not affect the amount at risk, since it is already zero. The partners could then contribute the cash received back into the partnership, thereby creating new amounts at risk which could be used to support further loss deductions. This maneuver is vulnerable to attack under the sham transaction doctrine, but it is unfortunate that the statute must be


39. Retroactive allocation of partnership losses and income is now prohibited. See I.R.C. §§ 706(c)(2)(B), 704(a)-(b); note 5 supra. Fees for organizing the partnership, whether paid to partners or outsiders, may, at the election of the partnership, be amortized over a period of not less than 60 months. I.R.C. § 709(b)(1). Prior law did not speak to this matter, and there was in general an attempt to deduct currently organization fees paid to partners. The dollar limit on additional first-year depreciation of I.R.C. § 179 (of use in the equipment leasing shelter, see note 25 supra) now applies at the partnership level, rather than at the level of the individual partners, hence drastically limiting the amount of that deduction available to the partners. See I.R.C. § 179(d)(8).

backstopped by a judicial doctrine whose scope is uncertain.\footnote{Another possibility is to provide that the cash distribution by the partnership give the partners negative amounts at risk, so that the cash contributions back to the partnership simply put the partners back at a zero-amount at risk. While this is a sensible approach, the legislative history specifically provides that the amount at risk shall not be less than zero. S. REP. NO. 938, 94th Cong., 2d Sess. 48, reprinted in \textsc{[1976]} U.S. \textsc{code cong.} & \textsc{ad. news} 3439, 3483-84. H.R. 13511, 95th Cong., 2d Sess., 124 \textsc{cong. rec.} 8367 (1978), at this writing passed by the House, would cure this problem by providing that the taxpayer would recognize income to the extent his amount at risk is reduced below zero by distributions to him.}

If the principal activity of the partnership is investing in real property other than mineral property, the “at risk” limitation does not apply.\footnote{I.R.C. \textsection 704(d) (last sentence).} Thus, the real estate tax shelter is untouched by the new “at risk” rules. Moreover, another significant exception is that section 704(d) does not apply if the activity of the partnership is movies, oil and gas, equipment leasing, or farming (other major shelter businesses heretofore); rather these activities are governed by new section 465. Hence section 704(d) applies to all activities carried on in partnership form other than real estate and the activities covered by section 465.

Section 465 applies to the motion picture, oil and gas, equipment leasing and farming activities whether or not they are carried on in partnership form. As to these activities, it provides, analogously to section 704(d), that losses (defined for these purposes as the excess of deductions over income)\footnote{I.R.C. \textsection 465(d). Thus, analogously to I.R.C. \textsection 704(d), these limitations apply only for the purpose of calculating operating losses; for other purposes, such as computing gain or loss on sale or exchange, the investor’s basis in the property would include nonrecourse debt. Note also that in computing depreciation, the basis \textit{would} include nonrecourse debt. It is only in ascertaining the total amount of deductions in excess of income allowed that the “at risk” limitations would apply. Thus, if depreciation so computed led to losses in excess of amount at risk, the excess loss \textit{would} be disallowed but the basis of the property depreciated \textit{would} be reduced by the full amount of the depreciation taken. The excess loss so disallowed could be carried over and used in subsequent years if the taxpayer puts sufficient additional amounts at risk. \textit{See} I.R.C. \textsection 465 (b)(5); \textit{see also} S. REP. NO. 938, 94th Cong., 2d Sess. 47, \textit{reprinted in} \textsc{[1976]} U.S. \textsc{code cong.} & \textsc{ad. news} 3439, 3482-83. If the taxpayer sells the property which has given rise to these carried-over losses, he should be allowed to use them, since he will have suffered the penalty of a decrease in basis due to the depreciation which was taken. This approach seems sanctioned by the legislative history, \textit{see Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976}, at 36 n.4. (Comm. Print 1976). Compare the treatment of the analogous problem under I.R.C. \textsection 704(d) at text accompanying note 41 \textit{supra}.} are allowed only to the extent that the investor is “at risk” in the activity.\footnote{I.R.C. \textsection 465(a).} The investor is at risk the amount of money and the adjusted basis of other prop-
The investor is at risk as to "amounts borrowed" if he is personally liable for repayment of the loan or if he has pledged property other than property used in the activity as security for the loan.\(^{46}\)

The statutory scheme and accompanying legislative history make clear that any indirect arrangement to secure the loan with the shelter property or otherwise to save the investor from personal liability on the loan will mean that the investor will not be considered at risk as to such amounts. Thus a nonrecourse loan directly to the partner secured by the partnership property or by the partner's share in the limited partnership will not be effective to increase the amount at risk,\(^{47}\) nor will any indirect "cross-collateralization," such as two shelters in which the loan funds contributed to each are secured by the property of the other shelter.\(^{48}\) If the investor is protected from personal liability on a loan by stop-loss, reimbursement, or insurance arrangements, he will not be considered to be at risk with respect to such a loan.\(^{49}\) Nor is the investor at risk for amounts borrowed, even with personal liability, from one who has an equity interest in the activity.\(^{50}\) Technical rules are provided to ascertain amounts at risk for an investor who engages in more than one of these activities simultaneously,\(^{51}\)

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\(^{45}\) I.R.C. § 465(b)(1).


\(^{50}\) I.R.C. § 465(b)(3). This section also provides that borrowing with personal liability from members of the family or entities related to the investor will not put the investor at risk with respect to such amounts.

\(^{51}\) For an investor not doing business through a partnership, each separate film, equipment rental property, farm, or oil and gas property is a separate activity. I.R.C. § 465(c)(2). Amounts at risk with respect to one film cannot be used to pick up losses incurred on another film venture. Thus, for the investor not doing business in a partnership, at risk is calculated on a project-by-project method. If the activity is being undertaken by a limited partnership, all the projects in one of the categories specified in I.R.C. § 465(c)(2) constitute a single activity. Id.; S. REP. No. 938, 94th Cong., 2d Sess. 51, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3439, 3486. Thus, all the films a partnership engages in constitute one activity and amounts at risk in one film can be used to pick up losses generated in another film, and so on. This suggests that a single investor seeking a tax shelter would be well-advised to form a partnership with another person, who would play a minor role, in order to take advantage of the more liberal partnership rules for allocating amounts at risk.
for carrying over losses which exceed amounts at risk to subsequent years.\textsuperscript{52}

This statutory scheme leaves some distinct crevices. Suppose a business does not use the partnership form—thus avoiding the “at risk” limitation of section 704(d)—and it is a business not specified in section 465, thus avoiding its “at risk” limitations as well. Such an activity would be, for example, coal mining, or records and books, where leasing of the property is not involved. It would appear that the investor who does not use the partnership form to carry on such businesses could successfully employ nonrecourse financing to increase his basis for the purpose of taking losses.\textsuperscript{53}

The Act’s assault on tax shelters did not stop with these devastating “at risk” rules. It also limited a number of the favorite deductions of the shelter lines of business. Although the real estate tax shelter survived the “at risk” rules, some of its most important deductions were severely tightened. Construction period interest payments and taxes must now be amortized over ten years, commencing when the property is first put into use.\textsuperscript{54} Prepaid interest must also now be capitalized and amortized, under regulations to be prescribed.\textsuperscript{55} Certain production costs for films, books, and records, which were currently deductible, must now be capitalized and amortized.\textsuperscript{56} The treatment of player contracts on the sale of a professional sports franchise was tightened.\textsuperscript{57}

\textsuperscript{52} See note 43 supra.

\textsuperscript{53} For an example of such an attempt, see text accompanying notes 88-89 infra.

\textsuperscript{54} I.R.C. § 189. There is a complex transition rule providing for a four-year amortization when the property is first put into use, which period gradually increases to 10 years. See I.R.C. § 189(b). The amortization rule starts to apply to various kinds of property in various years. Id. For further discussion of this transition rule, see Posin, supra note 4, at 213-14. The taxpayer, as before the Act, may still elect to capitalize construction period interest and taxes. I.R.C. §§ 266, 189(a).


\textsuperscript{56} The buyer of a professional sports franchise wants a large amount of his
The recapture provisions were also tightened. On the sale of residential real estate, all post-1975 depreciation in excess of straight line will be recaptured without reference to any holding period, thus bringing the treatment of residential real estate into line with commercial real estate.58 The sale of oil and gas property will give rise to recapture, at ordinary rates, of gain attributable to the deduction for intangible drilling and development costs.59 And on the disposition of a sports franchise, gain attributable to amortization of the player contracts and deductions for losses on the retirement or cutting of players will be recaptured at ordinary income rates.60 Also, the new carryover basis rule on death61 effected by the Act means that the bite of recapture cannot be escaped by a step-up of basis to fair market value if the investor dies while holding his shelter interest.

Thus, the Act provides a sophisticated and multileveled response to tax shelters. Almost all types of shelters except real estate appear foreclosed; and in real estate some of the rules are tightened.62 Although these changes might have been expected to engender some controversy, it is doubtful that anyone expected the burst of activity that ensued since these changes were enacted.

DEVELOPMENTS SINCE THE ACT

“At Risk”

The most interesting developments since the Act in the shelter field have involved the “at risk” rules. These developments have occurred on several fronts.

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58. I.R.C. § 1250(a)(1)(B). On the sale of low-income rental housing, less than 100% of accelerated depreciation over straight line may be recaptured, depending on the holding period. See id.


60. I.R.C. § 1245(a)(4).

61. I.R.C. § 1023.

62. In addition to the changes discussed, the bite of the minimum tax in the shelter area was increased. The minimum tax rate was increased from 10% to 15% and the exemption was reduced. See I.R.C. § 56. Several items relating to shelters were added as preferences. I.R.C. § 57.
Estate of Franklin v. Commissioner

Probably the single most intriguing development has been *Estate of Franklin v. Commissioner*, decided by the Ninth Circuit about the same time the final touches were being put on the Act. *Franklin* involved a sale of a motel to a limited partnership followed by a leaseback of the property to the original owner. The purchase price was to be paid in installments over ten years, plus a balloon payment at the end, for which the partnership had no personal liability. The annual rental payments on the leaseback just equaled the amount of the installment obligations. Thus no money was changing hands over the ten-year period, yet the partnership purported to own the property for purposes of depreciation and interest deductions.

The Ninth Circuit held, following *Crane*, that such an arrangement involving nonrecourse debt could be a valid sale and therefore support depreciation and interest deductions by the purchaser. However, the court held that in this instance the taxpayer had failed to carry the burden of showing that the nonrecourse debt did not exceed the fair market value of the property. Where the nonrecourse debt exceeds the fair market value of the property, the court stated, payments on the principal yield no equity in the property. Since the taxpayer had no equity in the property, the depreciation deduction would be denied because “‘depreciation is not predicated upon ownership of the property but rather upon an investment in property.’” The interest deduction also requires that the borrower have an equity in the property. The nonrecourse debt has no economic significance if it is for an amount greater than the value of the property securing it, since the borrower has no motivation to pay off the debt. Hence, since there was no bona fide indebtedness the interest deduction was disallowed. *Franklin*, therefore, resolved the question left open by *Crane* of what would happen if nonrecourse mortgage debt were used to buy property with a fair market value less than the debt. *Crane* and its progeny had held that where the property is worth

63. 544 F.2d 1045 (9th Cir. 1976).
64. Crane v. Commissioner, 331 U.S. 1 (1947); see text accompanying notes 20-22 supra.
65. Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 (9th Cir. 1976).
66. Id.
67. Id. at 1049 (quoting Mayerson v. Commissioner, 47 T.C. 340, 350 (1966) (citation omitted)) (emphasis in original).
68. See id.

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more than the nonrecourse debt, the nonrecourse debt would support deductions for depreciation and interest because the taxpayer would have an equity interest in the property and hence have a motivation to pay off the debt.69 Franklin has now held that where the nonrecourse mortgage debt is of an amount greater than the fair market value of the property, the debt will not support deductions for depreciation and interest.

The question might fairly be asked, "Why would a taxpayer purchase property for nonrecourse mortgage debt in excess of the fair market value of the property?" The answer appears to be that the Franklin court was using the concept of fair market value of the property without regard to the tax considerations. Obviously, no sane purchaser would pay more for property, whether using nonrecourse debt or not, than the property is worth. But where the purchaser, because he is in a high tax bracket, can enjoy substantial tax advantages on the purchase of the property, it may be rational for him to pay more than the property is worth in an economic sense.

Indeed, the facts in Franklin suggest that this is what was going on. Evidence was introduced in the lower court that the motel property involved had been purchased by the seller the previous year for about half the selling price to the taxpayer.70 Moreover, the property was insured for only about half this selling price.71

Franklin achieves a result similar to, but by no means identical with, the results under the "at risk" rules. Under the "at risk" rules, a nonrecourse liability is still considered part of the basis of

69. See, e.g., Bolger v. Commissioner, 59 T.C. 760 (1973), acq. 1976-1 C.B. 1, in which taxpayer bought property from a seller, leased it to a user and paid for the purchase by incurring nonrecourse liability to an institutional lender, secured by the property and an assignment of the lease. Lease payments were made directly to the lender. Thus, Bolger owned the property via the vehicle of nonrecourse debt, reported the lease payments as income and took the large depreciation and interest deductions. The Tax Court upheld this arrangement, following Crane, because the amortization of the mortgage increased taxpayer's equity in the property. See Mayer son v. Commissioner, 47 T.C. 340 (1966), acq. 1969-1 C.B. 21; Rev. Rul. 69-77, 1969-1 C.B. 9; see also Hudspeth v. Commissioner, 509 F.2d 1224 (9th Cir. 1975); American Realty Trust v. United States, 498 F.2d 1194 (4th Cir. 1974).

70. Estate of Franklin v. Commissioner, 544 F.2d 1045, 1048 n.4 (9th Cir. 1976).

71. Id. The Franklin court did not in fact make a substantive finding that the property had been purchased for more than its economic fair market value. See text accompanying notes 65-67 supra. Rather the court simply held that the taxpayer had failed to carry the burden of showing that the purchase price including the nonrecourse debt did not exceed the economic fair market value of the property.
property for purposes of computing depreciation and interest deductions and ascertaining basis. However, if depreciation and interest deductions give rise to operating losses in excess of amounts at risk, such losses will not be allowed (although they may be carried over and allowed if more amounts are put at risk). Thus, under the “at risk” rules, for purposes of ascertaining basis, the nonrecourse liability will be included in the basis of the property and the basis will be reduced by the full amounts of depreciation taken. This is not as harsh as the Franklin approach of disregarding the nonrecourse liability for all purposes, including computation of depreciation, deduction of interest, and ascertainment of basis, where the amount of the debt exceeds the fair market value of the property.

Franklin is therefore of great significance. All that is required to achieve its draconian results is for the Service to assert successfully that the taxpayer has failed to carry his burden of showing that the nonrecourse liability is not greater than the economic fair market value of the property. Since tax considerations tend to bid up the price of real estate shelter property beyond its economic value, the threat Franklin poses looms large indeed.

The Service, never one to procrastinate when a favorable decision is rendered, issued a ruling hard on the heels of Franklin, applying its rationale to a film tax shelter financed with non-recourse debt. The film shelter originated in 1974 and thus was not subject to the new “at risk” rules of section 465 which would have disregarded the nonrecourse debt for purposes of computing losses. Employing the same rationale as Franklin and citing it, the Service said that the nonrecourse note used to purchase the film would be disregarded in determining depreciation and interest deductions because the note was for an amount significantly greater than the economic fair market value of the film.

72. See note 43 supra.
73. Would the Service have the temerity to try to apply Franklin even in areas where the “at risk” rules do not apply in an attempt to achieve Franklin’s harsh results?
75. Id. In connection with this ruling, the Service has recently selected a number of pre-Act film tax shelter limited partnerships, which had been placed in suspense, to litigate in accordance with this ruling. After choosing a particular partnership for litigation, the Service will then bring cases against some partners and inform the other partners that their returns will remain in suspense until the cases are resolved, unless the other partners agree to be barred by the new ruling. IR Manual Supp. 45 G-287 (Aug. 24, 1977).
The implication of this ruling reaches far beyond film tax shelters originating prior to the Act. After that ruling taxpayers even outside the Ninth Circuit are faced with the threat of a Franklin analysis. Clearly, the ruling gives notice that the Service intends to press the Franklin approach in other types of businesses. Indeed several months after that ruling, the Service, in another ruling, addressed the purchase of a patent by a corporation for $5,000 plus a nonrecourse note for $1,995,000 secured by the patent and the receipts from it. Since the purchase of a patent is not one of the activities specified in section 465, the “at risk” rules of that section did not apply. Since a partnership was not involved, the “at risk” rules of section 704(d) did not apply. The Service thus applied the Franklin approach and held that since the taxpayer had failed to carry the burden of showing that the fair market value of the patent at least approximated the amount of the nonrecourse note, the note would be disregarded in ascertaining the taxpayer's cost of the patent for amortization purposes, and no deduction would be allowed for interest on the note.

Franklin and the Service's rulings in this area raise questions concerning the relationship among courts, Congress, and the Service. Where Congress has specifically exempted real estate and certain other activities from the new “at risk” rules, is it appropriate for a court to render a decision like Franklin and for the Service to press that rationale? It might be answered that the Franklin approach only applies where the nonrecourse debt is in excess of the fair market value of the property, whereas the new “at risk” rules disregard nonrecourse debt, for purposes of computing losses, regardless of the fair market value of the underlying property. However, it still seems that courts and the Service would be overreaching in pressing the Franklin analysis in real estate and other areas in light of Congress' clear purpose to exempt non-recourse financed real estate and certain other activities from the “at risk” sort of attack.

77. If the patent were licensed out, it might be argued that “equipment leasing” would be involved. See text accompanying note 89 infra. Also, I.R.C. § 465 did not cover this particular transaction because the taxpayer involved was a corporation.
Devices To Limit the Amount at Risk

If the debt involved in a transaction is not for an amount greater than the fair market value of the property, the arrangement will not be vulnerable to a Franklin-type attack. However questions can still arise as to whether there is the true personal liability for the debt which would avoid the "at risk" limitations. As discussed above, the Act and its legislative history make clear that arrangements which purport to subject the investor to personal liability on the debt, but which in fact stop the investor's loss or otherwise hold him harmless from personal liability on the debt will be ineffective to increase the investor's amount at risk. Nevertheless "hope springs eternal" and since the Act a number of such schemes have been tried. All that have been ruled on thus far have failed.

One of the more ingenious arrangements was a ten-year note with personal liability which financed eighty percent of the purchase price of a movie project. Fifty percent of the gross receipts from the movie were to be applied against the note. If at the end of the ten-year period there was any unpaid balance on the note, the taxpayer could obtain a loan from a third party to repay it. The loan was renewable from year to year at the taxpayer's option until the balance was finally paid from the receipts of the film. The Service ruled that the amount of this liability was not at risk. Although the Service gave no reason, undoubtedly it viewed the arrangement as simply a device to limit the taxpayer's personal liability.

79. See text accompanying notes 47-50 supra.
"Hope" is the thing with feathers—
That perches in the soul—
And sings the tune without the words—
And never stops—at all . . .
81. See Rev. Rul. 77-398, 1977-44 I.R.B. 8. In two rulings related to this, taxpayer used debt on which he had no personal liability to finance his business activity. The debt was secured by taxpayer's business property and guaranteed by taxpayer's customer. The Service said in both cases that the loan was really to taxpayer's customer and hence the loan was ineffective to increase taxpayer's basis for the purpose of calculating operating losses. Rev. Rul. 78-30, 1978-4 I.R.B. 9 (beachfront dredging engaged in by individual covered by neither § 465 nor § 704(d) of the Code); Rev. Rul. 77-125, 1977-1 C.B. 130 (film "production service" shelter arising prior to effective date of I.R.C. § 465).
Another strategy involved a general partnership engaged in roadbuilding which used a small downpayment and a nonrecourse note to finance machinery for the business. In its first taxable year the partnership sustained a loss which could not be used by the partners in that year because they did not have sufficient bases in the partnership under the new "at risk" rules.\textsuperscript{82} To increase the partners' bases, the partnership, on the last day of its taxable year, purchased a substantial amount of United States Treasury obligations, financed by a small downpayment and a large note on which the partners were personally liable. The interest rate on the note was greater than the rate of return on the Treasury obligations. The Service held that the recourse loan would be ineffective to increase the partners' amounts at risk.\textsuperscript{83} Clearly, the Service regarded the transaction as a stratagem to circumvent the congressional purpose in the "at risk" area. Although the Service did not explain its rationale, that the transaction made no sense from an economic standpoint must have played a major role in its decision.\textsuperscript{84}

Suppose, however, the rate of return on the Treasury obligations had been greater than the interest rate on the note. Or, suppose the partnership had borrowed, with recourse, to finance the purchase of common stocks on margin, an investment not doomed to be an economic loss. It would seem to be much harder for the Service to assert that such transactions would be ineffective to increase the partners' bases,\textsuperscript{85} unless the Service is beginning to fashion a rule that, for section 704(d) purposes, an increase in basis due to recourse liability must be incurred in the same line of business as are the losses sought to be deducted. Although this is the approach for section 465 activities,\textsuperscript{86} there is nothing in section 704(d) or its legislative history which would support such an approach un-

\textsuperscript{82} I.R.C. § 704(d) applied because roadbuilding is not an activity covered by I.R.C. § 465, and it is not real estate.


\textsuperscript{84} See Knetsch v. United States, 364 U.S. 361 (1960) where taxpayer used nonrecourse loans to finance purchase of annuities and took large prepaid interest deductions. The Court barred the deductions on the grounds that the transaction had no economic substance for taxpayer. This same theme was picked up in Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). For a discussion of this case, see text accompanying notes 63-73 supra. In connection with Knetsch, see I.R.C. § 264(a)(3). See also Rev. Rul. 78-175, 1978-19 I.R.B. 11, for another unsuccessful attempt to avoid the at risk rules using a grantor trust.

\textsuperscript{85} Such arrangements look even more plausible, of course, if they are not undertaken on the last day of the taxpayer's taxable year.

\textsuperscript{86} See text accompanying notes 43-46 supra.
der section 704(d). There undoubtedly will be further developments on this front.

The Reach of “At Risk” Rules

As discussed earlier,87 there are some possible crevices in the statutory “at risk” scheme. While real estate is intentionally excepted from the rules, it might be asked whether certain other activities might also escape the clutches of “at risk.” One valiant attempt was master recordings. The investor bought, for a down-payment plus a nonrecourse note, a metal master record, used to make the records bought by the public. The investor then licensed the record to a record manufacturer. The investor did not use the partnership form, so section 704(d) was not involved. Since the record was section 1245 property, leasing it would be an activity covered by section 465.88 However, the investor hoped that “licensing” the record would not be considered “leasing” for section 465 purposes. The Service, however, took a broad view of “leasing” and ruled that it encompassed the licensing arrangement.89 Thus the Service is taking an expansive view of what constitutes activities covered by section 465.

The Limited Partnership

While the “at risk” area has witnessed the most involuted developments since the 1976 Act, there has been significant activity in the limited partnership dimension of tax shelters as well.

As previously noted,90 where a partnership is the shelter vehicle, the Service may classify the entity as a corporation. The Service’s tale of woe in this area, however, borders on the pathetic. The Service initially promulgated regulations in this area to try to prevent partnerships of professionals, such as doctors and lawyers, from being classified as corporations, so that these entities would not enjoy pension and other employee benefits associated with corporations. This effort having failed,91 the Service was stuck with regul-

87. See text accompanying note 53 supra.
88. See I.R.C. § 465(c)(1)(C).
89. See Rev. Rul 77-397, 1977-44 I.R.B. 7. See also I.R. 1921 December 23, 1977 for a similar restrictive treatment of books, lithographs, and musical tapes. H.R. 13511, 95th Cong., 2d Sess., 124 CONG. REC. 8367 (1978), would explicitly extend the reach of the “at risk” rules to all activities other than real estate, thus sounding the death knell for possible shelters in such things as coal mining, books, and lithographic plates.
90. See text accompanying notes 6-10 supra.
lations that generally made it difficult for limited partnerships to be classified as corporations. The Service did not attempt to revise these regulations. When the Service then turned to attack limited partnership tax shelters by classifying them as corporations and thus denying them the passthrough of large losses, these regulations proved a millstone around the Service's neck. The tax shelter limited partnerships were generally classified as partnerships under these regulations.

The Service, belatedly realizing its problems under its own regulations, promulgated proposed regulations in January 1977 that would have made it very likely that the typical tax shelter limited partnership would be classified as a corporation. The reaction to these proposed regulations was so unfavorable and swift that then-Treasury Secretary William Simon ordered them withdrawn within a matter of hours. The Service, clearly cowed by these events, recently issued a Letter Ruling, conceding that a limited partnership which is organized under state law materially corresponding to the Uniform Limited Partnership Act will be treated as a partnership under these regulations. The only requirements are that the partnership meet the Service's rules relating to net worth requirements of general partners and qualify under the guidelines prescribing when the partnership will not be regarded as a "tax avoidance" or "sham" transaction.

This controversy is, of course, most relevant to the field of real estate which is the major area in which limited partnership shelter activity is possible after the Act. There have been other de-

92. See Treasury regulations cited note 10 supra.
93. See id.
94. The proposed regulations provided that an entity which had two of the characteristics would be a corporation. See text accompanying notes 6-7 supra. Hence an entity would have to lack three of the characteristics to be a partnership. N.Y. Times, Jan. 7, 1977, at A 11, col. 3.
97. Rev. Proc. 72-13, 1972-1 C.B. 735. Where a corporation is sole general partner in a limited partnership tax shelter, as is often the case, the corporation's net worth must be at least 10% of the total contributions to the partnership. In small partnerships the requirement is 15%. Id.
98. See text accompanying notes 11-14 supra.
99. President Carter's tax reform proposals would require limited partnerships other than those engaged in residential real estate to be treated as corporations if they have more than 15 limited partners. The particular bite of these new rules would therefore be on the large commercial real estate limited partnerships. President Carter's tax reform proposals would also apply the "at risk" rules to activities.
velopments in the partnership area as well.¹⁰⁰

**Large Deductions**

Since the Act, the Service has been leaning heavily on various large deductions, which are an integral part of tax shelters, that survived the "at risk" rules. The Service has also attacked deductions in arrangements originating prior to the effective date of the Act. The Service has, by ruling, significantly limited the deductions for prepaid timber royalties,¹⁰¹ the deductions using the income forecast method of depreciation in the movies, records and books areas,¹⁰² the deductions for movies and films using other methods of accelerated depreciation,¹⁰³ the deductions for options to sell interests in leases on federal lands,¹⁰⁴ and the amortization of covenants not to compete.¹⁰⁵ In addition to these rulings, the Service also issued final regulations restricting the immediate deduction of advanced royalties for coal or other mineral properties.¹⁰⁶

The only time the Service has failed in this area has been when it was unable to bar deductions in the courts for prepaid feed expenses on the ground that they "distort income."¹⁰⁷ Given the great taxpayer pressure in this area, it is likely that some of these other rulings will be attacked in the courts.

¹⁰⁰ Undertaken in the corporate form where there are five or fewer shareholders. See N.Y. Times, Jan. 22, 1978, § 1 (Main), at 33, col. 1.


¹⁰⁶ T.C. 7523, 1978-5 I.R.B. 11. The Service has also promulgated a proposed regulation that would generally require the computation of the investment credit to be limited to amounts at risk under the rules of I.R.C. § 465. 42 Fed. Reg. 63,791 (1977) (Proposed Treas. Reg. § 1.48-8(a)(4)).

¹⁰⁷ Owens v. Commissioner, 568 F.2d 1233 (6th Cir. 1977) (deduction upheld on ground that change to any other method of accounting would not lead to different result). But see Clement v. United States, No. 131-75 (Ct. Cl. July 14, 1978).
Winding Up the Shelter

Since passage of the Act, the only development in winding up tax shelters was a maneuver which the Service ruled was ineffect-ive to avoid gain on disposing of a shelter after its large early deductions had been exhausted. Taxpayer used a grantor trust to purchase a share of a real estate partnership. Under the grantor trust rules, the deductions from accelerated depreciation generated by the partnership were attributed to the taxpayer. When the major benefit of the depreciation deduction was exhausted and the venture was beginning to show income, taxpayer renounced his re-tained powers. Taxpayer’s theory was that since the trust was no longer a grantor trust, by virtue of the renunciation, the income from the partnership was not properly attributable to him. The Service ruled, however, that the renunciation was in effect a trans-fer of the interest in the partnership from taxpayer to the trust. Gain on that transaction would be computed under the usual rules for computing gain on the transfer of a partnership interest which include considering as part of taxpayer’s amount realized the elimi-nation of taxpayer’s responsibility for partnership liabilities. Since taxpayer’s basis in the partnership was almost zero, due to the loss deductions, taxpayer had a substantial taxable gain. Again this ruling illustrates the Service’s hard line on shelters after the Act.

Administrative Attack on Shelters

The Service’s bellicose attitude toward shelters is manifested also in the area of tax return administration. The policy initiated may well be even more far-reaching in practical effect than the sub-stantive developments. In fiscal 1978, the Service will double the number of partnership returns it audits, bringing the total to about three percent of all partnership returns filed. However it will focus in particular on “abusive” partnerships, identified by such criteria

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108. A grantor trust is a trust the income and losses of which are attributed to the grantor because of his retained powers to control or revoke the trust. See I.R.C. §§ 671-679.


110. See Rev. Rul. 77-402, 1977-44 I.R.B. 10. See also Austin v. United States, 461 F.2d 733 (10th Cir. 1972) (withdrawal from partnership causing liabilities to be assumed by other partners gives rise to amounts realized in amount of liabilities assumed); Rev. Rul. 75-194, 1975-1 C.B. 80 (same result for charitable gift of partner-ship interest where partnership has nonrecourse liabilities outstanding); Rev. Rul. 74-40, 1974-1 C.B. 1959 (same result for nonrecourse liabilities).
as partnership losses in excess of $25,000, low gross income, an entity formed late in its taxable year, negative capital account or substantial reduction in capital assets, and "mischaracterization" of payments to partners that should be considered capital items.\textsuperscript{111} The Service will also use computer systems to track partners' amounts at risk and to integrate examinations of partnerships with large numbers of partners in different districts.\textsuperscript{112} Perhaps most significantly, the Service will communicate with state securities agencies to help identify novel shelter arrangements. This procedure could presumably give rise to early and unfavorable rulings.\textsuperscript{113} H.R. 13511,\textsuperscript{114} at this writing passed by the House, would toughen the rules regulating partnerships by imposing a penalty on the failure to timely file a partnership return and by extending the statute of limitations for reporting certain partnership return items.

**SUMMING UP**

Although high-bracket taxpayers still follow the ancient instinct to seek refuge from the progressive rates, the areas of reliable shelter are shrinking substantially. The Tax Reform Act of 1976 sent a shock wave through the shelter field, the ramifications of which are still being worked out by rulings and court cases. And they are being worked out almost uniformly adversely to taxpayers. Following the Act and its aftermath, real estate appears to be the only viable limited partnership tax shelter, and even it has been restricted in significant respects. As to most other kinds of tax shelters, it is raining very hard.


\textsuperscript{112} Id. The revised partnership form 1065 will require general partners to indicate amounts at risk with respect to each 465 activity engaged in by the partnership. The Service also promulgated temporary regulations detailing transitional rules for computing partners' amounts at risk for partnerships already in existence prior to the effective date (January 1, 1977 for calendar year taxpayers) of the "at risk" rules. T.D. 7504, 1977-39 I.R.B. 9.

\textsuperscript{113} See, e.g., IR 1899, supra note 111. The Service is also considering seeking legislation which will allow partnership questions to be litigated at the partnership level with the result binding on the partners. This would be an improvement over the present system of putting some partners' returns in suspense while others are litigated, raising the possibility of having to relitigate identical issues in different forums.

\textsuperscript{114} 95th Cong., 2d Sess., 124 CONG. REC. 8367 (1978).