Corporate tax shelters

Many in the US agree on the problem, but not on a solution. Mark French and Paul Beecy of KPMG examine the proposals.

In the United States, recent reports and studies on so-called corporate tax shelters have focused on some type of legislative action. While the article below discusses the important points of these proposals, businesses that follow this issue should not forget that in the past two years, the US government has successfully mounted court challenges to several corporate transactions on the grounds that economic substance was lacking. (See eg, ASA Investerings v Commissioner, ACM v Commissioner*). Thus, certain types of transaction are subject to significant challenges notwithstanding the proposed legislative changes discussed in this article.*

In the US, there is widespread concern among lawmakers, tax professionals and the media that some corporations are sheltering income from tax by sophisticated transactions that lack economic substance. Recently, the Clinton Administration, an influential congressional committee and some members of Congress have separately recommended that changes be made to the US tax code to curtail corporate transactions sharing certain characteristics. While these efforts to remedy corporate tax avoidance are not uniform, they share a common goal: to disallow tax benefits from corporate transactions that appear to lack economic substance and possibly subject the taxpayer (and other involved parties) to sanctions.

None of the proposals targeting so-called corporate tax shelters, however, ended up in the tax-cut bill passed by Congress on 5 August, 1999. But this does not mean that the issue is dead. The leaders of the congressional tax-writing committees will hold hearings on corporate tax shelters this autumn and may follow them with legislation. At the very least, the signals are clear that concerns about corporate tax shelters will be a top priority until the perceived problems are resolved.

Clinton Administration proposals to curb corporate tax shelters

The President's FY2000 budget proposals, released in February 1999, contained provisions to curb the growth of corporate tax shelters and improve tax compliance. But why did the Clinton Administration chose this time to make these proposals? Previously, tax legislation addressed corporate tax shelters on an *ad hoc* approach. In proposing systemic changes to the tax code, the Administration believes that by focusing on certain identified common characteristics, it can stop the growth of corporate tax shelters.

After the release of the President's budget, numerous groups of taxpayers, businesses and their representatives commented on the proposals. A common theme in these comments was that the President's proposals are too broad and would affect too many ordinary business transactions. These comments were considered when in July 1999 the US Treasury Department produced a 'white paper' study: *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*. The 165-page report modified the President's proposals. It listed a number of common characteristics shared by corporate tax shelters, including:

- lack of economic substance;
- significant book / tax differences;
- arrangements guaranteeing tax benefits;
- tax-indifferent party involvement;
- marketing of the idea;
- confidentiality agreements; and
- contingent adviser fees.

Treasury would employ a four-prong approach to limit corporations' use of "tax shelter" arrangements:

- **Disclosure.** Transactions with tax shelter characteristics would need to be disclosed *both* on entering into a transaction and on the annual tax return. Failure to disclose would subject the taxpayer to a substantial penalty and corporate officers would be personally liable for mis-statements on the disclosure form.
- **Penalties.** The penalty for understatement of tax liability due to a tax shelter could be as much as 40%; however, the penalty could be reduced when, among other things, a taxpayer had a "reasonable belief

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that it has a strong chance of sustaining its tax position".

- **Disallow tax benefits.** Tax benefits would be disallowed for a "tax avoidance transaction" ie, any transaction in which the reasonably expected economic benefits are insignificant when compared to the expected tax savings.
- **Other party consequences.** Deductions for adviser fees would be disallowed, and a 25% excise tax would be imposed on anticipated tax benefits from recission agreements, unwind provisions, and insurance arrangements.

Joint Committee on Taxation staff study

In a July 1999 report on interest and penalty provisions of the US tax code, the staff of the US Congress' Joint Committee on Taxation (JCT) also offered legislative and administrative recommendations addressing corporate tax shelters. The JCT staff, a nonpartisan group that provides analysis and advice to the congressional tax-writing committees, concluded that "[t]here is evidence that the use of corporate tax shelters has grown significantly in recent years," and that "the number and complexity of the transactions that are used as corporate tax shelters suggests a need for a legislative solution." Accordingly, their report recommended the following solutions:

- **Definition of corporate tax shelters.** Clarify the present-law definition of a corporate tax shelter by adding several "tax shelter indicators". An arrangement would be considered to have a significant tax avoidance purpose if, in general, the arrangement:
  - generates pre-tax profit that is insignificant compared to its reasonably expected net tax benefits;
  - involves a tax-indifferent participant and, in general, has little or no negative effect on the tax-indifferent participant; or
  - is expected to produce significant net tax benefits to the participant *and*
    involves a tax indemnity (or similar arrangement) with a party other than a principal in the transaction; or
    generates "permanent differences" for US financial reporting purposes under GAAP; or
    exposes the corporate participant to little (if any) additional economic risk.

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An arrangement without any of these indicators could still be a tax shelter if it has the avoidance or evasion of federal income tax as a significant purpose.

- **Penalties.** Apply the existing substantial understatement penalty with respect to tax shelters whether or not the understatement is "substantial" and increase the penalty from 20% to 40% (with the IRS having no discretion to waive the understatement penalty for corporate tax shelters in settlement negotiations or otherwise).
- **Disclosure.** Require disclosure by a senior corporate officer under penalties of perjury and disclosure on the tax return when there is any arrangement that is described by a tax shelter indicator, regardless of the size of the benefit expected to be generated by the arrangement.
- **Provisions affecting other participants.** Impose enhanced penalties for aiding and abetting an understatement with regard to a tax shelter and other sanctions for tax advisers.
- **Registration.** Modify and expand existing requirements for registration of corporate tax shelters.

Legislative consideration of corporate tax shelters

An alternative approach concerning corporate tax shelters was offered by congressional Democrats, as the recent tax cut bill worked its way through the House of Representatives. Although the tax cut bill that Congress approved did not include any of the corporate tax shelter provisions, this alternative to the Treasury and JCT recommendations was viewed as being the first "line in the sand" as to how some members of Congress will approach the issue.

The House Democrats' proposal aimed to shut down abusive tax shelters by prohibiting "loss generators" – ie, transactions lacking any legitimate business purpose, but intending to obtain a loss, credit, or deduction to dodge taxes.

The Democrats' proposal would essentially amend the US tax code to deny tax benefits claimed from transactions that lack economic substance – by disallowing "noneconomic tax attributes" arising from these transactions and by increasing the penalties against taxpayers that claim the disallowed tax benefits.

What next?

Now that the Treasury white paper and JCT study have been issued, and the House Democrats have offered an alternative, the tax-writing committees of the US Congress will begin their review. The leaders of these committees expect to hold hearings (most likely this autumn) to consider issues raised in the Treasury and JCT studies.

It is possible that legislation later this year may incorporate some elements of the proposals that are on the table, although the time may not yet be ripe for broad changes. For example, proposals to curb individual tax shelters in the 1980s took a few years to 'mature' before they were enacted in 1986. Curbing corporate tax shelters may likewise take time. However, the US legislative process is unpredictable and legislation could be enacted at any time. Because the proposals could adversely affect the business arrangements of a wide array of corporations and their advisers, the business community would be wise to pay close attention to this issue. ■

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