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LOSS LIMITATION AND INDIVIDUAL MINIMUM TAX AFTER THE TAX REFORM ACT OF 1986: EVOLUTION OR REVOLUTION?

CARTER G. BISHOP†

The Tax Reform Act of 1986 is one of the most fundamental reforms of this country's tax system. With this legislation, Congress sought to address the problems created by tax shelter activity, and to create a more equitable distribution of the tax burden. This Article reviews the Tax Reform Act's attempt to equitably allocate the tax burden by analyzing passive activity loss rules, income tax rate reductions and the individual minimum tax, and concludes that the goal of paying a fair share of the tax burden is not met.

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INTRODUCTION

Over the past two decades, legislative decisions concerning tax practice and tax policy have been affected by an increased sensitivity to the importance of ensuring that every taxpayer pay a fair share of tax liability. This concern results largely from the confluence of several factors. First, prior to 1969 marginal taxable income in excess of $100,000 for married taxpayers filing joint returns was taxed at a 70% rate. These marginal rates were generally perceived as unrealistically high, thus encouraging many taxpayers to minimize tax liabilities by sheltering income.1 Second, interest rates were extremely high in the late 1970's and early 1980's, and they remain historically high. The high interest rates encourage taxpayers to seek methods to defer payment of tax liability as long as possible. The deferral is tantamount to an interest free loan from the government on the deferred tax liability. This combination of high income tax and high interest rates is generally believed to be at the bottom of the radical proliferation of tax shelter activity, which is designed to exploit the deferral value of the time value of money rules.2

The panoramic tax system impact created by the proliferation of tax shelter activity is well beyond the scope and imagination of this article. System level concerns, however, revolve around enormous revenue base deterioration and the general threat of taxpayer malaise. The latter is created by a perception that the system is not functioning properly because many taxpayers are not paying their fair share of taxes.

Congress has reacted to the problem in a piecemeal fashion since 1969 by enacting specific legislative strikes which are targeted to reduce the attractiveness of tax shelters to their most significant consumer, the high-income taxpayer. In 1969,

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Congress reduced the maximum tax rate on marginal earned income from 70% to 50%.\(^3\) A complex new individual minimum tax was also added in 1969.\(^4\) In 1981, the maximum tax rate of 50% was extended to all categories of income.\(^5\) In 1982 and 1984, complex time value of money rules were enacted to minimize the advantage of deferring taxes through tax shelters.\(^6\)

Notwithstanding these and many other reforms, tax shelter activity continued to flourish, bringing our tax system to the edge of disaster. Congress once again responded by enacting the Tax Reform Act of 1986 ("TRA 1986").\(^7\)

TRA 1986 unquestionably represents one of the most fundamental reforms of the federal income tax system since 1913. Its title does not do it justice, at least relative to previous tax reform acts, which pale in comparison. As such, TRA 1986 once again demonstrates that those whose professions revolve around interpretation of tax statutes are engaged in a most challenging and mind-bending sport. Tax practitioners are often led blindly into intellectual cul-de-sacs where poor professional advice and malpractice lurk.

Although it has been heralded as the deliverer of our tax system, is TRA 1986 really all that Congress promised or is it a harbinger of future legislation? Certainly tax shelter activity will be curbed, but at what hidden cost; and will every taxpayer now pay a fair share? As will be discussed, TRA 1986 has a few striking blemishes. Some classes of taxpayers, notably the middle class, will no doubt pay more tax. However, the wealthy class may still avoid paying a fair share and, in fact, may even pay less tax than before TRA 1986. The wealthy may still shelter their income and avoid even a minimum tax

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responsibility. The solution to this problem may be nothing short of more legislation. This possibility should cause us to critically examine the legislative process that created tax shelters in the first place and then spent nearly two decades unwinding the mistakes. Hopefully, much has been learned.

To examine these issues more completely, several facets of TRA 1986 will be analyzed: passive activity loss rules, income tax rate reductions, and the individual minimum tax. The impact of each of these factors on tax shelter activity will be explored as well as their collective and separate impact on the equitable allocation of tax burdens among all taxpayers.

I. PASSIVE ACTIVITY LOSS

The new passive activity loss rules are found in Section 469.\(^8\) In its conceptual form, Section 469 is designed to discourage investment in tax shelter activities by taxpayers who anticipate a passive relationship with, and activity level in, such tax shelters. For this purpose, all investment activities are presumed to be tax shelters if they produce losses in excess of income.\(^9\) Investment is discouraged by placing limitations on the ability of passive investors to use their passive shelter losses to offset unrelated income from activity sources in which the taxpayer actively participates.\(^10\)

Thus, Congress broadly designated groups of activities and investments as either passive or active. Once an activity is categorized, Section 469 attempts to eliminate crossover netting of income and losses between the two types of activities. For example, losses from all passive activities may not be utilized to offset or shelter income from active activities.\(^11\) Categorizing all activities as active or passive and preventing passive losses from offsetting active income is clearly a positive step in discouraging high-income professionals, who earn active salary income, from sheltering that salary income with passive tax shelter investment losses.

Congress created a third category of income described as "portfolio income," a special form of passive income. This

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distinction is an attempt to prevent those who earn their income from passive sources, theoretically the wealthy, from sheltering that special class of passive income with passive losses. In sum, these yeoman efforts do much to accomplish their objective of curtailing tax shelter activity, yet there is room for criticism in analyzing the specific detail of the approach.

The passive-active categorization process creates two primary pools of income and loss. Although crossover netting is proscribed between the two pools, netting rules are not applied within the pools on an activity-by-activity basis. Accordingly, once two or more activities are categorized as passive, losses from one passive activity may offset the income of another, thereby permitting a taxpayer to shelter income.

The central distortion of Section 469 may well be this permissive netting within the passive activity pool. Moreover, since activities are classified as passive or active for each separate taxpayer, the passive pool netting process permits and, therefore encourages, sheltering activity of passive losses against passive income (with the sole exception of portfolio income). It also encourages the generation of passive income to offset unused or phased out passive losses. Those taxpayers most capable of arranging their affairs to produce non-portfolio passive income and then to shelter such income with passive losses are the wealthy—those least dependent on active, salary income.

A. Legislative History

Before delving into a more detailed exploration of the statutory mechanics of Section 469, an examination of early congressional efforts in this area provides an illuminating comparison of congressional insights on the subject of passive losses even though such early thoughts did not materialize into legislation. At a different point in time, Congress might have dealt with the problem in a slightly different fashion.

Although Section 469 appears to be a creature of first impression, history reveals that its roots can be traced to 1969, and more specifically to 1976, when the House attempted to
limit deductions of passive losses. The House, however, was defeated by the Senate which opted exclusively for a minimum tax approach to solve the early tax shelter abuse problem. Interestingly, it was the Senate which, after rejecting the House approach in 1969 and 1976, ultimately proposed the Section 469 rules in TRA 1986. The 1986 House bill did not contain any provisions attempting to limit passive losses.13

1. Tax Reform Act of 1969

As early as 1969, Congress was concerned not only with specific tax shelter abuse, but also with the more general problem of the ability of individuals to escape tax payment on their economic income.14 The House bill proposed Section 301 as part of the Tax Reform Act of 1969 ("TRA 1969").15 The House expressed concern that individuals with high economic income resulting from the receipt of tax-exempt income, such as interest income from exempt state and local bonds, might exclude all income from tax.16 The House was also concerned that those with large amounts of capital gain income or those that utilized accelerated depreciation on real estate might escape tax on a large part of their economic income.17

The primary House weapon against such an abuse was an attempt to broaden the definition of taxable income to bring it more in line with conceptual economic income by placing a limit on tax preferences ("LTP").18 The goal of Section 301 was to include at least one-half of economic income in taxable income.19

Under the LTP approach, a 50% ceiling was imposed on individual’s total income (adjusted gross income plus the tax

17. Id. at 78, 1969 U.S. CODE CONG. & ADMIN. NEWS at 1725.
18. Id.
19. Id.
preference items) which could be excluded from income.\textsuperscript{20} The rule did not apply until total tax preferences exceeded $10,000.\textsuperscript{21} For purposes of the rule, five items were targeted tax preferences:

1. tax-exempt interest;\textsuperscript{22}
2. the 50\% portion of net long-term capital gains which was excluded from income;\textsuperscript{23}
3. the untaxed appreciation in the value of property that was donated to charity, treated as a charitable contribution and the subject of a deduction;\textsuperscript{24}
4. the excess of accelerated real property depreciation over the amount allowable under the straight-line method;\textsuperscript{25} and
5. the net amount of farm loss for the year (as determined under the excess deduction account rules) that exceeded what would have been allowed if the taxpayer had utilized the inventory method of accounting and had capitalized capital expenditures.\textsuperscript{26}

In addition to the $10,000 threshold in tax preferences before application of the rule, Section 301 contained two relief measures. The bill provided for a five year carryover of disallowed preferences and disallowed excess depreciation deductions attributable to real estate.\textsuperscript{27} The excess depreciation deductions could then be utilized to increase the basis of the assets to which they related.

The House also proposed Section 302, which operated in
tandem with Section 301 to reduce the double tax benefit of excluding tax-exempt income while permitting itemized deductions which related to the excluded tax-exempt income. The approach of Section 302 was to limit personal itemized deductions by disallowing that portion of the itemized deductions which specifically related to tax-exempt income. Since the income was not taxed, the related amount of itemized deductions should not be deductible.

Under TRA 1969, individuals may have been subject to both Sections 301 and 302. Thus, the taxpayer was to first apply the Section 301 LTP Rule and next, under Section 302, to allocate itemized deductions between adjusted gross income (as modified by Section 301) and allowed tax preferences.

Although concerned with the identical problems that troubled the House, the Senate chose to substitute an overall minimum tax. The Senate rationalized that a minimum tax would be more effective and considerably simpler than the House approach. With slight modification, the Senate approach was adopted.

The Senate approach noted three significant drawbacks to the House approach. First, combined use of the LTP and the allocation of deductions rules were projected to produce different tax burdens on preference income for two individuals with the same preference income but different taxable income. Second, the inclusion of both regular and preference income in the same base was predicted to produce enormous complexity because of the way the LTP was calculated. Finally, the House approach would not apply to corporations and therefore would not reach the preference income enjoyed by that group.

The Senate criticism of the House approach seems spurious. It is unclear why it makes a difference that the House approach

34. Id.
would yield different results for taxpayers with identical preference income but dissimilar taxable income. The House approach represents a tax on the overall economic income of a taxpayer. If two taxpayers have unequal economic income, it should not be surprising that their tax liabilities differ. Moreover, the Senate’s minimum tax approach could hardly have been classified as a simplification measure. Accordingly, it is doubtful that the Senate approach was less complex than the House approach. Finally, the House LTP could have easily been extended to corporations in a modified form.

Nevertheless, the Senate view prevailed and the minimum tax was born at the expense of the House approach which was directly aimed at limiting tax preference use. In theory, the House approach was a direct attack on tax shelter use whereas the Senate approach merely raised the cost of excessive sheltering.

2. Tax Reform Act of 1976

As part of the Tax Reform Act of 1976 ("TRA 1976"), the House once more attempted to directly limit preferential deductions. This effort, as opposed to the general effort in 1969, was specifically directed at selected tax shelter activities and was described as a limitation on artificial losses ("LAL"). One of the major goals of the House bill was to improve the equity of our tax system by reducing the undesirable effects of a tax-directed resource allocation system.

The House bill reflected the position that the success of the income tax system is based on a high degree of voluntary compliance since only a small portion of tax returns are actually audited. Voluntary compliance is in turn premised on taxpayers understanding the relevant tax laws and forms and believing that others are also paying a fair share of the overall tax burden. As such, the House was concerned that the ability of selected high-income taxpayers to utilize certain tax provisions

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38. Id. at 7, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2901-02. Presumably, once tax benefits were removed from a favored activity, investment resources would be directed more toward industries and activities based upon their non-tax economic return factors.
was unfair. The specific provisions causing concern were those intended as business investment incentives but used as tax shelters.

The House bill sought measures believed to be effective in ensuring that those with a high economic income would bear a reasonable share of the overall tax burden. In solving this problem, the House bill once again turned its attention to tax preferences and, in particular, to tax shelters.

The House bill recognized that the income tax system’s dual role, to promote economic growth and encourage various kinds of social behavior, led to complexity, economic inefficiency, and taxpayer tax treatment inequality.

It has generally been recognized that the tax system is a tool which can be used to promote economic efficiency and growth, and this has led Congress to enact a large number of tax provisions designed to promote certain activities and discourage others. These tax preferences, however, can outlive their usefulness or can have adverse effects on other goals, such as tax equity and simplicity. Your committee believes that these special tax incentives should be reviewed periodically, and this bill is an important step in that process.

The House bill targeted tax shelters as the greatest villain since they are understandably the heaviest users of tax preferences. In addition, the 1969 minimum tax was strengthened by lowering the exemption amount, raising the minimum tax rate, and halving the deduction for tax preference items. To coordinate minimum tax reform with tax shelter reform, the House exempted from minimum tax any deductions that were limited under tax shelter reform.

In this round, the House attack on tax preferences differed significantly from the 1969 combined approach of limiting tax preferences and disallowing itemized deductions related to the tax-exempt income. The 1969 approach was directed at limiting the use of tax preferences at the individual taxpayer level.

39. Id.
40. Id.
41. Id.
42. Id. at 8, 1976 U.S. Code Cong. & Admin. News at 2902-03.
44. Id. at 10, 1976 U.S. Code Cong. & Admin. News at 2904.
The 1976 attack directed its emphasis and focus more on the business or activity generating the tax preferences. This is substantially closer to the model that the Senate used as part of TRA 1986.

The 1976 House bill noted the explosive growth of tax shelters in which individuals utilized artificial deductions to generate losses which were in turn utilized to offset unrelated income. The House made several interesting observations about tax shelters. First, the House noted that tax shelters were economically inefficient and wasteful because large portions of capital raised were often not invested in the targeted industry but were paid to promoters of the shelter as a fee. Second, the House conceded that in some ways tax shelters were positive because they were usually the result of special tax provisions designed to serve worthwhile purposes, such as directing capital into certain vital industries. As such, the approach of the House bill was to maintain the underlying tax preference as an industry-wide incentive but to limit its use as a tax shelter device to shelter unrelated income of investors. These artificial deductions which sheltered unrelated income resulted in essentially a "negative tax," where income unrelated to the activity is exempt as well as income generated from the activity. For example, unrelated salary income could be sheltered. The House bill expressed concern that negative taxation on income from tax shelter investments constituted too great a tax preference.

3. 1976 LAL Approach

The House bill considered several techniques to accomplish

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46. Id. at 8, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2903 (artificial deductions were defined as "ones that do not accurately reflect their current expenses").

47. Id. If this was a principal concern, presumably measures could have been taken to restrict payments to promoters. For example, elimination of a deduction for any payments to promoters in any form and limitations on amounts paid to the promoter while still allowing the underlying activity to qualify for preferential deductions would have raised the after-tax cost of such payments and certainly discouraged them.

48. Id. at 9, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2903.

49. Id., 1976 U.S. CODE CONG. & ADMIN. NEWS at 2904. Of course, the negative tax in most contexts was an expression of deferral. Since the taxpayer's basis in the activity was being reduced, the negative tax would be repaid when the investment was sold. In some cases, the tax would be repaid at a lower capital gain rate than that which generated the ordinary income negative tax.
its goal of eliminating the negative tax aspect of tax shelters but selected LAL as the most promising. 50 Under the LAL approach, artificial deductions such as accelerated depreciation, intangible drilling expenses, prepaid feed expenses, and construction period interest and taxes would be allowed only against related income. 51 As an example, accelerated depreciation on a building would be allowed only to the extent of income from real estate; it would not be available to reduce tax liability on unrelated income such as an owner's or investor's wage or salary income. 52

The LAL provisions were subjectively imposed upon tax shelter investments in real estate, farm operations, oil and gas, motion picture films, equipment leasing, and professional sports franchises. 53 Although the bill was viewed as a part of an ongoing reform, 54 it was believed that these shelter areas were the most important targets. 55 Absent an attack on the major shelter areas, the House believed that the bill would simply encourage taxpayers to redirect their sheltering activity to more favorable areas. 56 At the bottom, the bill attempted to reduce shelter abuse associated with negative tax while leaving the underlying preference in place.

Nevertheless, it was believed that there still existed substantial tax preference for investments in oil and gas, and real estate. 57 Although the bill prevented artificial losses in the preferential activities from offsetting unrelated income, the income from the investment itself was still preferentially sheltered.

Under the LAL approach, specified accelerated deductions were not allowed in the taxable year in which the deductions were paid or incurred to the extent that they exceeded a taxpayer's net income from that activity. These losses were deferred until either the taxpayer had income from that activity in a future taxable year or until the taxpayer disposed of the

50. Id.
51. Id.
52. Id.
56. Id.
57. Id.
property. This approach did not limit true economic losses.

In order to properly confine the use of preferential accelerated deductions to the property or activity generating them, the House bill utilized the concept of net related income. In the real estate area, for example, net related income established the amount of accelerated deductions which could be taken in a taxable year. Net related income was defined as the gross income from real property less the sum of the ordinary deductions attributable to the entire class of real property. But if any one property produced an economic loss (ordinary deductions in excess of gross income), then that loss would be allowed.

Effective dates of the proposed LAL provisions depended upon the type of property involved. In the case of real estate, the LAL provisions applied only prospectively to real property actually constructed after the effective date of the bill.

Notwithstanding the extremely detailed position of the House bill, the Senate, as it did in 1969, decided to delete the LAL approach because of its perceived complexity and adverse economic impact. The Conference Committee supported the deletion. The Senate expressed concern for the complexity that LAL would create because of the need for taxpayers to keep records spanning several years in order to track deferred deductions. Complexity would also develop because of the need to distinguish related income from other income. The Senate believed that the determination of related income would be particularly difficult when the LAL was applied on a property-by-property basis.

On the economic impact issue, the Senate believed that LAL failed to properly distinguish between abusive tax shelters.

58. *Id.* at 28, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2921-22.
59. *Id.* at 34, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2928.
60. *Id.*
61. *Id.* at 37, 1976 U.S. CODE CONG. & ADMIN. NEWS at 2930.
65. *Id.*
66. Abusive tax shelters are economically inefficient investments which are undertaken purely for tax reasons.
and legitimate situations where tax incentives provide important encouragement to economically worthwhile investments.\textsuperscript{67} The Senate expressed concern that the LAL approach would unintentionally eliminate many productive investments.\textsuperscript{68} This would not be a desirable result because of high unemployment, a housing shortage, and foreign energy dependence.\textsuperscript{69} Accordingly, the Senate approach of strengthening the minimum tax, expanding the maximum tax, and specifically targeting tax shelter abuse provisions prevailed.\textsuperscript{70}

4. Tax Reform Act of 1986

Regardless of the wisdom of the 1976 Senate position in rejecting LAL and relying primarily upon a stronger minimum tax, history has vindicated the House LAL approach. In 1986, the Senate, after consistently rejecting House loss activity pro-

\textsuperscript{68} Id.
\textsuperscript{69} See id.

In general, the Senate expansion of the minimum tax on individuals included raising the rate from 10% to 15%, lowering the exemption to a maximum of $5,000, and adding several new preferences to the base of the tax. These preferences include construction period interest, accelerated intangible drilling costs, excess investment interest over investment income, excess itemized deductions (other than medical expenses and casualty losses) over 60% of adjusted gross income, and accelerated depreciation on all leased property. S. REP. No. 938, 94th Cong., 2d Sess. at 110, 1976 U.S. CODE CONG. & ADMIN. NEWS at 3445-46. The maximum tax rate of 50% was expanded to include a limited amount of investment income. In addition, income eligible for the maximum tax rate was to be reduced by all tax preferred income in order to discourage tax shelter investment. Id. at 3, 1976 U.S. CODE CONG. & ADMIN. NEWS at 3440.

Finally, specific provisions were contemplated to eliminate abusive tax shelters. First, losses from accelerated deductions incurred in farm operations, film purchases, equipment leasing, and oil and gas drilling (real estate was excluded) were limited to the amount that the taxpayer had at risk. Second, the recapture rules for real estate and professional sport franchises were expanded. Finally, rules were advanced to restrict the use of limited partnerships to syndicate tax shelter benefits as well as limit deductions for prepaid expenses. Id.

The Conference Agreement adopted a slightly modified approach for minimum tax expansion by eliminating construction period interest and excess investment interest as preference items and reducing tax exemption to the greater of $10,000 or one-half of the regular tax liability. See H.R. CONF. REP. No. 1515 at 426, 1976 U.S. CODE CONG. & ADMIN. NEWS at 4136. The report adopted the maximum tax provisions. Id. at 428, 1976 U.S. CODE CONG. & ADMIN. NEWS at 4138. It also generally adopted the tax shelter provisions. Id. at 411-15, 1976 U.S. CODE CONG. & ADMIN. NEWS at 4122-26.
posals in favor of amending the minimum tax provisions, proposed the pervasive new passive loss rules. The purpose of the rules was to limit the deductibility of losses against unrelated income where the taxpayer is not materially participating in the operations.

Statutorily, the new passive loss rules are embodied in the new Section 469. Section 469 is an express legislative response to the proliferation of tax shelters which had obviously not been cured by various legislative efforts since 1969. The legislative efforts included reducing the maximum tax rate, expanding the minimum tax, and decreasing preferential treatment of tax incentives in tax shelter areas through specifically designed provisions.

Extensive tax shelter abuses were contributing to public concern that the tax system was unfair because tax was paid by only the unsophisticated and the naive. The Senate noted that this perception not only undermines voluntary compliance, but also encourages proliferation of the tax shelter market. This in turn diverts investment capital from economically productive activities to those principally or exclusively serving tax avoidance goals. Thus, more effective methods were needed than those relied upon in past years to curb tax shelter activity expansion.

The Senate contemplated eliminating substantially all tax preferences, but this was deemed unwise since many preferences were believed to be socially or economically beneficial and it was deemed impossible to design a tax system that measured income perfectly. When a comprehensive tax base is designed, it is by nature extremely complex. This creates problems of both compliance and administration; however,

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72. Id. The Section 469 passive activity loss rules originated in the Senate bill. The House did not contain a similar provision. Id.
73. See generally S. Rep. No. 313, 99th Cong., 2d Sess. 713-18 (1986), reprinted in 1986-3 C.B. vol. 3, 713-18. The Senate noted that taxpayers were quickly losing faith in their tax system, primarily because of high marginal tax rates (50% for a single taxpayer with taxable income in excess of $88,270) and because of taxpayers sheltering income from one source with tax shelter deductions and credits from a wholly unrelated source. Id. at 713, 1986-3 C.B. vol. 3 at 713.
74. Id. at 714, 1986-3 C.B. vol. 3 at 714.
75. Id.
76. Id. at 715, 1986-3 C.B. vol. 3 at 715.
where simpler rules are used, opportunities for manipulation exist. Taxpayers can design techniques to undermeasure or defer income.

In orchestrating the 1986 attack on tax shelters, the Senate, as the House did in 1976, distinguished between preferences confined to an industry use and those that created opportunities for outside investors to avoid tax liabilities on unrelated income of the preferential industry. Thus, the Senate distinguished between income of those investors who are active in a trade or business and those who are not active. The Senate’s approach was to maintain the existence of tax preferences but confine their use against related active income and limiting their use against unrelated passive income. The Senate believed that the industries targeted for the tax preferences would still be benefited, but the preferences would not create the feared negative tax that the House discussed in 1976.77

The Senate indicated that in order for tax preferences to function as intended, their benefit must be directed primarily toward the taxpayers who have a substantial and bona fide involvement in the preference activity.78 It was believed that such a limitation would still encourage non-participating investors to invest in targeted preference activities even though they could not shelter unrelated income since the preferences would reduce the rate of tax on the targeted industry income vis-a-vis other non-targeted industry income.79

To determine which investors would qualify, the Senate chose a material participation standard. Under this standard, a taxpayer’s participation in an activity was examined to determine whether the taxpayer could use the tax benefits from that activity. The Senate indicated that the more significant the participation, the more likely the investor would approach an investment decision with non-tax economic profit motivation.80 A more passive investor was believed to seek a return on capital, including returns in the form of reductions on taxes owed on unrelated income, rather than a continuing source of livelihood.81

77. See id. at 715-16, 1986-3 C.B. vol. 3 at 715-16.
78. Id. at 716, 1986-3 C.B. vol. 3 at 716.
79. See id.
80. Id.
81. Id. This is accomplished by the preferential industry paying a lower rate of
With respect to non-participating investors, the Senate believed it would be appropriate to postpone recognition of losses exceeding the income of the activity until the investor's ultimate disposition of the interest in the activity. According to the Senate, the annual effort to measure real economic loss from passive activities prior to disposition created distortion. This is particularly due to the non-taxation of unrealized appreciation and the mismatching of tax deductions and related economic income. This result was magnified where debt financing was utilized. The Senate realized that it is not possible to determine whether or not a true loss has been sustained until the taxpayer actually disposes of the interest.

B. Section 469 Passive Loss Rules

1. Introduction

Accordingly, the passive activity loss ("PAL") rules governed by Section 469 were born. Section 469(a) denies an individual from currently deducting a PAL. Section 469(d) defines a PAL as the amount by which the aggregate losses from all passive activities for the taxable year (including PAL carryovers) exceed the aggregate income from all passive activities for such year. Section 469(b) allows any such disallowed PAL to be carried forward indefinitely. Section 469(c) defines passive activity as any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Section 469(h)(1) defines material participation as a regular, continuous, and substantial involvement in the operations of the activity. Any rental activity and any limited partnership interest are treated as passive activities under Sections 469(c)(2) and 469(h)(2) regardless of the level of the taxpayer's participation in the rental or other limited partner-tax on its income than a non-preferential industry because the preferential industry has greater preferential deductions. The problem with this notion is that, by definition, most tax shelter concerns were non-taxpaying, pass through, entities that produced losses well in excess of income. In the non-tax shelter industry, this concept may have viability.

82. See id. at 717, 1986-3 C.B. vol. 3 at 717.
83. Id.
86. I.R.C. § 469(c) (West Supp. 1987).
ship activity. Finally, Section 469(g) permits the PAL to be ultimately used against unrelated income or gain when the entire interest in the activity is disposed of in a fully taxable transaction.

Section 469(h) deals with the retroactivity of the provisions. Unlike the 1976 House LAL rules which were applicable only prospectively, Section 469 is partially retroactive. In essence, if the interest in the passive activity was being actively conducted on August 16, 1986 (a pre-enactment interest), then only the following portion of the PAL related to such an interest shall be considered a PAL for purposes of Section 469: 35% - 1987; 60% - 1988; 80% - 1989; 90% - 1990; and 100% thereafter.

2. Analysis of the Passive Loss Rules

The impact of TRA 1986 and Section 469 is clear. Except with regard to pre-enactment interests, when Section 469 applies it creates a deferred loss which can only be used against related income until the interest is finally disposed of in a fully taxable transaction. Thus, the use of losses exceeding related income from such activities is deferred. When combined with other provisions of TRA 1986, which lower the effective individual income tax rate to 28% in 1988 and raise the maximum capital gain rate from 20% to 28%, Congress has eliminated the two key return elements of tax benefits. Deferral and conversion benefits have been eliminated. Such benefits were created by taking tax shelter deductions against ordinary income in early years and paying those deductions back at a lower capital gain rate in a later year when the interest is sold.

In attacking deferral and conversion tax shelter benefits, Congress will no doubt stem the tide of the swelling tax shelter market, an admirable goal at the least. The larger tax policy question must deal, however, with the casualty list. Ultimately, an examination of those taxpayers who are the casualties strikes at the fairness of Section 469.

Section 469(g) reflects the position that, with respect to non-

89. I.R.C. § 469(g) (West Supp. 1987).
91. See I.R.C. § 469(a), (d) (West Supp. 1987).
participating investors, it is appropriate to treat business activity losses as not realized prior to the ultimate disposition of the interest in the activity. The obvious difficulties in measuring real economic losses from passive activities, including administrative enforcement and accuracy measurement, give rise to distortions of various magnitudes related to both the non-taxation of unrealized appreciation in the assets of the activity and the mismatch of deductions and related economic income. Of course, this is not newsworthy. It has always been recognized that true overall gain or loss from an investment is never known for certain until the investment is liquidated. Moreover, such appears to be the case in any activity, regardless of the presence or absence of passive or active investors.

What is newsworthy is that Congress has decided that the cost of these uncertainties, although justifiable at one point in time, are simply not acceptable if their cost includes proliferation of unwanted tax shelters. Accordingly, the benefits are being limited in the sense that they may not be utilized to offset investors’ income, such as salary and interest, that is functionally unrelated to the activity. The thought is that these benefits would be allowed to continue for only those investors who are active in the businesses to which preferences were diverted. The overall goal is to confine the use of preferential deductions to income generated from the related activity.

The material participation standard’s premise may be flawed, though, whether or not it accomplishes its intended purpose. Assuming the validity of the tax preference, it can certainly be argued that some social and economic goals are achieved if particular tax preference investments are made regardless of who makes the investment or how much of the investors’ income is sheltered. In this case, the amount of tax liability which an investor shelters is not logically related to whether or not the tax preference is valid. This analysis relates to a separate and arguably unrelated policy goal. On the other hand, it appears perfectly clear that if the goal is to stay or slow the flow of tax shelters, then the material participation standard will accomplish that goal.

For example, if Congress decides that more low income housing is needed and, to accomplish that goal, more private capital investment is necessary, then Congress may encourage private capital investment in low income housing by creating
special tax deductions which will increase the after-tax rate of return of such an investment. The issue of whether the investor is active or passive in the investment seems irrelevant. If a secondary goal is to prevent those who are primarily engaged in other occupations unrelated to operations of low income housing (such as lawyers, doctors, and business executives) from sheltering income earned in their principal occupations from investment losses incurred in a low income housing project, then the material participation standard will certainly accomplish that goal.

Unfortunately, Section 469 will most certainly achieve the latter result by simultaneously discouraging investment in activities that generate passive losses. These activities are generally the very activities blessed with tax preferences. In fact, it could be argued that traditionally those service providers who are actively involved in the business do not ordinarily provide the capital for the venture. The material participation limitation could mean that available investment capital for passive investors will nearly or entirely expire in the traditional preference investment areas until their non-tax rates of return more nearly resemble other competitive investment choices.

The counter argument is that the TRA 1986, itself, generally removes tax consideration from investment decisions by lowering the tax rate. As the argument goes, an investor should be less interested in sheltering income that is taxed at a 28% rate as opposed to that taxed at a 50% rate. This may beg the question, however, that since the shelter tax rate is lowered for all investments the desire to shelter income may continue to exist. After all, 28% of a large income is still a large number when compared to zero.

The unstated assumption regarding tax preferences prior to TRA 1986 was that certain investments with lower pre-tax economic returns would not be made without the tax preferences which increased the after-tax yield. This assumption remains equally valid after TRA 1986. Assuming investor sophistication, it is difficult to see why an investor would deliberately choose an investment with a lower after-tax rate of return. If this is true, the pre-TRA 1986 preference investments will suffer heavily after TRA 1986 until, or if, the non-tax intrinsic economic return factors (most notably, cash flow and apprecia-
tion) sufficiently increase through market forces to counter balance the withdrawal of the pre-TRA 1986 tax preference.

Thus, in the long run, it remains to be seen whether or not the tax decrease for renters of apartment units, for example, will ultimately translate into a rent increase which will increase the investment’s cash flow. It could be argued that new multiple unit housing will not be built until the investment community perceives a market rate of return that is not currently available absent preferential tax treatment. The withdrawal of tax preferences could cause a building shortage which would allow consumer rental demand for units to outpace supply. The result would be a rent increase, with new units being built only after the rent increases occur.\footnote{93. See Johnson, Financial Impact of the 1986 Act on Real Estate Investments - A View From the Spreadsheets, 36 Tax Notes 309 (1987) (for an excellent discussion concerning the impact of TRA 1986 on the value of real estate).}

In the short run, other behavior may occur. In fact, since Section 469(c)(1) allows passive activity losses to offset passive activity income, market forces may demand passive activity income (passive income generators (“PIG”)) which could be provided, for example, from unleveraged real estate investment. Unleveraged real estate investment would produce taxable income because of the absence of the interest deduction on the leverage. Promoters may be able to market this type of investment unit to absorb unused passive activity losses. In that case, real estate investment analysis would again be made based upon tax consequences and not economic market forces, a result clearly not contemplated by TRA 1986.

Moreover, the passive activity loss limitation rule does not fully address its intended purpose of ensuring that all taxpayers with substantial income pay their fair share of tax. This is because the aggregation principle of Section 469(c)(1) is too liberal. To be perfectly accurate, the rule should be restated as a per-activity rule with very narrow definitions of activities. In each activity, taxpayers should be allowed deductions only for cash losses, and even those losses should not be offset against other income until the investment is ultimately liquidated. It could be argued that, to be fair, if all passive income is to be taxed then all passive losses must be allowed as a deduction. To some extent this would simply be a casualty of tax reform if the per-activity rule were adopted.
To illustrate the potential effectiveness of the aggregate principle, assume that a model taxpayer, a physician, had wisely invested in a Subchapter S corporation two years ago. The corporation was engaged in the active conduct of the business of manufacturing and selling shoes, but the taxpayer has not and will not materially participate in that business. Assume also that in 1988, the business made a taxable profit of $2,000,000, of which $1,000,000 was the taxpayer's distributable share. Assume that the taxpayer has retired, has no other income, and buys leveraged real estate rental properties that generate $1,000,000 of tax losses at a break even cash flow. Since Section 469(c)(1) treats both the loss activity and the income activity as passive and aggregates the two, this taxpayer with substantial economic income will pay no tax, assuming that the minimum tax rules (discussed infra) do not apply.

Thus, the Section 469(c)(1) aggregation principle result may be continued tax relief for the very wealthy. In fact, when the impact of Section 469(c)(1) is combined with a cut in the top tax rate from 50% to 28%, the ultimate unintended beneficiaries of TRA 1986 will be precisely the wealthy group that was intended to be hit harder by the passive activity loss limitation rules and the revised alternative minimum tax. Only the sheltering limitations on portfolio income discussed above may be effective in ensuring that the wealthy do not shelter substantial economic income.

Finally, even assuming that Section 469 is a good idea, the transition rules which implement the initial impact of the statute are the best statement of the statute's basic lack of fairness.94 Inevitably, tax reform involves basic notions of fairness in the transition from pre-tax reform to post-tax reform. It is on this mark that Section 469 scores very poorly. Congress simply thought too little of the problem of protecting the reliance interests of those taxpayers who justifiably relied on pre-TRA 1986 law in making their pre-TRA 1986 investment decisions.

The Section 469(i) transitional rules phase the impact of the passive loss disallowance in over time. From 1987 through 1990, the percentage of passive activity loss that is disallowed is 35%-1987, 60%-1988, 80%-1989, 90%-1990, and 100%

94. See generally Sheppard, Transition Rules: But We've Always Done It That Way, 33 Tax Notes 393 (1986).
thereafter. In contrast, the 1976 House LAL approach was exclusively prospective, for example, only applying to real estate constructed after the proposed enactment date.

When enacting the Section 469(e) carryover provisions which allow unlimited carryover and use of prior years' disallowed excess passive activity loss, Congress argued that most current investors will ultimately be able to fully utilize their unused losses against income from the sale of the activity, thus the impact will be reduced. In addition, the lower phase-out rules in earlier years of Section 469 reflect the principle that most current losses will be deductible because most deductions occur in the early years of an activity. Finally, Congress believed that the deferred loss rules of Section 469 was a small compensation for a top marginal rate reduction from 50% to 28%.

These arguments may not be adequate compensation for investors who made decisions based upon pre-TRA 1986 tax law. Even though the transitional carryover rules may allow the pre-TRA 1986 investor to ultimately utilize the tax advantages, the future purchaser of the passive activity's asset will not be entitled, after TRA 1986, to utilize the same or similar tax advantages that existed pre-TRA 1986. Consequently, the after-tax yield of owning the passive activity asset will drop after TRA 1986. Hence, the value of the asset itself will theoretically drop. In summary, the asset will be worth less to the new buyer after TRA 1986 than it was to the current owner who purchased it prior to TRA 1986. Consequently, Section 469 may not avoid temporary massive value decays in tax preferenced assets such as real estate. The burden of this valuation decay is borne by the taxpayer who owned the real estate when TRA 1986 was enacted.

II. RATE REDUCTION AND ALTERNATIVE MINIMUM TAX

Since the Section 469 passive activity loss rules are a creature of TRA 1986 vintage, the prospective impact of the rules is somewhat speculative. In contrast, minimum tax and margi-
nal tax rate reduction efforts have been in place since 1969 as the two primary congressional attack weapons against tax shelter abuse. The other purpose of these efforts was to generally enhance the perceived fairness of a tax system in which every taxpayer pays a fair share.

The advent of TRA 1986 promises to make Section 469 the principal tax shelter weapon of the future, particularly when supported by rate reductions. What then does the future hold for the even tougher minimum tax rules and what impact can we generally expect from the TRA 1986 rate reduction efforts?

In examining these questions, a watchful eye should be fixed on the wealthy class to determine if these two provisions will ensure that this class of taxpayers pays its fair share of the tax burden. Unfortunately, the discussion below presents scenarios in which these two provisions, as the Section 469 rules discussed above do, operate ineffectively and yield unintended results when applied to wealthy taxpayers. In fact, as will be shown, many wealthy taxpayers may be substantially better off after TRA 1986 than they were before it was passed.

A. Rate Reduction

As part of TRA 1969, Congress added Section 1348 to reduce the maximum tax rate on earned income from 70% to 50%.

Section 1348 was not adopted as a tax relief measure but rather to reduce the pressure for the use of tax loopholes. Congress noted that a major taxpayer motivation was to protect earned income taxed at the 70% rate by creating artificial losses or converting the earned income into capital gains. Although the effort was criticized as overly complex, ineffective, and poorly drafted, the statute was broadened in 1976 to include unearned income. Also, as part of the Economic

100. See Coven, The Alternative Minimum Tax: Proving Again That Two Wrongs Do Not Make A Right, 68 Calif. L. Rev. 1093, 1119 (1980). "Under the alternative tax, deductions and credits are divided into seven different categories producing a multitude of different limitations. . . It seems improbable that any objective of the alternative tax requires such a complex mosaic." Id.
Reform Tax Act of 1981 ("ERTA"), the top marginal tax rate on all income was scaled back from 70% to 50%. Finally, as part of TRA 1986, the top effective rate was reduced to 28%, effective for taxable years beginning in 1988.

It remains to be seen just how effective the 28% top marginal rate will be in curbing tax shelters. One certainly would have to forecast little success, particularly if past rate reduction efforts are at all indicative. As stated, the advent of the Section 469 PAL rules are likely to overshadow this latest round of rate reduction in curbing tax shelter abuses.

The massive rate reductions of TRA 1986 were not achieved without cost. In an effort to reduce the economic and social engineering aspects of our tax system, Congress made massive rate cuts with the intent that tax reform in 1986 would be close to revenue neutral over a five-year period. Massive tax rate cuts coupled with income neutrality translate into a broadening of the income tax base. If Congress intends to reduce the marginal tax rate and still collect the same amount of tax revenue, simple mathematics dictate that the tax base must be sufficiently expanded to compensate for the rate reduction.

Under these circumstances, one really has to wonder if a rate reduction is truly effective. Admittedly, early taxpayer perceptions will be favorable, but these perceptions are likely to change when tax returns are filed and taxpayers as a whole understand that rate reduction does not necessarily translate into a tax cut in their personal circumstances. In fact, the opposite may occur. Revenue neutrality does not prevent tax burden redistribution. If the burden is redistributed, some taxpayers will pay less and some will pay more. Since a major goal of TRA 1986 is to remove the economically disadvantaged from the tax roles and the wealthy class may pay less, then middle

50% maximum marginal tax rate was expanded to a limited portion of net investment income).

105. H.R. Rep. No. 248, 99th Cong., 1st Sess. 62-63. Over the period between 1986-1990, the committee tax reform bill is predicted to be nearly revenue neutral. During that five-year period total revenues are estimated to be reduced by $364 million, less than 0.1% of total estimated tax revenues. Id.
106. See Staff of Joint Committee on Taxation, 99th Cong., 2d Sess., General
class taxpayers will pay more. After all, who could be more delighted with tax reform than a wealthy taxpayer with largely passive income and few deductions when the effective tax rate plummets from 50% to 28%?

In 1969, when the House first proposed and succeeded in injecting a Section 1348 maximum tax of 50% on earned income, the Senate rejected the House effort but lost the battle in conference.\textsuperscript{107} The Senate reasoned that a drop to 50% removed the critical element of substantial progressivity inherent in a fair tax system.\textsuperscript{108} Thus, one can only wonder whether the new 15% and 28% tax rate system contains enough progressivity to withstand similar upward spiralling pressures from budget and other political fronts. Many taxpayers no doubt sense that a future tax rate increase is in the offering when the real winners and losers of TRA 1986 rate reduction are known.

B. Minimum Tax

1. Introduction

Minimum tax provisions have been no less curious and certainly less effective in curbing tax shelter abuse than their rate reduction counterpart. What is in store for minimum tax provisions which were substantially modified in TRA 1986? This question becomes particularly important since TRA 1986 reduced the regular tax effective rate to 28%, and the minimum tax rate on a broadened tax base to 20%. The effectiveness of a minimum tax becomes particularly questionable as the gap between the regular tax rates and minimum tax rates narrow. The issue arises whether a maximum 8% gap between the regular and minimum tax rates justifies the complexity and compliance problems created by the parallel two-track regular and minimum tax system. This is particularly so since, as will be shown below, the minimum tax is fatally flawed by the same

\textsuperscript{107} See H.R. CONF. REP. NO. 782, 91st Cong., 1st Sess. 329, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2392, 2444 (the conference generally followed the House 50% rate limit on earned income, but limited earned income to that reduced by specified tax preferences).

passive income netting concept (of Section 469(c)(1)) that flaws Section 469 passive activity loss rules. The discussion below traces the legislative history of the failed minimum tax approach to solving the tax shelter abuse problem since 1969.

Theoretically, the alternative minimum tax is to work in tandem with the Section 469 passive activity loss rules under TRA 1986 to ensure that all taxpayers pay their fair share. Specifically, TRA 1986 adds Section 58(b) which substantially expands the pre-TRA 1986 minimum tax base by preventing the Section 469 passive activity loss amount from being deducted from the minimum tax base. Section 58(b)(3) further provides that the Section 469 transitional phase-in rules shall not apply for purposes of the minimum tax.

Accordingly, even though Section 469 will deny only a portion of pre-enactment passive activity losses until 1991, the new minimum tax will fully disallow any passive activity losses. Therefore, the minimum tax base will be greatly expanded through the pre-enactment investment phase-in period. An investor will be entitled to some phase-in deductions under Section 469, but none under minimum tax. Thus, for purposes of the alternative minimum tax, 100% of the passive activity loss would be disallowed for pre-enactment interests, even during the Section 469 phase-in period.

2. Minimum Tax Analysis

Returning to the tax policy analysis of the retroactive application of the passive activity loss under Section 469, one might argue that the same defect exists here, although with considerably less force. Since 1969, wealthy and sophisticated taxpayers have known about minimum tax and, through inartful congressional draftsmanship, have been able to avoid paying a minimum tax. It is difficult to believe that even those astute few believed that their bonanza was anything more than transitory. Accordingly, requiring such a taxpayer to prospectively pay a fair share of the tax burden does not seem offensive from a tax policy standpoint. These astute taxpayers were most likely aware, or should have been aware, that they were not playing on a level field since 1969.

109. An alternative minimum tax is paid if it is greater than the regular tax and essentially applies a separate independent tax rate to an expanded definition of income. I.R.C. § 55(a) (West Supp. 1987).
The real problem, of course, is that since Section 58(b) adopts the disallowance mechanism of Section 469, it suffers from the same malfunction—ineffectiveness against the wealthy taxpayers who have passive losses to shield their passive income. Its principal application is to persons that have service-based income and portfolio income, such as dividends and interest, who invested in pre-TRA 1986 activities which produced a tax loss as an essential ingredient of their return.

Consequently, during the TRA 1986 phase-in period (1987 through 1990), the alternative minimum tax will go beyond the reach of Section 469 to penalize persons who made pre-TRA 1986 tax shelter investments. This will occur because the full amount of passive activity losses will be subject to the minimum tax base. As noted, TRA 1986’s impact may not be too harsh because these taxpayers may have had no legitimate interest in not paying a minimum tax before TRA 1986’s enactment. The minimum tax’s continuing inability to truly require those with substantial economic income to pay a fair share of the tax burden, however, is clearly a defect since that is the principal purpose of the tax. Section 469 curbs the proliferation of tax shelters, and does so nicely, without the help of the alternative minimum tax. The minimum tax’s purpose seems, as it historically has been, is to ensure that all taxpayers with substantial income pay a fair share of taxes.

Since Section 58 adopts the aggregation rules of Section 469, it may not entirely accomplish its purpose. As noted under the Section 469 discussion, taxpayers will still be able to offset substantial economic non-portfolio passive income with passive tax shelter losses generated from sources such as leveraged real estate. Arguably, the wealthy are thus favored by TRA 1986 because, as a group, they are the most likely to be in a tax position to benefit from leveraged real estate transactions. As such, they may be in a unique position to take advantage of any price devaluation in real estate likely to occur under TRA 1986. Finally, they will also be able to hold their assets longer, until the non-tax economic returns of real estate increases, as discussed earlier. Thus, this group of taxpayers may get favored tax treatment, which in turn may assist the well-informed wealthy investor in capitalizing on an economic advantage from any anticipated TRA 1986 asset devaluation.

The foregoing discussion of the interplay between the mini-
Minimum tax and Section 469 highlights a principal defect in the combined statutory scheme. After TRA 1986, and particularly during the Section 469 phase-in period from 1987 through 1991, the principal defect of the combined effort is the flexibility afforded select taxpayers to avoid the application of the statutes through the passive activity aggregation rules found in Section 469 and repeated in the minimum tax provisions.

Criticism is much simpler to generate than solutions. Congress has a long record of sustained effort in attempting to create an effective minimum tax which indicates that even with all its problems, the minimum tax is likely to remain a permanent feature of our tax system for quite some time.

3. Legislative History

A review of the history of the minimum tax precipitates the conclusion that designing an effective minimum tax rule has not been easy for Congress. Beginning in 1969, Congress rejected the passive loss limitation approach of TRA 1986 in favor of a minimum tax. When experience revealed that the minimum tax provisions were ineffective, Congress attempted to cure the problem by amending the statutes; however, TRA 1986 and the discussion indicate that Congress has not yet been completely successful. The minimum tax provisions need more work if they are to reach their goal of insuring that all taxpayers bear a fair share of the tax burden. One amendment which may help this effort is the elimination of the ability of taxpayers to use the passive activity aggregation rules for minimum tax purposes.

Since 1969, Congress has tried many times to implement effective minimum tax provisions. The long series of statutory amendments following the 1969 introduction of the minimum tax is evidence of Congress’ lack of success. The amendments in 1974, 1976, 1981, 1982, 1984, and finally in 1986 were all motivated by a perceived ineffectiveness of the minimum tax. In fact, during the very period in which Congress was attempting to strengthen the minimum tax, the proliferation of tax shelters became the most widespread. Of course, tax shelter abuse was more likely the fault of an income tax system which was oriented to tax preference deductions rather than a weak minimum tax. It is odd, however, that tax shelter abuse should
mature so markedly during the same time that the minimum tax was enacted and strengthened.

It is also interesting that the House consistently proposed more stringent efforts in these areas than the Senate and yet, in the final analysis of TRA 1986, the Senate proposed the Section 469 rules which were discussed in the 1969 Treasury proposals, adopted by the House in 1969, but rejected by the Senate. Instead, the Senate adopted the minimum tax approach in 1969.

The minimum tax was not an entirely new concept even in 1969 when it was proposed by the Senate and adopted by Congress. During the Johnson Administration, and arguably earlier, it became apparent that selected taxpayers were availing themselves of tax preferences to the alarming extent that their otherwise significant tax liabilities were reduced to low levels that were simply unacceptable under equitable tax policy considerations. To remedy this situation, the Treasury proposed a new graduated alternative minimum tax with a rate from 7% to 35% which would be applied to an expanded tax base. The expanded tax base was comprised of taxable income increased by four tax preferences ("Johnson-Treasury Proposal").

The Johnson-Treasury Proposal also introduced an allocation of deductions concept, the first noticeable attempt to prevent preference related deductions from reducing taxable income. Under this concept, an individual was required to allocate certain non-business expense deductions between taxable and preference income. The result was that such deductions were only deductible to the extent allocable to taxa-


111. *Id.* The Johnson-Treasury Proposal isolated four essential income tax areas whose preferential treatment under current law were most significantly responsible for disparate tax treatment among individuals. Corporations were not yet the subject of attack. The four preferential treatment areas were: (i) the Section 1202 net long-term capital gain exclusion with the Section 1201 alternative of taxing the entire gain at 25 percent; (ii) tax-exempt interest income on state and local government bonds; (iii) the exclusion resulting from percentage depletion in excess of the capital invested in the ownership of qualified natural resources; and (iv) the untaxed appreciation inherent in charitable donations of appreciated property to the extent deductible under Section 170.

112. *Id.* The non-business deductions required to be allocated were most of the itemized deductions including interest, taxes, casualty losses, charitable contributions, medical expenses, and cooperative housing expenses.
ble income. This is the same approach utilized by Section 265, which prevents the deduction of expenses related to non-taxable income such as exempt interest income. It was also similar to the 1969 House approach under proposed Section 302 discussed above.113

Although this aspect of the Johnson-Treasury Proposal was adopted by the House in 1969,114 it seems appropriate that it was never adopted by the Senate which preferred a minimum tax approach.115 It seems inappropriate to limit the deduction for tax preference items by non-preferential itemized deductions, such as casualty losses and medical expenses, since these deductions are entirely unrelated to the production of the tax-exempt income. In addition, itemized deductions presumably have a separate and distinct policy base that support their deductibility independent of whether a taxpayer is engaged in tax shelter activity.

a. Tax Reform Act of 1969

The Johnson-Treasury Proposal was the basis of subsequent Nixon Administration submissions to Congress and was ultimately the foundation of the add-on minimum tax under the Tax Reform Act of 1969 ("TRA 1969"),116 the first major legislative assault on the excessive use of tax incentives.117 In 1969, the problem of those with significant economic income avoiding a fair share of the tax burden was so severe that Congress endeavored to ensure that tax incentives in the form of tax relief would not reduce the allocable tax burden of responding taxpayers below the levels which would be imposed if equitable considerations alone were determinative. On August 2, 1969, Wilbur Mills, Congressman from Arkansas and Chairman of the House Ways and Means Committee submitted the following report as part of TRA 1969:

113. See supra notes 28-29 and accompanying text.
115. Id.
117. Id. An add-on minimum tax is a minimum tax that is added to regular tax liability, whereas an alternative minimum tax is paid in lieu of the regular tax if it is greater than the latter. Conceptually, the alternative minimum tax encompasses a much broader definition of economic income than the add-on minimum tax, which is a penalty tax on the excessive use of tax preferences.
From time to time, since the enactment of the present income tax, over 50 years ago, various tax incentives or preferences have been added to the internal revenue laws. Increasingly, in recent years, taxpayers with substantial incomes have found ways of gaining tax advantages from provisions placed in the code primarily to aid some limited segment of the economy. In fact, in many cases they have found ways to pile one advantage on top of another. Your committee believes that this is an intolerable situation. It should not have been possible for 154 individuals with adjusted gross incomes of $200,000 or more to pay no income tax. Ours is primarily a self-assessment system. If taxpayers are generally to pay their taxes on a voluntary basis they must feel that these taxes are fair. Moreover, only by sharing the tax burden on a fair basis is it possible to keep the tax burden at a level which is tolerable for all taxpayers.  

To a limited degree, Congress responded in 1969 by curtailing tax incentives extended by specific statutes. Obviously this approach was limited since, if extended to eliminate perceived abuses, the incentives that Congress wanted to protect would also be destroyed.

Accordingly, Congress also partially adopted the Johnson-Treasury Proposal mechanism of an add-on minimum tax ("AOMT") to reconcile the tax policy objective of greater equity while continuing tax preferences. Such a mechanism would theoretically limit the proportion of a taxpayer's income that might be sheltered by tax preference incentives. In its primitive 1969 form, the AOMT was a penalty tax operating outside the existing tax framework. It established independent tax rates and a newly formed tax base. It has been criticized as being ineffectual, complex, and unfair.

The AOMT was unfair because it imposed an equal penalty on all preferences, regardless of the magnitude of the preference underlying the tax incentive itself. Consequently, the

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119. See, e.g., Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 1969 U.S. CODE CONG. & ADMIN. NEWS (83 Stat.) 509, 624-26 (section 1251, which requires the recapture of excess farm losses; and section 63(d), limiting the deductibility of excess investment interest).
121. Id.
122. See Coven, supra note 74, at 1096.
slight preference produced by the excess of accelerated depreciation over straight-line depreciation on short useful life property was the same as the penalty for the much greater capital gains exclusion preference.

Moreover, the 1969 AOMT was somewhat regressive and was inequitably based on a tax rate on preferences that was not integrated with the regular tax rate and computation. Not only was the separate rate schedule largely indefensible from a policy standpoint, but it also unnecessarily created complexity. In essence, a taxpayer was required to calculate two separate rate schedules.

Congress created the 1969 AOMT by adding Sections 56, 57, and 58, all effective for taxable years ending after December 31, 1969. Both individuals and corporations were subject to the tax. The 1969 AOMT was calculated by applying a 10% rate to the minimum tax base, which was computed as the sum of all specified tax preferences reduced by the sum of the regular tax liability paid and an exemption amount. This exemption amount varied depending upon filing status.

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123. Id.
126. Id. The tax preference items included in the original minimum tax base were:

(i) excess investment interest, which was defined as the amount of the excess of investment interest expense over the sum of the net investment income and the amount, if any, by which the deductions allowable under Sections 162, 163, 164(a)(1) or (2), and Section 212 attributable to property subject to a lease in excess of the gross rental income produced by such property (this item of tax preference applied only to individuals, Subchapter S corporations and personal holding companies until 1972);

(ii) excess accelerated depreciation on real property which exceeded the depreciation deduction which would have been allowable for the taxable year had the taxpayer depreciated the property under the straight-line method for each taxable year of its useful life;

(iii) accelerated depreciation on personal property subject to a lease in the amount by which the actual deduction exceeded the amount that would have been allowable for the taxable year had the taxpayer depreciated the property under the straight-line method for each taxable year of its useful life (Section 57(c)(1) defined net leases as property subject to a lease in which the sum of the deductions of the lease with respect to the property which were allowable solely by reason of Section 162 is less than 15% of the rental income produced by such property or the lessor is
but was $30,000 for taxpayers filing a joint return.\(^{127}\)

**b. Tax Reform Act of 1976**

By 1975, it was clear that the 1969 AOMT provisions had not accomplished their goal of ensuring that high income individuals and corporations pay a minimum tax on their tax preferences. The Senate noted in the Tax Reform Act of 1976 ("TRA 1976") that the 1969 AOMT had not achieved its original goal and, as a consequence, high income individuals were still able to avoid paying a minimum income tax.\(^ {128}\) Moreover, the Senate noted that the 1969 AOMT was principally a tax on only one type of preferred income, the excluded 50% of long-term capital gains, which then constituted approximately seven-eighths of the income in the minimum tax base.\(^ {129}\) Notwithstanding the 1969 AOMT, the appetite of the American taxpayer for tax preferences became so great that TRA
1976 enacted special provisions to deal with tax preferences created by tax shelters.\textsuperscript{130}

The Senate defined targeted tax shelters as "investments which permit persons to claim deductions that under a precise definition of income would be reclaimed in later years."\textsuperscript{131}

These accelerated deductions enabled the investor to deduct a loss against unrelated ordinary income. Generally, the use of accelerated deductions in one year means that in future years the investor will have less deductions than under the straight-line method, but still receives the benefit of tax deferral, the equivalent of an interest-free loan from the federal government. Also, the tax rate may be lower in that future year than in the year in which the accelerated deductions were claimed.\textsuperscript{132} In effect, tax shelters, as a separate form of tax preference, were creating the identical problems that the earlier tax preferences had created which were the genesis of the 1969 AOMT. Thus, by enabling high income individuals to avoid tax, tax shelters were impairing the equity of the tax system.

Moreover, Congress began to express concern that some investments were being undertaken not because of their economic merits, but because of the tax savings they were generating which resulted in an artificial resource allocation system.\textsuperscript{133} Therefore, under TRA 1976, Congress strengthened the 1969 AOMT by adding three new items of tax preference to the minimum tax base.\textsuperscript{134} These changes were:

\begin{itemize}
  \item[(i)] excess itemized deductions in an amount equal to the taxpayers' itemized deductions (other than the deductions for medical expenses and casualty losses) in excess of 60% of adjusted gross income reduced by the deductions for medical expenses and casualty losses;
  \item[(ii)] intangible drilling costs in an amount equal to the excess of deductible intangible drilling costs paid or incurred in connection with productive oil and gas wells over the amount that would have been deductible if such costs had been capitalized and either amortized over a ten-year period or deducted over the lives of the wells as a cost depletion; and
  \item[(iii)] accelerated depreciation on personal property which, treated as an item of tax preference the accelerated depreciation on personal property subject to a net lease (which was expanded to cover all leased personal property).
\end{itemize}

\textsuperscript{130} See id.
\textsuperscript{131} Id.
\textsuperscript{132} Id.
\textsuperscript{133} Pub. L. No. 91-172, 1969 U.S. CODE CONG. & ADMIN. NEWS at 623.
\textsuperscript{134} S. REP. No. 938, 94th Cong., 2d Sess. 110, reprinted in 1976 U.S. CODE CONG. & ADMIN. NEWS 3545-48. The new preferences were:

(i) excess itemized deductions in an amount equal to the taxpayers' itemized deductions (other than the deductions for medical expenses and casualty losses) in excess of 60% of adjusted gross income reduced by the deductions for medical expenses and casualty losses;

(ii) intangible drilling costs in an amount equal to the excess of deductible intangible drilling costs paid or incurred in connection with productive oil and gas wells over the amount that would have been deductible if such costs had been capitalized and either amortized over a ten-year period or deducted over the lives of the wells as a cost depletion; and

(iii) accelerated depreciation on personal property which, treated as an item of tax preference the accelerated depreciation on personal property subject to a net lease (which was expanded to cover all leased personal property).
generally effective for taxable years beginning after December 31, 1975.\footnote{135}

c. Revenue Act of 1978

In the Revenue Act of 1978 ("RA 1978"),\footnote{136} Congress responded to a sluggish economy and investment level by enacting changes to encourage capital formation. This approach weakened the 1969 and 1976 AOMT base. Congress believed that the current capital gains tax in effect at that time, which included two levels of analysis, was counterproductive because it discouraged investment and discouraged the sale of appreciated assets to such an extent that it was not providing as much revenue as would result from a lower capital gains rate.\footnote{137} The rules regarding taxation of capital gains involved a regular tax, minimum tax, alternative tax, and a maximum tax.\footnote{138} This combination was viewed as unnecessarily complex.\footnote{139} Moreover, the capital gains tax was viewed as inequitable to the extent that gains which were taxed represented only inflationary increases in value as opposed to real dollar increases in value of the disposed asset.\footnote{140}

In concert with these changes, Congress believed that the existing minimum tax on capital gains had adversely affected capital formation and that the purpose for which the minimum tax was enacted could be better achieved by implementation of a separate minimum tax on capital gains which would be payable only to the extent that it exceeded a taxpayer’s regular tax liability.\footnote{141} Thus, Congress enacted a dual minimum tax procedure under which the 1969 and 1976 AOMT no longer applied to capital gains and excess itemized deductions.\footnote{142} These two items of tax preference were excluded from the AOMT base and formed part of a new alternative minimum tax ("AMT") which generally applied to taxable years beginning

\footnotesize{\begin{itemize}
\item \textsuperscript{135} Id. at 114, 1976 U.S. Code Cong. & Admin. News at 3549.
\item \textsuperscript{138} Id.
\item \textsuperscript{139} Id.
\item \textsuperscript{140} Id.
\item \textsuperscript{141} Staff of Joint Committee on Taxation, 95th Cong., 1st Sess., General Explanation of the Revenue Act of 1978, 261-62 (Joint Comm. Print 1978).
\item \textsuperscript{142} Id.
\end{itemize}}
after 1978.143

C. Alternative Minimum Tax

After 1979, non-corporate taxpayers were thus subject to two distinct minimum taxes. Under Section 56, non-corporate taxpayers were subject to an AOMT as computed under prior law with the modifications discussed. They were also subject to an AMT under Section 55. In the final analysis, the new AMT added by Section 55 was viewed as a true alternative tax in the sense that the tax was paid only when it exceeded regular tax liability, which now included any AOMT liability from TRA 1969 and TRA 1976.144

The AMT base was computed by adding back to taxable income the preference items for adjusted itemized deductions and capital gains deductions for the taxable year.145 Consistent with this principle, both the adjusted itemized deductions and capital gains deduction preferences were excluded from treatment as items of tax preference for the purposes of the AOMT under Section 56.146 The AMT was imposed according to a new graduated rate schedule that ranged from 0% to 25%.147


By 1981, Congress believed that further statutory modifications were needed beyond those created by RA 1978 to speed and encourage economic recovery and, in response, it enacted President Reagan’s Economic Recovery Tax Act of 1981

143. Id. at 267.
144. Id. at 262.
145. Id.
146. Id. at 261, n. 1.
147. Id. at 263. Consistent with modifications to the capital gain rates and modification of regular and minimum taxation provisions on capital gains, the maximum tax provisions under section 1348 were modified under RA 1978 to be more favorable with respect to capital gains tax preference items. Prior to RA 1978, the maximum marginal tax rate applicable to taxable income from personal services was generally 50%. However, the amount of personal service income eligible for the maximum tax was reduced by the amount of an individual’s tax preferences for the year, and under prior law this offset reduction included the amount of an individual’s capital gains tax preference. As a consequence, RA 1978 removed capital gains tax preference as a deduction offset of the amount of personal service income eligible for the maximum tax rate.
Congress believed that substantial tax rate reductions were central to economic recovery. Thus, marginal tax rates were reduced from a high of 70% to 50%. The rate reduction impact was phased-in over a period of time. Moreover, in order to conform the 1978 AMT to the reduction in the maximum regular tax on net capital gains, ERTA 1981 reduced the top maximum tax rate on capital gains from 25% to 20%.

2. Tax Equity and Fiscal Responsibility Act of 1982

Notwithstanding the enactment of the 1969 AOMT, its expansion in 1976, and its contraction in 1978 and 1981, Congress was dissatisfied with the manner in which wealthy individuals continued to avoid paying any taxes through the use of exclusions, deductions, and credits. Perhaps Congress believed that it had acted too generously in 1978 and 1981. As a result, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA 1982"), and once again revised the minimum tax rules rather substantially.

TEFRA 1982 congressional revisions to minimum tax provisions had two goals. The first was to simplify taxpayer computations of the tax by repealing the separately calculated AOMT provisions, thereby leaving only the AMT provisions. The second goal was to provide a tax reduction for many middle income taxpayers who were paying a minimum tax on some preference income, but who also had substantial amounts of non-preference income. Congress believed that by combining all the tax preferences from the AMT and from the pre-

150. Id. at 28.
151. Id.
152. Id. at 30. Accordingly, under the Act, the alternative minimum tax rate is 10% for amounts, from $20,000 through $60,000, and 20% for amounts in excess of $60,000.
155. Id.
existing AOMT and by focusing the minimum tax on high income individuals, the modified AMT would increase the minimum tax liability only for targeted high income taxpayers with incomes in excess of $100,000.156

Generally, the tax base for the 1982 AMT was an individual's adjusted gross income plus the taxpayer's tax preference for the year, reduced by certain deductions.157 This amount was then reduced by a $30,000 exemption ($40,000 in the case of married taxpayers filing a joint return or a surviving spouse) and was subject to a minimum tax rate of 20%.158 The 20% rate was added under the conference agreement between the House and the Senate. The original Senate position contained a minimum tax rate of 10% on minimum tax base of up to $20,000 and 20% in excess of $20,000.159

The preferences for the 1982 AMT were the same as the preferences under prior law with some revisions. The deduction for long-term capital gains covered under the 1978 AMT was added as an item of tax preference, and the adjusted itemized deduction preference of the 1978 AMT and the preference for amortization of child care facilities were repealed.160 Several new preferences were added to the 1982 AMT, including the $100 dividend exclusion, the all-savers interest exclusion, the 15% net interest exclusion, the excess of expensing for mining exploration and development costs, research and development costs, and magazine circulation expenditures.161 Finally, a preference was added for the excess of the fair market value of stock received upon the exercise of an incentive stock option over the option price.162 The important incentive stock option preference was added in the conference agreement but was not contained in the original Senate proposal.163

157. Id.
158. Id.
159. Id. at 109, 1983 U.S. CODE CONG. & ADMIN. NEWS at 877.
161. Id.
162. Id.
3. Deficit Reduction Act of 1984

Under the Deficit Reduction Act of 1984 ("DRA 1984"),\textsuperscript{164} certain technical and clarifying amendments were made to the AMT provisions.\textsuperscript{165} The most important minimum tax revisions under DRA 1984 occurred with respect to corporate tax preference cutbacks and not with respect to the individual AMT provisions.\textsuperscript{166}

D. Tax Policy Process Analysis

If the scenario presented is correct in that the aggregate netting of passive activity income and loss is a critical defect of Section 469, which has been incorporated in the AMT provisions, it is painfully clear that future legislation will be needed to continually correct the current and future tax abuses which have been created by the deficiencies of past legislation. This continuing spiral of seemingly never-ending tax legislation creates a very real problem for tax practitioners and their clients. Continual legislation breeds complexity. Complexity translates into compliance problems for administrators and taxpayers alike.

Perhaps all this says something critical about the legislative tax policy process as it relates to the creation of tax preferences as a method of attracting private investment capital. If one divides the analytic hemisphere of incentive industries into two groups, asset-based and service-based, a few points become self-evident.

First, except for special services as they relate to ultimate asset or product development (such as research and development expenditures), most legislative preferences are extended to asset-based industries for obvious reasons. The radiations of encouraging private capital to purchase an asset would in theory create a demand for the asset which in turn means there is an expansive ripple effect through the economy on all the component jobs and products necessary to produce the asset necessary to satisfy the capital demand for the asset.

If the asset is a wasting asset, that is one whose value to its

\textsuperscript{164} Id.
\textsuperscript{166} Id. at 924, 1984 U.S. Code Cong. & Admin. News at 1542.
owner is premised upon its intrinsic value to produce other assets, then perhaps capital acquisition stimuli in our tax system, such as investment tax credits and accelerated depreciation, do legitimately stimulate demand for the acquisition of such wasting capital assets. A lingering question must always be whether or not such incentives are economically efficient. It can be argued that they merely accelerate, as opposed to create, demand for such assets. If true, this implies that the resulting economic upswing may be temporary as demand from one period has simply been borrowed from another, thereby creating an up-today down-tomorrow syndrome.

A precise economic analysis is beyond the scope of this work, yet one cannot help but wonder if tax incentives in the wasting asset area are simply not as potentially harmful to our system as those in the non-wasting asset area. Wasting asset incentives tend to be related to a calculated impact on our economy, usually a demand-side effort to reverse or stem a negative economic downturn. For purposes of this work, whether such measures are more beneficial than other non-tax related economic stimuli is not known. Yet, it is hard to see that major casualties are created by this process. One tends to focus more on efficiencies as opposed to casualties.

In this area, perhaps the tax incentive goal should be to increase the after tax yield of owning the wasting asset. This can be accomplished with some combined variant of expensing of part of the wasting asset and allowing economic depreciation with respect to the remaining cost of the asset.167 This process creates an atmosphere of tax neutrality among wasting asset investment choices. The rate of return of owning all such assets increases to a like amount without creating preferences among such assets. Hopefully, such tax incentives do not alter the pre-tax yield on such assets but merely impact the after tax yield.168

With non-wasting assets, such as real estate, however, preferential industry tax incentives are generally designed to attract private investment capital to create demand for real estate, which in theory stimulates building and building com-

ponent construction and hence jobs. When user demand begins to dwindle, vacancy rates in commercial and residential real estate theoretically increase and Congress returns to the well to cut the incentives and, thus the demand for new real estate, until user demand comes more in line with real estate supply.

In this way, Congress artificially stimulates asset demand for real estate when in fact consumer user demand for the use of real estate will not stimulate the demand for itself because the short run pre-tax yield of the investment in such real estate is not sufficient to attract market capital. In this sense, tax incentives in the non-wasting area tend to be more related to social goals (ensuring adequate housing for those who cannot afford to pay rents high enough to create demand for the new housing) than economic goals.

This focuses on the fact that a major component of rate of return ownership of a non-wasting asset is the resale value. These types of assets are purchased for resale unlike wasting assets which are purchased for their production of income until the end of their economic life cycle. It is of course true that in a world without taxes, the market will adjust the prices of these assets until they are nearly even, given equivalent risk quotients, or the lower rate of return asset will disappear from the market place. But if the lower rate of return asset has a longer range social utility which counter balances the shorter range market decision, the continued existence of the asset may be worthwhile in a non-economic sense.

In these circumstances, it is difficult to criticize Congress for "saving" the asset by enhancing the after tax yield of the investment. Yet a closer scrutiny is necessary to ensure that it is understood who bears the ultimate risk for the tax incentive in reality. The problem deserves serious thought.

What should be recognized is that, in effect Congress is shifting the responsibility for the economic benefits of such housing from the renters, who now enjoy lower rents, to the private capital market, which now enjoys a higher after-tax rate of return through ownership. The problem is that ultimately, Congress will pull the plug on the incentive, as it did in TRA 1986. When that occurs, those owning real estate purchased with those new incentives will find themselves saddled with an asset they cannot resell under the same conditions under
which they purchased it because Congress has changed the tax incentives that the new buyer may enjoy.

The basic fairness of this mechanism may be suspect. At the very least it deserves serious thought. It is easy to be critical of the mechanism if it creates traps for the unwary investment community caught in the wrong legislative disincentive cycle. One needs only compare legislation since 1969 to understand that Congress goes through rather obvious incentive and disincentive legislative swings. In 1978 and 1981, Congress was very incentive oriented. In 1969, 1976, 1982, and particularly 1986, Congress was of a different mind.

Who should bear the responsibility for these shifts in moods and how does a practitioner help the client deal with them? Certainly transitional rules, however artfully drafted, are not likely to cure the problem. Perhaps a fair solution would be to put sunset provisions on all such tax incentives in the non-wasting asset area, but it would probably be ineffective. Once again, no investor would buy into the incentive knowing that it would disappear on a fixed date for the reasons discussed above. Therefore the incentive would be, or at least should be, ineffective.

The better answer may be to not utilize these kind of tax incentives at all for non-wasting assets. When economics of the investment hinge upon a resale of the asset as with real estate, the investor who bought the asset under the tax incentive system and must resell in a non-tax incentive system will always be a loser in the short run. Perhaps in this area direct government subsidy versus tax incentives needs to be more fully analyzed.

**CONCLUSION**

Although the passive activity loss rules of Section 469 will be somewhat effective in curbing tax shelter abuses, its aggregation principles (expressed in Section 469(c)(1)) greatly inhibit

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169. See generally Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. Pa. L. Rev. 47 (1977); Kaplow, *An Economic Analysis of Legal Transitions*, 99 Harv. L. Rev. 509 (1986) (authors discuss effectiveness and appropriateness of various legal transitions in various contexts, including wasting and non-wasting assets). It is questionable, however, whether any legal transition can fairly correct the problem discussed in the text, which leads to the conclusion that in this area Congress may be better off abandoning the tax incentive approach.
its effectiveness, and its largely retroactive impact may be unfair. The 1969 limitation on loss rules appeared to be much more effective because they were imposed on a per activity basis. The new passive activity loss preference item of Section 58(b) appears wholly ineffective in achieving its goal of ensuring that those with substantial economic incomes pay their fair share of tax liability.

It would appear that taken with TRA 1986, the new rate reduction and Section 469 PAL rules curb tax shelter abuses for all but the most wealthy. TRA 1986, however, not only fails to assure an effective minimum tax, but it also reduces the tax burden on the wealthy through massive rate cuts. These rate cuts benefit many wealthy taxpayers who did not engage in sheltering prior to TRA 1986. One can only hope that the minimum tax provisions will be revised in future tax legislation to reflect a per activity rule.