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DETOURING THE TAX REFORM ACT OF 1976: TAX SHELTER PROPRIETORSHIPS

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After briefly reviewing the so-called abusive aspects of tax shelters which led Congress to enact the Tax Reform Act of 1976, the authors focus on an unintended loophole—the tax shelter proprietorship. The tax shelter proprietorship remains a viable method of reducing federal income taxes payable by high bracket taxpayers. The business mechanics and tax aspects of a sound recording proprietorship are analyzed and specific suggestions for future reforms to deal with the problem of tax shelter proprietorships are delineated.

I. THE TAX REFORM ACT OF 1976	1
II. A GAP LEFT UNCLOSED BY THE TRA	5
III. HOW A TAX SHELTER PROPRIETORSHIP WORKS	7
IV. INHERENT WEAKNESSES OF A TSP	12
V. SUGGESTED REFORMS AND CONCLUSION	19

I. THE TAX REFORM ACT OF 1976

The tax shelter provisions of the Tax Reform Act of 1976 (TRA) were motivated, in large part, by a Congressional desire to strengthen the equitable nature of the federal income tax system. The impetus for reform stemmed from the belief that "many persons hold the view that the system is unfair, presumably because they feel that high-income individuals do not pay their fair share of taxes."¹

The Joint Committee on Internal Revenue Taxation carefully documented² a parade of tax shelter "abuses." Some of the more

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1. H. R. REP. No. 94-658, 94th Cong., 2d Sess. 7, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 2902 [hereinafter cited as H.R. 94-658].

2. See, e.g., STAFF OF J. COMM. ON INT. REV. TAX, 94th CONG., 1ST SESS., TAX SHELTERS:

disturbing practices included: accelerated depreciation deduction;³ large first year tax write-offs for, among other items, organization and syndication expenses;⁴ heavily leveraged nonrecourse debt financing, which limited a taxpayer's personal risk and enabled an investor to increase his or her adjusted basis;⁵ the conversion of ordinary income to capital gains in certain tax shelter investments; and the pervasive use of limited partnerships to limit investor liability while maximizing tax deductions.⁶ A tax shelter allowed an investor to offset losses and deductions not only against the income from a venture but also against the taxpayer's other income. Principal payments on the debt used to finance the investment were also sheltered.⁷ In short, individuals used tax shelters to avoid or at least postpone the payment of significant amounts of federal income taxes.⁸ Congressional review of shelter investment in certain activities, namely, real estate, farm operations, oil and gas, motion picture films, equipment leasing and professional sports franchises, indicated that deductions from nonrecourse leveraged investments⁹

COMMITTEE MEMBER SELECTION OF PROPOSALS FOR CONSIDERATION IN FIRST PHASE OF TAX REFORM (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: EQUIPMENT LEASING (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: FARM OPERATIONS (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: MOTION PICTURES (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: OIL & GAS DRILLING FUNDS (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: PREPAID INTEREST (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: PROFESSIONAL SPORT FRANCHISES (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: REAL ESTATE (Comm. Print 1975); STAFF OF J. COMM. ON INT. REV. TAX, 94TH CONG., 1ST SESS., TAX SHELTERS: USE OF LIMITED PARTNERSHIPS, ETC. (Comm. Print 1975); STAFF OF HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 1ST SESS., TAX REFORM HEARING, STATEMENTS OF PUBLIC WITNESSES (Comm. Print 1975).

3. H.R. 94-658, *supra* note 1, at 25, 26. See I.R.C. § 167. See also I.R.C. § 163 (interest payments on debt financing for a venture are deductible).

4. H.R. 94-658, *supra* note 1, at 26. See also J. COMM. ON INT. REV. TAX, 94TH CONG., 2D SESS., OVERVIEW OF TAX SHELTERS at 1-7 (Comm. Print 1975) [hereinafter cited as OVERVIEW].

5. H.R. 94-658, *supra* note 1, at 26, 27. Prior to the TRA, if the sale was an "arm's length" transaction and the amount of the debt obligation used to finance the transaction did not exceed the fair market value of the property, a taxpayer's adjusted basis included such nonrecourse debt. *Crane v. Commissioner*, 331 U.S. 1 (1947); *Manuel D. Mayerson*, 47 T.C. 340 (1966); *Blackstone Theater Co.*, 12 T.C. 801 (1949); *Treas. Reg.*, § 1.752-1(e) (1957). *But see* *Leonard Marcus*, 40 TAX CT. MEM. DEC. (P-H) 1326 (1971), where a nonrecourse note was excluded from basis as too contingent to be included.

6. H.R. 94-658, *supra* note 1, at 27.

7. Sexton, *The Shrinking Tax Shelter Umbrella*, 52 TAXES 715 (1974).

8. H.R. 94-658, *supra* note 1, at 8.

9. Nonrecourse leveraged financing occurs, in this context, where the investor borrows capital on a nonrecourse basis; that is, with no personal liability and the creditor securing the loan with a chattel mortgage or some other security interest. The effect of such financing is to increase the venture's depreciable basis, thereby increasing the amount of "paper deductions" which may flow through and offset the taxpayer's other income. See, e.g., I.R.C. § 752(a).

substantially altered not only the economic substance of the investments but also distorted the workings of capital markets.¹⁰

The TRA utilizes two new statutory techniques to curb tax shelter abuses. First, to limit a taxpayer's losses in excess of an equity investment in a venture, Congress sought to restrict such losses to the amount "at risk" in farming, oil and gas, motion picture and video tape, and equipment leasing activities.¹¹ Second, Congress attempted to curtail the use of the partnership vehicle, specifically the limited partnership, as a tax shelter entity. Congress translated these twin objectives into two significant amendments to the Internal Revenue Code.

Section 465¹² prevents a taxpayer from deducting losses¹³ from

10. H.R. 94-658, *supra* note 1, at 27, 28. See also J. COMM. ON INT. REV. TAX, 94TH CONG., 2D SESS., TAX REVISION ISSUES—1976, at 9-11 (Comm. Print 1976).

11. These are identified by the House Committee on Ways and Means as "major tax shelters" to be eliminated. H.R. 94-658, *supra* note 1, at 9.

12. Section 465 of the Internal Revenue Code provides:

(a) General rule.—In the case of a taxpayer (other than a corporation which is neither an electing small business corporation (as defined in section 1371(b)) nor a personal holding company (as defined in section 542)) engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year. Any loss from such activity not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

(b) Amounts considered at risk.—

(1) In general.—For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) Borrowed amounts.—For purposes of this section, a taxpayer shall be considered at risk with respect to amounts borrowed for use in an activity to the extent that he—

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

(3) Certain borrowed amounts excluded.—For purposes of paragraph (1) (B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who—

(A) has an interest (other than an interest as a creditor) in such activity, or

certain specified activities to the extent that those losses are generated by nonrecourse loans. Such losses are deductible only to the extent that the taxpayer is "at risk." The amount "at risk" is defined as the sum of the money and the adjusted basis of other property contributed by a taxpayer to a venture, plus any borrowed amounts for use in the activity for which the taxpayer is personally liable for repayment, or property, other than the property used in such activity, pledged as security for such borrowed amount.¹⁴ The definition of "at risk" excludes nonrecourse loans as well as other loss protection arrangements, such as guarantees.¹⁵ The at-risk rule

(B) has a relationship to the taxpayer specified within any one of the paragraphs of section 267(b).

(4) Exception.—Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

(5) Amounts at risk in subsequent years.—If in any taxable year the taxpayer has a loss from an activity to which this section applies, the amount with respect to which a taxpayer is considered to be at risk (within the meaning of subsection (b)) in subsequent taxable years with respect to that activity shall be reduced by that portion of the loss which (after the application of subsection (a)) is allowable as a deduction.

(c) Activities to which section applies.—

(1) Types of activities.—This section applies to any taxpayer engaged in the activity of—

(A) holding, producing, or distributing motion picture films or video tapes,

(B) farming (as defined in section 464 (e)).

(C) leasing any section 1245 property (as defined in section 1245(a)(3)), or

(D) exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income.

(2) Separate activities.—For purposes of this section, a taxpayer's activity with respect to each—

(A) film or video tape,

(B) section 1245 property which is leased or held for leasing,

(C) farm, or

(D) oil and gas property (as defined under section 614), shall be treated as a separate activity. A partner's interest in a partnership or a shareholder's interest in an electing small business corporation shall be treated as a single activity to the extent that the partnership or an electing small business corporation is engaged in activities described in any subparagraph of this paragraph.

(d) Definition of loss.—For purposes of this section, the term "loss" means the excess of the deductions allowable under this chapter for the taxable year (determined without regard to this section) and allocable to an activity to which this section applies over the income received or accrued by the taxpayer during the taxable year from such activity.

13. I.R.C. § 465(d).

14. I.R.C. § 465(b).

15. I.R.C. § 465(b)(4).

applies to all taxpayers except corporations which are neither electing Subchapter S corporations nor personal holding companies.¹⁶ Furthermore, the taxpayer will be subject to the at-risk limitation only if engaged in certain activities.¹⁷

An amendment to section 704(d) complements the at-risk limitation rule of section 465. This amendment limits the adjusted basis of any partner's interest in a partnership to liabilities with respect to which the partner is personally liable.¹⁸ This limitation applies to all partnerships engaged in any activity, except if section 465 applies or if a partnership's principal activity is investing in real property, other than mineral property.¹⁹

II. A GAP LEFT UNCLOSED BY THE TRA

A serious deficiency exists with respect to the Congressional effort to limit tax shelter "abuses." The at-risk limitations of section 465 are broad as to type of taxpayers, but narrow as to type of activities. Consequently, the shelter-minded investor has less incentive to invest in farming, oil and gas, movies and video tapes, or equipment leasing ventures because the at-risk limitations of section 465 apply to *all* taxpayers. Other than corporations which have not elected under Subchapter S and are not personal holding companies, taxpayers subject to the at-risk limitation include individuals, sole proprietorships, estates, trusts, shareholders in Subchapter S corporations, and partners in general or limited partnerships engaged in the specified activities. Since the utility of most tax shelters depends, in large measure, on leveraged nonrecourse financing

16. I.R.C. § 465(a).

17. I.R.C. § 465(c). Specifically these activities are farming, equipment leasing, exploring or exploiting oil and gas resources, and holding, producing or distributing motion picture films or video tape.

The Internal Revenue Service also has taken the position that an individual taxpayer is subject to the at-risk provisions of section 465 where he purchases a sound recording of songs in an arms length transaction for a cash downpayment and a nonrecourse note, while also granting the right to use and exploit the master recording for a limited period to another individual in exchange for royalties on the records sold by the second individual. Rev. Rul. 77-397, 1977-44 I.R.B. 7. For a discussion of how to plan around this revenue ruling see the text accompanying notes 46.1-46.6 *infra*.

18. Section 704(d) provides:

For purposes of this subsection, the adjusted basis of any partner's interest in the partnership shall not include any portion of any partnership liability with respect to which the partner has no personal liability. The preceding sentence shall not apply with respect to any activity to the extent that section 465 (relating to limiting deductions to amounts at risk in case of certain activities) applies, nor shall it apply to any partnership the principal activity of which is investing in real property (other than mineral property).

19. *Id.*

to increase a limited partner's adjusted basis for tax write-offs,²⁰ the shelter-minded investor will look to activities other than those specified in section 465. Section 704(d) reinforces section 465 with a broad proscription limiting the use of a partnership entity, except for real estate ventures. The combined effect of sections 704(d) and 465²¹ may be to induce tax-oriented investors to look to ventures in fields outside the specific activities covered by the at-risk limitations of section 465 and to discard the partnership entity restricted by section 704(d). The shelter-minded investors may turn to sound recordings, book publishing, and the reproduction of artistic works while adopting a business entity new to the field of tax shelter investors—the sole proprietorship.²²

Congress failed to foresee the shift to tax shelter proprietorships. It also failed to broaden the list of activities to which the at-risk limitations apply. These shortcomings may be the result of an oversight by Congress, or they may be the product of practical political constraints. In this regard, the Joint Committee on Internal Revenue Taxation stated:

In selecting topics for inclusion in this bill, your committee has attempted to choose areas where urgent action is needed or where consensus could be reached quickly. Your committee intends that this bill be followed by other tax reform legislation. . . . The committee recognizes, however, that this bill does not represent a complete reform of the tax laws. Reform is a continuing process to which the committee intends to devote much effort in the years to come.²³

Further, the Committee indicated its approach was remedial rather than revolutionary:

Tax shelters are usually the result of provisions that have been put into the tax law to serve a worthwhile purpose, such as directing capital into certain vital industries. In these cases, your committee has decided to keep the underlying tax preferences intact but to limit their use as a device to shelter other, unrelated

20. See I.R.C. § 752 (e); Treas. Reg. § 1.752-1(e) (1957). This statutory provision and regulation were based on *Crane v. Commissioner*, 331 U.S. 1 (1947). For an example of leverage nonrecourse financing see *Manuel D. Mayerson*, 47 T.C. 340 (1966).

21. For a discussion of the interrelationship of sections 465 and 704(d) in the context of the production of graphic art prints, see the example given in *Shop Talk*, 45 J. TAX. 382-83 (1976). For an interpretation of the TRA, see also *Shop Talk*, 46 J. TAX. 63-64 (1977).

22. But see text accompanying notes 46.1-46.6 *infra*. The characteristics and advantages of this business form are discussed in C. ROHRlich, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES §§ 2.03-.04 (1949). See also INST. OF BUS. PLANNING, 2 TAX PLANNING ¶ 3601 (1976).

23. H.R. 94-658, *supra* note 1, at 8.

income from tax. Under existing law, the use of artificial deductions to shelter unrelated income from tax can mean that investments generate income that not only is itself exempt from tax but actually results in "negative taxes" in the sense that it reduces the tax burden of unrelated income. Your committee believes that this "negative taxation" on the income from tax shelter investments constitutes too large a tax preference, and, consequently, the bill eliminates the major tax shelters.²⁴

III. HOW A TAX SHELTER PROPRIETORSHIP WORKS

An analysis of a sound recording venture will reveal the business mechanics and tax aspects of a tax shelter proprietorship (TSP). Using several corporate entities owned by one or more individual shareholders of a corporate promoter, the corporate investment promoter will assemble a number of sound recording proprietorships for sale. The process may involve a convoluted series of transactions. For example, Corporation A acquires a collection of original performances from radio and television stations, artists' agents, and recording companies. Corporation A sells to Corporation B a number of master sound recordings (MSR), which consist of a reproduction of a performer's work from which other recordings are manufactured for sale to the public. Corporation B compiles²⁵ selections from 45 rpm singles, and 33-1/3 rpm long playing recordings, which require approximately two and ten MSRs respectively. Corporation B designs and prepares album covers and record sleeves for printing and prepares the MSRs for the manufacturing process. Corporation B then sells these packages to Corporation C. For each MSR purchased, Corporation C enters into an assignable ten year (or longer) contract with an independent corporate record distributor²⁶ for the manufacture and distribution of recordings made from each MSR. Pursuant to such contracts, the distributor possesses total responsibility for and complete discretion over the exploitation²⁷ of the MSR, including manufacture and distribution to sales outlets,²⁸ collection of sales receipts, and payment of all royalties.²⁹ Corporation C, in turn, sells the MSRs and respective contracts to the corporate promoter. For each MSR purchased, the corporate

24. *Id.* at 9.

25. S. SHEMEL & M. KRASILOVSKY, *THIS BUSINESS OF MUSIC* (rev. ed. 1971). Compilation of a master by a producer may generate considerable savings because of the absence of recording costs in a compilation of past performances.

26. *Id.* at 50.

27. *Id.* at 320.

28. *Id.* at 36, 74.

29. *Id.* at 65-69.

promoter gives Corporation C a ninety-day recourse note for part of the sales price, with the balance payable by a ten year nonrecourse promissory note secured by a security interest in the MSR. Principal and interest payments on the nonrecourse promissory note are payable exclusively from the gross receipts derived from exploitation of the MSR. The corporate promoter obtains one or more expert appraisals³⁰ on each MSR indicating that its useful life will exceed seven years or more³¹ and that estimated life net receipts expected from sales on such MSR will exceed the purchase price.³² Finally, the corporate promoter sells one or more MSRs to investors. Each investor, in acquiring his or her TSP property, makes a substantial cash down payment, large enough for the corporate promoter to recover its costs plus a profit.³³ In addition, the investor assumes the nonrecourse debt owed by the corporate promoter to Corporation C.³⁴ The corporate promoter pays off its ninety-day recourse note to

30. *Id.* at 34. Estimating the income stream from an MSR is even more difficult than estimating income from motion pictures, where test screenings and sneak previews are helpful. Accordingly, the record business is largely a gamble on the market potential of recordings. See also Harnack, *Techniques in Preparing a Valuation Case*, 30 N.Y.U. ANN. INST. FED. TAX. 163, 174-77 (1972); Tannenbaum, *Leverage Shelter Operations: Oil & Gas, Motion Pictures and Other Theatrical Shelters*, 31 N.Y.U. ANN. INST. FED. TAX. 777 (1973). Harnack suggests a taxpayer use several experts in a valuation dispute since the Service will use only one.

31. A useful life of seven years or longer is required to take full advantage of the ten percent investment tax credit on an investment property. See I.R.C. §§ 46, 48; Treas. Reg. §§ 1.46-1, 1.48-1 to -3 (1965). Further, a taxpayer must employ the same useful life for purposes of the investment tax credit and depreciation deduction. Treas. Reg. § 1.46-3(e) (7) (1973). See also Treas. Reg. § 1.48-1 (1965).

32. The sale of a sole proprietorship as a single business requires a determination of the tax cost to the purchaser. Harnack, *supra* note 30, at 164. See also Panel Discussion, *Problems in Acquiring a Business*, 26 N.Y.U. ANN. INST. FED. TAX. 815, 847 (1968). This panel discussion suggested that a taxpayer needs an appraisal if the price paid is greater than the basis in the seller's hands. Although a taxpayer's cost generally will constitute his or her basis, where price paid is greater than the fair market value the courts may exclude any excess from the taxpayer's adjusted basis. *Jordon v. Commissioner*, 60 T.C. 872, *aff'd*, 514 F.2d 1209 (8th Cir. 1975).

33. *But see* Marvin May, 41 TAX CT. MEM. DEC. (P-H) 294 (1972), where the Tax Court found the cash down payment equalled the true cost and, therefore, the adjusted basis. The court's conclusion was based on its finding that the transaction did not involve an "arms length" sale in that the balance of the purchase price was never to be paid despite the apparent paper obligation to do so. In so holding, the court was adopting the service's "substance over form" argument.

34. Tannenbaum, *supra* note 30, at 781. The *Crane* rule permits an investor to include in his or her adjusted basis the amount of the nonrecourse mortgage on the property. *Crane v. Commissioner*, 331 U.S. 1 (1947); Treas. Reg. § 1.752-1(e) (1957).

It should be noted that responsible commercial banks will not make nonrecourse loans on MSRs. The usual practice is for the promoters (or some corporate affiliate or alter ego) to hold the nonrecourse note secured by the chattel mortgage on the investor's MSR. This enables the promoters to realize additional income from the sale through the receipt of interest payments, as well as principal, on the note. Further, use of the satellite or affiliated corporation, as holder of the promissory note and mortgage, insulates the promoter from the

Corporation C. Corporation C then releases the promoter from any secondary liability on the nonrecourse promissory note assumed by the investor. Manufacture and distribution of the recordings commences.

It is highly unlikely that a TSP will ever generate sufficient receipts to produce profits or even to pay off the nonrecourse debt the investor assumed. The income flow of each TSP depends on net receipts from sales, which vary according to the type of record sold and the type sales outlet³⁵ through which the distributor sells the records. Notwithstanding this fact, it is well recognized in the record industry that revenues from the vast majority of long playing recordings will not meet costs.³⁶

Although a TSP probably will constitute a business failure, it also will create a highly successful tax shelter. For example, assume the investor purchased a TSP package, containing one or more MSRs, for \$100,000. The investor pays the corporate promoter \$20,000 in cash and assumes a nonrecourse promissory note for ten years. This note will be secured by a security interest in the MSR. In all likelihood it will become apparent, upon release of the recording for sale, that the venture will not prove to be a commercial success. As a result, the lifetime net receipts must then be reappraised for depreciation purposes.

The taxpayer's MSR property qualifies for use of the income forecast method of depreciation³⁷ to amortize the cost of the prop-

allegation of having retained any interest in the MSR. Another advantage to the corporate alter ego is psychological: in the event of foreclosure, ill will is directed at the corporate affiliate rather than the promoter.

35. 45 rpm "singles" bring the TSP less than half the return of a long playing album. At the top of the sales price scale is the normal retail music store which sells long playing albums for \$5.98 to \$6.98. Mail order sales prices approximate \$4.98, plus postage and handling. At the bottom end of the scale is the "budget line" price of \$2.98 to \$4.98. The distributor sells the record to various sales outlets at prices ranging from \$1.50 to \$3.50 per copy. Most compilations of previously released recordings will be sold through radio and television stations, which provide free advertising on the air in return for a royalty of \$.50 to \$.75 per record sold. The TSP investor will receive roughly \$.02 to \$.05 for each record sold. Initially, many new releases are "give aways," used to stimulate interest and demand. Therefore, to recognize this in the accounting for proceeds, twenty percent of all records pressed are not subject to accounting.

For an authoritative and comprehensive review of all aspects of the record making business see 2 A. LINDEY, ENTERTAINMENT, PUBLISHING AND THE ARTS—AGREEMENTS AND THE LAW 467 (Supp. 1975); S. SHELMEYER & M. KRASILOVSKY, *supra* note 25.

36. S. SHELMEYER & M. KRASILOVSKY, *supra* note 25, at 71. Discussions with a knowledgeable industry observer (Bob Cole of Liberty Recording Studios, March 29, 1977) revealed that only three of every 100 long playing albums issued per year will have revenues exceeding costs of production and distribution.

37. Rev. Rul. 60-358, 1960-2 C.B. 68, contains the phrase, "other property of a similar character." See also I.R.C. § 167(b) (4); Treas. Reg. § 1.167(b) (4) (1957). This suggests that any reasonable method of depreciation which is consistent with income and remaining useful life may be used. An explanation of income forecast method is contained in Fass, *Motion*

erty. The annual depreciation deduction is determined by multiplying the cost of the property by a fraction, the numerator consisting of the net receipts for the taxable year³⁸ and the denominator consisting of the proprietorship's forecast of the lifetime receipts from the investment property. If the first year net receipts total \$400,000, the lifetime net receipts are forecast to reach \$500,000 and the investment property costs \$1,000,000,³⁹ then the amount of first year depreciation deductions would equal \$800,000.⁴⁰

In the TSP example, assume the net lifetime receipts are estimated to equal the investor's \$20,000 capital contribution. Should that estimate prove accurate the taxpayer could still depreciate, under the income forecast method of depreciation, the full \$100,000 cost of his or her investment including that portion presented by the nonrecourse promissory note.⁴¹ Additionally, if the useful life of the master recording is seven years or more, the taxpayer could take an

Pictures as a Tax Shelter: A Current Analysis of the Technique and Problems, 40 J. Tax. 154, 156 (1974). The income forecast method of depreciation may constitute such a distortion of accepted accounting practices that investors in motion picture tax shelters are better off if such ventures lose money. See S. SURREY, P. MCDANIEL, & J. PECHMAN, *FEDERAL TAX REFORM FOR 1976* at 65 (1976). See also S. REP. No. 938, 94th Cong., 2d Sess. 72 (1976) (example).

38. The Internal Revenue Service insists that taxpayers using this depreciation method employ net receipts so as to reduce the amount of first year depreciation taken. Rev. Rul. 60-358, 1960-2 C.B. 68; 4 R. HAFT, *TAX SHELTERED INVESTMENT, TAXATION SECURITIES*, § 9.06 (1st ed. 1973); Hass, *Motion Picture Investments Adversely Affected by TRA but Opportunities Remain*, 46 J. Tax. 140, 142 (1977).

39. Since the useful life of tangible personal property is considered to begin when it is first placed into service, the investment property here is treated as new property. I.R.C. § 48(b) (2).

40. The depreciation is determined as follows:

$$\frac{\$400,000 \text{ (net receipts)}}{\$500,000 \text{ (forecast lifetime net receipts)}} \times \$1,000,000 \text{ (cost of new investment property)} = \$800,000$$

41. In this example tax losses might look like this:

Year	Net Income	Investment Tax Credit	Income Forecast Depreciation	Tax Loss
1	\$12,000	\$10,000	\$ 60,000	\$58,000
2	1,200	—	6,000	4,800
3	1,200	—	6,000	4,800
4	1,200	—	6,000	4,800
5	1,200	—	6,000	4,800
6	1,200	—	6,000	4,800
7	2,000	—	10,000	8,000
	<u>\$20,000</u>	<u>\$10,000</u>	<u>\$100,000</u>	<u>\$90,000</u>

investment tax credit of ten percent of the cost of the master recording.⁴² If the taxpayer receives \$12,000 in net receipts from sales during the first year, first year tax savings could total at least \$58,000, including a \$10,000 investment tax credit and depreciation deductions under the income forecast method of \$60,000. Assuming no repayment of principal on the debt, at the end of seven years the taxpayer's deductions will exceed \$110,000 on a \$20,000 investment. Interest payments on the tax are deductible, of course, but revenues from the TSP may equal or exceed such interest deductions.⁴³

Assuming the taxpayer makes no principal payments on the nonrecourse note, in the unlikely event the lender (Corporation C) forecloses on its security interest at the end of ten years, the taxpayer will recognize a gain measured by the amount due on the note.⁴⁴ The portion of such gain attributable to depreciation previously taken on the MSR is taxable as ordinary income.⁴⁵ The taxpayer has taken depreciation deductions of \$100,000, and has a zero adjusted basis. On foreclosure, the taxpayer will realize \$80,000. Such amount must be recognized as ordinary income in that taxable year. If the taxpayer abandons or otherwise disposes of the MSR prior to the due date on the note, the excess of the amount, if any, received on such transaction over the adjusted basis of the TSP plus the amount then owing on the note would be treated in a manner similar to a foreclosure at the end of ten years.⁴⁶ To avoid adverse tax consequences resulting from a foreclosure at the end of ten years or when the taxpayer abandons or otherwise disposes of the MSR, the taxpayer, on the occurrence of such an event, must look to a new and even larger tax shelter.

42. Investment tax credit is allowed only for the first taxable year in which the investment property is placed in service. Furthermore, the estimated useful life of the investment property must be seven years or more to obtain full credit of ten percent. The investment tax credit can offset total tax liability up to \$25,000 plus fifty percent of the liability for tax in excess of \$25,000 in the first taxable year. See I.R.C. § 46(a) (1). See also *Walt Disney Productions, Inc. v. United States*, 480 F.2d 66, 73-2 U.S. Tax. Cas. ¶ 9484 (9th Cir. 1973); Treas. Reg. § 1.46-1 (1965). The investment tax credit does not reduce the adjusted basis of the property on which it is taken.

43. The taxpayer may elect to place his TSP on the accrual accounting method. This seems particularly appropriate since some inventories of records are maintained. I.R.C. § 446(a) (1). Where this is done, interest on the nonrecourse promissory note would be deductible as it accrues, regardless of when the interest is actually paid. See also Rev. Rul. 68-643, 1968-2 C.B. 76; Treas. Reg. §§ 1.446-1(c), (d), (e) (1) (1973). The use of the accrual method affords the investor even greater deferral benefits from his TSP.

44. Rev. Rul. 76-11, 1976-1 C.B. 30; Treas. Reg. § 1.245-1 (a) (3) (1957). See also Fass, *Motion Pictures as a Tax Shelter: A Current Analysis of the Technique and the Problems*, 49 J. Tax. 154, 158 (1974); Krane, *Economic Analysis of Tax Sheltered Investments*, 54 TAXES 806, 815 (1976).

45. Treas. Reg. § 1.1245-1(b) (2), example 1 (1965).

46. Treas. Reg. §§ 1.1245-1(c) (1) (1965), 1.61-12(a) (1958).

IV. INHERENT WEAKNESSES OF A TSP

The investor must recognize a number of potential weaknesses in the TSP arrangement. A gamut of tax challenges must be surmounted, including the following: (1) the agreement between the TSP and the distributor may be deemed a lease of section 1245 property, thereby subjecting the taxpayer to the at-risk limitations contained in section 465; (2) the nonrecourse loan assumed by the taxpayer may be recast as an equity contribution or as debt financing provided by Corporation C; (3) the TSP may be deemed a sham because the taxpayer may lack a reasonable expectation and/or intention to make a profit from the venture; (4) the TSP may be treated as an association taxable as a corporation; (5) the TSP's acquisition of the MSR may be treated as a joint venture, taxable as a partnership; (6) the TSP's adjusted basis may be challenged as exceeding the fair market value of the MSR; (7) the acquisition by the TSP of the MSR may be treated as a loan or a license of the MSR; (8) the Internal Revenue Service may challenge the use of the income forecast method of depreciation of the MSR; and (9) the availability or amount of the TSP's investment tax credit may be challenged on grounds that the MSR is not tangible personal property or, alternatively, that it is not "new" property. With careful planning *most* of these challenges can be overcome, but three significant pitfalls remain: (1) the agreement between the TSP and the distributor may be deemed a lease of section 1245 property, thereby subjecting the taxpayer to the at-risk limitations contained in section 465, (2) the possibility of a disallowance of deductions because the loan is recast as equity or debt provided by Corporation C, and (3) the venture might be deemed a sham as the investor lacked any reasonable intention of repaying the loan.

The Service has taken the lead in promulgating a series of revenue rulings^{46.1} aimed at cracking down on tax shelters. One such revenue ruling applies to master sound recordings.^{46.2}

According to the Internal Revenue Service, a taxpayer who purchases an MSR is subject to the at-risk limitations contained in section 465 where the MSR is purchased in an arms length transaction for a cash downpayment and a nonrecourse note, *and* the purchaser also grants the right to use and exploit the MSR for a limited time period to another individual in exchange for royalties on each record sold by such other party.

46.1 For a summary of the Service's efforts to identify major unresolved tax shelter issues and to clarify these issues by publishing a revenue ruling or regulation, see *IRS Cracks Down on Tax Shelters*, [1977] STAND. FED. TAX. REP. ¶ 8082.

46.2 Rev. Rul. 77-397, 1977-44 I.R.B. 7.

The characterization of the agreement between the investor and the other party as a lease of section 1245 property rests at the heart of the revenue ruling. For purposes of section 465(c)(1)(C), the at-risk limitation applies to a taxpayer engaged in the leasing of section 1245 property, that is, property which is personal property and is or has been property of a character subject to depreciation allowances under section 167 of the Internal Revenue Code.^{46.3} The MSR qualifies as section 1245(a)(3) property because it is personal property and is subject to depreciation under section 167. The Service's reasoning and its conclusions, however, are deficient with respect to the interpretation of the concept of "leasing."

A lease, in the Service's view, is "any arrangement or agreement, which is not a sale or exchange, by which the owner of property receives consideration in any form for the use of the owner's property by another party."^{46.4} The right the investor in the revenue ruling grants to the other party (the distributor) pertains to the use and exploitation of an MSR for a limited period of time. Since the investor receives consideration for the other individual's use and exploitation of the MSR, the Service has concluded that the investor-owner is engaged in leasing section 1245 property and, therefore, is subject to the at-risk limitations of section 465.

Under the facts set forth in the revenue ruling, it is not clear whether the individual given the right to use and exploit the MSR possesses a substantial property interest in the MSR.^{46.5} The test of a substantial property interest turns on the nature of remedial enforcement rights. Rights enforceable in equity constitute an interest in the property itself; whereas, a money damage remedy indicates the lack of substantial property interest. Assuming the distributor's breach of the agreement with the investor would give rise to equitable remedies, one must conclude that the agreement is a lease because it represents a substantial property interest.

This line of reasoning encounters a difficulty not discussed in the revenue ruling. What if the distributor receives consideration for: (1) a subsequent transfer (by the distributor) of the agreement; or (2) a premature cancellation of the agreement? The receipt of consideration by the distributor, in either of these two instances,

46.3 I.R.C. § 1245(a)(3).

46.4 Rev. Rul. 77-397, 1977-44 I.R.B. 7, 8.

46.5 See generally *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962); *General Artists Corp.*, 17 T.C. 1517 (1952), *aff'd*, 205 F.2d 360 (2d Cir. 1953), *cert. denied*, 346 U.S. 866 (1953). For analyses of this confusing area of the law see Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 MINN. L. REV. 1 (1964); Eustice, *Contract Rights, Capital Gains, and Assignment of Income—The Ferrer Can*, 20 TAX. L. REV. 1 (1964).

would likely generate ordinary income, not capital gains, treatment. The distributor would be viewed as receiving consideration for personal services performed in the past, rather than for a property interest.^{46.6} In short, even under the facts set forth in the revenue ruling, the service aspects of the agreement may be more important than and outweigh the property aspects. The agreement between the investor and the distributor, therefore, should not be viewed as a lease of section 1245 property, but as a service contract.

In terms of planning to avoid the at-risk limitations of section 465, several conclusions flow from the revenue ruling. The agreement between the investor and the distributor should be cast in terms of payment for services to be rendered in connection with production and distribution activities, not for the use and exploitation or lease or license of an MSR. The agreement should also negate the existence of a proprietary interest on the part of the distributor in the MSR or in a copyright and avoid the use of the term "royalty" which may connote the lease or license of intellectual property. To defeat an argument that the agreement vests in the distributor equitable remedies for breach thereof, the contract should explicitly provide that it shall be revocable without any penalty, at any time, on thirty days notice, by the investor. Finally to strengthen the service or management aura of the agreement, the corporate promoter should give the investor a choice of distributors, and the investor should decide which distributor to engage. Even better, the investor should take the initiative in selecting an independent distributor. These planning techniques should prevent the Service from categorizing a personal services contract between the investor and the distributor as a lease of section 1245 property and thereby avoid the at-risk limitations of section 465.

The sales transaction between the corporate promoter and the investor may be recast as an equity contribution or debt investment by Corporation C, depending on the substance of the transaction and the intent of the parties. In assessing the substance of a transaction, a court will examine whether the transaction possessed some economic utility apart from tax avoidance.⁴⁷ There may be substan-

46.6 See, e.g. *United States v. Eidson*, 310 F.2d 111 (5th Cir. 1962). But see *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897 (5th Cir. 1962). See also *Holt v. Commissioner*, 303 F.2d 687 (9th Cir. 1962); *Lozoff v. United States*, 67-1 U.S. Tax. Cas. ¶ 9436 (E.D. Wis. 1967); *Maryland Coal and Coke Co. v. McGinnes*, 225 F. Supp. 854 (E.D. Pa. 1964), *aff'd*, 350 F.2d 293 (3d Cir. 1965).

47. *Gregory v. Helvering*, 293 U.S. 465 (1935). See also *Knetsch v. United States*, 364 U.S. 361 (1960), where the court examined the substance of the taxpayer's purchases of insurance company annuities contracts, which over several years realized only a miniscule economic gain but enabled the taxpayer to claim significant interest deductions. The court

tial doubt as to the taxpayer's intent to repay such indebtedness, since the repayment of the nonrecourse promissory note will be made only from income from the MSR and the note is secured only by the MSR.⁴⁸ The absence of the requisite intent to repay may lead a court to recast the debt as an equity contribution or debt financing by Corporation C, thereby reducing the investor's adjusted basis and substantially lessening the tax benefits to be enjoyed.

Taxpayer intent, a question of fact, generally determines whether a taxpayer has engaged in an activity for purposes of profit or for tax avoidance.⁴⁹ Absent some believable and otherwise acceptable showing that the taxpayer sought and reasonably expected to achieve an economic gain, deductions may be disallowed. A taxpayer need only show, however, that a chance exists that a venture will generate a profit or possesses the potential for economic benefit.⁵⁰ Such a showing can be made through advertising and the employment of professional help.

A TSP could be treated as an "association"⁵¹ taxable as a corpo-

held that the transaction was a sham and did not create an indebtedness upon which interest could be paid and deducted. See generally Blum, *Motive, Intent and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967); Note, *State of Mind Analysis in Corporate Taxation*, 69 COLO. L. REV. 1224 (1969).

48. A debt which is to be repaid exclusively from the revenue derived from the property sold does not create an interest in the property. *Anderson v. Helvering*, 310 U.S. 404 (1940). To be treated as "debt" an unconditional and legal obligation to pay the debt must exist. *Carnegie Productions, Inc.*, 59 T.C. 642 (1973). See also *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965), where the court held that bank loans to a taxpayer were investments. The court characterized such loans as sham transactions to provide a facade of a loan.

49. No deduction is allowed for activities not engaged in for profit. I.R.C. § 183. Under the Internal Revenue Code an activity is considered to be engaged in for profit where the gross income for two of the previous five taxable years, ending with the current tax year, exceeds the deductions attributable to such activity. So long as an objective to make profits exists, and there is some chance the venture will generate profits, the Service should not be able to successfully challenge the shelter as an activity not engaged in for profit. See *Treas. Reg. §§ 1.183-2(a), 1.183-2(c)*, example 5 (1973). See also *Marvin May*, 41 TAX CT. MEM. DEC. (P-H) 294 (1972); *Kanter & Pennell, Earmarks of Profit Motivation in Tax Shelters*, 45 J. TAX. 319, 320 (1976). In *Marvin May* the court found that the taxpayer never intended to pay the \$365,000 purchase price although he was obligated on paper to do so. The court held the transaction a sham, the taxpayer attempting a "technically elegant" arrangement to acquire large deductions for \$35,000. See generally *Young, The Role of Motive in Evaluating Tax Sheltered Investments*, 22 TAX LAW. 275 (1969).

50. *Kanter & Pennell*, *supra* note 49, at 320. In *Ginsburg*, 45 TAX CT. MEM. DEC. (P-H) 850 (1976) the court disallowed tax deductions absent some believable and otherwise acceptable, reasonable expectation of economic gain from the tax shelter in question.

51. See *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Phillip G. Larson*, 66 T.C. 159 (1976); I.R.C. § 7701; *Treas. Reg. § 301.7701-2* (1961); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 2.02 (Supp. 1977). See also *INST. FOR BUS. PLANNING*, para. 110.2, .3 (1975); *Lourie, Vehicles of Investment*, 16 N.Y.U. ANN. INST. FED. TAX. 727-33 (1958); *Mendenhall & Ferguson, What Risks Now for Partnership and Treatment of Shelters? Lessons of Larson, Zuckman*, 45 J.

ration, thereby curtailing the ability of an investor to deduct losses. Absent associates and an objective to achieve a joint profit or a common business objective, however, each TSP should be presumed to be engaged in business for separate profit. An enterprise owned by a single individual, furthermore, will lack such corporate attributes as continuity of existence and centralized management. Several cases holding one person enterprises not associations are best explained by the absence of the requisite corporate attributes.⁵² A failure of each TSP to retain control over its separate property and the production therefrom, however, could result in association status.⁵³

A transaction wherein separate business entities contribute separately owned property to an endeavor and share in the resulting profits may be characterized by the Internal Revenue Service as a "joint venture."⁵⁴ Where two or more investors own the several MSR "selections" compiled on one long playing record, even though the only connection between each TSP investor results from separate contractual arrangements with a common distributor, the respective TSPs could be characterized as a joint venture subject to taxation as a partnership under Code section 704(d). This determination turns on a factual question of intent as well as an inquiry into the sharing of management, control, risks and profits. Where neither the corporate promoter nor the distributor share the losses or profits from a TSP's exploitation of an MSR, the Service may experience difficulty in establishing the existence of a joint venture between a TSP and a corporate promoter or distributor.⁵⁵ For planning pur-

Tax. 66 (1976); Taubman, *Partnerships and Other Business Forms of the Entertainment Industry*, 16 N.Y.U. ANN. INST. FED. TAX. 217-26 (1958).

52. See *Coast Carton Co.*, 10 T.C. 894 (1948). See also BITTKER & EUSTICE, *supra* note 51, at ¶ 2.07.

53. BITTKER & EUSTICE, *supra* note 51, at ¶ 2.05.

54. A joint venture is a joint undertaking for profit by two or more persons or entities without any actual partnership designation. Taubman, *supra* note 51, at 219. See also Taubman, *What Constitutes a Joint Venture*, 41 CORNELL L.Q. 640 (1956). In many cases a joint venture has been formed where property is separately owned. Winger, *Joint Venture With Corporate Participants*, 22 N.Y.U. ANN. INST. FED. TAX. 611, 623, 626-27 (1964). A joint venture partakes of the nature of a partnership for a certain specific purpose but does not have all the qualities of a partnership. *Tompkins v. Commissioner*, 97 F.2d 396 (4th Cir. 1938). The joint venture relates to a single transaction while the partnership involves a continuing business of a particular kind. *Bartholomew v. Commissioner*, 186 F.2d 315 (8th Cir. 1951). An individual taxpayer, although not a member of a partnership, may be a joint venturer with one of the partners in sharing the profits. *Harry Klein*, 18 T.C. 804 (1952). In *Carnegie Productions, Inc.*, 59 T.C. 642 (1973), the court held that despite the several contractual arrangements, the producer and the financial distributor of the film were joint venturers during production. The Tax Court looked to the substance, not to the form, of the transaction.

55. *Lucia C. Ewing*, 20 T.C. 216 (1953), *aff'd*, 213 F.2d 438 (2d Cir. 1954). The fact that the repayment of the debt owed the producer (Corporation C) is to be repaid from the

poses the TSP should produce and sell forty-five rpm singles or an investor should be sold a sufficient number of MSR selections to constitute at least one long playing record. However, the cost of a TSP long playing record will lessen the utility of the investment tax credit, which is limited to liability for tax up to \$25,000 plus fifty percent of the liability for tax in excess of \$25,000 in the first taxable year.⁵⁶

If a taxpayer's adjusted basis for the TSP exceeds the fair market value of the MSR, the Internal Revenue Service may argue⁵⁷ that the adjusted basis of the TSP should be reduced to the MSR's fair market value.⁵⁸ Even if the purchase price of a TSP exceeds the fair market value of the MSR, however, the amount paid, if supported by an independent appraisal, still may establish the adjusted basis for the property. If the Service can establish that the amount due on the nonrecourse promissory note in the TSP venture exceeds the fair market value of the MSR, the excess of the debt over the fair market value of the MSR would be excluded from the taxpayer's adjusted basis on the TSP.⁵⁹ An expert appraisal would have considerable weight in fixing the fair market value of an MSR if the Serv-

revenues from sales does not create an economic interest in the TSP's property. Commissioner v. Culbertson, 337 U.S. 733 (1949); Bryant v. Commissioner, 399 F.2d 800, 806 (5th Cir. 1968).

56. I.R.C. § 46(a)(3). See also I.R.C. § 46(b) (relating to carryover of the unused investment tax credit).

57. In Leonard Marcus, 40 TAX CT. MEM. DEC. (P-H) 1326 (1971), the deliberately inflated purchase price of a bowling alley purchased by taxpayer prompted the court to disallow inclusion of any portion of the nonrecourse debt in the adjusted basis for depreciation of the property.

In a recent Tax Court decision, the court found that a motel purchase price of \$1,224,000 did not have any relationship to the actual market value of the property. The taxpayer's appraisals were "error-filled, sketchy" and "obviously suspect," and the motel was insured for only \$700,000. In affirming the decision, the Ninth Circuit held that in a nonrecourse purchase, no debt exists unless the purchaser has some equity in the investment. It must be presently reasonable for the purchaser to make a capital investment in the amount of the unpaid purchase price. However, the court went on to say that a sale does not cease to be a sale because the purchaser pays too much, that is, bad bargains do not cease to be a sale. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), *aff'g* 64 T.C. 752 (1975). See also CA - 9 Articulates Judicial "at-risk" rule in its Estate of Franklin Decision, 46 J. TAX. 124 (1977). The Service succeeded in challenging a fixed turnkey contract as excessive in Bermuth, 57 T.C. 225 (1971). See Satty, *Motion Picture Tax Shelters - A New Approach*, 55 TAXES 66 (1977). See also Rev. Rul. 77-110, 1977-16 I.R.B. 7.

58. I.R.C. § 752 (c); Treas. Reg. § 20.2031-1(b)(1959). See Alexander, *Valuation of Intangibles*, 20 N.Y.U. ANN. INST. FED. TAX. 567, 568 (1962). Alexander defines "fair market value" as the price at which the property would change hands as between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. See also, Bennett v. Commissioner, 450 F.2d 959, 71-2 U.S. Tax Cas. ¶ 9696 (6th Cir. 1971).

59. See Crane v. Commissioner, 331 U.S. 1 (1947); Blackstone Theatre Co., 12 T.C. 801, 805 n.37 (1949).

ice chooses to litigate; however, it must be emphasized that an expert valuation does not bind a court.⁶⁰

Three other possible challenges must be considered. The Service might attempt to characterize the TSP's acquisition as a loan⁶¹ or license⁶² of the MSR by the corporate promoter rather than a purchase by the "investor." Such a characterization would require a finding that a seller (the corporate promoter) possessed some residual interest in the MSR even after the TSP repaid the non-recourse promissory note in full. This would not be the case in the instant TSP because the seller's receipts are fixed at the time of acquisition regardless of the commercial success achieved by the TSP. Therefore, it would appear unlikely that the Service could characterize the instant transaction as a loan or a license.

Similarly, there is little likelihood the Service would challenge the use of the income forecast method of depreciation for sound recordings. This conclusion is premised on the following statement made by the Senate Finance Committee in reporting out the TRA: "Generally it is anticipated that taxpayers who are subject to this capitalization requirement [section 280 of the Internal Revenue Code] will (in effect) depreciate their capitalized expenses (in accordance with regulations to be prescribed by the Secretary) under a method analogous to the income forecast method. . . ."⁶³

The TSP's claimed investment tax credit also could be challenged on the grounds that a master sound recording is not tangible personal property.⁶⁴ For purposes of section 280 of the Code,⁶⁵ which

60. See *Gloyd v. Commissioner*, 63 F.2d 649 (8th Cir. 1933), *cert. denied*, 290 U.S. 633 (1933).

61. Where the transfer of property is questioned as a loan a court will look first to the *intent* of the parties to effect an absolute transfer to determine whether a sale or a loan was made. A court will then consider whether: (1) the seller retained any interest in the property; (2) the purchaser has only the right to recover his investment and no more; and (3) the purchaser has been guaranteed the recovery of his or her investment. If the transaction produces a negative answer to the foregoing questions it is unlikely the Service could successfully characterize the sale as a loan despite the limitations on repayment to revenue from the MSR. Ernest A. Wilson, 51 T.C. 713 (1969); Manuel D. Mayerson, 47 T.C. 340 (1969); Rev. Rul. 69-77, 1969-1 C.B. 59. See also *Russo v. Commissioner*, TAX CT. REP. DEC. (CCH) 34,379 (T.C. 1977) (challenged sale of property was a bona fide arms length transaction and not a loan).

62. In *Kaltenbach v. United States*, 66 Ct. Cl. 581 (1929), a contract for sale of a secret process was held to be a license because the seller retained a continuing interest in the property and the transfer was not absolute. However, where the seller retains no rights, no control, and no share in the income beyond the purchase price paid, no matter how great the profits might be, then it appears unlikely the Service could succeed in treating the sale as a "license."

63. SENATE COMM. ON FINANCE, REPORT ON TAX REFORM ACT 1976, S. REP. NO. 94-938, 94th Cong., 2d Sess. 78 (1976).

64. I.R.C. §§ 38, 46.

65. Section 280 requires a taxpayer to capitalize the production costs of an investment

pertains to the amortization of production costs and to depreciation using the income forecast method, sound recordings are treated like motion picture negatives and video tape recordings.

Finally, there may be a more significant problem. If previously released for general distribution, the MSR⁶⁶ used by the TSP may fail to meet the requirement of "new" property. This would limit the cost of such "used" property to \$100,000 per each investor for the investment tax credit purposes.⁶⁷ For this reason, MSRs of previously released performances ("golden oldies") are packaged by promoters in units of \$100,000 or less so as to assure that each investor will receive the full investment tax credit even if his or her MSR is determined to be "used" property.⁶⁸

V. SUGGESTED REFORMS AND CONCLUSION

The use of indirect tax subsidies, in the form of tax shelters, guides the allocation of resources. In time of mounting concern about future adequacy of investment capital, policymakers should be concerned with the diversion of capital to inefficient, nonproductive investments. Wealthy investors surely will continue to consider available tax deductions in their analysis of an investment, rather than simply calculating potential economic return. As a result of their analysis, wealthy investors may conclude that as a source of

in motion pictures, books, records and other similar property and deduct such costs over the life of the income stream generated from the production activity. I.R.C. § 280. *See also* S. REP. NO. 94-938, *supra* note 63, at 77. Further, with reference to Code sections 167 and 280, the Service has announced a study of the tax treatment of investments in section 280 property. The study focused on situations where investors employ nonrecourse loans as part of a purchase price, which exceeds the fair market value of the property at time of purchase, and employ the income forecast method of depreciation. Internal Revenue Service News Release IR-1729, January 4, 1977.

66. We assume the producer has made a direct copy of the investor's MSR for production purposes. Where an additional instrument has been added (e.g., a "synthesizer" or "bongo" drums) or the quality of sound has been enhanced by simulated stereo processing ("stereomonic") of the performance, the taxpayer could argue the MSR is not the same as the release of the original performance and is, therefore, "new."

67. I.R.C. § 48(c)(2).

68. The argument supporting a claim for investment tax credit on MSRs has been articulated in two decisions. *Walt Disney Productions, Inc. v. United States*, 75-2 U.S. Tax. Cas. ¶ 9824 (C.D. Cal. 1975); *Walt Disney Productions, Inc. v. United States*, 480 F.2d 66 (9th Cir. 1973). In the 1975 decision, the government stipulated that optical and sound master recordings are the same type property for purposes of investment tax credit. The court previously had determined that optical and sound portions of the motion picture negative qualified as section 38 property eligible for an investment tax credit. *Walt Disney Productions, Inc. v. United States*, 73-2 U.S. Tax. Cas. ¶ 9484 (C.D. Cal. 1973). By analogizing to section 280, it may be argued that where movies, books, records and similar property production costs are treated alike, the properties must themselves be similar. *See Fass & Howard, Motion Picture Investment Adversely Affected By TRA but Opportunities Remain*, 45 J. TAX. 257 (1977); *New Decisions*, 45 J. TAX. 28 (1977).

tax benefit, few profit seeking ventures can compete successfully with an investment in phonograph records, that will at best break even. In addition to diverting equity from other investments and providing tax benefits to the highest income bracket individuals, the production and distribution of records provides few jobs.

By failing to completely eliminate "improper" tax incentives, Congress has fallen short of its stated goal of improving allocation of capital in the economy.⁶⁹ Moreover, the TSP may cost the Treasury a significant amount of revenue and undermine the confidence of the American people in the equity of the tax system.⁷⁰ The success of the tax system employed in the United States depends, in large part, upon a high degree of voluntary compliance with the tax laws. Such compliance can be founded only on the belief that other taxpayers are paying their fair share of the overall tax burden.⁷¹ It appears inequitable to provide individuals a tax benefit by permitting the deduction of noneconomic losses, generated by tax shelter investments, to the extent those losses exceed the amount for which an investor is personally liable in any particular venture.⁷² This principle underlies the new at-risk provisions of the TRA.

The loopholes which have enabled TSPs to flourish were left unclosed by the TRA. This oversight should be corrected by administrative and legislative measures. This would implement the desires of the American people for an equitable tax system that promotes an efficient allocation of resources.⁷³

First, the Internal Revenue Service should require a certified appraisal of ventures involving paintings, books, sound recordings, or real estate, by two independent, expert appraisers.⁷⁴ Although it may prove difficult and inexact to document the useful life and expected lifetime income to be derived from artistic works depre-

69. S. REP. NO. 94-938, *supra* note 63, at 7, 47. See also H. COMM. ON WAYS & MEANS, 94TH CONG., 1ST SESS., TAX REFORM HEARINGS — STATEMENTS OF PUBLIC WITNESSES ON GENERAL SUBJECTS at 17-22 (Comm. Print 1975); S. SURREY, *supra* note 37, at 5-6.

70. S. REP. NO. 94-938, *supra* note 63, at 7.

71. H. REP. NO. 94-658, *supra* note 1, at 3, 7.

72. S. REP. NO. 94-934, *supra* note 63, at 46.

73. H. REP. NO. 94-658, *supra* note 1, at 7-12.

74. The estimation of the expected earnings from an MSR has been characterized as a "gamble." See SHEMEL & KRASILOVSKY, *supra* note 25, at 252-54. Nonetheless, there are accountants and attorneys who specialize in the music field and who assist established record companies by providing estimates or appraisals of the commercial merit of a proposed investment. The quality of an artistic work is opinion and therefore open to disagreement among highly regarded specialists; however, where acknowledged experts, totally disinterested, have appraised the value of the MSR at the time of acquisition, the promoters may be restrained from setting purchase prices greatly in excess of the potential earnings expected from an MSR. For an interesting related discussion of appraisals of paintings see O'Connell, *Defending Art Valuations for Tax Purposes*, 115 TRUSTS & ESTATES, 604 (1976).

ciated under the income forecast method; the Service should curtail the potential for abusive overvaluation. An investor's basis for depreciation and investment tax credit should reasonably approximate the fair market value of the property.⁷⁵ Such regulation would be entirely within the Congressional purpose and consistent with the language of sections 38, 46, 167 and 1012 of the Internal Revenue Code.

Second, statutory revisions should broaden the applicability of the at-risk rules both as to type of taxpayers and type of activities. Section 465(c)(1)(a) should be amended to *add the underlined words as follows*: "(1) Types of Activities. - This section applies to any taxpayer engaged in the activity of - (a) holding, producing, or distributing motion picture films or video tapes, *books, records, or art works or similar property*"

This proposed amendment would align section 465 with section 280 of the Code, which deals with the treatment of production costs for such properties. Additionally, Congress should specify that the Department of the Treasury should broadly define "similar property" in the regulations promulgated under section 465.

These modest proposals, to check the burgeoning growth of TSPs, are within the ambit of the announced purpose of the TRA in light of the express intent of Congress to enact further tax reforms, in particular, technically corrective amendments. Such proposals comport with the Congressional effort to achieve fundamental fairness in the federal income tax system and promote economic efficiency.

75. See R. HAFT, *supra* note 38, § 9.04; Tannenbaum, *supra* note 30, at 787, 793.