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THE TAX SHELTER: A REAPPRAISAL

by Fred A. Little and Fred Drasner*

INTRODUCTION

The tax shelter industry appears to have arrived at a temporary if uneasy truce with the several regulatory authorities. The dialogue to date has been intense, and at times heated. It appears fitting at this point to step back and assess what has gone before and to speculate on the future. This assessment is designed to stress the practical and, as will be apparent, the views expressed reflect the experience of the authors and, of necessity, are subjective. The focus is on regulation under the federal securities acts and the Internal Revenue Code. Tax and securities considerations are interwoven in this article in the same manner as they are in the typical tax shelter investment.

TAX SHELTERS

In order to place tax shelter investments in context, some introductory observations and a brief review of tax shelters are in order.

Attributes of a Tax Shelter

Although appearing in many forms, virtually all syndicated "tax shelter" investments are offered to investors by documents, often unread or unreadable, termed a "prospectus," an "offering circular" or a "private placement memorandum." These investments are carefully structured to distort taxable income.

In general, a tax shelter investment will have three principal tax characteristics. First, it will seek to generate losses which

1. The phrase "tax shelter" is a shorthand reference to those investments, particularly limited partnerships, in which tax attributes play a significant role.
2. All references in this article to the INTERNAL REVENUE CODE OF 1954 will be referred to by section number only.
3. The annual losses generated by tax shelter investments are not, typically, losses in an economic sense. That is, the taxpayer's net worth has not been reduced by the parting with something of value. These losses, to use a phrase adopted by the House of Representatives, in the Tax Reform Act of 1975, H.R. 10612, 94th Cong., 1st Sess. (1975), are "artificial losses"; non-economic losses created by certain accounting techniques. Under certain circumstances, these artificial losses can and
may be used by an investor not only to offset income from the
tax shelter investment but also other income derived from his
trade, business or profession. Second, it will have the potential
to allow for the recapture of those losses, either in whole or in
part, as capital gain, upon disposition of the investment. Third,
it will "leverage," by borrowing money in order to increase the
amount of the losses generated substantially in excess of the
investor's actual cash payment for the investment.

The generation of losses usually requires an election to
report income for federal income tax purposes on the cash
method of accounting. Under this method, subject to certain
exceptions, income is reported when received and expenses are
deducted when paid. The losses, which provide the "shelter" ele-
ment of the investment, are produced by accelerating the deduc-
tion of expenses into the early years of the investment, when
there is little or no income, rather than matching those deduc-
tions against income from the investment as it is earned. The
result of this acceleration of deductions is that instead of a uni-
form level of deductions tending to produce a more or less
uniform level of income or loss realization from the investment,
losses are increased in the early years with a resulting increase
in income in the later years. Assuming a constant tax rate, the
acceleration of deductions in the early years will result in a
deferral rather than a reduction or elimination of tax; the larger
losses (and concomitant reduction of tax liability) in those years
are followed by a correspondingly larger income and tax liabil-
ity in the later years. The overall effect is of an interest-free
loan from the federal government in the amount of the tax
defered, repaid through the higher taxes in the later years.

Although an interest-free loan from the federal government
may be a windfall, avoiding repayment of all or a portion of the
loan, which may be achieved by disposing of the investment, is a
bonanza. While the early losses may, in effect, have to be
reported as income upon disposition, in most cases it is possible
to have all or a portion of that income treated as capital gain.
The result is as if a portion of the loan were forgiven because
the losses of the early years reduced income which would have
been taxed at ordinary income rates, whereas the income upon
disposition is taxed, either in whole or in part, at the more favor-
able capital gain rates. The forgiveness may be measured by

do turn into economic losses when a tax shelter fails. For an excellent
article discussing the day of reckoning for an investor in a collapsing
tax shelter investment see Ginsburg, The Leaky Tax Shelter, 53 Taxes
719 (1975).

4. For example, a taxpayer in the 50% bracket who receives $50,000
of ordinary losses has reduced his tax liability by $25,000. If upon dis-
the difference between the ordinary income tax rates in the year of the losses and the capital gain rates in the year of disposition. This so-called "conversion" of ordinary income to capital gain is possible because in the usual case the investment is a capital asset in the hands of the investor which gives rise to capital gain upon its disposal.

The third characteristic, leveraging, is the use of borrowed money in the investment. In simplest terms, borrowed funds are treated, for tax purposes, as an investor's own funds and, therefore, may be used to maximize deferral by incurring deductible expenses in excess of the investor's actual cash investment.

In certain cases, the losses generated by expending borrowed money can produce a first year tax-saving in an amount equal to an investor's actual cash investment. This can be best illustrated by a simple example. Assume A, a taxpayer in the 50% income tax bracket acquires an investment for cash of $100,000 and a $900,000 bank loan. A is treated for tax purposes as having invested $1,000,000 in the investment. If deductible expenses of 20% of the investment are accelerated into the first year, A receives a $200,000 reduction in income which correspondingly reduces his tax liability by $100,000—the entire amount of his actual cash investment. Thus, with the repayment of that tax liability deferred until a future date, A has financed the entire investment by means of a $900,000 loan from his bank and $100,000 loan from the federal government. The federal government, being a much more liberal lender than the bank, has made its loan interest-free. A is now able to make another investment with his original $100,000 of cash. This result is the same even if the $900,000 loan from the bank was secured only by the investment property purchased and was without any personal liability on the part of A.

position of his investment he recognizes $50,000 of capital gain, he will pay only $12,500 in tax (disregarding for the sake of illustration the effect, if any, of the minimum tax imposed by § 56 of the Code). This produces a permanent forgiveness of $12,500 in tax.

In many instances, the Code has dealt with this situation by requiring all or a portion of the gain on a sale or other disposition to be treated as ordinary income rather than capital gain, to the extent of certain deductions previously taken. See, e.g., §§ 1245 and 1250 of the Code. This is what is referred to as "recapture." The several recapture rules only prevent the conversion of ordinary income to capital gain; they have no effect on the deferral. Additionally, these recapture rules do not apply to all tax shelter investments.

5. Section 1221.
6. This gain is subject, of course, to any applicable recapture rules. See note 3 supra.
The Limited Partnership

Most, if not all, tax shelter investments offered either through public offerings or private placements are in the form of limited partnership interests. A limited partnership, which meets certain requirements, is subject to the partnership rules of the Code. In general, a partnership is not a tax-paying entity. The individual partners are taxed currently on their share of partnership income and gains and may deduct their share of partnership losses to the extent of the basis of their partnership interest.

An investor's basis in a limited partnership interest generally includes his actual cash investment plus his share of the liabilities of the partnership. A limited partner may include in the basis of his partnership interest his share of non-recourse liabilities of the partnership even though he is not personally liable for such liabilities. This addition of non-recourse liabilities to basis makes the limited partnership particularly attractive because by the use of non-recourse financing an investor may substantially increase the tax basis of his investment, allowing him to claim deductions in excess of his cash investment, while limiting his liability for debts or claims against the limited partnership to the amount of his actual cash investment. The combination of the ability to pass losses through the limited partnership to the partners, the increase in the partners' basis for non-recourse debt and the limitation of liability to the partners' actual cash investment are primary reasons for the popularity of the limited partnership as a tax shelter investment vehicle.

The Tax Shelter “Product”

The investment media of the tax shelters span a multiplicity of diverse products and industries. Indeed, the only apparent limitation of the types of available tax shelter investments is the outer reaches of the imagination of tax lawyers and entrepreneurs. However, over the years, these investments have tended to be concentrated in real estate, farming, oil and gas drilling, equipment leasing, motion pictures and professional sports franchises—the areas presently receiving the most legislative attention. A review of the intricacies of each of the above areas is beyond the scope of this article; suffice it to say that each of the above, in its own inimitable way, accomplishes, with varying degrees of success and risk, the production of accelerated

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8. Section 752; Treas. Reg. § 1.752-1(e).

9. H.R. 10612, 94th Cong., 1st Sess. (1975), the Tax Reform Act of 1975, as passed by the House of Representatives on December 4, 1975, contained provisions which would substantially curtail or eliminate the tax advantages presently enjoyed in these areas.
losses, leveraging, and bears a potential for conversion of ordinary income to capital gain.\textsuperscript{10}

10. The following tabular summary of the principal tax shelter producing elements is taken from Staff of the Joint Comm. on Internal Revenue Taxation, 94th Cong., 2d Sess., Overview of Tax Shelters (Comm. Print Sept. 1975) [hereinafter Tax Shelters].

<table>
<thead>
<tr>
<th>Specialized investment area</th>
<th>Key shelter-producing deductions or other benefit</th>
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<tbody>
<tr>
<td><strong>A. Real Estate</strong></td>
<td></td>
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</table>
  b. Construction period taxes.  
  c. Accelerated depreciation.  
  d. Capital gain on sale. |
| 2. Land.                   | a. Current expensing of taxes, interest and certain other land development costs.  
  b. Capital gain on sale. |
| 3. Rehabilitation of low-income rental housing. | a. 60 month depreciation.  
  b. Capital gain on sale. |
| **B. Farming**             |                                               |
| 1. Cattle feeding.         | a. Feed costs (including pre-paid feed costs).  
  b. Other direct costs of fattening the animals. |
| 2. Cattle breeding (also breeding other kinds of livestock such as horses, mink, hogs, etc.) | a. Feed and other raising expenses (including breeding fees).  
  b. Accelerated depreciation of purchased animals.  
  c. Additional first year depreciation.  
  d. Investment credit (except on horses).  
  e. Capital gain on sale. |
| 3. Raising certain vegetables. | Expensing of growing costs, or plants. |
  b. Raising costs (including feed). |
| 5. Agricultural crops, vineyards, fruit orchards, Christmas trees.\textsuperscript{*} | a. Development and raising costs.  
  b. Accelerated depreciation on underlying grove (after crop matures).  
  c. Investment credit.  
  d. Capital gain on sale. |
| \* Citrus and almond grove costs must be capitalized (§ 278). |
  b. Stud fees.  
  c. Capital gain on sale. |
| **C. Oil and gas drilling** |                                               |
| (e.g., computers, airplanes, ocean-going vessels, railroad cars, CATV systems, etc.) | a. Intangible drilling costs.  
  b. Capital gain on sale. |
| **D. Equipment leases**    |                                               |
| (e.g., computers, airplanes, ocean-going vessels, railroad cars, CATV systems, etc.) | a. Accelerated depreciation or 5 year amortization.  
  b. First-year “bonus” depreciation.  
  c. Investment credit (corporate lessors only). |
| **E. Motion pictures**     |                                               |
  b. Investment credit. |
Public and Private Tax Shelters

The terms “public” and “private” often tend to blur when used to categorize tax shelter investments. In simplistic terms, a public offering is one which is registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933\textsuperscript{11} whereas a private offering is exempt from registration under Section 4(2) of the 1933 Act.\textsuperscript{12} A substantial portion of SEC registered tax shelter offerings, however, in fact partakes of the attributes of a private offering since they are directed to a relatively limited number of sophisticated and affluent investors. Registration under the 1933 Act is required because the number of purchasers exceeds the traditional or statutory norms.\textsuperscript{13} It is questionable whether as a matter of policy these quasi-public offerings should be cast in the mold of the traditional registration form without regard to their particular characteristics. To date, the SEC and the other regulators have not generally focused upon the differences among the public, the quasi-public and the true private offering. This undifferentiated approach, the authors believe, has accounted for recurring disclosure problems for the tax shelter.\textsuperscript{14}

Regulation of the Tax Shelter Offering

A typical tax shelter offering is subject to a multiplicity of securities and related regulation both on a federal and state level. A multi-state public offering will be subject to registration under

<table>
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<tr>
<th>2.</th>
<th>Production of a picture.</th>
<th>Expensing of production costs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>F.</td>
<td>Professional sports franchises</td>
<td>a. Rapid depreciation of player contracts.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b. Payroll and other operating costs.</td>
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<tr>
<td></td>
<td></td>
<td>c. Capital gains.</td>
</tr>
<tr>
<td>G.</td>
<td>Deductions available generally</td>
<td>a. Interest on borrowed funds used to finance costs of acquiring the investment and to pay some of the deductible expenses.</td>
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<tr>
<td></td>
<td></td>
<td>b. Real estate, sales and use taxes.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>c. Various prepaid expense items.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>d. Miscellaneous commissions, fees for professional services, etc.</td>
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\textsuperscript{11} 15 U.S.C. § 77(a) et seq. (1970) [hereinafter the 1933 Act].
\textsuperscript{12} Id. § 77(d)(2). The exemption is intended for a limited number of knowledgeable and sophisticated investors who acquire the securities for investment and not public resale. Rule 146 under the 1933 Act provides a safe harbor for private offerings which meet certain tests.
\textsuperscript{13} See id. § 77(d) et seq. The sections do not contain a numerical limitation on offerees or purchasers. Rule 146 permits sales to be made to a maximum of 35 qualified purchasers, not including purchasers of securities in an aggregate amount of $150,000, or more.
\textsuperscript{14} For example, financial projections and hypothetical income tax assumptions are frequently contained in private placement memoranda but, in general, are not permitted in SEC prospectuses.
the 1933 Act, as well as to qualification under the securities or blue sky laws of the various jurisdictions in which the offering is made. The SEC recently has adopted prospectus disclosure guidelines for real estate tax shelter offerings which administratively have been applied to tax shelter offerings generally. Many of the states have adopted rules and administrative policies directed at the tax shelter. California, in particular, has been a leader in following a combined regulatory and disclosure approach which takes into account the unique attributes of the tax shelter.

The seller of the tax shelter investment, as well as selling practices, also is subject to SEC regulation under the Securities and Exchange Act of 1934, the Investment Advisers Act of 1940 and comparable regulation under the state securities laws. The National Association of Securities Dealers, Inc. (NASD) has proposed rules bearing on the sale of tax shelters and the Federal Reserve Board has an interpretation relating to the sale of tax shelters on a deferred payment arrangement.

Even a private tax shelter offering, which is exempt from

15. Guide No. 60 to the Guides for Preparation and Filing of Registration Statements, CCH Fed. Sec. L. REP. ¶ 3820.
17. For example, the California prospectus guidelines (a) require projections in the case of specified property offerings, (b) prohibit specific conflicts of interest, (c) limit the amount and terms of payment of compensation, and (d) require certain democracy rights and safeguards for limited partners. However, the guidelines specifically provide that where they conflict with SEC requirements, the guidelines will not apply. Subarticle 10, California Regulations, BLUE SKY L. REP. ¶ 8626.
18. Section 15 of the Securities Exchange Act of 1934, 15 U.S.C. § 78o (1970), requires registration and regulates the selling practices of all brokers and dealers. A broker is defined as “any person engaged in the business of effecting transactions in securities for the account of others...” Securities Exchange Act of 1934 § 3a(4), 15 U.S.C. § 78(c) (a) (4) (1970), whereas a dealer is defined as “any person engaged in the business of buying and selling securities for his own account... but not as part of a regular business.” Id. § 3a(5), § 78(c) (a) (4).
19. Section 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-(11) (1970), defines an investment adviser to be “any person who, for compensation, engages in the business of advising others... as to securities generally excluding certain persons such as banks, lawyers who perform incidental advisory functions and broker-dealers.” Legislative proposals recently submitted by the SEC would, among other things, authorize the SEC to determine whether additional persons should be included within the above definition or whether the definitional exclusions should be narrowed. Investment Advisers Act Release No. 491 (Dec. 15, 1975).
21. Under a 1972 interpretation of the Federal Reserve Board a sale by a “broker-dealer” of a tax shelter program providing for installment payments constitutes “arranging for the extension of credit to purchase or carry a security in violation of the prohibitions of Regulation T.” See Interpretation of Board of Governors of Federal Reserve System (March 24, 1972).
registration under the 1933 Act, remains subject to substantial indirect regulation by the SEC\textsuperscript{22} and state authorities.

Finally, all tax shelter offerings, both public and private, are subject to the anti-fraud rules of the federal and state securities acts.\textsuperscript{23} In the late 1960's, when the regulators became familiar with the peculiarities of the tax shelter, this multiplicity of regulation was both bewildering and often inconsistent.\textsuperscript{24} In recent years, however, the regulators appear to have reached a general agreement on the form and content of tax shelter disclosure.\textsuperscript{25} Nevertheless, as described in a subsequent part of this article, uncertainties remain in the areas of post-sale disclosure and regulation of the selling process.

**Factors Accounting for the Decline of the Tax Shelter**

The decline in tax shelter offerings in recent years\textsuperscript{26} results from the coincidence of a number of factors which, to a large extent, are interrelated. Depressed economic conditions, particularly in real estate, a favorite form of the tax shelter investment, have accounted in large part for the decline. Questionable business practices and scandals have contributed. Additionally, an increasing awareness of the inherent risks of the tax shelter investment on the part of securities regulators and tax authorities undoubtedly has had an adverse impact. Finally, there is the shock, experienced by many investors caught in a failing tax shelter, of having a large amount of deferred income arrive from their investment unaccompanied by the slightest bit of cash.

**Increased Regulatory Concern and Expertise**

The sudden popularity of the public tax shelter in the mid-

\textsuperscript{22} Compliance with the private offering exemption and Rule 146 has resulted in documentation approaching that of a registration statement. A typical 146 offering involves a private placement memorandum, offeree suitability check lists, offeree representations and an investment letter. A certain number of the state securities laws require the filing of periodic reports evidencing compliance with the exemption.


\textsuperscript{24} See Little and Smith, Public Limited Partnerships, 11 Rev. of Sec. Reg. 1907 (June 19, 1973).

\textsuperscript{25} The prospectus has become a stylized document with the forepart serving as a summary and a preview of the more lengthy descriptions which follow. Visual and graphic aids are liberally used to point up the more significant disclosures.

\textsuperscript{26} According to the National Association of Securities Dealers, the dollar volume of real estate programs filed for 1974 was $521,457,932, compared with annual totals of $1,910,662,045, for 1972 and $849,436,164 for 1973. In 1973, 67 registration statements relating to the public offering of interests in limited partnerships were filed with the SEC compared with 39 in 1974. See Milton and Mooney, *The Rise and Fall of Public Real Estate Tax Shelters*, 4 J. Real Estate Taxation 463 (1975).
to-late 1960's caused increasing concern among the federal and state regulators. As the regulators acquired greater expertise, business practices in the tax shelter industry, which previously were largely unexamined, received greater scrutiny. This heightened regulatory concern brought into focus the distinctive attributes of the tax shelter offering.

The typical tax shelter offering involves prospective operations. The limited partnership customarily is formed to acquire real property, cattle or other tangible assets, and the prospectus, on the offering date, is rather a preview of what is to come rather than a report of what has been. Once the offering is sold, the partnership's securities are not traded on any exchange and the partnership often is not a "reporting company."27 In short, the partnership disappears from public view only to emerge in the abbreviated form of a "track record" in a later prospectus if the general partner has subsequent public offerings.28 Finally, the traditional ongoing monitoring devices inherent in the trading market, as well as industry supervision, do not exist for the tax shelter investment.

Tax shelters, moreover, are inherently complicated "merchandise." They involve an interweaving of federal and state taxation, partnership and tangible property law upon a hybrid of both corporate and traditional partnership attributes. Self-dealing and conflicts of interest are prevalent in the tax shelter. Moreover, there is rarely an independent third party, much less the existence of an adversary relationship, present in the typical tax shelter. The general partner, who is analogous to corporate management, rarely includes limited partner investors or public representatives. Perhaps in part because of these structural attributes of the tax shelter the 1970's have experienced a significant upsurge in SEC enforcement proceedings and private litigation involving tax shelters.

Tax Uncertainties

Predictably, the Commissioner of Internal Revenue appears to be less than overjoyed with the prospect of postponing, for

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27. Section 12(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l(g) (1970), which creates the reporting obligation, only applies to issuers with $1 million or more of total assets and 500 or more equity investors. Issuers who are not subject to § 12(g) but who have had an effective registration statement under the 1933 Act must file certain reports only for those years in which there are more than 300 shareholders as of the last day of the preceding year.

28. The SEC staff customarily requires selective statistical data on prior limited partnerships sponsored by the general partner provided the prior partnerships are comparable to the one in question. The extent of comparability among offerings tends to become highly subjective when viewed in the light of such factors as proximity on time, relative size and differences in tax benefits.
years, the collection of income taxes which would be currently collectible but for a mismatching of deductions and income. Evidence of the Commissioner's displeasure can be found periodically in administrative pronouncements and court decisions which, among other things, serve to complicate life for tax shelter syndicators and their counsel. A prime area of the Commissioner's concern has been the classification of partnerships for tax purposes.

Characterization of a limited partnership as such for tax purposes is essential for partnership losses to flow through to the investors. Failure to achieve or maintain recognition as a partnership results in taxation as a corporation, which prevents flow-through of losses and causes double taxation of income—one at the corporation level and again, as a dividend, when distributed to investors. For an investor, failure of the entity to qualify as a partnership is a tax and economic disaster.

The battle for partnership status revolves around sections 7701(a)(2) and 7701(a)(3) of the Code and the regulations promulgated thereunder. Under Regulation § 301.7701-2(a)(3), in order to qualify for partnership tax treatment, a limited partnership generally must possess no more than two of the following four characteristics: (a) centralization of management, (b) continuity of life, (c) free transferability of interests and (d) limited liability. Possession of three of the above characteristics means treatment as a corporation, with the rather displeasing results outlined above. Under the regulations standing alone, most limited partnerships would have little trouble establishing the lack of at least two of the four characteristics.

Continuity of life is missing if the partnership is formed pursuant to a state statute corresponding to the Uniform Limited Partnership Act; if the bankruptcy, dissolution, retirement, resignation, death, insanity or expulsion of a general partner causes a dissolution of the partnership (even if the partnership would not be dissolved if the remaining partners agree to continue); or if a general partner has the power at any time to dissolve the partnership.

Free transferability of interests may be eliminated by requiring prior consent by the general partners to a transfer. A limited

29. See, e.g., Internal Revenue Service, News Release No. 1532 (Nov. 28, 1975), in which the service announced it has been reconsidering the federal income tax consequences of movie tax shelters involving the use of production service partnerships. The release states that, "[t]axpayers should not infer from any recent articles in tax periodicals that IRS is now issuing letter rulings holding that the adoption of the cash method of reporting income and expenses is an accounting method clearly reflecting income by production-service partnerships engaged in making motion pictures."

partner may be allowed to assign his profits and losses from the partnership without detrimental effect to the free transferability characteristic. These provisions are typically found in most tax shelter limited partnership agreements.

The characteristic of limited liability is absent if a general partner has substantial assets which can be reached by creditors or if a general partner is not a "dummy" acting as agent of the limited partners. If substantially all of the interests in the limited partnership are owned by the limited partners, centralization of management will exist. Therefore, unless the general partners own a substantial interest in the limited partnership, which is not the usual case, centralization of management will be present.

While lack of two of the above characteristics should normally yield partnership status under the regulations, the Internal Revenue Service (IRS), has erected additional hurdles before it confers its blessing. The IRS will not issue an advance ruling that a limited partnership is a partnership for tax purposes unless the conditions imposed by Revenue Procedures 72-13 and 74-17 are met.

Revenue Procedure 72-13 deals with the case of a corporation serving as sole general partner of a limited partnership. Numerous tax shelter limited partnerships are formed with a corporation as sole general partner as a means for eliminating individual personal liability. Revenue Procedure 72-13 sets forth certain net worth requirements of a sole corporate general partner which must be met before the IRS will consider an advance ruling request. If the corporate general partner has an interest in only one limited partnership and if the capital contributions to that partnership are less than $1,666,667, the net worth of the corporate general partner must be at least 15 percent of the capital contributions. If the capital contributions are between $1,666,667 and $2,500,000, the net worth of the corporate general partner must be at least $250,000. If the capital contributions exceed $2,500,000, the net worth of the corporate general partner must be 10 percent of the capital contributions. If the corporate general partner has interests in more than one limited partnership, the above tests will be applied separately as to each limited

32. Treas. Reg. § 301.7701-2(d).
33. Treas. Reg. § 301.7701-2(c).
34. In Tax Shelters, supra note 10, it is indicated that if the general partners own, in the aggregate, a twenty percent or greater interest in the partnership capital, obtained through capital contributions, the characteristic of centralization of management will be treated as being absent by the Internal Revenue Service.
partnership and the net worth of the corporate general partner must be at least as great as the sum of the net worth requirements for each individual partnership. Additionally, the limited partners may not own, in the aggregate, more than 20 percent of the stock of the general partner and its affiliates.

The net worth tests set forth in Revenue Procedure 72-13 are concerned with the characteristic of limited liability. As noted above, limited liability is missing if the general partner has substantial assets which may be reached by creditors. Arguably, failure to comply with Revenue Procedure 72-13, although precluding the possibility of receiving an advance ruling from the IRS, should still permit recognition as a partnership under the regulations if two other characteristics are missing. A much broader brush stroke is painted by Revenue Procedure 74-17.

In Revenue Procedure 74-17, the IRS announced that it will not issue an advance ruling where factual questions are raised as to whether the principal purpose of the limited partnership's formation is the reduction of federal taxes. In order for the IRS to consider the issuance of an advance ruling that a limited partnership will be characterized as such, certain conditions must be met as follows:

1. The interests of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit must be equal to at least one percent of each such item at all times during the existence of the partnership;
2. the aggregate deductions to be claimed by the partners in the first two years must not exceed the amount of equity capital invested in the partnership; and
3. any creditor who makes a non-recourse loan must not have or acquire at any time, as a result of that loan, an interest in the profits, capital or property of the partnership other than as a secured creditor.

These Revenue Procedures have been a burr under the saddle of the hard riding tax shelter promoters and have removed some of the aid and comfort given by the regulations. Of course, the IRS is free to set forth conditions for the issuance of advance rulings. These conditions are couched in terms of procedure rather than substance. However, at times, procedural guidelines have a tendency to slip over the line to the audit side of the IRS as substantive rules and may be treated by an auditing revenue agent as commandments. Failure to comply with such guidelines may provoke a challenge to the partnership's characterization by the IRS. The possibility of such a challenge

is not remote since a number of tax shelter partnerships do not rely on advance rulings but instead rely on the opinion of tax counsel that the partnership qualifies as such. The absence of a ruling or the failure to meet ruling guidelines must be prominently disclosed in SEC prospectuses as a risk factor.

Another measure of potential uncertainty has been added by two recent cases decided by the Tax Court and the Court of Claims concerning the mechanics of applying the regulations' four-factor test for determining whether a limited partnership is taxable as a corporation. In Philip G. Larson, the Tax Court reviewed the major characteristics of the limited partnership involved and observed that in the light most favorable to the taxpayers the question would be a "standoff." As noted above, the regulations tend to indicate that a standoff should normally result in partnership status, since two of the four characteristics would be absent. Nonetheless, the court held that the limited partnership in question was taxable as a corporation, noting that the manner in which shares in the partnership were sold, and the relationship of the general and limited partners to one another made the limited partnership involved more akin to a corporation than a partnership.

In Zuckman v. U.S., decided by the Court of Claims on a motion for summary judgment, the court examined the four characteristics set forth in the regulation, found all four to be lacking, and held the partnership not to be taxable as a corporation. The court indicated that in general, absence of only two characteristics is necessary for partnership status. The court warned, however, that the mere absence of two of the four major characteristics will not entitle the taxpayer to prevail in every conceivable situation if other characteristics may be found which are significant in determining classification.

On November 7, 1975, the opinion in Larson was withdrawn by the Tax Court following a motion for reconsideration filed by the taxpayers. On April 27, 1976, the Tax Court issued a new opinion in Larson which, contrary to its withdrawn opinion, held the limited partnership taxable as a partnership. The court found the four characteristics in the regulations to be in equi-

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38. There are any number of reasons why an advance ruling would not be requested. Obviously, inability to meet the conditions of Rev. Proc. 72-13 and 74-17 would be one reason. In addition, time pressures, expense involved, protection of sensitive information, risk of an adverse ruling where similar previous transactions have been completed without a ruling and numerous other reasons may dictate that an advance ruling not be sought.
39. 65 T.C. No. 10 (1975).
40. See text at notes 29-36 supra.
41. Ct. Cl. No. 798-71 (1975); 75-2 U.S. TAX CAS., ¶ 9778.
42. 66 T.C. No. 21 (1976).
The court noted that if it were free to weigh all characteristics as it deemed appropriate, it would have held the limited partnership taxable as a corporation. The court held that the thrust of regulations and relevant precedent is that all factors must be given equal weight, with an actual majority necessary for a partnership to be taxed as a corporation.

Although the courts thus appear, for the time being, not to be very hostile on the characterization question, it is clear that the IRS both through rulings and on audit is taking an increasingly active role in challenging tax shelter investments. In absence of an advance ruling the initial status of the partnership cannot be stated with certainty and may ultimately require extensive litigation to defend the claiming of partnership benefits. Even if an advance ruling is obtained Revenue Procedures 72-13 and 74-17 impose criteria which must be met on a continuing basis in the future and the failure to meet those criteria in any particular year cancels the protection of the advance ruling.

The principal tax uncertainty, however, may rest with Congress rather than the IRS. The Tax Reform Act of 1975, as passed by the House of Representatives on December 4, 1975, contains numerous provisions designed to restrict substantially or eliminate completely the benefits of tax shelters. Although it failed to clear the Senate in 1975, the legislation will probably reappear in some form during 1976.

The principal change made by the new legislation is the so-called “limitation on artificial losses” (LAL) provision. In general, LAL would restrict the extent to which losses arising from accelerated deductions may be used to offset income unre-

43. See, e.g., Rev. Rul. 75-214, 1975 INT. REV. BULL. No. 23, at 9, (payments to general partners for services rendered in organizing and syndicating a partnership are capital expenditures which are not currently deductible); Rev. Proc. 74-22, 1974-2 Cum. Bull. 476 (no advance rulings as to whether principal purpose of a special allocation is the avoidance or evasion of federal income tax); Rev. Rul. 72-135, 1972-1 Cum. Bull. 200 (non-recourse loan from general partner to a limited partner or the partnership is a contribution to capital and not a loan thereby precluding an increase in the basis of the limited partner's interest); Rev. Rul. 72-350, 1972-2 Cum. Bull. 394, (non-recourse loan by a non-partner convertible into a partnership interest was not a loan but, in reality, equity capital); Rev. Rul. 75-152, 1975 Intr. Rev. Bull. No. 17, at 15, (limiting prepaid feed deductions); IRS News Release No. 1532, supra note 29. See also IRS Tax Shelter Training Manual (Training 3147-01 (2-76)), 19 CCH 1976 STAND. FED. TAX REP. (April 1976). (Therein, the IRS classes shelters as "Good Shelters", "Problem Shelters" and "Abusive Shelters" setting forth the attributes of each class. It is not beyond the realm of possibility that this manual could become a standard reference work for tax shelter investors seeking to evaluate the tax risks of a particular investment. Query, in view of its subjectivity, whether the classification of an investment under the Manual's guidelines is a material item requiring disclosure in the tax section of a tax shelter prospectus).

related to the investment. Accelerated deductions in excess of income from the investment would be deferred in a special account to later years when they could be used only to offset income from the investment, or in certain cases other similar investments. This provision in effect corrects the mismatching of deductions and income by requiring the deductions to be offset against income from the investment as it is earned. LAL would be applicable to investments in real estate, farm operations, oil and gas, movies, equipment leasing and sports franchises, with some differences in the precise method of application. In addition to LAL, the legislation contains other provisions designed to place limitations on the accelerated deduction of certain expenses, on the deductibility of certain expenses, on the ability to leverage, and on the conversion of ordinary income to capital gain.46

The overall effect of the changes proposed by the legislation would be virtual elimination of tax shelter investments in their present form. While it would still be possible to obtain tax benefits from certain types of investments, the broadly based market for tax shelter investments would certainly be substantially reduced if not altogether eliminated.

At this writing the future of LAL remains obscure. Tentative decisions announced by the Senate Finance Committee would remove real estate, oil and gas, farm operations, movie investments, equipment leasing and sports franchises from the LAL provisions passed by the House. Under the Senate Committee's decisions certain interest and depreciation incurred during

45. *Id.* § 201 (Recapture of all depreciation in excess of straight line on residential real estate except federal, state or local subsidized low-income housing (depreciation in excess of straight line taken after December 31, 1969 on non-residential real estate is presently subject to complete recapture under § 1250(a)(1) of the Code.)); Section 202 (Gain from the disposition of an interest in oil or gas properties or an interest in an oil or gas venture would be treated as ordinary income to the extent of the excess of the intangible drilling deductions taken over the deductions that would have been allowed had those expenses been capitalized); Section 205 (Taxpayers on cash method of accounting would be permitted to deduct prepayment of interest only in the period to which it relates under an accrual method of accounting. Points would have to be amortized over the term of the loan with an exception for home purchasers). Section 206 (The deduction of non-business interest, including investment interest, would be limited to $12,000 per year). Section 207 (The deduction of losses would be limited to the amount the taxpayer had "at risk" in movie productions, livestock and certain crops. This would exclude all non-recourse financing). Section 208 (The deductions for intangible drilling and development costs would be limited to the amount the taxpayer had "at risk"). Section 209 (Presumption that not more than 50% of the cost of a sports franchise could be allocated to player contracts. Recapture of all depreciation to the extent of any gain on the sale of a player contract or sports enterprise). Section 210 (Limits the allocation of partnership items of income, gain, loss, deduction or credit and restricts the amount of additional first year depreciation that may be passed through to the partners).
construction of improvements on real estate would instead be subject to the minimum tax on tax preference items. Deductions for oil and gas, farm losses, movie investments and equipment leasing would generally be limited to the amount of capital at risk in such investments. New basis allocation and depreciation recapture rules would be made applicable to player contracts in sports franchises. If passed by the Senate, conflict between the above provisions and LAL would be resolved by conferees representing the House and Senate.

**FUTURE REGULATORY CONCERNS**

*Disclosure and the Prospective Prospectus*

The view has surfaced in SEC pronouncements that disclosure in and of itself is not sufficient for the tax shelter investment and that disclosure should be complemented or supplanted by regulatory legislation.\(^46\) In support of this view, the argument has been advanced that the disclosure-oriented remedies of the contingent liability disclosure or rescission are not responsive to the tax shelter.\(^47\) Further, the analogy has been drawn between the “blind pool”\(^48\) tax shelter and the mutual fund where, in both cases, investors entrust to management a liquid pool of assets for investment. The SEC implicitly appears to have rejected this analogy, at least temporarily, since proposed legislation affecting tax shelters has only extended regulation analogous to the Investment Company Act of 1940 to oil and gas investment vehicles, and the SEC staff instead has opted for disclosure guidelines.\(^49\) However, the regulatory approach contin-

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\(^46\) See statement of then SEC Chairman Garrett at Congressional hearing regarding the SEC's fiscal 1975 budget. See also 252 CCH SEC. REG. L. REP., A-10 (May 15, 1974).

\(^47\) In the event of a violation of the 1933 Act, the SEC staff frequently will require disclosure of a contingent liability. In order to avoid this disclosure, issuers often choose to offer rescission. Where a corporate general partner manages more than one partnership, the existence of a contingent liability may have significant federal income tax ramifications to the extent that the contingent liability may impair the fair market value of the general partner's net worth under the “safe harbor” guidelines contained in Rev. Proc. 72-13, supra note 35. A failure to comply with the safe harbor guidelines also may jeopardize the tax treatment accorded limited partners in partnerships unconnected with the violation. The rescission alternative raises equally serious problems. From a practical standpoint, rescission may be unrealistic, if not impossible, where partnership funds have been fully invested. To realize cash funds for rescission, the general partner may be forced to liquidate investments at distress prices. Furthermore, rescission could result in adverse tax consequences to the limited partners. Finally, should rescission be permitted against the partnership where the general partner's actions gave rise to the rescission?\(^48\) Referred to in regulatory parlance as a nonspecified program in which, on the offering date, less than a specified percentage of the net offering proceeds are allocable to specific purposes.

\(^49\) See note 15 supra.
Tax Shelters

ues to surface in SEC staff pronouncements to the effect that all pooled investment vehicles, including tax shelters, have attributes similar to investment companies and hence should be comparably regulated.\textsuperscript{50} Certain of the state blue sky authorities, on the other hand, have adopted a combination of regulation and disclosure. Traces of a regulatory approach, however, linger and may be expected to influence the SEC's treatment of tax shelters in the areas of conflicts of interest, the role and responsibilities of counsel, the role of the general partner, selling practices and post-sale disclosure.

Conflicts of Interest

Subtle conflicts of interest may be embedded in a partnership structure which, regardless of good faith, often are insoluble. For example, where an entity serves as general partner for several limited partnerships engaged in the same general business, conflicts among the partnerships may well arise as a result of competition for the purchase and sale of properties, services of the common general partner, and the obtaining of loans. The conflicts are intensified where the partnerships operate in the same business and geographical areas or where there are differing management compensation arrangements among the partnerships. Under these circumstances, it is anticipated that increased attention will be given by the SEC staff not only to the full disclosure of potential conflicts, but also to the requirement that the prospectus highlight in detail the specific procedures to be followed for resolving the conflicts.

The Role and Responsibilities of Counsel

The role and responsibilities of counsel have received increasing scrutiny of late by the SEC, the courts and legal writers.\textsuperscript{51} Since this subject has been dealt with comprehensively by other commentators, this article will focus briefly on the practical considerations confronting counsel in a tax shelter offering—what counsel in fact does and what he represents to the public that he does.

The duties and responsibilities of counsel may well depend upon whom counsel represents and the scope of his representation. A typical tax shelter offering may involve separate counsel for the partnership, the general partner, the underwriter

\textsuperscript{50} Remarks of Anne P. Jones, Director of the SEC's Division of Investment Management, reported at Standard & Poor, \textit{Securities Week} 2 (April 12, 1976).

or the seller, as well as the present or prospective limited partners. In addition, the functions of counsel may be confined to specific areas such as securities, tax considerations or general partnership law. The importance of representation and function is brought into sharper focus when the tax shelter comes under economic and resultant legal stress. Questions of the respective duties to the general partner and the limited partners as well as the question of attorney-client privilege may turn on who in fact is counsel's client and how this representation has been communicated to the limited partners.

Customarily SEC counsel for the partnership or the limited partners has discharged his agreed upon assignment upon termination of the offering. This leads to the question of who represents the limited partners on a continuing basis in the post-offering period. Counsel for the general partner, who is usually the only counsel on the scene, may encounter an irreconcilable conflict of interest in matters affecting the general partner and the limited partners. Where a conflict arises, it is often impractical to appoint counsel for the limited partners upon short notice. Furthermore, counsel often is understandably reluctant to represent, and charge, clients who have not selected him. The SEC staff on occasion has acted reluctantly as the representative of the limited partners or has resorted to the appointment of a trustee or a special fiscal agent.

The engagement letter, in which counsel seeks to define his role in a given transaction, is a relatively recent development, perhaps arising out of counsel's concern for articulating his role in response to auditors' letters. A typical engagement letter may treat, among other things: (a) the scope and duration of counsel's assignment; (b) the extent of counsel's due diligence and other specific functions; and (c) the persons to whom counsel owes a duty. While an engagement letter serves a useful function between counsel and his client, it is questionable, at best, whether such a letter can effectively define or limit the responsibilities or liabilities of counsel to third parties.

Typically, counsel in a tax shelter offering will perform a "due diligence" of the limited partnership and will furnish an opinion to his client. Due diligence procedures have been developed by law firms, often, it would appear, at the insistence

53. See, e.g., SEC Litigation Release No. 6112 (Oct. 26, 1973) where, upon petition of the SEC, a court-appointed special fiscal agent was authorized to exercise an oversight function for twenty-five separate limited partnerships.
of the SEC.\textsuperscript{55} It is doubtful, however, if there is any due diligence blueprint of universal applicability for all offerings. At best certain minimum standards and general observations appear of general applicability to the tax shelter investment:

(1) Of primary importance is a thorough knowledge of the limited partnership and the business in which it operates;

(2) The extent of physical verification depends upon the partnership's business. Differing procedures are warranted for a tangible, an intangible and a blind pool investment;

(3) Undue reliance upon paper procedures, such as questionnaires and memoranda, may tend, unconsciously, to act as a substitute for hard checking;

(4) Verification of client information with third parties, such as competitors, lenders, suppliers or customers may be advisable;

(5) Care should be exercised by counsel in delegation of due diligence functions to the independent due diligence expert or to the junior associate;

(6) Due diligence techniques such as tape recorded interviews and procedures manuals should not be indiscriminately used; and

(7) Due diligence on a continuing basis beyond the offering date may be advisable.

The typical tax shelter offering customarily involves an opinion of counsel as to the tax status of the partnership and the tax incidents of the offering and also may include an opinion as to the non-tax aspects. The non-tax opinion may be confined to the legality of the securities being issued or, in the event of an underwriting, may pass upon various matters relating to the disclosures in the offering documents. The tax opinion, however, is of critical importance.

In a public offering, the SEC Guides to Registration prescribe the tax disclosures required to be included in the prospectus. Customarily, the prospectus will recite that the disclosures are included upon the authority of a named law firm, or sometimes inside counsel. (Generally, accountants do not render opinions in public tax shelter filings.) Although offering documents used in a private offering usually contain a description of tax consequences, there is little uniformity of presentation. In the case of private offerings, it is not uncommon for the responsibility for determining the tax consequences to be shifted to an accountant or to the attorney representing the investors. In the latter case, the SEC has taken the position that

the tax adviser's clients must be advised of any compensation from the promoter to the tax adviser.\textsuperscript{56}

The rendering of tax shelter opinions raises peculiar problems, due to the following factors:

(1) Tax shelter offerings frequently are highly complex involving the shifting of losses and profits among numerous affiliated entities.

(2) There is a relative paucity of reliable case law in the tax shelter area. Much of the available precedent is derived from revenue rulings and revenue procedures which reflect a policy of "cracking down" on tax shelters. Substantial uncertainties, discussed above, exist as to: (a) partnership vs. association treatment, (b) non-recourse loans incurred for the purpose of increasing the basis of limited partners, (c) the deductibility of prepaid expenses, such as interest, cattle feed and intangible drilling costs, and (d) deductibility or capitalization and amortization for points, loan processing fees and loan commissions.

The most significant unresolved problems, however, go to the very essence of the opinion. In counsel's view, the opinion represents a statement of his best opinion on a legal question to which no definite answer is available. Additionally, counsel's opinion may, of necessity, assume that the partnership will continue to operate in the future with its present capital structure, methods of allocation and general partner's net worth. The investor, however, may tend to view the opinion as a guarantee that certain predictable tax consequences will flow from his investment. As a result, tax counsel may seek to qualify his opinion. This in turn raises the question of whether a qualified or hedged opinion protects counsel or whether such an opinion even constitutes an "opinion" as the term is commonly used.

Counsel's precise role in the offering often is largely unknown to the investor. Such time-honored phrases as "passing upon certain legal matters" or "passing upon matters under the Securities Act of 1933" are hardly descriptive of what the lawyer in fact does. It is at least arguable that the prospectus disclosure of counsel's role and responsibilities should be a mirror image of what he in fact does. Thus, the prospectus would indicate whether counsel participated broadly in the preparation of the entire registration statement or only a portion thereof, whether he was responsible for a specific area of expertise, and his responsibility as counsel for ongoing partnership operations.

\textit{Role of the General Partner}

In some cases, the general partner may serve as a syndicator-

\textsuperscript{56} SEC Litigation Release No. 5145 (August 26, 1971).
seller and thereafter as the manager of the partnership's affairs. On the other hand, the general partner or its corporate parent may sell or construct projects for the partnership, furnish substantial operating and financial guarantees to the partnership or agree to maintain a specified net worth for federal income tax purposes. In the former case, extensive disclosure of the business and financial condition of the general partner appears unwarranted and perhaps undesirable to the extent it may influence an investor to look unduly to the future involvement of the general partner in partnership affairs. In the latter case, however, extensive disclosure of the general partner may be advisable, particularly in the case of continuing investments by limited partners, since the financial viability of the partnership may depend largely on the well-being of the general partner. Expanded disclosure, for example, could include complete financial statements of the general partner and its parent, if any, together with disclosure of the general partner's obligations to contingent liabilities arising from other limited partnerships which the general partner manages. The extent to which the veil should be lifted on the general partner, however, does not submit to a mechanistic approach, but rather depends on the extent of the general partner's involvement, as a factual matter, in the affairs of a given partnership.

The Sale, the Seller, and Others

In the formative years, tax shelters were mainly sold on a private basis to wealthy investors. With the advent of the public tax shelter, the distribution pattern altered to include a broader cross section of both purchasers as well as sellers and their representatives. Although the SEC and the states have shown an increasing awareness of the special considerations involved in the distribution of public tax shelters, as yet no discernable public guidelines have been posted.

The SEC has sought to expand its jurisdiction over sellers of tax shelters through a broad interpretation of the Securities Exchange Act of 1934 definition of a "broker-dealer." Simply stated, the SEC staff seems to believe that the fact that at least one of the participants in the offering has a broker-dealer license at risk will ensure more benign selling practices. Recent interpretative letters indicate that the staff may be abandoning a distinction between primary engagement in securities as contrasted to real estate or other industry activities as the test of broker-dealer registration.57

57. A series of interpretative letters by the SEC's Division of Market Regulation indicates that the staff will not adopt a mechanistic approach in determining who is a broker-dealer in a tax shelter offering. Thus
The states and the SEC have stressed suitability considerations in viewing an offering. The underlying theory, particularly on the state level, seems to be that the more stringent the suitability requirements, the less the regulatory concern. More cynically stated, the financially fortunate should be afforded a greater opportunity to lose their investments than less affluent investors.

The NASD first sought in 1972 to regulate sellers of tax shelters indirectly by proposing that NASD members could only participate in the sale of tax shelters which met prescribed substantive conditions. This approach raised serious jurisdictional considerations to the extent it related to issuer rather than seller regulation. For this reason this approach was first questioned by the SEC and then temporarily abandoned. The authors understand that the NASD and the SEC have recently renewed a dialogue designed to accommodate their respective views.

The Seller

To fully understand the selling process, the participants must be identified. Public tax shelters customarily are sold either by traditional independent securities brokers and dealers or by employees of the general partner, the "syndicator-sponsor" in regulatory parlance. The independent securities broker will be contemporaneously selling differing and competing equity products with differing commission structures. He also knows that the sale of a tax shelter is a one-way trip, for there is no practical possibility of a commission on the resale of a limited partnership interest. Moreover, there is little likelihood that the broker will be hearing from his customer about the wisdom of his investment (at least prior to tax time) since, as noted, tax shelters

Factors considered in the case of a general partner include, the nature and extent of selling compensation; securities experience of management and employees; the relative amount and profitability of its securities and its other business; whether any registered broker-dealers are involved in the offering; and the frequency of its limited partnership offerings. See, e.g., SEC Staff Interpretative Letters Regarding Coquena Oil Corp., Jan. 23, 1974, and Montana Commodity Fund, Nov. 29, 1973. The staff, however, appears to permit "one bite of the apple" and allows one limited partnership offering without broker-dealer registration. See SEC Staff Interpretative Letter Regarding Amvest, Inc., Sept. 26, 1975. On broker-dealer registration for the real estate syndicator generally, see Wertheimer & Mark, Special Problems of Unregistered Real Estate Securities, 22 U.C.L.A. L. Rev. 1219, 1225-29 (1975) and Hacker & Rotunda, Sponsors of Real Estate Partnerships as Brokers and Investment Advisers, 23 U.C.L.A. L. Rev. 322 (1975).

58. NASD, proposed Article III, Section 23 of Rules of Fair Practice (May, 1972).
Tend to disappear from the public eye after the sale, unlike the traditional equity security which is as close as the back pages of *The Wall Street Journal*. Apart from possible inherent, and largely unavoidable sales conflicts, questionable selling practices have occurred from time to time in the tax shelter industry.\(^{60}\)

The captive salesman raises problems that are the mirror image of those of the securities salesman. While experienced in the tax shelter industry, the captive salesman is frequently relatively unsophisticated in securities concepts. Often his financial well-being may be dependent upon sales from a particular program, such as for example, where a contractor-developer's building profits are directly related to the amount of equity funds raised for a given partnership in which it is the general partner.

**The Intermediary**

Intermediaries between the seller and the buyer appear in many forms, from tax shelter specialists to lawyers, to accountants to financial consultants. Tax shelter departments of brokerage concerns and of major commercial banks also may perform this function generally for their nondiscretionary clients. These intermediaries are largely unregulated except to the extent that they may be indirectly regulated in other facets of their activity as investment advisers or broker-dealers. Moreover, their presence is often unknown to the public since they are not identified in the prospectus as “underwriters” or “brokers” and, therefore, may be in a position to claim they are not subject to §11 liabilities under the 1933 Act. While, on balance, intermediaries perform a valuable service for their clients, and to the tax shelter industry, in isolated instances their independence has been questionable.

**The Buyer**

Typical purchasers of tax shelter offerings are wealthy investors who need year-end tax shelters and who base investment decisions upon the expected year-end “write off.” The particular investment vehicle is selected by the investor's investment adviser who typically meets the management, analyzes the prospectus and, on occasion, even performs due diligence or

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60. These have included reciprocal or back-scratching arrangements whereby hidden selling commissions are paid in the form of real estate and insurance commissions, and inducements, such as entertainment and travel, in return for sales. For example, the author understands that the SEC staff has reason to believe that selling commissions were rebated to a law firm in the form of substantial legal fees for alleged blue sky services.
“kicks the tires.” A hopefully atypical investor of this type is comedian Buddy Hackett who, when asked why he purchased $200,000 of a tax shelter sponsored by Home-Stake Production Co., said he “hadn’t the vaguest idea . . . I just tell jokes. My lawyers and accountants look into these things and explain them to me in baby talk. If it sounded okay, we’d go ahead.”61

In recent years, the small investor entered the tax shelter market in increasing numbers. This investor generally does not have access to an investment adviser, but instead deals directly with the salesman and relies upon the prospectus and sales literature.

The SEC appears to have embarked upon the necessary first step of gathering into the regulatory net as broker-dealers an increasing number of tax shelter sellers. Once ensnared, however, consideration should be given to specialized requirements applicable to the tax shelter seller. There is precedent for exacting special licensing requirements from the field of insurance securities. Concomitantly, capital maintenance, recordkeeping and bookkeeping requirements could be tailored to differentiate the tax shelter seller from the traditional securities broker-dealer. In addition, an effort could be made to succinctly differentiate the investment adviser from the seller. Persons who, in reality, participate in the selling effort should be identified as broker-dealers or underwriters and thereby be subjected to liabilities under §11 of the 1933 Act. From a policy standpoint, it seems desirable to encourage the involvement of investment advisers in tax shelter offerings since, among other things, they often perform a valuable due diligence service for their clients. However, it is at least arguable that investment advisers in the tax shelter field, as well as broker-dealers, should be subject to specialized licensing or examination requirements.

Post-Sale Disclosure

Once the sale is over, the typical limited partner customarily does not enjoy the flow of information and attention that generally has come to be accorded to the corporate investor. There is no newspaper which reflects the day-to-day fluctuations in the value of his investment. Annual reports and periodic reports, when they are furnished, tend to be sketchy and confined largely to financial information. Relatively few general partners concern themselves, to any significant extent, with follow-up literature and an information flow to the limited partners. Moreover,

few partnerships furnish limited partners financial and other
data covering the operations of the general partner. This in-
formation may be of critical importance where the success of
the partnership depends upon the continuing viability of the
general partner. The necessity of information is particularly
important where payment for a partnership interest is made on
a deferred basis. Even though the sale may be considered con-
summated for purposes of § 5 of the 1933 Act at the time of
the initial payment, a respectable argument can be made that
there is a continuing offer and sale for purposes of Rule
10b-5 under the Securities Exchange Act of 1934. Failure to dis-
close material information at the time of a subsequent deferred
payment thus could expose the general partner to liability under
that Rule.

The SEC has become increasingly aware of the need for
continuing disclosure in public offerings and it is anticipated that
the SEC's concern will be translated into more far reaching on-
going disclosure requirements for tax shelters. Thus far the SEC
has largely concentrated on the registration statement as a
vehicle for ensuring continuing disclosure. Undertakings and
representations to furnish post-sale reports to limited partners
have been exacted by the SEC staff as a condition of effec-
tiveness of the registration statement. This approach has been
particularly noticeable in the case of blind pools which comprise
the majority of tax shelter offerings. Prospectus disclosure in
the case of a blind pool occurs at a time when the partnership
is largely dormant and the meaningful "facts" relating to prop-
erty acquisitions occur only after the investor's decision. At the
same time, the SEC staff has sought to compel pre-effective dis-
closure of potential property acquisitions in the case of blind pool
and quasi-blind pools by liberally interpreting the conditions for
disclosure of a specific property acquisition.

It is anticipated that the concern for post-sale disclosures will
intensify, and in this respect the tax shelter may approach the
typical corporate issuer. In addition to information concerning
the partnership, it may be expected that attention will be
directed to the ongoing operations of the general partner or its
parent in cases where their operations ultimately affect the
viability of the partnership. Finally, it may be expected that

62. In the authors' experience, the SEC staff considers that a sale
occurs upon the initial payment under circumstances where there is an
economic penalty or forfeiture for failure to make succeeding payments.
63. Section 11 of Guide No. 60, CCH FED. SEC. L. REP. ¶ 3820, requires
prospectus disclosure of a property acquisition "[w]here a reasonable
probability exists that a property will be acquired and the funds to be
expended represent a material portion of the net proceeds of the mini-
mum offering . . . ." See also Section 21 of Guide 60.
the various reporting forms will be revised and made more responsive to the realities of limited partnership operations.\textsuperscript{64}

\textbf{CONCLUSION}

The future of the tax shelter investment is conjectural at this time. To a substantial extent tax shelters are hostage of the pending tax legislation, the adoption of which could drastically curtail, if not altogether eliminate, this form of investment. Regardless of the passage of the legislation, however, in view of an increasingly sophisticated regulatory attitude as well as investor disenchantment, it is unlikely that tax shelter investments ever will reemerge in the variegated and flamboyant form of the early 1970's.

\textsuperscript{64} Form 10-K, for example, limits disclosure to the registrant, which on its face would apply only to the partnership and not the general partner. The SEC staff, however, customarily interprets certain of the form 10-K items to apply equally to the general partner. In addition, the term "registrant" in forms S-1 and S-11 may refer either to the limited partnership or to the general partner, depending on context.