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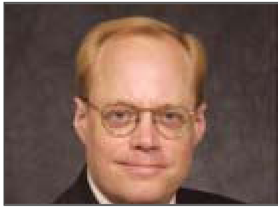

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Know Tax Shelters When You See Them?

The announcement that Deutsche Bank is the latest to pay a whopping ($553.6 million) payment settling charges it participated in a raft of tax shelters between 1996 and 2002 brings into sharper focus the need to know just what a tax shelter is. Sometimes it can be in the eye of the beholder, or even rekindle reference to Justice Potter Stewart's famous "I know it when I see it" definition of pornography.

Another similarity: like pornography, you generally don't want to say you're participating. Tax-advantaged investments are fine. See Gordon Gekko Tax Moves. In fact, people admire you if you lawfully manage to pull off major tax savings. Shelters? Not so much. You may come off like Leona Helmsley.

If the "I know it when I see it" analogy doesn't help, the tax code and the IRS define tax shelters. That's important, controlling not only the nature of the penalties that can be imposed if you participate, but also the type of disclosure you and your tax return preparer must make at tax return time. The penalties for shelters are more severe than the usual raft of IRS penalties, reaching beyond the taxpayer to the return preparer too. That also applies to "reportable transactions" that have a significant purpose of tax avoidance or tax evasion. See IRC Section 6662A.

Tax shelters are defined by the tax code to include any plan or arrangement having a significant purpose of avoiding or evading federal income tax. Obviously, that sounds very broad indeed. Of course, 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. Usually economics and business goals will be more important than tax goals. Often it is the ***manner*** of accomplishing the business goal that is designed to be tax efficient.

The mere fact that you're 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 literal 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're 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 don't want to pay tax on your gain; or

- An investment where the company qualifies for green energy tax credits and you'll get a share of the tax credit that will offset half the cost of your shares.

None of these is a tax shelter. Rather, they are specifically recognized tax benefits tied to real economic transactions. Indeed, despite occasional grey lines, in most cases, a tax shelter will be readily recognizable.

Keep an eye out for transactions that promise little economic gain other than tax benefits, that use financing techniques that don't conform to business practices, or that rely on strained (or incorrect) 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're supposed to enter it to make a profit, but the promoters tell you you'll 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.

When in doubt, get some independent advice from someone not involved in marketing the er, "shelter." If someone is making a commission off getting you involved, they're not independent.

For more, see:

Abusive Tax Shelters and Transactions

SILOs and LILOs Demystified

SILOs, LILOs, and Business Purpose

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