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**by
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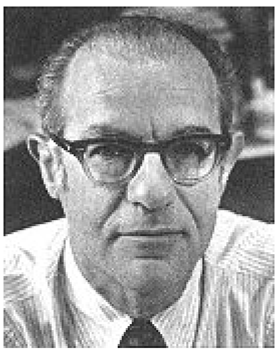

[Introductory note: Dr. Boris I. Bittker is a consummate craftsman in that most exacting of legal specialties, federal taxation. Yet he infuses his craft with a humanist's constant concern for the larger social values. The very titles of his books reflect that mix of comprehensive technical scholarship and ethical preoccupationFederal Income, *Estate and Gift Taxation* (1958, 1972), *Professional Responsibility in Federal Tax Practice* (1970); and *The Case for Black Reparations* (1973), to name just some of them.

Mr. Bittker was born in Rochester, New York, in 1916. He received his B A from Cornell and his LLB from Yale. After clerking for Judge Jerome N. Frank of the Second Circuit, he went to Washington to serve with the LendLease Administration at the outbreak of World War II, and with the Alien Property Custodian at the war's end. Between those two posts came a hitch in the Army.

Since 1946 Dr. Bittker has been a member of the Yale Law School faculty, holding the Sterling professorship for the last three years. He has also taught at Pavia and Siena in Italy, and at Stanford, New York University, and Colorado.

The range of Dr. Bittker's teaching is a further measure of the breadth of his interests. This year he is offering constitutional law and international transactions in addition to federal taxation. In the past his subjects have included corporations and corporation finance.

Professor Bittker's lecture, entitled "Tax Shelters: Their Cause and Cure," examines the burgeoning area of tax shelters, seeking to identify what characteristics the transactions embraced by the popular label "tax shelter" have in common. He then discusses the minimum tax on tax preferences, the proposed "Limitation on Artificial Accounting Losses," and other remedies proposed by the Treasury or enacted by Congress in this area.]

Tax shelters are very much in the news, not only in professional journals and at professional institutes but also in the popular press. A recent advertisement in the help wanted column of the Wall Street Journal, for example, sought "a tax shelter specialist. The qualifications for the post were not stated; apparently it was thought that the people to whom the advertisement was addressed needed no explanation.

What might be called the "classic" tax shelters are oil and gas drilling funds, equipment leasing arrangements, cattle breeding and cattle feeding activities, and highly mortgaged real estate. But if one collects examples of what are advertised as tax shelters, as I've been doing for a few months, the list rapidly expands. Foreign countries, usually exotic islands with low tax rates, are often described as tax shelters. We find tax-exempt municipal bonds referred to as tax shelters along with franchises for professional sports teams, citrus groves, movies, bulk whiskey, chickens, catfish, minks, and even the so-called Mexican vegetable roll over. Only last year the Assistant Secretary of the Treasury for Tax Policy described qualified pension and profit sharing plans as the biggest tax shelter of them all, costing the Treasury, according to his estimate, some $4 billion of revenue a year.

If one looks for more generalized description or definitions, one also finds a wide range of choice, with differences that depend upon the author you read.
I have picked two definitions for illustrative purposes. The first is from the West Coast:

> "A tax shelter, broadly defined, is any deduction, credit, exclusion or other allowance that permits income to come in tax-free. In this sense, the $103 exclusion for municipal bond interest is a shelter since the interest income comes in without tax. Some tax shelter investments attempt to shield not only their own income but to shelter other income as well. By producing excess loss or depreciation or depletion or interest or state tax deductions, an investment in an apartment house or a cattle feeding operation, equipment leasing or an orchard, can give the investor, at least temporarily, some deductions to use against income he or she earns from work or other investment sources." (1)

The second is from the East Coast:

> "There are two typical elements of a tax shelter. One, referred to as "deferral," arises in situations where taxpayers are permitted to deduct capital expenditures over a period of time shorter than normal tax rules would permit. In effect, the tax-payer is granted an interest-free loan in the amount of the tax saving, which he theoretically repays in later years when his deductions are less than he would ordinarily be entitled to claim. The second aspect of the tax shelter is "leverage," that is, the use of a high percentage of borrowed money to finance the acquisition of a capital asset which borrowing then produces the same deduction benefits for the taxpayer as are accorded to the taxpayer's own funds invested in the asset." (2)

These definitions diverge in important respects from each other, as well as from a recent Treasury definition:

> "The essence of a tax shelter is the deferral or postponement of tax on current income, accomplished by accelerating future deductions into the current taxable year." (3)

A curious aspect of this Treasury definition is that it does not embrace the qualified pension and profit sharing plans, which the same Treasury, through one of its spokesmen, had several months earlier described as the biggest tax shelter of them all, because the qualified pension plan involves deferral but through an acceleration of deductions. From the point of view of the employee the plan's tax shelter function results from the nonrecognition currently of credits and increases in the value of his or her pension and profit sharing rights; they fall in for tax purposes only when the cash is received in later years.

When I was preparing myself in this area, I though that I might get some help in defining tax shelters from California, whose Commissioner of Corporations has an active program of requiring registration of tax shelters under State Security Laws. I wrote, therefore, to the California Department of Corporations asking how they define tax shelters. They wrote back that anything advertised as a tax shelter, "we regard as a tax shelter." There seems to be a little circularity there.

In an effort to apply these general definitions to specific areas, I have picked out the central themes in a number of transactions that have been called tax shelters, at least by some writers. Here one finds again, that the descriptions are very broad, starting with almost anything that the writer feels is an excessively large tax allowance. The only two tax allowances that I have not seen described as tax shelters are the extra personal exemptions permitted to persons over the age of 65 and for the blind; but, for all I know, there may be some who regard old age as a tax shelter.

A feature of some transactions that are referred to as tax shelters is the lack of any nontax, economic purpose for the transaction. One example, which is no longer feasible but which illustrates the point, is the borrowing of money in order to buy tax-exempt bonds. If you borrow at 10 percent to buy tax-exempt bonds paying 8 percent, you lose 2 percent every year on your investment, but nevertheless would make money if the 10 percent paid for the borrowed funds is deductible while the 8 percent yield on the tax-exempt bonds is tax-free. This device has been forbidden by the Internal Revenue Code for a long time by ¶265(2), although, as many of you know, there are problems in determining when borrowed funds are to be linked with tax-exempt securities for purposes of disallowing the interest paid on the former. There are other instances of this kind of transaction, mostly much more complicated, some of them involving life insurance, where the taxpayer borrows money in order to pay the premiums. Often these transactions do not achieve the hoped-for results because the courts have concluded that transactions making no economic sense should not be treated as what they purport to be for tax purposes. (4)

I have already mentioned the simple postponement of the recognition of income, as in qualified pension plans. More frequently, the term "tax shelter" is applied to transactions where postponement of recognition of income is accomplished by speeding up deductions (e.g., accelerated depreciation on real estate or rapid amortization of other capital outlays), where eventually income will be realized. In these cases the transaction serves an economic purpose, at least if it turns out to be profitable as intended, but there are tax advantages in the earlier years. Sometimes it is expected, or hoped, that the transaction, though producing income that will not have to be reported until a later time, will permit the profit to be reported as long-term gain and taxed at the more lenient capital gain rate.

Another feature of some tax shelters is the production of excess losses, where the transaction not only produces no taxable income, at least in the early years, but in addition, generates losses which can be used to offset, and therefore to shelter, other forms of income. This is sometimes referred to as a "broad" shelter. Many of the most highly publicized tax shelters involve this feature. Oil and gas drilling is an example because the cost of drilling can be deducted in the year in which the drilling occurs. If the drilling and development expenditures exceed the income, if any, from the well in the year it is drilled (as is usual), the excess can be deducted from other income by the lawyer, accountant, or orthodontist. Sometimes a broad shelter producing these excess deductions will be used by a person who is in the same business, to shelter other income from the same kind of investment. But often, and these are the more dramatic cases so far as the public is concerned, the income that is being sheltered comes from other activities. I will return to this distinction a little later.

It should be noted that excess losses can arise from the rapid amortization of capital outlays in a variety of other fields other than those commonly identified as tax shelter areas (viz., real estate, oil exploration, and cattle feeding). Advertising, even of an institutional character designed to have long run advantages, for example, can be written off currently. Research and experimental expenditures can either be deducted currently or amortized over a short period, even if they create assets that will generate income for many years. The same is true of trade name and trademark expenditures. The deductions produced by these activities may be in excess of income from that particular part of the business and can be used to shelter income from other business activities. But this is an area that has not been much explored so far as tax shelters are concerned. It's hard to get the lawyer, accountant, or orthodontist into an arrangement by which he can participate in those losses in return for income from the business in later years; and leverage may be harder to achieve in these areas. But nothing at a theoretical level distinguishes these cases of rapid amortization or immediate deduction of capital expenditures from the commonly cited tax shelter transactions.

Another feature that is often encountered in the tax shelter area, stimulating some of the congressional interest and criticism, is syndication -- the bringing in of people from outside the industry -- when the investment requires a finder, investment broker, lawyer, accountant, or other person to act as the bridge between the industry needing the funds and the investors who would like to participate. Syndication may be formalized to the point where there is a public offering of securities within the meaning of the Securities Act of 1933, or it may entail no more than informal contacts with a small group of well-to-do investors in a single community. Syndication has often generated criticism because the middleman expects a profit for his activities; this is often seen by critics of the tax shelter area as a waste. Yet it might be argued that the syndicator is performing the normal function of bringing persons who want to invest into enterprises that need investment funds. But syndication seems to exacerbate the complaint that I mentioned earlier, that the entry of "outsiders" -- people who are not commonly engaged in the business -- is unfair to those already in the industry. Thus, it is often said that "genuine farmers" are being crowded out by "white collar cowboys" whose investments either increase the price of land by bringing more acreage into production or decrease the price of the product by throwing more on the market.

Once one recognizes how diversified a range of transactions can be called tax shelters, one finds that many of their features have been recognized over a long period of time. This in turn has led to many a number of statutory attempts to limit the use of these tax allowances, when Congress, the Internal Revenue Service, or the courts felt that they were being exploited to an unreasonable extent. This reaction can be seen in the statutory provisions and judicial decisions limiting the deduction of interest incurred to purchase or carry certain forms of life insurance and annuity contracts, where the transactions makes little or no economic sense. (5)

There are also many areas in which tax allowances are subject to dollar limitations, where Congress has restricted the use of a tax allowance by, so to speak, spreading the goodies around instead of permitting any one taxpayer to avail himself of the allowance to the hilt. Thus, the 25 percent rate on long-term capital gains is available only for the first $50,000 of such gains. Similarly, section 179 limits the amount qualifying for the special first year depreciation deduction. In 1969 and again in 1971 Congress imposed limits with respect to the write off of expenditures for citrus and almond groves, which had previously been deducted at the time the expenditures were incurred and now have to be capitalized. There are also several provisions for the recapture of certain types of tax allowances; the most familiar is the recapture of accelerated depreciation on personal and real property under sections 1245 and 1250. There is also a recapture provision for excess farm losses. Because the cash method of accounting is so broadly available for farming, farm losses are often incurred in early years of profitable operations. Congress intervened in this area by providing that if the farm is ultimately sold at a profit, the gain will have to be reported as ordinary income rather than capital gains up to the amount of the accumulated excess losses in the deferred excess loss account.

Still another type of Congressional response to what was seen as the exploitation of tax allowances is what I call the "channelization" of income. An example is ¶163(d), concerned with excess investment interest. Under this provision the taxpayer who borrows to carry portfolio securities is not always permitted to deduct all of the interest paid on the borrowing, because it felt that he would be getting excess deductions in the early years of an investment that might not produce taxable income for many years. In effect Congress decided that an allowance for interest genuinely paid on borrowed funds to carry a profit-making investment should not be allowed currently, beyond certain limits, because the income would not come in until a late date. The statutory restriction matched up the deduction with the income, in a sense, even though this kind of matching is not normally required of cash basis taxpayers. Congress provided that the interest paid would be allowable up to the amount of the taxpayer's net investment income plus capital gains and certain other adjustments, but that it could not offset income from other activities. This restriction, therefore, produces a kind of channelization, requiring investment operations to be held, so to speak, within a specific channel and not allowed to spill over (beyond a certain amount) to be used against other income.

I want now to turn from these individualized approaches, which are applied provision by provision or allowance by allowance, to two more general legislative approaches to tax shelters. The first is the minimum tax, enacted in 1969, though not in the form proposed by the Treasury, which has been proposed for amendment in certain respects by the House Ways and Means Committee. The minimum tax, as enacted in 1969, is a supplemental flat rate tax, to be paid on specified tax preferences in addition to the regular income tax. Some of these preferences are exclusions from income, like the deducted one half of long-term capital gains and percentage depletion in excess of the property's basis. Others are deferral items, like accelerated depreciation on real estate to the extent that it exceeds straight line. As originally proposed, and as revived in 1973 by the Treasury and recently by a tentative decision of the House Ways and Means Committee, it will be an alternative tax, with the taxpayer paying either the regular tax or the alternative minimum tax, whichever is higher. The alternative minimum tax would be imposed upon a concept that might be called economic income, in the sense that it is a broader base than statutory taxable income. Roughly speaking, the base on which the alternative minimum tax would be imposed is adjusted gross income plus some exclusions and minus certain items.

The minimum tax has been concerned primarily with exclusions from income rather than with provisions for the deferral of income. For this reason, in 1973, the Treasury proposed a so-called limitation on artificial accounting losses which would focus much more heavily on the deferral of income and the rapid amortization of capital outlays. This proposal, which has some earlier antecedents, pur-ports to focus directly on tax shelters. But it is concerned with tax shelters only in the sense that I described earlier; that is to say, the "broad" shelter, creating deductions that can be used to shelter income that is unrelated to the activity generating the deductions. The Treasury said the following about its proposal (and the House Ways and Means Committee's tentative decision follows along):

> "While such losses are frequently generated in the mineral, real estate and agricultural industries, LAL will normally affect neither the ordinary farmer, the professional oilman, nor the ordinary real estate developer, but rather the outsider who buys into those industries in search of tax "losses." Artificial "losses" from such sources as accelerated depreciation, the current deduction of pre-opening costs, intangible drilling costs on successful wells, and prepaid feed dells, will no longer be permitted to shelter unrelated income." (6)

Roughly speaking an "artificial accounting loss" is defined as a loss resulting from accelerated deductions -- rapid amortization, and so on -- which is in excess of the income produced by either the same project or other projects carried on by the taxpayer in the same business. Only to the extent that the deductions spill over beyond these types of income to so-called unrelated income would the Treasury impose restrictions. These excess amounts will not be currently deductible from income from the practice of law accountancy, and so on but will instead be carried forward in a deferred loss account. They will then be available for use when and if the taxpayer has related income from the favored business, and if not fully used up against related income, they will reduce the gain when the investment is sold or otherwise wound up.

Under this proposal the vague concept of "related income" will obviously be very important, since it will determine how much of these losses can be deducted currently and, conversely, how much must be held in abeyance and deferred until a later date. Related income as defined by the proposal is very broad for some industries and narrow for others. For example, all oil and gas income, whether from the field in which the taxpayer is drilling currently or from other fields, qualifies as related income. In the case of real estate, on the other hand, there is a distinction between residential property and nonresidential property. All rental income from residential property is related and, therefore, can be offset by current deductible expenditures. But for nonresidential property, the proposal operates property-by-property, and there are problems in defining when several related properties make up a single project and when, on the other hand, the properties are unrelated.

In reviewing these proposals and seeking to evaluate them, I am struck by the fact that most the public discussion has been concerned with details, to the exclusion of the broader issues that deserve attention. To make just one simple point, the tax allowances reached by the minimum tax and the limit on artificial accounting losses were presumably enacted by Congress for some economic or social purpose. I don't mean to say that political muscle was not at work as well; obviously, it was. But to some extent, accelerated depreciation was designed to increase investment in real estate, the allowances in the oil and gas field to increase investment in that area, and so on. One may or may not believe the tax allowances have been successful in achieving those objectives. Some are very enthusiastic about the results achieved; others are very are critical. There are differences of opinion about the cost of what has been achieved. But one finds very little discussion of whether the tax shelters that are under attack have or have not helped in increasing investment in the areas for which the allowance was originally enacted by Congress. There is also little discussion, except of a self-serving variety, of the extent to which investment would be adversely affected in particular industries if limitations of this kind are imposed. This is particularly surprising, it seems to me, because some tax commentators in the last few years have been arguing that if a tax allowance for a particular area is repealed, Congress ought to give serious thought to whether some other legislative measure should be adopted to take its place. For example, almost all the recent discussion of tax exempt bond interest has been of this type, in which criticism of existing law is tempered by recognition that it enables cities and states to borrow money at lower rates than they would otherwise have to pay. If Congress withdraws the exemption for future state and municipal bond issues, it will almost certainly have to increase revenue-sharing, provide an interest subsidy, create a federal bank to buy the securities, or enact other affirmative measures to take up the slack created by withdrawal of the tax allowance. It is surprising that discussion of tax shelters has not been coordinated with a consideration of similar alternative measures.

One of the reasons there has been little discussion of the consequences of taxing tax shelters is that they have usually been viewed as unadulterated bonanzas for the taxpayer. Of course, as those who read the newspaper know very well, a lot of promising tax shelters have turned out to be failures. Quite apart from the contrast between rosy prospectuses and dismal track records in this area, the idea that shelters are all gravy deserves closer analysis. I can illustrate what I mean by taking the case of tax exempt bonds. Let's assume that industrial bonds are being floated at a 10 percent interest rate. Assume, for the moment, that the exempt bonds to be floated are a relatively small amount in the aggregate, small enough so they can be bought up entirely by taxpayers whose marginal tax rate is 70 percent. On these assumptions, states and municipalities are not going to have to pay 10 percent to sell their bonds in competition with 10 percent taxable industrial bonds. Rather, if the exempt bonds are all taken up by persons at the 70 percent bracket, they ought to be willing to buy the bonds with a 3 percent interest rate, because 3 percent tax-free for them will be the same as 10 percent taxable. Of course, states and municipalities have been floating more and more bonds in recent years, and they are selling more than taxpayers in the 70 percent marginal bracket are willing to buy. Therefore, the bonds have got to be made attractive for people further down the line. If you want investors subject to a 50 percent tax rate to buy the bonds as an alternative to 10 percent taxable bonds, you have to pay 5 percent. If you want to reach further down and appeal to people whose tax rates are lower than 50 percent, you've got to pay still more; and this of course, is, what has happened in recent years. This inures to the benefit of people further up the line, who would have been willing to buy the bonds, on my original hypothesis, at a 3 percent yield. They can currently buy exempt bonds with a 7 percent or even higher yield, and, of course, this gives them a free ride. Still, wherever the interest rate ends up -- 5, 6, 7, or even 8 percent -- the rate is lower than the rate on taxable bonds. This means that the buyer of exempt bonds is paying something in the form of a reduced rate of return.

Tax shelters probably have a similar effect. As people are stimulated by tax allowances to make investments that previously did not look attractive, they probably accept a lower yield. Indeed, the complaint that tax shelters induce "white collar" cowboys to pay more for farm land (or sell its produce for less) than "real" cowboys or farmers, implies that persons attracted into the industry by tax shelters are making investments that would not have been otherwise attractive. This in turn implies a lower pretax yield, so that some of the tax allowance is being competed away; in short, it is not all gravy.

There are few studies of the consequences of competition on tax allowances, The most recent study of the gas and oil field -- done by a person who has been a critic of the tax allowances in that field -- concludes that only about 10 percent of the tax allowance goes to increase profits for oil and gas companies. About 40 percent of the tax allowances go to the owners of royalty interests, that is, the ranchers and landowners who hold areas that were not previously attractive enough to be drilled. Finally, about half of what the Treasury loses through the tax allowances is reflected in lower prices for oil and gas products. It seems likely that all other tax allowances similarly attract investment into their fields, resulting in some decline in the pretax yield on the investment. I suggest, then, that generalized proposals for dealing with tax shelters insufficiently examine the extent to which Congress is achieving its objectives through the tax allowances that are the target of the complaint.

Second, there may be a substantial amount of exaggeration or misunderstanding of the profits to be made, with prospectuses being taken at face value, though common sense, as well as economic theory, suggests a resultant decline in pretax yields.

Finally, I want to return to my comments about "channelization," the idea that tax allowance should be reserved for people in the industry, to the exclusion of "outsiders." The LAL proposal, if enacted, is capable of very substantial expansion over a period of time. This would undermine the global tax system that we now have. I refer to it as "global" because, by and large, all income is thrown together in one pot, deductions are then taken, and the residue is taxable income. (I simplify somewhat because, in point of fact, capital gains are handled differently, and there are some other existing exceptions to the "global" concept.) By contrast the British have, or used to have, a "schedular" form of income tax, involving separate computations of income from the taxpayer's profession or main occupation, income from investment, income from farming, income from other activities, etc., with a separate tax for each kind of income. A great deal would be, lost, in my view, if we move very far down the road toward a schedular system in which the income and deductions of each separate activity are kept in watertight channels. The proposed limit on artificial accounting losses is a step in that direction.

A curious thing about this approach is that it will not affect persons who are only, so to speak, ankle deep in an unrelated activity. The orthodontist who makes a small investment in farming will not be required to channelize because of the minimum allowance which creates a floor above which the limitation begins. On the other hand a person who is up to his ears in a particular business will be allowed to use the losses against all income from that business. Those who are waist deep, however, are "outsiders" who will be subject to the limitations.

This approach seems to me undesirable so far as the future of our tax system is concerned. I also have grave doubts about it from a business or economic point of view, although I am not here to offer an expert opinion in that area. Much can be said for permitting investment to flow wherever it is more profitable. And if it is made more profitable by tax allowances, much can be said for letting anybody go into the business, rather than reserving the allowances for those who have been in it in the past. The phrase "white collar cowboy" is amusing, but from an economic point of view why isn't someone who invests in the area "really" in that business just as much as that person who happens to live in Oklahoma, California, or Kansas. We don't say an investor in Xerox stock is an ersatz investor because he is "really" an orthodontist or a lawyer.

A few words of conclusion. Some may say that I have analyzed this area more than it deserves to be analyzed. Their view may be that the minimum tax and the limit on artificial accounting losses are really intended both by the Treasury and by their Congressional proponents to be cosmetic, enacted only to palliate a popular demand that "something be done." Cosmetic devices, it may be argued, should not be analyzed closely because they were never intended to stand up to close analysis. You may not like the music, but don't shoot the piano player; he's giving the customers just what they want. Unfortunately, even if a tax provision starts out as a cynical cosmetic operation, it will soon get a life of its own. Thus, most of the discussion of the minimum tax and LAL has focused on details and points to this or that defect. The commentators, understandably, suggest that the proposals are leaky sieves and should be plugged up. Before converting a cosmetic device into an effective one, I suggest that its basic assumption be debated. I would not want to appear to be an unqualified endorse of every tax allowance in the Code. Far from it. I would criticise many provisions. My point, rather, is that tax allowances ought to be examined one by one to see what can be said in favor of and against each of them and that remedies should grow out of the diagnosis of each particular allowance. Attempts to prescribe a cure-all for transactions that are as diversified as the allowances I have discussed here are likely, in my opinion, to be unsuccessful and, in the long, run, counter productive.

(1) A Kragen & J. McNulty, *Federal Income Taxation 700 (2 d ed.1974)*.

(2) S.Surrey, W.Warren, P.McDaniel & H.Ault, *Federal Income Taxation 392 (1972)*.

(3) *Hearings on General Tax Reform Before the House Committee on Ways and Means*, 93d Cong., 1st Sess. 6997(1973).

(4) See e.g., *Knetsch v. United States*, 364 U.S. 361 (1960).

(5) Int. Rev Code of 1954. ¶264(a)(2) and (3); see *Ballagh v. United States*, 331 F.2d 874(Ct. CI.1964), cert. denied, 379 U.S. 887 (1964), and Robert Gerstell, r62, 181 P-H Tax Ct. Mem. Dec.

(6) *House Hearings*, supra note 3, at 6996.