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I. Introduction ..................................................... 500
   A. Tax Preferences and Tax Shelter Mechanics ............. 502
      1. Tax Preferences ........................................ 502
      2. Tax Shelter Mechanics ............................... 508
   B. Policy Implications of Tax Shelters ................... 510

II. When Good Preferences Go Bad ........................... 513
   A. Common Antishelter Arguments ......................... 513
      1. The Problem of Nonprofitable Investments .......... 513
         (a) The lower return on preferred assets .......... 513
         (b) Inflation and investments with negative returns. 515
      2. The Netting Theory ..................................... 518
      3. Keeping Nonincentive Preferences Within Bounds ... 520
      4. The Problem of Abusive Shelters .................... 524
      5. Shelters, Appearances, Taxpayer Morale, and
         Compliance ............................................. 527
      6. Summary .................................................. 529
   B. An Economic Analysis of Tax Shelters and the
      Justification for Antishelter Legislation ............... 530
      1. If the Implicit Tax Equals the Top Marginal Rate ... 530
      2. If the Implicit Tax Approaches the Top Marginal
         Rate .................................................... 532
         (a) The Hickman analysis ............................ 533
         (b) The revenue cost .................................. 533
      3. If the Implicit Tax Is Significantly Lower than the
         Top Marginal Rate ..................................... 537
         (a) A critique of the Hickman analysis ............ 537
         (b) Policy considerations if significant windfalls
             remain ................................................. 539

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499
4. If There Is Little or No Implicit Tax on Preferred Income .......................................................... 547
   (a) Financial arbitrage ........................................ 548
   (b) Pure tax arbitrage ....................................... 551
5. Summary ......................................................... 554

III. An Examination of the 1986 Act's Antishelter Provisions .... 554
   A. The Details of the Antishelter Provisions .............. 555
      1. Passive Loss Limitations .............................. 555
      2. The Investment Interest Deduction Limitation ...... 562
   B. A Critique of the Antishelter Provisions ............... 566
      1. Baskets .................................................. 566
         (a) The origins of basketing ............................ 566
         (b) How many baskets? ................................ 568
      2. Tracing ................................................... 570
      3. The Material Participation Standard of Section 469 . 576
         (a) Unconvincing justifications from the legislative history ................................. 576
         (b) Realization, nontax economic profit motives, and real economic losses .............. 578
             (i) Realization .......................................... 579
             (ii) Nontax economic profit motives .............. 580
             (iii) The material participation standard as a response to the problem of real economic losses .......................................................... 581
   C. Material Participation in Activities Producing Taxable Income ........................................ 587

IV. Conclusion ..................................................... 588

I. Introduction

One of the most sweeping reforms of the Tax Reform Act of 1986 was its attack on tax shelters, embodied in its limitations on the deductibility of passive losses and investment interest. Under the Act, taxpayers can generally deduct losses from passive business activities only against income from other passive activities, and they can deduct invest-
Anti-Tax Shelter Provisions

ment interest expenses only against net investment income. 2

A tax shelter is an investment that produces losses used to shelter unrelated income—usually, income from personal services—from taxation. 4 Tax shelter losses are artificial: they do not represent real economic losses. Shelter losses result from the combination of tax preferences—provisions of the tax laws that allow taxable income to understate economic income from an investment—and interest expense deductions. The Act’s antishelter provisions aim to eliminate shelters without eliminating the preferences on which they are based. The Act does not prevent the use of a preference to understate the income from the investment to which the preference relates. It does, however, prohibit the use of a preference in combination with an interest deduction to shelter unrelated income from taxation.

The appropriateness of this seemingly inconsistent treatment of preferences has been the major policy question raised by the Act’s antishelter provisions. Is it reasonable to permit the use of preferences to understate related income while prohibiting their use to shelter unrelated income from taxation? Now that more than two years have passed since the Act’s promulgation, the question merits reexamination: Why does a good preference go bad when it becomes part of a tax shelter?

Part II of this Article considers this question. It first examines the proffered justifications for the antishelter provisions. Commentators have advanced several arguments in support of the Act’s treatment of preferences. (1) Tax shelters harm the economy by encouraging taxpayers to make investments that would be unprofitable but for the tax savings they generate. (2) The deduction of interest is appropriate only when the interest is a cost of generating fully taxable income. The tax laws should not allow interest expenses generated by shelters to offset unrelated income, because shelters combine interest expensing with tax-exempt income. (3) Some Internal Revenue Code provisions permit taxa-

that the provision would raise income tax revenues from individual taxpayers by $36 billion (but decrease corporate tax revenues by $12.6 billion) over the five-year period from 1987 to 1991. STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1363 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION]. For a journalistic account of the importance of § 469 to the enactment of the 1986 Act, see J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH 218-33 (1987).


4. For example, 31 C.F.R. § 10.33(c)(2) (1988) defines a tax shelter as:

[A]n investment which has as a significant and intended feature for Federal income... tax purposes either of the following attributes: (i) Deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (ii) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year.
ble income from certain assets to understate economic income for reasons of administrative convenience or necessity. Shelter limitations prevent taxpayers from exploiting these provisions to avoid tax on salaries and other easily measurable forms of taxable income. (4) All shelters must be eliminated in order to halt the proliferation of abusive shelters. (5) Shelters lead many taxpayers to believe that the tax system is fundamentally unfair. Subpart II(A) concludes that none of these arguments adequately supports the Act's sweeping antishelter provisions. Although some of the arguments identify real problems caused by certain shelters, Congress can better address these defects through more narrowly focused legislation.

Subpart II(B) offers a detailed economic analysis of the use of preferences in shelters, in terms of implicit taxes, revenue cost, resource allocation, windfalls to investors, and questions of fairness. Nothing in the economic analysis provides persuasive justification for the antishelter provisions of the Act; the analysis again suggests that other legislative changes might deal appropriately with particular problems.

Part III examines the details of the Act's antishelter provisions. This Part assumes, for the sake of argument, the propriety of the goal of eliminating shelters while leaving preferences intact and considers whether the Act's provisions accomplish that goal. It points to several serious technical problems with the design of the provisions. Moreover, it illustrates how some of these problems indicate not peculiar ineptitude in the Act's drafting but practical difficulties inherent in any attempt to attack shelters without also assaulting preferences.

The Article concludes that the Act's attempt to eliminate shelters without eliminating preferences makes little sense. A case can be made for attacking preferences themselves, which would eliminate shelters as a side effect. A case can also be made for the acceptance of preferences, both in shelters and out of shelters. It is difficult, however, to make a case for attacking shelters while leaving preferences intact—the approach of the 1986 Act.

A. Tax Preferences and Tax Shelter Mechanics

To understand the Act's attack on shelters, one must first understand the nature of tax preferences and the operation of tax shelters.

1. Tax Preferences.—Congress often uses the tax laws to influence economic behavior. By enacting a tax preference for a particular activ-
Anti-Tax Shelter Provisions

ity, Congress can encourage greater investment in it. The preference understates the amount of income from the activity for tax purposes. Congress can achieve this understatement with one or a combination of two methods: permitting taxpayers to exclude some portion of economic income from taxable income6 and allowing them to deduct expenses in excess of actual expenses in determining taxable income.7

A tax preference thus reduces the tax on income from a tax-preferred activity. If the pre-tax income from the activity remains constant while the tax on that income decreases, the activity's after-tax rate of return increases. This increased return attracts investors to the activity. The increased demand in turn drives up the price of investments in the activity, and a higher price lowers the pre-tax rate of return.8 If the market operates with perfect efficiency, the benefit of the preference eventually disappears; the market reduces the pre-tax return to a point at which the after-tax return from the preferred activity is no longer any higher than the after-tax return from other, nonpreferred activities.9 The final result of a tax preference, then, will be what Congress ordinarily

6. See id. at 25 (discussing the exemption from taxation of interest income from state and local government bonds).
8. See Warren, Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 Tax Law. 549, 564 (1985). These results—increased allocation of resources to the preferred activity and an increased price for investments in the preferred activity—are illustrated in the graph below. Line D1D1 represents the demand schedule for the asset prior to the enactment of the preference. The intersection of D1D1 with supply schedule SS results in an equilibrium price of P1 and investment in the asset at quantity level Q1. The preference increases demand for the asset, thus shifting the demand schedule to the right (line D2D2). The shift results both in a higher equilibrium price (P2) for the asset and in investment in the asset at a greater quantity level (Q2).

desires—an increased allocation of resources to the preferred activity, with no windfall to those who invest in it. If the market does not operate with perfect efficiency, however, the after-tax return from the preferred activity may remain higher than the after-tax return on nonpreferred investments. In that case, even though investment in the preferred activity rises, investors in the activity still receive the windfall of a higher after-tax return.

Not all tax preferences are “incentive preferences”: those that result from a congressional decision to use the tax system to encourage particular activities. Some “nonincentive preferences” stem instead from considerations of administrative convenience or necessity. A classic example of a nonincentive preference is the deferral of tax on unrealized appreciation, a measure most likely based not on a desire to encourage investment in appreciating assets but on the impracticality of taxing unrealized gain. The economic effects of a nonincentive preference resemble those of an incentive preference—increased investment in the preferred asset (such as property expected to yield unrealized appreciation) and some decrease in the pre-tax rate of return on the preferred asset. Despite this similarity of economic effects, the policy considerations underlying incentive and nonincentive preferences are very different. If one accepts the conventional wisdom concerning the administrative necessity of

10. Consider, for example, the following explanation of the purpose underlying the enactment of the Accelerated Cost Recovery System (ACRS) in 1981:
   The Congress concluded that prior law rules for determining depreciation allowances and the investment tax credit needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion. . . . The Congress agreed with numerous witnesses who testified that a substantial restructuring of depreciation deductions and the investment tax credit would be an effective way of stimulating capital formation, increasing productivity, and improving the nation’s competitiveness in international trade. Staff of Joint Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 75 (Comm. Print 1981).

11. Warren, supra note 6, at 564-65. Even if the market does operate perfectly, investors will still garner windfall during the period in which the market is adjusting to the existence of the preference. Id.

12. See Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111, 1183-84 (1986) (stating that the problems of valuation and liquidity undermine support for the taxation of unrealized appreciation, but arguing that those problems can be solved). Nonincentive preferences would also occur in a tax depreciation system that was not designed to allow greater than economic depreciation. For administrative purposes, such a tax system would have to base its depreciation regime on broad industry averages. The system would permit faster than economic depreciation for those assets that actually depreciated more slowly than the industry averages on which the tax depreciation schedules were based. The faster than economic depreciation for those assets would be a nonincentive preference. See Senate Comm. on Finance, Report on Tax Reform Act of 1986, S. Rep. No. 313, 99th Cong., 2d Sess. 714-15 (1986) (hereinafter S. Rep. No. 313).

13. Just as under incentive preferences, moreover, the decrease in the pre-tax rate of return on assets subject to a nonincentive preference may or may not be sufficient to eliminate all windfall to those who invest in them.
Anti-Tax Shelter Provisions

nonincentive preferences,\textsuperscript{14} no policy choice need be made on the propriety of nonincentive preferences; they are inevitable. By contrast, it is very much within the power of Congress to decide whether to enact any given incentive preference. This Article, therefore, now turns to two tax policy considerations raised by incentive preferences: the theoretical justification for government interference in the economy's allocation of resources and the desirability of using the tax system to accomplish such interference.\textsuperscript{15}

Many commentators object to incentive tax preferences as causing misallocation of resources by turning too much capital toward tax-preferred investments and away from nonpreferred investments.\textsuperscript{16} Such criticisms may assume, however, that the market would achieve an ideal allocation of resources but for the interference of tax preferences. Edward Zelinsky has explained that this assumption is not necessarily correct.\textsuperscript{17} Various market inefficiencies may cause investors to devote less than the optimum amount of resources to a particular activity.\textsuperscript{18} Consider a two-sector economy that produces only gadgets and widgets.\textsuperscript{19} If barriers to entry prevent the free flow of capital into the gadget industry, this economy may produce too many gadgets and not enough gadgets. A tax preference for gadget manufacturing could help to offset any such barriers to entry and move the economy closer to the optimal allocation of resources between widget and gadget production. Market inefficiencies might also occur because of positive externalities.\textsuperscript{20} Suppose that

\textsuperscript{14} For a challenge to the conventional wisdom concerning the inevitability of the nontaxation of unrealized appreciation, see Shakow, supra note 12, at 1122-23.

\textsuperscript{15} Edward Zelinsky has recently considered both of these questions in a thoughtful and thorough defense of tax preferences. Zelinsky, supra note 7, at 1019-35.

\textsuperscript{16} See, e.g., 1 OFFICE OF THE SECRETARY, DEPT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 42 (1984) [hereinafter TAX REFORM FOR FAIRNESS] (arguing that tax preferences violate the principle of economic neutrality and that market forces rather than taxation should drive the allocation of resources); Auerbach, The New Economics of Accelerated Depreciation, 23 B.C.L. REV. 1327, 1342-50 (1982) (arguing that ACRS produces distortionary investment incentives because the incentives are unevenly distributed across different assets that are sensitive to inflation rate fluctuations); Bittker, supra note 9, at 14 (reviewing "efficiency" theorists' arguments that tax incentives cause overproduction of tax-favored products and underproduction of fully taxed products); Yorio, The President's Tax Proposals: A Major Step in the Right Direction, 53 FORDHAM L. REV. 1255, 1262, 1287 (1986) (arguing that the reallocate effect of tax preferences produces economic distortions).

\textsuperscript{17} See Zelinsky, supra note 7, at 996-1002, 1023.

\textsuperscript{18} See id. at 996-1009.

\textsuperscript{19} The example is based on Zelinsky's work. See id. at 1002-05. As the example suggests, Zelinsky defends preferences as improving sectoral efficiency. "Sectoral efficiency compares discrete parts of the economy to determine if profitability could be increased . . . as between them." Id. at 986. He does not defend preferences in terms of "the optimal allocation of the society's total resources." Id. at 980-81, because it is impossible to determine whether any particular preference moves the economy toward or away from perfect universal market efficiency, id. at 996-1002.

\textsuperscript{20} An externality is a side effect of production or consumption that affects persons or businesses other than the producer or consumer. A vaccination is an example of a positive externality;
widget production creates positive externalities that gidget production does not and that widget manufacturers cannot collect any payment from the large and dispersed group benefited by the externalities. The inability of the widget industry to derive a return from its positive externalities would result in an underallocation of resources to widget production and a corresponding overallocation to gidget manufacturing. A tax preference for widgets could correct this misallocation.\textsuperscript{21}

Even if one accepts the argument that government intervention is justified to correct a particular market failure, a tax preference is not necessarily the best form of intervention. A tax preference might be a less effective means of subsidizing the activity in question than a direct subsidy, such as cash payments to those who engage in the activity. The late Stanley Surrey pioneered the notion that we should think of a tax preference as a tax expenditure (the expenditure being the amount of tax revenue lost because of the preference), and that we should analyze a preference in light of alternatives such as direct cash payments.\textsuperscript{22}

Although some commentators, including Surrey, maintain that tax expenditures are less desirable than direct expenditures, because they receive less legislative and public scrutiny,\textsuperscript{23} technical efficiency remains

pollution is an example of a negative externality. See P. WANNACOTT & R. WANNACOTT, AN INTRODUCTION TO MICROECONOMICS 83 (2d ed. 1982).

\textsuperscript{21} Zelinsky, supra note 7, at 1005-08. Zelinsky suggests that home ownership is an example of an investment that may produce various positive externalities. \textit{Id.} at 1007. Edward Yorio has suggested that domestic steel production may result in positive externalities through its contribution to national security. Yorio, \textit{Equity, Efficiency, and the Tax Reform Act of 1986}, 55 FORDHAM L. REV. 395, 414 (1987).

\textsuperscript{22} See generally S. Surrey, \textsc{Pathways to Tax Reform: The Concept of Tax Expenditures} 6-7 (1973) (noting that the tax expenditure concept embraces two phenomena: the imputed tax payment that would have been made in the absence of the special provision and the simultaneous expenditure of that payment as a direct grant).

\textsuperscript{23} One of Surrey's major arguments against tax expenditures was that because they are hidden in the Internal Revenue Code, they receive less legislative and public scrutiny than direct cash outlays. See id. at 141-46; S. Surrey & P. McDaniel, supra note 5, at 104-05; Surrey, \textit{Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures}, 83 HARV. L. REV. 705, 728-31 (1970). Ironically, Surrey's very success in institutionalizing what he called the "tax expenditure budget," \textit{id.} at 729-31, has blunted the force of his argument. The production of tax expenditure budgets, estimating the revenue loss from different tax preference items, is now a regular part of the legislative taxation process. The President must include a statement of the "level of tax expenditures under existing law in the tax expenditure budget" in the overall federal budget that he submits to Congress. 31 U.S.C. § 1105(a)(16) (1982); see also S. Surrey & P. McDaniel, supra note 5, at 1-68 (discussing the tax expenditure concept and its relation to budget policy). As a result, the level of legislative and public scrutiny of tax expenditures may now closely approximate that of direct expenditures. Zelinsky claims that, in this respect, "the opponents of tax expenditures may be victims of their own success." Zelinsky, supra note 7, at 1030. \textit{But see} Yorio, supra note 21, at 424 ("Despite the recent debates over tax reform and the heightened public awareness about tax preferences, it probably remains politically easier for Congress to provide an indirect subsidy through the tax system than to provide an equivalent direct subsidy.").
Anti-Tax Shelter Provisions

the basic question in choosing between the two. To determine technical efficiency, one should view tax incentives "from the perspective of the government as purchaser of economic behavior: what is the cheapest way the government can induce additional production of a particular good or encourage increased consumption of a specific service?" A preference is inefficient if it provides tax subsidies for activities or investments that taxpayers would have undertaken anyway. It does not necessarily follow, however, that a direct expenditure is therefore preferable; a direct expenditure may also subsidize an activity that investors would have undertaken without the subsidy.

Edward Zelinsky claims that because tax expenditures produce lower transaction costs, such mechanisms will often be more technically efficient than direct expenditures. A full measure of technical efficiency includes the costs of informing persons of the government's subsidy programs and of securing compliance with the terms of those programs. According to Zelinsky, embodying a subsidy in the Code will often be the least expensive way of communicating information about a program to the public. Zelinsky thus justifies both government interference in the economy's process of allocating resources and the use of tax preferences as sometimes the most technically efficient means of accomplishing that interference.

24. Zelinsky first used the term "technical efficiency" in this context. See Zelinsky, supra note 7, at 992 n.40.

25. Id. at 992.

26. See S. Surrey & P. McDaniel, supra note 5, at 82-83; Zelinsky, supra note 7, at 992-95.

27. See S. Surrey & P. McDaniel, supra note 5, at 102; Zelinsky, supra note 7, at 1032. But see Yorio, supra note 21, at 423 (arguing that it is usually easier to design a carefully targeted direct expenditure than a carefully targeted tax expenditure).

28. Communication through the tax system is frequently the government's cheapest method of conveying its policies, particularly in the case of small businesses and middle-income taxpayers. The taxpayer will incur the costs of complying with and receiving information about the tax system anyway. Middle-class and business taxpayers typically file annual returns. These taxpayers often require professional accounting and legal services to organize their financial data and prepare returns. Given this fixed annual expense of complying with the tax system, the marginal costs of communicating policies through the accounting and legal professions and the tax preparation process frequently would seem to be lower than the alternative.

Zelinsky, supra note 7, at 1011 (footnotes omitted). But see Yorio, supra note 21, at 426-28 (questioning Zelinsky's conclusion).

29. This analysis does not, of course, suggest that every tax preference in the Code moves the economy in the direction of a more efficient allocation of resources. It also does not suggest that a tax expenditure will always be more technically efficient than a direct expenditure. Given the great practical difficulties of determining whether a particular preference improves or worsens the allocation of resources, arguments over the propriety of a particular preference may well come down to whether the preference's proponents or opponents bear the burden of proof. On the question of the placement of the burden of proof, compare Zelinsky, supra note 7, at 1023-26 (arguing that the burden of proof should be on the opponents of preferences) with Yorio, supra note 21, at 419-21.
Part II assumes that a particular preference is a "good" preference—that it corrects a misallocation of resources and is at least as technically efficient as a direct subsidy. This Article considers whether there is any reason to restrict or prohibit the use of such a preference in connection with tax shelters. In other words, can a good preference go bad when it becomes part of a shelter?

2. Tax Shelter Mechanics.—A numerical example may be helpful in understanding how a tax preference can form the basis of a tax shelter. Suppose a taxpayer, A, buys a building for $100. During the first year, A's rental income from the building, net of all expenses except depreciation, is $10. During the same year, economic depreciation—the actual decline in the value of the building—is $2. A's net economic income from the building is: $10 - $2 = $8. Now suppose the tax system accurately measures A's economic income in all respects but one. To encourage investment in buildings, it provides for a tax preference—an accelerated depreciation deduction of $5, instead of the $2 of economic depreciation. With the preference, A's taxable income from the building is: $10 - $5 = $5. Taxable income thus understates economic income by $3, the amount by which the allowable depreciation deduction exceeds the economic depreciation. The $3 artificial portion of the depreciation deduction is a tax preference; it excludes $3 of economic income from taxable income.\(^\text{30}\) A's investment is not a tax shelter, however, in the commonly accepted sense of that term. A tax shelter is an investment that generates artificial tax losses that taxpayers can use to offset (shelter) income from other sources.\(^\text{31}\) The effect of A's depreciation

\(^{30}\) Accelerated depreciation is a deferral preference rather than an exclusion preference. If the depreciation deduction exceeds economic depreciation by $3 in the first year, at some later time the depreciation deduction will be $3 less than economic depreciation. Thus, a $3 overstatement at some later time will eventually match the $3 understatement of economic income. Tax on the $3 of economic income is deferred rather than forgiven. This deferral contrasts with an exclusion preference, such as in I.R.C. § 103 (1982), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1013(a)(37), (a)(12)(A), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3544, 3547 (excluding interest income from municipal bonds), under which the income subject to the preference will never be taxed. Because of the time value of money, however, even a "mere" deferral preference is a great benefit to a taxpayer. One can characterize deferral as an interest-free loan from the government for the amount of the deferred tax liability over the period of the deferral. On the value of deferral generally, see W. KLEIN, B. BITTKE & L. STONE, FEDERAL INCOME TAXATION 63-67 (7th ed. 1987) (noting that the advantage of deferral is simply that a tax liability deferred from the present to the future gives the taxpayer the use of the amount during the interim period); Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113, 1123-28 (1979) (noting that "[d]eferral reduces the burden of a tax because of the time value of money").

\(^{31}\) See supra note 4 and accompanying text.
Anti-Tax Shelter Provisions

preference is only to reduce the taxable income from the investment, not to shelter unrelated income.

A taxpayer can use the same $3 depreciation preference to create a tax shelter. Suppose A buys the same building as in the previous example, but with borrowed money. If the interest rate on the $100 loan is 8%, A must pay $8 in interest during the first year. A therefore has no net economic income from the investment: $10 − $2 − $8 = $0. If the interest is fully deductible, A has a $3 loss from the investment for taxable income purposes: $10 − $5 − $8 = −$3. If A can use this $3 deductible loss to offset $3 of taxable income from any other source, including income from personal services, A’s investment in the building is a tax shelter. The investment becomes profitable only because of the tax savings that it generates.

The amount by which taxable income understates economic income is the same ($3) in both examples. In the first example, economic income was $8 and taxable income was $5. In the second example, economic income was zero and taxable income was −$3. In each case, the $3 overstatement of depreciation created the $3 disparity between economic and taxable income. The difference between the two examples is thus not in the amount of the preference but in the nature of the income that goes untaxed because of the preference. In the first example, the untaxed income was $3 of economic income from the investment. In the second example, the $3 artificial tax loss resulted in the offsetting (sheltering) of $3 of unrelated income.

As the second example suggests, the interest deduction plays a crucial role in the operation of a tax shelter. Interest paid to finance an investment is a cost of earning the income from the investment. As long as the income from the investment is fully taxed, taxable income will accurately reflect economic income only if the interest paid to carry the investment is fully deductible. Suppose, in the second example, that the allowable depreciation deduction was only $2—the amount of economic depreciation on A’s building. With an $8 interest deduction, A’s taxable income would be: $10 − $2 − $8 = $0. Allowance of the interest deduction thus results in a level of taxable income that properly reflects economic income; in A’s case, both economic and taxable income are zero.

As the second example demonstrates, taxable income will be less than economic income if interest is fully deductible and the related in-

32. If, as is not unlikely, the lender requires A to make a $2 repayment of principal (to prevent the amount of the loan from exceeding the value of the property), A’s cash flow will also be zero.
come is not fully taxed because of a preference. It is the preference, however, and not the interest deduction that creates the misstatement of income. The interest deduction does not increase the amount of the preference in cases of debt-financed investment; it merely preserves for such investments the same preference that is available for equity-financed investments. If the amount of the preference exceeds the economic income from the investment, that preservation necessarily takes the form of a shifting of the preference onto unrelated income—that is, the form of a tax shelter. This tax shelter combination of tax-preferred income and deductible interest expense is sometimes referred to as tax arbitrage. Neither the tax preference nor the interest deduction acting alone is ordinarily sufficient to create a shelter. A preference without an interest deduction (that is, a preference related to an equity-financed investment) will understate the income from the investment, but will not normally allow taxpayers to shelter unrelated income. An interest deduction without a preference will not cause any understatement of economic income.

B. Policy Implications of Tax Shelters

What are the policy implications of the tax shelter phenomenon? One may, of course, think that some or all tax preferences represent bad tax policy, and that Congress should eliminate those preferences. Elimination of a preference would eliminate all shelters based on that preference. Alternatively, one might believe that preferences represent good tax policy, whether taxpayers use them to shelter related or unrelated income. In that case, there would be no reason to amend the Code at all.

33. Many commentators have noted this point. See, e.g., Hickman, Interest, Depreciation, and Indexing, 5 VA. TAX REV. 773, 779 (1986) (concluding that tax arbitrage is "a function of exempting the interest on the bond, not of allowing the interest deduction"); Klein, Borrowing to Finance Tax-Favored Investments, 1962 Wis. L. REV. 608, 614 (arguing that debt-financed investments and equity-financed investments should yield the same results); Mundstock, Accelerated Depreciation and the Interest Deduction: Can Two Rights Really Make a Wrong?, 29 TAX NOTES 1253, 1253-54 (1983) (arguing that the preference should be constant, in absolute terms, regardless of the form of financing).

34. See, e.g., Steuerle, Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts, 30 WAYNE L. REV. 991, 1002 (1984) (defining tax arbitrage as "[t]he process of borrowing to finance tax-preferred assets"); Warren, supra note 8, at 549 (noting that this type of sheltering is called "tax arbitrage" because it can involve transactions that have no nontax effects on an investor's financial position).

35. A tax shelter without an interest deduction would be possible if the deductions were sufficiently exaggerated. For example, suppose that taxpayer A's depreciation deduction was $15 instead of $5 and that all other numbers remained the same. In that case, A would have a $5 tax loss ($10 - $15 = -$5) that he could use to shelter unrelated income. In effect, the $13 by which tax depreciation exceeded economic depreciation sheltered $8 of economic income from the building and $5 of unrelated income. This situation is rare, and preference deductions alone will ordinarily be insufficient to create artificial losses.
Anti-Tax Shelter Provisions

But Congress chose neither of these alternatives in the Tax Reform Act of 1986. Its approach to tax shelters—now embodied in sections 163(d) and 469 of the Code—was to retain many preferences but to prevent the use of preferences to offset income from services and other unrelated income. Under section 469, A can use losses from passive activities, such as his investment in the building, only to offset income from other passive activities. In the case in which A borrowed $100 to invest in the building and had a $3 artificial tax loss from the investment, section 469 would prevent A from deducting that loss (unless he had passive income from another investment). Thus, A would lose the benefit of the $3 depreciation preference. By contrast, section 469 would not apply to the case in which A invested $100 of his own money in the building, because A would not experience a tax loss from the investment. In that situation, A would still enjoy the benefit of the $3 depreciation preference, because his taxable income from the building ($5) would understate his economic income ($8) by $3.

While section 469 applies to passive business activities, section 163(d) applies to nonbusiness investments. Its details are quite different


38. For a detailed explanation of § 469, see supra section III(A)(1).
from those of section 469, but its basic structure is the same: it permits the use of preferences to understate income from investments but prohibits the combination of a preference and an interest deduction to shelter unrelated income.39

Does the Act’s approach make sense? Can one reasonably support preferences but oppose shelters?40 At first glance, these positions seem inconsistent. After all, a shelter merely preserves for debt-financed investments the preference that is available for equity-financed investments. Eliminating shelters while retaining the underlying preferences thus leaves preferences available for equity-financed investments but not for debt-financed investments.41 Is this a sensible result? Accelerated Cost Recovery System (ACRS)42 depreciation deductions illustrate the problem. The accelerated depreciation preference is designed to encourage investment in the assets to which it applies. Given that purpose, Congress seemingly should make the preference available for both equity-financed and debt-financed investments. If a $3 depreciation tax preference (in the form of an offset of income from the investment) is appropriate to encourage $A to buy a building with $100 of his own money, a $3 depreciation tax preference (in the form of an offset of unrelated income) would seem equally appropriate to encourage $A to buy a building with $100 of borrowed money. It is true that in the first case it is $A’s $100 that is being invested in the tax-favored asset, while in the second case it is really the lender’s $100 that is being invested. It is not readily apparent, however, why that should make a difference. In each case, $100 has been invested in an ACRS asset, and a system designed to encourage such investment should be as ready to grant a tax preference in one case as in the other.43

39. For a detailed description of the operation of § 163(d), see infra section III(A)(2).
40. For an argument that a serious attempt to eliminate (or at least greatly reduce) tax preferences would have been preferable to § 469, see Peroni, A Policy Critique of the Section 469 Passive Loss Rules, 62 S. CAL. L. REV. 1, 6, 102-04 (1988).
41. This statement is only roughly true. On the one hand, a preference deduction for an equity-financed investment might be so great that it creates a tax shelter loss without an interest deduction. See supra note 35. On the other hand, income from a debt-financed investment might be so great that even with both the preference and the interest deduction, the result is an understatement of economic income from the activity rather than a tax shelter. Consider the hypothetical in which $A borrows $100 to buy the building. If $A had $15 rental income from the building (instead of $10), he would have economic income of $5 ($15 - $2 - $8 = $5) from the activity and taxable income of $2 ($15 - $5 - $8 = $2).
43. Of course, if a particular preference is intended to encourage savings, it might make good sense not to allow the use of the preference in connection with a debt-financed investment, because “[b]orrowing coupled with an investment does not increase aggregate savings.” Koppelman, Tax
Anti-Tax Shelter Provisions

Nonetheless, the approach of the Tax Reform Act of 1986 is to restrict shelters without eliminating preferences. Part II of this Article examines Congress’s decision that a good preference goes bad when a taxpayer uses it to shelter unrelated income.

II. When Good Preferences Go Bad

A. Common Antishelter Arguments

Congress (in the legislative history of the 1986 Act) and commentators have advanced a number of arguments supporting the policy of retaining tax preferences while preventing the use of those preferences in tax shelters. None adequately supports such a policy.

1. The Problem of Nonprofitable Investments.—A frequently advanced argument for curbing the deductibility of tax shelter losses is that the deductibility of such losses encourages taxpayers to make investments that would be losing propositions but for the tax savings they generate, and that such investments harm the economy. This argument takes two different forms. One aspect holds that because returns on preferred assets will generally be lower than the taxable interest rate, borrowing to invest in a preferred asset will ordinarily yield a net loss, tax savings aside. The other aspect provides that in periods of high inflation, tax shelter investors may actually find it profitable to invest in preferred assets that yield a negative return (a return that is lower than the rate of inflation). This section examines both forms of the argument.

(a) The lower return on preferred assets.—The Senate Finance Committee report on the 1986 Act makes the argument in its first form:

The availability of tax benefits to shelter positive sources of income . . . has harmed the economy generally, by providing a non-economic return on capital for certain investments. This has encouraged a flow of capital away from activities that may provide a higher pre-tax economic return, thus retarding the growth of the sectors of the economy with the greatest potential for expansion.44

To illustrate this argument, consider a simple example. A taxpayer borrows $100 at 8% and invests it in an asset yielding a tax-free 6%

Arbitrage and the Interest Deduction, 61 S. CAL. L. REV. 1143, 1195-96 (1988). But see infra text accompanying notes 183-86. Savings preferences are discussed at infra note 85 (arguing that in some cases a debt-financed savings preference investment may actually result in increased savings). The primary focus of this Article, however, is on preferences intended not to encourage savings but to encourage investment in preferred assets.

44. S. REP. NO. 313, supra note 12, at 716; see also Johnson, Is an Interest Deduction Inevitable?, 6 VA. TAX REV. 123, 130-36 (1986) (arguing that tax shelters encourage nonprofitable investments).
annual return (with Congress intending the nontaxability of the return to be an incentive preference). Tax consequences aside, this investment results in a $2 economic loss. But the investment generates an $8 tax loss (zero taxable income less $8 in interest expense), which will save a 50% bracket taxpayer $4 in taxes. The $4 tax savings turns a $2 pre-tax economic loss into a $2 after-tax economic gain, and it thus makes profitable what would otherwise be a losing investment. The artificial tax loss thus may have encouraged a taxpayer to invest in an asset yielding a $6 annual return, at an annual interest cost of $8. It is arguably bad policy for the tax laws to encourage such investments, and section 469, if it applies, would remove the encouragement by denying the investor the $8 loss deduction.45

A second example, however, calls into question the logic of the congressional approach. Suppose the same taxpayer has invested $100 cash in a certificate of deposit (CD) earning $8 of annual interest. If the interest is taxed at a 50% rate, the after-tax return is $4. Aside from tax consequences, it would not make sense for the taxpayer to withdraw his $100 from the CD and use it to buy the tax-favored asset for $100. The asset yields only a $6 annual return, and the certificate of deposit yields an $8 annual return. Just as it would not make sense (apart from tax consequences) to borrow from someone else at 8% to make an investment yielding a 6% return, it would not make sense (apart from tax consequences) to borrow, in effect, from oneself at 8% to make an investment yielding a 6% return.

But now consider the tax consequences. While the economic income from the preferred asset is $6, the tax preference sets the taxable income at zero. Thus, the taxpayer’s after-tax return from the asset is $6—the same amount as the pre-tax return. Even though the pre-tax income from the asset ($6) is $2 less than the pre-tax income from the CD ($8), the after-tax income from the asset ($6) is $2 more than the after-tax income from the CD ($4). Just as in the first example, the tax preference for the income from the asset in the second example causes a taxpayer to make an investment that he otherwise would not make. The tax system distorts the economy in the second example just as much as in the first; both illustrate tax-motivated investments in a relatively non-productive asset.46 If the distortion of the economy in the first example

45. If it applied, § 469 would deny not only the $6 artificial portion of the loss but also the $2 real economic loss. See infra text accompanying notes 317-20.

46. Other commentators have made this point. See, e.g., Klein, supra note 33, at 614 (noting that some transactions sacrifice before-tax income solely for tax advantages); Mundstock, supra note 33, at 1254-55 (arguing that accelerated depreciation induces before-tax noneconomic transactions).
Anti-Tax Shelter Provisions

calls for a legislative cure, the distortion in the second example—which is just as bad—should call for similar legislative action. Section 469 would not apply in the second example, however, because the preference shelters only income from the investment, not unrelated income.

The very purpose of an incentive preference is to encourage taxpayers to make investments that they would not make except for the preference. The existence of a preference signifies that by reducing the tax on income from a tax-favored asset, Congress has decided to encourage additional investment in that asset. Simply put, a preference that influences the investments of taxpayers is working exactly as it should. A preference is supposed to distort the economy, whether the taxpayer invests in the tax-preferred asset with his own money or with borrowed money. Thus, the Finance Committee’s complaint against tax shelters—that they cause capital to flow into tax-favored assets—is a complaint that preferences in shelters are doing what they are supposed to do. One can coherently oppose preferences generally because of the distortions they produce. One can also coherently favor some preferences, on the grounds that they cause a desirable shift in the allocation of resources. But one cannot coherently condemn the economic distortions caused by preferences in debt-financed tax shelters and at the same time approve of the distortions caused by preferences in equity-financed investments. If there is a valid justification for attacking shelters without attempting to eliminate preferences generally, it must be something other than concern about economic distortion.

(b) Inflation and investments with negative returns.—The second aspect of the nonprofitable investment argument concerns the impact of the availability of tax shelter loss deductions on investor behavior during periods of high inflation. During these periods, tax shelter investors will find it profitable to purchase not only assets with rates of return lower than the taxable interest rate but also assets bearing negative rates of return—that is, rates of return lower than the rate of inflation. 47

47. If a preference can be used in shelters, it will cause greater investment in the preferred asset, and thus greater distortion, than would occur if it could not be used in shelters. Given this fact, one might favor the existence of a preference, while opposing its use in shelters, on the grounds that the reallocation of resources caused by the preference outside of shelters is desirable but that the additional reallocation caused by use of the preference in shelters would be too great. The position, then, would be that some economic distortion may be good, but too much may be bad. As the text indicates, however, if one objects to economic distortion per se, one should logically oppose all preferences, not just preferences used in shelters.

48. C. Eugene Steuerle describes this phenomenon in C.E. STEUERLE, TAXES, LOANS, AND INFLATION: HOW THE NATION’S WEALTH BECOMES MISALLOCATED 101-06 (1985). Steuerle notes that the use of tax shelters during periods of high inflation may have additional undesirable consequences. Id. at 96-97. If the real (inflation-adjusted) rate of return from nontaxable assets...
Suppose the rate of inflation is 10%. A 50% bracket taxpayer borrows $100 at 16% nominal interest (consisting of a 10% inflation component and a 6% real interest component) to purchase a tax-exempt asset with a nominal rate of return of 9%. The $8 tax savings from the $16 interest deduction more than offsets the $7 pre-tax loss, leaving the taxpayer with a $1 after-tax profit. The shelter is profitable even though the tax-exempt asset is nonproductive: the 9% nominal return on the asset is really a 1% negative return when the 10% inflation rate is taken into account. The $1 after-tax profit results because the $5 tax savings from the $10 inflationary component of the interest deduction is sufficient to offset both the $3 after-tax cost of the $6 real component of the interest deduction (6 less $3 in tax savings) and the $1 inflation-adjusted loss on the preferred asset. The tax savings from the deduction of the inflationary component of the interest deduction make the entire transaction profitable despite the negative return on the preferred asset.  

What are the tax policy implications of this phenomenon of profitable shelters based on assets with negative returns? One might conclude that it is reasonable to tolerate shelters involving assets with relatively low rates of return but unreasonable to permit those involving assets with negative rates of return. Congress arguably should amend the tax laws so as not to encourage investments in losing assets, which confer no benefits upon society.

Section 469 is certainly one way of ending inflation-induced tax shelter investments in assets producing negative returns. It is not a very good solution to the problem, however, because it is both too broad and too narrow. It is too broad because it does not prevent only inflation-
Anti-Tax Shelter Provisions

induced shelter investments in assets with negative returns; it prevents all
sheltering, even in times of little or no inflation. If the only objection to
sheltering concerns the adverse effects that it may produce during peri-
ods of high inflation, eliminating all sheltering to solve a problem limited
to some sheltering in times of high inflation would constitute overkill.

Conversely, section 469 is too narrow a response, because it deals
with only one isolated aspect of the havoc that high inflation can wreak
on an income tax system. During inflationary periods, the tax system
overstates all interest income of lenders and interest expense of borrow-
ers, not just tax shelter interest. Because lenders tend to be tax-exempt,
or at least in lower brackets than borrowers, the government’s revenue
loss from the overstated interest deductions of borrowers will far exceed
the revenue gain from overstated interest income of lenders. High infla-
tion also causes the tax system to mismeasure economic income drasti-
cally, quite apart from the treatment of interest. The system taxes purely
nominal capital gains when the prices of assets merely keep pace with
inflation. Similarly, the tax system can understatement deductions for in-
ventory costs and for depreciation if it does not adjust to reflect
inflation.

An appropriate response to inflation’s effects on the tax system
would attempt to deal with all of these effects through an inflation index-
ing regime, not just with the problems peculiar to tax shelters. An ap-
proach based on inflation indexing can deal with all the problems posed
by inflation; section 469 can deal with only one small aspect of its effects.
Indexing is also a superior response to the problem of inflation-induced
nonproductive tax shelter investments, because unlike section 469, it
would eliminate only those shelters premised on the deductibility of the

52. See supra note 49.
53. See 1 TAX REFORM FOR FAIRNESS, supra note 16, at 6, 17.
54. See id.
55. See C.E. STEUERLE, supra note 48, at 166-70 (discussing the possibility of comprehensively
indexing the tax laws for inflation). The Department of the Treasury proposed such a response in
1984. See 1 TAX REFORM FOR FAIRNESS, supra note 16, at 98-116; 2 id. at 152-72, 177-200. Its
proposal would have comprehensively indexed the computation of taxable income for inflation.
The proposal called for the exclusion of a given fraction of interest income from tax and the denial of a
deduction for the same fraction of interest expense, with the fraction “set to reflect the approximate
relationship between the current inflation rate and the long-run real interest rate.” 1 id. at 114. The
proposal recognized that “[p]erfect adjustment of debt or interest for inflation would require that
lenders receive an annual deduction for each outstanding loan equal to the product of the inflation
rate and the principal of the loan; borrowers would report an offsetting amount of taxable income on
each loan.” Id. It rejected such an approach, however, calling it “extremely complicated.” Id. For
further details of the proposal, see 2 id. at 193-200. In addition, the proposal called for adjusting
basis to reflect inflation in computing capital gains, see 1 id. at 101; 2 id. at 178-88; adjusting deprici-
ation deductions, see 1 id. at 106; 2 id. at 152-72; and adjusting inventory costs, see 1 id. at 111; 2 id.
at 189-92.
inflationary component of interest expense. It would leave intact those shelters not dependent on inflation for their effectiveness.

2. The Netting Theory.—Calvin Johnson has argued that in theory, interest expense should be deductible only when it is a cost of generating fully taxed income, not when it is a cost of generating tax-exempt income. Johnson explains that because the income tax is a tax on net income (profit) rather than on gross receipts, all costs (including interest costs) of generating taxable income must be deducted in order to determine net income to be taxed. He contends, however, that the "process of netting does not require that we allow an ordinary deduction for a given cost if the gross receipts to which it is related are not fully taxed." The allowance of a deduction for costs related to tax-favored income "would strip apart or mismatch revenue and expense, would 'unnet' rather than net, and would describe the transaction inaccurately." Regarding tax shelter interest—interest expense incurred to generate tax-preferred or tax-exempt income—Johnson states:

Interest is like any other cost. It is netted against the item of which it is a cost and draws its appropriate tax treatment from that netting process. If the interest is a cost of tax-exempt income, it should reduce the net tax-exempt income and thus should not be deductible.

Johnson's position assumes that the goal of the tax system should be for taxable income to reflect economic income as accurately as possible. Thus, interest should be deductible when the related income is fully taxed, because that deduction will accurately reflect economic income. But the deduction of interest when the related income is not taxed will

56. Under a comprehensive indexing system, the tax shelter described at the beginning of this subsection would not be profitable. The investor could deduct only the $6 real portion of his interest expense. Even if he could also deduct the $1 real (inflation-adjusted) loss on the preferred asset, the transaction would still be unprofitable. The $7 tax loss would simply reflect the taxpayer's $7 pre-tax loss. The $3.50 tax savings from the tax loss would be insufficient to offset the $7 pre-tax loss.
57. See Johnson, supra note 44, at 123.
58. See id. at 127.
59. Id.
60. Id. at 128.
61. Id.
62. Johnson's remark that allowing a deduction for interest related to tax-exempt income "would describe the transaction inaccurately" evidences this assumption. Id. Johnson also states that disallowing a deduction for interest related to tax-exempt income is "disallowing artificial losses so that the tax accounts more accurately describe the taxpayer's economic nontaxation." Id. at 157. He also supports the disallowance of interest by reference to "the theory of second best," Id. at 158. The point of this reference seems to be that although the deduction of interest expense would be proper in a tax system without tax-preferred income, disallowance of interest deductions in a system with many preferences may bring taxable income closer to the ideal of accurately reflecting economic income.
usually cause taxable income to diverge further from economic income than would disallowance of the interest deduction; therefore, the interest deduction should be disallowed in such cases. 63

The weakness in this analysis is its assumption that the tax structure should incorporate a reasonably accurate reflection of economic income. When Congress enacts an incentive preference, it uses the tax system to achieve some nontax purpose by providing that taxable income need not accurately reflect the economic income from the preferred asset. 64 In the case of equity investments in preferred assets, Congress’s desire to further the purposes of the preferences subjugates any perceived need to measure economic income accurately. The netting argument fails to explain why the goal of the tax system should shift to an accurate measurement of economic income when the investment in the preferred asset happens to be debt-financed. 65 Nor does it explain why a mismeasurement of income that Congress considers good when it arises from an equity-financed investment in a preferred asset is bad when it stems from a debt-financed investment in the same asset. 66

63. Suppose a taxpayer borrows $100, at an annual interest cost of $10, to invest in an asset that produces $10 of tax-exempt income annually. If the interest is deductible, the $10 tax loss ($0 taxable income less $10 interest expense) will understate the net economic income of zero ($10 income minus $10 interest expense) by $10. If the interest is not deductible, however, the absence of either taxable income or loss (no taxable income and no interest deduction) will mirror the economic result. Of course, the tax result that follows from disallowing the interest deduction will mirror precisely the economic result only in the unusual case (of which the hypothetical is an example) in which the income that the system does not tax because of the preference exactly equals the non-deductible interest expense. Only in such a case does the disallowance of the interest deduction compensate precisely for the nontaxation of the preferred income. In any other case, disallowance of the deduction for interest expense associated with untaxed income will not yield a tax result that perfectly mirrors the economic result. Johnson is probably correct, however, in thinking that in most cases disallowance of the deduction for interest costs related to exempt income would come closer to an accurate reflection of economic income than would allowance of the deduction. Nevertheless, one can easily construct hypotheticals in which Johnson would be incorrect. Consider an extreme case with the same facts as in the above hypothetical, but in which the tax-favored investment fails— to the investor’s dismay—to produce any income. The economic result would then be a $10 loss ($0 income minus $10 interest expense). Allowing the interest deduction would accurately mirror the economic result; disallowance would cause taxable income ($0) to overstate economic income by $10.

64. See supra text accompanying notes 5-11.

65. As indicated in the text, this criticism of the netting theory considers the theory as it relates to shelters based on incentive preferences. The case for restricting shelters based on nonincentive preferences is considerably stronger. See infra text accompanying notes 67-84.

66. Some commentators have suggested that a theoretically attractive approach to tax shelters would be to allow the deduction of interest associated with an investment in a tax-favored asset, but only to the extent that the return on the asset bears an implicit tax. Cooper, The Taxing of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657, 722-33 (1985); Shavell, Confronting the Problem of Tax Arbitrage, 43 Tax L. Rev. 1, 11-16 (1987). A preferred asset is subject to an implicit tax if market forces have reduced the pre-tax rate of return from the preferred asset below the pre-tax rate of return on nonpreferred assets. See infra text accompanying notes 101-06. For example, if a taxable bond pays 10% and a tax-exempt bond pays only 7%, the return on the tax-exempt bond is subject to a 30% implicit tax. Suppose in this example that the top
3. Keeping Nonincentive Preferences Within Bounds.—In a recent article, Cecily Rock and Daniel Shaviro defended the passive loss rules as a means of improving the measurement of net income for tax purposes. Their analysis justifies section 469 primarily as a means of preventing shelters based on nonincentive preferences from interfering with the accurate measurement of unrelated income—especially income from personal services.

To illustrate the argument, consider the case of an equity investment in an asset that produces income in the form of unrealized appreciation (the nontaxation of which is the classic example of a nonincentive preference). The effect of the nonincentive preference is merely the avoidance or deferral of tax on the income from the investment. Now imagine a debt-financed investment in that asset, in which the interest expense equals the unrealized appreciation in the asset. Although the taxpayer has no net economic (pre-tax) gain or loss from the investment, the taxpayer will have a substantial tax loss if the interest is deductible while the unrealized appreciation is not taxable. The taxpayer could use this artificial tax loss to shelter unrelated income—especially income from services—from taxation.

Of course, the amount by which taxable income understates economic income is the same in either case: the amount of the unrealized appreciation (or other nonincentive preference). Rock and Shaviro suggest, however, that the use of a nonincentive preference to shelter unrelated income may be objectionable in a way that the use of the prefer-

statutory tax rate is 50% and that a taxpayer borrows $100 at 10% to buy a tax-exempt bond paying 7%. The 50% implicit tax rate is 60% of the 50% top statutory rate. In effect, then, 60% of the taxpayer’s return has been fully taxed (by the implicit tax), and 40% of the return has escaped tax altogether. The suggested approach would allow the taxpayer to deduct 60% ($6) of his interest expense, on the theory that 60% of the interest is the cost of earning fully taxable income. The other 40% of the interest, which is considered a cost of earning tax-exempt income, would not be deductible.

One could view this approach as a variation on the netting theory, to the extent it denies a deduction for the interest expense it associates with tax-exempt income. So viewed, it would be subject to the objection to the netting theory that this Article develops. Upon closer examination, however, this approach has considerable theoretical appeal, because it recognizes that most of the objections to tax sheltering disappear to the extent the tax-preferred income is subject to an implicit tax. See infra subpart II(B). Accordingly, this approach not unreasonably allows the combination of an interest deduction and a preference to the extent an implicit tax replaces the actual tax and denies the interest deduction to the extent an implicit tax does not replace the actual tax. An obvious problem with the approach, however, is the difficulty of determining the rate of the implicit tax in order to calculate how much of the interest deduction to disallow. See Cooper, supra, at 723; Shakow, supra, at 16. For additional criticisms of the partial interest disallowance approach, see infra note 159.

68. See id. at 25-31.
69. See supra text accompanying notes 30-33.
ence to shelter income from the preferred asset is not. Their argument posits that the tax system can measure some kinds of income with reasonable accuracy—primarily income from services, but also some kinds of capital income, such as interest and dividends—but has difficulty gauging other kinds of income—especially that undermeasured by nonincentive preferences, such as unrealized appreciation. 70 According to Rock and Shaviro, the system should not allow its problems in measuring these latter types of income to spill over into its assessment of those kinds of income that it can accurately measure. 71 It is one thing to accept the nontaxation of unrealized appreciation as an administrative necessity or as an unavoidable evil, when the result is simply the nontaxation of the unrealized appreciation itself; it is quite another to permit the nontaxation of unrealized appreciation to infect the accurate measurement of income from services through the use of tax shelters. Rock and Shaviro thus conclude that the passive loss rules are justified as a means of keeping nonincentive preferences within bounds. 72

The idea of prohibiting the use of nonincentive preferences in tax shelters has considerable appeal. If one accepts nonincentive preferences only as administrative necessities, it may make sense to limit their scope to the extent administratively feasible. The difficulty with the Rock-Shaviro position lies not in its logic but in its failure to explain the actual structure of section 469. The passive loss rules do not apply only to nonincentive preferences, as the Rock-Shaviro argument would suggest; section 469 applies to all passive losses, 73 whether attributable to nonincentive or incentive preferences. 74 Many—perhaps most—tax shel-

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71. See id. at 27-31.
72. See id. at 54-55. The Senate Finance Committee’s report offers a similar, though much less developed, argument that the passive loss rules are needed to prevent the exploitation of nonincentive preferences in sheltering unrelated income from tax:

[W]hen the tax system, in order to avoid . . . complexity, permits simpler rules to be applied (e.g., generally not taxing unrealized gain, and allowing depreciation based on broad industry averages), opportunities for manipulation are created. Taxpayers may structure transactions specifically to take advantage of the situations in which the simpler rules lead to undermeasurement or deferral of income.


74. Of course, there is a third possible source of passive losses. Rather than being attributable to either incentive or nonincentive preferences, a passive loss may reflect a real economic loss. The passive loss rules generally limit the deductibility of all three kinds of losses. For a discussion of § 469 and real economic losses, see infra text accompanying notes 317-39.
ters traditionally have been based on incentive preferences, such as ACRS,\textsuperscript{75} preferences for research and development,\textsuperscript{76} and preferences for development and exploitation of natural resources.\textsuperscript{77} The Rock-Shaviro analysis offers no explanation of why section 469 should apply to passive losses attributable to incentive preferences. In the case of an incentive preference, Congress has made a policy decision to measure economic income inaccurately for tax purposes, in order to further some nontax goal. Preventing the use of an incentive preference in a shelter would seem inconsistent with this nontax goal.\textsuperscript{78}

One might defend section 469's effect on incentive preferences as an unfortunate but unavoidable side effect of the effort to halt the exploitation of nonincentive preferences through shelters. The argument would be that because the tax system cannot identify and separate those shelter losses due to incentive preferences from those due to nonincentive preferences, it must necessarily limit the deductibility of all passive losses in order to control nonincentive preferences. But the premise of this argument is unsound. The tax system ordinarily can identify incentive preferences and the losses attributable to them. Section 57, for example, identifies many "items of tax preference" for purposes of implementing the alternative minimum tax.\textsuperscript{79} The tax system could identify a similar list of incentive preferences for purposes of the passive loss rules; the rules could limit the deductibility of passive losses only if and to the ex-


\textsuperscript{77} See, e.g., id. § 263(c), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1007(g)(5), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3435 (providing for deductibility of intangible drilling and development costs for oil, gas, and geothermal wells); id. § 613 (establishing percentage depletion). Section 469 does not apply to working interests in oil and gas property. See id. § 469(g)(3).

\textsuperscript{78} See supra text accompanying notes 64-66.

Anti-Tax Shelter Provisions

tent that they exceeded the amount of incentive preferences generated by the activity.\textsuperscript{80} The Subchapter K project of the American Law Institute (ALI)\textsuperscript{81} provides an example of an antishelter proposal designed to distinguish different types of preferences. The ALI project proposed limitations on the deductibility of limited partnership losses,\textsuperscript{82} a plan that resembled section 469 but which was considerably narrower in scope. The ALI’s argument in support of its proposal was that a nonincentive preference that initially seems a reasonable concession to practicality can become intolerable when aggressively exploited and marketed by tax shelter promoters—\textsuperscript{83} an argument quite similar to the Rock-Shaviro argument in support of section 469. Unlike section 469, however, under the ALI proposal Congress could have identified losses attributable to incentive preferences, to which the deduction limitations would not have applied.\textsuperscript{84}

\textsuperscript{80} Suppose that a taxpayer borrows $100, at 10% interest, and uses the money to buy land and a building. During the first year (in which the taxpayer pays $10 in interest), the property generates $12 in rental income (net of all expenses except depreciation), the land appreciates by $1, and the building undergoes $4 in economic depreciation. The taxpayer claims a depreciation deduction of $7; Congress intended the $3 difference between tax and economic depreciation as an incentive preference. The taxpayer has a net economic loss of $1: $12 in rental income plus $1 in unrealized appreciation, less $10 in interest expense and $4 in economic depreciation. Apart from any antishelter reductions, the taxpayer has a tax loss of $5: $12 in rental income, less $10 in interest expense and $7 in tax depreciation. The $5 tax loss consists of three components: $1 of real economic loss, $1 of nonincentive preference (unrealized appreciation on the land), and $3 of incentive preference (accelerated depreciation on the building). The proposed rule would identify the $3 of incentive preference and would allow the loss for tax purposes only to that extent. (For an attempt in the current tax law to identify the artificial portion of depreciation deductions, for purposes of the alternative minimum tax, see I.R.C. §§ 56(a)(1)(A), 168(g) (Supp. IV 1986), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1002(b)(2)(F), 1007(b)(15), 6027(b)(2), 6028(c), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3371, 3430, 3693-94.) The other $2 of tax loss, $1 attributable to unrealized appreciation and $1 reflecting a real economic loss, would be subject to § 469-type treatment.

It may seem strange to propose a system that would allow tax losses attributable to incentive preferences, but not real economic losses. The explanation, however, is straightforward, if one accepts the Rock-Shaviro position that the tax system should curb shelters based on nonincentive preferences. The system can limit shelters based on nonincentive preferences without affecting those based on incentive preferences, because it is feasible to identify losses due to incentive preferences. There is no easy way, however, to distinguish a real economic loss from an artificial loss based on a nonincentive preference. In the hypothetical, for example, a determination of whether the fourth and fifth dollars of tax loss reflected a real economic loss or unrealized appreciation would require a determination of the amount of unrealized appreciation, if any. But the impracticality of making such a determination was the reason for not taxing the unrealized appreciation in the first place. The ideal rule, under the Rock-Shaviro analysis, would allow both real economic losses and losses due to incentive preferences, and would disallow only losses attributable to nonincentive preferences. As a practical matter, however, denying shelter losses based on nonincentive preferences unavoidably requires denying real economic losses as well; it does not unavoidably require denying losses based on incentive preferences. For more on antishelter rules and the problem of real economic losses, see infra text accompanying notes 317-39.

\textsuperscript{81} AMERICAN LAW INST., supra note 72.
\textsuperscript{82} Id. at 428-51.
\textsuperscript{83} Id. at 430-32.
\textsuperscript{84} The ALI proposal would have drawn distinctions based on the nature of the preference:
The implementation of a distinction between incentive and nonincentive preferences seems crucial to any loss limitation provision based on the Rock-Shaviro analysis. The absence of such a distinction in section 469 undercuts the ability of the Rock-Shaviro analysis to justify the 1986 Act's passive loss rules.85

4. The Problem of Abusive Shelters.—Even if one accepts in theory the case for permitting the use of preferences in tax shelters, one might favor antishelter legislation as a way of controlling “abusive” shelters.86 Like a “legitimate” shelter, an abusive shelter generates artificial tax losses to shield unrelated income. The difference between the two is that a taxpayer can properly deduct the artificial losses from the legitimate shelter but not those from the abusive shelter.87 Abusive shelters may be based on misrepresentations of fact, misinterpretations (often intentional) of law, or both. Unlike a legitimate shelter, which furthers the congressional goals of the preference on which it is based, an abusive shelter serves no public purpose. It simply erodes the tax base and lessens taxpayers' confidence in the integrity of the system.

One might attempt to justify section 469 as a rather drastic way of ending the problem of abusive shelters. Abusive shelters have depended on their superficial similarity to legitimate shelters in order to escape detection by the Internal Revenue Service (IRS). If, because of section 469, previously legitimate shelters are no longer viable, abusive shelters can no longer be disguised as legitimate shelters. Although this approach certainly solves the problem of abusive shelters, it may be overly broad in application.

"The proposal contemplates that Congress may desire to exempt those activities for which it considers the pass-through of losses appropriate." Id. at 438.
85. In addition to nonincentive preferences, antishelter limitations might make good sense in the case of savings preferences—preferences designed not to encourage investment in particular assets but to encourage an increase in total savings. See supra note 43. Because borrowing to finance an investment in a savings preference does not increase aggregate savings, a savings preference that is good when equity-financed might well become bad when debt-financed. But see infra text accompanying notes 183-86 (arguing that in some cases a debt-financed savings preference investment may actually result in increased savings). If Congress determines that debt-financed savings preference investments do not serve the preference's purposes, it could appropriately impose antishelter limitations on the deductibility of interest expense associated with savings preference investments. But see infra text accompanying notes 285-303 (discussing the difficulties of associating interest expense with particular investments).
86. At least one commentator has assumed that the purpose of § 469 is to control abusive shelters. See Lewicki, The Regulation of Tax Shelters and New Internal Revenue Code Section 469: A Complex and Unnecessary Addition to the War on Abusive Tax Shelters, 19 Pac. L.J. 101, 105-07 (1987).
87. Although the phrase "abusive tax shelters" appears in the title of I.R.C. § 6700 (Supp. IV 1986) and the phrase "potentially abusive tax shelter" appears in id. § 6112(o)(1), (b), the textual reference to abusive shelters is not meant in a technical sense. Rather, it describes shelters yielding tax benefits that are not justified under existing law. For a somewhat broader usage of the term, see Lewicki, supra note 86, at 102 n.9.
Anti-Tax Shelter Provisions

its elimination of nonabusive shelters. If nonabusive shelters are consistent with good tax policy, their elimination as a means of controlling abusive shelters should be a last resort—that is, only if there are no other effective means of controlling abusive shelters.

In fact, Congress and the IRS have taken numerous steps in recent years to control abusive shelters without eliminating nonabusive shelters.Investors in and promoters of abusive shelters formerly relied on the audit lottery for the success of their shelters. They knew that it was unlikely that the IRS would detect an abusive shelter, and that even if it did, there was little risk of the imposition of any civil or criminal penalties. Legislation requiring tax shelter promoters to register their shelters with the IRS has reduced the chances that an abusive shelter will escape detection. Each registered shelter is given a tax shelter identification number, and an investor in the shelter must include that number on his return. Thus, the IRS now receives notice of the existence of shelters that it may wish to investigate and is aware of the identity of the investors in those shelters. If the IRS detects an abusive shelter, the investor may be subject to one or more of the tax shelter penalty provisions added to the Code in this decade. These congressional efforts

88. For detailed descriptions of the congressional and administrative attacks on abusive shelters, see Garbis & Strunz, Thorns Among the Roses—The Problems of the Investor in an “Abusive” Tax Shelter, 44 Inst. on Fed. Tax’n § 5.01-07 (1986); Kajan & Reitzenstein, IRS Weapons and Procedures To Combat Tax Shelters, 38 U. S. Cal. Major Tax Plan. 8-1 (1986); Lewicki, supra note 86.


90. See id. §§ 6111(b), 6707(b) (originally enacted as DefRA, supra note 89, § 141(a)-(b), 98 Stat. 494, 677-81). In addition, a promoter of a potentially abusive shelter must maintain and make available to the IRS a list of investors in the shelter. Id. § 6112 (originally enacted as DefRA, supra note 89, § 142, 98 Stat. 494, 681-82); id. § 6708(a) (originally enacted as DefRA, supra note 89, § 142, 98 Stat. 494, 681-82).

91. Even before these statutory innovations in 1983, the IRS had implemented a program to identify and investigate abusive tax shelters. See Rev. Proc. 83-78, 1983-2 C.B. 595. In gathering its information, the IRS program relies on federal, state, and local information agencies; other IRS investigations; magazines and newspapers; and any other available information. As part of the program, the IRS may send an investor a profiling notification letter, advising him that the IRS believes that the shelter is abusive and explaining the possible consequences if he claims unjustified tax benefits on his return. An investor receiving such a notice knows, even before he has filed his return, that the abusive shelter will not escape detection through the audit lottery.

92. Since 1982, the Code has imposed a penalty on substantial understatements of tax. See I.R.C. § 6661 (1982 & Supp. IV 1986) (originally enacted as Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323, 96 Stat. 324, 613-15 [hereinafter TEFRA]). The penalty had originally been 10% of the underpayment of tax attributable to the understatement; Congress increased the penalty to 25% in 1986. See id. § 6661(a) (Supp. IV 1986), as amended by Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, § 8002(a), 1986 U.S. Code Cong. & Admin. News (100 Stat.) 1874, 1951. Outside of the tax shelter area, the penalty does not apply to a substantial understatement if there was substantial authority for the position taken on the return or if the return adequately disclosed the relevant facts relating to the understatement. See id. § 6661(b)(2)(B) (1982). In any case concerning a tax shelter, however, a substantial understatement
have increased not only the likelihood that the IRS will detect an abusive shelter but also the adverse consequences if it does. The legislation should thus deter many taxpayers from investing in abusive shelters.93

It appeared that Congress and the IRS were well on the way to winning the war on abusive shelters, even without the 1986 addition of section 469.94 Moreover, much of the anti-abusive shelter arsenal was new—some of the most important weapons were added as recently as 198495—and enough time may not have passed for their full effect to be felt.96 Congress may not have already won the battle against abusive shelters at the time of section 469's enactment, but it was far too early to say that the existing weapons against abusive shelters had been fully tried and that they had failed. At the very least, a longer test period was

will escape the penalty only if there is substantial authority for the position taken on the return and if the taxpayer reasonably believed the position taken on the return was more likely than not correct. See id. § 6661(b)(2)(C)(i). Section 6659 imposes penalties for underpayments of tax due to overstatements of the value of property. Id. § 6659 (originally enacted as Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722(a)(1), 95 Stat. 172, 341-43). Such overstatements are a common feature of abusive tax shelters. The penalties range from 10% to 30% of the underpayment, depending on the degree of overvaluation. See id. § 6659(b). Under § 6621(c), interest on substantial understatements of tax due to tax-motivated transactions (defined so as to cover many abusive tax shelters) is charged at 120% of the normal interest rate on tax deficiencies. Id. § 6621(c) (Supp. IV 1986) (originally enacted as DEFRA, supra note 89, § 144, 98 Stat. 494, 682-84).

93. During the 1980s, Congress has added new deterrents to the promotion of abusive shelters. Section 6700, added to the Code in 1982, imposes a penalty on the promoter of an abusive tax shelter equal to the greater of $1000 or 20% of the income received by the promoter from the activity. Id. § 6700 (1982) (originally enacted as TEFRA, supra note 92, § 330, 96 Stat. 324, 611). Section 6701, also enacted in 1982, provides for a $1000 penalty ($10,000 in the case of corporate taxpayers) for knowingly aiding and abetting the understatement of another person's tax liability. Id. § 6701 (originally enacted as TEFRA, supra note 92, § 324, 96 Stat. 324, 615). These provisions pose a substantial threat to promoters of abusive shelters. Moreover, once a promoter has engaged in conduct subject to penalty under either of these provisions, § 7408 authorizes the IRS to seek, and district courts to grant, an injunction against any further activity subject to penalty under these provisions. Id. § 7408 (Supp. IV 1986) (originally enacted as TEFRA, supra note 92, § 321, 96 Stat. 324, 612).

An integral part of most tax shelter promotional materials is an opinion letter by a tax attorney or accountant on the tax treatment of the investment. Incomplete, false, or misleading opinion letters are characteristic of abusive shelters. Treasury acted in 1984 to prevent such opinions by promulgating regulations with which tax shelter opinions must comply. See 31 C.F.R. § 10.33 (1988). A practitioner who issues a tax shelter opinion in violation of the regulations may be suspended or disbarred from practice before the IRS. Id. § 10.52(b).

94. In September 1985, the Wall Street Journal quoted William S. Goldstein, a Philadelphia tax lawyer and a former chairman of an American Bar Association committee on tax shelters, as saying that "[n]inety percent of the problems and abuses have gone away." Ricks, IRS Crackdown on Tax Shelters Makes Headway, Wall St. J., Sept. 18, 1985, at 33, col. 3. Similarly, prominent tax practitioners and commentators Marvin Garbis and Stephen Strantz observed in 1986 that "[t]he tax shelter investor is more vulnerable than ever to detection, and the economic deterrents attendant to investing in a tax shelter that ultimately is determined to be 'abusive' have increased dramatically... [I]t is fair to say that the tide is beginning to turn against the tax shelter investor." Garbis & Strantz, supra note 88, § 5.01, at 5-3.


96. See Lewicki, supra note 86, at 120.
Anti-Tax Shelter Provisions

needed. Because there was good reason to think that the tax system could have eliminated abusive shelters without taking the drastic step of eliminating nonabusive ones, it is difficult to accept section 469 as a means of controlling abusive shelters.

Moreover, control of abusive shelters is strikingly absent from the Senate Finance Committee report’s explanation of the reasons for the enactment of section 469. The report addresses only difficulties caused by shelters that were legitimate under prior law; it does not discuss problems caused by abusive shelters. If the tax system did not need section 469 to control abusive shelters, and if Congress did not even offer that explanation for section 469, we must seek out its justification and purpose elsewhere. Supporters of section 469 must justify the elimination of previously legitimate shelters as an end in itself, not merely as a means of eliminating abusive shelters.

5. Shelters, Appearances, Taxpayer Morale, and Compliance.—A major problem with shelters is that they give many taxpayers the impression that the income tax is fundamentally unfair. A taxpayer without shelters pays a substantial tax on his earned income. He hears of other taxpayers, many of whom have much more earned income, who pay little or no tax because of their use of tax shelters. As a result, he loses faith in the tax system’s fairness and so loses respect for the system. He begins to cheat on his income tax by failing to report income or by claiming unjustified deductions. In this way, shelters undermine the voluntary compliance on which the income tax system depends. Even if a taxpayer who is demoralized by shelters does not turn to cheating, he will at least cease to give the income tax system his political support. This erosion of political support also threatens the income tax structure.

97. In a 1988 interview, IRS Deputy Chief Counsel Peter K. Scott said:
The passive loss rules pretty much put the final nail in the coffin, in terms of the shelter business. I’m egotistical enough to think that we have basically won the [tax shelter] war, anyway, or are in the process of winning it. It may have just ended it a little sooner.
98. The relevant void is in S. REP. No. 313, supra note 12, at 713-18. Lewicki assumes that the purpose of § 469 was to combat abusive shelters, see Lewicki, supra note 86, at 105-07, but the legislative history does not support that assumption.
99. The Senate Finance Committee report on § 469 emphasized these concerns:
Extensive shelter activity contributes to public concerns that the system is unfair, and to the belief that tax is paid only by the naive and the unsophisticated. This, in turn . . . undermines compliance . . . .
The committee believes that the most important sources of support for the Federal income tax system are the average citizens who simply report their income (typically consisting predominantly of items such as salaries, wages, pensions, interest, and dividends) and pay tax under the general rules. To the extent that these citizens feel they are bearing a disproportionate burden with regard to the costs of government because of their unwilling-
One can argue that these problems of appearances, taxpayer morale, and compliance are unique to tax shelters and thus provide a reason for attacking tax shelters without eliminating the availability of preferences outside of shelters. The argument goes as follows. A preference used to shelter earned income is highly visible and creates taxpayer morale problems, and thus must be curbed. When a taxpayer uses a preference merely to shelter income from the investment to which it relates, however, the general public does not care or even notice, and therefore the preference need not be eliminated.

Is this difference in appearances alone a sufficient justification for restricting the use of preferences in shelters without limiting the use of preferences outside of shelters? At a very pragmatic level, the answer might well be yes. Preferences that shelter earned income undoubtedly create appearance problems far exceeding any caused by preferences that merely shelter income from the property to which they relate.

Nevertheless, appearances alone provide an unsatisfactory rationale for distinguishing preferences in tax shelters from other preferences. If differences in public perception are the only good reason for treating shelter preferences differently from others, one of two things must be true. One possibility is that the average taxpayer would be just as outraged about the use of preferences outside of tax shelters as about their use in shelters if he understood that the two types of preferences understate economic income in essentially the same way. If so, attacking only the preferences of which the average taxpayer is aware and which he opposes, and leaving intact those preferences of which he is unaware, seems to be taking advantage of the ignorance of the average taxpayer. The other possibility is that the average taxpayer accepts the idea of non-shelter preferences and that he would also accept the use of shelter preferences if he understood that the same arguments support both. In that case, Congress should not legislate to limit shelters, but should educate the public as to why it should support shelters if it supports preferences.

Either way, the basic point is the same: if the only reason for a tax law that distinguishes between preferences used in shelters and preferences used outside of shelters is that the public irrationally distinguishes

ness or inability to engage in tax-oriented investment activity, the tax system itself is threatened.

S. REP. NO. 313, supra note 12, at 714.

100. Some commentators who have rejected all other arguments for attacking shelters without attacking the underlying preferences have been unwilling to reject out of hand the argument against shelters based on appearances. See, e.g., Hickman, supra note 33, at 775-76 (arguing that preferences create an appearance of impropriety); Mundstock, supra note 33, at 1258 (arguing that a public perception of unfairness may undermine compliance with the "voluntary" tax system).
Anti-Tax Shelter Provisions

between the two, that is not a very good reason. Congress should educate the public as to why its attitude is irrational, rather than enact legislation because of that irrationality. If education failed to convince the public that its attitude was irrational, Congress might then need to respond to that attitude with legislation. But unless and until education has been tried and has failed, public perception alone seems an inadequate reason for distinguishing between preferences used in shelters and the same preferences used outside of shelters.

6. Summary.—None of the five antishelter arguments examined provides persuasive support for the Act's policy of permitting the use of preferences outside of shelters while prohibiting the use of preferences in shelters. Some of the arguments, however, do identify problems caused by certain kinds of shelters. Congress could better deal with these problems by drafting more narrowly focused legislation. The criticism that the ability to use preferences in shelters encourages unprofitable investments is really nothing more than an observation that the preference is fulfilling its purpose of encouraging investment in the preferred asset. The use of preferences outside of shelters similarly affects the allocation of resources; thus, this criticism fails to explain why the tax laws should distinguish between shelter and nonshelter preferences. If the use of tax shelters during high inflation causes special problems, the solution is to inflation-proof the tax laws, not to prohibit sheltering. The netting argument against shelters is based on the assumption that the goal of the tax system is to measure economic income accurately—an assumption that is not valid in the case of incentive preferences. It may be reasonable to attempt to prevent the use of nonincentive preferences in shelters, but the provisions of the 1986 Act—which apply equally to shelters based on incentive and nonincentive preferences—are far broader than necessary to accomplish that limited purpose. Congress and the IRS were bringing abusive shelters under control without the draconian measures of the 1986 Act. The use of preferences in shelters may cause problems of appearances, taxpayer morale, and compliance that are not caused by the use of preferences outside of shelters. If, however, this is the only objection to shelters—if, in other words, the public is wrong in thinking that there is an important difference between the use of shelter and nonshelter preferences—it would be better to attempt to correct the public's misperception than to legislate on the basis of it.
B. An Economic Analysis of Tax Shelters and the Justification for Antishelter Legislation

Market forces may reduce the pre-tax rate of return from preferred assets below that from nonpreferred assets. This reduction is sometimes referred to as an implicit tax on the tax-preferred income.\textsuperscript{101} Any analysis of the merits of antishelter legislation must consider the existence and extent of the implicit tax. This subpart analyzes the economic effects of the use of preferences in shelters under various assumptions about the extent of the implicit tax. It focuses on questions of revenue cost, resource allocation, windfalls to investors, and fairness among different groups of taxpayers. It concludes that under any reasonable assumptions concerning the existence and extent of the implicit tax, there is no convincing justification for the 1986 Act's comprehensive attack on tax shelters. Problems occur if the implicit tax rate is less than the top statutory marginal rate, but there are better responses to those problems than sweeping antishelter legislation.

1. If the Implicit Tax Equals the Top Marginal Rate.—A dollar "spent" by the federal government in the form of tax not collected on preferred income serves either to further the policy goals underlying the preference or to confer a windfall on an investor in the preferred asset. Consider, as a simple example, the tax exemption for interest from municipal bonds.\textsuperscript{102} Suppose the top statutory marginal tax rate is 50\% and that taxable bonds pay 10\% interest. If an investor in the 50\% bracket buys a $100 tax-exempt municipal bond, the federal government will have a $5 revenue loss—the $5 tax the government would have received if the taxpayer had bought a $100 taxable bond paying $10 interest. If the tax-exempt bond also pays 10\% interest, the entire $5 revenue loss will serve only to enrich the investor, whose after-tax income from the tax-free bond is $10 ($10 - $0 tax) instead of only $5 ($10 - $5 tax) from the taxable bond.

The municipal bond, however, will likely pay a lower rate of interest

\textsuperscript{101} See, e.g., C.E. Steuerle, supra note 48, at 61; Cooper, supra note 66, at 698-701; Yorio, supra note 21, at 397-400.

Anti-Tax Shelter Provisions

than the taxable bond. The tax preference makes the municipal bond more attractive to taxpayer-investors than a taxable bond. Thus, as Congress desires,\textsuperscript{103} demand for investment in municipal bonds will increase. The increased demand will tend to drive up the price of municipal bonds, and a higher price will result in a lower pre-tax rate of return.

In the above example, the demand for municipal bonds by top bracket taxpayers could drive the pre-tax interest rate on such bonds to as low as 5%. At that point, top bracket investors would receive no windfall from the tax-preferred investment; their 5% tax-free return on the municipal bond would be no better than the 5% after-tax return that they could earn from a 10% taxable bond. The federal government would still lose $5 in tax revenue whenever an investor chose to purchase a $100 municipal bond instead of a $100 taxable bond, but the lost revenue would now exclusively serve the purpose of the preference—subsidizing municipal borrowing by reducing a local government’s annual interest cost on a $100 bond from $10 to $5—rather than line the pockets of top bracket investors.

The difference between the pre-tax return on a fully taxable investment and the pre-tax return on a preferred investment constitutes the implicit tax on the tax-preferred income. If taxable bonds are paying 10% interest, and exempt bonds are paying 5%, an investor in an exempt bond bears an implicit tax of 50%. The cost to an investor of the exemption from explicit tax is a 50% reduction in the rate of return relative to a comparable taxable investment. When, as in this example, the implicit tax rate equals the top statutory rate, no windfall accrues to top bracket investors from investing in tax-preferred assets,\textsuperscript{104} and investors in any bracket below the top bracket would obtain a higher return from nonpreferred assets.

If the market pricing mechanism results in an implicit tax equal to the top marginal rate, taxpayers cannot use preferences profitably in shelters.\textsuperscript{105} If a 50% bracket taxpayer borrows $100 at 10% to buy a $100 municipal bond paying 5%, he will not realize any profit. The $5 in tax savings from the interest deduction simply offsets the $5 pre-tax loss (from paying $10 interest and receiving only $5). The taxpayer merely breaks even. In short, an implicit tax rate that equals the top marginal explicit tax rate solves the problem of tax shelters by making shelter ac-

\textsuperscript{103} See supra section I(A)(1).
\textsuperscript{104} Top bracket investors would receive a windfall, however, from investing in preferred assets during the time the market was adjusting to the existence of the preference. See Warren, supra note 8, at 564-65.
\textsuperscript{105} But see id. (noting that windfalls would accrue during period of market adjustment).
tivity unprofitable, thus obviating the need for antishelter legislation.  

2. **If the Implicit Tax Approaches the Top Marginal Rate.**—The demand for a preferred asset may not be strong enough to reduce the pre-tax return to the point at which the implicit tax equals the top explicit marginal rate and no windfall to top bracket taxpayers remains. Suppose that section 265(a)(2), which disallows deductions for interest paid on debt “incurred or continued to purchase or carry” municipal bonds, completely prevented the use of municipal bonds in tax shelters. Only taxpayers with money of their own to invest would purchase these bonds. Demand for equity-financed municipal bonds among 50% bracket investors might be insufficient to absorb the entire supply of municipal bonds at an interest rate of 5%. That demand will be limited because top bracket taxpayers have limited funds to invest and because municipal bonds must compete with other investments—including many other tax-preferred investments—for that limited supply of funds. For the market to absorb the entire supply of municipal bonds, issuers might have to pay a rate of interest higher than 5%. If the market cleared at 7%, for example, the implicit tax would be only 30% (that is, the return on the preferred asset would be only 30% less than the pre-tax return on the taxable asset). On a $100 tax-exempt bond purchased by a top bracket investor, on which the federal government loses $5 in tax revenue (the $5 tax that it could collect from the investor’s return on a $100 taxable bond paying 10%), the investor would realize a $2 windfall, and the local government would receive only a $3 reduction in interest expense.

This windfall to top bracket taxpayers is objectionable as a matter of tax policy. Some of the lost revenue from the preference does not serve the purposes of the preference, and top bracket taxpayers avoid the burden of the statutorily mandated rates of tax on their investment income by purchasing tax-preferred assets. One would feel better about the preference if the tax system could eliminate this windfall by raising the implicit tax to the level of the top statutory marginal rate.

106. See Shakow, supra note 66, at 7-8.
107. I.R.C. § 265(a)(2) (Supp. IV 1986). There is good reason to question the effectiveness of this section. See infra text accompanying note 135.
108. Only demand from 50% bracket taxpayers can drive down the pre-tax return all the way to 5%; any taxpayer with a top marginal rate below 50% would be unwilling to accept a 5% tax-free return, because he could obtain a higher after-tax return from a taxable bond paying 10% interest.
109. See Cooper, supra note 66, at 700; Yorio, supra note 21, at 400-09.
110. This higher interest rate would increase the attractiveness of municipal bonds to top bracket investors. It might also create some demand for municipal bonds among taxpayers below the top bracket.
Anti-Tax Shelter Provisions

(a) The Hickman analysis.—Frederic W. Hickman claims that merely permitting the use of the preference in shelters will eliminate this windfall. In fact, he claims that not to allow the use of a preference in shelters is "deliberately to sabotage the efficiency" of the preference. Hickman contends that the inefficiency described above—the windfall to high bracket investors—would disappear if taxpayers could use municipal bonds in shelters. The opportunity to use exempt municipal bonds to shelter unrelated income would create substantial additional demand for the bonds and thus eventually reduce their interest rates. Taxpayers in the 50% bracket would find it profitable to use municipal bonds in shelters as long as the interest rate on the bonds was even marginally higher than 5%. Hickman concludes that the demand for bonds from shelter investors would thus reduce the return to just over 5%, which would raise the implicit tax rate to nearly 50% and virtually eliminate the windfall.

If we assume for the moment that the results Hickman foresees would occur, what is the impact of these consequences on the question of whether Congress should permit the use of preferences in shelters? An initial reaction might be that the use of preferences in shelters is not merely unobjectionable, but is actually desirable, because it would raise the implicit tax nearly to the level of the top marginal rate and eliminate any significant windfall to investors. Although top bracket investors would make a small profit from their shelter activities (just enough to induce them to engage in the activities), that profit would seem, from the government's viewpoint, a small price to pay for the rise in the implicit tax rate.

(b) The revenue cost.—Before concluding, based on the Hickman analysis, that the tax system should permit preferences in shelters, one should consider the revenue cost that the use of preferences in shelters would impose on the federal government. Even accepting Hickman's view that the use of a preference in shelters will virtually eliminate windfalls to taxpayers from the preference, a preference will reduce tax revenues considerably more if it can be used in shelters than if it cannot. Imagine that Congress repeals section 265(a)(2), thereby al-

111. Hickman, supra note 33, at 778.
112. Id. at 774.
113. Id. at 787-88.
114. See id. at 787.
115. In response to comments on his article, Hickman has retreated somewhat from this claim. See infra note 137.
116. There are good reasons to doubt that the results described by Hickman would actually occur. See infra subsection II(B)(3)(a).
allowing taxpayers to deduct interest paid on debt incurred to purchase municipal bonds—in other words, to use municipal bonds in tax shelters. A taxpayer with salary income in the 50% bracket would then find it profitable to borrow at 10% in order to invest in bonds paying tax-exempt interest at any rate above 5%. Suppose the taxpayer borrows $100 at 10% and buys a $100 municipal bond paying 5.1% interest. The $5 tax savings from the interest deduction would more than offset the $4.90 pre-tax loss from the interest rate differential and would thus save the taxpayer a net of 10 cents. In effect, the taxpayer would eliminate a 50% explicit tax on $10 of salary income, at a cost of a 49% implicit tax.

The ability to use municipal bonds in shelters would create additional demand for such bonds. The increased demand for the bonds would drive up the price of the bonds and thus reduce their rates of return. The reduced rates of return on bonds would decrease the borrowing costs of local governments, which would likely respond by borrowing more. The result, of course, would be an increase in the total amount of municipal bonds outstanding.

Consider the revenue costs of this increase. Suppose our 50% bracket taxpayer, who borrows $100 to buy a municipal bond, buys a bond that would not have been issued but for the increase in the total amount of bonds outstanding caused by the ability to use the bonds in shelters. Absent the ability to use the preference in a shelter, the 50% bracket taxpayer would simply have paid $5 tax on $10 of salary income. By allowing the shelter, however, the government no longer collects the $5 tax on the taxpayer’s salary income. The government incurs this cost even if, as Hickman contends, the increased demand drives down the interest rate on municipal bonds to a point at which the im-

117. If the taxpayer could not have used the bond in a shelter, he would have had no reason to borrow money and purchase the bond. Moreover, the person who loaned the $100 to the taxpayer would not have invested the $100 in a municipal bond if he had not loaned it to the taxpayer. With the exception of interest on municipal bonds, interest is fully taxed. See I.R.C. § 616(c)(4) (1982). All debt (other than that on municipal bonds) is thus a nonpreferred asset. As a fully taxable, nonpreferred asset, debt bears no implicit tax—that is, it has a higher pre-tax return than preferred assets. The attractiveness of this higher pre-tax return is more than offset by the unfavorable tax consequences for high tax bracket investors, but not for tax-exempt or low bracket investors. Thus, lenders tend to be tax-exempt (such as pension funds, charities, and foreign taxpayers), or at least in low brackets relative to borrowers. See supra note 49. A tax-exempt or low bracket lender would never buy a municipal bond bearing a significant implicit tax when it could avoid all implicit and all or most explicit taxes by investing in a taxable bond. Thus, the $100 that our taxpayer now borrows to purchase a municipal bond would not have been channeled into a municipal bond investment but for the taxpayer’s ability to use the bond in a shelter.

118. See Johnson, supra note 44, at 166-67. But see Hickman, supra note 33, at 795 (arguing that the supply of municipal bonds is “relatively inelastic”).

119. The tax-exempt lender would have invested its $100 in some nonpreferred asset, earning a tax-free return. See supra note 117.
Anti-Tax Shelter Provisions

...implicit tax nearly eliminates the windfall to investors. If, for example, the market drives the interest rate down to 5.1%, the taxpayer pays an implicit tax of 49% and makes an after-tax profit of only 10 cents. The taxpayer receives only a slight windfall gain, but the federal government incurs a substantial revenue loss. The $10 interest deduction reduces the taxpayer's taxable income by $10 and diminishes tax revenue by $5. The implicit tax burdens the taxpayer but does not enrich the federal coffers. What is not the taxpayer's gain is nevertheless the Treasury's loss.

The use of preferences in shelters might reduce revenues in yet another way: by causing a shift in the ownership of preferred assets from low bracket to high bracket taxpayers. Suppose section 265(a)(2) is in effect. The top marginal tax rate is 50%, the taxable interest rate is 10%, and municipal bonds are paying 7%. As a result, investors in brackets as low as 30% may reasonably hold municipal bonds. A 7% return on a municipal bond will equal the after-tax return on a 10% taxable bond for an investor in the 30% bracket. Assume that a particular 30% bracket taxpayer owns a $100 municipal bond, which he purchased with his own funds. Now suppose that Congress repeals section 265(a)(2). According to Hickman, the additional demand for municipal bonds from shelter-seeking top bracket taxpayers will drive down the interest rate on municipal bonds, perhaps to 5.1%. At this interest rate, ownership of the municipal bond by the 30% bracket taxpayer no longer makes sense. Instead, a 50% bracket taxpayer will buy the bond with borrowed money. When the 30% bracket taxpayer bought the bond, the lost revenue was only $3 (the tax that the 30% bracket taxpayer would have paid on $10 interest income from the 10% taxable bond he otherwise would have bought). When the 50% bracket taxpayer buys the same bond, however, the revenue loss is $5 (the tax that the 50% bracket taxpayer would have paid on the $10 income sheltered by the interest deduction). Thus, apart from the revenue loss from the increased investment in preferred assets caused by the use of such assets in shelters, revenue will decrease if the use of preferred assets in shelters causes a shift in the ownership of those assets from low bracket to high bracket taxpayers. 120

There is yet another reason why allowing the use of preferences in shelters may cause revenue loss. The ability to use borrowed money in shelters increases the demand for loans and thus tends to drive up taxable interest rates. 121 An escalation of interest rates causes a corresponding shift in taxable income from high bracket borrowers to low bracket or

120. See Johnson, supra note 44, at 161-66; Oliver, Section 265(2): A Counterproductive Solution to a Nonexistent Problem, 40 TAX L. REV. 351, 402-05 (1985).
121. Warren, supra note 8, at 567-68.
tax-exempt lenders. The greater that shift, the greater the revenue loss.

It is reasonably clear, then, that a preference that can be used in shelters will cost the federal government more revenue than a preference that cannot. It does not necessarily follow, however, that Congress should inhibit the use of preferences in shelters. The increased tax revenue cost, after all, serves the basic purpose of preferences—increasing investment in preferred assets. If we accept a $5 revenue loss when a 50% bracket taxpayer purchases, with his own funds, a $100 municipal bond paying 5.1% instead of a taxable bond paying 10%, there is no immediately apparent reason why we should not accept a $5 revenue loss when a 50% bracket taxpayer borrows $100 at 10% to buy a municipal bond paying 5.1%. In both cases the government loses $5 in revenue, but in both cases the government has “bought” increased investment in the preferred asset.

Of course, with respect to any particular preference, one can always conclude that the increased investment the preference causes is not worth the revenue cost, or even that the preference has caused too much investment in the preferred asset, irrespective of revenue cost. If so, one way of limiting the revenue cost of the preference, as well as the increase in investment due to the preference, would be through antishelter legislation. Such legislation would not, however, be the best way of limiting the cost of the preference. The ability to use a preference in shelters serves the useful purpose (from the government’s standpoint) of increasing the implicit tax and thus decreasing the windfall to investors in the preferred asset. This benefit would be lost under effective antishelter legislation. Moreover, if, as suggested above, there is no meaningful distinction in

122. Id.
123. For a thorough exposition of this point of view, see Auerbach, Should Interest Deductions Be Limited?, in UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 195, 195-219 (H. Aaron, H. Galper & J. Pechman eds. 1988). Auerbach contends that one should judge the appropriateness of tax sheltering in light of the appropriateness of the underlying preference. The ability to use a preference in a shelter increases the amount of investment in the preferred asset. If that increased investment is desirable, there is a strong case for not imposing tax shelter limitations.
124. For the criticism that preferences cause too much investment in preferred assets, see sources cited supra note 16. For the specific criticism that the ability to use preferences in shelters causes additional undesirable investment in preferred assets, see Koppelman, supra note 43, at 1189.
125. See Shakow, supra note 66, at 20 (“Thus, it may be desirable to restrict tax arbitrage because it causes a greater shift of resources to tax-favored investments than the tax advantage alone is supposed to produce.”).
126. Although Hickman probably overstates the case when he claims that permitting the use of preferences in shelters will virtually eliminate all windfall, see infra text accompanying notes 129-37, he is certainly correct that the use of preferences in shelters will tend to increase the implicit tax and thereby reduce windfall.
127. See supra text accompanying note 123.
Anti-Tax Shelter Provisions

terms of revenue costs or increased investment between shelter and non-shelter preferences, allowing a preference according to whether it is part of a shelter seems arbitrary and unfair.

If a less costly preference is desired, the better alternative is to reduce the amount of the preference itself. For example, instead of exempting from tax all municipal bond interest, Congress might exempt only a stated percentage of such income. This measure would reduce the revenue cost and the economic effect of the preference without making any distinction between shelter preferences and non-shelter preferences. Thus, although a preference that taxpayers can use in a shelter will cost more than a preference that they cannot, that fact supplies little, if any, justification for antishelter legislation. Congress can always achieve a less costly preference, without discriminating against preferences in shelters, simply by reducing the amount of the preference itself.

3. If the Implicit Tax Is Significantly Lower than the Top Marginal Rate.—The preceding discussion concludes that if permitting the use of preferences in shelters will virtually eliminate windfall to investors, the tax system should permit it. That the use of preferences in shelters entails additional revenue cost does not change that conclusion.128 One can question with good reason, however, Hickman’s conclusion that the use of preferences in shelters will eliminate windfall. This section first explains why Hickman’s conclusion is dubious. It then considers whether the tax system should permit the use of preferences in shelters even if such use does not virtually eliminate windfall—that is, if the implicit tax is significantly lower than the top marginal rate.

(a) A critique of the Hickman analysis.—Hickman seriously overstates his case when he claims that the implicit tax rate necessarily will nearly equal the top marginal rate if taxpayers can use preferences in shelters. Allowing the use of preferences in shelters will increase the demand for preferred assets and thus will tend to decrease the return on (and increase the implicit tax on) such assets.129 But this increased demand will not necessarily drive down returns to a point at which the implicit tax nearly eliminates the windfall.130 Just as the amount of tax-

128. See supra subsection II(B)(2)(b).
129. See Auerbach, supra note 123, at 202, 210-12; Koppelman, supra note 43, at 1187-88; Shakow, supra note 66, at 5, 7.
130. “Whether removing existing restrictions upon the interest deduction will cause the market to fully capitalize tax benefits at the top marginal rate thus becomes a key question... Unfortunately... the current state of knowledge does not provide the basis for confident prediction.” Koppelman, supra note 43, at 1176.
ble income in the top bracket is not unlimited, the demand for tax preferences to shelter that income is not boundless. Even with the increased demand that would result from the use of exempt bonds in shelters, demand for such bonds among top bracket taxpayers (both for equity investments and for debt-financed shelter investments) might still be insufficient to absorb the entire supply of municipal bonds at or near a 5% interest rate.131 The increased demand should lessen the gap between the implicit tax rate and the top statutory rate, but substantial windfall may remain.132

Another reason why the ability to use preferences in shelters will not necessarily raise the implicit tax to the level of the top statutory rate is that taxpayers may not set investment strategies merely to pursue tax advantages. Portfolio diversification to reduce risk may be another important factor. Alan J. Auerbach maintains that “[i]nvestors will not dissipate all the tax advantages from [using preferences in shelters] . . ., stopping at the point where the additional tax advantages . . . are balanced by additional distortions to portfolio balance.”133 He explains that

131. One factor working against the elimination of windfall is that municipal bonds must compete with many other tax-preferred investments for the attention of shelter-seeking top bracket taxpayers. The existence of these alternative tax shelter investments lessens these taxpayers’ demand for municipal bonds (compared with the demand that would exist if bonds were the only preferred asset), and so lessens the likelihood that the demand from top bracket taxpayers will be sufficient to eliminate all windfall. See Cooper, supra note 66, at 700 (“[E]xempt bonds are priced as favorably as they are relative to taxable ones . . . because they must compete in a market rich with tax-reduction opportunities.”); Johnson, Financial Impact of the 1986 Act on Real Estate Investments—A View from the Spreadsheets, 36 Tax Notes 309, 320 (1987) (“If the supply of alternative tax benefits swamped the high brackets, then one should not expect high bracket taxpayers to pay very much for the tax benefits in real estate.”); Yorio, supra note 21, at 408-09 (arguing that repeal of many preferences would increase demand for the remaining preferences and so decrease the windfall to investors in the remaining preferred assets).

132. Although windfall—in the sense of the difference between the implicit and statutory tax rates—would decrease, total windfall—in the sense of the total benefit to high bracket investors from tax-preferred investments—would not necessarily decrease. An increase in the number of units of tax-preferred investments would accompany the decrease in windfall per unit of tax-preferred investments. Thus, total windfall might remain about the same, or even increase. See Auerbach, supra note 123, at 212 nn.25-26.

133. Id. at 211. Auerbach explains further:

Standard models of portfolio choice in the absence of taxes call for investors to diversify their portfolios to reduce risk. This objective clearly works in opposition to the sorting of portfolios in response to relative tax advantages. Indeed, when both risk and relative tax advantages are present, it is still generally optimal for investors to diversify, but their portfolios will be shifted in the direction indicated by the tax advantages, with the relative importance of the two motivations depending on the magnitude of risk and risk aversion on the one hand and the tax advantages on the other. What these models suggest is that investors will not dissipate all the tax advantages from [using preferences in shelters] . . ., stopping at the point where the additional tax advantages . . . are balanced by additional distortions to portfolio balance.

Id. (footnotes omitted); see also Koppelman, supra note 43, at 1185 (“[M]ost . . . tax benefits . . . appear not to be fully capitalized even where interest is deductible and tax arbitrage thus is permitted. Risk, which includes diversification needs . . ., appears to be the major reason for the lack of full capitalization.”).
equalization of the implicit tax rate with the top statutory rate is unlikely to occur "because investors have nontax reasons for caring which assets they hold."\textsuperscript{134}

In addition to these theoretical objections to Hickman's analysis, there is also an objection based on experience. Because section 265(a)(2) is not a particularly efficient method of preventing the combination of deductible interest expense and tax-exempt interest income,\textsuperscript{135} sophisticated taxpayers can still use municipal bonds in tax shelters. According to the Hickman analysis, this activity should result in virtually no windfall to investors in municipal bonds. In fact, however, the market has not equated after-tax returns on taxable and tax-exempt bonds for top bracket investors. Over the years, the implicit tax on municipal bonds has consistently been significantly lower than the top statutory marginal rate.\textsuperscript{136} Thus, neither logic nor experience suggests that permitting the use of preferences in shelters will necessarily lead to the virtual elimination of windfalls.\textsuperscript{137}

\textbf{(b) Policy considerations if significant windfalls remain.}—The above discussion suggests that although the use of preferences in shelters moves the implicit tax closer to the top statutory rate, a significant gap might well remain. It is therefore necessary to examine the policy considerations related to the use of preferences in shelters when the implicit tax is significantly lower than the top marginal rate.

Suppose, for example, that the top marginal tax rate is 50% and that

\textsuperscript{134} Auerbach, \textit{supra} note 123, at 212. Auerbach, however, does suggest various measures that might raise the implicit tax closer to the top statutory rate. \textit{Id.} at 216-17.

\textsuperscript{135} See Oliver, \textit{supra} note 120, at 359-89. Section 265(a)(2) is not very effective because it disallows an interest deduction only if the government can establish a nexus between the interest expense and the tax-exempt income—in the words of the statute, that the debt was "incurred or continued to purchase or carry" tax-exempt bonds. I.R.C. § 265(a)(2) (1982). Thus, a sophisticated taxpayer can deduct interest expense while receiving tax-exempt income as long as he is able to avoid creating the requisite relationship between the debt and the tax-exempt asset. See Oliver, \textit{supra} note 120, at 384-85.

\textsuperscript{136} See Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Treatment of State and Local Government Bonds 48-52, 70-71 (Comm. Print 1985) [hereinafter Tax Reform Proposals]; Cooper, \textit{supra} note 66, at 698-99; Yorio, \textit{supra} note 21, at 400. For information on the extent of the implicit tax on municipal bonds in recent years, see \textit{infra} note 148.

\textsuperscript{137} Hickman himself finally retreats from this claim. In response to the comments of Alvin Warren, he states:

A.I argues that we cannot necessarily count on the marketplace to efficiently equate all after-tax returns. I agree. None of my conclusions is based on a contrary assumption. I argue only that the marketplace tends to do so in the municipal-bond-type case and that to the extent it does, borrowing will make things better, rather than worse, by increasing the share of the exemption benefit that goes to the issuing municipality rather than to the high-bracket holder.

\textit{Hickman, supra} note 33, at 821 (excerpts from panel discussion).
taxable bonds pay 10% interest. Suppose also that even after the repeal of section 265(a)(2), the implicit tax on the return from exempt bonds is only 30%, because the interest rate on exempt bonds is 7%. A top bracket investor can realize a windfall by investing in municipal bonds (with a 7% after-tax return) rather than taxable bonds (with a 5% after-tax return). Even though, in this example, the market has not eliminated all the benefits of preferences to top bracket investors, it may create a reasonably uniform after-tax rate of return among different investments (of equal risk) for top bracket investors, taking into account the effect of both implicit and explicit taxes. The investment choices for top bracket taxpayers may consist of a variety of wholly and partially tax-exempt investments, all of which (at any given level of risk) bear approximately the same combined burden of actual and implicit tax.

In our example, because the implicit tax burden is 30%, a rate lower than the 50% top statutory rate, an opportunity exists for a tax-sheltering windfall. A taxpayer with $10 of personal services income taxable in the 50% bracket can avoid the 50% tax on that income by borrowing $100 at 10% interest (assuming the interest is deductible) and investing it in a 7% exempt bond. The resulting $10 interest deduction eliminates the actual tax of $5 on the personal services income, and the taxpayer instead pays an implicit tax of $3, the amount by which the $10 interest paid exceeds the $7 interest received.

If tax-preferred assets bear an implicit tax of 30%, and if preferences can be used in shelters, taxpayers will never have to pay tax at a rate greater than 30% on earned income. A taxpayer can shelter any income taxed at a rate higher than 30% at the cost of a 30% implicit tax. However, a taxpayer can profitably shelter only income taxed at a rate higher than the implicit tax. A taxpayer with $10 of personal services income taxed at 30% would gain nothing by borrowing $100 at 10% and investing it in a 7% tax-exempt bond. The $3 tax savings from the $10 interest deduction would serve only to offset the $3 implicit tax. A taxpayer with $10 of personal services income taxable in the 20% bracket would lose $1 in the same transaction, because the $2 tax savings would be $1 less than the $3 implicit tax.

Some commentators have said that tax shelters threaten the ability of the tax system to tax any income from any source. For example, one commentator has written: “If interest has to be deductible in every case, then it is impossible to tax income from any source, once one source

138. See Cooper, supra note 66, at 698-701.
139. See C.E. Steuerle, supra note 48, at 64-65.
Anti-Tax Shelter Provisions

becomes tax-exempt. The interest deduction would just transport the exemption privilege from the favored source to all income."140 As the above examples demonstrate, this concern is overstated as long as tax-preferred investments are subject to a significant implicit tax. Tax shelters undermine the system's ability to tax income subject to marginal rates above the implicit tax rate, but they do not interfere with the taxation of income subject to marginal rates equal to or lower than the implicit tax rate.141

Nevertheless, the possibility of sheltering all income subject to marginal rates above the implicit tax rate may itself be objectionable. First, it makes a mockery of the statutory rate structure at all levels above the implicit tax rate. Second, sheltering of high bracket personal services income has serious revenue implications. Because the government receives no revenue from an implicit tax, by taking full advantage of sheltering opportunities, taxpayers could preclude the government's collection of any actual taxes on personal services income subject to any statutory marginal rate higher than the implicit tax rate.142 Finally, some high bracket taxpayers will not take advantage of sheltering opportunities, either out of ignorance or, more likely, out of distaste for purely tax-motivated transactions. Only those taxpayers will actually pay tax at rates higher than the implicit tax rate. The system arguably treats these taxpayers unfairly.

For these reasons, one might favor provisions to prevent the use of preferences in shelters. Even absent shelters for personal services income, however, one could equally apply each of these three criticisms to the effect on the taxation of capital investment income when the implicit tax rate falls below the top statutory marginal rate. If tax-free bonds and other tax-exempt investments bear an implicit tax burden of only 30%, investors can always avoid statutory marginal rates higher than 30% on their investment income simply by investing in the tax-exempt assets. This observation implicates the three criticisms leveled at the sheltering of high bracket personal services income. First, this ability to avoid high tax rates on investment income by investing in tax-exempt assets makes a

140. Johnson, supra note 44, at 130; see also id. at 145 ("Does the decision to exempt income from some source really imply that income from any source must similarly be exempted by the same amount?"). The quoted passages appear to constitute rhetorical exaggeration, because Johnson has indicated elsewhere that tax shelters do not threaten the system's ability to tax income subject to marginal rates equal to or lower than the implicit tax rate. See Johnson, Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation, 61 Texas L. Rev. 1013, 1037-39 (1983).
141. See Hickman, supra note 33, at 796 ("Interest deductible borrowing could not, for example—as some laymen seem to fear—cause all salaried persons to wipe out their salaried taxable income with interest deductions, to be replaced with interest income from exempt securities.").
142. See C.E. STEUERLE, supra note 48, at 64-65.
mockery of the statutory rates in excess of the implicit rate with respect to investment income. Second, the government can expect tax-preferred income subject only to the implicit tax to replace investment income that otherwise would be subject to marginal rates higher than the implicit rate. As a result, the government will collect little or no tax revenue on investment income at statutory marginal rates above the implicit rate. Finally, such a system is arguably unfair to any taxpayer who pays tax on investment income at a rate above the implicit tax rate.

Thus, each objection to the effect of shelters on the taxation of earned income when the implicit tax rate is significantly lower than the top statutory marginal rate applies as readily to the effect of preferences on the taxation of income from capital. If Congress retains any preferences, the only real solution to these problems would be to amend the tax laws so that the market would impose an implicit tax at least nearly equivalent to the top statutory rate. Such amendments would maintain the integrity of the statutory rate structure: top bracket taxpayers would either pay actual tax at the top marginal rate or bear the burden of an equivalent or nearly equivalent implicit tax. Additionally, this system would not treat unfairly those who chose not to invest in preferred assets or in tax shelters. The other “problem”—revenue loss—is an inevitable cost of the increased investment purchased by the government with preferences; however, changes in the tax laws to bring the implicit tax and the top marginal rate closer together might reduce the amount of revenue loss.143 Furthermore, virtually all of the revenue loss would directly further the purpose of the preference rather than line the pockets of high bracket taxpayers.

How could the tax laws achieve, or at least approach, this ideal situation? Success would require a great reduction in the supply of preferred assets,144 a large increase in the demand for preferred assets among top bracket taxpayers, or a combination of these two approaches.145 Simply eliminating or lessening many of the Code’s tax preferences could reduce the supply. Redesigning the statutory rate structure to increase the

143. If a decrease in the supply of preferences caused the implicit tax to rise to nearly the level of the top statutory rate, the supply decrease could lead to decreased revenue loss. See infra text accompanying notes 144-46. For example, suppose that a decrease in the supply of preferences caused the implicit tax to rise from 30% to 49% and that the top statutory rate remained at 50%. A 30% implicit tax presents the danger of no actual tax collections on income subject to statutory rates of greater than 30%. An implicit tax of 49% reduces that danger to the possibility of no actual tax collections on income subject to statutory rates above 49%.

144. Yoroi, supra note 21, at 408-09.

145. These changes would not address the problem of incomplete capitalization of tax benefits caused by the influence of risk on portfolio choice. See supra notes 133-34 and accompanying text. To the extent that diversification retains a significant influence, the implicit rate could remain below the top marginal rate even after the implementation of these changes.
Anti-Tax Shelter Provisions

amount of taxable income in the top bracket could increase the demand. The 1986 Act moved significantly in both of these directions. First, the Act reduced or eliminated a number of important tax preferences. Second, by introducing a top individual marginal rate of 28%, which takes effect at relatively low levels of income (compared with the former 50% top rate), the Act greatly increased the amount of income in the top bracket. Ironically, these changes respond more appropriately to the problems created by preferences and shelters than the Act’s explicit anti-shelter provisions.

If these changes proved sufficient to raise the implicit tax to, or nearly to, the level of the top statutory rate, the problems described above would disappear (except for some revenue loss) and there would be little reason to object to the effects of the remaining preferences, either within or outside of shelters (assuming, of course, that one agreed with Congress’s decision to encourage investment in the remaining preferred assets). If the implicit tax remained significantly below the top statutory rate, however, all the problems would persist—although the 1986 changes would at least ameliorate the problems by reducing the gap between the implicit and statutory rates. In the latter case, the basic question remains: if the objections to the effects of an implicit tax that is lower than the top statutory rate apply to both income from personal services and income from capital, why restrict the sheltering of personal

146. See supra note 37.
147. See I.R.C. § 1(a)-(c) (Supp. IV 1986). Section 1(g) complicates the picture by imposing a top marginal rate of 33% on high income taxpayers to the extent necessary to phase out the effect of the 15% rate and personal exemptions and effectively impose a 28% flat rate. See id. § 1(g), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1001(a)(3), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3349. If one considers 33% the true top tax bracket under the 1986 Act, then obviously much less income is in the top bracket than there would be without § 1(g). This fact is of limited significance, however, because of the small (5%) difference between the 33% and 28% rates. If the demand for preferred assets among 28% and 33% bracket individual taxpayers (as well as 34% bracket corporate taxpayers, see id. § 11, as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1007(g)(13)(B), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3436) was sufficient to result in an implicit tax of 28%, the windfall available to 33% bracket taxpayers from investing in preferred assets would be only 5%. See Yorio, supra note 21, at 407-08 (discussing reduction in the spread between tax brackets as a way of limiting windfall to high bracket taxpayers); see also Shalow, supra note 66, at 8-11 (suggesting that the flattening of tax rates brought about by the 1986 Act should result in implicit tax rates equal or nearly equal to the top statutory rate).
148. The early evidence on municipal bonds is that the 1986 Act has brought the implicit tax and the top statutory rate closer together, but has not completely eliminated windfall to top bracket investors. Table 1 (see the following page) illustrates this trend. The information necessary to compile the table is taken from Tax Reform Proposals, supra note 136, at 71 (for 1983-1984); 74 Fed. Reserve Bull. A24 (June 1988) (for December 1987-March 1988); 74 Fed. Reserve Bull. A24 (Sept. 1988) (for March-June 1988); 75 Fed. Reserve Bull. A24 (Jan. 1989) (for July-October 1988). The parentheticals in the last two columns for 1988 reflect the effect of the 33% bracket created by the phase-out of the 15% bracket and the personal exemptions. See supra note 147.
149. See supra sections II(B)(1)-(2).
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<th>Implicit tax</th>
<th>Top statutory marginal rate for individuals</th>
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1: Moody's Investor Service's selected long-term bonds.
2: Bond Buyer's 20-bond index.
services income as long as the low implicit tax is still available for investment income?

This Article has previously discussed a possible reason for discriminating against the sheltering of high bracket personal services income: revenue cost. Assuming an implicit tax rate of 30%, if taxpayers can use preferences only outside of shelters, the revenue cost is the tax on the income from capital that would have been taxed, but for investments in preferred assets, at statutory rates above 30%. If taxpayers can also use preferences in shelters, the government incurs the tremendous additional cost of the tax on the earned income that would have been taxed, but for tax shelter investments, at statutory rates above 30%.

As previously explained, however, the revenue cost from both shelter and nonshelter preferences is what the government pays to obtain the desired increased investment in preferred assets. The cost is greater if taxpayers can use preferences in shelters only because the government thereby obtains a greater increase in investment. If Congress would rather pay less and receive a smaller increase in investment, it would make more sense to decrease the amount of the preference itself than to distinguish between preferences in and out of shelters. One advantage of this approach is that it would more likely produce a higher implicit tax, and so less windfall, than antishelter legislation. The higher implicit tax will result both because such measures would decrease the total supply of tax preferences and because the increased demand for preferences in shelters would tend to drive down the return on preferred assets.

The most basic objection to antishelter legislation as a means of reducing the revenue cost of preferences (assuming that the implicit tax is significantly lower than the top statutory rate) is that such legislation discriminates against personal services income relative to income from capital. Legislation that restricts the sheltering of personal services income while permitting tax-preferred investments with low implicit tax rates gives rise to a dual tax rate structure: the statutory structure for earned income and a rate structure for investment income in which the use of preferences outside of shelters has eliminated all statutory rates.

150. See supra subsection II(B)(2)(b).
151. Id. For a discussion of increased investment in preferred assets as a justification for the use of preferences in shelters, see Auerbach, supra note 123.
152. The existence of a significant windfall does not affect this point. The windfall is simply part of the cost of inducing the desired increase in investment.
153. See supra text accompanying notes 124-27.
154. See supra note 143.
155. See supra text accompanying notes 111-14 & 128-36.
above the implicit rate. This structure, which would tax earned income at rates higher than those applicable to income from capital, is fundamentally unfair.156

Again, the better solution would be to decrease the supply of and increase the demand for tax-preferred investments to the point at which the implicit tax rate equaled (or at least approached) the top statutory marginal tax rate.157 But until we reach that goal, fairness requires that the system afford both laborers and property owners the same opportunity to avoid tax rates above the implicit rate on their respective incomes from wages and property.158 An attack on shelters that preserves the

156. Because the implicit tax on tax-exempt bonds was lower in 1983 than the highest marginal tax bracket, purchasers of these bonds received a tax advantage compared to taxpayers whose income consisted solely of salary or other earned income...[Significant tax inequity between municipal bond investors and wage earners exists to the extent of the difference between the maximum tax rate and the implicit tax on state and local government bonds. Yorio, supra note 21, at 401 (footnotes omitted). Yorio fails to note, however, that a wage earner can correct this inequity if he can use preferences in tax shelters.

Incidentally, it is rather odd to see § 469 used in this dual rate structure as part of legislation that also eliminated the special favorable rate for capital gains. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2085, 2216 (repealing I.R.C. § 1222 (1982)).

157. See supra text accompanying notes 144-49.

158. One might argue that income from property should go untaxed on the grounds that a tax on such income inappropriately favors consumption over savings. This argument might serve as a justification for imposing a higher tax rate on income from services than on income from capital. An example, based on a similar example in M. Chirelstein, Federal Income Taxation 290-91 (5th ed. 1988), will illustrate the point. Imagine two individuals, Consumer (C) and Saver (S), each of whom earns $1000 from services in a world without an income tax. C spends his $1000, and S uses her $1000 to buy a 10% bond that pays $100 annually in interest. S consumes the $100 interest annually in the year she earns it. Suppose we now impose a 50% income tax. If C wants to maintain his pre-tax level of consumption, he now must earn $2000: $1000 for taxes and $1000 for consumption. If S wants to maintain her $100 annual income flow, however, she must earn $4000: $2000 for taxes and $2000 for savings. The savings will yield a $200 pre-tax return, but half of that return will go to pay taxes on the interest income, leaving a $100 after-tax annual return. C needs only to double his income to maintain his pre-tax level of consumption, while S needs to quadruple her income to maintain her pre-tax return on her savings. Thus, relative to a nontax world, a comprehensive income tax (that is, a tax on income from labor and property) is less onerous on consumption than it is on saving. One way of eliminating this disincentive to saving would be to impose an income tax on labor income only. Under such a tax, imposed at a rate of 50%, $2000 of labor income earned by S would result in a $1000 tax liability. S could then save the remaining $1000, earning a $100 tax-free annual return. S, then, would only have to double her earnings to maintain her pre-tax annual return—the same increase C needs to maintain his pre-tax level of consumption. A consumption tax, under which income would not be taxed until consumed, would also eliminate the disincentive to save and has been proposed on that basis. See, e.g., Andrews, supra note 30, at 1167-69 (noting that a consumption tax is fairer and more economically efficient, "[i]nsofar as accumulation is viewed as deferred consumption").

Perhaps a system with a lower effective top rate for capital income than for labor income could be justified as a step in the direction of alleviating the disincentive to saving inherent in a comprehensive income tax. There are three problems, however, with that justification. First, the results under a comprehensive income tax are arguably appropriate. If income is an accurate measure of ability to pay, and hence an appropriate tax base, then S should be taxed more heavily than C, for the simple reason that S has more income than C. See Goode, The Superiority of the Income Tax, in What
Anti-Tax Shelter Provisions

availability of preferences outside of shelters is unfair to taxpayers whose taxable income comes from their own labor. 159

4. If There Is Little or No Implicit Tax on Preferred Income.—The rate of return on some preferred assets may closely approximate the pre-

SHOULD BE TAXED: INCOME OR EXPENDITURE? 49, 52-53 (J. Pechman ed. 1980). An income tax will necessarily penalize income-producing activities, such as saving, relative to non-income-producing activities, such as consumption. The income tax preference for consumption over saving is analogous to the income tax preference for leisure over labor, yet no one argues that an income tax on labor income inappropriately penalizes work. Why, then, does an income tax on property income inappropriately penalize investment? (In fact, there are even plausible arguments for taxing labor income at lower rates than property income. See Yorio, supra note 21, at 401 n.49.)

Second, if persuaded by the argument for not taxing property income, one would hardly respond by enacting tax shelter limitations that would have the effect of subjecting income from property to a lower rate of tax than income from labor. Instead, one would simply exempt all property income from tax or adopt a consumption tax. Antishelter legislation is an extremely indirect and ineffective response to the savings disincentive of a comprehensive income tax.

Finally, antishelter legislation is a surreptitious means of obtaining a lower tax rate for income from property than for income from services. If Congress wants to make such an important and controversial move, it should do so openly, after a full explanation to the public of what is at stake and a thorough national debate on the merits of such a system.

159. These fairness concerns suggest a criticism of the proposal to allow the deduction of interest associated with an investment in a tax-favored asset only to the extent that the return on the asset bears an implicit tax. See supra note 66. Under such a proposal, a taxpayer could not use a tax shelter to reduce the effective tax rate on labor income to the level of the implicit tax rate. See Cooper, supra note 66, at 722-23 ("The net return to the levered investor would then be precisely zero, denying him any benefit from tax leverage . . . .").

Consider the example discussed at supra note 66. The top statutory rate is 50%, a taxable bond pays 10%, and a tax-exempt bond pays 7%. The return on the exempt bond is thus subject to a 30% implicit tax. A taxpayer with labor income in the 50% bracket borrows $100 at 10% to buy a $100 tax-exempt bond paying 7%. If the $10 interest expense is fully deductible, the taxpayer will avoid the 50% tax on $10 of labor income, at the cost of a 30% implicit tax (determined by the difference between the $10 interest expense and the $7 interest income). The taxpayer thus will have reduced the effective tax on $10 of his labor income to the 30% rate of the implicit tax. He will have a $2 profit from the transaction—the difference between the $5 in actual taxes saved and the $3 implicit tax cost.

Now suppose that a partial disallowance rule is in effect. Because only 60% of the taxpayer's return on the debt financed tax-exempt bond is, in effect, fully taxed by the implicit tax, see supra note 66, only 60% ($6) of the taxpayer's $10 interest expense is deductible. The $6 interest deduction shelters $6 of 50% bracket labor income from tax, reducing the taxpayer's tax liability by $3. This $3 tax savings serves only to offset the $3 pre-tax loss (from paying $10 interest to earn a $7 return). The taxpayer has not made a profit from the transaction; he has not been able to replace his 50% statutory rate with a lower implicit tax. One way of understanding this is to note that the allowance of a $6 deduction against 50% bracket income is the equivalent, in terms of taxes saved, of allowing a $10 deduction against 30% bracket income. The rate of tax savings from the interest deduction is thus limited to the 30% implicit tax rate on the investment. This limitation makes profitable tax sheltering impossible, with such a limitation a taxpayer cannot use a shelter to replace the statutory tax burden with a lower implicit tax burden. Thus, if one is persuaded that tax shelters promote fairness by enabling taxpayers to reduce the effective tax rate on labor income to the implicit tax rate on income from capital, one must oppose the partial disallowance proposal.

One other objection to the partial disallowance proposal follows from this analysis. The partial disallowance proposal aims to eliminate the profitability of leveraged tax shelter investments. It should have the effect, therefore, of reducing the demand for preferred assets in tax shelters. The reduced demand should lead to lower prices for, and higher returns on, preferred assets. Higher returns mean a lower implicit tax. See supra text accompanying notes 111-15. The partial disallowance proposal thus would likely lower the implicit tax.
tax rate of return on fully taxable assets; these assets bear little or no implicit tax. Two different situations—one involving the effect of financial arbitrage on the rate of return on preferred assets sold in liquid markets, and the other involving "pure tax arbitrage"—may lead to this result. This section examines each of these situations and considers the policy implications of the lack of a significant implicit tax on some preferred assets.

(a) **Financial arbitrage.**—Market forces normally drive the return on preferred assets below the return on fully taxed assets and thus create an implicit tax. C. Eugene Steuerle argues, however, that an array of forces works against the preservation of an implicit tax on preferred assets sold in liquid markets.\(^\text{160}\)

Suppose the market has imposed an implicit tax of 30% on the income from tax-preferred assets; taxable bonds pay 10% interest, and the return on a tax-exempt asset of equal risk is 7%. A 50% bracket taxpayer will have an incentive to borrow cash at 10% interest (deductible) to invest in a preferred asset yielding a nontaxable 7% return. But consider the effect of the difference in pre-tax rates of return on a nontaxable investor.\(^\text{161}\) A nontaxable investor could profitably "borrow" the preferred asset at a cost of 7% to invest in cash (that is, to lend) at 10%.\(^\text{162}\) The nontaxable investor will be able to do this if it is possible to have what Steuerle calls a "negative holding"\(^\text{163}\) of the preferred asset. Suppose that the preferred asset is growth stock (the income on which will take the form of untaxed unrealized appreciation) and that the nontaxable investor can make a short sale of the stock—receive cash equal to the current value of the stock, in exchange for a promise to deliver the stock at a specified time in the future. The short sale amounts to a negative holding in the stock.\(^\text{164}\) If the stock appreciates at a 7% annual rate, the investor's "borrowing" cost on the short sale will be 7%. If, for example, the investor must deliver the stock one year after he receives the cash and the stock has appreciated 7% during the year, it will cost the investor 7% more than he received from the short sale to purchase the stock for the required delivery. In the meantime, the investor will have loaned out the cash from the short sale at a 10% rate of interest. Thus, the investor will have made a profit from the transaction equal to the difference between the 10% return he received and the 7% "borrowing"

\(^{160}\) C.E. STEUERLE, supra note 48, at 81-92.

\(^{161}\) Examples include a local government, a charity, a pension fund, or a foreign investor.

\(^{162}\) C.E. STEUERLE, supra note 48, at 83.

\(^{163}\) Id. at 81.

\(^{164}\) Id.
Anti-Tax Shelter Provisions

cost he incurred.\textsuperscript{165} This example illustrates financial arbitrage—profiting from the disparity in pre-tax rates of return on different assets.\textsuperscript{166} Even taxable investors can profit from such financial arbitrage, if they can arrange to recognize—and therefore deduct—the costs of engaging in the financial arbitrage transaction.\textsuperscript{167} If the income (10\%) from the transaction is taxable and the expense (7\%) is deductible, both at the same marginal tax rate, any financial arbitrage transaction that is profitable for a nontaxable investor will also be profitable for a taxable investor.\textsuperscript{168}

The significance of such financial arbitrage transactions, based on negative holdings of preferred assets, concerns their effect on the existence or nonexistence of an implicit tax. When the pre-tax rate of return on a tax-preferred investment was below the rate of return on loans and other fully taxable investments (in other words, when an implicit tax existed), financial arbitrage would operate to equalize the pre-tax rates of return on the preferred and taxable investments. Steuerle explains:

[Financial arbitrage is a major force that prevents the interest rate from rising relative to rates of return on many preferred assets. Whenever rates of return on assets of equal risk begin to depart from each other [because of the implicit tax], traders, governments, nontaxable firms, individuals, and foreign investors increase the share of their portfolios in interest-bearing assets and sell short their preferred assets.\textsuperscript{169}]

This financial arbitrage activity should continue until it equalizes the pre-tax rate of return on preferred assets and the taxable interest rate, thus eliminating the implicit tax on the preferred assets.\textsuperscript{170}

What are the implications of this analysis for the proper legislative treatment of tax shelters? Certainly, any large-scale use in tax shelters of preferences bearing no implicit tax poses an unacceptable threat to tax

\textsuperscript{165} Steuerle suggests this example. See id. at 83.
\textsuperscript{166} Id. at 57.
\textsuperscript{167} Steuerle explains: "Current tax rules . . . almost never require the exclusion of the losses and deductible payments even though the gains and receipts are excluded on the opposite side of the ledger." Id. at 84.
\textsuperscript{168} Id. at 83-85.
\textsuperscript{169} Id. at 91.
\textsuperscript{170} Id. at 85, 91-92. As demand for negative holdings of an asset increases, the rate of return on the asset will increase. (Consider the example of borrowing, which is a negative holding of cash. As demand for loans increases, the interest rate on loans—the rate of return on loaned cash—will increase.) Thus, when financial arbitrage creates demand for negative holdings of preferred assets, the rate of return on the preferred assets will increase, resulting in a greater cost to the "borrowers" who have negative holdings of the preferred asset. At the same time, financial arbitrage encourages investors to invest in interest-bearing assets, and the increased demand for such assets will cause the rate of return on those assets—that is, the taxable interest rate—to decrease, resulting in lower returns to holders of the nonpreferred asset. This process should continue until the rate of return on the preferred assets equals the taxable interest rate, which should eliminate the implicit tax.
revenues. As long as there is an implicit tax, actual tax collections will be replaced by the implicit tax only for income that would be taxed at statutory marginal rates above the implicit rate. The government would still collect actual taxes on income subject to marginal rates lower than the implicit rate. But if there is no implicit tax, taxpayers can use shelters to eliminate their entire tax liabilities. If a taxpayer can borrow at 10% interest (deductible) to invest at a 10% return (nontaxable), he will find it profitable to do so until he has eliminated all of his income tax liability, regardless of the rate at which his income is taxed.\footnote{171} This complete sheltering of income is possible because there is no pre-tax cost—no implicit tax—to the transaction. This monstrous threat to tax revenues is reason enough to prohibit the use in shelters of preferences that are not subject to an implicit tax.

Sweeping antishelter provisions, however, are not necessarily the best way of dealing with this threat. Rather than prohibiting the use of such preferences in shelters, eliminating the preferences themselves (so far as possible) would be a better approach.\footnote{172} Suppose, for example, that tax-free municipal bonds bore no implicit tax—that is, that they carried the same pre-tax interest rate as comparable taxable bonds. The use of these exempt bonds in shelters would be unacceptable, but the use of these bonds outside of shelters would be no less objectionable. A tax preference for municipal bond interest would not serve any public purpose if the entire federal tax revenue that was lost because of the preference went as a windfall to investors and none went toward reducing the borrowing costs of local governments. Thus, removing the preference from the Code altogether would be better than simply restricting the use of the preference in shelters.

Moreover, even if Congress should choose not to eliminate these preferences entirely, the present scope of the Code’s antishelter provisions is broader than necessary to control their use in shelters. As Steuerle acknowledges, preferred assets not sold in highly liquid markets bear significant implicit taxes.\footnote{173} The complex financial arbitrage mechanism requiring negative holdings of preferred assets can effectively eliminate implicit taxes only on liquid preferred assets. Thus, Steuerle recognizes the existence of substantial implicit taxes on real estate,\footnote{174} and one would also expect significant implicit taxes on other less liquid pre-
Anti-Tax Shelter Provisions

ferred assets, including machinery and equipment. In recent years, real estate has accounted for the bulk of syndicated tax shelter investments.\footnote{See Lewicki, supra note 86, at 102 n.6. In 1986, for example, sales of syndicated real estate limited partnership interests constituted approximately $11.1 billion of the approximately $16.7 billion in total sales of syndicated limited partnership interests. Id.} It would make little sense, then, to use the possibility of a lack of implicit taxes on some preferred assets to justify section 469, when the passive loss restrictions of section 469 primarily affect shelters based on a preferred asset—real estate—that bears a significant implicit tax.\footnote{Because the 1986 Act reduced the ACRS benefits for real estate, sales of real estate shelters would have diminished even without § 469. See I.R.C. § 168(b)(3), (c) (Supp. IV 1986), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1002(a)(11)(C), (i)(2)(A), (i)(2)(B)(i), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3354, 3370 (originally enacted as Tax Reform Act of 1986, Pub. L. No. 99-514, § 201(a), 100 Stat. 2085, 2121) (providing for straight-line depreciation for real property, over a 27.5-year period for residential rental property, and over a 31.5-year period for other real property). Prior to the Act, real property was generally eligible for depreciation over a 19-year period, using the 175% declining balance method. See I.R.C. § 168(b)(2) (1982) (repealed 1986).}

To the extent that tax preferences involving no implicit tax remain, limited versions of the antishelter provisions of the 1986 Act might focus solely on the use of these preferences in shelters. Depending on which proves more practical, such provisions could either identify the preferences that are subject to their limitations or apply to all preferences except those that the provisions expressly exclude, such as real estate preferences. In either form, these provisions, unlike the current antishelter measures, would focus on dealing with only the actual problems.

\textbf{(b) Pure tax arbitrage.}—The other situation in which there may be no implicit tax concerns "pure tax arbitrage." Suppose a taxpayer borrows $2000 at 10% interest and uses the borrowed money to fund an individual retirement account (IRA), the only asset of which is a $2000 bond paying 10% interest. Although the $200 in interest the bond pays annually is ordinarily taxable, the income of an IRA is tax exempt.\footnote{See id. § 408(e)(1) (1982). More precisely, the income of an IRA is not subject to tax as long as it remains in the IRA. Id. Instead, tax is deferred until the taxpayer receives distributions from the account. Id. § 408(d) (1982 & Supp. IV 1986), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1011(b)(1)-(3), (f)(5), 1011A(a)(2)(A), 1018(i)(3)(D), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3456, 3463, 3472, 3588.} If the taxpayer can deduct his $200 interest expense on the borrowed funds, the transaction will produce a $200 tax loss and shelter $200 of unrelated income from tax.

That the bond purchased for the IRA bore no implicit tax was not due to its status as a tax-preferred asset. The tax exemption was a feature of the entity holding the asset rather than of the asset itself. Whenever the tax exemption is an attribute of the taxpayer, rather than of the asset,
the taxpayer faces no implicit tax. In this situation, the taxpayer does not have to compete in the market to obtain the tax preference, and so the market does not reduce the pre-tax rate of return on the tax-preferred income. Commentators have termed this kind of tax sheltering, based on preferences that are not subject to the market pricing mechanism, “pure tax arbitrage.” This term reflects that “all the gains from these transactions are induced by pure manipulation of the tax system.” Borrowing at 10% to lend at 10% yields no possible economic gain or loss; the impetus for such transactions comes purely from the tax consequences of combining deductible expenses with nontaxable income.

The reason for the absence of an implicit tax in the case of pure tax arbitrage differs fundamentally from the reason for the lack of an implicit tax on liquid assets affected by financial arbitrage. In the case of tax-preferred liquid assets, market forces tend to create an implicit tax by driving down the pre-tax return, but countervailing market forces tend to eliminate the implicit tax. By contrast, in the case of pure tax arbitrage, the market simply cannot take into account the existence of the preference, because the preference is not an attribute of the asset that produces the preferred income.

What are the policy implications of pure tax arbitrage? Does the absence of any implicit tax in shelters based on pure tax arbitrage—and the consequent windfall to taxpayers who engage in such arbitrage—mean that Congress should prohibit such activities? The answer depends on one’s view of the purposes of the preference forming the base for the pure tax arbitrage. Each source of pure tax arbitrage (each preference not subject to the market-pricing mechanism) needs to be evaluated to determine whether permitting pure tax arbitrage based on that particular source makes sense. For example, one might argue that the tax system should not permit tax shelters based on IRAs, because the purpose of

178. See Hickman, supra note 33, at 821; Warren, supra note 8, at 565-67.
179. See Cooper, supra note 66, at 701; Shakow, supra note 66, at 4.
180. C.E. Steuerle, supra note 48, at 60.
181. See id.
182. See supra text accompanying notes 111-15 & 160-70.

552
Anti-Tax Shelter Provisions

IRAs is to encourage retirement savings\textsuperscript{184} and a purchase of an IRA with borrowed funds does not result in net savings.\textsuperscript{185} On the other hand, it may be appropriate to encourage borrowing to invest in an IRA if there is reason to believe the taxpayer will repay the loan with funds other than those from the IRA, which he otherwise would not have saved for retirement. In this situation, the taxpayer would actually increase his retirement savings despite the borrowing.\textsuperscript{186}

Even if one concludes that the system should not permit pure tax arbitrage based on IRAs, sweeping antisheelter provisions, such as those of the 1986 Act, would remain an inappropriate response. Pure tax arbitrage based on IRAs constitutes a minuscule part of all tax sheltering,\textsuperscript{187} and to prohibit all sheltering because of policy objections to such a small portion would be absurd. Even if one objected to all tax sheltering based on investments not subject to market pricing mechanisms, the 1986 provisions would constitute drastic overkill, considering one commentator’s estimate that prior to the enactment of the 1986 Act, tax-preferred investments not subject to the market pricing mechanism constituted only about 10% of the tax-preferred investments of individual taxpayers.\textsuperscript{188} If one objects to a particular kind of pure tax arbitrage, a less drastic and more sensible solution would be legislation narrowly aimed at preventing that type of arbitrage. Congress might amend the Code to prohibit the deduction of interest on, for example, debt associated with IRA investments. Or, if one believes that such legislation would be ineffective because of the difficulties of devising appropriate and effective rules for associating debt with particular investments,\textsuperscript{189} two other possible choices exist. One is to eliminate the source of the arbitrage itself, by repealing the particular preference not subject to the market pricing mechanism.\textsuperscript{190} An example would be the elimination of IRAs. The criticism of that contention, see Taggart, Denial of The Personal Interest Deduction, 41 TAX LAW. 195, 271-72 (1988).

\textsuperscript{184} See General Explanation, supra note 2, at 625.

\textsuperscript{185} See supra note 85.


\textsuperscript{187} The maximum amount that a taxpayer can contribute to an IRA (without penalty) is $2000 annually. See I.R.C. § 219(b)(1) (1982) (limiting deductible contributions to the lesser of $2000 or the amount of compensation includable in the taxpayer’s gross income for such taxable year); see also id. § 408(o)(2) (concerning the limit on nondeductible contributions); id. § 4973 (1982 & Supp. IV 1986), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1011(b)(3), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3456 (authorizing taxation of excess contributions).

\textsuperscript{188} Yorio, supra note 21, at 404 n.62.

\textsuperscript{189} On the difficulties such rules entail, see infra text accompanying notes 284-302.

\textsuperscript{190} Wholesale repeal of preferences that are not subject to the market pricing mechanism might have the favorable side effect of decreasing the pre-tax rate of return (and increasing the implicit tax)
other choice is to accept a certain amount of pure tax arbitrage as a side
effect of an otherwise desirable preference. For example, if the Code's
IRA provisions promote real retirement savings by many taxpayers and
if the expected damage from pure tax arbitrage is sufficiently limited,191
Congress might choose to accept that some taxpayers will use IRAs inap-
propriately as a source of pure tax arbitrage.

The basic point is simple. Some tax sheltering based on pure arbi-
trage—such as borrowing to invest in an IRA—may be considered objec-
tionable. But even if it is objectionable, it would make little sense to
prohibit all tax sheltering because of objections limited to a small portion
of the tax shelter universe. Other, less drastic responses to problems of
pure tax arbitrage are possible and preferable.

5. **Summary.**—The implicit taxes that the market imposes in re-
response to the existence of tax preferences can vary markedly. The mar-
ket may impose an implicit tax that equals or nearly equals the top
statutory marginal rate, levy an implicit tax significantly lower than the
top statutory rate, or exact little or no implicit tax. The analysis of tax
shelters in light of the implicit tax phenomenon suggests the advisability
of certain changes in the tax laws—particularly changes designed to
bring the implicit tax rate and the top statutory marginal rate closer to-
gether. The analysis does not, however, support the 1986 Act's sweeping
attack on tax shelters.

III. An Examination of the 1986 Act's Antishelter Provisions

The previous Part of this Article concludes that attempting to elimi-
nate shelters without eliminating preferences makes little theoretical
sense. An unavoidable tension arises in a system that permits the use of a
preference in one situation but prohibits the use of the same preference in

on preferences that are subject to the market pricing mechanism. Elimination of one category of
preferences would lead to a greater demand for others, and greater demand would lead to higher
prices for, and lower pre-tax returns on, the remaining preferences. See Yorio, supra note 21, at 401-
05. The extent of the reduction in the pre-tax returns on the remaining preferences, however, might
not be very significant. Edward Yorio has concluded that if Congress had repealed all the prefer-
ences not subject to the market pricing mechanism that existed prior to the 1986 Act, the effect on
the pre-tax returns of the remaining preferences would have been "relatively insignificant." Id. at
405. Because the implicit tax on those preferences would not have risen to the level of the top
marginal tax rate, substantial windfalls would have remained. He based this conclusion on a finding
that tax-preferred investments not subject to the market pricing mechanism constituted only a small
part of the total market in tax-preferred investments. Id. at 404 n.62.

191. In this regard, note that statutory limits on the source of the arbitrage may restrict the
opportunities for pure tax arbitrage. For example, as long as a taxpayer can contribute only $2000
per year to an IRA, see supra note 187, IRA-based pure tax arbitrage can do no more than slightly
dent the integrity of the income tax system.
Anti-Tax Shelter Provisions

a different situation. This Part assumes, for the sake of argument, the appropriateness of the goal of attacking shelters without attacking preferences and asks whether the 1986 Act’s antishelter provisions are well designed to accomplish that goal. This Part discusses three major objections to the structure of the antishelter provisions. First, the rationale for the Act’s rules concerning the kinds of deductions that can offset certain kinds of income (the basin gling rules) is difficult to discern. Second, the rules concerning the allocation of interest expense among various activities allow manipulation, discriminate among similarly situated taxpayers, and pose significant difficulties of administration. Finally, the “material participation” standard of section 469 is difficult to administer and has questionable policy justifications. Consideration of the material participation standard also brings to light another problem—what to do about real economic losses—inherent in the antishelter provisions of the 1986 Act.

A. The Details of the Antishelter Provisions

Before considering these objections in depth, it is first necessary to explore the particulars of the Act’s antishelter provisions.

I. Passive Loss Limitations.—Under section 469, a taxpayer may deduct losses from passive activities only against income from other such activities. Disallowed losses are suspended and may be taken against passive income of later years or against income from any source upon final disposition of the passive activity. Recall the example of taxpayer A, who borrows $100 at 8% interest to buy a $100 building. The building’s rental income, net of all expenses except depreciation and the $8 interest expense, is $10. Economic depreciation is $2, but the tax depreciation allowance is $5. In economic terms, the investment generates no net income or loss: $10 — $8 — $2 = $0. A, however, has a tax loss: $10 — $8 — $5 = —$3. If section 469 applies, A can deduct the $3 loss only against passive income. If A has no passive income, section 469

193. See id. § 469(b).
195. Section 469 generally applies to losses from passive activities, and passive activities include any rental activities. See id. § 469(c)(2). It does not apply, however, to a limited amount of losses from rental real estate activities in which the taxpayer actively participates. See id. § 469(f), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1005(a)(6)-(7), 6009(c)(3), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3388, 3690 (discussed at infra text accompanying notes 215-16). The facts of the hypothetical are insufficient to determine whether A would qualify for this exception.
suspending the loss. A may use the §3 depreciation tax preference to shelter passive income (if A has any), but not any other kind of income. Suppose, in the above example, the building generated $12 in net rental income instead of $10. A would then have $2 of economic income from the investment: $12 — $8 — $2 = $2. A’s tax loss thus would be: $12 — $8 — $5 = —$1. The $1 loss would be subject to section 469 and therefore could offset only passive income from other activities. Of the §3 depreciation preference, $2 would serve to shelter the $2 of economic income from the activity; section 469 does not restrict that use of the preference. But the other $1 of the preference created a $1 tax loss, and section 469 makes that loss deductible only against passive income.196

Section 469 defines a passive activity as the conduct of any trade or business in which the taxpayer does not materially participate.197 A taxpayer materially participates in an activity if he is active in its operations on a “regular, continuous, and substantial” basis.198 According to the Senate Finance Committee report on the 1986 legislation, “the presence or absence of material participation generally is to be determined with reference to all of the relevant facts and circumstances.”199 The Department of the Treasury, however, has issued temporary and proposed regulations that define material participation primarily in terms of the number of hours the taxpayer devotes to the activity.200 Under these regulations, an individual is considered to have materially participated in an activity if he spent more than 500 hours during the taxable year in the activity.201

The regulations also acknowledge that the material participation

196. A similar limitation applies to tax credits. A taxpayer may use credits from passive business activities only to offset tax attributable to passive income. See id. § 469(a)(1)(B), (d)(2). The section suspends excess credits, which a taxpayer may use in future years against tax due to passive income. See id. § 469(b). Unlike suspended losses, however, see id. § 469(g), disposition of the activity does not trigger the allowance of suspended credits.

197. See id. § 469(c)(1).

198. Id. § 469(b)(1).


201. Id. § 1.1469-5T(a)(1). Fewer than 500 hours will satisfy the test if an individual’s participation in the activity constitutes substantially all of the participation by anyone in the activity, id. § 1.1469-5T(a)(2), or if an individual devotes more than 100 hours to the activity and no one else devotes more time to the activity than that individual. Id. § 1.1469-5T(a)(3). Additionally, if an individual spends more than 100 hours on each of several activities and the total time spent on all those activities exceeds 500 hours, the IRS will treat those efforts as material participation in each of the activities. Id. § 1.1469-5T(a)(4). Two special rules treat an individual as materially participating based on the events of prior years. If an individual materially participated in an activity for any five of the ten immediately preceding years, then the rules treat the individual as materially participating for the current year. Id. § 1.1469-5T(a)(5). For any personal service activity, the rules treat an individual as materially participating for the current year if he materially participated in the activity for any three such preceding years. Id. § 1.1469-5T(a)(6).
Anti-Tax Shelter Provisions

standard may be satisfied on the basis of all the facts and circumstances. The regulations do not detail how the IRS will apply this test, but they do state that a taxpayer cannot satisfy the test if he did not devote more than 100 hours to an activity during the taxable year. The Senate Finance Committee report, on the other hand, discusses the application of the facts and circumstances test at some length. The report indicates that a taxpayer is most likely to participate materially in an activity if it is his principal business. The report states that this factor is not conclusive, however, as a taxpayer may materially participate in several businesses, or in none. Another factor indicating material participation is the taxpayer's regular presence at the activity's place of business. But this too is not conclusive. The report notes that the performance of management functions can constitute material participation, but warns that mere participation in management does not automatically satisfy the standard. Special rules apply concerning material participation by limited partners. The statute provides that limited partners ordinarily cannot materially participate with respect to their limited partnership interests.

All rental activity is treated as passive, even if the taxpayer materially participates in it. The statute defines rental activity as “any activity where payments are principally for the use of tangible property.” The regulations provide six exceptions to this definition, however, including an exception for rental activities in which each customer uses the

202. See id. § 1.469-5T(a)(7).
203. See id. § 1.469-5T(b)(2)(iii).
206. See id. at 733.
207. Id.
208. A taxpayer may frequently be present at the activity's place of business without materially participating, and he may materially participate without being present at the activity's principal place of business. Id.
209. Id. at 734.
210. See id. The regulations provide that an individual's participation in management cannot satisfy the facts and circumstances test if there is a paid manager for the activity or if any other person performs management services that exceed those performed by the individual. See Temp. Tres. Reg. § 1.469-5T(b)(2)(i) (1988).
211. See I.R.C. § 469(h)(2) (Supp. IV 1986). The regulations, however, provide exceptions to the general rule. It does not apply if the individual devoted more than 500 hours to the activity, if the individual is treated as materially participating under one of the rules based on activities in prior years, or if the owner of a limited partnership interest is also a general partner in the same partnership. See Temp. Tres. Reg. § 1.469-5T(e) (1988).
212. See I.R.C. § 469(c)(2) (Supp. IV 1986).
213. Id. § 469(j)(8).
property for an average of seven days or less. Under a special rule, a taxpayer may deduct up to $25,000 of losses from rental real estate activities against nonpassive income if he actively participates in the activity. The level of activity required to satisfy the active participation test is lower than that required for material participation.

The policy behind section 469 is that passive business losses should offset only passive business income and should not be deductible against either personal services income or portfolio income (such as interest, dividends, and royalties). Section 469 contains special rules designed to prevent taxpayers from avoiding the limitations on passive loss deductions through the strategy of combining a passive loss activity with personal services income or portfolio income. Suppose a lawyer is a limited partner in a tax shelter partnership that generates passive losses. Suppose also that the lawyer performs legal services for the limited partnership, for which he receives compensation. If the lawyer could treat the compensation as passive income from his limited partnership interest, he could shelter it with his share of partnership losses. The statute prevents this sheltering of earned income by providing that "[e]arned income . . . shall not be taken into account in computing the income or loss from a passive activity for any taxable year." This segregation of the earned income from the passive loss prevents a taxpayer from using the loss to shelter the income. A similar segregation requirement applies to portfolio income.


216. The statute does not define active participation, though it does state that a limited partner cannot actively participate with respect to his limited partnership interest, except as regulations may otherwise provide. See id. § 469(i)(6)(C), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1005(a)(7), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3388. According to the legislative history, a taxpayer can actively participate without satisfying the "regular, continuous, and substantial" involvement standard for material participation "so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense." S. REP. No. 313, supra note 12, at 737-38. The availability of the $25,000 in deductible losses begins to phase out when the taxpayer's adjusted gross income (determined without regard to passive activity losses) exceeds $100,000, and the phase-out is complete at $150,000 adjusted gross income. See I.R.C. § 469(c)(3)(A) (Supp IV 1986).

217. The performance of these services would not constitute material participation for two reasons. First, a limited partner generally cannot satisfy the material participation standard. I.R.C. § 469(h)(2) (Supp IV 1986). Second, even if the lawyer were a general partner, his performance of legal services would probably not amount to material participation: "Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public." S. REP. No. 313, supra note 12, at 735.

Anti-Tax Shelter Provisions

Portfolio income generally includes interest, dividends, annuities, royalties, and gains from the sale of property producing such income and property held for investment (other than passive activities). Net portfolio income (portfolio income less related expenses, including interest expense) is not taken into account in determining income or loss from a passive activity. This rule prevents a taxpayer from sheltering portfolio income by transferring portfolio investments to business entities that produce passive losses. The Senate Finance Committee report gives the example of a limited partnership that publishes a magazine at a tax loss and that also holds profitable portfolio investments in stocks and bonds. Each limited partner must account for the portfolio income separately from the magazine losses and cannot offset the portfolio income with those losses.

When a taxpayer disposes of his entire interest in a passive activity through a fully taxable transaction, the statute allows him to use any suspended losses from the activity in full against income from any source. Recall taxpayer A, who buys an apartment building with $100 borrowed at 8% interest. In the first year, A has a tax loss of $3 ($10 in rental income minus a $5 depreciation deduction minus $8 in interest), but the loss is suspended under section 469. Suppose that during the first year, A makes a (nondeductible) $2 principal payment on the loan, which reduces the loan balance to $98. At the beginning of the second year, A disposes of the property by transferring it to the lender in full satisfaction of the loan. This transfer is a taxable disposition of A's entire interest in the activity and thus triggers the allowance of A's $3 suspended loss. At first glance, this result might seem too generous, because the loss was artificial: A did not actually suffer a $3 economic loss. Note, however, that the full $5 depreciation deduction in the first year reduced A's basis in the building to $95, despite the suspension of the $3 loss. As a result, A has a $3 gain on the disposition ($98 realized from relief from...


221. See S. REP. No. 313, supra note 12, at 729.


223. “[B]asis is reduced as under present law, even in the case where deductions are suspended under the passive loss rule.” S. REP. No. 313, supra note 12, at 723 n.9.
the indebtedness less $95 basis). This $3 gain is offset by the $3 passive loss for a net tax result of no income or loss. This is the proper result, because A has experienced no economic gain or loss on the property.\textsuperscript{224} As this example suggests, allowing suspended losses upon disposition of an activity does not permit the deduction of artificial losses. Any artificial losses will be offset by artificial gains realized on disposition.

Full allowance of suspended losses is triggered only by a fully taxable disposition of a taxpayer's entire interest in a passive activity.\textsuperscript{225} Thus, identifying the scope of an activity is necessary to determine whether the taxpayer has made the requisite disposition of his entire interest.

The scope of an activity is also crucial in applying the material participation standard. Consider a taxpayer involved in two related undertakings who materially participates in only one of them. If the two undertakings are separate activities, the one in which the taxpayer does not materially participate will be a passive activity. If, instead, the two undertakings constitute a single activity, the taxpayer's material participation with respect to one undertaking will make the entire activity nonpassive.\textsuperscript{226} According to the Senate Finance Committee report, the determination of the scope of an activity is "to be made in a realistic economic sense."\textsuperscript{227} An activity includes those "undertakings [that] consist of an integrated and interrelated economic unit."\textsuperscript{228} The form of the legal entity is not controlling. An entity such as a partnership or an S corporation may be participating in several different activities, or several entities may jointly carry on a single activity.\textsuperscript{229}

The structure of section 469 makes income-producing passive activities attractive to taxpayers, because unrelated passive losses can shelter the passive income from such activities. However, a provision of the statute that gives Treasury the authority to write regulations "requiring net income or gain from a limited partnership or other passive activity to be

\textsuperscript{224} A's cash flow reflects his economic result: $10 (rental income) -- $8 (interest paid) -- $2 (principal paid) = $0.


\textsuperscript{226} S. REP. No. 313, supra note 12, at 738-39.

\textsuperscript{227} Id. at 739.

\textsuperscript{228} Id.

\textsuperscript{229} Id. at 740.
Anti-Tax Shelter Provisions

treated as not from a passive activity" may frustrate the quest for passive income. Treasury can use this authority to write regulations providing that even though losses from certain kinds of investments are passive (and thus subject to the limitations of section 469), income from those investments is not passive and therefore cannot be offset by passive losses. Relying in part on guidance contained in the legislative history, Treasury has issued temporary and proposed regulations recharacterizing passive income as nonpassive in six situations. In each of the situations, the recharacterized income closely resembles either active business income or portfolio income, so that its sheltering by passive losses arguably would be inconsistent with the purposes of section 469.

230. I.R.C. § 469(f)(3) (West Supp. 1988). In addition, § 469(f)(2) gives Treasury the authority to write regulations "which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)." Id. § 469(f)(2).

231. See S. REP. No. 313, supra note 12, at 730-32 (stating that the regulations "will prevent taxpayers from structuring income-producing activities . . . (including those that do not bear significant expenses) in ways that are designed to produce passive income that may be offset by unrelated passive losses" and giving examples of possible regulations to prevent this sheltering); 2 H.R. CONF. REP. No. 841, supra note 204, at 147 (discussing and giving examples of Treasury's regulatory authority in defining nonpassive income), reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4235.

232. See Temp. Treas. Reg. § 1.469-2T(f) (1988). The situations in which the regulations recharacterize passive activity gross income are so-called significant participation activities—that is, activities in which the taxpayer participates for more than 100 hours during the year, but in which he does not materially participate—see id. § 1.469-2T(f); the rental of nondepreciable property, see id. § 1.469-2T(f)(3); equity-financed lending activities, see id. § 1.469-2T(f)(4); the rental of property developed by the taxpayer, see id. § 1.469-2T(f)(5); self-rented property, see id. § 1.469-2T(f)(6); and the licensing of intangible property by pass-through entities, see id. § 1.469-2T(f)(7). The preamble to the regulations warns that additional recharacterization rules may be included in future regulations:

The Service recognizes that the rules in these regulations are not exhaustive and that taxpayers may structure additional investments that have economic characteristics similar to those of portfolio investments so as to derive passive activity gross income from such investments. The Service intends to monitor developments in this area closely, and anticipates prescribing additional regulations to the extent necessary to prevent portfolio-type income from being treated as passive activity gross income.


For a harsh criticism of many of the recharacterization rules of the proposed regulations, especially of the rules concerning significant participation activities, see American Bar Ass'n, Section of Taxation Special Task Force on Passive Losses, Preamble to the Comments on PAL Proposed Regulations, 39 TAX NOTES 1325, 1327 (1988).


Special unfavorable treatment is also provided for publicly traded partnerships by an amendment to § 469 in the Revenue Act of 1987. The amendment provides that § 469 "shall be applied separately with respect to items attributable to each publicly traded partnership." Revenue Act of 1987, Pub. L. No. 100-203, § 10212(a), 1988 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 1330, 1330-82 (codified at I.R.C. § 469(k)(1) (West Supp. 1988)). Because of this rule, income from such a partnership cannot be sheltered by passive losses from any other source, and losses from such a partnership cannot offset passive income from any other source. See H.R. REP. No. 391, 100th Cong., 1st Sess. 1072-75 (1987).

Another 1987 amendment treats certain publicly traded partnerships as corporations for in-
2. *The Investment Interest Deduction Limitation.*—Under section 163(d), taxpayers can deduct investment interest only against net investment income.234 The statute suspends and carries forward disallowed interest deductions.235 Net investment income is defined as the excess of investment income over investment expenses.236 Investment income generally includes: (1) interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business; (2) gain from the sale of property producing such income; and (3) gain from the sale of other investment property.237 Investment expenses are those deductions, other than interest, that are directly connected with the production of investment income.238 Investment interest is interest on indebtedness properly allocable to investment property.239

The preference concerned in cases to which section 163(d) applies will usually be the deferral of tax on unrealized appreciation.240 Suppose

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235. See id. § 163(d)(2).
236. See id. § 163(d)(4)(A).
238. See id. § 163(d)(4)(C).
that taxpayer B borrows $100 at 10% interest and invests the money in growth stock. During the first year, the stock pays a $3 dividend and appreciates $7 in value, and B pays $10 in interest on the loan. The economic result is a wash: $3 + $7 - $10 = $0. Without section 163(d), however, B would have an artificial tax loss of $7 ($3 - $10 = -$7), which would be available to shelter other income. Section 163(d) prevents this result. Assuming B has no other items of investment interest or income (and that he has no investment expenses), B may deduct only $3 of investment interest against the $3 of taxable dividend income, and section 163(d) disallows and carries forward the other $7 of interest deduction.

Suppose, in the above example, that B received a $5 dividend (instead of a $3 dividend) on the stock. His economic income would then be $2 ($5 + $7 - $10 = $2). Section 163(d) allows him to deduct $5 of interest expense against the $5 dividend income and disallows and carries forward the other $5 of interest deduction. This treatment leaves the taxpayer with no taxable income from the transaction. Thus, section 163(d), like section 469, does not prevent the sheltering of economic income from the investment itself, only the sheltering of certain kinds of unrelated income.

Other than the nature of the investments to which each section applies, the major difference between section 163(d) and section 469 lies in how they identify disallowed deductions. Section 163(d) disallows only those investment interest deductions in excess of net investment income, and section 469 disallows all passive losses without regard to the nature of the deductions creating the loss. Actually, in most cases the difference between these two approaches is of no practical significance. Either denying the interest deduction (in excess of net related income) or denying the loss itself can with equal effectiveness prevent a tax shelter loss created by the combination of an interest deduction and a preference. In the two examples given above, the results are the same under a section 469 loss denial approach and under a section 163(d) interest deduction denial approach.241 Results will differ under the two approaches only in the

investment expenses with respect to investment property on which appreciation has not been recognized.


241. In the first example, B has $3 of dividend income, $7 of unrealized appreciation, and $10 of interest expense. Absent any antishelter provision, the result would be a $7 tax loss ($3 - $10). The § 469 loss denial approach would simply prohibit deduction of the $7 loss, leaving B with no deductible loss. The § 163(d) interest deduction denial approach would reach the same result by permitting B to deduct $3 of interest expense against $3 of dividend income but denying the interest deduction in excess of $3. In the second example, B has $5 of dividend income, $7 of unrealized appreciation, and $10 of interest expense. Absent any antishelter provision, the result would be a $5 tax loss ($5 -
unusual situation in which a deduction is so large that it creates a loss even without being combined with an interest deduction. The section 469 approach would deny such a loss, but the absence of an interest deduction would prevent denial of the loss under the section 163(d) approach.242

Considered together, sections 469 and 163(d) constitute a “two basket” approach to tax shelter limitations.243 To ensure that section 163(d) does not overlap with the passive loss rules, it provides that investment income and expenses do not include “any income or expenses taken into account under section 469 in computing income or loss from a passive activity.”244 Investment interest also does not include any interest taken into account in computing passive activity income or loss under section 469.245 Passive activities—including interest expenses attributable to such activities—go into the section 469 basket, while investments and their related interest expenses go into the section 163(d) basket. As a result, passive activity losses can offset passive activity income but not investment (portfolio) income. Conversely, investment interest expense can offset investment income but not passive activity income.

This separate basket approach makes it necessary to determine in which basket a particular item of interest expense belongs.246 Section 469 grants Treasury the authority to prescribe regulations “which provide for the determination of the allocation of interest expense for purposes of this section.”247 The Conference Committee report on the 1986 legislation suggests that “in the case of individuals, interest expense generally will be traced to the asset or activity which is purchased or carried by incurring or continuing the underlying indebtedness.”248 Treasury accordingly has issued temporary and proposed regulations adopting a

$10. The § 469 approach would simply deny B the deduction for that $5 loss. The § 163(d) approach would reach the same result by permitting B to deduct only $5 of his $10 interest expense.

242. For example, suppose B buys a building with $100 of his own money. The building produces $10 of rental income, suffers $2 of economic depreciation, and becomes eligible for a $15 depreciation deduction. B would then have $8 in economic income ($10 − $2) and a $5 tax loss ($10 − $15). The loss denial approach of § 469 would deny that loss, but the absence of an interest deduction would prevent the application of a § 163(d)-type interest deduction denial.

243. For a discussion of the “basketing” approach to the limitation of tax shelters, see infra section III(B)(1).


246. The possibilities for interest allocation are actually broader than those presented by the § 163(d) and § 469 baskets. For a general discussion of the various activities and investments to which interest can be allocated and the resultant effect on the tax treatment of such interest, see infra note 284.


Anti-Tax Shelter Provisions

tracing approach to interest allocation.\textsuperscript{249} The regulations that apply for purposes of section 469, section 163(d), and section 163(h) (which disallows deductions for personal interest)\textsuperscript{250} provide generally that "[d]ebt is allocated by tracing disbursements of the debt proceeds to specific expenditures."\textsuperscript{251} The rules make this allocation solely according to the use of the proceeds; that the debt is secured by a particular asset does not affect the allocation.\textsuperscript{252} Interest expense is, of course, allocated in the same manner as the debt to which it relates.\textsuperscript{253}

The regulations set forth detailed rules governing the tracing of the use of borrowed funds.\textsuperscript{254} If the loan proceeds are deposited to the borrower's account and commingled with unborrowed funds, subsequent expenditures from the account are generally treated as having been made first from the debt proceeds.\textsuperscript{255} If the proceeds of more than one loan are deposited to the same account, subsequent expenditures from the account are generally treated as having been made first from the earliest deposited proceeds.\textsuperscript{256} Under an exception to these general rules, a taxpayer may elect to treat any expenditure from an account that is made within fifteen days after the deposit of borrowed funds into the account as having been made from the borrowed funds.\textsuperscript{257} Other rules govern interest expense allocation when the borrower receives the loan proceeds in cash\textsuperscript{258} and when the borrower does not receive the loan proceeds


\textsuperscript{251} Id. § 1.163-8T(a)(3).

\textsuperscript{252} See id. § 1.163-8T(e)(1). The legislative history of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-473, 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, suggests, but does not require, that Treasury reconsider the rule that security for a loan is irrelevant for tracing purposes:

For example, the Treasury could consider rules relating to the securing of property to mitigate some of the complexities of tracing where simplicity is desirable, so that, for example, any interest on a loan secured by personal property could be considered personal interest, and any interest on a loan secured by investment assets could be considered investment interest.


\textsuperscript{254} Treasury reserved for future regulations the difficult questions of how the rules should allocate interest expense in "cases in which partnerships and S corporations distribute debt proceeds to interest holders in the entity, and [in] cases in which taxpayers incur debt to acquire or increase their interests in partnerships or S corporations." T.D. 8145, 1987-2 C.B. 47, 49. The IRS provided temporary guidance on these questions, for taxable years ending on or before December 31, 1987, in I.R.S. Notice 88-20, 1988-9 I.R.B. 5.


\textsuperscript{256} See id.

\textsuperscript{257} See id. § 1.163-8T(c)(4)(ii)(B).

\textsuperscript{258} If the borrower receives the loan proceeds in cash, the rules allocate the proceeds to per-
at all.\textsuperscript{259} The regulations also provide rules governing the effect of debt repayments.\textsuperscript{260}

B. A Critique of the Antishelter Provisions

1. Baskets.—Central to the Act’s antishelter provisions is the use of baskets to determine whether a particular deduction may shelter a particular item of income.\textsuperscript{261} The Act’s provisions group certain items of income and deduction into baskets and specify that tax shelter deductions (passive losses under section 469 and investment interest under section 163(d)) can be used to shelter only income within the same baskets as those deductions.

(a) The origins of basketing.—The use of baskets to limit deductions represents a significant departure from the long-standing approach of the federal income tax system in combining all of a taxpayer’s items of income or loss into a single basket and thus allowing any loss to offset any income, no matter how unrelated. The separate basket rules of sections 469 and 163(d) thus might appear to depart radically from prior law. The separate baskets approach, however, has important precedents.

The Senate Finance Committee report on the 1986 Act notes several pre-1986 separate basket rules.\textsuperscript{262} Although most of the rules cited by the report are specialized, one has an extremely broad application—the limitation on the deductibility of capital losses, codified at section 1211.
Anti-Tax Shelter Provisions

Under this rule, a taxpayer may deduct capital losses only to the extent of his capital gains (and, in the case of individuals, against an additional maximum of $3000 in other income). That the 1986 Act retained the capital loss limitation despite the Act's repeal of the 60% capital gains deduction demonstrates that Congress did not intend the capital loss limitation to serve as a rough offset for the favorable tax rate formerly applied to capital gains. Rather, the purpose of the limitation is to prevent a taxpayer from sheltering income other than capital gains—such as income from personal services—through a selective realization of capital losses.

The policies underlying section 1211 and sections 469 and 163(d) are very similar. Just as nothing in section 469 prevents the use of tax preferences to understate the economic income from passive business activities, nothing in section 1211 prevents the use of the nontaxation of unrealized appreciation to understate the economic income from investments in capital assets. But section 469 does prevent the use of the combination of interest deductions and tax preferences from passive business activities to create artificial losses to shelter personal services or portfolio income, and section 1211 similarly prevents the combination of realized capital losses and unrealized capital gains to create artificial losses to shelter non-capital gain income.

The use of basketing in section 1211 does not, of course, mean that basketing is necessarily good policy. It does mean, however, that the 1986 Act's use of baskets to attack shelters is not so radical a departure from the past as it may at first appear.

The capital loss limitation does more than simply provide a precedent for basketing; it also indicates a difficulty inherent in any basketing approach—determining which items go into which baskets. If the Code

263. The capital loss limitation resembles both § 469 and § 163(d), because it permits suspended losses to be carried forward and deducted against capital gains in later years. See I.R.C. § 1211(b)(1) (Supp. IV 1986).


265. See The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 172 (1985) [hereinafter President's Tax Proposals] ("Were capital losses deductible without limit, taxpayers would dispose of capital assets selectively to produce a net loss with which to shelter non-investment income."). Suppose that a taxpayer holds two capital assets: Gainacre, which has a value $100 higher than its basis, and Lossacre, which has a value $100 lower than its basis. As long as the taxpayer does not dispose of either asset, he will realize neither a gain nor a loss. The taxpayer could sell Lossacre and realize a $100 loss without realizing the $100 gain on Gainacre. The $100 tax loss would be artificial, in the sense that the unrealized gain on Gainacre would fully offset it. Absent § 1211, the taxpayer could use that artificial loss to shelter $100 of personal services income. But see Note, Capital Loss Deduction Limits After the Tax Reform Act of 1986, 66 TEXAS L. REV. 159, 183-87 (1987) (outlining proposal to make capital losses fully deductible).
limits the deductibility of losses from the sale of capital assets but does not limit the deductibility of losses from the sale of other assets, determining whether an asset sold at a loss is a capital asset becomes crucial.\textsuperscript{266} The need to distinguish between capital and noncapital assets has long been "a leading source of tax complexity."\textsuperscript{267} We can expect similar complexity in the identification of passive activity income and loss under section 469\textsuperscript{268} and the identification of investment interest and expenses under section 163(d).

\textbf{(b) How many baskets?—}There are a number of possible approaches to antishelter basketing. One approach is to reject basketing completely and allow any deduction to offset income from any source, including personal services income. Aside from the capital loss limitations and a few other specialized rules,\textsuperscript{269} the Code embodied this approach before the 1986 Act. Of course, this approach imposes no limitation whatsoever on tax shelters.

At the opposite extreme, another approach would be to put each of a taxpayer's investments into a separate basket, so that a loss from one investment could never offset income from any other investment. This extreme approach permits taxable income from a given investment to understate economic income from that investment but prohibits the use of losses from an investment to shelter any unrelated income.

Proposals calling for antishelter provisions that put investments into many separate baskets are not new. The American Law Institute's Subchapter K Project proposed a rule under which a limited partner generally could not deduct pass-through losses from a limited partnership interest in excess of his income from that partnership.\textsuperscript{270} Each partnership interest constituted a separate basket, so that a net loss from one

\textsuperscript{266} Note, however, that if a taxpayer held an asset for personal use, any loss from its sale would be a nondeductible personal loss, thus mooting the question of whether the asset was capital. See Treat. Reg. § 1.262-1(b)(4) (1988).

\textsuperscript{267} J. B. Bittker, Federal Taxation of Income, Estates, and Gifts § 50.1, at 50-6 (1981). In many cases, the issue of whether an asset was capital arose in the context of determining whether a gain was eligible for favorable capital gains treatment. Although the 1986 Act eliminates those issues, see supra note 264 and accompanying text, it does not eliminate capital asset issues that will arise in the context of the § 1211 loss limitation.

\textsuperscript{268} J. J. Peroni contends that "[t]he passive loss rules . . . replace the capital gain and loss provisions as the major source of complexity in the Internal Revenue Code." Peroni, supra note 40, at 96. Under § 469, the primary source of this complexity will be the material participation standard. See supra text accompanying notes 197-216; infra section III(B)(3). As evidence of § 469's complexity, consider that the temporary and proposed regulations, published in the Federal Register on February 19, 1988, were 193 pages long. See Temp. Treas. Reg. § 1.469-0T, -1T, -2T, -3T, -4T, -5T, -11T (1988). Moreover, these regulations do not even address a number of difficult issues under § 469, including the definition of "activity."

\textsuperscript{269} See supra note 262.

\textsuperscript{270} See AMERICAN LAW INST., supra note 72, at 428-51.
Anti-Tax Shelter Provisions

limited partnership could not offset income from any source.271 The limitation on artificial loss (LAL) rules, which the House passed in 1975 but which never became law, also adopted a multibasket approach. The LAL rules restricted the deductibility of certain specified artificial losses arising from activities in six areas: real estate, farming, oil and gas, equipment leasing, movies, and sports franchises.272 The rules established a single LAL basket for all real estate activities.273 Thus, an artificial loss from one real estate activity could offset income from another real estate activity, but could not offset any other kind of income. There was another basket for all farming activities.274 For oil and gas,275 movies,276 equipment leasing,277 and sports franchises,278 however, the rules established a separate basket for each investment. Thus, a net loss from one oil or gas property, for example, could not offset any income—not even income from another oil or gas property.

Between the two extremes of no basketing at all and a separate basket for each property lies the approach of using a single basket for all of a taxpayer's investments and passive business interests. Under this approach, all income and expenses (including interest expenses) from investments and passive business interests would be placed in a single basket. A taxpayer could then use a loss attributable to an investment or a passive business interest to shelter any investment or passive business income but could not use that loss to shelter personal services or active business income. This was the general approach of the expanded versions of section 163(d), which were proposed by Treasury in 1984,279 by the President in 1985,280 and by the House in its version of what became the Tax Reform Act of 1986.281 These expanded versions applied to passive business interests as well as to nonbusiness investments.

The 1986 Act's approach is similar to these expanded versions of

271. See id. at 435-36.
273. See id. at 30-32 (describing as undesirable the use of accelerated depreciation and deductible construction costs of real estate ventures to defer taxation of income).
274. See id. at 39-40 (indicating the distinctions between farming and real estate development that justify treating farming separately). Each farming syndicate, however, went into a separate basket; therefore, a loss from one farming syndicate could not offset income from another syndicate. See id. at 44-45. For a rule permitting a limited amount of farm income to be deducted against nonfarm income in certain circumstances, see id. at 45.
275. See id. at 54-60.
276. See id. at 61-69.
277. See id. at 69-78.
278. See id. at 78-85.
279. See 1 TAX REFORM FOR FAIRNESS, supra note 16, at 140-41.
section 163(d), except that the Act places investments in one basket under section 163(d) and passive business activities in another basket under section 469. One cannot easily discern the philosophy behind the 1986 Act’s basketing approach. An extreme separate basket approach, which the LAL rules and the ALI proposal approximate, embodies the philosophy that the tax system should prohibit the use of an investment to shelter any unrelated income. An approach like that proposed by Treasury, the President, and the House—the creation of one basket for all investments and passive business activities—embodies the philosophy that the tax system should permit artificial losses to shelter income from property, but not from personal services. The Act clearly opposes the sheltering of personal services income, but it takes an odd middle ground concerning the sheltering of income from property. Investment income can be offset only by a particular kind of shelter, while passive business income can be offset only by a different kind of shelter.\textsuperscript{282} The Senate Finance Committee report offers this explanation of why a taxpayer cannot use passive losses to shelter portfolio income:

Since . . ., portfolio income [is] likely to be positive, [it is] susceptible to sheltering by means of investments in activities that give rise to tax benefits. The passive loss provision ensures that . . . portfolio income . . . cannot be offset by tax losses from passive activities until the amount of such losses is determined upon disposition.\textsuperscript{283}

The Senate report does not adequately explain the Act’s actual structure. It does not explain the apparent contradiction between section 469’s condemnation of the sheltering of portfolio income and section 163(d)’s acceptance of this very practice. Furthermore, it does not explain why, if sheltering of portfolio income is unacceptable under section 469 because portfolio income is likely to be positive, sheltering of passive business income from activities likely to produce positive income is acceptable under section 469.

2. Tracing.—Apart from the Act’s particular oddities, any basketing approach is subject to criticism for the difficulties it creates in assigning items of income and expense—especially interest expense—to their appropriate baskets.\textsuperscript{284} As noted earlier, Treasury has issued tem-

\textsuperscript{282} Under § 469, passive losses cannot shelter investment income; under § 163(d), however, investment interest expense can shelter investment income. Under § 163(d), investment interest expense cannot offset passive business income; under § 469, however, passive losses can shelter passive business income.

\textsuperscript{283} S. REP. NO. 313, supra note 12, at 719.

\textsuperscript{284} Tracing problems under the Act extend beyond questions of basketing under § 163(d) or § 469. The important varieties of interest under the current Code include not only § 163(d) and § 469 interest but also (1) nonpassive business interest (deductible in full), see I.R.C. § 163(a),
Anti-Tax Shelter Provisions

Several temporary and proposed regulations that allocate interest expense among baskets by tracing the use of loan proceeds.285

Given the fungibility of money, sophisticated taxpayers can manipulate tracing rules.286 For example, suppose a taxpayer owns a $100 bond that produces annual taxable interest income of $10. He borrows $100 at 10% interest and uses the money to buy an interest in a passive business activity producing $10 in annual economic income (not taking into account the $10 interest expense) but no taxable income. The tracing rules allocate the interest expense to the passive business activity. The result is a $10 passive loss ($0 in taxable income from the activity less $10 interest expense), which is not deductible against the $10 of investment income from the bond. If the taxpayer could trace the loan to the bond instead of to the passive business activity, however, he could deduct the interest expense against the interest income. The taxpayer might try to achieve this result, for example, by selling the bond, using the proceeds of the

(b)(2)(A) (1982 & Supp. IV 1986), as amended by Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1005(c)(4), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3390; (2) personal interest (nondeductible), see id. § 163(h)(1); (3) qualified residence interest (deductible in full), see id. § 163(a), (b)(2)(D); and (4) interest on debt incurred or continued to purchase or carry tax-exempt bonds (nondeductible), see id. § 265(a)(2). When a taxpayer borrows money to engage in a wide range of activities—such as personal consumption, home ownership, passive business activities, active businesses, and investment—he must attribute his interest expenses to one of more of those activities. The deductibility of the interest will depend on the nature of the activity to which it is attributed. Because of the wide variety of differently treated interest expenses under the current Code, interest allocation problems are considerably more complicated than just choosing whether to classify interest under § 163(d) or § 469. Moreover, the Code may treat taxpayers in similar economic situations differently depending on the tracing of interest. One taxpayer may be able to arrange his borrowings so that the application of the tracing rules will result in deductible interest expenses by causing borrowing to be traced to nonpassive businesses; to home mortgages; to investments, to the extent the taxpayer has net investment income that the interest deduction can shelter; or to passive business activities, to the extent the taxpayer has shelterable passive income. Another taxpayer with similar activities and borrowings, but with less tax sophistication or with greater nontax constraints on his ability to arrange his borrowings to receive favorable tax treatment, may find his interest expenses nondeductible, because his borrowings are traced to personal consumption, to tax-exempt bonds, to investment when investment interest expense exceeds net investment income, or to passive business activities when passive business income is insufficient to absorb the interest expense.

285. See supra text accompanying notes 249-60.

286. The IRS acknowledges this point in its comments on the temporary and proposed regulations on tracing:

The Service recognizes that some taxpayers will attempt to manipulate the tracing rules in the temporary regulations to maximize their interest deductions. For example, a sole proprietor may be able to maximize the amount of fully deductible interest expense allocated to trade or business expenditures by borrowing to pay business expenses and making personal expenditures from business receipts. Similarly, upper-income taxpayers may have sufficient liquidity to [make] business and investment expenditures from borrowed funds and personal expenditures from unborrowed funds. Finally, the fact that the allocation of interest expense is not affected by the use of any property to secure repayment of a debt may permit manipulation. For example, a taxpayer may use[ ] unborrowed funds to purchase an automobile for personal use, incur debt secured by that asset, and use the debt proceeds to replace the unborrowed funds.


571
sale to buy the passive business interest, and then borrowing $100 to buy a bond identical to the one he just sold.287

This attempt might or might not succeed. The IRS might claim that it should still trace the interest expense to the passive business activity on the basis of the step transaction doctrine288 or some kindred principle.289 Regardless of the outcome of this particular issue, two points should be noted. First, as this example suggests, there will be disputes over tracing.290 Second, tracing will treat taxpayers in equivalent economic circumstances differently. If two taxpayers own identical $100 bonds and $100 passive business interests and owe identical $100 debts, the taxpayer whose debt is traced to the bond will be able to deduct the interest, and the one whose debt is traced to the passive business will not. One must question the wisdom of adopting a rule so difficult to administer and so arbitrary in its application.291

287. The taxpayer’s recognition of significant gain on the sale of the bond would greatly decrease the attractiveness of this plan.

288. On the step transaction doctrine generally, see 1 B. BITTKER, supra note 267, ¶ 4.3.5, at 4-47 to 4-48 (explaining that the step transaction doctrine requires separate steps of an integrated transaction to be treated for tax purposes as a single transaction “if they are in substance integrated, interdependent, and focused on a particular end result”).


290. For a thorough discussion of the difficulties of tracing under § 265, see Oliver, supra note 120, at 359-89.

291. For a thoughtful defense of the tracing approach, both in terms of theory and practicality, see McIntyre, An Inquiry into the Special Status of Interest Payments, 1981 DUKE L.J. 765. McIntyre’s tracing proposal would incorporate two rules. Id. at 782-84. The first rule would trace interest attributable to purchase money loans to the purchased assets. The second rule would apply to all other loans (“united loans”). This rule would impose a rebuttable presumption that the taxpayer spent the loan proceeds on purchases made during the year in which he received the proceeds. The rule would also impose a conclusive presumption that if a taxpayer received more than one loan during the year, he spent the proceeds in the order received. Finally, taxpayers would match the loan proceeds with purchases in a specified order designed to “attribute united borrowed dollars and their associated interest payments to the use that would give the taxpayer the tax benefits he could have achieved through optimal tax planning under a physical tracing rule that operates without conventions.” Id. at 783.

The McIntyre proposal is probably about as good as a tracing rule can be. Its objective rules would be reasonably certain in their application. Additionally, to the extent it uses an ordering rule that automatically gives taxpayers the benefit of optimal tax planning, it eliminates the problems of opportunities for manipulation, traps for the unwary, and unequal treatment of similarly situated taxpayers.

On the other hand, even this tracing proposal has serious problems. For one thing, it imposes the burdensome requirement that taxpayers keep track of all their purchases in order to allocate the interest expense on united loans. It also assigns a great deal of importance to the determination of whether a loan is a purchase money loan or an united loan—a determination that might not always be easy to make in practice. At a more fundamental level, the proposal is objectionable because it does not fully eliminate the problems of opportunities for manipulation, traps for the unwary, and unequal treatment of similarly situated taxpayers. Because the proposal relies on simple tracing in the case of purchase money loans, the inequality of treatment between the taxpayer who incurs a purchase money loan to acquire an interest in a passive activity and the taxpayer who incurs a purchase money loan to acquire a bond would persist. Similarly, consider the case of a taxpayer who obtains a purchase money loan but who could have obtained an united loan instead. If the use of the
Anti-Tax Shelter Provisions

Given these serious weaknesses in the tracing method, is there a feasible alternative that does not treat differently taxpayers in equivalent economic circumstances? There is a possibility. Congress could retain the Act's basic structure—the same baskets and rules for treatment of income and expenses within baskets—but allocate interest expenses among baskets by a method other than tracing. The most theoretically appealing method would allocate debt (and the interest expense related to that debt) among the various baskets according to the relative fair market values of the assets in the baskets. This approach treats the value of each of the taxpayer's assets as attributable in part to his liabilities and in part to his net worth; the part attributable to his liabilities is the value of the particular asset multiplied by the ratio that the taxpayer's total liabilities bear to the value of his total assets. By avoiding tracing, this method negates the possibilities of manipulation by taxpayers and inconsistent treatment of taxpayers in equivalent economic circumstances.  

This approach, however, faces an insuperable practical difficulty. It would require annual (or at least periodic) valuations of all of a taxpayer's assets. As the IRS noted in its comments to the temporary and proposed regulations, "apportionment based on the fair market value of assets . . . would . . . require burdensome and otherwise unnecessary appraisals of asset value." This problem can be avoided, however, by using adjusted basis as a surrogate for value, so that interest expense is allocated among assets according to their relative adjusted bases. This approach would sacrifice theoretical purity—"[t]he use of either adjusted

purchase money loan instead of an untied loan causes the interest expense to be placed in a basket less favorable to the taxpayer, then the taxpayer has fallen into a trap for the unwary. McIntyre admits the existence of such traps under his proposal, but finds them "tolerable . . . because they arise infrequently." Id. at 786. The rule that traces the proceeds of untied loans to assets that the taxpayer acquired during the year he received the loan proceeds presents another trap. In some cases, a taxpayer would receive more favorable tax treatment if he could allocate the loan (and its related interest expense) instead to property he acquired in some previous year. Moreover, a sophisticated taxpayer may be able to reach that more favorable result by selling and then repurchasing that property. Depending on one's point of view, that possibility constitutes either an opportunity for manipulation by the sophisticated taxpayer or a trap for the unwary taxpayer. In either instance the result is unequal treatment of similarly situated taxpayers. McIntyre recognizes this problem, but says its significance is "undoubtedly modest." Id. at 788.

292. An argument can be made, however, that pro rata allocation is not necessarily the correct approach at the level of high theory:

The argument that pro rata allocation is theoretically "correct" is based on the assertion that any debt effectively "carries" all of a taxpayer's assets, because the taxpayer could have chosen not to incur the debt and instead to have obtained funds by liquidating the assets. This argument, of course, ignores practical constraints on the liquidation of assets. Moreover, it ignores the fact that economic decisions are made at the margin and that in many cases, if the taxpayer were unable to borrow, he would forego the marginal use of the funds rather than liquidating existing assets. As a result, a pro rata allocation rule may distort economic decision making.

or unadjusted basis as an apportionment base could distort the amount of debt associated with particular assets— but would bolster administrability.

In fact, Congress has adopted the allocation by basis approach in section 265(b). That provision denies financial institutions interest expense deductions if the interest expense is allocated to tax-exempt interest income, with the allocation of interest expense being made according to the ratio of the adjusted bases of the taxpayer's tax-exempt obligations to the adjusted bases of all the taxpayer's assets.

For taxpayers other than financial institutions, however, section 265(a)(2) provides a tracing rule for the denial of interest deductions related to tax-exempt income. For these taxpayers, the interest expense placed in the section 265 basket is the interest expense "on indebtedness incurred or continued to purchase or carry" tax-exempt bonds. This distinction between financial institutions and other taxpayers suggests the problem with allocating interest expense according to asset basis. Such an allocation method imposes heavy record-keeping and computational burdens on taxpayers. In the context of section 265, Congress thought it was reasonable to impose those burdens on financial institutions but not on other taxpayers.

Similar considerations apply in the broader contexts of sections 163(d) and 469. Application of the allocation by basis approach to those provisions would require each taxpayer with interest expenses to keep detailed records of the adjusted bases of all his assets and to allocate interest expenses annually among his assets according to those adjusted bases. This requirement may be more than Congress can reasonably ex-

294. Id.


296. Section 265— either § 265(b) with its interest allocation rule or § 265(a)(2) with its tracing approach— might seem different from the basketing approach to tax shelters, because when $265 applies it denies the interest deduction in full rather than allowing the deduction against taxable income within the basket. This is not a real difference. The $265 basket consists of the income from tax-exempt bonds and related interest expenses. Because such income is wholly tax-exempt, the basket will never contain any taxable income. Given this inevitable absence of taxable income, denying the interest deduction in full has the same effect as allowing the interest deduction to the extent of taxable income within the basket.

Anti-Tax Shelter Provisions

pect of individual taxpayers. Another problem with applying the allocation by basis method to individual taxpayers concerns borrowed money that taxpayers use to finance noncapital expenditures that do not produce identifiable assets—both noncapital personal expenditures (such as outlays for education, medical care, vacations, or general living expenses) and noncapital business expenses. Allocation of interest expense solely according to asset basis would allocate nothing to these noncapital expenditures.

In its comments accompanying the temporary and proposed regulations, the IRS noted that it had considered requiring the allocation of interest according to asset value or asset basis but had rejected both approaches because of “the practical and theoretical problems that a comprehensive apportionment system would present.” The IRS added, however, that it was “not foreclosing the possibility that future regulations may impose some form of pro rata apportionment.”

This section has demonstrated the significant weakness of any tax shelter limitations accomplished by basketing. This weakness arises from the need to assign interest expense among the various baskets. Performing this assignment through tracing results in a system that is subject to manipulation and that discriminates between similarly situated taxpayers. The alternative approach—a system that allocates interest expense by asset value or basis—would be less manipulable and more fair, but hopelessly complex.

298. See 2 H.R. CONF. REP. NO. 841, supra note 204, at 146 (suggesting that interest allocation “on the basis of assets” might be appropriate for entities to which the passive loss rules apply, but rejecting that method for individuals because of record-keeping difficulties), reprinted in 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4234; T.D. 8145, 1987-2 C.B. 47, 50 (rejecting the allocation by basis approach because taxpayers would consider the reporting requirements “unduly intrusive and burdensome” and because “it would be extremely difficult to enforce such requirements”).

299. See T.D. 8145, 1987-2 C.B. 47, 50 (“[A]ny general apportionment base would have to be adjusted . . . in order to allocate a reasonable amount of interest to noncapital expenditures. For example, to maintain the integrity of the rule that personal interest is not deductible, it might be necessary to apportion some interest to personal consumption.”). Similarly, labor-intensive businesses would be disadvantaged relative to capital-intensive businesses unless expenditures for noncapital items such as salaries, supplies, and research and development were capitalized for interest allocation purposes. See Johnson, supra note 44, at 175-76; Rubin, supra note 292, at 305-06.


301. Id.

302. This problem would continue to exist even under a system that combined § 163(d) and § 469 items into a single basket. Taxpayers would still have to assign their interest expense between that basket and whatever categories of interest expense existed outside of that basket. For example, if current law were changed by combining § 163(d) and § 469 interest into a single basket, other categories of interest expense would include nondeductible personal interest, deductible qualified residence interest, deductible nonpassive business interest, and nondeductible § 265 interest. See supra note 284.

303. Some commentators have suggested a third approach to assigning interest expense: the use of so-called stacking rules. See, e.g., Koppelman, supra note 43, at 1211-12. Stanley Koppelman characterizes the McIntyre tracing proposal, see supra note 291, as “really a form of . . . stacking”
method casts grave doubt on the wisdom of basking as a means of attacking tax shelters. Basking is an attempt to attack tax shelters without eliminating the preferences on which the shelters are based. The practical problems of basking suggest that if Congress desires to attack shelters, it should do so through a frontal assault on preferences, rather than through basking.

3. The Material Participation Standard of Section 469.—Recall that under section 469, a taxpayer who does not materially participate in a business activity may deduct losses from that activity only against passive income. A taxpayer who materially participates, however, may deduct losses against unrelated income. What is the rationale for basing the ability to shelter unrelated income on a material participation standard? This section considers a number of possible justifications—none of them entirely satisfactory—for the material participation standard.

(a) Unconvincing justifications from the legislative history.—The Senate Finance Committee report initially attempts to justify the material participation standard by examining congressional intent in enacting preferences:

For example, in providing preferential depreciation for real estate or favorable accounting rules for farming, it was not Congress's primary intent to permit outside investors to avoid tax liability

because of its use of ordering rules with respect to untied loans, Koppelman, supra note 43, at 1211 n.280. A stacking system would provide mandatory ordering rules for assignment of interest expense. Koppelman describes two types of stacking: permissive stacking, which attributes interest expense first to taxable income (thus allowing the deduction of interest expense to the extent of taxable income); and strict stacking, which attributes interest expense first to tax-exempt income (thus denying the deduction of interest expense to the extent of tax-exempt income). Id. at 1211-12. The IRS's comments accompanying the interest allocation regulations do not indicate that either sort of stacking rule was considered as an alternative to tracing or pro rata allocation. See T.D. 8145, 1987-2 C.B. 47.

In the Code's system of interest deduction limitations based on baskets, permissive stacking serves as a supplement, rather than an alternative, to tracing or pro rata allocation. Thus, interest expense is first allocated among baskets according to either a tracing system or a pro rata allocation system. Permissive stacking rules are then applied to determine the deductibility of the interest within each basket. Both § 163(d) and § 469 adopt permissive stacking rules, under which interest expense within a basket is deductible to the full extent of taxable income within the basket.

The IRS's probable reasons for not considering strict stacking as an alternative to tracing or pro rata allocation are quite different. First, strict stacking is inconsistent with the structure of the 1986 antishelter legislation. Strict stacking would disallow interest deductions even against passive income and investment income, as long as the taxpayer has tax-exempt income associated (under the strict stacking rules) with the interest expense. Such results would be incompatible with the deduction allowance rules of § 163(d) and § 469. A second problem with strict stacking is its impracticality. To disallow interest expense to the extent of untaxed income, it is necessary to measure that untaxed income. In many cases, however (including, most obviously, unrealized appreciation), difficulties of measurement are a large part of the reason why untaxed income goes untaxed. See Koppelman, supra note 43, at 1215.
Anti-Tax Shelter Provisions

with respect to their salaries by investing in limited partnership syndications. Rather, Congress intends to benefit and provide incentives to taxpayers active in the businesses to which the preferences were directed. 304

This conclusory statement is hardly a satisfactory explanation. 305 It explains what Congress intends, but not why Congress so intends.

The Senate report does, however, offer additional justifications for the material participation standard. First, it suggests that "[i]n some cases, the availability of tax preferences to nonparticipating investors has even harmed the industries that the preferences were intended to benefit." 306 The report offers farming as an example. Wealthy investors may find farming profitable solely because of tax shelter benefits, even without a positive cash flow. This may give wealthy outside investors a competitive advantage over full-time farmers who do not have substantial unrelated income to shelter and who must derive a positive cash flow from their farming to earn a profit. 307

If this problem is serious, drawing a distinction between active and passive farmers is not the best solution. The real problem seems to be that a tax preference can encourage investment in tax-favored assets only when taxpayers have economic income (related or unrelated to the preference) that the preference can shelter. If preferences are not serving their intended function for many active farmers lacking in economic income, the obvious solution is to create a mechanism that nevertheless allows such farmers to benefit from their tax preferences. The mechanism might entail a negative income tax (or a refundable credit) for farm losses, or a provision permitting the sale of such losses to taxpayers with shelterable income. 308 In short, if the inability of some farmers to use

305. Especially troubling is the report's statement that "Congress intends to benefit . . . taxpayers active in the businesses to which the preferences were directed." Id. Such an intent to benefit taxpayers is inconsistent with the basic justification for preferences: not to confer windfall benefits on taxpayers, but to increase the allocation of resources to the preferred activity. See supra text accompanying notes 8-11. (The author is indebted to Calvin Johnson for this criticism of the report.) On the other hand, the report's reference to a desire to benefit taxpayers may reflect inartful use of language rather than a misunderstanding of the justification for preferences. The report's drafters may have understood that a preference is supposed to cause increased demand for the preferred asset, which in turn causes an increase in the price of the asset, so that the tax benefit is offset by a decrease in the pre-tax rate of return on the preferred asset. If one reads the report in this way, the reference to the tax benefit to taxpayers would not signify that Congress intends to confer a windfall on the taxpayers toward whom the "benefit" is directed. Even under this reading, the question still remains as to why Congress would want to encourage debt-financed investments in preferred assets by active participants but not by passive investors.
preference-created losses is a problem, the solution is to find a way for them to use the losses, not to prevent other farming investors from using losses.

Another of the report's justifications for the material participation standard is that it prevents the marketing of tax shelters designed to take advantage of nonincentive preferences:

[Instances in which the tax system applies simple rules at the expense of economic accuracy encourage the structuring of transactions to take advantage of the situations in which such rules give rise to undermeasurement or deferral of income. Such transactions commonly are marketed to investors who do not intend to participate in the transactions, as devices for sheltering unrelated sources of positive income. ... Accordingly, by creating a bar against the use of losses from business activities in which the taxpayer does not materially participate to offset positive income sources such as salary and portfolio income, the committee believes that it is possible significantly to reduce the tax shelter problem.]

This discussion explains why the section 469 loss limitations should apply to passive investors in shelters designed to exploit nonincentive preferences. It does not explain, however, why the limitations should apply only to passive investors. Shelters marketed to passive investors may be the major means of exploiting nonincentive preferences, but they are not the only means. If tax shelter exploitation of nonincentive preferences is bad, Congress should stop such exploitation by both active and passive investors. Furthermore, the report's explanation does not justify the denial of loss deductions to passive investors in shelters based on incentive preferences.

(b) Realization, nontax economic profit motives, and real economic losses.—The Senate Finance Committee report offers two additional justifications for the material participation standard: that a nonparticipating investor has not realized the losses of a passive business activity, and that a participating taxpayer probably has a nontax economic motive for engaging in an activity. Neither justification is persuasive in the terms the report offers it. The combination of the two justifications, however, suggests a third: that the distinction resulting from the material participation standard between the deductibility of active losses and the nondeductibility of passive losses may be an attempt to confine the denial of deductions for real economic losses as narrowly as

309. S. REP. NO. 313, supra note 12, at 716.
310. See infra text accompanying note 316.
311. See supra text accompanying notes 73-84.
possible in the context of an attack on the deductibility of artificial tax shelter losses.

(i) Realization.—The Senate Finance Committee report argues that restrictions on the deductibility of passive losses are consistent with the principle that losses should not be deductible until they have been realized:

In the case of a nonparticipating investor in a business activity, the committee believes that it is appropriate to treat losses of the activity as not realized by the investor prior to disposition of his interest in the activity. The effort to measure, on an annual basis, real economic losses from passive activities gives rise to distortions, particularly due to the nontaxation of unrealized appreciation and the mismatching of tax deductions and related economic income that may occur, especially where debt financing is used heavily. Only when a taxpayer disposes of his interest in an activity is it possible to determine whether a loss was sustained over the entire time that he held the interest.\footnote{312}

One problem with this realization analysis is that it does not explain why the limitations on deductibility of losses should apply only to passive investors. If the tax system should suspend losses from investments until disposition because it cannot measure economic losses accurately prior to disposition, it should suspend all losses, whether or not related to a passive business activity. A loss from an activity in which the taxpayer materially participates is no more realized prior to disposition than a loss from a passive activity. The report correctly notes that the nontaxation of unrealized appreciation can interfere with attempts to measure accurately, on an annual basis, the loss (or income) from a passive activity. But “active” business investments also benefit from unrealized appreciation. If the possibility that a tax loss may be offset by unrealized appreciation justifies the disallowance of losses from passive business investments, the same possibility should justify the disallowance of the tax losses of active business investments.

Another problem with the realization argument is that it does not explain why passive income should be treated as realized (and thus currently taxable) while passive losses are treated as unrealized (and thus not currently deductible). If it is appropriate to deny a deduction for a

\footnote{312. S. Rep. No. 313, \textit{supra} note 12, at 716-17. The report repeats this point when it discusses the rules permitting the deduction of suspended losses upon the disposition of a taxpayer’s entire interest in a passive activity: “[P]rior to a disposition of the taxpayer’s interest, it is difficult to determine whether there has actually been a gain or loss with respect to the activity. For example, allowable deductions may exceed actual economic costs, or may be exceeded by untaxed appreciation.” \textit{Id.} at 725.}
passive loss because of the possibility that it may be offset by unrealized appreciation, why not defer the taxation of passive income because of the possibility that it may be offset by unrealized depreciation?\textsuperscript{313}

(ii) Nontax economic profit motives.—The Senate report also justifies the material participation standard as recognizing that "[a] taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value."\textsuperscript{314} The report explains: "A material participation standard identifies an important distinction between different types of taxpayer activities. In general, the more passive investor is seeking a return on capital invested, including returns in the form of reductions in the taxes owed on unrelated income, rather than an ongoing source of livelihood."\textsuperscript{315}

It is not easy to discern the point of these observations. It is simply not true that a materially participating investor will necessarily have a significant nontax economic profit motive for making his investment. The tax shelter benefits of the investment are as valuable to him as they would be to a passive investor. He will consider a $1 return in the form

\textsuperscript{313} In connection with its realization argument, the report analogizes a passive investor to a shareholder in a C corporation, who would not realize a loss on his stock until he disposed of it. \textit{Id.} at 717. The analogy is not persuasive. Never before has Congress thought the C corporation model, with shareholder nonrecognition of loss, so compelling as to require its extension to all passive investors. To the contrary, Congress has explicitly permitted passive investors to avoid the C corporation model by investing in S corporations, whose losses pass through to their shareholders. \textit{See} I.R.C. §§ 1361-1378 (1982 & Supp. IV 1986), as \textit{amended by} Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1006(f), 1007(g)(9), 1018(g)(2), 2004(n), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3403-07, 3435, 3585, 3608. Congress has also permitted passive investors to avoid the C corporation model by investing in partnerships. \textit{See id.} §§ 701-761, as \textit{amended by} Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §§ 1008(e)(1)-(3), 1009(f), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3439-40, 3445. Moreover, shareholder nonrecognition of a corporation's income until its distribution, \textit{see} Elsner v. Macomber, 252 U.S. 189, 209-12 (1920), and corporate recognition of gain and loss, \textit{see} I.R.C. § 11 (1982 & Supp. IV 1986), as \textit{amended by} Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1007(g)(13)(B), 1988 U.S. CODE CONG. & ADMIN. NEWS (102 Stat.) 3342, 3436, are equally crucial aspects of the taxation of C corporations. If Congress suddenly finds the C corporation model compelling for all taxpayers, should it not adopt the entire model rather than just one part of it?

Finally, the report's reliance on the C corporation model fails to explain the distinction § 469 draws between passive and active investors. A C corporation's losses do not pass through to its shareholders, whether or not the shareholders materially participate in the business of the corporation. If the logic of the C corporation model requires that no passive investor may deduct a loss prior to disposition of his investment (regardless of the form in which the investment is held), that logic should also dictate that no active investor may deduct a loss prior to disposition of his investment.

\textsuperscript{314} S. REP. No. 313, supra note 12, at 716.

\textsuperscript{315} \textit{Id.}

580
Anti-Tax Shelter Provisions

of a reduction in income tax liability from the sheltering of unrelated income just as attractive as $1 of nontax economic profit. Therefore, a substantial tax shelter opportunity may be enough incentive to motivate a materially participating investor to make his investment. If Congress wants to ensure that all taxpayers have significant nontax economic profit motives behind their investment choices, fully preserving tax shelter opportunities for materially participating investors makes no sense. If Congress wants investors always to have significant nontax economic profit motives for their investments, it should write tax laws that eliminate tax shelter opportunities for all investors.

(iii) The material participation standard as a response to the problem of real economic losses.—When a passive investment produces a tax loss, one can reasonably suspect that the taxpayer intended the investment to serve as a tax shelter by creating the artificial loss. If Congress has decided that a taxpayer should not be able to use artificial losses to offset unrelated income, section 469's disallowance of all passive losses—based on congressional suspicion that any given passive loss is probably artificial—might be an appropriate way of implementing that policy decision.

The problem with section 469 (or any blanket disallowance of passive losses) as a means of eliminating shelters is that it indiscriminately disallows all passive losses—real economic losses as well as artificial losses. One might view this disallowance of deductions for real economic losses as an unfortunate but unavoidable side effect of the decision to disallow artificial tax shelter losses. Congress apparently concluded

316. Investors who materially participate may be less likely than passive investors to have significant amounts of unrelated income, simply because the amount of time devoted by a taxpayer to material participation in an activity reduces the time he has available to earn personal services income from other sources. (A material participant, however, will not necessarily have less portfolio income than a passive investor.) It is true, of course, that a materially participating investor with no unrelated income will not have been attracted to an activity by the possibility of sheltering unrelated income. But such a taxpayer cannot serve as the justification for permitting those who materially participate to deduct losses against unrelated income, for the simple reason that such a taxpayer has no unrelated income. Thus, whether the § 469 limitations apply to such a taxpayer is a moot question.

317. Consider this example of how § 469 can disallow a deduction for a real economic loss. Taxpayer A borrows $100 at 8% interest and uses the borrowed money to buy a building. The building is eligible for a $5 depreciation deduction, and it suffers $2 of economic depreciation. The building produces only $4 of rental income. Of A's $9 tax loss ($4 - $8 - $5), only $3 stem from the artificial portion of the depreciation deduction; the other $6 is a real economic loss. Nevertheless, § 469 would disallow the real, as well as the artificial, portion of the loss. Similarly, deductions denied by § 163(d)—for investment interest expense in excess of net investment income—may represent either artificial tax losses or real economic losses. The disallowed interest deduction will represent an artificial loss only if nontaxed investment income (such as unrealized appreciation) offsets the loss. For a criticism of § 469's disallowance of real economic losses, see Peroni, supra note 40, at 3, 71-72.
that the typical passive loss was artificial and that there was no practical way to distinguish real losses from artificial ones on a case-by-case basis.

Although the denial of real losses may be unavoidable, it is also undesirable. Congress therefore may also have decided that the denial of real losses should be as limited as possible, consistent with its overriding goal of preventing the deduction of artificial tax shelter losses. Section 469(g) thus permits the deduction of suspended passive losses when a taxpayer disposes of his entire interest in a passive activity.\footnote{318} As the Senate Finance Committee report explains, it is only then that "the actual economic gain or loss on [the] investment can be finally determined."\footnote{319} The report adds that "the purpose of the disposition rule is to allow real economic losses of the taxpayer to be deducted."\footnote{320}

Although taxpayers can eventually deduct real economic losses, deferral of the deduction for a real economic loss until disposition of the activity is undesirable. The tax system should mandate deferral only to the extent necessary to disallow artificial losses. Indeed, the desire to restrict the deductibility of real economic losses no more than is absolutely necessary best explains why section 469 allows taxpayers to deduct losses from activities in which they materially participate against unrelated income.

This concern with real economic losses is the true significance of the Senate Finance Committee's observation that "[a] taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive."\footnote{321} Although an active business may result (by accident or design) in a preference-created artificial loss, that is considerably less likely than in the case of a passive investment—or so Congress not unreasonably concluded. Congress must have believed that most taxpayers engage in active businesses not primarily to use tax preferences to shelter unrelated income, but to make nontax economic profits—to build businesses that serve as "an ongoing source of livelihood."\footnote{322} When such businesses show tax losses, therefore, those losses more likely reflect real economic losses than losses of typically tax-oriented passive investments. So viewed, the provisions allowing materially participating investors to de-
duct their losses reflect a congressional desire to limit the deductibility of real economic losses no more than absolutely necessary to accomplish the purpose of section 469.

In sum, the report's statement that a materially participating investor is more likely than a passive investor to have a "significant nontax economic profit motive" may be an oblique way of saying that although the tax system should disallow passive losses because they are probably artificial, the system should allow losses of material participants because those losses are probably real.

The issue of artificial losses versus real losses also explains the otherwise mystifying distinction suggested in the report between the realization of passive losses and active losses: that losses of passive investors are appropriately treated as unrealized prior to disposition of the activity but that losses of materially participating investors are properly treated as currently realized. An important reason for not treating a particular gain or loss as realized is doubt as to whether the system can measure the amount of the gain or loss accurately. Thus, passive losses are deemed probably artificial—that is, inaccurately measured—and so are treated as not realized; but active losses are deemed probably real—that is, accurately measured—and so are treated as realized.

If concern over real economic losses is the reason for the material participation exception to section 469, is the exception an effective response to that concern? Material participation has some merit as a rough test for whether a tax loss reflects a real economic loss, but it is both tremendously underinclusive and tremendously overinclusive. The material participation standard is underinclusive because there will be many

323. Id.
324. See id. at 716-17; supra text accompanying note 312.
326. This suspicion that passive losses are artificial also explains why the Code treats passive income, but not passive losses, as currently realized. See supra text accompanying note 313. Congress has good reason to suspect passive losses of being artificially produced by tax preferences, because shelters are designed to produce artificial losses. Passive income could possibly be similarly artificial (for example, offset by unrealized depreciation), but no one would purposely design an investment to produce artificial taxable income. Thus, one can reasonably suppose that passive taxable income ordinarily will reflect real economic income. Thus, the tax system treats passive losses as unrealized because they are probably artificial; it treats passive income as realized because it is probably real. This treatment is similar to the inconsistent treatment of net capital gains and losses. Net capital losses (realized capital losses in excess of realized capital gains) are generally not currently deductible. See I.R.C. § 1211(b) (Supp. IV 1986) (providing that individuals may deduct the excess of capital losses over capital gains only to the extent of $3000 annually); supra text accompanying notes 262-67. This treatment reflects congressional suspicion that such losses are artificial because they are offset by unrealized capital gains. Net capital gains, by contrast, are fully taxable. This treatment apparently reflects congressional belief that net gains are probably not offset by unrealized losses.

583
real economic losses from passive investments that will not be deductible under section 469. It is overinclusive because there will be many active businesses with artificial tax losses that will be deductible despite their artificiality, because the material participation standard will have been satisfied.327

The material participation standard might be appropriate nevertheless as a very rough measure of whether a loss is a real economic loss, if it at least had the advantage of being easy to apply. Outside of per se rules for limited partnership interests and rental activities,328 however, the legislative history states that “the presence or absence of material participation generally is to be determined with reference to all of the relevant facts and circumstances.”329 Although the temporary and proposed material participation regulations should simplify administration of the standard to the extent they impose objective rules based on the number of hours a taxpayer devotes to an activity,330 major difficulties can still be expected in situations in which the rules do not resolve the issue.331

Another objection to the test is its potential for discrimination in favor of wealthy taxpayers. The typical middle class or upper middle class taxpayer looking for a tax shelter will be attracted to an interest (as a partner or S corporation shareholder) in a syndicated venture with numerous other taxpayers. Such a taxpayer usually has neither the financial resources nor the investment expertise to become the sole owner of a tax shelter property. In the case of syndicated shelters with many investors, each of the many investors cannot participate materially in the investment, and so section 469 will disallow the investors’ loss deductions (even if the shelters are not structured as limited partnerships).

By contrast, a wealthy taxpayer seeking to shelter his income is

327. See Peroni, supra note 40, at 71-72 (criticizing § 469 as sometimes disallowing real economic losses and as sometimes allowing artificial losses).

328. See supra notes 211-16 and accompanying text.


330. See Temp. Treas. Reg. § 1.469-5T (1988); supra text accompanying notes 200-01. At least one commentator has argued that the objective, hour-based standards of the regulations are inconsistent with the statute and the legislative history and are therefore invalid. Gunnar, Gunnar Questions “Quantitative” Approach to Material Participation, 38 TAX NOTES 192, 192-93 (1988).

331. If a taxpayer devotes more than 100 hours but less than 500 hours to an activity, the regulations provide that whether he has materially participated in the activity will be determined on the basis of all the facts and circumstances. Temp. Treas. Reg. § 1.469-5T(a)(7) (1988); see supra text accompanying notes 202-03.

It is worth noting that the ALI proposal rejected the idea of applying its loss limitations to passive general partners because “it will inevitably be difficult to determine who is a ‘passive’ general partner.” AMERICAN LAW INST., supra note 72, at 440.

See Peroni, supra note 40, at 95-102, for a thorough criticism of the complexity of many aspects of § 469, including the material participation standard.
Anti-Tax Shelter Provisions

more likely to have the financial resources and investment expertise necessary to pursue sole ownership of a tax shelter property. Although sole ownership does not automatically warrant a finding of material participation, the opportunity to satisfy the standard is much greater for a sole owner than for a small investor in a syndicated shelter. The wealthy taxpayer can satisfy the material participation standard solely by performance of management functions, and it is not necessary that the activity be the taxpayer's principal business.

In light of these objections to the material participation exception to the passive loss limitations of section 469, Congress might consider other responses to the problem of real economic losses. One alternative is the approach taken by the House in its 1975 LAL rules. The LAL rules identified certain artificial deductions and only disallowed losses attributable to those deductions. Whether the taxpayer materially participated in an activity was generally irrelevant to the application of the LAL rules. The LAL approach would not have disallowed deductions for real economic losses.

The LAL approach is attractive at the theoretical level. Unlike section 469, which sometimes disallows the real economic losses of passive investors and sometimes allows the artificial losses of active investors, the LAL rules, in theory, would have always allowed real losses and disallowed artificial losses. Unfortunately, the LAL approach is probably a quixotic attempt at unattainable precision. Any attempt to apply tax shelter limitations only to specified types of artificial deductions runs the risk that taxpayers will find and exploit tax preferences (especially nonincentive preferences) to which the limitations do not apply. An ap-

332. S. REP. No. 313, supra note 12, at 734. But the proposed regulations provide that the wealthy taxpayer can satisfy the facts and circumstances test on the basis of management activities only if there is no paid manager and no other individual performs more management services than the taxpayer. See Temp. Tress. Reg. § 1.469-5T(b)(2)(ii)(A)-(B) (1988). In addition, an individual who does not devote more than 100 hours to an activity cannot satisfy the facts and circumstances test. See id. § 1.469-5T(b)(2)(iii).

333. See S. REP. No. 313, supra note 12, at 733. The ALI proposal to disallow the deduction of pass-through losses by limited partners was also subject to the criticism that it restricted the tax shelter opportunities of the middle class much more than those of the wealthy. The ALI responded to this criticism by stating: "[I]t is difficult to see why a rational tax system should allow a tax benefit to be exploited by a broad class of investors for whom such benefits were not intended simply because some wealthy individuals cannot be prevented from doing so without extensive Code revision." AMERICAN LAW INST., supra note 72, at 434 n.9. This statement would not respond adequately to the criticism of the class discrimination inherent in § 469, because eliminating the material participation exception could cure that discrimination and prevent exploitation of tax benefits by all classes of investors.

334. For example, the targeted deductions for real estate activities were accelerated depreciation deductions in excess of straight-line depreciation, construction period interest, and real property taxes. See H.R. REP. No. 10612, 94th Cong., 1st Sess. 28-37 (1975).

335. See id.
proach such as the LAL rules cannot possibly prevent the deduction of all artificial losses.

Another response to the problem of tax shelter limitations preventing the deduction of real economic losses would be to do nothing. Having made the basic decision to attack shelters without eliminating preferences, Congress might conclude that the problem of artificial losses is so great that it calls for the drastic step of applying the section 469 limitations to all business losses, regardless of whether the taxpayer materially participates in the business. Under this view, section 469 would need to capture real economic losses to ensure that no artificial losses escape. Materially participating investors with real economic losses would be viewed as unfortunate but unavoidable casualties in the war on tax shelters, just as passive investors with real economic losses are viewed under the current version of section 469. In defense of this proposal, note that the typical material participant with real economic losses, who relies on his business as "an ongoing source of livelihood," will have little or no income from other sources. Even with the material participation exception to section 469, such a taxpayer will receive little or no tax benefit from his losses, because he has little or no unrelated income to offset. Thus, the law already denies this most sympathetic of materially participating investors the tax benefit of his losses. If one accepts this result, one might also accept—for the purpose of eliminating tax shelters—extending this denial to materially participating investors with substantial income from other sources. In further defense of this proposal, note that a taxpayer who desires to recognize a real economic loss from an activity subject to section 469 can always do so by disposing of the activity. Of course, one who considers the denial of deductions for real economic losses fundamentally unfair will reject this proposal as simply increasing the instances of unfairness.

There is no completely satisfactory response to the problem of real economic losses in the context of antishelter provisions based on basket-ting. The material participation response is particularly awkward, but all other possible responses also face serious objections. The intractability of this problem provides one more reason for questioning the advisability of eliminating shelters without eliminating preferences.

337. If he had substantial income from other sources, he would not need to rely on the business for his livelihood.
339. See id. § 469(g); supra text accompanying notes 222-25.
Anti-Tax Shelter Provisions

C. *Material Participation in Activities Producing Taxable Income*

The discussion in the preceding section concentrated on the deductibility of losses resulting from activities in which taxpayers materially participate. But there is, of course, another aspect to Congress’s decision to place material participation activities outside the scope of section 469: when such activities produce taxable income rather than tax losses, the classification of the income as nonpassive means that passive losses cannot shelter it. This treatment effectuates section 469’s purpose of preventing the sheltering of income from personal services. Much or all of the taxable income from a business in which a taxpayer materially participates may be attributable to the value of the taxpayer’s services. If, however, the taxpayer does not receive a salary from the business, none of the income will be officially designated as personal services income. If such income were brought within the scope of section 469, it could be sheltered by passive losses. This treatment would enable taxpayers who materially participate in businesses, but who do not collect salaries as such, to shelter personal services income—a result inimical to section 469’s philosophy. To prevent this result, Congress put businesses in which taxpayers materially participate outside the scope of section 469. Under this view, the favorable treatment of losses from these activities is an unavoidable by-product of the unfavorable treatment of income from such activities.340

One can imagine, however, a different way of ensuring that a materially participating taxpayer will not shelter income attributable to personal services. The system might require an appropriate allocation of the taxpayer’s income from the activity between the return from his services and the return from his capital. The personal services income would then be treated as nonshelterable by passive losses, while the income or loss allocated to capital would be treated as passive.341 This method would achieve the goal of preventing the sheltering of personal services income, without providing favorable treatment for material participation losses.

This allocation requirement would entail major administrative difficulties, and lawmakers might reject it for that reason. However, one who rejects an allocation requirement still need not accept the unlimited deductibility of material participation losses as the cost of preventing taxpayers from sheltering their personal services income. No compelling reason exists for linking the treatment of material participation losses to

341. *See id.* at 47.
the treatment of material participation income. The tax system could treat income from a business in which a taxpayer materially participates as active (that is, not shelterable by passive losses) and a loss from such a business as passive (that is, subject to the limitations of section 469). Some would undoubtedly object to this treatment as an unfair “heads-I-win, tails-you-lose” rule, but the asymmetrical treatment would be justified. Treating income from an activity in which a taxpayer materially participates as nonpassive prevents the sheltering of income from the activity attributable to the taxpayer’s personal services; viewing losses from the activity as passive prevents the deduction of artificial losses from the activity against personal services and portfolio income. Because there is no reason why the treatment of income must determine the treatment of losses, the need to treat the income from activities in which taxpayers materially participate as nonpassive does not justify the failure to apply the limitations of section 469 to losses from such activities.

IV. Conclusion

On a theoretical level, the case for restricting tax shelters without eliminating preferences is not persuasive. Even if one were to accept the theoretical case for the 1986 Act’s antishelter approach, there is good reason to be troubled by many aspects of the legislation. It is difficult to grasp the rationale for the particular baskets that the Act creates. The interest tracing regulations under sections 163(d) and 469 will be subject to manipulation by sophisticated taxpayers and will result in unequal treatment of similarly situated taxpayers. Moreover, that any alternative

342. Actually, treating such income as nonpassive does not completely prevent the sheltering of personal services income by a taxpayer engaged in an active business who receives income from the business that is attributable to his personal services, but which is not labeled as compensation income: “Due to preferences and the realization requirement, this taxpayer may be able to avoid recognizing net nonpassive income even if he has profited economically and even if such profits are, in fact, attributable to his rendering of personal services.” Id. Treating income from active businesses as nonpassive prevents the sheltering of the income by unrelated passive losses, but it does not prevent the use of preferences within the activity to offset personal services income from the activity. The system could prevent this “inside” sheltering only by an allocation requirement. See supra text accompanying note 341. The opportunity for “inside” sheltering of personal services income from active businesses is a tax advantage of active businesses, which might be viewed as roughly offsetting the supposed unfairness of a rule treating income from such businesses as nonpassive, and treating losses from the same businesses as passive.

343. Section 469 already provides for asymmetrical treatment in certain circumstances. It gives Treasury the authority to write regulations “requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity.” I.R.C. § 469(f)(3) (West Supp. 1988). The result of this regulation would be that income from the limited partnership or other passive activity could not be sheltered by passive losses, even though any losses from the same activity would be subject to the § 469 limitations on the deductibility of passive losses. The temporary and proposed regulations exercise this grant of authority. See Temp. Treas. Reg. § 1.469-2T(f) (1988); supra note 232.

588
Anti-Tax Shelter Provisions

method of interest allocation raises equally severe problems calls into question the wisdom of all tax shelter limitations based on basketing. An intractable problem with antishelter basketing provisions is the treatment of real economic losses. A provision drafted broadly enough to disallow all artificial losses will inevitably disallow some real losses, while a provision designed to allow the deduction of real losses will inevitably allow the deduction of some artificial losses. The difficulty, or even impossibility, of finding any satisfactory solution to the problem of real economic losses again calls into question the wisdom of all shelter limitations based on basketing.

These objections extend beyond flaws peculiar to the provisions of the 1986 Act; they suggest problems likely to beset any attempt to eliminate shelters without eliminating preferences. The restriction of shelters without the elimination of preferences is an unconvincing theory that becomes even more dubious in practice. Yet the attractiveness of this approach as a political compromise is not hard to understand. If one’s ideal tax system would eliminate preferences themselves, one might favor the Act’s antishelter provisions on the grounds that they constitute the greatest restrictions on preferences that Congress would be willing to approve.344 Conversely, one who favors no limitations on preferences might nevertheless accept the Act on the grounds that the political pressure to do something about shelters is irresistible and the Act responds to that pressure while preserving the preferences themselves.

The antishelter provisions of the Act are best understood as an exercise in political compromise,345 not as an exercise in pure logic. Whether that compromise can long survive is doubtful, however, given its weak theoretical foundations and its considerable practical difficulties.

344. For an interesting example of this kind of thinking, see Johnson, supra note 44. The theme of Johnson’s article is that it is appropriate to restrict the use of preferences in shelters, but Johnson’s antipathy to preferences themselves occasionally shows through. Consider, for example, his statement on the tax exemption for interest on municipal bonds: “Why do we need a subsidy for irresponsible deferral of the real costs of government on top of the existing political, structural bias? It would make more sense to subsidize restraint or contraction of municipal borrowing, instead of borrowing.” Id. at 168-69.

For another example of this attitude, see Koppelman, supra note 43, at 1194-98. Koppelman gives two reasons why Congress should restrict the use of incentive preferences in shelters, even if it does not eliminate the preferences themselves. The first reason is that it may be politically impossible to eliminate preferences that represent bad policy. If so, Koppelman favors limitations on the interest deduction as “damage control.” Id. at 1194. The second reason is quite similar. Koppelman argues that even if a government subsidy is justifiable in a particular case, a direct subsidy is almost always preferable to a subsidy embodied in a tax preference. He favors limitations on the deductibility of interest expenses associated with such preferences because “[c]omprehensive interest limitations might help convert tax expenditures into direct appropriations by making tax expenditures less attractive.” Id. at 1198. Both of these arguments against shelters are based, of course, on a dislike of the preferences themselves.

345. See J. BIRNBAUM & A. MURRAY, supra note 2, at 218-33.