TAX HAVENS VS TAX SHELTERS:
WHICH IS WHICH?

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Taxes—the principal similarity among individuals; everyone must pay taxes. This is one subject that has reached controversial proportions, especially in an election year. As long as taxes have been around, people have tried to reduce their tax burden. Some try through tax avoidance; others try through tax evasion. These two methods seem similar in the purpose of tax reduction, but the important distinction between the two involves the legal question. Tax avoidance is using whatever legal means are available to minimize the tax burden whereas tax evasion is the use of illegal means to achieve the same end.

People are continually trying to reduce their taxes; these taxes have some very serious consequences: "Heavy taxes always have the effect of penalizing individual initiative and productivity, reducing investment capital and thus the resources required for economic growth, reducing the standard of living, and forcing individuals to hide things, both activities and incomes, from the government and from one another."

More and more people are using tax havens and tax shelters to reduce the taxes imposed upon them through the government. Though not similar in context, both methods have one goal in mind—to reduce taxes and enable individuals to increase their after-tax dollars.

When planning a tax haven company, it should be planned in accordance with the financial goals it hopes to achieve. A simple definition of a tax haven includes "any country whose laws, regulations, traditions, and in some cases, treaty
arrangements make it possible for one to reduce his overall tax burden.\(^2\) A tax haven can also be described as a "foreign country with tax legislation especially designed to attract the formation of branches and subsidiaries of parent companies based in heavily-taxed industrial nations."\(^3\) Both definitions have a common thread that binds them together—a country with favorable tax laws.

Another important definition that must be discussed in context of a tax haven is a tax haven organization. Such an organization involves one or more legally structured corporations, at least one of which is formed under the laws of and located in a tax haven country.\(^4\) With this type of structure, the IRS views the tax haven entity as a foreign citizen, exempt from taxes on certain kinds of income. Once this organizational status is established, the only taxes to consider are those levied by the tax haven country which range from none to minimal.

The legality of havens is questionable at times, but a correctly organized haven operation that complies with the laws of the country in which it is organized is as legal from the viewpoint of the country of residence as the interpretation of that country's tax laws allow it to be.\(^5\) When setting up a haven organization, the responsible corporate executive should not establish any practices that smack of tax evasion, but he should set up an organization that is equally defensible in every respect. The same advice holds true for an individual who is thinking of using a haven.

Our tax system has two specific features which give rise to a distinct tax-minimizing principle: (1) Taxes are imposed
on net income. (2) Taxes are levied progressively. These
two principles are, essentially, the same as those involved in
tax planning when tax havens are used. They are used in
conjunction with a third principle introduced by havens; this
third principle is that of the free market.⁶

Tax havens involvement can range from the minimum of
buying offshore funds through using haven corporate and trust
entities to reduce taxes of investment returns and eliminate
death duties to fulltime involvement in international business
activities. The essence of using tax havens for tax reduction
purposes is the creation of legal entities that have some common
characteristics:

1. separate from their creator in a fashion
guaranteeing that the income they derive
from their assets cannot be considered
part of his income.
2. "reside" in countries where the tax
situation is much better than in U.S.
3. an investor can control them and their
assets and income as he pleases without
either U.S. tax or debt liabilities.⁷

Two basic forms of such entities include corporations and
trusts. Corporations alienate returns on investments from
personal income and thus save them from crippling U.S. tax rates.⁸
Trusts can be used in conjunction with tax haven corporations;
a trust established in the U.S. is subject to a flat-rate tax
on its income, but a foreign trust is not subject to this tax,
and so can serve to reinvest its income tax-free, growing
rapidly through whole-dollar investment.⁹

Several things must be taken into consideration when
choosing a tax haven; the tax minimizer must have both general
knowledge about the country and specific knowledge about current
political and social developments there. The first aspect to consider is the cost; the costs are borne by any company chartered in a tax haven. These costs include government fees such as stamp duties and nongovernment costs such as legal fees and trust company charges. The original incorporation costs are only the beginning; many times "legal presence" is required in the country of incorporation such as an office with a sign bearing the company name is needed, a local director, or a legal representative. These costs begin to add up, and they must be run against the tax savings to measure the effectiveness of the haven. But the tax minimizer must realize that the costs are essentially fixed, bearing no relation to the size of income involved, the larger the gross from the investment, the less important are the expenses of using tax havens.

Another consideration involves the flexibility of corporate structure; some tax havens may require that stockholders' meetings be annual and local, or a requirement for "minimum paid-in capital" may exist at the time of incorporation. Such restrictions on the structure may cost more than the tax savings. Another factor concerns exchange controls and monetary freedom. The tax minimizer must be aware of the restrictions on taking money out of the country; he must be familiar with the conversion of $ dollars into local currency and vice versa. Another question deals with the exchange ratios; are exchanges restricted to officially approved agencies at fixed official ratios? Detailed answers to these questions are vitally important when a tax haven is being chosen.

Accessibility is a crucial factor to consider; the haven
must be easily accessible by land, sea, or air. There must be
reliable and speedy communication such as telephone, telegraph,
telex, and airmail. Quick communication and easy accessibility
may be crucial to the efficient utilization of a tax haven. 13
Another must to be weighed heavily concerns professional services;
tax haven activities involve many related professionals, such as
lawyers, bankers, trust managers, and accountants. Some tax
havens may be too small or underdeveloped to have acceptable
professional services.

The tax haven business requires cross-cultural communication,
and this can be disrupted by language and matters of legal
tradition and practice. So the language and tradition of a
possible tax haven should be considered carefully: "In general,
countries that share the Anglo-Saxon common law tradition are
the best tax haven bets. There is usually the added advantage
of English being an official language." 14 The tax minimizer
must also look at the possibilities for local business activities.
Some tax havens offer positive business reasons for local invest-
ment such as subsidies, other special treatment, and low labor
costs; others may strictly forbid and "exempt" company from
local business dealings. 15

The last area to be considered involves the political and
social stability of the country. An individual must look at
the history of the country to get an idea of the political,
economic, racial, and social change over the years; has the
change been very moderate or radical? Is there a tradition of
conservative peacefulness? The population must be viewed closely;
a racially diverse population may mean racial tensions that could
bring about some form of social or political upheaval. The political and economic situations must be peered at intently; are each stable and fairly secure or is instability prominent? These areas must be viewed closely and individually, and each must be weighed carefully when making the decision on which tax haven to use.

After the tax haven has been chosen, there are some general requirements that must be met:

1. The company must maintain a local registered office to which legal notices can be addressed.
2. Company name must be present outside the registered office as well as any other office where business will be conducted.
3. Company must keep a register of shareholders, of directors and of secretaries, and of mortgages and charges at its registered office.
4. Company usually required to convene a general meeting of shareholders at least once annually, usually at any location that is agreeable to all.
5. Company must file an annual return.

Another requirement for companies being formed in tax havens involves documents; two documents are required in the forming of the foreign corporation: Memorandum of Association and Articles of Association. The Memorandum is the equivalent of the Articles of Incorporation or charter, and it contains the basic law of the company. In general it contains the following:

1. Company name
2. Objects clause that outlines the powers of the company
3. Clause stating that the shareholders have limited liability
4. Company's registered office address (located in tax haven jurisdiction)
5. Amount of authorized capital as well as the number and par value of the shares
6. Clause stating that the subscribers to the memorandum have associated themselves together for the purpose for forming the company
The memorandum must be typed or printed, with spaces provided for the signatures of the subscribers; the signatures must be witnessed. The Articles of Association are the equivalent of the by-laws of a U.S. corporation.

Many tax havens promote confidentiality for the benefit of the clients. Officers of financial institutions located in a haven will protect their clients for two basic reasons:

1. in many havens, stiff penalties are imposed for the unauthorized disclosure of a client's affairs
2. because tax havenry is an important source of revenue for the tax haven country, the business community has a vested interest in providing an atmosphere of confidentiality for its tax haven clients

Tax haven authorities refuse to disclose tax information on a foreign company unless a tax law of their own country has been violated, or unless a treaty compels them to make the disclosure. Therefore, when the U.S. sends agents abroad to uncover illegal tax schemes set up by Americans, the tax haven entity may fare somewhat better than its U.S. counterpart because of the need for tax havens to protect confidentiality.

The discussion now turns to the different varieties of tax havens and some examples of each.

One type of haven is known as a "No-Tax" haven. "No-Tax" havens are countries that have no income, capital gains, or wealth taxes, and in which it is possible to incorporate and/or form a trust; "No-Tax" means that what is paid is independent of income derived through a company. With some havens a corporation is presented with the sharp alternative between being allowed to deal locally and being exposed to the prospect of paying income taxes in some unspecified future in
which they may or will be imposed, or being able to deal locally and having a long-term guarantee against future taxation ("exempt" company).23

The latter alternative (being an "exempt" company) may be the most beneficial if one has no real business interest in the haven itself. But in considering this situation, "relevant considerations for the applications of certain important Internal Revenue Code provisions is whether or not a company does any local business in its domicile country."24 That is, does the company have real "business justification" or is it a tax dodge? If because of its exempt status in a tax haven a company cannot do any local business, its American owner may find himself paying unwanted United States taxes!

The advantages of "No-Tax" havens are many; one pertains to the fact that these havens do not have double taxation agreements. They have substantial privacy advantages which are enhanced by local codes, official and unofficial, that derive from the healthy vested interest of local government in cultivating the tax haven industry.25 Other advantages include the fact that most of these havens are island societies so foreign invasion is unlikely, and defense budgets are minimal to nonexistent. No racial friction is present; the countries are peaceful and nonviolent, and they are free of a strong central government. Also, the tax haven industry is an economic necessity to these countries.

One major disadvantage shared by all these havens is the difficulty to establish plausible business reasons for incorporating in them. Names such as the Bahamas, Bermuda, and the Cayman
Islands are immediately suspect in the eyes of the IRS! 26

One example of "No-Tax" haven are the Bahamas; they are highly accessible by air, and communication is no problem. English is widely spoken and all airmail, telegraph, direct-dial telephone, and telex services are of the highest quality. The exchange controls are strict; companies are only allowed to operate with local dollars and to pay foreign bills with U.S. dollars exchanged according to the official rate, each time with an express Exchange Control permission. 27 Advantages of the Bahamas include an abundance of available professional services, privacy of banking arrangements, and no personal income, corporate, profit, capital, estate or other death taxes. The Bahamas grant no-tax warranties against future tax should one be imposed. Although there are no taxes, stamp duties on documents of corporate registration and an annual business-license are imposed.

Two basic types of corporations can be formed in the Bahamas; companies limited by shares and companies limited by guarantee. Companies limited by shares have fixed, unmodifiable authorized capital; they cannot buy back their own stock, and the stockholder's liability is limited to his stock. Companies limited by guarantee can reduce their share capital by buying back their shares and canceling them; this means that they can present their creditors with an unpredictable security situation. In this case, shareholders' personal guarantees for some extra sum beyond their own investment is legally introduced. 28

Incorporating in the Bahamas requires the services of a local lawyer to prepare and file a memorandum of association and
articles of association. The regulations concerning annual directors' meetings are rather open; the directors can meet anywhere, not necessarily in the Bahamas. "Alternative directors" can stand in for the regular directors, and a circular, agreed to and signed by a majority of directors, can have the same official standing as any decisions reached by a majority at a regular directors' meeting. 29

In addition to these requirements, there are some statutory requirements that must be met:

1. a register of directors
2. a register or shareholders
3. a minute book must be maintained in the local office
4. an annual return must be submitted to the Registrar of Companies specifying shareholders, officers, directors, address of registered office, and amount of share capital

The local law firm handling incorporation will charge certain fees: the charges of preparing documentation; the costs of providing five local nominee shareholders; the costs of maintaining a local nominee director; and the cost of "office representation" in the Bahamas. On the average, incorporation costs run about $1,500. 31 Since approximately 13,000 corporations are registered in the Bahamas, it must be a viable choice for a tax haven.

Another example of a "No-Tax" haven is Bermuda. Bermuda is easily accessible and communications are excellent; the Bermuda dollar is on par with the U.S. dollar, but there are exchange controls for residents and resident companies. Bermuda has a large range of high quality professional services available. This tax haven has none of the following taxes: inheritance, personal, corporate, profits, capital, capital gains, or withholding.
Some disadvantages to Bermuda as a tax haven include problems with immigration and work permits for aliens, difficulty with hiring a local office in view of land restrictions, and the distinction between local and alien companies is very strict. There has also been an attempt to introduce an income tax in Parliament, and some racial tension exists between whites and blacks.

Two basic companies are recognized by Bermudan corporate legislation: local companies and exempt companies. Local companies are those formed by Bermudans for purposes of internal trade or Bermudan-based international trade; such companies have a minimum percentage of local stock ownership, prescribed by law, subject to strict exchange control, and have no guarantee against future taxes. Exempt companies are free of the first two above mentioned restrictions, but they are given an official guarantee against the levying of future taxes for 30 years.

The restrictions placed on an exempt company include the following:

1. It cannot buy, lease, or sell land, mortgages secured by land or bonds and debentures secured by land without special permission.
2. It cannot buy shares of local companies.
3. It cannot locally sell whatever it provides without special ad hoc permission.

These restrictions limit the "business justification" possibilities for Bermudan incorporation, and there are no ways around them.

Incorporation costs include a stamp duty on the shares of authorized capital and a stamp duty on bonds and debentures issued. There are annual fees for an exempt status, for an "ordinary" company, and for finance, insurance, or mutual funds companies. With these costs taken into account, plus the various professional services needed in order to incorporate, both
incorporation and annual maintenance run to $2,000-$2,500 a year.\textsuperscript{36}

Another tax haven is the Cayman Islands; the Islands are easily accessible plus adequate communication is available. A broad range of high quality professional services is easily obtainable; the exchange controls are less strict than the Bahamas and Bermuda. Racial tension, prejudice, segregation have never been serious factors in the Cayman Islands and are never likely to be. An automatic no-tax guarantee of 20 years is granted to nonresident exempted corporations, and there is a 50 year guarantee to trusts.\textsuperscript{27}

The Cayman Islands are a good choice for a tax haven; they offer a large range of possible business activities, and work permits and immigration licenses are easy to obtain. There is virtually no nationalistic spirit or land-scarcity anxiety. A very important advantage is the fact that bank privacy is strongly guarded; a government official who breaches bank privacy can expect heavy fines and a prison term.\textsuperscript{38}

Incorporation is quicker, easier, and cheaper than in the Bahamas and Bermuda. A Memorandum of Association, involving three initial shareholders, is required. Upon payment of the registration fee, the Registrar of Companies issues an immediate certificate of incorporation and files the Memorandum. An annual fee is required along with the standard office services. Total costs of incorporation run about $1,000 while annual maintenance averages about $650.\textsuperscript{39}

Out of the above mentioned tax havens, the Cayman Islands are clearly the most desirable; many tax haven companies
that have been firmly established in the Bahamas and Bermuda for years have recently transferred their bases of operation to the Cayman Islands. The Cayman Islands are clearly superior in every respect—future no-tax security, costs, expediency of incorporation, flexibility of corporate structure, business opportunities, privacy, immigration, and prospects for land ownership. Another big plus is the government interest in the tax haven industry. The costs of transferring a corporate base of operations are expensive, but the tax haven companies that have completed this process must think the costs worthwhile since they have moved to the Cayman Islands.

Another type of tax haven is the "No-Tax-on-Foreign-Income" haven. Such countries do impose income taxes both on individuals and corporations, but only on locally derived income; exempted from tax is any income earned from foreign sources that involve no local business activities apart from simple "house-keeping" matters. Within this category of tax havens are two subgroups; the first allows a corporation to do business both internally and externally, taxing only the income coming from internal sources; the second group requires a company to decide at the time of incorporation whether it will be one allowed to do local business with consequent tax liability or one permitted to do only foreign business and thus be exempt from taxation. The latter alternative might look good, but the matter of "business justification" may be an important consideration when making the final decision.

An example of this type of haven is the country of Panama. Transportation to Panama is easy, and communication facilities are extremely efficient; language is no barrier. There is absolute
monetary freedom. Panama levies taxes on locally generated income and exempts from taxation all income generated abroad; all income generated by movement of commodities that never pass through Panama, even though invoiced and managed from a Panamanian office, is completely exempt from taxation. Also, no withholding tax applies to dividends paid to stockholders residing outside Panama, provided the profits underlying the dividends are all derived from sources external to Panama. Likewise, if one inherits property owned by a Panamanian corporation, and the assets themselves are outside Panama, no inheritance taxes apply.

Some advantages of Panama as a tax haven include the fact that it is less expensive than the Bahamas, Bermuda, and the Cayman Islands; the costs of incorporation total approximately $530, and average annual maintenance costs are $100-$200. And one gets the same tax advantages for income generated outside the country. Another advantage for Panamanian companies that deal exclusively outside Panama is they do not need to keep financial records locally, nor do they need to submit any annual financial reports with local tax authorities. What must be locally kept is the stock-register book for registered stock and a minute book for meetings of stockholders; the minutes must be entered manually.

Hong Kong is another good example of a "No-Tax-on-Foreign-Income" haven; it is easily accessible though a good distance from the U.S. No exchange controls exist, and professional services are available. Superb transportation and communication facilities exist; airmail, telex, and international telephone and cable services are made highly efficient, regular, and reliable
through the pressures of demand.  

Hong Kong has no taxes on capital, gifts, or capital gains; plus there is no withholding tax on dividends. Another important advantage of Hong Kong as a tax haven involves the fact that the U.S. recognizes any taxes paid to Hong Kong as credit against U.S. tax liabilities. Hong Kong is a good choice for a tax haven; business justification is unlimited, local tax rate is low, and incorporation costs are substantially less. Total incorporation costs average $230 while annual maintenance, which includes an annual audit, average $130. Incorporations take approximately four weeks, and complete privacy is observed.

Liberia is another example of this type tax haven, but it is only for persons or corporations intending to derive income purely from external sources. Tax advantages in Liberia include the availability of good professional services, the use of English as the official language, reliability of telecommunication, geographical accessibility and the lack of exchange controls.

Incorporation in Liberia is not very different from any other tax haven; there are no domicile requirements for anybody associated with the company; no requirements exist for locally held stockholders' or directors' meetings; the necessity for a locally registered office decorated with a sign emblazoned with the name of the company is absent; and no documents need be kept anywhere in Liberia. Incorporation costs approximate $650 while annual maintenance averages $250, and a time span of approximately forty-eight hours is all it takes to incorporate a new company.

Of the three "No-Tax-on-Foreign-Income" havens, Hong Kong is the best possibility for the haven choice. Incorporation
costs and annual maintenance costs are less expensive than Panama and Liberia; the possibilities for business are unlimited and privacy is followed closely. The biggest advantage of Hong Kong seems to be the fact that the U.S. allows a tax credit for taxes paid in Hong Kong.

Another type of tax haven is "Low-Tax" havens; these countries impose some taxes on all corporate income, wherever earned. Most have double-taxation agreements with the U.S. that may reduce the withholding tax imposed on income derived from the U.S. by local corporations.\(^53\) One such example of this haven is the Netherlands Antilles. These islands are accessible and have adequate communication. The availability of professional services is limited, and strict exchange controls exist.

The Netherlands Antilles taxes the worldwide income of a corporation, but taxes on dividends, capital gains, dividends and interest from investment and holding companies, inheritance and estate do not exist.\(^54\) But any tax savings depend on the nature of the investments included in the portfolio transferred to the Antilles. The costs for using a tax haven are high; a "shelf company," already incorporated and approved, can be purchased for $1,200-$1,500 and maintained for $600-$1,000.\(^55\)

Two other samples of this particular tax haven are the British Virgin Islands and Barbados. Each country is easily accessible; each has good communication systems, and each has no exchange controls. English is spoken in each country, and each has extensive professional services available. Incorporation is easy and relatively inexpensive. Taxes are imposed on worldwide income, and no taxes exist on capital, capital gains,
or sales; also, no death taxes exist. Each country has a double-taxation agreement with the U.S., but Barbados has one extra advantage that puts it at the front— it has virtually no local taxes. It does have a corporate tax, but a corporation owned and controlled by nonresidents and doing business exclusively outside Barbados is taxed differently. The company pays no tax on profits of trade and manufacture and only a small rate on investment returns. This small rate means that the double-taxation agreement with the U.S. applies to it. Clearly, Barbados is the most favorable of the three "Low-Tax" havens.

The last two types of tax havens discussed in this paper are "Special-Tax" and "Immigration Countries" havens. "Special-Tax" havens are those countries that impose all or most of the usual taxes but either allow special concessions to special types of companies or allow very special types of corporate structure. One such example is Liechtenstein and the flexible corporate arrangements offered. Immigration countries include those countries where Americans are officially welcome and where one can retire and live on income from investments, pension plans, etc. derived from U.S. sources, but free of the U.S. tax burden. This might possibly mean that one must give up one's American passport, but some countries offer a new passport immediately.

The above paragraph concludes the discussion on tax havens; as one can tell, one must go outside the U.S. to find a tax haven, and many tax havens exist for the individual and the corporation. Each has its advantages and disadvantages, and one has to know what to look for and what to consider when choosing a tax haven. For the person who is serious about a tax haven venture and who looks carefully and intently, there is a tax haven somewhere; the tax
minimizer will find the one tax haven that will suit the particular needs and wants of the tax haven seeker.

The second method of reducing tax liability is the use of a tax shelter. People who use tax shelters share a common desire to decrease their tax bite and increase their wealth through investment. Such tax shelters are supposed to be great investments because they are to make great profits for their investors.

A tax shelter is a direct investment in a business activity. The investment is passive; the investor does not actually operate the business. Because it is a direct investment, the losses and gains of the business are reported directly on the tax return of the investor. A tax shelter will be a business which exploits the tax incentives given for business investment; the business will lose money for tax purposes in its early years, and these losses will be used to shelter the investor's other income. Tax shelter losses directly offset, on a dollar-for-dollar basis, the investor's taxable income from other sources. In later years, when the investment shows a tax profit, that profit must also be reported by the investor.

Shelters are designed to use available dollars in a way that will maximize the tax benefits that flow through to the investors. The tax shelter losses decrease a person's taxable income. The greater the tax shelter losses available to the investor, the more personal income that is sheltered. When the shelter begins making a profit, increased tax liability results to the individual because the profit is added to personal income thereby increasing the taxable income.
Shelters are an investment, generally one of two types. The first is an investment in which the profits earned are tax-free. The second type is investments that provide the investor with fully or partially tax-free returns and with enough excess deductions and credits to reduce the current tax bill. In a sense, tax shelters are really the sum total of many separate deductions and credits; whenever business of investment-related property is involved, certain tax allowances and incentives are available. These include depreciation and depletion deductions plus the investment tax credit.

Shelters work because the Internal Revenue Code allows for certain tax deductions and credits for money spent in the conduct of business, trade, or activities engaged in for profit. Also, tax shelters are legal without question although state and federal securities laws require that most tax shelter offerings—both public and private—be fully disclosed in prospectus form, stating all major aspects of the venture, including the risks.

Some of the people and corporations deriving tax benefits from tax shelters include:

1. self-employed professionals
2. individuals with substantial unearned income
3. high salaried business executives
4. taxpayers earning a large income for a short period
5. married couples whose joint incomes place them in the 50% or higher bracket
6. individuals working in states where the combined federal and state income tax rates place them in the 50% or higher tax bracket
7. individuals receiving a large amount of unearned income in one year
8. beneficiaries of a substantial trust fund
9. corporations taxed in the highest corporate brackets
10. corporations facing a problem with the unreasonably accumulated earnings tax
The tax shelter offers these individuals and corporations three things:

1. Current deductions which offset of shelter current income.
2. Future deductions which shelter income for investments.
3. Capital gain treatment of profits when tax-sheltered investment is sold.65

When tax shelters are used, a form of structure is required; this form or structure is a vehicle for raising capital and managing its affairs. The structure depends on the nature of the enterprise, the amount of capital available or needed, the number of investors, the economic risks, and the tax considerations.66 The structure filters the tax benefits through to the investor, who in turn uses them to offset other income.

Many structures are used, and each has its advantages and disadvantages. One vehicle is co-ownership; this is common in oil, gas, and coal shelters. All investors actively participate in management, and they are fully responsible for any debts or obligations involved; no limited liability is available. A second vehicle used is joint venture; the disadvantage of this type involves the fact that ventures have liability beyond their original contribution. General partnership is the third vehicle of the structures used; this vehicle also has no limited liability for the partners.

A fourth vehicle is the Subchapter S Corporation; this type of corporation combines the benefits of a corporation and partnership, and it offers limited liability and pass through of losses. These losses, however, can be passed through only to the extent of the investor's basis; this particular tax disadvantage limits the usefulness of the Subchapter S as a tax
shelter. A regular corporation is another possible vehicle used for tax shelters, but it is a taxpaying entity and losses remain trapped at the corporate level; shareholders cannot benefit from loss years.68

But the most popular form of vehicle used is the limited partnership; the liability is limited to the original contribution and loss pass through is available to the investors. But the investors have no participation in the project management. The limited partnership is a hybrid of the general partnership and the corporation; it provides both the flow-through tax advantages and the economic protections needed by tax shelter investors, with a minimum of restrictions and conditions.69 These partnerships are created in accordance with the laws of the state in which they are formed under the Uniform Limited Partnership Act of 1916. They are regulated on two levels; under state law, the rights, duties, liability of the partners to each other and to third parties are clearly defined. Under federal law, the relationship of the partners and partnership to the federal government for income tax purposes is outlined.70

A limited partner has limited liability, but he cannot take part in the management of the partnership; a limited partner shall not become liable as a general partner unless he goes beyond his rights and powers as a limited partner and takes part in the management of the business.71 The rights of a limited partner include:

1. Right to inspect and copy partnership records.
2. Right to receive true and full information of all matters affecting the partnership.
3. Right to a formal accounting of partnership affairs if demanded.
4. Right to have the partnership books kept in the principal place of business.
5. Right to demand dissolution and a winding up of the partnership by decree of the court.

The limited partnerships are required by state law to have a certificate; the purpose of this certificate lets all those dealing with the partnership know which partners have the right to act on behalf of the partnership and which have limited liability. This certificate is required to disclose the following information:

1. Name of the partnership
2. Character of the partnership's business
3. Location of the principal place of business of the partnership
4. Name and residence of each partner with general and limited partners being respectively designated
5. Amount of time for which the partnership is to exist.
6. Investment of the limited partners
7. Additional contributions of the limited partners
8. Time, if agreed upon, when the contribution of each limited partner shall be returned
9. Share of the profits, or other consideration, which each limited partner shall receive by reason of his investment
10. Right, if given, and the terms for substituting limited partners
11. Right, if given, of the partners to admit additional limited partners
12. Priority of limited partners
13. Right, if given, of the remaining general partner(s) to continue the business upon the death, retirement, or insanity of a general partner
14. Right, if given, of a limited partner to demand and receive property instead of cash in return for his investment?

The advantages of the limited partnership are divided into the general and the tax advantages. The general advantages are many and include some of the following:

1. Personal liability is avoided by limited partners so long as they do not exercise any of the powers of management.
2. Corporate formalities of incorporation, minutes, by-laws, Board of Directors, franchise tax returns and other formalities are avoided.
3. Double taxation of earnings is prevented.
4. Losses pass through directly to partners and offset other income.
5. Corporate problems of personal holding company status and unreasonable accumulations of income are eliminated.
6. Tax basis of a limited partner includes his share of nonrecourse loans to the partnership.
7. State and local real property transfer taxes can generally be avoided since an interest in a limited partnership is considered personal property.
8. Collapsible partnership rules have more limited application than collapsible corporate rules.
9. Partnership losses in excess of a limited partner's tax basis will not be wasted if the partner obtains additional basis in a later year.\footnote{74}

The tax advantages are few but extremely beneficial to the investor:

1. Investor should obtain tax deductions in excess of his investment.
2. Partnership earnings will be taxed only once.
3. Sale of the property should primarily result in capital gains.
4. A refinancing of the project will generate nontaxable distributions to the partners.\footnote{75}

When an investor is planning to use a tax shelter, many risks are involved. These different risks must be taken into account when evaluating a particular shelter. Sometimes the risks involved do not outweigh the tax benefits to be gained from the shelter. These risks consist of the following:

1. Risk as a function of the tax bracket-how much does the government pick up vs. the investor's real exposure.
2. Psychological risk-how much risk the investor is comfortable in assuming.
3. Business/Investment risk
4. Tax risk
5. Inflation risk\footnote{76}

Tax shelters are categorized by four functions. The first category consists of deferrals; deferrals are designed to postpone
taxable income and are most suitable for people facing retirement whose taxable income will drop sharply in anywhere from two to six years. The first year's write-offs range from 50-200% of the investment. The best examples of deferrals include cattle breeding and feeding, equipment leasing and book publishing, movies, and records. The second category is equity builders; equity builders are designed to increase an investor's net worth rather than to provide immediate sizable write-offs. The write-offs range anywhere from 30-100% of the investment in anywhere from the first year to the first three or four years. Examples of this category include oil and gas ventures, conventional real estate, and agriculture.

Deep tax shelters describe the third category of tax shelters; these shelters provide a series of very large, predictable tax losses which usually total 300-400% of the investment in stages over approximately 14-20 years. They are perfect for those investors who need to offset high, predictable long-term incomes. Examples include government subsidized housing and net lease tax-oriented real estate. The last category covers investments that provide tax-free or tax-sheltered income, but they must be purchased with after-tax dollars because they do not generate any tax deductions; the investor must first earn the investment money, then pay taxes on it, and then finally make the investment. This type of shelter is appropriately called "Not really a tax shelter," and examples include annuities and income-oriented real estate.

The most popular tax shelter seems to be real estate; the tax benefits from real estate can take one of two forms. Either
there will be cash returns on the investment which can be tax-free for many years or there can be substantial excess deductions and credits for the investor. Some real estate investments include apartments under construction, raw land, recreational real estate, existing multifamily residential projects, commercial/industrial buildings, and orchards, farms, and other agricultural syndications. The high risk real estate tax shelters include the conventional (to-be-constructed) real estate, subsidized-housing real estate, and farming and agricultural real estate. The most conservative is a building already built and leased to a single tenant with an excellent credit rating.

Oil and gas shelters are another popular sample of shelters; excess deductions are available from ventures engaged in exploratory and development drilling. Oil and gas shelters generally offer excess losses only in the first year of operations, but in order to achieve the other main benefit of a tax shelter—partially tax-free returns to investors—the exploratory and development activities of the venture must be successful. The exploratory programs are the highest risk, but the rewards are also the highest with this particular venture while the development programs are less risky.

Some miscellaneous high risk tax shelters include municipal bonds as speculations, theatrical and movie investing, and equipment leasing. Additional conservative shelters include straight life insurance, deferred annuities, tax-exempt securities, and Clifford Trusts. A life insurance is considered a tax shelter because dividends, if reinvested, are completely free
from income and capital gains taxes since they are considered to be a return of premium.\textsuperscript{81} Deferred annuities shelter income by providing a tax-free compounding of interest, and a Clifford Trust shelters income from taxes by placing the assets in a ten-year living trust, which dissolves at the end of ten years and one day and reverts the property back to the original owner; the income will be taxed to the trust or its beneficiaries who are in a lower income bracket even though the property reverts to the original owner.\textsuperscript{82} Other miscellaneous shelters include professional sport franchises, commodity straddles, and patents and research and development expenditures.

Tax shelters need to be evaluated carefully and extensively before an investor becomes involved; the accuracy of the shelter cash flow projections, investor's share of the projected cash distributions from operations and his benefits from sale or refinancing should be analyzed. The anticipated tax benefits should be evaluated and considered part of the return, and the risks need to be weighed carefully. Once the investment is made, the investor needs to know his rights and, most importantly, the extent of his liability.

Robert Stranger, author of the \textit{Stranger Report} and consultant to a dozen extremely wealthy private clients who pay him $10,000 yearly to evaluate tax shelters, gives the investor some do's and don'ts to consider when evaluating a tax shelter:

1. Never consider any investment proposed in a classified ad or by an unknown or "cold" caller.
2. Avoid any deal that promises 50\% or more of your money back from the investment tax credit.
3. Reject any program that fails to provide detailed information on the sponsor's prior performance.
1. Stick with publicly offered partnerships which are registered with the Securities and Exchange Commission. Stranger makes the comment that "almost all the fraudulent shelters are private placements." Any venture can be converted into a "tax shelter" if the project will be marked by a high level of initial losses due to start-up costs, but the Internal Revenue Service is beginning to crackdown on the fraudulent shelters, and new guidelines are being implemented that will help the IRS evaluate and examine tax shelters to determine whether they are abusive or investors are being swindled.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) is one action against tax shelters; TEFRA encourages interest in tax shelters, but revisions in the amount provisions of the alternative minimum tax limit the amount of shelter a taxpayer can effectively seek. TEFRA also spells out compliance provisions for shelters; these provisions are intended to, and should work to discourage the truly abusive tax shelter. Specific sanctions against promoters of abusive tax shelters include a penalty for promoting the abusive shelter and civil action to enjoin promoters from continuing to promote abusive shelters.

The purpose of the new promoter penalty provisions is to attack abusive tax shelters at their source rather than by auditing tax shelter returns. The new provision applies to anyone directly involved in the design or promotion of any transaction with material tax considerations; this includes tax advisors as well as the principals and sales persons. However, the penalty provisions are only applicable to such persons if
they make one of the following prohibited statements:

1. gross valuation overstatement
2. statement with respect to the allowability of any tax benefit from the entity plan, or arrangement which the person knows or has reason to know is false or fraudulent as to any material manner.87

The complete overhaul of amount provisions for the alternative minimum tax had three principal impacts on tax shelters:

1. Makes more attractive tax shelters which generate losses which reduce a taxpayer's adjusted gross income with minimal use of tax preference items.
2. Provides a clearcut answer to the question of how deep to shelter income through the use of tax preference items and nonfavored itemized deductions.
3. Makes it necessary to analyze thoroughly how a particular tax shelter will affect a taxpayer's income.88

TEFRA does not make tax shelters illegal; it just makes the law stricter in order to limit the use of abusive tax shelters. This Act, in fact, encourages more interest in tax shelters rather than limiting the interest.

Other actions against shelters include bills that are now before Congress; one such bill concerns managed commodity pools. The Hutton Commodity Reserve Fund, Ltd. gives the fund's investor's the chance to take out futures profits as long-term capital gains subject to the maximum 20% tax; Hutton uses two tiers of offshore holding companies to duck the 1981 law imposed upon commodity futures trading. Representative Fortney Stark, a California Democrat who chairs a tax subcommittee, is trying to have the Fund backfire with profits taxed as ordinary income at rates up to 50%; the bill that is being introduced would outlaw the technique Hutton is using to minimize taxes on managed commodity pools.89
The IRS have been given new guidelines for identifying and examining burned-out tax shelters; to determine when popular types of shelters may be expected to generate taxable income, the IRS uses the following crossover points:

<table>
<thead>
<tr>
<th>Type</th>
<th>Crossover Point</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate</td>
<td>10-15 years</td>
</tr>
<tr>
<td>Low-income housing</td>
<td>5 years</td>
</tr>
<tr>
<td>Research and development</td>
<td>5 years</td>
</tr>
<tr>
<td>Cattle feeders</td>
<td>1 year</td>
</tr>
<tr>
<td>Commodity spreads</td>
<td>1 year</td>
</tr>
<tr>
<td>Coal</td>
<td>3-4 years</td>
</tr>
</tbody>
</table>

The IRS continuing crackdown on "abusive" shelters includes the screening of these shelters for deductions that are clearly illegal; the IRS intends to notify investors who go into these deals to expect an audit. Screening the "deals" and "programs" now coming on the market may prevent not only an IRS audit, and new penalties, but also may prevent the chance of the investors being fleeced.

Another area the IRS is beginning to crack down on involves transfer pricing; transfer pricing decisions are ripe for potential abuse and major sums are involved. Disputes arise when a U.S. corporation sets up a foreign subsidiary from which it buys or sells a product. Sometimes the relationship falls short of what the IRS says arm's length transaction means, and that is when the troubles start. The IRS is now equipped with new policing tools for tax shelters; it now has the right to get an injunction to stop a whole investment promotion, instead of working on each individual investor, as it has done in the past. The IRS can now attack all the investors in a suspect shelter deal simultaneously instead of having to nip at them case by case.

The Treasury Department is now aiming to knock out the "negative opinions" that tax professionals provide for a fee to
the promoters, who in turn use them in selling shelters. The negative opinions of public shelter offerings are inappropriate and destructive, and the threat by the Treasury Department is aimed specifically at opinions that cast doubt on the promised benefits. The IRS, and even the Treasury Department, is cracking down on the promotion and use of abusive tax shelters. Guidelines have been developed to accomplish this task; the new weapons provided in 1981 by ERTA and in 1982 by TEFRA enable the IRS to aggressively combat "abusive" tax shelters. This does not mean that tax shelters are illegal, but that the IRS will now keep a sharper look for those who promote illegal shelters.

Tax shelters are a big business today and they are expected to also be big business in the future, but investors need to be careful when choosing such a shelter. Many promoters overvalue shelter properties (creating artificially high tax write-offs), grabbing huge fees "off the top" or making false promises about tax breaks. Roscoe L. Egger, Commissioner of Internal Revenue, says, "Screen the deal you buy." And Joe Bianco, who designed a $4.7 million tax shelter for financing a U.S. distributorship for the Lotus, says, "Be careful of add-on loads or markups on assets from wrap financing, and know who the promoters and general partners are. Never, never do anything without truly independent expert advice."

People are continually trying to reduce their tax burdens and keep more of their paychecks for themselves; some do this through tax avoidance while others through tax evasion. Edouard Chambost, Paris lawyer and author of one of the most comprehensive tax haven guides, describes it like this: "Avoiding unnecessarily high
taxes is like looking for the best bargain-buying in the cheapest store. Evasion, by contrast, means that you are walking away without paying your bill."  

Some avoid taxes through tax havens while still others through the use of tax shelters. Both methods are thriving: "The tax-haven industry is alive and prospering and is likely to have a bright future," states Edouard Chambost.  

"Heavy taxes, whether used to provide luxury for a ruling elite or to support welfare schemes, always have the effect of penalizing individual initiative and productivity, reducing investment capital and thus the resources required for economic growth, reducing the standard of living, and forcing individuals to hide things, both activities and incomes, from the government. Heavy taxation, therefore, is a danger to the future of the United States. If more and more Americans would consciously and systematically act to reduce their individual tax burdens, they would not only improve their own lot, they would make a tremendous contribution to their country and the safety and freedom of the Western World."
ABBREVIATIONS USED IN THIS PAPER

IRS- Internal Revenue Service

TEFRA- Tax Equity and Fiscal Responsibility Act of 1982

ENDNOTES

2 Ibid., p.21.
4 Ibid., p.V.
5 Ibid., p.2.
6 Starchild, Tax Havens, p.37.
7 Ibid., p.65.
8 Ibid., p.79.
9 Ibid., p.84.
10 Ibid., p.24.
11 Ibid., p.24.
13 Ibid., p.27.
14 Ibid., p. 28.
15 Ibid., p. 28.
16 Ibid., p.29.
18 Ibid., p.16.
19 Ibid., p.16.
20 Ibid., p. 4.
21 Ibid., pp.3-4.
22 Starchild, Tax Havens, p.21.
23 Ibid., p.22.
24 Ibid., p.22.
26 Ibid., p.107.
28 Ibid., pp.112-113.
29 Ibid., p. 114.
30 Ibid., p.114.
31 Ibid., p.114.
32 Ibid., p. 118.
33 Starchild, Tax Havens, p.118.
34 Ibid., p.118.
35 Ibid., p. 119.
36 Ibid., p.119.
37 Starchild, Tax Havens, p.124.
38 Ibid., p. 128.
39 Ibid., p.125.
40 Ibid., p. 121.
41 Ibid., p.128.
42 Starchild, Tax Havens, p.22.
43 Ibid., p.23.
44 Ibid., p.141.
46 Ibid., p.144.
47 Starchild, Tax Havens, p.145.
48 Ibid., p.150.
49 Ibid., p.152.
50 Ibid., p.153.
51 Ibid., p. 157.
52 Starchild, Tax Havens, p. 158.
53 Ibid., p. 23.
54 Ibid., p.176.
55 Starchild, Tax Havens, p. 175.
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60 Ibid., p. 29.
62 Ibid., p. 30.
63 Ibid., p. 17.
66 Tannehauser, p. 38.
68 Ibid., p. 73.
69 Tannehauser, p. 39.
70 Ibid., p. 40.
71 Wilkinson, p. 100.
72 Ibid., p. 93.
73 Tannehauser, pp. 42-44.
75 Ibid., p. 87.
76 McQuown, p. 22.
77 Ibid., p. 32.
78 Ibid., p. 33.
80 Tannehauser, p. 134.
81 McQuown, p. 117.
82 Ibid., p. 125.
84 Ibid., p. 57.
86 Ibid., p. 290.
87 Ibid., p. 291.
88 Ibid., p. 292.
91 "Refuge is Still Possible, But Beware the IRS," Business Week, 27 December 1982, p. 118.
93 "Refuge is Still Possible," p. 119.
95 "Refuge is Still Possible," p. 118.
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