

Defining Tax Shelters and Tax Arbitrage

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[1] One of the most important developments in modern taxation is the extended use of "tax shelters" and "tax arbitrage." It has long been recognized that individual taxpayers have an incentive to move their saving toward tax-preferred investments, such as tax-exempt interest or corporate stock on which capital gains could be deferred from taxation. Similarly, corporations have incentives to move investment to low-tax countries. However, the opportunities to find these shelters has become far more interesting and dynamic as investment and saving has become increasingly global, while the opportunity for tax arbitrage makes the shelter issue more complicated and at times threatening to the Treasury's fiscal health. Tax arbitrage exaggerates the normal incentive to buy preferred assets by allowing taxpayers essentially to leverage up these differences. Here I wish to place the current debate over tax shelters in context -- in particular, to show how they are of the same species, but a different family, from the shelters that grew and then were attacked in the 1980s.

[2] We must begin with the simple fact that relative to pure interest income, almost 80 percent of the returns from assets benefit from one tax preference or another. Seldom are assets subject to individual tax on both their cash yield and their change in value. For instance, houses and stocks may provide rental and dividend streams, but the gains in value are not subject to tax until sale, if ever. Even depreciable assets at times benefit from allowances that accelerate the amount of deductions taken and, hence, provide the equivalent of an interest-free loan from the government.

[3] When individuals and corporations do more than shelter their investments and engage in tax arbitrage, it shows up in the world economy through an increase in the number of financial transactions. Usually tax arbitrage involves some combination whereby a taxpayer essentially sells or "sells short" one type of asset and "buys long" another. The easiest and most common way of selling short is to borrow -- that is, to promise to deliver the amount of borrowed dollars plus a return at a rate equal to the interest rate in some future year. But there are a variety of other ways as well, including short selling of stock or simply converting ownership to a rental contract and then using the proceed to purchase other assets.

[4] When a taxpayer sells short one type of asset, the payments made on that asset are essentially all made by the end of the year. In that way, the taxpayer recognizes in full all of the losses or payments made. Thus, in the case of interest, the entire income stream, including both real interest and inflation, are deducted. Inflation actually adds a subsidy for borrowers because the taxpayer is allowed to write off more than the full cost of the asset.

[5] Now it is true that some other person or business somewhere owns the right to those payments and could be forced to pay a penalty in the same way that the borrower is subsidized. However, the markets work wonders here, and it turns out that many of these penalties are avoided. For instance, in the case of interest, many receipts are garnered by pensions and life insurance companies where the individual accrual of income is deferred from tax. Also, parts of the tax system are discretionary. Thus, one person can avoid declaring capital gains earned even while another person makes sure to declare all capital losses. Over time the law has attempted to restrict loss write-offs as a way of paring this activity, but it is not always effective -- especially when one has other income against which the losses can be deducted.

[6] Individuals and businesses don't even have to know they are engaging in arbitrage as long as they follow incentives. Thus, it has become common for individuals to maintain higher levels of mortgages even as they hold more assets in the form of individual retirement or 401(k)-style retirement accounts. Essentially, the individual is borrowing from himself, taking deductions for the interest paid and then deferring tax on the interest received. Note that the arbitrage is often playing tax games that add nothing to the total productivity of the economy. Tax-motivated borrowing and investing involve transaction costs that must be paid, but no

necessary addition to saving and investing if the borrowed amount equals the invested amount.

[7] Tax arbitrage is pervasive. It affects the lives and habits of almost every individual and business in society. Taxpayers continuously engage in tax arbitrage. Examples include borrowing to purchase housing, consumer durables, pension assets, and IRAs, state and local bonds, as well as real estate and corporate stock for which special treatment or exclusions are provided for capital gains. Businesses often engage in tax arbitrage when they borrow to buy stock, create a merger, or engage in a leveraged buyout of another company. Within a business, borrowing to purchase equipment may involve some amount of tax arbitrage, as can borrowing to buy inventory to which favorable methods of accounting are provided. Some corporations purchase stock of other companies and are allowed to deduct dividends from income even when interest costs of financing the purchase are also deducted. Other corporations attempt to make use of partnerships both as tax shelter and tax arbitrage vehicles -- sheltering income from corporate tax first and sometimes adding to borrowing and arbitrage through the partnership in a way that does not show up as debt on their financial books. (Enron engaged in many partnership deals, although the tax enticement may not have been the primary factor.)

[8] These developments have had serious consequences for tax administration. While many of these transactions are legitimate, some are not. The IRS has generally had to play a game of catch-up to new developments. Moreover, many types of shelters are hidden in the books in ways that make them hard to detect so that if a taxpayer is skirting on the edge of what is legal, the IRS may have a hard time even finding the item, much less contesting it.

[9] Two periods of time have become especially identified with the growth in tax shelters (with or without the extra arbitrage component). The first was from the early-1970s to the mid-1980s. Some lay that problem to the creation of new preferences in the tax code, but much was driven by a very high rate of inflation, which, in turn, led to very high deductions for the share of the interest payment that was not real in nature. This period was ended essentially by a four-fold attack: tax reform cut back on tax preferences; tax reform limited further the extent to which losses from one place could be used to offset gains or income elsewhere; tax rates were lowered; and inflation rates began to fall. The latter two were especially effective in cutting back on arbitrage incentives due to borrowing.

[10] We are in the second period now, one identified with the mid- 1990s stretching at least into the first part of this century. Here the issue has become much more complicated than in the inflationary era, when most shelters were similar in nature and involved the leveraged purchase through partnerships of tax-preferred assets such as real estate or oil and gas tax shelters. Today, on the other hand, what has essentially happened is that businesses and their financial advisers have become extremely adept at taking advantage of every tax differential in the code -- between interest and capital gains, corporate and partnership earnings, corporate stock and corporate debt, tax rates in one country versus another, dividend-received deductions for a company with a lot of debt versus dividend-received deductions by a company with little debt, government or charitable ownership versus private ownership of real estate, limitations on tax deductions and credits (for example, for foreign credits, capital losses, research and development credits) in one company or country or subsidiary but not in another.

[11] It is not so much that these differentials in tax treatment are new under the sun. Rather it is that trained lawyers and accountants, abetted by the instantaneous ability to transfer financial assets electronically, have learned how to engage in sheltering and arbitrage transactions at increasingly lower transactions costs.

[12] There remains a large and unresolved debate over just how large and significant these types of generally hidden transactions have become, which is one reason that Treasury and IRS are placing such emphasis on a better reporting system. By the same token, so many sheltering and arbitrage activities fall out of normal business activity. Even if the quick tax-motivated transactions can be identified and somehow attacked, there still would likely be significant revenue loss because the incentives to take advantage of the differentials remain.

[13] Beyond tax enforcement efforts, at some point a 1980s- style of reform may be required. One effort might be made to identify economically justifiable, administrable, and legitimate ways of preventing losses from some activities from being used to offset income from other activities. A second and perhaps more important effort would be to cut back on some of the differentials so that there are fewer incentives to engage in sheltering and arbitrage activities. The complication this time around is that there are so many of these differentials to be exploited; moreover, some are created by foreign countries, not by the United States. There may be no single, simple solution and a multi-pronged approach may prove effective.

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