TAX INVESTMENTS

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ABSTRACT

Tax investments are one of the vehicles that many investors may consider to reach their personal financial goals. A good tax investment lets you use dollars that would otherwise be paid in taxes, along with some out of your own pocket, to acquire assets that will help increase your net worth. To understand how it works, you have to look at how a tax investment is set up, as well as what it does.

INTRODUCTION

It may be helpful to contrast a tax investment with an investment in the stock of a company. A tax investment is a business that's set up in a way that lets you, as an investor, participate in the economic and tax benefits that any business enjoys. Because it's a direct investment, the profits and the tax benefits flow through directly to you. On the other hand, when you purchase a stock, you own a share of the company and the company owns the assets. Only a portion of its after-tax income will be distributed to you as a dividend, and that will be taxed a second time when you pay your individual taxes. Any tax benefits are accounted for at the corporate level and have no direct impact on your tax return.

A tax investment usually involves the purchase of assets such as real estate, capital equipment or, in the case of oil and gas, drilling rights. Under existing tax legislation, these areas of the economy have the benefit of certain tax incentives. These incentives, together with the economic potential of the underlying assets, can provide investors with sound tax investments in these areas with a return in the form of cash flow, plus the opportunity to make a profit when the underlying assets are sold.

Investment in real estate provides the country with housing and commercial facilities. Oil and gas investments help to develop our own natural resources and ease the nation's increasing dependence on foreign oil. Investments in equipment provide business with the tools they need to increase productivity. For these reasons, the Government has created tax incentives for such investments.

ARE TAX INVESTMENTS FOR YOU?

Tax investments are not suitable for all investors. Consider investing in one only if it fits in with your personal financial needs and goals. Some tax investments are appropriate for the risk portion of an investor's portfolio. Some tax investments represent sound diversification into assets that can benefit from inflation, but because there is risk involved, you must be prepared for the possibility of losses. Moreover, tax investments are generally not freely and easily transferable. Thus, investors may not be able to liquidate their investment at their own pleasure or in the event of an emergency.

The higher your tax bracket, the more benefit you can derive from most tax investments because part of your investment return comes from tax benefits. The tax bracket at which any extra income you receive is taxed is your marginal tax bracket. For most tax investments, you should be in the 49% tax bracket or higher to derive the full tax benefit. In general, investors who would like to participate in tax investments should be in the 49% tax bracket and have a net worth of at least $50,000. However, some tax investments are only appropriate for investors with a net worth of $250,000 or more and an annual income of $100,000. An appropriate tax investment should, therefore, only be made after a careful review of the individual's financial condition.

In effect, a substantial part of the investment you make is money you would otherwise have paid to the IRS. Nevertheless, you should not choose a tax investment on that basis alone. You should also consider your desire for tax-sheltered income and long-term capital gains and choose an investment that is structured to meet your personal objectives.

The economic viability of a tax investment is the foundation on which all of the other benefits rest. Only a well structured and well managed program that's based on a sound business venture can deliver maximum benefits to investors. Since a good tax investment is usually a way of deferring or postponing taxes, the money you invest should be put into an asset that should appreciate in value and/or generate substantial cash flow over its economic life. It is important to choose tax investments that are economically sound for another reason. Investments designed solely for tax losses, not economic profits, face serious challenge by the IRS. According to the tax code, "if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed." So, underlying motive of tax losses alone would seriously weaken the very possibility of obtaining the desirable tax losses.

HOW TAX SHELTERS WORK

A tax investment is usually set up either as a limited partnership or a sole proprietorship. Both types of business organizations allow the profits and losses generated by the investment to flow directly down to your tax return because both provide for direct investment in tangible assets such as real estate, equipment, or oil and gas.

Most tax investments are set up as limited partnerships. A general partner manages the business and you and other limited partners put up the capital. This form of ownership benefits the limited partners in a number of ways.

By pooling resources with other investors, you can acquire a direct participation in a portfolio large enough to be diversified and made up of high-quality assets. You can invest a limited amount of money and your liability is usually limited to the amount of your cash investment. You are not responsible beyond your investment for any of the partnership debts or other liabilities. These obligations are the responsibility of the general partner. Unlike a corporation, which can go on forever, a partnership terminates and your share of any proceeds will be distributed to you. As a limited partner, your role is that of a passive investor. The general partner manages the program and relieves you of any managerial responsibility.

When you buy a tax investment that's set up as a sole proprietorship, you become the sole owner of the investment assets. They normally require substantially greater net worth and a larger cash investment than would an investment in a limited partnership. However, you have greater flexibility as a sole proprietor. You can select the way the equipment will be financed, depreciated, and even how it will be sold.

TAX SHELTER BENEFITS

As an investor in a tax investment that's set up as a limited partnership or a sole proprietorship, you can enjoy the tax benefits of depreciation, the depletion allowance, and the investment tax credit. The tax deductions from a tax investment program lower your taxable income, and therefore the taxes you'll have to pay. What's more, the tax savings start at your highest marginal tax rate, the rate at which each additional dollar of income is taxed. The higher your tax bracket is, the greater the tax benefits will be. In a sense, these tax savings reduce your out-of-pocket cost for the investment.

Depreciation deductions allow you, in effect, to recover the capital cost of equipment or a building tax free over the asset's useful life. In some cases where the Government deems it appropriate, you can use accelerated depreciation.

Depletion allowance allows you to recover the cost of assets such as oil or gas, coal, and other minerals that are extracted from the ground. In a sense, depletion is similar to depreciation. Each barrel of oil pumped from the ground depletes the remaining supply of oil by one barrel. By giving you a tax deduction to recover your costs of acquiring that oil or gas, the Government encourages further exploration and development.

Investment tax credit, a dollar for dollar reduction of taxes due, has been designed to foster capital investments that boost productivity. The investment tax credit can amount to as much as 10% of the cost of equipment or other tangible personal property that is: (1) used in business to produce income, (2) has a useful life of at least three years, (3) can be depreciated. To retain the full investment tax credit, the asset must be held for at least seven years. The effect of the investment tax credit is an even bigger tax break than depreciation or the depletion allowance because an investment tax credit is a direct reduction of your tax liability.

Deferral of taxes, makes a lot of sense because a dollar today may be worth more than a dollar tomorrow. For one thing, the dollars that escape being taxed today can be invested to earn even more money for you. For another, you will be able to use those dollars now before they lose any more of their purchasing power. And when you do pay the taxes that you have deferred, you will be paying them with dollars that have lost some of their value. Moreover, you can choose a tax investment that provides that the taxes you have deferred will be payable when you have retired and are in a lower tax bracket.

Long term capital gains. Tax investments can change income that might otherwise be taxed at up to a 70% rate into capital gains that will be taxed at a maximum 28% rate.

Tax sheltered income. Immediate tax benefits are only part of the story. Some investment programs will also generate some tax sheltered income. For example, the cash flow to the investors in the early years of some tax investment programs in real estate and equipment leasing is almost totally sheltered from income taxes by depreciation deductions. And a good part of the cash pumped out by an oil and gas program is sheltered from taxes by depletion allowance.

REAL ESTATE TAX SHELTERS

It is important to keep in mind that property values depend, in great part, on how the properties are managed as well as where they are located. How the properties are financed, rented up, operated, and refinanced or sold will in large part determine your return on the tax investment. The amount of immediate tax benefits you will be able to enjoy and your return on investment from a real estate tax investment depend in great part on whether the program is engaged in constructing new buildings or buying existing ones. As a rule, a tax investment program that constructs new buildings is somewhat riskier but potentially more rewarding than one which buys existing buildings. Any delay in construction can be expensive because the interest payment clock keeps ticking. The cost of supplies and labor may also be rising. And once the building is completed, there's always the risk that it won't rent up as fast as you would like. In terms of tax benefits, new buildings can be depreciated at a faster rate than existing buildings. That gives you larger immediate tax savings and also helps shelter more of the income from the property from taxes in the early years. By contrast, investing in existing property is safer but provides fewer tax benefits. An existing property is a safer investment because of the very fact that it is a seasoned operation. You know what you are getting in terms of revenues and also what the operating costs will be like.

EQUIPMENT LEASING TAX SHELTERS

Any equipment that can be leased for business purposes probably could be used in an equipment leasing tax investment. For their part, the businesses leasing the equipment get to enjoy all the benefits of the equipment without having to tie up the capital necessary to buy the equipment. Individual investors in an equipment leasing tax investment can get substantial tax benefits from the investment tax credit and accelerated depreciation. A typical tax investment in new equipment would give you a one-time, first year investment tax credit amounting to 10% of the equipment's purchase price. As we noted before, the investment tax credit cuts your tax liability dollar for dollar and therefore is worth far more than a tax deduction, which only lowers your taxable income.

OIL AND GAS TAX SHELTERS

There are three basic types of oil and gas tax investments: exploration programs, development programs, and balanced programs.

Exploration programs, as their name implies, try to find oil and gas in new areas or in geological formations that have not been productive in the past, consequently drilling risks are higher for this type of program. One way to reduce the risk in unexplored areas is to acquire a large number of drilling sites to provide diversification. The prices of acquiring drilling leases can be the least expensive. By the same token, royalties to property owners and others are also lower than those on properties with proven reserves. Because of lower costs for leases and royalties, a successful exploration program can be a rewarding investment.

Development programs are those that drill in areas or geological formations where previous exploration has found oil or gas. Consequently, the risks are much lower than those of an exploratory program and the return on investment probably won't be as high. As a result, the program has to pay more for leases and royalties. Because the support and transportation facilities may already be in place, income from production may begin sooner than for exploratory program.

Balanced programs combine exploratory drilling with development drilling. The exploratory drilling gives the program a chance to make some large profits. Congress has given investors some very generous tax incentives. Investors in oil and gas programs can usually deduct between 50% and 90% of the amount invested in the first year, with smaller deductions in later years. The tax savings from these deductions reduce the out-of-pocket cost for the investment. And that in turn, means that only a portion of your money is actually at risk in the investment.

An oil and gas tax investment provides investors with three basic tax benefits.

Immediate Tax Deductions

Intangible drilling costs - which include expenses such as labor, chemicals, and other materials that have no salvage value - can be deducted in the year they are paid.

Tax Sheltered Income

Depletion allowances are a method by which the investor can shelter part of each property's gross income from taxes. There are two basic methods for applying the depletion allowance: (1) percentage depletion and (2) cost depletion. The investor will use the method that produces the greatest tax advantage, which will usually be the percentage depletion allowance. Depletion allowances are scheduled to decline in the future as follows: 1981: 20%, 1982: 18%, 1983: 16%, 1984 and thereafter: 15%.

Conversion of Income to Long-Term Capital Gains

Most programs have a provision that allows the limited partners to sell their interest back to the programs sponsor. If you decide to sell your partnership interest back to the sponsor, most of the proceeds will be taxed as long-term capital gains. Thus, you will have converted unearned income that might have been subject to as much as a 70% rate into a capital gain taxable at no more than a 28% rate.