Sunday News Journal, Wilmington, Del.

Easy money

Corporate tax scams cost Treasury billions, leaving ordinary payers holding the bag

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Tax shelters assign business income to offshore investors, say, in the Cayman Islands, while American clients write off the losses.

By SHELDON D. POLLACK

Congress shut down the tax shelter industry back in 1986. Until then, the wealthy could find all sorts of dodges to avoid paying taxes on their income. Rich taxpayers could buy investments that would generate artificial tax losses to shelter income and reduce taxes. Under tax law at the time, this was perfectly legal.

But tax shelter promoters got more and more greedy in the late 1970s and early 1980s. Deals turned aggressive and ugly, with outright fraud becoming commonplace. The Internal Revenue Service was caught up in a near futile effort to police these phony deals, and the docket of the U.S. Tax Court was swamped with litigation involving tax shelter cases. Congress struck back with the Tax Reform Act of 1986, which effectively closed down the tax shelter industry. Or so everyone thought.

Today tax shelters are back with a vengeance. Only this time, the Big Five accounting firms and Wall Street investment bankers are leading the assault on the U.S. Treasury. This time, rather than selling to wealthy individual investors, promoters are peddling their new products to some of the largest, most profitable corporations in the United States.

In deals that would have made tax lawyers blush a few years ago, tax shelter promoters are creating losses out of thin air for corporate clients. And accounting firms and investment bankers who put them together are making millions in fees.

The Treasury Department, Congress and federal courts have been [illegible] the havoc caused in the tax code. In the meantime, the corporations that buy into these schemes are cutting their tax bills and promoters are lining their pockets at the expense of the rest of us taxpayers.

The new tax shelters go by various names. The schemes are complicated and rely on use or abuse of [illegible] technical tax rules. Wall Street investment bankers provide the financial products (so-called derivatives) that hedge the "investment" for all parties, so that no one is really at risk of losing one penny. There are no bona fide business purposes for this kind of deal— just meaningless transfers of funds to take advantage of the tax code and camouflage what's really going on.

Usually, a technical tax rule is exploited to create artificial losses in ways that were never imagined by the tax authorities. Typically, a foreign investor is brought into the deal to pick up the offsetting income recognized on the deal. The foreign investor (e.g., an entity created under the laws of some tax haven, such as the Cayman Islands or Netherlands Antilles) is not subject to U.S. taxation, and is allocated all taxable income, while the U.S. corporate investors are allocated the artificial tax losses.

To date, Congress and the IRS have tackled the new shelters on a case by case basis. The IRS has had considerable success in litigating against individual deals. The federal courts have been favorably inclined toward IRS challenges, which invoke established principles holding that tax deductions produced by sham transactions are disallowed and tax motivated transactions lacking a business purpose or "economic substance" shall be disregarded.

For example, in a 1998 case, ACM Partnership v. Commissioner, an abusive tax shelter marketed by Merrill Lynch to Colgate-Palmolive Co. was slammed by the Third Circuit Court of Appeals, thereby providing precedent for the IRS. But a case such as this represents only one taxpayer in one deal. Promoters market the same scheme to numerous clients. There are at least eight cases similar to ACM still in dispute, with as much as $1 billion in additional tax at stake.

Of course, many similar tax cases won't be uncovered. In testimony before the House Ways and Means Committee, Lindy Paull, chief of staff of the Joint Committee on Taxation, warned that it is beyond the capacity of government to police all the corporations claiming tax benefits: "In many cases, the corporation that claims the tax benefit from a tax shelter escapes audit, or the tax shelter arrangement goes undetected during an audit."

Even when detected, the IRS doesn't have the manpower to litigate all these case in the courts. Thank budget cuts inflicted by Congress on the tax agency for that. Because of shortage of funds, the IRS often agrees to a settlement favorable to the taxpayer — or at least one that doesn't penalize the taxpayer for trying to claim sham deductions. So by taking questionable deductions and then playing the audit lottery, corporations stand to save millions.

Los Angeles Times Syndicate/DONNA MARIE GRETHEN-TONG

Shell game

The problem with a case-by-case attack on tax shelters is that the promoters are always one step ahead of the government. As the promoters market their various products to more clients, eventually the IRS and Congress get wind of what's going on. Professional tax journals report on the latest schemes virtually weekly. While such exposure is the kiss of death for that particular deal, it doesn't really matter to promoters. They know there is a limited shelf life for all their deals. Even if the IRS doesn't step in, once competitors and corporate managers learn the specifics of a particular arrangement, no one is going to pay big fees again for that tax savings investment.

The promoter's fees are justifiable only so long as the scheme is confidential and marketed to a limited number of clients who all keep quiet. As soon as word gets out about an existing shelter, promoters necessarily must abandon it and cook up another scheme. An IRS challenge simply hastens the process.

Even if Congress responds with legislation or the Treasury Department with a public notice, it is almost always on a prospective basis, hereby implicitly sanctioning those deals in place before the effective date of the new law or regulations.

If a case-by-case approach has its limits, the alternative may not be much better. House Ways and Means Committee member Lloyd Doggett, D-Texas, has repeatedly introduced legislation in Congress to grant the IRS expansive authority to disallow deductions generated by tax shelters. The problem is no one can readily define a tax shelter, and thus the power granted to the IRS must be broad, vague and discretionary.

No surprise that the IRS and Treasury Department support this approach. Others urge a more cautious approach that wouldn't give Treasury vast powers that could be used to attack perfectly legitimate business transactions.

The influential Tax Section of the American Bar Association and the American Institute of Certified Public Accountants both have come out in favor of increased penalties and disclosure requirements for tax shelter investors. So has the Joint Committee on Taxation.

That also was how the Clinton administration approached the problem. Former Treasury Secretary Lawrence Summers, who called the growth of corporate tax shelters "a matter of national importance" and "the most serious compliance problem in the U.S. tax system," proposed new disclosure requirements for corporations that claim substantial tax savings in transactions designed by outside promoters.

These Treasury regulations impose disclosure requirements, as well as registration requirements on those who promote confidential shelter deals to clients. The IRS recently announced that promoters have already registered more than 2,500 such tax shelters marketed under terms of confidentiality.

In the waning days of the Clinton administration, additional regulations were proposed imposing [illegible] rules professional standards on attorneys who issue so called opinion letters that are used by promoters to help sell deals to investors. The jury is still out on whether such regulations will do very much. In the past, penalties and disclosure requirements haven't worked very well to curb other tax abuses.

While the Clinton administration pushed hard in the last two years to combat tax shelter promoters, things have changed in Washington since January. Certainly don't expect President Bush to support reforms to rein in tax shelters that save millions in taxes for the well heeled corporate PACs that supported his presidential campaign. The regulations proposed by the Clinton administration have yet to be completed. Lobbyists are lining up to pressure the Bush Treasury officials to back off.

While it is impossible to determine with certainty how much corporate tax shelters are actually costing the U.S. Treasury, most experts believe the revenue loss is significant. Back in 1999, Joseph Bankman of Stanford Law School threw out a figure of $10 billion a year. Journalists and Treasury officials repeatedly cited that figure, but Bankman later admitted it was just an off-hand estimate. Nevertheless, Bankman's estimate is now widely cited as if it were an authoritative figure.

One serious attempt to appraise revenue loss from the new corporate tax shelters comes from economist Martin Sullivan, who concludes the annual cost is somewhere between $3 billion and $30 billion. Sullivan is quick to admit his own estimate is based on all sorts of assumptions about the magnitude of fees earned by promoters and the associated tax benefits realized by their clients.

Obviously, there is no easy way to measure the extent of tax shelter activity. Still, a recent report from the Treasury Department supports claims of a surge in corporate activity. The report shows that over the past three years, the annual rate of growth of corporate tax refunds has been more than 20 percent this despite surging corporate profits. From 1985 to 1996, refunds ranged from $13 billion to $19 billion. In 1997 and 1998, refunds hit $22 billion and $25 billion respectively.

Refunds set a record of over $31 billion for 1999, and when the numbers are in for 2000, they will likely exceed $30 billion. While no one knows for sure what is behind this increase, the prime candidate is increased tax shelter activity.

Whether Congress and the IRS will win the battle is anyone's guess. Personally I'd bet on the ingenuity and audacity of the promoters, accountants and investment bankers.

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