# 1.C Characteristics of Corporate Tax Shelters

**Introduction**

Corporate tax shelters take many different forms and utilize many different structures. For this reason, a single comprehensive definition of corporate tax shelters is difficult to formulate. However, corporate tax shelters have the following characteristics:

- lack of meaningful economic risk of loss or potential for gain
- inconsistent financial and accounting treatment
- presence of tax-indifferent parties
- complexity
- unnecessary steps or novel investments
- promotion or marketing
- confidentiality
- high transaction costs
- risk reduction arrangements.

**Lack of Meaningful Economic Risk or Potential for Gain**

Professor Michael Graetz defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid." This definition highlights an important characteristic common to most corporate tax shelters, the lack of significant economic risk of loss or potential for gain to the taxpayer(s) seeking the tax benefit.

Often in corporate tax shelters, a corporate participant purportedly makes a significant investment. In most cases, however, the risk of loss or gain is illusory. Through hedges, circular cash flows, defeasances, and similar devices, the participant in a shelter is insulated from significant or all economic risk. Transactions with little or no economic risk typically generate little or no pre- tax profit. In light of the expectation of little or no pre-tax profit, no one rationally would participate in such transactions without significant tax benefits. After factoring in expected tax benefits, however, a negligible pre-tax profit is transformed into a significant after-tax return.

Corporate tax shelters can arise even in transactions that produce more than a negligible amount of pre-tax economic profit. For example, a taxpayer may attempt to disguise the tax avoidance nature of the transaction by placing high-grade, income-producing financial instruments in a corporate tax shelter.

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**Inconsistent Financial and Accounting Treatment**

In recent corporate tax shelters involving public companies, the financial accounting treatment of a shelter item has been inconsistent with its federal income tax treatment.

A significant segment of corporate America has in recent years appeared to place a larger premium on tax savings, particularly tax savings in transactions where the tax treatment varies from the financial accounting treatment.

There is also a tendency for corporations to view their tax liability as just another cost of doing business that can be reduced through aggressive management. Shareholders expect corporate managers to keep the corporation's effective tax rate (i.e., the ratio of corporate tax liability to book income) low and in line with competitors.

A transaction that reduces both a corporation's taxable and book income lowers the corporation's tax liability, but does not affect its effective tax rate. More importantly, where there is a book loss the corporation could fail to meet the earnings expectations of investors. Executives will generally pass on an opportunity to reduce taxes if it also entails a reduction in reported earnings.

Although some disclosure of book-tax disparities is required for both federal income tax and GAAP purposes, the amount of detail required is limited and provides little evidence concerning the existence of corporate tax shelters. Financial statement disclosure is limited to items of materiality. Tax return disclosure is not limited to corporate tax shelters, but rather applies to all book-tax differences. Therefore, book-tax differences attributable to shelters often remain hidden and corporations have no incentive to voluntarily disclose the existence and nature of their shelters.

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**Presence of Tax-indifferent Parties**

A significant characteristic found in many corporate tax shelters is the participation of tax-indifferent parties. Recent examples of shelter transactions that relied on the use of tax-indifferent parties include:

- fast-pay preferred stock transactions,
- LILO transactions, and
- contingent installment sales transactions.

Tax-indifferent parties are accommodation parties that are paid a fee or an above-market return on investment for absorbing taxable income or otherwise "leasing" their tax-advantaged status. Tax-indifferent parties may include:

- foreign persons,
- Native American tribal organizations,
- tax-exempt organizations (e.g., charitable organizations and pension plans), and
- domestic corporations with net operating losses or credit carry-forwards that they do not expect to use to offset their own income.

When taxpayers use different methods of accounting, the difference may be arbitraged to create a tax shelter. For example, taxpayers subject to mark-to-market accounting have acted as accommodation parties in tax shelters because they are indifferent to the realization principle and can absorb the gains of taxpayers.

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## 1.C Characteristics of Corporate Tax Shelters, Continued

**Complexity**

Corporate tax shelters typically involve complex transactions and structures. This complexity arises from a number of sources. Corporate tax shelters often require the completion of certain formalistic steps to gain the desired tax result. The use of certain entities or structures may be necessary to achieve the desired tax result or to facilitate the use of tax-indifferent parties. Other steps may be added to establish or buttress a claim of business purpose or economic substance. Also, corporate tax shelters often use innovative financial instruments to facilitate the exploitation of tax law inconsistencies.

Financial innovation is growing rapidly and the tax law has not kept pace. Many of the rules governing financial instruments were developed in the early part of the 20th century to deal with financial instruments common at the time, such as plain vanilla stock, debt, and short-term options. Modern-day sophisticated financial products do not fit neatly into the existing regimes. Consequently, taxpayers exploit the uncertainty regarding the taxation of these instruments, by creating the economic equivalent of a traditional investment without the unfavorable tax consequences. Once inconsistencies are identified, they frequently are manipulated.

The use of a complex structure may also be used as a device to cloak the tax shelter transaction from detection.

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**Unnecessary Steps or Novel Investments**

Corporate tax shelters may involve:

- unnecessary steps implemented to achieve the corporation's purported business purpose, or
- property or transactions that the corporate participant either has little or no experience with, or
- transactions that lack a bona fide business purpose.

A taxpayer generally must demonstrate a business purpose for entering into a transaction (or series of transactions) in order to sustain the claimed tax results. In many cases, however, certain steps are undertaken solely to obtain the desired tax benefits and are not necessary for the taxpayer to achieve the purported business purpose.

Some corporate tax shelters may involve new activities that the corporation had not in the past been a party to or used, such as:

- leasing transactions,
- novel financing arrangements,
- tax-indifferent party transactions, or
- REIT transactions.

On the other hand, some corporate tax shelters involve activities that fall within the corporation's normal business operations. Many of the participants are publicly traded conglomerates involved in a host of diverse activities, including financing transactions. Many corporate tax shelters involve financing transactions. Tax-indifferent parties, particularly pension plans and foreign persons are a major source of corporate finance. Some corporations that are active in the trade or business of financial intermediation (e.g., banks or insurance companies) also participate in tax shelters involving financing transactions. The fact a transaction is not "novel" for the taxpayer is not necessarily determinative of whether it is a corporate tax shelter.

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# 1.C Characteristics of Corporate Tax Shelters, Continued

**Promotion or Marketing**

Tax advisors are no longer just devising specific strategies to deal with their client's tax needs as they arise. Today's tax shelter promoters capitalize on complexities in the tax law (statute, regulations, and rulings) to devise schemes that can be pitched to corporate prospects. Tax shelter promoters sell their schemes methodically and aggressively as "products," using a powerful distribution network.

Many tax shelters are designed today so that they can be used by different investors, rather than addressing the tax planning of a single taxpayer. This allows the shelter "product" to be marketed and sold to many different clients, thereby maximizing the promoter's return from its shelter idea.

There are various ways in which promoters become aware of corporations who have a need for shelter transactions. For example, promoters may work with corporations in other capacities, such as underwriters, legal advisors, consultants, or auditors and learn of events that give rise to tax planning. Using this knowledge, the advisor can communicate the needs of their clients to other members of their firm who have expertise in designing corporate tax shelters. In addition, some corporations that generate significant profits are known to have an interest in transactions that can reduce the tax liability on such profits. Frequently, promoters approach people that they know have realized large gains.

New technologies have greatly increased the distribution and marketing of shelters. In the past, it may have taken weeks or months to distribute a corporate tax shelter nationwide, now it takes a matter of minutes.

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# 1.C Characteristics of Corporate Tax Shelters, Continued

**Confidentiality**

Like marketing, maintaining the confidentiality of a tax shelter transaction helps to maximize the promoter's return from its shelter idea.

A promoter has no generally enforceable intellectual property rights in the tax shelter idea. The idea can be expropriated, not only by the company shown the shelter, but also by any other prospective purchaser that finds out about the shelter. Promoters attempt to limit expropriation by requiring confidentiality agreements from prospective purchasers and their advisors.

Before pitching tax shelter ideas to prospective participants, promoters may require non-disclosure agreements that provide for million dollar payments for any disclosure of their "proprietary" advice. These arrangements limit but do not preclude the expropriation of the idea by other promoters.

Confidentiality agreements serve another essential purpose for promoters. Confidentiality agreements protect the efficacy of the idea by preventing or delaying its discovery by the Treasury Department and the IRS. Congress was concerned that confidentiality agreements would hinder tax administration. Therefore, in 1997 Congress expanded the tax shelter registration requirements to cover "confidential" corporate tax shelters. One of three conditions for registration is that some one other than the taxpayer has a proprietary interest in the arrangement or can prohibit the taxpayer from disclosing the arrangement.

It is unlikely that limiting confidentiality agreements alone will greatly impact the corporate tax shelter market. In lieu of formal confidentiality agreements, many promoters already rely on tacit understandings or other arrangements requiring a prospective participant to use the law firm selected by the promoter to protect their proprietary interest and reduce the risk of detection.

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# 1.C Characteristics of Corporate Tax Shelters, Continued

**High Transaction Costs**

Corporate tax shelters carry unusually high transaction costs that are borne in whole or substantial part by the corporate beneficiary. For example, the reported transaction costs in ASA ($24,783,800) were approximately 26.5 percent of the purported tax savings (approximately $93,500,000). Transaction costs include:

- fees paid to the promoter,
- fees paid to the tax-indifferent party,
- fees for legal services (e.g., tax opinions and drafts of organizational documents and financial instruments,), and
- expenses incurred in connection with the shelter activity.

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## 1.C Characteristics of Corporate Tax Shelters, Continued

**Risk Reduction Arrangements**

Corporate tax shelters often involve contingent or refundable fees in order to reduce the cost and risk of the shelter to the participants. In a contingent fee arrangement, the promoter receive a portion (often as much as one-half) of any tax savings realized by the corporate participant. If no tax savings are realized, the promoter gets nothing. Although tax return preparers are precluded from charging contingent fees in connection with the preparation of a tax return, there is generally no prohibition on charging contingent fees in connection with providing tax-planning advice. Similarly, under a refundable fee arrangement, a promoter would agree to refund its fee to a client whose tax benefits are not realized because of IRS challenge or a change in the law.

Corporate tax shelters may also involve insurance or rescission arrangements. Like contingent or refundable fees, insurance or rescission arrangements reduce the cost and risk of the shelter to the participants. These arrangements provide the corporate participant with some measure of protection in the event the expected tax benefits do not materialize. In a claw back or rescission arrangement, the parties to the transaction agree to unwind the transaction if the purported tax benefits are not realized. Often there is a so-called “trigger” event, such as a change in law or an IRS audit that is determined by an independent third party to constitute a significant risk to the tax benefits of the transaction. If the trigger event occurs, the transaction is unwound. The unwinding may take the form of the liquidation of any entity formed for purposes of the tax shelter, the redemption of any securities issued pursuant to the shelter, or the termination of any contractual agreements. By utilizing a recession arrangement or claw back, the corporate participant is not burdened with any complex or costly financial or legal structures that were part of the design of the suddenly defunct tax shelter. An example of an unwound transaction is the fast-pay preferred stock transactions that provided for the tax-free unwind of the REIT structure through liquidation of the REIT.