INCOME TAX PLANNING FOR ATHLETES AND ENTERTAINERS

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INTRODUCTION

Athletes and entertainers who enjoy success in their respective professions face serious income tax problems. Each is involved in an industry where uncertainty is the rule rather than the exception, and a few years of high income and notoriety may be followed by a much longer period of inadequate means and relative obscurity. In contrast to other professionals who earn income in a predictable pattern, the income of an athlete or entertainer is often subject to extreme variations. Thus, the possibility of paying a disproportionate amount of income tax on total career earnings is of primary concern. Moreover, since the athlete and entertainer are often high-bracket taxpayers as well as public figures, their income tax returns may be subjected to close scrutiny by both the Internal Revenue Service and State taxing authorities.

The purpose of this article is to review the common tax planning techniques which might be employed to lessen the impact of federal income taxes on the athelete and entertainer. The broad topics include, 1) tax motivated incorporations, 2) utilization of the maximum tax on personal service income, 3) income averaging, 4) the use of tax-sheltered transactions, and 5) nonqualified deferred compensation plans. The foregoing list of topics is by no means all-inclusive. For example, the tax aspects of estate planning and problems related to business and entertainment expenses are but two of the many areas which also deserve consideration. Moreover, the article only addresses the subject of federal income taxes. The reader is directed elsewhere for more comprehensive literature.[1]

I. OPERATING IN CORPORATE FORM

A. *Introduction and Advantages*

Full consideration should be given to incorporating the activities of the athlete or entertainer for purposes of both tax reduction and financial security. Generally speaking a major reason for incorporating has been the benefit of the maximum corporate tax rate of 48 percent,[2] in an effort to achieve capital gains upon disposition of the stock in the corporation, or to avoid the capital gains tax altogether by holding the stock until death.[3] Incorporating has also meant that

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1. *E.g.*, GERSHON AND BLACKMAN, COUNSELING PROFESSIONAL ATHLETES AND ENTERTAINERS, Practicing Law Institute; Brawerman & Kopple, *Income Tax Planning for Composers, Entertainers and Others Performing Personal Services*, 49 TAXES 211 (1971).
2. INT. REV. CODE OF 1954, §§ 11(b) and (c).
3. INT. REV. CODE OF 1954, § 1014.

self-employed persons could participate in the deferred compensation packages and other fringe benefits available only to employees. Particularly valuable are the tax benefits of corporate pension and profit-sharing plans which qualify under the Internal Revenue Code.[4] For example, the contributions made by the corporation into the qualified plan for the benefit of an "employee" are not taxed to the employee (or his beneficiaries) until received,[5] and the corporation may deduct these contributions currently.[6] The income generated by the contributions also accumulates tax-free until distributed.[7] In contrast, a self-employed person has faced stringent limitations on deductible contributions into qualified plans.[8]

However, certain provisions of the Tax Reform Act of 1969[9] and of the Employee Retirement Income Security Act of 1974[10] [hereinafter cited as ERISA], should have reduced the number of tax-motivated incorporations. For example, the adoption of the maximum tax[11] substantially equates the maximum tax rate for individuals on "personal service" income with that of corporations. Further, that maximum rate is reached at a level of $25,000 of corporate income,[12] but at a much higher level for a married individual taxpayer.[13] Thus there is little justification for exposing the income to the corporate tax. Secondly, the taxation of capital gains has also been affected by the 1969 Tax Reform Act. The maximum 25 percent rate now applies only to the first $50,000 of net long-term capital gain.[14] Additional capital gains were taxed at a maximum of 29-1/2 percent in 1970, 32-1/2 percent in 1971, and, for taxable years beginning after December 31, 1971, 50 percent of the maximum ordinary tax rate.[15] Therefore, any disposition of the stock of the corporation may be taxed at higher rates, and, combined with the taxes paid on the operating income of the corporation, could result in a greater overall tax liability.

Further, as a result of ERISA fewer incorporations will be motivated exclusively by the benefit available under corporate pension and profit sharing plans.

4. INT. REV. CODE OF 1954, §§ 401 - 407.
5. INT. REV. CODE OF 1954, § 402(a)(1).
6. INT. REV. CODE OF 1954, § 404(a).
7. INT. REV. CODE OF 1954, § 404.
8. Under the provisions of the Self-Employed Individuals Retirement Act of 1962 (commonly called the "Jenkins-Keough Bill"), self-employed persons could adopt a retirement plan into which a maximum of $2,500 per year on behalf of the owner-employee could be contributed. *See* INT. REV. CODE OF 1954, §§ 401(c)(8), (d) and (e).
9. Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.).
10. Pub. L. No. 93-406, 88 Stat. 829.
11. INT. REV. CODE OF 1954, § 1348.
12. INT. REV. CODE OF 1954, §§ 11(c) and (d). However, note that for the tax year 1975 the surtax exemption was increased from $25,000 to $50,000 (Tax Reduction Act of 1975, Pub. L. No. 94-12 § 303, 89 Stat. 26, *amending* INT. REV. CODE OF 1954, §§ 11(b) and (d).) The tax Reduction Act also reduced the so-called "normal tax" to 20% on the first $25,000 of taxable income and reduced the "surtax" to 22% on the next $25,000 of taxable income. Income in excess of $50,000 is taxed at 48%. The Tax Reform Act of 1976 extends these reductions in effective . corporate tax rates and the increase in the surtax exemption through December 31, 1976. (Pub. L. No. 94-455, § 901, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, §§ 11(b) - (d)).
13. INT. REV. CODE OF 1954, § 1(a).
14. INV. REV. CODE OF 1954, § 1201(d).
15. INT. REV. CODE OF 1954, § 1201(c). The Tax Reform Act of 1976 has also effected two significant modifications. First, it raises the amount of ordinary income against which the excess of capital losses over capital gains may be offset from $1,000 per year to $2,000 in 1977, and to $3,000 in 1978 and subsequent years. (Pub. L. No.94-455, § 1401, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1211(b)). Second, the 1976 Act lengthens the holding period for capital gain or loss treatment from six months to nine months in 1977 and to one year in 1978 and subsequent years. (Pub. L. No. 94-455, § 1402, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1222)).

One of the most significant features of the legislation is the reduced disparity between the benefits available under corporate and self-employed plans. For example, ERISA limits the amount which can be placed annually into the account of a participant in a qualified defined contribution plan (the "annual addition") to the lessor of $25,000 or 25 percent of the participant's compensation.[16] Prior to ERISA such plans had no such specific statutory limitation. ERISA also limits the benefits payable under a qualified defined benefit plan to the lesser of (1) $75,000 or (2) 100 percent of the participant's average compensation for the highest three consecutive years during which he participated in the plan.[17] Neither of the above described limitations can be avoided by creating multiple plans.[18] However, the limitations do permit cost of living adjustments.[19]

While contributions and benefits of corporate plans are limited by ERISA, it does authorize an increase in deductions for contributions to a self-employed plan (and for contributions on behalf of an employee-shareholder of a Subchapter S corporation) equal to the lesser of $7,500 or 15 percent of earned income.[20] ERISA also permits defined benefit self-employed plans, which were not previously available.[21]

Notwithstanding the contribution limitations contained in the 1974 legislation, incorporation may still be advisable in many instances. For example, the new contribution and benefit payment limitations are probably significant only for the true "superstar." Moreover, once the cost-benefit analysis necessary for determining whether a self-employed or corporate plan is preferable has been completed, the result may still dictate the use of a corporate plan.[22]

While the principal tax advantage of incorporating for the athlete or entertainer is the ability to adopt a corporate pension or profit-sharing plan and trust, other benefits are worth noting. For example, the corporation may adopt a plan under which it becomes obligated to pay, or reimburse for, the medical expenses of the athlete or entertainer, his wife and dependents. In general, the payments or reimbursements will not constitute income to the athlete or entertainer[23] and are deductible by the corporation.[24] However, for the medical reimbursement plan to qualify, all amounts paid or reimbursed must be pursuant to a plan established for the benefit of corporate "employees" rather than shareholders.[25] Subject to significant limitations, wages or other amounts paid to an employee during the

16. Pub. L. No. 93-406, § 2004(a)(2), 88 Stat. 979 (codified at INT. REV. CODE OF 1954, § 415(c)). The amount of the annual addition subject to this limitation is the sum of (1) employer contributions, (2) the lesser of (a) employee contributions exceeding 6% of his compensation and (b) one-half of employee contributions, and (3) forfeitures.

17. Pub. L. No. 93-406, § 2004(a)(2), 88 Stat. 979 (codified at INT. REV. CODE OF 1954, § 415(b)(1)). The $75,000 limit is to be adjusted where retirement begins prior to age 55. INT. REV. CODE OF 1954, § 415(b)(2)(c). Generally, an annual benefit of $10,000 or less can be paid without regard to the $75,000 and average compensation limitations. INT. REV. CODE OF 1954, § 415(b)(4). However, where a participant has less than 10 years of service with the employer, the $75,000 average compensation and $10,000 limitations are proportionately reduced. INT. REV. CODE OF 1954, § 415(b)(5).

18. Pub. L. No. 93-406, § 1014, 88 Stat. 924 (codified at INT. REV. CODE OF 1954, § 413(c).

19. Pub. L. No. 93-406, § 2004(a)(2); 88 Stat. 979 (codified at INT. REV. CODE OF 1954, § 415 (d)).

20. Pub. L. No. 93-406, § 2001(a), 88 Stat. 952, *amending* INT. REV. CODE OF 1954, § 404(e).

21. Pub. L. No. 93-406, § 2001(d)(2), 88 Stat. 952 (codified at INT. REV. CODE OF 1954, § 401(j)).

22. For an example of the comprehensive analysis required, *see* Kalish and Lewis, *Professional Corporations Revisited (After the Employee Retirement Income Security Act of 1974)*, 28 TAX LAWYER 471 (1974).

23. INT. REV. CODE OF 1954, §§ 105(b) and (c).

24. INT. REV. CODE OF 1954, § 162(a).

25. INT. REV. CODE OF 1954, § 105(b); *see Alan B. Larkin*, 48 T.C. 633 (1967).

period he is absent from work due to injuries or illness are not includible in gross income.[26] The corporation may also adopt a group-term life insurance program for the employees of the corporation, under which the cost of the first $50,000 of the face amount of such insurance per employee would be deductible by the corporation,[27] and not includible in the employee's gross income.[28] Payments not exceeding $5,000 made by the corporation to a deceased employee's beneficiaries or his estate may be deductible by the corporation,[29] and excluded from the gross income of the recipient.[30] The corporate form also makes available a variety of stock option, stock bonus and stock purchase plans, both qualified and non-qualified.[31] Operating in corporate form may prompt the athlete or entertainer and/or his manager to conduct their business affairs in a more orderly and business-like manner, particularly if a professional board of directors is chosen which conscientiously assists the manager in the exercise of his responsibilities.

However, the decision to incorporate must not be made lightly. A host of potential obstacles and pitfalls await the unsuspecting athlete or entertainer who does little more than engage an attorney to file corporate documents and arrange for the adoption of a standard form pension plan. Many of the tax problems involved with the newly created corporate "monster" are discussed in the succeeding pages.

B. *Recognition as a Separate Entity*

As a general rule, a corporation is considered an entity separate and distinct from its shareholders for tax purposes. However, the corporate entity may be disregarded unless it is formed for a substantial business purpose or actually carries on a business activity of substance. This principle was established by the Supreme Court in *Moline Properties, Inc. v. Commissioner of Internal Revenue ("Moline")*.[32] In *Moline*, the Court stated:

> Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.[33]

Thus, where there is a bona fide business purpose for incorporating[34] or the corporation carries on business activity, the test is satisfied.

26. INT. REV. CODE OF 1954, § 105(d). The benefits of this section are quite limited. The exclusion does not apply to the extent payments exceed $100 per week, nor is there an exclusion during the first 30 days of the period of illness if the amounts paid exceed 75% of the employee's regular weekly wages, and no exclusion to the extent the payments during this period exceed $75.00. There is also no exclusion during the first seven calendar days unless the employee is hospitalized because of personal injuries or sickness for at least one day during this period.

27. INT. REV. CODE OF 1954, § 162.

28. INT. REV. CODE OF 1954, § 79(a). To qualify, the life insurance program must consitute a "plan of group insurance". The Regulations provide that "to constitute a plan of group insurance, the plan must make term insurance available to a group of lives. Such group must include all of the employees of the employer . . . or . . . a class or classes of such employees the members of which are determined on the basis of factors which preclude individual selection." Treas. Reg. § 1.79-1(b)(1)(iii)(b) (1966, *as amended*, 1972).

29. INT. REV. CODE OF 1954, § 162.

30. INT. REV. CODE OF 1954, § 101(b).

31. INT. REV. CODE OF 1954, §§ 421 - 425; Treas. Reg. § 1.421-6 (1959, *as amended*, 1966).

32. 319 U.S. 436 (1943).

33. *Id.* at 438, 439.

34. Jackson v. Comm'r, 233 F.2d 289 (2d Cir. 1956); Sam Siegel, 45 T.C. 566 (1966), *acquiesced in* 1966-2 Cum. Bull. 7.

The Tax Court relied upon the principles of *Moline* in deciding *George Cukor v. Commissioner*.[35] Cukor, a prominent film director, formed a wholly-owned corporation called G-D-C Enterprises, Inc., through which his services as a director were sold. Cukor then transferred his stock in G-D-C to a second Cukor-owned corporation called Laurette Enterprises, Inc. in exchange for its stock; thus G-D-C became a wholly-owned subsidiary of Laurette. G-D-C paid a dividend to Laurette in the amount of $137,000. Shortly after its formation, Laurette became a participant in a joint venture, and within a few months also acquired an interest in a joint venture owned by G-D-C. The Internal Revenue Service (herein sometimes referred to as the "Service") argued that Laurette should be disregarded so as to cause the dividend to be taxed directly to Cukor.[36] The Tax Court rejected this argument, relying exclusively upon Laurette's participation in the joint venture.[37]

The Service may also use the sham transaction doctrine in alleging that a corporation should be disregarded. For example, Floyd Patterson, former World Heavyweight Boxing Champion, formed a corporation to exploit the ancillary rights arising from his professional boxing contests.[38] However, apparently without professional guidance, Patterson and his manager never paid for the few shares of stock issued to them. In addition the corporation failed to function with respect to Patterson's personal appearances, claimed no interest in the ancillary rights to a particular boxing contest, did not obtain an assignment of the ancillary rights it claimed to own, and failed to maintain adequate books and records or hire bona fide employees. In essence, there was a complete failure to observe business and corporate formalities.[39] The Court treated the corporation as a sham without reference to *Moline*.[40] Interestingly enough, Ingemar Johanson, Patterson's opponent in a series of controversial matches, was also defeated in his sham corporation battle.[41]

A case which appears to create its own unique standard is *Estate of Nathaniel Cole*.[42] One of the many income tax questions faced by Cole's estate was whether a Panamanian corporation should be disregarded and its total income attributed to Cole. The corporation had arranged and paid the expenses of promotional tours for Cole, reporting various amounts of income and loss during the years involved. Cole and the corporation also entered into an employment agreement pursuant to

35. 27 CCH Tax Ct. Mem. 89 (1968).

36. The 85% dividend exclusion applied, and Laurette excluded most of the dividend from its taxable income.

37. *Id.* at 93. The Commissioner also took the position that Cukor was the true owner of the G-D-C shares at the time the dividend was declared, and therefore, should report it as income. This contention was rejected. *See* 27 CCH Tax Ct. Mem. at 94.

38. Floyd Patterson Enterprises, Ltd., 25 CCH Tax Ct. Mem. 1230 (1966), *aff'd per curiam*, 68-2 U.S. Tax Cas. ¶ 9471 (2d Cir. 1968).

39. Other examples were the failure to obtain the State Athletic Commissioner's approval of the corporate arrangement, the failure to report income and expenses on the appropriate tax returns, and the commingling of funds. The fact that Patterson's mother-in-law was on the corporate payroll was noted disapprovingly. *Id.* at 1234-6.

40. *Id.* at 1235.

41. Johansson v. United States, 336 F.2d 809 (5th Cir. 1964). Johansson unsuccessfully alleged the existence of a Swiss corporation in order to avail himself of an exemption from United States income taxes under a tax convention with Switzerland. The fact the Johansson was the corporation's employee and sole source of revenue, and that his affairs were conducted "largely independent of (the corporation's) sole director or its stockholders" were factors leading the Court to conclude that the corporation should be ignored. *Id.* at 813.

42. 32 CCH Tax Ct. Mem. 313 (1973).

which Cole was paid $8,500.00 per week while on tour. The Tax Court ruled that the corporation was "viable" since it bore "entrepreneurial risk."[43]

Doctors, lawyers and other professionals have achieved much-publicized success in their incorporation battles with the Internal Revenue Service. Generally, the decisions have turned on whether the formalities of business relationships have been observed so as to reflect that the corporations rather than individual professionals are providing the particular services in question. Based on this criterion, the Internal Revenue Service finally tasted victory in *Jerome Roubik*.[44] Here the taxpayer and other doctors formed a professional corporation, which, in turn engaged the physicians to perform services under employment agreements. However, the doctors continued to conduct their practices as individual practitioners except that the corporation provided a central office for bookkeeping and billing. The Tax Court disregarded the corporate entity and Roubik was charged with additional income.[45]

Whether a corporation will be treated as such appears to depend upon all the circumstances surrounding its formation and operation. However, sufficient guidelines do exist to suggest the following strategy:

(1) *Observe Business and Corporate Formalities.*

The activity most within the province of legal counsel is the observance of the formalities of business relationships and corporate existence. Thus, the corporation should be properly formed under state law and legally empowered to act under the laws and regulations governing the particular profession involved. The relationship between the corporation and the athlete or entertainer should be carefully defined and appropriately documented, and at least some business assets should be transferred to the corporation. Further, at all times subsequent to formation, the separateness of the corporation and the athlete or entertainer must be respected.[46]

(2) *Engage in Business Activity.*

The corporation itself should engage in substantive business activity. It is

43. *Id.* at 320. The opinion did not cite *Moline* or any of its progeny, and the criteria of "entrepreneurial risk" does not appear to have traceable origin. Moreover, the use of such a test may have unfavorable implications, since in the typical situation involving the incorporated talent there may be little "entrepreneurial risk"; in other words, the amount of income may be unpredictable, but its existence clear.

44. 53 T.C. 365 (1969).

45. *See* 53 T.C. at 378. Since the corporation did not exist for tax purposes, the doctors were self-employed and not entitled to participate as employees in a corporate pension plan.

In a concurring opinion it was observed that in each of the earlier cases involving taxpayer victories the corporation was found to have been a viable entity under the standard set by *Moline* and other cases. *Id.* at 381-82.

The Internal Revenue Service has reflected the *Roubik* decision in its recent rulings on professional corporations. *See e.g.*, Rev. Rul. 70-101, 1970-1 CUM. BULL. 278; REV. RUL 72-4, 2972-1 CUM. BULL. 105.

46. It is important that once the formal process of incorporation is completed, shareholders' and directors' meetings are held, contracts are executed on behalf of the corporation where appropriate, a satisfactory set of books and records is maintained, personal funds are not commingled with corporate funds, title to property is correctly taken and recorded, and that tax returns are filed which reflect the separateness and the nature of the activities performed by both the corporation and the incorporated talent. An independent employee should be engaged to perform services for the corporation (if possible), and a corporate office with the appropriate paraphernalia maintained. *See* United States v. Empey, 406 F.2d 157 (10th Cir. 1969) in which the Court carefully detailed the business activities carried out in the corporate name. *See, generally*, Kronovet, *Straw Corporations: When Will They Be Recognized; What Can and Should Be Done*, 39 TAXATION 54 (1973).

normally not enough merely to give form to the corporate skeleton without also adding flesh.[47] Sufficient activity would appear to consist of the ownership of income producing property,[48] or participation in a joint venture.[49] Reasonable adherence to form and the acceptance of entrepeneurial risk in connection with making arrangements for the services of the athlete or entertainer may satisfy the requirement.[50] Assumption by the corporation of all business activity carried on by the athlete or entertainer may be sufficient.[51]

C. *Section 482 and Reallocation of Income*

The Internal Revenue Service's second line of attack on incorporated talents is Section 482 of the Internal Revenue Code, which authorizes the Service to apportion income among controlled businesses to clearly reflect income or to prevent the evasion of taxes.[52] Some of the reported cases under Section 482 deal with efforts on the part of the Service to reallocate income reported by personal services corporations to the individual responsible for creating such income. An example is the well-known *Victor Borge* case.[53] Borge began a poultry business which engaged primarily in the raising and marketing of Rock Cornish hens. The venture consistently generated losses, and in the fifth year of operations the activity was incorporated, Borge becoming an employee. His employment agreement required that he perform entertainment and promotional services for the corporation for a five-year period at a salary of $50,000 per year. A substantial amount of the income generated by Borge for the corporation was reallocated to him individually on the basis that Borge was insufficiently compensated by the corporation.[54] A tax avoidance motive is not a prerequisite to the application of

47. *E.g., Shaw Construction Co.*, 323 F.2d 316 (9th Cir. 1963). However, this statement cannot be made categorically as rigid adherence to form may be considered the equivalent of business activity. For example, in the professional corporation line of cases in particular, the assumption of administrative responsibilities by the corporation coupled with scrupulous concern for formalities turned the tide against the Commissioner. United States v. Empey, 406 F.2d 157 (1969), is perhaps the best example.

48. *E.g.*, Van Dale Corporation, 59 T.C. 390 (1972).

49. Sam Siegel, 45 T.C. 566 (1966) George Cukor, 27 CCH Tax Ct. Mem. 89 (1968); Britt v. United States, 431 F.2d 227 (5th Cir. 1970); Perry R. Bass, 50 T.C. 695 (1968). But *see* Lloyd F. Noonan, 52 T.C. 907, 910 (1969) in which the ownership of a limited partnership interest in a partnership in which the controlling shareholders were partners was not enough "flesh on the corporate skeleton".

50. *Est. of Nathaniel Cole*, 32 CCH Tax Ct. Mem. 313 (1973).

51. It has been suggested that substantial business activity (in the case of an incorporated writer) consists of the following:

(1) the writer pays cash for stock of the corporation,

(2) the contract between the writer and producer is terminated,

(3) the corporation make all necessary contracts, including a new contract with the producer, an exclusive employment agreement with the writer and contracts with the agent and business manager, (4) becomes a signatory to the appropriate guild agreement, (5) makes contributions to start the guild pension plan and health and welfare plan for the account of the writer, (6) leases an office, (7) hires a secretary for the writer, (8) withholds income tax from salaries paid to the writer and secretary, (9) purchases furniture and equipment, books, and supplies, and (10) pays all normal business expenses". Brawerman & Kopple, *supra* note 1 at 215.

52. "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." INT. REV. CODE OF 1954, § 482.

53. Borge v. Comm'r, 405 F.2d 673 (2d Cir. 1968).

54. The Service allocated $75,000 per year to Borge. The Tax Court so held and the Second Circuit affirmed, stating:

"Here the determination of the Commissioner and the decision of the Tax Court are

Section 482.[55]

D. *Section 269*

Section 269 of the Code provides that where any person acquires control of a corporation for the principal purpose of evading or avoiding federal income taxes by securing the benefit of a deduction or other allowance not otherwise available, the Internal Revenue Service may disallow the deduction or allowance.[56] By its terms Section 269 is not applicable to the extent the controversy involves whether the corporate entity should be disregarded or whether corporate income should be reallocated to the athlete or entertainer. Thus, in *Sam Siegel*,[57] the Tax Court rejected the Service's efforts to use Section 269, stating that "in determining the deficiency for 1958 the Commissioner added to petitioner's reported income . . . (the corporation's) . . . profit for that year. He did not disallow any 'deduction, credit, or other allowance' claimed by petitioner. As a consequence, Section 269 is not applicable. . . ."[58] On the other hand, where the purpose of incorporating is to obtain deductions for contributions into a corporate pension plan or to have the corporation adopt a fiscal year, Section 269 may be operative.[59]

E. *Section 61 and Assignment of Income Principles*

The Internal Revenue Service may seek to attack the incorporated talent utilizing the "assignment of income" doctrine. Based upon Section 61 of the Code[60] and the familiar case of *Lucas v. Earl*,[61] the doctrine is essentially that income should be taxed to the individual or entity generating it. Typically the focus of attack will be the employment relationship of the incorporated talent to his corporation, as it relates to whether the corporation or the employed talent

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supported by substantial evidence that the income of Borge's two businesses has been distorted through Borge's having arranged for Danica to receive a large part of his entertainment income although Danica did nothing to earn that income, and the sole purpose of the arrangement was to permit Danica to off-set losses from the poultry business with income from the entertainment business. The amount allocated by the Commissioner ($75,000 per year) was entirely reasonable—indeed, generous—in view of the fact that Danica's annual net income from Borge's entertainment services averaged $166,465 during the years in question." *Id.* at 677.

55. *E.g.*, Richard Rubin, 56 T.C. 1155 (1971), *aff'd*, 460 F.2d. 1216 (2d Cir. 1972). *Rubin* also sought to distinguish *Borge* on the ground that his rendition of managerial services was not a trade or business for purposes of Section 482. The Court disagreed stating:

> "It is immaterial that Borge had been in the entertainment business long before the formation of the controlled corporation whereas Rubin, although engaged in the textile business for many years, began his services to Dorman concurrently with the formation of Park. It is likewise immaterial that tax avoidance loomed large in Borge's plan; existence of such a motive is not a prerequisite for application of § 482." *Id.* at 1218.

For a more comprehensive discussion of the application of Section 482 see, Lewis, *Section 482: An Eminently Amendable Provision,* 25 ALA. L. REV. 23 (1972); *Delisi, Section 482 Allocations of Income to Stockholders for Services Rendered to Closely-Held Corporations*, 1972 UTAH L. REV. 491; Barr, *A Threat to the Lifeless Corporate Skeleton: Disregarding the Corporate Entity*, 51 TAXES 555 (Sept. 1973).

56. INT. REV. CODE OF 1954, § 269.

57. 45 T.C. 566 (1966).

58. *Id.* at 578. By contrast, in Borge v. Comm'r, 405 F.2d. 673 (2d Cir 1968), Section 269 was directly applicable since it was determined that Borge's purpose in organizing his corporation was to avoid the $50,000 per year loss limitation of former Section 270 (now repealed). See 405 F.2d at 678.

59. *See* Brawerman and Kopple, *supra* note 1 at 267-68.

60. Section 61 provides for the inclusion in gross income of "all income from whatever source derived, including . . . compensation for services, including fees, commissions, and similar items." INT. REV. CODE OF 1954, § 61(a).

61. 281 U.S. 111 (1930).

controls the earning of the income.[62] In this regard the factors used to determine whether the corporation should be respected as a corporate entity may also be used to determine the assignment of income issue.[63] On the other hand, the Tax Court opinion in *Richard Rubin*[64] suggests that certain distinct factors may control the outcome. Here the taxpayer acquired an option to purchase a majority interest in a corporation created to manufacture certain fabrics. At the same time, he and his two brothers created a separate corporation of which he owned 70 percent of the stock, which contracted with the fabric manufacturing corporation to acquire the taxpayer's nonexclusive management services. The issue of whether the corporation or the taxpayer earned the management fees was decided in favor of the Service based upon the doctrine of "substance over form" *and* on assignment of income principles. In making its determination the Court conceded that the difference between the substance versus form and assignment of income approaches may be purely a matter of semantics but did isolate certain facts it considered probative on the latter question.[65]

Each of the doctrines discussed above represents a frontal attack on the incorporated talent, and may serve to eliminate most if not all of the benefits sought by incorporating. There are also other means of attack, perhaps less threatening, by which the Service might seek to limit those benefits; these are the subjects of the next succeeding sections.

F. *Reasonableness of Compensation*

It is likely that the incorporated talent will be paid the highest salary possible so as to minimize the corporation's exposure to income taxes and to maximize current contributions into the corporate money-purchase pension plan.[66] However, the Internal Revenue Service may seek to limit the salaries paid to the athlete or entertainer with some likelihood of success. For example, in *Klamath Medical Service Bureau v. Commissioner*[67] all doctors in Klamath County, Oregon participated in a prepaid medical services plan. Initially each participating doctor was paid one-half of the amount set forth on a patient fee schedule and later was paid certain additional amounts. Together the payments aggregated 115 percent and 130 percent of billings during the years in question. The Court

62. The nature of the inquiry in this area has been described as follows:

> "The distinction . . . is grounded on the question of who has the ultimate direction and control over the earning of this compensation. If such control lies with the taxpayer who actually performs the services, then he remains taxable on the earnings from his personal services, whether or not he chooses to divert the receipt of that compensation to a third party. However, if the direction and control of the performer's activities resides in a superior authority, and the consideration paid for the performance of those services is made to the person having such ultimate direction and control, then the mere fact that the taxpayer has performed the services does not render him taxable on the amount paid for these services."

Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 TAX. L. REV. 393 (1962).

63. *See, e.g.*, American Savings Bank, 56 T.C. 828, 840 (1971) in which the Tax Court implies that a finding that the corporate entity should be disregarded invites the application of the assignment of income doctrine.

64. Richard Rubin, 56 T.C. 1155 (1971), *aff'd.* 460 F.2d 1216 (2d Cir. 1972).

65. First of all, the Tax Court observed that the taxpayer "negotiated" the management service contract before his employer corporation was formed. Secondly, the Court stated that the lack of exclusivity of the taxpayer's employment was crucial "because it is evidence that petitioner, not Park, directed and controlled the earning of the income in question." Lastly, the fact that the taxpayer controlled both corporations was considered relevant. 56 T.C. at 1159.

66. The pension plan contribution is commonly expressed as a percentage of salary.

67. 261 F.2d 842 (9th Cir. 1958).

disallowed amounts paid in excess of fees billed. The 100 percent of billings limitation was followed in *McClung Hospital, Inc.*[68]

However, more recent cases have established the principle that notwithstanding the reasonableness of salary payments, a return on equity capital is required. The leading case is *Charles McCandles Tile Service v. U.S.*,[69] in which 50 percent of the profits of a ceramic tile laying business were paid as salary to each of two shareholder-employees. While the Court found that the key employees were responsible for the success of the business, and that the salaries were small compared to others in the industry and were reasonable, it held that a 15 percent return on equity capital was required.[70] Some of the factors relied upon were the proportionality of salary payments to stock ownership, the lack of corporate dividends and the presence of substantial nonoperating assets.[71] While other courts have followed the rationale of *McCandles*, *supra*,[72] a 15 percent return is not a fixed standard.[73] On the other hand, it is likely that the return on equity required in the case of a personal services corporation is substantially less than in businesses in which capital is vital to operations, such as a manufacturing corporation. In *Barton-Gillet Co.*,[74] for example, the Tax Court ruled that a return on equity was required in a case involving a personal services corporation, but observed this distinction.[75] Nevertheless, commentators have begun to warn that unreasonable compensation is the emerging issue in the area of the incorporated professional.[76]

G. *Personal Holding Company Tax*

Still another problem faced by the incorporated talent is the possible imposi-

68. 19 CCH Tax Ct Mem. 449 (1960).

69. 422 F.2d 1336 (Ct. Cl. 1970).

70. In so ruling, the Court stated that:

> "Even a payment deemed reasonable, however, is not deductible to the extent that it is in reality a distribution of corporate earnings and not compensation for services rendered . . . [w]e think it clear that any return on equity capital is so conspicuous by its absence as to indicate, given all the facts, that the purported compensation payments necessarily contained a distribution of corporate earnings within." *Id.* at 1339.

For a comprehensive discussion of *McCandless* and its implications, see Walthall, *McCandless—Implications for Compensation Planning and Dividend Policy*, 6 CUMBERLAND L. REV. 1 (1975); Note, 26 STAN L. REV. 441 [1974).

71. *Id.* at 1339-40.

72. *See, e.g.*, Nor-Cal Adjusters, 30 CCH Tax Ct. Mem. 837 (1971); Carole Accessories, Inc., 32 CCH Tax Ct. Mem. 1285 (1973); Schneider v. Comm'r, 7402 U.S. Tax Cas. ¶ 9563 (8th Cir. 1974; Shiocton Lumber Co., Inc., 33 CCH Tax Ct. Mem 599 (1974).

73. In Giles Industries, Inc. v. U.S., 496 F.2d 556 (Ct. Cl. 1974), the Court of Claims rejected the argument that a 15% return on capital contributions was a standard requirement.

74. 29 CCH Tax Ct. Mem. 679 (1970), *aff'd* 442 F.2d 1343 (1971).

75. The Tax Court commented that:

> "While Barton was entitled to be well rewarded, a degree of commensurate recognition should also be given to the contributors of capital. Obviously in a service-type corporation like the petitioner such contribution does not deserve the recognition that it should receive in a manufacturing corporation, but that is no reason to justify its being totally ignored". *Id.* at 688.

It should also be noted that the Court questioned the need for incentive compensation for a major shareholder. *Id.* Other courts have done likewise. *See, e.g.*, Charles Schneider & Co. v. Comm'r, 500 F.2d 148 (8th Cir. 1974).

76. For example, it has been suggested that shareholder-employees may no longer necessarily support their salary levels by reference to amounts earned before incorporating, or to amounts earned by unincorporated professionals. Horsley & Dray, *Compensating Officer-Shareholders of Professional Corporation: An Analysis*, 34 Journal of Taxation 146 (1971). Similar comments have been made by others. *See* Jones, *Is There a Dividend Requirement For Professional Corporation*, 34 TAXATION 139 (1971); Eaton, Jr., *Operation of A Professional Service Corporation*, N.Y.U. 29th INST. ON FED. TAX 1243, 1268-69 (1970).

tion of a "personal holding company" tax on the net income of the corporation. Section 541 of the Code imposes a tax at the rate of 70 percent on the "undistributed personal holding company income" of a "personal holding company".[77] A personal holding company is a corporation the stock of which is 50 percent or more owned, directly or indirectly, by five or fewer individuals and at least 60 percent of the adjusted gross income of which constitutes personal holding company income.[78] Included in the definition of personal holding company income is income from personal service type contracts for the services of a person owning more than 25 percent of the corporation's stock, if someone other than the corporation has the right to select the person who is to perform the services.[79] This definition may well include the performance of services by the incorporated talent. However, since the corporation will probably pay its entire net income to the athlete or entertainer in the form of salary[80] there will be no personal holding company tax problem unless the salary payment is found to be unreasonable.[81]

II. Maximum Tax on Personal Service Income

The concept of a maximum 50 percent tax rate on "earned income" was enacted into law as part of the Tax Reform Act of 1969.[82] Its purpose was to reduce the incentive for high-bracket taxpayers to search for and/or invest in tax-shelter devices.[83] The 50 percent maximum tax rate applies to all individual taxpayers except married individuals filing separate returns or individuals who elect to employ the income averaging provisions.[84] The Tax Reform Act of 1976 replaced the concept of "earned income" with that of "personal service income."[85] The term is defined in Sections 401(c)(2)(C) and 911(b) of the Code, and, as a result of the 1976 Act, includes amounts received as a pension or annuity and deferred compensation.[86]

A potentially serious limitation on the use of the maximum tax by high-bracket taxpayers is the reduction in the amount of income qualifying as "personal service income" by the amount of "tax preferences" for the year. In particular, and in furtherance of the Congressional purpose of discouraging tax avoidance devices, personal service income qualifying for the maximum tax rate is reduced by an individual's tax preferences for the taxable year.[87] The more common tax preference items include the excess of accelerated depreciation over straight-line depreciation on real property and on personal property subject to a lease, excess

77. Int. Rev. Code of 1954, § 541.

78. Int. Rev. Code of 1954, §§ 541(a)(1) and (2).

79. Int. Rev. Code of 1954, § 543(a)(7). Note, however that the Internal Revenue Service has virtually eliminated the personal holding company income problem in the physician professional corporation context by ruling that, in most cases, the income earned by a single physician dominated corporation will not constitute personal holding company income. Rev. Rul. 75-67, 1975-1 Cum. Bull. 169.

80. It is common practice for substantially all of the net income generated from a professional corporation to be paid out as salary or in some other deductible form, primarily to avoid a corporate tax on the same income.

81. *See, e.g.*, McCandless Tile Service vs. U.S., 422 F.2d 1336 (Ct. Cl. 1970).

82. Tax Reform Act of 1969, Pub. L. No. 91-172, § 804,83 Stat. 487 (codified at Int. Rev. Code of 1954, § 1348).

83. H.R. Rep. No. 91-413, 91st Cong., 1st Sess. 208 (1969).

84. Int. Rev. Code of 1954, §§ 1348(a) and (c).

85. Tax Reform Act of 1976, Pub. L. No. 94-455, § 302,90 Stat. 1525 (codified at Int. Rev. Code of 1954, § 1348(b)).

86. *Id.*

87. Int. Rev. Code of 1954, § 1348(b)(2).

itemized deductions, the amount by which the value of the underlying stock exceeds the exercise price of either a qualified or restricted stock option at the time of exercise, the excess of the depletion allowance for the current year over the adjusted basis of depletable property, excess intangible drilling and development costs, and, in the case of taxpayers other than corporations, fifty percent of the amount by which net long-term capital gains exceed net short-term capital losses for the taxable year.[88] A $30,000 exclusion for tax preference items was eliminated by the Tax Reform Act of 1976.[89] Prior to this reform legislation it was possible to realize tax preference items indefinitely and without adverse effect to the extent they did not exceed the exclusion in any one year. However, some planning may yet be possible. For example, the use of the installment method for reporting capital gains[90] may serve to reduce the impact of tax preferences. Further, income averaging may produce greater tax savings than the maximum tax.[92]

III. INCOME AVERAGING

Income averaging[93] is yet another tax reduction provision with some limited effectiveness under the appropriate circumstances. Section 1301 of the Code provides, in effect, that if an eligible taxpayer has "averageable income" for a particular taxable year ("the computation year") in excessof $3,000, the tax for the year may be computed by spreading that averageable income over the four preceding years (the "base period" years) and that taxable year.[94] Prior to the Tax Reform Act of 1969, taxable income in both the computation year and in the base period year was adjusted to eliminate the excess of net long-term capital gains over short-term capital losses, but the Tax Reform Act liberalized the

88. INT. REV. CODE OF 1954, §§ 1348(b)(2)(B) and 57(a)-(c). "Excess itemized deductions" and "excess intangible drilling and development costs" were added as tax preference items by the Tax Reform Act of 1976. (Pub. L. No. 94-455, § 301(c)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, §§ 57(a)(1) and (11).

89. Pub. L. No. 94-455, § 302(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1348(b)(2)(B).

90. INT. REV. CODE OF 1954, § 453.

91. INT. REV. CODE OF 1954, § 1201(d).

92. INT. REV. CODE OF 1954, §§ 1301 *et seq.* The taxpayer's income may also not be high enough to benefit from the maximum tax provision. For example, unless the taxable income of a single taxpayer in a particular year exceeds $32,000, or that of a married couple exceeds $52,000, the maximum tax provisions are of no benefit. On the other hand, income averaging may generate substantial benefits depending upon the amount of the taxpayer's taxable income during the preceding four years. The factor of extreme variation in income and the amount of income in the taxable year in question may also work in combination to militate against using the maximum tax provisions in favor of income averaging. For more comprehensive discussions of the maximum tax provisions, see Halperin, *supra* note 7; Skilling, *Current Compensation: Steering Through Max-Tax; Preference Tax and Income Averaging*, N.Y.U. 32ST. INST. ON FED. TAX 847 (1973).

93. INT. REV. CODE OF 1954, §§ 1301-05.

94. The amount of the averageable income is that portion of the income of the computation year which exceeds 120% of the average taxable income of the four preceding years. INT. REV. CODE OF 1954, § 1302(a). The amount of tax is computed as five times the increase in tax which would result from adding 20% of the averageable income to 120% of the average base period. For taxable years beginning prior to 1970, averageable income was that part of computation year taxable income which exceeded 133-1/3% of average base period income. The tax thereon was five times the increase in tax to result from adding 20% of averageable income to 133-1/3% of the average base period income.

While no such statutory limitation exists, the Regulations restrict an individual's income to zero (even though itemized deductions and personal exemptions decrease it below zero) in all base period years. Treas. Reg. § 1.1302-2(b)(1) (1966, *as amended*, 1972). These Regulations were upheld in Fabian Tebon, Jr. 55 T.C. 410 (1970), where the taxpayer had negative taxable income even before itemized deductions and personal exemptions. *See also*, Section 1.1304-3(c) of the Regulations involving an individual whose marital status was different in any base period year from the computation year.

averaging provisions by permitting the inclusion of this item.[95] The averaging provisions are not available if certain other provisions also apply, including the alternate capital gains tax and the maximum tax on earned income.[96]

For the "bonus baby" athlete, perhaps the most troublesome requirements of the income averaging provisions are those relating to support.[97] An individual is not eligible for income averaging if for any base period year he did not provide at least one-half his own support, unless one of three exceptions are met. Thus, the college superstar subsisting during his college years on some form of grant-in-aid may not be eligible to average the bonus received upon signing his professional contract. The problems raised by the support provisions are illustrated by *James B. Heidel*.[98] Heidel was a celebrated football player for the University of Mississippi during the years 1961 to 1965. During each of those years he received a standard athletic grant-in-aid scholarship. However, during 1961, the year in issue, he received $963.65 from his parents, $115.81 from a summer job, $600.00 from a guardianship established for him in 1960, and $657.35 from the athletic scholarship. During 1965 Heidel signed a contract with the Saint Louis Cardinals, and in that year received $50,000 as a bonus, $5,000 as additional compensation, and $1,000 for travel expenses. In 1965 he computed his tax liability using the income-averaging method, which the Internal Revenue Service disallowed. The primary issue was whether the 1961 grant-in-aid constituted Heidel's contribution to his own support, or the contribution of the University. The Tax Court ruled against Heidel, finding that he did not provide more than one-half of his support during 1961 and was not a taxpayer Congress intended to benefit from the averaging provisions.[99]

95. A separate averaging mechanism was earlier applied. Other excluded items were income from gambling and income realized on properties received as a gift or inheritance.

96. INT. REV. CODE OF 1954, §§ 1304(b)(5) and (6).

97. Section 1303(c) provides in relevant part:

"For purposes of this part, an individual shall not be an eligible individual for the computation year if, for any base period year, such individual (and his spouse) furnished less than one-half of his support.

(2) Exceptions. Paragraph (1) shall not apply to any computation year if—

(A) such year ends after the individual attained age 25 and, during at least 4 of his taxable years beginning after he attained age 21 and ending with his computation year, he was not a full-time student,

(B) more than one-half of the individual's taxable income for the computation year is attributable to work performed by him in substantial part during 2 or more of the base period years . . . ."

98. 56 T.C. 95 (1971).

99. "Petitioner hardly qualified, 'within the letter and spirit of the Congressional grant,' as indicated by the committee reports, as an individual to whom relief was sought to be granted by the income-averaging provisions. Throughout the base period years he was a full-time student, was not a regular member of the labor force, and the value of the scholarship which he claims as support furnished to himself was not subject to U.S. taxes." *Id.* at 103.

The Tax Court relied primarily on the legislative history supporting the averaging provisions, relevant portions of which contain the following:

"To be eligible for averaging, one of the principal concerns is that the individual's income must have been subject to tax by the United States throughout the entire base period as well as the computation year . . . .

A second concern of this provision is that the individual be a member of the labor force in both the computation year and in the four base period years . . . . However, it was not intended to exclude from the benefits of the averaging provision an individual who, although in the labor force, was unemployed in part of all of the base period years . . . . Thus, generally, individuals age 25 or over will be eligible for averaging so long as they have been out of school for at least four years since age 21." H.R. Rep. No. 749, 88th Cong., 1st Sess. 114 (1963); Sen. Rep. No. 830, 88th Cong., 2d Sess. 144 (1964).

Heidel also argued that he came under the exception contained in Paragraph 1303(c)(2)(B), in that his collegiate athletic activities constituted work and that the bonus was attributable to such work. The Court disagreed, viewing the bonus as an inducement to sign the professional contract. 56 T.C. at 105-6.

The Service successfully used the support requirement to deny the benefits of income averaging to a former Miss America.[100] Deborah Bryant Wilson sought to average the income received from personal appearances on behalf of certain companies which sponsored the Miss America pageant. She sought to satisfy the support requirement by qualifying under the exception contained in Section 1303(c)(2)(B), claiming that her participation in beauty contests, modeling and dramatics in earlier years constituted work to which the income from subsequent personal appearances was attributable. The Court disagreed, stating that the work which produced the income was the personal appearances and not the general preparatory activities.[101] Thus, in many cases the support requirement will pose a major obstacle to qualification for the income averaging provisions for the former college superstar or instant talent.

Another potential problem of the athlete or entertainer seeking the benefits of income averaging is the inability to substantiate taxable income during the base period years. This problem is illustrated by the Tax Court case of *Mark P. Binstein*.[102] Binstein did not have copies of his tax returns for two of the base period years in question. The Internal Revenue Service had no record of his filing a return for one of the years and conceded that the return for the other year had been destroyed in accordance with its normal destruction cycle. Since Binstein could not provide accurate information as to his income and deductions, the Tax Court ruled that he could not average his income.[103]

The averaging provisions should always be examined for applicability in any success year of the athlete or entertainer. There is no prohibition against their continued use in successive years if the athlete or entertainer qualifies. The principal caveat is that certain other beneficial provisions may be inapplicable if the athlete or entertainer averages his income, including the alternative capital gains tax and the maximum tax.[104] Thus, a series of computations may be required to determine whether the benefits of either of these provisions overshadow the benefits of income averaging in any particular year.

IV. THE USE OF TAX SHELTERS

Tax planning for the athlete or entertainer, as with other high-bracket taxpayers, should include an evaluation of the potential use of "tax-sheltered" transactions in minimizing tax liability. However, the Tax Reform Acts of 1969[105] and 1976[106] reduced the benefits produced by certain tax sheltered transactions and made investment analysis much more complex. The desired objectives normally include generating current tax deductions or credits to apply against income or tax, respectively, and capital gain upon disposition of the

Later, in William L. Frost, 61 T.C. 488, 494 (1974), the Tax Court stated that "the fact that the bonus was paid as an inducement should not preclude a finding that it was also attributable in substantial part to work performed in the base period years". However it again ruled against the taxpayer feeling bound by the statute and committee reports. *Id.* at 496.

After the decision in *Frost*, the Service published Revenue Ruling 75-40, 1975-1 CUM. BULL. 276, to the effect that the support requirement is not met where a scholarship exceeds the amount otherwise used by a taxpayer for support.

100. Comm'r v. Wilson, 322 F. Supp. 830 (D.C. Kans. 1971).
101. *Id.* at 451.
102. 32 CCH Tax Ct. Mem. 450 (1973).
103. *Id.* at 451.
104. INT. REV. CODE OF 1954, § 1304(b).
105. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, (1969).
106. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525.

investment.[107] These benefits have been particularly limited by the Tax Reform Act of 1976.

A. *General Considerations*

1. *Leverage and Depreciation*

One of the more significant aspects of a tax sheltered investment has been the ability to leverage investment dollars with borrowed funds. While the mass marketing of tax sheltered transactions is relatively new, the leverage concept has been in existence since the Supreme Court in *Crane vs. Commissioner*[108] established that a taxpayer's basis for depreciation included not only the cash consideration paid, but the mortgage on the property as well. Thus, the taxpayer could claim deductions for depreciation[109] which exceeded his actual cash investment; and since depreciation is a non-cash expense, it did not reduce the cash flow generated by the property. Moreover, the depreciation deductions would often create a tax loss which served to reduce the taxpayer's other income.[110]

Since depreciation has so often been a critical aspect of tax-sheltered transac-

107. *See generally* Calkins, *Tax Sheltering in Perspective*, 51 TAXES 758 [1973); Packman, *Tax Shelters: A Non-Dilettante's View*, 53 TAXES 279 (1975); Hardyman, *How Real Estate Can Help An Investor Achieve The Three Benefits Of A Tax Shelter*, 12 IAXATION FOR ACCOUNTANTS 228 (1974). For post-1976 literature, see Dailey and Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127 (1977).

108. 331 U.S. 1 (1947). In *Crane* the taxpayer inherited land and buildings encumbered by a mortgage equal to the fair market value of the property at the decedent's death ($262,000). The taxpayer held the property for several years, deducted depreciation of $28,000, then sold the property subject to the mortgage, receiving $2,500 cash, and claimed that the gain was limited to the cash received. The Service argued successfully that the "amount realized" was $257,500 ($2,500 cash plus the mortgage of $255,000); that the taxpayer's basis was $234,000 ($262,000 less the $28,000 of depreciation claimed); and that the gain was $23,500.

The rule of the *Crane* case has been discussed in Adams, *Exploring the Outer Boundaries of the Crane Doctrine and Imaginary Supreme Court Opinion*, 21 TAX LAW REV. 159 (1966) and in Perry, *Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX LAW REV. 525 (1972).

109. INT. REV. CODE OF 1954, § 167.

110. Examine the following facts adapted from McKee, *The Real Estate Tax Shelter: A computerized Expose*, 57 VA. L. REV. 521, 528 (1971):

An individual acquires an apartment complex for $1,000,000 paying $200,000 down and obtaining an $800,000 first mortgage for the balance of the purchase price. The complex produces annual rentals of $90,000. The mortgage requires annual payments of $70,056 which are applied first to interest and then to principal. The building has a useful life of 40 years and is depreciated using the double-declining balance method.

Given the above assumptions, depreciation in the first year will equal $50,000 [at twice the straight-line rate of 2 1/2% per year). The first year's cash flow will include $90,000 of rental income less interest ($64,000) and principal ($6,056). Consequently, the net cash yield is $19,944:

RENTAL INCOME		$90,000
INTEREST	$64,000	
PRINCIPAL	6,056	
NET CASH YIELD		$19,944

Thus a before tax yield of almost 10% has been achieved.

Taxable income, however, consists of the $90,000 of rental income less the mortgage interest and less depreciation:

RENTAL INCOME		$90,000
INTEREST	$64,000	
DEPRECIATION	50,000	
NET TAX LOSS		($24,000)

As illustrated, the investment has yielded a net tax loss of $24,000, which, of course, can be offset against the taxpayer's other income; in other words, his other income may be "sheltered" to that extent.

tions it merits some special attention. Prior to the 1969 Tax Reform Act it was considered prudent to depreciate real estate under the then liberal so-called "double-declining balance" and "sum-of-years digits" methods rather than the normal or "straight-line" method, in order to accelerate tax deductions. However, the 1969 Act drastically modified the rules for depreciating real estate. For example, the double-declining balance and sum-of-years digits methods were restricted to new residential rental property.[111] New nonresidential property acquired after July 24, 1969 is now limited to an accelerated method which may not exceed 150 percent of straight line.[112]

Used residential rental property with a useful life of 20 years or more may be depreciated under an accelerated method limited to 125 percent of the straight-line rate.[113] Moreover, the depreciation "recapture" rules for real property were made much more stringent.[114] These changes, particularly coupled with the problems raised by accelerated depreciation with respect to both the minimum tax on tax preferences and the maximum tax on earned income should discourage accelerated depreciation, and encourage the adoption of a component rather than a composite approach to determining the useful lives of depreciable property.[115] Ground leases should also be more desirable.[116]

The Tax Reform Act of 1976 did not change the rules with respect to claiming depreciation, but did alter the depreciation recapture rules for residential real property. The 1976 Act requires the recapture (treatment as ordinary income) of all post-1975 depreciation in excess of straight-line, in the same manner as is the case for nonresidential real estate.[117]

2. *The "At Risk" Limitations*

The Tax Reform Act of 1976 dealt a virtual death blow to the leverage benefit of tax shelters by so-called "at risk" rules. These rules provide generally that a taxpayer may not deduct losses generated by certain tax shelters in excess of

111. INT. REV. CODE OF 1954, § 167(j)(2) and (b)(2).

112. INT. REV. CODE OF 1954, § 167(j)(1).

113. INT. REV. CODE OF 1954, § 167(j)(5).

114. For residential real property, including rehabilitated low-income rental housing, the percentage of post-1969 additional depreciation to be recaptured decreases one percentage point for each month the property is held more than 100 months. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(iii) and (iv). To avoid recapture entirely on post-1969 depreciation, residential property must be held 16-2/3 years rather than the 10-year period for additional depreciation claimed prior to 1970. Nonresidential property is always subject to full recapture of additional depreciation claimed after 1969. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(v). However, certain government sponsored low-income housing development programs as well as similar state programs enjoy the same recapture rules in existence prior to the Act. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(ii). *See, e.g.*, Gould, *Trends in Tax Planning for Real Estate Investments*, 50 TAXES 732, 734 (1972). The component approach assumes that each item or class of items that is a part of the property improvement depreciates at a rate based upon a separate useful life. The composite approach assumes that the real estate improvement as a whole depreciates at a rate based upon an overall useful life.

The component approach tends to produce a larger deduction in early years than if the property were depreciated under the composite method. Thus the annual depreciation deduction produced by the use of the component approach is, to a certain extent, similar to that produced by an accelerated method of depreciation.

The Service, after a defeat in Herbert Schainberg, 33 T.C. 241 (1959), has acquiesced in the use of the component approach for new property. 1960-1 CUM. BULL. 5. There is also authority for the use of the component approach with used property. *See* Harsh Investment Corp. v. U.S., 323 F. Supp. 409 (D.C. Ore. 1970).

116. Land is not depreciable while lease payments on the ground lease are deductible. TREAS. REG. § 1.162-11 (1958, *as amended*, 1960).

117. Pub. L. No. 94-455, § 202(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1250(a)).

the amount for which he is economically at risk in terms of dollars or property.[118] The limitations apply to taxpayers engaged in farming (except farming operations involving trees other than fruit and nut trees); holding, distributing and/or producing motion pictures; exploring for, or exploiting oil gas resources; and equipment leasing.[119]

The amount of investment at risk is considered to be the amount of money and adjusted basis of property contributed, any amounts borrowed for use in the shelter to the extent the taxpayer is personally liable for such amounts and the net fair market value of personal assets that secure nonrecourse borrowings, the proceeds of which are used in the venture.[120] Moreover, the taxpayer is not considered at risk with respect to an investment protected against loss through guarantees and similar arrangements.[121]

Where the taxpayer invests in the designated shelters through a partnership, the specialized at risk rules apply to limit the deductibility of losses, except under limited circumstances in which a so-called "partnership at risk rule" applies. The partnership at risk rule specifically forbids the deduction of losses in excess of a taxpayer's adjusted basis, which, in turn, may not include any portion of any partnership obligation with respect to which the taxpayer has no personal liability.[122] The partnership at risk rule does not apply to partnerships the principal activity of which is investing in real property (other than mineral property).[123]

3. *Interest*

Another favorable characteristic of many tax-sheltered investments has been the availability of prepaid interest deductions.[124] Such prepayments were a boon to high-bracket taxpayers seeking to defer the realization of income by shifting future years' interest deductions into the current year.[125] Prior to 1968 the Internal Revenue Service permitted the prepayment of interest for a period of five years.[126] In Revenue Ruling 68-643[127] the Service ruled that a prepayment of interest for a period extending beyond twelve months after the end of the taxable year of payment would always be considered to result in a "material distortion of income", and that any prepayment will be scrutinized to determine if such a material distortion exists. Revenue Ruling 68-643 was followed by Revenue Ruling 69-188,[128] in which the Service ruled that a "loan processing fee" was "a sum paid for the use or forbearance of money" and therefore interest, and later by

118. Pub. L. No. 94-455, § 204(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, §§ 465(a) and (b)).

119. Pub. L. No. 94-455, § 204(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 465(c)).

120. Pub. L. No. 94-455, § 204[a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 465(b)). However, borrowings from others in the venture and certain relatives and(b)(3).

121. Pub. L. No. 94-455, § 204(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954 § 465(b)(4).

122. Pub. L. No. 94-455, § 213(e), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 704(d)).

123. *Id.*

124. INT. REV. CODE OF 1954, § 163(a) provides that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

125. *See* Kanter, *Interest Deduction: Use, Ruse, Refuse*, 46 TAXES 794, 798 (1968); Asimow, *Principle and Prepaid Interest*, 16 U.C.L.A. L. REV. 36, 41 (1968); Comment, 56 CALIF. L. REV. 1250, 1258-61 (1968).

126. I.T. 3740, 1945 CUM. BULL. 109. The Service also acquiesced in Tax Court cases allowing deductions for prepaid interest, John D. Fackler, 39 B.T.A. 395 (1939), *acquiesced in*, 1939-1 CUM. BULL. 11; and Court Holding Co., 2 T.C. 531 (1943), *acquiesced in*, 1943 CUM. BULL. 5.

127. Rev. Rul. 68-643, 1968-2 CUM. BULL. 76.

128. 1969-1 CUM. BULL. 54.

Revenue Ruling 69-582[129] in which such a fee was held to be deductible in full in the year the loan was originated. The Tax Court in *Andrew A. Sandor*[130] approved the principles behind Revenue Ruling 68-643 without specifically approving the Ruling itself as applied to all situations. In *Sandor* the Commissioner used his broad powers under Section 446 to disallow prepaid interest where the taxpayer prepaid five years of interest on a $100,000 loan. The Tax Court relied both on the "distortion of income" theory and considered the interest prepayment a deposit because the interest could be refunded if the loan were repaid ahead of schedule.[131]

A further setback to the interest deduction oriented investor is represented by new Code Section 163(d), enacted as part of the Tax Reform Act of 1969, which for taxable years beginning after 1971, limits the interest deduction on funds borrowed to purchase or carry investment assets under certain circumstances.[132] In enacting the investment interest provision, Congress sought to discourage individuals from borrowing large amounts (and deducting substantial amounts of interest with respect thereto) in order to acquire an investment asset producing little current income.[133]

Property which a taxpayer leases under a "net lease" is treated as investment property subject to investment interest limitations.[134] Property will be deemed subject to a net lease if either of two tests are satisfied—the expense test or the return test. Under the expense test, property is considered as net leased if the lessor's deductions with respect to the property that are allowable solely as business expenses under Section 163 are less than 15 percent of the gross rental income from the property.[135] This test is applied on a year-by-year basis; thus property may be considered as net leased one year but not the next. The return test is satisfied if the lessor is assured by the lessee (or a related party) that he either will receive a specified return or will not suffer a loss for any period of the lease, with the lease being treated as a net lease for that period.[136]

The Tax Reform Act of 1976 further limited investment interest deductions by allowing a maximum deduction of $10,000 per year plus the taxpayer's net investment income.[137] Disallowed investment interest deductions are subject to an unlimited carryover, subject to the yearly limitation.[138]

Finally, Congress eliminated deductions for prepaid interest paid after January 1, 1976 by enacting Section 208 of the Tax Reform Act of 1976, which amended Section 461 of the Internal Revenue Code.[139] A deduction for interest is now permitted only in the taxable year in which the interest represents a charge for the use or forbearance of borrowed money during that period.[140] Moreover,

129. 1969-2 CUM. BULL. 29. For a discussion of these rulings see Gabinet, *The Interest Deduction: Several New Installments in A Continuing Saga*, 21 CASE W. RES. L. REV. 466, 476 (1970).
130. 62 T.C. 469 (1974).
131. *Id.* at 482-83.
132. INT. REV. CODE OF 1954, § 163(d).
133. H.R. Rep. No. 413, 91st Cong., 1st Sess. 72 (1969).
134. "Investment Interest" is defined as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." INT. REV. CODE OF 1954, § 163(d)(3)(D). However, property held for investment is not defined.
135. INT. REV. CODE OF 1954, § 163(d)(4)(A)(i).
136. INT. REV. CODE OF 1954, § 163(d)(4)(A)(ii).
137. Pub. L. No. 94-455, § 209(a)(1), 90 Stat., 1525, *amending* INT. REV. CODE OF 1954, § 163(d)(1).
138. Pub. L. No. 94-455, § 209(a)(1), 90 Stat. 1525
amending INT. REV. CODE OF 1954, § 163(d)(2).
139. Pub. L. No. 94-455, § 208(a), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 461(g)).
140. *Id.*

points charged on a loan must be deducted ratably over the term of the loan, except in the case of a mortgage incurred in connection with the purchase of or improvements made to, and secured by the taxpayer's principal residence, if, and to the extent that, points are generally charged in the geographical area in which the loan is made.[141]

By Section 201 of the Tax Reform Act of 1976 the deductions for construction period interest and taxes have been severely limited.[142] Generally, the 1976 Act requires the capitalization of nonresidential real property construction period interest and taxes and their amortization over a ten year period, which ten year period is phased in over seven years.[143] Thus, for commercial real property, 50 percent of the construction period interest and taxes paid in 1976 would be deductible in 1976, with the remainder capitalized and deductible over the succeeding three years.[144] In 1977 the amortization period lengthened to five years, increasing by one year until 1982 when the period is ten years.[145] For residential real property, construction period interest and taxes may be deducted in full for 1976 and 1977.[146] Beginning in 1978 these items must be capitalized and deducted over a four-year period. In each succeeding year thereafter the amortization period increases by one year until 1984 when a ten-year period is reached.[147]

4. *Minimum Tax on Tax Preferences*

Prior to the Tax Reform Act of 1976, the so-called "minimum tax" was a tax of 10% imposed on certain "tax preference" items to the extent that these items exceeded $30,000 plus the taxpayer's regular tax liability for the year, plus a carryforward of taxes not used to offset preference income in the previous seven years. The computational offsets built into the minimum tax caused it to apply to relatively few taxpayers. The Tax Reform Act of 1976 increased the rate of the minimum tax from 10% to 15%, decreased the exclusion to $10,000 ($5,000 in the case of a married person filing a separate return) and added new items of tax preference.[148] The carryforward of unused taxes provision was also eliminated.[149] As a result of these modifications the minimum tax should affect a substantial number of additional taxpayers.

5. *Maximum Tax on Earned Income*

As noted above, the amount of "personal service income" qualifying for the benefits of the maximum tax.[150]

6. *The Limited Partnership Form*

For a number of reasons the limited partnership has been a popular vehicle for the tax shelter investments of passive investors. Since the partnership is not a

141. Pub. L. No. 94-455, § 208(a) 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 461(g)(2)).
142. Pub. L. No. 94-455, § 201(a) 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 189).
143. Pub. L. No. 94-455, § 201(a) 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 189(b)).
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.*
148. Pub. L. No. 94-455, § 301, 90 Stat. 1525 (codified at Int. Rev. Code of 1954, § 56(a), 57(a) and (b)).
149. Pub. L. No. 94-455, § 301(a), 90 Stat. 1525.
150. See text accompanying notes 82 through 92, *supra*.

separate taxable entity, the benefits of any losses suffered by or tax credits accruing to the partnership are passed through to the investors.[151] Secondly, under State law,[152] a limited partner is normally liable for the obligations of the partnership only to the extent of his capital contribution. Thirdly, the tax basis for the limited partner's interest may be increased by his allocable share of partnership obligations, provided no partner, general or limited, has any personal liability with respect to the obligation.[153] Moreover, the partnership is permitted some flexibility in the allocation of profits and losses among investors.[154]

This is not to suggest that the limited partnership form is free from problems. For example, the question usually arises of whether the limited partnership will be treated as a partnership for tax purposes or will be considered an "association" taxable as a corporation. In this regard, the Regulations list six major characteristics ordinarily found in a corporation: (a) associates; (b) an objective to carry on business and divide the gains therefrom; (c) centralization of management; (d) continuity of life; (e) free transferability of interests; and (f) limited liability.[155] The limited partnership will not be classified as an association taxable as a corporation unless it has more corporate than non-corporate characteristics. Certain characteristics are common to both a limited partnership and a corporation. Thus a limited partnership has associates and an objective to carry on business and to divide the gains therefrom. Therefore, the inquiry is whether the limited partnership possesses three out of the four remaining characteristics of centralization of management, continuity of life, free transferability of ownership interests, and limited liability; if the limited partnership possesses at least three of the four characteristics, it will be taxed as a corporation.[156]

Centralization of management exists when there is a "concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organizations.[157] A limited partnership organized under a statute corresponding to the Uniform Limited Partnership Act generally does not have centralized management.[158] However, the Regulations provide that centralized management ordinarily does exist in a limited partnership if substantially all the interests in the partnership are owned by the limited partners.[159] A limited partnership possesses continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not effect a dissolution.[160] Since the Uniform Limited Partnership Act provides for dissolution on the death, withdrawal, bankruptcy, etc. of the general partner, the Regulations state that a limited partnership

151. INT. REV. CODE OF 1954, § 702.

152. *See, e.g.*, Uniform Limited Partnership Act. § 1.

153. Section 1.752-1(e) of the Regulations first sets forth the general rule that a limited partner's share of partnership liabilities is limited to the difference between his actual contribution and the total contribution which he is obligated to make to the partnership. It further provides that where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, are considered as sharing such liability under section 752(c) in the same proportion as profits are shared. Therefore each limited partner's basis is effectively increased, permitting deductions for losses which exceed cash contributions to the partnership. *See* Treas. Reg. § 1.752-1(e)(1956).

154. *See* text accompanying notes 165 through 176. *Infra*.

155. Treas. Reg. § 301.7701-2 (1960).

156. Treas. Reg. § 301.7701-2(a)(3) (1960).

157. Treas. Reg. § 301.7701-2(c)(3) (1960).

158. Treas. Reg. § 301.7701-2(c)(4) (1960).

159. *Id.*

160. Treas. Reg. § 301.7701-2(b)(1) (1960).

conforming to the Uniform Limited Partnership Act lacks continuity of life since any member of the limited partnership has the power to dissolve the organization.[161]

The corporate characteristic of free transferability of interest exists if members of the partnership have the power, without the consent of other partners, to substitute an outside person for themselves with all the rights of membership.[162] However, there is no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the partnership and the formation of a new partnership.[163] The typical solution to this problem has been to provide that each limited partner may transfer his interest in profits and losses but the transferee may not become a "substituted limited partner" without the consent of the general partner.

A limited partnership is considered to have the corporate characteristic of limited liability if under local law there is no member of the limited partnership who is personally liable for partnership debts and obligations.[164] In the case of a limited partnership organized under a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner.[165] However, limited liability may be deemed to exist if the general partner, whether an individual or a corporation, has no substantial assets (other than his interest in the partnership) which can be reached by a creditor of the organization and is merely a dummy acting as the agent of the limited partners.[166] Where a corporate general partner is involved, the Service has set forth corporate net worth requirements for securing an advance ruling on the question of partnership status.[167]

Two recent cases, one in the Tax Court, and the other in the Court of Claims, have clarified the application of the foregoing rules. The first of these decisions, *Phillip G. Larson*,[168] in its original opinion, held that two real estate limited partnerships organized under the California Limited Partnership Act constituted associations taxable as corporations. After a petition for reconsideration was granted, the Tax Court withdrew the opinion. On April 27, 1976, the Tax Court reissued the *Larson* opinion, finding that the two entities were partnerships for tax purposes.[169] With respect to the question of continuity of life, the Court decided that under its interpretation of California law, the bankruptcy of the

161. Uniform Limited Partnership Act, § 20; Treas. Reg. § 301.7701-2(b)(3) (1960).
162. Treas. Reg. § 301.7701-2(e)(1) (1960).
163. *Id.*
164. Treas. Reg. § 301.7701-2(d) (1960).
165. Treas. Reg. § 301.7701-2(d)(1) (1960).
166. Treas. Reg. § 301.7701-2(d)(2) (1960).
167. Rev. Proc. 72-13, 1972-2 CUM. BULL. 735. This provides that the Service will consider a request for a ruling on the classification of an organization as a partnership when the sole general partner is a corporation under the following circumstances:

(1) The limited partners will not own directly or indirectly more than twenty percent of the stock of the corporate general partner or an affiliate corporation. For purposes of determining stock ownership, the attribution rules of section 318 of the Code are applicable.

(2) The purchase of a limited partner's interest does not entail either a mandatory or discretionary purchase of any type of security of the corporate general partner or its affiliates.

(3) The net worth of the corporate general partner, computed on the basis of the current fair market value of the corporation's assets, is at all times equal to at least fifteen percent of the total contributions made to the partnership by the partners (both general and limited) where such total is less than 2,500,000 dollars, and ten percent of such contributions where the total is in excess of 2,500,000 dollars. In computing the corporate general partner's net worth, its interest in the limited partnership and accounts and notes receivable from the limited partners is excluded.

168. 65 T.C. No. 10 (Oct. 21, 1976).
169. 66 T.C. No. 21 (April 27, 1976).

general partner would not cause a dissolution of the partnerships; therefore continuity of life could not exist. The Court so held despite the fact that in one of the partnerships a simple majority vote was required to replace the general partner upon bankruptcy.[170] In the *Zuckman* case[171] the partnership involved was formed under a statute conforming to the Uniform Limited Partnership Act. The Court of Claims decided that for this reason, and because the bankruptcy of the general partner would effect a technical dissolution of the partnership continuity of life ' did not exist; this result was reached despite the fact that the general partner had surrendered its right to voluntarily dissolve the partnership.[172]

The Tax Court in *Larson* found that centralization of management existed in both partnerships under scrutiny. This decision was reached for the most part because the general partners lacked a substantial present economic interest in the projects involved. The Court also observed that the ability of the limited partners to remove the general partner was evidence that the general partner did not have an independent proprietary role normally occupied by a general partner.[173] In the *Zuckman* case the Court of Claims held that centralization of management did not exist.[174]

In the *Larson* case the Tax Court, as to both partnerships involved, found that the corporate characteristic of limited liability did not exist; it reasoned that whether or not the common general partner had substantial assets during the year in question, it was not a "dummy" acting for the limited partners.[175] The *Zuckman* opinion adopted the same test as the majority opinion in *Larson*, and consistent with the Regulations, also ruled that the corporate characteristic of limited liability was not present.[176]

The Tax Court found the interests in the partnerships in *Larson* to be freely transferable so as to satisfy this test of corporate existence. The Court so found despite the fact that limited partnership interests were transferable only with the consent of the general partner (the consent of which could not be unreasonably withheld).[177] In *Zuckman* the Court of Claims held that only the interest of the limited partner who had control of the general partner was freely transferable. The Court so held since the partnership agreement provided that a limited partner could only transfer his partnership interest with the consent of the general partner; logically, the Court reasoned, the limited partner who controlled the general partner could obtain that consent without restriction.[178] In neither *Larson* nor *Zuckman* did the opinions give much importance to the remaining characteristics of the corporate existence set forth in the Regulations.[179]

7. *Special Partnership Allocations*

In recent years a considerable amount of attention has been focused on the

170. *Id.* at 36.
171. Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975).
172. *Id.* at 735-36.
173. 66 T.C. No. 21 at 40.
174. 524 F.2d at 737-39.
175. 66 T.C. No. 21 at 49-51.
176. 524 F.2d at 739-742.
177. 66 T.C. No. 21 at 51-55.
178. 524 F.2d at 742-44.
179. For comprehensive analyses of the *Larson* and *Zuckman* opinions, see Mendenhall & Ferguson, *What Risks Now for Partnership Treatment of Shelters? Lessons of Larson, Zuckman*, 44 J. TAXATION 66 (Aug. 1976); Livesy, *Limited Partnerships With a Sole Corporate Partner: The Impact of Larson and Zuckman*, 54 TAXES 132 (1976).

special allocation of partnership income, losses, deductions and credits among partners. The special allocation has taken many forms but frequently involved allocating deductions (particularly prepaid interest and depreciation) to a high bracket taxpayer or to partners joining the partnership after the deductions had been incurred, or specially allocating appreciation, income and/or cash flow to groups of investors in the same partnership. Amended Section 704(b) of the Code provides that a partner's distributive share of any item of income, gain, loss, deduction or credit is determined in accordance with his interest in the partnership unless the partnership agreement provides for a different allocation; however, a special allocation in the partnership agreement determining a partner's distributive share of a particular item will not be recognized unless the allocation has "substantial economic effect."[180] The amended Section 704(b) represents a codification of existing case law relating to special allocations. One of the leading cases is *Stanley C. Orrisch.*[181] In *Orrisch* all depreciation attributable to particular partnership properties was specially allocated to one of two partners. It was further agreed that upon the sale of the properties at a gain, the gain would be specially allocated to the same partner to the extent of the special allocation of depreciation. Applying the criteria set forth in the Regulations, the Tax Court sustained the disallowance of the special depreciation deduction based upon the following: the taxpayer had large amounts of ordinary income which would be offset in part by the additional deduction, while his partner, by reason of certain investments, expected not to report taxable income; in addition, depreciation was the only item specially allocated; the income from the properties and operating expenses, repairs and maintenance were shared by the partners equally; and due to the nature of the depreciation deduction, the partners were able to forecast its amount with accuracy at the time the special allocation was adopted; the allocation was also considered to be without substantial economic effect apart from its tax consequences since a sale of the properties at a gain would not result in a change in the dollar distributions to each partner, whether or not the amount of gain exceeded the amount of specially allocated depreciation. The Court further concluded that finding an economic effect in the special allocation would require determining who was to bear the economic burden of the depreciation if the properties were sold at a loss.[182]

While *Orrisch* involved an attempt to allocate an individual item of partnership income or loss (that is, depreciation), *Jean v. Kresser*[183] involved an attempt to allocate the total income of the partnership to a single partner. In *Kresser* an oral modification of an oral partnership agreement allocated all of the taxable income of the partnership to a partner with a net operating loss that was about to expire. The taxable income so allocated was to be restored to the other partners in future years. The Tax Court concluded that the special allocation was not bona fide.[184] Kresser had provided some support for the theory that former Section

180. Pub. L. No. 94-455, § 213(d) 90 Stat. 1525, INT. REV. CODE OF 1954, § 704(b)).
181. 55 T.C. 395 (1970). *aff'd per curiam* (unpublished opinion).
182. *Id.* at 403.
183. 54 T.C. 1621 (1970).
184. "It is quite true, as petitioners contend, that the partners may readjust their respective partnership shares of income and that, apart from the provisions of section 704(b)(2), effect will be given to the partners' agreement and their modifications thereof . . . Moreover while one of the purposes of the statute was to provide flexibility to a certain extent . . . the modifications contemplated must at least be bona fide. Thus, although the partners are to be permitted to readjust their distributive shares *inter sese*, such readjustments must be real, and we are therefore faced with the threshold question on this issue as to whether there was any

704(a) by its literal language permitted the special allocation of overall income and loss as opposed to the special allocation of items of income, loss, deduction or credit under former Section 704(b).[185] However, amended Section 704(b) does not provide for any such distinction.

Retroactive allocations of income or loss of a partnership are now forbidden by the Tax Reform Act of 1976. Partners must now be allocated profits and losses based upon the time during which they were members of the partnership during the tax year.[186] Prior to the 1976 Act, losses, deductions and credits generated during the taxable year by tax shelter partnerships would be allocated in large part to individuals joining the partnership at year end seeking tax reduction. By retroactively allocating losses, deductions or credits, the incoming partners were treated as if they had been members of the partnership for the entire year.

B. *Real Estate*

Probably the most popular form of tax shelter investment has been real estate, since generally speaking, real estate has offered a relatively strong potential for capital appreciation. In the past, real estate has also generated immediate as well as long-term tax savings. For example, during construction a project would generate deductions for interest on construction financing, and in lesser amounts, deductions for real estate taxes, sales taxes and other operating expenses. Once construction was completed, deductions for interest and operating expenses would continue, and the project's real and personal property could be depreciated over their respective useful lives. Moreover, the acquisition of the property would usually be structured so as to create what are commonly called "soft dollars"—that is, investment dollars which are currently deductible. In particular, the developer of the property was often concerned only with the total dollars received rather than the form in which the dollars were paid. It was therefore possible to classify a portion of the purchase price as deductible expenditures, using a "wrap-around mortgage"[187] and providing for the payment of points, prepaid interest, and management fees.

However, the Tax Reform Act of 1976 drastically restricted some of the foregoing tax characteristics and eliminated others. Section 201 limited deductions for construction period interest and taxes,[188] and Section 202(a) tightened up the depreciation recapture rules for residential rental property.[189] Prepaid interest and points were substantially eliminated,[190] and deductions for management fees were severely limited.[191] These changes make it mandatory that taxpayers look to real estate as an investment medium rather than for its tax deferral potential.

Drastic changes have been made in the rules relating to deductions for so-called "guaranteed payments" and syndication and organizational expenses of tax shelter partnerships. Prior to the 1976 Act, it was contended that payments

genuine readjustment of the partner's distributive shares. In our view of the record the evidence indicates the contrary and certainly does not establish that there was any such bona fide reallocation." *Id.* at 1630-31.

185. 54 T.C. 1631, n.5.

186. Pub. L. No. 95-455, § 213(c), 90 Stat. 1525, codified at INT. REV. CODE OF 1954, § 706(c).

187. *See* Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unusable Interest Deductions, and Interest Subsidy*, N.Y.U. 29TH INST. ON FED. TAX. 1107 (1971).

188. See text accompanying notes 142 through 147, *supra*.

189. See text accompanying note 117, *supra*.

190. See text accompanying notes 139 through 141, *supra*.

191. See text accompanying notes through , *infra*.

made under Section 707(c) of the Code were automatically deductible by the partnership without regard to the "ordinary and necessary" requirements of Section 162(a) or Section 263. The 1976 Act amends Section 707(c) to make it clear that, in determining whether a guaranteed payment is deductible by the partnership, it must meet the same tests under Section 162(a) as if the payment had been made to a person who is not a member of the partnership; further, the normal rules of Section 263 (relating to capital expenditures) must be taken into account.[192]

In recent years it has been common for limited partnership tax shelters to claim a deduction for payments made to a general partner for services rendered by him with respect to the syndication and organization of the limited partnership. The 1976 Act requires that fees paid in connection with the organization and syndication of a partnership be capitalized. However, the Act permits these fees to be amortized over a period of not less than five years.[193]

Other problems and pitfalls exist in a real estate tax shelter. Perhaps the most fundamental consideration is that the investment creates a deferral of income taxes, rather than a permanent reduction. In early years, the investment will create tax losses in large but decreasing amounts attributable to the excess of deductions for accelerated depreciation, interest and operating expenses over rental income. However, at some point in the history of the project the income will exceed deductible expenses in increasing amounts. The cash flow may also become inadequate to pay the tax on the net income. Another negative aspect is that the excess of accelerated depreciation over straight-line is a tax preference item[194] which will reduce personal services income for purposes of the maximum tax provisions,[195] and which is subject to the minimum tax.[196] To the extent the gain on the sale of the property is not subject to recapture as ordinary income,[197] one-half of such gain also constitutes a tax preference.[198] Thus an effort to dispose of the investment at the point where it no longer generates artificial losses may result in disastrous consequences.[199]

C. *Equipment Leasing*

An equipment leasing tax shelter is usually formed as a limited partnership (or less frequently as a trust) which acquires a depreciable asset such as an airplane, railroad car, or ocean vessel, using the capital contributed by the limited partners for a downpayment. The balance of the acquisition price is borrowed with the equipment and the partnership's rights under a lease to the ultimate user as collateral. The lease payments will be established at an amount sufficient to

192. Pub. L. No. 94-455, § 213(b)(3), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 707(c)).
193. Pub. L. No. 94-455, § 213(b), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 709).
194. INT. REV. CODE OF 1954, § 57(a)(2).
195. INT. REV. CODE OF 1954, § 1348(b).
196. INT. REV. CODE OF 1954, § 56(a).
197. *See* note 117, *supra*.
198. INT. REV. CODE OF 1954, § 57(a)(9).
199. A sale or other disposition of the property could result in unintended gain. Where partnership assets are sold subject to a mortgage liability, the amount of that liability is considered part of the proceeds of the sale, increasing the amount of potential gain. Crane v. Comm'r, 331 U.S. 1 (1947). Other methods of disposition may result in less undesirable tax consequences but are beyond the scope of this article. *See, e.g.*, Hamovit, *Termination of a Partnership*, N.Y.U. 32ND INST. ON FED. TAX. 1579 (1974); Winokur, *Getting Out of a Real Estate Tax Shelter*, 31 N.Y.U. 31ST INST. ON FED. TAX. 1817 (1973).

cover management fees, loan interest, and a modest cash return to the limited partners.[200] Partnerships acquiring equipment with a useful life of at least six years are entitled to claim an additional first-year depreciation allowance equal to twenty percent of the cost of the equipment.[201] As with the real estate shelter, in the early years of the partnership, the interest and depreciation deductions will exceed rental income from the lease, thereby creating tax losses which are allocable to and deductible by the limited partners.

An important tax advantage of equipment leasing which is not available with real estate investments is the investment tax credit.[202] The investment credit provisions were first enacted in 1962, suspended briefly in 1966, reinstated in 1967, repealed in 1969, and then restored again in the Revenue Act of 1971.[203] Generally speaking the provisions permit a taxpayer to reduce his otherwise determined tax liability in the year of acquisition by a maximum of seven percent of the cost of the equipment. A carryback of three years and a carryforward of seven years is available for investment tax credit in excess of the current limitations.[204] A seven percent credit is available for property with a useful life of seven years or more, a four and two-thirds percent credit for property with a useful life of five to seven years, and a two and one-third percent credit for property with a useful life of three to five years.[205] No credit is available for property with a useful life of less than three years.[206] Section 301 of the Tax Reduction Act of 1975 amended the Code to provide for an increase in 1975 to ten percent for the investment tax credit on qualifying property, and for an additional increase to eleven percent if a corporation established an employee stock ownership plan meeting the special requirements of Section 301(d) of the Act and transferred "employer securities" to the plan equal to one percent of the qualifying investment.[207] The Tax Reform Act of 1976 extends the ten percent credit for four additional years to apply to property placed in service before January 1, 1981.[208]

One impediment to the use of the investment tax credit in equipment leasing is Section 46(e)(3) of the Code, which provides that noncorporate lessors, such as limited partnerships, are entitled to claim the credit only if the property has been manufactured or produced by the lessor, or the term of the lease is less than 50 percent of the useful life of the property *and* the trade or business deductions taken under Section 162 for the first 12 months of the lease exceed 15 percent of the rental income.[209] It is usually possible to satisfy these requirements since both the term of the lease and the rental charged can be arranged accordingly.

200. *See generally*, Stine, *Ships and Equipment Leasing as a Tax Shelter*, N.Y.U. 31st INST. ON FED. TAX. 755 (1973).

201. INT. REV. CODE OF 1954, § 179. The deduction is limited to (2,000 ($4,000 for married persons filing a joint return). However, the Tax Reform Act of 1976 provides that the dollar limitation applies with respect to each individual partner *and* the partnership, dramatically reducing the amount of bonus depreciation potentially available. Pub. L. No. 94-455, § 213(a), 90 Stat. 1525, *amending* INT. REV. CODE OF 1954, § 179(d).

202. INT. REV. CODE OF 1954, §§ 38 §§ 46-50.

203. *See generally* B. BITTKER & L. STONE, FEDERAL INCOME ESTATE AND GIFT TAXATION 323 (4th ed. 1972).

204. INT. REV. CODE OF 1954, § 46(b).

205. INT. REV. CODE OF 1954, § 46(a) and (c).

206. INT. REV. CODE OF 1954, § 46(c).

207. Pub. L. No. 94-12, §§ 301(a) and (d), 89 Stat. 26, *amending* INT. REV. CODE OF 1954, §§ 46(a)(1) and (a)(2)(b).

208. Pub. L. No. 94-455, § 802(a)(1), 90 Stat. 1525, amending INT. REV. CODEOFXS 1954, § 46(A)(2).

209. INT. REV. CODE OF 1954, § 46(e)(3).

A negative characteristic that equipment leasing transactions share with real estate shelters is that depreciation and interest deductions will normally decline year by year. Thus the "tax yield" created by the investment also diminishes. At or before the time the partnership begins to realize net taxable income on the investment, the limited partners may be compelled to dispose of the investment or find new mechanisms for sheltering this additional income.[210]

There are other potentially unfavorable characteristics of equipment leasing shelters. For example, certain aspects of the equipment leasing investment, such as accelerated depreciation and capital gain on the sale of the equipment are potential tax preference items for purposes of both the minimum tax on tax preferences[211] and the maximum tax on personal service income.[212] Secondly, interest expense deductions passed through to the limited partners may be subject to investment interest limitations,[213] or, if prepaid, disallowed altogether.[214] Further, such shelters are subject to all the provisions of the Tax Reform Act of 1976, which substantially limits the benefits of the more popular tax shelter programs.

D. *Investments in Cattle*

There are two commonly used tax shelter forms of investments in cattle—cattle feeding and cattle breeding. Cattle feeding is clearly a short-term shelter which simply effects a deferral of tax, often for only one year. Cattle breeding, on the other hand, is considered of a longer term and may involve some appreciation in value of the acquired herd.

In the past, a cattle feeding operation has claimed deductions for feed, interest, management fees, and care and maintenance costs. The largest deduction in the cattle feeding operation has generally been for the purchase of feed. The feed lot manager would buy several months' feed in advance, and the investor would deduct the purchase currently. The money to purchase the herd of feeder cattle was borrowed, which resulted in deductions for interest expense. In sum, the investor, operating on the cash basis,[215] deducted substantial expenses in the first year; he would then sell the fattened cattle for a profit in the second year, thereby shifting his income from the first year into the second year. His income might fall in lower tax brackets in the second year so as to increase his tax yield.

Cattle breeding represents a longer term investment than cattle feeding. In cattle breeding, a herd of female cattle is purchased and used solely for breeding additional cows. Since there is no tax on the birth of a calf, the herd can grow without any tax consequences. If the cattle are held for two years, capital gain treatment may be available upon sale.[216] Losses may be deductible as ordinary losses.[217] The investment tax credit is also available for purchased breeder cattle.[218]

210. See, Hamovit, supra note 199; Winokur, supra note 199.
211. See text accompanying note 148 *supra*.
212.
213. See text accompanying notes 132 through 138, *supra*.
214.
215. Treas. Reg. §§ 1.162-12 (1958, as amended, 1972) 1.461-1(a)(1)(1957, as amended, 1967); See Branscomb, The Cash Method As Applied in Agriculture—A Re-examination, 25 Tax Lawyer 125 (1971); Griffith & Joy, What the Act Does to the Farmer; Farm Parity or Class Discrimination, 23 Tax Lawyer 495 (1970).
216. INT. REV. CODE OF 1954, § 1231(b)(3).
217. INT. REV. CODE OF 1954, § 1231(a).
218. INT. REV. CODE OF 1954, §§ 46 and 48-50.

The principal items of deduction in cattle breeding are the cost of feed, operating costs, management fees, and interest on indebtedness. In addition, the purchaser of the herd is entitled to claim accelerated depreciation and the investment tax credit, which are not available in the cattle feeding programs or when the livestock is included in inventory. The additional first year depreciation deduction may also be claimed on the first $10,000 of cattle purchased ($20,000 for married persons if a joint return is filed).[219] The ordinary income depreciation recapture provisions of Section 1245 apply to livestock.[220] Consequently, depreciation recapture applies to the original herd if and when it is sold.[221]

The Tax Reform Act of 1976 has imposed serious limitations on the utility of forming tax shelters as tax deferral mechanisms. The 1976 Act provides that farming syndicates may only deduct expenses for feed, seed, fertilizer and other farm supplies as they are consumed,[222] and must capitalize the costs of planting, cultivating, maintaining and developing a grove, orchard or vineyard that are incurred prior to the year they become productive.[223] The 1976 Act also requires the capitalization of costs relating to poultry production.[224]

A farming syndicate is defined by the 1976 Act so as to include a partnership or other enterprise (other than a corporation that is not an electing small business corporation) engaged in farming if, at any time, any interest in the partnership or other enterprise has been offered for sale in an offering required to be registered with a federal or state agency having authority to regulate the offering of securities for sale. It also includes such partnerships or other enterprises if more than 35 percent of the losses during any period is allocable to limited partners or entrepreneurs.[225] In general, a limited entrepreneur for purposes of the Act means a person who has an interest, other than a limited partnership interest, in an enterprise and who does not actively participate in the management of the enterprise.[226]

The determination of whether a person actively participates in the operation or management of a farm depends upon all the facts and circumstances surrounding the particular participation. However, the Act provides for certain situations in which an individual's interest will not be treated as the interest of a limited partner or entrepreneur: 1) the interest is attributable to a period of active participation of not less than five years; 2) the individual is a resident on the farm; 3) the individual is actively participating in the management of any farming business, or is an individual described in 1) or 2) above, and who participates in the further processing of livestock which was raised in any of the foregoing described farming businesses; 4) for an individual whose principal business activity involves the active participation in the farming business, any interest in any other farming business; and 5) the individual is related to a person who is actively participating in the management of the farming business.[227]

219. INT. REV. CODE OF 1954, § 179. But see text accompanying notes through, supra.
220. INT. REV. CODE OF 1954. § 1245(a)(2)(c).
221. *Id.*
222. Pub. L. No. 94-455, § 207(a)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 464(a)).
223. Pub. L. No. 94-455, § 207(b)(2), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 278(b)).
224. Pub. L. No. 94-455, § 207(a)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 464(b)).
225. Pub. L. No. 94-455, § 207(a)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 464(c)).
226. Pub. L. No. 94-455, § 207(a)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 464(e)).
227. Pub. L. No. 94-455, § 207(a)(1), 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 464(c)(2)).

E. *Oil and Gas Drilling Programs*

Still another popular form of tax shelter is represented by a variety of oil and gas drilling programs. The primary tax incentives underlying an investment in oil and gas are the deduction of intangible drilling costs,[228] the percentage depletion allowance,[229] and capital gain on the disposition of the investment. Intangible drilling costs are the substantial expenses incident to the drilling of the well. The taxpayer may deduct his proportionate share of intangible drilling and development costs firmly contracted for in the year paid even if the drilling and development are not performed until the next year.[230] Percentage depletion deductions may be taken even after the basis of the property has been reduced to zero. However, the depletion allowance is a tax preference to the extent it exceeds the taxpayer's basis in the property.[231]

A gain on the sale of an interest in an oil well will be treated as a capital gain.[232] The depreciation recapture provisions of Sections 1245 and 1250 do not apply to the sale of oil properties.[233] The 1976 Tax Reform Act provides for the recapture as ordinary income of certain intangible drilling and development costs upon the disposition of oil and gas properties.[234] The amount recaptured is equal to the amount deducted for the intangible costs reduced by the amounts that would have been deductible had the intangible costs been capitalized and amortized, but limited to the amount of gain recognized from the disposition.[235] If there is no gain recognized, as in the case of some dispositions other than by sale, the limit equals the excess of the fair market value of the property transferred over the adjusted basis of that property. The amount recaptured is treated as ordinary income.[236] In addition, recall that the "at risk" limitations enacted as part of the Tax Reform Act of 1976 apply to investments in oil and gas shelters.[237]

V. NONQUALIFIED DEFERRED COMPENSATION CONTRACTS

A. *General Considerations*

A common tax deferral device employed by high-bracket taxpayers is the deferred compensation contract.[238] A nonstatutory device, it involves a contract by which an employer (or other person or entity) makes an unsecured promise to

228. INT. REV. CODE OF 1954, § 263(c).

229. INT. REV. CODE OF 1954, § 613.

230. In 1971 the Internal Revenue Service issued two rulings on this point. In Revenue Ruling 71-252, 1971-23 Cum. Bull. 17, the Service ruled that intangible drilling and development costs paid by a cash basis taxpayer when required under a drilling contract are deductible in the year paid even though a substantial part of the work is performed in a subsequent year. In a later ruling the deduction was denied when a payment was made before it was required to be paid. Rev. Rul. 71-579, 1971-51 Cu. Bull. 11. New Section 263(c), enacted as part of the 1976 Act, affirms the deductibility of these costs and directs the Treasury to promulgate new Regulations.

231. INT. REV. CODE OF 1954, § 57(a).

232. INT. REV. CODE OF 1954, § 1221.

233. INT. REV. CODE OF 1954, § 1245(a)(3).

234. Pub. L. No. 94-455, § 205, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1254).

235. Pub. L. No. 94-455, § 205, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, 1254(a)(1)).

236. Pub. L. No. 94-455, § 205, 90 Stat. 1525 (codified at INT. REV. CODE OF 1954, § 1254(a)).

237. See text accompanying notes 118 through 122, *supra*.

238. See generally, Eisenstein, A Case of Deferred Compensation, 4 Tax L. Rev. 391 (1949); Knight, Income Tax Consequences of Nonqualified Deferred Compensation, A Recapitulation, 21 Tax Lawyer 163, 166, 172-74, 183-85 (1967); Magill, The Taxation of Unrealized Income, 39 Harv. L. Rev. 82, at 83-84 (1925): McDonald, Deferred Compensation: Conceptual Astigmatism, 24 Tax L. Rev. 201, 203-4 (1969); Rothschild & Ness, IRS Confines Hicks Case and Sanctions Deferred Compensation Choices, 19 J. Taxation 216, 217 (1963); Zysman, Constructive Receipt of Income, 16 Tax Magazine 715 (1938).

compensate an individual in the future for services performed currently. The purpose is to defer taxability until a time when the individual will be in a lower tax bracket. The relevant statutory provision in this area is Section 451 of the Code which provides that "the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer . . ."[239] Revenue Ruling 60-31 is the first important ruling issued by the Internal Revenue Service in the area of nonqualified deferred compensation plans.[240] The first of five distinct examples analyzed in the Ruling involves a five-year executive employment contract. The executive's compensation was an annual salary plus deferred compensation to be credited annually to a reserve created by the employer on its books; the deferred compensation was to be paid after termination of employment. Once credited, the amounts deferred were nonforfeitable. The employment contract was entered into before the rendition of the services for which the deferred compensation was to be paid. It was ruled that the deferred portion of compensation was taxable only when received.[241]

The second example involved a division among participating employees of a percentage of an employer's profits. While funds were not segregated for the employees, separate accounts were established on the employer's books to which the respective shares of profits were credited. Any income earned on amounts invested with respect to the employees' accounts would be paid at future dates along with the balance in the accounts. The Service again ruled that there was no constructive receipt.[242]

The third example involved an author and publisher entering into an agreement pursuant to which the publisher was to pay the author certain royalties. On the same date, the parties entered into a second agreement providing that the publisher would not pay the author more than a specified sum in any one calendar year, and sums in excess of this amount accruing in any year would be paid in subsequent years. The ruling concludes that since the second agreement was made before the royalties were earned, there was no constructive receipt.[243]

The next example involved a football player contract. In addition to other compensation the athlete was entitled to a bonus, which, according to the ruling, he could have received upon execution of the contract. The bonus was delivered to a bank pursuant to the terms of an escrow agreement approved by the athlete, his employer, and the bank. Under the escrow agreement the bank was to pay the bonus to the athlete over a five year period. The athlete's rights under the escrow agreement were nonforfeitable and assignable. The Service ruled that the bonus was taxable immediately.[244] In a more recent ruling the Service came to the same conclusion where a nonqualified trust was utilized.[245]

239. INT. REV. CODE OF 1954, § 451. The regulations which deal with the constructive receipt of income provide in part as follows:

> "Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitions or restrictions". Treas. Reg. § 1.451-2 (1957, as amended, 1971).

240. 1960-1 Cum. Bull. 174.
241. *Id.* at 178.
242. *Id.*
243. *Id.* at 179.
244. *Id.* at 180.
245. Rev. Rul. 71-352, 1971-2 Cum. Bull 221.

The final example involved a professional boxer who contracted with a boxing club to receive a certain percentage of the gross receipts from a bout. The parties simultaneously executed a second agreement providing for payment of 25 percent of the boxer's share of the receipts immediately, with the remainder to be paid over a three year period. The Service ruled that the receipts were taxable immediately.[246] However, the Service altered the facts of that example,[247] in view of a contrary decision based upon similar facts in the *Ray S. Robinson* case.[248] Robinson, in connection with the defense of his middleweight title against Carmen Basilio in 1957, entered into a contract with the International Boxing Club of New York ("IBC") to receive a guarantee of $255,000 or 45 percent of IBC's share of the receipts from closed circuit television. Payment of these amounts was guaranteed by Madison Square Garden, the parent corporation of IBC, by James Norris, the controlling shareholder of Madison Square Garden, and still another guarantee was given by Theater Network Television, Inc., a corporation which has been granted the ancillary rights to the fight. However, under the terms of Robinson's contract with IBC he was to receive only 40 percent of his agreed compensation during 1957. The Service argued that the contract was a sham, that Robinson constructively received all amounts due, and that the guarantee by Theater Network Television triggered immediate taxability. It also alleged that a joint venture had been created. The Tax Court rejected each of these contentions and found that no constructive receipt had taken place.[249]

Generally speaking, to insure the effectiveness of a cash deferral arrangement, the following minimum guidelines should be followed: (1) the obligation of the payor must not be assignable, nor evidenced by a note or secured in any way; in effect, the recipient's rights should be the same as those of a general creditor; (2) the deferred amounts should not be placed in escrow, trust or in any special fund, but may be credited on the books of the payor; (3) the arrangement should be entered into prior to the rendition of services; and (4) the recipient must utilize the cash receipts and disbursements method of accounting. However, deferred compensation credited to the account of the recipient may be invested or interest credited thereto (without current taxation) with any accumulation paid out in the

246. The Ruling concludes that:

> ". . . the proposed match is a joint venture . . . and the taxpayer is not an employee of the boxing club. The taxpayer's share of the gross receipts from the match belongs to him and never belonged to the boxing club. . . . Thus, the taxpayer acquired all of the benefits of his share of the receipts except the right of immediate physical possession; and, although the club retained physical possession, it was by virtue of an arrangement with the taxpayer who, in substance and effect, authorized the boxing club to take possession and hold for him". Rev. Rul. 60-31, 1960-1 Cum. Bull 174 at 180.

247. Rev. Rul. 70-435, 1970-2 Cum. Bull 100.

248. 44 T.C. 20 (1965), acquiesced in, 1970-2 Cum. Bull, xxi.

249. With respect to the constructive receipt issue, the Court commented that:

> "The proceeds of the fight were not placed in escrow or trust, or set aside in any special fund, or segregated in any way by IBC for petitioner's benefit. They were commingled with all of IBC's other assets, and petitioner's claim against its assets would have rested on no firmer ground than those of other creditors similarly situated". Id. at 37 note 2.

And the Court dismissed the argument that the guarantee accelerated income by stating:

> "Alternatively, the Government argues that under the contract, as supplemented by the subsequent $255,000 guarantee in respect of closed-circuit theater television, petitioner became entitled in 1957 to receive $255,000 plus his contractual 40 percent of the remainder of the fight proceeds. We think that this latter alternative is incorrect in any event, because the (255,000 guarantee did not modify the June 31, 1975, contract as to the time of payment, and under than contract petitioner became entitled to only 40 percent of the proceeds in 1957". *Id.* The service acquiesced in the Robinson case at the time it issued the modification, in the form of Rev. Rul. 70-435, 1970-2 Cum Bull. 100.

future along with the deferred compensation. In Revenue Procedure 71-19[250] the Service has set forth the conditions or circumstances under which it would issue advance rulings concerning the application of the constructive receipt doctrine to unfunded deferred compensation arrangements.

B. *Property Transfers*

In order for income to be deferred with respect to "property" transferred to an athlete or entertainer in connection with the performance of services, it is necessary that the property be "subject to a substantial risk of forfeiture" and be nontransferable.[251] Section 83 provides that income resulting from the property transferred is to be reported at the time the risk of forfeiture first ceases to be substantial, or the property first becomes "transferable", in an amount equal to the excess of the fair market value of the property at that time over the amount, if any, paid for the property.[252] Thus any appreciation in the property in the interim will be treated as part of the amount taxable as ordinary income, unless an election is made to report income immediately.[253] In determining the fair market value of the property at the time the restriction first ceases to impose a substantial risk of forfeiture, or the property first becomes transferable, all restrictions except those which never lapse are ignored. The transferor of the property is entitled to a deduction in the year (and in the same amount) the recipient includes the property in income.[254]

C. *Evaluate Individual Circumstances*

It is not a foregone conclusion that deferral is advantageous. For example, it is customarily assumed that deferral of income to later years is desirable because the athlete or entertainer expects to be in a lower tax bracket at that time. In some instances that assumption may prove to be erroneous. Moreover, part of the price of deferring payment of earnings to future years is the loss of the economic benefit of current use of the funds. Perhaps the most important consideration is the requirement that the payee rely solely on the credit of the obligor.[255] Unless the contract obligates a substantial individual or organization, or strong guarantees are obtained, the arrangement may be extremely unwise. However, on the positive side, the reader should recall that deferred compensation now qualifies as personal services income for purposes of the maximum tax.

CONCLUSION

Tax planning for the athlete or entertainer, as with other high-income individuals, has become increasingly complex. Not only has the Internal Revenue Service intensified its efforts at minimizing the substantial benefits otherwise

250. 1971-1 Cum. Cull. 698. The Ruling requires that if the plan provides for an election to defer payment of compensation, the election must be made before the beginning of the period of service for which the compensation is payable, regardless of the existence in the plan of forfeiture provisions; and that if any elections, other than the initial election referred to above, may be made by an employee subsequent to the beginning of the service, the plan must set forth substantial forfeiture provisions that must remain in effect throughout the entire period of deferral.

251. INT. REV. CODE OF 1954, § 83(a)(1).

252. INT. REV. CODE OF 1954, § 83(a).

253. INT. REV. CODE OF 1954, § 83(b).

254. INT. REV. CODE OF 1954 § 83(h).

255. See Ray S. Robinson, 44 T.C. 20 at 37.

256. Pub. L. No. 94-455, § 302(a), 90 Stat. 1525, amending INT. REV. CODE OF 1954, § 1348(b)(1).

available through tax shelter transactions, but recent legislation, such as the Tax Reform Act of 1969, ERISA, and particularly the Tax Reform Act of 1976, has discouraged the use of this and other tax avoidance mechanisms. The impact of ERISA has been to force a number of tax advisors out of the pension area because of the comprehensive and complex nature of the legislation. Some companies have even chosen to freeze their employee benefit plans rather than to amend them to conform to ERISA's requirements. The Tax Reform Act of 1976 cuts the heart out of tax shelter investments, particularly by the at risk limitations and the prohibition against prepaid interest deductions. In sum, Congress has substantially completed its expressed aim of closing so-called tax loopholes allegedly available to the rich. With the virtual elimination of tax shelters as a viable tax deferral mechanism tax advisors must look more to the benefits of current and deferred compensation and the careful utilization of qualified pension and profit-sharing plans.