TAX POLICY AND THE PASSIVE LOSS RULES: IS ANYBODY LISTENING?*

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I. INTRODUCTION

In early 1997, at the midyear meeting of the American Bar Association's Tax Section, the Committee on Tax Structure and Simplification[1] met to decide what deadwood could be cut from the Internal Revenue Code ("Code").[2] The Committee focused on section 469, the passive activity loss rules. Generally, the passive activity loss rules restrict loss deductibility for taxpayers' passive investment activities. The members agreed the tax shelter industry, at least as it existed in the 1970s and 1980s, was dead. The members also agreed section 469 was a theoretical nightmare with little justification. The group disagreed about the role that section 469 played in the demise of the tax shelter industry. Ultimately, the discussion slid into a debate over the underlying tax preferences that gave rise to the shelter situation in the first place. One who walked into the middle of the meeting might have felt some sense of déjà vu. The same debate has taken place many times, both before and after the enactment of section 469.

Twelve years ago, Congress enacted the passive loss rules under section 469.[3] The rules have been in full force since 1990, the last phase-in year. The

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1. American Bar Association, 1997 Section of Taxation Midyear Meeting, Scottsdale, AZ (Jan. 8–12, 1997).

2. Audio tape of Meeting on Tax Structure and Simplification, American Bar Association, 1997 Section of Taxation Midyear Meeting, Scottsdale, AZ (Jan. 8–12, 1997) [hereinafter Meeting on Tax Structure and Simplification] (on file with author).

3. I.R.C. § 469 (West 1998) (originally enacted as part of the Tax Reform Act of 1986, Pub. L. No. 99–514, 100 Stat. 2085 ("1986 Act")). Unless otherwise indicated, all

passive loss rules, however, are still controversial. Many question the appropriateness of the passive loss rules in the attack on abusive tax shelters.[4] Congress has enacted several proposals to cut back on or clarify the provisions,[5] the most recent in 1996.[6] In addition, the Treasury Department has issued a maze of regulations designed, ironically, to help taxpayers decipher the rules.[7]

Because of the continuing debate over the scope and complexity of the passive loss rules and regulations, the original enactment of the passive loss rules needs reexamination. This Article examines the policy considerations behind the passage of section 469. Additionally, this Article measures the passive loss rules against normative tax policy criteria to determine whether section 469 and the accompanying regulations constitute sound tax policy.

The results of this analysis reveal that section 469 suffers from numerous defects under traditional tax policy criteria. Thus, Congress should repeal the passive loss rules. If necessary, Congress should replace section 469 with rules that restrict the underlying tax preferences.[8] Legislation should seek to curtail abusive tax shelters by eliminating the underlying tax preferences that generate artificial shelter losses. Section 469, on the other hand, focuses on artificial distinctions between passivity and participation. It is over- and underinclusive in scope and inexcusably complex.

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references or citations to sections of the Internal Revenue Code in this paper are references or citations to sections of the Internal Revenue Code of 1986, as amended.

4. *See* Meeting on Tax Structure and Simplification, *supra* note 2.

5. *See, e.g.*, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103–66, § 13143(a), 107 Stat. 312, 440 (removing restrictions on real estate activities in section 469(c)(7)); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101–508, §§ 11704(a), 11813(b), 104 Stat. 1388, 1388–518, 1388–536; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101–239, § 7109(a), 103 Stat. 2106, 2322; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100–647, § 1005, 102 Stat. 3342, 3387; Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100–203, § 10212(a), 101 Stat. 1330, 1330–405.

6. Small Business Job Protection Act of 1996, Pub. L. No. 104–188, §§ 1704(d)(1), (e)(1), 1807(c)(4), 110 Stat. 1755, 1878, 1902.

7. *See, e.g.*, T.D. 8645, 1996–1 C.B. 73 (Treas. Reg. § 1.469–9); T.D. 8565, 1994–2 C.B. 81 (Temp. Treas. Reg. § 1.469–3T); T.D. 8495, 1993–2 C.B. 226 (amending Temp. Treas. Reg. § 1.469–2T); T.D. 8477, 1993–1 C.B. 82 (Temp. Treas. Reg. § 1.469–2T); T.D. 8417, 1992–1 C.B. 173 (Temp. Treas. Reg. § 1.469–1T and Treas. Reg. § 1.469–5); T.D. 8253, 1989–1 C.B. 121 (Temp. Treas. Reg. §§ 1.469–4T, 1.469–5T).

8. A tax preference is an exclusion from income (or a deduction allowed in excess of actual expenses) enacted by Congress to influence economic behavior. Preferences are enacted to encourage greater investment in a particular activity. The preference understates the amount of income from the activity for tax purposes. *See* Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 502–03 (1989); *infra* Part III (concerning whether other relevant congressional action curtaining tax shelters was sufficient prior to enactment of section 469).

Amendments curtailing section 469 demonstrate that its impact has exceeded any original congressional intent.[9] Over several decades, Congress deliberately enacted a series of preferences to influence the direction of capital investment.[10] When these preferences successfully moved taxpayers into activities designed to take advantage of these rules, Congress attempted to cut back on their use without engaging in the political battles that would have been necessary to repeal them. The passive loss rules resulted. This indirect method of dealing with preferences makes neither good tax legislation nor sound tax policy.

This Article begins with an explanation of the perceived problem: tax shelters. Next, the Article chronicles the legislation leading up to the passage of section 469 in the Tax Reform Act of 1986 ("1986 Act"). The Article then describes the operation of the passive loss rules and regulations. It evaluates how these rules fare under traditional tax policy criteria. Finally, this Article recommends that Congress should abandon the passive loss rules in favor of tax laws that are more carefully crafted to accomplish normative and political goals.

II. AN EXPLANATION OF TAX SHELTERS

In order to understand the motives behind the enactment of section 469, one must have some knowledge of tax shelters[11] and tax preferences. Abuse of tax shelters was the primary impetus behind the creation of the passive loss rules.

Prior to the enactment of section 469, a taxpayer could use deductions and credits from one activity to offset income from other sources, such as wages, earned income, or investment income. During the period when tax shelters were most heavily utilized, high-income taxpayers invested in transactions solely to generate artificial losses that would "shelter" other income.[12] These transactions, many in the form of limited partnerships, were premised on deferral. Taxpayers structured transactions in such a way that the early years of the investment reflected losses consisting mostly of artificial or noneconomic deductions, known as preferences. Taxable income, if any, would be reported in later years.[13]

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9. *See, e.g.*, I.R.C. § 469(c)(7) (West 1998).

10. *See* STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 6–25 (1985).

11. Debate continues over the definition of a tax shelter. For example, section 469 defines a tax shelter as a passive activity, while many consider deductibility of noneconomic losses to be the crux of tax shelters. *See, e.g.*, Calvin H. Johnson, *What's a Tax Shelter?*, 68 TAX NOTES 879 (1995).

12. The highest marginal income tax bracket until 1981 was 70%. Between 1981 and 1986 the highest rate was 50%. S. REP. NO. 99–313, at 713–14 (1986).

13. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., TAX REFORM PROPOSAL: TAX SHELTERS AND MINIMUM TAX 1, 2–3 (Comm. Print 1985) [hereinafter TAX SHELTERS AND MINIMUM TAX]; Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 7 (1988).

Operating as limited partnerships, investors also minimized personal liability.[14] Additionally, there was no taxation on any appreciation in value of the activity until the taxpayer disposed of the interest. The tax deferral these investments offered amounted to an interest-free loan from the government during the early years of the investment.[15] These upfront deductions distorted the real economic income or loss and delayed realization of appreciation. The use of debt financing (leveraging) increased this distortion.

Although the realization requirement—postponing gain recognition until disposition—results from administrative convenience or necessity,[16] specific Code provisions authorized most of the deduction or deferral opportunities.[17] Theoretically, Congress enacted these deferral opportunities and tax preferences to stimulate certain economic behavior.[18] Activities able to utilize these tax preferences have lower taxable net income, relative to activities unable to utilize the preferences. The after-tax rate of return on these transactions thereby increases, attracting more investment capital. As demand increases, the price of the investment increases, resulting in the phenomenon known as "capitalization of tax benefits." Eventually, the after-tax return on the congressionally desired activity stabilizes at approximately the after-tax return available on other, similar activities.[19] Congress thereby achieves its goal of shifting capital, but without any long-term windfall to investors. An example of such a tax preference was the Accelerated Cost Recovery System ("ACRS") of depreciation. This system provided deductions far in excess of economic depreciation in the first years after a taxpayer's acquisition of ACRS property.[20] The combination of ACRS deductions and the investment tax credit ("ITC") reduced the effective tax rate on capital to zero for many taxpayers.[21]

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14. *See generally* Elizabeth K. Lewicki, *The Regulation of Tax Shelters and New Internal Revenue Code Section 469: A Complex and Unnecessary Addition to the War on Abusive Tax Shelters*, 19 PAC. L.J. 101 (1987).

15. *See* Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 STAN. L. REV. 15, 26 (1989); Martin J. McMahon, Jr., *Applied Tax Finance Analysis of Real Estate Tax Shelter Investments*, 27 B.C. L. REV. 721, 724 (1986); Peroni, *supra* note 13, at 8.

16. *See* Zelenak, *supra* note 8, at 504.

17. Examples included ACRS deductions and investment tax credits. *See infra* text accompanying notes 20–21.

18. Congress often designs economic net income deviations to achieve nontax policy objectives. *See* SURREY & MCDANIEL, *supra* note 10, at 25–27 (1985).

19. *See* Zelenak, *supra* note 8, at 504.

20. *See* Calvin H. Johnson, *Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation*, 61 TEX. L. REV. 1013, 1013 (1983). The 1986 Act substantially modified ACRS. Tax Reform Act of 1986, Pub. L. No. 99–514, §§ 201(a), 203(b)–(e), 204, 100 Stat. 2085, 2121–37, 2143–46 (codified as amended at I.R.C. § 168 (West 1998)); *see also infra* text accompanying note 90.

21. In fact, for some taxpayers the effective rate was negative, meaning that such taxpayers—mostly large corporations—were better off under a 46% corporate income tax

Some commentators have argued that such incentives can provide the necessary stimulus to encourage investment in risky, but socially justifiable, activities.[22] Furthermore, taxpayer use of preferences was not only anticipated but, in fact, "affirmatively intended by Congress."[23] Nevertheless, even if Congress originally intended that taxpayers use these preferences in shelters, it is clear that Congress no longer does.[24]

In addition to the use of preferences to increase the after-tax rate of return on investment, tax leverage (or tax arbitrage) also increases the rate of return by exaggerating the deferral aspect of tax shelter investments.[25] The tax treatment of the debtor's use of the borrowed funds and the deduction of interest by the debtor combine to provide the debtor with tax leverage on an investment. Property purchased with borrowed funds receives the same tax treatment as property purchased with the taxpayer's own funds. As a result, the depreciable basis or deductible cost includes the borrowed amount, even if it is nonrecourse.[26] In addition, the cost of borrowing (interest) is for the most part deductible.[27]

The combination of tax leverage and tax deferral can produce tax benefits that not only eliminate tax on the investment, but also eliminate tax on other income sources. The "shelter," in effect, produces a negative tax whereby the taxpayer is better off after tax than he would have been if the investment had not been subject to tax at all. The following examples illustrate this possibility.[28]

(as the rate was then), plus ITC and ACRS, than they would have been if their property-generated income had been completely exempt from tax. *See* Pamela B. Gann, *Neutral Taxation of Capital Income: An Achievable Goal?*, LAW & CONTEMP. PROBS., Autumn 1985, at 77; Peroni, *supra* note 13, at 9 n.27; John P. Steines, *Income Tax Allowances for Cost Recovery*, 40 TAX L. REV. 483, 520 (1985); *see also* Alan J. Auerbach, *The New Economics of Accelerated Depreciation*, 23 B.C. L. REV. 1327, 1347–48 (1982).

22. *See* Lewicki, *supra* note 14, at 105. Most research and development projects, as well as virtually all alternative energy projects, are highly risky and unlikely to be undertaken without tax incentives. *Id.*; *see also* STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 75 (Comm. Print. 1981); RICHARD A. WESTIN, MIDDLE INCOME TAX PLANNING AND SHELTERS §§ 14.35–14.38 (1982 & Supp. 1986) (discussing research and development partnerships).

23. *See* Lewicki, *supra* note 14, at 105; *see also* Zelenak, *supra* note 8, at 504–07.

24. Although Congress has since eliminated certain of the deferral opportunities, many others still remain in the Code. *See, e.g.*, I.R.C. §§ 174, 263(c), 613, 616(a), 617(a) (West 1998).

25. *See* C. Eugene Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 WAYNE L. REV. 991, 1002–03 (1984); Zelenak, *supra* note 8, at 510 n.34.

26. *See* Crane v. Commissioner, 331 U.S. 1, 11 (1947) (known affectionately as the "father of all tax shelters"); *see also* Boris I. Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 278–79 (1978).

27. *See* I.R.C. § 163 (West 1998). *But see id.* §§ 163(d), 263A(f), 265(a) (West 1998) (limiting the interest deduction).

28. Both Examples 1 and 2 can be found in Zelenak, *supra* note 8, at 508–09.

Example 1. A taxpayer buys a building for $100. In year 1, rental income from the building, net of all expenses except depreciation, is $10. Economic depreciation[29] for that year is $2. Net economic income for year 1 is $8 ($10 - $2). However, assume that the tax system distorts economic income through implementation of a preference—accelerated depreciation. Accelerated depreciation in year 1 is $5. Taxable income is therefore $5 ($10 - $5). Economic income is understated by $3. This $3 artificial deduction is the tax preference, because it causes exclusion of $3 of economic income. This investment does not fall into the definition of a tax shelter, however, because the preference does not "shelter" income from other sources.

Example 2. Suppose the taxpayer borrows $100 to make the investment. If the interest rate on the loan is eight percent, the taxpayer must pay an additional $8 in interest expense in year 1. Assuming the interest expense is fully deductible, economic income in year 1 is $0 ($10 - $8 - $2).[30] Taxable income for the same year is a loss of $3 ($10 - $8 - $5), which the taxpayer can use to offset income from other sources. The result is that this loss "shelters" other income. The investment is profitable only because of the tax savings generated by offsetting the loss against other income.

In both examples, taxable income understates economic income by $3. But in example 1, the artificial $3 deduction shelters economic income from the investment. In contrast, in example 2, the $3 of artificial loss offsets $3 of unrelated income.

Interest deductions play an important role in the shelter scheme. As long as interest is fully deductible and debt is includible in depreciable basis, taxable income will always be less than economic income. Note, however, that it is the accelerated depreciation preference and not the interest deduction that misstates economic income, and it is the shifting of that preference onto unrelated income that forms the basis for the tax shelter.[31]

A final characteristic of a tax shelter is conversion. Conversion occurs when the artificial deductions the taxpayer takes in the early years of the investment are ordinary in nature (offsetting the taxpayer's ordinary income at the highest marginal rates) and the income the taxpayer realizes upon disposition of the investment is long-term capital gain (subject to preferential tax treatment).[32]

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29. Economic depreciation is the real economic decline in the value of the building.

30. The depreciable basis of the building includes the entire $100 of borrowed funds. *See Crane*, 331 U.S. at 11.

31. *See* George Mundstock, *Accelerated Depreciation and the Interest Deduction: Can Two Rights Really Make a Wrong?*, 29 TAX NOTES 1253, 1254 (1985); Zelenak, *supra* note 8, at 509–10.

32. *See* TAX SHELTERS AND MINIMUM TAX, *supra* note 13, at 3; George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 671–72 (1985).

After taking conversion into account, a tax shelter investment almost always generates a negative tax.[33]

Congress attacked conversion long before attacking preference abuses.[34] In addition, the 1986 Act eliminated the long-term capital gains preference, thereby neutralizing the conversion element of a tax shelter.[35] For good or evil, however, Congress almost immediately thereafter reinstated a capital gains preference.[36] This preference, combined with several rate increases over the last ten years, makes conversion, once again, an important tax consideration.

Arguably, tax shelter investments harm the economy because they promote investment in loss activities solely for tax savings.[37] They channel capital "away from activities that may provide a higher pretax economic return, thus retarding growth of those sectors of the economy with the greatest potential for expansion."[38] This argument, however, seems flawed in that it is the congressionally enacted preferences that have caused these economic distortions in capital flow, and in doing so, they have done exactly what Congress intended them to do.[39] As such, one cannot criticize the shelter without also criticizing the underlying preference.

Another criticism of tax shelters centers around a supposed distinction between "legitimate" and "abusive" tax shelters.[40] Tax preferences, according to their proponents, are a legitimate part of the tax structure. Legislation is necessary only to curb the use of "abusive" tax shelters: "Unlike a legitimate shelter, which furthers the congressional goals of the preference on which the shelter is based, an abusive shelter serves no public purpose. It simply erodes the tax base and lessens taxpayers' confidence in the integrity of the system."[41] Tax shelters foster the impression in the minds of many taxpayers that the income tax system is fundamentally unfair.[42] As a result, shelters undermine the voluntary compliance

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33. *See* Cooper, *supra* note 32, at 671–72.

34. *See* I.R.C. §§ 1245, 1250 (West 1998).

35. *See* Tax Reform Act of 1986, Pub. L. No. 99–514, §§ 301, 311, 100 Stat. 2085, 2217, 2219 (repealing the 60% deduction for an individual's net capital gain and eliminating the 28% alternative tax on corporate capital gains).

36. *See* I.R.C. § 1(h) (West 1998). Starting in 1990, Congress began raising the marginal tax rates, while leaving the lower capital gains rate in place. *See, e.g.*, Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101–508, § 11101(a), 104 Stat. 1388, 1388–403 to 1388–404. In 1997, Congress then reduced the long-term capital gains rate significantly. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 311(a), 111 Stat. 788, 831.

37. *See* S. REP. NO. 99–313, at 716 (1986).

38. *Id.*

39. *See* Zelenak, *supra* note 8, at 515.

40. *See id.* at 524; *see also* Lewicki, *supra* note 14, at 102 n.9.

41. Zelenak, *supra* note 8, at 524; *see also* Lewicki, *supra* note 14, at 140–41.

42. *See* S. REP. NO. 99–313, at 714 ("Extensive shelter activity contributes to public concerns that the system is unfair, and to the belief that tax is paid only by the naive and the unsophisticated.").

upon which our tax system heavily relies.[43] The Senate Finance Committee report to the 1986 Act concludes "[t]o the extent that [taxpayers] feel they are bearing a disproportionate burden with regard to the costs of government because of their unwillingness or inability to engage in tax-oriented investment activity, the tax system itself is threatened."[44]

In response to this general feeling, Congress and the Internal Revenue Service took numerous steps—prior to the enactment of section 469—to curb the use of abusive tax shelters.[45] For example, legislation requiring registration of shelters with the Internal Revenue Service greatly increased the visibility of abusive tax shelters.[46] Congress enacted penalty provisions that exposed tax shelter investors to substantial liability for aggressive tax positions.[47] These enforcement provisions, along with other reform legislation, went a long way toward eliminating tax shelter abuse.[48]

Back in 1986, when Congress enacted section 469, many commentators believed (as many continue to believe), that the tax preferences themselves, and not the tax shelter vehicles they produced, constituted the "bad" tax policy.[49] These observers argued that Congress needed to focus on curtailment or elimination of these preferences in order to eliminate tax shelter abuse.[50] Ultimately, however, Congress chose to enact section 469. In short, prior to the enactment of section 469, Congress and the Internal Revenue Service had already taken significant steps to eliminate abusive tax shelters. Many believe that these efforts, along with various other provisions of the Tax Reform Act of 1986, would have been sufficient to eliminate the abusive tax shelter.[51]

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43. *See id.*; Zelenak, *supra* note 8, at 527.

44. S. REP. NO. 99–313, at 714.

45. *See* Marvin J. Garbis & Stephen C. Struntz, *Thorns Among the Roses—The Problems of the Investor in an "Abusive" Tax Shelter*, 44 INST. ON FED. TAX'N 5–1 (1986); Lewicki, *supra* note 14, at 107–20.

46. *See* I.R.C. §§ 6111(a), 6707(b) (West 1998).

47. *See id.* § 6662 (West 1998) (formerly I.R.C. § 6661); *see also* discussion *infra* Part III.

48. *See* Lewicki, *supra* note 14, at 107–08; Zelenak, *supra* note 8, at 525–26.

49. *See* Peroni, *supra* note 13, at 14; Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263 (1994); Zelenak, *supra* note 8, at 515; Meeting on Tax Structure and Simplification, *supra* note 2.

50. Additionally, public perception about tax shelters may stem in part from a lack of taxpayer understanding of how preferences operate, both in and out of tax shelters. Professor Zelenak believes that if Congress had educated taxpayers, they would have realized that the preference, not the shelter, causes economic distortions, and that remedial legislation should focus instead on curbing the preferences that led to abuse. *See* Zelenak, *supra* note 8, at 528–29.

51. *See* Lewicki, *supra* note 14, at 107; Sims, *supra* note 49, at 332; Zelenak, *supra* note 8, at 527; Meeting on Tax Structure and Simplification, *supra* note 2.

III. ANTISHELTER LEGISLATION UP TO AND INCLUDING THE TAX REFORM ACT OF 1986

A. Antishelter Legislation in 1969

The war against tax shelter abuses dates back at least to 1969. The Tax Reform Act of 1969[52] curtailed the tax advantages of farming operations (one of the original types of tax shelters).[53] Upon certain triggering events, section 1251 required recapture of farm losses deducted from nonfarm income.[54] Additionally, section 1252 requires recapture of farm expenses as ordinary income upon the sale of land.[55] Congress also enacted section 163(d), which limits deductibility of investment interest expense.[56] Furthermore, in 1969, the Treasury Department made two more general proposals regarding the preferences that gave rise to tax shelters. One would have allowed a taxpayer to use certain preferences only to the extent they did not exceed the taxpayer's economic income.[57] The second would have disallowed certain itemized deductions allocable to preference income.[58] The Senate ultimately rejected these proposals on the grounds of economic inefficiency and complexity.[59] But Congress substituted for these proposals, and enacted as part of the Tax Reform Act of 1969, the add-on minimum tax.[60]

B. Antishelter Legislation from 1976 to 1985

In 1973, the Treasury Department again issued a report attacking tax shelter abuses and proposing limitations on artificial losses ("LAL").[61] This proposal would have limited certain artificial accounting losses in specified industries by suspending them until subsequent years when related income from the same activity, or from other activities of the same type, was available to offset them.[62] In 1975, the House passed a modified version of LAL.[63] The Senate Finance Committee in 1976, however, rejected LAL, again on the grounds of

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52. *See* Tax Reform Act of 1969, Pub. L. No. 91–172, 83 Stat. 487.

53. *See* Lewicki, *supra* note 14, at 108. Farming was an important early tax shelter because farmers could, and generally still can, deduct costs that other taxpayers must capitalize. Additionally, farmers need not maintain inventories. *See, e.g.*, I.R.C. §§ 175, 180 (West 1998).

54. *See* I.R.C. § 1251 (1984), *repealed by* Deficit Reduction Act of 1984, Pub. L. No. 98–369, § 492(a), 98 Stat. 494, 853.

55. *See id.* § 1252 (West 1998).

56. Tax Reform Act of 1969 § 221(a), 83 Stat. at 574.

57. *See* H.R. REP. NO. 91–413, pt. 1, at 77–84 (1969).

58. H.R. 13,270, 91st Cong. § 302 (1969).

59. S. REP. NO. 91–552, at 111–18 (1969).

60. Tax Reform Act of 1969 § 301, 83 Stat. at 580.

61. U.S. DEP'T OF THE TREASURY, PROPOSALS FOR TAX CHANGE 94–104 (1973).

62. *See id.* at 96–97. For a detailed discussion of similarities between LAL and the passive loss rules, see Peroni, *supra* note 13, at 15–19.

63. H.R. 10,612, 94th Cong. § 101(a) (1975).

complexity and negative economic impact.[64] In place of LAL, the 1976 Tax Reform Act included section 465, the at-risk rules, and section 464, which limited deductions by "farmer syndicates."[65]

The at-risk provisions of section 465 have been some of the most important restraints on tax shelter activity.[66] Under section 465, a taxpayer must be "at risk" to qualify for deductions.[67] A taxpayer is "at risk" to the extent of his cash investment and the adjusted basis of property he contributes to an activity.[68] Section 465, as enacted in 1976, did not apply to all activities and was subject to circumvention. But subsequent legislation expanded its scope to cover all activities (except certain real estate financing arrangements).[69]

The 1976 Tax Reform Act included several other provisions to curb shelter abuse. These provisions included an increase in the minimum tax rate from ten percent to fifteen percent,[70] mandatory capitalization of certain partnership expenses,[71] disallowance of the prepaid interest deductions (for cash basis taxpayers),[72] and new recapture provisions applicable to sales of property.[73]

Thereafter, Congress continued to cut back on tax shelters. The alternative minimum tax, which taxes specific excess deductions, appeared in 1978.[74] Additionally, in 1981, Congress added section 6659, penalizing valuation overstatements.[75] Furthermore, Congress expanded the at-risk rules to cover the investment tax credit.[76]

Section 6700, which appeared in 1982, penalizes promoters of abusive tax shelters. The penalty under section 6700 can be as great as $1000 per interest sold or one-hundred percent of the promoter's gross income derived from each

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64. S. REP. NO. 94–938, at 39 (1976).

65. I.R.C. §§ 464–465 (West 1998); *see* Lewicki, *supra* note 14, at 109; Peroni, *supra* note 13, at 17.

66. *See* Bankman, *supra* note 15, at 25.

67. I.R.C. § 465(a)(1) (West 1998).

68. *See id.* § 465(b)(1)(A) (West 1998); Lewicki, *supra* note 14, at 109 n.38. The Code allows a taxpayer to consider at risk amounts for which the taxpayer has borrowed the funds. This allowance has the effect of undermining the restrictiveness of the provisions.

69. *See* I.R.C. § 465(b)(6) (West 1998) (excepting "qualified nonrecourse financing" from the at-risk limitations).

70. Tax Reform Act of 1976, Pub. L. No. 94–455, § 301, 90 Stat. 1520, 1549–54 (codified as amended at I.R.C. §§ 56–58).

71. I.R.C. §§ 704, 709 (West 1998); *see also id.* § 706(d)(1) (West 1998) (preventing the use of retroactive allocations in a partnership).

72. *Id.* § 461(g) (West 1998).

73. *Id.* § 1254 (West 1998).

74. *See id.* §§ 55, 58 (West 1998).

75. Economic Recovery Tax Act of 1981, Pub. L. No. 97–34, § 722(a)(1), 95 Stat. 172, 341–42 (repealed 1989).

76. *See* I.R.C. §§ 46(c)(8)–(9), 47(d) (West 1998).

sale, if less.[77] A taxpayer can contest these penalties in a refund suit only after payment of fifteen percent of the penalty.[78]

In 1982, Congress also enacted section 6221, which allows the Internal Revenue Service to audit partnership items at the partnership level, rather than at the partner level.[79] (An investigation of an abusive shelter is significantly more efficient if conducted at the partnership level.) Also in 1982, Congress enacted the accuracy-related penalty.[80] This penalty adds a twenty percent tax to any portion of certain underpayments attributable to any of the following: (1) negligence or disregard of rules or regulations; (2) any substantial understatement of income tax; (3) any substantial valuation misstatement under chapter 1; (4) any substantial overpayment of pension liabilities; and (5) any substantial estate or gift tax valuation understatement.[81] Furthermore, Congress imposed stricter substantiation requirements on tax shelters than on those that apply to other taxpayers.[82]

In 1984, Congress added provisions requiring promoters to register tax shelters with the Internal Revenue Service,[83] and requiring sellers and organizers to keep lists of investors.[84] There are penalties for failure to do either.[85] Furthermore, Congress enacted section 706(d)(2), which effectively forces cash-basis partnerships (common tax shelter vehicles) onto the accrual method of accounting for certain abusive year-end allocations.[86]

Each of these reforms increased the Internal Revenue Service's ability to control abusive tax shelters. Over time, full implementation of these provisions would likely have driven the abusive tax shelter into extinction.[87]

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77. *Id.* § 6700(a) (West 1998).

78. *See id.* § 6703 (West 1998). Normally, a taxpayer can choose either to pay the tax and sue for a refund in federal district court, or withhold payment and sue in the tax court. Under this promoter penalty, however, no such option exists.

79. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97–248, § 402(a), 96 Stat. 324, 648 (amended 1997).

80. Internal Revenue Code § 6662 (West 1998) replaced former Internal Revenue Code § 6661 (repealed in 1989). *See* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101–239, § 7721(c), 103 Stat. 2106, 2394. The 1986 Act increased the 10% rate to 20%. Tax Reform Act of 1986, Pub. L. No. 99–514, § 1504(a), 100 Stat. 2085, 2743.

81. *See* I.R.C. § 6662(a)–(b) (RIA 1998).

82. *Id.* § 6662(d)(2)(C) (West 1998).

83. *See id.* § 6111 (West 1998).

84. *See id.* § 6112 (West 1998).

85. *See id.* §§ 6707–6708 (West 1998).

86. *Id.* § 706(d)(2) (West 1998). Under section 706(d)(2), "allocable cash basis items" (such as interest, taxes, and rent of a cash-basis partnership) must be allocated to the particular days to which they relate economically, and then allocated among the partners in accordance with their partnership interest on those days. Thus, year-end loss manipulation by cash-basis partnerships are prevented.

87. *See, e.g.*, Lewicki, *supra* note 14, at 116.

C. Antishelter Legislation in 1986

Not satisfied with the progress, however, Congress enacted section 469 as part of the Tax Reform Act of 1986.[88] But section 469 was not the only provision Congress enacted that year to regulate tax shelter activity. Congress again extended the at-risk rules under section 465, this time to include real estate activities.[89] The 1986 Act also substantially modified ACRS, lengthening depreciable lives and lowering depreciation rates for most assets.[90] In addition, Congress repealed the investment tax credit.[91]

The Tax Reform Act of 1986 also restricted the accounting rules for many taxpayers. Calendar tax years became mandatory for most taxpayers,[92] and tax shelters could no longer use the cash method of accounting.[93]

Congress also stiffened penalties for failure to register tax shelters and for failure to keep investor lists.[94] The new legislation required that taxpayers report real estate transactions and imposed penalties for failure to comply.[95] Finally, the 1986 Act flattened tax rates. The top marginal rate dropped from fifty percent to twenty-eight percent.[96] Because one of the goals of sheltering was to reduce the amount of income subject to taxation at the taxpayer's highest marginal rate, lowering the top rate so substantially dramatically decreased the incentive to invest in activities merely for tax benefits.[97] While this discussion is not exhaustive,[98] it

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88. Tax Reform Act of 1986, Pub. L. No. 99–514, § 501(a), 100 Stat. 2085, 2233.

89. I.R.C. § 465 (West 1998) (as amended by the Tax Reform Act of 1986 § 503, 100 Stat. at 2243).

90. *See id.* § 168 (West 1998). The depreciable life for nonresidential real property went from 19 years to 27.5 years. In 1988, it was increased to 39 years.

91. *See id.* § 46 (West 1998) (as amended by the Tax Reform Act of 1986 § 211, 100 Stat. at 2166).

92. *See, e.g.*, I.R.C. § 706(b)(1) (West 1998); Temp. Treas. Reg. § 1.706–1T(a)(2) (1988) (restricting most partnerships to the taxable year that results in the least aggregate deferral of income).

93. *See* I.R.C. § 448(a)(3) (West 1998).

94. *See id.* §§ 6707, 6708 (West 1998) (increasing penalty from $50,000 to $100,000).

95. *See id.* § 6045(e) (West 1998) (requiring reporting); *id.* § 6721 (West 1998) (imposing penalty).

96. Tax Reform Act of 1986 § 101(a), 100 Stat. at 2096.

97. Tax rates have gradually crept back up, with the highest marginal rate currently at 39.6%. I.R.C. § 1 (West 1998). Even with this increase, however, marginal rates are still well below where they were in the tax shelter's heyday.

98. Congress has enacted many other reforms that directly or indirectly decreased the attractiveness of abusive tax shelters. For example, Congress substantially restricted potentially abusive partnership transactions. *See, e.g.*, I.R.C. §§ 704(c)(1)(B), 707(a)(2), 731(c), 732(c), 737 (West 1988); Treas. Reg. § 1.701–1 (1995); *id.* § 1.704–1(b) (as amended in 1997); *id.* § 1.704–3 (as amended in 1997); *id.* § 1.707–3 (1992).

makes clear that, prior to enactment of section 469, Congress had already taken significant steps toward resolving the abusive tax shelter problem.

The legislative history of the 1986 Act indicates that section 469 was not part of the tax bill until late in the process.[99] The Senate Finance Committee's proposal included the passive loss provisions only after a closed-door retreat in April 1986.[100] Congress needed these provisions in order to raise a significant amount of revenue from upper income taxpayers, while keeping the tax burden off the middle class.[101] Congress approved the passive activity loss rules in September 1986,[102] and President Reagan signed the Tax Reform Act of 1986 on October 22, 1986.[103] Criticism abounds over the hasty passage of section 469 and the lack of congressional review before its enactment.[104] Nonetheless, section 469, warts and all, is now part of the Code.

IV. PASSIVE LOSS RULES AS THE SOLUTION TO THE TAX SHELTER PROBLEM

Without consideration of the mechanics of section 469, an evaluation of its effectiveness is meaningless. In many instances, section 469 is overbroad and attacks unintended activities. In other ways, section 469 is too narrow. Because section 469 does not focus on the underlying tax preferences, its effect may be hit-or-miss.

A passive activity is any activity involving the conduct of any trade or business in which the taxpayer does not materially participate, as well as any rental activity.[105] Section 469 allows a taxpayer's passive activity losses to offset only the taxpayer's passive income and gains for the taxable year.[106] Passive credits may only offset a taxpayer's regular tax liability from passive sources.[107] Excess passive losses in any one year may not offset any active or portfolio income.

Excess passive losses carry forward indefinitely to subsequent taxable years and can offset passive income from both the passive activity in which they

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99. *See* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 218–21 (1987).

100. David E. Rosenbaum, *Proposals for a Tax Bill Revive in Senate Panel*, N.Y. TIMES, Apr. 30, 1986, at D1.

101. *See* S. REP. NO. 99–313, at 714 (1986); BIRNBAUM & MURRAY, *supra* note 99, at 218–21.

102. *See* Peroni, *supra* note 13, at 20 n.79.

103. *See id.*

104. *See* Lewicki, *supra* note 14, at 120–22; Peroni, *supra* note 13, at 20.

105. *See* I.R.C. § 469(c)(1)–(2) (West 1998). After 1994, however, taxpayers in a real property trade or business who meet certain participation requirements need not treat these activities as passive. *See id.* § 469(c)(7) (West 1998).

106. *Id.* § 469(a)(1)(A), (d)(1) (West 1998).

107. *See id.* § 469(d)(2) (West 1998).

arose and other passive activities.[108] Credits receive similar treatment. When a taxpayer fully disposes of his entire interest in the activity, the suspended losses are fully deductible.[109] Suspended credits entitle a taxpayer to adjust his basis in the activity.[110]

Individuals, trusts, estates, personal service corporations, and closely held C corporations are all subject to the passive loss rules.[111] The income, losses, deductions, gains, and credits flowing through a general or limited partnership or an S corporation are subject to the passive loss limitations at the individual partner or shareholder level.[112] Most C corporations may continue to use their losses from passive activities to offset income from active businesses and portfolio investments, because the passive loss rules do not apply to C corporations, except for personal service corporations and closely held C corporations.[113] A limited partnership interest is presumptively passive, except as provided in the regulations.[114]

Section 469 requires a taxpayer to segregate all income, gains, losses, deductions, and credits for a taxable year into four categories of activities: (1) passive business and investment activities; (2) publicly traded partnerships; (3) portfolio investments; and (4) active business and investment activities.[115] Much of the difficulty in applying section 469 is in the determination of what income and losses fall into each of these four categories.

Any rental activity is per se a passive activity, regardless of whether the taxpayer materially participates in the activity.[116] A "rental activity" is any activity where payments are "principally for the use of tangible property."[117] Originally, this definition included virtually all rental activities, except for payments for the use of property for short periods, such as car rentals or hotel rooms.[118] Much of

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108. *See* Temp. Treas. Reg. § 1.469–1T(f)(4) (as amended in 1995).

109. *See* I.R.C. § 469(g) (West 1998).

110. *Id.* § 469(j)(9) (West 1998).

111. *See id.* § 469(a)(2) (West 1998). Internal Revenue Code section 469(j)(2) defines a personal service corporation, and section 469(j)(1) defines a closely held C corporation.

112. *See id.* § 469(a)(2).

113. Temp. Treas. Reg. § 1.469–1T(g)(1) (as amended in 1995). A modified version of the passive activity loss limitations applies to closely held C corporations. Such a corporation may use its passive losses to offset active income, but not portfolio income. I.R.C. § 469(e)(2) (West 1998).

114. *See* I.R.C. § 469(h)(2) (West 1998); Temp. Treas. Reg. § 1.469–5T(e) (as amended in 1992); *see also* S. REP. NO. 99–313, at 720, 731 (1986).

115. Peroni, *supra* note 13, at 27.

116. I.R.C. § 469(c)(2), (4) (West 1998).

117. Temp. Treas. Reg. § 1.469–1T(e)(3)(i) (as amended in 1995).

118. *See id.* § 1.469–1T(e)(3)(ii) (as amended in 1995); S. REP. NO. 99–313, at 720, 742–43. The provisions defining rental activities are very specific. For a detailed discussion of the intricacies of determining what is a rental activity and identifying the income and deductions properly, see Peroni, *supra* note 13, at 32–34. Originally, the only

the criticism of section 469 has centered around the "per se" passive standard for rental activities. As a result, Congress liberalized the rules regarding rental activities in 1993.[119]

Section 469 defines portfolio income and deductions in detail.[120] In general, the classification of an activity as active, passive, or portfolio in nature depends on the surrounding facts and circumstances. The Treasury Department, however, has wide discretion to issue regulations defining passive income so as to prevent taxpayers from transforming portfolio income into passive income in order to absorb passive losses.[121] In many cases, the distinction between passive and portfolio income is not clear, because section 469 requires the taxpayer to distinguish between two types of "passive" investments that are often economically similar.

Several other aspects of section 469 are important to an understanding of how these amazingly complex provisions operate. First, to the extent that the taxpayer "materially participates" in the trade or business activity during a given year, the activity is not a passive activity for that year. Second, the material participation standard applies on an activity-by-activity basis, so the definition of an "activity" is very important. Finally, one often needs an understanding of the interrelationship between section 469 and the other provisions of the Code to determine when section 469 applies. These three aspects are discussed in turn.

The Senate Finance Report states that "[a] taxpayer who materially participates in an activity is more likely than a passive investor to approach the activity with a significant nontax economic profit motive, and to form a sound judgment as to whether the activity has genuine economic significance and value."[122] Based on this assumption, the material participation standard is

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important exception to the presumption that all rental activities were passive was the special rule for rental real estate activities in which the taxpayer "actively participated." I.R.C. § 469(i) (West 1998); Temp. Treas. Reg. § 1.469–1T(a)(2)(i) (as amended in 1995); S. REP. NO. 99–313, at 737. Section 469(i) of the Internal Revenue Code allows a taxpayer to offset up to $25,000 of net passive losses from a rental real estate activity in which he actively participates against active or portfolio income. This exception phases out ratably for taxpayers whose adjusted gross incomes are between $100,000 and $150,000, and is not applicable to trusts, personal service corporations, and closely held C corporations. I.R.C. § 469(i)(3)(A) (West 1998); *see also* H.R. CONF. REP. NO. 99–841, at II–106 (1986). Special rules determine the level of participation necessary to qualify under this exception. I.R.C. § 469(i)(3)(A) (West 1998); S. REP. NO. 99–313, at 721, 737.

119. *See* I.R.C. § 469(c)(7) (West 1998). Under this provision, the rental real estate activities of certain full-time real estate professionals escape the per se passive treatment of rental activities. As such, the rental real estate activity of a qualifying taxpayer is not passive if the taxpayer materially participates in the rental activity.

120. *Id.* § 469(e)(1)(A) (West 1998); *see also* Peroni, *supra* note 13, at 35–42.

121. *See* I.R.C. § 469(l) (RIA 1998); H.R. CONF. REP. NO. 99–841, at II–147; S. REP. NO. 99–313, at 730. The regulations have been criticized for focusing on limiting the activities that generate passive income. *See* ABA Task Force, *Comments on Passive Activity Regulations*, 5 TAX MGMT. REAL EST. J. 245 (1989).

122. S. REP. NO. 99–313, at 716.

fundamental to the determination of whether an activity is passive or not. Material participation in an activity is determined on a year-to-year basis.[123] A taxpayer can satisfy the material participation requirement under any one of seven different tests. The temporary regulations set forth these tests.[124] The first four tests are quantitative in nature and focus on the number of hours the taxpayer devotes to the activity during the year. The next two focus on the taxpayer's material participation in certain previous taxable years. The final test looks to facts and circumstances to determine whether the taxpayer's level of participation meets the material participation standard.[125]

Because the material participation standard applies on an activity-by-activity basis, the scope of what constitutes an activity is vital. A taxpayer must establish material participation with respect to each activity in which he is involved.[126] This determination is also important because the rule allocates income and deductions on an activity-by-activity basis. Moreover, in order to make suspended losses available, a taxpayer must dispose of his entire interest in the activity that generated the losses.[127] In addition, several of the special exceptions under section 469 apply on an activity-by-activity basis.[128] The Senate Report focuses on "what undertakings consist of an integrated and interrelated economic unit, conducted in coordination with or reliance upon each other, and constituting an appropriate unit for the measurement of gain or loss."[129] The regulations provide that business activities may be treated as a single activity if the "activities constitute an appropriate economic unit for the measure of gain or loss for purposes of section 469."[130] The regulations look to five factors to determine whether activities constitute an "appropriate economic unit," making clear that more than one reasonable grouping of activities can result after taking into account all the relevant facts and circumstances.[131] Again, as with many provisions of section 469, the determination of what is an activity is not always clear, adding to the complexity of compliance.

The passive loss limitations apply, however, only after application of all other judicial doctrines and Code provisions relating to the measurement of

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123. *See id.* at 731; Temp. Treas. Reg. § 1.469–5T(a) (as amended in 1992).

124. Temp. Treas. Reg. § 1.469–5T(a).

125. *Id.*

126. S. REP. NO. 99–313, at 738–39.

127. *See* I.R.C. § 469(g) (West 1998); S. REP. NO. 99–313, at 739.

128. The most notable exception is for certain oil and gas working interests, which are completely exempt from the passive loss rules. I.R.C. § 469(c)(3) (West 1998).

129. S. REP. NO. 99–313, at 738.

130. Treas. Reg. § 1.469–4(c)(1) (as amended in 1995).

131. *Id.* § 1.469–4(c)(2) (as amended in 1995). The factors taken into account are "(i) [s]imilarities and differences in types of trades or businesses; (ii) [t]he extent of common control; (iii) [t]he extent of common ownership; (iv) [g]eographical location; and (v) [i]nterdependencies between or among the activities." *Id.*; *see also id.* § 1.469–4(c)(3), Example 1 (as amended in 1995).

income and the allowability of deductions from the activity for the year.[132] As a result, each of the restrictions discussed in Section III, among many others, can limit deductibility of passive losses before section 469 even applies.[133] This aspect of section 469 is precisely what makes it unnecessary.

V. TAX POLICY AND THE PASSIVE LOSS RULES

Many years ago, Judge Sneed enumerated seven pervasive purposes that have shaped the tax rates and structure:

> (1) to supply *adequate* revenue, (2) to achieve a *practical* and workable income tax system, (3) to impose *equal* taxes upon those who enjoy equal incomes, (4) to assist in achieving economic *stability*, (5) to *reduce economic inequality*, (6) to avoid impairment of the operation of the *market-oriented economy* and (7) to accomplish a high degree of harmony between the income tax and the sought-for *political order*.[134]

These purposes translate into seven tax policy criteria: adequacy; stability; political order; fairness, which includes both vertical equity and horizontal equity; economic efficiency; and simplicity. These criteria, however, do not always point in the same direction. In many instances, what enhances one criterion violates another.[135] The extent to which a particular tax provision complies with these criteria is therefore necessarily a balance between those criteria under which the provision is successful and those under which the provision is less successful.[136] Section 469 is no exception. In evaluating section 469, one must balance the net positive and negative effects under each criterion against those effects under the others.

A. Adequacy

The adequacy criterion refers to the aggregate revenue impact of the particular feature under consideration. Adequacy occurs when a proposed tax law generates significant tax.[137] Another aspect of adequacy is a preference for

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132. *See* Temp. Treas. Reg. § 1.469–2T(d)(6) (as amended in 1993); S. REP. No. 99–313, at 723.

133. *See, e.g.*, I.R.C. §§ 183, 704(d) (West 1998).

134. Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). Written while a professor at Stanford, Judge Sneed's comprehensive formulation of the tax policy criteria relevant to evaluation of federal income tax provisions has been the starting point for many tax policy debates. *See, e.g.*, Peroni, *supra* note 13, at 62 n.262.

135. For example, section 469, while arguably improving fairness, dramatically violates the tax goal of simplicity.

136. *See* Sneed, *supra* note 134, at 599–601.

137. *See id.* at 571–72.

payment sooner rather than later. Thus, provisions reducing tax deferral generally satisfy the adequacy criterion.[138]

Section 469 originated as a revenue generator.[139] The staff of the Joint Committee on Taxation estimated that section 469 would raise $23.4 billion between 1987 and 1991.[140] To the extent they raise revenue, the passive loss rules clearly serve the adequacy criterion. Still, it is likely these estimates were too high. Professor Peroni argues that staff overstated revenue because (1) it underestimated the ability of taxpayers to avoid the passive loss rules, and (2) it underestimated the revenue loss from the detrimental efficiency effects of section 469.[141] The passive loss rules do, however, significantly reduce tax deferral. By reducing deferral, the passive loss rules improve adequacy.

B. Stability

The objective of the stability criterion is "to assure a full utilization of resources, human and material, under a given rate of growth in output without inflation."[142] This criterion focuses on the countercyclical role that the tax system plays in our economy. In general, the impact of the tax system declines in economic downturns. Alternatively, as use of economic resources approaches capacity, the tax burden should increase. Thus, an income tax provision enhances stability if it promotes investment and economic growth, while helping the tax system achieve its countercyclical effect on the nation's economy.[143]

The passive loss rules can both promote and hinder stability. Many of the deductions that give rise to passive losses, such as interest and depreciation, increase during inflationary times. These deductions increase losses that, in turn, decrease taxes. The passive loss rules, however, muffle this effect by limiting

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138. *Id.*

139. *See* S. REP. NO. 99–313, at 714, 746 (1986); BIRNBAUM & MURRAY, *supra* note 99, at 219, 229.

140. *See* STAFF OF JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 254 (Comm. Print 1987).

141. *See* Peroni, *supra* note 13, at 62 n.262. However, when Congress enacted section 469(c)(7), which excepts real estate trades and businesses from the passive loss rules, section 469's potential to generate revenues declined significantly. The staff of the Joint Committee on Taxation estimated that section 469(c)(7) would lose over $2.6 billion in revenue during the period from 1994–1998. *See* JOINT COMM. ON TAX'N, ESTIMATED BUDGET EFFECTS OF REVENUE RECONCILIATION PROVISIONS AS APPROVED BY THE COMMITTEE ON WAYS AND MEANS ON MAY 13, 1993, at 3 (Comm. Print 1993).

142. Sneed, *supra* note 134, at 591 n.86.

143. *See* William J. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703, 1715–16 (1986). In recent years, the government has moved away from countercyclical fiscal policy. *See* Donald W. Kiefer, *Whatever Happened to Counter-cyclical Economic Stimulus?*, NAT'L TAX ASS'N F. 1–5 (1993).

deductibility of inflated losses.[144] In this sense, section 469 contributes to economic stability during inflationary times. Conversely, during recessionary times, the passive loss rules continue to limit losses, causing the tax burden to be higher during times of economic slack than it would be otherwise. In this way, the passive loss rules hinder economic stability.[145]

C. Political Order

The political order criterion measures a tax provision "against those standards, guidelines, and practices reflected in the political process."[146] Tax laws must rest on the constitutional power to tax[147] without interfering with the constitutional liberty of the individual. Additionally, the enactment and enforcement of tax laws must be consistent with the principle of separation of powers.[148]

Several arguments indicate that section 469 does not fare well under this criterion. First, Congress incorporated section 469 at the end of the legislative process culminating in the 1986 Act.[149] Members of the Senate Finance Committee drafted the provisions in a closed-door conference without the opportunity for public debate or public hearings.[150] This is not the political process at its best. Additionally, Congress' delegation of power to the Treasury Department, allowing it to define terms in section 469 and recharacterize income and deductions under the passive loss rules, may constitute a violation of the delegation doctrine.[151] Meanwhile, the Treasury Department has taken advantage of the delegation. Treasury regulations under section 469 have bombarded taxpayers with numerous intricacies of application.[152]

D. Fairness

The fairness criterion addresses the manner in which a provision apportions the resulting tax burden.[153] Fairness is critical in a tax system that relies

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144. *See* Zelenak, *supra* note 8, at 516–17.

145. *See* Peroni, *supra* note 13, at 62–63 & n.262; *see also* James R. Follain et al., *Understanding the Real Estate Provisions of Tax Reform: Motivation and Impact*, 40 NAT'L TAX J. 363, 366 (1987).

146. Sneed, *supra* note 134, at 594.

147. U.S. CONST. amend. XVI; Eisner v. Macomber, 252 U.S. 189 (1920) (discussing the constitutional power to tax).

148. *See* Sneed, *supra* note 134, at 594–97.

149. The passive loss rules first appeared in the tax reform package in late April 1986. *See* BIRNBAUM & MURRAY, *supra* note 99, at 218–21.

150. *See* Rosenbaum, *supra* note 100, at D1.

151. *See* Peroni, *supra* note 13, at 41 n.163.

152. Some question the validity of some of the regulations under section 469 as violative of the Administrative Procedure Act's notice requirements. *See Shop Talk: Will IRS's 'Bait and Switch' Invalidate Passive Loss Regs.?*, 82 J. TAX'N 61 (1995).

153. Sneed, *supra* note 134, at 574.

on self-assessment. When taxpayers perceive a tax system as unfair, they find ways to avoid and evade taxes.[154] As a result, administration of the system becomes costly and burdensome. One of the primary rationales for enactment of section 469 was to eliminate tax shelters, which many held responsible for a loss of taxpayer confidence in the system.[155]

A fair tax, in the sense of horizontal equity, affects all taxpayers of equal income[156] in the same way. Restrictions, such as the passive loss rules, should help to achieve that goal.[157] Fairness, in the sense of vertical equity, focuses on the difference in income of various taxpayers. Vertical equity increases when the tax burdens of taxpayers of different means differ accordingly.[158] Most believe that those with greater income should bear a greater tax burden. The passive loss restrictions are thought to advance this goal by increasing taxes on capital. Such taxes affect higher-income taxpayers more than lower-income taxpayers.[159]

1. Horizontal Equity

According to Judge Sneed, "Equity's influence has been more powerful than other criteria in shaping the outlines of gross income."[160] To a large degree, taxpayer confidence in a tax system stems from its perceived fairness. Professor Bankman believes:

> Individuals who invest in tax favored assets are thought to shirk their fair share of the tax burden and to benefit at the expense of other taxpayers with equal economic income. A regime of tax

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154. S. REP. NO. 99–313, at 714 (1986).

155. *Id.*; *see also* Bankman, *supra* note 15, at 40; Zelenak, *supra* note 8, at 528.

156. For purposes of tax policy analysis, income is measured under the accretion of wealth approach, as characterized by the Haig-Simons definition of income. Simons defined income "as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (University of Toronto Press 1965) (1938); *see also* Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, *in* THE FEDERAL INCOME TAX 1 (Robert Murray Haig ed., 1921). The net accretion approach represents the prevailing theoretical view of income. Sneed, *supra* note 134, at 579; *see* Bankman, *supra* note 15, at 41 n.117; Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967). For alternative concepts of the proper measurement of income, see Bankman, *supra* note 15, at 41.

157. Bankman, *supra* note 15, at 16.

158. *See* Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1906–10 (1987); *cf.* Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

159. *See* STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., ANALYSIS OF PROPOSALS RELATING TO COMPREHENSIVE TAX REFORM 3–4 (Comm. Print 1985).

160. Sneed, *supra* note 134, at 580.

> favored assets is said to violate Haig-Simons definition of income and the canon of horizontal equity.[161]

To the extent that section 469 causes taxpayers with equal amounts of economic income to bear equal tax burdens, it promotes and improves horizontal equity.

The passive loss rules have a strong positive effect on the equalization of taxation among taxpayers with the same economic income. When the passive loss restrictions limit a taxpayer's ability to utilize noneconomic losses against economic income, they improve horizontal equity. Some commentators have argued that the main theoretical justification for the passive loss rules is that they promote a more accurate measurement of net income.[162]

In application, however, the passive loss limitations do not distinguish between economic and noneconomic losses. To determine whether a loss is a real economic loss, one must examine the underlying deductions. Section 469, however, focuses on the level of the taxpayer's participation to determine whether a loss is passive. As a result, section 469 may or may not improve horizontal equity, depending on the nature of the underlying deductions. In relation to Haig-Simons measurement of income,[163] the passive loss limitations are both over- and underinclusive. Section 469 is overinclusive because it limits the deduction of real economic losses.[164] It is underinclusive because it still allows deduction of noneconomic losses in a large number of instances.[165]

The use of a taxpayer's level of participation in an activity to determine whether losses are deductible creates several problems that undermine horizontal equity. The level of a taxpayer's participation does not indicate whether the underlying deductions result from tax preferences. Congress supposedly designed the passive loss rules to stop abusive use of tax preferences. Section 469, however, allows a taxpayer to use losses to offset other income when the taxpayer "materially participates."[166] In contravention of horizontal equity, the rules differentiate between taxpayers based on a taxpayer's level of participation, rather than on the basis of economic income. The regulations exacerbate this problem when they quantify material participation.[167] The focus on participation also allows taxpayers to distort both the nature and the timing of income or losses. The

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161. Bankman, *supra* note 15, at 41. See *supra* note 156 for a definition of Haig-Simons income.

162. Cecily W. Rock & Daniel N. Shaviro, *Passive Losses and the Improvement of Net Income Measurement*, 7 VA. TAX REV. 1, 25–27, 54–55 (1987); *see also* S. REP. NO. 99–313, at 714–16 (1986). For a detailed discussion of the fallacies in the Rock & Shaviro argument, see Peroni, *supra* note 13, at 69–70 n.288.

163. See *supra* note 156 for a definition of Haig-Simons measurement of income.

164. *See* Peroni, *supra* note 13, at 71 (arguing that this results from the presumption that all losses are noneconomic when in fact this is not true).

165. Bankman, *supra* note 15, at 43. For instances in which section 469 allows deduction of noneconomic losses, see *infra* text accompanying note 169.

166. I.R.C. § 469(c)(1)(B) (West 1998).

167. *See* Temp. Treas. Reg. § 1.469–5T (as amended in 1992).

taxpayer can accelerate or delay the recognition of losses by increasing or decreasing his level of participation in a given activity. In the same way, a taxpayer can change the nature of a passive loss or active income.[168] The focus on participation levels, rather than on the nature of the underlying loss, results in a departure from both horizontal equity and economic efficiency. The primary source of income mismeasurement has nothing to do with an investor's level of participation but, instead, stems from underlying tax preferences.

Section 469 departs from the goals of horizontal equity in several additional respects. First, the passive loss rules do not prevent a taxpayer from using tax preferences to generate artificial deductions, thereby offsetting income from the activity in which the deductions arise, be that activity "active" or "passive." Second, the rules do not prevent use of artificial losses from one passive activity to offset income from another passive activity.[169] Finally, the passive loss rules sharply distinguish between passive income, portfolio income, and active income, despite the fact that these types of income are economically indistinguishable.[170] These distinctions also add a substantial amount of complexity to the tax laws.

Another way in which section 469 runs afoul of horizontal equity is in its distinctions between types of activities. Losses from oil and gas working interests are completely exempt from the passive loss rules, without regard to a taxpayer's level of participation.[171] Many regard the preferences subsidizing the oil and gas industry as among the most egregious departures from a "theoretically pure definition of economic income."[172] Furthermore, the carve-out provision for oil and gas interests occurred for political, not policy, reasons.[173]

Originally, all rental activities were passive, regardless of the taxpayer's level of participation. However, Congress granted relief in the case of real estate activities, and now taxpayers who can establish themselves as engaged in a real property business effectively enjoy the same exemption that oil and gas working

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168. The regulations do, however, disregard any work a taxpayer does in connection with an activity if the work is not typical of an owner and the purpose of performance is to avoid application of section 469. *See* Temp. Treas. Reg. § 1.469–5T(f)(2)(i) (as amended in 1992); *see also* Richard A. Westin, *Shooting Pool in the Dark: Coping with the Passive Loss Rules*, 11 REV. TAX'N INDIVIDUALS 139, 163 (1987).

169. *See* I.R.C. § 469(d)(1) (West 1998); *cf. id.* § 469(k) (West 1998) (restricting aggregation of passive income and losses generated by different publicly traded partnership interests held by a taxpayer).

170. *See* Peroni, *supra* note 13, at 73–74.

171. *See* I.R.C. § 469(c)(3) (West 1998).

172. *See* Peroni, *supra* note 13, at 76; *see also* FRIENDS OF THE EARTH, DIRTY LITTLE SECRETS 10–14 (1995) (discussing tax breaks for oil and gas); ROBERT REPETTO ET AL., WORLD RESOURCES INST., GREEN FEES: HOW A TAX SHIFT CAN WORK FOR THE ENVIRONMENT AND THE ECONOMY (1992) (discussing the effect of taxes on the environment); Calvin H. Johnson, *Seventeen Culls from Capital Gains*, 48 TAX NOTES 1285 (1990).

173. *See* BIRNBAUM & MURRAY, *supra* note 99, at 229.

interests have.[174] In this fashion, section 469 differentiates between taxpayers who have the same economic income on the basis of the type of activity in which they engage, rather than on the basis of the nature of the underlying deductions. Since those who engage in favored activities are exempt from the passive loss limitations, section 469 violates horizontal equity.

A final argument with respect to the failure of section 469 under the principle of horizontal equity focuses on the theory of capitalized taxes.[175] If complete capitalization has occurred with respect to a tax-favored investment, passive loss restrictions would be unnecessary because the price of the asset would already reflect the purchaser's supposed tax savings. Unfortunately, this argument is difficult to substantiate, because it is not easy to determine at what price level capitalization is complete.[176]

Although in some ways section 469 may improve horizontal equity, in many ways the passive loss rules create inequity. At best, the passive loss rules operate like a blunt instrument in moving the tax system toward horizontal equity.

2. Vertical Equity

One of the goals of section 469 was to prevent high-income taxpayers from using tax shelter losses to offset tax liability from other income sources.[177] The effective tax rate applicable to such taxpayers would, accordingly, increase. Thus, the passive loss restrictions were intended to enhance vertical equity.[178] The Senate Finance Committee Report discusses the necessity of section 469 in alleviating the effects of the substantial rate cuts of the 1986 Act.[179] Without section 469, the tax rate cuts would have shifted a substantial portion of the tax burden away from upper-income taxpayers.[180] Therefore, in the context of the 1986 Act as a whole, the passive loss rules were instrumental in the effort to achieve vertical equity.

Undoubtedly, section 469 affects taxpayers in higher income brackets far more profoundly, and far more frequently, than it impacts those in lower brackets. It is not so clear, however, that these impacts enhance vertical equity. The passive loss rules should drive down the effective rate of return on tax shelter investments

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174. *See* I.R.C. § 469(c)(7) (West 1998).

175. For a discussion of capitalized taxes, see Bankman, *supra* note 15, at 43. *See also supra* text accompanying notes 18–19.

176. *See* Zelenak, *supra* note 8, at 530–34.

177. *See supra* text accompanying notes 12–16.

178. This discussion assumes that a progressive tax rate structure is appropriate under an ideal tax system. *See* Bankman, *supra* note 15, at 41 n.117; Sneed, *supra* note 134, at 581; *cf.* Blum & Kalven, *supra* note 158.

179. S. REP. NO. 99–313, at 714 (1986).

180. *See id.*; BIRNBAUM & MURRAY, *supra* note 99, at 218–20, 227.

by imposing a higher tax burden on those who own them.[181] To the extent that higher-income taxpayers hold higher concentrations of tax shelter investments, vertical equity should thereby increase. Professor Bankman, however, argues that it is not clear whether the additional taxes on these investments will be borne by capital or passed on to labor and consumers.[182]

Vertical equity increases to the extent that the passive loss rules preclude high-income taxpayers from utilizing noneconomic losses against salaries or income from active businesses. Conversely, the passive loss rules do not preclude high-income taxpayers from using passive losses to offset income from passive sources. Thus, the passive loss rules tend to discriminate in favor of high-income taxpayers who derive most of their income from the investment of capital and can readily shift investments. The rules discriminate against high-income taxpayers with salaries or active businesses who cannot readily make such shifts.[183]

The exemption of C corporations from the application of the passive loss rules also diminishes vertical equity. Even after enactment of section 469, C corporations are still able to use passive losses to shelter income from any source. To the extent that corporate shareholders consist mostly of higher income taxpayers or tax-exempt entities, they thus can continue to reap the benefits of sheltering.[184] C corporations are subject to double taxation.[185] The 1986 Act sought to strengthen the impact of this double taxation.[186] The exemption of C corporations from section 469 clearly conflicts with this goal.

Similarly, the exceptions for working interests in oil and gas properties and real estate activities undermine any increases in vertical equity. These special-interest provisions undoubtedly benefit high-income taxpayers. As such, they undercut vertical equity. Additionally, by retaining these exceptions, section 469 fails to accomplish the congressional goal of mitigating the appearance of unfairness.[187] Oil and gas industry tax shelters are very apparent abuses of the tax

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181. *See* Bankman, *supra* note 15, at 45; *see also* Peroni, *supra* note 13, at 83 (discussing the effect of capitalization of taxes on the transitional rules).

182. *See* Bankman, *supra* note 15, at 45. Additionally, Bankman argues that in the long run labor bears the brunt of capital taxes. *Id.* at 46; *see also* Stanley A. Koppelman, *Tax Arbitrage and the Interest Deductions*, 61 S. CAL. L. REV. 1143, 1162–88 (1988); John B. Shoven, *Comments*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME CONSUMPTION TAX 342, 344 (Henry J. Aaron et al. eds., 1988) (commenting on Charles R. Hulten & Robert A. Klayman, *Investment Incentives in Theory and Practice*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME CONSUMPTION TAX, *supra*, at 317).

183. *See* Peroni, *supra* note 13, at 80.

184. *See, e.g.*, Lee A. Sheppard, *Beating the Passive Loss Limitations*, 32 TAX NOTES 733, 734 (1986).

185. *See* I.R.C. § 11 (West 1998) (taxing corporate income); *id.* § 61 (West 1998) (taxing shareholder dividend income).

186. *See* HOUSE WAYS & MEANS COMM., 99TH CONG., REPORT ON H.R. 3838, at 274 (1985).

187. *See* S. REP. NO. 99–313, at 714 (1986).

code. As a result, Congress has probably not done much to mitigate the "public concerns that the tax system is unfair."[188]

The passive loss rules in many instances do improve both horizontal and vertical equity. But by focusing on the level of a taxpayer's participation and the type of activity or entity, the passive loss rules are imprecise in their effect on equity. Thus, they levy "an unpredictable and differential set of rates on investment."[189]

E. Economic Efficiency

Judge Sneed believed that "[t]he aim of fiscal policy is to make the presence of government as unobtrusive as possible so that the optimum allocation of resources may be approached as closely as possible."[190] An economically efficient tax system would subject *all* items of income to tax. It would define income broadly and impose tax on items for which taxpayers cannot substitute untaxed alternatives.[191] Exclusions from the tax base are inconsistent with economic efficiency and must find justification elsewhere.[192] When a tax system does provide for exclusions and limitations, taxpayers will tend to select tax-favored assets over others, resulting in distortion of choice and reduction in societal welfare.[193]

The Senate Finance Report uses efficiency as another primary reason for enactment of section 469. The report states that tax shelters have "harmed the economy generally, by providing a noneconomic return on capital for certain investments. This has encouraged a flow of capital away from activities that may provide a higher pretax economic return, thus retarding the growth of the sectors of the economy with the greatest potential for expansion."[194] Clearly, section 469 has had a significant impact on economic behavior. To the extent that the tax preferences that gave rise to abusive tax shelters can no longer distort efficiency, the passive loss rules tend to restore economic efficiency. However, in many situations, their impact creates, rather than reduces, distortion.

Because the determination of whether an activity is passive depends on the level of a taxpayer's participation, the passive loss rules encourage taxpayers to adjust their levels of participation in various activities on the basis of whether

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188. *Id.*

189. Bankman, *supra* note 15, at 43.

190. Sneed, *supra* note 134, at 587.

191. *See id.* at 588.

192. *See id.* at 588–89.

193. *See* Bankman, *supra* note 15, at 26. Not everyone agrees that a reduction in societal welfare results from tax expenditures. *See* Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986).

194. S. REP. NO. 99–313, at 716 (1986).

they need passive/active income or losses.[195] A taxpayer would probably want to increase the time he spends in activities generating losses, thus converting passive losses into active losses capable of offsetting active income. To the extent that a losing activity is inefficient, the taxpayer would be shifting his time from a presumably more efficient use to a less efficient use. The passive loss rules thereby distort behavior.[196] The temporary regulations exacerbate this situation through their quantitative approach to determining participation.[197] An additional problem is that this fixation on how taxpayers allocate their time encourages them to falsify their time records.[198]

The material participation standard is problematic because it tends to penalize economic activities in which the taxpayer can operate efficiently without spending a substantial amount of time. Although participation is sometimes an indicator of a taxpayer's economic profit motive,[199] often it is not. A successful economic enterprise may operate with some participants providing the management expertise, some performing the needed labor, and others supplying the requisite capital.[200] The passive loss rules are simply biased in favor of activities that require physical labor from the taxpayer and against those activities that require only investment of capital.[201]

The passive loss rules distort efficiency because they cause capital to move from passive investments to actively managed investments, regardless of the underlying viability of the investment. Investors will shift capital away from more risky passive activities to less risky passive investments.[202] Additionally, an investor with passive losses will pay more for a safe passive investment generating income than a safe active investment. The passive loss rules also affect decisions regarding the disposition of passive activities, especially those with suspended losses.

Additionally, section 469 affects a taxpayer's choice of business entity. This is not efficient. The exemption for C corporations clearly favors C corporations over all others.[203] Conversely, section 469(k) accords publicly traded

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195. Cherie J. O'Neil & Clarence C. Rose, *Real Estate Tax Shelters Under the Tax Reform Act of 1986*, 14 J. REAL EST. TAX'N 115, 118 (1987).

196. *See* Peroni, *supra* note 13, at 87.

197. *See* Temp. Treas. Reg. § 1.469–5T(a) (as amended in 1992).

198. *See* Bankman, *supra* note 15, at 35.

199. *See* S. REP. NO. 99–313, at 716.

200. Peroni, *supra* note 13, at 88.

201. *See* Bankman, *supra* note 15, at 32; Peroni, *supra* note 13, at 88.

202. *See* Bankman, *supra* note 15, at 33. Lewicki maintains that we should encourage investment in socially beneficial risky technology. Lewicki, *supra* note 14, at 140.

203. The "check-the-box" regulations, codified in Treasury Regulations section 301.7701–3 (1997), which allow taxpayers freely to select the type of taxable entity they prefer, further distort efficiency, after taking into account the exception of C corporations from the passive loss rules.

partnerships the most unfavorable treatment under the rules. General partnerships, rental real estate activities, and S corporations all fare better than limited partnerships and closely held C corporations, which generally cannot qualify under any of the rental real estate exceptions to the passive loss rules.[204] In a similar way, the passive loss rules misallocate resources because of their varying impacts on different industries. Certain working interests in oil and gas are exempt from the passive loss limitations, whereas rental activities are presumptively passive.[205] Thus, the rules encourage a shift in capital away from rental activities and toward oil and gas investments. With enactment of the exception for certain real estate activities, Congress further distorted investment decisions.[206] Section 469 encourages investors with passive loss activities to invest in passive income activities. The soundness of these passive income generators is questionable.[207] Moreover, the regulations include a number of provisions that seek to prevent taxpayers from converting portfolio income into passive income.[208] The passive loss rules thus distort market allocation of resources by encouraging investment in certain activities due to tax incentives. This is precisely the result Congress intended to avoid.

Finally, the complexity of the passive loss rules has undoubtedly resulted in an increase in the resources taxpayers devote to tax planning. The rules require intricate computations; they implement complicated accounting rules that require an inordinate amount of taxpayer time to achieve compliance. Thus, they divert these resources from more useful investment.

In conclusion, section 469 decreases efficiency in several ways. Congress should reconsider the passive loss rules in light of these distortions.[209] Rather than focusing on the taxpayer's participation or on the type of activity involved, Congress should redesign the law to reduce use of tax preferences in abusive ways. Efficiency would increase even more if Congress simply eliminated most preferences.

F. Simplicity/Complexity

The criterion of simplicity, or as Judge Sneed called it "practicality," includes "structural unity and simplicity of the tax, convenience and ease in assessment and collection from the standpoint of both the government and taxpayer, certainty of obligations imposed on both taxgatherer and payer, and

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204. *See* Peroni, *supra* note 13, at 90. *But see* I.R.C. § 469(c)(7)(D)(i) (West 1998) (allowing certain closely held C corporations to be engaged in real property trade or business).

205. *See supra* text accompanying notes 116–19, 171–74.

206. *See supra* note 119 and accompanying text.

207. *See, e.g.*, Barry Vinocur, *In Partnership, You Can Buy a PIG in a Poke*, BARRON'S, Mar. 9, 1987, at 81, *available in* 1987 WL–BARRONS 2001579.

208. *See* ABA Task Force, *supra* note 121.

209. *See* Bankman, *supra* note 15, at 37 tbl.I.

adequate powers in government to deal effectively with the recalcitrant and fraudulent."[210]

The passive loss rules fail miserably under the criterion of simplicity. In fact, the arbitrary impact and complexity of the rules may well offset any increase in the public's perception of fairness. Complexity is the most serious problem facing the passive loss rules, particularly in light of the numerous regulations promulgated by the Treasury.[211]

For example, the passive loss rules require a taxpayer to separate all income, deductions, and credits into a large number of categories.[212] These categories include income, deductions, and credits for: active trades and businesses, portfolio investments, oil and gas working interests, rental real estate activities in which the taxpayer materially participates, and publicly traded partnerships. To keep track of these categories, taxpayers will have to keep separate records for each "activity," as well as each category of income or loss.[213] But the boundary lines of an "activity" are not necessarily the same as those of the taxpayer's entities for financial accounting purposes. Thus the passive loss rules may force taxpayers to create two sets of records. These complexities add not only to the cost of record keeping for the taxpayer, but also to the cost of compliance for both the taxpayer and the Internal Revenue Service. The passive loss rules certainly surpass the capital gain and loss provisions as sources of complexity in the Code.[214]

As discussed in Section IV, the passive loss rules apply to an activity only after application of all other judicial doctrines and Code sections.[215] Thus, they add another level of complexity in determining taxable income or loss. In addition, the passive loss limitations work differently under the alternative minimum tax. As a result, the taxpayer who uses depreciable property, for example, might have as many as eight different amounts to keep track of: (1) depreciable basis for regular tax purposes; (2) depreciable basis for alternative minimum tax purposes; (3) the property's basis for earnings and profits purposes; (4) the basis in the activity for regular tax purposes; (5) the basis in the activity for alternative minimum tax purposes; (6) suspended losses under the at-risk rules; (7) suspended losses under the passive loss rules for regular tax purposes; and (8) suspended losses for the

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210. Sneed, *supra* note 134, at 573; *see also* Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267.

211. *See* Gerald M. Brannon, *Some Economics of Tax Reform, 1986*, 39 NAT'L TAX J. 277, 278 (1986); *cf.* S. REP. NO. 99–313, at 713–14 (1986).

212. *See supra* text accompanying notes 115–21.

213. The passive loss limitations are implemented on an activity by activity basis. *See* Treas. Reg. § 1.469–4 (as amended in 1995).

214. *See* Peroni, *supra* note 13, at 96. Even proponents of section 469 recognize the significant complexity passive loss rules add. *See* Rock & Shaviro, *supra* note 162, at 5.

215. *See supra* text accompanying notes 132–33.

passive activity under the alternative minimum tax.[216] Each of these amounts may be necessary for each of a taxpayer's activities.

This complexity undoubtedly has a chilling effect on business transactions.[217] Both the inordinate complexity and the resulting uncertainty may cause taxpayers to delay or forgo transactions. Efficiency declines. Some may argue that Congress intended for the passive loss rules to stifle certain transactions. But planned uncertainty is a poor way to achieve tax reform under normative tax policy criteria.[218]

In conclusion, section 469 adds significant complexity to an already complex tax system. Former Chief Judge Samuel Sterrett of the U.S. Tax Court has predicted that litigation to distinguish between passive and active losses and gains will replace tax shelter cases in the coming years.[219] As Professor Peroni has stated, "It is the ultimate irony that a provision that was intended to restore morale to the self-assessment system may instead lead to greater taxpayer dissatisfaction and a further erosion of support for the federal income tax system."[220] Unfortunately, neither the regulations under section 469 nor the statutory amendments alleviate the provision's tax policy deficiencies.

VI. RECOMMENDATIONS FOR SECTION 469 AND OTHER TAX SHELTER LEGISLATION

Section 469 suffers from serious theoretical problems. Commentators, as well as practitioners, have complained about section 469 since its enactment.[221] One might wonder why Congress has doomed taxpayers to suffer the complexities of section 469. Three reasons come to mind. First, upon enactment of a law, inertia sets in. As difficult as it is to enact a provision, it is even more difficult to repeal one.[222] Second, to the extent Congress believes that the taxpaying public perceives

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216. *See* Peroni, *supra* note 13, at 100.

217. *See, e.g.*, O'Neil & Rose, *supra* note 195.

218. *See* Sidney I. Roberts et al., Committee on Tax Policy, N.Y. State Bar Ass'n, Tax Section, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972).

219. *See Chief Judge Predicts Passive Loss Rules Will Be Major Litigation Issue*, Daily Tax Rep. (BNA), No. 43, at G–2 (Mar. 4, 1988). Tax cases involving section 469 are on the rise. In 1992, only one section 469 case was reported. However, by 1996, there were ten, and in 1997, nine cases. Unpublished data, on file with the author (a Westlaw search was performed looking for cases in which "section 469" appeared; these cases were then checked to determine whether section 469 was a key issue).

220. Peroni, *supra* note 13, at 102.

221. *See, e.g.*, Bankman, *supra* note 15; Lewicki, *supra* note 14; Peroni, *supra* note 13; John Pierre, *Wow! Tax Relief for Rental Real Estate Activities from Passive Loss Rules Under the 1993 Revenue Reconciliation Act*, 21 S.U. L. REV. 45 (1994); Zelenak, *supra* note 8.

222. For example, see the legislative history of section 1014. Section 1014 provides a stepped-up basis at death on a decedent's property. As such, any unrealized appreciation in such property goes forever untaxed. Not surprisingly, section 1014 has

section 469 to be the slayer of tax shelters, it may be reluctant to undermine the resulting taxpayer confidence. Finally, while many believe that the passive loss rules were unnecessary to eliminate abusive tax shelters, some fervently believe that section 469 was necessary for that task.[223] Unfortunately, the data is inconclusive. Though plausible, these rationales for leaving section 469 in the Code are not compelling. The passive loss rules are a poor excuse for sound tax legislation. The "right" answer is so simple: section 469 should be repealed.

Prior to 1986, Congress had already completed much of the necessary groundwork for ending abusive tax shelters. By the time section 469 was enacted, Congress had already eliminated many of the worst preferences.[224] In addition, many of the other changes Congress enacted as part of the 1986 Act further reduced the attractiveness of tax shelters.[225] In particular, expanding the at-risk rules and extending depreciable asset lives went a long way towards reducing the after-tax rate of return on most shelter activities. Other changes in the law since 1986 have also decreased the likelihood that the repeal of section 469 would revive the tax shelter industry.[226] On the other hand, Congress has allowed tax rates to creep back up to nearly forty percent, while reducing capital gains rates.[227] Thus, Congress has also increased the incentive for taxpayers to find ways to shelter ordinary income and engage in conversion strategies. Nonetheless, it was specific Code provisions, not conversion, that generated most serious tax shelter abuses. Given the hoard of legislation in place that effectively curtails abusive tax shelters, section 469 is deadwood. Its cost and complexity make it obscene.

Some do not agree that the Code currently contains sufficient anti-tax shelter weapons to defend itself if Congress were to repeal section 469.[228] However, retention of section 469 is not the answer. Instead, Congress should eliminate or restrict the underlying tax preferences that give rise to shelter situations. For example, repealing the at-risk exception for qualified nonrecourse financing would frustrate deductibility of many losses currently subject to the passive loss limitations, without drawing artificial distinctions between investments on the basis of investor participation. Furthermore, the current tax treatment of debt, combined with the interest deduction, significantly enhance after-tax rates of return. Even if Congress is unwilling to reform the tax treatment

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always been controversial. In 1976, Congress garnered enough support to repeal section 1014, but due to popular demand, Congress postponed its repeal and ultimately reinstated section 1014 a few years later. *See* WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 161–62 (11th ed. 1997).

223. *See, e.g.*, Johnson, *supra* note 11.

224. *See supra* Part III.A–B.

225. *See supra* text accompanying notes 88–97.

226. *See* Sims, *supra* note 49 (discussing the role that section 453 and subsequent amendments to section 453 have played in the demise of tax shelters).

227. *See* I.R.C. § 1(h) (West 1998) (enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 311(a), 111 Stat. 788, 831–34).

228. *See* Johnson, *supra* note 11.

of debt (i.e., to reverse *Crane v. Commissioner*),[229] curtailing interest deductions would alleviate the problem. For example, Congress could expand the scope of the investment interest limitations under section 163(d).

Depreciation deductions also create noneconomic deductions, because depreciable lives for tax purposes are significantly shorter than economic lives. Congress could lengthen depreciable lives to reduce this distortion. Special interest legislation, such as the numerous oil and gas industry preferences, are complex, unfair, and frustrate tax policy goals. Congress should do away with this type of legislation. These suggestions are not novel,[230] but serve, by way of example, to illustrate the numerous tax preferences that facilitate shelter activity. By repealing or limiting existing tax preferences, Congress could enhance tax policy goals, as well as political goals, without the complexity and cost the passive loss rules generate.

VII. CONCLUSION

Historically, tax shelters have generated tremendous economic distortions. Tax shelters have shifted capital toward tax-favored investments, even when these investments made no sense, apart from the tax benefits they promised. Tax shelters have also destroyed equity in the tax system and caused taxpayer dissatisfaction. But, the passive loss rules suffer from numerous defects under traditional tax policy criteria. For example, they create unfairness because they favor taxpayers who engage in activities that are exempt from the rules. They cause distortions in investment behavior through limitations that target a taxpayer's participation level, rather than an investment's economic viability. Finally, the passive loss rules create excessive complexity. Congress should therefore repeal section 469. If existing laws are an insufficient defense against abusive tax shelters, Congress should reexamine tax preferences and reform them in accordance with traditional tax policy criteria. Legislation curtailing or eliminating underlying tax preferences would go a long way toward achieving this goal.

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229. *See supra* text accompanying notes 25–31 (discussing *Crane* and the treatment of debt).

230. The literature discussing the problems with tax preferences is formidable. *See, e.g.*, Auerbach, *supra* note 21; Alan J. Auerbach, *Should Interest Deductions Be Limited?*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME CONSUMPTION TAX, *supra* note 182, at 195; Bankman, *supra* note 15; Erik M. Jensen, *The Unanswered Question in* Tufts: *What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455 (1991); Calvin H. Johnson, *The Front End of the Crane Rule*, 47 TAX NOTES 593 (1990); Koppelman, *supra* note 182; Mundstock, *supra* note 31; Peroni, *supra* note 13; Rock & Shaviro, *supra* note 162; Zelenak, *supra* note 8.