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TAX REFORM AND THE REVENUE ACT OF 1971: LESIONS, LAGNIAPPES AND LESSONS

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I. FOREWORD†

The Revenue Act of 1971 produced for the cause of tax reform a number of wounds (some serious, some minor), a few small gifts, and some valuable lessons. Predictably, where new tax preferences were introduced—or old ones reinstated—as incentives or subsidies for particular types of economic behavior, the familiar process of integrating these financial benefits into the economic life of the country began promptly. Tax advisors for the individuals or corporations benefited by the tax preferences quickly moved to analyze the provisions and formulate the adjustments in business practices and methods of operation necessary to facilitate use of such preferences as the investment credit, the asset depreciation range (ADR) system that accelerates depreciation for qualifying assets, the work incentive program (WIN) tax credit, and the special provisions for “domestic international sales corporations” (DISC). Law review articles, tax institute programs, trade newsletters, and the like all reflect the skill and facility with which lawyers, accountants, economists, and business advisors put these provisions to work for their clients. Similarly, in those few areas where the 1971 Act limited the availability of tax preferences, the necessary shifts and adjustments in business practice were made, often with the effect, as will be seen below, that the use of the tax preferences simply shifted to different groups of taxpayers who were unaffected by the limits as drafted. Here, too, the literature is plentiful.

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† As this article was going to press, the Department of the Treasury released its Proposals for Tax Change (April 30, 1973). Rather than revising the body of the article, it appeared more useful to examine the Treasury's proposals in light of the text discussion as originally drafted and to make some preliminary comparisons between the recommendations advanced herein and those of the Treasury. A discussion of the Treasury's proposals is therefore deferred to an Afterword, p. 852 *infra*.

The articles in this issue move beyond a technical analysis of the Revenue Act of 1971. They focus rather on the Act in terms of its implications for tax reform. They analyze major provisions of the Act by drawing our attention to the forces that operated to produce them, the impact of those measures on tax equity, and their economic and social justifications, real or fanciful.

Of the lesions referred to in the title of this article, the most serious setbacks to tax reform efforts were created by the provisions providing capital recovery allowances for industry: the restored 7% investment credit¹ and the ADR system² with its accompanying class lives repair allowance system. Professors Brannon and Taubman discuss the extraordinarily weak economic arguments advanced by the Treasury on behalf of these provisions.³ The Democratic members of Congress, however, proved unable or unwilling to develop a coherent and organized set of responses, either on economic or tax equity grounds, to those arguments. From the standpoint of tax reform, passage of the investment credit and ADR raises serious equity issues at the *corporate* level, producing tax disparities between capital intensive and labor intensive business, and between classes of corporations—primarily commercial banks—that can use these special benefits as tax shelter devices and those that cannot. At the *individual* level, the introduction of ADR added an alternative to the various five-year rapid amortization provisions which high-bracket taxpayers could utilize in tax shelter equipment leasing devices, and resulted in a corresponding adverse impact on the equity of the progressive individual income tax.

The introduction of the WIN tax credit⁴ and the provision for rapid amortization of on-the-job training facilities⁵ were of lesser impact in terms of the revenue involved, but nonetheless ran counter to the interest of tax reform. These new "tax expenditures"⁶ were adopted, as has been Congress' wont, without any studies that would measure their effectiveness or efficiency as compared to federal programs providing direct financial assistance to place low-income individuals in productive employment. For example, Congress never asked even such a basic question as why it wanted to encourage employment of those individuals only in profit-making industries and not in government or in

¹ Int. Rev. Code of 1954, §§ 46-48, 50.

² Int. Rev. Code of 1954, § 167(m).

³ See Brannon, *The Revenue Act of 1971—Do Tax Incentives Have New Life?*, 14 B.C. Ind. & Com. L. Rev. 891 (1973); Taubman, *The Investment Tax Credit, Once More*, 14 B.C. Ind. & Com. L. Rev. 871 (1973).

⁴ Int. Rev. Code of 1954, §§ 50A, B.

⁵ Int. Rev. Code of 1954, § 188.

⁶ The term "tax expenditure" in this article is used in the sense developed in Surrey, *Tax Incentives—Conceptual Criteria for Identification and Comparison with Direct Government Expenditures*, in Tax Institute of America, *Symposium on Tax Incentives* 3 (1971).

tax-exempt activities such as hospitals or educational institutions; by definition, the tax credit and the amortization provision that it enacted are usable only by employers with a business profit that generates tax liability. Professor Brannon observes that these provisions may constitute part of a passing fad, but Congress' willingness to rush in with a tax preference to meet each new social or economic problem that engages the attention of the country does not bode well for tax reform efforts. Too much time and effort are diverted in attempts to eliminate these aberrations from the Code—time and effort that should be devoted to basic research and education on the more fundamental problems created by the major tax preference provisions.

The adoption in the 1971 Act of the Nixon Administration's DISC proposal,⁷ a measure which in general permits qualified corporations to defer the tax on one-half of their export income, caused a third lesion in the side of tax reform. As Professor Brannon's article suggests, the justifications offered by Treasury officials for DISC were so embarrassingly weak as to be humorous, were it not for the fact that as a result of this measure taxpayers either paid some \$170 million in additional taxes in 1971 or had to forego government services that such funds would otherwise have provided. DISC represented a pure windfall to corporate exporters, since there was no requirement that they increase their exports to qualify for the Treasury largesse. And, while we are relatively accustomed to the process by which private financial advisors promote the use of tax preferences, it has been somewhat disconcerting to see the Treasury shouldering aside private advisors to become the foremost purveyor and advocate of this new tax loophole.⁸

Some minor contusions caused by the 1971 Act may be noted. The exceptions to the restrictions in industrial development bonds were expanded.⁹ While the 1971 changes were relatively small, the movement was in the wrong direction. What is needed is elimination of the exemptions from the industrial development rules, not expansion. For example, investment bankers predict that the dollar volume of bonds issued under the exemption for pollution control facilities¹⁰ alone will equal in 1974 the total of *all* industrial development bonds issued in 1968,¹¹ the year in which Congress responded with section 103(c) to the pressures created on the municipal bond market by the volume of industrial development bonds.

The revisions in section 214—the deduction for household services

⁷ Int. Rev. Code of 1954, §§ 991-97.

⁸ See U.S. Treasury Dep't, DISC: A Handbook for Exporters (1972).

⁹ See Staff of Joint Comm. on Internal Revenue Taxation, 92nd Cong., 1st Sess., General Explanation of the Revenue Act of 1971, at 75-76 (1972) [hereinafter cited as General Explanation].

¹⁰ Int. Rev. Code of 1954, § 103(c)(4)(F).

¹¹ N.Y. Times, Oct. 22, 1972, § F, at 13.

and child care expenditures—serve as a useful transition from lesions to lagniappes. As the article in this issue by Professor Klein¹² illustrates, it is a complex matter to decide whether the child care provision represents a tax expenditure or an attempt to work out a structural problem within the income tax system. Proponents of the 1971 changes were by and large thinking in tax expenditure terms.¹³ Viewed in such terms, the 1971 actions regarding child care programs provide a classic illustration of the inconsistency with which Congress deals with direct expenditure and tax expenditure programs. As a tax expenditure program, section 214 provides the greatest financial benefit to taxpayers with \$18,000 adjusted gross income. The benefits decrease with income as a function of lower marginal rates; and, for the mother or father who heads a family of three children and earns \$4300 per year or less, the tax expenditure provision provides no federal assistance at all. Yet in the same session in which section 214 of the Internal Revenue Code was expanded, Congress also passed a direct program of federal financial aid for child care.¹⁴ Under this program, 100 percent of day care costs were provided for poverty-level families—the group to whom the tax system gives no help at all—and the federal aid decreased as family income increased—again, precisely the opposite of the tax expenditure program. Indeed, it was apparently contemplated that benefits under the direct assistance program would be phased out entirely at about \$10,000 of income—the level at which the tax benefits begin to produce a substantial financial benefit.¹⁵

Advocates of still further liberalization of section 214 seem to have changed their view of the provision and now regard it primarily as a structural provision intended to provide the mechanics for deducting a cost of producing income.¹⁶ It is true that if the child care deduction has any rational place in the Code, it must be regarded as a cost of producing income. However, as Professor Klein's article points out, much research and analysis remain to be done before the appropriate dimensions of such a deduction can be developed. Viewed as a tax expenditure measure the 1971 changes in the child care deduction were unfortunate; if those changes, however, prove to be the cause for more reflective consideration of the nature of expenditures for child care within an income tax system, the congressional action may rate a qualified plus.

¹² Klein, *Tax Deductions for Family-Care Expenses*, 14 B.C. Ind. & Com. L. Rev. 917 (1973).

¹³ See 117 Cong. Rec. S18,550-55 (daily ed. Nov. 15, 1971).

¹⁴ S. 2007, 92d Cong., 1st Sess. (1971). The bill was vetoed by the President.

¹⁵ See 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, *Federal Income Taxation* 641-44 (1972).

¹⁶ See, e.g., H.R. 1442, 93d Cong., 1st Sess. (1973), allowing expenses for household help as a deduction from gross income.

TAX REFORM, TAX SHELTERS AND TAX PREFERENCES

The gifts laid at the altar of tax reform in the 1971 Act were meager indeed when compared with the lesions discussed above. Nonetheless, as Professor Brannon's comments indicate, that Congress took action insuring that poverty-level persons will not be required to pay income tax is a hopeful sign.¹⁷ The acceleration of the increase in the standard deduction¹⁸ may be viewed as constructive both in terms of simplification of the tax system and as a reform reducing the disparity between persons claiming the standard deduction and those itemizing personal deductions.¹⁹ Finally, in what surely must have been regarded as a reform measure by Congress, individual investor-lessors were generally denied the opportunity to utilize the reinstated investment credit.²⁰ This provision was intended to preclude use of the credit in syndicated equipment leasing tax shelter programs.²¹ Whether the overall effect of the provision has proved beneficial is a matter considered in greater detail below.

There are valuable lessons to be learned by tax reformers from the experience in 1971. The primary lesson, one we learned long ago but which was reinforced by the process that produced the 1971 Act, is that the Treasury can wield immense power—especially when forcefully backed by the White House—to secure adoption of its views by Congress when it is advocating measures that constitute tax preferences for particular economic activities. The reinstatement of the investment credit is a useful example. In 1969, when Senators Harris, Kennedy, and others proposed suspension or repeal of the investment credit,²² repeal was easily accomplished once the Nixon Administration took the same position. But in 1971, when the Administration was seeking reinstatement of the credit, Senator Nelson could muster only a handful of votes for an amendment that would have placed a limit on the

¹⁷ The low-income allowance was increased to \$1300, Int. Rev. Code of 1954, § 141(c). Coupled with the personal exemption of \$750 per person, the level of tax-exempt income for family units of varying sizes closely approximates federal poverty level figures. See General Explanation, *supra* note 9, at 49-51.

¹⁸ The maximum standard deduction is 15% of adjusted gross income, with a ceiling of \$2000. Int. Rev. Code of 1954, § 141(b).

¹⁹ An additional reform relating to the standard deduction is provided in Int. Rev. Code of 1954, § 141(c), which denies use of the standard deduction by a dependent to offset unearned income. This action puts some limits on wealthy individuals who set up grantor trusts designed to spin off an amount of income to each dependent approximately equal to the amount of income that a single individual can receive free of tax. Prior to the 1971 amendment, the figure was \$1750 (the then \$1000 low-income allowance plus \$750 personal exemption). A restriction similar to § 141(c) would appear in order for the personal exemption under § 151. Receipt of tax-free income from a trust by offspring of wealthy parents is consistent neither with the purpose of the low-income allowance nor with that of the personal exemption.

²⁰ Int. Rev. Code of 1954, § 46(d)(3).

²¹ General Explanation, *supra* note 9, at 40-41.

²² See 115 Cong. Rec. 9170 (1969) (remarks of Sen. Harris).

amount of investment that could qualify for the investment credit.²³ DISC is another example of the Treasury's effectiveness. The Treasury had initially tried to ease the DISC proposal through the Senate Finance Committee, without any public hearings, on the last day of its executive sessions on the Tax Reform Act of 1969. Frustrated in this attempt by Senator Gore, the Treasury tried once more in 1970,²⁴ but again was beaten back. But in 1971, the tax reform forces in Congress were simply unable to withstand continued Treasury persistence and pressure.

The converse of the lesson, of course, is the inability of Congress to enact major tax reforms over the opposition of the Treasury, indeed perhaps in the absence of active assistance from the Treasury. Since 1969 the present Treasury's efforts have been largely devoted to advocating further tax preferences rather than tax reform.²⁵ Given the experience in 1971, one cannot be optimistic that Congress can generate major tax reform on its own initiative.²⁶

This analysis, if correct, permits certain implications to be drawn for a strategy of tax reform over the next two years. The House Ways and Means Committee has concluded its Panel Discussions and Hearings on Tax Reform.²⁷ Presumably the topics selected for the Panel Discussions represent those areas where reform is seen as most necessary and/or most likely. Reform in the nine income tax areas²⁸ covered in the

²³ 117 Cong. Rec. S18,488-96 (daily ed. Nov. 13, 1971). The amendment was defeated by a vote of 53-13.

²⁴ The measure passed the House, but not the Senate. See H. Rep. No. 91-1435, 91st Cong., 2d Sess. 58 (1970).

²⁵ Reportedly much of the present Treasury's efforts at tax "reform" have been devoted to developing new tax expenditures to provide property tax relief for the elderly and tuition assistance for parents of children in private schools. See, however, p. 852 *infra*.

²⁶ Some might argue that the Tax Reform Act of 1969 resulted from congressional initiative. While the Ways and Means Committee did commence the legislative process on its own, I suggest that the emergence of a bill resulted from two actions by the executive branch: (1) the publication of the U.S. Treasury Department, Tax Reform Studies and Proposals (House Ways and Means Comm. and Senate Finance Comm., 91st Cong., 1st Sess.) (Comm. Print 1969) [hereinafter cited as Tax Reform Studies]; and (2) the adoption of many of the 1968 Treasury Proposals by the Nixon Administration in 1969. The 1968 Studies gave Congress the research and background material so necessary to effect significant tax reform, material that to date the tax-writing committees have not shown an ability to develop on their own.

²⁷ The formal statements of the members of the eleven panels have been published by the House Ways and Means Committee; see Prepared Statements Submitted by Witnesses Invited to Appear Before the Committee on Ways and Means to Participate in Panel Discussions on Tax Reform, 93d Cong., 1st Sess. (1973) [hereinafter cited as Panel No. —]. Useful summaries of the panelists' prepared statements are contained in Staff of the Joint Comm. on Internal Revenue Taxation, 93d Cong., 1st Sess., Summary of Testimony of Panelists on Tax Reform Topics (Comm. Print 1973).

²⁸ The eleven panels treated nine income tax areas. Panel No. 1 (Feb. 5, 1973) *supra* note 27, covered in broad terms "Objectives and Approaches to Tax Reform and Simpli-

Panel Discussions is certainly needed, but a realistic appraisal of those areas indicates that the prospects for significant reform may well be limited to only two.

As to the most important tax preferences—capital gains (Panel No. 2), accelerated depreciation, the investment credit, and the various rapid amortization provisions (Panel No. 3), real estate (Panel No. 4), percentage depletion and the intangible drilling and development expense deduction (Panel No. 9), and the tax rules for farm operations (Panel No. 5)—the Treasury is firmly on record not only as being opposed to elimination of these items, but as sponsoring many of them. Accordingly Treasury opposition can be expected with respect to any proposals for direct curtailment or elimination of these tax preferences. Thus if my conclusions from the congressional experience in 1971 are correct, there is little realistic possibility that substantial direct reform in these areas will be achieved in the next two years.

In the area of pension and profit-sharing plans (Panel No. 7), substantial work has been done by the Senate Labor and Public Welfare Committee. However, the likelihood of reform with respect to the *tax provisions* governing employee benefit plans appears slight. This conclusion is based on this writer's view that the Nixon Administration's proposals in this area move in the wrong direction, *i.e.* toward additional tax preferences instead of rigorous examination of the present tax expenditure provisions.²⁹

The area of taxation of income from foreign business operations will presumably be reviewed in connection with the Congressional consideration of the President's trade proposals. Again, however, the Nixon Administration has taken a strong stand against any major reform of the tax treatment of foreign income.³⁰

The above analysis leads to the conclusion that there are only two areas considered in the Panel Discussions that represent likely candidates for congressionally initiated tax reform.³¹ The first of these configurations." Panel No. 10 (Feb. 27, 1973) was devoted to "Estate and Gift Tax Revision," a subject not included in this discussion.

²⁹ See the Administration's proposals at 119 Cong. Rec. H2596-97 (daily ed. April 11, 1973). For a persuasive and detailed criticism of the Administration's recommendations, see Statement of Prof. Daniel I. Halperin, in Panel No. 7 (Feb. 22, 1973), *supra* note 27.

³⁰ See 119 Cong. Rec. H2556 (daily ed. April 10, 1973).

³¹ A third area of tax reform may be achieved if Congress enacts the proposed federal subsidy for taxable bonds issued by state and local governments. See statements in Panel No. 8 (Feb. 23, 1973), *supra* note 27. Since the tax exemption of § 103 is not directly removed by such a measure, I have not included it in the category of direct tax reform measures likely to be enacted. The proposed federal subsidy for taxable bonds does provide, however, an example of the utility of achieving tax reform by introducing direct financial assistance programs as alternatives to tax expenditures. The hope in the case of the subsidy, of course, is that the federally subsidized taxable bonds will prove so attractive to state and local governments that tax-exempt bonds will die a natural death.

cerns tax shelters and the second is the minimum tax. I suggest them as prime candidates for significant reform by virtue of my reading of the lessons learned in 1971.⁸² Curtailing of tax shelter operations appears possible for two reasons: one, Congress appears aware of and willing to take action with respect to tax shelters, as evidenced by its 1971 action largely limiting the investment credit to corporate lessors; two, the Nixon Treasury, while favoring the underlying provisions that give rise to tax shelter devices, has not made any effort to defend the shelter arrangements themselves.

Action to strengthen the minimum tax—which can be viewed both independently and as one response to the tax shelter problem—also appears possible. The basic study on the concept of a minimum tax was done by the Treasury in 1968.⁸³ The task that remains is to improve upon the structure now contained in sections 56-58 of the Code. Congress has before it the views of academicians and private practitioners regarding steps that can be taken to strengthen the minimum tax. Further, the Nixon Treasury has tended in the past to look with favor on the minimum tax concept and thus here too, as in the case of tax shelters, tax reform efforts may be able to win Treasury support or at least avoid active Treasury opposition.⁸⁴

Against this backdrop, the articles in this issue by Professors Brannon, Taubman, and Klein make a valuable contribution to the ongoing tax reform effort. Professor Brannon focuses our attention on the vagaries of the legislative process, paying specific attention to the investment credit and ADR, two principal tools in current tax shelter operations. Professor Taubman's article on the investment credit provides needed analytical tools if Congress is to grapple with the general role of the investment credit in the tax system and, more particularly, its utilization in tax shelter transactions. The Ways and Means Committee has continued to be concerned about the proper tax treatment of family units where both spouses work and of family units headed by one working adult.⁸⁵ Professor Klein's article here focuses attention on

⁸² I should note that I participated in Panel No. 6 (Feb. 20, 1973), *supra* note 27, and presented testimony with respect to these two subjects. I may, therefore, be engaging in wishful thinking by suggesting these areas as likely candidates for tax reform action. The reader will have to balance for himself the arguments advanced in the text for this proposition against the bias that may be present by virtue of my personal involvement in the panel discussions on these subjects.

⁸³ Tax Reform Studies, *supra* note 26, at 132.

⁸⁴ The Treasury in 1969 proposed a minimum tax system known as the Limitation on Tax Preferences (LTP), which was adopted by the House. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 77 (1969). However, the Treasury in 1970 favored enactment of the very liberal carryover provision contained in Int. Rev. Code of 1954, § 56(c). This provision materially weakened the impact of the minimum tax.

⁸⁵ See Hearings on the Tax Treatment of Single Persons and Married Persons Where Both Spouses are Working Before the House Ways and Means Comm., 91st Cong., 2d Sess. (1972).

the central issues of this complex problem and points the discussion in the right direction from the standpoint of tax reform.

This writer's contribution to this issue will consist of a development of the theme suggested above. At the outset some aspects of tax shelter operations and a range of possible responses to the problems created by tax shelters will be considered. Second, suggestions for strengthening the minimum tax will be offered. The goal of both discussions is to develop tax reform positions in these two areas where reform appears feasible, positions that seem to be both responsive to the problems and within the range of political acceptability. The purpose of the following discussion is therefore not to develop the ideal tax reform positions with respect to the range of problems created by tax preferences in our income tax structure, but to explore limited but potentially enactable responses to the problems presented by tax shelters and tax preferences.⁸⁶

II. TAX REFORM AND TAX SHELTERS

Introduction

The problems created by tax shelter devices and the problems to which the minimum tax is directed arise from two basic propositions:

- (1) Congress desires, as a matter of national policy, to provide federal financial assistance to selected industries or economic activities; and
- (2) Congress has determined that it will provide that financial assistance through the federal income tax system in the form of special tax provisions—credits, deductions, exemptions, deferral of tax liability, or preferential rates—which function as “tax expenditures.”

Generally, few would quarrel with the desirability of most of the goals sought to be obtained through the federal financial assistance—low income housing, adequate energy resources for a technological society, abatement of industrial pollution, modernization of plant machinery and equipment, rehabilitation of low income housing, development and conservation of our agricultural resources, and the like. While many question whether the tax system is the best means for rendering that financial assistance,⁸⁷ the analysis in this section accepts *arguendo*

⁸⁶ The material in sections II and III is based on the writer's statement submitted to the House Ways and Means Committee during the Hearings on Tax Reform Topics (Panel No. 6: Minimum Tax and Tax Shelter Devices, Feb. 20, 1973, *supra* note 27).

⁸⁷ See, e.g., Surrey, Tax Incentives as a Device for Implementing Government Policy:

that the congressional decision to employ tax expenditures in selected areas will continue.

Increasingly, however, we have become aware that the decision to employ the federal income tax system as the vehicle for delivering federal financial aid creates problems. One problem is that every time Congress enacts a tax preference for a particular industry or economic activity, a highly skilled band of tax and financial advisors with a battery of computers is ready and able to convert that provision into a tax shelter for their high-bracket clients. Tax expenditures for industry and tax shelters for high-bracket taxpayers are thus opposite sides of the same coin.

A second problem is to determine whether the marketing of these tax benefits through the syndication of tax shelters channels federal tax funds to those actually engaged in the activities to be aided, or whether the federal aid is in fact siphoned off by persons who are really unconnected with the activity. If the latter is the case, then attention should be focused on developing responses to reduce or eliminate the trafficking by high-bracket individuals and corporations in tax provisions that were intended to benefit a particular industry or activity.

These two major problems created by tax shelter devices may be approached in one or more of three ways:

- (1) Place direct limits on one or more of the elements essential to a tax shelter. The various recapture rules, for example, deal with the capital gain aspect of tax shelters.

- (2) Identify and correct those elements in the tax system that permit the tax benefits to be utilized, *e.g.*, through the syndication mechanism, by persons outside the industry or activity to be aided. One limited and incomplete example of this approach is the provision in the Revenue Act of 1971 denying the investment credit to individual investor-lessors.⁸⁸

- (3) Place overall limits on the extent to which individuals or corporations can utilize tax preferences. This is the approach of the minimum tax enacted in 1969.⁸⁹

In the following discussion in this section several types of tax shelter arrangements will be examined with special reference to the tax rules that facilitate *syndication* of the tax shelter. Next, suggested

A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705 (1970); McDaniel, Alternatives to Utilization of the Federal Tax System to Meet Social Problems, 11 B.C. Ind. & Com. L. Rev. 867 (1970).

⁸⁸ Int. Rev. Code of 1954, § 46(d)(3).

⁸⁹ Int. Rev. Code of 1954, §§ 56-58.

solutions to the tax shelter problem, representing approaches (1) and (2) outlined above, will be offered. In section III, we will examine steps that should be taken to strengthen and improve the minimum tax.

A. *The Syndicated Real Estate Tax Shelter*

1. *The Elements of the Tax Shelter*

There are four basic components of the tax sheltered investment in real estate:⁴⁰

(1) The *shelter* of income other than that derived from rentals from the real estate—such as dividends, interest, executive compensation and the like—as the result of the excess deductions generated by accelerated depreciation and interest.

(2) The *deferral* of tax resulting from accelerated depreciation, in effect an interest-free loan from the government.

(3) The use of *leverage* which enables the investor to obtain deductions at a faster rate than that at which he makes his equity investment in the property⁴¹ and in excess of his actual investment.

(4) The availability of *capital gain* treatment upon ultimate sale of the property, which is, in effect, a requirement that the taxpayer repay only a part of the loan previously made by the government through the deferral mechanism.

2. *The Syndication of the Tax Shelter*

The net result of combining the four factors is the delivery of a very substantial dollar benefit to the person who can take advantage of the tax shelter. Presumably, in the case of residential real estate, the tax benefits were intended to provide federal financial assistance to those engaged in the business of developing housing. The actual developer may not, however, be able to utilize fully tax benefits provided for real estate. Further, those benefits are realized over a period of time, while the developer usually desires immediate compensation for his services in providing the housing. The answer to the developer's problem is to make a current sale of these future tax benefits to high-bracket individuals—doctors, dentists, lawyers, corporate executives. Since it is unlikely that any one of these investors could utilize the tax benefits in full, the developer employs underwriters, salesmen, lawyers and ac-

⁴⁰ See the Statements of Jerome Kurtz and Adrian DeWind, in Panel No. 4 (Feb. 8, 1973), *supra* note 27, for expanded discussions of the real estate tax shelter.

⁴¹ This point may be illustrated by reference to Exhibits A and B in Appendix A *infra*. At the end of year 6 the project has generated depreciation deductions of over \$2.5 million. Yet the investors have an equity of only \$1.55 million at this same point.

countants to syndicate the tax benefits and thus sell them to a large number of investors, each investor acquiring his allocable share of the tax benefits.

The syndication of the real estate tax shelter is made possible by a long-standing regulation⁴² applying to limited partnerships the rule, developed in the context of individual taxation, that a taxpayer is entitled to include in his cost basis for depreciation purposes the amount of a nonrecourse mortgage. Application of this rule in the limited partnership context means that the syndicator is able to divide up and sell very large tax benefits for a very small equity investment.

This country has a commitment to provide housing for its people, especially low- and middle-income housing. Therefore the question is whether the syndication of the tax benefits available for residential real estate assists in achieving this goal. To help answer this question, reference may be made to the sample housing project presented in Appendix A.⁴³ In that example, an apartment unit costing approximately \$9 million to build was financed by an \$8.9 million FHA mortgage and \$1.4 million from the sale of interests in the limited partnership. Thus, while the FHA mortgage paid for over 98% of the cost of constructing the building itself, those federal funds did not provide any compensation for the developer who put the project together and oversaw its construction. In order to obtain current compensation, it was necessary for the developer to sell to the investor group the tax losses that would be generated by the project. These investors were themselves looking for a profit from the transaction and, as a result, they paid the developer less than the present value of the tax losses that would be borne by the Treasury.

In effect, then, at the inception of the real estate project, the Treasury as well as HUD was making a financial commitment to the project. The Treasury promised to forego taxes over twenty years and then require that only a part of such taxes be repaid. That Treasury commitment was a benefit that businessmen could quantify in terms of its present value. And this is what businessmen do in the tax shelter syndication process—reduce the projected tax benefits to a present value and then sell those benefits for as much of that value as can be obtained.

But if businessmen can quantify the projected Treasury tax losses in terms of a present value, the Treasury can and should do the same and then determine where and for what its contribution to the project

⁴² Treas. Reg. § 1.752-1(e).

⁴³ The sample in Appendix A *infra* is excerpted from 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, *Federal Income Taxation* 425-40 (1972) [hereinafter cited as *Federal Income Taxation*].

is going. Then an evaluation can be made of the contribution, if any, that the syndication of the tax shelter makes to the construction of the housing project.

3. *Evaluation of the Syndicated Real Estate Tax Shelter*⁴⁴

For the project shown in Appendix A, the present discounted value of the tax losses that the Treasury could expect to realize over the life of the project can be arrived at by assuming a Treasury borrowing rate of 6%, an average 60% marginal tax rate for the investor group,⁴⁵ and capital gain treatment upon sale of the project—at a sale price of \$1 plus the balance of the mortgage—after twenty years. (In fact, of course, if one or more of the investors dies during the twenty-year period the Treasury loss will be increased because the gain at death goes untaxed.)⁴⁶ The Treasury tax losses in the example thus consist of 60% of the tax-free cash and tax “losses” generated by the project. Using a 6% discount rate, these benefits can be reduced to the present value of the cumulative revenue loss to the Treasury. The Treasury will collect some taxes in the final two years, and the present value of these prospective tax collections may be similarly determined. According to this computation method the present value of the Treasury revenue loss in the Appendix A example is over \$2 million.

It was this \$2 million Treasury commitment that was syndicated through the tax shelter limited partnership. Where did the \$2 million go? As noted above, the investor group wanted a profit from the transaction and, in the sample project, it paid \$1.4 million for the tax benefits. Thus \$600,000 of the Treasury's \$2 million check stayed with the investor group—a group that had nothing to do with the construction of the housing project. The developer received \$1.4 million, but he did not get to keep all of this sum as his compensation. Approximately 15% of this amount had to be paid to those who marketed the tax benefits—the underwriter, salesmen, lawyers, accountants. Thus some \$210,000 went to persons whose presence in the transaction resulted solely from the syndication process, not from the construction process.

The net result was that the developer finally received a fee of under \$1.2 million—a little more than 10% of the project cost—for his services. Presumably the developer is the one for whom the federal tax

⁴⁴ I am greatly indebted to Mr. Fred R. Becker, a member of the Massachusetts Bar, for sharing with me his insights and efforts in developing the following analysis.

⁴⁵ Prospectuses and sales materials for syndicated tax shelter operations routinely recommend that investors be in tax brackets in excess of 50%.

⁴⁶ Int. Rev. Code of 1954, § 1014.

benefits were intended. But note that in order to get the developer a fee of \$1.2 million, the Treasury spent \$2 million! The Treasury paid doctors, dentists, lawyers and investment bankers \$600,000 to act as conduits for delivering a fee to the developer—a true negative income tax for the wealthy.⁴⁷ From the standpoint of federal spending, it is obvious that the federal government could have obtained precisely the same housing by simply paying the developer the \$1.2 million fee that he was prepared to build the project for. The other \$800,000 of federal money was wasted.

This result is not the inevitable consequence of using the tax system to aid housing. The process of reducing the tax benefits to a present value is just another way of determining a federal tax credit. Granting a tax credit to the developer in an amount designed to provide him with the requisite compensation (say 10% of the estimated construction costs) would eliminate the waste in the tax shelter syndication process. To the extent that the tax credit exceeded the developer's tax liability, a positive tax refund could be generated. In this manner the federal tax benefit would be confined to the one person who has contributed something to the creation of housing—the goal of the tax preference. Substantial tax reform and substantial savings to taxpayers can thus be achieved even if Congress elects to continue to provide federal financial aid to residential real estate through the tax system. This approach is further discussed below.⁴⁸

B. *The Oil and Gas Tax Shelter*

1. *The Elements of the Tax Shelter*

Present tax rules provide the necessary elements for the oil and gas tax shelter. The element of *deferral* is provided by the right granted under section 263(c) of the Internal Revenue Code to expense immediately intangible drilling and development costs incurred in connection with the drilling of the oil and gas well. Under ordinary tax accounting rules, these intangible drilling and development costs should be capitalized and recovered over the productive life of the well. The element of *shelter* of non-oil income results from the fact that ordinarily production will not take place in the year in which the intangible drilling

⁴⁷ A negative income tax generally results in a shelter transaction when current deductions can be used to offset ordinary income, followed by sale at capital gain rates. See Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy*, 12 B.C. Ind. & Com. L. Rev. 387 (1971). The text example quantifies the amount of the negative income tax to the investors in the sample transaction.

⁴⁸ See text following note 77 *infra*.

and development expenses are incurred; hence these deductions are offset against income other than that to be derived from the well. The *capital gain* element is involved because upon sale of the property there is no recapture of the previously deducted intangible costs. *Leverage* is available in the form of nonrecourse loans for the bulk of the intangible costs. An additional tax benefit is then provided in the form of *percentage depletion*,⁴⁹ which may have the effect of converting into an *exemption* the *deferral* obtained through the deduction of intangible drilling and development costs.

The following example illustrates the operation of the oil and gas tax shelter.⁵⁰ Assume that a driller expends \$1 million in the first year to drill a well. His intangible drilling and development expenses comprise 90% of this amount. Therefore he secures a \$900,000 deduction in the year in which the well is drilled. For an individual in the 70% tax bracket, this produces a tax savings of \$630,000 in year 1, and the driller has remaining a net after-tax investment in the well of \$370,000. Assume that the well is successful and in year 2 generates \$150,000 of gross income and \$100,000 of net income. The percentage depletion allowance in year 2 will be \$33,000 (22% of \$150,000), taxable income will be \$67,000 (\$100,000 minus \$33,000), and the driller will incur a tax liability of \$46,900 (70% of \$67,000). The driller will, however, have received in the second year \$53,100 in cash (consisting of \$20,100 in after-tax income and \$33,000 in tax-free income from the percentage depletion allowance). In the third year the driller sells the property for \$900,000. Assuming that the cost basis is \$100,000, the driller will have capital gain of \$800,000 on which he will pay \$280,000 in tax (35% of \$800,000), leaving net receipts from the sale of \$620,000.

What are the combined results of this transaction? The driller will have received \$673,100 of after-tax cash from income and the sale of the property, from which he subtracts his after-tax investment of \$370,000, leaving a net after-tax cash profit of \$303,100. In fact, of course, the profit is even greater because the above computations do not take into account the factor of timing; *i.e.*, the benefits of the deduction are available in year 1, but the taxes incurred are not paid until years 2 and 3.

The following table illustrates the above transaction in simplified form:

⁴⁹ Int. Rev. Code of 1954, § 613.

⁵⁰ The example in the text is based on one developed in Rossbach, *To Buy or Not to Buy—A Trust Officer's View of Tax-Shelter Oil and Gas Drilling Programs*, 110 *Trusts and Estates* 906 (1971), reprinted in *Federal Income Taxation*, supra note 43, at 469-73.

Year 1:

Investment	Deductible Intangibles	Tax Benefit	Driller's Net After-Tax Investment
\$1,000,000	\$900,000	\$630,000	\$370,000

Year 2:

Net Income	Percentage Depletion	Taxable Income	Tax	Net Cash
\$ 100,000	\$ 33,000	\$ 67,000	\$46,900	\$ 53,100

Year 3:

After-Tax Cash from Year 2 Income and Sale Proceeds	Net After-Tax Investment	Net After-Tax Profit
\$ 673,100	\$370,000	\$303,100

A major advantage of the oil tax shelter over the real estate tax shelter is the existence of the percentage depletion allowance. Absent percentage depletion, the intangible drilling and expense deduction would operate like accelerated depreciation—in effect as an interest free loan in year 1, which would be repaid over the productive life of the well. But percentage depletion changes this result. The percentage depletion allowance is unrelated to basis and therefore reduces the driller's income from the well each year even though basis has long since been exhausted. In effect, then, the existence of percentage depletion insures that the driller will never have to repay the taxes saved by deduction of the intangible expenses if he holds the well for its productive life. The "loan" is thus converted to an outright grant. If the driller sells prior to the exhaustion of the well, capital gain treatment insures that only a part of the taxes saved by the intangibles deduction will have to be repaid.

2. *Leveraging the Tax Shelter*

In the above example, we have assumed that the driller put in the full \$1 million from his own funds. But under current tax laws this is not necessary in order to obtain the three tax benefits: deduction in full of intangible drilling and development expenses, percentage depletion, and capital gains. Suppose that the driller had been able to borrow \$700,000 out of the \$1 million necessary to drill the well. In such a case, he would in effect, have been able to secure \$900,000 in deductions by putting up \$300,000 of his own money. This advantage is heightened if the driller has been able to borrow on a nonrecourse basis, *i.e.*, the lender looks only to the well for security and not to the personal liability

of the individual driller. Current tax rules permit the driller to deduct in full the intangible drilling and development costs even though he personally has no liability to repay the loan that generated the funds to make the expenditures for intangible drilling and development costs.

3. *Syndication of the Tax Shelter*

From the standpoint of the driller, the major problem in the above situation is that he cannot get the full benefits of the three elements of the tax shelter in the year he drills; he must wait for three years in order to realize fully the tax benefits made available to him in the above example. Accordingly the driller then seeks a mechanism whereby he can transfer these tax benefits to other high-bracket individuals who can fully utilize the deduction for intangible drilling and development costs in the first year and who will pay cash to the developer for the package of tax benefits. The tax shelter limited partnership provides that mechanism.

There are many variations on the form that the tax shelter limited partnership may take in connection with oil and gas transactions. Essentially, however, the process follows that described above with respect to the syndicated real estate tax shelter.⁵¹ A limited partnership is formed and interests therein sold to investors. The limited partnership agreement will call for a fee to be paid to the driller for his services in connection with drilling the well, the fee to be derived from the syndication proceeds. From the driller's standpoint, therefore, he has secured his fee for drilling the well in the form of immediate cash. This cash consists of the present value of the tax benefits derived from the intangible drilling and development expense deduction, percentage depletion, and ultimate sale at capital gain rates.

From the standpoint of the investors, of course, the limited partnership investment is very attractive. By putting up \$300,000 they secure \$900,000 in immediate deductions against other income. If they are all in the 70% bracket, this means that they have received a \$630,000 tax benefit from the federal government which, assuming production, they can either retain entirely by holding onto the asset or repay to the extent of only one-half if they sell the property. Even as to the amount repayable, they will have the interest-free use of those funds until such time as the sale is made.

4. *Relationship of the Syndication Process to the Objective of the Tax Benefit*

Presumably the objective of the tax provision that allows immediate deduction of intangibles with no requirement that those intangibles

⁵¹ See Statement of Milton A. Dauber, in Panel No. 6 (Feb. 20, 1973), *supra* note 27.

be recaptured upon sale of the property is to encourage exploration and drilling for new oil reserves. Thus, some persons viewing the above syndication process conclude that there is nothing inherently wrong with the syndication of the tax benefits since, after all, another oil well has been drilled. But upon closer analysis of the transaction, it will be found that a considerable portion of the federal contribution to the drilling of the oil well does not go to drilling at all. It is siphoned off by the syndication process itself, as was true in the case of the real estate syndications. Only a part is used for the actual cost of drilling for oil.

The point can be illustrated by the following example. Assume that a driller obtains a \$100,000 nonrecourse loan, which amount is sufficient to enable the driller to pay the costs of actual drilling, but not pay the driller any fee for his efforts. He syndicates the tax benefits from the project for \$100,000, of which \$15,000 goes to pay for the costs of syndication, and \$85,000 for the driller's fee. Assuming 70% marginal tax brackets for the investor group, the Treasury check on this transaction totals \$129,500 ($70\% \times \$185,000$). (This computation assumes that the full drilling fee of \$85,000 can qualify for the intangibles deduction.) It is apparent that in this transaction a commercial lender was willing to give the driller a \$100,000 loan for the cost of drilling the well. The driller has indicated by his actions that he is willing to do this for an \$85,000 fee. He obtains this fee by selling some of the tax benefits. Where has the other \$44,500 of the Treasury check gone? Part of it, \$15,000, went to those in the syndication process—a group whose presence in the transaction was totally unnecessary to the actual drilling. The other \$29,500 stayed with the investor group—in effect it constituted a commission paid by the federal government for delivering the driller's check. Thus one-third of the Treasury check was wasted, going to persons whose presence produced no more drilling and no more oil than would have been the case had the Treasury paid the driller his \$85,000 fee directly.

The obvious question is why, if the federal government wishes to provide assistance to drillers to explore and develop for new reserves, it does not simply confine its financial assistance to the driller as such, thereby reducing the total revenue cost of obtaining the well. Even if it is deemed desirable to provide this assistance through the tax system, it may be provided more efficiently by, for example, giving a tax credit to the driller in an amount equal to a given percentage of the drilling costs.⁵²

⁵² See text following note 78 *infra*.

*C. Equipment Leasing Tax Shelters**1. The Tax Benefits*

A number of significant tax benefits are provided as a means of assisting industry to modernize plant equipment and machinery or to acquire special purpose equipment. Thus the investment credit and accelerated depreciation (including ADR) are available generally for capital investment in qualified property. In addition, special five-year amortization provisions have been introduced to help reduce the cost of installing pollution abatement or control facilities,⁵³ acquiring railroad rolling stock,⁵⁴ installing mine safety equipment,⁵⁵ rehabilitating low-income housing,⁵⁶ installing on-the-job training and child care facilities,⁵⁷ and, under a highly questionable ruling issued by the Internal Revenue Service, developing computer software.⁵⁸

But these tax benefits are not equally available or valuable to all companies. Accelerated depreciation and the investment credit, for example, are of no benefit to a loss corporation. Even a profit corporation may find it difficult or undesirable to utilize the tax benefits directly because, for example, it is unable to borrow the requisite capital for the investment, must pay prohibitively high interest rates, or desires to keep such an additional liability off its balance sheet. In such situations, the corporation will look to a leasing arrangement as a means of financing the capital improvements.

Because of the tax benefits of accelerated depreciation, the interest deduction, and, in some cases, the investment credit, the business can find high-bracket investors who can take advantage of the tax benefits and will therefore be willing to finance the acquisition at a relatively low cost to the business. The leasing arrangement is the financing mechanism utilized and provides the vehicle for insuring that the individual investors obtain the tax benefits. The business benefits by being freed from the need for making a capital outlay, and it obtains favorable rental terms because the tax benefits intended for business are being made available to the investor-lessors. In the case of accelerated depreciation, the benefits to the investor of tax deferral are enhanced by highly leveraging the transaction.

The Revenue Act of 1971 imposed restrictions on the use of the investment credit by individual lessors in leasing transactions. There-

⁵³ Int. Rev. Code of 1954, § 169.

⁵⁴ Int. Rev. Code of 1954, § 184.

⁵⁵ Int. Rev. Code of 1954, § 187.

⁵⁶ Int. Rev. Code of 1954, § 167(k).

⁵⁷ Int. Rev. Code of 1954, § 188.

⁵⁸ Rev. Proc. 69-21, 1969-2 Cum. Bull. 303.

fore, depending on the particular tax benefit to be utilized, one of two different forms of equipment leasing transactions are generally used:

(1) Individual lessors acting through a limited partnership are involved where one of the five-year rapid amortization provisions is utilized.

(2) A corporate lessor, normally a bank or a subsidiary thereof, is involved where the investment credit plus ADR provides the tax assistance.

The first of these techniques involves the syndication of the tax shelter; the second involves the use of the tax shelter by the financing institution itself. It is therefore useful to treat each type of transaction separately.

2. Individual Lessors—The Syndicated Equipment Leasing Tax Shelter

Syndicators of equipment leasing tax shelters using one of the five-year rapid amortization provisions are selling just one thing: tax deferral. The investor obtains a loan in the first five years which he repays through higher taxes (as the result of no depreciation deductions) over the remaining useful life of the property. Standing alone, then, the federal government seems merely to be postponing the collection of its taxes, and the Treasury has lately taken to assuring Congress that accelerated depreciation is "only deferral" of tax liability.⁵⁹

But the syndicators of tax shelters know that this "only deferral" is a very valuable commodity in the marketplace and can command a high price if properly packaged. The principal elements of the "deferral package" are

(1) Seventy to one hundred percent nonrecourse financing of the property;

(2) The use of a limited partnership with the corresponding tax result that the investor-limited partners include the full amount of the mortgage in their tax basis;

(3) Use of a five-year rapid amortization provision to deduct against the basis and thus to accrue tax deferral for the investor.

It is helpful to analyze a sample tax shelter syndication for a railroad locomotive that used the five-year amortization provisions of

⁵⁹ Statements by the President and by Secretary David M. Kennedy on Asset Depreciation Range, Jan. 11, 1971, 7 CCH 1971 Stand. Fed. Tax Rep. ¶ 6366. The Treasury, when it is free to be more objective, knows better; see Treasury Dep't Study on Tax Depreciation Policy (1970), reprinted in 116 Cong. Rec. E6963-75 (daily ed. July 23, 1970).

section 184. In this transaction,⁶⁰ a limited partnership acquired a locomotive to lease to a railroad. The investor-limited partners contributed \$1,614,000, and the balance of the cost, \$4,015,000, was obtained through a nonrecourse mortgage. The locomotive was leased to a railroad under a fifteen-year net lease at a rental sufficient to pay the interest, amortize the mortgage over the term of the lease, pay certain administrative costs, and make small cash distributions to the partners. In this transaction the following characteristics of the tax shelter noted above are present:

(1) In return for putting up \$1,614,000 the investors obtained a \$5,629,000 locomotive; *i.e.*, the transaction was over 70% financed, with no personal liability for the \$4,015,000 loan on the part of the investors.

(2) Despite the fact that they actually invested less than 30% of the cost of the locomotive, the investors were entitled to deduct the entire cost over a five-year period.

(3) The five-year rapid amortization produced a "tax loss" for the first five years which the investors used not only to eliminate tax on the rentals paid by the railroad, but also to offset other income; thus the investors obtained a deferral of tax on these amounts.

(4) The federal loan in the amount of the investors' tax savings will be repaid over years 6 to 15, without interest.

The schedules in Appendix B summarize the anticipated results for the investors. In the example an individual investor has put up \$50,000, and yet the schedules prepared by the syndicators show that after fifteen years the investor will have only \$44,002 in cash plus tax benefits; see Schedule A of Appendix B. Why would any investor deliberately enter into a losing proposition? The answer is that this purely cash analysis does not tell the whole story. Schedule B in Appendix B indicates that if the investor doubled up on tax preferences and invested his tax benefits in 5% tax-exempt municipal bonds, he would end up with \$85,390 net profit after taxes plus his original \$50,000 investment. This is to be compared to only \$58,005 that he would have earned had he originally invested in 5% tax-exempt bonds.

In short, the syndicator of the equipment leasing tax shelter says to the investor: "If you put your \$50,000 in 5% tax-exempt bonds, you will end up with only \$58,005 profit after fifteen years. But if you give me the \$50,000 and then invest your tax benefits in tax-exempt bonds, you will end up with an \$85,390 profit after 15 years." This result flows from the fact that the investor is able to take accelerated depreciation

⁶⁰ The example is from Federal Income Taxation, *supra* note 43, at 445-50.

not only on his equity, but also on the amount of the nonrecourse loan obtained by the partnership—an amount for which the investor is never personally liable.

The example given above illustrates the use of the syndicated tax shelter involving five-year amortization for railroad rolling stock. The same type of transaction can, of course, be structured for the five-year write-off provisions for pollution control facilities, mine safety equipment, and computer software. From a federal spending standpoint, the question regarding these syndicated tax shelter transactions is whether the syndication of the tax benefits has in any way aided the federal program of assistance for which the tax benefits were intended. As was the case with the tax shelters discussed above, the answer is clear: part of the federal expenditures goes simply to paying the cost of the syndication process—a process that produces, for example, no railroad locomotives. However, it is only the structure of the tax provisions that makes this process necessary. If the railroad or other intended beneficiary could obtain the federal tax benefits directly and immediately—instead of over time—the syndicate could be eliminated and federal funds be saved. Even if Congress wishes to use the tax system to deliver financial assistance, it can do so without involving the investor syndicate at all.⁶¹

3. *Individual Lessors—The Syndicated Pollution Control Equipment Leasing Tax Shelter with Tax-Exempt Financing*

Section 169 of the Code provides five-year rapid amortization for the cost of certified pollution control equipment. Thus the tax benefits resulting from this provision—intended to provide federal cost-sharing for industries investing in certain types of pollution abatement or control equipment—can be syndicated and marketed on the same basis as the equipment lease transaction described above. But in the case of pollution control equipment, still another tax benefit can be added. In the example of equipment leasing given above, the leveraging was obtained through a commercial lending institution, which charged customary interest rates. Suppose that the leverage could instead be supplied by tax-exempt financing. Then the benefits of lower interest charges resulting from the tax exemption could be added onto the other tax shelter benefits.

Present tax rules permit this to be done. Section 103(c)(4)(F) contains an exemption from the industrial development bond rules for bonds issued for qualified pollution control facilities. Thus a local government unit can agree to issue industrial development bonds for a pollution control facility for, say, 80% of the total cost of the facility.

⁶¹ See text at notes 74-77 *infra*.

The investor group, through a limited partnership, puts up the balance of the funds (perhaps borrowed on a nonrecourse basis). The city "leases" the facility to the investor group for a rental sufficient to amortize the tax-exempt bonds and pay interest thereon. The investor group in turn leases the facility to a manufacturing company. The investor group gets not only the tax benefits from the five-year write-off but also additional profit from the fact that its interest costs are lower than would be the case in ordinary financing.⁶²

4. *Corporate Lessors—The Equipment Leasing Tax Shelter*

When Congress reinstated the investment credit in 1971, it provided that the investment credit was in general not to be available to individual investor-lessors.⁶³ Concern was expressed over "the extent to which individuals (singly or as a group in a joint venture) are able to utilize the tax benefits of leasing transactions . . . as a means to shelter from tax a substantial part of their other income."⁶⁴ Similar restrictions were not placed on the availability of the credit to corporate lessors, however. Thus there continues to be widespread use of the benefits of the investment credit in tax shelter transactions—only now, the income being sheltered is that of banking or other financial institutions instead of high-bracket individuals.

In addition to reinstating the investment credit in 1971, Congress also approved an additional form of accelerated depreciation by authorizing the adoption of the Asset Depreciation Range (ADR) system of depreciation.⁶⁵ Under ADR, a taxpayer is entitled to shorten guideline lives for equipment by as much as 20%. Any of the authorized forms of accelerated depreciation can then be utilized with respect to the property. Thus the combination of the investment credit plus accelerated depreciation under ADR provides a great potential for tax shelter devices. In situations where the taxpayer has the choice of utilizing one of the five-year rapid amortization provisions (for example, for investment in railroad rolling stock), the availability of the investment credit plus ADR must also be considered. Utilization of the investment credit plus accelerated depreciation under the ADR system will often produce a greater tax benefit than is produced by a five-year write-off of the same costs. For example, it is possible that the investment credit plus the sum-of-the-year digits method of accelerated depreciation, using ADR lives, will produce a greater tax benefit even for equipment that has a useful life of up to fourteen years than will a five-year amortiza-

⁶² See Lynch, *The Developing Role of Leveraged Tax-Shelter Leasing in Pollution Control Financing*, *Investment Dealers' Digest* (Sept. 12, 1972).

⁶³ Int. Rev. Code of 1954, § 46(d)(3).

⁶⁴ S. Rep. No. 92-437, 92d Cong., 1st Sess. 43 (1971).

⁶⁵ Int. Rev. Code of 1954, § 167(m).

tion of the costs of that same equipment.⁶⁶ Thus it is obvious that many companies that seek to use a leasing transaction will prefer one in which the lessor is able to utilize the investment credit plus ADR, since lower rentals should be generated for the lessee as the result of the greater tax benefits flowing to the lessor.

Increasingly banks have moved into this leasing business for two reasons: (1) the leasing transactions are essentially financing transactions wherein banks normally operate; (2) since only a corporate lessor can take advantage of the investment credit, banks have conducted the leasing operations directly instead of providing nonrecourse financing to limited partnerships for leasing transactions utilizing one of the five-year rapid amortization devices.

The Internal Revenue Service has ruled that the investment credit can be utilized by a bank against its total income tax liability, regardless of the fact that the property qualifying for the investment credit was utilized solely in a loss operation by the bank.⁶⁷ Thus a bank entering into a leasing transaction can take advantage both of the tax "losses" generated by ADR and the investment credit to offset its profits and taxes from its regular banking operations. The transaction can be effected either through a leasing division of the bank or through a leasing subsidiary, with the bank and the subsidiary filing consolidated returns.⁶⁸

While Congress was properly concerned in 1971 with the utilization of the investment credit in syndicated tax shelter devices benefiting high-bracket individual taxpayers, it is not clear why banks and other financial institutions should be permitted to shelter banking income as the result of the leasing transactions. The tax shelter is operating for banks in exactly the same manner as for individual taxpayers, even though in 1971 Congress decided that individuals should not be able to use the investment credit in tax shelter transactions.⁶⁹ In sum, the congressional action in denying the credit to individual lessors in the 1971 Act was appropriate; however, that prohibition should be ex-

⁶⁶ See Worthy, *Pollution Facilities Continue to Provide Substantial Tax Benefits*, 37 J. Tax. 2 (1972).

⁶⁷ Rev. Rul. 71-386, 1971-2 Cum. Bull. 59.

⁶⁸ For discussions of the equipment leasing tax shelter for banks, see, e.g., Brown, *Return on Investment and Book Accounting for Leveraged Lease Investments*, 54 J. Com. Bank Lending 24 (Aug. 1972); Prochnow, *Bank Leasing: A Lawyer's View*, 86 Banking L.J. 305 (1969).

⁶⁹ Permitting commercial banks to employ the equipment leasing tax shelter may go far to reverse the effects of the reforms enacted in 1969 which were intended to increase the low effective rates paid by banks as a result of artificially high bad debt deductions. See H.R. Rep. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 120-24 (1969). The tax sheltered equipment leasing transaction simply substitutes different artificial tax rules by which the effective rates of taxation on commercial banks are reduced.

tended to corporate lessors as well. And in both cases, attention must be given to the role of accelerated depreciation in the shelter operations.

As with the other tax shelter arrangements considered in this section, the question arises whether the financial assistance that Congress desires to give through tax benefits can be given more efficiently: here, specifically, whether the aid intended for industry for modernization of plant equipment and machinery can be made available via the tax system to corporate users who for non-tax reasons desire to lease rather than purchase the equipment. It appears that such a system can be devised, and it is discussed below.⁷⁰

D. Possible Legislative Responses to the Tax Shelter Problem

Congress could choose among at least three approaches for dealing with the problems created by the existence of tax shelters and the syndication thereof. *The first approach* would place direct limitations on one or more elements of the tax shelter:

(a) The tax shelter aspect can be limited by providing that the tax benefits attributable to a particular activity can be deducted only from income generated by that activity. Thus, for example, depreciation with respect to a leased railroad locomotive could be deducted only against the rental income derived under the lease of the locomotive.⁷¹

(b) The advantages of tax deferral can be limited by treating the deferral as a loan and requiring the repayment thereof with interest.⁷²

(c) The advantage of leverage can be limited by providing that a taxpayer can deduct depreciation only to the extent of his actual investment in the property.⁷³

(d) The advantage of capital gain can be limited by providing for full recapture of depreciation in the case of real estate and intangibles in the case of oil and gas.⁷⁴

Under a *second approach*, Congress could deal with the syndication

⁷⁰ See text following note 77 *infra*.

⁷¹ This was the approach adopted with respect to the farm "loss" tax shelter by the 1968 Treasury Tax Reform Studies. See U.S. Treasury Department, *Tax Reform Studies and Proposals* 152-63 (House Ways and Means Comm. and Senate Finance Comm., 91st Cong., 1st Sess.) (Comm. Print 1969) [hereinafter cited as *Tax Reform Studies*].

⁷² This approach was adopted in 1969 by the Senate Finance Committee with respect to the deferral of tax obtained by beneficiaries of accumulation trusts. S. Rep. No. 91-552, 91st Cong., 1st Sess. 129-30 (1969).

⁷³ This is the approach proposed in S. 1439, 93d Cong., 1st Sess. (1973). See 119 Cong. Rec. S1050 (daily ed. Jan. 23, 1973) (remarks of Sen. Muskie).

⁷⁴ *Id.*

aspects of the tax shelter quite apart from addressing itself to the question of the tax shelter itself. The possible solution would be to repeal the present Treasury regulations with respect to limited partnerships and provide that limited partners would be entitled to deductions only to the extent of their actual equity in the limited partnership.⁷⁵ Thus nonrecourse loans would not be added to the basis of the limited partners, and under partnership tax rules their share of partnership deductions would be correspondingly limited to their actual investment. This rule would correspond in principle with the rules applicable to shareholders in Subchapter S corporations.⁷⁶

The treatment of limited partners in substantially the same manner as shareholders in Subchapter S corporations appears entirely appropriate as a conceptual matter. While arguably it may be proper to allow an individual who has unlimited liability with respect to a real estate project, for example, to include the amount of a mortgage in his cost basis for depreciation purposes, it is entirely inappropriate to treat limited partners as if they were individuals with potentially unlimited liability. They do not have unlimited liability with respect to the project; for example, they are totally insulated from tort liability in the same manner as are shareholders of a Subchapter S corporation. Therefore, if investors seek to obtain the advantages of limited liability which a limited partnership affords, it would appear that they should be treated by tax law the same as other investors who seek limited liability through stock ownership in a corporation.

However, the results of the 1971 Act's limitation of the investment credit to corporate lessors should give Congress pause before it employs this second approach. Adoption of this more limited response to the tax shelter problem would leave tax shelters intact for individuals willing to accept total liability and for corporations. Its major drawback is that it would probably shift the bulk of present tax-sheltered transactions to banks and other financial institutions.⁷⁷ A predictable result of such a shift is that banks would succeed in maintaining low effective rates of taxation despite the reforms enacted in 1969 with respect to taxation of financial institutions.

A third approach would eliminate tax expenditures for taxpayers other than those for whom the tax benefits were intended, yet continue to provide federal financial benefits through the tax system to the industries to be assisted. Thus, for example, it would be possible to

⁷⁵ This is the approach proposed in H.R. 1040, 93d Cong., 1st Sess. (1973). See 119 Cong. Rec. H44 (daily ed. Jan. 6, 1973) (remarks of Mr. Corman).

⁷⁶ Int. Rev. Code of 1954, § 1374.

⁷⁷ Regulation Y, § 225.4 of the Bank Holding Company Act treats investment in low-income housing as a financing transaction in which banks can properly invest. 12 C.F.R. § 225.4 (1973).

extend the investment credit concept of the Revenue Act of 1971 by providing that the credit be available only with respect to the *user* of the qualified property. Where the user would be in a negative tax liability situation as a result of the credit, a positive tax refund could be generated for the taxpayer. Where the taxpayer for non-tax reasons leased the property, the rents would reflect full rental value, but the investment credit would be available to the user in the form of a subsidy for the rental payments. Thus the advantages of the investment credit would be available whether the taxpayer owned the property outright or whether he leased it and regardless of whether or not the taxpayer was generating a positive tax liability. In the case of the investment credit it would be necessary to correct the deficiency in present law by providing that the amount of the credit itself be included in the gross income of the taxpayer receiving the benefit thereof.

With respect to accelerated depreciation, a similar approach could be adopted. The simplest solution would be to convert the various forms of accelerated depreciation to an increased investment credit and require that it too be included in gross income.⁷⁸ A somewhat more complex solution would provide that the accelerated depreciation be available only to the user of the property and that any unusable depreciation generate a positive tax refund-loan from the Treasury, which would, however, be repayable over the life of the property. This treatment of course corresponds to the current provision of interest-free loans by means of the depreciation deduction.

Of the three approaches, the *second* is perhaps the easiest for Congress to adopt. Yet because it would have the effect of driving still more tax sheltered transactions into the exclusive orbit of commercial lending institutions, more is required than the mere application to limited partnerships of Subchapter S rules regarding deduction of net operating losses; additional action would be required to limit the extent to which commercial banks could reduce tax liability as the result of investment in tax-shelter transactions. In contrast, the *first* approach—or some combination of the measures suggested therein—would obviously be the most effective in dealing with tax shelters. In addition, fewer biases would be created in favor of corporate investors than under the second approach. However, because some of these measures would move beyond the syndication problem and involve direct changes in present tax benefits, greater Treasury opposition may be expected.

The *third* approach is intriguing. It retains present tax expenditure levels and it employs the tax system to deliver benefits, but it eliminates utilization of tax benefits by persons or corporations not directly in-

⁷⁸ It should be noted that the analysis in text following note 44 *supra* is in effect a computation of the proposed credit in the case of real estate.

volved in the activity Congress desires to aid. Further research appears warranted to determine the feasibility of this approach to the tax shelter problem, especially where corporations are the principal investors in the tax shelters.

III. THE MINIMUM TAX

A. *Background*

The minimum tax for tax preferences⁷⁹ adopted in the Tax Reform Act of 1969 represents still another approach to the tax equity problems created by tax preferences, tax shelters, and the syndication thereof. In effect, the approach of the minimum tax is based on the following analytical progression:

- (1) Congress does not wish to change the tax rules that provide the basis for the tax shelters discussed above;
- (2) Congress does not wish to prohibit entirely the syndication of the tax shelters;
- (3) Congress does wish, however, to place some overall limits on the extent to which any individual can take advantage of tax preferences, and therefore of tax shelters, either individually or through the syndication device.

The minimum tax constitutes a limitation not only on the use of special tax benefits but also on tax shelters and the syndication of those tax shelters. While the minimum tax adopted in 1969 was based on a sound principle—that individuals or corporations should not be able to combine tax preferences in such a way as to escape totally their liability for federal income taxation—the tax as adopted needs to be strengthened in order for it to perform its avowed purpose. As presently constituted, the minimum tax falls short of achieving its goal. This conclusion is buttressed by the somewhat disappointing revenue yielded by the minimum tax in 1970.⁸⁰ It is further evidenced by the fact that, while prospectuses in syndicated tax shelter transactions routinely advise of the possible applicability of the minimum tax, the tax has obviously not slowed in any significant way the tax shelter syndication process.

In order to formulate the steps that need to be taken to strengthen the minimum tax, it is helpful to review the context out of which the present minimum tax arose. The 1968 U.S. Treasury Department Tax

⁷⁹ Int. Rev. Code of 1954, §§ 56-58.

⁸⁰ The yield from the minimum tax in 1970 was only \$117 million from individuals as compared to an expected \$290 million. See Federal Income Taxation, *supra* note 43, at 1195. This result is not surprising if one applies the minimum tax as adopted to the cases of high-income, low-taxpaying individuals set forth in the Tax Reform Studies, *supra* note 71, at 92-94.

Reform Studies and Proposals proposed a minimum tax as an *alternative* to the tax liability computed under regular rules.⁸¹ They required that the taxpayer first compute his regular tax liability, utilizing in full the tax preferences available to him. He then recomputed his tax liability, this time including the specified items of tax preference in income, and applied a rate schedule incorporating rates at one-half those applicable to regular tax computations. If the resulting minimum tax was higher than tax liability computed under regular rules, then the minimum tax became the taxpayer's tax liability for the year. Thus the 1968 proposal was based on the assumption that the minimum tax should be a *progressive tax*, conforming in its rate progression to that contained in the rates specified in section 1 of the Code for individuals. It was also a *comparative tax*, which determined the applicability of the minimum tax by comparing that tax liability to the taxpayer's regular tax liability.

In April of 1969 the Nixon Administration proposed a minimum tax which was in general based on the same assumptions, although the mechanics differed. Under the Nixon proposal for a Limitation on Tax Preferences (LTP), the taxpayer could not utilize tax preferences to exclude more than one-half of his expanded income—his adjusted gross income plus defined tax preferences. Thus if a taxpayer had \$100,000 of adjusted gross income and \$200,000 of tax preferences, he would be entitled to utilize the tax preferences only to the extent of \$150,000; and the disqualified \$50,000 of tax preferences would be includible in the tax base and taxed at normal rates. The House adopted the LTP concept in its version of the Tax Reform Act of 1969.⁸² Like the minimum tax proposed by the 1968 Treasury Studies, LTP was essentially a *comparative tax* and a *progressive tax*.

In both the 1968 Treasury Proposals and the LTP approach, a system of allocation of deductions was adopted as a necessary adjunct to the minimum tax.⁸³ The allocation of deductions provision applied to the personal deductions of a taxpayer and required, in effect, that an individual with itemized personal deductions allocate those deductions between taxable and tax-exempt income, with the deductions being disallowed to the extent allocable to the latter category. The theory of the allocation of deductions approach was, of course, that a taxpayer could pay personal expenditures either out of taxable or tax-exempt income. It was reasonable to assume that he paid those expenses in the same proportion that his taxable income bore to his total income.

⁸¹ Tax Reform Studies, *supra* note 71, at 132.

⁸² For a comparison of the Nixon Administration Proposals and the House version, see Hearings on Tax Reform, House Ways and Means Committee, 91st Cong., 1st Sess. pt. 14, at 5060 (1969), and H.R. Rep. No. 91-413, *supra* note 69, at 77.

⁸³ Tax Reform Studies, *supra* note 71, at 142; H.R. Rep. No. 91-413, *supra* note 69, at 80.

In its consideration of the Tax Reform Act of 1969, the Senate Finance Committee abandoned the approach represented by the 1968 Treasury minimum tax proposal and LTP. Instead, it substituted a flat 5% (later changed to 10%) rate on preference income in excess of a \$30,000 exemption.⁸⁴ The minimum tax adopted by the Senate Finance Committee rested on completely different assumptions from those that underlay LTP and the 1968 Treasury proposal. The minimum tax adopted by the Senate Finance Committee was an *additive tax*, not a comparative tax. That is to say, the minimum tax applied regardless of the relationship which a taxpayer's preference income bore to his taxable income. Further, the tax was a *proportional tax*—aside from the exemption—as opposed to a *progressive tax*. A Senate floor amendment, ultimately adopted by the Conference Committee,⁸⁵ engrafted back onto the minimum tax adopted by the Senate Finance Committee a part of the comparative approach of the LTP proposal. This was done by permitting a deduction for minimum tax purposes of the amount of regular tax liability incurred by the taxpayer. The result of the amendment was an uneasy amalgam of the comparative and additive approaches to a minimum tax system that is causing substantial difficulty with the minimum tax now in effect.

In addition, all three approaches to the concept of a minimum tax omitted from the tax base significant items of tax preferences. In order to make the minimum tax fully effective in dealing with the tax shelter problem, the minimum tax must be expanded to include these omitted items. Other steps must be taken both to improve the rate structure and to make structural improvements in the minimum tax system itself. The actions to be taken may be considered under the following categories:

- (1) Expansion of the minimum tax base.
- (2) Changing the rate structure to provide a progressive rate system for individuals and a separate flat rate structure for corporations.
- (3) Reduction of the \$30,000 exemption for individuals and elimination of the exemption for corporations.
- (4) Structural changes within the minimum tax.
- (5) Adoption and strengthening of supportive provisions for the minimum tax.

B. *Expansion of the Minimum Tax Base*

If the minimum tax is to fulfill its function of insuring that every taxpayer in the United States makes some minimum contribution to

⁸⁴ S. Rep. No. 91-552, 91st Cong., 1st Sess. 111-18 (1969).

⁸⁵ H.R. Rep. No. 91-782, 91st Cong., 1st Sess. 302 (1969).

the Government, then the first requisite for the reform of the minimum tax system is to expand the minimum tax base to include those items that presently enable a wealthy individual to escape tax altogether, or to reduce his tax liability below an acceptable minimum. There are a number of tax preferences that are candidates for inclusion in the minimum tax base. It is useful to place these items of tax preference into two categories: the first covers those items of tax preference that should immediately be included in the minimum tax base. The case for their inclusion is clear, and they present no conceptual or administrative problems. In the second category should be listed those items of tax preference that clearly involve significant revenue losses and whose inclusion in the minimum tax base is a question requiring further study.

Category I: Items that Should Immediately Be Included in the Minimum Tax Base

1. *Intangible Drilling and Development Expenses.* The right to deduct these expenditures which, under proper tax accounting rules, should be capitalized and recovered through amortization over the productive life of the well, represents a glaring omission from the minimum tax base. The case for inclusion of this item in the minimum tax rests on the same ground as does requiring inclusion of the excess of accelerated depreciation over straight-line in the case of real estate. The proper amount to be included in the minimum tax base is the excess of the intangible drilling and development expenses deducted over the amount that would have been deducted in the year had the expenses been properly capitalized.⁸⁶

2. *Interest on Tax-Exempt Bonds.* The continued omission of the interest on tax-exempt bonds from the minimum tax base presents high-bracket individuals with an opportunity to escape totally any liability for federal income tax. And, as seen above, tax-exempt bonds play a significant role in the analysis of tax shelters: many syndicators of tax shelters recommend that the tax benefits spun-off from the shelters be invested in tax-exempt bonds. At the same time that tax-exempt interest is placed in the minimum tax base, Congress should enact a provision for a federal subsidy of taxable bonds issued by state and local governments similar to the provision passed by the House in the Tax Reform Act of 1969.⁸⁷ As a transition provision, the exemption from minimum

⁸⁶ This tax preference was included in the allocation of deductions provision in the House version of the Tax Reform Act of 1969, although not in LTP. H.R. Rep. No. 91-413, supra note 69, at 82. Intangibles were included in the list of tax preferences under the Senate Finance Committee version, S. Rep. No. 91-552, supra note 84, at 114-15, but the item was deleted in conference, H.R. Rep. No. 91-782, supra note 85, at 302.

⁸⁷ In 1969, the House included tax-exempt interest in LTP and provided a federal subsidy for taxable bonds issued by state and local governments. H.R. Rep. No. 91-413, supra note 69, at 172. Both provisions were deleted in the Senate.

tax could continue for bonds outstanding on January 1, 1973 *so long as they remained in the hands of the owners of the bonds on that date*. The interest would be subject to the minimum tax in the hands of any subsequent transferee, except that the first purchaser from a dealer in municipal bonds would be entitled to the exemption.

3. *Construction Period Interest and Taxes*. Under present tax rules, interest and taxes incurred during the construction period of real estate are currently deductible. In fact, these expenditures represent additional costs of construction and should properly be capitalized and recovered through depreciation over the useful life of the property. The amount deducted in excess of the amount that would be deductible if these expenses were properly capitalized should be included in the minimum tax base.

4. *Investment Credit*. At the present time there is a significant defect in the investment credit. A taxpayer who makes a qualified investment is entitled both to the 7% credit and to depreciation with respect to the amount represented by the credit. Thus an individual making \$100 of qualified investment is entitled to a \$7 credit but is also allowed the full \$100 as his depreciation basis. If in such a case depreciation is to be allowed on the full \$100 basis, then the amount of the investment credit should be included in the income of the taxpayer. Until such time as measures are taken to correct this defect in the investment credit, the amount of the investment credit should be subject to the minimum tax.⁸⁸

5. *Accrued Gain on Property Transferred at Death or by Gift*. One of the most glaring weaknesses in the present income tax system is the failure to tax accrued gain on transfers at death or by gift. While this is an income tax problem, it is frequently considered in connection with estate and gift tax reform.⁸⁹ Until such time as full taxation of gain on property transferred at death or by gift is instituted, such gain should at least be included in the minimum tax base. In the case of gain realized on sales or exchanges, the excluded one-half of the capital gain is included in the minimum tax base. Since the full amount of the gain is excluded from the normal tax base in the case of accrued gain on transfers at death or by gift, the proper amount to be included in the minimum tax base is the full amount of the gain.

⁸⁸ As originally enacted in 1962, § 48(g) adopted an approach different from that suggested in the text. It provided for a basis reduction by the amount of the allowable investment credit. The provision was repealed in 1964. Congress in 1971 instructed the Treasury and congressional tax committee staffs to "study and develop a basis adjustment mechanism for consideration within the next two years." S. Rep. No. 92-437, 92d Cong., 1st Sess. 45 (1971). Inclusion of the credit in income seems a conceptually more sound and a much more simple approach to the problem than devising the complex mechanics needed for the basis adjustment.

⁸⁹ See Tax Reform Studies, *supra* note 71, at 331.

Category II: Items That Should Be Studied Further for Possible Inclusion in the Minimum Tax Base

1. *Exclusion of Interest on Life Insurance Savings.* One of the elements of life insurance proceeds is the amount built up in the policy that represents interest on saving as opposed to the pure protection element in the policy proceeds. Under present tax rules, interest on this form of saving is completely exempt from income tax, although interest on competing forms of saving, such as a savings account in a bank, is taxable. As a policy matter, there appears to be no reason to favor interest earned on this form of investment as opposed to interest earned on other types of investments. There are, however, administrative problems to be worked out in determining the proper amount of interest allocable to a given policy in a particular year. Nonetheless these problems do not appear to present overwhelming difficulty, and the estimated revenue loss of over \$1 billion for 1971 for interest on life insurance savings indicates that this exclusion represents a tax preference of substantial magnitude.⁹⁰

2. *Net Imputed Rental Income from Owner-Occupied Housing.* Another form of investment that is accorded highly preferential treatment by present tax laws is the investment in housing which in effect is rented by the owner to himself. While interest and taxes with respect to owner-occupied housing are fully deductible, the rental value of the property is not included in the income tax base. It is estimated that approximately a \$5 billion revenue loss results annually from the failure to tax this net rental income (net imputed rental income equals rental value minus interest, maintenance and repair expenses, and depreciation). Because of the exemption for individuals from minimum tax liability suggested below, most home owners would not, of course, be subjected to the minimum tax by virtue of inclusion of this item in the minimum tax base. Nonetheless, the benefits of this preference increase substantially with income, and there appears to be no reason why those who have large amounts of other preference income should be able to escape tax on this particular form of investment income. There are problems of valuation but these do not appear insurmountable. Because of the large revenue loss involved the matter deserves serious study.⁹¹

3. *Social Security Benefits.* The exclusion of social security benefits from the normal income tax base involves an annual revenue loss of almost \$3 billion. This exclusion can hardly be justified on the basis of assisting taxpayers with below-poverty-level incomes, since the low-income allowance and personal exemptions in fact exempt from federal

⁹⁰ See R. Goode, *The Individual Income Tax* 130-39 (1964).

⁹¹ See Aaron, *Income Taxes and Housing*, 60 *Am. Econ. Rev.* 789 (1970).

income tax those individuals whose total income does not reach the poverty level. Reform proposals submitted by the Treasury in 1965 and 1968 in connection with reform of the taxation of the elderly were rejected by Congress.⁹² Nonetheless, inclusion of the social security payments in the minimum tax base appears an entirely appropriate step. For most social security recipients, of course, the minimum tax exemption provided below will continue to insure that no tax liability will be incurred with respect to their social security payments. However, there appears to be no policy reason why persons who have retired with high amounts of tax preference income should also be entitled to exclude social security payments. Thus these payments should be includible in the minimum tax base so that they will generate at least some tax liability where the individual recipient also has large amounts of other tax preference income.

There are other items that conceptually would appear proper for possible inclusion in the minimum tax base, but those listed above appear to be the most likely candidates for inclusion at the present time. Immediate inclusion of the items in Category I in the minimum tax base will go a long way toward insuring that the avowed purpose of the minimum tax is met, *i.e.* that each individual and corporation will make some significant contribution to the cost of government. The items in Category II deserve further study since the amounts of revenue involved are very large and the benefits of the exclusion for the very wealthy seem disproportionately large if not subject to the minimum tax.

C. *Changes in the Rate of the Minimum Tax*

With respect to *individuals*, one of the problems with the present minimum tax system is that it imposes a proportional tax on top of a progressive rate structure. It is true that the existence of the \$30,000 exemption and the deduction of regular taxes from the minimum tax base⁹³ provide a type of progressivity within the minimum tax structure itself, but only if one considers the *minimum tax alone*. Moreover, the existence of the \$30,000 exemption reduces the overall progressive impact of the minimum tax when it is considered in conjunction with the regular tax system. That is to say, the \$30,000 exemption for tax preferences allows a taxpayer to start all over again at the bottom of the minimum tax structure, whereas in a truly progressive overall system the tax preference liability should be added onto the regular tax liability in an incremental fashion.

⁹² See, e.g., Tax Reform Studies, *supra* note 71, at 231.

⁹³ Int. Rev. Code of 1954, §§ 56(a)(1), (2).

Further, the deduction for regular taxes produces a progressivity in the minimum tax that is inverse to the progressivity of the regular tax. In other words, the higher the regular taxes paid, the lower the minimum tax; and, conversely, the lower the regular tax paid, the higher the minimum tax. The net result of this system is that two people with identical tax preferences may pay different amounts of minimum tax, a result that is at variance with the *additive* nature of the minimum tax, albeit consistent with the *comparative* approach of the 1968 Treasury minimum tax proposal. The minimum tax will perform its function better if it is integrated in principle with the progressive nature of the regular income tax. That is to say, a dollar of tax preference should bear a higher marginal tax rate in all situations, aside from the small exemption suggested below. As noted, the present minimum tax has both additive and comparative aspects. Nonetheless the basic premise of the minimum tax now provided in sections 56-58 appears to be that the minimum tax is an *additional* tax on tax-preferred income. On balance it seems desirable to build on this concept and effect a minimum tax which enhances the progressivity of the regular tax system.

For *individuals* the minimum tax rate structure should be amended to provide graduated rates at one-half the normal rates. Thus the minimum tax rates could range, for example, from 7% to 35%. Brackets of minimum taxable income could correspond in size to those applicable to regular taxable income.⁹⁴ For *corporations*, which in general are not taxed under a progressive rate structure, the minimum tax rate can remain a flat rate. Because of the increase in minimum tax rates applicable to individuals, it would appear appropriate to provide a minimum tax rate for corporations of about 20%.

In order to insure that the proposed progressive minimum tax rates for individuals operate as a direct supplement to the progressivity of the regular tax rate structure, the deduction for regular taxes from the minimum tax base should be repealed. Thus each dollar of minimum taxable income should be taxed at a progressively higher rate on an absolute basis, rather than inversely to normal tax liability. Such a step would materially increase the overall progressivity of the income tax system.

⁹⁴ The primary effect of such a change would be on capital gains. The proposed rate structure would increase the present 36.5% maximum capital gain rate (regular tax plus minimum tax) to 52.5%. This change with respect to the top capital gain rate should be compared to the increase in top capital gain rates from 25% to 36.5% enacted in 1969. Economists do not appear to have found that the 1969 change had an adverse effect on investment. It should also be noted that the operation of the maximum tax can increase the capital gain rate to 46.5% under present rules; see *Federal Income Taxation*, supra note 43, at 940-41. The repeal of the maximum tax in its entirety would be a welcome reform in conjunction with the proposed changes in the minimum tax.

D. *Change in Exemption*

At the present time, the effectiveness of the minimum tax is substantially impaired by the existence of the \$30,000 exemption for minimum tax purposes. Presumably the purpose of any exemption from the minimum tax is to insure that persons with relatively small amounts of preference income are not subject to the minimum tax. Thus, for individuals, the \$30,000 exemption operates somewhat like the personal exemption and standard deduction, including the low-income allowance, that individuals take in computing their regular tax liability.

There is a certain anomaly in granting an exemption above and beyond the personal exemption to anyone who has used tax preferences materially to reduce or escape regular tax liability.⁹⁵ Nonetheless, some argument for a small exemption can be made on the basis of administrative convenience. The present \$30,000 minimum tax exemption, however, far exceeds the amount required by administrative considerations.

For *individuals*, therefore, the \$30,000 flat exemption should be converted to a \$5,000 vanishing exemption. The \$5,000 floor would insure that persons with relatively small amounts of preference income would not need to compute and pay a minimum tax. However, the \$5,000 exemption should be phased out to disappear once \$10,000 of tax preferences is reached. The argument for administrative convenience does not apply where preference income exceeds \$10,000 per year. Nor does a taxpayer with this amount of preference income appear to be an appropriate candidate for an exemption in addition to the ones granted in computing regular personal tax liability.

For *corporations*, no exemption should be available. Neither reasons of administrative convenience nor tax concepts justify an exemption for corporations.

E. *Structural Changes in the Minimum Tax*

1. *Treatment of Deferral Items*

The principal structural defect in the present minimum tax system is its failure to distinguish between tax preferences that amount to outright exemptions and those that involve tax deferral. No problems are involved in applying the minimum tax to *exemption items*. The tax is imposed in the year the exemption is taken and, in effect, the amount of the exemption is reduced.

⁹⁵ Providing a \$30,000 exemption for minimum tax purposes has ironic overtones when compared with the basic \$750 personal exemption for regular tax purposes. A \$750 personal exemption is provided to help a taxpayer meet the necessities of life; but once he has demonstrated that he has no financial difficulty in providing those necessities and has attained a marginal bracket where tax preferences are beneficial, an exemption 40 times as great is granted.

However, the problem is different with respect to *deferral items*. Here the minimum tax may be imposed on an amount which itself is later subject to regular taxation, but present rules do not permit any adjustment in the subsequent year for the minimum tax previously paid. Thus, for example, the minimum tax may be applied in the case of the rapid amortization of pollution control facilities to tax the amount by which the amortization allowable exceeds depreciation otherwise allowable with respect to the property. In a subsequent disposition of the facility the entire depreciation will be subject to section 1245 recapture and taxed at ordinary income rates. In theory it would appear that some adjustment should be made in the year of disposition for the minimum tax previously paid.

Under the present system, there may be some justification for not getting involved in the complexities of adjustments for deferral items. A deferral item is involved; thus it can be argued that the minimum tax in the above situation may be viewed as an interest charge on the tax loan. If so, it is a highly erratic way of charging interest: the interest charge varies with the length of the deferral period, the taxpayer's tax rate, and the return which the taxpayer can realize on investment of the deferred taxes. For example, the shorter the deferral the higher the interest rate.⁹⁶

While this degree of inexactitude may be tolerable when the minimum tax rate is only 10%, it is probably not acceptable if minimum tax rates of up to 35% are adopted. Therefore, if a higher progressive rate structure is adopted for the minimum tax, as recommended above, taxpayers should be entitled to an adjustment for the minimum tax paid to the extent that an item subject to the minimum tax is subsequently included in the regular tax base. Here the best solution appears to be that upon disposition of deferral property a tax credit be allowed for the minimum tax previously paid. The credit would have to be adjusted to reflect the period of time over which the property was held. The credit should thus be highest for shorter-term deferrals—because the taxpayer has had the use of the federal tax monies for a shorter period of time. As the length of deferral increases, the credit should correspondingly be reduced by a predetermined percentage each year. The reduction percentage could be determined by reference to an average tax bracket (say 40-50%) and an assumed discount rate.⁹⁷

It is possible to achieve something of the same result as outlined above by basis adjustments with respect to deferral items subject to

⁹⁶ See McDaniel & Kaplinsky, *The Use of the Federal Income Tax System to Combat Air and Water Pollution: A Case Study in Tax Expenditures*, 12 B.C. Ind. & Com. L. Rev. 351, 363 (1971).

⁹⁷ The credit mechanism outlined in the text was developed by Professor Stanley S. Surrey, Harvard Law School, and I am indebted to him for sharing his analysis.

the minimum tax. This approach, however, appears to involve greater complexity than the credit approach.

2. *The Averaging Device*

Under the present minimum tax, a special averaging device is provided which permits a taxpayer to carry over for seven years the excess of the regular tax for a given year over tax preferences less \$30,000. The effect is to reduce minimum tax liability in the subsequent years because the taxes carried over are deducted for minimum tax purposes just as are regular taxes incurred in such years. Under the proposal made above, however, the deduction for regular taxes would be eliminated. The question then is whether an averaging device should be provided under the revised system.

The need for an averaging device depends upon one's view of the minimum tax. If it is seen as a special tax structure against which an individual's tax preference income is to be checked each year, then an averaging device is probably not appropriate. Such an approach seems especially justified under the present minimum tax structure. After the proposed revision of the minimum tax set forth above, however, averaging for minimum tax purposes would seem appropriate. An approach like that in present sections 1301-05 could be adopted for the minimum tax so that, in effect, minimum tax liability would be averaged over a period of, say, five years.

F. *Supportive Provisions for the Minimum Tax*

While a strengthened minimum tax would be an appropriate response to tax-sheltered income and other tax preferences, it would not alone provide adequate limitations on all tax preferences. Thus, for example, under the recommendations outlined above, the minimum tax would have no direct effect on special itemized personal deductions.⁹⁸ It does not deal with the problem of allowing the deduction of interest incurred to carry investments which will be sold at capital gain rates. Nor does it lend itself readily to resolution of the "farm loss" problem, which is a preference arising in large part from tax accounting rules rather than from specific tax expenditure provisions. Therefore the minimum tax needs several backstopping measures to deal with these special tax preference problems. The following steps are recommended:

1. *Adoption of the allocation of deductions proposal.* While a minimum tax reduces the extent to which an individual can escape

⁹⁸ The present minimum tax has an erratic effect on itemized personal deductions because of the deduction for regular tax liability from the minimum tax base: the higher the amount of personal deductions, the lower the regular tax liability, and, hence, the higher the minimum tax liability.

proper tax liability, the preferences are enhanced in value if personal expenditures can be deducted in full against taxable income. The allocation of deductions provision adopted by the House in 1969⁹⁹ represents an appropriate response to this problem. It should now be reconsidered and adopted, with an expanded list of preference items, regardless of the action taken with respect to the minimum tax.

2. *Limitation on interest deduction.* Section 163(d) imposes a limit on the extent to which the interest deduction can be taken against ordinary income where the asset being carried by the loan is sold at capital gain rates. A minimum tax, depending upon the rates adopted, may adequately deal with this problem. The present minimum tax certainly does not. Therefore the provisions limiting the deduction for interest should be retained and strengthened. The present \$25,000 exemption is much too high and should be reduced to \$5000. In addition, the entire excess deduction, not just one-half, should be disallowed, subject to being carried forward and utilized against investment income in subsequent years.¹⁰⁰

3. *Farm "losses."* The farm "loss" problem arises primarily from accounting rules developed for a smaller and more simple agricultural economy. These rules permit a significant tax deferral to be achieved by nonfarmers who utilize them to produce "losses" that reduce tax on their non-farm income.¹⁰¹ The minimum tax, as noted above, is limited as a tool for dealing with deferral items. A separate provision directed specifically at the farm "loss" problem would appear a better means of attacking the deferral involved in the cash accounting rules for farmers. Section 1251 of the Code represents an attempt to cope with the problem, but it is limited in scope and approaches the problem from the wrong direction. That is, the Excess Deduction Account (EDA) approach in section 1251 is a recapture provision and thus permits tax deferral to continue in the farm "loss" area. A more appropriate response would be that recommended by the 1968 Treasury Tax Reform Studies and Proposals,¹⁰² which proposed the disallowance of all deductions for farm "losses" to the extent they exceeded farm income plus \$15,000. Such an approach deals directly with the deferral problem, leaving the issue of the treatment of gain on the sale of farm property to be resolved in the context of capital gain rules generally.

⁹⁹ H.R. Rep. No. 91-413, supra note 69, at 80.

¹⁰⁰ This was the approach adopted by the House in 1969 in its version of present § 163(d). See H.R. Rep. No. 91-413, supra note 69, at 72-73.

¹⁰¹ See Statement of Prof. Charles Davenport, Panel No. 5 (Feb. 20, 1973), in Prepared Statements Submitted by Witnesses Invited to Appear Before the Committee on Ways and Means to Participate in Panel Discussions on Tax Reform, 93d Cong., 1st Sess. (1973).

¹⁰² Supra note 71, at 152.

The 1968 Treasury Proposal should be adopted in order to supplement effectively the minimum tax in the farm "loss" area.

IV. AFTERWORD

On April 30, 1973, the Treasury Department submitted its Proposals for Tax Change¹⁰³ to the House Ways and Means Committee. The package is a mixture of proposed tax reforms and new tax expenditures.¹⁰⁴ In general the Treasury recommendations conform to those anticipated in the Forward to this article. The Treasury proposals will be subjected to analysis in depth and detail beyond the scope of this article. But some preliminary comparisons to the suggestions set forth in Sections II and III, above, are in order.

A. *Treasury Proposals and Tax Shelters*

The Treasury proposes to deal with the problem of tax shelters through its new Limitation on Artificial Accounting Losses (LAL).¹⁰⁵ Under this proposal, "artificial losses" resulting from acceleration of deductions cannot shelter "unrelated income" of the taxpayer. In general, if in a given year accelerated deductions generated by an activity exceed the income derived from that activity, the excess deductions must be placed in a suspense account (called a Deferred Loss Account (DLA)) and can be deducted only in the future against income generated by the activity. Accelerated deductions subject to LAL include the intangible drilling and development expense deduction, accelerated depreciation, construction period interest and taxes, deductions from farm operations, investment interest deductions (in some situations), and other deductions that "will from time to time be specifically identified by regulation where it appears that they are being used as tax shelters."¹⁰⁶

More technically, an "artificial loss" is the amount by which the

¹⁰³ Department of the Treasury, Proposals For Tax Change (April 30, 1973) [hereinafter cited as Proposals].

¹⁰⁴ Thus on the reform side the Treasury submitted recommendations to strengthen the minimum tax, to deal with tax shelters, and to provide a federal subsidy for taxable municipal bonds. See Proposals, *supra* note 103, at 83, 94, and 143. In addition, some particularized reforms were advanced to deal with arbitrage securities and taxation of U.S. business operations abroad. See Proposals at 148, 159, and 169.

As new tax expenditures, the Treasury recommended tax credits for property taxes paid by the elderly, for tuition paid to private schools, and for domestic oil and gas drilling and exploration expenditures. See Proposals at 118, 126, and 135.

In addition, in an effort to secure "simplification," the Treasury proposed a \$500 standard deduction for certain itemized deductions which would, however, operate as an itemized deduction itself.

¹⁰⁵ Proposals, *supra* note 103, at 94.

¹⁰⁶ *Id.* at 97.

accelerated deductions for the year exceed "associated net related income" (ANRI) for the year. Net related income (NRI) is computed by ignoring the accelerated deductions (*e.g.*, in the case of accelerated depreciation by using only straight-line depreciation). Accelerated deductions are allowed as deductions only to the extent of net related income and any excess must be added to the Deferred Loss Account. As income is generated by the activity in a subsequent year, an amount equal to the excess of NRI over accelerated deductions for that year will be subtracted from the account and allowed as a deduction in that year.¹⁰⁷

In the case of residential real estate, related income is computed by aggregating income from all residential real estate plus income from the sales of housing held primarily for sale to customers. Aggregation is also permitted for oil and gas properties.¹⁰⁸ But in the case of other potential tax shelter activities, accelerated deductions apparently would be allowed only to the extent of the income generated by the particular property involved.

Where the proceeds from a sale of property do not constitute related income, the balance in the Deferred Loss Account attributable to the property would be subtracted from the account and added to the basis of the property.¹⁰⁹

A partnership or Subchapter S Corporation would make the LAL computation at the entity level and then pass through to each individual partner or shareholder his distributive or ratable share of the LAL item.¹¹⁰

What would be the impact of LAL on the tax shelter investments analyzed in Section II of this article? In general, it can be concluded that LAL has a decided impact on each of the elements that produces the present tax shelter device. Thus the pure *shelter* aspect is eliminated. No longer, for example, would accelerated depreciation from a real estate project be available to offset earned income, dividends, and royalties; accelerated depreciation on buildings could only be deducted against income generated from buildings. *Deferral* of tax is likewise eliminated by requiring that accelerated deductions match income; the deductions only become available as the income is generated. The use of leverage appears less attractive since deductions for accelerated depreciation will more closely parallel repayment of the principal of the loan. Finally, LAL appears to eliminate the negative income tax feature noted above, which resulted from allowing deductions against ordinary income but taxing gain on the sale at capital gain rates. For

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 98, 99.

¹⁰⁹ *Id.* at 102.

¹¹⁰ *Id.* at 103-04.

example, assume that a taxpayer purchased an asset for \$100 and could deduct the entire cost in year one. The property generated no income in year 1 so no deduction would be permitted under LAL; the taxpayer would add the \$100 to his Deferred Loss Account. Upon a sale in year 2, the tax basis of zero would be increased by the \$100 in the Deferred Loss Account, leaving the taxpayer with no gain and no deductions in the transaction. Thus LAL correlates the tax result to the economic result of the transaction, a resolution that is not achieved under present law.

LAL apparently would not apply to the sample syndicated real estate tax shelter in Appendix A because it is an FHA 236 project.¹¹¹ LAL is, however, applicable to non-federally subsidized housing tax shelters. If LAL did affect FHA 236 projects, it would appear to disallow the excess of accelerated depreciation over straight-line depreciation through year 18 of the project in Appendix A. This result would materially impair the attractiveness of the investment to high-bracket taxpayers.

In order to analyze the impact of LAL on oil and gas tax shelter arrangements, the Treasury's recommendation to provide still more tax benefits to the oil and gas industry must be taken into account. The Treasury's April 30 proposals included the President's recommendation to provide a 7% investment credit for domestic exploration and drilling, with an additional 5% credit for successful wells.¹¹²

We can analyze the impact of LAL (plus that of the new credits) on the example set forth in Section II.B. Assuming no other income from oil investments by the investor in the sample drilling project, LAL would deny the \$900,000 intangibles deduction in year 1; that amount would go into a Deferred Loss Account. However, in year 1, a tax credit of \$63,000 would be available under the President's proposal.

In year 2 net related income would be the \$100,000 in income generated by the property. Hence the deductions resulting from subtractions from the DLA would eliminate tax liability on income generated by the well in year 2, *i.e.*, an investor could receive \$100,000 free of tax. In addition, the investor would receive \$33,000 tax-free income from percentage depletion and the 5% supplemental investment credit would produce a tax benefit of \$45,000. Upon sale in year 3 for \$900,000, the balance in the DLA of \$800,000 would be added to the tax basis of \$100,000, producing a break-even situation. Thus, by virtue of LAL the tax benefits from the investment are confined to

¹¹¹ FHA 236 projects may be exempt from LAL; Proposals, *supra* note 103, at 103.

¹¹² Proposals, *supra* note 103, at 135. The proposed credit is 7% of intangible drilling and development expense costs (plus certain geological and geophysical costs). If the well is successful, a supplemental credit equal to 5% of such costs is allowed.

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percentage depletion (\$33,000) and the proposed investment credit (\$108,000).

The above results may be illustrated in the following diagram:¹¹⁸

				Investor's Net After-Tax Investment
<i>Year 1:</i>	Deductible Intangibles	Tax Benefit		
Investment				
\$1,000,000	\$900,000	\$ 63,000		
<i>Year 2:</i>	Percentage Depletion	Deduction From DLA	5% Investment Credit	Net After-Tax Cash
Net Income				
\$ 100,000	\$ 33,000	\$100,000	\$45,000	\$178,000
<i>Year 3:</i>				Net After-Tax Profit
After-Tax Cash From Year 2 Income and From Sale Proceeds	Net After-Tax Investment			
\$1,078,000	\$937,000			\$141,000

As a result of LAL, the net after-tax profit for the investor in the example has been reduced from \$303,100 to \$141,000. If the proposed investment credit for oil were removed from the example, the after-tax profit would be reduced to \$33,000, the amount of the percentage depletion allowance. In this latter situation, the investor would have done better if he had just placed his \$1 million in a savings account.

LAL thus appears quite effective in dealing with the oil tax shelter as presently constituted. However, its effectiveness will be diluted if the new investment credit is enacted and made available to investors in a syndicated drilling fund.

With respect to the sample equipment leasing tax shelter described in Appendix B, where a net lease is involved, LAL applies to treat as an artificial loss the amount by which the five-year rapid amortization exceeds straight-line depreciation. The only related income from which the artificial loss can subsequently be deducted is income from the leased property itself. No aggregation of income from a number of leasing transactions is permitted, in contrast to the treatment of oil and gas and real estate properties. Thus, in the example in Appendix B the excess of rapid amortization over straight-line depreciation can be deducted only from the rental income subsequently generated by the particular leased property. If we assume that the interest deduction is fully allowable in computing related income and that the projected

¹¹⁸ Compare the diagram, p. 828 *supra*.

rental income in Schedule A in Appendix B is maintained, then the LAL computation for an investor would be as follows:

Rental Income		\$13,209
Less:		
Interest	11,816	
Straight-line Depreciation	11,626	23,442
Net Related Income		(\$10,233)

Rapid amortization would exceed straight-line depreciation in each of the first five years of the lease by \$21,641 (\$34,267 minus \$11,626). This amount therefore would not be deductible by the investor in any of these years, but would be deferred until years 6 through 15 when the project would generate net related income.

LAL does not purport to deal directly with the interest deductible in arriving at adjusted gross income. Nonetheless, it appears from the application of LAL to the leveraged leasing transaction in Appendix B that it will not be possible to use leverage (with corresponding interest deductions) to purchase *accelerated* depreciation deductions. This results from the fact that interest on the loan reduced net related income to a point that the excess of rapid amortization over straight-line depreciation was required to be deferred in its entirety in each of the first five years of the lease. It seems safe to predict that leveraged transactions to acquire *straight-line* depreciation deductions are unlikely to have the requisite appeal to tax conscious investors.

On the other hand, in the example in Appendix B, the combination of the interest deduction plus straight-line depreciation still produces a loss in each of the first five years. Some shelter potential thus would remain even after LAL. Perhaps the answer here is that part of the interest for the first five years shown in Schedule A of Appendix B in fact should be disallowed under the Internal Revenue Service prepaid interest rules.¹¹⁴ But, as discussed below, more stringent rules with respect to the deduction for investment interest may be warranted.

How should the tax reformers in Congress react to LAL? On the whole, a preliminary examination of the proposal seems to indicate that it would generally be quite effective to deal with the problems created by high-bracket professionals and business executives investing in tax shelter transactions. The underlying theme of the Treasury proposal is that LAL is designed to deny tax benefits intended for a particular industry to persons not engaged to any significant extent in that activity.

But some structural changes in LAL should be considered. First, the Treasury may be overly optimistic in its view that section 163(d)

¹¹⁴ See Rev. Rul. 68-643, 1968-2 Cum. Bull. 76.

is rendered unnecessary by LAL. The prepaid interest rules may not prove sufficient to deal with the problem of interest incurred to carry investment assets. Further analysis appears in order to determine if there would not be a role to be played by a strengthened section 163(d) properly integrated with LAL.

Second, LAL does not apply to corporations. While the Treasury apparently accepts the proposition that businesses for which special tax benefits have been granted should be able to eliminate tax on the income generated by their business activity, it does not follow that banks should be able to eliminate tax on their banking income by utilizing, through leasing transactions, tax preferences intended for plant equipment and machinery. Again, more analysis is required to determine whether there is a proper role for the LAL principle in corporate tax shelter transactions.

Finally, LAL seems too lenient even with respect to persons engaged full time in activities for which special tax preferences have been accorded. So long as a real estate developer, for example, continues to expand his activities, LAL may never apply. Thus a proper matching of income-producing properties with new projects generating accelerated deductions will still permit full utilization of the deductions unhindered by LAL. And since, as discussed below, the Treasury proposes to remove all deferral items from its minimum tax, it would apparently be possible for oil drillers, real estate developers, farm operators, and movie producers to eliminate, by proper planning, any liability for federal income tax.¹¹⁵ While one can understand the Treasury's desire to avoid the complications in the minimum tax that inclusion of deferral items would involve, it does appear that some shoring up of LAL (or the minimum tax) is required to avoid such consequences.

B. *Treasury Proposals and the Minimum Tax*

The Treasury's Minimum Taxable Income (MTI) proposal is intended to "prevent the combination of exclusions and itemized deductions from off-setting more than one-half of a taxpayer's income, and every individual will be required to pay tax on at least the balance."¹¹⁶

As noted above, MTI applies only to enumerated items completely

¹¹⁵ Standing alone, the proposals for a refundable tax credit made in Section II, p. 838 *supra*, might appear to assume a like result. This would not be the case, however, since the investment credit and deferral items would be included in the minimum tax as proposed in Section III. Hence some tax contribution would be required even from persons for whom tax preferences are intended.

It is of interest to note that the refundable credit is a feature of the Treasury's proposals for tax credits for property taxes paid by the elderly and for private school tuition costs.

¹¹⁶ Proposals, *supra* note 103, at 83. The Treasury MTI system would apply only to individuals. The present 10% minimum tax would continue to apply to corporations.

excluded from gross income; it does not apply to tax preferences accorded through a deferral mechanism. The four exclusions are: (1) percentage depletion in excess of adjusted basis; (2) the excluded one-half of net long-term capital gain; (3) in the case of a qualified or restricted stock option, the amount by which the fair market value of the stock at the time of exercise of the option exceeds the option price; and (4) income earned outside the United States which is exempt under section 911.

To determine an individual's liability under MTI, he must, after computing his taxable income under regular rules, compute his "minimum taxable income." If the latter exceeds the regular taxable income, then the usual progressive rate schedule is applied to determine tax liability.

Minimum taxable income is arrived at by adding to adjusted gross income the amount of the four preference items. From this total is subtracted the amount of the taxpayer's personal exemptions, a basic \$10,000 exemption, extraordinary medical expenses and casualty losses (amounts in excess of 10% of AGI plus exempt covered by MTI), and investment interest and expenses (to the extent such items equal investment income). The result of the computation is the taxpayer's "MTI Base," which is then divided by two to arrive at "minimum taxable income."

The MTI proposal thus returns to the concept that a minimum tax system should be comparative and progressive. One can readily agree with the progressivity aspect of MTI, but the comparative feature must be more carefully analyzed.

It is helpful to compare the proposed MTI with the suggestions for strengthening the present minimum tax advanced in Section III of this article. First, as to *income* items, MTI shares the same defects of omission as the present minimum tax. Tax-exempt interest is not included in the MTI Base nor is the accrued gain on property transferred by gift or at death. The omission of tax-exempt interest means, of course, that MTI cannot fulfill its laudable purpose; omission of accrued gain substantially weakens its impact. Thus the suggestions in Section III for items to be included in the present minimum tax base are also applicable to MTI.

In addition, MTI has no direct impact on capital gain rates. Thus, an individual whose income is \$1 million derived solely from capital gains would be totally unaffected by MTI. If the taxpayer has other items of tax preference or personal deductions, then the presence of capital gains in the MTI Base will serve to use up all or part of the 50 percent of permissible tax preferences, thus perhaps causing such other items to be disallowed under MTI. The treatment of capital gains

by MTI may be compared to this writer's recommendations and to the present minimum tax. Thus under the proposal in Section III, a single individual with \$1 million of capital gain income would pay a minimum tax of approximately \$75,000¹¹⁷ plus some \$333,000 in regular tax. The present minimum tax on the \$500,000 of excluded gain would be about \$13,700 [$10\% \times (\$500,000 \text{ minus } \$30,000 \text{ minus } \$333,000)$], which would be added to the \$333,000 normal tax.

Thus, as was suggested by the analysis in Section III, a decision to adopt a *comparative* approach or an *additive* approach in a minimum tax system may turn on the question of what one wishes to do about capital gains. The Nixon Administration has consistently opposed efforts to narrow the tax gap between capital gains and ordinary income. Its advocacy of a comparative minimum tax is consistent with this record. But for those who wish to bring the tax burden on capital gain income more closely in line with that borne by ordinary income, the additive approach (coupled with a progressive rate structure) may be preferable. Of course, one can structure MTI to have a direct impact on capital gain rates by, for example, permitting only 40 percent of total income to be excluded from the MTI Base.

As to *deduction* items, the MTI proposal is interesting on a number of counts. Its most important feature is its elevation of itemized personal deductions to membership in the hierarchy of tax preferences coordinate with percentage depletion, capital gains, and the like. For an excessive amount of itemized personal deductions brings MTI into operation just as will the presence of excessive amounts of preference income. Thus, for a single individual with \$1 million of ordinary income from salary and dividends, MTI will disallow itemized personal deductions in excess of \$510,750. In such a case, neither the minimum tax nor the allocation of deductions proposals in Section III would have any impact on itemized personal deductions regardless of amount.

The MTI policy stance toward itemized personal deductions is thus quite different from the policy for an allocation of deductions provision. The latter proposal assumes the validity of the itemized personal deductions per se; it only operates to disallow such deductions when they are used in conjunction with exempt income. If no exempt income is involved, there is assumed to be no abuse. MTI, on the other hand, is based on the proposition that itemized personal deductions, if present to an excessive degree, can result in the same unacceptable low levels of tax liability as are produced by large amounts of exempt income. Hence MTI would operate to disallow personal deductions even if no exempt income is present in the taxpayer's income make-up.

¹¹⁷ Assuming one-half normal rates were applied to tax brackets under a progressive minimum tax which corresponded to regular tax brackets.

It is difficult to evaluate MTI's effect on personal deductions as compared to an allocation of deductions provision. For example, assume that a taxpayer has \$1 million of income, of which \$250,000 is capital gain. He also has \$250,000 of itemized personal deductions. MTI would have no effect in this case, either on the itemized personal deductions or on the capital gains. But the allocation of deductions proposal would operate to disallow approximately one-eighth of the itemized deductions. And the strengthened minimum tax suggested in Section III would also apply to the capital gain income.

It should be noted parenthetically that MTI does contain a type of allocation of deductions system within itself. Thus "ordinary" medical expenses and casualty losses are allocated to the preference category; extraordinary amounts of these two items are allowed to be deducted in arriving at the MTI Base. Similarly, only investment interest and expenses in excess of investment income are considered as preference items; such expenditures are deductible in arriving at the MTI Base to the extent of investment income.

A Congressman interested in tax reform with respect to itemized personal deductions really need not make a choice between either an MTI approach or an allocation of deductions rule. For it appears that both could be adopted. That is, itemized deductions could be treated as items of tax preference under MTI, and then still be subject to allocation between exempt and tax-exempt income to the extent not disallowed by MTI. Each proposal stands on a sound conceptual base and, properly integrated, could combine to reduce substantially the erosion of the tax base by the present itemized personal deductions.

The MTI proposal must also be compared with a more effective section 163(d) limit on the interest expense deduction, as recommended in Section III above. MTI only affects interest deductible *from* AGI to the extent such interest exceeds investment income. Under the Treasury proposal, if MTI would operate to disallow a deduction for investment interest, the taxpayer is granted an option to treat such interest expense as an artificial accounting loss under LAL. The deduction would then be deferred until receipt of related income from the investment, rather than being disallowed.

Thus as to interest deductible from AGI, MTI, where applicable, is stronger than the present section 163(d) treatment. For if MTI applies, the excess investment interest deduction is either disallowed completely or is required to be deferred in its entirety (not just to the extent of one-half as under section 163(d)). But MTI disallows excess investment interest only as a function of its relation (plus other itemized deductions and exempt income) to AGI expanded by the MTI exclusion

items. Section 163(d), if amended as recommended in Section III, would be operative wherever investment interest exceeded investment income and would then apply the LAL deferral technique to the entire excess deduction. In addition, a strengthened section 163(d) approach appears to avoid the problems that would be encountered under MTI and LAL of determining whether interest is properly deductible *to* or *from* AGI. On balance, therefore, the approach of section 163(d) recommended in Section III appears preferable to the MTI-LAL proposals in dealing with the problem of excess investment interest.

V. CONCLUSION

The proposals of the Treasury on April 20, 1973, dealing with the problems of tax shelters and tax preferences appear to verify the judgment expressed at the outset of this article that these two areas represent the most promising candidates for immediate income tax reform. The Treasury MTI and LAL proposals, despite some reservations outlined above, represent a significant and useful source of support for such reform and are therefore to be commended. The task of tax-reform minded Congressmen and their staffs is to analyze the Treasury proposals and compare them to alternative methods of strengthening the tax rules dealing with tax shelter devices and tax preferences. With the submission of the Treasury tax proposals, significant improvement in the equity of our tax structure during the Ninety-Third Congress appears a realistic possibility.

APPENDIX A

A Sample Investment Proposal for Low Income Housing Project

XYZ ESTATES CO.
\$1,400,000

Limited Partnership Interests
In Units of \$50,000 Each
(An FHA 236 Development)

* * * * *

This memorandum describes a transaction in which a selected group of investors (the "Limited Partners") will be offered and entitled to purchase limited partnership interests (the "Units") in XYZ Estates Co., a limited partnership organized to acquire, own and develop a 500 unit low and moderate income garden apartment project.

* * * * *

Capital Contributions

The Limited Partners will contribute a total of \$1,400,000 to the capital of the Partnership and will not be required to make any other capital contributions. Each Limited Partner will make his capital contribution to the Partnership in three equal installments: one-third at the time of his admission, one-third on June 1, 1971, and one-third either on June 1, 1972, or upon completion of construction, whichever is later.

The Limited Partners will be entitled to share 95% of all profits and losses and 95% of cash flow from the normal rental operations of the Partnership from January 1, 1970 until twenty years after final endorsement of the mortgage note (the "Final Endorsement") by the Federal Housing Administration (the "FHA") and 50% thereafter. (See Exhibit A). Final Endorsement is expected to occur in August of 1971, which is shortly after the projected time for substantial completion of construction.

Construction Mortgage

FHA insured construction financing in the amount of \$8,905,000 has been obtained under a participation agreement whereby 95% of the construction loan is held by Federal National Mortgage Association (FNMA) and 5% by the Ames National Bank which will also administer the loan. The interest rate on the loan is 8.5% together with an additional financing fee in the amount of 2% of the mortgage (\$178,100) which was paid at Initial Endorsement.

Permanent Mortgage

A permanent mortgage commitment in the amount of \$8,905,000, at an interest rate of 8.5% has also been obtained from FNMA. The price of this mortgage commitment is 1.5% of the mortgage (\$133,575) of which 1% (\$89,050) was paid to FNMA at Initial Endorsement and ½ of 1% (\$44,525) will be paid at Final Endorsement.***

Neither the Partnership nor any Partner will have any personal liability for repayment of either the Construction Mortgage or Permanent Mortgage.***

Payback Period

Estimated period of time for a Limited Partner's Investment to be recovered through tax savings and distributions of cash flow (see Exhibit C):

Timing	50% Tax Bracket	60% Tax Bracket
First Installment	1 year, 3 months	1 year, 0 months
Second Installment	1 year, 10 months	1 year, 3 months
Third Installment	2 years, 9 months	1 year, 11 months

TAX REFORM, TAX SHELTERS AND TAX PREFERENCES

Rate of Return

Estimated Rate of Return for a Limited Partner's Investment
as shown in Exhibit D:

Limited Partner's Tax Bracket	After Tax Annual Rate of Return	Equivalent Pre-Tax Annual Rate of Return
50%	20.2%	40.4%
60%	27.5%	68.8%

* * * * *

EXHIBIT A
XYZ ESTATES CO.
(A Limited Partnership)
PROJECTION OF INCOME AND EXPENSE

Year	Rental Income (Note 1)	Government Subsidy (Note 2)	Income on Replacement Fund (Note 3)	Total Income	Operating Expenses	Deprecia- tion	Interest	Mortgage Insurance (Note 4)	Total Expenses	Taxable Income (Loss)	Cumulative Taxable Income (Loss)
1	10,350			10,350	317,458	9,723	133,808	7,871	468,860	(458,510)	(458,510)
2	621,000	232,283		853,283	379,629	507,004	678,374	39,905	1,604,912	(731,629)	(1,210,189)
3	795,752	557,453		1,353,205	428,185	561,101	756,354	44,491	1,790,131	(436,926)	(1,647,065)
4	795,752	557,322	1,435	1,354,509	428,185	537,608	754,065	44,357	1,764,215	(409,706)	(2,056,771)
5	795,752	557,169	3,421	1,356,342	428,185	514,116	751,473	44,204	1,737,970	(381,636)	(2,438,407)
6	795,752	557,004	5,506	1,358,262	428,185	493,623	748,653	44,039	1,714,500	(356,238)	(2,794,645)
7	795,752	556,823	6,179	1,358,754	428,185	470,130	745,583	43,858	1,687,756	(329,002)	(3,123,647)
8	795,752	556,626	8,406	1,360,784	428,185	446,637	742,242	43,661	1,660,725	(299,941)	(3,423,588)
9	795,752	556,412	10,744	1,362,908	428,185	423,144	738,605	43,447	1,633,381	(270,473)	(3,694,061)
10	795,752	556,180	13,200	1,365,132	428,185	426,651	734,647	43,215	1,632,698	(267,566)	(3,961,627)
11	795,752	555,926	2,113	1,353,791	428,185	403,063	730,339	42,961	1,604,548	(230,757)	(4,212,384)
12	795,752	555,650	4,133	1,355,535	428,185	379,053	725,650	42,685	1,575,573	(220,038)	(4,432,422)
13	795,752	555,350	6,255	1,357,357	428,185	361,521	720,546	42,385	1,552,637	(195,280)	(4,627,702)
14	795,752	555,024	8,484	1,359,260	428,185	344,175	714,992	42,059	1,529,411	(170,151)	(4,797,853)
15	795,752	554,668	10,827	1,361,247	428,185	329,828	708,947	41,703	1,508,663	(147,416)	(4,945,269)
16	795,752	554,281	11,770	1,361,803	428,185	309,481	702,367	41,316	1,481,349	(119,546)	(5,064,815)
17	795,752	553,860	14,278	1,363,890	428,185	292,135	695,206	40,895	1,456,421	(92,531)	(5,157,346)
18	795,752	553,401	16,914	1,366,067	428,185	274,788	687,412	40,436	1,430,821	(64,754)	(5,222,100)
19	795,752	552,902	19,684	1,368,338	428,185	257,441	678,929	39,937	1,404,492	(36,154)	(5,258,254)
20	795,752	552,359	22,593	1,370,704	428,185	213,094	669,696	39,294	1,350,369	20,335	(5,237,919)
21	795,752	551,768	25,650	1,373,170	428,185	195,683	659,647	38,803	1,322,318	50,852	(5,187,067)
22	1991 (7 mos.)	464,189	28,861	814,621	249,775	103,887	379,803	22,342	755,807	58,814	(5,128,251)

Note 1—Basic annual rent (per FHA Form #2264), \$828,908; 4% vacancy factor, 33,156; Net rental income, 795,752.

Note 2—Subsidy by government is computed as the difference between the payments necessary to amortize an 8½% mortgage including mortgage insurance and payments necessary to amortize a 1% mortgage.

Note 3—FHA regulations require monthly deposits of \$3,149 in an escrow account as funding for future property replacements. Income is computed on the assumption that the escrow funds will be invested to yield 4% compounded semi-annually.

Note 4—Mortgage insurance premium is payable at .05% on the outstanding mortgage.

EXHIBIT B
XYZ ESTATES CO.
(A Limited Partnership)
PROJECTION OF NORMAL CASH RECEIPTS AND DISBURSEMENTS FROM NORMAL OPERATIONS
(commencing from completion of construction)

Year	Cash Receipts			Cash Disbursements					Cash Flow Available for Distribution (Note 3)
	Rental Income (Note 1)	Government Subsidy (Note 1)	Operating Expenses (Note 1)	Interest (Note 1)	Mortgage Insurance (Note 1)	Mortgage Amortization	Replacement Fund Deposits (Note 2)	Payment of Capital Improvements or Liabilities	
1971	476,100	232,283	276,256	428,643	25,214	20,416	28,340	3,536	24,734
1972	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1973	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1974	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1975	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1976	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1977	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1978	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1979	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1980	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1981	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1982	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1983	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1984	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1985	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1986	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1987	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1988	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1989	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1990	795,752	557,453	428,185	756,354	44,491	20,416	28,340	16,058	59,361
1991 (7 mos.)	464,189	321,571	249,775	379,803	22,342	77,171	22,042		34,627

Note 1—See Exhibit A. Figures for 1971 differ from those for 1971 in Exhibit A because construction is assumed to be completed in 1971 and Limited Partners are entitled to cash distributions only after completion of construction.

Note 2—See Exhibit A—Note 3.

Note 3—According to FHA regulations, the amount of cash which may be distributed annually to the owner computed on the actual equity will not be less than 6% of 11.11% of the final FHA approved mortgage (6% X 11.11% X \$8,905,000 (estimated) = \$59,361). Such distributions are projected to commence at final endorsement of the mortgage (estimated at August 1, 1971).

EXHIBIT C
XYZ ESTATES CO.
(A Limited Partnership)
PROJECTION OF INCOME AND CASH DISTRIBUTIONS FOR A \$50,000 CLASS A LIMITED PARTNERSHIP INTEREST
(Based on a Total Class A Investment of \$1,400,000)
(Note 1)

Year	Taxable Income (Loss) (Note 2)	Cash Distrib- ution	Date of Investment on or Before	After-Tax Cash Benefit—50% Tax Bracket			After-Tax Cash Benefit—60% Tax Benefit					
				Contri- bution	Tax Savings or (Tax Payment)	Cash Distrib- ution	Cumu- lative	Tax Savings or (Tax Payment)	Distrib- ution	Total	Cumu- lative	
1 1970	(15,556)		6/1/70	16,667	7,778		7,778	7,778	9,334		9,334	9,334
2 1971	(25,502)	839	6/1/71	16,667	12,751	839	13,590	21,368	15,301	839	16,140	25,474
3 1972	(14,824)	2,014	6/1/72	16,666	7,412	2,014	9,426	30,794	8,894	2,014	10,908	36,583
4 1973	(13,901)	2,014			6,951	2,014	8,965	39,759	8,341	2,014	10,355	46,737
5 1974	(12,948)	2,014			6,474	2,014	8,488	48,247	7,769	2,014	9,783	56,520
6 1975	(12,087)	2,014			6,044	2,014	8,058	56,305	7,252	2,014	9,266	65,786
7 1976	(11,163)	2,014			5,582	2,014	7,596	63,901	6,698	2,014	8,712	74,498
8 1977	(10,177)	2,014			5,089	2,014	7,103	71,004	6,106	2,014	8,120	82,618
9 1978	(9,177)	2,014			4,589	2,014	6,603	77,607	5,506	2,014	7,520	90,138
10 1979	(9,078)	2,014			4,539	2,014	6,553	84,160	5,447	2,014	7,461	97,599
11 1980	(8,508)	2,014			4,254	2,014	6,268	90,428	5,105	2,014	7,119	104,718
12 1981	(7,466)	2,014			3,733	2,014	5,747	96,175	4,480	2,014	6,494	111,212
13 1982	(6,626)	2,014			3,313	2,014	5,327	101,502	3,975	2,014	5,989	117,201
14 1983	(5,773)	2,014			2,887	2,014	4,901	106,403	3,464	2,014	5,478	122,679
15 1984	(5,002)	2,014			2,501	2,014	4,515	110,918	3,001	2,014	5,015	127,694
16 1985	(4,056)	2,014			2,028	2,014	4,042	114,960	2,434	2,014	4,448	132,142
17 1986	(3,139)	2,014			1,570	2,014	3,584	118,544	1,883	2,014	3,897	136,039
18 1987	(2,197)	2,014			1,099	2,014	3,113	121,657	1,318	2,014	3,332	139,371
19 1988	(1,227)	2,014			614	2,014	2,628	124,285	736	2,014	2,750	142,121
20 1989	690	2,014			(345)	2,014	1,669	125,954	(414)	2,014	1,600	143,721
21 1990	1,725	2,014			(863)	2,014	1,151	127,105	(1,035)	2,014	979	144,700
22 1991 (* mos.)	1,995	1,175			(998)	1,175	177	127,282	(1,197)	1,175	(22)	144,678
	(173,997)	40,280										

Note 1.—The Limited Partners are entitled to 95% of the income, losses and cash flow from normal operations of the partnership from 1970 up to a date twenty years after final endorsement (estimated at July 31, 1991).

Note 2.—Construction period expenses that are immediately deductible, such as interest and taxes, are reflected in the figures for 1970 and 1971. . .

EXHIBIT D
XYZ ESTATES CO.
(A Limited Partnership)
PROJECTED RATE OF RETURN PER UNIT OF LIMITED PARTNERSHIP INTEREST

Year	50% Tax Bracket Taxpayer					60% Tax Bracket Taxpayer				
	After-Tax Cash Benefit (Note 1)	Income @ 20.2% of Unrecovered Investment (Note 2)	Income @ 5% net of Taxes on Sinking Fund Capital	Return of Capital	Net Investment End of Year	After-Tax Cash Benefit (Note 1)	Income @ 27.5% of Unrecovered Investment (Note 2)	Income @ 5% net of Taxes on Sinking Fund Capital	Return of Capital	Net Investment End of Year
1	1970	7,778	1,964	5,814	10,853	9,334	2,674	6,660	16,667	10,007
2	1971	13,590	4,156	9,434	18,086	16,140	5,426	10,714	16,667	15,960
3	1972	9,426	5,617	3,809	30,943	10,908	7,063	3,845	16,666	28,781
4	1973	8,965	6,250	2,715	28,228	10,355	7,915	2,440		26,341
5	1974	8,488	5,702	2,786	25,442	9,783	7,244	2,539		23,802
6	1975	8,088	5,139	2,919	22,523	9,266	6,546	2,720		21,082
7	1976	7,596	4,550	3,046	19,477	8,712	5,797	2,915		18,167
8	1977	7,103	3,934	3,169	16,308	8,120	4,996	3,124		15,043
9	1978	6,603	3,294	3,309	12,999	7,520	4,137	3,383		11,660
10	1979	6,553	2,626	3,927	9,072	7,461	3,206	4,255		7,405
11	1980	6,268	1,833	4,435	4,637	7,119	2,036	5,083		2,322
12	1981	5,747	937	4,810	(173)	6,494	639	2,322		(3,533)
13	1982	5,327		4,637	(5,509)	5,989		177		(9,699)
14	1983	4,901		4,534	(10,685)	5,478		485		(15,662)
15	1984	4,515		4,387	(15,734)	5,015		783		(21,460)
16	1985	4,042		4,042	(20,563)	4,448		1,073		(26,981)
17	1986	3,584		3,584	(25,175)	3,897		1,349		(32,227)
18	1987	3,113		3,113	(29,546)	3,332		1,611		(37,170)
19	1988	2,628		2,628	(33,651)	2,750		1,859		(41,779)
20	1989	1,669		1,669	(37,002)	1,600		2,089		(45,468)
21	1990	1,151		1,151	(40,003)	979		2,273		(48,770)
22	1991 (7 mos.) Rounding	177		1,167	(41,347)	(22)		1,420		(50,118)
					278					836
					(41,069)*					(49,282)*

* On the assumption that the partnership interest is sold for \$1 in year 22, the capital gains tax is computed as follows: Net tax losses (\$173,997) are added to tax-free cash distributions (\$40,280) and the \$1 sale proceeds, for a total of \$214,278. The \$50,000 investment is then subtracted, leaving a capital gain of \$164,278.

Note 1—See Exhibit C.

Note 2—The annual rate of return on investment was calculated assuming that a Limited Partner would sell his partnership interest in year 22 for \$1 (plus assumption of the remaining mortgage liability) and that some of the cash benefits in year 12 and all of the cash benefits in years 13 to 22 will be set aside to pay the federal capital gains tax which would result from the sale. The calculation assumes that the funds set aside for this purpose will earn 5% (after-tax) annually. The cash benefits during years 1 to 11 and a portion of year 12 have been presented annually as yielding income on the outstanding investment and the balance as a return of capital.

APPENDIX B

SCHEDULE A (ONEWAY) EQUIPMENT COMPANY (a Limited Partnership) PROJECTION OF TAXABLE INCOME (Loss) FOR INVESTOR PAYING IN \$50,000

Year	Rental Income (A)	Debt Service (B)		Depreciation (C)		Taxable Income or (Loss)	(D) Return of Cash	After-Tax Savings Cost Tax Rate (E) 70%
		Interest	Amortization	Balance	Expenses			
1970 (F)	0	0	0	\$124,386	\$174,386	(\$17,134)	0	\$11,994
1971	\$ 13,209	\$ 11,816	0	124,386	157,252	(32,574)	\$ 1,393	24,405
1972	13,209	11,816	0	124,386	34,267	(32,874)	1,393	24,405
1973	13,209	11,816	0	124,386	85,718	(32,874)	1,393	24,405
1974	13,209	11,816	0	124,386	54,451	(32,874)	1,393	24,405
1975	13,209	11,816	0	124,386	20,184	(32,874)	1,393	24,405
1976	21,845	11,833	0	124,386	17,286	(15,803)	1,393	12,518
1977	21,845	10,864	\$ 7,908	116,478	305	9,907	2,304	(4,631)
1978	21,845	10,020	8,677	107,801	305	10,676	2,304	(5,169)
1979	21,845	9,094	9,521	98,280	305	11,520	2,304	(5,760)
1980	21,845	8,078	10,447	87,833	305	12,446	2,304	(6,408)
1981	21,845	6,963	11,463	76,370	305	13,462	2,304	(7,119)
1982	21,845	5,740	12,578	63,792	305	14,577	2,304	(7,900)
1983	21,845	4,398	13,801	49,991	305	15,800	2,304	(8,756)
1984	21,845	2,925	15,143	34,848	305	17,142	2,304	(9,696)
1985	21,845	1,309	16,616	18,232	153	18,615	2,304	(10,727)
			18,232	0	153	20,383	2,304	(11,964)
	\$284,495	\$130,104	\$124,386		\$174,386	(\$19,995)	\$30,005	\$44,002

Assumptions:

- (A) Rental income payable semiannually in arrears commencing in 1971.
- (B) 15-year conditional sale indebtedness of \$124,386 bearing interest at 9½% (100% payout), amortization commencing in 1976.
- (C) Includes equipment cost of \$169,808 (5-year amortization as provided in the Tax Reform Act of 1969) and financing costs of \$4,578 (15-year amortization on straight-line basis).
- (D) Net return of cash is an annual average of approximately 4% of initial investment.
- (E) Assumes an effective tax rate as shown which remains constant during the term of the lease.
- (F) Based on an average holding period of 5 months in 1970.

SCHEDULE B
[ONEWAY] EQUIPMENT COMPANY
(a Limited Partnership)
AFTER-TAX CASH BENEFIT AND CUMULATIVE CASH POSITION TO A 70% TAX BRACKET
INVESTOR ABLE TO INVEST FUNDS AT 5% OR 10% AFTER TAXES

Year	Annual After-Tax Cash Benefit (Detriment) (A)	Cumulative Cash Position Employing Cash Benefit from Partnership Investment		Cumulative Compounded Cash Position of a \$50,000 Investment in the Partnership		Cumulative Compounded Cash Position of a \$50,000 Alternative Investment	
		5% (B)	10% (B)	5%	10%	5%	10%
1970	\$11,994	(\$50,000)	(\$50,000)	\$ 12,069	\$ 12,144	\$ 51,258	\$ 52,531
1971	24,405	(39,189)	(40,387)	37,550	38,740	53,869	57,984
1972	24,405	(16,519)	19,244	64,329	68,097	56,613	64,004
1973	24,405	7,716	4,093	92,473	100,502	59,498	70,648
1974	24,405	32,975	29,854	122,049	136,270	62,528	77,982
1975	12,518	59,521	58,288	141,022	163,411	65,714	86,077
1976	(4,631)	75,308	77,334	143,485	175,566	69,061	95,013
1977	(5,169)	74,424	80,553	145,528	188,425	72,579	104,876
1978	(5,760)	72,949	83,549	147,072	202,005	76,277	115,763
1979	(6,408)	70,795	86,242	148,035	216,322	80,162	127,780
1980	(7,119)	67,873	88,542	148,323	231,388	84,246	141,045
1981	(7,900)	64,077	90,343	147,830	247,207	88,538	155,687
1982	(8,756)	59,292	91,520	146,438	263,780	93,048	171,849
1983	(9,696)	53,390	91,931	144,019	281,097	97,788	189,689
1984	(10,727)	46,231	91,408	140,427	299,142	102,770	209,380
1985	(11,964)	37,657	89,762	135,390	317,776	108,005	231,116
	Initial Investment	27,385 (C)	86,560 (C)	(50,000)	(50,000)	(50,000)	(50,000)
	Net Increase			\$ 85,390 (C)	\$267,776 (C)	\$ 58,005	\$181,116

(A) It is assumed that all of the cash benefits (detriments) will be in equal quarterly installments during each year, received at the end of each quarter.

(B) These figures are based on the assumptions that first there will be a recovery of the original investment, plus interest calculated quarterly at the applicable rate during the period of such recovery. Thereafter tax benefits (detriments) are accumulated with interest calculated quarterly.

(C) Does not include residual value of equipment, after applicable taxes.

SCHEDULE C
[ONEWAY] EQUIPMENT COMPANY
(a Limited Partnership)

ILLUSTRATION FOR A 70% TAX BRACKET INVESTOR OF THE SINKING FUND METHOD OF
PROVIDING FOR TAX PAYMENTS FUND INVESTED AT 5% AFTER-TAX

Year	Annual After-Tax Benefit or (Detriment)	Capital Returned to Investor Through Tax Benefits (A)	Tax Benefits In Excess of Capital (B)	Sinking Fund (C)		Fund Balance
				Benefits Invested and (Tax Payments)	Assumed 5% After-Tax Income	
1970	\$11,994	\$11,994				
1971	24,405	24,405				
1972	24,405	13,601	\$10,804			
1973	24,405		6,725	\$17,680	\$ 211	\$17,891
1974	24,405			24,405	1,372	43,668
1975	12,518			12,518	2,459	58,645
1976	(4,631)			(4,631)	2,899	56,913
1977	(5,169)			(5,169)	2,803	54,547
1978	(5,760)			(5,760)	2,670	51,457
1979	(6,408)			(6,408)	2,500	47,549
1980	(7,119)			(7,119)	2,287	42,717
1981	(7,900)			(7,900)	2,027	36,844
1982	(8,756)			(8,756)	1,711	29,799
1983	(9,696)			(9,696)	1,335	21,438
1984	(10,727)			(10,727)	888	11,599
1985	(11,964) (E)			(11,964)	365	0
				<u>\$50,000 (F)</u>	<u>\$17,529 (F)</u>	<u>\$23,527</u>
					<u>\$23,527</u>	

Average period of investment (D) 13.92 Months

Assumptions and Explanations:

(A) Assume that the investment will be recovered out of the earliest tax benefits applied against estimated tax payments on a quarterly basis, commencing with the third quarter of 1970, without consideration for lost earnings during the period of such recovery.

(B) Represents the amount of benefits to be retained by the investor, after return of capital, which are not required for sinking fund for future payment of taxes.

(C) Represents the amount of benefits required to be funded which, with interest compounded quarterly at the indicated rate after tax, will be sufficient to pay the indicated taxes on a quarterly basis.

(D) Represents the period of investment on a weighted average basis.

(E) Does not include residual value, after applicable taxes.

(F) This technique with its assumptions as stated, is only one of several alternative methods of analyzing this investment. This illustration indicates that capital will be fully recovered in about 24 months. Based on financial compound interest and annuity tables, the above after-tax flows may be considered as resulting in a rate of approximately 21.3% during the period of recovery for the original \$50,000 investment and the \$17,529 excess.