PARTNERSHIPS AND TAX SHELTERS: AN ANALYSIS OF THE IMPACT OF THE 1986 TAX REFORM

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The partnership form of enterprise has been effectively used by partners to shelter income from other sources from taxation. Studies have shown that partnership losses were the single largest means by which high income individuals substantially reduced their tax bills [1]. The Tax Reform Act of 1986 (TRA) was a major legislative change toward closing tax loopholes and restoring greater equity to the federal tax code [2]. Provisions of the Tax Reform Act were targeted at reducing these tax shelter benefits of partnerships. At last year's meetings, an initial analysis of time series data through 1987, the first year affected by tax reform, was presented to see if the provisions were having an impact. That paper examined the conceptual and statistical issues for both partnerships and individual partners [3]. This paper is a more-detailed examination of the issues directly affecting partnerships, and it adds data for 1988, a year less-protected by phase-in provisions of the new tax law.

The first section of this paper provides a brief summary of the taxation of partnership income in the pre- and post-reform periods, and it describes how partnerships have been used as tax shelters. The second section describes provisions of the "landmark" Tax Reform Act of 1986 and examines and relates them to the partnership taxation issues. The third section examines time series data on the income and deficits of partnerships, focusing on how the post-reform period (1987-88) compares with earlier years. Partnership data are examined by legal status, profitability, industry, and age. The final section presents some conclusions.

I. TAX SHELTERS AND THE TAXATION OF PARTNERSHIP INCOME

A partnership is not a taxable entity. Each partnership files with the Internal Revenue Service (IRS) an information return (Form 1065) which shows the partnership's taxable income or loss for the year and the allocation of that income or loss to the separate partners. Thus, to fully ascertain the effective taxation of partnership income, the income and separately reportable items must be followed to the tax returns of the partners. While conceptually straightforward, the methodology of such a study is quite complex and time consuming and exceeds the scope of this study. Instead, this paper examines partnership behavior, as reflected in time series data to see if the effects of the 1986 Tax Reform Act are evident.

TRA was a carefully-crafted legislative compromise which blended tax rate reductions and income base-broadening. However, relatively late in the process of building this delicate coalition of supporters, it became evident that agreement might not be reached if something were not done about the equity concerns and fiscal hemorrhage caused by tax sheltering activities.

Tax shelters are generally defined as investments "in which a significant portion of the investor's return is derived from the realization of tax saving with respect to other income, as well as the receipt of tax-favored (or, potentially, tax-exempt) income from the investment itself" [4]. Tax shelters commonly involve one or more of the following advantages:

- Deferral of tax liability through the use of tax provisions or tax preferences that accelerate deductions. Deferral, in effect, produces an interest-free loan from the government to the taxpayer. Examples of such provisions are accelerated depreciation and expensing of intangible drilling costs.
- Conversion of ordinary income into capital gains or other forms of income subject to lower rates of tax.
- Leveraged purchasing which magnifies the other tax advantages.

Because of its nature as a "flow-through entity" and its flexibility in allocating income among partners, the partnership form provides an attractive structure for tax shelters. Before TRA, individuals with substantial amounts of positive income from other sources, such as wages and salaries or self-employment earnings, could invest in partnerships and offset some (or even all) of that income with their distributive share of any tax losses from the partnership. If they invested in a "limited" partnership (as opposed to a "general" partnership), they could receive the limited liability benefit comparable to incorporation as well as the flow-through benefits of partnerships [5,6].

II. PROVISIONS OF THE 1986 TAX REFORM ACT

One of the main goals of the 1986 Tax Reform Act was to reduce the ability of individual taxpayers to offset income with losses from tax shelters thereby lowering their tax liabilities [4]. The Tax Reform Act of 1986 took several steps to reduce the attractiveness of tax shelters, including:

1. Eliminating the preferential tax rate on capital gains.--Before Tax Reform, only 40 percent of most long-term capital gains were included in taxable income; after TRA, 100 percent were included.
2. Reducing the acceleration of depreciation deductions.--This change essentially extends the duration of the allowable depreciation deduction thereby reducing the effective "interest-free loan" from the government to the taxpayer in cases where taxable service lives are shorter than economic service lives.
3. Lowering overall marginal tax rates.-- In addition to reducing the disincentive to increase income, this provision also reduces the value of deductions since their value is equivalent to the size of the

deduction times the marginal tax rate.

4. Imposing limitations on "passive losses.-- The Tax Reform Act added a new category of "passive" income or loss as generated by a flow-through business, such as a limited partnership in which the individual does not actively or materially participate. Before Tax Reform, there were no limitations on "passive" losses offsetting other types of income. After Tax Reform, passive losses could only be used to offset passive gains.

While the passive loss limitations apply to most forms of flow-through business, they particularly concern partnerships. They mean that passive partners, those who do not "materially participate" in the business of the firm, which include most limited partners, can no longer use any temporary losses generated by the business to offset income from other sources such as wages and salaries, or interest and dividends [5]. (Exceptions were provided for certain partners for losses from oil and gas operations and from certain rental real estate activities.)

Although phase-in rules provided some short-term relief [7], it was hypothesized that tax shelter partnerships would be dealt a very serious, if not fatal, blow by these provisions. Specifically, it would be expected that net losses would decline and net income would rise, and that loss partnerships, particularly limited ones, would become less attractive. These expectations are examined in the next section.

III. EXAMINATION OF PARTNERSHIP DATA

Time series data on partnerships for the period 1981-1988 are presented in Figures 1-3. In each of these figures, partnerships were classified by legal type (whether they were limited or general partnerships) and by profitability (whether they had positive or negative net income). With the limitations on personal liability, limited loss generating partnerships were most conducive for tax sheltering prior to TRA [8] and the most likely to show reductions in the numbers of firms, partners, and the size of their losses beginning in 1987, the first year affected by TRA.

Figure 1 presents data on the numbers of partnerships by legal type and profitability. The total number of partnerships grew steadily in the 1981-85 period. However, for 1986, amid the public debates and eventual passage of TRA, the total number of partnerships dropped by 11,000. While this was a relatively small decline (0.6 percent), it marks the first decline in the number of partnerships since 1967. In 1987, the number of partnerships dropped substantially (by over 50,000 firms) but then essentially levelled off for 1988.

The data for each of the four types of partnerships show where the changes in numbers occurred. All four types generally registered increases through 1985, with limited partnerships (both gain and loss) rising more rapidly than general partnerships. The recession of 1982 appears to have contributed to the overall decline in gain partnerships for

Figure 1.-- Number of Partnerships by Type of Partnership and Profitability, 1981-1988

(Thousands of Partnerships)

Year	Total	Type of Partnership			
		General		Limited	
		Gain	Loss	Gain	Loss
1981	1,461	677	576	75	133
1982	1,514	707	581	87	139
1983	1,542	707	601	82	152
1984	1,644	750	636	101	157
1985	1,714	774	660	107	173
1986	1,703	766	663	92	181
1987	1,648	769	617	96	166
1988	1,654	782	587	119	166

For data sources, see note following Figure 3.

1983. After 1985, profitability appears to be the determining factor for increasing or decreasing numbers. The modest overall decline for 1985-86 may reflect anticipation of TRA becoming effective in 1987. The decreases of both limited and general gain partnerships with continued growth among both types of loss partnerships may indicate partners' desires to defer income until the lower tax rates of 1987 and to move up losses to 1986 to avoid the passive loss limitations. For 1987 and 1988, the patterns reversed, with gain partnerships growing and loss partnerships declining for both years as would be consistent with a response to TRA.

The overall number of partners, as shown in Figure 2, exhibited substantial and uninterrupted growth throughout the entire period, even in years in which the number of partnerships dropped. The number of partners of limited partnerships grew much more rapidly and consistently than those of general partnerships, which may be attributable to the growth of large master limited partnerships (MLPs) and similarly large, public investment-type partnerships [9]. The number of partners of general gain partnerships show a large decline for 1985 mirroring a comparably-sized increase in the

Figure 2.-- Number of Partners by Type of Partnership and Profitability, 1981-1988

(Thousands of Partners)

Year	Total	Type of Partnership			
		General		Limited	
		Gain	Loss	Gain	Loss
1981	9,095	2,883	2,036	1,628	2,548
1982	9,765	2,886	2,167	2,027	2,684
1983	10,589	2,939	2,216	2,488	2,947
1984	12,427	3,527	2,215	3,082	3,603
1985	13,245	2,990	2,340	3,680	4,234
1986	15,301	3,061	2,426	4,709	5,105
1987	16,963	3,185	2,255	6,054	5,469
1988	17,291	3,421	2,197	6,664	5,009

For data sources, see note following Figure 3.

number of limited gain partners. While the number of partners in limited loss partnerships did continue to grow for 1987, they declined substantially for 1988, as predicted, and the number of general loss partners declined for both years.

In Figure 3 the net income of partnerships is presented. Despite the growth in the numbers of partnerships and partners through 1985, partnerships overall had losses for each year prior to 1988. These losses peaked in the 1982 recession, dropped for 1983, then began steady and uninterrupted growth culminating with a record loss of $17.4 billion for 1986. For 1987, this trend abruptly reversed with losses falling dramatically before profitability returned with $14.4 billion for 1988, the first time since 1980.

Figure 3.-- Partnership Gain or Loss in Ordinary Income by Type of Partnership and Profitability, 1981-1988

(Billions of dollars)

Year	Total	Type of Partnership			
		General		Limited	
		Gain	Loss	Gain	Loss
1981	- 2.7	42.8	-29.8	7.8	-23.5
1982	- 7.3	44.4	-34.2	9.2	-26.7
1983	- 2.6	48.6	-32.5	11.7	-30.4
1984	- 3.5	55.7	-36.6	14.0	-36.6
1985	- 8.9	60.5	-42.4	16.6	-43.5
1986	-17.4	63.5	-45.3	16.8	-52.3
1987	- 5.4	66.2	-43.4	21.5	-49.6
1988	14.5	81.2	-42.7	30.1	-54.2

SOURCES FOR FIGURES 1-3: Internal Revenue Service, Statistics of Income (SOI) Bulletin selected issues; Internal Revenue Service, 1978-82 Partnership Returns; and unpublished data from Office of Tax Analysis and SOI tabulations of the SOI Partnership files. "Profitability" is defined as gain or loss in ordinary income. Zero is included with loss.

The data for each of the four types of partnerships show more as to where the changes in net income occurred. Net income for gain partnerships (both general and limited) grew in every year between 1981 and 1988. Losses for both general and limited loss partnerships also increased in every period except the post-recession year of 1983 until 1987, the first post-TRA year. For 1987, both types of loss partnerships showed declining losses, which continued for general loss partnerships for 1988. Limited loss partnerships, however, had increased losses for 1988.

Despite the increasing losses of loss partnerships (both general and limited) throughout the pre-TRA period, the number of loss partnerships increased. Such behavior is counter to conventional economic motives which would have predicted that resources (firms and investors) would expand in profitable activities and decline where losses were incurred. This pattern is instead consistent with tax sheltering motives in which investor/partners were seeking tax losses to be used as offsets for other income. For 1987, in an apparent response to the provisions of TRA, this pattern changes, and a movement away from loss partnerships is evident. The substantial increase in limited partnership losses for 1988 is inconsistent with this picture, however, and will be examined later.

The net income of partnerships by industry is presented in Figures 4 and 5 for the period 1985-1988, the period surrounding the passage and implementation of TRA. The first year, 1985, was chosen because it was a year well recognized for tax shelter activity, and because it was the last year totally unaffected by both the publicity as well as the provisions of TRA. The Act was passed in the fall of 1986 amid widespread publicity so, although 1986 was not directly affected by the provisions of the new law, the debate and passage had a large psychological impact. In addition, there were some more tangible effects for 1986, such as realization of long-term capital gains before the preferential treatment was eliminated in 1987 and, whenever possible, shifting losses and deductions into 1986 and shifting income into 1988. Figure 4 presents net income by industry broken down by profitability (gain or loss), while in Figure 5, the data is broken down by legal status (limited or general). In the discussion that follows, the emphasis will be on those industries known for their tax sheltering activities and their effect on the increased profitability of the partnership sector as a whole.

Overall, the substantial improvement in net income from the loss of $17.4 billion in 1986 to a gain of $14.4 in 1988 is attributable more to growth in gains rather than to a reduction in losses. The net income of gain partnerships increased by $31.2 billion in this two-year period, while losses declined by only $0.7 billion.

About $2 billion of the total partnership improvement from 1986 to 1988 came in Agriculture, Forestry, and Fishing. While some of this can be attributed to TRA [10], it appears to result primarily from good years in farming [11]. The improvement is balanced between a $1.1 increase in gains and a $1.0 decrease in losses.

The Construction, Manufacturing, Transportation, and Trade industries all show improvements in net income, usually through increasing gains with modest changes in the amounts of losses. The "Communication" industry in the Transportation industrial division is least typical of this group in that it is still showing an overall loss for 1988 and its loss, though down from 1987, is still larger than for 1986.

"Oil and gas extraction" in the mining industry contributed substantially to the improvement from 1986 to 1988. While the energy sector as a whole was recovering during this period from the sharp decline in oil prices in late 1985, the partnership figures suggest a strong response to TRA. "Oil and gas extraction" was one of the few industries

Figure 4.-- Partnership Net Income Less Deficit by Profitability and Selected Industries, 1985-1988

(Billions of dollars)

Industry	All Partnerships				Gain Partnerships				Loss Partnerships			
	1985	1986	1987	1988	1985	1986	1987	1988	1985	1986	1987	1988
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
All Industries[1]..........	-8.9	-17.4	-5.4	14.5	77.0	80.2	87.7	111.4	85.9	97.6	93.1	96.9
Agriculture, Forestry, Fishing....................	-1.0	-0.9	2.0	1.1	2.8	2.7	4.5	3.8	3.7	2.5	3.7	2.7
Mining.....................	1.5	-3.5	-1.4	0.9	7.9	5.2	5.7	6.6	6.4	8.7	7.1	5.7
Oil & Gas Extraction.....	2.3	-2.7	-1.3	0.5	7.3	4.7	5.1	5.7	5.0	7.3	6.4	5.2
Construction..............	2.2	2.5	2.8	3.3	2.7	3.2	3.3	3.9	0.5	0.7	0.6	0.6
Manufacturing.............	-1.1	-0.5	0.8	1.5	1.2	1.5	2.5	3.6	2.3	2.0	1.7	2.1
Transportation, Communication, Electric, etc.....	-3.1	-3.0	-3.8	-2.3	1.4	1.7	2.0	3.0	4.4	4.7	5.8	5.2
Communication............	-1.7	-2.5	-3.2	-2.7	0.2	0.3	0.5	0.9	1.9	2.8	2.7	1.8
Wholesale & Retail Trade...	2.0	2.3	2.7	3.4	3.5	3.7	4.2	4.7	1.5	1.4	1.5	1.4
Finance, Insurance and Real Estate...........	-25.9	-33.0	-26.8	-19.3	30.4	32.5	36.1	47.8	56.3	65.5	62.8	67.1
Real Estate Operators and Lessors.............	-26.2	-32.8	-33.1	-31.3	17.0	17.8	17.0	20.1	43.2	50.6	50.1	51.5
Subdividers & Developers.	-2.7	-3.0	-2.0	0.0	2.8	3.6	4.3	8.0	5.4	6.6	6.6	8.0
Other Holding and Investment Companies [2]..	0.6	1.1	4.0	4.6	4.9	5.8	7.4	9.5	4.3	4.7	3.4	4.9
Services..................	16.5	18.6	18.1	25.6	26.9	29.0	29.1	37.5	10.4	10.5	11.0	11.9

SOURCES: Internal Revenue Service, Statistics of Income (SOI) Bulletin (selected issues) and unpublished data from the Office of Tax Analysis and SOI Division tabulations of SOI Partnership files.

[1]Includes "Nature of business not allocable", not reported separately.
[2]Excludes Investment Clubs and Common Trust Funds.

Figure 5.-- Partnership Net Income Less Deficit by Type of Partnership and Selected Industries, 1985-1988

(Billions of dollars)

Industry	All Partnerships				General Partnerships				Limited Partnerships			
	1985	1986	1987	1988	1985	1986	1987	1988	1985	1986	1987	1988
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
All Industries[1].........	-8.9	-17.4	-5.4	14.5	18.0	18.1	22.7	38.5	-25.8	-35.5	-28.2	-24.0
Agriculture, Forestry, Fishing....................	-1.0	-0.9	2.0	1.1	-0.2	-0.1	2.3	1.2	-0.9	-0.8	-0.3	-0.1
Mining.....................	1.5	-3.5	-1.4	0.9	0.2	-3.0	-3.6	-1.5	2.4	-0.5	2.3	2.5
Oil & Gas Extraction.....	3.3	-2.7	-1.3	0.5	0.8	-2.3	-3.6	-1.9	2.5	-0.3	2.3	2.4
Construction..............	2.2	2.5	2.8	3.3	2.2	2.4	2.6	2.9	0.0	0.1	0.2	0.4
Manufacturing.............	-1.1	-0.5	0.8	1.5	-0.8	-0.2	0.6	1.2	-0.2	-0.3	0.2	0.3
Transportation, Communication, Electric, etc.....	-3.1	-3.0	-3.8	-2.3	-1.9	-1.6	-2.2	-0.8	-1.1	-1.4	-1.5	-1.5
Communication............	-1.7	-2.5	-3.2	-2.7	-0.9	-1.5	-1.9	-1.5	-0.8	-1.0	-1.3	-1.2
Wholesale & Retail Trade...	2.0	2.3	2.7	3.4	1.8	2.2	2.5	2.6	0.2	0.1	0.2	0.7
Finance, Insurance and Real Estate...........	-25.9	-33.0	-26.8	-19.3	-3.0	-3.5	-0.6	5.0	-23.0	-29.5	-26.1	-24.2
Real Estate Operators and Lessors............	-26.2	-32.8	-33.1	-31.3	-4.7	-6.1	-5.4	-3.5	-21.5	-26.7	-27.8	-27.8
Subdividers & Developers.	-2.7	-3.0	-2.0	0.0	-1.3	-0.5	-0.6	1.9	-1.4	-2.5	-1.5	-1.9
Other Holding and Investment Companies [2]..	0.6	1.1	4.0	4.6	0.8	1.1	1.7	0.8	-0.1	-0.1	2.3	3.8
Services..................	16.5	18.6	18.1	25.6	19.7	21.7	21.3	27.7	-3.2	-3.2	-3.2	-2.0

SOURCES: Internal Revenue Service, Statistics of Income (SOI) Bulletin (selected issues) and unpublished data from the Office of Tax Analysis and SOI Division tabulations of SOI Partnership files.

[1]Includes "Nature of business not allocable", not reported separately.
[2]Excludes Investment Clubs and Common Trust Funds.

granted major exceptions to the passive loss limitations. The improvement in oil and gas is also a combination of increases in gains in the two year period ($1.0 billion) as well as a reduction in losses ($2.1 billion).

A total of $13.7 billion or 43 percent of the overall improvement in net income for 1986-88 came in the Finance, Insurance, and Real Estate (FIRE) industrial division. This is not surprising in view of the large and growing losses in that industry before TRA. What is surprising, though, is that "real estate operators and lessors" (the source of most of FIRE's losses) contributed only $1.5 billion to the 1986-88 improvement. While the gains of profitable real estate operators and lessors grew by $2.3 billion in this two year period, the losses also grew, though by only $0.9 billion. Services showed a $7.0 billion improvement from 1986 to 1988 brought on by an $8.5 increase in gains and a $1.4 increase in losses.

To examine these issues further, Figure 5 presents the net income data by industry broken down by legal status. Overall, the $31.8 billion improvement in net income is attributable to a $20.4 increase in the gains of general partnerships and an $11.5 reduction in the losses of limited partnerships.

In the oil and gas industry, the $3.2 billion improvement in net income was the result of a small reduction in losses of general partnerships ($0.4 billion) combined with a $2.7 billion improvement among limited partnerships. This is not surprising, however, since losses from most general partnerships in oil and gas could continue to shelter ordinary income from other sources, while losses from limited partnerships in oil and gas could not. Thus, these changes are consistent with the incentives provided by TRA.

Among real estate operators and lessors, the $1.5 billion improvement in net income was the result of a reduction of $2.6 billion in the losses of general partnerships, and an increase of $1.1 billion in limited partnership losses. This occurred in spite of the fact that some partners in general partnerships, but not in limited partnerships, could qualify for the special $25,000 exemption from the passive loss limitations for losses from "active" real estate rentals. Real estate has contributed so heavily to partnership losses, yet, despite the provisions of TRA, the losses have leveled off, not declined.

Does the experience in the real estate industry mean that TRA had little effect on the use of real estate partnerships as tax shelters? To the contrary, the fact real estate losses in limited partnerships grew by only $1.1 billion between 1986 and 1988, amounting to 4 percent over a two year period, is a major reversal of the trend for the rest of the decade when losses grew by 30 percent per year. This lack of reduction in losses is also likely attributable to a depressed real estate industry in certain geographic areas, particularly the Sun Belt, which may in part be due to overbuilding caused by the pre-TRA tax incentives.

The largest part of FIRE's improvement in net income less deficit came from "other holding and investment companies," where net income grew by $3.5 billion between 1986 and 1988. How much of this is a response to TRA is uncertain. Some of the increase might be due to investors looking for "passive income" to offset their passive losses. However, most of the income reported in this industry cannot be used to offset passive losses.

This discussion suggests that the partnership sector has indeed responded to the tax shelter provisions of TRA in the 1987-1988 period. However, this response came more through larger gains than through lower losses, and less from real estate. To examine these issues further, data on the distribution of partnerships by year formed or established are presented in Figure 6. In this figure, the percentage distribution of partnerships is presented for all partnerships, oil and gas extraction, real estate operators and lessors, and the total excluding these two industries. Even if the tax shelter industry is not contracting much, we would expect growth among such new firms to be appreciably less than for other types of businesses.

Figure 6.-- Number of Partnerships and Percentage Distribution by Year Formed

Number of Partnerships and Year Formed	All Partner-ships	Oil and Gas Extraction	Real Estate Operators and Lessors	All less (2) and (3)
	(1)	(2)	(3)	(4)
Number of partner-ships (1,000s)...	1,654.2	45.3	591.3	1,017.7
	Percentage (%) distribution			
1988..............	11.0	9.5	6.6	13.7
1986-1987..........	19.3	8.2	13.8	23.1
1983-1985..........	24.4	21.2	26.8	23.2
1978-1982..........	22.4	41.3	28.6	18.0
before 1978........	22.8	19.6	24.2	22.1
Total............	100.0	100.0	100.0	100.0

Overall, 11 percent of partnerships were established in 1988. For the earlier periods, about 20 percent were formed in each of the other age classes listed. For oil and gas and real estate, however, the picture is quite different. Only 9.5 percent of oil and gas partnerships were established in 1988 and only 8.2 percent in 1986-1987. Further, the pattern is much less uniform for earlier periods with 41 percent being established in the 1978-82 period.

Real estate, though not peaking as sharply in the earlier periods, declines very sharply in the 1986-88 period. Only 6.6 percent of active real estate partnerships were formed in 1988. Column 4 in the figure shows the effect of excluding oil and gas and real estate from the total. For 1988, the formation of real estate partnerships was at a rate of only 48 percent of this total excluding real estate and oil and gas. Thus, there is strong evidence that real estate and oil and gas are in decline with fewer firms now entering from this examination of the age profile of partnerships. Of course, economic conditions as well as the effects of TRA can be contributing too.

Additional examinations of the age profiles of real estate and oil and gas partnerships were carried out, specifically by type and profitability. For real estate, some variance across these four groups was present. The percentage of "births" in 1988 ranged from a high of 10.5 percent for limited loss partnerships to a low of 4.6 percent for general loss partnerships. For oil and gas, however, a much stronger pattern emerged as shown in Figure 7. Births in 1988 of general gain and general

Figure 7.-- Number of Oil and Gas Extractor Partnerships and Percentage Distribution by Year Formed

Number of Partnerships and Year Formed	General Partnerships		Limited Partnerships	
	Gain	Loss	Gain	Loss
	(1)	(2)	(3)	(4)
Number of partnerships (1,000s).....	21.8	8.1	10.3	5.1
	Percentage (%) distribution			
1988...............	12.5	15.6	1.4	3.9
1986-1987...........	5.3	9.7	8.3	18.1
1983-1985...........	8.0	8.5	40.5	59.1
1978-1982...........	63.3	24.5	22.2	12.3
before 1978.........	11.0	41.6	27.6	6.7
Total.............	100.0	100.0	100.0	100.0

loss partnerships were 12.5 and 15.6 percent, respectively. However, limited gain and limited loss partnership births in 1988 were only 1.4 and 3.9 percent, respectively. This clearly seems attributable to the provision that losses from oil and gas general partnerships could continue to shelter other partners' ordinary income, while losses from limited oil and gas partnerships could not.

IV. SUMMARY AND CONCLUSIONS

The goal of this paper was to see if, after two years, the 1986 Tax Reform Act was achieving its intended effect, that of curbing the activities of tax shelter partnerships. The evidence suggests that this has begun to happen, although not exactly as hypothesized. The partnership sector responded to the tax shelter provisions of TRA in 1987, more by increasing positive income than by reducing losses. In real estate, the source of over half of all partnership losses, the losses stopped growing but have yet to decline.

As the phase-in of the passive loss limitations proceeds and partnerships are able to restructure even their illiquid investments, we expect that partnership losses, the number of partnerships, and the numbers of investor/partners will decline in unprofitable sectors in which pre-TRA tax benefits were a large part of their attractiveness. Of course, if the elimination of tax shelter benefits are combined with real economic declines in these industries, losses may continue to mount and the real effect of TRA may never be fully ascertained. Only time will tell.

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[6] Shapleigh, Colbert C., and Raley, Terry M., "The Effect of the Passive Loss Rule and Other Related Provisions of the Tax Reform Act," Journal of Partnership Taxation, Spring 1987.

[7] In 1987, 65 percent of passive losses from pre-TRA investments were allowed; in 1988, 40 percent; in 1989, 20 percent; in 1990, 10 percent; and none in 1991.

[8] Dworin, Lowell, "An Analysis of Partnership Activity, 1981-83," Statistics of Income Bulletin, Spring 1986, Volume 5, Number 4.

[9] Nelson, Susan, and Martens, Joann, "Master Limited Partnerships: A View from their 1986 Tax Returns", OTA Paper 63, U.S. Treasury Department, May 1989.

[10] "Beef cattle except feedlots," which had benefited from treating most income as capital gains and deducting most expenses against ordinary income, went from a net loss of $0.3 billion in 1986 to a net gain of $0.1 billion in 1988.

[11] According to the Department of Agriculture, farm income rose from $37.5 billion in 1986 to $43.5 billion in 1987, but dropped slightly to $42.6 in 1988.