TAX SHELTERS

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There are basically three groups of tax shelters. The first group are those investments which allow the investor to deduct a large percentage of actual investment funds from income taxed. The second group are those investments which allow a person to defer his taxes to a later time when he may be at a lower tax level and the third group are those moneys which are not of themselves deductible as invested but have income which is tax free or which avoids other taxes such as death taxes.

Because of the complexity of tax shelters, it will be necessary to divide this subect into several articles covering each of the above groups. Only a very broad overview is possible because each of the above groupings contains many specific investments which may be used.

The first group is investments where the acutal paid-in investment is tax deductible. The bulk of this grouping is moneys used for research and development. They are granted by Congress as incentives to promote development of projects in the national interest. Just as administrative expenses are deductible from income in determining taxes, the costs of development and research are usually expenses which are classified as business expenditures and offset profits. Usually, in development stages there is no income but only expenditures. As a consequence, these expenses are permitted by law to be losses which are deductible from one's ordinary income. In a recent example of such an investment there were several limited partnerships formed for the development of a new patent for drying lumber at a fraction of the normal drying time and cost. Since all the money being raised was for development of manuals and research on drying time of various species of wood, it was determined that all of the money was being raised and spent for development. As a consequence a man in the 50% tax bracket could invest $50,000 into this limited partnership. This $50,000 would then be completely tax deductible and would represent a $50,000 offset against ordinary income. If he earned $150,000 in salary, he would deduct $50,000 and calculate his taxes based on $100,000. Assuming that his tax rate is 50%, this deduction would mean that he pays $25,000 less in taxes. Accordingly, his risk in the patent is acutally $25,000 because had he not invested, he would have paid out $25,000 more in taxes anyway. In this case the resulting patents were licensed in exchange for royalties on future income which are taxed at capital gains rates up to $50,000. This was a bona fide tax shelter.

Oil exploration and drilling is another good example of a tax shelter under this first group. The national economy is quite dependent on oil and by allowing a tax deduction in offset of ordinary income, there is participation by private investors in providing risk capital needed in discovering and developing new oil fields. Using oil and gas investments one can deduct development and intangible drilling, labor, suppliers, repairs, etc. This may include investments in known oil reserves or for pure exploration itself. In addition are the well known depletion allowances which allows a 22% deduction from the income of successful wells. This depletion allowance is similar to a depreciation allowance to compensate for the fact that they will someday go dry.

For those with new ideas or inventions who seek investors there are often possibilities of adding tax deduction features to encourage research and development which go unnoticed and oftentimes are lost. Some developers choose to have two investment partnerships whereby one group raises money solely for research/development and others for operating or expansion costs. One would have high current deductibility and the other would have high income.

As with all investments, the most important objective is not tax benefits but rather the soundness of the investment. The deductibility is like cream on the dessert which makes the dessert more appetizing, Likewise, if the investment is not sound, then the deduction will be no different than if you received a deduction by gifts to charity. As with any investment, care should be taken before entering into any investment.

The next two articles will deal with tax deferment schemes and how you can postpone taxes to a later period when you are in a lower tax bracket.