

Background

What is a tax shelter?

TAX GAP AND TAX SHELTERS

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Q. What is a tax shelter?

A. Tax shelters are ways individuals and corporations reduce their tax liability. Shelters range from employer-sponsored 401(k) programs to overseas bank accounts.

The phrase “tax shelter” is often used as a pejorative term, but a tax shelter can be a legal way to reduce tax liabilities. Someone who thinks a feature of the tax code giving taxpayers the ability to reduce taxes is not a good idea might label it a shelter. Someone else might call that feature of the tax code an incentive. And as the esteemed jurist, Learned Hand, explained: “Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury.”

Individuals and corporations can reduce their final tax liabilities by allocating some portion of their incomes to tax shelters. Although they are classically associated with wealthy households and corporations who use anonymous Swiss bank accounts, tax shelters are more accessible and widespread than the usual association may suggest. For example, employer-sponsored 401(k) programs and individual retirement accounts are widespread and accessible ways individuals can “shelter” some of their income from taxation.

ABUSIVE TAX SHELTERING

But a tax shelter also may be defined narrowly, as a transaction or strategy that generates tax benefits unintended by the Congress or the IRS. Often a tax shelter relies on a literal interpretation of a statute to achieve a result that is “too good to be true.” Professor Michael Graetz once defined a tax shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid.”

The Internal Revenue Service makes a distinction between tax sheltering (which encompasses legal forms of reducing tax liability, like retirement plans) and “abusive” tax sheltering (including tax evasion, which is illegal). One example of an abusive tax-sheltering scheme is the use of trusts to reduce tax liability by overclaiming deductions or even by hiding income and assets from taxation.

EFFECTS

Tax shelters are generally beneficial if considered from the individual or firm perspective. And tax shelters may also be desirable from an overall societal perspective. That is because the erosion of the tax base may be an acceptable loss for largely beneficial tax shelters (such as charitable contributions). Of course, some tax shelters have little to no social benefits or are even harmful.

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TAX HAVENS

“Tax havens” are a specific means of tax sheltering. A tax haven is a locality—be it a state, country, or region—that often has a lower corporate or personal income tax rate. Tax havens may also have other properties that make storing assets or income there desirable, such as bank secrecy laws, or ease of incorporation (for forming shell companies), or lack of transparency for business operations.

Further Reading

Barthold, Thomas A. 2016. [Letter to the Honorable Kevin Brady and the Honorable Richard Neal, Joint Committee on Taxation](#). August 31.

Johannesen, Niels, and Gabriel Zucman. 2014. [“The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown.”](#) *American Economic Journal* 6 (1): 65–91.

US Government Accountability Office. 2014. [“Questions for Assessing a Tax Expenditure’s Effectiveness.”](#) Washington, DC: US Government Accountability Office.