THE KINGDOM OF PAL:
A PARABLE OF TAX SHELTERS
AND THE PASSIVE ACTIVITY
LOSS RULES

by Daniel S. Goldberg

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Gather 'round to hear the tale of a well-meaning,
but misguided sovereign who chose to use his kingdom's
tax system to influence his subjects' economic behavior
thereby to improve the lot of the kingdom. The tale is
a tragic story of how the subjects accepted the subsidy
only to be viliﬁed and to see the subsidies removed
with great pain to them and at the cost of destabilizing
the kingdom.

THE STORY OF THE KINGDOM OF PAL

"Far back in the mists of ancient time, in the
glorious days of the former Galactic Empire, life
was wild, rich, and largely tax free.

Mighty starships plied their way between exotic
planets seeking adventure and reward among the
furthest reaches of galactic space. In those days spirits
were strong, the stakes were high, men were real men, wom
men were real women, and furry small creatures from Alpha
Centauri were real small furry creatures from Alpha Cen
tauri. And all dared to brave unknown terrors, to
to mighty deeds, to boldly split inﬁnitives that no man
dared to split before—and thus was the empire forged.

Many men, of course, became extremely rich, but
twas perfectly natural and nothing to be ashamed
of. And for all the richest and most success
ful merchants, life inevitably became rather dull and
and they began to imagine that this was therefore
fault of the worlds they'd settled on. None of them
were entirely satisfactory: either the climate wasn't quite
in the later part of the afternoon, or the day was half
hour too long, or the sea was exactly the wrong
shade of pink." (Excerpt from The Hitchhiker's Guide to
Galaxy, page 634784, section 5a. Entry: Magrathea.)

Within the empire, there was a kingdom known as
Kingdom of PAL, in which the king held the enlighter

view that public services should be supplied to his sub-
jects. To pay for those services, a tax had been enacted
based upon income, so that each of the subjects of the
kingdom was required to pay a certain percentage of his
income to the king. Income subject to tax was to be
determined after subtracting various expenses incurred
in earning that income.

While the people were not happy paying a tax, they
tried to accept the obligation because the percentage of their
income that was required to be paid in tax was fairly
small, the computation of the tax was fairly simple, and
the collection of the tax did not require a great deal of
work on their part. Farmers, for example, would simply
report the amount of crops they sold, the amount expended as
growing expenses, and the amount left over after those expenses. They
would then deliver in coin the realm the appropriate
portion of their income to the king's courier, who would
verify that the amount delivered was the appropriate
amount. And thus was the empire forged.

The kingdom was happy and proﬁtable, and the sub-
jects were content that the tax levy was not overly
burdensome. A farmer was free to choose what he grew and
would make that choice based upon his anticipation of
what the people of the kingdom desired to eat and the
anticipated rainfall for the season. The king did not
attempt to inﬂuence the farmer's choice, nor did he want
to because the subjects of the kingdom through exercise
of their buying power would reward any farmer who grew
the crops that were most in demand. Thus, the king was
revered as a wise and generous king, because his
subjects' lives were happy and productive and his sub-
jects were able to choose what they wished to buy and
consume and what they wished to produce, without the
king's permission or interference.

One day, there came into the Kingdom of PAL a great
philosopher from a famous university of another kingdom. He
brought with him volumes of great learning and ideas
never before known in PAL.

The king observed him that grain is a marvelous
crop. It is the stuff out of which bread is baked and bread
is the staff of life. Wouldn't it be good, the king wondered
aloud, if we could bake more bread in the kingdom? Who

2The royal counters would argue, in this connection, that
merchants would never have grown the grain if it were not for

...
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could deny that bread was good? Who could object more of a good thing?

The Great Philosopher, a great lover of sandy
himself, considered the idea. Noting the king's desire
seeking to please him, the Great Philosopher sug-
ggested that the worthy goal of more bread could be accomp-
ished if the farmers could be persuaded to grow more gi-

'Grain growing could be encouraged
through special incentives and,' the C
Philosopher assured the king, 'the far-
i would not object.'

"But, farmers are free to grow grain for vegetables without any interference from the king. I would not want to command farmers to grow more grain, as they do in certain portions of the empire."

"On the contrary, grain growing could be encour-
gaged through special incentives and," the Great Philos-
opher assured the king, "the farmers would not object."

The king was overjoyed by the prospect of more grain and happy farmers.

The Great Philosopher described, in greater detail, how grain production would be increased by means of tax incentives to farmers. Every expense that a farmer could incur growing grain would be doubled for the purpose of calculating the farmer's tax. At tax time, the farmer would be audited by the king's official counters, which would verify what the farmer had grown and sold as well as the farmer's expenses. But the counters would then double the expenses of growing grain as if they were twice the amount of the actual expenses.

Upon hearing the plan, Surrey, the Court's jester, tugged on the king's robe. "Your Highness, I implored the Great Philosopher's plan is just like paying the farmers to grow grain. Do you really want to pay to grow grain?"

The king responded: "Collecting less tax is no subsidy."

The Great Philosopher agreed. And so it was done.

Before the first growing season ended, it became apparent that the Great Philosopher's plan was working. More grain had been planted than had previously been planted, and everybody could look forward to having more bread and sandwiches to eat.

Yet, the kingdom was not made any happier course, bread became more plentiful and therefore expensive to buy. As a result, more was bought by subjects of the kingdom. But less fruits and vegetables were available because many fruit and vegetable farmers stopped growing them and instead planted grain, on fields not readily suitable for grain. The price of fruits and vegetables increased.

In addition, at the time that taxes were collected, the king's official counters noticed that overall tax collection was less than they had been in the previous year. Lightly-taxed grain was produced and the production of more highly-taxed grain and vegetables declined. Yet people still wanted the king to provide the same services that had been provided in the past.

Seeing these unexpected effects, the king approached his Great Philosopher with the dilemma. It did not

the philosopher very long to arrive at a solution that was satisfactory to him. "Merely increase taxes," said the philosopher.

"Grand idea," said the king, "but won't the people be angry?"

"Well," remarked the philosopher, "the fruit and vegetable farmers may complain, but surely the grain farmers will not, because the savings to them from the special tax treatment applicable to grain would be greater than the extra tax that they would have to pay on their grain production." In addition, knowing the king's great liking of bread, the philosopher assured the king: "More delicious bread was certainly worth the extra taxes, and surely the people would come to realize that."

To the king's great surprise, however, the people were angered by the tax increase. Simply put, they were receiving no greater public services, but were asked to pay more taxes. Also, the prices of fruits and vegetables had increased. Yes, there was plenty of bread to be had throughout the land and at a somewhat lower price than what it had formerly been. But, there had always been a sufficient plentiful supply of bread to satisfy most people's demands. At least, no one could remember anything different. Moreover, there was now a select group of people who were paying less tax proportionately than the rest of the kingdom: the grain growers. Indeed, a grain grower who had substantial earnings was paying much less in taxes than subjects of the king who were much less well-off.

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News of the inequity soon spread and indeed, The Crier, the official newspaper of the realm, reported that hundreds of grain growers were paying too little tax and that the entire tax system had been corrupted. Indeed, reports circulated that merchants, who knew nothing about farming, were buying farmland and hiring farmers to grow grain, because grain production was taxed in such a favorable way. Even though a sufficient amount of grain could be grown on merchant land to pay both the farmers' compensation and other expenses and still return a profit, those merchants were treated as having suffered a loss because their expenses were doubled in computing their income from grain activities, and when doubled, exceed their income from grain sales. Those losses could be used to reduce the tax liability on their merchant income.

Eventually, the king was able to deflect much of the popular animosity toward the merchants and grain growers themselves. According to the press, the grain growers were the greedy farmers who had their hand out for a "subsidy" and therefore were being supported by the honest and hard working people of the realm. Even more defensible, according to an editorial in The Crier, were the merchants who were investing money with the grain farmers and receiving some of the subsidy themselves. Surely this was not what was intended by the special tax treatment accorded grain production.

The Great Philosopher reassured the king: "It was not Your Highness' decision that was the problem. How could it be; you are the king."
Who was at fault? The king was certain that the Great Philosopher, who had suggested the program, surely could not be at fault, because he had all the academic degrees that were possible within the empire. So the king concluded that it must be the fault of the greedy merchants and some of the grain farmers who were abusing the system and not paying their fair share.

The king communicated these observations to his subjects. When stated in this way, the people of the kingdom overwhelmingly accepted the king’s explanation. The king, after all, not only held his throne by divine right, but was therefore by definition worthy of it, but was also a great communicator.

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knowing of the great displeasure throughout the realm, royal counters also picked up this theme. Often when a royal counter would visit the farm of a merchant to verify sales and expenses, the counter would deny that the grain was indeed grain and therefore that the expenses were eligible for the special treatment. To be seen frequently the royal counters were correct, because fending merchants had disguised other products as grain. Sometimes, however, the counters would contend that although though the grain was grain, it was not eligible for the special tax treatment because it was grown as grain. Grain growing merchants, predictably, would protest the counters’ determination and petition convene the Board of Wise Men, appointed by the king to settle the disputes. The Board of Wise Men would attempt to reach their determinations as to whether the merchant’s grain was indeed grain or whether it was kind of grain eligible for the special tax treatment. They would do that sometimes without examining the grain carefully, but rather evaluating the merchant’s motives for becoming a grain grower or emotional commitment for grain growing.

It came to pass that when the royal counters came to visit the merchants, the merchants would dress like genie farmers, donning appropriate boots, cloak, and hat for this purpose. Indeed, a rental business in grain farming began to emerge in the areas of the kingdom where merchants and their advisors gathered. Frequently, disguise was successful. Unusually perceptive count or wise men, however, sometimes were able to discern particular merchant characteristics or habits or sometimes an article of dress that they could use to distinguish them from true grain farmers and therefore disallow special tax benefits. In fact, royal counters and wise men began to classify some cases as “generic merchant in farmer’s clothing cases.”

Most of the subjects of the realm regarded the situation as unacceptable and clamored for fairer taxation and reduced tax rates. The fiscal condition of the kingdom was unsatisfactory. The king knew it, the Great Philosopher could see it, the people felt it, and even the counters, both the royal counters and the subjects’ counter-advisors, perceived it. The Board of Wise Men was also tiring of its attempts to discover merchants in grain farmer’s clothing. Something had to be done.

The King’s Solution: The Passive Activity Loss Rules

The king turned to the Great Philosopher for a solution. Undaunted, the Great Philosopher thought of a way by which the people’s grievances could be redressed and tax rates reduced to their former levels. He suggested that grain growing be separated from all other activities for purposes of tax collection and that the subsidy (for now it was regarded as a subsidy) received by a farmer from grain growing be restricted. That could be accomplished by not allowing tax losses from grain production (largely resulting from doubling expenses from grain production in computing income) to be used to offset the real income from other sources. Rather, the grain “loss” would be held in suspense until such time as the farmer had tax profits (expenses could still be doubled) from his grain growing activities. For those farmers who were managing activities for merchants who were attracted into grain growing, the income from managing the farm was not to be considered income from grain growing activities. If, therefore, could not be offset by losses from grain growing activities for their own account.

The king’s previous policy of encouraging grain growing through subsidies caused the market for grain to be flooded and the price of grain to drop to a level that precluded... an economic profit without the subsidy.

Most significantly, merchants who had hired farmers to grow grain for them found that their subsidies disappeared. That was because the tax losses from grain growing were not usable to offset their merchant incomes. The loss of the subsidy was very disappointing to those merchants because the king’s previous policy of encouraging grain growing through subsidies caused the market for grain to be flooded and the price of grain to drop to a level that precluded grain growers from earning an economic profit without the subsidy.

Farmers, as well as merchants, had borrowed heavily and committed resources to the growing of grain during those several years in which the subsidy was in effect. They had planted fields, purchased harvesting equip-

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1The royal counters would argue, in this connection, that merchant would never have grown the grain if it were not for special tax treatment, because he could not have made a profit absent that special treatment. Without that requisite profit, he should be denied the special treatment.

2The most famous case to come before the Board of Wise Men was the case of Rose v. Royal Counter, 7 Board of Wise Men 3 (reprinted as Rose v. Commissioner, 86 T.C. 386 (1987), aff’d, 868 F.2d 851 (6th Cir. 1989), in which the Board, coining the phrase “generic tax shelter,” discovered a way to decide such cases without the need to resort to examining the facts, to be sure, a great time saver.
ment, and purchased or rented on a long-term basis for the growing of grain. With the price of grain having fallen to an amount less than the cost of producing it, the farmers and others who had endeavored to be involved in the grain growing business were unable to pay their loans. Money lenders, in turn, whose business it was to borrow money from the king's subjects and lend it at a profit, began to experience collectible loans. They, in turn, were unable to pay interest or even return the money of their lenders, the hard-working subjects.

Now the king was faced with a financial crisis in his kingdom, because many of the kingdom's money lenders had become insolvent. To assure the savers within his kingdom that they would be able to obtain return of money from the money lenders, the king arranged to borrow money from other savers to repay the money lenders' creditors. These new expenses had to be either by reducing public services provided to the king's subjects or by increasing taxes to them. Neither solvency was terribly appealing.

In addition, grain farmers as well as the merchants who had hired the grain farmers to farm fields for them realized that the root of their problem lay in the fact that they were engaged in the activity of growing grain. What exactly is grain? There were many varieties of crop that could be used to bake bread in the form of loaves and not all of them may have fallen within the definition of grain as set forth in the king's edict. They there sought out philosophers who could tell them what was real and whether the crops they were planting the next growing season would constitute grain.

The king announced to his subjects that there was a money-lending crisis, but manageable proportions. He therefore ordered several public executions of the money lenders.

The king, seeing this army of philosophers throughout the empire descend on his kingdom for purpose of determining what grain really was, sought the help of his own band of philosophers to create a royal definition of grain.

Meanwhile, the king announced to his subjects that there was a money-lending crisis, but of manageable proportions. The crisis arose because of the unmitigated greed of the money lenders who impossibly lent their money to grain growers on grain fields, grain planting and harvesting equipment. He therefore ordered several public executions of these money lenders. Yet, the king persisted in his tax policy and kept the subsidy in place.

During this time, several fruit and vegetable growers had dedicated a portion of their fields to grain growing in order to be entitled to a portion of the king's large crop of fruits and vegetables. They had stayed high during these years, and a profit could easily be made from growing and selling these crops. But if these crops could be made to appear like grain, the profit from their sale could be offset by the tax losses from the grain growers in the current and previous years. In addition, fruit and vegetable growers could attract capital from merchants who had unusable losses from grain activities. Thus, fruit and vegetable growers hired some of the philosophers from around the empire to explain why fruits and vegetables were actually a type of grain.

The philosophers who had been hired by the grain growers and merchants held weekly luncheon meetings with the philosophers who had been hired by the fruit and vegetable growers (and some merchants who had hired those fruit and vegetable growers). They discussed why grain was not really grain if grown in a certain way, but fruit and vegetables were really a type of grain. These weekly luncheon meetings were begun by responsive readings from the Farmer's Almanac and other similar authoritative sources.

An alarmingly large amount of the kingdom's intellectual resources were being devoted to the determination of what was grain and what was not grain.

The king's philosophers were feverishly at work attempting to explain to the subjects of the kingdom what grain really was. Those philosophers were aware of the other two groups of philosophers, one group attempting to narrow the definition of grain so that their clients' crops would fall outside of that definition and be free from restrictions on their use of losses from the activity, and the other group attempting to expand the definition of grain so that their clients' income from crops, which would fall within the definition of grain, could be offset by grain losses. The king's philosophers, however, sought to do both: Use a narrow definition to deal with those subjects who desired a broad definition and a broad definition to deal with those subjects who desired a narrow definition.

While the king's philosophers were scratching their collective heads over the problem, the king's counters, who were not schooled in philosophy, had to make daily decisions of whether crops they examined on farms were grain or not grain in order to determine the appropriate treatment of growing expenses. What little guidance they received from the philosophers was completely unintelligible to them. Moreover, the farmers' counters, who usually computed the farmer's tax liability and accompanied the farmers during the royal counters' visits, could neither understand the guidance given by the king's philosophers nor their employers' philosophers. Their solution to the characterization problem, however, was quite simple. If their employer wanted the crops to be grain, then they were grain; if the employer wanted the crops to be not grain, then they were not grain. Those were easy instructions to understand and carry out.

To the king's surprise, then, much less grain appeared to be grown in some quarters of the kingdom than had been reported in previous years, although crops of other varieties appeared to be growing in increased amounts. Other quarters appeared to show increased grain production. In any event, the penalty imposed upon grain growers did not appear to be yielding sufficient revenues to offset the reduced taxes resulting from reduced production of non-grain crops. What was most distressing, however, was that an alarmingly large amount of the kingdom's intellectual resources were being devoted to the determination of what was grain and what was not grain. All of the philosophers were being paid by their respective clients or the king, as the case may be, but of course the king's philosophers were not paid nearly as much as the farmers' philosophers. Not surprisingly,
several of the king's philosophers left the king's empic and sought out farmers to whom they could sell the expertise on grain definition.

As time passed, the kingdom became an unhappy place. How could a kingdom with so many philosophers so hard at work be in such disarray? Clearly, something had gone wrong. The king was well meaning; the farmers simply obeyed the galactic laws of supply and demand over which the king had no control, in choosing the crops; the merchants simply employed their capital in manner designed to maximize their return; the money lenders loaned money at a profit to entrepreneurs who were pursuing profitable endeavors. Yet the gods themselves appeared to conspire against the kingdom because, spite of all these well-meaning participants, the economy and revenue collection system of the kingdom was in shambles.

THE ANALYSES

Every person and group within the realm knew where the fault lay.

The King

"I don't understand how we could be in this situation. When I assumed the throne, we had bread, but sure more bread would be good for my subjects. Bread, they said; staff of life, should be available for all and I was in the best position to cause that to happen. I sought out the most sophisticated help available to accomplish the objective. I used my power to provide farmers extra incentive to grow grain out of which bread could be baked. Those farmers not only increased their planting of grains; as I expected, but sought out merchants to purchase land and equipment so that they could grow grain for them as well. The farmers got rich from a program designed to increase the supply of bread to the kingdom.

"The merchants behaved even worse. Instead of continuing to devote their time and energies to selling products, including bread, to the people of the kingdom, they became involved in growing grain, an activity about which they had no knowledge and experience. They were able to get farmers to do their work and merely profit from the tax subsidies available to them as newly incentivized grain growers.

"The money lenders also misused the subsidy. Because the demand for capital to purchase land and equipment to grow grain became so great, the money lenders saw an opportunity to lend large amounts of money unconscionably high rates of interest. They should have known that the profits were too good to be true and the lending would lead to disaster.

"The philosophers hired created an unworkable system of revenue collection and then never stayed around long enough to solve the problems they created. Rather they went to work for the merchants and farmers a used their knowledge and experience gained at co against the kingdom.

"All of these greedy people used a well-meaning program designed to benefit the subjects of the realm to their own profit and created great unhappiness throughout the land."

The Farmers

"Every year I choose which crops to plant based upon which crops I expect will yield the most in the market harvest time. When the king increased my expected yield on grain, of course I increased my growing of grain. Is that what His Highness wished me to do and indeed we did nothing wrong. We simply employed capital in the manner desired by the king and now we are being punished for it.

"The king has now imposed penalties on me by way of precluding me and other merchants from getting any benefits from the tax subsidies at a time when grain prices are at an historical low. I am not sure why my fellow merchants and I were singled out for this special harsh treatment. We did nothing wrong. We simply employed capital in the manner desired by the king and now we are being punished for it."

"Moreover, we have to suffer the double punishment of hiring philosophers to determine the extent of the punishment, because the system for extracting that punishment is so complex."

The Philosophers

"The king, at the suggestion of the Great Philosopher, had instituted a system whereby grain growing was sub-
We can have no sympathy for those people who seek to make their living in the tax system of the kingdom but are not intelligent enough or energetic enough to learn the intricate and detailed rules that we create.

"It is true that the resultant rules are quite complex and many merchants and farmers are unable to understand them, much less apply them to their own situation. But only those merchants and farmers who are able to understand the rules will be affected. Those who are not attempting to abuse the system need never have to deal with those rules. Those merchants and farmers who attempting to abuse the system should have that knowledge.

As for the counter, both for the king and for the subjects of the realm, who claim that they also understand the rules, they simply have to put in effort to educate themselves. We can have no sympathy for those people who seek to make their living in the tax system of the kingdom but are not intelligent enough or energetic enough to learn the intricate and detailed rules that we create. It is no excuse that they have many responsibilities in their jobs in addition to the philosophy associated with the definition of grain and the true grain farmer worthy of the king's subsidies.

The Great Philosopher

The Great Philosopher could not be reached for comment. He was last seen traveling through the galaxy in search of another kingdom.

Epilogue

The next phase of the story has not yet unfolded. Subjects of the kingdom, learning of the hardships that resulted from the violent swings in the king's policy, would be slower to react to tax incentives in the future. That would cause a lengthening of any period of new tax incentive provisions, slowing the movement of capital into the newly favored activities, allowing unreasonably high profits in those activities to continue for longer periods than were warranted by the need to attract capital. The people's experience with the king's taxing policies caused distrust of the kingdom's tax system, the king's philosophers, and, ultimately, the king himself.

The king could not figure out how to undo the mess. To simply dismantle the loss limitation structure and reinstate the tax incentives, unfettered once again, would create imbalance in the economy of the kingdom and perhaps more importantly, at least from a perceived equity point of view, reward those subjects who anticipated its dismantling and were able to purchase grain production activities at distressed prices. Moreover, the revenue cost of fully reinstating the subsidies was likely to be unacceptable because it would require raising tax rates for all other subjects of the realm. It would also increase the public's distrust of tax policy and tax policy incentives because of the wide swings of the pendulum again.

To leave the structure restricting losses unchanged was also not acceptable. That alternative would continue to create the destructive punishments caused by the penalties, the overwhelming administrative burden placed on grain growers and the costs of the superstructure necessary to administer the new tax laws.

The king could accede to the now increasingly loudest cries for a complete overhaul of the tax system. Some recommended a complete departure from an income-based system in favor of a consumption-based system. Any change, however, would result in some subjects being winners and some subjects being losers. As a result of past changes in the revenue-raising system, theoretical justifications became less important to the subjects of the kingdom than the effects of any shift on their own personal wealth.

The king's most important error was his departure from the theory that permitted him to impose an income tax on his subjects in the first place.

Indeed, many of the king's subjects were coming to the realization that the king's most important error was his departure from the theory that permitted him to impose an income tax on his subjects in the first place. The income tax had always enjoyed popular support as fair. For it to work efficiently, it must also be a large degree consensual. For members of a society to accept the tax and pay their share, they must believe the system to be fair, equitable, and not overly burdensome. Even in a nondemocratic framework, as was the case in the kingdom, those same ideals must obtain.

Nevertheless, Crown Prince George, next in the line of succession, proposed as a solution to the kingdom's problems a special tax incentive for merchants entering new businesses. One-half of the receipts from eventual sales of those businesses would be excluded from their income. The Crown Prince assured the kingdom that the incentive would pull the kingdom out of its morass. And so the tale continues.