The Tax Reform Act of 1969 -- Tax Deferral and Tax Shelters

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The Tax Reform Act of 1969 had a rapid journey through the Congress. The rapidity of the trip is measured in terms of the relatively short time spent on the Act by the Committees compared with the range of items dealt with and the degree of complexity they involved. On the completion of the Act, the task began of absorbing the great variety of changes into the day-to-day application of the income tax. All the groups engaged in that application commenced to swarm over the measure, each with its appointed task. First the quick articles in the professional tax journals giving the initial road directions to harried practitioners. Then the tax institutes with more detailed descriptions and responses to the perplexities, questions and sudden new insights raised by these practitioners. Next the law reviews attempting to provide perspective and analytical comment. Within the Treasury the huge task of regulations and rulings commenced. Outside the Treasury the tax advisers began to shape their clients' planning to the new rules, probing for the safe areas, charting the new pitfalls and risks, exploring the new tax escapes that were provided, searching for the unforeseen tax escapes, remodeling the tax shelters that serve the well-to-do.

Several of the articles in this issue of the Boston College Industrial and Commercial Law Review relate to the 1969 Act provisions pertinent to some of these shelters and thus provide one overall theme. Much of the legislative struggle in 1969 was over these shelters, and properly so, for they demonstrate glaring inequities in our income tax. It is in the syndication of these tax shelters—real estate, oil, cattle, farming activities, leasing of equipment—that we can see portrayed many of the essential defects of the tax law. Each carefully

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developed investment prospectus, with its description of how the tax law turns ventures that investors would never think of on a before-tax basis into highly profitable after-tax arrangements, is a graphic illustration of the failures of tax reform. Unfortunately, despite the 1969 Act, and sometimes because of it—for example, the newly introduced five-year amortization for railroad equipment and rehabilitated housing—the prospectuses still stream out and investment advisers still maintain their tax shelter departments. Indeed, one would suggest that well-rounded Treasury and congressional tax staffs should each contain a resident physician, whose main qualifications are that he be in the 50 percent to 70 percent brackets and promises to turn over all the investment proposals he receives. For each proposal would contain, when properly read, a signpost for tax reform.

There are many explanations why these shelters persist—among them being lobbying pressures and political forces in the cases of farming and oil; the pull of housing needs in the case of real estate and the failure to develop an adequate set of non-tax subsidies, especially for low-income housing;¹ and technical inadequacy in the shaping of provisions affecting leasing.² Each shelter has a history and story of its own. But there is a common theme and perhaps its tracing and understanding may be helpful in thinking about the congressional attitude toward these shelters.

The shelters essentially turn on the acceleration of the tax deduction for investment expenditures, through writing-off the cost of the investment either fully at the outset or in the first few years, or writing-off most of it in the early years of the investment. The key to the tax shelter is this ability to recover the investment quickly and thus achieve "tax losses" consisting of the excess of deductions representing the cost of investment over income from the investment. These "tax losses"—which are not real losses but only the return of investment—eliminate from tax not only the income from the project but, more importantly, other income as well, as the "tax losses" spill over to be used as offsets against that other income—a doctor's fees, an investment banker's commissions, an actor's earnings, an investor's dividends, a top executive's salary. This is what the syndicators are selling and their investors are buying—be it in the form of accelerated depreciation in real estate and the expensing of interest and taxes during cons-


² Thus, the IRS has not succeeded in framing a standard to separate lease from sale that adequately measures the required residual of the lessor, so as to denigrate the influence of tax maneuvering. With still greater acceleration of depreciation being promised (see p. 310 infra) the leasing shelter will regain a significance that had previously been lessened through repeal of the investment credit.
struction, coupled with the leverage of debt financing that magnifies the depreciation basis; five-year amortization and like leverage in rehabilitated housing; current deduction of intangible drilling expenses in oil; current expensing of development cost in cattle or apple orchards; accelerated depreciation or amortization, also mixed with debt leverage, in leasing. The tax laws make these deductions marketable commodities in the hands of an oil drilling syndicate, a real estate developer, a cattle operator, or leasing syndicate.\(^8\) The opportunities for maneuver are many and tempting. For example, syndicators of oil and cattle shelters are learning about the debt leverage that illuminates the real estate shelter. They are also realizing that leverage in oil and cattle investments, where the deductions for investment are immediate, will provide even greater tax advantages than where the investment write-off is through the accelerated depreciation of the real estate shelter.

The investor in buying these deductions is buying “deferral” of his tax liabilities on the income offset by the deduction. He escapes current taxes on current income and need only pay the deferred taxes when the investment is either closed out or in its later stages—unless before then his advisors may have worked out an arrangement that even escapes that consequence. In a number of instances, this postponement of tax and the nature of the shelter operate to switch the deferred tax liability from ordinary income to capital gain, which often improves the shelter considerably. The Congress, when it does think about these shelters unfortunately has usually focused only on the capital gain aspect and moved only to correct it, while letting the deferral stand. One has the feeling that “deferral” is not considered by legislators as much of an advantage—after all, the taxpayer is “only postponing” a tax payment that he will have to pay at some point.

Indeed, how could a legislator have cause to think otherwise when he hears a Treasury Department pushing hard to legislate a tax escape for exporters—DISC—tell him that only “deferral” is involved in the measure.\(^4\) Or when a President and a Secretary of the

\(^8\) This facet of the tax shelter raises the interesting question of what Section 183 of the Internal Revenue Code of 1954, added in 1969, is referring to when it speaks of “an activity not engaged in for profit.” Clearly the investors in tax shelters are not investing in the before-tax profit yielded in these transactions, but only in the after-tax result. As the text indicates, they are investing in a tax deduction. Does the real thrust of section 183 lie in requiring an expectation of a realistic before-tax profit, one commensurate with the investor’s normal investment outlook? Should the existence of a small before-tax profit, a paltry plus, in some of these shelters be enough to provide safe conduct to an investor who in his other, not tax-sheltered, investments seeks a far greater before-tax return?

\(^4\) See generally Hearings on Tariff and Trade Proposals, House Ways and Means
Treasury in announcing increased acceleration of depreciation through the use of shortened tax lives unrelated to a taxpayer's replacement experience (Asset Depreciation Range System), state that the "liberalization of depreciation allowances is essentially a change in the timing of a tax liability. The policy permits business firms to reduce tax payments now . . . and to make up these payments in later years" (italics in original).5

The syndicators of tax shelters know differently. They are using their computers and investment know-how to explain to their investors just how valuable this "only deferral" and "only timing" can be. They do so by relating the benefits of the deferral to investment yield after tax and thereby directly quantify the value of the deferral. But who tells this to the legislator? He understands "exemption" from tax liability and will usually feel he should do something about that. But he views "deferral" as almost the opposite of exemption and hence not a cause for moral indignation. Indeed, how would one graphically and simply make it clear to a busy Congressman just how valuable is this "deferral" which he often so casually approves because at best he sees it as only a minor benefit? How would one make it clear that very often "deferral" may mean as much as "exemption" to the investor in a tax shelter?

I suspect the task of communication is not an easy one. Suppose A, in the 60 percent tax bracket, invests $100 in an asset. Assume business accounting and ordinarily applied tax rules would require the cost of the asset to be capitalized, but that a special tax provision permits the cost to be expensed in the year of acquisition, thus deferring tax liability on the income offset by the deduction. Assume that a sale of the asset in ten years would produce ordinary income. How do you express or describe A's tax benefit?

Do you use the analogy of the interest-free, non-recourse loan without collateral? Do you ask the Congressman if he would blithely let his debtors say they will pay their debts to him at some indeterminate future date and forget about interest or security in the meantime?

The immediate deduction of $100 saves A $60 in tax. On sale of the asset A will repay that $60 in tax, since his tax liability then will be $60 more than it would have been if the $100 cost had been capitalized. One way to describe the result is to say

Committee, 91st Cong., 2d Sess. 499 et seq. (May 12, 1970); Hearings on Amendments 925 and 1009 to H.R. 17550, Senate Finance Committee, 91st Cong., 2d Sess. 9 et seq. (Oct. 9, 1970).

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that the government has made a loan of $60 to A without asking for interest, collateral or a definite time for payment of the loan. The higher A's tax bracket, the larger the interest-free loan.

What is this loan worth to A? Assume that borrowing $60 from a bank would cost him 10 percent interest. A thus saves paying 10 percent a year on $60—or $6—less the benefit of the income tax deduction of $6 interest a year, or a net of $2.40 per year, for a total of $24. That saving can be expressed in terms of the present value of money; it would be presently worth $19.46 to A (using a discount rate of 4 percent if A can freely borrow at that after-tax rate) to accelerate the deduction from year ten to year one. If A can earn 15 percent on his investment, then we could ask what A would pay to get this interest-free loan, and the answer would be "up to $26.49" using an after-tax discount rate of 6 percent in relation to net annual interest of $3.60.

Does it help to say that the after-tax rate of profit on what is left at risk under the tax accounting of immediate deduction and deferral of tax is equal to the before-tax rate of profit on the investment as counted under financial accounting?

Assume the asset in which A invested $100 will be sold for $250 in ten years, leaving A a profit of 150 percent before tax. If A had capitalized the cost of the asset, he would owe in tax 60 percent of $150 ($250 sales proceeds less $100 cost) or $90. A thus would have an after-tax gain of $60 on a $100 investment (sales proceeds of $250 less $90 tax less $100 investment), giving an after-tax profit of 60 percent. But if A expenses the cost, his tax on sale is 60 percent of $250 ($250 sales proceeds less zero cost), or $150, leaving A with $100. A, however, in this situation has actually only invested $40, since $60 of the cost of the initial investment was repaid to him by the government at the start. A has thus gained $60 ($250 sales proceeds less $150 tax less $40 initial investment) on a $40 investment, or a profit of 150 percent after-tax. In effect, his after-tax rate of profit on the $40 investment is equal to the before-tax rate of profit on the overall investment. (If taxpayer B in the same bracket had invested $40 with the cost capitalized, earned 150 percent before-tax and sold the asset, B would pay a tax of $36 and net $24, for an after-tax profit of 60 percent.)

In a progressive tax system, after-tax rates of profit should decline as the taxpayer's rate bracket increases. With expensing of cost substituted for capitalization, the rates of profit are not affected.
Does it help to say that the investor is really treated, on what he has at risk after the expensing, in exactly the same way as a tax-exempt organization investing that same amount?

In the above example A has ended up in the same situation as would a tax-exempt organization which had invested $40 and obtained a profit of $60, or 150 percent of its investment.

Do you explain that the immediate expensing of an investment is the equivalent of allowing the investor a tax-free return of the income yield from what he has left at risk in the venture—his initial investment less the tax benefit of its write-off?

In the example above, it can be seen that A has made a tax-free investment of his $40, since his after-tax rate of profit on $40 is equal to his before-tax rate of profit on the overall investment.9

This is the form of explanation used by Professor Shoup in his book on Public Finance:8

Thus, if a corporation is contemplating construction of a plant costing $1,000,000 it need supply only $600,000, if the tax rate is 40 per cent. The remaining $400,000 will come from its savings of tax on profits from the remainder of its business. By deducting $1,000,000 instead of nothing, in the year of construction, it saves $400,000 in tax for that year.

The cash flow from the $1,000,000 plant in future years will

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9 The matter can be expressed in still another way. A can be considered as investing $40 and receiving back his original investment plus $60. The government has "invested" $60 and also received back that investment plus $90. A's gain on the investment he made is 150%, free of tax. Looking back at the interest-free loan analogy, it will be seen that if A had borrowed $60 from a bank and then capitalized the $100 cost, A would have ended up with a $30 profit on his original $40 investment, or an after-tax profit of 90% (proceeds of $250 less tax of $30 less $60 loan repayment less $24 net interest cost less $40 investment) compared with that of 60% if he had used $100 of his own capital. The leverage of the loan has increased A's after-tax profit from 60% to 75%. When A "borrows" interest-free from the government, he ends up with $60 profit ($24 more than in the bank loan case because of the absence of interest cost), or an after-tax profit of 150%. A is obtaining the advantage of leverage without paying the cost of leverage, i.e., interest. The leverage of the loan plus the absence of interest enable A to achieve after tax the same rate of return on his investment as he would expect to make before tax, i.e., his investment is tax-free.
be taxed at 40 per cent, since no further depreciation will be allowed. The corporation retains 60 per cent of this cash flow. It contributed only 60 per cent of the capital that made the cash flow possible. The corporation therefore obtains the same percentage rate of return on what it put in, of its own money, as if (1) there had been no income tax and (2) it had financed the entire $1,000,000 itself and had kept all the cash flow.  

The fact that completely accelerated depreciation, when coupled with complete loss offset, is equivalent to exemption of net return from the asset, under an income tax, was discovered by E. Cary Brown (see his "Business-Income Taxation and Investment Incentives," in Income, Employment, and Public Policy: Essays in Honor of Alvin H. Hansen [New York: Norton, 1948], pp. 309-10), reprinted in Musgrave and Shoup, Readings in the Economics of Taxation. See also Musgrave, Theory of Public Finance, pp. 343-44.

The use by Professor Shoup of the term "discovered" in this context (see his footnote 20 above) is interesting. Perhaps a Congressman can be pardoned for not appreciating the benefit of deferral when it apparently eluded public finance specialists for 35 years of our income tax history.

Does it help to say that "permitting the capital cost of an asset to be expensed has the effect of exempting the income from ownership of the asset from taxation"?

This is the way the Treasury Department, when it is being analytically objective, explains the tax benefits from an immediate write-off of an investment cost. The quotation is from the 1970 Treasury Department Study on Tax Depreciation Policy. Footnote 4 of that Study amplifies the point:

An intuitive explanation of this somewhat surprising result takes the following form: A $1,000 asset will generate some stream of revenue over its life; if the cost is expensed and the tax rate is 48 percent, the net cost of the asset to the owner (ignoring the slight discount of the deduction as above) is only $520, after tax. However, in the future, each $1 of revenue will be taxed fully, with no allowance for depreciation, leaving $0.52 of net return on the $520 investment, the same ratio as $1 to $1,000 as if there were no tax. Incidentally, in those cases, as in minerals taxation, where the total present value of expensing and depletion deductions may actually exceed the cost of the investment, the effective

tax rate is negative. That is, in some instances the tax rate equivalent of an investment tax incentive is a tax rate less than zero.

In the example used earlier of A investing $100 and having $60 of cost repaid to him, it is said that A received a tax-free return on the $40 he had at risk equal to the before-tax rate of return. But the story can be continued. A may reinvest the $60 return of cost obtained through the initial deduction. If this investment is also expensed, it will generate an additional return of $36. On this second investment A thus has $24 at risk. Once again it can be shown that, on the $24 at risk, the after-tax rate of return is 150 percent. A third round is possible. A invests the $36 and receives back $21.60. The money at risk is $14.40. If A continues to reinvest the returns of the cost of the investments, the total investment will be $250 but the money at risk only $100. On this $100 at risk, A will earn 150 percent after taxes. A can thus be regarded as receiving back tax-free a profit of 150 percent on his $100 at risk. This is the return that an investor would receive on $100 at risk in a world without taxes, assuming he also earned 150 percent on his investment.

In this sense, assuming A can reinvest his cost repayments with similar expensing of the cost, A is indifferent to whether he is offered (1) full exemption from income tax on his initial investment or (2) a deferral of tax on a total sum invested (an immediate expensing of that sum) that would leave him with an amount of his money at risk equal to that initial investment. This is the way the Treasury Study appears to view the situation. Some of the tax shelters, such as oil and cattle, essentially provide for immediate expensing of all or a major part of the investment, so that the Treasury Department's description, and that of Professor Shoup which is along the same line, are fully applicable. Other tax shelters, such as real estate and leasing, while not giving immediate expensing, provide for an acceleration of the deduction of the investment cost and hence a very rapid write-off of the investment in its early years. The essentials of the analysis are the same, however, with the rate of tax on the money at risk being somewhere between the zero point of im-

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10 This is the way the matter is described in P. Musgrave, The Theory of Public Finance (1959) 343-344, and presumably is the way Professor Shoup views the matter in his footnote 20 quoted supra at 313, where he uses the term "asset", as does the Treasury Department. The term presumably does not refer to the overall amount of the investment. While A may be indifferent to the choice of exemption or deferral posited in the text, there is a difference to the economy since the deferral route, to provide indifference to A, does involve a larger amount of investment.
mediate expensing and the full tax rate, depending on the degree of acceleration of deduction. Thus, the Treasury Study indicates a variety of ways to show the benefits of accelerated depreciation—equivalence in asset price reduction, lowered effective tax rate, increased rate of return. There is, however, no reference to these benefit descriptions, and their upside-down effect depending on the taxpayer's tax bracket, in the President's and Treasury Department's 1971 announcement of depreciation revision, referred to above, providing an arbitrary 20 percent reduction in Guideline depreciable lives and abandonment of any linkage with useful life.¹¹

Assuming that a taxpayer really was replacing his assets at the former Guideline life (itself presumably a generous assumption for many business taxpayers in view of the campaign they were mounting to repeal the reserve ratio test—a successful campaign with the President's depreciation announcement), the 20 percent shortening of that life amounts for a 48 percent corporate taxpayer (12 year life) to a rate reduction of 4.4 percentage points on income from the assets, bringing the rate to 43.6 percent.¹²

For a taxpayer who was falling behind the Guideline life in his actual replacement policies, the freedom to use a life 20 percent shorter than the Guideline will involve a still greater reduction

¹¹ This depreciation revision was presaged in the Report of the President's Task Force on Business Taxation 3 et seq. (Sept. 1970), recommending a 40% reduction in Guideline lives as well as elimination of the reserve ratio test. The latter step of course ends any effort to link tax accounting and taxable income with business income and financial accounting in the use of depreciation to measure income. In this light the following quotations from the Task Force Report, found in setting of a recommendation to depart from the tax rule of including prepaid income received by an accrual basis taxpayer, have an ironic twist:

The Task Force has given consideration to the increasing differences which exist between the determination of net income of business taxpayers according to generally accepted accounting principles and the determination of taxable income for federal income tax purposes . . . .

This divergence results in unnecessary complexity and controversy. The objective of generally accepted accounting principles and tax accrual concepts is basically the same—the determination of the net income of the business on an annual basis. Both business taxpayers and government auditors are generally familiar with accounting principles, and compliance would be facilitated by conforming the determination of taxable income more closely with such principles. Business taxpayers would have greater confidence in the fairness and integrity of the tax if such differences were minimized.

Id. at 60. The Task Force Report also totally overlooks the link between tax shelters and accelerated depreciation and seems oblivious to the damage done in 1954 to the tax system when accelerated depreciation was introduced without any protection against its potential for manipulation and the "sale" of its benefits.

The Treasury Department, in its announcement of changes in the depreciation rules, unfortunately followed the lead of the Task Force, though using a 20% reduction.

¹² Treasury Department Study on Tax Depreciation Policy, supra note 9, giving data for 40% shortening of lives.
in tax rate. Is the public informed of this when the President and Treasury Secretary speak only of a "change in the timing of a tax liability"?

In terms of the tax itself deferred, does it help to say that the deferral permits a taxpayer to receive, without any investment of his money and without an interest cost, the after-tax amount that others in the same bracket would have received on an investment equal to the tax deferred (assuming the same before-tax rate of return)?

Suppose $A$, in the 60 percent bracket, receives $100 of income which would normally be taxable, but a special tax provision relating to the income permits $A$ to defer the tax on the income until a later date. Assume that date is ten years in the future, when the transaction is closed. Assume $A$ would have invested the $40 of after-tax income he would have obtained, if the $100 of income had been taxable, in an asset that earned 150 percent in ten years. $A$ would thus have $60 more, and owe a tax of 60 percent, or net $24 ($100 of proceeds less tax of $36 less investment of $40, or $24). This, on an investment of $40, is an after-tax return of 60 percent. But if the $100 was not presently taxable when received and tax was deferred, $A$ can invest $100. He will here end up after ten years with $60 of profit, which is $36 more than he would have received if he had invested $40. This $36 is equal to the net after-tax profit of a taxpayer in the 60 percent bracket who invests $60 and obtains a profit of 150 percent before tax. The higher the taxpayer's bracket, the larger is the amount he can so receive.
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I ask these questions with the feeling that these ways of putting the matter do not clearly get the point across to a busy legislator of the value of deferral. But how to do it?

There is another aspect that must also be made clear, and that is how the value of deferral increases as the investor's tax bracket rises. This part of the task may be easier. Thus, one method of communication may be to compare the benefit of deferral with an equivalent subsidy made directly by the government in the form of a grant or a loan. As the McDaniel-Kaplinsky article indicates, it can then be shown that, the better off the investor is and the higher is his tax bracket, then the more he would receive as a grant, or the larger the loan and the larger the interest saved and so on. In this way the lopsided or indeed upside-down character of deferral benefits presumably can be seen.

In our example involving $A$ above, the higher $A$'s bracket, the greater is the "loan" or leverage obtained and hence the less of $A$'s money he has to risk to earn the 150 percent rate of profit. Thus, in any situation in which $X$ dollars are needed to earn a certain rate of profit, if the cost of the investment is expensed, then the result is that (1) the higher the taxpayer's bracket the less is his share of the investment and the greater the leverage accorded him by the government, that is, the less is the amount of his money at risk; and (2) since the leverage is awarded free of interest, the interest saved in obtaining the leverage will increase his after-tax gain so that the after-tax rate of profit on his investment is equal to his before-tax rate.

Articles in this issue explore the variety of remedies Congress has used to counter these tax shelters built on deferral. The articles illustrate either the inadequacy of the remedies or their undeveloped form. Thus, in farming we have described in Professor Davenport's article the sorry state produced by the current Treasury's splitting and distracting the forces of reform and thus fatally weakening them by its sponsorship of the EDA recapture approach, although the reformers in Congress had opted for the more effective initial disallowance of excess deductions. Professor Halperin's article, in contrast, shows how the sanction of initial disallowance of excess deductions unsuccessfully advanced by the reformers in the farm area survived in strengthened form as a technique in the limitation of the deduction for interest on investment indebtedness. The analysis in this article describes the possibilities for growth which this concept possesses, as opposed to the false trail and dead end of the EDA technique.

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We might here refer to the minimum tax for tax preferences, 14 which may also contain the seed of a counter-attack on the deferral benefit. This tax, coming along after reform efforts have still permitted the deferral, in effect then places an interest charge on that deferral. The Senate Committee Report thus states: "[The] fact of deferring tax for an extended period of time is itself a tax preference for which the 5-percent [10-percent in final Act] tax is a moderate charge." 15 The charge is indeed moderate, for the effective rate of "interest" which it produces is equal only to 10 percent divided by the period of deferral. 16 But the idea is there, and perhaps the provision may develop effectiveness in the future.

The above-mentioned set of articles dealing with some of the tax shelters thus shows the tangle of incomplete remedies and false starts emerging from the 1969 Act. The articles on foundations and charitable remainder trusts in contrast describe the stronger provisions that emerged in the charitable area when Congress, prior proposals and the current Treasury were pretty much all working in concert. The article on foundations prophesies that the small family foundation will not survive the 1969 Act. The provisions of that Act make the foundation far less useful as a tool for family planning, say to maintain control of a business or as a device to gimmick "charitable" gifts. At the same time, the new operational requirements and the sanction of penalties on foundations managers combine to require an attentive management markedly in contrast with the careless handling that often characterized a family's operation of its foundation. But we can hardly see this as a loss to society when we realize that most of these foundations were the result of planning to solve a family's tax and business problems, and philanthropy was but an incidental and hence neglected attribute. Indeed, the real "causa mortis" of the small foundation lay in its having been discovered by the tax and estate planners. The 1969 Act is only the belated effort of Congress to take the foundation device back from them and restore it to philanthropy.

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