Avoid 'Tax Shelter' Taint

By Robert W. Wood

Some phrases just sound unsavory. Increasingly, the "tax shelter" label is one of them. By tax shelter, I don't mean investing in real estate, the home mortgage interest deduction or your 401(k). Those may "shelter" taxes but they are not "tax shelters."

We've had several tax shelter eras since 1913 when our federal income tax was born. Our most recent shelter era saw the collapse of Enron, the disappearance of accounting giant Arthur Anderson, and trials of lawyers and accountants from KPMG and other firms accused of criminal tax fraud. The Internal Revenue Service and Congress have done their best to regulate tax shelters, which cost the government billions.

Of course, tax planning and tax reduction strategies are not only all-American, but universal, extending to every country in the world. One oft-quoted case (from Judge Learned Hand) eloquently enunciates the proposition that it's perfectly OK to pay less:

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"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. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands." Gregory v. Helvering.

There is a long history of taxpayers arranging their affairs to lawfully minimize taxes, despite Joe Biden's "paying higher taxes is patriotic" gaffe. Perhaps what then-candidate Biden meant to say was that it was unpatriotic to engage in the kind of sharp practice and shenanigans that seem to surround tax shelters. We recall with disdain Leona Helmsley's "only the little people pay taxes."

How do you distinguish between proscribed tax shelters and legitimate tax planning? Definitions are important, and some people are surprised to find that tax shelters are actually defined in the tax code. They are subject to special rules, generally including registration and special disclosure.

"Tax shelters" are defined to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. That sounds very broad, since a huge number of transactions have tax ramifications as a significant purpose. The key question is whether the tax ramifications are the reason the person is entering into the transaction.

Whether or not there are tax aspects of a transaction, usually economics and business goals are more important than tax goals. The mere fact that you are trying to do the transaction in a tax-advantaged or tax efficient way does not mean the transaction is a tax shelter. However, if the tax goals are paramount and the transaction is marketed specifically for tax benefits, it seems fair to call it a tax shelter.

The challenge is that the statutory definition is broad enough to encompass many ordinary transactions. For example, you could worry over: a large charitable contribution at year end, where you are giving stock or land away just for the tax advantage, not because you particularly want to benefit the charity; a tax free tax swap deal, where you exchange shares in your family company for shares in IBM or Microsoft rather than selling for cash since you do not want to pay tax on your gain; or an investment where the company qualifies for green energy tax credits and you will get a share of the tax credit that will offset half the cost of your shares.

Fortunately, none of these qualify as a tax shelter. In fact, they are specifically recognized tax benefits. Plus, they are tied to real economic transactions. Despite occasional grey lines, in most cases, a tax shelter can be readily recognized if you know what to look for.

Keep an eye out for transactions that promise little economic gain other than tax benefits. Beware of transactions that use strange financing techniques or rely on strained interpretations of the tax laws. Watch for transactions in which seemingly disparate parts are cobbled together in a way that makes little economic sense.

If a transaction looks on paper like you are supposed to enter into it to make a profit, but the promoters say that you will get multiple tax benefits for every dollar you invest, beware. Many shelters attacked by the IRS involve 5 for 1, 10 for 1 or greater tax write-offs (meaning for every dollar you invest, you'll get $5 or $10 dollars of tax benefits).

It may sound silly, but acronyms can be another bad sign. Deutsche Bank recently agreed to pay $553.6 million to settle matters involving tax shelters in which it was involved from 1996 to 2002. Many of these shelters were enormously complicated but had slick acronyms, including FLIP, OPIS, BLIPS, CARDS, COBRA, COINS and more. With epic allusion, one shelter was even called HOMER.

When in doubt about whether a particular transaction is a tax shelter, get some independent advice. That should ideally not be someone involved in marketing the product or investment. If someone is making a commission off getting you involved, they are probably not independent.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.