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Tax Shelter Registration: An Alternative Proposal That Leads to the Efficient Identification of Abusive Tax Shelters

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TAX SHELTER REGISTRATION: AN ALTERNATIVE PROPOSAL THAT LEADS TO THE EFFICIENT IDENTIFICATION OF ABUSIVE TAX SHELTERS

INTRODUCTION

Congress, by enacting the Deficit Reduction Act of 1984,[1] has provided the Internal Revenue Service (IRS) with the means to identify taxpayers who promote and invest in potentially abusive tax shelters.[2] The 1984 Act introduced provisions which require organizers, sellers and investors to register with the IRS if they are engaging in potentially abusive tax sheltering activity.[3] The IRS, through its

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1. Pub. L. No. 98-369, 98 Stat. 494 (1984) [hereinafter cited as the 1984 Act].

2. For the purposes of this note, tax shelters are defined as investments that are specifically designed to "shelter" 100% of the income to be derived from the investment as well as some of the investor's income from sources other than the investment. A legitimate, tax favored investment, on the other hand, is designed to "shelter" part of the income that the investment itself is projected to generate, but is primarily motivated by profit and is expected to produce not only net taxable income, but also net income tax liability. Hence, an investment can offer favorable tax treatment on the income that it is expected to generate, but it will not be considered a tax shelter unless it "shelters" 100% of its own income as well as income from an investor's other sources. *See infra* note 27 and accompanying text.

The Internal Revenue Code (I.R.C.) defines the term "potentially abusive tax shelter" in § 6112(b):

> POTENTIALLY ABUSIVE TAX SHELTER—For purposes of this section, the term "potentially abusive tax shelter" means—
>
> (1) any tax shelter (as defined in section 6111) with respect to which registration is required under section 6111, and
>
> (2) any entity, investment plan or arrangement, or other plan or arrangement which is of a type which the Secretary determines by regulations as having a potential for tax avoidance or evasion.

I.R.C. § 6112(b) (CCH 1986). For a general statement regarding abusive and nonabusive tax shelters, *see infra* text accompanying note 28.

3. Pub. L. No. 98-369, § 141(a), 98 Stat. 494, 677 (1984) (current version at I.R.C. § 6111 (CCH 1986)) (registration of tax shelters); Pub. L. No. 98-369, § 142(a), 98 Stat. 494, 677 (1984) (current version at I.R.C. § 6112 (CCH 1986)) (organizers and sellers of potentially abusive tax shelters must keep lists of investors). I.R.C. §§ 6111(a), (b), and 6112(a) read as follows:

> SEC. 6111. REGISTRATION OF TAX SHELTERS.
>
> (a) Registration.—
>
> (1) In General.—Any tax shelter organizer shall register the tax shelter with the Secretary (in such form and in such manner as the Secretary may prescribe) not later than the day on which the first offering for sale of interests in such tax shelter occurs.
>
> (2) Information Included in Registration.—Any registration under paragraph (1) shall include—

accompanying temporary regulations,[4] initially required many investments to be registered as tax shelters, including investments that were expected to produce net taxable income and have no sheltering effect on an investor's income from other sources.

The Treasury Department solicited and received public comments to the IRS's originally proposed temporary regulations.[5] Legitimate investors were concerned that registration would increase their chances of being audited, and could be a potential source of harassment by the IRS. Other commentators welcomed these regulations, which made it virtually impossible for the IRS to differentiate between legitimate tax favored investments and potentially abusive tax shelters.[6] The tax shelter industry in general, however, called for a

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(A) information identifying and describing the tax shelter,

(B) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and

(C) such other information as the Secretary may prescribe.

(b) Furnishing of Tax Shelter Identification Number; Inclusion on Return.—

(1) Sellers, Etc.—Any person who sells (or otherwise transfers) an interest in a tax shelter shall (at such times and in such manner as the Secretary shall prescribe) furnish to each investor who purchases (or otherwise acquires) an interest in such tax shelter from such person the identification number assigned by the Secretary to such tax shelter.

(2) Inclusion of Number on Return.—Any person claiming any deduction, credit, or other tax benefit by reason of a tax shelter shall include (in such manner as the Secretary may prescribe) on the return of tax on which such deduction, credit, or other benefit is claimed the identification number assigned by the Secretary to such tax shelter.

SEC. 6112. ORGANIZERS AND SELLERS OR POTENTIALLY ABUSIVE TAX SHELTERS MUST KEEP LISTS OF INVESTORS.

(a) In General.—Any person who—

(1) organizes any potentially abusive tax shelter, or

(2) sells any interest in such a shelter,

shall maintain (in such manner as the Secretary may by regulations prescribe) a list identifying each person who was sold an interest in such shelter and containing such other information as the Secretary may by regulations require.

I.R.C. §§ 6111(a), (b), and 6112(a) (CCH 1986).

4. Procedure and Administration; Tax Shelter Registration: Temporary Regulations [T.D. 7964], 49 Fed. Reg. 32,712 (1984) (codified as amended at 26 C.F.R. § 301.6111-1T (1985) [hereinafter cited as Originally Proposed Temporary Regulations].

5. Tax Shelter Registration; Proposed Rulemaking: Notice of Proposed Rulemaking, Comments and Requests for a Public Hearing [LR-142-84], 49 Fed. Reg. 32,728 (1984) [hereinafter cited as Requests for Public Comments].

6. *See, e.g.*, Walbert, *Oops!*, FORBES, Oct. 8, 1984, at 114 ("What the IRS needed was a registration system that would sift out the potentially abusive shelters. In-

limit on the type of investments that would have to be registered as tax shelters. Soon thereafter, the Treasury Department properly limited the scope of its tax shelter registration drive by excluding from registration investments that were expected to produce net taxable income as well as a net income tax liability.[7]

Suspending the registration requirements for these so called "projected income investments"[8] made sense, since it limited tax shelter registration to investments that were expected to shelter a taxpayer's other sources of income.[9] The current tax shelter registration provisions are still flawed, however, since they do not give the IRS the tools necessary to accurately measure the quantitative effect that the tax shelter is expected to have on a taxpayer's income from other sources. It will be shown that an appropriate solution lies within Congress' power to amend the present statutory scheme.

This note focuses on the tax shelter registration provisions set forth in the internal revenue code and the IRS's accompanying temporary regulations. It begins with a discussion of what a tax shelter essentially is, and then goes on to outline the measures taken by Congress and the IRS to curb both abusive and nonabusive tax shelters over the past seventeen years, the failure of these measures to effectively deter the growth of the tax shelter industry, and the enactment of compliance measures, aimed directly at tax shelter opinion writers, to attack the industry from within. The note then examines the registration provisions passed by Congress, how the IRS initially extended those provisions to get as many taxpayers registered as possible, and what problems the temporary regulations initially raised. The public comment proposal and the Treasury Department's response are then examined and compared; their relative strengths and weaknesses are explored. Finally, an amendment to the present statutory scheme is suggested, one which is designed to accurately measure the sheltering effect that a tax shelter is expected to have on other income, and to make the efficient identification of abusive tax shelters possible.

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stead, the Service will be snowed in with filings from the innocent as well as the questionable.")

7. Net taxable income is the projected amount of investment income that exceeds the allowable tax deductions it provides. Assuming that the taxpayer is in the 50% bracket, if the projected amount of net taxable income exceeds 200% of the allowable income tax credits that the investment has to offer, it is also expected to generate a net income tax liability.

8. *See infra* text accompanying note 177.

9. This is consistent with the definition of a tax shelter contained within the regulations which govern tax shelter opinion writers. *See infra* text accompanying note 27.

TAX SHELTERS

Tax shelters can be described in many different ways, since tax shelter investments can take a variety of forms. As the name implies, a tax shelter is an investment which allows a taxpayer to "shelter" part or all of his income from taxation by the IRS.[10] Most tax shelters generate artificial losses in the early years of the investment which can be deducted from ordinary income, leaving the investor with a lower tax burden than he would normally have.[11] Although there are a great number of different tax shelter investments,[12] they can be classified by certain features which are common to most tax shelters.[13]

Tax shelters are defined in terms of three basic elements: deferral, conversion, and leverage. The first two elements, deferral and

10. By definition, one of the goals of an income tax system is to measure income. If one's income is to be described as a realizable gain in one's net worth, the income tax system must be able to match costs with revenues. The difference between revenues received and the costs incurred to generate that revenue is income. The Internal Revenue Code divides income into three categories: gross income, adjusted gross income, and taxable income. Gross income is generally defined in I.R.C. § 61 as "all income from whatever source derived." Adjusted gross income is defined by § 62 as gross income minus certain deductions allowed for costs generally incurred in conducting a trade or business (referred to as "above-the-line" deductions). Taxable income equals adjusted gross income less the allowable personal deductions which are set out in §§ 63 and 151 (referred to as "below-the-line" deductions). In order to determine how much tax is owed to the federal government, one multiplies his amount of taxable income by the appropriate tax rates imposed by § 1. The amount of the savings generated by a deduction, therefore, is the amount of the deduction multiplied by the tax rate. Tax credits, on the other hand, are more valuable to the taxpayer, since they are credited directly against one's total amount of federal income tax liability. I.R.C. §§ 1, 38, 61, 62, 63, and 151 (1982).

11. As one writer describes it, taxation is "a continuing struggle among contending interests for the privilege of paying the least." L. EISENSTEIN, THE IDEOLOGIES OF TAXATION 3-4 (1961). Another has described a tax shelter as "an investment that succeeds in generating a mismatching of income and deductions: the deductions now; the income, like sermons and soda water, the morning after. Many mornings after." Ginsburg, *The Leaky Tax Shelter*, 53 TAXES 719, 719 (1975).

12. Common examples of tax shelters that are being promoted to the general public include investments in timber, fast food restaurants, real estate (including commercial, residential, and subsidized housing developments), as well as oil and gas exploration. Fraser, *A Diverse New Kind of Tax Shelter Offers Less Risk and Easier Access*, THE CHRISTIAN SCIENCE MONITOR, Sept. 21, 1984, at B-9.

13. For a good general discussion of the elements of a tax sheltered investment, see JOINT COMMITTEE STAFF PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS (February 17, 1984), *reprinted in* J. EUSTICE, THE TAX REFORM ACT OF 1984, A SELECTIVE ANALYSIS A-24 to A-27 (1984). *See also* Calkins, *Tax Sheltering in Perspective*, 51 TAXES 758 (1973); Krane, *Economic Analysis of Tax Sheltered Investments*, 54 TAXES 806 (1976).

conversion, both involve a postponement of current tax liability to some future point in time. If the taxpayer is taxed at the same rate over time, he is said to have deferred his tax burden to a later date. If, however, one's income is taxed more favorably in future years, he has effectively converted ordinary income into tax favored income.[14] The third element, leverage, is the use of a high percentage of borrowed funds in financing an investment. In the discussion that follows, each of these elements will be explored, focusing on how the tax code makes sheltered investments possible, and what rules limit the use of conversion and leverage.

Deferral

Deferral of a tax obligation generally occurs when an investment generates artificial losses in its early years. These losses appear as deductions from ordinary income. If the deductions are economically premature, costs are not matched with revenue, and the measurement of income is distorted downward.[15] Ordinary income, therefore, becomes sheltered, and the taxes owed are greatly reduced. The taxpayer effectively receives an interest-free loan from the government in the form of deferral of his tax obligation.[16] Theoretically, this obligation will automatically be repaid in future years, since there will be smaller deductions allowed later on, resulting in an upward distortion of income and a greater future tax liability.

One source of income distortion in the tax code is the Accelerated Cost Recovery System (A.C.R.S.).[17] Congress enacted A.C.R.S. in 1981 to stimulate investment in capital assets[18] by allowing depreciation

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14. The code defines ordinary income as any gain from the sale or exchange of property which is not capital gains property. I.R.C. § 64 (1982). Income which is generated from a capital investment, on the other hand, receives favorable tax treatment. For a taxpayer in the fifty percent bracket, $100,000 of ordinary income would result in a tax obligation of $50,000. Alternatively, $100,000 of capital gain for the same taxpayer is treated in the following manner: a sixty percent deduction is allowed, leaving $40,000 to be taxed at fifty percent, resulting in $20,000 in taxes owed. I.R.C. § 1202 (1982). Thus, on $100,000 of income, a taxpayer in the fifty percent bracket saves $30,000 in taxes when the income is treated as a capital gain.

15. In other words, if the deductions from gross income are unrealistically high, the measurement of adjusted gross income will be distorted downward. *See supra* note 10.

16. The amount of income that is sheltered is not taxed in that year. When this tax obligation is deferred, it is as if the government has given the taxpayer an interest-free loan in the amount of taxes which otherwise would be paid currently.

17. I.R.C. § 168 (1982).

18. A capital asset is an asset that is expected to either appreciate in value, or produce income over its "useful life." If revenues will be generated over time, it

deductions to be taken earlier than the economically useful life of the asset.[19] The effect of A.C.R.S. is to give taxpayers an interest-free loan when making a capital investment..

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is necessary to spread the costs over time to accurately measure income. *See supra* note 10. This matching of cost and revenue is achieved by capitalizing the asset and depreciating it over time.

For accounting purposes, capitalization of an asset simply means that the cost of the asset is "attached" to the asset itself, and is not immediately expensed (deducted from ordinary income). When the cost is "attached" to the asset, it is no longer referred to as "cost." It is now referred to as "basis." Basis is the means by which one records how much he has invested in an asset. Therefore, any future capital expenditure which is made for the improvement of a capital asset is not immediately deducted from ordinary income, but is added to basis. On the other hand, depreciation deductions allowed for the wear and tear on the capital asset are subtracted from both ordinary income and basis.

19. For example, assume a taxpayer purchases a building used in his trade or business for $100,000. Assuming that the building will help generate income for 10 years, the following straight-line depreciation schedule is produced:

Year	Straight-Line Depreciation Deduction	Adjusted Basis of the Building
1	$10,000	$90,000
2	10,000	80,000
3	10,000	70,000
4	10,000	60,000
5	10,000	50,000
6	10,000	40,000
7	10,000	30,000
8	10,000	20,000
9	10,000	10,000
10	10,000	0

I.R.C. § 167(b)(1) (1982).

Under A.C.R.S., however, deductions are pushed forward in the early years of the investment. If the building can be classified as five year recovery property, the following schedule results:

Year	A.C.R.S. Deprecation Deduction	Adjusted Basis of the Building
1	$15,000	$85,000
2	22,000	63,000
3	21,000	42,000
4	21,000	21,000
5	21,000	0
6	0	0
7	0	0
8	0	0
9	0	0
10	0	

I.R.C. § 168(b)(1) (1982).

Conversion

The second element of a tax shelter is the conversion of ordinary income into tax favored income. Conversion can take place in two basic ways. A common example is when one purchases a capital asset and later sells it at some point during its "useful life" at a capital gain.[20] Deductions taken from basis and ordinary income over time are converted into tax favored capital gains upon disposition of the asset.[21] A second type of conversion occurs when, due to the amount of his investment, the taxpayer finds himself in a lower rate bracket when the investment starts to produce income. This is a straight downward conversion of the tax rate.

Leverage

Leverage is the use of a high percentage of borrowed funds to finance an investment. Leveraged investments give the taxpayer two advantages. First, the taxpayer receives an economic advantage since the money he saves by borrowing may be invested elsewhere. More importantly, the taxpayer is also given a significant tax advantage since the investment's basis and all subsequent depreciation deductions will include not only what the taxpayer has invested, but the amount of borrowed money as well.[22] One way that a taxpayer can leverage his investment is through nonrecourse financing. Nonrecourse financing gives the investor a loan for which he is not personally liable in case of a default upon repayment.[23] Limited partnerships are one of the most common vehicles that taxpayers use when making lever-

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20. The term "useful life" can be misleading. The useful life of an asset, as it is used here, is the time when deductions are still being taken on the asset, i.e., when the adjusted basis of the asset is greater than zero.

21. Income from the sale of a capital asset is measured by subtracting the asset's adjusted basis from its selling price. *See supra* note 10. Depreciation deductions taken during the capital asset's useful life are deducted from the asset's adjusted basis as well as from the taxpayer's ordinary income. That portion of basis which was originally deducted from ordinary income will be recognized as a capital gain upon the liquidation of the asset, and will receive favorable capital gains treatment. *See supra* note 14. Thus, ordinary income which was deducted during the useful life of the asset is effectively "converted" into capital gain upon the sale of the asset.

22. This result was inadvertently achieved in Crane v. Commissioner, 331 U.S. 1 (1946) (mortgage on apartment building included in building's basis and in subsequent depreciation deductions).

23. Nonrecourse financing may be used, for example, when one invests in real estate. If the borrower defaults, the asset may be liquidated to repay the debt or foreclosed if subject to a lien, but the creditor has no other recourse against the investor's personal assets.

aged investments. Comprised of one general partner and any number of limited partners, the limited partnership is set up to give a group of investors who pool their money together an even greater amount of leverage. Unlike a corporation which is considered a separate tax-paying entity,[24] a partnership is treated as a conduit through which gains and losses are passed directly to the partners.[25] Consequently, an investment that generates deductions in excess of income creates a net tax loss which is allocated among, and passed through to, the individual partners who use it to shelter their other sources of income.

Definitions

For the purposes of this note, the term "tax shelter" is defined generally, in accordance with the regulations governing the practice of attorneys before the IRS.[26] The regulations define "tax shelter" in terms of net deductions and credit:

> A "tax shelter" . . . is an investment which has as a significant and intended feature for federal income or excise tax purposes either of the following attributes:
>
> (i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or
>
> (ii) Credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.[27]

Therefore, under this definition, only investments that shelter a taxpayer's income from other sources can be properly called tax shelters. By matching deductions with income generated by the investment and credits with the tax attributable to the income from the investment, this definition accurately measures the sheltering effect that the tax shelter has on an investor's other income.

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24. I.R.C. § 11 (1982).

25. I.R.C. §§ 701 (partners, not partnership, subject to tax), 702(a) (each partner's income includes his distributive share of the partnership's gains and losses) (1982). Note that I.R.C. § 704(d) limits a partner's distributive share of partnership loss to the amount of his adjusted basis in his partnership interest at the end of the partnership year in which the loss occurred. I.R.C. § 704(d) (1982).

26. Regulations governing the practice of attorneys, certified public accountants, enrolled agents, and enrolled actuaries before the Internal Revenue Service, 49 Fed. Reg. 6719 (1984) (codified at 31 C.F.R. pt. 10). These regulations are discussed later in this note. *See infra* text accompanying notes 93-129.

27. 49 Fed. Reg. at 6723 (codified at 31 C.F.R. 10.33(c)(2) (1985).

Tax shelters are further delineated into "abusive" and "nonabusive" tax shelters. In 1982, IRS Commissioner Roscoe L. Egger outlined the distinction as follows:

> Nonabusive tax shelters involve transactions with legitimate economic reality, where the economic benefits outweigh the tax benefits. Such shelters seek to deter or minimize taxes.
>
> Abusive tax shelters involve transactions with little or no economic reality, inflated appraisals, unrealistic allocations, etc., where the claimed tax benefits are disproportionate to the economic benefits. Such shelters typically seek to evade taxes.[28]

The primary distinction between abusive and nonabusive tax shelters is that the promoters and organizers of abusive tax shelters offer investments that seek to evade taxes by claiming false tax benefits that will ultimately be disallowed if challenged by the IRS. Nonabusive tax shelters, on the other hand, offer legitimate tax benefits which allow a taxpayer to legally shelter his income from other sources. The following section briefly outlines the steps taken by Congress and the Treasury Department over the past seventeen years to limit the provisions in the code which made nonabusive tax shelters possible. It also examines the enactment of compliance measures in recent years that are directed at the elimination of abusive tax shelters.

LEGISLATIVE HISTORY

Congress and the IRS have taken measures to curb both abusive and nonabusive tax shelters over the past seventeen years. This section highlights tax legislation, revenue and procedural rulings, and tax court decisions that deal specifically with tax shelter activity. The first part of the discussion focuses on the Tax Reform Act of 1969,[29] the Revenue Act of 1971,[30] the Tax Reform Act of 1976,[31] and the Revenue Act of 1978,[32] and how effective each one was in limiting the use of tax shelters. The second part of the discussion examines the Economic Recovery Tax Act of 1981 (ERTA)[33] and the Tax Equity

28. Egger, *Warning: Abusive Tax Shelters Can be Hazardous*, 68 A.B.A.J. 1674, 1674 (1982). *See also supra* note 2.
29. Pub. L. No. 91-172, 83 Stat. 487 (1969).
30. Pub. L. No. 92-178, 85 Stat. 497 (1971).
31. Pub. L. No. 94-455, 90 Stat. 1520 (1976).
32. Pub. L. No. 95-600, 92 Stat. 2763 (1978).
33. Pub. L. No. 97-34, 95 Stat. 172 (1981).

and Fiscal Responsibility Act of 1982 (TEFRA),[34] focusing on the compliance provisions contained therein, which were aimed directly at the promoters and organizers of abusive tax shelters.

Tax shelters have not always been available to such a wide range of taxpayers as they are today. Until about seventeen years ago, tax shelters were not a major problem for the IRS since they were not widely marketed to the middle-income taxpayer.[35] The tax shelter industry did not really begin to flourish until the early 1970s,[36] consequently, tax favored investments were generally limited to upper-income taxpayers before 1970. As tax shelters became specifically designed and promoted to generate tax losses, the IRS began to challenge the tax shelter industry directly.

The Tax Reform Act of 1969[37] was not primarily directed at tax shelters as they presently exist, but rather focused on preferential rules in the tax code which allowed high income individuals to pay little or no tax.[38] Focusing on certain provisions of the tax code which allowed individuals to escape taxation, the 1969 Act imposed recapture provisions on property used in farm tax shelters,[39] limited

34. Pub. L. No. 97-248, 96 Stat. 324 (1982).

35. According to Richard C. Wassenaar, assistant chief commissioner for criminal investigations at the Internal Revenue Service:

> Now we are having the problem, which is relatively new, that no longer are illegal shelters being made available strictly for the rich . . . [t]hey are also being marketed now for the wage-earner, the guy who's making $30,000 or $40,000 in W-2 wages. Up until recently, we saw very, very few shelters being marketed for those people.

Hershey, *Pursuing Cheaters And Bogus Shelters*, N.Y. Times, Sept. 19, 1984, at A-24, col. 4.

36. Note, *Abusive Tax Shelters: Will the Latest Tools Really Help?*, 57 S. CAL. L. REV. 431, 434 (1984); Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 TAX LAW. 5, 6, 9 (1980).

37. Pub. L. No. 91-172, 83 Stat. 487 (1969) [hereinafter cited as the 1969 Act].

38. In his address to the Congress on April 21, 1969, President Nixon called for limitations on "preferences built into the law . . .[which] permit many thousands of individuals and corporate taxpayers to avoid their fair share of Federal taxation." President Nixon's Message to Congress Regarding Tax Reform, H.R. DOC. NO. 103, 91st Cong., 1st Sess. 2 (April 21, 1969), *quoted in* Sax, *supra* note 36, at 6.

39. Pub. L. No. 91-172, § 211(a), 83 Stat. 487, 566 (1969), repealed by Pub. L. No. 98-369, § 492(a), 98 Stat. 494, 853 (1984). Prior to its repeal, I.R.C. § 1251(c)(1) required that any gain realized on the sale of farm recapture property (as defined in § 1251(e)(1)) be recognized as ordinary income. This provision hindered certain tax shelters that involved the breeding and racing of horses (considered a trade or business of farming in § 1251(e)(4)(A)). § 1251 disallowed the conversion of ordinary income into capital gain which would have occurred if the gain was treated as capital in nature. *See supra* text accompanying notes 20-21.

accelerated real estate depreciation,[40] imposed a minimum "add-on" tax of ten percent (10%) on tax preferences which exceeded one's regular tax liability by $30,000,[41] restricted the losses allowed for activities not engaged in for profit,[42] and limited the amount of excess investment interest deductions allowed.[43] These amendments to the tax code did not have a great deterrent effect on the growth of tax shelter investments, however, and further changes were necessary.[44]

The Revenue Act of 1971[45] brought changes that, in fact, made tax sheltering a bit easier. The 1971 Act reinstated the investment tax credit, imposing limitations on the availability of the credit to individual, noncorporate lessors.[46] Although noncorporate lessors were not allowed a credit unless certain criteria were met, the mere reinstatement of the investment tax credit opened the door to corporate lessors who were already benefiting from leasing operations.[47] This fact, coupled with the enactment of the asset depreciation range (ADR) system,[48] may have stimulated more tax shelters than it limited.

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40. Pub. L. No. 91-172, § 521(a), 83 Stat. 487, 649 (1969) (current version at I.R.C. § 167(j) (1982)).

41. Pub. L. No. 91-172, § 301(a), 83 Stat. 487, 580 (1969) (current version at I.R.C. § 56 (CCH 1986)). When enacted in 1969, the minimum "add-on" tax applied to both individuals and corporations. The current version now applies to corporations only, and imposes a tax of fifteen percent on tax preferences which exceed the corporation's regular tax liability by $10,000. I.R.C. § 56 (CCH 1986).

42. Pub. L. No. 91-172, § 213(a), 83 Stat. 487, 571 (1969) (current version at I.R.C. § 183 (CCH 1986)). Known as the "hobby loss" provision, § 183 limits the amount of allowable deduction in activities not engaged in for profit to the amount of gross income derived from the "hobby" activity. I.R.C. § 183 (CCH 1986).

43. Pub. L. No. 91-172, § 221(a), 83 Stat. 487, 574 (1969) (current version at I.R.C. § 163(d) (CCH 1986)).

44. A number of authors have discussed the shortcomings of the 1969 Act, which included the lack of cogent provisions with regard to equipment leasing, leveraged oil and gas drilling funds, and certain real estate opportunities. One commentator, in fact, stated that the 1969 Act may have fostered tax shelters as much as it limited them. *See* Sax, *supra* note 36, at 6, 7. *See also* Geller, *Depreciation on Real Estate and Its Recapture: Resolving Problems Raised by the 1969 Act*, 29 N.Y.U. INST. 1033 (1971); Goldstein, *Equipment Leasing After the 1969 Act*, 29 N.Y.U. INST. 1589 (1971); Morris, *New Developments in Packaging the Real Estate Venture for the Private Investor*, 20 TUL. TAX INST. 147 (1971).

45. Pub. L. No. 92-178, 85 Stat. 497 (1971) [hereinafter cited as the 1971 Act].

46. Pub. L. No. 92-178, § 108(a), 85 Stat. 497, 507 (1971) (current version at I.R.C. § 46(e)(3) (CCH 1986)).

47. Sax, *supra* note 36, at 7, 8.

48. Pub. L. No. 92-178, § 109(a), 85 Stat. 497, 508 (1971) (current version at I.R.C. § 167(m) (1982)). The ADR system allowed the class lives of certain depreciable property to be shortened by up to twenty percent, thereby allowing depreciation deduction to be accelerated. Congress terminated § 167(m) in 1981, rendering it inapplicable

Between 1971 and 1976, congressional action on tax shelters was virtually nonexistent, but the IRS began to challenge the classification of certain syndicated limited partnerships. The leading case at the time was *Larson v. Commissioner*,[49] which initially held that syndicated limited partnerships were to be taxed as corporate associations. The original opinion by Judge Quealy was withdrawn within three weeks of filing, and was replaced with an opinion by Judge Tannenwald which invited the Service to revise its characterizations of business associations in order to make the law clearer.[50] Judge Quealy's unpublished opinion, along with revenue procedures and rulings dealing with limited partnership classifications,[51] and aimed directly at common tax shelter devices,[52] produced some *in terrorem* effects in the newly developing tax shelter industry.[53] These effects were not sufficient to discourage the public sale of tax sheltered investments,[54] however, and in 1976, it was Congress' turn to respond.

The Tax Reform Act of 1976[55] attacked tax shelters by limiting the advantages of leveraging and restricting losses through partner-

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to § 168 recovery property placed in service after December 31, 1980. ERTA, Pub. L. No. 97-34, § 203(b), 95 Stat. 172, 221 (1981) (current version at I.R.C. § 167(m) (4) (1982)).

49. 66 T.C. 159 (1976), acq., 1979-1 C.B. 448. For further discussion on the impact of the *Larson* case or the tax treatment of limited partnerships, see Fisher, *Classification Under § 7701: The Past, Present and Prospects for the Future*, 30 TAX LAW. 627 (1977); Reid, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U.L. REV. 408 (1977).

50. Judge Tannenwald's decision applied the Service's regulations as they stood, but called for a new characterization of business associations that would "impart a degree of certainty to a subject otherwise fraught with imponderables." *Larson*, 66 T.C. at 172. New partnership regulations were proposed on January 5, 1977, but were immediately withdrawn, since the broad scope of the provisions would have eliminated as many legitimate partnerships as tax shelters. Sax, *supra* note 36, at 8.

51. Rev. Proc. 72-13, 1972-1 C.B. 735 (requiring that sole corporate general partners meet artificial net worth tests despite regulations section 1.7701-2(d)(2) that net worth is irrelevant if general partner is not a mere dummy acting as agent of limited partners); Rev. Proc. 74-17, 1974-1 C.B. 438 (requiring that general partners have one percent interest in each partnership item, that aggregate tax loss for first two years does not exceed investment, and that nonrecourse lenders can have no interest in the partnership).

52. Rev. Rul. 71-252, 1971-1 C.B. 146 (regarding the deduction for prepaid drilling expenses); Rev. Rul. 72-135, 1972-1 C.B. 200 and Rev. Rul. 72-350, 1972-2 C.B. 394 (attacking leveraging by nonrecourse loans from interested parties); Rev. Rul. 75-214, 1975-1 C.B. 185 (attacking "upfront" deductions for payments to the general partner); Rev. Proc. 75-21, 1975-1 C.B. 715 (requiring detailed information for true lease treatment of equipment leases).

53. Sax, *supra* note 36, at 8.

54. Note, *supra* note 36, at 436; Sax, *supra* note 36, at 9.

55. Pub. L. No. 94-455, 90 Stat. 1520 (1976) [hereinafter cited as the 1976 Act].

ships. Congress enacted "at risk" provisions which limited the amount of allowable deductible losses to the amount of money the taxpayer had "at risk" in an investment.[56] The "at risk" rules applied to any taxpayer engaged in the holding, production, or distribution of motion picture films or video tapes, farming, equipment leasing, or oil and gas exploration in a trade or business or for the production of income.[57] A similar "at risk" provision was made for partnerships, limiting the amount of deductible loss to the taxpayer's adjusted basis in his partnership interest.[58] In addition to the "at risk" rules, partnerships were legislated further by certain other provisions. The "substantial economic effect" test was codified,[59] and no immediate deductions were allowed for the promotional and organizational costs of setting up a partnership.[60] Other provisions of the 1976 Act included a ban on prepaid interest deductions for cash basis taxpayers[61] and the requirement that construction period interest and taxes be capitalized and amortized rather than expensed immediately.[62] These rules severely limited the advantages which were once available through leveraging, and restricted the losses which could be passed through partnerships.

In the Revenue Act of 1978,[63] Congress expanded the "at risk" rules to cover all activities other than real estate,[64] and required losses

56. Pub. L. No. 94-455, § 204(a), 90 Stat. 1520, 1531 (1976) (current version at I.R.C. § 465 (CCH 1986)). § 465(b) defines the amount "at risk" as the amount of money and the adjusted basis of other property invested plus any amount borrowed that taxpayer is personally responsible for repaying. These "at risk" rules severely limit the tax advantages which were previously available through leveraging. *See supra* text accompanying notes 22-25.

57. Pub. L. No. 94-455, § 204(a), 90 Stat. 1520, 1531 (1976) (current version at I.R.C. § 465(c)(1) (1982)).

58. Pub. L. No. 94-455, § 213(e), 90 Stat. 1520, 1548 (1976) (current version at I.R.C. § 704(d) (1982)).

59. Pub. L. No. 94-455, § 213(d), 90 Stat. 1520, 1548 (1976) (current version at I.R.C. § 704(b)(2) (1982)). The "substantial economic effect" test looks at whether an allocation to a partner will actually affect the dollar amount of the partner's share of total partnership income or loss *independently of the tax consequences*. Under § 704(b)(2), if an allocation to a partner does not have "substantial economic effect," then the allocation will be disallowed. *See* Orrisch v. Commissioner, 55 T.C. 395 (1970).

60. Pub. L. No. 94-455, § 213(b), 90 Stat. 1520, 1547 (1976) (current version at I.R.C. § 709(a) (1982)).

61. Pub. L. No. 94-455, § 208(a), 90 Stat. 1520, 1541 (1976) (current version at I.R.C. § 461(g) (1982)).

62. Pub. L. No. 94-455, § 201(a), 90 Stat. 1520, 1525 (1976) (current version at I.R.C. § 189 (CCH 1986)).

63. Pub. L. No. 95-600, 92 Stat. 2763 (1978) [hereinafter cited as the 1978 Act].

64. Pub. L. No. 95-600, § 201(a), 92 Stat. 2763, 2814 (1978) (current version at I.R.C. § 465(c)(3) (1982)).

to be recaptured if the "at risk" amount fell below zero.[65] Compliance rules for partnerships were also enacted, imposing penalties on those who failed to file partnership information returns on time.[66] Similar to the 1969 Act, which was ineffective in dealing with tax shelters in general, at least one writer believes that the 1976 and 1978 Acts led to the proliferation of abusive tax shelters.[67] The statutory changes severely curtailed the sheltering effect of leverage, but did not deter a rapidly expanding tax shelter industry.[68] The Service initiated its own crusade against tax shelters in 1977 and 1978 by instituting a vigorous auditing program that targeted partnerships as a primary form of tax sheltering activity,[69] and by issuing a large number of revenue rulings directed at specific tax shelter investments.[70]

Congressional changes in the code, IRS revenue rulings and procedures, and tax court decisions were, unfortunately, limited because of their specificity. As long as tax incentives were provided to stimulate investment, the taxpayer who wanted to shelter his income was able to find provisions in the code which allowed him to do so.[71] Realizing this, Congress and the Treasury Department modified their attack by concentrating on abusive tax shelters, and promulgated rules which focused on taxpayer compliance with the law.

The Economic Recovery Tax Act of 1981 (ERTA),[72] was designed

65. Pub. L. No. 95-600, § 203, 92 Stat. 2763, 2816 (1978) (current version at I.R.C. § 465(e) (1982)).

66. Pub. L. No. 95-600, § 211(a), 92 Stat. 2763, 2817 (1978) (current version at I.R.C. § 6698 (1982)).

67. Sax, *supra* note 36, at 10.

68. Note, *supra* note 36, at 437; Sax, *supra* note 36, at 10-11; *see also* Shefsky, *Take the Helter out of Shelter*, 58 TAXES 299 (1980).

69. Note, *supra* note 36, at 450-51; Sax, *supra* note 36, at 11; *see also* Kurtz, *Commissioner's Remarks on Abusive Tax Shelter Issues*, 55 TAXES 774, 775 (1977).

70. The eight so-called Halloween rulings of 1977 addressed questions that arose out of the 1976 Act, largely dealing with the § 465 "at-risk" requirements, and the § 704(d) "at-risk" rules for partnerships. The eight rulings are: Rev. Rul. 77-403, 1977-2 C.B. 302; Rev. Rul. 77-402, 1977-2 C.B. 222; Rev. Rul. 77-401, 1977-2 C.B. 215; Rev. Rul. 77-400, 1977-2 C.B. 206; Rev. Rul. 77-399, 1977-2 C.B. 200; Rev. Rul. 77-398, 1977-2 C.B. 179; Rev. Rul. 77-397, 1977-2 C.B. 178; Rev. Rul. 77-395, 1977-2 C.B. 80. In response to the Halloween rulings, one commentator observed that "[t]here can be no doubt that the Rulings are intended to have a chilling effect on the investor since they supplement the Service's other public announcements in regard to a tax shelter audit program including the introduction of a new expanded partnership return form. . . ." Olinger, *The New Tax Shelter Rulings: What Devices They Would Eliminate; Questions They Raise*, 48 J. TAX'N 8, 12 (1978). *See also* Schelenger, *Comments on the Proposed Regulations on Tax Shelter Opinions*, 59 TAXES 173, 175 (1981).

71. Shefsky, *supra* note 68, at 300 (the use of tax incentives is so much ingrained in our tax system, its elimination would be impracticable and undesirable).

72. Pub. L. No. 97-34, 95 Stat. 172 (1981) [hereinafter cited as ERTA].

to stimulate the economy through a reduction of the tax rates.[73] In order to lessen the demand for tax sheltering activity, Congress lowered the maximum ordinary income tax rate from seventy percent (70%) to fifty percent (50%),[74] the apparent logic being that if one was taxed at a lower rate, he would have less incentive to shelter his income. Other provisions, some writers believe, may have actually enhanced some tax sheltering arrangements.[75] For example, ERTA made two changes in the investment tax credit. First, the allowable percentages were extended to properties with a shorter useful life.[76] While this change may have enhanced the investment tax credit to a certain extent, an "at risk" rule was enacted, limiting the allowable credit to be based on the amount of money the taxpayer actually had "at risk" in the investment.[77] The compliance provisions of ERTA included a penalty for the overevaluation of property which resulted in a tax underpayment,[78] as well as an addition to the existing negligence and fraud penalties.[79] Further compliance measures came in the following year.

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73. The preamble to ERTA states that is was "[a]n Act . . . [designed] to encourage economic growth through reduction of the tax rates. . . . " ERTA, Pub. L. No. 97-34, 95 Stat. 172 at 172 (1981).

74. Pub. L. No. 97-34, § 101(a), 95 Stat. 172, 176 (1981) (current version at I.R.C. § 1 (CCH 1986)).

75. Note, *supra* note 36, at 446. These rules included the enactment of the Accelerated Cost Recovery System (A.C.R.S.) (Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203 (1981) (current version at I.R.C. § 168 (CCH 1986)). *See also supra* notes 17-19 and accompanying text. The rules also included fewer restrictions on leasing transactions (Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203 (1981), current version at I.R.C. § 168(f)(8) (CCH 1986)); and an extension of the capitalization rules covering construction-period interest and taxes to include all corporations (Pub. L. No. 97-34, § 262(b), 95 Stat. 172, 264 (1981), current version at I.R.C. § 189 (CCH 1986)); and a tax credit allowed for research and development costs (Pub. L. No. 97-34, § 221(a), 95 Stat. 172, 241 (1981), current version at I.R.C. § 30 (CCH 1986)).

76. Pub. L. No. 97-34, § 211(a)(1), 95 Stat. 172, 227 (1981) (current version at I.R.C. § 46(c)(7) (CCH 1986)). § 46(c)(7) allowed a 10% investment credit for five year recovery property and a 6% credit for three year recovery property, whereas the prior law allowed a 10% credit only for property with a useful life of seven years or more, a 6.67% credit for five to six year property, and a 3.33% credit for property with a useful life of three to four years. *See* Note, *supra* note 36, at 446 n.97.

77. Pub. L. No. 97-34, § 211(f)(1), 95 Stat. 172, 229 (1981) (current version at I.R.C. § 46(c)(8) (CCH 1986)).

78. Pub. L. No. 97-34, § 722(a)(1), 95 Stat. 172, 341 (1981) (current version at I.R.C. § 6659 (CCH 1986)). For underpayments of at least $1,000 which are attributable to valuation overstatements of 150% or more, the amount of the penalty is based on an applicable percentage of the underpayment. I.R.C. § 6659 (CCH 1986).

79. Pub. L. No. 97-34, § 722(b)(1), 95 Stat. 172, 342 (1981) (current version at I.R.C. § 6653(a)(2) (CCH 1986)) (penalty for unpaid taxes attributable to negligence or fraud equal to 50% of the interest charged on taxes owed under § 6601(a)).

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[80] had as one of its main goals taxpayer compliance with the law.[81] In furtherance of that goal, Congress enacted certain provisions regarding the promotion of abusive tax shelters. If one was classified as a promoter of an abusive tax shelter, the Service had two remedial options available. First, a penalty of one thousand dollars ($1000) or ten percent (10%) of the promoter's gross income derived from the activity could be imposed, whichever was greater.[82] Second, the organizer could be enjoined from further promotion of the tax sheltering scheme.[83] TEFRA also added penalties for the substantial understatement of income tax liability,[84] as well as for the aiding and abetting of any such understatement.[85] Other rules were enacted,[86] but these compliance measures set the stage for a broad attack on the tax shelter industry.

The focus of Congress' fight against tax shelters has shifted over the past seventeen years. When tax shelters became a problem in the early 1970's, Congress tried to reduce the incentives that taxpayers had to shelter their income. Statutory changes in the code which attempted to reduce the sheltering effects of deferral, conversion, and leverage,[87] were usually offset by tax laws which were intended to encourage investment and stimulate the economy.[88] As a

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80. Pub. L. No. 97-248, 96 Stat. 324 (1982) [hereinafter cited as TEFRA].

81. Note, *supra* note 36, at 447 n.101, citing a statement of Rep. Dan Rostenkowski, Chairman, House Comm. on Ways and Means, *reprinted in* 2 1982 U.S. CODE CONG. AND AD. NEWS 1486, 1489-90 (30% of revenue from the bill comes from changes designed to promote compliance with the tax laws).

82. Pub. L. No. 97-248, § 320(a), 96 Stat. 324, 611 (1982) (current version at I.R.C. § 6700 (CCH 1986)) (penalty amended to 20%).

83. Pub. L. No. 97-248, § 321(a), 96 Stat. 324, 612 (1982) (current version at I.R.C. § 7408 (CCH 1986)).

84. Pub. L. No. 97-248, § 323(a), 96 Stat. 324, 613 (1982) (current version at I.R.C. § 6661 (CCH 1986)).

85. Pub. L. No. 97-248, § 324, 96 Stat. 324, 615 (1982) (current version at I.R.C. § 6701 (1982)).

86. Pub. L. No. 97-248, § 344(a), 96 Stat. 324, 635 (1982) (current version at I.R.C. § 6621(b) (1982)) (interest rate readjusted every six months to match the prime rate); Pub. L. No. 97-248, § 344(a), 96 Stat. 324, 635 (1982) (current version at I.R.C. § 6622 (1982)) (interest rate compounded daily); Pub. L. No. 97-248, § 201(a), 96 Stat. 324, 411 (1982) (current version at I.R.C. § 55 (CCH 1986)) (alternative minimum tax replaced the "add-on" minimum tax for individuals); Pub. L. No. 97-248, § 201(d)(1), 96 Stat. 324, 419 (1982) (current version at I.R.C. § 56 (CCH 1986)) (retaining the corporate "add-on" tax).

87. *See supra* text accompanying notes 14-25.

88. For example, see the discussion of A.C.R.S., *supra* notes 17-19 and accompanying text. *See also* the discussion of ERTA, *supra* text accompanying notes 72-79.

result, Congress enacted compliance measures directed at partnerships in 1978[89] and at the promoters and organizers of potentially abusive tax shelters in 1982.[90] The most recent measures taken by Congress and the Treasury Department attempt to regulate the tax shelter industry from within. These measures include the Treasury Department rules which govern tax shelter opinion writers,[91] and the provisions in the Deficit Reduction Act of 1984[92] that require tax shelter registration.

TAX SHELTER COMPLIANCE PROVISIONS OF 1984

Tax Shelter Opinions

One of the compliance provisions directed at the legal community is the regulation of attorneys who write tax shelter opinions. A tax shelter opinion is a lawyer or accountant's written advice that concerns the legality of the net deductions and credits which are offered by the promoter of a tax shelter investment.[93] Tax shelter opinions are offered to potential investors as part of the promotion, hence, an attorney's ethical obligations extend beyond those normally owed to third parties because he knows that his opinion will be relied upon by others.[94] The tax shelter opinion, therefore, often plays a major role in the offering and sale of tax sheltering ventures. Consequently, the Treasury Department has taken measures to insure that attorneys are not contributing to the proliferation of abusive tax shelters.

These measures came in the form of amendments to the rules

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89. *See supra* note 69 and accompanying text.

90. *See supra* text accompanying notes 80-86.

91. The 1984 Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 49 Fed. Reg. 6719 (codified at 31 C.F.R. pt. 10).

92. Pub. L. No. 98-369, 98 Stat. 494 (1984).

93. A "tax shelter opinion,". . . is advice by a practitioner concerning the Federal Tax aspects of a tax shelter either appearing or referred to in the offering materials or used or referred to in connection with sales promotion efforts, and directed to persons other than the client who engaged the practitioner to give the advice . . . .

Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries before the Internal Revenue Service, 49 Fed. Reg. 6719 (1984) (codified at 31 C.F.R. pt. 10) [hereinafter cited as The Final Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230)].

94. *Id.* at 6719; The ABA Comm. on Ethics and Professional Responsibility Formal Opinion 346 (revised), *reprinted in* 68 A.B.A.J. 471, 472 (1982) (The legal duty of a lawyer who knows that his opinion will be relied upon by third persons "goes beyond the obligations a lawyer normally has to third persons.").

which govern attorney practice before the IRS. The first indication that ethical requirements were needed came in 1980, when the Treasury Department called for the development and enforcement of ethical guidelines specifically aimed at tax shelter opinion writers.[95] The Treasury Department then proposed rules which governed the tax shelter opinions written by attorneys and accountants who were entitled to practice before the IRS.[96] The American Bar Association (ABA) responded in 1981,[97] and once again in 1982,[98] enumerating its own ethical standards to be followed by members of the bar. A modified proposal then came from the Treasury Department in December of 1982,[99] which adopted some of the guidelines set forth by the ABA. After receiving public comments on the modified proposal, a final ruling was issued in 1984,[100] which defined the legal and

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95. On January 18, 1980, Robert H. Mundheim, General Counsel of the Treasury Department, gave a speech before the Securities Regulation Institute in San Diego, California, stating that the privileged position of the tax attorney who gives tax shelter opinions "creates professional responsibilities which we feel are not sufficiently appreciated in the tax shelter area." *Reprinted in* HOW TO PREPARE AND DEFEND TAX SHELTER OPINIONS 71, 74 (M. Caplin and A. Sommer eds. 1981). *See also* Note, *supra* note 36, at 439.

Former 31 U.S.C. § 1026 (1976) stated:

> The Secretary of the Treasury may prescribe rules and regulations governing the recognition of agents, attorneys, or other persons representing claimants before his department, and may require of such persons, agents, and attorneys, before being recognized as representatives of claimants, that they shall show that they are of good character and in good repute, possessed of the necessary qualifications to enable them to render such claimants valuable service, and otherwise competent to advise and assist such claimants the presentation of their cases. And such Secretary *may after due notice and opportunity for hearing suspend, and disbar from further practice before his department any such person, agent, or attorney shown to be incompetent, disreputable, or who refuses to comply with the said rules and regulations,* or who shall with intent to defraud, in any manner willfully and knowingly deceive, mislead, or threaten any claimant or prospective claimant, by word, circular, letter, or by advertisement.

Act of July 7, 1884, ch. 334 § 3, 23 Stat. 258, *revised by* Pub. L. No. 97-258, 96 Stat. 884 (1982) (emphasis added) (current version at 31 U.S.C. § 330 (1982)). *See infra* note 121.

96. The 1980 Proposed Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular No. 230), 45 Fed. Reg. 58,594.

97. The ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 346, *reprinted in* 67 A.B.A.J. 1057 (1981) (withdrawn in 1982).

98. The ABA Comm. on Ethics and Professional Responsibility, Formal Opinion 346 (revised), *reprinted in* 68 A.B.A.J. 471 (1982) (superceding the 1981 opinion, *supra*).

99. The 1982 Proposed Amendments to 31 C.F.R. pt. 10 (Treasury Department Circular 230) 47 Fed. Reg. 56,144.

100. The Final Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 49 Fed. Reg. 6719 (1984).

ethical framework that attorneys had to work within when drafting tax shelter opinion letters.

The Service was mainly concerned about opinions that were either inadequate or misleading.[101] The Treasury Department set up guidelines in the form of proposed amendments to the regulations governing practice before the IRS.[102] These regulations set forth three basic proposals for public comment.[103] Ethical standards were enumerated, requiring IRS practitioners to exercise due diligence in representing the facts and federal tax aspects of the transaction,[104] and to assure that the opinion was accurately and clearly described in the offering materials.[105] Most importantly, however, was the proposal that opinions could be offered only if they concluded that it was more likely than not that the bulk of the tax benefits promoted were allowable under the law.[106] This was to insure that negative opinions would not be used in the promotion or sale of tax shelters.[107] Indeed, if the opinion writer felt that the projected tax benefits of a transaction would not be allowed by the IRS, the Treasury Department wanted the attorney to discourage the investment altogether and not tacitly approve of it by rendering even a negative opinion.[108]

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101. Specifically, four opinions that were especially problematic were identified:

> (1) The opinion that is intentionally false, incompetent, or knowingly or recklessly misstates the law or the facts;
>
> (2) the opinion that purports to rely upon factual representations of the promoter even where certain critical facts are questionable in light of other facts and circumstances of the transaction;
>
> (3) the opinion that never actually comes to a conclusion on the tax aspects raised by the particular offering to which it is attached. Variants on this include the opinion based on hypothetical facts and the opinion addressing some but not all key tax aspects;
>
> (4) the opinion which states that there is a "reasonable basis" for a taxpayer's claiming the tax benefits on the basis of which the shelter is promoted, but indicating, explicitly or implicitly, that if challenged, the taxpayer probably would ultimately lose.

The 1980 Proposed Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 45 Fed. Reg. 58,594 at 58,595 (1980). For a good discussion on these four types of opinions, see Sax, *supra* note 36, at 15, 30-39.

102. The 1980 Proposed Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 45 Fed. Reg. 58,594.

103. Request for Public Comments, 45 Fed. Reg. 75,835 (1980).

104. 45 Fed. Reg. 58,594, 58,594 (1980).

105. *Id.*

106. *Id.* at 58,594-95.

107. *Id.* at 58,597 (The Treasury Department is concerned about possible defrauding of the Government, and believes that "reasonable basis" opinions should never be allowed in the promotion of a tax shelter if the opinion writer believes it would ultimately be disallowed by the IRS).

108. The Treasury Department's position seemed to be that even negative opin-

The proposed amendments drew both positive and negative responses from the legal community. Some commentators challenged the amendments as being too broad,[109] while others questioned the Treasury Department's authority to issue the proposed regulations at all.[110] The ABA responded by issuing Formal Opinion 346,[111] which enumerated its own ethical standards to be followed by attorneys who rendered tax shelter opinions.[112] The ABA recognized that since a lawyer knows his tax shelter opinion will be relied on by potential investors, his legal duty in properly drafting that opinion goes beyond the normal obligations owed to third persons.[113] Since a tax shelter opinion is offered to third parties, the ABA saw the role of the attorney as more of an advisor than an advocate,[114] and therefore rejected the view of the Treasury Department that negative opinions should never be allowed.[115]

In 1982, the Treasury Department issued a second set of proposals,[116] slightly modified to conform with the ethical standards developed by the ABA. Although the Treasury Department viewed negative opinions as contrary to the basic tenets of a self-assessment tax system, the ban on negative opinions had been lifted.[117] The reason for the change was the department felt that the increased penalty provisions for substantial understatements of tax liability enacted by TEFRA[118] would provide an adequate deterrent against the use of

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ions were tacit approval of a tax shelter, the problem being that the mere existence of an opinion could be misused by the tax shelter promoter, especially if it was difficult to tell whether the opinion was, in fact, negative. "A promoter who would use a negative opinion as part of the offering materials is expecting investors either not to read the opinion, not to understand the opinion, or to view it as insurance against the imposition of penalties if the claimed tax benefits are ultimately disallowed." *Id.*

109. In addition to the public comments received in response to the Treasury Department's proposed amendments of 1980, see Sax, *supra* note 36, at 5-6, 39-46.

110. *See, e.g.*, Schelenger, *supra* note 70, at 177-81.

111. The ABA Comm. on Ethics and Professional Responsibility Formal Opinion 346 (revised), *reprinted in* 68 A.B.A.J. 471 (1982) [hereinafter referred to as Formal Opinion 346].

112. The rules set forth in the ABA's Formal Opinion 346 are comparable to similar rules promulgated by the American Institute of Certified Public Accountants (AICPA). AICPA Code of Professional Ethics, Section 201.01E. *See* 47 Fed. Reg. at 56,145, 56,148 (1982).

113. Formal Opinion 346, *reprinted in* 68 A.B.A.J. at 472.

114. *Id.*

115. *Id.* at 473.

116. The 1982 Proposed Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 47 Fed. Reg. 56,144.

117. *Id.* at 56,146.

118. Pub. L. No. 97-248, 96 Stat. 324 (1982).

negative opinions in tax shelter offerings.[119] Other important modifications included adoption of the ABA's definition of "tax shelter" and "tax shelter opinion" with certain clarifications.[120] Despite public comments which insisted that the Treasury was exceeding its statutory authority in proposing these rules, they were passed in the following year pursuant to the authority vested in 31 U.S.C. § 330(b).[121]

The Treasury Department passed the final amendments to the rules governing practice before the IRS in 1984.[122] A number of key elements that must be considered by practitioners that render tax shelter opinions were delineated. These rules required tax shelter opinion writers to exercise due diligence as to factual matters,[123] offer an opinion on each material tax issue,[124] give an overall evaluation of the tax benefits offered,[125] and make sure that an accurate description of

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119. 47 Fed. Reg. at 56,146 (1982).

120. *Id.* at 56,150. In 1982, the Treasury Department's definition of the terms "tax shelter" and "tax shelter opinion" were greatly influenced by the ABA's definitions. These definitions remained virtually unchanged when the final definitions were adopted in 1984. *See supra* note 93. *See also infra* note 27 and accompanying text.

121. 31 U.S.C. § 330(b), relating to suspension or disbarment from practice before the Treasury, provides:

> (b) After notice and opportunity for a proceeding, the Secretary [of the Treasury] may suspend or disbar from practice before the Department [of the Treasury] a representative who—
> (1) is incompetent;
> (2) is disreputable;
> (3) violates regulations prescribed under this section; or
> (4) with intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.

31 U.S.C. § 330(b) (1982). *See* 49 Fed. Reg. at 6720 n.1 (1984).

122. The Final Amendments to 31 C.F.R. pt. 10 (Treasury Dept. Circular 230), 49 Fed. Reg. 6719 (1984) (codified at 31 C.F.R. pt. 10).

123. A practitioner generally does not need to conduct an independent verification of the facts when he knows, or should know, that the facts provided to him are untrue. Furthermore, a practitioner need not inquire as to an asserted valuation of property, an appraisal, or a projection only if they make sense on their face, and in the case of an appraisal or projection, only if the practitioner reasonably believes that the person providing the appraisal or projection is competent to do so. 49 Fed. Reg. at 6720, 6722 (1984) (codified at 31 C.F.R. § 10.33(a)(1)).

124. The practitioner must always relate the law to the actual facts, and when addressing future projections must clearly identify what facts are assumed. Opinions are only necessary with respect to material issues that involve a reasonable possibility of a challenge by the IRS. The practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each such material issue. 49 Fed. Reg. at 6720, 6722 (1984) (codified at 31 U.S.C. § 10.33(a)(2)-(4)).

125. Only when is possible to do so, an overall evaluation must be made. If substantially more than half of the material tax benefits more likely than not will

the opinion appears in the offering materials.[126] These regulations, coupled with the penalty provisions enacted by TEFRA[127] and increased by the Deficit Reduction Act of 1984[128] have had a substantial impact on attorneys who are asked to write tax shelter opinion letters.[129]

The Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984[130] contained a number of compliance provisions that were directly aimed at the tax shelter industry.[131] The penalty on promoters of abusive tax shelters originally enacted in TEFRA[132] was raised from ten to twenty percent (20%) of the gross income that the promoter derived from the investment or one thousand dollars ($1000), whichever was greater.[133] The power to enjoin promoters of abusive tax shelters from further activity was extended to aiders and abettors in the preparation of false tax returns.[134] In

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be realized, a favorable overall evaluation must be made. If it is not possible to give a favorable overall evaluation because of the practitioner's inability to render an opinion, or because the benefits in the aggregate more likely than not will not be realized, then "the fact that the practitioner's opinion does not constitute a favorable overall evaluation, or that it is an unfavorable overall evaluation, must be clearly and prominently disclosed in the offering materials." 49 Fed. Reg. at 6720, 6722 (1984) (codified at 31 U.S.C. § 10.33(a)(5)).

126. It is the practitioner's responsibility to assure that the nature and extent of the tax shelter opinion is correctly and fairly represented in the offering materials. 49 Fed. Reg. at 6723 (1984) (codified at 31 U.S.C. § 10.33(a)(6)).

127. Pub. L. No. 97-248, 96 Stat. 324 (1982). *See also supra* text accompanying notes 80-86.

128. Pub. L. No. 98-369, 98 Stat. 494 (1984).

129. The regulations regarding tax shelter opinion writers, coupled with the penalty provisions enacted by TEFRA and increased by the Tax Reform Act of 1984 have had a substantial impact on attorneys who are asked to write tax shelter opinion letters. For a further discussion on this matter, see Pike, *Shelters: A Legal Minefield*, Nat'l L.J., Mar. 19, 1984, at 1, col. 4.

130. Pub. L. No. 98-369, 98 Stat. 494 (1984).

131. For a general discussion of the compliance measures enacted by the 1984 Act, see J. EUSTICE, THE TAX REFORM ACT OF 1984, A SELECTIVE ANALYSIS 5-28 to 5-36 (1984).

132. Pub. L. No. 97-248, 96 Stat. 324 (1982). *See supra* text accompanying note 82.

133. Pub. L. No. 98-369, § 143(a), 98 Stat. 494, 682 (1984) (current version at I.R.C. § 6700 (CCH 1986)). Congress felt that the 10% penalty was inadequate, since promoters operate on such high margins. S. REP. NO. 98-169 at 434; H.R. REP. NO. 98-434, pt. 2 at 1357. The minimum $1000 penalty was retained, however, to deter small promoters who derive very little income from such activity. H.R. REP. NO. 98-432, pt. 2, at 1357-58.

134. Pub. L. No. 98-369, § 143(b)(1)-(3), 98 Stat. 494, 682 (1984) (current version at I.R.C. § 7408(a), (b) (CCH 1986)).

order to alleviate the backlog of the Tax Court,[135] Congress increased the interest rate for underpayments of tax attributable to certain tax-motivated transactions to one hundred twenty percent (120%) of the prior statutory amount.[136] The 1984 Act also provided that the Treasury Department submit a study on tax shelters, analyzing their overall effect on the Federal income tax system.[137] The most significant compliance measures taken by Congress included the registration of tax shelters by the organizer,[138] and the requirement that organizers and sellers of potentially abusive tax shelters maintain lists of their investors.[139]

THE REGISTRATION OF TAX SHELTERS

Introduction

Congress enacted tax shelter registration requirements in order to give the IRS a mechanism by which it could identify potentially abusive tax shelters before they were used. The problem in the past was that the Treasury Department and Congress had to wait until after the damaging effect of tax shelters had already been felt. Now, instead of taking care of the problem after the fact, the compliance measures, in general, and the registration requirements, in particular, would be utilized to prevent tax shelter abuse before it occurred.

The originally proposed temporary regulations which accompanied the code's registration provisions were made intentionally broad in order to require as many taxpayers to register as possible. The

135. *See* H.R. REP. NO. 98-861, at 985 for a discussion on the attempts made to lighten the Tax Court's caseload.

136. Pub. L. No. 98-369, § 144(a), 98 Stat. 494, 682 (1984) (current version at I.R.C. § 6621(d) (CCH 1986)).

137. Pub. L. No. 98-369, § 1081, 98 Stat. 494, 1056 (1984).

138. Pub. L. No. 98-369, § 141(a), 98 Stat. 494, 677 (1984) (current version at I.R.C. § 6111 (CCH 1986)) (registration of tax shelters); Pub. L. No. 98-369, § 141(b), 98 Stat. 494, 680 (1984) (current version at I.R.C. § 6707 (CCH 1986)) (penalty for failure to furnish information regarding tax shelters).

139. Pub. L. No. 98-369, § 142(a), 98 Stat. 494, 677 (1984) (current version at I.R.C. § 6112 (CCH 1986)) (organizers and sellers of potentially abusive tax shelters must keep lists of investors); Pub. L. No. 98-369, § 142(b), 98 Stat. 494, 682 (1984) (current version at I.R.C. § 6708 (CCH 1986)) (penalty for failure to maintain lists of investors in potentially abusive tax shelters). The requirement that promoters or organizers of tax shelters maintain investor lists may be a violation of the attorney-client privilege if the promoter or organizer is a lawyer. *See* United States v. Liebman 742 F.2d 807 (3rd Cir. 1984) (attorney-client privilege applicable to IRS summons seeking names of all clients with law firm who paid fees over a three year period in connection with acquisition of certain tax shelters), cited in *The Federal Tax Coordinator 2d Weekly Alert*, Sept. 27, 1984, at 285.

Commissioner of Internal Revenue acknowledged the broad scope of the rules, and admitted that a number of legitimate investments would have to be registered.[140] Some commentators accepted the original temporary regulations with open arms, realizing that if such a large number of legitimate investors would have to register, the IRS would be hard put to locate and identify the real abusers of the system.[141]

The following analysis first examines the tax shelter registration provisions of the 1984 Act,[142] and the Treasury Department's originally proposed temporary regulations.[143] These regulations were overly broad in their scope, did not carry out the congressional intent behind the registration provisions set forth in the code, and were not effective in efficiently identifying the real abusers of the tax system. A narrower proposal, elucidated from public comments to the original temporary regulations,[144] is also examined. The public comment proposal took into account the projected amount of income expected to be derived from the investment, something that the originally proposed temporary regulations never did. Unfortunately, this proposal would have allowed some tax shelters to be left unregistered; consequently, the Treasury Department properly chose not to incorporate it into the statutory scheme.

The Treasury Department's response was to suspend the tax shelter registration rules for investments that were not expected to reduce an investor's cumulative tax liability,[145] and therefore were not expected to have a sheltering effect on an investor's income from other sources.[146] Even by suspending registration for what the Treasury

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140. In a speech before the National Association of Enrolled Agents at Disney World in Orlando, Florida, on August 23, 1984, Internal Revenue Service Commissioner Roscoe L. Egger, Jr. stated: "We recognize that perfectly acceptable shelters will be registered along with abusive shelters. . . [i]t was not our intention to register only the abusive ones." Sheppard, *Tax Shelters for the Poor*, TAX NOTES, Sept. 10, 1984 (the full text of this speech is available in the Sept. 10, 1984 TAX NOTES Microfiche Database as Doc. 84-6010); *see also IRS Counsel Says Registration Rules Don't Hit Lawyers, Accountants*, BNA's WEEKLY TAX REPORT, Sept. 17, 1984, at 1221, 1222 [hereinafter cited as *Registration Rules*].

141. *See supra* note 6.

142. Pub. L. No. 98-369, § 141(a), 98 Stat. 494, 677 (1984) (current version at I.R.C. § 6111 (CCH 1986)).

143. 49 Fed. Reg. 32,712 (1984) (codified as amended at 26 C.F.R. § 301.6111-1T (1985)).

144. The public comments were specifically requested by the Treasury Department in the Federal Register. Requests for Public Comments, 49 Fed. Reg. 32,728 (1984).

145. Treas. Reg. § 301.6111-1T, 57A, T.D. 7694 (1984).

146. At first glance, this provision may appear to be an exception for investments that cannot be considered tax shelters under the general definition found

Department calls "projected income investments,"[147] the regulations do not identify potentially abusive tax shelters in the most efficient manner. The only way that such identification can be accomplished efficiently is by properly measuring the sheltering effect that an investment is expected to have on other income and including it on the tax shelter registration form.

Congressional Enactment

The congressional intent behind the registration requirements was to identify taxpayers who promoted, organized, and invested in potentially abusive tax shelters. The registration of tax shelters originated in the Senate.[148] The House bill contained no registration provision for tax shelters.[149] The Senate originally wanted any investment that showed a net loss during any of the first five years to be registered.[150] The House-Senate Conferees compromised, and drafted legislation which limited the registration to tax shelters that generated losses of two hundred percent (200%) or more of the taxpayer's initial investment.[151] This was a limiting compromise from the Senate's original position which would have required the registration of any investment that resulted in a net loss.[152] Congress ultimately decided to limit the registration to multiple write-off tax shelters, where taxpayers in the fifty percent (50%) bracket would recoup their investment many times over in tax savings alone.[153]

Congress enacted the tax shelter registration requirements in order to provide the IRS with the tools necessary to identify poten-

in the regulations governing tax shelter opinion writers, *supra* text accompanying note 27. The Treasury Department still labels these "projected income investments" as tax shelters, even though they are not required to be registered as such. *See infra* text accompanying note 177. It is not clear why this label is retained.

147. Treas. Reg. § 301.6111-1T, 57A, T.D. 7694 (1984).

148. H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 977-78, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1665-66.

149. H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 977, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1665.

150. H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 977-78, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1665-66.

151. H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 978-81, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1666-69.

152. H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 977-78, *reprinted in* 1984 U.S. CODE CONG. & AD. NEWS 1445, 1665-66.

153. For example, a taxpayer in the 50% bracket who invests $50,000 in a tax sheltered venture which yields a $100,000 deduction in the first year saves $50,000 in taxes that year (50% x $100,000), and recovers 100% of his investment in tax savings alone.

tially abusive tax shelters as they were being promoted to investors.[154] For the purposes of tax shelter registration, I.R.C. § 6111(c)(1) states:

> In general.—The term "tax shelter" means any investment—
>
> (A) with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interest in the investment that the tax shelter ratio for any investor as of the close of any first 5 years ending after the date on which such investment is offered for sale may be greater than 2 to 1, and
>
> (B) which is—
> (i) required to be registered under Federal or State law regulating securities,
> (ii) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities, or
> (iii) substantial investment [of at least $250,000 in which there are expected to be five or more investors].[155]

Clearly, the way in which the tax shelter ratio is computed will often determine whether an investment will have to be registered as a tax shelter.

The code, in § 6111(c)(2), defines the term "tax shelter ratio," with respect to any year, as the ratio which:

> (A) the aggregate amount of the deductions and 200 percent of the credits which are represented to be potentially allowable to any investor under subtitle A for all periods up to (and including) the close of such year, bears to
>
> (B) the investment base as of the close of such year.[156]

A strong point of contention that originally arose was exactly what was meant by the phrase "aggregate amount of the deductions and 200 percent of the credits."[157] Given its ordinary meaning, this langauge

154. I.R.C. § 6111(a)(1) (CCH 1986) (requiring registration not later than the day on which interests in the tax shelter are offered for sale).

155. I.R.C. § 6111(c)(1) (CCH 1986).

156. I.R.C. § 6111(c)(2) (CCH 1986).

157. The numerator of the tax shelter ratio was drafted with the fifty percent bracket taxpayer in mind. For a taxpayer in the fifty percent bracket, two hundred percent of income tax credit shelters the same amount of income as an equivalent amount of deduction. To illustrate, suppose that a fifty percent bracket taxpayer in-

suggests that (at least for the purpose of defining an investment's tax shelter ratio) the total amount of tax benefits that an investment offers would not be offset by any amount of projected investment income. This meant that even if an investment was expected to generate net taxable income,[158] it would have to be registered as a tax shelter as long as all the terms of § 6111(c) were met. This was in direct conflict with the general definition of a tax shelter as it appeared in the rules governing tax shelter opinion writers.[159] In its originally proposed temporary regulations, the IRS defined the term "tax shelter" quite differently for the purposes of tax shelter registration.

The Orginially Proposed Temporary Regulations

The IRS broadened the scope of the registration requirements by setting the rules by which an investment's tax shelter ratio is calculated. The Service's originally proposed temporary regulations initially cast a very broad net, and required investments to be registered as tax shelters without taking into account the amount of income projected to be generated by the investment.[160] The regulations, as they presently exist, base the tax shelter ratio on gross, not net, deductions plus two hundred percent (200%) of credits:

$$\text{Tax Shelter Ratio} = \frac{\text{Gross Deductions} + 200\%\ \text{Credits}}{\text{Investment Base.}}$$[161]

vested in a tax shelter that offered an investment tax credit of $50,000 in the first year. The tax credit would reduce the investor's cumulative income tax liability $50,000. Two hundred percent of this amount, or $100,000, represents the equivalent amount of deductions necessary to reduce the fifty percent bracket taxpayer's cumulative income tax liability by the same amount, or $50,000.

158. Recall the distinction made between income projected to be derived from the investment and income from other sources. When a tax shelter offering is made to a potential investor, the promotion is usually based on how much the investment can be used to shelter the taxpayer's income from other sources. In general, tax shelters by definition are specifically designed not only to shelter income from the investment itself, but from other sources as well. *See supra* text accompanying note 27.

159. Recall that the term "tax shelter" was defined in the regulations governing tax shelter opinion writers in terms of net deductions and credit available to shelter income from other sources. *See supra* text accompanying note 27.

160. The New York State Bar Association issued a formal opinion stating that the originally proposed temporary regulations were too inclusive, and that the definition of the "aggregate amount of deductions" as the amount of gross, rather than net deductions, was unsupported by the statute. *Section 6111—Tax Shelter Registration*, TAX NOTES, Nov. 19, 1984, at 684.

161. Treas. Reg. § 301.6111-1T, A-5, T.D. 7694 (1984). At A-13, the regulations define the term "investment base," with respect to any year, as "the cumulative amount

The amount of allowable deductions and 200% of credits are not offset by any income which is expected to be derived from the investment;[162] consequently, the sheltering effect that the investment is expected to have on an investor's income from other sources is not measured here.[163] The above formula, standing alone, was insufficient because it may have required legitimate investments which were expected to generate net taxable income[164] to be registered as tax shelters.

Legitimate syndicated transactions which were expected to produce net taxable income should not have been required to register

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of money and the adjusted basis of other property (reduced by any liability to which such property is subject) that is unconditionally required to be contributed or paid directly to the tax shelter on or before the close of such year by an investor." At A-14, the regulations state that the investment base must be reduced by:

> (1) Any amount borrowed by the investor, even if borrowed on a recourse basis, from any person who participated in the organization, sale, or management of the investment or who has an interest (other than an interest as a creditor) in the investment ("a participating person") or from any person who is related . . . to a participating person, unless the amount is unconditionally required to be repaid by the investor before the close of the year for which the determination is being made. . . .
>
> (2) Any amount borrowed by the investor, even if borrowed on a recourse basis, from a person, if the loan is arranged by a participating (or related) person, unless the amount is unconditionally required to be repaid by the investor before the close of the year for which the determination is being made. . . .
>
> (3) Any amount borrowed, directly or indirectly, from a lender located outside the United States ("foreign-connected financing"), of which a participating (or related) person knows or has reason to know.
>
> (4) Any amounts to be held for the benefit of intestors in cash, cash equivalents, or marketable securities. . . .
>
> (5) Any distributions (whether of cash or property) that will be made without regard to the income of the tax shelter, but only to the extent such distributions exceed the amount to be held as of the close of the year in cash, cash equivalents, or marketable securities.

Treas. Reg. § 301.611-1T, A-13, A-14, T.D. 7694 (1984).

162. Treas. Reg. § 301.6111-1T, A-5, T.D. 7694 (1984).

163. *See supra* note 158 and text accompanying note 27. It is apparent that the IRS never intended to measure the investment's sheltering effect on other income. The IRS, through its regulations, wanted to identify investment schemes which allowed taxpayers to recover their investment at some point during the first five years through the tax savings alone. *See supra* note 153. It is important to note that this was a policy decision made by the IRS that was based on the need to identify the wide variety of tax favored investments available. It was not based on the tax sheltering effect of the investment on other income, since this is never measured by the regulations.

as tax shelters for a number of reasons. Primarily, if an investment produced net taxable income, it could not shelter income from other sources, and therefore should not have been considered a tax shelter.[165] Taxpayers who would have been required to register as investors in potentially abusive tax shelters[166] would have been subjected to a greater chance of being audited.[167] Since "projected income investments"[168] were not exempt from registration under the originally proposed temporary regulations,[169] the IRS could not have differentiated between legitimate investments and potentially abusive tax shelters.[170] This situation necessarily would have led to arbitrary enforcement, and may have had a chilling effect on legitimate investors.[171] From the IRS's standpoint, identifying the truly abusive tax shelters would have been virtually impossible if they were buried in a morass of filings by legitimate investors.

Alternate proposals which would accurately measure the projected tax sheltering effect of an investment on other income could

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164. *See supra* note 7.

165. *See supra* note 2, and text accompanying note 27.

166. *See supra* note 2.

167. For a perspective on how the originally proposed temporary regulations affected professionals who drafted opinion letters, see *Registration Rules, supra* note 140, at 1221, 1222 ("[T]he real problem is the stigma of being considered a tax shelter by the IRS. We could all be required to hang cards around our necks. . . .").

168. *See infra* text accompanying note 177.

169. 49 Fed. Reg. 32,712 (1984) (later codified as amended at 26 C.F.R. § 301.6111-1T (1985)).

170. To illustrate, assume a real estate offering that involves a building that has $1,000,000 of rental income and $900,000 of deductions resulting in taxable income of $100,000. Because of very favorable terms, the investors must pay in only $100,000 a year for each of the five years. The ratio as interpreted by the IRS is 9 to 1. Now compare this investment to one involving a leaseback that provides for an improperly low rent and thus results in a substantial tax loss. To illustrate, rental income is $300,000 a year, deductions are $600,000 a year and the investor pay-in is again $100,000 a year for five years. Here the "ratio" is 6 to 1. The latter, is however, a true 3 to 1 tax shelter while the former (which produces a higher ratio and will more readily attract the attention of the IRS, since it appears to be a more abusive tax shelter) is an economic real estate investment reflecting taxable income.

Public Comment from the accounting firm of Laventhal and Horwath, New York, N.Y. to Cynthia L. Clark, of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service, the principal author of the proposed regulations (Sept. 12, 1984) (RE: Proposed Regulation 301.6111-1T).

171. This chilling effect may be compared to that felt when the IRS imposed regulations against partnerships in 1977 and 1978. *See* Olinger, *supra* note 70, at 12.

utilize the definition of "tax shelter" found in the regulations governing tax shelter opinion writers.[172] The definition requires the net tax benefits of a tax shelter to be greater than zero. This net tax benefit rule could have been incorporated into the original regulations in a number of ways. Public comments to the original regulations suggested a hybrid tax shelter ratio that would define an investment's tax shelter ratio in terms of net, not gross, deductions plus two hundred percent (200%) of credits. The Treasury Department properly chose not to incorporate the net tax benefit concept into the tax shelter ratio, since this would have allowed some tax shelters to escape registration. It decided instead to suspend the registration rules for investments that were expected to generate a net income tax liability, so-called "projected income investments."[173]

The Public Comment Proposal

Focusing on the large tax sheltering effect that some investments have on other income, the public comments would redefine "tax shelter ratio" as the ratio which the net tax benefits bear to the investment base. For the sake of clarity, this ratio will be referred to as the hybrid ratio.

$$\text{Hybrid Ratio} = \frac{\text{Gross Deductions} + 200\%\ \text{Credits} - \text{Projected Income}}{\text{Investment Base.}}$$[174]

As long as an investment's hybrid ratio was not less than two, it would have to be registered as a tax shelter with the IRS. This proposal would considerably lessen the number of investments that were originally required to be registered as tax shelters, since it would only require registration by investors who have successfully sheltered all investment income and have recouped at least one hundred percent (100%) of their investment base totally by sheltering other income.[175] Unfortunately, this proposal would allow some tax shelters to escape registration. Investments that are expected to generate

172. *See supra* text accompanying note 27.

173. *See infra* text accompanying note 177.

174. This hybrid proposal was found throughout the public comments received by the office of George H. Bradley, chief of technical section, Internal Revenue Service. The comments suggested that the proposed tax shelter ratio be based on net, not gross, deductions and two hundred percent of credits.

175. This assumes that the investor is in the fifty percent rate bracket, *see supra* note 153.

deductions and two hundred percent (200%) of credits in excess of the investment's projected income would not be required to register unless their net tax benefits equalled at least two hundred percent (200%) of the taxpayer's investment base. This proposal would have the same effect as keeping the original regulations as they were but would raise the threshold level for the tax shelter ratio higher than two, depending on how much income was expected to be generated by the investment.

Projected Income Investments

After it solicited and received public comments on its originally proposed temporary regulations,[176] the Treasury Department amended its regulations by allowing the tax shelter registration rules to be suspended for "projected income investments." Regulation § 301.6111 - 1T, 57A and 57E state:

> Q-57A. Are the registration requirements suspended with respect to any tax shelters?
>
> A-57A. Yes. If a tax shelter is a projected income investment, it is not required to be registered before the first offering for sale of an interest in the tax shelter occurs, but is subject only to the registration requirements set forth in A-57H through A-57J of this section [pertaining to the requirement that an investment must be registered as a tax shelter if it ceases to be a projected income investment].
>
> A tax shelter is a projected income investment if—
>
> (a) The tax shelter is not expected to reduce the cumulative tax liability of any investor for any year during the 5-year period described in A-4(I) of this section; and
>
> (b) The assets of the tax shelter do not include or relate to any property described in A-57E of this section.
>
> A-57E. A tax shelter is not a projected income investment if more than an incidental amount of its assets include or relate to any interest in a collectible (as defined in section 408(m)(2)), a master sound recording, motion pic-

176. Requests for Public Comments, 49 Fed. Reg. 32,728 (1984); Originally Proposed Temporary Regulations, 49 Fed. Reg. 32,712 (1984) (codified as amended at 26 C.F.R. § 301.6111-1T (1985)).

ture or television film, videotape, lithograph plate, copyright, or a literary, musical, or artistic composition.[177]

These regulations clearly state that projected income investments are tax shelters for which the registration requirements are suspended. The IRS could have listed projected income investments under the exceptions to tax shelter registration,[178] but chose instead to keep the tax shelter label and suspend the registration requirements. Framing the provision in this way does not change the broad definition of a tax shelter for the purposes of registration, but effectively pares it

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177. Treas. Reg. § 301.6111 - 1T, 57A, 57E, T.D. 7964 (1984). § A-57C(b)-(e) reads as follows:

> (b) The cumulative projected deductions for an investor as of the close of a year are the gross deductions of the investor *with respect to the investment*, for all periods up to (and including) the end of such year, that are included in the financial projection or upon which the representation is based. . . .
>
> (c) The cumulative projected income for an investor as of the close of a year is the gross income of the investor *with respect to the investment*, for all periods up to (and including) the end of such year, that is included in the financial projection or upon which the representation is based. . . .
>
> (d) The cumulative projected credits for an investor as of the close of a year are the gross credits of the investor *with respect to the investment* for all periods up to (and including) the close of such year, that are included in the financial projection or upon which the representation is based. . . .
>
> (e) The cumulative projected tax liability (without regard to credits) for an investor as of the close of a year is 50 percent of the excess of cumulative projected income for the investor over cumulative projected deductions for the investor *with respect to the investment* as of the close of such year.

Treas. Regs. §301.6111 - 1T, A-57C(b)-(e), T.D. 7964 (1985) (emphasis added).

178. Regulations § 301.6111-1T, A-24 provides:

> The following investments are not subject to tax shelter registration:
>
> (1) Sales of residences primarily to persons who are expected to use the residences as their principal place of residence,
>
> (2) Sales or leases of tangible personal property (other than master sound recordings, motion picture or television films, videotapes, lithograph plates, or other property relating to a literary, musical, or artistic composition) by the manufacturer (or a member of an affiliated group, within the meaning of section 1502, including the manufacturer) of the property primarily to persons who are expected to use the property in their principal active trade or business. . . .
>
> (3) Any other investment as specified by the Secretary in a rule-related notice published in the Federal Register.

Treas. Reg. § 301.6111-1T, A-24, T.D. 7694 (1984).

down to the point where it is consistent with the general definition of a tax shelter found in the regulations governing tax shelter opinion writers.[179]

Broader than the proposal received from the public comments, the suspension of the registration requirements with regard to projected income investments depends on whether the investment reduces the cumulative tax liability of an investor. Regulations § 301.6111-IT, 57C(a) provides:

> A-57C. (a) An investment reduces the cumulative tax liability of an investor with respect to a year during the 5-year period described in A-4(I) of this section if, as of the close of such year, (i) cumulative projected deductions for the investor exceed cumulative projected income for the investor, or (ii) cumulative projected credits for the investor exceed cumulative projected tax liability (without regard to credits) for the investor.[180]

Simply stated, an investment (other than those listed in § 301.6111-1T, 57E, above) has to be registered as a tax shelter if the code requirements are met, but only if the net tax benefits are greater than zero:

$$\text{Net Tax Benefits} = \text{Gross Deductions} + 200\% \text{ Credits} - \text{Projected Income} > 0.$$

(In order to be concise, this short hand expression will be used in the following comparative analysis.) This provision requires registration by investors in the fifty percent (50%) bracket who expect to recover their investment base through sheltering the entire amount of investment income, as well as part of their income from other sources. In this way, an investment that is projected to generate income in excess of the allowable tax benefits is not required to be registered as a tax shelter, since no net tax benefits are expected to be available to shelter other ordinary income.

In order to illustrate the differences between the tax shelter registration requirements as they were originally proposed, the public comment proposal, and the suspension of registration for projected income investments, consider the following syndicated transaction:

> Assume that a partnership purchases an office building for $7,300,000 with a $157,000 downpayment, a $7,143,000

179. *See supra* text accompanying note 27.
180. Treas. Reg. § 301.6111-1T, A-57C(a), T.D. 7694 (1984).

mortgage, and a ten-year balloon note at 14%, with annual interest payments of $1,000,000. Other tax deductible annual expenses include real estate taxes of $100,000, insurance of $15,000, management fees to the general partner of $120,000, first-year depreciation of $120,000, amortized loan and organization costs producing a first-year deduction of $16,000 and transfer taxes of $70,000, for a total of $1,441,000 in expenses. Rental income the first year is expected to be $1,500,000. The partnership has 100 investors who each contribute $2,000 to the partnership in the first year. As promoted to investors, the partnership would project no tax write-off at all, as the $1,441,000 in projected expenses is more than offset by the $1,500,000 in projected income.[181]

It is important to note that the investment is not expected to shelter an investor's other sources of income since the investment itself is expected to generate net taxable income in the first year.

This investment would have been registered as a tax shelter under the originally proposed temporary regulations, even though it is projected to generate net taxable income. All other registration requirements having been met,[182] the computation of the investment's tax shelter ratio is:

$$\text{Tax Shelter Ratio} = \frac{\text{Gross Deductions} + 200\%\ \text{Credits}}{\text{Investment Base}}$$
$$= \frac{\$1{,}441{,}000 + \$0}{100 \text{ investors} \times \$2{,}000/\text{investor}}$$
$$= \frac{\$1{,}441{,}000}{\$200{,}000}$$
$$= 7.205.$$

Since the tax shelter ratio is greater than two, the investment would have been registered with the IRS under the original regulations which did not take into account the projected amount of rental income that this office building is expected to generate.

181. Public Comment from the law offices of Malin, Franklin, & Goldberg, P.C. (Washington, D.C.) to Cynthia L. Clark of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service, the principal author of the proposed regulations (Sept. 7, 1984) (RE: Proposed Regulation 301.6111-1T).

182. The investment is a substantial one (greater than $250,000), in which there are more than five investors. IRC § 6111(c)(4) (1984).

The investment, as stated above, is expected to generate net taxable income; consequently, it would not have to be registered under either the public comment proposal or the current regulations. The public comment proposal would not require the investment to be registered since its hybrid ratio is less than two:

$$\begin{aligned}\text{Hybrid Ratio} &= \frac{\text{Net Tax Benefits}}{\text{Investment Base}}\\ &= \frac{\$1{,}441{,}000 + \$0 - \$1{,}500{,}000}{100 \text{ Investors} \times \$2{,}000/\text{Investor}}\\ &= \frac{-\$59{,}000}{\$200{,}000}\\ &= -0.295.\end{aligned}$$

Similarly, the current regulations would exempt this from tax shelter registration as a projected income investment, since the net tax benefits are negative:

$$\begin{aligned}\text{Net Tax Benefits} &= \text{Gross Deductions} + 200\% \text{ Credits}\\ &\quad - \text{Projected Income}\\ &= \$1{,}441{,}000 + \$0 - \$1{,}500{,}000\\ &= -\$59{,}000.\end{aligned}$$

Hence, no investment which is projected to generate net taxable income would be required to register under either the public comment proposal or the tax shelter registration provisions as they presently exist.

Suppose, however, that the office building is expected to produce $1,100,000 instead of $1,500,000 in rental income during the first year. Although the investment would still have to have been registered under the original regulations, this situation yields different results under the public comment proposal and the current regulations. Under the public comment proposal, even though the investment has some sheltering effect on other income, it would escape registration since its hybrid ratio is less than two:

$$\begin{aligned}\text{Hybrid Ratio} &= \frac{\text{Net Tax Benefits}}{\text{Investment Base}}\\ &= \frac{\$1{,}441{,}000 + \$0 - \$1{,}100{,}000}{100 \text{ Investors} \times \$2{,}000/\text{Investor}}\\ &= \frac{\$341{,}000}{\$200{,}000}\\ &= 1.705.\end{aligned}$$

The current regulations, on the other hand, would require this investment to be registered since its tax shelter ratio is greater than two, and its net tax benefits are greater than zero:

$$\begin{aligned}\text{Tax Shelter Ratio} &= \frac{\text{Gross Deductions} + 200\%\ \text{Credits}}{\text{Investment Base}} \\ &= \frac{\$1{,}441{,}000 + \$0}{100\ \text{Investors} \times \$2{,}000/\text{Investor}} \\ &= \frac{\$1{,}441{,}000}{\$200{,}000} \\ &= 7.205\end{aligned}$$

$$\begin{aligned}\text{Net Tax Benefits} &= \text{Gross Deductions} + 200\%\ \text{Credits} \\ &\quad - \text{Projected Income} \\ &= \$1{,}441{,}000 + \$0 - \$1{,}100{,}000 \\ &= \$341{,}000.\end{aligned}$$

Consequently, an investment that has a tax shelter ratio greater than two, and is expected to generate positive net tax benefits would always be registered as a tax shelter under the current regulations, but would have escaped registration under the public comment proposal if its hybrid ratio was less than two.

Finally, assume that the office building is projected to generate a maximum of $1,041,000 in rental income during the first year. The investment would have been registered under the original regulations, the current regulations, and would even have to be registered under the public comment proposal since its hybrid ratio is not less than two:

$$\begin{aligned}\text{Hybrid Ratio} &= \frac{\text{Net Tax Benefits}}{\text{Investment Base}} \\ &= \frac{\$1{,}441{,}000 + \$0 - \$1{,}041{,}000}{100\ \text{Investors} \times \$2{,}000/\text{Investor}} \\ &= \frac{\$400{,}000}{\$200{,}000} \\ &= 2.000.\end{aligned}$$

Therefore, the only investments that would be required to be registered as tax shelters under the public comment proposal would be those whose net tax benefits equaled at least two hundred percent (200%) of the investment base.

Summary

Although the Treasury Department's current temporary regulations suspend the tax shelter registration rules for "projected income investments,"[183] they do not measure the sheltering effect that a registered tax shelter is expected to have on an investor's other sources of income. The public comment proposal did attempt to measure this sheltering effect by incorporating the investment's projected amount of income into the tax shelter ratio, but this was not acceptable because it would have allowed some tax shelters to escape registration.[184] The following discussion proposes that Congress amend the code's tax shelter definition for purposes of registration. The proposed amendment accurately measures the sheltering effect that the registered tax shelter is expected to have on an investor's other sources of income, and is therefore consistent with the general tax shelter definition found in the Treasury Department's regulations which govern tax shelter opinion writers.[185]

PROPOSAL

The fundamental problem with the current law regarding tax shelter registration is that it offers a definition of the term "tax shelter" which, in some circumstances, is inconsistent with the definition found in the regulations governing tax shelter opinion writers.[186] A discrepancy regarding a term so vital to this area of the law is both unwarranted and unnecessary. The problem arises in the case of "projected income investments," investments which are expected to generate net taxable income, yet also offer investors at least a two-to-one tax write-off.[187] The Treasury Department decided to suspend the tax shelter registration rules for such investments because they are not expected to reduce an investor's cumulative income tax iiability.[188]

Suspending the tax shelter registration rules for "projected income investments" is consistent with the general notion that tax shelters are investments which generate net tax losses that shelter an investor's other sources of income. As stated, the current temporary regulations suspend the registration rules for any *"tax shelter* [which] is not expected to reduce the cumulative tax liability of any

183. *See supra* text accompanying note 177.
184. *See supra* text accompanying notes 174-75.
185. *See supra* text accompanying note 27.
186. *See supra* text accompanying note 27.
187. Treas. Reg. § 301.6111-1T, 57A, T.D. 7694 (1984).
188. *Id.*

investor."[189] If one superimposes the general definition of a tax shelter found in the rules governing tax shelter opinion writers,[190] this statement becomes a contradiction in terms. "Projected income investments" do not meet the general definition of a tax shelter found in the regulations governing tax shelter opinion writers, nor are they required to be registered as tax shelters under the present law. Instead of stating that "projected income investments" are an *exception* to the tax shelter definition for the purposes of registration and therefore should not be registered as such, the Treasury Department stayed loyal to their new definition by referring to these investments as tax shelters and *suspended* the registration rules in order to comply with the general definition.

Even with the suspension of the registration rules for "projected income investments,"[191] the current temporary regulations make it virtually impossible for the IRS to distinguish between potentially abusive and nonabusive tax shelters because they do not measure the amount of an investor's other income that is expected to be sheltered. The public comment proposal did attempt to measure this sheltering effect by incorporating the investment's projected amount of income into the tax shelter definition.[192] This hybrid proposal sought to incorporate the investment's projected amount of income into a hybrid ratio; but, unfortunately, this kept tax shelters which offered less than a two-to-one tax write-off against other income from being registered.[193] Conversely, the present regulations require the registration of all tax shelters by specifying that the investment reduce an investor's cumulative tax liability.[194] The problem is that the effect that these tax shelters are expected to have on an investor's other sources of income is never measured.

The solution lies in Congress' power to amend the code definition of a tax shelter for the purposes of registration. Such an amendment would incorporate the general definition of a tax shelter found in the regulations governing the tax shelter opinion writers,[195] and would reflect the Treasury Department's concern that "projected income investments" not be registered as tax shelters.[196] This amendment would render the present suspension of the registration rules

189. *Id.* (emphasis added).
190. *See supra* text accompanying note 27.
191. Treas. Reg. § 301.6111-1T, 57A, T.D. 7694 (1984).
192. *See supra* text accompanying notes 174-75.
193. *See supra* text accompanying notes 174-75.
194. *See supra* text accompanying note 177.
195. *See supra* text accompanying note 27.
196. *See supra* text accompanying note 177.

for "projected income investments" nugatory because they would properly never be considered tax shelters in the first place. More importantly, the amendment would accurately measure the amount of cumulative tax liability that the registered tax shelter is expected to reduce, something that the present statutory scheme never attempts to do.

The amendment would be an addition to the present definition of a tax shelter as it appears in the internal revenue code. As amended, section 6111(c)(1)(A) would read:

SEC. 6111. REGISTRATION OF TAX SHELTERS.

(c) Tax Shelter.—For the purposes of this section—

> (1) In General.—The term "tax shelter" means any investment—
> (A) [which, as of the close of any of the first 5 years the investment is offered for sale, the tax shelter ratio is greater than 2 to 1, and]
> which has as a significant and intended feature for Federal income tax or excise tax purposes either of the following attributes:
> (i) deductions in excess of income from the investment being available as of the close of any of the first 5 years ending after the date on which such investment is offered for sale to reduce income from other sources in that year, or
> (ii) credits in excess of the tax attributable to the income from the investment being available as of the close of any of the first 5 years ending after the date on which such investment is offered for sale to offset taxes on income from other sources in that year.
>
> This subsection shall not apply to investments where more than an incidental amount of its assets include or relate to any interest in a collectible (as defined in section 408(m)(2)), a master round recording, motion picture or television film, video tape, lithograph plate, copyright, or a literary, musical, or artistic composition.[197]

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197. This amendment incorporates the provisions of the tax shelter definition found in the regulations governing tax shelter opinion writers, as well as the definition of "projected income investments" present in the current proposed regulations regarding tax shelter registration. *See* I.R.C. § 6111 (CCH 1986). *See also supra* text accompanying notes 27 and 177.

This proposed amendment would require the projected amount of net tax benefits to be reported on the investor's tax shelter registration form. This figure, coupled with the tax shelter ratio, would enable the IRS to efficiently identify taxpayers who organize, sell, and invest in potentially abusive tax shelters.

CONCLUSION

Tax shelters are defined by provisions in the internal revenue code which make the use of deferral, conversion, and leverage possible. Tax shelters are generally defined as investments that generate net tax benefits and are designed to shelter a taxpayer's income from other sources. Congress and the Treasury Department have taken measures over the past seventeen years to deter the growth of the tax shelter industry. These measures originally came in the form of changes in the internal revenue code which attempted to eliminate the advantages of deferral, conversion, and leverage, but were often outweighed by other provisions that were designed to stimulate investment.

In recent years, the fight against tax shelters has shifted from changes in the internal revenue code which were designed to lessen the effects of deferral, conversion, and leverage, to the enactment of measures which are designed to enhance taxpayer compliance with the law and put an end to abusive tax shelters. These compliance measures are directed at regulating the tax shelter industry from within. They focus on tax shelter opinion writers, as well as those who promote, organize, and invest in tax shelters. The most recent compliance provisions require all tax shelters to be registered.

The registration requirements outlined by Congress in the Deficit Reduction Act of 1984 gave the IRS the opportunity to enact regulations that would lead to the identification of potentially abusive tax sheltering schemes. In order to get as many taxpayers to register their investments as possible, the IRS initially promulgated regulations that required even legitimate investments that were expected to generate net taxable income to be registered as tax shelters. Since these proposed regulations did not measure the tax sheltering effect that an investment was expected to have on an investor's other sources of income, it was impossible to tell which investments were legitimate, and which were potentially abusive tax shelters.

The public comments to the original temporary regulations as well as the Treasury Department's response have been described. The public comment proposal measured the tax sheltering effect that an investment was expected to have on other ordinary income, but would have allowed certain tax shelters to avoid detection if the net tax write-off from an investor's other income was less than two hundred percent (200%) of the investment base. The Treasury Department responded by suspending the tax shelter registration rules for what it called "projected income investments." This suspension of the tax shelter registration rules is a compromise between the general definition of a tax shelter found in the rules governing tax shelter opinion writers and the definition of a tax shelter as it presently appears for the purposes of registration. Suspending the registration rules for projected income investments appropriately limits tax shelter registration to investments that are projected to generate net tax benefits that shelter an investor's other sources of income. In this way, all tax shelters are required to be registered, while investments that are projected to generate net taxable income are not. The current temporary regulations, unlike either the IRS's originally proposed temporary regulations or the public comment proposal, are consistent with the congressional intent behind the registration provisions outlined in the internal revenue code. The problem is that the current statutory scheme defines the term "tax shelter" for the purposes of registration in a way that is inconsistent with the general definition in the case of "projected income investments."

The amendment that this note proposes is a viable alternative to the present temporary regulations. It incorporates the general definition of a tax shelter into the code's present registration provisions and makes the definition of a tax shelter for the purposes of registration wholly consistent with the one found in the regulations which govern tax shelter opinion writers. More importantly, however, this proposal efficiently identifies taxpayers who organize, sell, and invest in potentially abusive tax shelters by measuring the amount of income from other sources the tax shelter is expected to offset, something that the current temporary regulations fail to do.

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