Tax Shelters: Exotic or Just Plain Illegal?

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They were unusual tax shelters that went by incomprehensible names like BLIPS, OPIS, BOSS and FLIP -- and they boomeranged on the companies that sold them.

In February, German bank HVB Group agreed to pay $29.6 million in fines to avoid indictment for defrauding the Internal Revenue Service with abusive tax shelters that gave rich clients phony losses to reduce taxes.

The settlement was part of a broadening investigation into exotic shelters that wealthy individuals used to escape about $2.5 billion in taxes from the mid-1990s through 2003, according to the government. Indeed, the IRS recently announced that a string of law firms, banks and accounting firms will be fined billions of dollars for failing to admit their role in promoting these improper investments.

Last fall, KPMG LLP, the accounting firm that created and marketed many of the shelters, agreed to pay $465 million to avoid indictment. In addition, 17 former KPMG employees and two other individuals have been charged with criminal offenses for plotting to defraud the IRS and are scheduled for trial in September. KPMG has been sued for hundreds of millions by clients who got into trouble for using the shelters.

Yet despite government efforts, there is no silver bullet that can stop promoters from cooking up new shelters, says William C. Tyson, professor of legal studies and business ethics at Wharton. Whenever a new regulation is imposed, "people just start looking for new ways to get around the tax law. Before 1986, these shelters were rampant. There are not nearly as many of them now because the law has closed up so many of the loopholes. It's just that there is still some room to squeak through.... People are really creative."

If it's difficult for regulators and tax experts to tell what constitutes an abusive shelter, it's virtually impossible for a taxpayer to know if he's buying into a strategy that could come back to haunt him later. "This is an area that is difficult to define with precision," notes Stuart E. Lucas, CEO of Integrated Wealth Management LLC and author of the Wharton School Publishing book, *Wealth: Grow It, Protect It, Spend It, and Share It*. "I guess I come down on the side of using a smell-test rule. I think the intent of the tax law is fairly clear, and if you are doing things that fulfill the intent of the tax law, then you can feel reasonably safe."

But he suggests that even legitimate tax-reduction strategies can backfire if they involve paying big ongoing fees or leave the taxpayer with his hands tied when conditions change years down the road. It's especially hazardous, he says, to take on a fixed, long-term obligation, like a debt to be repaid, and plan to pay it with an asset that can lose value in the meantime.

The Miracle Workers

Yet despite all the recent news, the U.S. is not in a heyday of abusive tax shelters. They were probably more prevalent in the 1970s, 1980s and 1990s. But the IRS, Congress and other regulators are focused on

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the issue because a loss of tax revenue is especially serious when the federal government is running budget deficits, and because promoters have been standardizing shelters to expand their market. "There is money involved.... From a business point of view, why shouldn't [lawyers, accountants and bankers] try to make money? That's their point of view," says Edward B. Kostin, an adjunct faculty member in Wharton's accounting department.

U.S. tax laws are extremely complex and offer many legitimate ways to reduce taxes. Ordinary taxpayers, for example, can deduct mortgage interest payments and home office expenses, and they can use losses on one investment to offset profits on others, reducing taxes. Businesses can deduct expenses, claim depreciation on buildings and equipment, book their profits in low-tax foreign countries.... The list goes on and on.

Typically, according to Lucas, as a person gets wealthier, a larger share of his or her net worth and annual income comes from investments rather than wages. Investments provide all sorts of options in navigating the tax shoals. While ordinary income is taxed at rates as high as 35%, the long-term capital gains tax rate is only 15%. The lower rate also applies to dividends, while the higher one applies to interest. Municipal bonds are tax free. Capital gains tax can be postponed until an investment is sold. Trusts and gift giving offer additional layers of tax-minimizing possibilities.

"The U.S. government really acts as a silent partner to any investor," Lucas says. "It sets the rules, but then the investor has to decide how to implement them. By managing your taxes carefully, you can significantly impact your wealth."

The term "tax shelter" generally means a product or strategy that strings together various elements of the tax code for an especially useful benefit, and many tax shelters are considered acceptable. The line between proper and improper shelters is so unclear that the IRS uses terms like "abusive" to characterize unacceptable shelters rather than calling them "illegal."

But in a 2005 study, the Senate Permanent Subcommittee on Investigations described abusive shelters as "transactions in which a significant purpose is the avoidance or evasion of federal, state or local tax in a manner not intended by the law."

Shelters that are considered proper in one period may not be permitted in another, says Tyson, who also holds a secondary appointment at the University of Pennsylvania Law School. He recalls helping clients set up legal tax shelters in the 1970s and early 1980s. "I would say the tax shelters started into their prime in the 1970s."

Back then, investors could claim accelerated depreciation on assets such as real estate, writing off part of an asset's value each year as if it were a vehicle or piece of machinery gradually wearing out. Also, taxpayers were allowed to apply losses from passive investments, like limited partnerships, to offset large amounts of ordinary income from other sources. Using depreciation, investors could claim losses on investments that actually produced profits. "This is what I used to call a miracle," Tyson says.

Some of his shelters, he adds, were limited partnerships that invested in assets like apartment complexes. Rental income would be more than offset by operating expenses, interest on the loan and depreciation, creating a loss the partners could use to eliminate tax on tens of thousands of dollars in other income. After five years, the complex would be sold at a profit.

In those days, well-heeled investors hungered for tax shelters because tax rates were considerably higher than they are today. In 1979, for instance the top income tax rate was 70% and the top capital gains rate was 35%. Today they are 35% and 15%, respectively. "Individuals were motivated to do various kinds of transactions in agriculture, oil and gas, and real estate, to reduce their tax levels and to convert ordinary income to long-term capital gains," Kostin says.

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But the Tax Reform Act of 1986 made depreciation schedules less generous and barred the use of losses on passive investments to shelter other income, Tyson adds. "These passive-loss rules have gone a long way to curb abusive tax shelters."

However, clever accountants, lawyers and bankers kept looking for new ways to help clients avoid taxes, and the demand grew as investors faced big potential tax bills from the stock-market boom of the 1990s.

Misleading Loan Accounting

The Senate investigation found that KPMG had in 1997 established a Tax Innovation Center which turned tax shelters into a major business by creating generic products that could be marketed to more people. Previously, shelters typically were tailor-made for individuals or groups of investors. "By 2003, dubious tax shelter sales were no longer the province of shady, fly-by-night companies with limited resources," the subcommittee found. "They had become big business, assigned to talented professionals at the top of their fields and able to draw upon the vast resources and reputation of the country's largest accounting firms, law firms, investment advisory firms, and banks."

In addition to BLIPS -- Bond Linked Issue Premium Structures -- the subcommittee found that KPMG and accounting firms PicewaterhouseCoopers and Ernst & Young developed products called the Foreign Leveraged Investment Program, the Offshore Portfolio Investment Strategy, the Bond and Option Sales Strategy and the Contingent Deferred Swap, among others. "Each of these products generated hundreds of millions of dollars in phony paper losses for taxpayers, using a series of complex, orchestrated transactions, structured finance, and investments with little or no profit potential," the subcommittee found.

BLIPS, for example, were created in 1998 to replace an earlier product called OPIS that the IRS labeled abusive. Internal KPMG emails found by the subcommittee show the firm felt tremendous pressure to get the product to market even though the company's own experts had serious doubts about the BLIPS' appropriateness.

Marketing began in 1999 and BLIPS were sold to 186 individuals before they were discontinued a year later when the IRS labeled them potentially abusive. The IRS found that BLIPS allowed clients to use misleading loan accounting to create an artificially high purchase price when they bought into certain partnerships. When they later cashed out of the partnership for a lower price, the inflated purchase price allowed them to report a tax-reducing loss. In fact, they had not suffered a real loss.

As a rule of thumb, says Tyson, "investors should be wary when there is a paper loss that doesn't reflect an economic loss." An investor who made money on a transaction and claims a loss could well run into trouble. Adds Kostin: "If it's just cosmetic and not economic, then it looks like it's definitely not appropriate -- not ethical and probably not legal."

Congress, he notes, is wrestling with efforts to tighten loopholes further by permitting only those shelters that involve "economic substance." But it's having such a hard time defining that term that he doesn't think the effort will succeed. How much economic value should a transaction have before a tax loss is permissible? Would a dollar's worth be enough, or should the threshold be higher? "It's a gray area," Kostin says. "We don't know the answer."

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