Forbes

The Pleasures and Perils of Tax Loopholes

Jim Powell

3/07/2012

"You're born, you suffer and you die," evangelist Billy Graham remarked, "but fortunately there's a loophole."

Movie comedian W.C. Fields wasn't known as a God-fearing man, so he was asked why he read the Bible. "I'm just looking for loopholes," he said.

To some degree, a loophole is in the eye of the beholder. As U.S. Senator Russell Long explained, "A tax loophole is something that benefits the other guy. If it benefits you, it's a reform."

The pursuit of a loophole can be a starting point for challenging bad policies. This was the case with the American Revolution, perhaps the first quest for a major loophole in our history. American colonists wanted an exemption from policies applied to people in other parts of the British Empire.

In particular, American colonists objected to paying taxes imposed by the British Parliament, since they didn't have any elected representatives there. In 1761, Boston attorney James Otis began representing merchants who objected to writs of assistance that, issued by a judge, permitted British customs agents to enter a merchant's premises, then search for and seize any smuggled goods – evidence of tax evasion.

After the British defeated French forces in North America, Parliament decided Americans should pay some of the war costs, and it enacted the Sugar Act (1764) and the Stamp Act (1765) that imposed taxes on a wide range of items. "Taxation without representation" became a battle cry as American tax resistance gradually turned into a struggle for independence.

Since most people recognize that it isn't smart to start a fight with someone who's bigger than you are, tax rebels generally try to avoid a direct confrontation with the IRS. The

higher tax rates go, the greater the incentive people have to change their behavior in ways that will reduce their tax liabilities, and almost always the result is less tax revenue collected. Taxpayers might switch to investments taxed at lower rates. They might incorporate themselves. They might move to jurisdictions – at home or abroad — with lower tax rates.

Many taxpayers have reacted to higher taxes by setting up tax shelters. A principal aim is to avoid paying an excessive tax rate by creating a tax benefit – a loss, expense or exclusion from gross income, arising more from byzantine tax rules than from economic transactions. In the event the IRS decides that a particular tax shelter is illegitimate, a taxpayer could face tax penalties as high as 75 percent of the tax due. In an effort to protect themselves, taxpayers pay law firms to issue 40-50 page opinions about why a tax shelter is "more likely than not" to be upheld in court. This phrase suggests there's a 51 percent chance that a tax shelter will be upheld and a 49 percent chance that it will be struck down, which doesn't sound like great odds.

Politicians have tried to justify tax shelters by claiming that they'll help some part of the economy that needs a little something. During the high-tax, high-inflation 1970s, tax shelters began to be marketed aggressively, especially for farming, gas, oil, movies, real estate and business equipment. There have been plenty of other tax shelters, too. "Every conceivable device, animal or property has become a candidate for a tax shelter," remarked former IRS commissioner Roscoe Egger. Tax shelters have been set up to produce azaleas, roses, almonds, jojoba beans, macadamia nuts, chinchillas, cows, horses, minks and trout, to name a few. Often the result has been gluts. For example, the number of movie releases went up faster than theater revenues. Tax-driven real estate development exceeded demand, and the amount of vacant office space surged – contributing to the collapse of S&Ls during the 1980s.

The U.S. tax code was simplified in 1986, eliminating many tax shelters, but members of congressional tax writing committees continued doing what they did best – introducing more tax loopholes in exchange for campaign contributions from every imaginable interest group. A new generation of tax shelters appeared. Moreover, journalist Gerald Carson pointed out that "as exception continued to be piled upon exception, each departure from strict neutrality created the need for new adjustments. Consequently, there were anomalies and mysteries. An apple farmer was taxed at ordinary rates. A Christmas tree farmer filed under the much more favorable capital gains schedule. But somebody who raised sod for sale wasn't a farmer at all – he was a miner of an exhaustible natural resource, so he deducted sod as a 'natural deposit' under the same dispensation as oil and gas wells."

And so, once again the tax code became hideously complicated. Lindy L. Paull, who served as chief of staff for the Joint Committee on Taxation, told the Senate Finance Committee: "The Internal Revenue Code consists of nearly 1.4 million words and includes 693 separate sections that impact individual taxpayers. The Treasury Department has issued some 20,000 pages of regulations containing over 8 million words. Individual taxpayers who file an annual Form 1040 must deal with its 79 lines, 144 pages

of instructions and 11 schedules totaling 443 lines plus instructions to go with them. There are 19 separate worksheets imbedded in the Form 1040 instructions, and the possibility of filing numerous other forms, depending on the circumstances." We owe all this to higher tax rates that sparked lobbying for offsetting loopholes.

Trade law is also great for loopholes. In early America, the general principle of free trade applied to the majority of imports, but after the outbreak of the Civil War there were tariffs on more imports, and the tariffs were higher than they used to be. As the economist Henry George explained, "To introduce a tariff bill into Congress or Parliament is like throwing a banana into a cage of monkeys. No sooner is it proposed to protect one industry than all the industries that are capable of protection begin to screech and scramble for it."

When President Herbert Hoover signed the Tariff Act of 1930 (the Smoot-Hawley Tariff), the general principle of free trade applied to few if any imports, and U.S. trade law consisted almost entirely of loopholes. Altogether, Smoot-Hawley imposed tariffs on some 25,000 agricultural commodities and manufactured goods. On average, U.S. tariffs went up 59 percent. Consequently, during the worst depression in American history, people struggling to make ends meet had to pay substantially more for all sorts of things than they would have without that monstrous law.

Smoot-Hawley antagonized interest groups everywhere, and they clamored for loopholes in their trade laws, too. Some 60 countries enacted retaliatory tariffs against U.S. exports. Many of these countries were long-time friends like Great Britain, Canada, France and Switzerland. Trade collapsed, making the depression worse than it would have been otherwise. As this experience made clear, when everybody has a loophole, everybody loses from all the other loopholes.

Just as the pursuit of a tax loophole launched the American revolution, the Catholic Church's pursuit of a religious loophole could help bring down the Obamacare mandate. By now, everyone must be aware that the mandate requires employers, including religious institutions, to provide birth control and abortion services for their employees.

There's an important lesson here: the hand that giveth a loophole can taketh away. Apparently the Catholic Church was seduced into supporting the odious Obamacare law including the mandate for compulsory health insurance coverage. Church officials didn't seem to care how others would be affected by the mandate, because they counted on their political clout to secure a loophole. But politicians maintain their power by juggling many, often conflicting interest groups, and from time to time this involves betraying a major supporter. President Obama betrayed his labor union allies when he nixed the Keystone XL pipeline that would have created thousands of jobs, because he was under intense pressure from his environmentalist allies who don't seem to care about jobs. Now, evidently, it's the Catholic Church's turn to be betrayed.

The Church would have been better-served to take a principled position against the mandate during the Obamacare debate and to support the constitutional challenge now

before the U.S. Supreme Court. Nonetheless, the controversy might make Supreme Court justices more sensitive about what happens when big government intrudes into people's personal lives.

Prohibition, during the 1920s, also involved religious loopholes. The crusade for Prohibition was led by women whose drunken husbands squandered their paychecks and imperiled their families. October 28, 1919, Congress passed the Volstead Act that made it illegal to manufacture, transport and sell alcoholic beverages, but there were some loopholes.

Alcohol could be used for religious purposes. Catholics were permitted to consume alcohol in church (during communion). Jews were permitted to consume alcohol at home (as during Sabbath observances). Jews were allowed to consume 10 gallons a year per person. According to journalist Daniel Okrent, "You joined a congregation, and you got wine from your rabbi. One congregation in Los Angeles went from 180 families to 1,000 families within the very first 12 months of Prohibition. Other people who claimed to be rabbis would get a license to distribute to congregations that didn't even exist."

There were other Prohibition loopholes. Farmers could preserve fruit, which mainly meant turning apple juice into apple jack. This became a widespread practice. Ironically, most farm state voters seemed to support Prohibition.

Even though the American Medical Association ruled that alcohol wasn't a legitimate medicine, it could be prescribed. Daniel Okrent reported, "you could go into virtually any city in the country and buy a prescription for $3 from your local physician, take it to your local pharmacy and go home with a pint of liquor every 10 days. And this is how many of the large distilleries stayed in business throughout the Prohibition years."

For a while, George Remus was a kingpin of the medicinal booze business. In 1920, he was a Cincinnati criminal lawyer – earning about $45,000 annually — who noticed that his clients were becoming wealthy. He studied the fine print of the Volstead Act and discovered the medicinal whiskey loophole. He began buying distilleries in Illinois, Indiana, Kentucky, Missouri and Ohio, plus a bonded whiskey warehouse and a drug company licensed to handle medicinal whiskey. There wasn't any legal limit on the amount of whiskey he could distill, store or sell.

Remus arranged to have his liquor hijacked to himself, so he could get it off his books and sell it for exorbitant prices on the black market. "By 1924," historian John Kobler wrote, "he employed 3,000 truckers, salesmen and guards, and controlled approximately one-seventh of all the medicinal whiskey in the United States. From $2 million in his first year, Remus' gross income soared to $25 million in his third year. His capital together with the value of his regal estate exceeded $40 million." Alas, the feds caught on to his bootlegging operation, and he ended up spending time in the slammer.

Most Americans aren't permitted to open a casino, but there's a loophole enabling Native American Indians to do that. In 1976, the U.S. Supreme Court ruled that states cannot tax

Indians or regulate Indian activities on their reservations. This led Indian tribes to look for ways they might generate revenue, and many hit on gaming. Seminole Indians built a six day-a-week bingo business near [Fort Lauderdale](), Florida, which violated a state law limiting bingo parlor operations to two days a week. The Indians were challenged in court but won. The Seminoles offered prizes greater than allowed by state regulations, which led to yet another win. Before long, there were Indian gaming operations across the country. Now there are some 400. The largest is reported to be Foxwoods Resort Casino, Ledyard, Connecticut, with 4.7 million square feet of space, 380 gaming tables and 7,200 slot machines, among other amenities.

Sometimes Native Americans over-reached as they scrambled for more loot. For example, the Golden Hill Paugussetts filed a lawsuit for 17,000 acres in Bridgeport, Trumbull, Orange, Seymour, Southbury and Shelton, Connecticut — worth some $10 billion. "Given Bridgeport's financial problems," the *New York Times* reported, "some people joked that the Indians should just take it." The Indians turned out not to be interested in recovering ancestral lands. The aim of their lawsuit was to generate pressure for federal recognition of the tribe, so they could build a casino in Bridgeport. But recognition was denied by an appeals board in the U.S. Bureau of Indian Affairs, reportedly because there wasn't enough proof that the tribe had a continuous history.

There was also the scandal involving lobbyist Jack Abramoff who lobbied for various Indian tribes that wanted to build more casinos. Abramoff bribed officials and hired congressional staffers to influence their respective members of Congress. He simultaneously lobbied against the Indian tribes to generate pressure for them to pay him more. Altogether, he pocketed some $85 million of fees from the Indians. He was found to have defrauded the Indians of some $25 million.

This didn't deter Indians from spending big bucks to hit the jackpot with more casinos. In a 15 year period, journalist Fergus M. Bordewich discovered, tribal campaign contributions to federal candidates soared 3,500-fold. "In California, Native Americans became the largest contributors, spending $70 million on a single campaign."

Probably the most outrageous loopholes are those that enable members of Congress to exempt themselves from laws they impose on us. Surely if a law is good enough to impose on the general population, it should be good enough to impose on the lawmakers. If they don't like it, then they should repeal it rather than evading it with a loophole.

For many years, members of Congress exempted themselves from the (1) the Fair Labor Standards Act of 1938, (2) Title VII of the Civil Rights Act of 1964, (3) the Age Discrimination in Employment Act of 1967, (4) the Occupational Safety and Health Act of 1970, (5) the Rehabilitation Act of 1973, (6) the Employee Polygraph Protection Act of 1988, (7) the Americans with Disabilities Act of 1990, (8) the Family and Medical Leave Act of 1993, (9) the Federal Service Labor-Management Relations Statute and (10) Veterans' employment and reemployment rights at Chapter 43 of Title 38 of the U.S. Code. Publicity about these loopholes embarrassed members of Congress into voting for the Congressional Accountability Act (1995) that repealed the loopholes.

But members of Congress continue to find loopholes irresistible. In November 2011, CBS *60 Minutes* broke the story that members of Congress exempted themselves from insider trading laws that apply to everyone else. The story was inspired by Peter Schweizer, a research fellow at the Hoover Institution, who wanted to know how some members of Congress managed to amass wealth far beyond their salaries. Schweizer and 60 Minutes discovered that members gain valuable inside information about coming federal policy changes, then use this information to take positions in affected securities – often with gratifying success. Schweizer called the resulting gains "honest graft."

Meanwhile, although Congress officially banned earmarks, resourceful members appear to have found ways they can exempt themselves from the ban. Basically, they insert special funds in appropriation bills. For example, there are 26 special funds for the Army Corps of Engineers to do water projects in various congressional districts. The total appropriation for the Army Corps ($507 million) is about the same as the previous budget that had earmarks.

Myriad loopholes past and present ought to help us better understand why the best policy is a rule of law, not a rule of loopholes.

Jim Powell, a Senior Fellow at the Cato Institute, is the author of FDR's Folly, Bully Boy, Wilson's War, Greatest Emancipations, Gnomes of Tokyo, The Triumph of Liberty and other books.