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Gary G. Perry
University of the Pacific; McGeorge School of Law

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Legislative Alternatives to Tax Shelters

In recent years, a growing concern has developed about the availability of tax avoidance devices that allow the high-income taxpayer to eliminate or substantially reduce his income tax ability. "Tax shelter" is the term usually ascribed to an investment or business which enables the taxpayer to reduce the amount of tax he would normally owe on his non-tax shelter income.

Various tax incentives currently exist in our tax system;[1] their purpose is to encourage investment in the areas where the incentives exist, thereby altering the allocation of resources so as to improve economic efficiency.[2] Businesses and investments entered into primarily to obtain tax shelter benefits, however, represent a misuse of the tax incentives and prevent tax incentives from fulfilling their intended function in our tax system. It has been argued that most tax shelters, rather than improve economic efficiency, distort property values and construction costs, interfere with the efficient allocation of resources, and result in economically unsound investments.[3] Also, the equity of the tax system is severely impaired by tax shelters. Reduction or elimination of tax liability through tax shelters increases the tax burden of those who are not wealthy enough either to invest in tax avoidance schemes or benefit from them. Moreover, many of the benefits provided by the tax incentive provisions do not go to those actively involved in the activities intended to be aided by the incentives.[4] Instead, the tax benefits flow to individuals who take no active part in the operation and who are only interested in reducing their taxable income.[5] Tax incentives, therefore, frequently are used by a substantial number of taxpayers who were not intended to be benefitted by the incentives, but who are taking advantage of the tax law to the detriment of the nation and the State of California.

Attempts to correct the abuses associated with tax shelters have been made by California and the federal government. Prior to 1976, the last major reform to federal law was the Tax Reform Act of 1969.[6] It added many of

1. *See* Aaron, *Inventory of Existing Tax Incentives—Federal*, in TAX INCENTIVES 39 (1971) [hereinafter cited as Aaron].
2. *Id.* at 39-40.
3. [1976] 17 SPECIAL STAND. FED. TAX REP. (CCH) 13.
4. For example, the owner of a limited partnership interest in a farming tax shelter does not actively participate in the farming enterprise, but he benefits from the tax provisions that allow current deductibility of development and raising costs and that provide for accelerated depreciation on the orchard and grove.
5. *See* McDaniel, *Tax Reform and The Revenue Act of 1971: Lesions, Lagniappes, and Lessons*, 14 B.C. IND. & COM. L. REV. 813, 822-26 (1973) [hereinafter cited as McDaniel].
6. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969).

the existing provisions that attempt to control the abuses of tax shelters.[7] California followed the federal lead and amended its tax code to conform to the revised federal law.[8] Those attempts, however, have not been successful in remedying the abuses.

The attempts at tax reform are continuing and have resulted in the passage by Congress of the Tax Reform Act of 1976 [the Act].[9] This legislation contains various provisions that are intended to reduce the opportunities for tax avoidance.[10] The House and the Senate took different approaches to the problem, but the Act represents the Senate approach. The House relied on a limitation on artificial losses provision,[11] whereas the Senate proposed modifications to the minimum and maximum tax provisions, inclusion of an "at risk" limitation on losses and a section aimed at farming syndicates, and strengthened depreciation recapture rules.[12] An examination of the Tax Reform Act of 1976 and the original bill passed by the House would present the various alternatives to the tax shelter problem that are available to California.

This comment will examine the general nature of real estate and farming tax shelters and analyze the legislative alternatives that are available to California. While this comment will deal with the problems inherent in the California income tax scheme, an analysis of federal tax law and reform is instructive because California law in the tax field is significantly influenced by federal law. Although California is not required to conform to federal tax law,[13] the California Legislature has followed the federal lead many times and amended California law to conform to the revised federal law in order to promote consistency in the tax laws.[14] Thus an examination of the Tax Reform Act of 1976 and the original bill passed by the House will be instructive. This analysis will conclude with a recommendation that changes be made in the tax law of California in order to eliminate some of the current abuses of our tax system.

CHARACTERISTICS OF TAX SHELTERS

Tax shelters have three basic characteristics: (1) deferral; (2) conversion;

7. The Tax Reform Act of 1969 made several changes in the Internal Revenue Code. The 1969 amendments include: (1) Section 1251 which deals with the recapture of previously deducted farm losses; (2) Section 1252 which requires that depreciation taken on farm improvements be recaptured; (3) Section 278 which mandates that the taxpayer capitalize the development costs of certain fruit groves; and (4) Sections 1245 and 1250 which are concerned with the recapture of depreciation taken on real and personal property.

8. *E.g.*, CAL. REV. & TAX. CODE §§18212-18213 *amended*, CAL. STATS. 1st Ex. Sess. 1971, C.1, §§117, 118, effective December 8, 1976.

9. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

10. 122 CONG. REC. S16,013 (Sept. 16, 1976) (remarks of Senator Long).

11. H.R. 10612, 94th Cong., 1st Sess. §101 (1975).

12. H.R. 10612, 94th Cong., 2d Sess. (1976).

13. *See* Coast Elevator Co. v. State Bd. of Equalization, 44 Cal. App. 3d 576, 118 Cal. Rptr. 818 (1975).

14. *E.g.*, CAL. REV. & TAX. CODE §§18200-18219.

and (3) leverage.[15] An examination of each characteristic is essential to an understanding of the legislative alternatives.

A. *Deferral*

Deferral refers to the shifting of income tax liability for income received in a current period to a later tax period.[16] Deferral commonly occurs where an investor is involved in an activity which uses the cash basis of accounting[17] and is allowed to accelerate certain deductions such as depreciation.[18] The amount representing the accelerated portion of the depreciation deduction may result in losses for the current tax period that reduce his taxable income and his tax liability. Taxation of the income from the investment is deferred to a later period when the asset being depreciated is sold or otherwise disposed of, or when the investment is producing income and the offsetting deductions have been used up. Thus tax otherwise payable during the current taxable year is deferred to a later period.[19]

The benefit provided to the taxpayer is essentially an interest-free loan of the tax dollars saved in the year of deferral.[20] The magnitude of the deferral benefit depends on the degree of acceleration of the deduction and the investor's tax bracket.[21] The value of deferral increases as the investor's tax bracket increases because the amount of taxes deferred also increases.[22]

B. *Conversion*

Conversion refers to the situation in which deductions representing the cost of an asset are used to reduce ordinary income, but any profit on the sale of that asset is taxed as a capital gain.[23] Since the effective rate of tax on a capital gain is less than the rate applied to ordinary income, the taxpayer is required to repay only part of the amount previously deferred. Thus, the taxpayer not only receives the benefits of an interest-free loan from the government, but he also has to repay only part of the loan.[24]

The depreciation recapture rules[25] limit the operation of conversion. On

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15. S. SURREY, PATHWAYS TO TAX REFORM 108 (1973) [hereinafter cited as SURREY].
16. E. GRISWOLD & M. GRAETZ, FEDERAL INCOME TAXATION 1049 (1976) [hereinafter cited as GRISWOLD & GRAETZ].
17. *See* J. CHOMMIE, FEDERAL INCOME TAXATION 228 (1973):

> Under the cash method receipts and income items are reported in the year received and deductions and credits in the year paid.

18. I.R.C. §167; CAL. REV. & TAX. CODE §§17208-17210.
19. *See generally* GRISWOLD & GRAETZ, *supra* note 16, at 1049-50.
20. GRISWOLD & GRAETZ, *supra* note 16, at 1049.
21. SURREY, *supra* note 15, at 111.
22. McKee, *The Real Estate Tax Shelter: A Computerized Expose*, 57 VA. L. REV. 521, 537 (1971) [hereinafter cited as McKee].
23. GRISWOLD & GRAETZ, *supra* note 16, at 1049.
24. McDaniel, *supra* note 5, at 823.
25. I.R.C. §§1245, 1250; CAL. REV. & TAX. CODE §§18211, 18212-18218. Depreciation recapture refers to the treatment accorded the amount deducted as depreciation in excess of that available using the straight-line method when the asset being depreciated is disposed of. The amount of gain that is normally treated as capital gain is characterized as ordinary income to the extent the depreciation is recaptured.

the disposition of a depreciated asset, the law provides that the gain will be treated as ordinary income to the extent of the accelerated depreciation previously taken on the asset. Of course, the greater the time period between the initial deferral and the later sale, the less significant depreciation recapture becomes.[26] Since the measure of the benefit of deferral is the present value of the amount of taxes deferred, whether the tax treatment is ordinary or capital gain would be of little importance after ten or 15 years of deferral.[27]

An example of the operation of conversion is where an asset on which accelerated depreciation has been taken is later sold and the proceeds are taxed as a capital gain. There has been a conversion of deductions against ordinary income into capital gain. The scope of the recapture rules will limit the amount subject to the favorable capital gain treatment.

C. Leverage

Leverage is basically the use of borrowed money in an investment by a taxpayer. Usually the amount of borrowed money will exceed the taxpayer's equity in the investment.[28] Thus by using debt financing the taxpayer can purchase property worth many more times his initial investment. As an additional advantage to the use of leverage, the taxpayer has more funds available for other investments.

The tax benefit that results from leverage is caused by the manner in which the tax system treats borrowed funds and the repayment of those funds. Borrowed funds are included in the cost of an asset and its depreciable basis to the same extent as the taxpayer's own funds.[29] Thus, the individual can depreciate the portion of the asset's cost represented by borrowed funds in addition to the portion comprised of his personal funds.[30] Moreover, the taxpayer is allowed to deduct the interest on the loan paid by him.[31] Thus the investor can not only take deductions for the interest paid on the loan, but he can also take deductions for accelerated depreciation calculated on a basis which includes the amount of the loan.

The characteristics of tax shelters can be combined for even greater tax savings. For example, the benefits of deferral can be magnified significantly through the use of leverage, in that the amount that can be ultimately deferred can be greater than the taxpayer's investment.[32] The resulting tax

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26. SURREY, *supra* note 15, at 116.
27. *Id.*
28. H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 26 (1975) [hereinafter cited as HOUSE REPORT].
29. SURREY, *supra* note 15, at 112-13.
30. *See* 1969-1 CUM. BULL. 21, *acq. in* Manuel Mayerson, 47 T.C. 340 (1966). The taxpayer can take depreciation deductions greater than his original investment.
31. I.R.C. §163; CAL. REV. & TAX. CODE §17203.
32. Andrews, *A Consumption-Type Personal Income Tax*, 87 HARV. L. REV. 1113, 1138-39 (1974).

savings could more than equal the net investment.[33] Thus the taxpayer can maximize the benefit of deferral by incurring deductible expenditures in excess of his equity investment.[34] Leverage, however, does not cause the value of conversion to increase. Instead, the value of conversion decreases as leverage increases the rate of return to the taxpayer because conversion has the effect of requiring the taxpayer to pay only one-half of the tax previously deferred.[35]

LEGISLATIVE PROPOSALS

As a guide to potential California tax reform measures, an analysis of the House proposal and the Tax Reform Act of 1976[36] is instructive. The approaches taken by the House and the Act are similar in some respects but are substantially different in others. Basically, the House relied on the limitation on artificial losses (LAL) provision to curb the abuses of tax shelters,[37] while the Act relies on significantly revised minimum tax[38] and maximum tax provisions,[39] the "at risk" limitation on losses,[40] strengthened depreciation recapture rules,[41] and a provision aimed at farming syndicates.[42] This section will discuss these approaches and their effect on real estate and farming tax shelters.

A. *House Proposal*

1. *Explanation of the LAL*

The limitation on artificial losses would have applied to real estate, farming, and other tax shelter investments.[43] In the case of real estate, the LAL would have provided that accelerated deductions attributable to real property that exceed a taxpayer's net related income from real property would not be deductible in the taxable year in which they are incurred.[44] The accelerated deductions in excess of the taxpayer's net related income would have been deferred either until the taxpayer had received net related income in a subsequent year, or had disposed of the property.[45] The term "accelerated deduction" includes interest, real property taxes during the construction period, and accelerated depreciation.[46] Net related income consists of

33. *Id.*
34. SURREY, *supra* note 15, at 112.
35. McKee, *supra* note 22, at 546.
36. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).
37. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975). The Tax Reform Act of 1975 was passed by the House of Representatives on December 4, 1975.
38. I.R.C. §§56, 58.
39. I.R.C. §1348.
40. I.R.C. §465.
41. I.R.C. §1250.
42. I.R.C. §§278, 464.
43. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975).
44. *Id.*
45. *Id.* The accelerated deductions that are deferred are placed in the taxpayer's deferred deduction account. The taxpayer would be required to keep detailed records over many years in order to account for the accelerated deductions that have been deferred.
46. *Id.* The taxpayer can capitalize construction period interest and real property taxes,

the gross income from the property less the ordinary deductions[47] attributable to the property.[48]

The bill treated the taxpayer's real property as a class rather than separately in calculating whether an excess of accelerated deductions over net related income existed.[49] Thus, gross income from the class would include rents, gains from the sale of all real property within the class, and fees earned with respect to real estate management.[50] However, where the non-accelerated deductions exceeded gross income for a separate item of property, the economic loss thus incurred would not have reduced the net related income for the class under the LAL.[51]

The operation of the LAL with respect to farming would have been similar to that provided for real property.[52] Accordingly, the accelerated deductions allowable in one taxable period could not have exceeded the net related income for that period. However, the bill would have allowed an individual to offset a limited amount of accelerated deductions against his non-farm income, if such income did not exceed $40,000.[53]

The amount of net related farm income would have been determined by grouping the class of farm properties that had given rise to the accelerated deductions.[54] Except for certain farm syndicates, all farm property would have been treated as one class of property.[55] The accelerated deductions for farming include preproductive expenses, prepaid supplies, and accelerated depreciation of property having a crop or yield after such property has entered its productive periods.[56]

After the accelerated deductions are calculated, net related income would

and they will not be considered to be accelerated deductions. Construction period interest is interest on an obligation used to purchase real property to the extent the interest is attributable to the construction period for the property. Real property taxes would be considered an accelerated deduction when the taxes are attributable to the construction period. *Id.*

47. *E.g.*, maintenance and repairs, utilities, and wages are ordinary deductions.

48. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975).

49. *Id.*

50. HOUSE REPORT, *supra* note 28, at 35. Gross income from the class would also include interest on obligations secured by mortgages on real property and fees earned for real estate brokerage activities. *Id.*

51. *Id.* at 34. The taxpayer must maintain adequate accounting records to qualify for this treatment. There must be some record of the deductions attributable to each item of property. *Id.*

52. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975).

53. *Id.* Specifically, the limited offset against non-farm income would allow the taxpayer to deduct in the current period a farm loss produced by accelerated deductions against the non-farm income not in excess of $20,000. However, the amount of farm loss deductible against non-farm income decreases from $20,000 by one dollar for each dollar of non-farm income above $20,000. Therefore, the limited offset is not available to the taxpayer whose non-farm income exceeds $40,000.

54. *Id.*

55. *Id.* Thus, income from one crop or farming activity is used to offset accelerated deductions from another crop or farming activity. HOUSE REPORT, *supra* note 28, at 46.

56. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975). Preproductive period expenses are those costs attributable to crops, animals, trees, and other producing property incurred prior to the period that the property becomes productive. Livestock other than poultry are expressly excepted from this provision. Under the bill, prepaid feed is not considered an accelerated deduction for those taxpayers who produce more than 50 percent of the feed consumed by the taxpayer's livestock. *Id.*

then be considered to determine the amount of accelerated deductions that could be taken into account in a current taxable year. As in the case of real property, the excess of the accelerated deductions over the net related income would be placed into the taxpayer's deferred deduction account.[57] A disposition of farm property would have caused a reduction in the deferred deduction account equal to the amount that is attributable to such property.[58] Thus the amount previously deferred would then be deductible even if there were an economic loss on the sale of the property.[59] The deferred expenses would also be deductible in a future taxable year when the taxpayer has net related income.[60]

The current statutory provisions enabling tax shelters to exist are not new but have been used for many years to gain tax benefits. A major problem today is the packaging of the various tax benefits by farming syndications into interests which are then sold to investors who do not actively participate in the management of the operation. This recent phenomenon has been a catalyst for discontent over the ability of many to escape tax liability through abuse of the tax system.[61] The House proposal treated syndicates differently than other farming operations because syndicates are often formed primarily for tax reasons.[62]

Where a farming syndicate[63] is involved, each activity begun during any taxable year would have been designated a separate class for purposes of the LAL. A farming syndicate may elect to use the accrual method of accounting[64] and to capitalize preproductive expenses, thereby escaping the rule that treats each activity as a separate class.[65] The House excepted from the definition of "farming syndicate" the business association where a member

57. *Id.*
58. *Id.*
59. *Id.* However, where a farming syndicate is concerned, all property attributable to any one activity must be disposed of before any amount will be removed from the deferred deduction account. *Id.*
60. *Id.*
61. *See* STAFF OF THE JOINT COMMISSION ON INTERNAL REVENUE TAXATION, 94th Cong., 1st Sess., Overview of Tax Shelters 12, 18 (1975).
62. HOUSE REPORT, *supra* note 28, at 44.
63. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975). A farming syndicate is defined in this section as:

> (i) A partnership engaged in the trade or business of farming if at any time interests in such partnership have been offered for sale in any offering required to be registered with a Federal or State agency having authority to regulate the offering of securities for sale,
> (ii) a partnership engaged in the trade or business of farming, if more than 50 percent of the losses during any period are allocable to limited partners, and
> (iii) any other enterprise engaged in the trade or business of farming if at any time interests in such enterprise have been offered for sale in an offering described in clause (i) or if the allocation of losses in such enterprise is similar to an allocation described in clause (ii).

64. T. FIFLIS & R. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 36 (1971):

> An important function of accounting principles to allocate items of expense (or costs) and revenues to accounting periods and to obtain a proper matching thereof, regardless of when the cash expenditures or receipts occur or when obligations to pay or rights to receive cash arise. This process of allocation is called accrual accounting. It includes both the process of accrual and the process of deferral.

65. H.R. 10612, 94th Cong., 1st Sess. §101(a) (1975).

had previously participated actively in the management of the business.[66] It was believed that if a person was involved in the management of the enterprise, then it is less likely that he participated in the syndicate solely for tax shelter purposes.[67]

In summary, the LAL would have limited the amount of accelerated deductions currently deductible to the amount of net related income for that year. The deductions in excess of net related income would have been deferred and placed in a deferred deduction account until the taxpayer either had net related income in a subsequent year or disposed of the property.

2. *Analysis of the LAL*

The LAL was intended to limit tax shelters significantly.[68] The provision would substantially affect the continued existence of the benefits of tax shelters. Under the LAL, the ability to gain the benefits of tax deferral would be curtailed by the elimination of the deductibility of losses caused by accelerated deductions against non-shelter income. The accelerated deductions would be required to match the corresponding income.[69] The main emphasis of the LAL as proposed by the House is the elimination of the deferral benefit.[70] The LAL, however, would not limit the deferral of tax that resulted from expenses that do not represent accelerated deductions.[71] Also, the taxpayer would still be able to defer taxes on the current operating income from the investment.[72] The benefits of conversion would also be lessened by decreasing the deductions that could be used to offset ordinary income.

The LAL would have substantial impact on the leverage benefit because of the limitations on the deductibility of construction period interest. Leveraged investments are dependent on the current deductibility of interest. Thus adoption of the LAL provision would have substantial effect upon all three characteristics of tax shelters—deferral, conversion, and leverage.

Despite its advantages, the LAL has been attacked for its complexity and its adverse economic impact.[73] Many commentators believe that simplicity is a major consideration in any tax reform legislation,[74] and the House itself has recognized the serious problem of complexity in the tax system.[75] The

66. *Id.* The exception provides that where a farming enterprise would be classified a farming syndicate because of a more than 50 percent loss allocation to limited partners or other passive parties, the loss allocations will not be treated as made to such parties where a person had previously actively participated in the management of the business.
67. HOUSE REPORT, *supra* note 28, at 48.
68. *Id.* at 9.
69. McDaniel, *supra* note 5, at 853.
70. Bacon, *Legislative Outlook for Shelters*, in U.S. CAL. 1975 TAX INST. 618 (1975).
71. *Id.* at 619.
72. *Id.*
73. S. REP. NO. 94-938, 94th Cong., 2d Sess. 9 (1976) [hereinafter cited as SENATE REPORT].
74. *See* Hall, *Our Tax Structure: Personal Observations*, in U.S. CAL. 1974 TAX INST. 1007 (1974).
75. HOUSE REPORT, *supra* note 28, at 7.

LAL necessitates that the taxpayer keep records over a long period of years in order to account for his deferred deductions. In addition, the taxpayer would be required to keep records in order to differentiate net related income from other income. Arguably, the LAL would only add to the already overly complicated tax system.[76]

Another major criticism of the LAL is the adverse effect that it would have on the economy. Critics contend that the LAL fails to distinguish between the actual abuses of tax shelters, where economically inefficient investments are undertaken purely for tax reasons, and the use of tax incentives which provide important encouragement to economically worthwhile investments.[77] The Senate Finance Committee believed that by disallowing the deductions for both beneficial and detrimental investments, the LAL would prevent the economically worthwhile productive business from existing.[78] Thus, the House approach of the LAL could be very detrimental in circumstances of high unemployment and housing shortage, where tax incentives are crucial to the continued existence of many businesses.[79]

These criticisms may be answered by the response that the LAL would still allow the taxpayer to deduct his investment expenses from the investment's profit, thus providing a continuing incentive to invest in high risk investments.[80] The taxpayer who is already involved in an activity would not be affected significantly by the limitation on artificial losses.[81] The LAL permits a taxpayer to aggregate all the income from related investments, thus enabling the investor to deduct any accelerated deduction from a recent investment against the current related income from an older investment.[82] Therefore, the only taxpayers who may be dissuaded from investing because of the LAL are those who have no current investments in the particular activity. Thus it appears that the LAL would effectively deter many of the abuses associated with tax shelters, while still providing needed incentives to established investors.

B. The Tax Reform Act of 1976

Congress eventually rejected the LAL and adopted the Senate proposal in the Tax Reform Act of 1976. In the Act, Congress has included an "at risk" limitation on losses,[83] provided a section directly affecting the availability of certain tax benefits to farming syndicates,[84] strengthened the minimum[85]

76. Corman, *The Use and Misuse of Tax Shelters: The Congress and Tax Reforms*, 49 NOTRE DAME LAW. 509, 520 (1974).
77. SENATE REPORT, *supra* note 73, at 39.
78. *Id.*
79. *Id.*
80. *Proposals for Tax Change*, 21 FED. TAXES REP. BULL. (P-H) 11 (May 3, 1973).
81. *Id.*
82. Comment, *Limitation on Artificial Accounting Losses (LAL): Another Assault on the Tax Shelter*, 5 ST. MARYS' L.J. 586, 589 (1973). *See also* Hardymon, *The Real Estate Venture As A Tax Shelter*, 51 N.C.L. REV. 735, 737-38 (1973).
83. I.R.C. §465.
84. I.R.C. §§278, 464.
85. I.R.C. §§56, 58.

and maximum tax[86] provisions, and widened the scope of the depreciation recapture rules.[87] These provisions must be considered as a package, and not as separate and distinct proposals, because each provision is directed to a different part of the tax shelter problem.

1. *The "At Risk" Limitation on Losses*

a. Explanation

Under the provisions of the Act, the amount of any loss that may be deducted in connection with farming activities cannot exceed the aggregate amount with respect to which the taxpayer is "at risk" in each such activity at the close of the taxable year.[88] The taxpayer will be considered to be "at risk" to the extent of his cash and the adjusted basis[89] of other property contributed to the farming investment, as well as any amounts borrowed for use in the investment with respect to which the taxpayer has personal liability for payment.[90] The taxpayer will not be found to be "at risk" with respect to the proceeds from any nonrecourse loan[91] used to finance the operation or the acquisition of property used in the investment.[92] Of course, any loan where the lender's only recourse is the taxpayer's interest in the investment does not increase the taxpayer's amount "at risk."[93] However, the taxpayer is "at risk" to the extent of the fair market value of personal assets that secure nonrecourse loans.[94]

The amount of any loss which is allowed as a deduction in a particular year reduces the amount "at risk."[95] A loss in excess of the taxpayer's "at risk" amount will be disallowed and will not be allowed in a subsequent year unless the taxpayer increases his "at risk" amount.[96] Thus, the taxpayer will be able to deduct previously disallowed losses only to the extent that his amount "at risk" is increased in later years.

The House bill also included an "at risk" limitation on losses that dealt with certain farming operations, but the provision applied only to livestock operations and certain crops.[97] The Senate broadened the application of the "at risk" limitation so that it would serve as the primary limitation on the tax benefits available to taxpayers who are involved in farming operations.[98] This broadening appears necessary in light of the deletion of the LAL

86. I.R.C. §1348.
87. I.R.C. §1250.
88. I.R.C. §465(a).
89. *See* I.R.C. §§1011-1024.
90. I.R.C. §465(b).
91. A nonrecourse loan is one on which the taxpayer has no personal liability for repayment. SENATE REPORT, *supra* note 73, at 47.
92. I.R.C. §465(b).
93. I.R.C. §465(b).
94. I.R.C. §465(b).
95. I.R.C. §465(b).
96. SENATE REPORT, *supra* note 73, at 48.
97. H.R. 10612, 94th Cong., 1st Sess. §207 (1975).
98. SENATE REPORT, *supra* note 73, at 63-64.

proposal,[99] which was intended by the House to be the overall limitation on the tax benefits in farming.[100] Real estate is not included among the activities to which the "at risk" limitation is applicable.[101] The "at risk" limitation on farming losses will apply to all taxpayers except corporations which are not subchapter S corporations.[102] The provision applies regardless of the accounting method used[103] and the kind of expenses which contributed to the loss.[104] For an individual, each farm is considered a separate activity,[105] and whether an individual is engaged in one or more farming activities is determined by examining all the facts and circumstances.[106] Where a partnership or subchapter S corporation is involved, however, all farming activities are treated as one activity.[107]

The "at risk" provision was included in the Act to prevent an investor from deducting losses in a single taxable year which are greater than the amount he could ultimately lose with respect to his investment. Even though a provision dealing specifically with farming syndicates is included in the Act,[108] the "at risk" limitation is necessary because not all farming tax shelters are syndicates. It will prevent leveraging of tax shelter benefits through the use of nonrecourse loans.[109]

b. Analysis

The "at risk" limitation on farming losses was designed to limit abuses occurring through tax shelters by the use of limited risk financing.[110] It is contended that this provision deals more directly with the abuses than the LAL proposal.[111] Allowing the taxpayer to include amounts representing nonrecourse loans in his basis is a major problem in tax shelters, because investors are able to use nonrecourse leveraging to produce tax savings greater than the amounts for which the taxpayers are personally liable.[112] One result of the availability of this leveraging technique is a distortion of the choices available in the market place, thereby resulting in the investment

99. *Id.*
100. House Report, *supra* note 28, at 9.
101. I.R.C. §465(c).
102. I.R.C. §465(a).
103. I.R.C. §465.
104. I.R.C. §465.
105. I.R.C. §465(c).
106. Senate Report, *supra* note 73, at 63. The facts and circumstances that the Senate Finance Committee believes to be relevant are:

> the degree of organizational and economic interrelationship of various activities in which the taxpayer is engaged, the business purpose which is (or might be) served by carrying on the various activities separately or together, and the similarity of the various activities. *Id.*

107. I.R.C. §465(c).
108. I.R.C. §§278, 464. See text accompanying notes 119-134 *infra*.
109. Senate Report, *supra* note 73, at 63-64.
110. *Id.* at 47.
111. *Id.*
112. *Id.*

of capital in economically unsound projects.[113]

The "at risk" limitation will substantially limit the tax benefits provided by nonrecourse financing. However, the taxpayer will still be able to deduct an amount equal to his equity against his non-shelter income. Thus, the ability to defer taxes is not totally eliminated where recourse loans are involved. Also, the Senate Finance Committee Report has suggested one possible approach to obtaining the benefits of nonrecourse financing.[114] The Report indicates that a taxpayer will be "at risk" while he is personally liable on the debt, but will cease to be "at risk" if the loan becomes a nonrecourse debt.[115] The taxpayer could claim large losses at the beginning of the investment when he has a sufficient amount "at risk" and then eliminate his personal liability by converting the obligation into a nonrecourse debt.[116] Consequently at least one loophole may exist in the provision.

It appears that the "at risk" provision will force investors to look more closely at the alternatives in the investment market. No longer will the seeker of the tax write-off be able to invest leisurely in highly-leveraged ventures, knowing that the tax savings will more than offset any loss of the original investment. Of course, it appears that the proposal has no effect on the deductibility of losses where the taxpayer is personally liable on the debt. Thus, the leverage aspect of farming tax shelters is not eliminated, although the nonrecourse type of leverage seems to be extinguished. One collateral effect of the "at risk" limitation could be a decrease in the demand for loans. As the demand decreases, assuming demand and interest rates have an elastic relationship,[117] the interest rates available to investors will decrease, thus giving the investor who is willing to risk personal liability on loans a greater opportunity to benefit from leverage.[118]

2. *Farming Syndicates Provision*

a. Explanation

Another significant provision in the Tax Reform Act of 1976 concerns farming syndicates. This section requires farming syndicates to capitalize expenses incurred for planting, cultivation, maintenance, and development, and to deduct expenses for farm supplies only when consumed.[119]

113. *See* Surrey, *Tax Incentives As A Device For Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705, 725 (1970).
114. SENATE REPORT, *supra* note 73, at 48 n.1.
115. *Id.*
116. Reisman & Taub, *Effect of New Law on Tax Shelters*, 5 TAX. FOR LAW. 196, 198 (1977).
117. *See* P. SAMUELSON, ECONOMICS 380 (9th ed. 1973), stating that elasticity of demand indicates the "degree of responsiveness of Q demanded to changes in market P." Where an elastic relationship exists, a decrease in demand would have a corresponding effect on price or interest rates as in this case.
118. McKee, *supra* note 22, at 537.
119. I.R.C. §§278, 464.

Prior law allowed farming syndicates to benefit from the special tax rules, used by those actively engaged in farm operations, that permitted a current deduction for most of the costs of raising animals or growing crops.[120] Also, many types of improvements to farm property may be deducted currently rather than capitalized.[121] The opportunities for deferral will be significantly reduced by the farming syndicates provision in the Act.

The capitalization requirement in the Act applies to those expenses incurred prior to the taxable year in which the grove, orchard, or vineyard began to produce crops in commercial quantities.[122] This provision does not apply to forestry or the growing of timber.[123] The Act has excepted from the farming syndicate provision certain enterprises where a member of the business had previously participated actively in the management of the farm operation.[124] It is intended that only the passive investor not be allowed to benefit from the beneficial farming rules.

b. Analysis

The "at risk" limitation on farming losses,[125] when joined with the farming syndicate provision,[126] places great obstacles in the path of the potential abuser of the tax system. Requiring farming syndicates to adopt the accrual method of accounting for farm supplies will end the practice of reporting such expenses on the cash method. Prior law did not require the syndicate to capitalize or inventory expenditures that would normally be accorded such accounting treatment;[127] thus the deductions for those expenditures were accelerated and tax deferral occurred.[128] However, under this provision, farming syndicates will have to conform to the practices already observed in nonfarming operations,[129] thus reducing the opportunities for deferral to occur.

The main thrust of the provision is to limit the deferral benefit.[130] It will substantially eliminate the accelerated deductions which provide for the

120. Treas. Reg. §1.162-12(a) (1972). CAL. REV. & TAX. CODE §17235 requires that certain development costs of fruit and nut groves be capitalized.
121. *E.g.*, I.R.C. §175; CAL. REV. & TAX. CODE §17224.
122. I.R.C. §278(b).
123. I.R.C. §278(b).
124. I.R.C. §464(c). In this section, Congress has defined farming syndicates to include:
(A) a partnership or any other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371(b)) engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or any State agency having authority to regulate the offering of securities for sale, or
(B) a partnership or any other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371(b)) engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.
125. See text accompanying notes 87-108 *supra*.
126. I.R.C. §§278, 464.
127. SENATE REPORT, *supra* note 73, at 52.
128. See text accompanying notes 16-22 *supra*.
129. *See* I.R.C. §§278, 464.
130. SENATE REPORT, *supra* note 73, at 56.

deferral of taxes on non-farm income.[131] For non-syndicate farmers, it was apparently believed that the simplicity of the prior law justified the continuance of the special farm provisions.[132]

The syndicate farmer will be more affected by the farming syndicate provision in the Tax Reform Act than he would have been by the House proposed LAL. While the LAL would have limited the deductibility of accelerated deductions, the farming syndicate provision appears to be a more direct limitation on the use of the provisions which enable farming syndicate tax shelters to exist. Also, this limitation appears to be superior in another respect. By definition, the syndicate rules do not apply where there is active participation in the management of the farming enterprise;[133] the passive investor is the only one affected. There is a general feeling that the true farmer should be treated differently from the investor looking for tax advantages.[134] However, the active farmer who has substantial amounts of nonfarm income and attempts to use the farming operation as a tax shelter will still be subject to the "at risk" limitation on losses. Thus the "at risk" provision will be especially important where the farming syndicate section is not applicable and nonrecourse financing is used.

3. *Depreciation Recapture Provisions*

a. Explanation

Another important provision in the Tax Reform Act of 1976 relates to depreciation recapture on the sale of real property.[135] Under federal law, all post-1969 and pre-1976 depreciation in excess of straight-line depreciation is recaptured to the extent of gain when the property is sold.[136] For residential property, however, the amount of post-1969 and pre-1976 depreciation in excess of straight-line depreciation which is recaptured is reduced by one percent for each month the property is held over 20 months.[137]

Under the Tax Reform Act of 1976, when residential property is sold, to the extent of gain recognized on the sale, all depreciation in excess of straight-line depreciation is recaptured.[138] There is full recapture of all depreciation, straight-line and the amount in excess of straight-line, when the property is not held for more than 12 months.[139]

131. Davenport, *A Bountiful Tax Harvest*, 48 TEX. L. REV. 1, 11-13 (1969).
132. SENATE REPORT, *supra* note 73, at 52.
133. I.R.C. §464(c).
134. SENATE REPORT, *supra* note 73, at 57.
135. I.R.C. §1250.
136. I.R.C. §1250(a).
137. I.R.C. §1250(a). CAL. REV. & TAX. CODE §18212 was amended in 1971 to conform to I.R.C. §1250. The California amendments apply to post-1970 excess depreciation while §1250 applies to post-1969 excess depreciation. CAL. REV. & TAX. CODE §18212.
138. I.R.C. §1250(a).
139. I.R.C. §1250(b); CAL. REV. & TAX CODE §18212.

b. Analysis

By broadening the scope of the depreciation recapture provisions, Congress has reduced the benefits of conversion.[140] Increasing the amount of depreciation that is recaptured as ordinary income decreases the amount of gain treated as a capital gain, thus limiting the operation of conversion.

4. *The Minimum Tax*

a. Explanation

A significant change to the tax law contained in the Tax Reform Act of 1976 concerns the minimum tax for individuals.[141] Prior federal law imposed a minimum tax on certain tax preferences.[142] The items classified as tax preferences included: (1) accelerated depreciation on real property in excess of straight-line depreciation; (2) accelerated depreciation on personal property subject to a net lease; and (3) the untaxed half of capital gains.[143] The minimum tax is designed to limit the ability of taxpayers to completely escape their tax liability by combining tax preferences.[144]

Under prior law, the tax amounted to ten percent of the sum of the tax preferences in excess of a $30,000 exemption and the taxpayer's income tax.[145] Both prior and current federal law provide that the minimum tax be added to the taxpayer's income tax to determine the total amount that he will pay.

The Tax Reform Act made various changes to the prior law, including increasing the rate of the minimum tax from ten percent to 15 percent,[146] lowering the $30,000 exemption to $10,000 or one-half of the regular income tax liability, whichever is greater,[147] and deleting the deduction for regular federal income taxes paid.[148] These changes are intended to increase the tax burden of taxpayers who attempt to avoid paying their share of taxes through the use of tax preference items.

b. Analysis

The minimum tax provision contained in the Tax Reform Act has been criticized as being overly complex and not directly attacking the basic problem of tax avoidance.[149] The purpose of the minimum tax is to allow the current tax incentives to remain intact while simultaneously limiting the existing tax shelter abuses by preventing investors from combining tax

140. See text accompanying notes 23-27 *supra*.
141. I.R.C. §§56, 58.
142. Tax Reform Act of 1969, Pub. L. No. 91-172, §301, 83 Stat. 580 (1969).
143. Tax Reform Act of 1969, Pub. L. No. 91-172, §301(a), 83 Stat. 581 (1969).
144. *See* I.R.C. §§56-58.
145. Tax Reform Act of 1969, Pub. L. No. 91-172, §301(a), 83 Stat. 580 (1969).
146. I.R.C. §56(a).
147. I.R.C. §56(a).
148. *See* I.R.C. §56(a).
149. Wall St. J., Aug. 11, 1976, at 10, col. 3.

preferences to escape their tax liability. This is accomplished through the use of a tax on those preferences which exceed the statutory exemption.[150] Attaining the goal envisioned for the minimum tax required that the pre-existing federal minimum tax be substantially strengthened by the Tax Reform Act of 1976.[151] Prior law had little impact because of the law's narrow reach and large exemption.[152]

The revision of the $30,000 exemption and federal income tax deduction provisions and the increased minimum tax rate are intended to increase the effective rate of minimum tax on the individual's tax preferred income.[153] These changes will undoubtedly have such an effect. The tax system will be more equitable by reducing the opportunities for tax avoidance.[154] Also the deterrent effect of the minimum tax provisions cannot be underestimated. There will be many who, for the first time, will be deterred from using tax preferences because changes in the law may cause tax shelters which were once attractive to investors to lose their appealing quality. An increase in the amount of tax that an investor must pay because of strengthened minimum tax provisions could substantially reduce the tax benefits provided by tax preferences, thus decreasing the number of investments in tax shelters.[155]

5. *The Maximum Tax*

a. *Explanation*

Federal law provides that income from personal services will be taxed at a maximum marginal tax rate of 50 percent.[156] Wages, salaries, and compensation for personal services, and a reasonable amount of net profits from a business where both personal services and capital produce income are considered income from personal services.[157] The amount eligible for the maximum marginal rate is reduced by certain deductions to reach the final amount that is subject to the maximum rate.[158]

Although the House did not include any changes to the maximum tax in the original bill,[159] the Tax Reform Act of 1976 does contain revisions to the maximum tax, including a provision that will reduce the amount of personal service income subject to the maximum tax by the total amount of the taxpayer's tax preferences as determined under the minimum tax provi-

150. SENATE REPORT, *supra* note 73, at 110.
151. McDaniel, *supra* note 5, at 840.
152. *See* Tax Reform Act of 1969, Pub. L. No. 90-172, §301(a), 83 Stat. 580 (1969).
153. SENATE REPORT, *supra* note 73, at 110.
154. *Id.* at 109.
155. An important revision to the minimum tax was deleted from the final version of the legislation. A Senate Finance Committee amendment would have added construction period interest and excess investment interest to the list of tax preferences. This change, however, was rendered unnecessary by the inclusion in the Act of sections that deal directly with construction period interest and excess investment interest. *See* I.R.C. §§163(d), 189.
156. I.R.C. §1348.
157. SENATE REPORT, *supra* note 73, at 114. *See* I.R.C. §1348(b).
158. I.R.C. §1348(b).
159. *See* H.R. 10612, 94th Cong., 1st Sess. (1975).

sion.[160] Prior law had allowed the taxpayer a $30,000 preference exemption before tax preferences would reduce the amount of income subject to the 50 percent marginal rate.[161] Thus the total amount of tax preference items, rather than the amount above $30,000, will reduce the amount of personal service income that will be taxed at the 50 percent marginal rate.

b. Analysis

One purpose of the maximum tax was to discourage the use of tax shelters.[162] By limiting the marginal rate of tax on personal service income to 50 percent, instead of subjecting such income to the regular income tax rates where the maximum marginal rate is 70 percent, it was believed that upper bracket taxpayers would save their money rather than invest in tax shelters.[163] The maximum tax, however, has not been effective in deterring the use of tax shelters.[164]

The Tax Reform Act of 1976 will make tax shelters somewhat less inviting by the deletion of the $30,000 tax preference exemption. The taxpayer who qualifies for the maximum tax will find that each dollar of tax preference will result in one dollar of personal service income being taxed at marginal income tax rates that could be as high as 70 percent. The taxpayer, therefore, will be more likely to be discouraged from using tax preferences.[165]

This review of the Tax Reform Act of 1976 leads to the conclusion that future abuses of the tax system will be reduced. The revised minimum and maximum tax provisions along with the "at risk" limitation on losses, the farming syndicate provision, and the broadened depreciation recapture provision will substantially limit the opportunities for tax-avoidance and result in a more equitable tax system. These provisions are superior to the limitation on artificial losses proposal of the House which was far more complicated and fraught with adverse economic consequences.

ALTERNATIVES FOR CALIFORNIA

California is faced with the decision of whether to amend or add to its tax law in light of the Tax Reform Act of 1976. A review of existing California law is necessary before a recommendation of future legislation can be forthcoming.

A. Current California Law

California tax law is patterned after federal law. Thus the impact of the

160. *See* I.R.C. §57.
161. Tax Reform Act of 1969, Pub. L. No. 91-172, §804(a), 83 Stat. 685 (1969).
162. SENATE REPORT, *supra* note 73, at 115.
163. *Id.*
164. *Id.*
165. *Id.*

changes resulting from the adoption of the Tax Reform Act of 1976 in California would be almost identical to the impact of the Act on prior federal law. Various provisions in the California Revenue and Taxation Code allow farming and real estate tax shelters similar to those available under federal law to exist in California.

1. *Deferral*

California law is almost identical to federal law with respect to the accelerated depreciation methods that an investor can use.[166] Accelerated depreciation is one type of deduction that enables the taxpayer to defer his income tax liability to a later period. In addition, the Californian who invests in a farming operation can deduct currently certain costs that would normally be capitalized or accrued under recognized financial accounting standards. For example, amounts expended for soil and water conservation can be deducted in the year paid even though the expenditure increases the value of the land or has an effectiveness longer than one year.[167] Development expenses incurred before the farming operation becomes operative are also currently deductible.[168] California does, however, require that certain development costs of fruit and nut groves be capitalized.[169]

2. *Conversion*

The availability of capital gains treatment upon the sale or other disposition of an asset in California enables conversion to occur. California law provides that a sale of property used in a trade or business will be subject to the more favorable capital gains treatment.[170] However, the Code, as in the federal law, includes provisions that require the taxpayer to treat a gain on the disposition of an asset as ordinary income to the extent of the accelerated depreciation allowed in the case of real property[171] and to the extent of expenditures previously deducted for soil conservation or the prevention of erosion where a sale of farming property is involved.[172] These recapture provisions limit but do not preclude the opportunity for conversion to occur.

3. *Leverage*

The tax benefits associated with leverage can also be obtained in California. The taxpayer is allowed to deduct interest expense in arriving at taxable income.[173] Moreover, the obligation on which the interest is paid is included

166. *See* I.R.C. §167; CAL. REV. & TAX. CODE §§17208-17210. See text accompanying notes 16-27 *supra*.
167. I.R.C. §175; CAL. REV. & TAX. CODE §17224.
168. I.R.C. §162; Treas. Reg. §1.162-12 (1972); CAL. REV. & TAX. CODE §§17202-17202.3.
169. CAL. REV. & TAX. CODE §17235.
170. CAL. REV. & TAX. CODE §§18181-18182.
171. CAL. REV. & TAX. CODE §§18212-18218.
172. CAL. REV. & TAX. CODE §18219.
173. CAL. REV. & TAX. CODE §17203.

in the taxpayer's basis in determining the amount subject to depreciation.[174] The deductibility of interest and the ability to include the amount of the debt in the asset's basis allows the investor to gain the greatest tax benefit from leverage.

Under California law, therefore, as with federal law, the three characteristics of tax shelters appear and provide the opportunities for tax avoidance. The rules providing for the recapture of depreciation and soil conservation expenses, and the provisions requiring the capitalization of certain expenditures are examples of California law that currently attempt to limit the abuses associated with tax shelters.

B. Recommendation for California

California is not required to follow the changes to the tax law made by the Tax Reform Act of 1976.[175] The complexity of the tax law, however, does make consistency in the law desirable when feasible. There should be serious consideration of the following recommendations not only for the reason of consistency, but also because of the need to limit the operation of tax avoidance devices in Calfornia.

1. *Limitation on Artifical Losses*

Adoption of a provision such as the LAL would have a substantial impact upon leverage, deferral, and conversion.[176] However, rejection of the LAL is recommended because it would place the taxpayer beginning a new business at a disadvantage due to the provision that requires the taxpayer to aggregate his properties in determining related income.[177] It would not significantly affect the taxpayer already involved in an activity. The beginning entrepreneur would be required to pay taxes on his invested capital while attempting to compete with established businesses.[178] Unless the taxpayer has the benefit of the current tax incentives, he cannot compete with the established competition. Since the tax system is intended to be equitable, the LAL would not further equity because it would place a greater burden on the new businessman. In addition, the complexity of the LAL is another factor that supports rejection of the proposal. Thus the complexity of the LAL, its bias against the new businessman, and its failure to distinguish between legitimate attempts to operate economically successful businesses and investment schemes seeking tax losses indicate that the LAL should be rejected.[179]

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174. *See* CAL. REV. & TAX. CODE §§17211, 18041-18042; 18 CAL. ADMIN. CODE §18042.
175. *See* Coast Elevator Co. v. State Bd. of Equalization, 44 Cal. App. 3d 576, 118 Cal. Rptr. 818 (1975).
176. See text accompanying notes 15-35 *supra*.
177. See text accompanying notes 43-82 *supra*.
178. Comment, *Limitation on Artificial Accounting Losses (LAL): Another Assault on the Tax Shelter*, 5 ST. MARYS' L.J. 586, 609 (1973).
179. See text accompanying notes 43-82 *supra*.

2. *The "At Risk" Limitation on Losses*

Investors are able to use nonrecourse leveraging to produce tax savings greater than the amounts for which they are personally liable.[180] There are no limitations on the use of nonrecourse financing in California. The "at risk" limitation on farming losses would be a substantial improvement of current law. The abuses associated with nonrecourse financing would be eliminated, and concomitant with this change would be an increased awareness on the part of the investing public of investment risks because of the use of loan proceeds on which there would be personal liability for repayment. Thus, there would be a decrease in the number of unsound investment projects and a limitation on one of the most substantial abusese in our tax system, nonrecourse leveraging.

3. *Farming Syndicates*

Past abuses of the tax incentive provisions evidence a reasonable basis for making the distinction between the syndicate and nonsyndicate farmer.[181] California makes no such distinction in its tax system. Farming syndicates have enabled passive investors to benefit from the tax incentives intended to benefit only those actively involved in farming.[182] Requiring farming syndicates to capitalize certain expenditures and use the accrual method of accounting would significantly reduce tax deferral.[183] Consequently, California should consider adopting a similar provision.

4. *Depreciation Recapture*

Under California law, the amount of depreciation recaptured on the sale of residential property is reduced by an amount determined by the number of years that the property was owned.[184] As the amount of gain that is recaptured decreases, the amount subject to favorable capital gains treatment increases, thus enabling conversion to occur.[185] Total recapture of the excess of the accelerated depreciation over the striaght-line depreciation would reduce the opportunities to benefit from conversion. California, therefore, should follow federal law and provide for full recapture.[186]

5. *The Minimum Tax*

California has already made significant changes in its minimum tax. In 1975, two major amendments were enacted: (1) the two and one-half percent rate of tax imposed on tax preferences was replaced with a progres-

180. See text accompanying notes 88-118 *supra*.
181. See text accompanying notes 119-134 *supra*.
182. *See* McDaniel, *supra* note 5, at 822-26.
183. See text accompanying notes 17-22 *supra*.
184. CAL. REV. & TAX. CODE §§18212-18218.
185. See text accompanying notes 23-27 *supra*.
186. See text accompanying notes 135-140 *supra*.

sive rate that ranges from one-half percent to five and one-half percent;[187] and, (2) the previously existing $30,000 exemption was reduced to $4000 for a single person and $8000 for a married couple.[188]

In adopting the progressive rate structure, California followed the suggestions of some commentators that a progressive rate system be substituted for the flat rate structure.[189] Congress rejected the progressive approach in favor of the flat rate because the progressive rate was believed to be more complex, with such increased complexity outweighing any contended benefits.[190]

California's approach decreases the effectiveness of the minimum tax on those taxpayers who are at the lower levels of the progressive rate. Of course, these taxpayers at the lower levels had never been subject to the minimum tax under the $30,000 exemption provision. With the lower exemption, a married taxpayer with $9000 of tax preferences will pay an additional five dollars in state income tax.[191] Realistically, the extra five dollars in tax will not affect the taxpayer's investment decision-making process. Thus, the progressive rate of California is not ineffective per se, but, rather, the tax rate at the lower amounts of tax preferences is too low to have any significant impact on the investor or to make any meaningful contribution to the state's treasury. Therefore, it appears that the rates at the lower levels of the rate scale should be increased to at least the two and one-half percent level that existed prior to the 1973 revision.

The California minimum tax exemption is comparable to the exemption provided in the Tax Reform Act of 1976. It apparently would not be feasible in California to follow federal law and provide for an alternative exemption of one-half of the state income tax paid since state income tax rates are substantially lower than federal income tax rates.[192] Therefore, the California minimum tax exemption should not be changed in light of the Tax Reform Act of 1976. The only apparent weakness in California minimum tax is the low tax rates at the bottom end of the tax rate scale.

6. *The Maximum Tax*

One purpose of the maximum tax is to deter investments which are intended to shelter income that would be taxed at rates above 50 percent.[193] California does not have a maximum tax provision. The apparent justification for the absence of such a provision is the inherent difference that exists

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187. CAL. REV. & TAX. CODE §§17062-17062.2.
188. CAL. REV. & TAX. CODE §§17062-17062.2.
189. SURREY, *supra* note 15, at 405-46 & n.67.
190. *See* HOUSE REPORT, *supra* note 28, at 130-31.
191. This five dollar figure is arrived at by subtracting the $8000 exemption from $9000, and multiplying the remaining $1000 by one-half of one percent.
192. The maximum regular income tax rate in California is 11 percent. CAL. REV. & TAX. CODE §17041.
193. SENATE REPORT, *supra* note 73, at 115.

in the federal and state income tax rate structures. The maximum California tax rate of 11 percent begins at $31,000 of taxable income,[194] while the maximum federal rate of 70 percent does not begin until taxable income reaches the $200,000 level,[195] and the 50 percent income tax bracket begins at $44,000 of taxable income.[196] Thus, the maximum California income tax rate is applied at a taxable income level lower than that at which the favorable federal maximum tax rate is applied. Moreover, the taxpayer who is intended to be deterred from using tax shelters by the maximum tax provision usually has a taxable income figure substantially in excess of $31,000, the amount where the maximum California income tax rate begins. Consequently, the narrow range of tax rates in California, in conjunction with the maximum rate applied at a relatively low level of taxable income would appear to preclude the operation of a maximum tax in California.

CONCLUSION

The citizenry is becoming more aware of those taxpayers who comprise the upper-income stratum of the population and of their attempts to reduce their income tax liability through investments in tax shelters. Prior attempts at tax reform have not solved the problem of tax shelters and the abuses that accompany them. In response to this continuing problem, Congress enacted the Tax Reform Act of 1976. This legislation contains many provisions dealing with tax shelters, some of which should be considered by the California Legislature.

California tax law, similar to prior federal law in many important respects, contains various provisions which enable tax shelters to exist and prosper. Adoption of the "at risk" limitation on farming losses, the farming syndicate provision, and a strengthened depreciation recapture provision would significantly limit the current abuses while improving economic efficiency and furthering the goal of equity in the tax system.

Gary G. Perry

194. CAL. REV. & TAX. CODE §17041.
195. I.R.C. §1.
196. I.R.C. §1.