The Latest ‘ZITCOM’ and My New Tax Shelter Bank

It’s too bad that the lifetime savings account (LSA) proposal of the administration seems to have no legs. I had already seen what a great boon this was going to be for society (or at least my personal corner of it) and had begun preparations for a special Steuerle cyberspace bank to help out the lowly taxpayer. Now my bank would be unique because it would allow people to “save” and gain the tax breaks without coming up with any money at all. Because of my deep social concern for the individual with no money to save — not unlike my tax shelter brethren who really only want to help out the lowly corporation with no money to invest — I would set up an account with net “Zero deposit,” a ZIT. Someone opening a ZIT would merely have to pay me a little bit of a fee, and then at the end of the year they would get back much more than their fee in the form of a tax reduction due to additional net interest deductions on their tax return. My main concern was to attract enough deposits before Merrill Lynch, Bank of America, and other financial intermediaries caught up and started competing with my bank. ZIT.com would be to the new tax shelters as Amazon.com was to book sales.

First, a bit of a clarification. What is involved here is tax arbitrage, a type of tax sheltering that involves not simply taking advantage of low or zero tax rates on preferred assets, but leveraging those tax breaks by multiplying up financial assets and liabilities. The most common form of tax arbitrage involves borrowing to buy preferred assets, but tax deductions can also be generated through a short sale of one asset and simultaneous purchase of another. It is through the additional leveraging that one can generate extra tax deductions without doing any saving at all.

Certainly tax arbitrage is not new. Much of the growth in private debt in the economy is due to these opportunities. Individuals borrow against their houses and business and then effectively invest the proceeds in other assets that generate little in the way of taxable income. They do this now when they borrow (or pay down their mortgages more slowly) and buy individual retirement accounts (IRAs), make deposits in 401(k) plans, buy stock on which they defer capital gains from tax, and put money into Coverdell educational savings accounts, section 529 plans, or medical saving accounts. It works in reverse as well. People make the deposits in these preferred assets, then find themselves a bit short on money, and so borrow a bit more, take out a second mortgage, or pay off their debt a bit slower. Individuals don’t even have to know they are engaged in this arbitrage as long as they simultaneously write off debt payments from a mortgage or business loan and avoid tax on the receipts from some assets.

Ever wonder how Congress could enact so many saving incentives over the years and yet generate little or no net personal saving? Now you know. Congress doesn’t really provide saving incentives. Instead it provides incentives for making gross purchases of certain types of assets even if there is no saving at all.

The opportunities are so many and the limits so high in cases like section 529 plans that the initial Treasury effort to establish LSAs seems to have been directed more at simplification than expansion of tax sheltering opportunities. In particular, Treasury wanted to combine together all the separate savings vehicles for selective purposes outside of retirement. Thus, it would remove separate requirements in various accounts that the savings be spent on students under age 18 or in college or on medical expenses. The effort got out of hand, however, as the White House wanted higher limits for the new saving vehicle, no lifetime limit was established, and it refused to restrict any existing tax preference as a means of folding them together or limiting revenue cost.

Why would my bank help expand arbitrage opportunities beyond the extraordinary extent to which they exist already? Under existing law, it is often hard to match up liabilities with assets in a riskless manner. Often the asset has a different maturity or risk structure than the liability. As an example, it is possible to borrow to invest in an education account, but educational needs are often way down the road and the money not easy to withdraw until then. One can also borrow to invest in stock whose yield is expected in the form of unrealized capital gains, but the returns received on the stock investment are unlikely to match exactly the timing and risk of the payments made on the borrowing. As a final example, borrowing to put money into retirement accounts creates some problems of liquidity: If the money is needed at some point, withdrawal from the retirement account may lead to a penalty.

Not that attempts are wanting to create essentially riskless tax arbitrage opportunities. Many of the new corporate shelters come close. A common type of device fought by the IRS for years was a straddle in futures, where a trader might sell, say, wheat futures due in one year and buy wheat futures due in one year and one month. Then, as wheat prices changed, the
trader would recognize the loss on one part of the straddle but not the gain on the other side. Here the law now requires most traders to recognize all gains and losses at the end of the year — "mark them to market" is the technical term — so that losses cannot be recognized in the current year and gains deferred.

With lifetime savings accounts, new opportunities would abound for even the most risk-averse individual to buy and sell short the same asset, recognize the loss (the interest payment), and never pay tax on the gain (the interest receipt). If I borrow $10,000 and put $10,000 in the bank, both at a 5 percent interest rate and both with a common maturity date (or simply some common interest rate compounded daily), then my net assets are zero, my net interest is zero, and my risk exposure is essentially zero.

The main difference between the old world and the new LSA world is that the tax preference — in this case, the nontaxation of the returns from the asset — is now available for short-term assets, not just for items like retirement and education. There is no penalty for withdrawing at almost any time. Now, for the first time, short-term liabilities could be matched up with short-term assets, yielding an exponential growth in tax arbitrage opportunities.

This ability to save taxes using assets and liabilities that almost match in short-term risk and maturity is what would make my bank so successful. With ZITs, I would offer homeowners as high a mortgage as possible, while keeping principal payments to zero (perhaps even doing a little bit of reverse mortgaging) and essentially refinancing any interest owed. For small business owners, I would insist on a small business loan to finance their tax avoidance activity, and then have them purchase separate LSAs as members of households.

Alas, it is true. Congress would eventually try to write some laws or Treasury would try to write some regulations preventing my direct marketing of these ZITs. They would try to come up with requirements similar to those that restrict direct borrowing to buy tax-exempt bonds. Of course, such borrowing takes place all the time, as long as it cannot be traced directly. Also, state and local bonds are limited in supply, hence people pay a premium for them, thereby limiting demand. With my ZITs, there would be no limit on supply, hence the interest rate wouldn’t have to fall on the assets relative to what is paid on the debt.

When these new laws or regulations were promulgated, my bank would have to operate on a more subtle basis of providing advice to clients to borrow to the hilt and then buy whatever LSAs were available, but, of course, no longer tying the two transactions together. Hey, what do I know when the individual’s mortgage goes up by $5,000 a year and the LSA account goes up by $5,000?

The Steuerle bank brings to light one of the greatest problems with saving incentives in current law — the political unwillingness to treat borrowing as negative saving when subsidies are provided to positive saving. The administration’s proposal, in turn, reveals that one cannot go much further in pushing the income tax toward a consumption tax without tackling this overriding issue. In the meantime, we will continue to have a law that encourages excess debt and provides saving subsidies that are often independent of any saving at all. You could say we’ve got a real ZITCOM situation already.