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ABUSIVE TAX SHELTERS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

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ABUSIVE TAX SHELTERS

FRIDAY, JUNE 24, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE,
Washington, D.C.

The committee met, pursuant to notice, at 9:38 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman) presiding.

Present: Senators Grassley and Dole.

(The press release announcing the hearing and an explanation of this Background on Tax Shelters by the Joint Committee on Taxation follow:)

[Press Release]

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON ABUSIVE TAX SHELTERS

Senator Charles E. Grassley (R., Iowa), Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, announced today that the committee will hold a hearing on June 24 on abusive tax shelters.

Of particular interest to the subcommittee will be testimony relating to charitable contribution tax shelters and the ability of the IRS and the courts to process the large volume of tax shelter returns that are under examination by the IRS. The subcommittee will also review the effectiveness of recent legislative changes intended to combat abusive tax shelters. "The Commissioner of Internal Revenue has testified that we lose $3 billion or more in revenue annually through abusive tax shelters. We need to know what types of shelters are involved, and what more we can do to stop them," Senator Grassley concluded.

The hearing will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

BACKGROUND ON TAX SHELTERS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON

JUNE 24, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance has scheduled a hearing on June 24, 1983, on abusive tax shelters. This pamphlet, prepared in connection with that hearing, provides background information relative to tax shelters.

The first part of the pamphlet is an overview. This is followed by a description of elements of a tax-shelter investment (Part II), a summary of income tax provisions designed to limit tax shelters (Part III), a discussion of the time value of money (Part IV), and a description of specific areas of present law that provide the base for tax shelters (Part V).

I. OVERVIEW

Tax-shelter investments enable taxpayers to reduce their tax liabilities by use of tax benefits generated by the investments. There are three selling points that are common to most tax-shelter investments: (1) the ability to defer tax liability to a later year; (2) the opportunity to convert ordinary income to tax-favored income (such as capital gains); and (3) the use of borrowed funds to finance the investment (leverage). The elements of a tax-shelter investment are described in Part II.

Beginning in 1969, Congress has enacted a series of income tax laws that are designed to reduce the use of tax shelters. Part III contains brief summaries of tax-shelter legislative provisions contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, and the Tax Equity and Fiscal Responsibility Act of 1982.

Certain aspects of present law continue to provide taxpayers with opportunities to obtain possibly unintended tax benefits, providing the basis for tax-shelter investments. For example, the benefits of deferring a tax liability are attributable, in large part, to the fact that present law does not take adequate account of the present value (or cost) of a future expense or receipt. The tax-law implications of the time value of money are discussed in Part IV.

Other identified abuses under present law include (1) the use of partnerships to achieve tax results not otherwise available, (2) the use of generally available deductions (*e.g.*, interest) to offset unrelated income, (3) the overvaluation of property that is used to generate tax deductions (*e.g.* charitable contributions), and (4) the organization of foreign corporations to avoid the application of U.S. tax rules. Part V describes tax-shelter operations that take advantage of loopholes in these areas of present law.

II. ELEMENTS OF A TAX-SHELTER INVESTMENT

In general, a tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings on other income, as well as the receipt of tax-favored (or, effectively, tax-exempt) income from the investment itself. Tax shelters are typically characterized as abusive if they are formed primarily to obtain tax benefits, without regard to the economic viability of the investment.

In some instances, tax shelters are used to take advantage of specific incentives, such as the accelerated cost recovery system, the deduction for intangible drilling costs, or the deduction for research and experimental expenses, which Congress has legislated. Other shelters use devices in the tax law to achieve tax savings which were never specifically intended by Congress, and some shelters attempt to inflate certain deductions, credits, etc. beyond the properly allowable amount.

Although tax-shelter investments take a variety of forms, there are several elements that are common to most tax shelters. The first of these is the "deferral" of tax liability to future years, resulting, in effect, in an interest-free loan from the Federal Government. The second element of a tax shelter is the "conversion" of ordinary income (subject to tax at a maximum rate of 50 percent) to tax-favored income (such as capital gains subject to tax at a maximum rate of 20 percent). Finally, many tax shelters permit a taxpayer to leverage his investment (*i.e.*, to use borrowed funds to pay deductible expenditures), thereby maximizing the tax benefit of deductibility. What follows is a general description of the elements of a tax shelter.[1]

Deferral

Deferral generally involves the acceleration of deductions, resulting in the reduction of a taxpayer's tax liability in the early years of an investment, instead of matching the deductions against the income that is eventually generated by the investment. Deferral also occurs when, for example, taxpayers funnel U.S. investments through a foreign corporation the earnings of which are not subject to current U.S. tax.

The effect of deferral is that the taxpayer grants himself an interest-free loan from the Federal Government, which loan is repayable when, and as, the tax-shelter investment either produces taxable income or is disposed of at a gain. For example, consider the case of a taxpayer who, at the end of year one, realizes that he or she requires a $1,000 loan for use in year two. If this taxpayer obtained a one-year loan when the prevailing rate of interest is 15

[1] The elements of a tax shelter investment are fully described in the pamphlet "Overview of Tax Shelters" (JCS-22-75), published in 1975 by the staff of the Joint Committee on Taxation.

percent (compounded annually), he or she would repay $1,150 at the end of year two. If, instead of obtaining a loan, the taxpayer were to invest in a tax shelter that generated a current deduction of $2,000 in year one, and the underlying investment were not expected to generate $2,000 of income until the following year, the taxpayer would have a $1,000 tax savings (at the 50-percent maximum rate of tax). In the latter case, at the end of year two, instead of repaying a lender $1,150, the taxpayer would incur a Federal income tax of $1,000 on the $2,000 of income generated by the investment. Obviously, the longer the deferral period, the greater the benefit obtained by the taxpayer. Alternatively, the taxpayer could invest the $2,000 of income in another tax shelter to provide a "rollover" or further deferral of the tax.

In some cases, deferral is obtained by the use of legislatively sanctioned tax benefits, such as, for example, the Accelerated Cost Recovery System (ACRS) or the expensing of intangible drilling costs. Other benefits associated with deferral reflect the tax law's treatment of the time value of money, and are discussed at length in Part IV below.

Conversion

The second aspect of most tax-shelter investments is the "conversion" of ordinary income to tax-favored income (such as capital gains or income that is otherwise subject to a reduced rate of tax). Conversion is achieved where, for example, a taxpayer takes an accelerated deduction against ordinary income, and the income that is eventually generated by the investment is taxed at the 20-percent capital gains rate. Also, if the taxpayer is in a lower tax bracket in the year when the investment generates income, he or she effectively "converts" the tax rate.

In the case of certain deductions (*e.g.*, depreciation deductions), as described in Part III below, Congress has dealt with conversion by requiring a portion of the gain on disposition of an investment to be treated as ordinary income (rather than capital gains). However, the current "recapture" rules apply only to prevent the conversion of some ordinary income to capital gains, and do not apply to all tax shelters.

Leverage

The use of borrowed money to fund a tax-shelter investment may result in an economic benefit, as well as a tax benefit. Generally, a taxpayer will borrow an amount of money that equals or exceeds his or her equity investment. From an economic viewpoint, to the extent that a taxpayer can use borrowed money to fund a tax-shelter investment, he or she can use his or her own money for other purposes (such as other investments), resulting in an increase in earnings if the investments are profitable. From a tax viewpoint, borrowed funds generally are treated in the same manner as a taxpayer's own money that he or she puts up as equity in the investment. Because a taxpayer is allowed deductions for expenditures paid with borrowed funds, the tax benefits of deductibility (*e.g.*, deferral) are maximized.

Because interest payments on indebtedness are themselves deductible, a debt-financed investment provides an additional tax advantage relative to an equity-financed investment. This is so because the deductibility of interest payments lowers the effective tax rate [2] on the income generated by the investment.

The benefits of leveraging a tax-shelter investment can be illustrated by a simple example. Assume that a 50-percent bracket taxpayer invests $10,000 of his or her own money, and borrows $90,000 to fund a $100,000 investment. If the investment generates a "tax loss" of $30,000 in the first year by reason of accelerated deductions, the taxpayer will save taxes of $15,000 on his or her investment of $10,000.

The significance of leverage increases where a taxpayer obtains a nonrecourse loan (i.e., where there is no personal liability to repay the loan). The benefits associated with the use of nonrecourse loans are discussed below in connection with the partnership rules.

Scope of tax shelter cases

Tax shelter cases require substantial resources of the Internal Revenue Service and the Tax Court. As of September 30, 1982, 284,828 returns with tax shelter issues were in the Internal Revenue Service examination process, an increase of 36,000 returns over the prior year. During 1982, 71,793 returns were closed after examination, with recommended tax and penalties totaling $954.2 million.[3]

On January 1, 1982, the Tax Court had 10,522 tax-shelter cases docketed. At the end of 1982, that number had increased to 15,693. During the 10-month period beginning March 1, 1982, 6,780 tax shelter cases were received by the Tax Court and 2,362 cases were disposed of.

According to a private register of tax shelters, taxpayers invested $8 billion in "tax-advantaged investments" (excluding IRAs and municipal bonds) in 1981 and $9 billion in 1982, and will invest an estimated $11 billion in 1983. According to a related newsletter, investments in public tax shelters (i.e., limited partnerships registered with the Securities and Exchange Commission) for the first quarter [4] of 1983 were 53 percent higher than they were one year ago. This increase appears partially attributable to the improvement in the oil and real estate markets, two major tax shelter areas.

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[2] The effective tax rate on income derived from an investment is the amount of tax paid per dollar of income earned. The concept of an "effective tax rate" is explained more fully in the pamphlet "Analysis of Proposals for Depreciation and Investment Tax Credit Revisions, Part I: Overview" (JCS-18-81), published in 1981 by the staff of the Joint Committee on Taxation.

[3] 1982 Annual Report, Commissioner and Chief Counsel, Internal Revenue Service, p. 11.

[4] The Stanger Register: Tax Shelter Profiles (Robert A. Stanger & Co.), Feb. 1983, pp. 1-9; The Stanger Report: A Guide to Tax Shelter Investing (Robert A. Stanger & Co.), April 1983, p. 2.

III. SUMMARY OF INCOME TAX PROVISIONS DESIGNED TO LIMIT TAX SHELTERS

Beginning in 1969, Congress has enacted substantive and procedural income tax provisions that deal with tax-shelter investments. Following are brief summaries of the major changes contained in the Tax Reform Act of 1969, the Revenue Act of 1971, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981 (ERTA), and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Minimum tax

In 1969, a minimum tax was enacted which applied to both individuals and corporations. The original minimum tax was an "add-on" tax which applied to a taxpayer whose defined tax preferences exceeded his regular tax by more than $30,000. In 1976, the tax rate was increased from 10 percent to 15 percent and the exemption greatly reduced. Since that time, the individual minimum tax has been amended several times.

TEFRA repealed the individual "add-on" minimum tax and replaced it with an "alternative" minimum tax beginning in 1983. This tax requires all individuals to pay a tax of at least 20 percent on their "economic" income (i.e., taxable income plus tax preferences) in excess of an exemption level of $40,000 for married couples and $30,000 for single taxpayers. The corporate "add-on" minimum tax was retained.

Investment interest limitation

Prior to 1969, a taxpayer was able to reduce tax on income from the taxpayer's professional or other income-producing activities by voluntarily incurring interest deductions attributable to tax-shelter investments. The 1969 Act limited the deduction for interest paid or incurred by an individual (and other noncorporate taxpayers) on funds borrowed to purchase or carry an investment. Under the 1969 Act, the deduction for investment interest was limited to 50 percent of the interest in excess of the taxpayer's net investment income, long-term capital gains, plus $25,000. The 1976 Act further limited the deduction for investment interest to $10,000 per year plus the taxpayer's net investment income. Disallowed interest deductions are carried over and may be deducted in future years.

Investment tax credit: Noncorporate lessor limitation

The 1971 Act, which reinstated the investment credit, imposed limitations on the availability of the investment credit to individual (and other noncorporate) lessors. This provision was enacted to limit the extent to which individuals are able to utilize the tax benefits of leasing transactions (*i.e.*, the credit, depreciation deductions, and interest deductions) to shelter other income. Under present law, the investment credit is available to noncorporate lessors in only two situations: (1) if the leased property was manufactured or produced by the lessor, and (2) in the case of a short-term lease, where the lease term (including renewal options) is less than 50 percent of the useful life of the property, and for the first 12 months after the transfer of the property to the lessee, the sum of certain deductions allowable to the lessor with respect to the property exceeds 15 percent of the rental income produced by the property. The credit not usable by a noncorporate lessor may be passed through to a corporate lessee (sec. 48(d)).

At-risk rules

Loss limitation.—As part of an effort to limit abusive tax shelters, the 1976 Act enacted an at-risk limitation for deductions from an economic activity. The at-risk limitation is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in the activity. The limitation applies to all activities except the holding of real property.[5]

Under the at-risk rules, a taxpayer may deduct losses (including depreciation) from an activity only to the extent of his or her aggregate at-risk investment in the activity at the close of the taxable year. In general, the at-risk investment includes (1) cash and the adjusted basis of property contributed by the taxpayer to the activity, and (2) amounts borrowed for use in the activity for which the taxpayer has personal liability for repayment. This amount is generally increased by the taxpayer's share of net income from the activity and decreased by its share of losses. At-risk investment does not include the proceeds of nonrecourse loans. The at-risk amount also excludes (1) amounts borrowed from other participants in the activity, (2) amounts borrowed from related parties, and (3) amounts with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements. However, the at-risk rules often will not apply, for example, where the taxpayer is personally liable on a note for the purchase of property, which is then leased to a credit-worthy lessee under a long-term lease.

The at-risk rules are applicable to individuals and certain closely held corporations.[6] An exception is provided for certain equipment leasing activities (not including the leasing of master sound recordings and other literary or artistic properties) engaged in by closely held corporations. In the case of partnerships or S corporations, the rules are applicable at the partner or shareholder level. Thus, a partner is considered at-risk with regard to a loan to the partnership only if the partner is personally liable for repayment.

Investment tax credit.—ERTA added a new at-risk limitation with respect to the investment tax credit (ITC). The limitation ap-

[5] As enacted in 1976, the at-risk rules applied to four specific activities: (1) farming; (2) oil and natural gas exploration; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property. The Revenue Act of 1978 extended the at-risk rules to other activities.

[6] The Revenue Act of 1978, expanded the at-risk rules to cover closely held corporations. A corporation is subject to the at-risk rule if more than 50 percent in value of its outstanding stock is owned (directly or indirectly) by 5 or fewer individuals.

plies to the same activities, and to the same taxpayers, as the loss deduction at-risk rules.

Under the ITC at-risk rule, the basis of property for ITC purposes may not exceed the taxpayer's at risk investment in the property at the close of the taxable year. In general, the amount at risk for ITC purposes is determined on the same basis as under the loss deduction rules. However, an exception is provided for amounts borrowed from certain "qualified lenders" (including banks, savings institutions, and other commercial lenders) or from governmental authorities. A taxpayer is considered at risk with regard to these amounts if he or she has at least a 20 percent at-risk investment in the property (determined without regard to the exception).[7] The law also provides an exception for property used in connection with various alternative energy sources.

Farm operations

Farm operations are governed by special tax provisions, many of which confer tax benefits on farming activities. Under prior law, the special tax rules available to farmers were utilized by passive investors who were motivated, in large part, by a desire to use the special farming rules to shelter income from other sources. The 1976 Act contained several provisions designed to reduce the tax incentives for passive investors to invest in syndicated farming operations. In general, the 1976 Act limits the deductions of farming syndicates that serve as tax-shelter vehicles for passive investors.

The 1976 Act limits the deductibility of prepaid feed, etc. by a farm syndicate, requires the capitalization of the pre-production expenses of a farm syndicate in growing fruits or nuts and requires the use of the accrual method of accounting by farm corporations, other than certain small corporations and family corporations. The farm syndicate rules are intended to deny the farm tax benefits to persons who are not actually engaged in the business of farming.

Recapture rules

The recapture rules under present law prevent the conversion of ordinary income to capital gains, by requiring gain on a sale or disposition of certain property to be taxed as ordinary income (rather than capital gains), to the extent depreciation deductions were taken with respect to the property.

Real estate.—Among the tax benefits derived from a real estate tax shelter are accelerated depreciation deductions. The 1969 Act imposed more stringent recapture rules on real estate investments, requiring a larger portion of gain attributable to accelerated depreciation deductions to be taxes as ordinary income. However, under the 1969 Act, residential real property received favorable treatment. With limited exceptions, the 1976 Act provided for complete recapture of all depreciation in excess of straight-line depreciation, regardless of whether the property was residential real property. However, unlike personal property, only accelerated depreciation deductions are recaptured.

[7] In the case of partnerships and S corporations, the 20-percent test is applied at the partner or shareholder level.

Finally, under the Accelerated Cost Recovery System enacted by ERTA, all gain or disposition of nonresidential real property whose cost is recovered on an accelerated basis over the allowable 15-year period will be treated as ordinary income, to the extent of recovery allowances previously taken under the prescribed accelerated method. Thus, in the case of nonresidential property, taxpayers may either use straight-line recovery with no recapture, or accelerated recovery with recapture of all recovery deductions to the extent gain is recognized.

Intangible drilling and development costs.—Under present law, an investor in an oil and gas tax shelter can defer tax liability by deducting intangible drilling and development costs against ordinary income. The 1976 Act contained a recapture provision that prevents the conversion of the ordinary income against which such deductions are taken to capital gains. The amount subject to recapture is the amount deducted for intangible drilling and development costs, reduced by the amounts which would have been deductible had those costs been capitalized and deducted through cost depletion.

Production costs

The 1976 Act contained a provision that requires a taxpayer (other than a corporation that is not an S corporation or a personal holding company) to capitalize production costs of producing films, sound recordings, books, or similar property, and to deduct such costs over the life of the income stream generated by the production activity. This provision prevents a taxpayer from accelerating production costs, and, thereby, producing a mismatching of income and expenses attributable to the income.

Sports franchises: Player contracts

Under prior law, the purchaser of a sports franchise attempted to allocate a large portion of the purchase price to player contracts that could be depreciated. The amount allocated to player contracts usually represented a large portion of the purchase price, and could be depreciated over a short life. The depreciation deductions taken in the early years usually exceeded the income generated by the franchise and, thus, sheltered other income. On the other hand, upon a subsequent sale of the sports franchise, the seller attempted to allocate most of the sales price to other assets (such as good will) that were not depreciable and, therefore, not subject to recapture. Thus, a sports franchise tax shelter could be used to obtain conversion, as well as deferral.

Under the 1976 Act, on the disposition of a sports franchise (or the creation of a new franchise), the amount of consideration allocated to a player contract must not exceed the sum of the adjusted basis of the contract in the hands of the transferor and any gain recognized by the transferor on the transfer. On a sale or exchange of a franchise, there is a presumption that not more than 50 percent of the sales price is allocable to player contracts. Further, the 1976 Act provided special recapture rules for depreciation deductions taken with respect to player contracts.

Partnerships

The Tax Reform Act of 1976 contained numerous provisions relating to the taxation of partnerships and their partners.

Election to expense certain depreciable assets.—The Tax Reform Act of 1976 amended the provision relating to additional first-year depreciation (as subsequently amended by ERTA, an election to expense certain depreciable business assets) to require a limitation on the amount of the deduction to be applied to the partnership and to each partner.

Capitalization requirements.—The 1976 Act amended the rules governing guaranteed payments to a partner, (i.e., payments made by the partnership to a partner for services or for the use of capital that are determined without regard to partnership income), to require such payments to be capitalized if such payments to a party who is not a partner would have to be capitalized. The Act also required costs of organizing a partnership or promoting or selling interests when incurred by the partnership, to be capitalized, subject to an election to amortize organization fees over a period of 60 months or longer.

Allocation of income and loss.—The 1976 Act limits allocations of partnership income or loss to a partner to the portion allocable to the part of the taxable year during which he is a partner. Further, the 1976 Act amended the provisions relating to allocations of income and loss to provide that such allocations will be controlled by the partnership agreement, unless they do not have a substantial economic effect, in which case the allocation is to be made in accordance with the parners' interests in the partnership. Prior to the Act, the allocation provisions referred only to items of partnership income, loss, deduction or credit and it was unclear whether they applied to allocations of overall income or loss. Prior to the Act the allocation in the partnership agreement was not controlling only if the principal purpose of the allocation was evasion or avoidance of tax. The "substantial economic effect" test has been adopted under Treasury regulations in applying the principal purpose test of prior law.

At-risk provision.—The 1976 Act imposed limitations to disallow partnership losses attributable to nonrecourse liability except for investments in real property (other than mineral property). These restrictions were incorporated into the general at-risk rules of section 465 by the Revenue Act of 1978 and the special partnership restrictions were repealed.

Prepaid interest

Under the general rule of section 163(a), a taxpayer using the cash method of accounting can claim a deduction for interest paid within his taxable year. Prior to the 1976 Act, prepaid interest was used in many types of tax shelters to defer tax on ordinary income. In many cases, a deduction for prepaid interest was generated without adverse cash flow consequences by borrowing more than was needed and promptly repaying the excess as "prepaid interest." Under the 1976 Act, if a taxpayer uses the cash method of accounting, interest that is prepaid but that is properly allocable to a later taxable year must be deducted ratably over the period of the loan. This rule applies to all taxpayers (including individuals, corporations, estates, and trusts), and covers interest paid for personal, business, or investment purposes. Once prepaid interest has been allocated to the proper periods, such interest is then subject to other applicable limitations (*e.g.*, the limitations on the deduction of investment interest).

Construction-period interest and taxes

Under prior law, amounts paid for interest and taxes attributable to the construction of real property were allowable as current deductions, even if there was no income from the property. The ability to take current deductions for construction-period interest and taxes permitted the deferral of tax on other income. Under the 1976 Act, a taxpayer (other than a corporation that is not an S corporation or a personal holding company) is required to capitalize construction-period interest and taxes attributable to the construction of real property (other than low-income housing). The capitalized expenditures are amortized over a 10-year period. TEFRA extended the scope of the capitalization rule for construction-period interest and taxes to require all corporations to capitalize construction-period interest and taxes attributable to the construction of nonresidential real property.

Straddles

Prior to ERTA, commodity straddles and straddle-related transactions were used to defer tax liability and to convert ordinary income or short-term capital gain into long-term capital gain. Straddles generally involved both the buying and selling of similar items, and then realizing the loss in one year and the gain in the subsequent year. The 1981 legislation adopted a number of provisions to deal with these issues.

Gains or losses on straddles.—Under ERTA, all commodity futures contracts are marked-to-market at year end and treated as if 60 percent of the capital gains and losses on them were long-term and 40 percent were short-term. Net losses under the mark-to-market rule may be carried back three years against mark-to-market gains. This treatment was extended by the Technical Corrections Act of 1982 to cover certain cash settlement contracts and foreign currency contracts traded in the interbank market.

In the case of straddles involving property other than futures that are marked-to-market, ERTA allows straddle losses only to the extent such losses exceed the unrecognized gains on offsetting positions. Disallowed losses are deferred. The wash sale and short sale principles of present law are extended to straddles by regulation. The loss deferral rule applies to actively traded personal property but not to such property as real estate, stock and short-term stock options. Hedging transactions are excepted from this provision.

Because short-term stock options are excepted from these rules, straddle transactions in these options have become widely used since the enactment of ERTA.

Interest and carrying charges.—Under ERTA interest and carrying charges for purchasing or carrying commodity investments are required to be added to the basis of the commodity if it is part of a straddle. Hedging transactions also are excepted from the capitalization rule.

Hedging exception.—ERTA excepts hedging transactions from the mark-to-market, loss deferral and capitalization rules. Syndicates are not entitled to the hedging exemption. A requirement that hedging transactions be entered into in the normal course of the taxpayer's trade or business prevents persons otherwise entitled to the hedging exemption from relying on that exemption in connection with transactions whose motivation is the deferral or avoidance of tax liability. Taxpayers are attempting to structure transactions to qualify losses not entered into in the normal course of business as ordinary losses.

Characterization of Treasury bills.—Prior to ERTA gain and loss on certain governmental obligations (including Treasury bills) issued at a discount and payable at a fixed maturity date less than one year from issue date were treated as ordinary income and loss. Under ERTA such obligations are defined as capital assets and the discount on these obligations as ordinary income.

Dealer identification of securities held for investment.—Prior to ERTA dealers were required to identify securities held as investments within 30 days of the date of acquisition. ERTA requires identification of securities by the close of business on the date of acquisition. Floor specialists are allowed seven business days to designate stock for which they are registered specialists.

Sale or exchange of capital assets.—Prior to ERTA for gain or loss to be capital gain or loss, it must have resulted from the sale or exchange of a capital asset. ERTA provides that taxable dispositions of capital assets which are commodity-related property are treated as sales or exchanges.

Original issue discount obligations

Prior to TEFRA, holders of corporate bonds issued at a discount were required to include the total discount in income on a straight-line basis over the life of the bond and corporate issuers were permitted to deduct discount on the same basis. As amended by TEFRA, the original issue discount rules require the income inclusion and deduction at a constant interest rate, i.e., at a compound rate which parallels the manner in which interest would accrue on interest-paying nondiscount bonds. The original issue discount rules were also extended by TEFRA to cover noncorporate obligations other than those issued by individuals.

Stripped-coupon bonds.—Prior to TEFRA, some taxpayers took the position that a disposition of the corpus without the coupons with respect to coupon-bearing bonds resulted in income deferral by allocating the entire cost of the bond to the stripped corpus, producing an artificial loss. The stripped coupons in the hands of a purchaser became capital assets which, if disposed of prior to redemption, could result in capital gain. Under TEFRA, upon a disposition which separates ownership of the bond and the detached coupons, the stripped corpus and detached coupons are treated as obligations issued by a corporation on the date of disposition and are subject to the periodic income inclusion applicable to original issue discount bonds. The basis of the bond is allocated to the com-

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ponents, i.e., the corpus and each coupon, in accordance with their relative fair market values on the date of disposition.

Reorganizations.—Prior to the Technical Corrections Act of 1982, the original issue discount rules did not apply to obligations issued in a corporate reorganization. New obligations issued in exchange for a corporation's outstanding obligations in a recapitalization could provide for the deferral until maturity of payments exceeding both the issue price and the fair market value of the old obligations. Some issuers claimed deductions for interest accruals prior to payment without regard to the limitations applicable to the newly issued obligations under original issue discount rules. There was no taxable income to cash basis holders until maturity unless they disposed of the bonds earlier. This treatment would result in a substantial mismatching of the holder's income and the deduction under the claimed treatment by the issuer. The original issue discount rules were amended by the Technical Corrections Act to remove the exception for recapitalizations and other tax-free reorganizations.

Audit provisions

In 1982, new audit procedures were enacted for partnerships and S corporations. These provisions are effective for taxable years beginning after 1982. Under these provisions, the tax treatment of partnership and S corporation income, deductions, credits, etc. will be determined administratively and judicially in a single proceeding at the entity level. Partners and shareholders generally must be notified of the proceedings and may participate. The partners and shareholders are bound by the determinations and may not contest the determinations in separate proceedings.

Because these proceedings were not effective for years beginning before 1983, there is no experience as to the effect on tax shelters.

Penalties

Overvaluation penalty.—ERTA provided a graduated addition to tax applicable to certain income tax "valuation overstatements." The addition to tax applies to the extent of any underpayment of income tax attributable to such an overstatement, in the case of a taxpayer who is an individual, a closely held corporation, or a personal service corporation.

If there is a valuation overstatement, the following percentages are used to determine the applicable addition to tax:

If the valuation claimed is the following percent of the correct valuation—	The applicable percentage is—
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

The penalty may be waived if the valuation had a reasonable basis and was made in good faith. The penalty is effective for returns filed after December 31, 1981.

Addition to negligence and fraud penalties.—Prior to ERTA, an addition to tax, or penalty, with respect to certain tax underpayments due to negligence or civil fraud, was imposed. That penalty for negligence was 5 percent of any underpayment that is due to negligent or intentional disregard for rules and regulations. The penalty for fraud was 50 percent of any underpayment due to fraud.

ERTA imposed a nondeductible addition to tax equal to 50 percent of the interest attributable to that portion of an underpayment which is attributable to negligent or intentional disregard for rules or regulations. TEFRA added a similar addition to tax in the case of fraud.

Substantial understatement.—Under TEFRA, a penalty of 10 percent is imposed on any substantial understatement of income tax. For this purpose, an understatement is the excess of the amount of income tax imposed on the taxpayer for the taxable year, over the amount of tax shown on the return. A substantial understatement of income tax exists if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for the taxable year, or $5,000 ($10,000 for corporations other than S corporations and personal holding companies).

The amount of the understatement will be reduced by the portion of the understatement that is attributable to (1) the treatment of any item for which there is or was substantial authority, or (2) any item for which there was adequate disclosure of the relevant facts on the return. In the case of a tax shelter, the reduction when there is substantial authority will apply only to the portion which the taxpayer reasonably believed was more likely than not to be the correct treatment. The disclosure defense is not available in a tax shelter case. A tax shelter is defined as a transaction for which evasion or avoidance of income tax is the principal purpose.

The Secretary may waive all or a part of the penalty on a showing by the taxpayer that there was a reasonable basis for the understatement and the taxpayer acted in good faith. This penalty is in addition to all other penalties provided by law.

The penalty is effective with respect to returns which have a due date after 1982.

Penalty for promoting abusive tax shelters, etc.— Under TEFRA, a new civil penalty was imposed on persons who organize or sell any interest in a partnership or other entity, investment, plan or arrangement, when, in connection with such organization or sale, the person makes or furnishes either (1) a statement, which the person knows or has reason to know is false or fraudulent as to any material matter with respect to the availability of any tax benefit said to be available by reason of participating in the investment, or (2) a gross valuation overstatement as to a matter material to the entity which is more than 200 percent of the correct value.

The penalty for promoting an abusive tax shelter is an assessable penalty equal to the greater of $1,000 or 10 percent of the gross income derived, or to be derived, from the activity.

The Secretary is given authority to waive all or part of any penalty resulting from a gross valuation overstatement upon a showing that there was a reasonable basis for the valuation and the valuation was made in good faith. This penalty is in addition to all other penalties provided for by law.

This provision took effect September 4, 1982.

Action to enjoin promoters of abusive tax shelters.— TEFRA permits the United States to seek injunctive relief against any person engaging in conduct subject to the penalty for organizing or selling abusive tax shelters. Venue for these actions generally is the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the promoter penalty.

This provision took effect September 4, 1982.

The IRS has been successful in obtaining two injunctions restraining the seller from promoting illegal trust schemes under these provisions.[8] Two more civil suits have been instituted by the government to enjoin the selling of certain tax shelters involving the leasing of master plates for stamps and the sale of a trust scheme.

[8] *U.S.* v. *Hutchinson,* 83-1 USTC ¶ 9322 (S.D. Cal.) (Apr. 6, 1983); *U.S.* v. *Buttorff,* 83-1 USTC ¶ 9342 (N.D. Tex.) (Apr. 13, 1983).

IV. TIME VALUE OF MONEY

From an economic viewpoint, the present value of a future expense or receipt is less than the face amount thereof. The treatment of the timing of income and deductions attributable to original issue discount is one area in which the income tax laws deal with the time value of money. Another is section 483 which imputes interest in a deferred-payment sales contract that has an unstated interest element. However, in many cases, a taxpayer is not required to take the time value of money into account in computing taxable income. Thus, by use of an advantageous accounting method, contractual arrangement, or other device, a taxpayer can obtain the economic equivalent of an interest-free loan from the Federal Government simply by currently deducting the full amount of a payment to be made in the future.

Time value concept

The present value (or cost) of a receipt or expense deferred one year is equal to the amount that will grow, at the prevailing interest rate, in one year to the face amount of the receipt or expense. The more distant a future expense or receipt, the lower its present value. For example, at an interest rate of 10 percent (compounded annually), the present value of $1 deferred one year is 90.9¢ (*i.e.*, 90.9¢ invested at a 10-percent interest rate will grow to $1 in one year). If the receipt of $1 were deferred two years at a 10-percent interest rate, the present value of the receipt would be 82.6¢ (the amount required today that will grow to $1 by the end of two years).[9]

Significance of accounting method

Taxpayers generally compute taxable income and file Federal income tax returns on an annual basis. In computing taxable income, most taxpayers use either the cash method of accounting or the accrual method of accounting. A taxpayer's choice of accounting method can affect the timing of both income and deductions.

Cash method of accounting.—Under the cash method of accounting, receipts are included in income for the year when the income is actually or constructively received, and expenditures are deducted for the year in which they are actually paid.[10]

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[9] Conversely, for any annual rate of interest, the future amount that will be exchangeable for any present value can be computed: at 10-percent simple interest, $1 received today will be worth $1.10 at the end of one year.

[10] A cash-basis taxpayer may be required to use the accrual method of accounting with respect to certain items of income or deduction. For example, if a cash-basis taxpayer acquires an original issue discount bond (where the issue price is less than the redemption price) the taxpayer would be required to accrue the daily portions of original issue discount during the period the bond is held (sec. 1232A). Also, section 461(g) requires a cash-basis taxpayer who prepays interest to treat the interest as paid in the year (or years) to which it is properly allocable.

Many tax-shelter promoters tout the availability of deductions for prepaid expenses (paid with borrowed funds). Some tax-shelter offerings rely on *Zaninovich* v. *Commissioner*, 616 F.2d 429 (9th Cir. 1980), as authority for deducting prepaid expenses that do not result in the creation of an asset having a useful life of more than one year. *Zaninovich* was recently cited with approval as authority for deducting prepaid rent by the Supreme Court in *Hillsboro National Bank* v. *Commissioner*, U.S.—(Mar. 7, 1983).[11] The Supreme Court's citation of *Zaninovich* provides some support for the position that the "one-year" rule adopted therein may be relied upon.

Taxpayers may argue that the rationale of *Zaninovich* applies to other types of expenses, such as prepaid breeding fees. Thus, cash-basis taxpayers may retain the ability to shelter other income by prepaying expenses (other than interest subject to section 461(g)). To deal with this problem, consideration may be given to extending the rule of section 461(g) to prepayments of items other than interest.

Accrual method of accounting.—Under the accrual method of accounting, income is included, and expenditures are deductible, for the taxable year when all events have occurred which fix the right to receive such income or establish the liability to pay such expenditures, and the amount thereof can be determined with reasonable accuracy.[12] In general, an accrual-basis taxpayer can deduct the face amount of an accrued expense if the "all events" test is met.

The "all events" test may not require that the taxpayer have a current liability, or that the ultimate recipient be known, in order to deduct an expense.[13] Thus, except for the "at-risk" rules (discussed in part III), present law may be inadequate to prevent a taxpayer from deducting accrued expenses with respect to which the taxpayer has no current liability.

Apart from the vagaries of the "all events" test, the accrual rules overstate the true cost of future expenses by failing to take the time value of money into account. An accrual-basis taxpayer in the 50-percent bracket can obtain a tax savings with a present value of $1 by taking a $2 current deduction for an expense to be paid in the future, notwithstanding the fact that the present value (or cost) of the future payment is less than $2, and the present value of reduction in future tax liability is less than $1.[14]

A requirement that taxpayers take the time value of money into account in computing deductions for accrued but unpaid expenditures would raise several unresolved issues: (1) what the appropri-

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[11] Although the *Hillsboro* case turned on the application of the tax benefit rule, in reaching its decision, the Supreme Court determined that a rental paid 30 days in advance was properly deducted under *Zaninovich.*

[12] In certain circumstances, an accrual-basis taxpayer is prevented from taking a current deduction for accrued expenses that are not paid within a specified time. For example, if an accrual-basis taxpayer fails to pay an accrued expense within 2-1/2 months after the close of its taxable year, and the amount accrued is payable to a related person who uses the cash method, then section 267 would disallow a deduction for the expense.

[13] Thus, in *Ohio River Colleries Co.* v. *Commissioner*, 77 T.C. 1369 (1981), the Tax Court held that the accrual-basis taxpayer could deduct the reasonably estimated costs of its obligation to reclaim strip-mined land during the mining operation, even though reclamation had not started and the taxpayer had no present liability to perform the work. The Treasury department has testified that they believe the case was incorrectly decided.

[14] To illustrate this point, consider that the taxpayer in this example could set aside 90.9¢ today at a 10-percent interest rate, and earn the $1 required to pay the deferred tax liability by the end of one year.

ate discount rate should be (*e.g.*, the interest rate offered by the local savings bank or the prime rate available to the most creditworthy commercial borrowers), (2) how often taxpayers should be required to compound interest (*e.g.*, section 6622 requires all interest payable under the internal revenue laws to be compounded on a daily basis, while the bond market normally calculates yields to maturity by compounding on a semi-annual basis), (3) whether taxpayers should be able to agree within a range of interest rates where valuation of property or services are at issue, and (4) how should accrued income be treated.

The accrual rules could be amended to provide that an expense is not currently deductible unless the recipient of the payment is known and the taxpayer has a present liability to make the payment. Another alternative would be to require taxpayers to report certain deferred payment transactions using the cash method of accounting.

Accelerated cost recovery

In general, income taxes are paid on the basis of net (or taxable) income. In computing net income, deductions are allowed for ordinary and necessary expenditures incurred in a trade or business or for the production of income. However, capital expenditures (i.e., expenditures for assets with useful lives extending substantially beyond the close of the year) are not deductible in the year the expenditure is made. Under present law, capital costs generally are recovered under the Accelerated Cost Recovery System (ACRS).

ACRS is a system for recovering capital costs using accelerated methods over predetermined recovery periods. Congress intended ACRS to serve as an investment stimulus; thus, ACRS does not reflect only the annual loss in value of property (i.e., the true measure of a taxpayer's economic cost). Rather, ACRS concentrates larger deductions in the earlier years of the property's use and, thus, accelerates the return of the taxpayer's investment in the asset.

Under ACRS, the acceleration of cost recovery allowances results in net cash flows (i.e., economic income less tax on that income) that are larger in the early years of the property's use. Thus, because the cash flows are received earlier rather than later, the present value of the net income generated by the property will be greater than if the taxpayer were required to measure the income from the property by reference to the economic decline in the value of the property.

Deferred-payment contracts

Transactions in which payment for the purchase of property, rents, or services is deferred afford taxpayers the opportunity to reduce the present value (or cost) of the tax liabilities of the parties thereto.

Deferred-payment sales.—Under section 453, all sales of property (other than dealer sales of personal property) in which at least one payment is to be received by the seller after the close of the taxable year of the transaction must be reported under the installment method, unless the seller elects not to have that method apply.[15] Under the installment method, a seller of property postpones recognition of gain until the receipt of payments from the purchaser, recognizing the gain ratably as payments are received. The purpose of section 453 is to make it easier for installment sellers to pay their taxes by deferring gain recognition until cash is received. However, in view of the time-value of money, one of the effects of section 453 is to reduce the effective tax burden on taxpayers who receive deferred payments.

By way of example, if a seller (in the 50-percent bracket) sold a building, with an adjusted basis of $20,000, for $100,000 in cash, assuming no depreciation recapture, it would realize $80,000 of capital gain and owe a current tax of $16,000. By contrast, if the taxpayer received a $20,000 downpayment and an $80,000 note, payable at the rate of $20,000 a year in each of the succeeding four years, the taxpayer's current tax liability would be only $3,200 (*i.e.*, the tax on 80 percent of the $20,000 actually received). Thereafter, the installment seller would pay a $3,200 tax in each of the four succeeding years. The present value of the future tax liability will be less than the tax due from a cash sale. While the installment seller defers the recognition of gain, the buyer is entitled to a cost basis of $100,000, regardless of whether the building is paid for with cash or with a note. ACRS deductions based on the $100,000 purchase price may be used by the buyer to reduce its tax liability.

Deferred rents.—Under the accrual rules, an accrual-basis lessee can maximize the benefits of rental deductions by entering into a lease that provides for deferred rentals. The Internal Revenue Service (IRS) has ruled that an accrual-basis lessee can deduct deferred rentals on a straight-line basis, so long as the "all events" test is met. Rev. Rul. 70-119, 1970-1 C.B. 120. In Rev. Rul. 70-119, a 21-year lease of improved real property called for an annual ground rent plus an amount equal to six percent of the cost to the lessor of buildings on the land. The lessee was permitted to withhold portions of the stipulated rentals during the first three years of the lease; the rentals withheld were payable, in all events, ratably during the remaining 18 years of the lease term. The IRS ruled that, under the accrual rules, the rentals withheld by the taxpayer each year were deductible in the year in which they were accrued but withheld. Thus, if an accrual-basis lessee amortizes the aggregate rental on a straight-line basis, notwithstanding the deferral of a portion of the rentals, the tax deductions in the early years will shield other income (which can be put to other use). Similar issues arise in the context of accruing deductions currently for deferred fees.

Accounting for interest

Section 163(a) provides that there "shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." For section 163(a) to apply, assuming that there is a valid indebtedness of the taxpayer, the item sought to be deducted must be "interest" (as distinguished from other expenses), and the item must be "paid or accrued" within the taxable year.

[15] Installment sales of dealer property may qualify for installment treatment under section 453A.

Interest" is commonly defined as the amount charged for the use or forbearance of money.[16] There are several income-tax provisions dealing with the treatment of items that serve as payments for the use of money but are not labeled as interest, or which are not structured as a percentage of the principal amount due, as well as the timing of deductions for such items. However, because the scope of the statutory provisions that address the treatment of unconventional items of "interest" is not comprehensive, taxpayers have sought to structure financing arrangements to generate interest deductions that do not reflect the economics of the arrangement. Many of these arrangements attempt to combine the acceleration of interest deductions to the borrower with deferral of its inclusion in income to the lender, who typically is on the cash method. Thus, these schemes often involve a mismatching of deductions to one taxpayer and offsetting income to another.

Original issue discount

Original issue discount (OID) arises when a borrower receives less from the lender than the amount to be repaid to the lender. The difference between the amount received by the borrower and the amount to be repaid (*i.e.*, the OID) is functionally equivalent to an increase in the stated rate of interest, and is intended to compensate the lender for the use of money.[17] Under present law, the issuer of an OID bond (other than a natural person) is allowed deductions for the OID over the life of the bond.[18] Conversely, the holder of the bond is required to include in income the daily portions of OID determined for each day of the taxable year the bond is held.[19] The statutory provisions for the treatment of OID do not apply to an obligation issued in exchange for property unless the obligation is part of a publicly funded issue or the property for which it is exchanged is publicly traded stock or securities. They also do not apply to obligations issued for consideration other than cash or property transfers, such as the performance of services or the use of property.

The rules for amortizing OID parallel the manner in which interest would accrue through borrowing with interest-paying nondiscount bonds.[20] The OID is allocated over the life of the bond through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary thereof). The adjustment to the issue price for each bond period is determined by multiplying the adjusted issue price (*i.e.*, the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity, and then subtracting the interest payable during the bond period. The adjustment to the issue price for any bond period is the amount of the OID allocated to that bond period.

[16] *See Old Colony Railroad Co.* v. *Commissioner*, 284 U.S. 552 (193?).

[17] *See United States* v. *Midland-Ross Corporation*, 381 U.S. 54 (1965) (a case that arose under the 1939 Code).

[18] Sec. 163(e).

[19] Sec. 1232A.

[20] Under pre-TEFRA law, OID was computed on a straight-line basis over the life of the bond. Thus, the issuer of an OID bond was allowed larger deductions in the early years of a bond's term relative to deductions allowed issuers of interest-bearing nondiscount bonds.

Computing interest on deferred-payment sales

Under section 483, if a deferred-payment sales contract does not provide for interest (or calls for an unrealistically low rate of interest), a portion of the deferred payments must be treated as interest income rather than as part of the selling price. The unstated (or imputed) interest element of deferred payments is deductible as interest by the purchaser. Section 483 applies only to payments that are due more than six months after the date of sale, under a contract, with a selling price of more than $3,000, that provides for the payment of one or more installments more than one year from the date of sale.

If interest is provided for in a deferred-payment sales contract, section 483 would not apply unless the rate provided is less than the rate fixed by the Treasury Department, currently 9 percent simple interest. In determining whether the contract contains unstated interest, the present value (at the test rate) of all payments under the contract is required to be computed. If the total payments due more than six months after the date of sale exceeds the sum of the present value of such payments (including the stated interest payments), then interest will be imputed at the rate set by the Treasury, currently 10 percent compounded semi-annually. Once the amount of imputed interest is determined, certain general rules of accounting for interest come into play, including the limitations for investment interest (sec. 163(d)), interest to purchase or carry tax-exempt income (sec. 265(2)), and prepaid interest (sec. 461(g)).

Accounting for interest on installment obligations

The general rule for accounting for interest deductions had been thought to be that the interest deduction can be computed on a straight-line basis, although a different method (such as the "Rule of 78's," described below) is permissible if the underlying contract so provides.[21] This pro rata spreading, in some cases, may result in larger deductions in the early years of an obligation's life than would result if interest were charged in the contract and payable (as is normally the case) on a declining balance. However, on June 6, 1983, the IRS published a revenue ruling that requires interest to be accounted for on the basis of an economic accrual method (with an exception for short-term consumer loan transactions). Rev. Rul. 83-84, 1983-23 I.R.B. 12.

Rule of 78's.—The "Rule of 78's" represents a formula for allocating interest over the term of a loan. The calculation of interest under this rule is illustrated by the following example: In the case of a 30-year loan, interest would be calculated by obtaining the sum of the years (*i.e.*, 1+2+3+4...and so on up to 30), or 465. The debtor would then accrue 30/465 (or 6.45 percent) of the interest in

[21] In *James Brothers Coal Co.*, 41 T.C. 917 (1964), *appeal dismissed per stipulation*, (6th Cir. 1964), the taxpayer borrowed $164,683.61 from a bank for a period of three years, under an arrangement whereby the borrower's obligation to repay the principal sum and interest thereon of $27,172.99 -computed at 5-1/2 percent per annum for the entire three-year period -were evidenced by a single promissory note for $191,856.60, payable in 36 equal monthly installments of $5,329.35 each. The taxpayer accrued and deducted interest using the sum-of-the-month digits method (a variation of the Rule of 78's). However, the Tax Court held that the interest was deemed to accrue in equal installments over the entire period of the loan. *Accord, Lyndell E. Lay v. Commissioner*, 69 T.C. 421 (1977).

the first year, 29/465 (or 6.24%) in the second year, and so on down to 1/465 in the 30th year.

In recent years, the Rule of 78's has been used in tax-shelter schemes to generate extremely large interest deductions. Under one scheme, individual cash-basis taxpayers formed an accrual-basis partnership to buy real property at a price of $30,000. The partnership made a downpayment of only $10,000 and gave a mortgage of $20,000 for the balance of the purchase price. The loan documents stated that the partnership would be required to pay an "add-on" finance charge (*i.e.*, included in the face amount of the note) as computed under the Rule of 78's in case the mortgage were prepaid. Over the 30-year term, the finance charge was $620,155 (an average annual percentage rate of 16.44 percent) on the $20,000 balance. However, the only payments required in the early years of the loan were three $10,000 interest payments in years two, three, and four, ending with a balloon payment of the principal and all unpaid interest at the end of the 30-year term. The promoters of this scheme took the position that the general tax accounting rules permitted the accrual-basis partnership to accrue interest under the Rule of 78's and to pass through the deductions to its cash-basis partners. If this scheme were successful, the cash-basis partners would deduct a total of $40,000 of interest for the first year of the investment, the equivalent of a 200-percent annual interest rate on the unpaid loan balance.

Effect of Revenue Ruling 83-84.—Consistent with the present-law rules for computing OID (secs. 1232A and 163(e)), generally accepted accounting rules, and sound economic conceptions, in Rev. Rul. 83-84 the IRS ruled that the amount of interest attributed to the use of money for a period between payments must be determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of a loan is the amount borrowed, plus interest earned, minus amounts paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made, and is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the indebtedness for a given period. The concept of the true cost of the amount borrowed is referred to as the economic accrual of interest. The concept of economic accrual of interest is applied in the statutory provisions dealing with OID.

Rev. Rul. 83-84 holds that, in the case of a discount obligation, no deduction for interest will be allowed for any year in excess of the amount of the economic accrual of interest. Thus, for a cash-basis taxpayer, any interest paid on a loan in excess of the amount of interest that has economically accrued is not deductible in the year of payment. Similarly, in the case of an accrual-method taxpayer, no deduction will be allowed to the extent that the taxpayer's liability is for interest that does not economically accrue in the current year. Because interest is earned by application of the effective rate of interest over the term of the loan, any agreement that provides that interest is earned in another manner (such as the Rule of 78's) fails to reflect the true cost of borrowing. Thus, an accrual-basis taxpayer can no longer deduct any additional interest attributable to the Rule of 78's computation.

Exception for short-term consumer loan transactions.—In Rev. Proc. 83-40, 1983-23 I.R.B. 22, a companion document to Rev. Rul. 83-84, the IRS provided an administrative exception to the requirement of economic accrual. This exception will apply only to consumer loans, if there is a self-amortizing loan that requires level payments, at regular intervals at least annually, over a period not in excess of five years (with no balloon payment at the end of the loan term), and if the loan agreement provides that interest is earned in accordance with the Rule of 78's.

Possible areas for Congressional consideration

For deferred payment obligations reflecting both stated and unstated interest exchanged for property, whether or not of a kind that is publicly traded, consideration could be given to requirement that both parties use the cash method unless they elect to apply the OID rules to a stated value for the property. In such a case, the portion of the deferred payment to be treated as unstated interest could be determined in accordance with section 483. This treatment, including elective-application of the OID rules, could be applied to obligations issued by natural persons. It could also be extended to obligations issued in exchange for services or for the use of property.

The section 483 imputed interest rules are inapplicable so long as a contract calls for at least 9 percent simple interest. When interest rates are high taxpayers can still disguise interest as part of the selling price so long as the 483 test rate is provided for. Consideration could be given to re-examining these rules.

Finally, regardless of the correctness of the requirement of economic accrual, the new IRS ruling relating to the computation of deductible interest may be challenged by taxpayers. A statutory mandate for the economic accrual of interest could remove any ambiguity.

V. DESCRIPTION OF SPECIFIC AREAS OF PRESENT LAW THAT PROVIDE THE BASIS FOR TAX SHELTERS

This part describes specific areas of present law that provide taxpayers with opportunities to obtain apparently unintended tax benefits, providing the basis for tax-shelter investments. The present-law rules discussed involve: (1) the use of partnerships to achieve tax results not otherwise available; (2) the use of generally available deductions to convert ordinary income to tax-favored income; (3) the overvaluation of property that is used to generate tax deductions; and (4) the use of foreign corporations to avoid the application of U.S. tax rules.

A. The Use Of Partnerships As Tax-Shelter Vehicles

In general

The form of entity most commonly used to maximize tax benefits in a tax shelter investment is a partnership. A partnership does not incur income tax liability; rather individual partners are taxed currently on their share of partnership income and deduct currently their share of partnership losses to the extent of the basis of their partnership interests.

An investor's initial basis in his partnership interest includes the amount he invests and his share, if any, of partnership liabilities. Treasury regulations generally provide that partnership liabilities are allocated in accordance with the partnership ratio for sharing losses. In the case of a limited partner, this amount is limited to any contribution which he may be required to make under the partnership agreement in excess of his original investment. However, where no partner is personally liable for repayment, i.e., nonrecourse liabilities, liabilities are allocated to all partners, including limited partners, in accordance with the ratio for sharing profits.

The allocation of partnership overall income or loss, as well as items of partnership income, loss, deduction or credit is generally determined by the partnership agreement if the allocation has a substantial economic effect. Otherwise, allocations are made in accordance with the partners' interests determined by taking into account all facts and circumstances.

The limited partnership is generally preferred over the general partnership for tax shelter investments because the limited partners, generally passive investors, have limited liability for the debts of or claims against the partnership and because limited partnership interests can be readily marketed. Commencing with the Tax Reform Act of 1976, the limitation of the deduction of losses to amounts for which the taxpayer is personally at risk has diminished this advantage for most activities. However, real estate activities are excepted from the "at risk" limitations and real estate tax shelter investments in the form of limited partnership interests continue to provide deductions for losses attributable to nonrecourse liabilities.

Allocation of income and loss

The requirement that the allocation of partnership income and loss under the partnership agreement must have substantial economic effect has been interpreted to permit the agreement to govern the allocation of deductions only if the partner to whom the allocation is made is liable to restore the amount deducted in the event that the amount deducted corresponds to an economic loss sustained by the partnership.[22] For example, if a partnerhsip acquires property at a cost of $100, allocates partnership losses to partner A, incurs losses of $50 wholly attributable to cost recovery deductions, the property is thereafter disposed of for $50 and the partnership is liquidated, the allocation to partner A of the partnership losses will be allowed only if he is required, except to the extent he has other funds invested in the partnership, to restore to the partnership the $50 deducted. This interpretation of the substantial economic effect requirement has been incorporated in proposed regulations recently issued by the Treasury Department.[23]

Where losses are attributable to nonrecourse liability, their allocation to any partner is without substantial economic effect since, by definition, no partner is liable to restore the amount deducted in the event that it reflects a true diminution in value which is realized upon disposition of partnership property. Only the creditor providing the nonrecourse loan is at risk and the creditor sustains the economic loss in such case. However, the basis of partnership property includes both recourse and nonrecourse indebtedness to acquire the property. Basis reductions attributable to cost recovery deductions may result in taxable gain when the property is disposed of, whether by sale, foreclosure, or other disposition, because the indebtedness, to the extent not previously amortized, is treated as an amount realized when discharged upon such disposition. Reductions in the loan through loan amortization payments are treated as payments of cash to the partners and may also produce taxable gain if they exceed the basis of the partner for his interest in the partnership.

The proposed regulations would allow an allocation of deductions attributable to nonrecourse liability provided the partners to whom such allocation is made are charged with any taxable gain from amortization of the indebtedness or its discharge upon disposition of the property. Since any special allocation of nonrecourse liability is without economic effect, this gain-chargeback rule, in order to comply with the requirements of the statute, must be considered to satisfy the requirement that the allocation accords with the partners' interests in the partnership. However, it excludes from consideration other facts and circumstances, particularly facts bearing on the economic sharing of profits and losses aside from tax consequences, which would be required to be considered in determining

[22] This interpretation of what constitutes a substantial economic effect is based largely on the analysis in *Stanley C. Orrisch* 55 T.C. 395 (1970), aff'd *per curiam* AFTR 2d 73-1069 (9th Cir., 1974).

[23] 48 *Fed. Reg.* 9671 *et seq.* (March 9, 1983).

whether allocations not attributable to nonrecourse liability satisfy the statutory standard. It is understood that the Treasury Department may reconsider that portion of the proposed regulations dealing with nonrecourse liability.[24]

Item allocations.—Allocations of particular items of income and deduction may be provided for in the partnership agreement, as well as the allocation of overall partnership income or loss. As long as such item allocations are reflected as adjustments in a partner's investment, i.e., his capital account in the partnership, and upon liquidation of the partnership proceeds are distributed in accordance with the partners' capital accounts, the allocation may satisfy the economic effect requirement as interpreted by case law and the proposed regulations. This requirement is largely mechanical and does not preclude a partnership with, for example, $100 of net income exclusive of cost recovery deductions and $100 of cost recovery deductions, from allocating the income to partner A and the cost recovery deductions to partner B although the partnership overall has no taxable income or loss, provided the economic effect of such allocations is substantial in relation to their tax effect. The result is an assignment of income and losses between partners not permitted elsewhere in the tax law.

It has been suggested that the partnership rules should be revised to permit allocations of only overall partnership income or loss. Alternatively, special allocations of items of income or deduction could be restricted to preclude the allowance of losses not economically sustained by the partnership.

Capitalization of organization and syndication fees.—Amounts expended to organize a partnership or promote the sale of partnership interests, subject to an election to amortize certain organizational expenses, are not deductible. Denial of the current deduction of such costs was made explicit in the partnership provisions of the Tax Reform Act of 1976. However, if the organizer or syndicator is also a general partner, allocation of partnership gross income to such person may produce the same result as a deduction to the other partners for organizational and syndication fees paid to such person. The capitalization requirement for other types of expense can be avoided as well by this technique. Generally, if amounts are paid or payable to a partner when he engages in a transaction with the partnership in a capacity other than as a member of the partnership or if guaranteed payments are made to a partner for services, such payments are required to be capitalized to the same

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[24] The application of the proposed regulations to nonrecourse liabilities has been criticized as offering a vehicle for the transfer of tax benefits similar to safe harbor leasing. Comments of the Commtitee on Partnerships of the New York State Bar Association Tax Section (May 12, 1983) at pp. 32-38. It has also been suggested that a gain-chargeback provision will not satisfy the statutory requirements as applied to nonrecourse liability and that the allocation of tax benefits must be compared to economic benefits calculated without regard to tax benefits in order to determine the validity of the allocation. Krane and Sheffield, "*Beyond Orrisch: An Alternative View of Substantial Economic Effect Under Section 704(b)(2) Where Nonrecourse Debt is Involved*". 60 *Taxes* 937 (1982); American Law Institute Federal Income Tax Project, Subchapter K, Tentative Draft No. 3, p. 115 *et seq.* (1979). On the other hand, it is contended that the proposed regulations insofar as they relate to the treatment of losses attributable to nonrecourse debt, are a valid and appropriate interpretation of present law. However, the proponents of this view also suggest that certain additional restrictions could be added to provide a safe-harbor rule for nonrecourse deductions. Memorandum dated May 24, 1983 from ad hoc committee of tax lawyers to the Assistant Secretary for Tax Policy on proposed regulations relating to nonrecourse liability dated May 24, 1983.

extent as comparable payments to a party who is not a partner. The payments described would be subject to the capitalization requirement only if they are guaranteed payments since the payee receives payment in his capacity as a partner. However, guaranteed payments are defined to include only those which are made without regard to partnership income. Where a partnership payment is based on partnership gross income, the partnership provisions have been construed to characterize the payment as a special allocation of partnership income. *Edward T. Pratt*, 64 T.C. 203 (1975), *aff'd*, 550 F. 2d 1023 (5th Cir., 1977). The effect is to avoid the requirement that certain expenses be capitalized by characterizing them as allocations of partnership gross income and thus excluding them from the income of the partners on whose behalf the expenses are incurred.

If the definition of guaranteed payments included only those determined with regard to partnership net income, payments which require only that the partnership have sufficient gross income could be characterized as guaranteed payments and made subject to the capitalization requirement. Another approach, which would eliminate the possibility that this technique could be employed with net income allocations, would be to amend section 707(a) to cover all organizations and syndication services performed by partners.

Like-kind exchange treatment of partnership interests.—Property held for productive use in a trade or business or for investment may be exchanged tax-free for property of like kind but this treatment does not apply if the property exchanged consists of inventory, stocks, securities, choses in action or other evidences of indebtedness or interest. It is unclear whether an interest in one partnership may be exchanged for an interest in another partnership as a tax-free exchange of like-kind property. The Internal Revenue Service has ruled that the exception for interests in financial enterprises applies to partnership interests and thus they do not qualify as like-kind property that may be exchanged tax-free. Rev. Rul. 78-135, 1978-1 C.B. 256. Court decisions have held that exchanges of partnership interests may qualify for tax-free treatment as like-kind property where the underlying assets of the partnerships are substantially similar in nature. *Estate of Rollin E. Meyer, Sr.* 58 T.C. 311 (1972); *Gulfstream Land and Development Co.* 71 T.C. 587 (1979). However, it was also held that an exchange of a general partnership interest for a limited partnership interest does not satisfy the like-kind requirement. *Estate of Meyer, supra, aff'd, per curiam* 503 F. 2d 566 (9th Cir., 1974).

Special considerations may apply in determining whether like-kind exchange treatment should be available to facilitate the exchange of partnership interests in tax shelter investments for interests in other partnerships. Under certain circumstances, taxation of the gain inherent in a partnership interest in a "burned out" tax shelter, i.e., one with substantial outstanding liability which has been reflected in prior tax losses without reducing the indebtedness, may be avoided if the interest may be exchanged tax-free for an interest in another partnership.

Retroactive allocations and tiered partnerships.—The Tax Reform Act of 1976 amended the partnership provisions to preclude a partner who acquires his interest late in the taxable year from deducting partnership expenses incurred prior to his entry into the partnership, so-called "retroactive allocations" of partnership losses. Some taxpayers take the position that, in applying this restriction, partnership income and losses are considered to pass through to partners until the close of the partnership's taxable year and that if an investor, rather than acquiring an interest in the operating partnership which sustained the loss, acquires an interest in a second partnership which in turn is a partner in the operating partnership, there is no retroactive allocation because the operating partnership's loss does not pass through to the second partnership until the close of the second partnership's taxable year, i.e., until after the investor has acquired his interest. The Internal Revenue Service has taken the position that losses are sustained by the second partnership in this case at the same time they are sustained by the operating partnership and that the limitation against retroactive allocations is equally applicable whether an investor acquires his interest in an operating partnership directly or through a second partnership. Rev. Rul. 77-311, 1977-2 C.B. 218.

The partnership provisions could be clarified to adopt expressly the Internal Revenue Service's interpretation.

B. Conversion of Ordinary Income to Tax-favored Income

Interest deduction

The availability of a deduction for interest under the general rule of section 163(a) has proved to be a fertile source for arrangements to convert ordinary income to tax-favored income.

Deferred-payment sales.—Notwithstanding Rev. Rul. 83-84, 1983-23 I.R.B. 22 (applying the concept of economic accrual of interest), transactions involving deferred-payment contracts continue to afford accrual-basis taxpayers the opportunity to claim huge current deductions for interest where the cash basis creditor defers the inclusion in income. For example, deferred payments sales can be used in tax-shelter schemes to generate deductions for accrued but unpaid interest.[25] In one scheme, an accrual-basis purchaser acquires non-depreciable property with a low value relative to the nominal amount of the deferred obligation (which could be nonrecourse), and claims deductions for the "discount" under the general rule for the deduction of interest (sec. 163(a)). In this case, no interest would be taxable to a cash-basis seller until payment. Thus, even though no deduction will be allowed for excess interest that does not economically accrue (under Rev. Rul. 83-84), the purchaser would be able to take current deductions for economically accrued amounts that are not includible in the seller's income. If the purchaser has received the property's full value, the obligation may never be paid. If all or some of the deferred obligation is later paid, the seller could also claim that the face amount of the obligation equalled the value of the property and no discount was present.

[25] If nonpublicly traded property is acquired for a non-traded obligation that provides for deferred interest payments, or if the issuer of the deferred-payment obligation is an individual, the rules requiring the accrual of original issue discount would not apply. Further, the parties to the transaction could avoid the imputation of interest by providing for 9 percent simple interest.

The use of deferred-payment sales to generate excessive interest deductions could be prevented by one of several proposals. As already suggested (Part IV, Supra), both the seller and the purchaser could be required to use the cash method of accounting with respect to deferred payments, with section 483 determining the extent to which such payments are treated as interest. However, the parties could elect to agree to the value of the property (within an acceptable range of discount rates) and accrue OID under the general rules of sections 1232A and 163(e). Absent the election, no deductions for OID would be permitted. As indicated, this proposal could be applied to individual purchasers if the elective OID treatment were extended to obligations issued by individuals and further the proposal could apply to obligations issued for services or for the use of property.

Interest incurred on indebtedness borrowed to finance the purchase of market-discount bonds.—Market discount arises as the result of a decline in the value of an obligation after it has been issued (because, for example, of an increase in prevailing interest rates or a change in the issuer's credit rating). Under present law, upon maturity of a bond that was purchased at a market discount, the difference between the face amount of the bond and the price paid for the bond is taxable at the favorable capital gains rate (sec. 1232). When a taxpayer borrows the funds used to purchase a market-discount bond it can deduct the interest on the acquisition indebtedness against ordinary income, even though the income eventually generated by the financed investment is taxed as capital gains.

There are several options that would prevent the use of market-discount bonds to achieve deferral of tax liability and rate conversion. One option is to extend original-issue-discount treatment to market-discount bonds (*i.e.*, to require accrual of the daily portions of market discount during the period the bond is held). To simplify the computation of the amount of market discount to be included in income, taxpayers could be permitted to use a straight-line computation, rather than the constant -interest method. Since discount is the economic equivalent of interest, extension of the OID rules to cover market discount on bonds issued in the future may be appropriate, regardless of whether the acquisition of the bond is financed by interest bearing obligations. This rule currently applies to short-term Treasury bills. Inclusion of market discount over the life of the bond would be in accordance with the present law treatment of bond premium, which is amortized against the interest due on the bond, in order not to produce a capital loss on maturity of the bond. Alternatively, leveraged purchases of market discount bonds could be discouraged by requiring taxpayers to capitalize the interest on the amount borrowed to finance the purchase or on the debt collateralized with the bond.

Interest incurred by a corporation to finance the purchase or carrying of stock.—Under present law, a corporate shareholder generally can deduct 85 percent of dividends received from other corporations (sec. 243). Because the maximum rate of tax on corporate income is 46 percent, the maximum (effective) rate of tax on dividends received by a corporation is only 6.9 percent. Thus, when a corporation takes interest deductions against ordinary income, and the interest is attributable to indebtedness incurred to purchase stock, the corporation effectively converts ordinary income to tax-favored income.

A corporation that borrows to purchase stock is in a situation similar to that of a taxpayer who borrows to purchase a tax-exempt security. Under present law, for a taxpayer who borrows to purchase a tax-exempt security, a tracing concept is employed and no deduction is allowed for interest on indebtedness incurred or continued to carry the tax-exempt security (sec. 265(2)). A similar rule could be applied to a corporation that borrows to finance purchases of portfolio stock.

Transactions in mutual fund shares

Distributions by a regulated investment company (commonly called a mutual fund) from long-term capital gain may be treated as long-term capital gain to its shareholders (*i.e.*, the character of the capital gain is flowed through to the shareholders), regardless of whether a shareholder has held the mutual fund for over one year (the long-term capital gain holding period. After the distribution of a capital-gain dividend, the market value of a mutual fund's shares usually decreases by approximately the amount of the capital-gain dividend. Thus, absent an applicable statutory provision, a taxpayer could convert short-term gain to long-term gain by purchasing mutual fund shares just before a capital-gain dividend becomes payable, and then, immediately after the receipt of the dividend, selling the shares (realizing a short-term capital loss which is deductible against short-term capital gain).

Under a special rule, if mutual fund shares are sold at a loss after a capital-gain dividend date, and the shares were held for less than 31 days, then the loss is treated as a long-term capital loss to the extent of the capital-gain dividend on the shares (sec. 852(b)(4)). However, a taxpayer can avoid the application of this rule simply by holding mutual fund shares for 31 days or more. Thus, taxpayers retain the ability to engage in transactions in mutual fund shares as a device to achieve conversion.

In order to restrict a taxpayer's ability to use mutual fund shares in the manner described above, the applicable statute could be revised to permit short-term loss treatment only if the stock is held by the taxpayer at the close of the taxable year in which the capital-gain dividend is paid, or the taxpayer has held the shares for six months.

Mutual funds which accumulate earnings

Certain mutual funds, sometimes called tax-managed funds, rather than paying dividends currently, accumulate the dividend income derived from their portfolio stock. While such funds are taxable, they are eligible for the 85-percent dividend-received deduction, thus paying a corporate tax at a maximum rate of 6.9 percent (.15 x 46%) while increasing the fund net asset value. Shareholders who satisfy the 1-year long-term capital gain holding period before disposing of their stock in such a fund can realize the earnings from their investment at a maximum tax rate of 20 percent.

Present law imposes an accumulated earnings tax on corporations formed or availed of to avoid the tax on their shareholders by accumulating rather than distributing their earnings. The funds which accumulate earnings rely on the position, supported by some case law, that the accumulated earnings tax only applies to closely held corporations. The Internal Revenue Service has ruled to the contrary. Rev. Rul. 77-399, 1977-2 C.B. 200. Present law could be amended to provide explicitly for the application of the accumulated earnings tax to these funds.

Expenses for the production of income

Section 212 allows as a deduction all ordinary and necessary expenses paid or incurred for the management, conservation, or maintenance of property held for the production of income. Expenses are deductible under section 212, even if the related property produces no current income.[26]

Short sale of stock that is about to go ex dividend.—In a "short sale" of stock, the taxpayer sells borrowed property and later closes the sale by repaying the lender with identical property. Section 1233 contains several rules that operate to prevent the use of short sales to convert short-term capital gains to long-term capital gains. However, under present law it is still possible to use a short sale to convert ordinary income to short-term gains. This conversion permits a taxpayer to utilize capital losses that cannot be deducted against ordinary income except, to a limited extent, in the case of noncorporate taxpayers. It further may allow the taxpayer to convert the short-term capital gains to long-term capital gains by use of mutual fund transactions, described above.

The IRS has ruled that amounts paid with respect to cash dividends on stock borrowed to cover a short sale are allowable as deductions under section 212. Rev. Rul. 62-42, 1962-1 C.B. 133. Thus, a taxpayer can enter into a short sale of stock that is about to go *ex dividend*, and deduct the amount paid in lieu of dividends against ordinary income. After the dividend is paid (and, as a result, the market value of the stock has decreased), the taxpayer can close the short sale by purchasing identical shares (at the lower value), realizing a short-term capital gain. This transaction is particularly used where relatively large dividends are to be paid. This device could be prevented by requiring the seller to capitalize the payment made in-lieu-of-the-dividend to the lender.

C. Overvaluation of Property

Charitable contributions of precious gems, etc.

Present law (sec. 170) allows a deduction subject to certain limitations, for charitable contributions made within the taxable year. If a charitable contribution is made in property other than money, the amount of the contribution is generally the fair market value of the property at the time of the contribution.[27] Treasury regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller,

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[26] *Herschel H. Hoopergarner*, 80 T.C. No. 26 (1983).

[27] See Treas. Reg. sec. 1.170A-1(c). Most other tax deductions are either limited to the basis of property (e.g., losses under sec. 165), or gain is recognized when appreciated property is used to pay a deductible expense.

neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[28]

In general, a taxpayer may not deduct that portion of fair market value which would not have qualified as long-term capital gain had the property been sold at the date of the contribution. Thus, a taxpayer must generally hold property for at least 1 year in order to deduct the full appreciated value of the property.[29]

Tax shelter opportunities.—Because the value of donated property is frequently subjective, charitable contributions may be an attractive form of tax shelter. This is particularly true for donations of artistic or literary property.[30] For example, assume that an individual purchases a work of art for $10,000, but is able to have the art appraised, a year or more later, at a value of $50,000. By donating the art to a museum, the individual may claim a $50,000 tax deduction. Assuming that the individual is in a 50 percent tax bracket, this deduction is worth $25,000, or 250 percent of the original purchase price.

One popular tax shelter [31] involves the purchase of precious gems for donation to a museum. In a typical transaction, an individual purchases gems from a promoter at a nominally "wholesale" price. The promoter represents that the gems, at the time of donation, will have an appraised value substantially in excess of the purchase price. In certain cases, the gems are subjected to chemical treatments which allegedly increase their value. After holding the gems for at least 1 year, the taxpayer donates them to a museum, claiming a deduction based on an expert appraisal of the value of the gems.[32] This value is frequently 5 or more times the price the individual actually paid for the gems. Thus, a 50-percent bracket taxpayer may receive a tax benefit 2 or 3 times the initial investment. Congress may wish to consider lengthening the holding period to obtain a fair market value deduction for contributions of property of this type.

Determination of fair market value.—To provide an attractive tax shelter, donated property (including precious gems) must be appraised at a value significantly in excess of the purchase price. The validity of these appraisals, in turn, depends, in part, upon the applicable definition of fair market value.

The courts have generally held that fair market value is the publicly available retail price in the relevant market.[33] For example,

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[28] For contributions of inventory-type property, fair market value is the price which the taxpayer would have received if he had sold the property in the ordinary course of business. Treas. Reg. sec. 1.170A-1(c)(2).

[29] Sec. 170(e)(1)(A).

[30] Under the Tax Reform Act of 1976, donations of artistic or literary property by the creator of the property are denied favorable tax treatment. However, the owners of such property (other than the creator and persons whose basis in the property is determined by reference to the creator's basis) may receive a deduction for the full value of the property.

[31] *See* Wash. Post, March 29, 1983, p. A-1; March 30, 1983, p. A-1; and April 15, 1983, p. A-1 (concerning donations to the Smithsonian Institution).

[32] In certain cases, the promoter has provided an appraisal as part of the original transaction. *See, e.g., Anselmo v. Commisioner*, 80 T.C. No. 46 (May 12, 1983).

[33] Treasury Regulations under the estate and gift taxes state that fair market value is the price of an item in the market in which that item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Treas. Reg. sec. 20.2031-1(b) (estate tax); sec. 25.2512-1 (gift tax). These regulations are not binding for charitable contribution cases. However, they appear to state the general rule applicable in those cases. *See Anselmo v. Commisioner*, 80 T.C. No. 46 (May 12, 1983).

in *Goldman v. Commissioner*, 388 F. 2d 476 (6th Cir. 1967), *aff'g* 46 T.C. 136 (1966), the court held that the value of donated books should be computed based on the price that an ultimate consumer would pay, rather than a dealer buying to resell. However, the courts have held that the determination of fair market value must be based on the facts of the particular case.

In Rev. Proc. 66-49, 1966-2 C.B. 1257, the Internal Revenue Service provided guidelines for appraisals of contributed property for charitable deduction purposes. The revenue procedure stated that all factors bearing on the value of donated property are relevant including, where pertinent, the cost or selling price of the item, sales of comparable properties, cost of reproduction, opinion evidence and appraisals. The revenue procedure stated further that appraisals and other opinion evidence will be given appropriate weight only when supported by facts having strong probative value.

Rev. Rul. 80-69, 1980-1 C.B. 55, stated that the best evidence of the fair market value of an assortment of gems was the price at which a taxpayer bought the gems from the tax shelter promoter. The ruling involved a taxpayer who purchased an assortment of gems from a promoter for a price of 500x dollars. The promoter asserted that the price was wholesale, although the promoter and other dealers engaged in numerous sales at similar prices with other individuals who were not dealers in gems. The taxpayer contributed the gems to a museum 13 months after purchase and claimed a charitable contributions deduction of 1500x dollars. According to the ruling, the best evidence of fair market value depends on actual transactions and not on an artificially calculated estimate of value.[34]

In *Anselmo v. Commissioner*, 80 T.C. No. 46 (May 12, 1983), the Tax Court held that the fair market value of unset gems was the price that would have been paid by a jewelry store to a wholesaler to obtain comparable items. The case involved a taxpayer who donated some 461 colored gems to the Smithsonian Institution approximately 9 months after purchasing them.[35] The taxpayer claimed a charitable contribution deduction in an amount ($80,680) more than 5 times the purchase price ($15,000). The appraised value of the gems was based on the retail prices charged by jewelry stores for jewelry containing similar gems. The taxpayer purchased the gems from a promoter which promised to obtain appraisals of 5 times the purchase price as part of the contract of sale.

The court held that the ultimate consumers of gems like those contributed were the jewelers who set the gems into finished items of jewelry. Accordingly, the effective retail market for the gems (as opposed to the finished jewelry) was the market for sale to the jewelers. Based on these holdings, the court determined the fair market value of the gems as $16,800 (approximately 10 percent more than the purchase price). The charitable contribution deduction in this case was claimed before the ERTA overvaluation penalty became effective.

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[34] In another 1980 ruling, the Service stated that the best evidence of the value of Bibles donated to charities was the price at which similar quantities of Bibles were actually sold in arm's length transactions. Rev. Rul. 80-233, 1980-2 C.B. 69.

[35] Under the then applicable rules, property held for 9 months qualified for long-term capital gains treatment.

Enforcement and administration.—The Internal Revenue Service has had success in *Anselmo*, and in several art donation cases,[36] in challenging charitable deductions. However, the effort to limit charitable deduction and other tax shelters presents problems of enforcement and administration. One of these problems arises from the volume of these cases. According to the Internal Revenue Service, 2,895 returns relating to charitable contribution deductions were under examination at the end of May, 1983.

A further problem arises in detecting excessive charitable deductions at the administrative level. The Art Advisory Panel of the Internal Revenue Service, composed of 12 outside art experts, has helped the Service to detect excessive valuations in the art donation area. In the last 8 years, the panel has recommended approximately $24 million in reductions out of $141 million of appraised contributions.[37] The Service has also initiated a special audit program to combat charitable contribution tax shelters. However, it is not possible to detect all or even most instances of excessive deductions. Because of the subjective nature of valuation, taxpayers may continue to play the "audit lottery" and claim excessive charitable deductions.

Nonrecourse seller-financed property

Another area in which the valuation of property can provide the basis for a tax shelter involves purchase-money nonrecourse loans to acquire depreciable property where the seller, or a party related to the seller, is the creditor.

The parties may try to inflate the purchase price, since a higher price benefits the purchaser by reason of larger tax deductions (for depreciation or accrued interest). Because the purchaser is not personally obligated to repay the loan, the higher price, in many situations, will not be detrimental to the buyer, since the property may be simply repossessed by the seller after the buyer has benefitted from the tax deferral.[38] The higher price may economically benefit the seller, but cannot be to its economic detriment and may not increase the seller's tax liability where the seller is not taxable or where it uses installment reporting and no payments are received.

If the nonrecourse indebtedness unreasonably exceeds the fair market value of the property acquired with the indebtedness, the courts have found that the "loan" is not a genuine debt and have denied depreciation and/or interest deductions to the "purchaser."[39] However, the taxpayer may take the position that the transaction is a purchase with bona fide nonrecourse debt. The IRS must then contest the valuation.

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[36] *See, e.g., Farber v. Commissioner*, 33 T.C.M. 673 (1974), *aff'd* 76-1 USTC par. 9118 (2d Cir. 1976) ($150,000 deduction reduced to $10,000); *Vander Hook v. Commissioner*, 36 T.C.M. 1394 (1977) ($12,000 deduction reduced to $1,200).

[37] N.Y. Times, May 2, 1983, p. D-1.

[38] The obligation discharged on the repossession will be an amount realized from disposing of the property regardless of its value and generally will result in taxable gain to the taxpayer, some of which may be recaptured as ordinary income. *Commissioner v. Tufts* 461 U.S.—(May 2, 1983). See partnership discussion infra.

[39] *See e.g., Estate of Franklin* v. *Commissioner*, 544 F.2d 1045 (9th Cir. 1976), *affg*, 64 T.C. 752 (1975); *Odend'hal* v. *Commissioner*, 80 T.C. 588, 604 (1983); *Hager* v. *Commissioner*, 76 T.C. 759, 788 (1981); *Narver* v. *Commissioner*, 75 T.C. 53 (1980), *affd, per curiam* 670 F.2d 855 (9th Cir. 1982); *Beck* v. *Commissioner*, 74 T.C. 1534 (1980), *affd*, 678 F.2d 818 (9th Cir. 1982); *Oden* v. *Commissioner*, 80 T.C. 588 (1983).

The at-risk rules, which were first enacted in 1976, and expanded to apply to all activities other than real estate for taxable years beginning after 1978, reduce this problem for non-real-estate activities. (See Part III above.)

Investment tax credit pass-through

Under present law, a lessor of property eligible for the investment tax credit may elect to allow the lessee to claim the credit (sec. 48(d)). The lessee's credit is based on the fair market value of the property. In certain instances, lessors have acquired property at an inflated price using seller nonrecourse financing or seller recourse financing by a corporation with little net worth and then leased the property to an investor who claims the credit based on an inflated purchase price. It is uncertain whether the at-risk rules apply where the lessor is not a closely held corporation or is a thinly capitalized corporation with "recourse" debt and passes the credit through to an individual. Although the taxpayer may, in fact, not be entitled to the full investment credit claimed, the question of the value of the property may need to be litigated. Congress may desire to apply the at-risk rules specifically to the lessee in the case of certain "pass-through" leases.

D. The Use of Foreign Corporations

Under present law, taxpayers can defer (and thereby minimize) U.S. tax on earnings derived through a foreign corporation until the earnings are distributed as dividends or the taxpayer disposes of the shares in the corporation. The advantage of using a foreign corporation to defer U.S. tax is enhanced when the corporation is organized in a tax-haven country that imposes little or no tax on the corporation's earnings. In recent years, U.S. investment firms have organized foreign corporations not only as a means of deferring U.S. tax liability, but also to circumvent the application of recent tax reforms.

"Mark to market" rule applicable to commodity futures

The Economic Recovery Tax Act of 1981 (ERTA) contained a provision that effectively taxes net gains from regulated futures contracts at a 32-percent maximum rate (by treating gains and losses as 60-percent long-term and 40-percent short-term capital gains and losses). This treatment applies to positions open at the end of the taxable year as well as those closed during the year.

In one scheme, investors are offered stock in a foreign corporation that trades in commodities futures on U.S. exchanges through an offshore subsidiary. The corporations are insulated from U.S. taxation by incorporating offshore and, although potentially liable for tax on U.S. source accumulated earnings, seek to escape that tax through distributions from the subsidiary to the parent corporation in whose hands the earnings become nontaxable foreign-source dividends. The deal is structured so that the investors will not be subject to tax until they dispose of their stock and then, if the long-term capital gain holding period requirements are satisfied, will pay tax at a maximum capital gain tax rate of only 20 percent. If successful, this scheme results not only in deferral of tax, but in taxation of gain from futures trading at a maximum 20-percent rate, rather than the 32 percent rate that Congress prescribed in 1981 for taxpayers who engage in such futures trading directly. The plan is also intended to avoid the present law treatment of gain that results from the disposition of the stock of certain foreign investment companies. Under the foreign investment company rules, gain attributable to untaxed corporate earnings is taxed as ordinary income, but this ordinary income treatment is not applied to corporations trading in commodities.

The straddle rules

Under another provision of ERTA, the deduction of a taxpayer's losses from straddled investments is deferred to the extent that the taxpayer has unrecognized gains in offsetting positions.

Under one offering, U.S. investors may invest in stock in an offshore corporation that enters into forward contracts in U.S. Government guaranteed debt instruments, such as GNMA certificates. The U.S. investors enter into offsetting positions in their individual capacities. The offshore corporation does not pay U.S. tax on its gains and the U.S. investors are not required to defer the deduction of losses on their individually held positions notwithstanding unrealized gain in their stock. Direct investment in both legs of this type of straddle would result in deferral of the deduction of loss until the gain was recognized. Under the tax shelter investment the result is that losses are deducted and gain is deferred. This offering is a deliberate effort to exploit the exclusion of corporate stock from the restrictions of the 1981 straddles legislation.

H.R. 3096.—A bill (H.R. 3096) was introduced in the House this year by Congressman Stark in order to prevent certain abuses involving tax straddles and to prevent the avoidance of the accumulated earnings tax through the use of foreign corporations. Under the bill, a foreign corporation that engages primarily in trading in commodities or interests in commodities, and which is at least 50-percent owned (directly or indirectly) by U.S. persons, will be treated as a foreign investment company. Thus, on the disposition of shares in such a corporation, gain attributable to previously untaxed earnings will be treated as ordinary income subject to tax at regular tax rates of up to 50 percent (rather than the lower capital gains rate).

The bill contains a new source-of-income rule, applicable solely for purposes of the accumulated earnings tax. Under this provision, if more than 10 percent of a foreign corporation's earnings and profits is derived from U.S. sources (or is effectively connected with a U.S. trade or business), then any dividends distributed from such a corporation (directly or through one or more other entities) to a "U.S. owned foreign corporation" will be treated as from U.S. sources. For purposes of this provision, the term "U.S. owned foreign corporation" is defined as any foreign corporation 50 percent or more of the stock of which is owned (directly or indirectly) by U.S. persons. Under this provision, it will no longer be possible to avoid the accumulated earnings tax by interposing a holding company between U.S. shareholders and a foreign corporation that earns significant U.S.-source income.

The bill also would provide for a limited category of stock that will be treated as an offsetting position for purposes of the loss deferral rules of current law. Under this provision, "offsetting position stock" is included in the definition of property that is subject to the straddle rules. The term "offsetting position stock" is defined as any stock of a corporation formed or availed of to take positions in personal property that offset positions taken by such corporation's shareholders.

Senator GRASSLEY. I would like to call this hearing of the Subcommittee on Oversight of the Internal Revenue Service to order. The topic of our hearing today is abusive tax shelters. Our aim is to focus public debate on this important problem, and to develop a framework to analyze solutions to this unacceptable tax evasion.

After the enactment of the penalty and injunctive relief provisions of the Tax Equity and Fiscal Responsibility Act of 1982, the Ways and Means Subcommittee on Oversight held a hearing on the topic of tax shelters. They created a valuable record which has been helpful to this subcommittee and to myself. Not only would this subcommittee like to take a snapshot of where we are today in the process of tax shelter proliferation and enforcement, we would also like to devise a long-term approach for analyzing tax shelters and assessing our attempts to combat them.

The Internal Revenue Service will give us a status report on the growth of abusive tax shelters. They will explain the types of tax shelters currently employed by taxpayers and their prevalence. Not only have the types of shelters been altered, many promoters are using different forms of organization, other than the limited partnership, to transfer tax benefits. The subcommittee also needs to examine whether the problem in the expansion of abusive tax shelters is best addressed administratively or with new legislation. To exercise effective oversight, it is important to ascertain what we can do to assist the Internal Revenue Service in curtailing this unlawful activity.

It is my hope that our witnesses today can provide us with some helpful advice on how best to address the issue of abusive tax shelters on an ongoing basis.

TEFRA gave the Internal Revenue Service new tools in their fight against abusive tax shelters. It created a new penalty for anyone who sells an interest in tax shelters if the seller had reason to know of a false or fraudulent statement as to a material regarding a tax benefit or a gross valuation overstatement. This penalty is the greater of $1,000 or 10 percent of the gross income derived from the illegal activity. TEFRA also gave the Internal Revenue Service the power to seek an injunction to stop any promoter from engaging in the illegal conduct described above.

Since this subcommittee and both Houses of Congress recently enacted new legislation to assist the Internal Revenue Service in battling tax shelters, I think it would be particularly useful to focus on what the Internal Revenue Service is doing administratively to stop this abuse of our revenue laws. Not only does this subcommittee seek a status report on current tax shelter activity, it is seeking ways to work with this agency to spot emerging problems quickly and to address them in an efficient manner to restore taxpayer confidence in the revenue collection system.

One of the most destructive effects of illegal tax shelter activity is that it fosters a feeling among all taxpayers that the system is unfair. It creates the impression that honest taxpayers are being foolish for paying the correct amount of taxes when so many individuals are skirting the system. As more taxpayers become convinced that the system is unfair and inequitable, they will join the ranks of tax evaders or become increasingly cynical about our tax system and the Government which tolerates this illegal activity. Stopping illegal tax evasion is important in the committee's efforts to improve compliance. If we collect from everyone the taxes they properly owe, the committee can resist tax increases and lower the marginal tax rate.

The compelling attraction of a flat rate tax to many of my constituents is its fairness and simplicity. Most Americans would like to move to a simplier tax system with lower rates even if their tax bill was increased. They view abusive tax shelters as an unwarranted abuse of the law financed by their tax dollar. They resent paying higher taxes while others avoid the financial obligation to this Nation by the use of complicated, economically unproductive schemes.

I look forward to the testimony of our excellent witnesses on this important topic. And, as I stated earlier, these are just beginning steps in defining the problem and devising flexible, constructive solutions for addressing current and future problems.

Our first witness is going to be Philip E. Coates, Associate Commissioner for Policy and Management of the Internal Revenue Service. Mr. Coates is presently Acting Commissioner while my friend, Roscoe Egger is recuperating from heart bypass surgery. I understand Commissioner Egger is doing well, and I would hope the next time we have a hearing he will be well enough so he will be able to attend. I know that Commissioner Egger is sorry that he cannot be here with us today.

I will not go into a long dissertation on your qualifications because I think your service to the Government has been well established, Mr. Coates. I ask you to begin your presentation, and then when you are done I have some questions to ask you before we hear Mr. Woodard's testimony.

Would you like to introduce your colleagues?

STATEMENT OF HON. PHILIP E. COATES, ACTING COMMISSIONER OF THE INTERNAL REVENUE SERVICE, ACCOMPANIED BY PERCY WOODARD, ASSISTANT COMMISSIONER (EXAMINATION), AND JOEL GERBER, ACTING CHIEF COUNSEL

Mr. COATES. I certainly will. Thank you, Mr. Chairman. We are pleased to be with you today to discuss the Service's recent experiences with abusive tax shelters. In my testimony, I will provide some background information on abusive tax shelters, attempt to profile the size and scope of the abusive tax shelter problem, and offer some insights on our operational experiences with abusive tax shelters under TEFRA. I will attempt to summarize my statement and ask that the written statement be included for the record.

Senator GRASSLEY. It will be. All written statements will be included in the record of this hearing today. We would also like to have a summarization of 10 minutes or less, which is standard procedure. It is possible that additional questions will be submitted to each witness in writing by myself and my colleagues on the full committee or on the subcommittee, who are not here today due to other obligations. Additionally, the record will be open for additions or corrections for those testifying today, as well as for those individuals who desire to contribute written testimony for the record.

[The prepared statement of Mr. Coates follows:]

STATEMENT OF

PHILIP E. COATES

ACTING COMMISSIONER OF INTERNAL REVENUE

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE IRS

SENATE FINANCE COMMITTEE

JUNE 24, 1983

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

I AM PLEASED TO BE WITH YOU TODAY TO DISCUSS THE SERVICE'S RECENT EXPERIENCES WITH ABUSIVE TAX SHELTERS. IN MY TESTIMONY, I WILL PROVIDE SOME BACKGROUND INFORMATION ON ABUSIVE TAX SHELTERS, ATTEMPT TO PROFILE THE SIZE AND SCOPE OF THE ABUSIVE TAX SHELTER PROBLEM, AND OFFER SOME INSIGHTS ON OUR OPERATIONAL EXPERIENCES WITH ABUSIVE TAX SHELTERS UNDER TEFRA.

COMMISSIONER EGGER, AS YOU MAY KNOW, IS STILL RECOVERING FROM HIS SURGERY, AND HAS NOT YET RETURNED TO HIS DUTIES. DEPUTY COMMISSIONER OWENS IS REPRESENTING THE SERVICE AT AN IMPORTANT INTERNATIONAL CONFERENCE THIS WEEK. I AM NOW THE ACTING COMMISSIONER, BUT NORMALLY SERVE AS THE ASSOCIATE COMMISSIONER FOR POLICY AND MANAGEMENT. PRIOR TO THIS, I SERVED AS THE REGIONAL COMMISSIONER IN THE IRS CENTRAL REGION, AND AS THE ASSISTANT COMMISSIONER (COMPLIANCE) HERE IN WASHINGTON.

WITH ME TODAY ARE JOEL GERBER, THE ACTING CHIEF COUNSEL, AND PERCY WOODARD, THE ASSISTANT COMMISSIONER FOR EXAMINATION. THEY WILL BE AVAILABLE TO ASSIST ME IN ANSWERING ANY QUESTIONS YOU OR THE MEMBERS MAY HAVE AT THE CONCLUSION OF MY TESTIMONY.

DEFINITION OF AN "ABUSIVE TAX SHELTER"

IT IS DIFFICULT TO DEFINE IN A PRECISE, ACADEMIC MANNER AN "ABUSIVE TAX SHELTER." ANY DEFINITION WOULD BE UNLIKELY TO COVER ALL OF THE POSSIBLE STRUCTURAL ALTERNATIVES WHICH COULD BE CREATED BY PROMOTERS OF SUCH SHELTERS.

THE INTERNAL REVENUE CODE ITSELF DOES NOT DEFINE AN ABUSIVE TAX SHELTER, ALTHOUGH IT SHOULD BE NOTED THAT ANY TAX SHELTER CONTEMPLATED BY THE CODE IS BY DEFINITION NON-ABUSIVE, WHATEVER ITS FORM OR SUBSTANCE. WHLE SECTION 320 OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT (TEFRA) OF 1982, IN ADDING SECTION 6700(A)(2)(A) TO THE CODE, DOES DESCRIBE CERTAIN CHARACTERISTICS OF AN ABUSIVE SHELTER, IT IS NOT A DEFINITION PER SE.

THE INTERNAL REVENUE MANUAL CONTAINS WHAT WE HAVE FOUND TO BE USEFUL WORKING DEFINITIONS OF ABUSIVE AND NON-ABUSIVE TAX SHELTERS. THOSE DEFINITIONS MAKE THE FOLLOWING DISTINCTIONS:

- o <u>NON-ABUSIVE TAX SHELTERS</u> - INVOLVE TRANSACTIONS WITH LEGITIMATE ECONOMIC REALITY, WHERE THE ECONOMIC BENEFITS OUTWEIGH THE TAX BENEFITS. SUCH SHELTERS SEEK TO DEFER OR MINIMIZE TAXES.

- o <u>ABUSIVE TAX SHELTERS</u> - 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.

OUR MANUAL'S DEFINITION IMPLIES -- CORRECTLY, I BELIEVE -- THAT THERE IS A BROAD SPECTRUM OF TAX SHELTERS. AT THE OBVIOUS EXTREMES, THERE ARE THE CLEARLY ABUSIVE AND CLEARLY NON-ABUSIVE SHELTERS. BETWEEN THESE EXTREMES, THERE IS A GRAY AREA, WHERE THE BASIC NATURE OF A TAX SHELTER CAN ONLY BE DETERMINED BY A FACTUAL ANALYSIS OF ITS COMPONENTS. HOWEVER, ONCE ALL THE FACTS ARE KNOWN, THE DETERMINATION OF ABUSIVE VS. NON-ABUSIVE IS RELATIVELY EASY TO MAKE. BUT GETTING THOSE FACTS IS OFTEN THE MOST COMPLICATED PART OF THE PROCESS; THIS IS PARTICULARLY TROUBLESOME IN THE CASE OF CERTAIN OF THESE SCHEMES WHICH INVOLVE FOREIGN JURISDICTIONS.

GENERALLY, ABUSIVE TAX SHELTERS UTILIZE EXTREME, IMPROPER, AND EVEN ILLEGAL INTERPRETATIONS OF THE LAW OR INVOLVE INCOMPLETE OR MISLEADING FACTS TO ATTEMPT TO SECURE FOR INVESTORS SUBSTANTIAL TAX BENEFITS WHICH ARE CLEARLY DISPROPORTIONATE TO THE ECONOMIC REALITY OF THE TRANSACTIONS. IN A VERY REAL SENSE, ABUSIVE TAX SHELTERS ARE ENTERED INTO WITH LITTLE OR NO EXPECTATION OF A POSITIVE FINANCIAL OUTCOME, BUT RATHER THE SOLE EXPECTATION OF EVADING TAXES.

MR. CHAIRMAN, WE BELIEVE THAT A LARGE NUMBER OF THE ABUSIVE TAX SHELTERS BEING SOLD TODAY ARE NOT REALLY TAX SHELTERS IN ANY TRADITIONAL SENSE, BUT ARE FRAUDS EUPHEMISTICALLY REFERRED TO AS TAX SHELTERS. SUCH FRAUDS ARE CHARACTERIZED BY BACKDATED DOCUMENTS, FICTITIOUS NOTES, FALSE AFFIDAVITS, INFLATED APPRAISALS, RIGGED TRANSACTIONS, FORGED TRADING RECORDS AND DISTORTED ACCOUNTING METHODS, AS WELL AS A NUMBER OF OTHER CLEARLY ILLEGAL MECHANISMS. WE ARE SEEING MORE AND MORE OF THESE DEVICES ALL THE TIME, MANY OF WHICH INVOLVE FOREIGN TAX HAVENS, SUBSTANTIALLY HINDERING OUR ABILITY TO OBTAIN EVIDENCE RELATING TO THEIR TRUE NATURE.

WE RECOGNIZE THAT LEGITIMATE INVESTMENTS IN SOUND BUSINESS ACTIVITIES SHOULD BE ENCOURAGED; IN FACT, EXISTING TAX LAWS IN MANY CASES ARE STRUCTURED FOR THIS VERY PURPOSE. HOWEVER, THE VIABILITY OF OUR TAX ADMINISTRATION SYSTEM DEPENDS TO A GREAT EXTENT ON TAXPAYERS' PERCEPTIONS THAT THE SYSTEM IS FAIR

AND EQUITABLE, AND IS ADMINISTERED IN A FAIR BUT FIRM MANNER. WHEN ABUSIVE, ILLEGAL, AND FRAUDULENT TAX SHELTERS ARE OPENLY TOUTED AS PROPER INVESTMENTS, PUBLIC CONFIDENCE IN THE TAX SYSTEM DECLINES RAPIDLY, PRODUCING THE LIKELIHOOD OF REDUCED REVENUES AND VOLUNTARY COMPLIANCE AND ALL THAT THAT IMPLIES. WE DO NOT BELIEVE IT IS IN THE BEST INTERESTS OF THE SERVICE, THE ADMINISTRATION OF THE TAX SYSTEM, OR THE NATION AS A WHOLE TO ALLOW THIS TO HAPPEN.

A BRIEF HISTORY OF TAX SHELTERS

TAX SHELTERS ARE NOT A NEW FORM OF INVESTMENT, NOR WERE THEY CREATED BY ANY PARTICULAR GROUP FOR ANY PARTICULAR PURPOSE. THE GROWTH IN THE MERCHANDISING OF TAX SHELTERS WE HAVE WITNESSED BEGAN AS A REFLECTION OF CERTAIN PROVISIONS OF THE CODE DESIGNED TO FOSTER POSITIVE CAPITAL INVESTMENTS. CONGRESS INTENDED THESE PROVISIONS AS INVESTMENT INCENTIVES FOR USEFUL ECONOMIC PURPOSES. NOW, HOWEVER, WE ARE SEEING A PERVERSION OF THESE PROVISIONS INTO MECHANISMS TO INTENSIFY IMPROPER TAX AVOIDANCE OR DEFERRAL. THEY DO NOT FUNCTION AS INTENDED WHEN CARRIED TO EXTREMES IN THIS WAY.

THE GROWTH OF THE SHELTER INDUSTRY INTENSIFIED THROUGH THE 1960'S AND INTO THE EARLY 1970'S, AT LEAST PARTIALLY IN RESPONSE TO TAX LEGISLATION OF THE PERIOD, AS WELL AS VARIOUS ECONOMIC CONSIDERATIONS (INFLATION, STOCK MARKET DECLINES, ETC.). THIS RAPID GROWTH FORCED RESPONSES BY BOTH CONGRESS AND

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THE SERVICE. THE SERVICE DEVELOPED A NUMBER OF ADMINISTRATIVE AND OPERATIONAL ARRANGEMENTS, INCLUDING THE TAX SHELTER PROGRAM I WILL DISCUSS LATER. CONGRESS RESPONSED BY ENACTING LIMITS ON THE USE OF THESE DEVICES, SUCH AS THE "AT RISK" RULES FIRST INTRODUCED IN THE 1976 TAX REFORM ACT.

OVERALL, THIS PERIOD CAN BE CHARACTERIZED AS ONE OF CONTINUAL "LEAPFROGGING" BETWEEN THE SERVICE AND THE CONGRESS ON THE ONE HAND, AND TAX SHELTER PROMOTERS ON THE OTHER. EACH TIME THE IRS OR CONGRESS DEVELOPED A METHOD OF SLOWING OR HALTING SOME OBJECTIONABLE SHELTER PRACTICE, PROMOTERS AND/OR INVESTORS WOULD FIND SOME WAY AROUND IT -- ESSENTIALLY JUMPING OVER THE ROADBLOCKS. THE IMPORTANT THING TO REMEMBER HERE IS THAT WHILE AT THE BEGINNING THE PROMOTERS WERE ONLY <u>STRETCHING</u> THE LAW, BY THE END OF THIS PERIOD THEY WERE <u>OPENLY BREAKING</u> THE LAW. THIS IS THE SITUATION WE FIND OURSELVES IN TODAY.

THIS "LEAPFROGGING" EFFECT CREATES ANOTHER PROBLEM FOR THE SERVICE -- CASE BACKLOGS. I WILL HAVE MORE TO SAY ABOUT THIS LATER. ESSENTIALLY, THOUGH, THE EFFORTS OF THE SERVICE AND CONGRESS TO KEEP AHEAD OF SHELTER PROMOTERS CREATES A SITUATION IN WHICH THE LAWS, REGULATIONS, AND PROGRAMS WE JOINTLY DEVELOP ARE PROSPECTIVE IN NATURE; THEY ALL TAKE EFFECT IN THE FUTURE, LEAVING UNRESOLVED THE PROBLEMS ASSOCIATED WITH THE EXISTING WORKLOAD IN PROCESS. FOR THIS REASON, OLD CASES PILE UP, SINCE THEY ARE LESS SUSCEPTIBLE TO RESOLUTION THAN THE CASES COVERED BY NEW LEGISLATION.

EXAMPLES OF ABUSIVE TAX SHELTERS

TO ILLUSTRATE OUR CONCERNS, LET ME PROVIDE JUST A FEW EXAMPLES OF CURRENT TAX SHELTER SCHEMES WE BELIEVE ARE ABUSIVE. THERE ARE OTHER EXAMPLES WE WOULD BE PLEASED TO SHARE WITH YOU AT A LATER DATE. FOR OBVIOUS REASONS, WE HAVE ELIMINATED NAMES AND OTHER IDENTIFYING INFORMATION FROM THE FOLLOWING FACT PATTERNS.

LAST SEPTEMBER BEFORE THE WAYS AND MEANS COMMITTEE OVERSIGHT SUBCOMMITTEE, THE COMMISSIONER OUTLINED ONE OF THE MOST FLAGRANT TAX SHELTER SCHEMES TO APPEAR IN THE LAST FEW YEARS. THE SCHEME INVOLVED THE LEASING OF A MASTER RECORDING WHERE THE VALUE HAD BEEN INFLATED TO 100 TIMES ITS COST. THE PROMOTER ELECTED TO PASS-THROUGH TO THE INVESTORS THE INVESTMENT TAX CREDIT (ITC) OF 10%, BASED ON THE INFLATED VALUE OF THE MASTER RECORDING. THIS CREATED UNUSED ITC WHICH THE INVESTORS CARRIED BACK BY FILING FORM 1045 AND OBTAINING A QUICK REFUND OF PRIOR YEARS' TAXES.

I WOULD NOW LIKE TO SHOW YOU HOW DARING PROMOTERS HAVE BECOME WITH THIS PARTICULAR SCHEME. INSTEAD OF LEASING A MASTER RECORDING, PROMOTERS ARE NOW SELLING SCHEMES INVOLVING THE LEASING OF EQUIPMENT WHICH PURPORTEDLY QUALIFIES AS ENERGY PROPERTY. THE SCHEME INVOLVES THE SALE OF THE EQUIPMENT FROM THE MANUFACTURER TO ONE CORPORATION, A RESALE TO A SECOND

CORPORATION, AND A SUBSEQUENT LEASE TO A PARTNERSHIP. THE MANUFACTURER SELLS THE EQUIPMENT TO CORPORATION I FOR $9.1 MILLION, PAYABLE $720,000 IN CASH AND THE BALANCE ($8.43 MILLION) IN A 12-YEAR NONRECOURSE NOTE, SECURED BY THE EQUIPMENT. THE NOTE IS PAYABLE AT $120,000 A MONTH AT 13 1/3% INTEREST WITH PAYMENTS BEGINNING 9 MONTHS AFTER CLOSING.

CORPORATION II BUYS THE EQUIPMENT FROM CORPORATION I FOR $10.5 MILLION; PAYABLE $829,500 IN CASH AND THE BALANCE ($9.67 MILLION) IN A 12-YEAR RECOURSE NOTE SECURED BY THE EQUIPMENT. THE NOTE IS PAYABLE AT $120,000 A MONTH AT 10% INTEREST WITH PAYMENTS BEGINNING 9 MONTHS AFTER CLOSING.

THE PARTNERSHIP LEASES THE EQUIPMENT PAYING $960,000 (8 MONTHS PREPAID RENT) AT CLOSING. THEN, BEGINNING IN THE NINTH MONTH, THE PARTNERSHIP WILL PAY $120,000 A MONTH FOR 9 1/2 YEARS.

THE PARTNERSHIP THEN ENTERS INTO A JOINT VENTURE WITH THE MANUFACTURER TO PLACE, SHIP, AND INSTALL THE EQUIPMENT. THE MANUFACTURER IS TO PAY THE PARTNERSHIP A JOINT VENTURE FEE OF $120,000 COMMENCING 9 MONTHS AFTER THE JOINT VENTURE BEGINS.

CORPORATION II ELECTS TO PASS-THROUGH TO THE PARTNERSHIP THE INVESTMENT TAX CREDIT OF 10% AND THE ENERGY TAX-CREDIT OF 10% ON THE $10.5 MILLION PURCHASE PRICE (20% OF $10.5 MILLION; $2.1 MILLION IN CREDITS). THE SALES PRICE OF THE EQUIPMENT COULD BE MULTIPLIED BY A THOUSAND OR A MILLION AND PROVIDED THE

JOINT VENTURE FEE IS MULTIPLIED BY A LIKE AMOUNT NO EXHANGE OF MONEY BEYOND THE DOWN PAYMENT EVER OCCURS WHILE THE INVESTMENT AND ENERGY CREDITS ARE MULTIPLIED ACCORDINGLY. WE SUBMIT THAT THE EQUIPMENT IN QUESTION IS OVERVALUED BY AT LEAST 500%. IN THE MASTER RECORDING SCHEME, ONLY A 10% ITC CREDIT WAS BEING CLAIMED BASED ON AN ASSET WHOSE VALUE WAS INFLATED 100 TIMES. THE EQUIPMENT LEASING SCHEME RESULTS IN CREDITS OF 20% BASED ON AN ASSET INFLATED 500 TIMES.

HERE AGAIN, THERE WILL BE UNUSED CREDITS WHICH THE PARTNERS WILL CARRYBACK BY FILING FORM 1045 AND OBTAINING A QUICK REFUND OF PRIOR YEARS' TAXES.

IN ORDER TO ASCERTAIN THE IMPACT THAT THIS SCHEME HAS ON OUR COMPLIANCE EFFORTS AND WHAT ADDITIONAL ACTIONS, IF ANY, ARE NEEDED, WE ARE CONDUCTING A STUDY AT THE NATIONAL OFFICE LEVEL. THE STUDY JUST COMMENCED THIS MONTH WITH VISITS TO TWO SERVICE CENTERS TO REVIEW FORMS 1045. I WOULD LIKE TO SHARE WITH YOU THE RESULTS OF THOSE VISITS.

AT ONE SERVICE CENTER,WE REVIEWED 41 RETURNS THAT WERE INVOLVED IN FORM 1045 ABUSIVE TAX SHELTER SCHEMES. OF THE 41 RETURNS REVIEWED, 24 RETURNS (58% OF TOTAL) HAD ADJUSTED GROSS INCOME (AGI) OF LESS THAN $50,000. BECAUSE OF THESE TAX SHELTERS, IT APPEARS THE GOVERNMENT IS COLLECTING 1.5% OF THE INCOME TAX IT SHOULD HAVE RECEIVED ON THESE 24 TAXPAYERS.

ALSO, THESE SAME 24 TAXPAYERS HAVE $230,000 IN UNUSED CREDITS AVAILABLE FOR CARRYBACK OR CARRYOVER. THESE TAX SHELTER SCHEMES WILL NET THESE 24 TAXPAYERS A TOTAL OF $368,113 IN REFUNDS OR AN AVERAGE REFUND OF $15,338. THE TOTAL REVENUE LOST ON THE 41 TAXPAYERS REVIEWED WAS $703,931, OR AN AVERAGE OF $17,169 PER TAXPAYER.

WE REVIEWED 70 RETURNS AT THE OTHER SERVICE CENTER OF TAXPAYERS INVOLVED IN ABUSIVE TAX SHELTER SCHEMES. BECAUSE OF THESE TAX SHELTERS, IT APPEARS THE GOVERNMENT IS COLLECTING ONLY 1.4% OF THE INCOME TAX IS SHOULD HAVE RECEIVED FROM THESE 70 TAXPAYERS. ALSO, THESE 70 TAXPAYERS HAVE $900,373 IN UNUSED CREDITS AVAILABLE FOR CARRYBACKS OR CARRYOVER. THESE SCHEMES WILL NET THESE 70 TAXPAYERS A TOTAL OF $1,377,133 IN REFUNDS, OR AN AVERAGE REFUND OF $18,865 PER TAXPAYER.

UNDER IRC 6411(D), THE SERVICE MUST PAY REFUNDS REQUESTED ON FORM 1045 WITHIN 90 DAYS. SINCE MIDDLE INCOME BRACKET TAXPAYERS ARE INVOLVED, WE ARE CONCERNED THAT ONCE AN EXAMINATION IS CONDUCTED AND THE INVESTOR HAS TO REPAY THOSE REFUNDS, THE SERVICE MAY ENCOUNTER DIFFICULTIES IN COLLECTING THE MONEY.

ANOTHER SCHEME WHICH HAS BEEN WIDELY PUBLICIZED AND SOLD IN 1982 AND 1983 INVOLVES THE SALE OF TIME-SHARING UNITS IN A TOWNHOUSE OR CONDOMINIUM, OFTEN LOCATED IN A RESORT COMMUNITY. THE INVESTOR PURCHASES EXCLUSIVE POSSESSION AND AN UNDIVIDED INTEREST IN AND TO THE TOWNHOUSE/CONDOMINIUM FOR ONE WEEK OUT OF EVERY YEAR. TOTAL COST FOR THE WEEK IS $21,000. THE INVESTOR PAYS $5,250 AS A CASH DOWN PAYMENT AND EXECUTES A NONRECOURSE NOTE FOR THE BALANCE OF $15,750. THE TERM OF THE NOTE IS 30 YEARS AT 17 PERCENT COMPOUNDED DAILY WITH THE INVESTOR REQUIRED TO PAY $4,200 PER YEAR FOR THE FIRST 8 YEARS OF THE 30-YEAR NOTE. THE INVESTOR MAKES NO FURTHER PAYMENTS UNTIL YEAR 30, WHEN ONE FINAL BALLOON PAYMENT OF THE OUTSTANDING PRINCIPAL AND INTEREST IS DUE. THE INVESTOR MUST FORM A PARTNERSHIP IN ORDER FOR THE ACCRUED INTEREST TO PASS THROUGH AND BE CLAIMED AS A DEDUCTION FOR A CASH-BASIS TAXPAYER.

INTEREST OVER THE 30-YEAR TERM OF THE NOTE IS PURPORTEDLY EARNED AND ACCRUED IN ACCORDANCE WITH THE RULE OF 78'S. THE RULE OF 78'S IS A METHOD OF CALCULATING INTEREST SIMILAR TO THE SUM-OF-THE-YEARS-DIGIT METHOD OF CALCULATING DEPRECIATION. IN THIS EXAMPLE, OVER THE FIRST 9 YEARS, THE INVESTOR WILL DEDUCT AN AVERAGE OF $7 OF INTEREST EXPENSE FOR EVERY $1 INVESTED OR IN EXCESS OF $286,000 FOR $38,850 ACTUAL CASH INVESTED. AT THE END OF 30 YEARS, THE INVESTOR OWES WELL IN EXCESS OF $500,000 WHICH INCLUDES THE NOTE OF $15,750 AND AN INTEREST CHARGE IN EXCESS OF $534,000. HOWEVER, THE NOTE WILL NOT BE REPAID AT YEAR 30, AND THE PROMOTER CAN ONLY TAKE BACK THE WEEK OF TIME-SHARING SINCE THE NOTE IS NONRECOURSE.

ANOTHER TYPE OF SCHEME THAT YOU MAY FIND PARTICULARLY INTERESTING INVOLVES CHARITABLE CONTRIBUTIONS. A PROMOTER OFFERS AN INVESTOR A PACKET OF GEMS FOR $5,000 WITH THE UNDERSTANDING THAT THE INVESTOR WILL HOLD THE GEMS FOR 1 YEAR, AT WHICH TIME THE PROMOTER ARRANGES FOR A WRITTEN APPRAISAL INFLATING THE VALUE TO $40,000. THE PACKET OF GEMS IS THEN DONATED TO A CHARITABLE ORGANIZATION, SUCH AS A MUSEUM, AND THE INVESTOR CLAIMS A CONTRIBUTION DEDUCTION EIGHT TIMES GREATER THAN THE ORIGINAL INVESTMENT. OR, A TAXPAYER MAY BUY $10,000 WORTH OF BOOKS "WHOLESALE" FROM A PROMOTER. THE TAXPAYER HOLDS THEM FOR ONE YEAR TO QUALIFY FOR CAPITAL GAINS TREATMENT AND THEN AGAIN DONATES THEM TO AN EDUCATIONAL ORGANIZATION. THE TAXPAYER DEDUCTS $40,000 AS THE SO-CALLED FAIR MARKET OR RETAIL VALUE OF THE BOOKS.

SCOPE OF THE PROBLEM

IN 1973, THE SERVICE BEGAN A TAX SHELTER PROGRAM FOCUSING ON FOUR AREAS -- OIL AND GAS, REAL ESTATE, MOVIES, AND FARMING. INITIALLY, ABOUT 400 SHELTER CASES WERE UNDER EXAMINATION. IN THE LATE 1970'S, AS THE POPULARITY OF TAX SHELTERS INCREASED, THEIR MARKETING BECAME MORE AGGRESSIVE, AND THE NUMBER OF ABUSIVE SCHEMES GREW. THE SCHEMES OFFERED BECAME MORE AND MORE EGREGIOUS.

BY THE BEGINNING OF 1980, WHEN THE SERVICE INITIATED ITS CURRENT PROGRAM TO COMBAT ABUSIVE SHELTERS, THERE WERE OVER 174,000 SHELTER RETURNS UNDER EXAMINATION (INVOLVING 19 DIFFERENT GENERAL CATEGORIES OR TYPES), AND 1,900 CASES IN LITIGATION. TODAY, THERE ARE ALMOST 325,000 SHELTER RETURNS UNDER EXAMINATION BY THE SERVICE. ROUGHLY 16,300 SHELTER CASES INVOLVING OVER $1 BILLION IN PROPOSED DEFICIENCIES ARE CURRENTLY PENDING BEFORE THE TAX COURT, EQUAL TO ROUGHLY 1/3 OF THE TOTAL DOCKET.

THE INVENTORY OF TAX SHELTER CASES IN OUR APPEALS FUNCTION EXCEEDED 16,500 IN APRIL OF THIS YEAR, SOME 21 PERCENT HIGHER THAN THE YEAR BEFORE. EVEN THOUGH APPEALS IS CLOSING NEARLY 1,000 CASES A MONTH NOW, AND FOR FY 1983 WILL CLOSE MORE THAN TWICE THE NUMBER OF CASES IT DID IN FY 1982, THE TOTAL INVENTORY CONTINUES TO GROW. THE ULTIMATE DISPOSITION OF THE RETURNS CURRENTLY UNDER EXAMINATION COULD CAUSE THE APPEALS INVENTORY TO INCREASE DRAMATICALLY.

OUR CRIMINAL INVESTIGATION DIVISION RECOMMENDED PROSECUTION OF APPROXIMATELY 102 PROMOTERS/BROKERS OF "TAX SHELTER" SCHEMES DURING FISCAL YEAR 1982 AND HAS ALREADY RECOMMENDED 52 SUCH INDIVIDUALS FOR PROSECUTION FOR THIS FISCAL YEAR (AS OF 4/29/83). THERE WERE APPROXIMATELY 13,000 INVESTORS INVOLVED IN THE 102 RECOMMENDATIONS IN FISCAL YEAR 1982, AND

APPROXIMATELY 19,000 INVESTORS INVOLVED IN THE 52 RECOMMENDATIONS TO DATE IN 1983. FOR FY 1982 AND 1983 TO DATE, 50 PROMOTERS/BROKERS WERE CONVICTED AND 42 OF THEM WERE SENTENCED, WITH 70 PERCENT RECEIVING A PRISON TERM.

RECENTLY, CRIMINAL INVESTIGATION IDENTIFIED OVER 680 INVESTIGATIONS WHERE THERE WAS EVIDENCE OF FOREIGN ACTIVITY. THESE INVESTIGATIONS COVERED THE PERIOD 1978 THROUGH MARCH 1983. AT LEAST 98 OF THESE INVESTIGATIONS CONCERNED AN ALLEGED FRAUDULENT TAX SHELTER. A MAJORITY OF THESE TAX SHELTER INVESTIGATIONS INVOLVED ALLEGED ACTIVITY IN ONE OR MORE FOREIGN TAX HAVEN COUNTRIES. THESE COUNTRIES ARE USED TO THWART OUR EFFORTS IN DETERMINING COMPLIANCE WITH OUR TAX LAWS.

IRS ACTIONS

ONE PORTION OF THE SERVICE'S EFFORTS IN ATTACKING TAX SHELTERS HAS BEEN FOCUSED ON THE IDENTIFICATION, SELECTION, AND EXAMINATION OF TAXPAYERS WHO CLAIMED A DEDUCTION/CREDIT FROM AN INVESTMENT IN AN ABUSIVE TAX SHELTER. THIS HAS RESULTED IN AN EVERGROWING INVENTORY OF OLD CASES AT ALL LEVELS OF THE ADMINISTRATIVE AND LITIGATION PROCESS.

IN AN EFFORT TO ADMINISTRATIVELY DISPOSE OF THESE OLD CASES AND TO FREE RESOURCES FOR THE NEWER SCHEMES BEING MARKETED, THE COMMISSIONER APPROVED A POLICY STATEMENT IN AUGUST 1982 TO ALLOW DISTRICTS TO OFFER OUT-OF-POCKET EXPENSES FOR CASES INVOLVING YEARS PRIOR TO 1981. WE ARE WATCHING THIS EFFORT CLOSELY TO SEE IF IT HAS ACHIEVED THE ANTICIPATED RESULTS. OUR VERY PRELIMINARY EVIDENCE SUGGESTS THAT IT MAY NOT BE, PERHAPS BECAUSE PROMOTERS AND PRACTITIONERS ARE ADVISING INVESTORS TO NOT ACCEPT THE OUT-OF-POCKET OFFER. ECONOMIC CONDITIONS AND THE SITUATIONS OF INDIVIDUAL INVESTORS MAY ALSO BE RESPONSIBLE. THEY SEE THE CASE INVENTORY GROWING, AND BELIEVE THAT THE SERVICE AND THE COURTS WILL NOT BE ABLE TO EFFECTIVELY HANDLE THE VOLUME. THUS, THEY ADVISE INVESTORS TO CONTINUE TO "HOLD OUT," ANTICIPATING THAT THE SERVICE, AT SOME POINT, WILL OFFER A BETTER DEAL THAN OUT-OF-POCKET EXPENSES. THIS WILL NOT BE THE CASE. WE ARE CONTINUING TO MONITOR THIS SITUATION CLOSELY, TO DETERMINE IF FURTHER CORRECTIVE ACTIONS ARE NEEDED.

ANOTHER APPROACH THE SERVICE IS TAKING WITH THESE TAX SHELTERS IS DEVOTING RESOURCES TO TRYING TO STOP PROMOTERS FROM SELLING AND MARKETING THESE SCHEMES THROUGH IMPLEMENTATION OF THE PROMOTER PENALTY AND THE INJUNCTION PROVISIONS OF TEFRA.

SINCE THE ENACTMENT OF TEFRA, WE HAVE OBTAINED A PRELIMINARY INJUNCTION ORDER INVOLVING A FAMILY TRUST SCHEME IN DALLAS. A CONSENT ORDER TO ENTRY OF AN INJUNCTION HAS BEEN OBTAINED AGAINST A SAN DIEGO PROMOTER INVOLVING A TRUST SCHEME. INJUNCTION SUITS HAVE BEEN FILED IN DALLAS AND MANHATTAN AGAINST PROMOTERS INVOLVED IN A TRUST SCHEME AND A STAMP MASTER SCHEME. OTHER INJUNCTION CASES ARE CURRENTLY PENDING BEFORE THE DEPARTMENT OF JUSTICE.

WHEN IRC 7408 WAS ENACTED, WE ENVISIONED BEING ABLE TO QUICKLY MOVE FORWARD AND OBTAIN AN INJUNCTION AGAINST A PROMOTER BEFORE THE ENTIRE PROMOTION HAS BEEN SOLD. THUS, WE WOULD NOT HAVE TO IDENTIFY AND EXAMINE THE INDIVIDUAL INVESTORS, WHICH WOULD ONLY ADD TO OUR INVENTORY. HOWEVER, OUR EXPERIENCE TO DATE INDICATES THAT WE WILL NOT BE ABLE TO PROCEED THIS QUICKLY. THIS IS DUE NOT ONLY TO THE CASE DEVELOPMENT WORK NEEDED IN ORDER FOR THE GOVERNMENT TO CARRY ITS BURDEN OF PROOF, BUT ALSO TO THE USUAL TIME DELAYS ASSOCIATED WITH IMPLEMENTING A NEW PROVISION OF THE CODE.

ANOTHER APPROACH THAT WE ARE CURRENTLY TESTING IS THE PRE-FILING NOTIFICATION TO INVESTORS THAT THE SHELTER THEY HAVE PURCHASED IS ABUSIVE, THE DEDUCTIONS ARE NOT ALLOWABLE, AND IF CLAIMED ON THEIR RETURN, THE RETURNS WILL BE EXAMINED AND PENALTIES ASSERTED. TO BE SUCCESSFUL, IT IS IMPERATIVE THAT

THE PRE-FILING CONTACT BE CONDUCTED PRIOR TO THE FILING OF THE RETURN FOR THE YEAR FOLLOWING THE INVESTMENT. THUS, WE MUST FIRST SECURE THE NAMES, ADDRESSES, AND TAXPAYER IDENTIFICATION NUMBERS OF THE INVESTORS. UNLESS THE PROMOTER VOLUNTARILY WILL PROVIDE THIS INFORMATION (WHICH IS UNLIKELY), OR WE ARE ABLE TO OBTAIN IT FROM PUBLIC RECORDS (WHICH ARE NOT ALWAYS AVAILABLE), WE MUST ISSUE AND SEEK ENFORCEMENT OF A JOHN DOE SUMMONS TO OBTAIN THE NEEDED INFORMATION. THE PROCEDURE RECOMMENDED BY ASSISTANT SECRETARY CHAPOTON YESTERDAY REQUIRING SHELTERS TO MAINTAIN LISTS AND TURN THEM OVER TO US WOULD BE OF GREAT HELP. AS YOU KNOW, THERE ARE TIME DELAYS INVOLVED IN OBTAINING ENFORCEMENT OF THE SUMMONS. WHEN THERE ARE EXTENSIVE TIME DELAYS, THE IMPACT OF A PRE-FILING CONTACT IS GREATLY REDUCED, BECAUSE THE INVESTOR HAS ALREADY FILED THE RETURN AND OBTAINED A REFUND. AT THIS TIME, FINAL RESULTS FROM THIS TEST ARE NOT AVAILABLE. HOWEVER, VERY PRELIMINARY RESULTS INDICATE THAT THE APPROACH IS SUCCESSFUL.

THE SERVICE THROUGH CRIMINAL INVESTIGATION HAS RECENTLY INITIATED A TASK FORCE, WITH PARTICIPATION FROM OUR EXAMINATION FUNCTION AND THE CUSTOMS SERVICE, TO IDENTIFY U.S. TAXPAYERS WHO ARE USING TAX HAVEN COUNTRIES AND/OR OFFSHORE BANKS TO EVADE U.S. TAXES AND TO COMMIT OTHER RELATED VIOLATIONS (SUCH AS TITLE 31). THE TASK FORCE WILL ALSO FOCUS ON THE EXTENT OF NONCOMPLIANCE IN THIS AREA AND THE SCHEMES AND TECHNIQUES USED. THE INFORMATION DEVELOPED BY THE TASK FORCE WILL BE ANALYZED AND DISSEMINATED TO OUR FIELD OFFICES FOR INVESTIGATIVE PURPOSES.

OUR CHIEF COUNSEL'S OFFICE HAS TO DATE TRIED OR SUBMITTED BY MOTION FOR SUMMARY JUDGMENT APPROXIMATELY 137 ABUSIVE SHELTER CASES IN THE TAX COURT. THERE HAVE BEEN 42 DECISIONS ALL FAVORABLE TO THE SERVICE. IN 35 OF THOSE 42 DECISIONS, THE COURT DID NOT PERMIT ANY DEDUCTIONS FOR OUT-OF-POCKET COSTS. IN 5 OF THE CASES, A VERY SMALL PART OF THE OUT-OF-POCKET EXPENSES WERE ALLOWED BY THE COURT. IN ONLY 2 CASES HAVE THE COURTS ALLOWED OUT-OF-POCKETS COSTS; BOTH OF THESE CASES WERE CHARITABLE CONTRIBUTION CASES.

JUST WITHIN THE PAST FEW WEEKS, THE TAX COURT DECIDED SEVERAL IMPORTANT TAX SHELTER CASES INVOLVING GOLD MINING, DREDGING, BOOKS, MASTER RECORDINGS, AND GEMSTONES. IN SEVERAL OF THE WRITTEN OPINIONS, THE COURT -- ADOPTING THE SERVICE'S NOMENCLATURE -- REFERRED TO THE TAX SHELTER SCHEMES AS "ABUSIVE."

IN ONE OF THE CASES, SAVIANO [SAVIANO V. COMMISSIONER, 80 T.C. NO. 51 (FILED MAY 18, 1983)] -- INVOLVING THE WIDELY-PROMOTED INTERNATIONAL MONETARY EXCHANGE (OR IME) GOLD MINING PROMOTION "GOLD FOR TAX DOLLARS" -- THE SERVICE SUCCESSFULLY ATTACKED ARTIFICIAL TAX DEDUCTIONS DERIVED FROM ALLEGED GOLD MINING ACTIVITIES IN PANAMA AND FRENCH GUIANA. SIGNIFICANTLY, THE SERVICE DID NOT ACTUALLY TRY THE CASE -- A PROCESS THAT COULD HAVE INVOLVED MONTHS OF EXHAUSTIVE TRIAL

PREPARATION AND COST THE GOVERNMENT THOUSANDS OF DOLLARS IN LITIGATION COSTS; INSTEAD, COUNSEL WAS ABLE TO ESTABLISH THE FAVORABLE PRECEDENT BY FILING A MOTION FOR SUMMARY JUDGMENT. THE GOLD MINING SHELTER OPINION DIRECTLY CONTROLS OVER ONE THOUSAND IME CASES PENDING BOTH ADMINISTRATIVELY AND IN COURT.

IN A COMPANION CASE, GRAF [GRAF V. COMMISSIONER, 80 T.C. NO. 50 (FILED MAY 18, 1983)], THE SERVICE SIMILARLY WAS SUCCESSFUL IN ATTACKING AN THER IME PROMOTION INVOLVING ALLEGED DREDGING OF LAND IN PANAMA. AGAIN, THE CASE WAS RESOLVED FOR THE SERVICE WITHOUT AN ACTUAL TRIAL.

IN ANOTHER RECENT CASE, ANSELMO [ANSELMO V. COMMISSIONER, 80 T.C. NO. 46 (FILED MAY 12, 1983)], A TAXPAYER WHO PURCHASED LOW QUALITY GEMSTONES OF NOMINAL VALUE, AND THEN DONATED THEM TO THE SMITHSONIAN, WAS DENIED A GROSSLY INFLATED CHARITABLE CONTRIBUTION DEDUCTION. THE GEMSTONE CASE HAD RECEIVED CONSIDERABLE PUBLICITY IN THE WASHINGTON POST. WHILE THE TAX COURT SUSTAINED THE SERVICE'S DETERMINATION OF TAX LIABILITY, IT NONETHELESS DISAGREED IN SOME RESPECTS WITH THE COMMISSIONER'S INTERPRETATION OF LAW. WE ARE NOW REVIEWING THE GEMSTONE OPINION TO DETERMINE WHETHER OR NOT WE AGREE WITH THE COURT'S ANALYSIS. IN ANY EVENT, AS POINTED OUT, THE COURT DID NOT ALLOW THE TAXPAYER TO DEDUCT THE FULL CLAIMED VALUE OF THE GEMS.

ON JUNE 6, 1983, THE SERVICE PUBLISHED REV. RUL. 83-84, 1983-23 I.R.B. 12, TO THWART THE ARBITRARY MANIPULATION OF INTEREST DEDUCTIONS THROUGH THE USE OF THE RULE OF 78'S BY TAXPAYERS USING THE ACCRUAL METHOD OF ACCOUNTING. USED IN LONG-TERM FINANCING TO COMPUTE INTEREST DEDUCTIONS, THE RULE OF 78'S CAN EASILY INFLATE DEDUCTIONS IN EXCESS OF THE ACTUAL PAYMENTS REQUIRED UNDER A LOAN AGREEMENT AND FAR IN EXCESS OF THE ACTUAL ECONOMIC COST FOR THE USE OF MONEY.

FINALLY, MR. CHAIRMAN, THE GENERAL ACCOUNTING OFFICE (GAO) HAS RECENTLY COMPLETED A DRAFT REPORT AT THE REQUEST OF THE JOINT COMMITTEE ON TAXATION DEALING WITH THE SERVICE'S EFFORTS ON ABUSIVE TAX SHELTERS. DRAFT REPORTS ARE BY DEFINITION SUBJECT TO REVISION, AND HAVE THEIR CIRCULATION CONTROLLED BY THE GAO, SO I AM NOT IN A POSITION TODAY TO SHARE WITH YOU THE DETAILS OF THE REPORT. I CAN SAY, HOWEVER, THAT IN GENERAL IT REACHES FAVORABLE CONCLUSIONS ABOUT THE SERVICE'S ACTIONS IN THE ABUSIVE TAX SHELTER AREA, AND MAKES SEVERAL USEFUL RECOMMENDATIONS FOR IMPROVING OUR PERFORMANCE EVEN MORE. THE REPORT SHOULD BE AVAILABLE IN FINAL FORM LATER THIS SUMMER.

CONCLUSION

I HAVE THOUGHT QUITE A BIT ABOUT THE APPROPRIATENESS OF THE TERM "ABUSIVE TAX SHELTERS." MANY OF THE SCHEMES BEING MARKETED TODAY ARE NOT REALLY TAX SHELTERS AT ALL, BUT OUTRIGHT FRAUDS. AS I NOTED EARLIER, WHEN THE TAX SHELTER BUSINESS FIRST STARTED, THE SHELTERS THAT WERE MARKETED STRETCHED THE

LAW IN MANY CASES, BUT GENERALLY DID NOT BREAK IT. CONGRESS, IN REACTING TO THOSE PROBLEMS, CLOSED LOOPHOLE AFTER LOOPHOLE EXPLOITED BY SHELTER PROMOTERS. LACKING THE OPTIONS PERMITTED BY EARLIER LAW, A GROWING NUMBER OF UNSCRUPULOUS PROMOTERS HAVE TURNED TO OUTRAGEOUS ASSET OR SERVICE VALUE OVERSTATEMENTS, NON-EXISTENT OR RIGGED "TRANSACTIONS," AND SIMILAR CLEARLY FRAUDULENT SCHEMES.

I WANT TO MAKE IT VERY CLEAR TO INDIVIDUALS WHO MAY BE THINKING OF INVESTING IN TAX SHELTERS, AND TO THOSE PROMOTERS WHO MAY BE THINKING OF STARTING ONE, THAT THE DOWNSIDE RISKS ARE NOW VERY DIFFERENT AND QUITE SUBSTANTIAL. IN CASES WHERE ESSENTIALLY TAX EVASION IS INVOLVED, WE INTEND TO IMPOSE IN VIGOROUS FASHION THE NEW FINES AND PENALTIES RECENTLY ENACTED BY CONGRESS AND, WHEN APPROPRIATE, PROSECUTE UNDER THE CRIMINAL SANCTIONS OF THE CODE THOSE RESPONSIBLE.

MY ASSOCIATES AND I WILL BE PLEASED TO TRY AND ANSWER ANY QUESTIONS YOU OR THE MEMBERS MAY HAVE.

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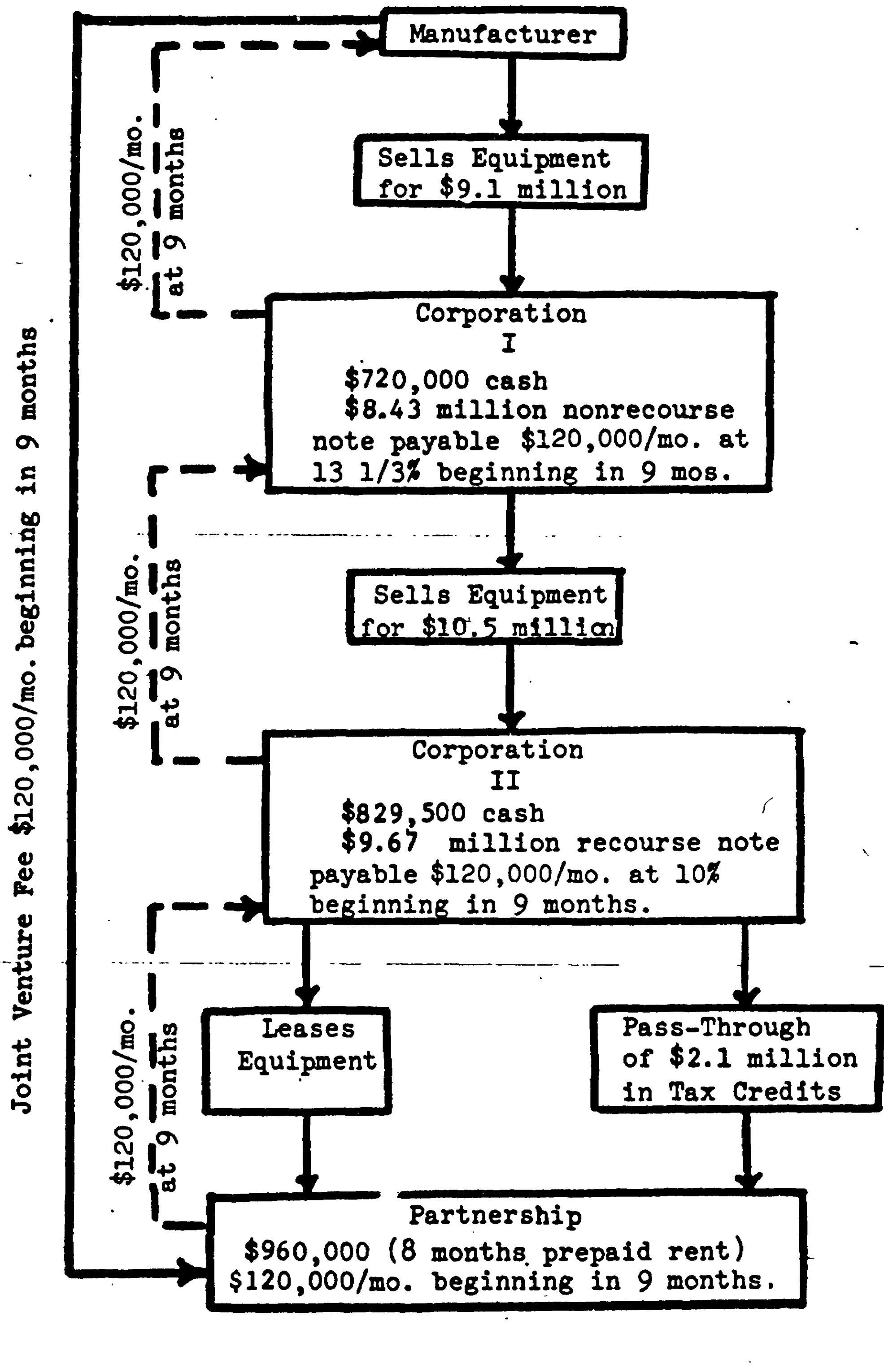

Manufacturer
Sells Equipment for $9.1 million
Corporation I
$720,000 cash
$8.43 million nonrecourse note payable $120,000/mo. at 13 1/3% beginning in 9 mos.
Sells Equipment for $10.5 million
Corporation II
$829,500 cash
$9.67 million recourse note payable $120,000/mo. at 10% beginning in 9 months.
Leases Equipment
Pass-Through of $2.1 million in Tax Credits
Partnership
$960,000 (8 months prepaid rent)
$120,000/mo. beginning in 9 months.
$120,000/mo. at 9 months
$120,000/mo. at 9 months
$120,000/mo. at 9 months
Joint Venture Fee $120,000/mo. beginning in 9 months

Mr. COATES. Fine. Thank you. Sitting with me on my right is Joel Gerber, the acting Chief Counsel, and on my left, Mr. Percy Woodard, who is the Assistant Commissioner for Examination. They will assist me in answering any questions you have following the opening statement.

It is difficult to define in a precise, academic manner an "abusive tax shelter." Any definition would unlikely cover all the possible structural alternatives which could be created by promoters of such shelters. Generally, abusive tax shelters utilize extreme, improper, and even illegal interpretations of the law or involve incomplete or misleading facts to attempt to secure for investors substantial tax benefits which are clearly disproportionate to the economic reality of the transactions. In a very real sense, abusive tax shelters are entered into with little or no expectation of a positive financial outcome, but rather the sole expectation of evading taxes.

Mr. Chairman, we believe that a large number of the abusive tax shelters being sold today are not really tax shelters in any traditional sense, but are frauds euphemistically referred to as tax shelters. Such frauds are characterized by backdated documents, fictitious notes, false affidavits, inflated appraisals, rigged transactions, forged trading records and distorted accounting methods, as well as a number of other clearly illegal mechanisms. We are seeing more and more of these devices all the time, many of which involved foreign tax havens, substantially hindering our ability to obtain evidence relating to their true nature.

We recognize that legitimate investments in sound business activities should be encouraged; in fact, existing tax laws in many cases are structured for this very purpose. However, the viability of our tax administration system depends to a great extent on taxpayers' perceptions that the system is fair and equitable, and that it is administered in a fair but firm manner. When abusive, illegal, and fraudulent tax shelters are openly touted as proper investments, public confidence in the tax system declines rapidly, producing the likelihood of reduced revenues and voluntary compliance and all that that implies. We do not believe it is in the best interest of the Service, the administration of the tax system, or the Nation, as a whole, to allow this to happen.

In my formal statement, Mr. Chairman, I have several examples, but we are going to review just one example. I am going to ask Mr. Woodard to review that with us, using a chart, and explain to you an example of an egregious situation that we wanted to bring to your attention.

Mr. WOODARD. This is a promotion, whereby the promoter forms a corporation to manufacture and sell equipment that qualifies for both the investment tax credit and the energy credit. As part of the promotion arrangement, the equipment is sold to corporation I for a nonrecourse note payable at $120,000 a month beginning 9 months after the transaction. The equipment is then sold to corporation II for cash and a recourse note, payable again at $120,000 a month, beginning 9 months after the transaction. An outside independent appraisal of this equipment has indicated a fair market value in this case of approximately $300,000. Corporation II then leases the equipment to a partnership composed of investors, and at this point this is the first place where the outside investors enter this scheme and arrangement.

The partnership, under the terms of the lease, makes a payment of 8 months' advance rental, again at the rate of $120,000 a month, and incurs the obligation to pay that same amount over a period beginning at the 9-month period. The partnership, which is composed of the investors, then enters into a joint venture arrangement with the manufacturer, whereby they propose to sell or lease this equipment to independent third parties. As part of this particular arrangement, the partnership is contributing the equipment. The manufacturer undertakes to negotiate the lease arrangements, and also agrees to provide a joint venture fee payable back to the partnership of $120,000 a month, again beginning at the ninth month. And this fee will be paid whether or not that equipment is ever leased to any third party or not. So at this point you have the only cash ever being paid to the manufacturer being the first cash payment on the front end. The note payments, as it moves through each tier, in each case, is a method of refunding the same money back through a chain of entities. The only difference in the cash payments are to cover the fees incurred by the other corporations of some $100,000, plus the interest differential on the various notes.

At the end of this transaction, what has happened is that equipment with an estimated fair market value of about $300,000 has been sold to the investors in their partnership at a price of $10.5 million, and therefore, the basis has been stepped up in a fashion that gives them an immediate credit, both for the investment tax credit and the energy credit, of $2.1 million. Also, the net effect is such that with these payments working in cycle, plus essentially the sale price of the first transaction being returned to them through joint venture fees that you have them obtaining for a $960,000 cash investment tax credits of $2.1 million. This problem is further compounded by the fact that these individual investors will then file with us applications for a tentative carryback of those tax credits on form 1045 because they can carry back the credits to their 3 prior tax years resulting in refunds. One of the most difficult problems is that we have to make that refund, by law, within 90 days, even though we have identified this as an abusive situation which we do not think will stand up on examination.

Mr. COATES. To ascertain the impact that this type of scheme had on our compliance efforts and what additional actions, if any, are needed, we are conducting a study at the national level. The study just commenced this month with visits to two service centers to review the forms 1045 that Mr. Woodard mentioned. I would like to share with you the results of those visits.

At one service center, we reviewed 41 returns that were involved in form 1045 abusive tax shelter schemes. Of the 41 returns reviewed, 24 had adjusted gross income of less than $50,000. Because of these tax shelters, it appears the Government is collecting 1.5 percent of the income tax it should have received on these 24 taxpayers. These tax shelter schemes will net the 24 taxpayers a total of $368,000 in refunds, or an average refund of about $15,000. The total revenue lost on the 41 taxpayers reviewed is $700,000, or an average refund of about $17,000 per taxpayer.

We reviewed 70 returns at the second service center. These schemes will net these 70 taxpayers a total of $1,300,000 in refunds, or an average refund of about $18,000 per taxpayer.

As Mr. Woodard mentioned, under section 6411(D) of the Internal Revenue Code, the Service must pay refunds requested on form 1045 within 90 days. Since middle-income bracket taxpayers are involved, we are concerned that once an examination is conducted and the investor has to repay these large refunds, the Service may, and indeed probably will, encounter difficulty in collecting the tax due.

By the beginning of 1980 when the Service initiated its current program to combat abusive shelters, there were over 174,000 shelter returns under examination involving some 19 different categories or types of shelters, and about 1,900 cases in litigation. Today, there are almost 325,000 shelter returns under examination by the Service. Roughly, 16,000 shelter cases, involving over $1 billion in proposed deficiencies, are currently pending before the Tax Court which is equal to roughly one-third of the total docket.

The inventory of tax shelter cases in our Appeals function exceeded 16,500 in April of this year, some 21 percent higher than the year before. Even though Appeals is closing nearly 1,000 cases a month now, and for fiscal year 1983 will close more than twice the number of cases it did in 1982, the total inventory continues to grow. The ultimate disposition of the returns currently under examination could cause the appeals inventory to increase dramatically.

Our Criminal Investigation Division recommended prosecution of approximately 102 promoters or brokers of the "tax shelter" schemes during fiscal year 1982, and has already recommended 52 such individuals for prosecution for fiscal year 1983, the current year. There were approximately 13,000 investors involved in the 102 recommendations in fiscal year 1982, and approximately 19,000 investors involved in the 52 recommendations to date in 1983. For fiscal years 1982 and 1983 to date, 50 promoters or brokers were convicted and 42 of them were sentenced, with 70 percent receiving a prison term.

A major part of the Service's efforts in attacking tax shelters has been focused on the identification, selection, and examination of taxpayers who claimed a deduction or credit from an investment in an abusive tax shelter. This has resulted in an evergrowing inventory of old cases at all levels of the administrative and litigation process.

In an effort to administratively dispose of these old cases and to free resources for the newer schemes being marketed, the Commissioner approved a Policy Statement in August 1982 to allow us to offer out-of-pocket expenses for cases involving years prior to 1981. We are watching this effort closely to see if it has achieved the anticipated results. Our very preliminary evidence suggests that it may not, perhaps because promoters and practitioners are advising investors not to accept the out-of-pocket offer. Economic conditions and the situation of individual investors may also be responsible. They see the case inventory growing, and believe that the Service and the courts will not be able to effectively handle the volume. Thus, they advise investors to "hold out," anticipating that the

Service, at some point, will offer a better deal than the out-of-pocket expenses. This will not be the case. We are continuing to monitor this situation closely to determine if further corrective actions are needed.

Another approach the Service is taking with these tax shelters is devoting resources to trying to stop promoters from selling and marketing these schemes through implementation of the promoter penalty and the injunction provisions of TEFRA.

Since the enactment of TEFRA, we have obtained a preliminary injunction order involving a family trust scheme in Dallas. A consent order to entry of an injunction has been obtained against a San Diego promoter involving a trust scheme. Injunction suits have been filed in Dallas and Manhattan against promoters involved in a trust scheme and a stamp master scheme. Other injunction cases are currently pending before the Department of Justice.

When the injunction procedure—IRC 7408—was enacted, we envisioned being able to quickly move forward and obtain an injunction against a promoter before the entire promotion had been sold. Thus, we would not have to identify and examine the individual investors, which would only add to our inventory. However, our experience to date indicates that we will not be able to proceed this quickly. This is due not only to the case development work needed in order for the Government to carry its burden of proof, but also to the usual time delays associated with implementing a new provision of the code.

Another approach that we are currently testing is the prefiling notification to investors that the shelter they have purchased is abusive, the deductions are not allowable, and if claimed on their return, the returns will be examined and penalties asserted. To be successful, it is imperative that the prefiling contact be conducted prior to the filing of the return for the year following the investment. Thus, we must first secure the names, addresses, and taxpayer identification numbers of the investors. Unless the promoter voluntarily provides this information—which is unlikely—or we are able to obtain it from the public records—which are not always available—we must issue and seek enforcement of a John Doe summons to obtain the need information. The procedure recommended by Assistant Secretary Chapoton yesterday requiring shelter promoters to maintain lists and turn them over to us would be of great help. Our Chief Counsel's office has, to date, tried or submitted by motion for summary judgment approximately 137 abusive shelter cases in the Tax Court. There have been 42 decisions, all favorable to the Service. In 35 of those 42 decisions, the Court did not permit any deductions for out-of-pocket costs. In five of the cases, a very small part of the out-of-pocket expenses were allowed by the Court. In only two cases have the Courts allowed out-of-pocket costs; both of these cases were charitable contribution cases.

In conclusion, Mr. Chairman, I have thought quite a bit about the appropriateness of the term "abusive tax shelters." Many of the schemes being marketed today are not really tax shelters at all, but outright frauds. As I noted earlier, when the tax shelter business first started, the shelters that were marketed stretched the law in many cases, but generally did not break it. Congress, in reacting to those problems, closed loophole after loophole exploited by shelter promoters. Lacking the options permitting by earlier law, a growing number of unscrupulous promoters have turned to outrageous asset or service value overstatements, nonexistent or rigged "transactions," or similar fraudulent schemes.

I want to make it clear to individuals who may be thinking of investing in tax shelters, and to those promoters who may be thinking of starting one, that the downside risks are now very different and quite substantial. In cases where essentially tax evasion is involved, we intend to impose in vigorous fashion the new fines and penalties recently enacted by Congress and, when appropriate, prosecute under the criminal sactions of the Code those responsible.

Thank you, Mr. Chairman. My associates and I will be pleased to answer any questions you may have.

Senator GRASSLEY. I am going to ask Mr. Woodward to present his testimony for the Treasury Department, if that is all right with you. We will then proceed with questions.

Mr. WOODWARD. Yes, sir. I would be happy to. That is fine.

Senator GRASSLEY. Would you begin. Mr. Woodward is the Acting Tax Legislative Counsel, of the Department of Treasury.

STATEMENT OF ROBERT G. WOODWARD, ACTING TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. WOODWARD. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the view of the Treasury Department concerning issues presented by certain tax shelter transactions. In his statement, Acting Commissioner Coates has described certain abusive tax shelter transactions and the efforts being taken by the Internal Revenue Service to deal with such transactions. We share the concern of the Internal Revenue Service that abusive tax shelter transactions, which, in many cases, border closely on fraud, pose a substantial threat to the functioning of our self-assessment system of taxation. As you know, a principal focus of the compliance provisions contained in title III of the Tax Equity and Fiscal Responsibility Act was abusive tax shelter tranactions.

I want to take the opportunity today to bring to the subcommittee's attention a number of transactions that we understand are being employed by taxpayers to support claims for unintended tax benefits. In many cases, these transactions provide the basis for tax shelter schemes. In general, we believe that the transactions to be discussed, illustrate significant deficiencies in the current law that merit the immediate attention of Congress.

Our written statement goes into extensive detail in discussing a number of unintended tax avoidance opportunities under current law. We have divided these transactions into three general categories. First, there are tax straddle transactions that arguably are not covered by the tax straddle limitations enacted in ERTA, and other similar tax avoidance devices. Second, there are transactions that are structured to exploit the incorrect tax treatment of the time value of money. Third, a variety of other transactions frequently employed by tax shelter partnerships, including special allocations, are discussed in our statement, and also certain like-kind exchanges, charitable contribution tax shelters, and prepayment abuses.

I will highlight some of the problems in each of these areas. However, before discussing these specific problems, I want to emphasize that a desire for additional revenue should not be the sole motive in dealing with tax shelters. The purpose of our testimony before this subcommittee is to carry out our responsibility to make the Congress aware of significant problems we see in the current tax law which allow taxpayers to claim unintended tax benefits. Where appropriate, we suggest ways that these problems might be addressed in order to make the tax system more equitable and to protect existing sources of federal revenue.

I will begin with a discussion of tax straddles and similar problems. The tax straddle restrictions enacted in ERTA adopted two general rules. First, commodity futures contracts trade on a domestic board of trade or exchange that are held on the last day of the taxpayer's year are treated as sold on that day under the mark-to-market rule. All capital gains and losses from transactions in these commodity futures are treated as 60 percent long term and 40 percent short term, resulting in a maximum rate of tax on gains of 32-percent.

Second, for transactions in actively trade property other than commodity futures contracts that are subject to the mark-to-market rule, a loss deferral rule denies loss deductions on positions sold to the extent there is unrecognized gain in an offsetting position at the close of the year. For convenience, I will refer to the second restriction as the loss deferral rule.

A problem we have encountered in the tax straddle area involves straddles in which one leg consists of a directly held position and the other leg consists of stock in a foreign corporation that holds a position that offsets the directly held position. In some cases, taxpayers may be able to struture the transaction so that they may claim a loss on the directly held position while the offsetting position held through the foreign corporation's stock will produce a gain. By closing out the loss leg prior to the close of the taxable year, a loss can be established for tax purposes. The reciprocal gain in the foreign corporation's stock will not bring the loss deferral rules into play because stock is not treated as an offsetting position under the current statute. If effective, this transaction would involve a circumvention of the tax straddle rules enacted in ERTA solely by means of utilizing a foreign corporation to hold one leg of the straddle. The Internal Revenue Service could well be successful in challenging such transactions on a variety of theories. And I assure you that they will attempt to do so. Nevertheless, we would suggest that the tax straddle rules be modified to clearly eliminate these abusive transactions.

Legislation has been introduced on the House side to deal with that particular device, I might add.

A second problem involves offshore commodity funds. Recently, interests in foreign corporations that invest in commodity futures contracts trade on U.S. exchanges have been sold to U.S. investors. As structured, these funds may produce two unintended tax benefits for investors. First, the investors' profits on the futures investments are not marked to market and taxes at year end as they would be if the futures contracts were held directly or through a U.S. investment vehicle. Second, profits on the futures investments are taxed at the long-term capital gains rate, a 20-percent maximum rate, instead of the 32-percent maximum rate provided for gains on futures contracts. Although these transactions also are subject to a tax under existing law, Treasury believes that legislative changes are needed to deal with these transactions designed to avoid the rules applicable to regulated futures contracts.

A third straddle problem—and I might add, the continuing instances of these tax straddles indicate that we continue to have very definite problems in dealing with abusive devices in that area—has come up with respect to certain trading activities in stock options. In general, stock options traded on a domestic exchange are exempt from the loss deferral rule previously discussed. However, since the enactment of ERTA, we have seen substantial indications that investors are attempting to defer the taxation of income through tax straddles in exchange-traded stock options. These transactions have taken two forms. In the first case, limited partnerships of wealthy investors claim to be acting as market makers in stock options. Straddle transactions in stock options are undertaken to produce losses, which are passed through to the investors, through the partnership vehicle, as ordinary losses.

In the second case, investors take offsetting positions in stock options—typically deep-in-the-money options which have a smaller time premium and a more predictable response to price fluctuations in the underlying stock—to defer short-term capital gains by taking the short-term capital loss on the loss leg of the straddle.

Structurally, these stock option straddles closely paralled the straddle transactions in commodity futures that were barred by ERTA. An example that illustrates this point is included in our written statement.

In our view, the ability to defer substantial amounts of income through essentially riskless transactions in stock options is just as objectionable as the straddling in regulated futures contracts and other actively traded property that occurred prior to enactment of the tax straddle rules in ERTA. The deferral of tax liability claimed to be achieved through these transactions, is, in substance, an interest-free loan from the Government of the deferral tax. We therefore believe that Congress should reexamine the exemption of exchange-traded stock options from the loss deferral rules. Certainly, we would favor a mechanical rule that would prevent the use of certain market maker partnerships as a means of passing through ordinary losses to defer taxation of ordinary income. Such rules are provided in S. 13, recently introdued by Senator Dole and others, to provide for the reduction of the long-term capital gains holding period to 6 months.

There are also a number of other current transactions which are not technically tax straddles, but which to attempt to achieve tax objectives comparable to those of certain tax straddles. For example, the short sale of stock that is about to go exdividend is a device that can be used to concert ordinary income to short-term capital gain. Although, in general, short-term capital gain is taxed in the same manner as ordinary income, capital gain income can be fully offset by capital losses, including loss carryforwards. In the absence of capital gain income, the deduction of the capital losses is severely limited. In effect, therefore, this transaction may permit taxpayers to circumvent the restrictions on the deductibility of capital losses. An example of this technique is included in our written statement.

We believe that the avoidance of the limitation on the deductibility of capital losses under this scheme should be prevented.

Similar to the transaction just described, taxpayers may, by means of brief ownership of shares in a regulated investment company that pays a capital gain dividend, convert short-term capital gain income to long-term capital gain income. As you know, long-term capital gains are taxes at 40 percent of the rate applicable to short-term gains. Again, an illustration of this transaction is set forth in our lengthy written statement.

Another problem involves the use of tax-sheltered investment funds as a device to convert dividend income to capital gain, and to defer payment of tax on that income. Although, again, these funds are subject to attack under the accumulated earnings tax of the present law, which was intended specifically to deal with problems of the sort that are involved with these tax shelter investment funds, the funds to continue to be marketed. Therefore, we think a clarification of the current statute may be needed to remove any doubt that the sanction of the accumulated earnings tax does apply to these funds.

The next major section of my testimony deals with time value of money problems.

Senator GRASSLEY. May I ask you to summarize that point?

Mr. WOODWARD. All right. I would be glad to, Mr. Chairman.

The time value of money, and the fact that the current tax law fails to treat it properly in a number of ways, is a foundation of many tax shelter transactions, and also devices, some of which have become fairly standard methods, to be used by business taxpayers to obtain unwarranted acceleration of deductions. We have testified on this subject previously. We go into extensive detail with the problems created in this area concerning the overstatement of accrued deductions, certain manipulative transactions that can be engaged in involving purchase money loans, and other transactions involving delayed payments for services or for the use of property. Another problem in this area is the interest-free loan device which is gaining continuing and increased play in the press as a device to be used to shift income within family and other units from high bracket taxpayers to low bracket taxpayers. It is being talked about widely on radio talk shows and in the newspapers. And we think that it is a significant problem that deserves attention.

There are also problems involving leveraged acquisitions of bonds that are traded at a market discount. We go into all of these problems in extensive detail in our written statement.

The final section of the statement deals with partnership schemes and various other problems. The partnership schemes involve special allocations which can be used effectively to assign income and deductions among partners to obtain maximum tax advantages, really distorted transactions at the expense of the Federal Treasury. You will probably be hearing a good deal more about that from some of the other witnesses today. I know that some of the bar groups may have some comments on that subject.

There also is the problem of misallocation of payments in transactions typically involving tax shelter real estate investments and prepayment devices which can be used to convert what are essentially down payments for property into a soft cost that is arguably deductible on a current basis by the partners.

We also talk about a potential problem that is known by some sophisticated tax planners that involves the use of the like-kind exchange mechanism with partnership interests as a potential device for bailing out of burned-out tax shelters without the payment of the gain attributable to liabilities in excess of basis. If successful, it is a way of avoiding the recapture income that the current law is intended to impose. There are also problems that we think are fairly serious, potentially, and if they are not already, involving deferred like-kind exchanges. We have fought these cases, unsuccessfuly to this point, in the courts. Under the *Starker* decision, deferred like-kind exchanges provide parties selling real estate, who are well-advised, essentially the option of whether they want to pay capital gains tax or not, or at least to defer their decision. If they want to invest in other real estate down the road some way some day, they can simply put ~~in a~~ deferred like-kind exchange provision in their contract and avoid the capital gains tax on what essentially are real estate sales.

Finally, in our statement, we deal with the charitable contribution tax shelter problem, which has received, again, a good deal of publicity, as you know. We are very concerned with the problem of the widespread abuse of the charitable contribution provision. Charitable deduction tax shelters result primarily from the fact that taxpayers are able to deduct the full fair market value of appreciated capital gain property without being required to pay tax on that appreciation.

An argument could be made that that is the heart of the problem. But we recognize that charitable organizations depend on the tax incentive of the nontaxation of the appreciation in capital gain property that is contributed to charities as a crucial means of acquiring property. This tax rule is certainly important to many charities.

We are not suggesting, by any means, a broad sweeping change in the tax rules concerning the charitable deduction for gifts of appreciated property. However, we think that some of the problems—and they often involve overvaluations, as you have heard from the Service—can be alleviated to a significant extent by providing that capital gain property which is not readily tradeable on an established market, and which has been held by the taxpayer for less than a 5-year period, should be treated as ordinary income property for purposes of the charitable contribution rule. This would limit the deduction to the taxpayers' basis in the property in those cases where the taxpayer buys an asset, holds it for, say, a year, and then contributes it to a charity.

We also think that the overvaluation penalty might be strenghtened in view of the continuing overvaluation problems that the Service and the Treasury continue to experience in that area. Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you, Mr. Woodward. I would like to call on Senator Dole, chairman of the full Committee on Finance, and my colleague, for his opening statement at this time.

Senator DOLE. I don't have an opening statement. Will that raise $73 billion? [Laughter.]

Mr. WOODWARD. We have not done any revenue estimates on any of these, I must emphasize. We, again, are not looking at it in that context. We think that these things should be considered wholly apart from any revenue raising effort.

Senator DOLE. We are willing to do that. We are willing to consider it wholly apart. But we would like some estimates.

Senator GRASSLEY. But you don't think these changes would amount to $73 million?

Mr. WOODWARD. Well, no.

Senator DOLE. But there are probably abuses that should be corrected very quickly. Do you have legislation drafted to address those areas?

Mr. WOODWARD. Many of the things I have discussed involve problems that we at the Treasury Department have been concerned about for some time. On many of these, we have given thought to possible legislative solutions, and we have drafted or at least thought about how you would go about drafting them. Many of them are fairly discreet, and they would not involve a significant drafting effort, particularly the tax straddle arrangements that I noted in the first part of my testimony. But we are always happy to work with the committee in this process, and we are happy to provide whatever information we can to assist you.

Senator DOLE. Well, I assume you are here because you think they should be corrected. Is that correct?

Mr. WOODWARD. That is correct.

Senator DOLE. So if it takes legislation, we ought to get it drafted.

Mr. WOODWARD. We would be happy to work with the committee staff. And, indeed, we have previously discussed many of these items with your staff and with the joint committee staff as well.

Senator DOLE. Well, we will probably have a lot of hearings around here in the next few weeks as we look at dead cats that we passed yesterday, $73 billion in new revenues. Eighty-eight percent of that budget resolution was dropped in the laps of this committee and the House Ways and Means Committee, and we have an obligation to try to put something together, and certainly these areas, should be addressed I think on a high priority before we start looking at other areas in the Tax Code. And I didn't hear Mr. Coates' testimony, but we heard yesterday about the $100 billion noncompliance gap, but we didn't hear how we closed it. I know it is difficult. And I don't have any other statement, but I appreciate your testimony.

Senator Grassley has done an outstanding job in this area trying to focus on compliance, and it seems to me that that must be our first priority, even though we have had a little loss on withholding.

It was suggested yesterday that there is another way to design withholding that wouldn't be so offensive to financial institutions, and perhaps we need to explore that.

Senator GRASSLEY. Yes. I will associate myself with all the remarks, including the comment on the cat——

[Laughter.]

Senator GRASSLEY. That the chairman of the committee said, except I would move very cautiously in defining the word "obligation."

Mr. WOODWARD. Mr. Chairman, if I might make a comment.

Senator GRASSLEY. Certainly.

Mr. WOODWARD. The position of the administration on the various proposals to raise revenues is well known. I think that nothing that I say here should be interpreted in any way as inconsistent with that. But as we and as this committee knows and believes and I think has accepted in the past, it is clearly unfair to consider raising tax rates on ordinary taxpayers before we have made every reasonable effort, not only to insure that the taxes assessed are complied with through compliance measures, but also that arrangements that might be permitted under the current statutes but which provide unintended tax benefits are seriously examined to see whether there is a way to deal with those matters that might relieve some of the pressure to raise general tax rates.

Senator GRASSLEY. It would be a good idea if someone from the administration would make the same comment you made about taxes daily.

I would like to ask a few questions now. From your charts, would you characterize this as an extreme and unique example of abuse, or not necessarily the most extreme example, with many others of a similar nature?

Mr. COATES. The latter, Senator. We could put a large number of those types of schemes and schemes similar to that, as well as many other examples of schemes. It just happens to be at the present time one of the more egregions types of shelters that we are dealing with.

Senator GRASSLEY. Would you repeat for Senator Dole, the amount of money lost to the Treasury through a shelter such as this?

Mr. COATES. We will let Mr. Woodard walk through that.

Senator GRASSLEY. All right.

Mr. WOODARD. Just to go back very quickly, what I was pointing out is that this is an arrangement whereby a promoter forms a company to manufacture a piece of equipment that qualifies both for the investment tax credit and for the 10 percent energy credit, and as part of the entire promotion package makes arrangements for all these transactions to occur nearly simultaneously. First, it is sold to a related corporation for a cash downpayment and a nonrecourse note payable at $120,000 a month with the payments beginning 9 months from the transaction date. This corporation, in turn, sells to Corporation II, again, for an additional consideration, but for a cash downpayment, and this time a recourse note, again payable at $120,000 a month, beginning 9 months from the day of the transaction.

At this point, the recourse note is necessary to permit the passthrough in a subsequent lease and to make that appear to qualify with the statutes.

Corporation II, in turn, leases this same equipment to a partnership for a cash payment equivalent to 8 months prepaid rent. Again, each of those months is the equivalent of the $120,000 a month arrangement carried out here. At the same time, the partnership and the manufacturer enter into a joint venture, whereby the partnership contributes the equipment, and the manufacturer agrees to undertake or attempt to lease that equipment to a third party, and as part of this arrangement, also agrees to pay as a joint venture fee back to the partnership, or the investors, an amount equal to $120,000 a month, whether or not that equipment is ever leased to a third party or not.

So the net effect of this is that you have a piece of equipment where we have an outside appraisal that indicates a fair market value of approximately $300,000 move through a series of entities in a way that increases the basis to $10.5 million, making the equipment subject to 20 percent in combined credits or an immediate tax benefit to those investors of $2.1 million based on an out-of-pocket expenditure on their part of $960,000.

The details of this are not that significant. The differences in the cash payment are made to cover some of the out-of-pocket expenses of these entities, plus an amount equal to the interest differential between the notes involved.

Also, these partners, as individuals, on the passthrough claim that credit on their individual tax returns and then file the tentative carrybacks on form 1045. And one of the problems we are experiencing there is because of the statute relating to those tentative carrybacks, we must make that refund withn 90 days, even though we can see that it comes from an abusive situation that will not stand up on examination. Very shortly put, that is the scheme.

Mr. COATES. And going one step further, those carrybacks, as I mentioned, amount to an average refund of $16,000 in tax refund from the study that we have just commenced. Those are going to be potential collection problems, and those collection problems are going to be another whole ball game.

Senator GRASSLEY. You have testified that we have 16,000 tax shelter cases before the Tax Court, and we have hundreds of thousands more under examination. Somewhere the figure of 325,000 cropped up, is that correct?

Mr. COATES. That is correct.

Senator GRASSLEY. These figures tell me that we haven't done a lot to solve the tax shelter problem. I am not blaming you for that. In fact, our tax administration system may be on the brink of a total collapse if these figures are correct.

I hope there is something that you could offer us here today in the way of comfort.

Mr. COATES. Senator Grassley, I would not characterize it as a complete collapse. Obviously, our inventories are building. We are closing more cases than we have ever closed, but we have not cut off the sources. The cases are still coming in.

Senator GRASSLEY. But we are losing ground?

Mr. COATES. We are losing ground in terms of our inventory, yes, sir.

Mr. WOODWARD. Mr. Chairman, if I might make a statement.

Senator GRASSLEY. Certainly.

Mr. WOODWARD. I think that for schemes such as this, of course, we did a lot last year to address these kinds of abusive transactions, and also in ERTA in the overvaluation penalty.

Senator GRASSLEY. But have we done enough so that we are making progress?

Mr. WOODWARD. It takes a while to get those penalty provisions implemented and enforced. And it may be that there are going to have to be some taxpayers who have to be hit pretty hard before the word really gets out and is understood that we mean business in dealing with this type of arrangement.

Senator GRASSLEY. Well would it be your judgment that the changes we have made will be effective enough to reverse the trend and enable to reduce the tax shelter problem within a reasonable period of time?

Mr. WOODWARD. I think that we certainly have every hope that we will be gaining ground. There is no question about that. And we have certainly appreciated your efforts in that regard.

Senator GRASSLEY. You have hope, but do you have confidence?

Mr. WOODWARD. Well, again, I would have to defer to those people who are out in the field—that is, the Internal Revenue Service—about that. But I know that they are confident that the tools that were given last year will be very helpful.

Senator GRASSLEY. I don't think it hurts if we are candid here. The point of this hearing is to determine if you think we have to do more, or you have to do more, or, together, we have to do more, in improving taxpayer compliance.

Mr. WOODWARD. From a legislative standpoint, I think that with this particular arrangement, there are two possibilities. First of all, there is the overvaluation penalty. The continuation of these kinds of arrangements might indicate that that penalty, although it is significant, is still not a sufficient deterrent and it might need to be increased. Second, we are looking at an approach to deal with these kinds of arrangements under the at risk rules applicable to investment tax credits. That has a lot of problems because it affects other things. And we will continue to study that and have done so with the staff already.

Senator GRASSLEY. Mr. Coates, you wished to respond.

Mr. COATES. I was just going to say, Mr. Chairman, that obviously I agree with Mr. Woodward that the impact of TEFRA has not yet been felt. Also, I think we are going to get a lot of benefit out of the TEFRA provisions.

We are doing something else, as my opening statement indicated. We are up front now in identifying, and if we can get some of the help that the Assistant Secretary Chapoton mentioned yesterday, or suggested, in terms of identifying these lists from the promoter of the protesters. We are now attempting to contact taxpayers before they file their returns, called a prefiling notification program, to tell them they have indeed invested in a shelter that is abusive and one that is almost going to guarantee an examination of their return and penalties and deficiency.

Senator GRASSLEY. Can the names of the taxpayers involved in abusive tax shelters be obtained quickly enough to notify each person of the consequences of their actions?

Mr. COATES. Before they file their return? Today we are not able to get those. We have to go through a John Doe summons procedure to get those lists of investors. If we had a way of getting those lists sooner if the promoter was required to maintain lists, and we could get our hands on them, then we could move up front and attempt to cut off the source of these cases.

Senator GRASSLEY. Can you or can you not accomplish this?

Mr. COATES. We cannot do that today.

Senator GRASSLEY. Thus the investor does not know until he has filed his income tax, if he has run afoul of the IRS.

Mr. COATES. Well, he may know he has a problem, but he hasn't heard it directly from us. We would like to tell him before he files his return that he surely has a potential problem.

Senator GRASSLEY. We gave injunctive power to the Internal Revenue Service under the abusive tax shelter provision of TEFRA last year. Have you used that injunctive power at all?

Mr. COATES. Yes, sir, we have. And I am going to let our acting chief counsel, Mr. Gerber, address that.

Mr. GERBER. Mr. Chairman, as Mr. Coates testified, we have four cases which we have put forward so far, two of which have resulted in injunctions, one by consent and one by determination on the merits by the court. There are two other cases which we have filed for, but have not yet received results on. I might note that we have acted early in this particular area by forming a group of people who specialize in reviewing requests for injunctions and forwarding them over to the Department of Justice. Representatives from different functions of the Service are in the national office, review various requests submitted from the field for injunctions, and we have a number moving toward the Justice Department.

Senator GRASSLEY. Is that a fairly thorough description of your clearance procedures? If not could you describe those clearance procedures?

Mr. GERBER. I could be more specific, yes, Mr. Chairman. We have formed a group in Washington which represent various functions of Internal Revenue and the legal divisions of the Chief Counsel's Office. That group receives from all parts of the country, from all of the districts of Internal Revenue Service, recommendations for injunctions which must, as you well know, be sent to the Department of Justice for prosecution. The Government has the burden of proof in these cases. And so this group spends a great deal of time—it is very labor intensive—reviewing the materials that must go forward to the Department.

The group does not spend large amounts of time. We have been moving them rather quickly. But the problem is that it is labor intensive, both in terms of agents' time, attorney time, and when the case is brought to court, we must have the ability to sustain our burden.

Senator GRASSLEY. Since TEFRA was enacted, has an analysis been made by your group as to whether or not the provisions are working as effectively as anticipated? Will an administrative analysis be made shortly?

Mr. GERBER. Well we pointed out in the testimony, and I would reiterate it here to some extent, that this is a new program and it takes some time to get it started. That is the first thing, the startup cost and extra resources expended on a learning curve. The second part of it—and I am noting that it is very labor intensive to develop these cases, not only in terms of our agents' time but in terms of the Department of Justice's time. And I think that the number of injunctions that we have seen so far is not necessarily indicative of the number that we will have, say, a year from now. It is hard to quantify though, or even qualify, at this point whether we have met our expectations since we are really in a startup mode and we are not certain of how many injunctions we will have, say, a year from now.

Senator GRASSLEY. Mr. Gerber, recently an injunction was denied against a tax return preparer despite allegations of fraud by the Internal Revenue Service. Are you satisfied with the Internal Revenue Service's ability to obtain injunctive relief under such provisions?

Mr. GERBER. I believe that the case that you are referring to, Mr. Chairman, was a criminal case. We have not lost any civil cases to this point under the new TEFRA provision under section 7408. My understanding is that that was a criminal case and related to a different type of situation.

Senator GRASSLEY. Prior to TEFRA you had injunctive authority against preparers, is that correct?

Mr. GERBER. Yes. There was a case in Georgia where the judge determined that under sections 7407 and 7402 of the Internal Revenue Code that the Service was not entitled to enjoin a preparer in a situation where they had posted bond. That case is presently on appeal in the circuit court, and the Service did lose the case; however, the case has not been finally determined and it is now before the circuit court.

Senator GRASSLEY. How does that affect your consideration of whether or not the Internal Revenue Service has the ability to obtain injuctive relief under such provisions? Have you reached a conclusion on that?

Mr. GERBER. No, we have not. Although we are hopeful that we will be successful in the second round of that case in the circuit. I might note that we had an earlier case in Minnesota in which we used section 7407 and 7402 in order to enjoin a promoter of a double foreign double trusts, and we were very successful in that setting. This was our first loss in the area, and we are still awaiting the outcome of the circuit court case. The addition of section 7408, providing for injunctions for promoters has so far been very successful, and we are hopeful that we will be continuing to stop promoters early on, which is the better way to deal with the problem rather than tying up audit resources after we have allowed them to sell these tax shelters over a period of time.

Senator GRASSLEY. Mr. Coates, your recent revenue ruling preventing the early accrual of large interest deductions by the method called rule of 78's should stop an abuse prevalent in condominium time-sharing agreements. Is there any evidence that this ruling has halted this flagrant shelter type activity?

Mr. COATES. It is a very recent ruling, Senator. It was issued in the past few weeks and we have not yet had the opportunity to use the ruling, or we have no evidence or indication that it has been used to date. We have every expectation that it is going to help us

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considerably in dealing with the rule of 78 in the time-sharing schemes.

Senator GRASSLEY. Using that as an example of an abusive tax shelter and the problems your agency has experienced in discovering those types of tax shelters, can you tell us how much time it takes to collect the funds owed the Treasury once the shelter has been identified?

Mr. COATES. No, sir. We do not have any way of saying how long it takes. Some may close sooner than others. But shelter investors/promoters typcially are not quick to agree, and the time does become lengthy. Obviously if they go all the way through the administrative appeals and into court, we could talk about literally months or years of putting money in the bank.

Mr. GERBER. Mr. Chairman, I might add to Mr. Coates' comment. We have had some experience in the litigation area with shelter investors. They tend to want to stay in the system because it adds to the deferral and puts off the day of reckoning with respect to paying the tax. I think that our experience has been that they are abnormal. They are not like our regular cases in that the people are not interested in resolving their tax controversy with the Government, on the front end. They want to wait until the last possible moment. And that is one of the reasons that they tend to clump or group up in the system, as they have both in our examination, our appeals and in our litigation stream. There is no benefit to settle their case on the front end.

Senator GRASSLEY. I believe that you, Mr. Coates, recently testified on behalf of the Treasury Department that approximately $90 billion is lost annually from noncompliance with our tax laws. Yet, the revenue loss from tax shelters is judged to be about 5 percent of that figure. I think we need a response for those who criticize the Internal Revenue Service for spending so much time on tax shelters when it is such a small part of that total noncompliance. In conjunction with that, do we have any sort of cost benefit analysis to support the current allocation of resources toward investigating and litigating tax shelter abuses?

Mr. COATES. We do not have a cost benefit analysis, Senator Grassley. We do know roughly or approximately what it is costing us in terms of staff power to administer the tax shelter program. It is extremely difficult to project what the revenue that will result. We know it is large. We know there are lots of dollars. But at any stage, many of these tax returns are in different stages of the examination process, and we are not able to predict with any degree of reliability what the potential revenue or tax result will be. We are confident that it will pay off in terms of the resources that are being spent. I would ask Mr. Woodard if he has any additional comments.

Mr. WOODARD. We have data concerning the cases that we have closed by year, and to give you an example, in the cases closing from examination during the current fiscal year there is a variation in the dollar results per return by different classes of tax shelter. But, overall, the recommended tax coming out of examination is in excess of $15,000 per return. And that amount is substantially in excess in what we get in other programs where we are using our other selection systems.

Senator GRASSLEY. From a historical perspective, can you provide this subcommittee with the results of your examination in prior years?

Mr. COATES. We have the results of our examinations for prior years, and we can certainly provide it for the record.

Senator GRASSLEY. All right.

Senator GRASSLEY. Do you see this as justification for the resources put into this, even though it is only 5 percent of the noncompliance.

Mr. COATES. Yes, sir.

Senator GRASSLEY. You do?

Mr. COATES. We sure do.

Mr. GERBER. I might not, Mr. Chairman, it appears clearly cost productive * * * this particular activity. There are approximately $1 billion worth of deficiencies pending in the Tax Court with respect to 16,000 some odd cases. There are 325,000 more cases in the examination area. And we have been extremely successful, as our testimony points out, we recover a high percentage of the deficiencies, so that the recovery rate is near to 95 to 100 percent. That, I think, is an indicator of the quality of the type of deficiencies we are dealing with and I think helpful to any estimates we may be able to make.

Mr. WOODWARD. Mr. Chairman, I would also like to add a comment on that. I think that focusing on the direct cost of tax shelters in the tax system overlooks the indirect cost of these type arrangements on other types of noncompliance. When individuals who might not be actual tax shelter investors read all the publicity about tax shelters, they tend to question why they should pay their taxes and might resort to less sophisticated means of noncompliance. Those who invest in tax shelters tend to talk about them, and even joke about them. And this has an impact in the system on the perception of all taxpayers as to whether they ought to worry about paying their true tax liability. So I think that at least some, and I think it is probably a substantial part of the other noncompliance figure, may well be attributable to the tax shelter item in the figures that you indicate.

Senator GRASSLEY. Mr. Coates, when you supply that information, why don't you put it in terms of this question. What is the marginal return in increased receipts from $1 dollar spent on shelter enforcement? In other words, in terms of the return for every dollar that we spend on enforcement.

Mr. COATES. All right, sir.

[The information follows:]

Examination utilizes a resource allocation model which enables us to maximize yield to cost. During fiscal year 1982, resources allocated to examinations of individual returns produced the following results:

	Dollars per	
	Return	Hour
Tax shelters	14,322	1,105
All other individual returns	6,339	339

We are unable to determine the "marginal" return in increased recommended tax from $1 spent in shelters enforcement. However, on the average we received a yield to cost of approximately 27:1 in the Tax Shelter Program as compared to a yield to cost of 8:1 in all other individual examinations, based on recommended tax. In our largest tax shelter class of returns (total positive income over $50,000) even in the lower DIF score ranges, tax shelters produce on the average $6,500 a return while all other individual examinations produced $1,500 a return, for returns filed in 1980 and examined since that time.

Senator GRASSLEY. All right. I have just one or two more questions at this time. I will submit all other questions in writing. Many nonabusive tax shelters combine certain tax benefits and then market them through limited partnerships. Many of these tax benefits, such as accelerated depreciation, investment tax credits, and intangible drilling costs, are recaptured by the Treasury when a taxpayer transfers the property. These deductions, or a portion of these deductions, should be included in the taxpayer's ordinary income when the property is transferred. Based on that presumption, how does the Internal Revenue Service monitor whether or not a taxpayer pays tax on the recaptured benefits?

Mr. COATES. I think you are speaking, Senator, of what we refer to as a burnout or at the time of the burnout. At the present time, we do not have a sophisticated tracking system for all of the shelter investors. We will have before the end of this year a data processing system, or an automated system, that will provide us the means to track every shelter investor at any time they are in the system and where they are. At that time we will be able to track exactly what happened to the shelter to insure that benefits are recaptured. And if we know that there is a problem, then we can treat it at that time or handle it at that time.

Senator GRASSLEY. Do you have any way, then, of telling us how much recaptured tax income you might be missing?

Mr. COATES. No, sir, not at this time. But let me defer to Mr. Woodard to see if he has any additional thoughts or information.

Mr. WOODARD. Nothing, except that we will have, beginning October 1, a computer based tracking system, as Mr. Coates mentioned, that will push those returns automatically for identified investors. So that those returns will automatically come out to us for tracking as to whether or not there has been a disposition of the property.

Senator GRASSLEY. Is there any way to monitor whether a taxpayer rolls his recaptured liability into another investment without performing an audit?

Mr. WOODARD. The rollovers are principally in the commodity area which has been addressed by Treasury. The most common thing we are seeing in the noncommodity type tax shelters is really not the disposition of the property showing up or the rollover of the profit, but simply the acquisition of substantially additional numbers of abusive tax shelters. In most of these situations, the principal benefits, or the excess deductions, are obtainable in the first 3 years of the tax shelter. And after that period, we are seeing more and more investors go out and acquire additional abusive tax shelters, so now you see many that have interests in 10 or more different abusive tax shelters.

Senator GRASSLEY. Thank you all very much for testifying here today. I will send you questions to answer in writing, and would appreciate you prompt response. So please respond as quickly as you can.

[The information follows:]

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

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The Honorable Charles E. Grassley
Chairman, Subcommittee on Oversight of the
Internal Revenue Service
Senate Finance Committee
Washington, DC 20510

Dear Mr. Chairman:

Thank you for your June 29 letter to Associate Commissioner Coates and your comments about the June 24 oversight hearing on tax shelters.

I have enclosed responses to the three questions raised in your letter, which I trust will be responsive to your needs.

With kind regards,

Sincerely,

Roscoe Egger

Enclosures

1. Can you explain the structure of your tax shelter enforcement division? How many people does the agency employ and in which capacities to track down abusive tax shelters?

The Service does not have any "tax shelter enforcement division" as such in its organization. Instead, tax shelters are addressed primarily through the Tax Shelter Program, which uses the combined skills of representatives of our Examination, Criminal Investigation, Appeals, and Chief Counsel functions in both the field and the National Office. The Tax Shelter Program began in 1973, and has continued under various organizational and administrative alignments ever since.

In those districts with the largest volume of tax shelter returns, Examination has formed tax shelter groups to examine only abusive tax shelter promoters and investors.

The Service's information systems typically do not track resources by program, so it is not possible to provide definitive figures on the staff devoted to tax shelters. However, the major functions involved have estimated their commitments to tax shelters for FY 1982 as follows:

	Estimated FY 1982 Staff-Years
Examination	2,330
Criminal Investigation	200
Appeals*	210
Chief Counsel	150
Total	2,890

The Appeals Division is organizationally part of Chief Counsel, but is shown separately here for information.

2. You testified that we lose over $90 billion annually from tax noncompliance. Yet the revenue loss from tax shelters is less than 5 percent of that figure. How do you respond to criticism that the IRS has, for the past several years, allocated too many resources to tax shelters? Do you have cost-benefit studies that support the current allocation of resources? What is the marginal return in increased receipts from a $1 spent on shelters enforcement?

Mr. Coates' testimony as Acting Commissioner on the tax gap took place at a June 23 hearing before the full Finance Committee. At that time, he noted that the estimated total tax gap was some $90.5 billion for 1981, consisting of approximately $81.5 billion in the legal sector and some $9.0 billion in the illegal sector.

The statement that the revenue loss from tax shelters is less than 5 percent of the $90 billion apparently refers to an earlier IRS estimate which put the annual revenue loss from tax shelters at some $3.6 billion. That figure was a projection, based on 1979 TCMP data on just one abusive tax shelter area (commodities). More recent experience with abusive tax shelters leads us to believe that the annual revenue loss may be higher, although we are unable to pinpoint it exactly.

We are unaware of any criticism of the level of resources being devoted to tax shelters. In any event, the Service believes that its current resource commitment is well justified in light of the effect tax shelters have on both revenues and voluntary compliance. At the same time, we recognize that additional resources are not the only answer to this problem. Overall, we feel the collective impacts of the relevant ERTA and TEFRA provisions, effective administrative techniques (such as the out-of-pocket approach and the pre-filing notification), and efficient use of existing resources will ultimately help bring the tax shelter problem under better control.

Our Examination function utilizes a resource allocation model to maximize yield to cost. During FY 1982, resources allocated to examinations of individual returns produced the following results:

	Dollars Per	
	Return	Hour
Tax Shelters	$14,322	$1,105
All Other Individual Returns	6,339	339

We are unable to determine the "marginal" return in increased recommended tax from $1 spent in shelters enforcement. However, on the average we received a yield to cost of approximately 27:1 in the Tax Shelter Program as compared to a yield cost of 8:1 in all other individual examinations, based on recommended tax. In our largest tax shelter class of returns (total positive income over $50,000) even in the lower DIF score ranges, tax shelters produce on the average $6,500 a return while all other individual examinations produced $1,500 a return, for returns filed in 1980 and examined since that time.

3. Judge Tannenwald and Mr. Alexander have urged that the tax shelter litigation explosion has not yet been solved. They recommend, at least implicitly, a further increase in the interest rate even on a compound basis. Do you agree? Could such a rule be targeted to tax shelters?

The testimony given by Judge Tannenwald and Mr. Alexander at the June 24 oversight hearing stated explicitly that the relevant provisions of ERTA and TEFRA should be given time to work as intended by Congress, and that it was still too early to determine if that was happening. For example, the provisions of TEFRA section 344 (IRC 6622), that all interest due be compounded daily, and TEFRA section 345 (IRC 6621), that interest rate adjustments be made semi-annually, have only been in effect about seven months -- a relatively brief period for gathering operational statistics and assessing their meaning.

The Service supports the position of the Treasury Department, as expressed by Assistant Secretary Chapoton at the June 23 Finance Committee hearing on the tax compliance gap, that further legislative changes at this time may be premature, and would only serve to burden those in both the public and private sector working to implement ERTA and TEFRA provisions.

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

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Dear Mr. Chairman:

I appreciated having the opportunity to testify before your Subcommittee on the subject of abusive tax shelters. In your letter of June 29, 1983, you raised several questions regarding my testimony. I will answer each of your questions in turn. At the outset, however, I would like to emphasize that our comments relating to abusive tax shelters are not motivated by a desire simply to obtain additional Federal income tax revenues. Rather, we are merely carrying out our responsibility to make the Congress aware of significant problems we see in the current tax law which allow certain taxpayers to obtain unintended tax reductions.

Question 1: Judge Tannenwald and Mr. Alexander share the view that the tax shelter litigation explosion has not yet been solved. They recommend, at least implicitly, a further increase in the interest rate charged on underpayments. Do you agree? Could such a rule be targeted to tax shelters?

Answer: A tax underpayment is the equivalent of a loan to the taxpayer in an amount equal to the amount of the underpayment. Consequently, the rate of interest charged on underpayments should approximate the rate of interest at which taxpayers can borrow. However, the current statutory rate, the prime rate, is well below the borrowing rate of most taxpayers.

Unfortunately, raising the rate of interest charged on underpayments presents certain difficulties. Under current law, the same rate of interest is paid on overpayments as is charged on underpayments. An overpayment represents a lending by the taxpayer to the Government. Since the cost of funds borrowed by the United States is below the prime rate, an increase in the overpayment rate--is not desirable. Different rates for underpayments and overpayments, however, likely would require new, and more complicated, statutory rules for interest computations. Legislation raising the underpayment interest rate should not be considered until satisfactory solutions have been found to the problems raised by imposing these different rates. We would welcome the opportunity to work with your Subcommittee in developing these rules.

We would oppose limiting any increased rate of interest charged on underpayments to those underpayments that arise from disallowed tax shelter deductions. We do not believe that a different rate of interest is appropriate because the borrowing represented by an underpayment attributable to unjustified tax shelter deductions is not sufficiently different from borrowings attributable to other underpayments.

Question 2: Do I understand that if you and I form a partnership with equal contributions and those contributions are used to purchase depreciable income producing property, that all partnership income may be allocated to me and all partnership deductions allocated to you?

Answer: Taxpayers have taken the position that the scheme of allocations you describe is permissible and there is some support for this position in the tax literature. There are substantial arguments that can be made to strike down allocations of this type, and it is not clear how this issue would be resolved in the courts. You can readily see the potential for abuse if these allocation schemes are permitted, and we think now is an appropriate time for legislative action to stop these abuses.

Question 3: Does this Treasury effort to close loopholes have any impact on the tax system as a whole or does it just affect the taxpayers who are taking advantage of those loopholes?

Answer: Closing tax loopholes has significance far beyond the impact that the legislation has on those taxpayers directly affected. A critical part of our voluntary tax system is each taxpayer's willingness to bear his fair share of the tax burden. The high rate of compliance with the tax laws that has existed in this country is attributable in part to the perception of most taxpayers that other taxpayers are paying their fair share. Public awareness of the fact that many taxpayers reduce or eliminate taxes through arcane transactions surely erodes the perception that our tax system is fair, and inevitably will reduce voluntary compliance. Thus, closing loopholes is a matter that the Treasury Department takes very seriously.

Question 4: Will the Treasury's proposed rules for charitable contributions of personal property adversely affect legitimate charitable giving?

Answer: As I indicated in our testimony, we believe that much of the problem of "tax shelter giving" can be alleviated if the following two provisions are enacted:

a. The amount of the deduction permitted for gifts of capital gain property which is not readily tradeable on an established market and has been held by the taxpayer for five years or less will be limited to the taxpayer's basis in the property; and

b. The overvaluation penalty would be extended to all donated property, including property held for more than five years.

We do not believe that either provision will have any effect on legitimate charitable giving. As to the first provision, except in the case of tax-motivated giving, taxpayers do not acquire property with the expectation of holding it for a year or so and then giving it to charity. Rather, property is purchased for investment, personal use or both. Thus, this provision should have no impact on taxpayers who donate to charitable organizations items such as family heirlooms, art collections, art objects, stock in closely held companies or land. These donations typically are made only after the donor or his family has owned and enjoyed the property for many years.

Similarly, extending the overvaluation penalty to gifts of property held for more than five years would not affect any legitimate charitable gift. The penalty does not apply to minor discrepancies in valuation. It only applies where the value of property claimed as a deduction is 150 percent or more of its actual value. Thus, the penalty would not affect any taxpayer who takes a deduction for a charitable gift based on a good faith estimate of value.

Question 5: Do I understand the Starker case to mean that I can sell unimproved real estate at a gain and not recognize that gain if instead of taking cash I simply tell the seller to take the cash and use it to purchase other real estate for me? And is it true that I can wait as long as I want before I designate the property to be acquired?

Answer: It is true that a taxpayer can essentially sell at a gain real property used in a trade or business or held for investment and avoid recognizing that gain by instead of taking cash, having the buyer use such cash to purchase other real property that he may designate in the future. These transactions, called "deferred like-kind exchanges," are permitted by existing case law.

With respect to the second part of your question, the Starker case indicates that a taxpayer would have at least five years before he would be required to designate the property he wished the buyer to purchase on his behalf. We do not believe the like-kind exchange provisions were intended to permit this type of deferral. There is no justification for a deferral rule that is this liberal, and such a rule would certainly be abused. Accordingly, we believe that legislation should be enacted to reverse the Starker decision.

Sincerely,

Robert G. Woodward

Robert G. Woodward
Acting Tax Legislative Counsel

The Honorable
Charles E. Grassley
Chairman, Subcommittee on Oversight
of the Internal Revenue Service
Committee on Finance
United States Senate
Washington, D.C. 20510

Senator GRASSLEY. I would like to encourage continued dialog regarding specific changes in the law. I do not want to pursue this, though, in the guise of writing another big tax bill, such as the $73 billion called for in the budget resolution. Compliance is a subject in and of itself which we need to address. I think reestablishing the credibility of our tax system is very basic to keeping the volunteer aspects of taxpayer compliance. I believe this to be a worthy goal, regardless of the need to raise revenue or to reduce taxes.

Mr. COATES. Thank you, Senator.

Mr. GERBER. Thank you, Mr. Chairman.

[The prepared statement of Mr. Woodward follows:]

For Release Upon Delivery
Expected at 9:30 a.m., E.D.T.
June 24, 1983

STATEMENT OF
ROBERT G. WOODWARD
ACTING TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department concerning issues presented by certain tax shelter transactions.

In his statement, Acting Commissioner Coates has described certain abusive tax shelter transactions and the efforts being taken by the Internal Revenue Service to deal with such transactions. We share the concern of the IRS that abusive tax shelter transactions -- which in many cases border closely on fraud -- pose a substantial threat to the functioning of our self assessment system of taxation. As you know, a principal focus of the compliance provisions contained in Title III of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") was abusive tax shelter transactions.

We wish to take the opportunity today to bring to the Subcommittee's attention a number of transactions that we understand are being employed by taxpayers to support claims for unintended tax benefits. In many cases, these transactions provide the basis for tax shelter schemes. In general, we believe that the transactions to be discussed illustrate significant deficiencies in the current law that merit the immediate attention of Congress.

For convenience, we have divided these transactions into three categories:

(1) Tax straddle transactions not covered by Title V of the Economic Recovery Tax Act of 1981 ("ERTA") and other similar tax avoidance devices.

(2) Transactions structured to exploit the tax treatment of the time value of money.

(3) A variety of other transactions frequently employed by tax shelter partnerships, including special allocations, and like-kind exchanges, charitable contribution tax shelters, and prepayment abuses.

I will discuss problems in each of these categories in turn. However, before discussing these specific problems, I want to emphasize that a desire for additional revenues should not motivate changes relating to tax shelters. The purpose of our testimony before the Subcommittee is to carry out our responsibility to make the Congress aware of significant problems we see in the current tax law which allow taxpayers to claim unintended tax benefits. Where appropriate, we will suggest ways that these problems might be addressed in order to make the tax system more equitable and to protect existing sources of Federal revenue.

I. Tax Straddles and Similar Problems

(1) Use of Foreign Corporation to Avoid Loss Deferral Rule

The tax straddle restrictions enacted in ERTA can be summarized for present purposes as two general rules:

- Commodity futures contracts traded on a domestic board of trade or exchange that are held on the last day of the taxpayer's year are treated as sold (marked to market) on that day; all capital gains and losses from transactions in such commodity futures are treated as 60 percent long-term and 40 percent short-term, resulting in a maximum rate of tax on gains of 32 percent.

- For transactions in actively traded property other than commodity futures contracts subject to the above rules, a loss deferral rule denies loss deductions on positions sold to the extent that there is unrecognized gain in an "offsetting position" at the close of the year. Separate wash sale and short sale rules also are made applicable to straddle transactions. The foregoing rules are embodied in Internal Revenue Code section 1092; for convenience, they will be referred to as the "loss deferral" rules.

A problem we have encountered in the straddle area involves straddles in which one leg consists of a directly held position and the other leg consists of an interest in a foreign corporation that holds a position that offsets the directly held position. In some cases, taxpayers may be able to structure the transaction so that they may claim a loss on the directly held position while the offsetting position held through the foreign corporation will produce a gain. By closing out the loss leg prior to the close of the tax year, a loss can be established for tax purposes. (As is typical of straddle transactions, after establishing the loss, the taxpayer would promptly acquire a position similar to the position closed out to maintain a balanced position, thereby avoiding risk of market fluctuations.) The reciprocal gain in the foreign corporation will not bring the loss deferral rules of section 1092 into play because "stock" is never treated as a "position." As a result there is neither an "offsetting position" nor a "straddle."

If effective, this transaction would involve a circumvention of the tax straddle rules of ERTA, solely by means of the utilization of a foreign corporation to hold one leg of the straddle. The Internal Revenue Service could well be successful in challenging such transactions on a variety of theories. Nonetheless, we would suggest that the tax straddle rules be modified clearly to eliminate these abusive transactions.

H.R. 3096, recently introduced by Representative Stark, would remedy the problem presented by this transaction by including in the definition of a "position" stock which constitutes "commodity substitute stock." Commodity substitute stock would be defined as "stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders."

We agree that in circumstances such as those described above, corporate stock should be treated as a "position." We have some concern, however, that a test that looks only to the intention for forming or utilizing the corporation might not be effective in some cases in which taxpayers are willing to adopt aggressive return filing positions. Therefore, we would prefer a remedy that looks to certain objective criteria -- primarily the asset composition of the corporation, and the extent to which the corporation lends itself to avoidance of the tax straddle rules -- to determine the circumstances under which stock should be treated as a position.

(2) Offshore Commodity Funds

Recently, interests in foreign corporations that invest in commodity futures contracts traded on U.S. exchanges have been sold to U.S. investors. As structured, these funds may produce two unintended tax benefits for investors:

- The investors' profits on the futures investment are not marked to market and taxed at year end as they would be if the futures contracts were held directly or through a U.S. investment vehicle.
- Profits on the futures investment are taxed at long-term capital gains rates (20 percent maximum), instead of the 32 percent maximum rate provided for gains on futures contracts.

A simplified description of the organization of a typical fund is as follows: An investment adviser will set up a foreign corporation ("X"), which in turn will set up a foreign subsidiary ("Y"). Both X and Y are incorporated in tax haven jurisdictions. X issues its shares to a large number of U.S. persons. Y engages in trading in commodity futures on a U.S. exchange through an independent U.S. broker. The hoped for tax consequences of this structure are as follows:

- Y is not subject to current U.S. taxation on its trading income because it is not engaged in the conduct of a U.S. trade or business.
- Y is not subject to the accumulated earnings tax because it distributes dividends annually to X.
- X is not subject to current tax on its income or the accumulated earnings tax because it derives no U.S.-source income (the dividends from Y are not U.S.-source income since Y is not engaged in a U.S. trade or business).

- The shareholders of X are not subject to current U.S. tax under the personal holding company, foreign personal holding company or controlled foreign corporation provisions of the Code because of the widely diversified ownership.

- The shareholders of X can obtain long-term capital gains treatment on a sale of their X stock. X is not treated as a foreign investment company under section 1246 of the Code. Section 1246 provides that gain from the sale of the stock of a foreign corporation will result in ordinary income if more than 50% of the voting power or value of the foreign corporation is owned by U.S. persons and if the corporation is primarily engaged in the business of investing or trading in securities, as defined under the Investment Company Act of 1940. However, commodity futures contracts are not "securities" for this purpose.

H.R. 3096 would deal with the accumulated earnings tax and section 1246 problems presented by these funds. First, Code section 535 would be amended to provide that if a foreign corporation derives more than 10% of its earnings from U.S.-source income (or income effectively connected with the conduct of a U.S. trade or business), then any distribution out of such earnings received by another foreign corporation that is controlled by U.S. persons will be treated as U.S.-source income for purposes of the accumulated earnings tax. Thus, under the facts above, X could be subject to the accumulated earnings tax. Second, section 1246 would be amended to include commodities as "securities," with the result that dispositions of the stock of X would result in ordinary income treatment.

Treasury believes that the changes made by H.R. 3096 are needed to deal with these transactions designed to avoid the rules applicable to regulated futures contracts. Thus, we support the provisions of H.R. 3096 dealing with offshore commodity funds.

(3) Stock Options

In general, stock options traded on a domestic exchange are exempt from the loss deferral rules of section 1092. Only in the case where options are written for a term in excess of the long-term capital gains holding period (currently one year) do the loss deferral rules apply. At this time, exchange-traded stock options have a maximum term of approximately nine months; thus, exchange-traded stock options are exempt from the loss deferral rules. This exemption was provided in the tax straddle provisions enacted in ERTA because the Congress believed that, for several reasons, tax straddling in stock options would not occur.

Since the enactment of ERTA, we have seen substantial indications that investors are attempting to defer the taxation of income through tax straddles in exchange-traded stock options. These transactions have taken two forms:

- Limited partnerships of wealthy investors claim to be acting as market makers in stock options. Straddle transactions in stock options are undertaken to produce losses, which are passed through to investors as ordinary losses.

- Investors take offsetting positions in stock options -- typically deep-in-the-money options which have a smaller time premium and more predictable response to price fluctuations in the underlying stock -- to defer short-term capital gains by taking the short-term capital loss on the loss leg of the straddle.1/

Structurally, stock option tax straddles closely parallel the straddle transactions in commodity futures that were barred by ERTA. A typical transaction would be the following:

> Shares of T Corp. stock are trading at 75. On December 1, X buys (goes long) a T Corp. May 35 call option and simultaneously sells short a T Corp. May 40 call option. The premium required to be paid on the May 35 call is 41, while the premium to be received on the May 40 call is 36. T stock subsequently rises to 85. At the same time, the May 35 call increases in value from 41 to 51, and the May 40 call increases in value from 36 to 46. X closes out the May 40 call at a loss of 10 and immediately sells short a May 45 call, for 41. T stock does not change in value until year end. On January 2, X closes out the May 35 call at a profit of 10, and the May 45 call for no gain or loss. If,

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1/ Even though the straddle rules of ERTA do not apply to these two types of transactions, the transactions are subject to challenge under Rev. Rul. 77-185, 1977-1 C.B. 48. In one Tax Court case, the court disallowed commodity straddle losses due to the absence of a profit motive. Smith v. Comm'r, 78 T.C. 350 (1982).

on the other hand, T stock had declined in value, X would have experienced a loss on the long May 35 call, and a corresponding gain on the short May 40 call with the result that the straddle loss would have been claimed on the long side. Thus, irrespective of the direction in which the market moved, X would have been able to produce a tax loss without material risk or cost (other than transaction costs).

In our view, the ability to defer substantial amounts of income through essentially riskless transactions in stock options is just as objectionable as the straddling in regulated futures contracts and other actively traded property that occurred prior to enactment of Title V of ERTA. The deferral of tax liability claimed to be achieved through these transactions is, in substance, an interest-free loan of the deferred tax from the government. Alternatively, such deferral can be viewed as an actual reduction of tax liability as a result of the time value of money. We therefore believe that Congress should re-examine the exemption of exchange-traded stock options from the loss deferral rules. Certainly, we would favor a mechanical rule that would prevent the use of so-called market maker partnerships comprised of more than 35 percent limited partners from claiming ordinary losses in order to defer taxation of ordinary income. Such rules are provided in S. 13, recently introduced by Senator Dole and others to provide for the reduction of the long-term capital gains holding period to six months.

(4) Short Sale of Stock Before Ex-Dividend Date

By means of a short sale of stock that is about to go ex-dividend, a taxpayer may, without incurring any substantial risk or cost (other than transaction costs) transmute ordinary income into short-term capital gain. Although, in general, short-term capital gain is taxed in the same manner as ordinary income, capital gain income can be offset by capital losses (including capital loss carryovers). In the absence of capital gain income, the deduction of capital losses is severely restricted. In effect, therefore, the transaction may permit taxpayers to circumvent the restrictions on the deductibility of capital losses. A typical transaction would be as follows:

Assume X Corp, whose shares are trading at $10, has declared but not yet paid a dividend of $2 per share. A borrows 100 shares of X stock from broker B, and sells the shares short, receiving $1,000. On the dividend payment date, A must pay B $200 as a substitute for the dividend. Following payment of the dividend, the stock drops from $10 to $8 (reflecting the decrease in value of the shares from payment of the dividend). Thus, A may close the short position by buying 100 shares for $800, profiting $200 on the short sale -- the profit corresponding exactly to the amount of the dividend substitute payment. Under Rev. Rul. 62-42, 1962-1 C.B. 133, the dividend substitute is allowed as an ordinary deduction under section 212. The corresponding gain on the short-sale transaction is short-term capital gain.

We believe that the avoidance of the limitation on the deductibility of capital losses under this scheme should be prevented. In our view, the Code should require the taxpayer to capitalize, rather than deduct, the payment of the dividend substitute on the borrowed stock.

(5) Capital Gain Dividend From Mutual Fund

Similar to the transaction described in (4), taxpayers may, by means of brief ownership of shares of a regulated investment company ("RIC") that pays a capital gain dividend, convert short-term capital gain income to long-term capital gain income. Long-term capital gains are taxed at 40 percent of the rate applicable to short-term gains. The transaction is the following:

A, who has a $35,000 short-term capital gain from a previous transaction, learns that RIC R is about to declare a capital gain dividend of $35. R shares presently trade at $100. On November 1, 1983, A buys 1,000 shares of R for $100,000. On November 15, 1983, a capital gain dividend of $35 is declared and paid, at which time A has a $35,000 long-term capital gain and the value of the R shares falls to $65. On December 2, A sells his R shares for $65,000, realizing a $35,000 short-term capital loss. A's $35,000 short-term capital loss from the transaction in R shares is netted against A's short-term gain from the previous transaction, leaving A with $35,000 of long-term gain that will be taxed at $7,000. A's short-term gain would have produced a tax of $17,500. Thus, merely by owning R shares for one month -- and incurring minimal risk of market price fluctuation -- A has reduced his tax liability by $10,500.

Under section 852(b)(4)(A) of the Code, short-term loss treatment on the sale of RIC shares is denied to shareholders who hold such shares for less than 31 days. This 31-day rule reflects a desire to insure that where a taxpayer's RIC share ownership is transitory, capital gain dividends are not accorded preferential treatment because the shareholder has not, to any meaningful degree, participated in the risk of fluctuation in value of the RIC assets. In our view, the 31-day period currently provided is not sufficiently long. In its place, we believe that Congress should consider adopting a rule that requires that the shares be held until the earlier of (a) 6 months after purchase of the shares, or (b) 3 1/2 months after the close of the year following the purchase of the RIC shares. This rule would restrict the ability of taxpayers to acquire RIC shares for the primary purpose of converting short-term gains to long-term gains. The shorter 3 1/2-month period for year-end purchases would enable taxpayers to satisfy a longer holding period requirement, and, at the same time, to file timely returns of tax. Because the pattern of taxation of real estate investment trusts ("REITs") closely parallels the rules applicable to RICs, a similar rules should be provided for REITs.

(6) Tax Sheltered Investment Funds

Recently, several large investment funds have been organized with the objective of investing in corporate stocks. The funds avoid status as a regulated investment company in order to preclude the pass through to the shareholders of dividend income received by the funds. The funds typically invest in high-yield corporate stocks, but pay no dividends. Instead the funds apply the investment returns to acquire additional stock investments. Although investors in the funds do not receive dividends, they obtain a return on their investment in the form of a formula redemption price: to the extent that the assets of the fund increase in value, so does the price at which shares will be redeemed. Because of the widely diversified ownership of the funds, it is not difficult to insure that all gains arising on redemptions are taxed at long-term capital gains rates, with the result that shareholders obtain a market rate of return on their investment that is taxed as long-term gain rather than at ordinary rates.

These funds largely avoid liability for corporate tax through the 85 percent corporate dividends received deduction. Because of the funds' intention merely to invest in portfolio assets, and not to pay dividends, the funds appear to be subject to the accumulated earnings tax as a mere holding or investment company. Indeed, the IRS has ruled that such funds are subject to the accumulated earnings tax. Rev. Rul. 77-399, 1977-2 C.B. 200. Nevertheless, the funds apparently take the position that the accumulated earnings tax does not apply because shares of the funds are publicly held, relying on court cases holding that the accumulated earnings tax did not apply to certain publicly held companies.

In our view, the case for imposition of the accumulated earnings tax on investment companies of this type is very strong. We believe, however, that it would be desirable to confirm by amendment to the Internal Revenue Code that the mere fact that shares of a corporation are publicly held does not prevent the imposition of the accumulated earnings tax.

II. Time Value of Money Problems

The high interest rates and inflation that we have experienced in recent years bring into question the economic assumptions that underlie certain provisions of the Internal Revenue Code. These high rates have resulted in a material increase in the "time value of money." In the simplest terms, the time value of money is the difference between the value of immediately available funds and the right to receive funds at some time in the future. In many respects, the Code ignores time value of money concepts. For example, where an accrual basis taxpayer is entitled to accrue a $1 deduction, the Code permits a full $1 deduction whether the $1 is paid today or ten years in the future. Obviously, the value of a $1 deduction today is more than a $1 deduction ten years from now. The failure of the Code to recognize this difference has led to numerous tax shelter transactions that enable taxpayers to produce substantial unintended tax benefits -- at a substantial revenue loss to the government. Even though interest rates have fallen and the inflationary spiral of recent years has been broken, we believe the time has come for a fundamental reexamination of several provisions of the Code that do not properly take time value of money concepts into account.

The time value of money concept was the basis for two recent legislative changes:

- Sections 1232A and 163(e) were added to provide for a geometric or constant interest computation for original issue discount ("OID") arising on the issuance of certain debt obligations. Prior to the change, the OID on such obligations was deducted ratably (on a straight line basis) over the life of the bond. This straight line deduction had been exploited by the issuance of deep-discount, long-term obligations to tax-exempt entities. The faulty method of computing the issuer's interest deductions had the effect of materially overstating the issuer's tax deductions over the life of the bond.

- The Technical Corrections Act of 1982 prevents taxpayers from amortizing the discount on certain OID obligations issued in reorganization transactions without a corresponding inclusion of the discount in income by the holders of the obligations. The claiming of current deductions for the discount on these obligations without concomitant inclusions in income, if allowed, would produce a very substantial revenue loss to the government on a present value basis.

In this section, we will discuss several problems involving time value of money problems, together with proposed solutions to those problems.

(1) Overstatement of Accrued Deductions

As noted above, one of the most fundamental and obvious time value of money issues is the determination of the proper amount of the deduction to be allowed where a liability arises today in connection with a payment to be made in the future. Assume, for example, that A, an accrual basis taxpayer, incurs in 1983 a legal obligation to pay $100 to B in 1990 for work to be performed in 1990. Two issues are presented in determining the amount and timing of A's deduction. The first -- which goes beyond the scope of this statement -- relates to the proper interpretation of the test (the "all events" test) for determining when an expense is to be accrued and deducted by accrual method taxpayers. In our view, a deduction for expenses is allowable under the all events test only when the taxpayer has a present liability to pay for the expenses. In the above example, we believe no accrual of a deduction would be permitted because the work has not been performed and, therefore, there is no present liability to pay the expense.

More pertinent to the discussion at hand, however, is the second issue presented by the example -- the amount to be deducted. If A is allowed to deduct $100 in 1983, a gross overstatement of the deduction will occur. As the $100 need not be paid for seven years, A can fund that liability today for much less than $100. Thus, if A set aside $57.23 in 1983, and invested that amount at an 8 percent after-tax rate until 1990, he would in 1990 have exactly the $100 needed to satisfy his liability to B. A's obligation can be described in two ways:

- An obligation to pay $100 of cash in 1990.
- An obligation to pay an amount in the future which in 1983 has a present value of $57.23.

From an economic point of view, therefore, A's deduction should be $57.23 in 1983 or $100 in 1990. In no case should A be permitted to deduct $100 in 1983.

Because of the uncertainty as to the proper discount rate to be employed in determining the present value of future liabilities, we are concerned that a rule allowing deductions for the present value of future expenses could be subject to manipulation. Permitting a deduction at the time of payment avoids this problem, however. The taxpayer is not disadvantaged by such a rule because the amount to be deducted will correspond precisely to the true economic cost of the liability.

We propose, therefore, that the "all events" test for accrual of deductions be amended expressly to provide that no deduction will be allowed until the taxpayer has a present liability to pay the expense.2/ We would, of course, support administrative rules of convenience that would permit deductions currently for liabilities to be paid in the near future. Thus, a present liability might be defined as one that is paid in the year it arises or in the next taxable year. To insure that taxpayers obtain the full benefit of any deduction required to be deferred under this rule, the net operating loss carryback rules could be amended to provide for longer carryback periods for losses attributable to such deductions.

(2) Purchase Money Loans

Under the original issue discount rules of the Code, discount on a debt obligation is treated as interest and is required to be taken into account by both borrower and lender over the term of the obligation. Take the following simple example: Borrower wishes to borrow $100 from Lender for a period of 2 years at a 10 percent rate; Borrower also wishes

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2/ In our discussion below, we suggest a rule that permits earlier accruals where both parties to the transaction agree to report the transaction consistently. If, in the example in the text, A and B agreed to accrue deductions and income of $57.23 in 1983, generally we would have no objection to allowing such accruals. However, permitting the accrual of the present value of future deductions could be used as a tax shelter device to create deductions to offset current income. Thus, the clear reflection of income notions of section 446(b) would continue to be an important limitation on the proper time for accruing and deducting future expenses.

to borrow the interest that will fall due prior to maturity. Thus, the parties agree that Borrower will obtain $100 at the beginning of year 1 in exchange for Borrower's obligation to repay $121 at the end of year 2. The transaction alternatively could have been structured as Borrower's payment of $10 interest to Lender at the end of year 1, with Lender immediately reloaning that amount to Borrower, and Borrower's repayment at the end of year 2 of (a) the total amount borrowed, $110 ($100 plus $10 advanced at the end of year 1), plus (b) $11 interest due for year 2 on the $110 "principal."

The OID rules achieve the same result as a borrowing where the periodic interest is reloaned by applying the yield to maturity of the obligation (10 percent in this example) to the amount borrowed ($100) for the first year; and by applying the yield to maturity to the amount borrowed plus the amount of interest considered paid and reloaned in subsequent years. Thus, for year 1, the OID includible in income by Lender and deductible by Borrower is $10 (10 percent of $100). In year 2, the OID amount is $11 (10 percent of $100 plus $10).

Under the Code, the OID rules are not applicable where a debt obligation is issued in exchange for property, unless either the debt obligation issued or the property acquired is traded on an established securities market. Take the case, therefore, where A buys Blackacre from B. The price of Blackacre is agreed to be $100, and A and B further agree that B will lend A the purchase price of the property for a period of two years together with interest due at maturity at a 10 percent rate compounded annually. Thus, A will pay B $121 at the end of year 2, in exchange for B's transfer of Blackacre to A at the beginning of year 1.

In the case where A is an accrual method taxpayer, the economically accrued interest in year 1 is $10. Some persons have claimed that A is entitled to deduct $10.50 under a straight-line method (or even more under other methods) as interest in year 1. Since B, a cash method taxpayer, will include no interest in income until he receives payment at maturity, mismatching of income and deductions occurs. In a long-term lending transaction, the value of deductions being claimed by the borrower is very substantial on a present value basis because the deductions will be claimed over the life of the obligation. The income inclusions of the lender, however, will come only at maturity, and the present value of the tax revenue to be derived will be very small. The result of this disparity between the present value of the interest deductions and the present value the income inclusions is a substantial revenue loss to the government. Take a more realistic example, involving a $20,000,000 purchase money mortgage with interest accruing at the rate of 12.5 percent, but payment of the interest deferred for a period of 20 years at which time the instrument matures. The present value of the tax reduction attributable to the aggregate deductions to be claimed by a taxpayer in a 50 percent marginal tax bracket -- and, therefore, the revenue loss to the government -- is $22.2 million. On the other hand, the present value to the government of the income inclusion to a cash method lender also in the 50 percent bracket is $9.1 million. Thus, the mismatching in this transaction costs the government $13.1 million on a present value basis.

This disparity in the tax treatment of borrowers and lenders was the basis for adoption of the ratable inclusion rule for holders of OID instruments in 1969. Under these rules, OID is required to be taken into account annually by lenders and borrowers -- irrespective of their method of accounting. Obviously, a purchase money transaction is simply a loan in combination with a purchase transaction. We believe that the material disparity in the tax treatment of purchasers and sellers in the case of discount purchase money transactions now requires a legislative solution similar to the 1969 changes in the treatment of OID.

In examining purchase money transactions in 1969, the difficulty encountered was determining the value of the property sold and the true interest rate applicable to the borrowing. Given these two variables, multiple solutions are possible. There was concern that buyers might claim a low property value (particularly where the property was non-depreciable and non-amortizable) and a high interest rate (to produce large interest deductions), whereas sellers would be inclined to place a high value on the property (to produce maximum capital gain and to defer recognition of installment sale gain), while claiming a low interest rate (to minimize ordinary income). Leaving the two variables open to independent resolution by the parties obviously could result in the government being whipsawed.

Our proposed solution to this problem is similar to the proposed rule for deferred accruals discussed in (1) above. The general rule would be that discount interest on a purchase money obligation is neither taxable to the lender (seller) nor deductible by the borrower (buyer) until the year that payment actually occurs. Earlier accruals would be permitted, however, where two conditions are satisfied:

- Seller and purchaser agree on the purchase price charged for the property and the yield to maturity on the obligation. (The interest agreed upon must, however, exceed a rate fixed by imputed interest rules to prevent artificial understatements of interest.)

- The seller must agree to include annual accruals of interest on the obligation in income, consistent with the agreed terms.

These rules would eliminate the whipsaw concern that led to the exception for purchases of non-traded property in the OID rules in 1969. It would remedy a significant problem in the current tax law without imposing undue burdens on buyers and sellers of property.

(3) Application of OID Rules to Transactions Other than Purchases of Property

We believe it is also appropriate to apply the rules just discussed in the context of obligations given in exchange for services or for the use of property. Three somewhat dissimilar cases will illustrate how present law provides opportunities for tax avoidance by failing to take into account time value of money concepts:

> Case 1: In year 1, Landlord rents Blackacre to Tenant for 3 years, for $331,000, payable at the end of year 3. Under present law, Tenant, an accrual method taxpayer, takes the position that he may deduct $110,333.33 each year, in effect deducting an equal portion of the total amount to be paid in each year. Landlord, a cash method taxpayer, would include nothing in income until the end of year 3.

In substance, Tenant is paying $100,000 per year as rent, which Landlord then loans to Tenant until the end of year 3 at 10 percent interest, compounded annually. Thus, Tenant should deduct, and Landlord should include in income, $100,000 as rent in year 1. In year 2, there should be income and deductions of (a) $100,000 as rent, and (b) $10,000 as interest for the year 1 loan of $100,000. In year 3, income and deductions should be (a) $100,000 as rent, (b) $11,000 as interest on the year 1 loan balance of $110,000 ($100,000 plus accrued but unpaid interest of $10,000), plus (c) $10,000 interest on the year 2 loan of $100,000. It is not clear whether the IRS could sustain this characterization of the transaction under present law. Under the claimed treatment, however, the Tenant's accelerated deductions together with the deferral of the Landlord's income results in significant distortion.

Case 2: U underwrites an offering of securities for X. U will sell the securities for $1,000,000 on January 1 and receive on that date a commission of $50,000 from X. Instead, it is agreed that U will deliver the $1,000,000 to X on July 1 and forego its commission, since U will be able to earn $50,000 on the $1,000,000 by investing it for six months. If X had received the $1,000,000 on January 1 and invested it, X also would earn roughly $50,000 in interest, which X could then pay to U. The $50,000 paid to U, however, would have to be capitalized and recovered over the life of the securities while the interest income would be taxable currently. By arranging what is in effect an interest free loan in tandem with a contract for services, X may be able to avoid imputation of interest income and an offsetting nondeductible payment, thereby deferring and reducing liability for tax.

Case 3: Rather than charging Parent tuition of $5,000 in 1985, College will accept $4,000 in 1983. Because College can earn $1,000 on the $4,000 over the two years without incurring any income tax liability, it is indifferent between $4,000 today and $5,000 in 1985. Parent is not indifferent, however. If he invested the $4,000 for 2 years, he would owe tax on the $1,000 earned and would have only $4,500 in 1985 (assuming he is taxed at the 50 percent rate). In effect, the arrangement allows College to invest Parent's $4,000 and apply the tax-free earnings to Parent's tuition obligation, without subjecting Parent to tax on those earnings.

My purpose here is to show that there are a wide variety of common situations in which the failure to separate lending transactions from underlying business or service transactions may allow the deferral and avoidance of tax liability. We are not proposing a specific set of rules to deal with these problems at this time. Determining the proper solution to these problems will necessitate a review of the imputed interest provisions of section 483 of the Code and the original issue discount provisions of sections 1232, 1232A and 163(e), as well as other rules. We should point out that there are many cases in which discount lending transactions are minor elements of other transactions. An attempt to provide a proper analysis of discount lending transactions therefore will, in our view, need to reflect certain _de minimis_-type exceptions in order to make the rules workable.

(4) Interest-Free Loans

Interest-free loans offer an opportunity for high marginal bracket taxpayers to divert income to low marginal bracket taxpayers. Assume, for example, that Father lends $100,000 on a demand basis for a period of three years to Son in order to finance Son's education.

If Father had retained and invested the funds, he would have earned $30,000 (assuming a 10 percent interest rate) which then would have been subjected to tax at a 50 percent rate, leaving $15,000 after tax. By loaning the funds to Son, Son will earn the $30,000 of investment return, and be subject to tax of approximately $4,000 (assuming Son is unmarried and has no other income).

There are specific provisions of the Code which permit the use of trusts, within certain limits, to deflect income to children and other donees. These provisions allow income to be assigned only where the donor is willing to part with substantial rights of ownership in the property. The assignment of income by means of interest-free loans is possible, however, even where the donor retains complete dominion and control over the loaned property because he may call the loan at any time. This abuse exists because the tax law has not fully embraced the concept that an implicit interest return exists even though interest is not specifically stated. Clearly, no independent lender would have loaned Son $100,000 on an interest-free basis. We believe many of the alleged interest-free loans used by taxpayers to attempt to shift income to lower-bracket taxpayers are not true loans. For example, there would be little economic substance to a nonrecourse loan by Father to Son with the loan proceeds being invested in stock that is pledged as security for the loan. Thus, in many cases the hoped for tax benefits should not be available. Nevertheless, we believe legislation in this area is necessary.

Aside from the opportunity to shift income within family groups, interest-free loans may furnish an opportunity to avoid restrictions on the deductibility of interest, such as the limitation on the deductibility of investment interest (section 163(d)) and the disallowance of interest on indebtedness incurred to purchase or carry tax-exempt obligations (section 265(2)). For example, in the recent decision of the Federal Circuit Court in Hardee v. U.S., 83-1 USTC para. 9353 (Fed. Cir. 1983), the court held that a taxpayer who had borrowed on an interest-free basis from his corporation was not chargeable with income with respect to the loaned funds, notwithstanding that the taxpayer could not have claimed an offsetting interest deduction if an interest-bearing loan had been made because the debt was incurred to purchase or carry tax exempt obligations. The failure to impute income in the Hardee case had the effect of rendering the disallowance provision of section 265(2) ineffective.

Finally, interest-free loans may furnish opportunities to avoid the estate and gift taxes.3/ In the Crown case, the taxpayer made demand loans of $18,000,000 to trusts for his children and other close relatives. At current interest rates the right to the use of $18 million for one year has a value of $2.16 million. A transfer of that amount in cash would result in substantial liability for gift taxes, notwithstanding the increased per donee exclusion available under ERTA ($10,000 per year, increased from $3,000 per year). Nevertheless, the Tax Court and Seventh Circuit Court of Appeals held that the loans produced no taxable gifts.

In our view, interest-free loans -- which, as shown above, reflect an actual transfer of value equal to the interest not charged -- should be treated for tax purposes as if interest actually had been paid at a market rate and rebated to the lender. Such a rule should apply in every case where an interest-free loan is made between related parties or where an interest-free loan is made for services rendered to the lender. We recognize the need for a *de minimis* type exception in this area as well.

(5) Market Discount on Bonds

Under current law, market discount on debt obligations issued by corporations and governmental entities is taxed as a capital gain on payment of the obligation at maturity. Market discount arises when the interest rate on an existing bond is less than the current market interest rate for bonds with similar terms and credit risk. Market discount must be distinguished from original issue discount which arises when an issuer sells a bond for less than par to compensate the holder for the below market "coupon" interest rate. Accruals of OID are includable in the income of bondholders over the life of the bond, irrespective of the bondholder's method of accounting.

3/ The question of whether an interest-free demand loan results in a taxable gift is currently before the United States Supreme Court in the case of Dickman v. Commissioner, T.C. Memo. 1980-575, rev'd, 690 F.2d 812 (11th Cir. 1982), cert. granted, ___ U.S. ___ (1983). In Dickman, the Eleventh Circuit Court of Appeals declined to follow the prior decision in Crown v. Commissioner, 585 F.2d 234 (7th Cir. 1978), aff'g 67 T.C. 1060 (1977).

Market discount is in all respects the equivalent of interest income to the holder of the bond because it exists in lieu of coupon interest, and is reflected in the fixed and predictable growth in value of the bond according to a compound interest formula. The current tax treatment of market discount offers opportunities for deferral of taxes on ordinary income, and conversion of ordinary income to capital gain.

Because the market discount element of the interest return on a bond accrues currently but is not taxable until maturity, and then only at capital gains rates, tax shelter transactions have arisen in which taxpayers acquire market discount bonds using borrowed funds. The cost of carrying the market discount bond is deducted currently against ordinary income, while the reciprocal return on the bond -- accretion of market discount -- accrues, but is not taxed currently. In these transactions, ordinary income is deferred and converted to capital gain.

To treat market discount correctly, the bondholder should be required to include the discount in income annually on a constant interest method. We believe, however, that another approach which would be more easily administered and complied with by taxpayers might be adopted at this time. This alternative approach would require computation of the periodic accrual of market discount, and recognition of the market discount as ordinary income when the bond is sold or paid at maturity. Gain in excess of accrued market discount would, as under present law, be treated as capital gain, and losses would receive parallel treatment. The computation of the accrual of market discount would be made on a straight-line basis or the constant interest method, at the taxpayer's election.

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III. Selected Partnership and Other Tax Shelter Issues

In General

A partnership is not a taxable entity for Federal income tax purposes. Its taxable income or loss is determined at the partnership level and is passed through to the partners to be reported on the partners' returns. This pass-through scheme of taxation has made partnerships the most favored tax shelter vehicle.

The key features of a typical tax shelter are the deferral of tax liability, the conversion of ordinary income into capital gain, and the use of leverage to maximize the benefits of deferral and rate conversion. In addition, as the earlier discussion points out, exploiting deficiencies in the tax law regarding the time value of money is becoming a key feature of some tax shelters.

While one or more of these key features are usually present in tax shelters transacted through partnerships, certain tax shelter techniques have been developed that turn on specific provisions of the Code governing the taxation of partnerships. Among the most troubling of these techniques are those involving partnership special and retroactive allocations. In addition, we would like to take this opportunity to discuss tax shelters that are based upon the prepayment of expenses, like-kind exchanges of partnership interests and other property, and charitable contributions of personalty.

(1) Partnership Allocations

Section 704(a) of the Code provides that a partner's distributive share of partnership income, gain, loss, deduction, or credit (or item thereof) is determined by the partnership agreement, except as otherwise specifically provided in the Code. Under section 704(b) of the Code, which was amended as part of the Tax Reform Act of 1976, if an allocation to a partner under the partnership agreement lacks "substantial economic effect" it is disregarded and each partner's distributive share is determined in accordance with the partners' respective interests in the partnership (taking into account all the facts and circumstances).

Whether an allocation to a partner possesses economic effect depends upon whether the allocation actually affects the dollar amount to be received by such partner independent of tax consequences. Generally, economic effect exists if the following requirement are met: (i) the allocation to a partner of income, gain, loss, or deduction (or item thereof) is reflected as an increase or decrease in the partner's capital account; (ii) liquidation proceeds are distributed in accordance with the partners' relative capital account balances; and (iii) any partner with a deficit balance in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. For an allocation to be sustained, not only must it possess economic effect, but such effect must be substantial in relation to the tax effect of the allocation.4/

Some partnerships have taken the position that the allocation rules can be used to (1) create income and loss for partners where the partnership has no net taxable income or loss, and (2) transform what would otherwise be a capital expenditure into the equivalent of a deductible expense.

Simple examples will illustrate how these results are claimed.

- Partnership ABC is formed in January, 1983 by A, B and C, each of whom contribute $333,333 to the partnership. The partnership acquires a fully leased apartment complex for $2 million, $1 million of which is provided by a recourse loan from an unrelated lender. No principal payments on the loan are required during the first three years.

  The partnership agreement allocates the first $150,000 of gross rental income to C, and all other profits and losses are shared equally. The agreement also provides for a priority cash distribution of $150,000 to C, with all other net cash flow from operations to be distributed equally. On a sale of the property, the net cash proceeds will be distributed according to the ending balances in the partners' capital accounts. Partners are obligated to restore any deficit balances in their capital accounts.

  Assume that in year one the partnership has no net taxable income or loss as it realizes gross rental income of $400,000 and incurs operating expenses of $60,000, interest charges of $100,000, and cost recovery deductions of $240,000.

4/ Proposed regulations interpreting the substantial economic effect requirement were issued on March 9, 1983. Treasury is currently considering comments received on these proposed regulations.

If valid, the net effect of the special allocation (and equivalent cash distribution) of $150,000 to C is to give C taxable income of $100,000 from the partnership [$150,000 of specially allocated gross income plus $83,333 of the remaining gross income, less $133,000 of deductions]. A and B each report a loss of $50,000 from the partnership [$83,333 of gross income less $133,000 of deductions]. The hoped for results of the partnership allocations are summarized by the following table.

	A	B	C
Gross Income			
Special allocation			$150,000
Residual	83,333	83,333	83,333
Total	83,333	83,333	233,333
Deductions	(133,333)	(133,333)	(133,333)
Net Income	(50,000)	(50,000)	100,000

Although the partnership has no net taxable income or loss, the partners will claim that the allocation of $100,000 of net income to C and $50,000 of net loss to each of A and B is permitted. The partners also will assert that this assignment of income is allowable because item allocations are specifically sanctioned by section 704(b) of the Code as long as the allocations have substantial economic effect.

If this type of special allocation is recognized, it creates obvious opportunities for abuse. Treasury believes that section 704(b) of the Code should be modified to eliminate or significantly restrict item allocations (except as provided in section 704(c)(2) of the Code with respect to property contributed to the partnership by the partners).

- Assume the same facts as in the above example except that the reason for the special allocation of $150,000 to C is that C is to provide services relating to the syndication of the partnership, and that the allocation is made in lieu of paying C a fee for his services.

If the $150,000 distributed to C had been designated and paid as a syndication fee, C would have had $150,000 of income (having received a payment in a non-partner capacity under section 707(a) of the Code), and that amount would have been capitalized by the partnership as a syndication expense under section 709 of the Code. Moreover, the partnership still would have had no net taxable income or loss [$400,000 of gross income less $400,000 of deductions] and no net income or loss would be allocated to any partner.

The partnership will assert, however, that the $150,000 special allocation and equivalent distribution to C are not subject to the capitalization requirement of section 709 of the Code. By structuring the syndication fee as an allocation and equivalent distribution to C the partnership claims to have converted a $150,000 capital expense into an additional $50,000 deduction for each partner. If allocations of this type are valid, they may be used for all types of services performed by partners, fees for which would have to be capitalized under the general rules of section 263 of the Code. Furthermore, eliminating item allocations would not totally solve the problem since the same technique could be attempted with a special allocation of all or a portion of the net taxable income of the partnership. Technical changes to section 707 of the Code should be considered in order to make it clear that this technique is not available.

We also would like to point out the income and loss assignment possibilities that may result from the operation of section 704(c)(1) of the Code. That section provides that the partners' distributive shares of depreciation, depletion, and gain or loss on property contributed to the partnership may be determined as if the partnership had purchased the property. An example will illustrate our concern with this Code section.

- Assume X and Y form a partnership, with X contributing $100 cash and Y contributing stock with a $10 adjusted basis and a $100 fair market value. Under the terms of the partnership agreement, the capital accounts of X and Y are initially set at $100 each. It is further provided that X and Y are entitled to equal distributions and are allocated all income, gain, loss, deductions, and credits equally. Thus, in accordance with section 704(c)(1) of the Code, the $90 pre-contribution appreciation on the stock contributed by Y will be allocated equally between X and Y. Assume that the stock is sold for $100 and the partnership is liquidated, distributing $100 each to X and Y. Y has managed to shift to X $45 of the gain from the stock sale. Conversely, if the stock contributed by Y had an adjusted basis of $200 and the stock were sold and the partnership liquidated as described above, Y would have shifted to X $50 of the loss from such sale.

These allocations are sanctioned by section 704(c)(1) of the Code and are generally thought not to be subject to the standards of section 704(b) of the Code, which they undoubtedly would not meet. Treasury believes that when Congress enacted section 704(c)(1) as part of the 1954 Code it did so to provide administrative simplicity and did not envision that the section would be used as a tax shelter device. Accordingly, Treasury recommends that consideration be given to making the rule contained in Code section 704(c)(2) of the Code mandatory. Under that rule, depreciation, depletion, and gain or loss attributable to the pre-contribution appreciation or diminution in the value of property contributed to a partnership would be required to be allocated to the partner contributing the property.

Before leaving the subject of partnership allocations, we would like to note that, notwithstanding a contrary published revenue ruling, some limited partnership tax shelters are employing "tiered partnership structures" as a means of avoiding the retroactive allocation rules of section 706(c)(2)(B) of the Code. These rules generally prohibit allocations to a partner of partnership income, gain, loss, deduction, or credit that are attributable to the portion of the taxable year that precedes the entry of such partner into the partnership. Two acceptable methods are provided for determining what portion of a partnership's income, gain, loss, deduction, or credit is attributable to the period preceding the partner's entry. One method provides for an "interim closing" of the partnership books whenever a new partner enters the partnership, and traces the income, gain, loss, deduction, and credit of the partnership to the particular segment of the taxable year to which it relates.

The following example illustrates how a tiered partnership arrangement that is used in conjunction with the interim closing method arguably provides an end-run around the prohibition on retroactive allocations.

- Assume that AB partnership ("parent") owns a 90 percent interest in XYZ partnership ("subsidiary"). Each partnership has adopted the calendar year as its taxable year. During 1983, the subsidiary incurs net losses of $10,000, $9,000 of which are properly allocable to the parent. On December 30, 1983, C is admitted to the parent as a one-third partner. The parent uses the interim closing method to determine the varying interests of each partner. Under this method, the parent's books are closed when C is admitted to the parent partnership on December 30, 1983. C is a member of the parent partnership for only one day, December 31, 1983. The parent asserts that it "incurs" the full amount of its $9,000 share of the subsidiary's loss on December 31, 1983 (regardless of when the loss is incurred by the subsidiary), and C, as a one-third partner on that day, is entitled to deductions totalling $3,000.

The Internal Revenue Service has specifically rejected this position in Revenue Ruling 77-311, 1977-2 C.B. 218. That ruling concludes that a new partner entering the parent partnership cannot be allocated a distributive share of pre-entry losses of the subsidiary. Notwithstanding Revenue Ruling 77-311, many partnerships continue to use this retroactive allocation technique on the basis of the statutory language of Code section 706(a). Consideration should be given to amending that section to provide results consistent with those in Revenue Ruling 77-311.

(2) Partnership Misallocations and Prepayments

Numerous partnership tax shelters prepay deductible partnership expenses during the start-up period of the partnership in an attempt to maximize front-end partnership deductions. This is not surprising since large, current deductions make the tax shelter more attractive. As part of the Tax Reform Act of 1976, Congress enacted section 461(g) of the Code to preclude a cash basis taxpayer from deducting prepaid interest. No similar explicit statutory provision exists, however, with respect to other prepaid deductible expenses.

As a result, the question of the appropriate timing of prepaid deductible expenses has been the subject of a significant amount of recent litigation. The case law to date has not adopted an objective standard that can be applied to all prepayments. Instead, most courts have examined all the facts and circumstances of the particular case to determine whether allowing a full deduction for the prepayment would result in a material distortion of income. This approach, however, does not lead to consistent results, and is looked upon in some opinions with disfavor when applied to prepayments of intangible drilling costs, research and experimental expenses, and certain other items.

Additional confusion results from the so-called one-year rule that has been adopted by several circuits. See, e.g, Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980). This rule interprets the Treasury regulations under Code sections 461 and 263 to permit current deductibility of prepayments which provide the taxpayer with benefits not extending beyond one year.

The uncertainty of present law has led to prepayments being a common feature of tax shelters. One of the prepayment abuses most prevalent in tax shelters is an allocation scheme whereby amounts which otherwise would have been paid out as capital expenditures or nondeductible payments are designated as prepaid expenses in order to accelerate deductions. An example will illustrate this scheme.

- Assume a partnership is willing to purchase a shopping center from X, a real estate dealer, for \$1 million, and X is willing to manage the center for 5 years for a fee of \$100,000 a year (payable at the end of each year). X is willing to sell on these terms if he receives a \$500,000 downpayment on the property and principal payments of \$100,000 at the end of each of the next 5 years, together with accrued interest at the annual rate of 18%. When combined with his management fee, X would receive \$500,000 at closing, and \$200,000 a year (plus interest at 18%) for the next five years. The partnership would have real estate with a cost recovery basis of \$1 million and would be entitled to deduct \$100,000 per year for management services. However, in order to accelerate deductions, the characterization of this stream of payments may be recast. The partnership's \$500,000 down payment may be earmarked as a management fee and the purchase money note increased from \$500,000 to \$1 million, providing for 5 annual payments of \$200,000 (with interest at 9%). The partnership will still have real estate with a cost recovery basis of \$1 million and will claim that it is entitled to deduct \$500,000 in year one for prepaid management services.

In Treasury's view, there is no doubt that this result is improper and that this deduction should not be sustained under current law. Nevertheless, taxpayers continue to claim these deductions in reliance upon case law which permits the current deduction of prepaid expenses that relate to relatively short time periods. Even where the above-illustrated misallocation scheme is not present, to permit a taxpayer to shift deductions into a period preceding the period to which the expense relates is contrary to fundamental tax accounting principles.

We recommend that consideration be given to enacting an objective rule, similar to the rule contained in Code section 461(g), to limit the deductibility of prepaid expenses. Any such rule will have to address the proper method for determining the periods to which the prepayment should be allocated. In deciding upon the proper methodology, it must be recognized that prepaying a deductible item involves time value of money issues similar to those discussed above.

(3) <u>Like-Kind Exchanges</u>

Under section 1031 of the Code, gain is not recognized on an exchange of like-kind property held for use in trade or business or for investment, except to the extent the taxpayer receives property that is not like-kind (boot). Rather, the potential gain is deferred and recognized when and if the property received in the exchange is sold. The existing cases generally hold that section 1031 applies to certain exchanges of general partnership interests. See, e.g., Gulfstream Land and Development Co., 71 T.C. 587 (1979).

There are substantial administrative problems that arise when the like-kind exchange provision is applied to exchanges of partnership interests. For example, if a partnership interest in one partnership is exchanged for an interest in another partnership, it is not clear what portion of the underlying assets of the two partnerships must be of a like kind in order for section 1031 to apply. It is arguable that the like-kind test should be applied on an asset-by-asset basis. In addition, we understand that the like-kind exchange provision has been used by some taxpayers in conjunction with certain highly technical partnership provisions to dispose of "burned out" tax shelter investments without recognition of income attributable to liabilities in excess of basis.

In view of these problems, consideration should be given to making like-kind exchange treatment unavailable for exchanges of partnership interests in different partnerships. It is questionable whether the like-kind exchange provision was ever intended to apply to exchanges of partnership interests. Section 1031 does not apply to exchanges of stock, certificates of trust or beneficial interest, or "other securities or evidences of . . . interest." Partnership interests can be viewed as investment interests very similar to these other excluded items.

Before leaving the subject of like-kind exchanges, we would like to express our concerns about deferred like-kind exchanges. Although such exchanges may not be thought of as tax shelters in the traditional sense, we view such exchanges as tax shelters in that they unjustifiably permit taxpayers to avoid recognition of gain on sales of real property.

The case of Starker v. United States, 602 F.2d 1341 (9th Cir. 1979), held that an exchange of property in return for like-kind property to be designated by the taxpayer up to five years in the future qualifies as a like-kind exchange, even though the taxpayer eventually might receive boot rather than like-kind property in settlement of the other party's obligation in the exchange. The court further held that gain to the extent of boot received in later years must be recognized in the year of the original transfer.

When a taxpayer exchanges property for like-kind property in a simultaneous exchange, nonrecognition of gain may be appropriate because of valuation difficulties. No valuation difficulties are involved in a deferred like-kind exchange. Where a taxpayer is given the right to designate properties in the future, the property he has transferred must be valued at a specific dollar amount in order to determine the aggregate value of the properties that he may receive in the future. Thus, the taxpayer's gain may be accurately measured in the year of the original transfer.

Deferred like-kind exchanges also expand significantly the ability of taxpayers to avoid recognition of gain on deferred payment sales. Taxpayers who make installment sales of real property or other qualifying property may be given the right to designate like-kind property to be received in lieu of cash payments. Furthermore, in contrast to the rules of section 1033 (relating to replacement of property involuntarily converted) and section 1034 (relating to the replacement of a personal residence), deferred like-kind exchanges under section 1031 have no express statutory limit on the time in which the nonrecognition transaction must be completed.

Finally, the Starker holding raises a host of problems that burden the efficient administration of the tax laws. For example, to determine whether the nonrecognition provisions of section 1031 apply to a deferred exchange, determination of the tax treatment of the transaction must be suspended until the taxpayer receives property. Moreover, if boot is received in a year subsequent to the exchange, Starker indicates that gain must be recognized and reported in the year of the original transfer. Thus, if the Starker decision is followed, the tax consequences of deferred exchange transactions will be unknown for many years.

In view of these problems, we believe that section 1031 should be amended to provide that property to be received after the close of the taxable year in which the exchange occurs cannot qualify as like-kind property.

(4) Charitable Contributions as Tax Shelters

Under current law, the deduction for charitable gifts of ordinary income property generally is limited to the taxpayer's basis in the property contributed, that is, the amount it cost the taxpayer to produce or acquire the property. However, taxpayers generally may deduct the full fair market value of any property contributed to public charities which, if sold, would yield long-term capital gain.

Individuals, closely held corporations or personal service companies are subject to a penalty for underpayments of tax resulting from certain overvaluations of the fair market value of property, including an overvaluation of property donated to charity. The penalty is a graduated addition to tax, with a maximum penalty of 30 percent of the underpayment for overvaluations in excess of 250 percent of actual value. The penalty does not apply to underpayments of under $1,000 or to property held by the taxpayer for more than five years.

Treasury is very concerned with what has become the widespread abuse of the charitable contribution provision. This "tax shelter giving" results primarily from the fact that taxpayers currently may deduct the full fair market value of appreciated capital gain property without being required to pay tax on that appreciation.

The fair market value of any property which is not readily tradeable on an established market is difficult to determine. The existence of wholesale and retail markets for some items further complicates the valuation process.

A typical charitable donation tax shelter transaction involves a taxpayer who purchases items, such as art books or gems (often at a discounted or wholesale price), holds the property for a year and then contributes it to charity claiming a deduction for the appraised value. This appraised value is often 500 percent or more of the taxpayer's original cost, thus providing him with a substantial alleged tax deduction. Despite the Internal Revenue Service's success in correcting many inflated valuations on audit, we continue to see an alarming volume of such transactions. Given the volume of these transactions, the IRS' limited resources, and the difficulty of detecting overvaluations on audit, overvaluation of charitable gifts will continue to be a difficult enforcement problem for the Service.

A strong argument can be made for eliminating any advantage that charitable gifts of appreciated property have over gifts of cash. This could be done by limiting the deduction for contributions of all property to the donor's basis in such property. However, we recognize that charitable organizations depend on this tax incentive as a means of acquiring valuable property. Further, we believe that much of the abuse in this area can be curtailed without such a far-reaching proposal.

For instance, we believe problems in this area could be alleviated to a significant extent by providing that capital gain property which is not readily tradeable on an established market and which has been held by the taxpayer for less than five years will be treated as ordinary income property for purposes of the charitable contribution rules. Thus, a taxpayer's deduction would be limited to his basis in the property if he contributes property within five years of its acquisition. We understand that such a proposal would have the support of a number of charitable organizations.

We also request that Congress consider strengthening the overvaluation penalty. For instance, a strong argument can be made that the overvaluation penalty should apply even where the donated property has been held for more than five years. We do not see why abuse of the tax system should be excused merely because a taxpayer has held property for a designated period of time.

Senator GRASSLEY. Our next witness is the Hon. Theodore Tannenwald, Jr., Chief Judge of the U.S. Tax Court. We have had an opportunity to work with Judge Tannenwald on many occasions before, and we appreciate his involvement with our writing of tax legislation.

Judge Tannenwald was elected chief judge for a 2-year term beginning July 1, 1981. He was first appointed to the U.S. Tax Court for a term expiring June 1, 1974, and then reappointed for a 15-year term, ending June 1, 1989. Judge Tannenwald is a graduate of Harvard Law School and has been very active in bar association and tax matters. As I know your reputation is well known, I will proceed immediately to your testimony.

I would like to thank you, Judge Tannenwald, for impressing upon us the tremendous workload faced by the U.S. Tax Court. I hope you will be able to offer us your suggestions on how Congress can help you do your job better.

STATEMENT OF HON. THEODORE TANNENWALD, JR., CHIEF JUDGE, U.S. TAX COURT, WASHINGTON, D.C., ACCOMPANIED BY JUDGES DAWSON AND NIMS

Judge TANNENWALD. Thank you very much, Senator. I appreciate your inviting me to appear at this hearing and giving me the opportunity to express my views.

I have submitted a statement which I assume, from your remarks at the opening of the hearing, will be made part of the record, and I do not propose to repeat what is in that statement.

Senator GRASSLEY. Yes, sir.

[The prepared statement of Judge Tannenwald follows:]

UNITED STATES TAX COURT

Before the Subcommittee on Oversight of the Internal Revenue Service of the Senate Finance Committee

Statement by Chief Judge Theodore Tannenwald, Jr.

June 24, 1983

Mr. Chairman and members of the committee, I appreciate this opportunity to appear before the committee and discuss the problems of the United States Tax Court in processing tax shelter cases.

At the outset, let me note that the overall backlog of cases before the Court has increased substantially over recent years. Thus, in fiscal year 1975 the number of new cases filed was 11,213, and on September 30, 1975 there were 16,448 cases pending before the Court. In fiscal year 1982, 30,776 new cases were filed and, as of September 30, 1982, there were 52,773 cases pending before the Court. Thus far in fiscal 1983 there has been substantial equivalence between the number of cases filed and the number of cases closed. However, it cannot be assumed that this trend will continue, because June and July are traditionally heavy months for the filing of new cases and because of anticipated increases generally in the number of cases filed for a variety of reasons.

Factors which are operating to reduce our overall case load are the increase in the interest rate, more flexible settlement policies on the part of the Internal Revenue Service, increased filing fees, and the increase in the penalty where the case was filed for purposes of delay or where the continued maintenance of a case is considered frivolous. Factors which will tend to increase our case load are general dissatisfaction with the tax system because of the complexity of the tax laws and the perception that they favor the rich at the expense of the poor, the authorization of awards for litigation costs, the increased efforts to pursue participants in the underground economy, the increased penalties for fraud, negligence, etc., and the increase in the number of tax protester and shelter cases.

Of the 53,702 cases pending as of June 16, 1983, approximately 16,000 fall within the tax shelter category. I understand you will hear from the Internal Revenue Service about the potential increase in the number of tax shelter cases likely to be filed, but my understanding is that there are over 300,000 cases under audit by the Internal Revenue Service and that a large percentage of these cases could result in the filing of petitions in the Tax Court. Obviously, not only the current situation in respect of tax shelters, but also the likely future-situation with respect to tax shelter cases, presents the Court with a very serious problem.

Tax shelter cases fall into a variety of categories. One category involves partnerships where there is a common transaction but there are numerous taxpayers involved. Another category is represented by cases involving separate transactions for each taxpayer but the type of transactions involved follows the same pattern. Falling within this category are cases involving commodity straddles, family trust cases, and a variety of cases dealing with vows of poverty by members of a particular church group or alleged contributions to organizations which are claimed to be exempt as religious entities.

The Congress has already faced the litigation problems involved in partnership tax shelters by enacting the so-called partnership audit provisions as part of the Tax Equity and Fiscal Responsibility Act of 1982. It is still too early to tell what impact these new provisions will have on reducing the number of cases in the tax shelter - partnership area. However, even assuming a favorable impact of such provisions, there will still be some serious problems remaining. One problem will derive from the requirements of notice contained in the partnership audit provisions. There is bound to be litigation with respect to compliance by the Internal Revenue Service with these notice provisions. Another problem derives from the fact that in many situations there is not simply one partnership involved; there are often a series of partnerships involved -- so-called tier partnerships, where partnership A is a partner of partnership B, which, in turn, is a partner in partnership C, etc.

In the nonpartnership tax shelter cases, where the partnership audit provisions do not apply in resolving the common issue, i.e., shelters involving commodity straddles, movies, mineral properties, options trading in securities, art objects, books, etc., it is necessary to determine whether the taxpayer entered into the shelter transaction with the expectation of making a profit. This necessitates -- at least in theory -- a case-by-case determination even after the common legal issues arising from the shelter transaction as such are resolved.

The foregoing will give you a broad outline of some of the problems which the Court faces in the tax shelter area. What I propose to do now is to describe for you some of the procedures which the Court has evolved to facilitate the handling of tax shelter cases.

First of all, in the last two or three years the Court has issued a large number of opinions dealing with various types of tax shelters. These opinions have provided the taxpaying public and the tax bar with a rather detailed picture of the Court's views, and that should have a significant impact on the disposition of future cases short of actual litigation. Having said that, I should remind you that, even with the increase in interest on tax deficiencies, the name of the game in the tax shelter area still seems to be "buying time" and in this context the impact of the Court's opinions may not be as great as one would hope.

The Court has sought to identify groups of cases involving the same shelters or types of shelter at an early point in time in order to assign those cases to a particular Judge as soon as possible so as to provide continuity of case management.

The Court has expanded its discovery rules to permit more third party discovery -- for example, of a promoter of a tax shelter -- which we expect will be particularly helpful in facilitating the disposition of shelter cases by way of settlement or trial.

The Court has also developed the following techniques for handling tax shelter cases.

(1) The parties have been urged to select one or two test cases out of a given group of tax shelter cases and to agree to be bound by the final decisions in those cases. Where a group of tax shelter cases is being handled by a single lawyer representing all the taxpayers, this has proved to be a very effective technique.

(2) Where the parties cannot agree on test cases, the Court has selected them. Obviously, decisions in these test

cases will not be determinative because the parties have not agreed to be bound by them. In such situations, however, the test cases can have a significant impact because the parties in the other cases know that the same Judge will be disposing of their cases. At this point, I think I should remind you that, absent an agreement by a taxpayer to be bound by a decision in another case, that decision will not be binding upon him under either the doctrine of res judicata or collateral estoppel.

(3) In tax shelter cases which involve numerous separate taxpayers and transactions which, although separate for each taxpayer, involve similar transactions, we have sometimes consolidated the cases in order to facilitate the taking of common testimony and decision of the common issues. Some of these cases involve several hundreds of taxpayers, and the management of these cases presents very serious problems. First, usually many lawyers or taxpayers without legal representation are involved. In this context, we have tried to work out a procedure whereby either the parties, or the Court in consultation with the parties, appoint a lead counsel to be responsible for the actual handling of the trial of the common issues and a liaison counsel to be responsible for working with the lead counsel and keeping all of the parties informed. Involved in this procedure is the problem of working out arrangements for a fund to which each party is asked to

contribute his or her proportionate share of the anticipated counsel fees in order that no party gets "a free ride." Also involved in this procedure is the problem of placing a cap on the legal fees which can be charged by lead counsel and liaison counsel. Second, as I have previously pointed out, there may be sub-issues arising from the common issue such as the issue of the profit motive on the part of each individual taxpayer or issues unrelated to the common transaction. As a consequence, it is likely that more than one hearing may be required in a particular case after the common testimony has been taken and/or the common issues have been decided. Because of the number of individual cases involved, it is highly likely that another Judge will be called upon to decide these other issues and that there will be more than one opinion in each case, i.e., an opinion on the common issues (which are usually severed from the other issues) and an opinion on the other issues. The problems involved in these consolidated cases are not insurmountable, but they do present difficult questions of management.

In all of the shelter cases, there can be several subsidiary problems of a procedural or management nature. Obviously, there is an enormous amount of paperwork which puts a burden on the office of the Clerk of the Court. There is also the problem arising from the fact that 28 U.S.C. sec. 1291, which permits certification of important questions stemming from interlocutory orders for purposes of appeal, does not apply to interlocutory orders of the United States Tax Court. Finally, there can be considerations relating to the disclosure of tax return information about a taxpayer in proceedings involving other taxpayers -- disclosure which may be restricted by 26 U.S.C. sec. 6103.

In sum, the Court is handling tax shelter cases in an aggressive and imaginative fashion but to a certain degree it is inhibited by the complexity of the management problems involved. I think that we are moving as well as can be expected under the circumstances and that in due course we will find the means of adequately dealing with the situation. Many of the cases which are before the Court and which are likely to be filed in the near future involve taxable years prior to the effective date of the "at risk" provisions enacted as part of the Revenue Acts of 1976 and 1978. Hopefully, these provisions will have a significant impact in eventually reducing that portion of the Court's case load which is represented by tax shelter cases.

I know that this committee would like to have suggestions as to whether there is any legislation which might be helpful in the handling of tax shelter cases. This presents a complex problem. As far as taxable years since 1975 are concerned, it may be that the "at risk" provisions of the Revenue Act of 1976 and the partnership audit provisions of the 1982 Act will substantially staunch the flow. It is a bit early to determine what their effect will be. The issue of retroactivity may impact the applicability of new legislation to earlier taxable years, which are the years involved in a large portion of the pending and prospective cases.

The partnership audit provisions were evolved through a cooperative effort on the part of the Chief Counsel's Office and the tax bar in consultation with the Tax Court and the staffs of the Joint Committee on Taxation, the Senate Finance Committee, and the House Ways and Means Committee. It seems to me that a similar procedure to examine what more can be done with respect to tax shelter litigation would be in order. The procedure might even be formalized in the form of an advisory committee along the same lines as has been utilized in the past with respect to various changes in the substantive provisions of the Internal Revenue Code. In the course of such a process, a number of matters could be considered, for example, an evaluation of the impact of the "at risk" and partnership audit provisions, the possible adaptation of the partnership audit provisions to the nonpartnership tax shelter cases using the class action techniques which have been developed in other litigation areas as a model, the possible enactment of statutory provisions disallowing any deductions (including interest on any deficiencies) where there has been a gross overstatement of valuation or gross abuse on the part of promoters of tax shelters. The disallowance of any deductions would appear to provide a technique for avoiding the determination of the taxpayer's profit motive in each case and, if made applicable to interest on deficiencies, would counteract the "buying time" factor in respect of tax shelter litigation. I should observe, however, that such provisions will generate litigating issues as to what constitutes a gross overstatement of valuation (an issue with which we will have to grapple in any event under the provisions of section 6700 of the Code) or what constitutes gross abuse.

Judge TANNENWALD. What I would like to do is to focus on those few elements that I think are critical to the task that the subcommittee has undertaken. I, of course, have to emphasize again that we have an enormous caseload, some 54,000 cases now pending, of which 16,000 are tax shelter cases. And we have the problem of dealing with those. There are management problems involved, particularly in the tax shelter areas, cases which do not involve partnership tax shelters, and the partnership audit provisions therefore do not apply. We have not yet been able to evaluate, as indeed the previous witnesses indicated, the impact of the at risk rules which cut across all kinds of shelters, and the partnership audit provisions which deal with partnership shelters.

As I see it, Mr. Chairman, there are four parameters, or guidelines, or principles, which ought to guide your consideration. First of all, the problem that we have is an urgent one. It may be that the partnership audit provisons and the at risk rules will be very helpful in staunching the flow of cases in the future. But they do not apply to many of the taxable years which are now involved in the audit process, and indeed in cases before the Tax Court. And, therefore, we have the problem of how can we construct something that will help us with the pending cases, not only the ones that we have pending but the ones that were described as in the pipeline of the Service. And I realize that this gets right squarely into the question of retroactive legislation. But I think—and I will mention them before I finish—that there are some areas where you could effectively not make the provisions directly retroactive, but in their application they would have retroactive effect.

I want to associate myself with you, Mr. Chairman, and with Mr. Woodward on the impact of these tax shelter schemes on all taxpayers. There is a perception abroad that the present revenue laws are so complex, and so favor the rich at the expense of the poor that people are rebelling. And I am not talking about the tax protesters who say the 16th amendment is unconstitutional and things like that. I am talking about the ordinary man in the street who comes before us with a small deficiency, and says, why should I have to be the victim when all these other rich fellows are getting off. This is very difficult to handle. It is not our job; our job is to apply the law for the rich and the poor alike. But there is that perception. And the tax shelter schemes and the ability of those who are involved in them to get away with the tax shelter schemes inevitably impacts other taxpayers.

In terms of our own work, the amount of time that we have to devote to the tax shelter cases obviously impacts the amount of time we can spend on other cases, much more numerous in nature. I think that any legislation which the committee or the Congress may come up with should be directed to the question of the buying time element in the tax shelter. That is the name of the game. And it seems to me that any legislative action ought to be directed toward making it as expensive as possible to buy time. I think in the interest of facilitating the disposition of cases, both future and pending—and this principle could be applicable to the Internal Revenue Code, generally—that any rules or provisions you come up with ought to be as simple and as clear cut as possible. You are dealing with deductions, Mr. Chairman. And I think that gives the Congress a great deal of flexibility in selecting those types of deductions that may be flatly disallowed. And in the interest of simplicity, it may be that that is the kind of provisions that you should have. You need provisions that do not invite litigation. The provisions that are now in the Code dealing with gross overvaluation are fine as far as they go, but they leave us with the difficult fact question of valuation. They leave also the courts—in the nonpartnership area at least, shelter area—with the problem of the individual motive of each particular taxpayer. Did he or did he not have the objective of making a profit?

As I say, I think these provisions ought to be simple. I think they ought to, as far as possible, be applicable to prior taxable years, or at least the future cases that are filed, even though they involve prior taxable years, and I think you have to act urgently.

I heard Mr. Woodward and Mr. Ccates testify that they are glad to work with the staffs of the committee. Well I have to tell you, Mr. Chairman, that the house is on fire. And if we don't do something about it and do something quickly, we are going to have some very serious problems which will affect not only the administration of the tax laws generally but the judicial system that is charged with enforcing the tax laws when they reach the point of litigation.

I think, for example—and I suggested in my statement—that you could make it expensive on a buying time basis and also make it applicable to previous taxable years because it would impact future events. You could say that in any tax shelter case where the taxpayer lost, he would not get a deduction for any interest on deficiencies. Most taxpayers are on a cash basis, and the interest that they would have to pay would be deductible in the future. And since many of them are at a 50-percent rate, or very close to it, the prospect of being able to deduct interest is attractive. Take it away from them.

I think you could perhaps in order to facilitate our work—and I haven't thought this through completely—Congress has been known to legislate on the burden of proof. I think you might say in the tax shelter area certainly that the taxpayer would have to carry his burden by clear and convincing evidence which Congress has done in other areas, or indeed, you might even go so far as to impose the criminal standard of the burden of proof that is on the Government on the taxpayer in the tax shelter area.

Now I realize that I am talking about tough, harsh medicine, but I think something along these lines will affect directly and simply the ability of people to use tax shelters including those that have been used in the past and to do it on an urgent basis is absolutely critical. Thank you, Mr. Chairman.

Senator GRASSLEY. Many of your suggestions would require some changes in legislation obviously is that correct?

Judge TANNENWALD. I am suggesting that it be done by legislation.

Senator GRASSLEY. I would like to recognize that Judge Dawson, your successor, in the audience.

Judge TANNENWALD. That is correct. Judge Dawson is with me and also Judge Nims, who has handled and is handling several tax shelter cases. They decided to come as observers rather than as participants, but they would be glad to respond to any questions that you might have.

Senator GRASSLEY. I would like to acknowledge Judge Dawson's presence and invite him to the table to comment with Judge Tannenwald. I don't want to put you on the spot, but some day you will be doing what Judge Tannenwald is doing.

Judge TANNENWALD. Judge Dawson has done it before, Mr. Chairman. He's a glutton for punishment.

Mr. GRASSLEY. We have plenty of evidence of the weight of the caseload burden before the U.S. Tax Court. The Internal Revenue Service testified this morning that there are 325,000 possible cases before the courts. You have already stated to some degree, the steps Congress needs to take to relieve this dangerous situation. In answering the specific question you may wish to make one or two specific points for the record.

Judge TANNENWALD. You mean as to the type of legislation?

Senator GRASSLEY. Yes.

Judge TANNENWALD. Well I thought I had suggested the possibility of denying deductions on interest on deficiencies that are found to be due from participants in the tax shelter area and the question of shifting the burden of proof. I have suggested in my statement that there may be other aspects of the problem. I would not want to comment on the substantive provisions that might be enacted. I don't think that is particularly appropriate for me. But I suggested an advisory group to do in the overall picture of the tax shelter area what the Internal Revenue Service and the tax bar was able to do on a fairly urgent basis in connection with the partnership audit provisions.

Senator GRASSLEY. Does the Tax Court appoint certain judges to hear tax shelter cases? In other words, do these judges specialize in the area of tax shelter litigation?

Judge TANNENWALD. The answer to your question, Mr. Chairman, is yes and no. We do not have specialists on the court in any particular area. The normal process is for a judge to go out on a trial session at a particular location and take whatever cases appear on the calendar. We have dealt with the tax shelter cases in a variety of ways. Some calendars which used to be 1 week in length have been stretched to 2 weeks. And we would put big cases which often involve tax shelter cases on those calendars to be handled presumably in the second week. We have also in many of the tax shelter cases, which have numerous taxpayers, assigned a group of cases to a particular judge—and Judge Nims has one now, the so-called London option case, where he has 1,400 taxpayers involved. They were assigned to Judge Nims at a very early date, because they require a good deal of case management. And the tendency in the tax shelter cases, particularly where there are groups of cases, is to assign them to a particular judge early in the game, but not because that particular judge has acquired any expertise but because the case require considerable management. We spread that work around.

Judge Nims, would you like to add anything? Or Judge Dawson?

Judge NIMS. Well in connection with the so-called London option cases, one thing we have learned from attempting to deal with a mass of taxpayers in one case is that some of our procedures are rather cumbersome in consolidating this large group of taxpayers together at some point. This committee or some branch of the Congress may want to look at the possibility of giving the Tax Court some sort of class action jurisdiction possibly patterned somewhat along the lines of what was done with the partnership audit legislation.

Senator GRASSLEY. Judge Tannenwald, you suggested denying deduction for interest on tax shelter underpayments. How would we define "tax shelter"?

Judge TANNENWALD. Well that is a good question. But you would have to leave that as the litigating issue for the court. You have already done that with the additional penalty, where you were talking about a shelter where there is gross overvaluation. And there would be some definitional problems. But I think the prospect of losing the interest deduction on tax deficiencies on deficiencies found to be due in shelter cases might well be an incentive to settling pending cases, and certainly an incentive not to into the shelter in the future. And I should say, Mr. Chairman, that my ideas are my own. And I have not, with the exception of a couple of my colleagues, consulted anybody on the court. So I am really speaking for myself rather than the court as a whole.

Senator GRASSLEY. How long does the average tax shelter case wait before it is heard by the Tax Court?

Judge TANNENWALD. I cannot give you any answer to that, Mr. Chairman, because so often it depends on the parties.

Senator GRASSLEY. Would it be longer than other cases of the nontax shelter type?

Judge TANNENWALD. The answer is yes, primarily because when the current administration of the Internal Revenue Service came into power back in 1981 they evolved a new settlement policy, and in order to give that settlement policy an opportunity to work, practically all shelter cases were put on the back burner, except those that the Service knew clearly it wanted to litigate. The answer is that they are not tried rapidly because generally the parties are not ready. The Government is not ready from an evidentiary point of view and from management personnel view often. And since the name of the game is time, the taxpayer doesn't really care how long it takes to try it.

Senator GRASSLEY. Do taxpayers realize the serious nature of your backlog, and the Internal Revenue Service's backlog, and factor that delay into their decision to participate in a tax shelter?

Judge TANNENWALD. I have seen no evidence of that. I don't know whether Judge Nims or Judge Dawson have seen any of that factor as such. I would not expect it to show up with us since the name of the game is time. Regardless of what the reasons may be, if they can buy time they will take it.

Senator GRASSLEY. Have the increased interest penalties and substantial understatement penalties had any effect on reducing your backlog?

Judge TANNENWALD. I cannot answer that, Mr. Chairman, because they are of such relative recent vintage that we have not seen them at work.

Senator GRASSLEY. Do you anticipate a reduction in the backlog by 1985 due to the implementation of increased interest penalties and substantial understatement penalties?

Judge TANNENWALD. I think it may show up, but I am not sure we are going to be able to tell you. I think it more likely will be evidenced by what happens in the audit process, or in the settlement process if the case is pending before the court. We don't really know what makes people settle. We have enough problems with those who don't want to settle.

Senator GRASSLEY. Judge Tannenwald, do you share Mr. Woodward's optimism that the tax shelter problem is turning around?

Judge TANNENWALD. I think the tax shelter problem is turning around for the future. I happen to think that the partnership audit provisions and the at-risk provisions will have their effect in the long run. I do not share anybody's optimism at this point that the pot of the pending 16,000 cases which involve tax years mostly not involving the years to which the new provisions are applicable, and the 300,000 which I think, for the most part, fall in the same category. I don't share any optimism at all that that is going to taper off. In fact, I have heard that the Service has had increasing difficulty settling the pending cases. And principally one of the reasons being, not only buying time, but the interest rate has gone down now. And the willingness of taxpayers to settle is apparently, quite understandably, a function of the interest rate.

Senator GRASSLEY. To what extent is the Tax Court responsible for the caseload problem by its unwillingness to impose penalties for frivolous petitions and in the very loose construction of the standard of care required to avoid the negligence penalty?

Judge TANNENWALD. There was a considerable reluctance over a long period of time, Mr. Chairman, on the part of the Court to impose the penalty. That has increasingly changed. We are now imposing the penalty quite frequently. We are still only imposing the $500 penalty because the increase of the penalty to $5,000, that provision was made applicable only to proceedings begun after December 31 of 1982.

Senator GRASSLEY. I will send any additional questions to you in writing.

Judge TANNENWALD. We would be delighted to answer them. If it is July 1, it will be Judge Dawson's problem. But I will be glad to work with him.

[The answers from Judge Tannenwald follow:]

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CHAMBERS OF
THEODORE TANNENWALD, JR.
JUDGE

UNITED STATES TAX COURT
WASHINGTON D C 20217

July 13, 1983

The Honorable Charles E. Grassley
United States Senate
135 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Grassley:

I have your letter of June 29, 1983, requesting my views with respect to additional questions about tax shelter litigation arising out of the hearings held on June 24, 1983, before the Subcommittee on Oversight of the Internal Revenue Service of the Senate Finance Committee.

The following represents my personal views with respect to each of the questions raised:

1. The possibility of variable or increased interest rates for disallowed deductions or losses in tax shelter cases falls in the same category as the suggestion in my statement to the subcommittee that a deduction for interest on deficiencies found to be due in tax shelter cases be disallowed. It is difficult for me to evaluate whether any such provision would in fact be effective in discouraging the use of tax shelters. The impact of such a provision (as well as provisions which would deny all deductions in abusive tax shelters, which my statement also suggested) can best be evaluated by the tax bar and the Internal Revenue Service. The point is that there are a variety of techniques which might be effective in discouraging the "buying time" factor in tax shelter litigation and it is important that they be fully explored. In reiterating this observation, I again observe that there will be difficulties in drafting definitional provisions for determining when those techniques would be applicable.

2. If petitions are filed with the Tax Court in only 10 percent of the 300,000 prospective tax shelter matters under audit by the Internal Revenue Service, we would certainly be confronted with a serious workload situation. While the present 16,000 tax shelter cases now pending in this Court involve management and logistical problems, as I pointed out in my statement, steps are being taken to identify shelters by groups and assign them to particular Judges for handling, to select test cases, and to handle large groups of such cases on a consolidated basis. Also, more precedential opinions are being issued.

The Court is continuing to try out new procedures in an effort to dispose of shelter cases more expeditiously. It occurs to me that Congress might consider adopting further procedural provisions which would help the situation:

(a) The taxpayer in a tax shelter case might be required to pay the deficiency before he is entitled to file a petition or, at least, before he would be entitled to a trial in the Tax Court. A comparable requirement has been incorporated in the partnership audit provisions. See 26 U.S.C. sec. 6226(e). Such a requirement would discourage litigation designed merely to delay the time of payment. I realize that such a provision would constitute a drastic sanction, and here again great care would have to be taken in defining the cases in which payment would be required. Additionally, such a provision would raise problems as to the jurisdiction of the Tax Court, the District Courts, and the Claims Court.

(b) Provision might be made with respect to a particular tax shelter (often involving hundreds of participants) that the Internal Revenue Service would issue a notice of deficiency to only a few (3 to 5) taxpayers and hold the remainder in suspense on statute of limitations waivers until the expiration of some period after the tax shelter issue has been finally decided by the courts. If a particular taxpayer declined to execute a waiver, Congress could provide that the statute of limitations would be suspended automatically for the applicable period.

3. I do not believe the appointment of "a short term panel" of Judges to hear tax shelter cases would at this time be helpful or advisable. The President has recently nominated two regular Judges and a third one is expected to be nominated soon (at which point the Court will for the first time have a full complement of 19 regular Judges), and the Court has very recently appointed three additional special trial judges. The Court expects to continue its procedures for the early assignment of tax shelter cases to Judges and special trial judges, the selection of test cases, etc. However, I believe that the time required for indoctrination and training of temporary Judges to handle complex shelter cases (the handling of which requires experienced Judges) would require an extensive training period and would not be likely to be productive in sufficient time to have an impact. Moreover, it is questionable whether qualified persons could be found to

take such temporary appointments. I hasten to add, however, that if the tax shelter workload continues to remain heavy, the Court may need additional permanent judicial resources at some future time.

I am sure that the Court appreciates your interest and that of your subcommittee in the Tax Court's operations and that it will be pleased, under the leadership of its new Chief Judge, Howard A. Dawson, Jr., to continue to cooperate in the efforts to deal with the problems of tax shelter litigation.

Sincerely yours,

Theodore Tannenwald, Jr.

Theodore Tannenwald, Jr.
Judge

Judge TANNENWALD. I would like before I leave, Mr. Chairman, to ask Judge Dawson or Judge Nims if they have anything they would like to add.

Senator GRASSLEY. Please do so.

Judge DAWSON. Mr. Chairman, we are taking a hard look at how we can improve our procedures to moving these cases, and that is one of the matters that I am going to concentrate on right after July 1 to see if we can move the cases that are presently in litigation quicker than we have moved them in the past.

Senator GRASSLEY. I hope you will reconsider my suggestion to contact me if there is anything as a member of the Senate Finance Committee I can do to cooperate in accomplishing the goal of reducing court backlog. I would be glad to discuss this with you.

Judge DAWSON. Very well. We will.

Senator GRASSLEY. I hope we will not create any additional problems for you. Would you like to add anything else at this time, Judge Nims?

Judge NIMS. No; I think my colleagues have covered this ground very well.

Senator GRASSLEY. Judge Tannenwald, thank you for your excellent testimony and cooperation for the 2 years that you have been Chief Judge. We look forward to working with you in the future.

Judge TANNENWALD. Thank you very much.

Senator GRASSLEY. I would like to call Donald Alexander, Bernard Aidinoff, and Richard Cohen to testify. Due to the time constraints faced by Mr. Alexander, I will ask him to testify first.

Mr. ALEXANDER. I will go ahead, Mr. Chairman, but I can stay around for questions.

Senator GRASSLEY. You can?

Mr. ALEXANDER. I can and will, sir.

Senator GRASSLEY. All right.

Mr. ALEXANDER. I can and will, sir. My time problem is pressing, but I think that the topic that you have before you is even more pressing, Mr. Chairman.

STATEMENT OF DONALD C. ALEXANDER, WASHINGTON D.C.

Mr. ALEXANDER. My name is Donald Alexander, and I am here solely in my personal capacity, and I am not going to read any of my statement. Judge Tannenwald's suggestion of denying a deduction for interest on deficiencies reminded me of an unsuccessful proposal I made in this room back in 1975. I suggested that we consider adopting the interest structure on deficiencies and refunds that were then in effect in Jamaica, 20 percent interest on deficiencies and 5 percent on refunds. That might have had a therapeutic effect in the areas that you are reviewing.

Mr. Chairman, the Internal Revenue Service's interest in the tax shelter area basically arose in November 1973, when a certain former Commissioner made a speech about the problem in Cleveland and announced that the Internal Revenue had interest in it, and that then resources in IRS would soon deal with the problem. That is, of course, one of the incorrect predictions of all time.

The problem is greater now. And I want to associate myself with your concerns about it and what you said earlier, Mr. Chairman. The perception created by tax shelters, and created by the interest that the press has, quite properly, in tax shelters, are not only a reflection of a problem with our system—does it work very well in the tax shelter area—but a symptom of a much more pervasive problem: Is our system fair? Is it efficiently and effectively enforced? And the answers to those questions are hardly yes, not yes to either of them.

The penalties that you added in ERTA and TEFRA should be given a chance to work, at last, as a genuine downside risk. And as those penalties do work, I think you are going to find the tax shelter market—those that market bad tax shelters—slowly drying up.

I don't know how my colleagues up here at the panel would vote, but it is my personal experience that there are fewer abusive promotions this year than there were last, and there were fewer last year than there were the year before of the abusive kind of tax shelter. I don't think you need to add any more penalties until you find out whether those that you so recently added are working, as the Internal Revenue and Treasury witnesses predicted that they would. But I do think you need to cope with certain things that are springing up.

The *Hardee* case, decided on appeal from the from the Claims Court by the Federal Circuit recently, opened up a glaring loophole in the no-interest loan area by declaring that the interest-free award of money does not create income. Of course it creates income. The only question is whether that income is offset by a constructive interest deduction. As long as you have the Federal Circuit taking this position, you can be sure the taxpayers are going to take advantage of it until the loophole is closed up, and you ought to close it next week.

Another case: educational benefit trust. The same court has blessed a way of compensating executives and owners of closely held corporations. They are paying the educational expenses of their children with a deduction at the corporate level, and so far as anyone can see, no tax to the benefited executive. And that loophole ought to be closed. So you need to close up some loopholes and you need to act on them pretty quickly.

But another thing you must ask: Is the Internal Revenue Service capable of doing its job? Does it have the equipment, the resources, and does it allocate its equipment and resources soundly in a way to make sure that this downside risk embodied in the new penalties becomes an actuality rather than a theory?

Thank you, Mr. Chairman.

[The prepared written statement of Mr. Alexander follows:]

STATEMENT
before the
SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE
by
Donald C. Alexander
June 24, 1983

My name is Donald C. Alexander, and I am a partner in the Washington office of Morgan, Lewis & Bockius. I am testifying solely in my personal capacity, at the request of the Subcommittee, to discuss abusive tax shelters. As a former tax administrator with a deep and continuing interest in preserving the fairness and effectiveness of our self-assessment system, I want to commend this Subcommittee and Chairman Grassley for holding this hearing.

The effectiveness of our broad-based self-assessment tax system depends upon voluntary compliance with the tax laws. Voluntary compliance, in turn, depends upon public respect for a system which is equitable and efficient and is effectively enforced. The foundation of our tax system rests on the belief of each taxpayer that he or she is not the only one paying his or her fair share of taxes.

The concept of tax shelters is not new. Numerous incentives have been placed in the Internal Revenue Code to promote specific investments. As taxpayers have moved into higher tax brackets, their desire to shelter income from taxation has grown, resulting in a huge increase in tax shelter offerings in recent years.

In attempting to curb abusive tax shelters, the Internal Revenue Service is hampered by the difficulty of defining what is abusive, a project comparable to defining "tax expenditure". Clearly, incentives were placed in the Internal Revenue Code to be used, and one person's abuse is another person's incentive. The complexity of the law provides large areas of ambiguity, and the tax benefits -- particularly if a combination of incentives not only renders income from the investments tax-free but also shelters other income -- encourage promoters to take advantage of any latent ambiguities.

The recent growth in tax shelters and in IRS' efforts to cope with them has been so great as to swamp IRS and the Tax Court and to endanger the effectiveness of the entire system for ensuring tax compliance. At the present time, I understand that 14% of IRS' resources are currently being expended on tax shelter issues alone, an amount as large as the total expended on the coordinated audit program. This diversion of administrative resources has a negative impact on IRS' remaining functions. If the IRS spends much of its time and money chasing tax shelters and dope dealers, "ordinary" tax cheating will rise undetected.

The backlog at the Tax Court is even more disturbing. Of the 53,000 cases which I understand are now pending in the Court, some 16,000 cases involve tax shelter issues. While this figure is staggering when viewed on its own, the expected influx of appeals from the Commissioner's office to the Tax Court could prove to be a nightmare. Some have estimated that most of the 285,000 tax shelter cases currently under review at the IRS may be appealed to the Tax Court. Even assuming a large settlement rate, a high number of additional cases would remain for the Court to review, and TEFRA improvements have yet to take effect. The backlog prevents the Tax Court from resolving the tax shelter cases before it in a timely fashion, thus encouraging the venturesome to abuse tax incentives.

A key problem has been prompt identification of potential abuses in the tax shelter area and timely action to curb them. For example, the Rule of 78's had been used by some to assign very heavy interest deductions during the early years of a long-term loan. Only very recently in Revenue Ruling 83-84, 1983-23 I.R.B. 12, has IRS responded. Earlier action would have been desirable. Another instance in which the IRS identified a potential abuse area but apparently has been slow to act involves inflated charitable deductions taken for donations of gems and similar property.

Once abuses are identified, the IRS has several tools at its disposal, many added to the Code by TEFRA, to deter abusive tax shelter deductions: a penalty of $1,000 or 10% of the gross income derived from promoting abusive tax shelters; a 10% penalty for substantially understating tax liability, and a $1,000 penalty for aiding and abetting the understatement of any tax liability. Furthermore, TEFRA provided the IRS with the right to seek a civil injunction against promoters of abusive tax shelters. The IRS is now seeking a permanent injunction in the U.S. District Court in New York City against a promoter who promised a $4 writeoff for every $1 invested.

Of course, IRS must have the equipment and personnel needed to utilize these powerful tools effectively and the good judgment and restraint to use them wisely. IRS has no authority to rewrite the Code.

As long as our income tax remains riddled with incentives, limitations upon incentives and exceptions to the limitations, the problems discussed today will remain. Congress should simplify the law, lower the rates, and reduce or eliminate many of the credits, deductions, and differentials. This would reduce the areas of ambiguity that lend themselves to abuse, promote voluntary compliance, and strengthen IRS' ability to administer and enforce the law efficiently and effectively.

Senator GRASSLEY. Mr. Alexander was Commissioner of Internal Revenue Service from 1973 to 1977. Mr. Alexander frequently testifies because he is an expert in the area of abusive tax shelters, and also because he can provide a historical perspective to the problem of abusive tax shelters. What would you see as the biggest emerging problem areas in the future? Do you consider the educational benefit trust to be an abusive tax shelter?

Mr. ALEXANDER. That is a small but growing area, thanks to the fact that one court has blessed this particular device, but other courts have struck it down. But the court that blessed it has national jurisdiction. And that is the problem you should deal with. A much longer problem is the interest free loan problem. That is a major and growing problem.

Senator GRASSLEY. Would you describe further the concept of interest-free loans?

Mr. ALEXANDER. Interest-free loans. A company makes available to a major stockholder very substantial sums of money without the payment of any interest. The major stockholder, it so happens, has very substantial holdings in municipal bonds, over 300,000 to 400,000 dollars of such holdings. The time value of money is considered by the Federal circuit to result in no income at all, thanks to an ill-advised decision by an Internal Revenue official in 1961 which was not corrected until 1973. And I do not think that an Internal Revenue official's incorrect decision should make the law one way or the other, against the taxpayer or for the taxpayer, but it seems to be making the law for the taxpayer if one can take this case seriously.

Senator GRASSLEY. Our staff has developed legislation to close that interest-free tax loophole. This is a problem that undermines the credibility of the income tax system.

You have mentioned specific areas that we ought to be watching. Could you explain the trends we ought to be watching as Members of Congress?

Mr. ALEXANDER. I think the trend—and you heard much about this yesterday at the compliance hearing—is a disturbing one. Compliance with our broadbased income tax system is decreasing rather than increasing. Much of the problem stems from the Internal Revenue Service's inability to engage in a comprehensive administration and enforcement effort, indeed its inability to collect the $25 billion of overdue but unpaid taxes out there. Much of the problem stems from the fact that our Internal Revenue Code is more than 2,000 pages long; it is almost indecipherable to the human mind. And it is very difficult for any agency, however dedicated, however skilled, to try to administer it, and it is very difficult for the public to try to understand it and comply with it. We are doing too much with that tax system. We should take out many of the incentives, and the limitations on the incentives, and the exceptions to the limitations, and turn our tax system back to what it was a few years ago. A code of maybe 400 pages, which would be a vast improvement over the present code, and a code that could be administered effectively and understood and respected by taxpayers.

Senator GRASSLEY. How can the Subcommittee on the Oversight of the Internal Revenue Service and the full Congress, exercise more effective oversight? Would you submit your answer to this question in writing after you have had an opportunity to think about this matter?

[The information follows:]

The Subcommittee on Oversight of the Internal Revenue Service should have regular and targeted oversight hearings. I know how difficult this is, in the light of the many demands upon the time of Senators, but it is vitally important. Oversight hearings scheduled in advance at regular intervals, with each hearing devoted to a particular IRS function (e.g., examination, collection, taxpayer service, criminal investigation, returns processing), should be very beneficial to Congress, the Internal Revenue Service, and the taxpaying public.

GAO should participate in each hearing, and the Subcommittee should obtain the views of responsible professional organizational such as the New York State Bar Association Tax Section.

Senator GRASSLEY. Do you think we need to change the substance of our current laws, or simply make administrative changes in order to correct the problem of abusive tax shelters that exists today?

Mr. ALEXANDER. I think you need both. First, you do not need the annual model change in the law. You introduce additional complexity. And, God knows, we do not need a son of TEFRA.

Senator GRASSLEY. Are you arguing against any major tax legislation this year?

Mr. ALEXANDER. I am arguing against my own proposition in a way. No. 1, I do not think the annual model change is a good idea; No. 2, I think basic simplification is a good idea, as you mentioned earlier at the introduction of this hearing, Mr. Chairman. And, No. 3, continued interest by the Oversight Subcommittee in what Internal Revenue is doing is essential to make sure that Internal Revenue does its job right. You need to be watching Internal Revenue and working with Internal Revenue. You also need—and this is a matter for Congress as a whole and the appropriations committees—the appropriations committees need to understand that the revenue collecting agency is different from spending departments, and that it is a wise idea if we want to have a broad-based tax system to have one that works better so we don't have that enormous revenue gap that you heard about earlier. Therefore, we should try to help the Internal Revenue cope with its problems. Congress needs to make sure that Internal Revenue has the equipment, which it does not have now to do its job; to have the personnel, which it does not have now to do its job; and then Congress needs to watch Internal Revenue to make sure that it uses that equipment and that personnel in a sensible way.

Senator GRASSLEY. Thank you, Mr. Alexander. I appreciate your taking the time to testify before this subcommittee today. I do have at least three specific questions I will be sending to you for answer in writing. Thank you very much.

Mr. ALEXANDER. Thank you, sir.

[The answers from Donald Alexander follow:]

Responses to Questions from Senator Charles E. Grassley, Hearing on Abusive Tax Shelters Held June 24, 1983 by Senate Finance Subcommittee on Oversight of Internal Revenue Code.

1. From your perspective as a former Commissioner, how much have tax shelters grown since your term of office?

I believe that tax shelters generally have grown at an alarming rate since I left office, even though IRS has expanded its program, begun during my tenure as Commissioner, for reviewing tax shelter abuses. However, I think that the percentage of abusive tax shelters has recently decreased because of IRS' continuing attacks on the worst offerings. It is hard to estimate the rate of increase in tax shelter offerings since my tenure of office because statistics were not maintained and because it took some time for IRS to begin its crackdown on abusive shelters.

Although IRS began challenging many tax shelter deductions years ago, the time-consuming procedures of administrative and court review have delayed the final resolution of most of the cases involving challenged deductions. Tax shelter audits are not completed until years after the actual offering. In addition, the clog of cases in the Tax Court has lengthened the time it takes to review challenged tax shelter deduction cases.

Two major sources of statistics currently available to provide a rough measure of tax shelter growth are SEC figures reflecting the number of tax shelter offerings that are registered and recent IRS statistics about the number of tax shelter audits conducted each fiscal year. Both sets of statistics show a dramatic increase. According to the SEC, public sales of registered real estate tax shelters in 1980 amounted to $1 billion. By 1982, the figure was $2.7 billion, and the SEC estimates that the amount spent for real estate tax shelters in 1983 will approach $4 billion. Similarly, IRS audited approximately 182,000 individual returns containing questionable tax shelter deductions in fiscal year 1979. IRS estimates that it will review over 325,000 returns involving tax shelter deductions in fiscal year 1983. However, the IRS statistics may largely reflect IRS' increased emphasis and enforcement efforts in the tax shelter area.

2. Are new types of shelter being devised, or is it broader marketing of the same types of shelters?

It is my impression that over the years new types of tax shelters have been devised and marketed. I took part in initiating the IRS program to review tax shelter abuses. The early shelters that IRS investigated involved abuses of oil and gas tax incentives through excessive deductions. IRS broadened its review of shelters to include real estate, cattle feeding, equipment leasing and motion pictures. My successors have emphasized investigations of abusive shelters, including schemes involving master recordings, coal, books and lithographs, among others.

As IRS cracked down on the most abusive shelters, Congress assisted IRS by enacting "at risk" rules in 1976 and 1978, and, more recently, by providing strong penalties for overvaluation and understatement of tax liability in TEFRA. TEFRA also provided a civil penalty for injunctive relief against promoters of abusive tax shelters. I strongly supported enactment of these measures.

Of course, not all tax shelter packages are abusive. Indeed, Congress has encouraged the creation of new tax shelters through investment incentives provided for various activities, e.g., low-income housing, rehabilitation credits and energy credits.

There are fads in shelters, and they respond to nontax conditions like the rise and fall in the price of oil. Publicity tends to drive shelter activity and to spur IRS' reaction.

As long as taxpayers feel compelled to shelter income from taxation and the law remains riddled with preferences, new tax shelter schemes, or variations on old ones, will proliferate.

The tools given to IRS in TEFRA should help to curb the most abusive tax shelters provided IRS has the people and the funds to utilize them effectively.

Senator GRASSLEY. I would like to now ask Mr. Aidinoff and Mr. Cohen to proceed with their testimony before I ask any further questions. Mr. Aidinoff is the chairman of the section of taxation of the American Bar Association.

Mr. AIDINOFF. I am here to speak for the section of taxation of the American Bar Association. We have 26,000 members.

Senator GRASSLEY. Yes. Richard Cohen is a practitioner in New York.

Mr. COHEN. Yes, sir. And I am, Mr. Chairman, the reporter for the American Law Institute study of the partnership tax provisions; however, I am here today speaking in my personal capacity.

Senator GRASSLEY. Mr. Aidinoff.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. AIDINOFF. Mr. Chairman, we share this subcommittee's concern about the impact of tax shelters upon the administration of our tax laws. We think it is extremely important that resources be devoted to the tax shelter problem, and that, of course, includes increased appropriations to both the Internal Revenue Service and to the Tax Court in order that they can perform their jobs.

I would like to associate myself with many of the comments made by Mr. Woodward, Judge Tannenwald, and Don Alexander about the importance of doing something in the tax shelter area, even though it may affect only 5 percent of the compliance gap. There is no question that there is a general perception that the wealthy—and the wealthy means anybody who makes more than the particularly affected taxpayer—is not paying his full share of taxes because deductions or investments are available to him that are not available to others. This has caused increased disrespect for our system, and I think is probably the major cause for so many people to be willing to moonlight and not report their income, but also for the failure to report small amounts of interest and dividend income which, in the aggregate, may be large, and to falsify deductions. We are at the point in our tax system where basically everybody has lost respect for it. As pointed out recently by a Washington columnist, every suburbanite is willing to pay the plumber in cash. It is terribly important that resources be devoted to increased audits and in being tougher on tax shelters that may not even be really tax shelters. Participants are just taking advantage of a promoter's claim that a deduction is allowable whether or not that deduction is in fact allowable.

It has been pointed out that tax shelters reduce tax liability in a number of ways, most commonly through leverage, sometimes by conversion of ordinary income into capital gain, and by the use of accelerated depreciation, and current expension to defer a tax liability.

Many of these opportunities to use these techniques have been substantially reduced by Congress introducing the at risk concept in areas outside of real estate. The effect of that change, however, is not going to be felt for a long time since the cases that are being tried in the courts right now are pre-1976 cases. And as indicated by some of the testimony today, there are still areas where the at risk concepts do not work, and perhaps tightening is needed.

Inflating the value of assets has been a particular abuse in the charitable area, and I have got to say that it is an abuse engaged in by ordinary taxpayers. Whether it is an overinflation on the value of clothing that is given to a thrift shop, or the overvaluation of a gem given to a museum, they both reflect attitudes of taxpayers toward our tax system. I suggest that serious consideration be given to one of the proposals by the Tax Legislative Counsel that perhaps property that is not readily marketable should be deductible only to the extent of cost.

There is no question that the TEFRA penalties will curb a lot of tax shelters which many of us regard as abuses. There has not been sufficient time to know the effect of these penalties, but they do have an effect on the tax professional and the tax adviser. And, hopefully, the result of the imposition of these penalties will be a reduction in so-called reasonable basis opinions, and that more taxpayers will be encouraged to claim deductions only when there is not only substantial authority but a belief that they are actually entitled to the deduction. The compounding of interest as a result of the TEFRA penalties, and the using of more current market rates are going to make the game play a little less favorable to the taxpayer in terms of future investment in questionable tax shelters. Obviously the penalties are not going to cure the problem of the person who invests and really doesn't have enough money to pay his taxes, he doesn't really worry about the interest until it has to be paid.

I think we have got to give some of those penalty provisions a chance to operate and see how they work. In the meantime, I think that probably the most important thing that this committee can do is make sure that our Internal Revenue Service and Tax Court have the necessary resources to do their job. There ought to be more auditing rather than less auditing. There ought to be more information matching rather than less information matching. In my own opinion, we have made a serious mistake in eliminating withholding. But the result of all this is that we have to give our enforcement agencies the funds with which to work. We have some new substantial criminal penalties and injunctive penalties, but it does not do very much good to have those penalties on the books unless the Justice Department and the Internal Revenue Service have the resources to implement those penalties. Thank you.

Senator GRASSLEY. Thank you. Mr. Cohen.

[The prepared statement of Mr. Aidinoff follows:]

Statement of M. Bernard Aidinoff, Chairman
Section of Taxation
American Bar Association

before the

Subcommittee on Oversight of the Internal Revenue Service
Senate Finance Committee

with respect to

Abusive Tax Shelters

June 24, 1983

I am M. Bernard Aidinoff of New York, New York. I presently serve as Chairman of the Section of Taxation of the American Bar Association. I appear on behalf of the Section of Taxation and its 26,000 members.

I share this Subcommittee's concern, as expressed in Chairman Grassley's statement in the press release announcing this hearing, about the impact of abusive tax shelters upon the administration of our federal tax laws by the Internal Revenue Service and upon our courts, particularly the Tax Court. The proliferation of tax shelters during the last decade is another indication of increasing noncompliance with our tax laws about which all of us should be concerned.

It has been pointed out that legitimate and abusive ax shelters reduce tax liability by (1) leverage that produces tax losses through increased depreciation of assets purchased with borrowed funds; (2) conversion of ordinary income into capital gain, or of short-term capital gain into long-term capital gain; and (3) the use of accelerated depreciation and current expensing to defer tax liability. Opportunities to use these techniques in legitimate tax shelters have been substantially reduced in recent years by the introduction of the at-risk concepts and modification of other substantive areas, such as the treatment of interest during construction.

As Congress has acted to reduce the use of these benefits in legitimate tax shelters, many tax shelter promoters have responded by introducing more exotic and borderline tax reduction arrangements. Although abusive tax shelters may use some of the same techniques as legitimate tax shelters, they also tend to have other characteristics. Two techniques often used in abusive tax shelters include the claiming of deductions for debts not actually at risk and inflating the value of assets. Obviously, if there is outright evasion of the at-risk rules, we are dealing with criminal conduct. However, there may be instances where legitimate questions may be raised about whether the investor is at risk and, more particularly, the time at which he is at risk. It is, of course, important that the legitimacy of the at-risk investment be examined in order to discourage investors from treating as at-risk those liabilities that are not.

Inflating the value of assets may raise the amount of deductions available with respect to investments which are financed

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with non-recourse purchase money debt in areas that are not subject to the at-risk rules. To the extent that property is subject to the non-recourse purchase money debt, additional basis for depreciation is obtained only if the debt does not exceed the fair market value of the property. Even with investments subject to the at-risk rules, an inflated value of the assets may accelerate the deduction of that portion of the investment that is at-risk.

Overvaluation has also resulted in abusive tax shelters in the charitable area. I am afraid that the steady inflation of fair market value on charitable gifts of real and personal property has been too common. It is part of many taxpayers' normal game plan. The only remedy is constant vigilance and appropriate Justice Department action in select cases. In the Economic Recovery Tax Act of 1981, the new penalty was added with respect to overvaluation. It was a penalty endorsed by tax administrators and many members of the tax bar. There has not been sufficient time to test the effect of this penalty; but in my opinion, it should be a useful tool in handling gross overvaluation cases. Hopefully, the existence of the penalty will itself reduce substantial overvaluation.

Other, more flagrant abusive tax shelter techniques include back-dating of documents, assuming the existence of non-existent assets, and using foreign corporations or foreign bank accounts to camouflage the nature of transactions and the identities of parties. In most of these instances, we are dealing with criminal conduct. We do not have a tax shelter at all, but an outright evasion of taxes, no different from the claiming of non-existent deductions or failing to report income. These are situations that can be handled only by vigorous enforcement of our criminal tax laws and the assertion of civil fraud penalties, with adequate publicity being given to prosecutions in this area. Of course, how much can be done in this area is dependent upon the Internal Revenue Service having the machinery and resources to find the illegal conduct and the ability of the Justice Department to prosecute these cases. These abilities are very much dependent upon our enforcement agencies having the necessary financial resources.

During the last several years, Congress, the Internal Revenue Service, and the Justice Department have increased their efforts to curb abusive tax shelters. I do not know whether or not these actions have diminished the number of abusive tax shelters. Taxpayers, particularly those in top brackets, are still interested in reducing their tax liabilities. On the other hand, by reducing marginal tax rates, Congress has reduced the marginal utility of tax shelters for many taxpayers. In addition, many taxpayers who previously made investments in tax shelters have realized that some of them do not make economic sense and that the tax advantages promised have not in fact materialized. Many taxpayers have been subject to recapture liabilities as a result of the foreclosure of transactions that were badly structured from an economic standpoint. Other tax shelters are maturing, and taxpayers are beginning to realize that there are substantial tax liabilities which may be payable at the time of sale or during the period when there is no more available depreciation and cash flow is committed entirely to repayment of debt.

I still receive in the mail advertisements and offering circulars for tax shelters. Many are legitimate transactions; others are almost laughable. Several years ago the Internal Revenue Service instituted a practice of publishing Revenue Rulings covering new types of tax shelter transactions that had serious defects. In my judgment, prompt publication has the effect of discouraging investments in many of these tax shelters by taxpayers who do not want to be involved in questionable transactions. At the same time, publication carries with it the risk of publicizing such shelters and causing cynical taxpayers to invest.

Congress recently enacted the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), which contains numerous new penalty provisions affecting not only taxpayers, but promoters of tax shelters and advisors. The new penalty with respect to substantial understatement of tax liabilities should discourage investment in borderline shelters. It should also encourage the disclosure of aggressive tax positions by taxpayers in shelters with legitimate economic objectives. The authority to seek injunctions against promoters of abusive tax shelters should also be useful.

The partnership audit provisions should considerably aid the Internal Revenue Service in handling tax shelter cases. The advantages of the interest play previously available with respect to faulty tax shelters has been eliminated through the new interest compounding provisions and through additional penalties. These are also desirable new provisions. In my opinion, however, this is not the time for further legislation but a time to utilize these new tools and see whether they will work. Hopefully, they will reduce the attractiveness of borderline tax shelters.

I would like to specifically note the recent Congressional and administrative changes which have increasingly placed the professional tax advisor in the role of assisting the Internal Revenue Service in the compliance process. This is certainly the effect of the tax return preparer penalties, and it is also the effect of the overvaluation and substantial understatement penalties. Hopefully, the substantial understatement penalty will reduce reasonable basis opinions and cause taxpayers to take positions on their returns only when there is substantial authority supporting such position and where they believe the position is likely to prevail. In addition, recent revisions to the Treasury Department's Circular 230 incorporate much of Opinion 346 of the Standing Committee on Ethics and Professional Responsibility of the American Bar Association, which sets forth the standards and ethical considerations which should be applicable to opinions by lawyers analyzing the tax effects of an investment in a tax shelter offering. Responsible members of the tax bar have the same interest as members of this Subcommittee and the Internal Revenue Service in curbing the use of abusive tax shelters. Our tax system can only work if the public has respect for it, and those of us to whom the public looks for tax guidance should be willing to demonstrate our respect for the tax laws through compliance with these new rules.

To assist the Internal Revenue Service and the Tax Court in dealing with their increasing workload in the abusive tax shelter area, I urge your Subcommittee and the Congress to support existing Internal Revenue Service and Tax Court programs through appropriations to provide the personnel and resources necessary to continue and enhance those programs. Approximately one year ago, my predecessor as Chairman of the Section of Taxation, testified in favor of increased appropriations for the Internal Revenue Service and the Tax Court. I wish to re-emphasize the continued support of the Tax Section for adequate funding of the Internal Revenue Service and the Tax Court.

In summary, I believe that meaningful tools are presently in place to combat abusive tax shelters. If the new tax shelter and penalty provisions are wisely used and if the Internal Revenue Service, Department of Justice and Tax Court functions are supported through sufficient appropriations, I believe that it is likely that the trend toward increasing use of abusive tax shelters can be reversed.

Thank you for permitting me to testify today. I will be happy to answer any questions that the Subcommittee may have.

STATEMENT OF RICHARD G. COHEN, ATTORNEY AT LAW, NEW YORK, N.Y.

Mr. COHEN. Mr. Chairman, partnerships are the most frequently used vehicle for marketing tax shelters. I will speak today about limiting the use of partnerships to promote tax shelters. The American Law Institute has recently completed a 6-year study of partnership taxation. Tentative drafts of the institute's proposals have been published over the last several years. These constitute approximately 800 pages of proposals for legislative changes. They are now being revised for final publication in the near future, but are available in draft form.

Two recent pieces of legislation have significantly reduced the potential use of partnerships for tax shelter purposes. Until this year, partners were each audited separately. This made effective enforcement very difficult. The American Law Institute, the American Bar Association, and other organizations proposed that there be a single partnership level audit, working with Treasury and the Internal Revenue Service officials the partnership audit rules that were ultimately enacted as part of the Tax Equity and Fiscal Reform Act of 1982 were developed. Although they have not yet been tested in practice, my guess is that they will have a substantial impact on the use of partnerships in the tax shelter area.

Your committee might consider, Mr. Chairman, one aspect of the new rules, I am sure the legislation adequately covered—and that is the new rules create a multiplicity of tax years. A single taxpayer can have 6 or 7 tax years if he is involved in six or seven partnerships. This is going to raise statute of limitation problems. The code now contains rules to alleviate those statute of limitation problems. They are in sections 1311 through 15. I think they could be expanded to cover the partnership area very usefully. The model is already there, and it will eliminate some of the controversy which I would expect to arise in this area.

I also expect substantial definitional problems to arise out of what I consider an unfortunate exception from the audit rules for small partnerships, those with 10 or less members. At this point, I suppose all we can do is wait and hope that those definitional problems can be minimized by effective regulations.

TEFRA added a penalty for substantial understatement of tax for tax shelters. The rules for avoiding the penalty are quite strict, and these should reduce the use of partnerships for the tax shelter vehicle. However, partnerships can still be syndicated more readily than any other form of tax shelter. Furthermore, they permit the passthrough of deductions based on third party indebtedness, something which subchapter S, for example, does not permit and, thus, partnerships continue to be by far the most effective way to syndicate tax shelter. One aspect of this is the ability of partners to allocate various components of income differently among the partners. Frequently, in tax shelter situations, noncash deductions and credits are allocated to the persons who are to be sheltered, and cash or significant economic rights are allocated to the promoter. In some cases, this can make the tax shelter work.

Item allocations which play a significant role in many partnerships in which they are economically justified can also contribute substantially to the effectiveness of the tax shelter partnership. I think your committee should consider restrictive rules on item allocations.

All allocations are tested under the code by a substantial economic effect test. The Treasury has recently issued regulations which impose a capital account test on such allocations, and I think materially improve the present climate for testing such allocations. However, in many respects, I should mention, the proposed regulations follow the American Law Institute recommendations on this point.

There are some aspects of the regulations that are more troublesome. The first of these is the minimum gain charge back rule under which an allocation based on nonrecourse debt will be respected if the beneficiary of the allocation agrees to pick up the gain at the end of the partnership. This permits early deductions with a pay back sometimes as late as 7 or 8 years, sometimes as late as 15 years, after the deduction is initially taken. I understand that Treasury is reconsidering this rule, and I would hope that they would when the regulations are finalized that a different rule is proposed for this point. I should note that the rule has been criticized by the tax section of the New York State Bar, and by the Committee on Taxes of the Association of the Bar of the City of New York, both of which noted the tax shelter possibilities of such a rule.

The American Law Institute has proposed an additional restriction on losses in certain limited partnerships. In any case, once you have a limited partnership which has been syndicated—that is the interest held by a number of, say, 60 percent of the interest held by limited partners—the American Law Institute proposal would restrict such limited partners to losses or tax credits that could not exceed their cash investment in the partnership. We assume that Congress would permit certain industries, such as the real estate, perhaps oil and gas, and perhaps others that you can think of, exemption from such a restriction, but the example that Mr. Coates gave you of the partnership that bought a piece of equipment that had a fair market value of $300,000, and bought it for $9.6 million in a way that arguably avoids the at risk rules, such a partnership could not be marketed at all if the partner could not deduct more than he invested. And I think that would be a simple and effective way to restrict such losses. These comments are not comprehensive. The American Law Institute made 26 major recommendations. Within those recommendations there are subrecommendations. And I hope your committee will consider them. I think that many of them will be useful in restricting the use of tax shelters. Others will hopefully simplify the operation of subchapter K.

Thank you very much for inviting me to speak today, Mr. Chairman.

[The prepared statement of Mr. Cohen follows:]

Remarks of Richard G. Cohen, Esquire
New York City

Good morning. My name is Richard Cohen. Thank you for asking me to speak today.

I am an attorney specializing in federal income tax matters, and practising law in New York City. I am also the Reporter for the American Law Institute's study of the partnership tax provisions. My comments today are in a personal capacity and should not be taken as representing the views of the American Law Institute which views only appear in its official publications.

The American Law Institute has recently completed a six-year study of partnership taxation. Tentative drafts of the Institute's proposals have been published over the last several years. These drafts are presently being revised for final publication in the near future.

I will speak today about limiting the use of partnerships to promote tax shelters. Partnerships are frequently used as a vehicle for marketing tax shelters. However, two recent pieces of legislation have significantly reduced the potential use of partnerships for tax shelter purposes.

Until this year, partners were each audited separately. This made effective enforcement very difficult. Auditing every partner's return so that common issues could be treated consistently was time-consuming and administratively difficult, particularly if partners were located in more than one audit district. After an audit of partners, the Service might have to contest a number of actions, possibly involving conflicting positions. Even when all the partners were willing to act together, there were substantial difficulties. The partners might ~~be in~~ separate audit districts and, even if they all sued in the same court, it might be difficult to try all the partnership related issues together.

The American Law Institute and other organizations proposed that there be a single partnership-level audit.[1] Partnership audit rules were enacted as part of the Tax Equity and Fiscal Reform Act. Although the new partnership audit rules have not yet been tested in practice, I expect them to significantly improve the audit of partnerships. This would

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1 Before the new legislation was introduced, partnership audit proposals were developed and published by the American Law Institute in its Subchapter K Project (part of the Institute's Federal Income Tax Project supervised by Professor Stanley S. Surrey) and by a special committee of the Tax Section of the American Bar Association, chaired first by William Smith of the D.C. Bar and then by John Pennell of the Illinois Bar. Both groups cooperated with the Service and Treasury lawyers in working on these proposals, which were the forerunners of the new legislation.

The American Law Institute's proposals were developed by William A. Rosoff, Esq., of the Pennsylvania Bar, the Associate Reporter for the Institute's Subchapter K Project, and were improved by suggestions and criticisms by the Consultants to the Project and members of the American Law Institute's Tax Advisory Group as well as the American Law Institute's Council and general membership.

greatly reduce the extent to which abusive tax shelters can be marketed on the assumption that most of the participants will win the "audit lottery".

Under the new partnership audit rules a taxpayer will have separate tax years for each partnership in which he is a member and for his non-partnership items. This is a necessary aspect of the new rules but the multiplicity of tax years will raise statute of limitations problems. These problems should be mitigated by expanding the present mitigation rules of §§1311-15 of the Internal Revenue Code, an issue which should be promptly addressed. In addition, I expect substantial definitional problems to arise out of the unfortunate exception from the audit rules for small partnerships--those with ten or less members that meet certain other requirements.

It is important that the new audit rules work effectively and I hope that legislation resolving the statute of limitations problems will be enacted promptly.

In addition, TEFRA added a penalty for substantial understatement of tax. For tax shelters, the rules for avoiding the penalty are quite strict. This should also reduce the use of partnerships as a tax shelter vehicle.

To some extent, however, partnerships remain useful in tax shelters. One aspect of their continuing use is that partnerships can still be syndicated more readily than other forms of tax shelters. Although the new audit rules and penalties will have a substantial impact on the types of transactions marketed in this fashion, they cannot be expected to eliminate all marketing of tax shelters.

Two other attributes of partnership taxation are subject to potential abuse. One is the ability of partners to allocate various components of income differently among the partners. Frequently, in tax shelter situations, noncash deductions and credits are allocated to the persons who are to be sheltered, and cash or significant economic rights are allocated to the promoter.

Item allocations, which play a significant role in many partnerships in which they are economically justified, can also contribute substantially to the effectiveness of a tax-shelter partnership. They should be reviewed by the Committee. One common example of an item allocation is the service partnership in which, although each partner receives a share of each type of income, a particular partner may receive a special share of income for which he is primarily responsible. This may be the income from clients for whom he provides the primary services, or from types of income of which he is the major generator. In non-service partnerships, the partners may also have reason to allocate a disproportionate share of income and loss on assets contributed by one partner to that partner. It would therefore be inappropriate to eliminate all item allocations. Instead, the critical issue for such item allocations is what should be the appropriate grounds for justifying a particular allocation.

One problem arises because taxable income is not always equal to net cash received or spent. If it were, most allocation issues would be simple -- the taxable income would be allocated in the same way that partnership cash is distributed. In practice, however, there are many differences between taxable income and cash. These include noncash expenses, such as depreciation, the effects of borrowing and the tax realization rules. As a result, a much more complex process for testing allocations is required.

In general, the primary touchstone has been whether a particular allocation reflects the way in which the value of the partner's interest changes. A test, dependent on "substantial economic effect" has developed, under which the question is whether an allocation of income or loss to a partner can actually affect the amount that partner will receive. The American Law Institute's study of Partnership Taxation considers the question of appropriate allocations at length. The Institute's proposals call for a more complete exposition of the meaning of substantial economic effect and provide detailed suggestions for appropriate rules.

More recently, regulations proposed by the Treasury Department have provided more detailed rules for partnership allocations. In many respects, the proposed regulations follow the American Law Institute's recommendations (in turn based on decided cases) that substantial economic effect be tested by a capital account analysis.

There are some aspects of the regulations, analyzed below, that I would question but since the regulations are proposed and are still being reviewed at Treasury, it is reasonable to expect appropriate solutions for many of these problems. In general, the proposed regulations would test substantial economic effect by considering whether appropriate capital accounts are maintained. This is a useful rule for qualifying substantial economic effect. It provides significant clarity and allows fairly mechanical testing.

The proposed regulations, however, may make less relevant other factors that were in the regulations under Section 702(b), prior to the 1976 amendment of Section 702. Among these factors are the existence of a business (as opposed to tax) purpose, and whether an allocation reflects the economics of the situation. Similar factors might appropriately receive greater emphasis in the final version of the new regulations.

As proposed, the regulations might be exploited for several types of tax shelters. For example, I note that the proposed regulations provide an example of an acceptable allocation which appear to lack business purpose. In Example (2)(ii) a partnership leases equipment to a major commercial tenant. The lease rentals will fully pay for the equipment over a period of 6 years. During the first three years, however, depreciation on the equipment will exceed the lease rentals. The depreciation is allocated entirely to one partner, as is future income from the lease in an equivalent amount. The proposed regulation apparently sanctions this procedure even though there is no economic justification for that particular partner getting all the depreciation; the partner is not taking any significant business risk in accepting the depreciation and the allocation lacks business significance.

A second area of allocation problems arises when an allocation is based on non-recourse debt. The substantial economic effect test is not adequate to test allocations of depreciation on assets financed by non-recourse debt. It would, therefore, be appropriate to have a fairly strict rule for allocating items financed by debt for which none of the partners is liable.

In the proposed regulations, Treasury has attempted to resolve the issues relating to non-recourse debt. The present proposals permit a broad choice for allocating these deductions but require equivalent gain to be charged to the same partner later. This rule has been criticized by the Tax Section of the New York State Bar and the Tax Committee of the Association of the Bar of the City of New York, both of which noted the tax shelter possibilities of such a rule. I understand that Treasury is reconsidering this aspect of the proposed rules. I am hopeful that they will propose a more restricted rule, based on the most realistic possible determination of the partners' actual interests in the partnership.

An aspect of partnership taxation which is critical to the use of partnerships as tax shelters is the ability of partners to utilize losses well in excess of the amount they invest. To some extent the at risk rules have limited this opportunity for individuals to utilize losses in excess of investment other than in real estate transactions. There are, however, cases in which the use of tax credits effectively allows partners a tax deduction worth more than their investment. In addition, some partners circumvent the at risk rules by becoming technically liable for debts with very little risk that they will ever be called upon to pay the debt.

The American Law Institute has proposed an additional restriction on losses in certain limited partnerships. The rule would apply to a limited partnership which is broadly-held, in effect, syndicated. The American Law Institute proposal would restrict such limited partners to losses and credits totaling no more than their cash investment in the partnership. (A credit would be treated as a loss equal to twice the credit.) Additional partnership losses would be suspended until the partnership had profits or until the partner terminated his involvement with the partnership. The proposal contemplates that certain specified activities, such as real estate and oil and gas investments, will be exempted from this restriction on losses.

These comments are not meant to be comprehensive. The American Law Institute study recommends many other changes in partnership law, some of which are motivated by tax shelter considerations. For example, one American Law Institute proposal limits deduction to a partner or a partnership arising from a transaction between a partner and a partnership if the income is not accounted for at the same time. A similar rule was added to Subchapter S when that subchapter was modified in 1982. The proposed rule would make it more difficult to use partnerships for tax shelters and I hope

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it will be enacted into law.

Another proposal calls for contributions of property to a partnership to be treated as a sale when the contributor receives a distribution from the partnership shortly after the contribution. It should also restrict use of partnerships as tax shelters.

Other American Law Institute proposals deal with such matters as fragmentation of gain or loss on the disposition of partnership interests, the receipt of a partnership interest for services and definition of a partnership.

Many of these proposals are motivated by concerns other than tax shelters. Because the focus of the American Law Institute proposals is on economic reality and on eliminating differences resulting from choosing different forms for similar transactions, many of the proposals will also inhibit the use of partnerships as tax shelters.

There are undoubtedly other areas of partnership tax which are susceptible to tax shelter abuse and other proposals which would be valuable in limiting tax abuse without significantly impinging on the legitimate use of partnerships. I hope that your Committee will consider these proposals and enact into law those it considers appropriate.

June 24, 1983

Senator GRASSLEY. Yes. I have questions to ask you now, and later, I may have additional questions to submit to you in writing. I would encourage both of you to comment.

Mr. Cohen, I would like you to expand your point regarding tax years for individual taxpayers?

Mr. COHEN. Yes, sir.

Senator GRASSLEY. From your experience in the field of partnership taxation, would you suggest any legislative changes in the partnership audit provisions enacted in last year's legislation or any changes in the regulations? How would you recommend making the regulations more exacting?

Mr. COHEN. Well, Mr. Chairman, I think that invariably this was a major piece of legislation, the partnership audit rules. It is quite a thick part of the code, and it is not conceivable to me that there won't be some stresses and strains that will develop. One that I see already is, I don't think I would say too many tax years so much as there is a proliferation of tax years. There is a simple remedy for it, for which there is a pattern now in the code. And I think it will be useful to your committee to consider expanding that remedy to cover partnerships. I personally expect stresses to develop over the definition of the small partnership exception. I am not sure that it is a useful piece of the law. But I would not recommend the change at this point. I think that the tax bar, the Internal Revenue Service, and the Congress might let these rules develop over a period of several years to see how they are working. I think if people get very comfortable with partnership audits, as I expect they will, that you won't see the need for small partnership exception and you will eliminate it. But I think it is too early to say that people are comfortable now, and I think it would be a mistake to attempt that. A very small part of the regulations have been issued, the most necessary part, by the Internal Revenue Service, by Treasury. They are now drafting regulations which will be quite extensive under these rules, and it is just too early for me to comment until I see those regulations as to whether they are appropriate, whether they should be more extensive or not.

Senator GRASSLEY. Do you believe the partnership audit rules will decrease the number of tax shelters once they become effective?

Mr. AIDINOFF. May I try to answer that? I don't think it will cut down on the number of tax shelters. What it does is it cuts down on the difficulties of auditing tax shelters and of subsequently handling them in the court. And that means that it is going to give the Internal Revenue Service an easier time to pick up the tax that is due in those tax shelters where people have taken improper deductions.

Now in the long run when more tax shelters fail to accomplish their intended objectives, obviously taxpayers are going to look with more skepticism upon investing in new tax shelters. I mean, there are many people who invested in tax shelters in the 1960's, and all of a sudden are finding that they are faced with huge liabilities, are more reluctant to go into new tax shelters. But I think the importance of the partnership audit provisions is it gives the Internal Revenue Service, and later the courts, an ability to deal with partnership syndications in an orderly fashion.

Senator GRASSLEY. Would you like to add anything to that, Mr. Cohen?

Mr. COHEN. Yes. I quite agree that you cannot tell whether these are going to affect a number of shelters. I think that is really more a factor of the amount of deductions that have been thrown into the tax system, really since 1954, but almost at a geometrically accelerated rate in the last 5 years. And with those deductions in the system, people are going to do the mathematical work necessary to produce a tax shelter with them. And some of these shelters really are going to work and be effective. And the partnership audit rules, while they are terribly important, they are going to permit the Internal Revenue Service to function at all in this area, and permit them to monitor it, are not necessarily in themselves going to cut down tax shelters. And if you want to do that, you ought to address directly such issues as do you want this machinery that Mr. Coates talked about widely marketed? If you are willing to give the energy tax credit and the fast appreciation to the manufacturer of such equipment to the user of such equipment, to the direct user of such equipment, but don't want to give it to a dentist in Middletown, U.S.A., then you might consider rules that will restrict the marketing of such losses, that will restrict the passthrough of losses to partnerships. That will be an effective way to eliminate them, Mr. Chairman.

Senator GRASSLEY. Have the Finance Committee staff and the Ways and Means Committee staff been furnished copies of the American Law Institute proposals?

Mr. COHEN. Mr. Chairman, some of them have been furnished with some of the material, and I will talk to whomever you think is appropriate to find out, and I will see that they are furnished with a full set of them in a sufficient quantity to be useful.

Senator GRASSLEY. Is there a need for a rule to restrict loss deductions by limited partners after the ·isk rules have been enacted?

Mr. COHEN. Yes; I believe there is, Mr. Chairman. I think that you saw one example again, the example that Mr. Coates presented, as a useful one to pursue where arguably the at a risk rules do not work because you have inserted between the investor and the original manufacturer somebody who is in fact at risk, although with very little to lose, or arguably qualifies under the at risk rules. I think that there are many tax shelters being marketed in the United States today through partners. And I would be very interested in Mr. Aidinoff's comments on this, but he probably gets approximately the same mail I do. There are many of these tax shelters being marketed through partnerships in which through quite questionable means the at-risk rules are being avoided. But a tighter rule on loss passthrough by partnerships I think would not complement the at-risk rules and not be redundant.

Senator GRASSLEY. The American Bar Association has been most helpful to this subcommittee and the full committee on the general subject of compliance. As you have had an opportunity to visit with members of the tax section, are practitioners observing a rise in client interest in tax shelters?

Mr. AIDINOFF. Well, I certainly can say that over the last 10 years there has been an increase by all sorts of individuals in finding tax shelters of various types. In some instances, the tax shelter sometimes have taken the form of investment in what we would certainly regard as areas in which Congress has wanted to encourage investment. There certainly has been a tendency by a lot of individuals to take at face value advertisements that they receive in the mail, ads that may appear in business magazines, and it is very difficult sometimes to tell individual clients that if you find today a tax shelter which gives you more than a 1-to-1 writeoff outside of the real estate area, you are probably dealing with something that is either abusive or you are getting poor advice. There is no question that individuals think that there are all sorts of opportunities out there. And, for example, in the at risk area we have had the appearance of a substantial number of tax shelters where there has been full recourse debt, but the debt is not payable for 10, 20 years in the future, and the interest rate on the debt is either nonexistent or very, very low. While there may be argument in that type of situation, what is the liability for purposes of the at-risk rules? But there certainly have been tax shelter promoters who have been willing to advise prospective investors that the full amount of that note is at risk and, therefore, is includable in basis, and therefore gives a higher deduction. And this is certainly one area where the at risk rules could be tightened.

Senator GRASSLEY. My first question is in regard to the subject of tax shelters in general. Have you seen an increase in the interest of your clients in tax shelters?

Mr. AIDINOFF. Over the last 10 years.

Senator GRASSLEY. Have you seen an increase in the more narrow category of abusive tax shelters, as we defined last year, which obviously existed even before that time?

Mr. AIDINOFF. Well most of the abusive tax shelters are just outright frauds. And I think most responsible lawyers know that and do not advise clients with respect to them.

Senator GRASSLEY. Has there been any indication, in discussions with your colleagues, whether or not there is an increasing interest in abusive tax shelters?

Mr. AIDINOFF. I think that probably over the last 2 or 3 years there probably has been a realization by more and more people that they are taking greater risks in investing in that type of tax shelter. I think that what Commissioner Kurtz did when he was Commissioner, we had a substantial number of Revenue rulings which approved almost immediately after the existence of a new shelter, a Revenue ruling would come out pointing out that it didn't work, was very, very helpful. On the other hand, I can also say that the commodity straddle ruling, which really was litigated in the Tax Court in the *Smith* and *Jacobson* cases, I have got to say that after that one came out, there was probably an increase in commodity straddle transactions, perhaps not quite as on the borderline as the particular transaction in the ruling, but it certainly caused a greater increase in commodity straddle transactions by people outside of the commodities area.

Senator GRASSLEY. Has Canon number 346 been controversial within the bar?

Mr. AIDINOFF. You mean ABA opinion 346?

Senator GRASSLEY. Yes.

Mr. AIDINOFF. Yes. ABA opinion 346 was very controversial when it first came out. It was revised. My predecessor, Jack Nolan and I were criticized by many members of the tax section because we worked very hard on that. But I would say that, in general, it has been supported by most members of the tax bar. I think there are portions of it that individual practitioners may find difficult to work with. But I would say the leaders of the tax profession certainly support it. And I think that even a good number of responsible tax lawyers who have been given opinion in the tax shelter area have begun to realize that having ABA opinion 346 enables them to give the type of tax advice they would prefer to give, and it helps them resist pressure from just giving reasonable basis opinions.

Senator GRASSLEY. Do you know of any disciplinary action that has been instituted against any member of the bar for violating the canon?

Mr. AIDINOFF. No. You have got to remember that ABA opinion 346 concerns primarily ethical considerations. It is not yet part of the Code of Professional Responses.

Senator GRASSLEY. So there could not be any disciplinary action brought against any member of the bar?

Mr. AIDINOFF. Well you could have disciplinary action brought in individual States. You would not hear of that, generally. It would not be just on the basis of violating ABA opinion 346. It would be on the basis of generally disreputable conduct in giving false opinions.

As you probably know, the Treasury Department has proposed amendments to Circular 230 which is the circular which governs practice before the Internal Revenue Service and the Treasury Department, which would amend its rules so that the constant giving of opinions that do not meet certain standards could cause disciplinary action. And those standards are essentially the same standards that are set forth in ABA opinion 346. Those amendments have not yet been adopted, but my understanding is that they probably will be soon. I think it is the hope of everybody that ABA opinion 346 and the proposed amendments to Circular 230 will both improve conduct by members of the tax bar, but, more important, enable members of the tax bar to address problems in an ethical fashion. It gives them a total to stand up to their clients in situations where perhaps some might waiver.

Senator GRASSLEY. Did our reduction of the marginal tax rate, from 70 percent to 50 percent, diminish the attractiveness of tax shelters to your clients?

Mr. AIDINOFF. I think the answer is yes, not only in abusive tax shelters but in—I mean, quite frankly, it makes an investment in, let's say, an oil transaction, where one would be willing to go into it because of the balancing of the intangible drilling deduction against what the income to come off in the future is much less attractive.

Senator GRASSLEY. Is the attractiveness of such tax shelters, then, not worth the gamble of the possible consequences of litigation?

Mr. AIDINOFF. Is not worth the gamble anymore.

Senator GRASSLEY. Do you have anything to add, Mr. Cohen?

Mr. COHEN. No, Mr. Chairman. I agree with that.

Senator GRASSLEY. Thank you both. Mr. Cohen and Mr. Aidinoff. You have been very helpful today and, more importantly, your whole profession has been tremendously helpful to the members of this committee and our staffs for the 2½ years I have been on the committee. Thank you very much.

Mr. AIDINOFF. Thank you, sir.

Senator GRASSLEY. Do you have any further comments Mr. Cohen?

Mr. COHEN. Mr. Chairman, could I take one moment to just say that on the time value of money, which I know is something your committee is concerned with, the New York State, first of all, the Committee on Taxation of the Association of the Bar of the City of New York has just issued a report on that which I think will be interesting to your committee. And the New York State bar is now studying the question, and I think their report should be interesting to you.

Senator GRASSLEY. How do we obtain a copy of this report?

Mr. COHEN. You will get it in the normal course of business, sir.

Senator GRASSLEY. Thank you. We appreciate your helpfulness very much.

Would Timothy Kincaid, first vice president, E. F. Hutton and Co., Inc., New York, N.Y., and Mr. Phillip S. Hughes, Under Secretary, Smithsonian Institution approach the witness table, please? I would like each of you to testify in that order, before I ask questions. Please proceed with your testimony. Mr. Kincaid is first.

STATEMENT OF TIMOTHY J. KINCAID, FIRST VICE PRESIDENT, E. F. HUTTON & CO., INC., NEW YORK, N.Y.

Mr. KINCAID. I am Timothy Kincaid. I am first vice president in charge of the tax shelter direct investment product originalation department. My department is responsible for originating, reviewing, and approving all tax shelters and direct investments offered and sold by E. F. Hutton. This involves the complete review of the investment, tax, and legal considerations involved in a particular offering.

I want to commend the subcommittee for holding this hearing and for allowing us the opportunity to share our concern about abusive tax shelters. We hope the subcommittee will find our perspectives and insights on tax shelters useful. I will be brief and ask that my full statement be included in the record.

[The prepared statement of Mr. Kincaid follows:]

STATEMENT BY

TIMOTHY KINCAID
FIRST VICE PRESIDENT
E.F. HUTTON & COMPANY

Mr. Chairman and Members of the Subcommittee:

My name is Timothy Kincaid. I am First Vice President in charge of the Tax Shelter Sales/Direct Investment Product Origination Department at E.F. Hutton & Company. I commend the subcommittee for holding this hearing and for allowing us an opportunity to share our concern about abusive tax shelters. We hope that the subcommittee will find our perspectives and insights on the tax shelter market useful. I will be brief, but ask that my full statement be included in the record.

As you may know, E.F. Hutton is the nation's largest packager of tax shelters and direct participation partnerships. In 1982, we offered 100 different partnerships with an aggregate value exceeding $850 million. Most of our offerings are in the congressionally-sanctioned areas of oil and gas, real estate, equipment leasing and research and development.

The primary purpose of our partnerships is to allow individual investors to directly participate and benefit from special investment incentives placed in the tax code by the

Congress. Historically, E.F. Hutton has always taken a very conservative tax posture on these programs and that is why we are the largest promoter and underwriter in the industry; investors are confident that their deductions and credits will be allowed by the Service. Consequently, the enactment of TEFRA, with its new penalties and restrictions, has had little impact on our business.

Although publicity about tax shelters is often adverse, I would like to remind the subcommittee that investments which take advantage of incentives developed by the Congress serve important public purposes. Among the public purposes served by such investments are:

- The construction of rental housing for low- and moderate-income persons;
- The development of alternative energy sources, thus reducing our dependence on imported oil;
- The production of domestic oil and natural gas;
- Investment in productive capital; and
- Improving the nation's productivity and economic growth through increased research and development spending.

Abusive tax shelters are those that are based on clearly unsustainable tax positions, misrepresentations of tax law, gross overvaluation of assets, or fraudulently undisclosed side agreements which, if disclosed, would make the stated tax positions clearly unsustainable. However, tax shelters are often characterized as abusive, if they take an aggressive but supportable position on a current provision of tax law that is ambiguous. I would caution the subcommittee from including those programs in its investigation. Rather, the Service should clarify the law administratively, or if necessary, the Congress should enact new legislation.

With that as background, I would like to say that we at E.F. Hutton share the committee's concern about abusive tax shelters. These schemes divert the limited amount of investment dollars from productive congressionally-sanctioned objectives to those offering apparently higher, but in reality unsupportable write-offs. This results in unnecessary revenue losses to the Treasury without the accompanying social benefits resulting from the congressionally-sanctioned tax-advantaged investments.

In addition, unscrupulous promoters tarnish the public image of the tax shelter/direct investment industry as a whole. While we are not concerned about these schemes from the standpoint of our own competitive position, we do believe that the unfair and misleading competition represented by abusive shelters should be penalized.

From our perspective, the number of abusive shelters has declined significantly over the past six months following the adoption of TEFRA and its provisions regarding tax shelters. E.F. Hutton reviews over fifty proposals for every one we actually underwrite. In addition, our customers are often approached to invest in tax shelters being promoted by other firms and we are frequently asked to review those proposals on our clients' behalf. Consequently, very little passes through the market of which we are not aware.

We believe there are five factors that help explain the reduced volume of abusive shelters being promoted in the marketplace:

1. Regulations. The Service has continually refined its regulations making it increasingly more difficult to structure abusive shelters without being out and out fraudulent.
2. American Bar Association Canon of Ethics. An interpretation of the ABA Canon (ABA Formal Opinion 346) increases the ethical responsibilities

of lawyers in connection with shelters. It is now clearly stated that a lawyer must evaluate and report the likelihood that a particular valuation or deduction might be disallowed. This significantly reduces the opportunity for misrepresentation.

3. The Tax Equity and Fiscal Responsibility Act. TEFRA closed certain loopholes and increased the penalties for promoting abusive tax shelters.
4. Internal Revenue Service Publicity. The Service has recently publicized its efforts to crackdown on abusive shelters. This has dampened the interest of the sophisticated investors who participate in such financings.
5. Enforcement. Injunctions have recently been granted against several promoters of abusive schemes. The word of this has spread and created apprehension among potential investors.

In addition to the volume of abusive tax shelters declining, we have noticed another change in the market that might be of interest to the subcommittee. The classic notion of a tax shelter is some type of investment that creates deductions and credits sufficient to shelter income from other sources. More recently, investment programs are being structured that do not shelter other income. Rather, "tax-free" income similar to municipal bond interest is the result. The availability of and demand for these types of shelters may have attributed to the reduction in the volume of abusive tax shelters by reducing the market for them.

While the volume of abusive tax shelters may be declining, we believe that abusive shelters are and will continue to be a problem. Further sanctions are needed, but we do not believe new legislation is necessary.

Rather, the easiest way to curb the volume of abusive shelters is to increase the likelihood that promoters and investors are caught. The increased penalties of TEFRA have raised the consciousness of the investment community, but enforcement remains the key. If promoters and investors believe there is a reasonable chance of their being caught and penalized, abusive tax shelters will all but disappear. We believe that this can be accomplished if the Service is given adequate resources and is diligent in its duty.

E.F. Hutton and other reputable providers of direct participation partnerships were not seriously affected by the penalty and enforcement provisions of TEFRA. We encourage increased enforcement. It can only assist legitimate promoters by discouraging false and misleading representations by disreputable promoters of purported tax shelters.

We thank the subcommittee for its time, and I am willing to answer any questions that members may have.

Mr. KINCAID. As you may know, E. F. Hutton is the Nation's largest seller of tax shelters and direct participation partnerships. In 1982, we offered and sold more than 100 different partnerships and raised in excess of $850 million in partnership proceeds. Most of our offerings are in the congressionally sanctioned areas of oil and gas, real estate, equipment leasing, and research and development. The primary purpose of our partnerships is to allow individual investors to directly participate and benefit from the economic profit of the transaction and the special investment incentives placed in the Tax Code by Congress. Historically, E. F. Hutton has always taken a very conservative tax posture on these programs, and that is one of the primary reasons that we are the largest in the industry. Investors are confident that their deductions and credits will be allowed by the Service. Consequently, the enactment of TEFRA, with its new penalties and restrictions, has had little impact on our business.

Although publicity about tax shelters is often adverse, I would like to remind the subcommittee that investments which take advantage of the incentives developed by Congress serve important public purposes. Among the public purposes served by such investments are the construction of rental housing for low- and moderate-income persons; the development of alternative energy sources; the production of domestic oil and gas; investment in productive capital assets; and improving the Nation's productivity and economic growth through increased research and development.

With that as a background, I would like to say that we at E. F. Hutton share the committee's concerns about abusive tax shelters. These schemes divert the limited amount of investment dollars from productive congressionally sanctioned objectives to those offering apparently higher, but, in reality, unsupportable writeoffs. This results in unnecessary revenue losses to the Treasury without the accompanying social benefits resulting from the congressionally sanctioned tax-advantaged investments.

In addition, unscrupulous promoters can tarnish the public image of the tax shelter/direct investment image as a whole. While we are not concerned about these schemed from the standpoint of our own competitiveness position, we do believe that the unfair and misleading competition represented by abusive shelters should be penalized.

From our perspective, the number of abusive shelters which have come to our attention has declined significantly over the past 6 months following the adoption of TEFRA and its related provisions regarding tax shelters and penalties for tax shelters. E. F. Hutton reviews over 50 proposals for every 1 that we actually offer and sell. In addition, our customers are often approached to invest in tax shelters being promoted by other firms, and we are frequently asked to review these proposals on our clients' behalf. Consequently, very little passes through the public market of which we are not aware.

We believe that there are five factors that help to explain what appears to be the reduced volume of abusive shelters being promoted in the marketplace. The first is the regulations of the Service. The Internal Revenue Service has continually refined its regulations making it increasingly more difficult to structure abusive shelters without being out-and-out fraudulent. Second, the American Bar Association's interpretation of the canons of ethics and the ABA formal opinion 346, which you referred to a few minutes ago, increases the ethical responsibilities of lawyers in connection with shelters. It is now clearly stated that a lawyer must evaluate and report the likelihood that a particular valuation or deduction might be disallowed. This significantly reduces the opportunity for misrepresentation. Third, the Tax Equity and Fiscal Responsibility Act closed certain loopholes and increased the penalties for promoting abusive tax shelters. Fourth, publicity by the Internal Revenue Service in its efforts to crack down on abusive tax shelters. This has dampened the interest of the sophisticated investors who may have previously participated in such financings. And, finally, enforcement. Injunctions have recently been granted against several promoters of abusive schemes, and word of this has spread and created apprehension among potential investors and the promoters.

While the volume of abusive tax shelters may be declining, we believe that abusive shelters are and will continue to be a problem. Further sanctions are needed, but we do not believe that new legislation is necessary. Rather, the easiest way to curb the volume of abusive shelters is to increase the likelihood that promoters and investors are identified and penalized. The increased penalties of TEFRA have raised the conciousness of the investment community but enforcement remains the key. If promoters and investors believe that there is a reasonable chance of their being caught and penalized, abusive tax shelters will all but disappear. We believe this can be accomplished if the Service is given adequate resources and is diligent in its duties.

E. F. Hutton and other responsible providers of direct participation partnerships were not seriously affected by the penalty and enforcement provisions of TEFRA. We encourage their increased enforcement. It can only assist legitimate promoters by discouraging false and misleading representations by disreputable promoters of purported tax shelters. We thank this subcommittee for its time and I am willing to answer any questions that you may have.

STATEMENT OF PHILLIP S. HUGHES, UNDER SECRETARY, SMITHSONIAN INSTITUTION, WASHINGTON, D.C.

Mr. Hughes. Thank you, Mr. Chairman. We are pleased to be here and be of any help that we can to the committee. I think listening to the morning testimony has made me considerably more aware of the complexity of the issues that confront the committee, and it is making me relatively more happy to be in the museum business at this point rather than the tax shelter abuse prevention business.

We are, of course, in the museum business, but we are concerned that we are not unwittingly in the tax abuse business or the tax fraud business as well. Our detailed statement, which I understand you will put in the record, describes in some depth our collections management policies, as well as a series of actions that we have taken over the past several years to assure that the collections are properly handled.

I think the part of that statement that may well be of direct concern to this committee has to do with the review which we have made of valuable collections—the anthropological collections of native American artifacts, for example, and stamps and coins—areas where there is at least the possibility of similar potentiality for similar kinds of abuse. We are convinced from that review that abuse has not occurred in those areas.

Until very recently, we have followed the generally accepted museum practice of not expressing an opinion about the monetary value of objects donated to our collection, believing that an appraisal should be the work product of a disinterested party, and that a museum, as a recipient or prospective recipient, cannot claim that objectivity. However, our recent experience, together with the observations of the market for precious gems and minerals have caused us to modify our traditional procedures, particularly with regard to objects offered to our gem and mineral collection. We now require that any proposed donation to the Department of Mineral Sciences, which exceeds $1,000 in value, must be accompanied by an independent appraisal submitted by the donor. And objects exceeding $1,000 in value will be accepted by the Department only if the donor's appraisal appears to the Department to fall within reasonable limits. This additional step was initiated to curb the abuses that have received wide publicity. And we are watching rather carefully the practicability and the effectiveness of this new requirement.

In addition, we also now more explicitly require that there must be a determination that the object in question is truly of collection quality, and that it can be accepted in good faith as an object which will remain in the collection. In other words, Mr. Chairman, we are avoiding being in the gem trading business, a practice which concerned us over the past several years. And we want simply to limit our acquisitions to objects which are of a quality suitable for keeping in the collection. Second, there must be full documentation of all of our acceptance actions, including a description of the object, evidence of donation intent, and further specific information. All acceptance records must be retained and be made available to all of the proper parties.

Our concerns in the gem and mineral area originated during the course of a routine internal audit in late 1981. Questions were raised as to whether the records of a few transactions were adequate, and whether appropriate administrative processes were actually in effect in that area covering both accessions and deaccessions. While we were not aware then or now of deliberate wrongdoing, and while there had been during the period that we addressed an almost immeasurable strenthening of the holdings of that collection, we concluded there was a need for a significant tightening and improving of administrative procedures covering the management of those collections, and that tightening is reflected in the comments previously made.

We brought the matter to the attention of the Smithsonian's Board of Regents through its audit and review committee, and the Regents and the committee have been strongly supportive of our efforts.

In addition to the management actions that I have described, in July of last year we thought it wise to seek the advice of the Department of Justice with regard to a few transactions, which we did, and subsequently, as we understand it, the Department of Justice has referred the matter to the U.S. attorney's office, the FBI and the IRS.

In February of this year, at the direction of the audit and review committee, I wrote the U.S. attorney to express our continued interest and that of the Regents in the matter and our desire to cooperate in every way possible. I did receive a response from the U.S. attorney expressing his appreciation and satisfaction with our cooperation. I would be happy to respond to any questions you may have, sir.

[The prepared statement of Mr. Hughes follows:]

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STATEMENT BY PHILLIP S. HUGHES, UNDER SECRETARY, SMITHSONIAN INSTITUTION

S U M M A R Y

A routine internal audit of the gems and minerals records and procedures in late 1981 raised questions as to whether the records of a few transactions were adequate and whether appropriate administrative processes were actually in effect in that area covering accessions and deaccessions. As a result, we concluded that there was a need for a significant tightening and improving of administrative procedures covering the management of those collections.

In addition to Institution-wide acquisition requirements, it is now also required that any proposed donation to the Department of Mineral Sciences which exceeds $1,000 in value must be accompanied by an independent appraisal submitted by the donor. An object exceeding $1,000 in value will be accepted by the Department only if the donor's appriasal appears to fall within reasonable limits. This additional step was initiated to curb apparent wide-spread abuses involving the donation of gems to museums, and the practicability and effectiveness of this new requirement is being monitored closely.

In addition to taking this and other management actions, in July 1982, we thought it wise to seek the advice of the Department of Justice with regard to a few transactions. It is our understanding that subsequently the Department of Justice referred the matter to the U.S. Attorney's Office, the FBI and the IRS.

Thank you, Mr. Chairman.

We appreciate the opportunity of appearing before you today to discuss charitable contribution tax shelters to the extent that we can. Our interests in the issue are related to the over-all management of the national collections with which the Smithsonian is entrusted. I would like to set forth for you the actions that the Institution has been taking over the past several years to assure the safeguarding of all the Smithsonian's collections and the proper handling of accessions to and deaccessions from those collections.

I think it is fair and accurate to say that generally speaking these actions were given their initial impetus by the complete inventory of Smithsonian collections which began in 1978 and will be completed this month. Much of the work of reconciliation and of more detailed description of the collections for research purposes will remain to be done, but we have now virtually a full and accurate record of all of the objects and collections in the Institution at the present time.

From the beginning, the Smithsonian has been concerned with the proper care and safeguarding of our collections by assuring the correct handling of accessions to and deaccessions from those collections, by establishing standards for the care of objects in our custody, and by defining the responsibilities of curators and other staff. All of these matters, like the maintenance of an accurate and complete inventory, come under the general heading of collections management. For most of the history of the Institution such matters have been the decentralized responsibility of individual curators and sometimes of the directors of individual museums. This is not to say that policies were nonexistent or that they were inadequate or inappropriate, but rather that they were widely variable and were based on the practices and customs of the particular field of science, history or art.

In July of 1980, stimulated by concern that individual museum collections management policies be adequate and consistent as appropriate, the Institution issued Office Memorandum 808 which established the policy of the Smithsonian Institution "that each of its organizations which has collecting authority maintain and follow an authorized, written collections management policy to assure that all collections are properly controlled, inventoried, and cared for." The policy further provided that "where conditions warrant, a collecting organization may elect to promulgate separate collections management policies applicable to individual subordinate units." The memorandum set forth the procedures for the development of policies and for their review and authorization, and an attachment to that memorandum established a set of guidelines for preparing them.

In accordance with Office Memorandum 808, the individual museums developed collections management policy statements and transmitted them for review in accordance with the guidelines. The initial set of policies were placed in effect in 1980 and 1981 with the understanding that they were subject to revision and improvement as experience and further review might indicate. I should point out and emphasize that while the provisions of the collections management documents are being revised continually, including the accession and deaccession procedures, we believe that from drafts first received, the policies set forth have been adequate to assure the protection of the collections. The revisions that have occurred are generally to bring fundamental criteria into greater uniformity and to assure that basic standards are adequate but not unduly burdensome. You can appreciate that collections management policies for entomology would and should differ from invertebrate zoology, gems and minerals, and philately.

During the course of a routine internal audit of the gems and minerals records and procedures in late 1981, questions were raised as to whether appropriate administrative processes were actually in effect in that area covering accessions and deaccessions. While we were not aware then or now of deliberate wrongdoing, and while there had been an almost immeasurable strengthening of the holdings, we concluded that there was a need for a significant tightening and improving of administrative procedures covering the management of those collections. We brought the matter to the attention of the Regents through their Audit and Review Committee. That Committee and the Regents have been strongly supportive of our efforts and have been kept fully and currently informed down to the present time.

Two areas of particular concern in our review of the gems and minerals department were restricted gifts and the valuation of gifts offered to the collections. With regard to the former, the collections management policy of the department now states clearly the Institution's policy which forbids the acceptance of restricted gifts. Any exception to this policy must, at a minimum, have the approval of the Director of the museum and any approved restriction must be made a part of the official accession records. With respect to objects in the collection which have restrictions or appear to have restrictions, the advice of the Office of the General Counsel must be sought before decisions can be made concerning the disposition of such objects.

Regarding the valuation of gifts, it was determined that the gem market was such that the Institution had cause to deviate from its traditional procedures with regard to certain objects offered to its gem and mineral collections. The Smithsonian has followed the generally accepted practice of not expressing an opinion regarding the monetary value of objects donated to its collection, believing that an appraisal should be the work product of a disinterested party and that a museum as donee (or prospective donee) cannot claim this objectivity.

Institution-wide acquisition procedures now focus on these requirements:

1. There must be a determination that the object in question is truly of collection quality and that it can be accepted in good faith as an object which will remain in the collections for the foreseeable future.
2. There must be complete documentation of all acceptance actions. This includes a description of the object in question, the evidence of donation intent (usually the Deed of Gift), the date the object actually is received by the museum, and the museum's use of the object.
3. All acceptance records must be retained and made available to all proper parties.

Late in 1982 an additional acceptance requirement was put into effect in the Department of Mineral Sciences at the National Museum of Natural History. The new requirement states that any proposed donation to the Department of Mineral Sciences which exceeds $1,000 in value must be accompanied by an independent appraisal submitted by the donor. An object exceeding $1,000 in value will be accepted by the Department only if the donor's appraisal appears to fall within reasonable limits. This additional step was initiated to curb apparent wide-spread abuses involving the donation of gems to museums, and the practicability and effectiveness of this new requirement is being monitored closely.

In addition to taking the management actions just described, in July 1982 we thought it wise to seek the advice of the Department of Justice with regard to a few transactions. It is our understanding that subsequently the Department of Justice referred the matter to the U.S. Attorney's Office, the FBI and the IRS. In February of this year, at the direction of the Audit and Review Committee, I wrote the U.S. Attorney to express the continued interest of the Smithsonian's Board of Regents in the matter, their desire to cooperate in every way possible, and their hope for early resolution.

Finally, to give further assurance to ourselves, the Regents, Congress, and the public, we have brought together the accessions and deaccessions records for all museums in the Institution for the period since January 1980. While they are voluminous and detailed, a simple scanning of the individual records shows several things: (1) Accessions are many times more numerous than deaccessions in all museums, with objects and collections coming to us by a variety of means: purchase, donation, bequest, and from Government agencies. This emphasis on accessions reflects the overall bias of the Institution toward collecting, rather than disposing or trading. (2) Deaccessions are not only relatively very few in relation to accessions but are, like accessions, carefully documented. (3) Review of the kinds of items accessioned and deaccessioned indicates that the vast majority of items have entirely different characteristics than gems or minerals. While some are valuable in an intrinsic, as well as in a scientific or historic sense, the nature of the "markets" involved and, therefore, of the incentives, is so different from the gem market over recent years as to basically alter the conditions of collecting. In every other area of items of high intrinsic value, the volume of deaccession activity has been very low.

In summary, we have been working hard and steadily for several years to establish appropriate control over the collections in our custody and over additions to and subtractions from the collections. We believe that with the establishment of collections management policies and the completion of the inventory, we have accomplished that. In the process staff throughout the Institution have become convinced of the necessity for clearly established collections management policies appropriate to the particular collection, and we have all become more aware of the value of the inventory for scientific purposes, as well as for management.

Senator GRASSLEY. You have explained, Mr. Hughes, through your testimony, the efforts taken by the Smithsonian to strengthen the administrative procedures governing the management of the collections. You have been very clear in that area and I want to commend you for it.

Mr. HUGHES. Thank you, Mr. Chairman. I would also like it to appear in the record that we took all those actions long before the publicity.

Senator GRASSLEY. The Smithsonian began strengthening its administrative procedures long before the publicity surrounding the valuation of gem stone. Did you see such problems becoming apparent?

Mr. HUGHES. Yes, sir. In 1981, during the course of a routine audit of the gems and minerals area, we became concerned about documentation and the processes that had been followed in that area, and took steps to correct those practices. Even though there was no evidence available to us, or, as far as I know yet, of deliberate wrongdoing, we became sufficiently concerned to seek the advice of the Justice Department, which has skills and authority which we don't have in the Smithsonian, and they, in turn, have sought help from the appropriate agents for them. That all occurred in 1981 and the earlier part of 1982.

Senator GRASSLEY. As you know, TEFRA imposed penalties on the promoters of abusive tax shelters. One type of tax shelter classified as abusive is one in which the asset or the deduction is overvalued by at least 200 percent. It is possible for a taxpayer can escape the penalty if the taxpayer convinces the Commissioner of Internal Revenue Service that there was a reasonable basis for the valuation, and if the valuation was made in good faith.

With regard to this possibility, will the Tax Equity and Fiscal Responsibility Act diminish the number of gifts that you or other museums receive?

Mr. HUGHES. No, sir, we are not fearful. It may well diminish the gifts, but we think diminish those in appropriate fashion and appropriate degree. I might add that we would not have any difficulty with the increasing of penalties which IRS talked about, nor would we have difficulty with the lengthening of the qualifying time period to 5 years, which they referred to, from our perspective. We are interested, from our standpoint, in bona fide donations of museum quality items. And we think that collectors and friends of the Institution with a bona fide interest in contributing collection quality items to the Institution will continue to do that.

Senator GRASSLEY. Is there any possibility that a taxpayer or taxpayers might seek indemnification against you for penalties for accepting gifts which are grossly overvalued?

Mr. HUGHES. I suppose, Mr. Chairman, there is always that possibility. As I understand it, one can sue for almost anything. Whether one is successful or not is the question. That is not a matter that we are concerned about.

Senator GRASSLEY. Mr. Kincaid, as the Nation's largest seller of tax shelter investments do you see any increase in the market for tax shelters?

Mr. KINCAID. I see it increasing. It has increased steadily for the past several years, and I anticipate that it will continue to increase. The character of the market is changing. With the changes in the tax law, with the reduction of the tax rates, more emphasis is being placed upon investments which generate a cash flow, some of which is fully sheltered, some of which could be partially sheltered. And with many of those investments, the actual after tax rate of return to the investor may increase as the tax rates decrease.

Senator GRASSLEY. Well following on that line then, and, more specifically, has the reduction of the tax rate from 70 percent to 50 percent limited your business in tax shelters?

Mr. KINCAID. No, it has not. It has changed the character of it somewhat, but it has been accompanied with changes in depreciation schedules which make particularly the real estate investments equally as attractive to a 50-percent taxpayer as they previously were under the longer depreciation schedules to a 70-percent taxpayer.

Senator GRASSLEY. As a legitimate business, I am sure you do not appreciate people who are not legitimate business operators undercutting your business. What are some current abusive tax shelter schemes which might be undercutting your business?

Mr. KINCAID. There are a few that the clients invest in rather than investing in the more conservative investments that we believe they should be investing in that do take funds away from that area. I suppose, generically, the types of investments that I would point out that would be the most typical of abusive investments were those in which there is either a gross overvaluation of the assets providing for a larger depreciable base, or providing for a larger base for claiming of an investment tax credit, and those in which there is just out and out fraud by virtue of stating that a certain indebtedness may be recoursed, and having a side agreement which is undisclosed indicating that none of the indebtedness will ever be called.

Senator GRASSLEY. What emerging trends in the area of abusive tax shelters should this subcommittee and the full Senate be watching?

Mr. KINCAID. I think that what you ought to be focusing on are the impacts that the new penalty provisions of TEFRA will have on the business. I think that we are already seeing it. I think that the IRS will start to see it in a few months or maybe even a few years once the volume of tax shelters and the tax returns related to those abusive tax shelters are filed with the IRS. I think that following that will be very indicative of how effective the TEFRA penalties have been.

Senator GRASSLEY. Do you have any suggestions on what the IRS ought to be doing to stop the growth of abusive tax shelters?

Mr. KINCAID. I think that they are doing what they ought to be doing right now, but perhaps they should be doing more of it. Publicizing the problems with regard to the shelters. Publicizing the enforcement actions that they are taking, and clarifying the regulations so as to make it harder to structure around them.

Senator GRASSLEY. What additional legislation is needed to restrict the growth of illegal tax avoidance schemes?

Mr. KINCAID. I don't think any is needed right now. I think that monitoring of the TEFRA penalties will indicate in a year or two whether anything more is necessary.

Senator GRASSLEY. Have the TEFRA provisions had any effect in reducing the proliferation of illegal tax shelters?

Mr. KINCAID. I think that they have. It seems to me and to others that I have spoken to that the abusive tax shelters tended to reach a crescendo in later 1981 and early 1982, and they have been fairly steadily declining since then. And the real watershed has been the adoption of TEFRA with its stricter penalties.

Senator GRASSLEY. Is there any customer reticence to invest in your tax shelter programs since the enactment of TEFRA?

Mr. KINCAID. No, not really. Again, it is really just a question of the type of investment that is made, and whether that investment focuses upon immediate writeoffs, conversion of ordinary income to capital gains, or tax sheltered cash flow, either fully or 100 percent sheltered. Among those various investment vehicles the clients have made changes. The primary change has been toward more income oriented with some shelter aspect to it.

Senator GRASSLEY. Earlier today, you made an assertion that investors generally obtain the tax benefits for which they bargain in investing in your tax shelters. Do you have any statistical evidence for this claim?

Mr. KINCAID. Well, as of today we have not had any case go all the way through to a final conclusion which has resulted in our investors being denied any significant tax benefit of any of the investments that we have structured. We have a couple that are being processed right now, but we feel confident that we are going to prevent it.

Senator GRASSLEY. How do you monitor these developments?

Mr. KINCAID. We usually get involved in either actually hiring the attorneys that will handle the audit, or monitor very closely by discussing it with out limited partners on a frequent basis.

Senator GRASSLEY. Why shouldn't the promoter of a tax shelter be liable for a substantial penalty if the benefits are disallowed?

Mr. KINCAID. It depends on how the deal is structured. It depends on whether the promoter has intentionally built into the deal a structure that does not work from a tax standpoint. In those sort of situations I can see a basis for a substantial penalty to the promoter. If the promoter has merely been aggressive in interpretation of IRS regulations, which may be ambiguous, then I think the penalties may be unnecessary.

Senator GRASSLEY. Would you characterize the use of a foreign corporation as a means to defer tax an abusive tax shelter?

Mr. KINCAID. I do not have enough knowledge about that area to comment.

Senator GRASSLEY. I have some follow up questions to that, I will submit to you in writing.

Mr. KINCAID. Fine.

[The answers to questions from Senator Grassley follow:]

EFHutton

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Timothy J. Kincaid
First Vice President

August 2, 1983

Senator Charles E. Grassley
United States Senate
135 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Grassley:

I was pleased to have the opportunity to testify on behalf of E.F. Hutton at your oversight hearing on June 24, 1983, regarding abusive tax shelters.

By letter dated June 29th, you requested my responses to several questions. My responses are set forth below.

Question 1: Have the TERFA provisions had any effect in reducing the proliferation of illegal tax shelters? Is there any customer reticence to invest in your shelter program after the enactment of the TERFA provisions?

I believe that the penalties relating to abusive tax shelters imposed by TEFRA have been a factor in reducing the proliferation of illegal tax shelters. Several additional factors were also reviewed by me at the oversight hearing.

A significant impact of TEFRA has been to cause investors to pay more attention to the validity of the projected tax results of proposed investments. This has aided E.F. Hutton and other responsible providers of direct participation programs because investors are more and more, looking for investments which are sold on the basis of conservative tax positions.

Question 2: Would you characterize the use of a foreign corporation as a means to defer tax an abusive tax shelter? What if a foreign corporation through an offshore subsidiary engages in commodity trading so that the earnings became non-taxable foreign source income which were changed from 60/40 treatment to capital gains assets once the stock of the foreign corporation is sold. Would such a transaction be abusive in your view?

The short answers to your questions in this section are no, the transactions are not abusive.

The Internal Revenue Code contains extensive rules on the U.S. taxation of foreign corporations and even more complex rules on the taxing of United States shareholders of foreign corporations. Nevertheless, foreign corporations are recognized as such by our tax laws and in many cases the presence of a foreign corporation, particularly where the corporation is widely held, still gives rise to deferral of U.S. tax on U.S. shareholders of such corporations until some repatriation of the stock, or other realizable event, occurs. Accordingly, I would not call this a "tax shelter" in the usual sense of the word and it certainly would not be an abusive tax shelter. (Of course, I assume here that all disclosures required under United States laws are made by all concerned without concealment, deception or other sub-standard conduct).

The foregoing would certainly apply, for example, to the Hutton Commodity Reserve Fund Limited created last year for the ultimate purpose of establishing an international commodity "mutual fund". Because of sales resistance which Hutton experienced a few years ago in connection with an all-foreign investor fund — the typical European, Middle Eastern and Asian potential investor wanted to know why there were no U.S. investors joining him in the investment — I am told E.F. Hutton's commodity department decided to create a fund for the smaller investor which would start in the U.S. and then expand its sales efforts into Canada, Europe, the Middle East and elsewhere. This is, in fact, what was done and is now being done. The average investment in the Fund is $8,000 and there are a great number of investments by IRA accounts which invest as little as $2,000 each.

Under these circumstances it is entirely customary and appropriate, and certainly not improper or abusive, for such a fund to be formed in a neutral offshore jurisdiction, particularly where the commodity trading itself is also to be done partly in the U.S. and partly abroad, as in Hutton Commodity Reserve Fund.

I note that the mark-to-market 60/40 system for taxing commodities that you advert to can be quite advantageous in realizing actual losses currently, partly as short term losses and partly as long term losses. A U.S. investor in the Fund forgoes this advantage and has no loss deduction at all while holding shares and then ultimately, if there is a loss, has only long term losses. (In fact this has been the current situation; the Fund is in a loss position to date, but, to the advantage of the U.S. Treasury, the shareholders have not been able to take any tax deductions whereas if the Fund were onshore and set up in limited partnership form -- as is usual -- the investors would have had loss pass throughs in the 1982 taxable year and would also have such loss pass throughs so far this year). If, as and when the Fund moves into a gain position, U.S. shareholders together with the foreign shareholders, under the Code as now in effect, would not have any gain until they sell or redeem their shares and then only at long term capital gains rates (if the shares were held for 12 months or more). Under the circumstances, we at E.F. Hutton consider such an arrangement to be a perfectly fair trade off as well as being the correct result under the current tax laws. In any event, if experts on tax policy differ with this view, it certainly does not make the Fund an "abusive tax shelter" or abusive in other respects. If the Code is ultimately amended to alter the taxation of foreign corportions with widely held U.S. and foreign shareholders, or if the Code is amended to reverse the current provisions which expressly encourage foreign corporations to engage in commodities trading on U.S. markets, the Fund will, of course, abide by these new laws. However, we do not believe that any such new laws are necessary or wise, and if they should be enacted, they must certainly contain appropriate delayed effective dates which will guarantee fairness to the investors who in good faith (which no one questions) invested in the Fund in 1982 and 1983 on the basis of the tax laws then in effect. Otherwise, in our opinion, it would be the Government that was being abusive.

Question 3: I believe you stated in your comments that E.F. Hutton does not counsel clients to become investors in foreign corporations as part of its shelter program. Has this put you at a competitive disadvantage?

Hutton does not use foreign corporations as part of its tax shelter program and accordingly I cannot comment on the competitive aspects.

Sincerely,

Timothy J. Kincaid

TJK:lj

Senator GRASSLEY. Does E. F. Hutton counsel their clients to become investors in foreign corporations as part of its sheltering program?

Mr. KINCAID. That is not a part of our tax shelter program. We deal primarily with domestic partnership and domestic investments.

Senator GRASSLEY. Do you have anything you want to add Mr. Hughes?

Mr. HUGHES. Not at all, Mr. Chairman, unless you have further questions.

Senator GRASSLEY. I want to thank both of you for being with us today. The slate of witnesses before us today has been very helpful. With their followup responses to our written questions, I think we will have a very complete record of the scope of and solutions to the problem of abusive tax shelters. As you could tell from Senator's Dole's interest in this matter, I am certain you will see followup activity by the Congress.

Thank you all. The meeting is adjourned.

[Whereupon, at 12:30 p.m., the hearing was concluded.]

[By direction of the chairman the following communication was made a part of the hearing record:]

NATIONAL ASSOCIATION OF INDEPEDENT COLLEGES AND UNIVERSITIES,
Washington, D.C., July 13, 1983.

Mr. RODERICK A. DEARMENT,
Chief Counsel, Committee on Finance,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. DEARMENT: The National Association of Independent Colleges and Universities (NAICU) and the American Council on Education (ACE) together represent more than 1,500 public and independent colleges and universities across the country. Both memberships include institutions of higher education whose variety in size, control, and mission exemplify the rich diversity of both the public and independent non-profit sector. We ask that this letter, presented on behalf of NAICU and ACE, be made a part of the record for the June 24 Subcommittee on Oversight hearing on the subject of abusive tax shelters.

In testimony before the Subcommittee, the Treasury Department indicated concern over the substantial number of transactions involving overvaluation of donated property, and corresponding deductions for such donations. Although the Treasury Department has not yet acted to put their proposals into legislative form, at first blush, their recommendations seem overreaching. We, the higher education community, in no way approve of the abuses which have received public recognition over the last several months. We are concerned, however, that the solution will go beyond the scope of these few abuses and will have an unintended impact on the entire charitable community.

We would be happy to work with the Committee to arrive at a reasonable solution to the problem and ask that we be given an opportunity to respond once the proposals are in legislative form. Thank you for your time and consideration of this matter.

Sincerely,

KATHLEEN CURRY, *Legislative Representative.*

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