GEORGE ENGLER MARCH 7, 1985

TAX SHELTERS - ARE THEY NECESSARY?

Recently a headline in the Louisville Courier-Journal stated, "Nader group says tax shelters cost U. S. $24 billion in '84". The Nader group stated that 82% of the $24 Billion lost to the Federal Government went to people with annual incomes above $100,000.00.

Joan Claybrook, president of Public Citizen, a Ralph Nader research group, said that "It is scandalous that our tax system is handing out more than $20 billion in tax subsidies for wealthy taxpayers to invest in these umproductive shelters at a time of $200 billion deficits". She and her group blame President Reagan's tax policies for a one-third increase in tax shelter losses to the Treasury since 1981.

This $24 billion put in perspective would save the average taxpayer $300 per year or stated another way, "roughly equals the total amount the federal government spent on food stamps, student loans and Aid to Families with Dependent Children".

Richard Meyer wrote a report for Public Citizen entitled "Running for Shelter". In this report Meyer concluded that:

1) Tax shelters threaten to wipe out family farms by inflating land prices, encouraging overproduction of some commodities and encouraging non-farmers to invest in croplands just for the tax benefits".

2) "Shelters are responsible for overbuilding in many areas and for inflating prices of commercial real estate by as much as 20 percent".

3) "Illegal shelters, or abusive shelters as the Internal Revenue Service calls them, are the nation's fastest growing type of swindle. The IRS estimates a tax loss of $3.6 Billion a year".

Meyer defines a tax shelter as "any kind of transaction designed to use investment losses to shield other income from taxes".

A tax shelter may also be defined as any type of investment that aids the investor in deferring, avoiding, or reducing taxes.

This paper is not designed to applaud the abusive or illegal tax shelter but to clarify and justify some forms of sheltered income.

The interest paid by most home owners is a tax deduction. If we did not have this "tax shelter" how many new home buyers would be discouraged from buying a home. There is a proposal in Washington to disallow the tax deduction for this interest.

Our Churches, Hospitals, Libraries and other charitable organizations operate on donated funds from generous Americans. How would these organizations function if charitable deductions were disallowed as a tax deduction? There is a proposal in Washington to do away with these "shelters".

Pension plans, Keough's, and Individual Retirement Accounts are actually tax shelters for they defer taxable income to a later date. How would our lives change if we had to depend solely on the Social Security for our retirement years?

Interest derived from Municipal bonds are free from federal income tax. If this income were taxed, our schools, hospitals, water and sewer systems, highways, and other municipal projects would find it difficult to find proper financing. Municipal bonds are a form of tax sheltering that aids every taxpayer in the form of lower school taxes, lower water rates, and other benefits too numerous to list.

Mr. Richard Meyer noted earlier as the author of "Running for Shelter" added in his remarks that "in reality (the Reagan tax cut) proved an unprecedented bonanza for shelters because of its generous revisions of the depreciation laws". These generous revisions in depreciation noted by Mr. Meyer are partially attributable to the resurgance of our own economy and the rapid reformation of capital for future expansion, growth, and jobs. These laws affect the large and small businessman alike in his decision to expand his enterprise. The American free enterprise system is based on hard work, good judgement, and taking business risks.

We cannot expand capital and encourage growth without allowing the investor to have a chance of a rapid return on his investment. Depreciation allows an investor to shelter his income from taxation in order that he might re-deplay his assets to future growth.

The capital gains taxes are also under fire by many "public action" committees. If an individual, corporation, or partnership wish to invest their capital in an investment which offers degrees of risk and reward, that entity is given preferential tax treatment if the investment makes a profit and if it is held for a period longer than six months. If this were not the case, how many people would be willing to invest their money an any sort of speculative endeavor? Favorable capital gains laws are necessary, in my opinion, to foster growth of new and old businesses both on the local and national level.

The American taxpayer wants more. He wants to shelter his income at a much lower cost, at a cost in cash which is only a fraction of the amount he is sheltering. He doesn't want to pay a dollar to shelter a dollar. He wants to pay a dollar and shelter six or seven dollars. He even wants to get his first dollar back. These are the type of tax shelters that Ralph Nader, Joan Claybrook, and Richard Meyer refer to in their writings.

The Internal Revenue Service considers a shelter to be abusive if it is created with no thought of making a profit and if it promises deductions that are more than double the size of the investment. Congress does not intend to write tax laws which enable you to make money on investments just by avoiding taxes. When people invest, Congress expects them to profit because they make good investments and manage them properly, not because they weave their way through the tax laws, collecting their profits only at the expense of the federal treasury. There are special laws enacted by Congress and most often enforced by the Internal Revenue Service to prohibit abusive tax shelters. An entire industry has built up over the last generation with many of the finest legal minds in our country devising ways to circumvent the existing tax laws.

On any given day in our country you may pick up a news publication which decries the unfair complicated tax laws now in existence and demanding the total upheaval of our entire tax system. This system, in my opinion, is as fair as any system could be under the existing conditions. The United States of America is truly a melting pot in many ways. We have many different religions, ethnic groups, and races but we also are the land of varied economic groups, special interest groups, and powerful political factors. How then can we evaluate what is a valuable necessary tax shelter and what is an abusive shelter? The answer is not easy and this paper is not attempting to pass judgement on what is essential to the free enterprise system and what is not. This paper will attempt to explain how these so called abusive tax shelters work and some rationale behind their creation.

Shelters may range from investments in oil exploration, to leasing of airplanes, to the construction of office buildings. The tax advantages arise from the use of borrowed money, the deferral of taxable gains and the transformation of regular income into capital gains.

No discussion of tax shelters is complete without mentioning Real Estate. People tend to trust real estate more than they trust oil, equipment leasing, cable television, cattle, horses, movies, timber, mining or any other exotic tax shelters. Our tax laws favor real estate, and the IRS seems to get less disturbed when they see a real estate related deduction. Theoretically, a real estate shelter is typically one in which you buy a portion of a rental property, participate in the tax deductions, then a few years later also participate in the profits from the sale of the property. This property may take the form of apartments, office buildings, shopping malls, subsidized housing, or historic buildings. These shelters may be either private or public offerings and they may be heavily leveraged. The theory is simple but the accounting, management, and legal work is extensive. An investor takes a chance when he buys a piece of property. He may or may not be able to keep it fully rented. His expenses in operating this property could possible exceed his revenue. But the greatest risk is will he be able to sell the property when he wants to and will he have a profit or a loss. If the investor makes an astute purchase when he acquires the property and the economy experiences mild inflation and he is able to hold the property long enough, then he has a good chance of making a profit. This profit can be increased if debt leverage is used but the exposure to loss is also increased. Real estate offers a popular form of sheltering income.

Oil and gas is the second most popular form of sheltering income. Oil and gas shelters may take the form of development drilling programs, royalty programs, completion programs, option to buy production programs, and more. The theory in these shelters is that you either drill for oil (exploratory), you buy existing oil wells, or some combination of these two. The tax advantages are tremendous when you consider drilling costs, depletion allowances, and liberal depreciation schedules. If you are lucky and strike oil with exploration or the price of oil increases, then you stand a good chance of making a profit. The rationale behind this investment is that the demand for clean efficient energy is greater than the supply. The large oil companies do not have the proper economiés of scale to allow them to drill all the potential energy reserves in the world. The tax laws make it condusive for the small investor to consider oil and gas as an investment. An investor should without question find out as much as possible about the organization presenting the potential investment to him.

Equipment leasing is fast becoming a close third in the tax shelter derby. The theory in this shelter is you buy a piece of equipment, rent it, take the numerous tax advantages, and then sell it. Tax benefits in this type of investing come through investment tax credit, accelerated depreciation of the equipment, and interest deductions on loans. Gains can come from rental payments during the term of the lease. In addition, you may receive residual values that may occur when the equipment is sold. Computers are a favorite in this area, although airplanes, ships, trucks, or any other major piece of equipment may be used. The problems one may incur with this shelter are lack of proper rental or lease opportunities and early obsolescence of the equipment.

The glamour of Hollywood and the aura of big box office stars make the next task shelter appealing to many investors. Investing in the production of a movie is a relatively new type of tax shelter. The first publicly registered limited partnership program became available in the latter part of 1979. There has developed an almost insatiable appetite for feature-length movies by the major television networks. Off-network cable systems, pay television, video tapes, video discs, and nontheatrical outlets also are demanding large quantities of movies. This increasing demand often makes it possible for the movie makers to prelease their movies for from two-thirds to 100 percent of the cost of production, greatly reducing their risks.

The original movie tax shelters were heavily leveraged and an investor was able to write off as much as ten times his original investment using accelerated depreciation on an asset with a relatively short useful life, maybe two years. The investor was able to purchase a million dollar production cost movie for one hundred thousand dollars. It was abuses such as the movie tax shelter that prompted Congress to enact the at risk limitation. If all you put up is $10,000 and if that is all you have "at risk", all you can deduct in any one year is $10,000. In summary, if the movie is a modest success and you use proper depreciation and investment tax credits, you may make a handsome profit.

A relatively new and small industry has cropped up across the land. Most of us come in contact with this industry every day. Cable television tax shelters offer many varied tax saving devices. The tax shelter is created primarily by the depreciation of the system, the interest on loans, the investment tax credit earned on purchasing the system, and, in the case of a new system, actual operating losses in the first year or two. If an investor buys a cable television partnership, he can look forward to a modest cash flow beginning the second or third year and continuing throughout the life of the partnership. The large reward that one would hope for would be if a large cable television system wished to acquire your system at a sizeable profit to you. The pitfalls are almost identical to any other real estate investment with inflation being a pre-requisite to a successful venture.

We could continue this discussion with quick overviews of cattle feeding, cattle breeding, horse breeding, new cropland development, timber and mining, but I believe the picture is clear. All of these programs have different twists, but the same storyline; buy something, take all the tax advantages that the law will allow, and finally sell it. The last phase is always the key to any successful investment; selecting the proper time and price to liquidate that investment.

This paper has attempted to explain and possibly justify some forms of so called sheltered income. We have not touched on the most important aspect of any investing; an individual's personal situation. Every investor has different needs, likes, and dislikes; therefore there is no panacea for the common man in tax sheltered investments.

In summary, remember the key to success and happiness in any investment is buy low and sell high.