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IMPLICATIONS OF IMPLICIT TAXES

David A. Weisbach*

IN *Some Explicit Thinking About Implicit Taxes*,¹ Professor Charlotte Crane argues that policymakers, courts, and scholars often miss the effect of implicit taxes. An implicit tax is simply the effect of taxes on the price of an asset. For example, if an asset is tax-preferred, the price will be bid up to reflect the tax preference.

One must think explicitly about implicit taxes to avoid missteps. Although there is substantial literature on implicit taxes, Crane shows that many areas of tax policy have not fully incorporated the concept, pointing out five or six different areas of the law that fail in this regard. For example, Crane argues that the tax treatment of unpaid interest on a tax-exempt bond is dependant on whether the price of the bond is supposed to reflect the benefit of tax exemption. Similarly, the pre-tax profit requirement for tax motivated transactions does not take into account implicit taxes and, therefore, is likely to be too broad and potentially incoherent.

Crane's observation is important and surely correct—implicit taxes may change policy prescriptions. I have two comments. First, I will discuss what exactly implicit taxes are and why we might care about them. In doing so, I will expand on some of Crane's arguments regarding implicit taxes. Second, I will discuss how much we learn from explicitly discussing implicit taxes in the context of a pre-tax profit requirement for tax shelters. The appropriate treatment of tax shelters is an increasingly important topic as evidence mounts of a growing proliferation of aggressive shelters.² Yet the definition of a shelter and the appropriate treatment, once identified, remains uncertain. Crane, as well as others, argue that implicit taxes are central to a coherent definition.³ Implicit taxes would clearly be part of any complete picture, but I will argue that the core of the problem lies elsewhere.

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1. Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 SMU L. REV. 339 (1999).

2. See Joseph Bankman, *The New Market for Corporate Tax Shelters*, forthcoming TAX L. REV.

3. See, e.g., David J. Shakow, *Confronting the Problem of Tax Arbitrage*, 43 TAX L. REV. 1 (1987); Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263 (1994); Alvin Warren, *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981).

I. IMPLICIT TAXES

Implicit taxes are misnamed. Implicit taxes are not taxes in the sense of the confiscation of resources by the government. They are simply asset price adjustments in response to a tax benefit or detriment. Tax capitalization is the general concept; assets change price in response to taxes. The term implicit tax usually refers to a tax benefit. It is the additional amount one pays for an asset above and beyond the price if there were no tax benefit associated with owning the asset. So, for example, if a taxable bond would sell for \$100, a tax-exempt bond might sell for \$120. The buyer has paid a \$20 implicit tax. But it is not really a tax. It is simply an allocation of the benefit of tax-exemption between the new owner and the seller of the asset. The tax law nominally allocates the benefit only to the new owner, but the owner and seller can split the benefit through a side payment.⁴ Between the seller and the owner, the tax benefit is fully realized and the government in the abstract is indifferent as to how it is split; implicit taxes initially seem to be simply a matter of private dealings between individuals, not between individuals and the government.

There are several confusing elements in the term "implicit taxes." First, while the term "implicit taxes" usually refers to capitalization in response to a tax benefit, the same logic applies to tax detriments. For example, stock prices adjust to the imposition of the corporate tax, so that the return to existing equity is the same as the return to other capital, notwithstanding the corporate tax. There is an implicit subsidy (i.e., the opposite of an implicit tax) to the purchaser of the stock that offsets the cost of the corporate tax.

Second, implicit taxes can be defined by comparison to the no tax state of the world or the full tax state of the world. The scope of the term will differ depending on the reference point. If the reference point is the no tax state of the world, all price adjustments are implicit taxes. If the reference point is the full tax state of the world, only price adjustments in response to under or over-taxation of a particular asset or transaction are implicit taxes. The most common definitions use the fully taxed state of the world.⁵ I prefer the no tax comparison as any change in prices from the no tax world represents a sharing of tax liability between the nominal payer and other parties. The definition does not really matter so long as one is explicit.

Even though implicit taxes involve only payments between private parties, the government is not indifferent. To begin with, if a tax benefit is targeted to a particular group, it is important that the group receive the benefit. So if tax exemption for municipal bonds is targeted at municipalities, it is important that the sales price of the bond fully allocate the

4. Like any other price, the amount of the side payment is determined by the market. For example, the difference in price between municipal bonds and corporate bonds, which is the amount of the side payment, is determined by the market.

5. See, e.g., MYRON S. SCHOLES & MARK A. WOLFSON, *TAXES AND BUSINESS STRATEGY* 83 (1992).

benefit in that direction. The government made the lender (the holder of the bond) the nominal beneficiary, but wants the benefit to be allocated to the borrower. Therefore, the government usually wants high implicit taxes on the lender.

In some situations, however, the government wants no implicit taxes. Suppose the target group for an education incentive, such as the Hope Scholarship credits, is students. If the price of education is bid up, the benefit is split between students and schools, which is contrary to the goal of the tax benefit. Implicit taxes can alter the effectiveness of a policy. Note also that there is nothing distinctive about tax policy here. Any government subsidy, tax, or regulation will have price effects that may redistribute the benefits or costs of the policy.

Crane uses the example of unpaid interest on a tax-exempt bond to illustrate this concept. Suppose the goal of the exemption is to lower the cost of borrowing for local governments. The nominal beneficiary of the exemption is the holder of the bond. To fulfill its objectives, the government must hope that the benefit of the exemption is fully capitalized into the price of the bond, thereby transferring the benefit to the local government. In this case, what is the appropriate treatment of unpaid interest? The government wants all the benefits to go to the issuer so buyers of taxable bonds and tax-exempt bonds should be in equal places. Not allowing a deduction for unpaid interest comes closest to achieving this, so no deduction is appropriate.

Suppose, on the other hand, that the government does not want capitalization because, for example, the benefit of the exemption is supposed to stay with the bond holder. We can think of the bondholder as purchasing two things: a set of cash flows from the borrower and a tax benefit worth (at a 40 percent tax rate) \$4 for each \$10 of interest paid. What if the borrower fails to make a payment? There is no reason to also deny the bondholder the other benefit it purchased, the \$4 of tax benefits for each \$10 of interest. There is no reason government nonpayment should occur at the same time as nonpayment for the borrower. Another way to think about it is that the linking of the tax benefit to interest payments is a mere convenience. The same policy could have been implemented by giving the bondholder a deduction upon purchase of the bond equal to the present value of the tax benefits under current law. Then there would be no connection between payment by the borrower and the tax benefits. Mere conveniences of accounting methods should not affect policy.

The example is troubling because capitalization, or the lack of capitalization, may defeat the arguments just given. Suppose the government wants the holder of the bond to get the benefit. It therefore wants to discourage capitalization and, based on the arguments above, should give a deduction for unpaid interest to benefit the holder. If the tax benefit of exemption is capitalized, the tax benefit for the deduction for unpaid interest might also be capitalized, defeating the purpose of the deduction. There would be no benefit to the holder for the deduction. If the govern-

ment wants the benefit to go to the local government, it will want to encourage capitalization and give no deduction for unpaid interest. But if capitalization is not occurring, it is not clear that either treatment of unpaid interest will change the result.

Suppose that the arguments above were not affected by capitalization. It is still not clear what the appropriate treatment is because the treatment of unpaid interest affects tax revenues. To determine correct policy one would have to determine whether the government should spend money to achieve its desired result or whether partially achieving its result at a different cost is better.

The more common example used to illustrate implicit taxes for tax-exempt bonds is the treatment of borrowing to purchase a tax-exempt bond.⁶ Allowing an interest deduction for such borrowing would encourage capitalization while disallowing the deduction, as under current law, discourages capitalization. In any event, leaving aside the details of the example, the larger point Crane makes is correct. Whether the government policy is to encourage or discourage implicit taxes will often affect one's views of the treatment of a variety of transactions.

Implicit taxes affect norms beyond the effectiveness of government policy, such as the fairness or efficiency of the tax system. Returning again to the tax-exempt bond case, it may look like the rich holders of the bonds get a tax benefit, but not if the benefit is allocated through the market to the issuers. Thus, implicit taxes can affect vertical equity, or, in other words, how progressive the tax burden is. Implicit taxes may also affect horizontal equity. It may look like holders of a tax-exempt bond pay less tax than similarly situated individuals who do not hold the bonds. It is correct that holders pay less tax, but they are not better off because they made a side payment to some state or city that the similarly situated person did not.

The effect of implicit taxes on efficiency is more complex. If the underlying subsidy is inefficient, implicit taxes often only reflect that underlying inefficiency. As the price of municipal bonds goes up, local governments find it more attractive to issue bonds and will issue more than they would if the market alone determined their price. A local government's decision to fund a project is changed, so that the city may well enter into a project that could not pass market tests. Implicit taxes achieve this result, but it is simply a consequence of government policy, not implicit taxes per se.

In some cases, implicit taxes may defeat what would otherwise be an efficient policy. Suppose, for the sake of argument, that because individuals are not fully capturing the benefits of education (for example, an educated public might produce less crime), a government policy is necessary to make market prices better reflect the social costs and benefits.

6. See, e.g., Alan J. Auerbach, *Should Interest Deductions be Limited*, in *Uneasy Compromise, Problems of Hybrid Income-Consumption Tax* 195 (Aaron, Galper & Pechman, eds., 1988).

The government might simply subsidize students. But if there are implicit taxes on education subsidies, tuition goes up, which means individuals will still not internalize the positive externality of education. Their effective price will be the same. The program would just be a windfall to schools.

Implicit taxes can also reduce inefficiencies. For example, if the corporate tax is capitalized into share prices, there is no reason to repeal the corporate tax (at least with respect to existing shares) as any inefficiency has already been born by the initial shareholders. Secondary holders would just get a windfall if the corporate tax were repealed.

So we care about implicit taxes, but it is difficult to make general statements about which way they cut. Sometimes we want them, sometimes we do not. Sometimes they create inefficiencies and sometimes they do not. They usually affect the distribution of taxes and benefits, but the direction is uncertain. Crane is correct that one must think about them in a given context, but each case will be different. I know of few general statements that can be made other than Crane's thesis: that one must think about implicit taxes in each case.

II. PRE-TAX PROFIT MOTIVE

To obtain tax benefits associated with a transaction, the tax law requires taxpayers to have an expectation of making a profit on the transaction without regard to taxes. For example, in *Knetsch v. United States*,⁷ Mr. Knetsch borrowed money from Sam Houston Life Insurance at 3.5% and purchased an annuity (from Sam Houston) that yielded 2.5%. He was guaranteed to lose money on the transaction. But tax on the gain from the annuity was deferred while interest deductions on the borrowing could be taken immediately. If tax rates were high enough, taxes turned a losing transaction into a winner. The tax benefits in this transaction were disallowed.⁸

It does not take a degree in economics to see that this behavior is inefficient, unless one had some reason to believe that there was a market flaw causing too few purchases of annuities, even ones that were financed through a borrowing. In *Knetsch*, no real resources were used other than the resources used to plan the transaction. In such a case, where the taxpayer has literally done nothing, the only cost is the planning cost. In most cases, however, some resource is misallocated to obtain a tax benefit, in which case the inefficiency consists of both the misallocation and the planning costs. For example, if Mr. Knetsch had been smarter, he would have born some risk, say by creating a mismatch between the interest payments and the annuity payments. The transaction would have had a greater chance of being respected in this case, but it would have created inefficiencies by misallocating risk.

7. 364 U.S. 361 (1960).

8. *See id.* at 370.

The pre-tax profit motive requirement is an attempt to limit this type of inefficient behavior. If a transaction would not clear at least a zero profit (not a market profit) without taxes, we know the behavior is inefficient. Taxes for a transaction that fails the pre-tax profit requirement are negative.

The pre-tax profit requirement has long been subject to criticism. In 1981, Al Warren noted the problem both with implicit taxes and with the arbitrariness of setting the profit requirement at zero.⁹ If there are implicit taxes, what looks like a losing transaction without regard to taxes, is actually a perfectly sensible transaction. The pre-tax profit motive simply misses the fact that included in the transaction is a side payment to transfer tax benefits. For example, suppose a taxpayer borrows to buy a tax-exempt bond. If there were no implicit tax, the return on the tax-exempt bond would equal the cost of the taxpayer's borrowing, resulting in zero economic profit, without regard to taxes. If the tax-exempt bond has an implicit tax, the taxpayer loses money on the transaction, but only because included in the transaction is a side payment to transfer tax benefits to the municipality. If one is to ignore tax benefits when determining profit, one should also ignore the side payments made to transfer the benefits. Either count implicit taxes and real taxes or do not count either.

Ted Sims similarly argues that implicit taxes completely eliminate the problem with leveraged tax shelters (other than for seller financing, which at the time had particular flaws not generally implicated in other shelters).¹⁰ Leveraged tax shelters were the bane of the tax system in the 1970's and early 80's and were arguably the cause of a significant misallocation of resources, such as empty glass buildings in downtown Houston. Sims' argument was that the price of tax-preferred assets will be bid up so that there is no advantage to a leveraged purchase of the asset.¹¹ If the taxpayer who borrows to buy tax-exempt bonds pays an implicit tax equal to the full value of the exemption, the transaction has no after-tax profit and is not more attractive than non-sheltered investments. Effectively, the argument is the same as that made above – that critics of tax shelters were inconsistently counting tax deductions but not implicit taxes. David Shakow also makes essentially the same argument.¹²

Even aside from implicit taxes, the pre-tax profit test had problems. The test looks to whether the taxpayer makes above zero. Zero is the wrong number, because a transaction that made zero, but involved an investment of capital, would not clear market hurdles. Note that zero might be the right number if the test used present values determined at the market rate of return, but the test does not use present values. In fact, without present values, it becomes almost impossible to compare the rates of return on different transactions, which makes the test completely

9. See Warren, *supra* note 3, at 986.

10. See Sims, *supra* note 3, at 309.

11. See *id.*

12. See Shakow, *supra* note 3, at 37.

incoherent. If the goal is to identify tax-caused distortions, one must require a market rate of return and require discounting.

It is not clear, however, whether there is a better alternative. After 80 years we do not seem to be any closer to the definition. Perhaps tax shelters are like obscenity, and further attempts to elucidate the concept are in vain.

I will not attempt to give a definition of tax shelters here but I would like to suggest the place to begin looking. The argument is that current attempts to define tax shelters pay insufficient attention to the legal implementation of the tax system. Instead, these attempts rely too much on the economics of the transactions, attempting to identify directly efficient and inefficient transactions. The study of implicit taxes follows this approach. Ultimately, the economic concepts must be part of any notion of a shelter, but I believe the hard work lies elsewhere, in the study of the law, particularly concepts such as the appropriate degree of detail in the law, the use of rules and standards, the effect of discontinuities in the law, and other concepts related to the legal implementation of the tax system.

Begin with an attempt to define tax shelters based on economics without regard to the implementation of the law. An investment is worth making if it has a positive net present value and should be rejected if it has a negative net present value. Ideally, a tax system would not affect the decision to make an investment, which means that it should be allowed only if its pre-tax net present value is positive. The tax shelter test would simply require a zero pre-tax profit when expected cash flows are discounted using pre-tax prices. To be conservative about which transactions are disallowed, the discount rate can be set lower than the market rate (for example, at the risk-free rate at which the Treasury borrows). Then, only projects that have at least a minimum yield without taxes would be permitted to go forward (at least without a tax penalty).

The problem with this definition of a shelter is that taxes change prices. If the tax on rice causes one to eat more potatoes, eating more potatoes cannot be tax avoidance. As Crane says, at some level, the tax system has to let people take prices as given. Requiring pre-tax prices would force irrational actions in the face of actual market prices. Implicit taxes completely undermine the notion of a tax shelter based on pre-tax present values. Assuming some transactions are tax shelters, the problem becomes a complex one of determining when taxes may be considered and when they may not be. There is no clear economic line.

The problem with implicit taxes occurs even if one uses the more narrow definition of implicit taxes: price changes caused by variations from full taxation. For example, if the price of stock is bid down to reflect the corporate tax, one should be allowed to purchase stock at its after tax price even if its pre-tax price would make the purchase irrational. So again, the problem is determining *when* tax benefits and detriments should be taken into account, not *whether* they should be.

One response, advocated by Sims and others, is to reject the notion of a tax shelter altogether and to believe that implicit taxes will resolve the problem. Allow people to choose between rice and potatoes, based on after-tax prices. This inefficiency is what we bought when we chose our current tax system. To the extent there are special preferences that might cause further misallocations, these will be quickly eliminated through implicit taxes. For example, if taxpayers were allowed to borrow to invest in tax-exempt bonds or other tax-favored assets, the price of these assets would be bid up, creating implicit taxes and eliminating the benefit of the shelter.

This seems naive for two reasons. First, unless there is full capitalization of tax benefits and detriments, implicit taxes will not cure the shelter problem. Reliance on full capitalization is utopian. Full capitalization has never happened and is unlikely to ever happen.¹³ Second, Mr. Knetsch's annuity had no implicit tax as it was created out of thin air. Nothing actually happened, so the prices could have been set arbitrarily high or low. Implicit taxes cannot cure Mr. Knetsch's shelter, nor can they cure most modern shelters. These modern shelters, which will be discussed below, look more like the Knetsch shelter than borrowing to invest in tax-favored assets.

Al Warren suggests a solution to this problem: he suggests, roughly, to use a pre-tax profits test (with discounting), except where it is clear that Congress has enacted an incentive intended to create implicit taxes.¹⁴ In those cases, consider both the tax benefits and the implicit taxes. This solves both the discounting problem of current law and the problem with implicit taxes. I think this test moves in the right direction but, by looking to congressional intent, it points to a different underlying problem. The underlying problem is the way that the law is promulgated—the administrative compromises, the lack of perfect information by drafters, the effect of rules and standards, and other issues relating to the legal implementation of the tax system.

Consider an example of a modern tax shelter, an abusive transaction described recently by Joe Bankman.¹⁵ Suppose a profitable domestic corporation would like to generate a tax loss to use against its profits. The strategy is to generate offsetting gain and loss and to have the gain recognized by a nontaxable entity, such as an offshore corporation, and the loss recognized by the domestic corporation. This can be accomplished in the following.

A foreign party, not subject to U.S. tax, enters into a straddle on a currency in a country in which it does not conduct business. For example, a foreign party, domiciled and conducting business in Nation A, might

13. See Calvin H. Johnson, *Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters*, 96 TAX NOTES 20 (1996).

14. See Warren, *supra* note 3, at 989.

15. See Joseph Bankman, *The New Market for Corporate Tax Shelters*, TAX L. REV. (forthcoming 1999).

enter into offsetting long and short options in the currency of Nation B. In time, one option will increase in value and one will decrease in value. Assume, for example, each option was purchased for an amount equal to \$50 million (U.S. dollars) and that the gain position increases in value to \$90 million and the loss position falls in value to \$10 million. The foreign party sells the gain position and contributes the loss position, with a basis of \$50 million and fair market value of \$10 million to an existing subsidiary (Sub) of the domestic corporation (Parent). In return, the foreign party receives non-voting preferred stock with a value of, say, \$11 million. At the same time, Parent contributes an amount of cash to Sub equal to 10% of the value of the Sub. Parent and Sub take the position that the transfers of Parent and foreign party are governed by section 351 and related provisions. Consequently, the Sub takes a basis in the loss position equal to its basis in the hands of the foreign party—\$50 million. Sub sells the property and takes a \$40 million foreign currency loss, which is ordinary rather than capital and, therefore, can be used against operating income.

I chose this example because it has been made public already (most shelters are marketed under strict secrecy), because it is exotic and sufficiently complex to show how modern shelters work, and because it is sufficiently simple that it can be readily understood. There are hundreds of similar shelters, and this shelter, while perhaps simpler than many, is typical.

This shelter does not take advantage of any particular tax subsidy and is not affected by implicit taxes. It looks like Knetsch, in the sense that it is totally independent of market prices (it can be done regardless of prices) and very little has actually taken place. Most modern shelters have these features.

The underlying problem is how the law was drafted.¹⁶ By allowing an offshore loss to be domesticated, the tax law created a loophole. The law was imperfectly drafted and included administrative compromises such as the realization requirement. The taxpayer took advantage of these flaws. Determining how to react to this problem involves studying how the law is best implemented given the inevitability of imperfect drafting and administrative compromises. Let me suggest four areas that need further study before an adequate definition of a shelter can be developed.

First, we must understand the appropriate degree of complexity of the law and its relationship to tax shelter rules, or more generally, to the use of rules and standards in the tax law. Eliminating loopholes like the offshore currency straddle most often creates additional complexity in the law. A broad definition of a shelter may reduce the need to create this type of complexity by preventing loopholes from being exploited. But a broad shelter definition might deter efficient transactions or might create uncertainty. To determine the appropriate breadth of a shelter definition,

16. See Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 473 (1988).

we must understand the connection between the definition and the complexity and uncertainty of the law.¹⁷

Second, the definition of a shelter will affect the government's incentive to draft clear laws. If there is a substantial backstop to errors in drafting, it is likely that the drafters will be less attentive to detail. This may be good or bad, but the definition will affect government incentives in ways that must be accounted for.

Third, the definition must be related to the sanction. If we were to execute those who engage in tax shelters we might have a more narrow definition than if we merely deny them the contemplated tax benefits. Definitions do not stand on their own. More generally, one must have views on the costs of under- or over-inclusiveness. An over-inclusive definition will capture some admittedly legitimate transactions. An under-inclusive definition will let some shelters go. Any real definition will be both under- and over-inclusive, but the question is how much of each and how we weigh the costs.

Finally, we must consider the revenue and distributional effects of the definition. The desirability of a tax rule is determined by its effects on behavior, its distributional effects, and the amount of money it raises (or loses). The focus so far has been only on effects on behavior. But a broad definition will raise more money than a narrow definition. And tax shelters tend to be concentrated in high bracket groups, so a broad definition will increase progressivity.

These factors are only a starting point, and we have very little idea how to answer any of these questions. The questions, however, point to a definition of shelters that refers to the legislative process and intent behind a statute, an understanding of the appropriate scope of administrative compromises, and the legal implementation of the tax system. Shelters cannot be defined in the abstract by reference to economic definitions. They exist because of the necessary compromises in the promulgation of the law and must be addressed by reference to these compromises.

This is not a criticism of Crane. She makes the more narrow and, I believe, correct point, that current law is incoherent in its treatment of implicit taxes and that implicit taxes will ultimately play a role in any coherent definition of a shelter. Nevertheless, I think the bulk of the work in developing a response to shelters lies elsewhere.

17. For an initial exploration of this topic, see, David A. Weisbach, *Formalism in the Tax Law*, CHICAGO. L. REV. (forthcoming 1999).