Where Tax Shelters and Core Values Collide:

THE CASE OF XYZ BANK

By Robin Boneck, CPA, and David Christensen, CMA

The computer industry is constantly on high alert for rogue viruses that can't be contained. In the financial world, the equivalent "bug"—at least as far as the Internal Revenue Service (IRS) is concerned—is the illegal tax shelter.

But recently the federal government has been winning the war against bogus shelters. Prompted by victories against three large banks, last fall the IRS offered 45 other corporations—across a wide range of industries—a deal to terminate now-banned lease-in/lease-out (LILO) and sale-in/lease-out (SILO) tax shelters and settle their debts to the government. In these fabricated shelters, banks and other companies typically buy or lease large public assets such as subway cars and sewer systems from foreign municipalities and then lease them back to the original owners for tax deductions, such as depreciation. The lease payments provide revenues to the municipalities and tax deductions to the banks.

Naturally, the IRS objected to such transactions because their only purpose was to produce tax deductions on assets the original lender never truly owned. Under settlement terms with the IRS, the 45 corporations that engaged in more than 1,000 of these questionable tax shelters through 2007 would be allowed to avoid penalties and keep up to 20% of the deductions if they agreed to abandon the shelters by December 2010. The remaining 80% of any claimed deductions would have to be paid to the government. On Aug. 6, 2008, IRS Commissioner Douglas Shulman stated:

> *"The public has a right to expect that large corporations be good corporate citizens and meet their compliance obligations. The nation's leading commercial enterprises have the legal and accounting resources to take full advantage of favorable provisions of tax law. But they are not entitled to use their extensive resources to twist provisions of tax law to the point that they no longer reflect the Congress's intent. As a basic matter of fairness to all taxpayers, the IRS cannot allow LILO and SILO deals to stand."*

Thomas Jefferson once cautioned that our rulers will become corrupt and our people careless if our focus is solely on making money. This notion isn't restricted to rulers, of course; the concept applies equally to the business world since the primary focus of most businesses is to make money. Laws exist to protect shareholders and others with a vested interest against corrupt activity and set a minimum standard of acceptable behavior. Unfortunately, laws aren't foolproof. Motivated organizations often exploit unintended loopholes in the law, using tax shelters to minimize their liabilities and bolster profits. We learned from Enron that astute tax practitioners can twist the technical provisions of the law to achieve significant benefits for their clients. Regrettably, most of these techniques fall below commonly accepted ethical standards and become illegal once the IRS discovers them.

In his famous essay, "The Social Responsibility of Business is to Increase its Profits," published in *The New York Times Magazine* in September 1970, Milton Friedman cautioned that organizations have a duty to conform "to the basic rules of society, both those embodied in law and those embodied in ethical custom." Today, most organizations have established codes of conduct that provide guidelines to both employees and executives to help ensure that corporate activity is conducted with ethics in mind.

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A values-based approach toward ethics and corporate behavior appears to have taken a strong foothold in corporate America—at least on paper. At the heart of this approach are the corporate mission statement and a set of core values. These statements are often displayed on office walls, posted to company websites, and even published in the annual report. Executive actions, including tax transactions, are expected to be conducted within the parameters of a company's code of conduct.

Of course, expectations don't always match reality. In this article, we examine a fictional bank, XYZ Corporation, and its participation in a questionable tax shelter, a transaction that was incompatible with the organization's ethical values. First, though, a little background.

Tax Shelters Grow in Complexity

During the early 1990s a dramatic cultural shift within the tax industry occurred, most noticeably among the larger CPA firms, which devised and marketed a variety of complex tax shelters promising substantial federal income tax savings. The firms charged unusually large fees for these products based on the percentage of a client's tax savings—touted as a win-win for both parties. This was a departure from the traditional method of charging hourly fees and signaled a stronger focus

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on revenue maximization.

The federal government began to notice this extraordinary trend during its investigation of Enron's tax activity. During a Senate probe in February 2003, Senator Charles Grassley (R.-Iowa), former chairman of the Committee on Finance, made the following comment regarding the culture of the time:

"Money above honesty and financial accounting, money above tax return compliance, money above professional and business ethics, money above common sense. Money, money, money."

The investigation revealed that Enron repeatedly abused the tax code by using shady tax shelters to completely eliminate its federal income tax liability for four consecutive years, even though it regularly reported an annual multibillion-dollar net income. Additionally, Enron had a written code of conduct and a vision statement, but the actual behavior of its executives fell far below the standards specified in the code. It was as if upper management was unaware that there even *was* a code. Other corporations and accounting firms were investigated in the wake of the Enron scandal, confirming the unsettling tax trend.

This tax shelter frenzy even infected the banking industry, generally thought to follow very conservative tax reporting principles. Separately, several major financial institutions engaged in a profitable tax transaction, the aforementioned "LILO" (lease-in/lease-out) shelter. Leasing and financing activities are a common item on bank financial statements. Therefore, a LILO transaction didn't stand out as being unusual because it was meant to generate large rent deductions from leasing activities. A typical LILO arrangement contained a primary lease granting a bank or corporation the right to possess or use assets leased from a foreign municipality. Simultaneously, a sublease provided the foreign municipality—which still owned the assets—the right to continue using them.

In the early years of such an arrangement, the bank typically enjoyed enormous rent deductions. Unfortunately, the *substance* of the transaction didn't conform to the written arrangement in that the bank never took possession of, nor ever used, the assets of the foreign municipality. The municipality simply went about its business as if no leases existed. Furthermore, neither party paid any actual rent. The complex arrangement involved offsetting and reciprocal obligations between the two parties and circular transfers of funds that never left the bank's control. Generally, the only money exchanged between the two parties was a multimillion-dollar upfront fee that the bank or corporation paid to the foreign municipality to entice it to participate in the transaction. Also, the fee itself served as a write-off or was used to adjust the lease payments.

During this time, IRS audits of some large firms revealed an upward spike in leasing activity. But because of the complex design of the LILO transaction, combined with limited government resources, it took the IRS more than two years to discover the shelter's illusory nature and true purpose. In 1999, the IRS published a revenue ruling placing taxpayers on notice that the tax benefits derived from any future LILO transactions would be disallowed (Ruling No. 99-14).

Prior to 1999, dozens of banks participated in this aggressive structure and successfully reduced, or even completely eliminated, their federal income tax liabilities. For example, First Union Bank, and later its acquirer, Wachovia Bank, significantly reduced its tax liabilities (to a reported 6% in 1998 alone) by purporting to lease the streetcars of Dortmund, Germany, and the sewer system of nearby Bochum. It was around this time, too, that XYZ Corporation engaged in a LILO transaction.

The Saga of XYZ Corporation

XYZ Corporation is a fictional financial institution ranked among the top-10 financial holding companies in the United States. Its assets are valued at more than $100 billion, with reported income of well over $1 billion each year. Like many companies, XYZ publishes its vision, mission, and value statements on its website. It claims to follow a set of integrated values designed to help it achieve its mission and purpose. Nevertheless, a few of these values appear to conflict with XYZ's involvement in an illegal tax shelter. Here's what transpired.

In the late 1990s, XYZ entered into a LILO transaction with ABC, a foreign company that makes plastic products. The contracts purported to lease manufacturing equipment to XYZ and immediately sublease the same equipment back to ABC. Prior to engaging in the transaction, XYZ performed an internal analysis that described it as a "tax-driven deal," creating tax benefits from accelerated rent deductions. Over the course of six years, the transaction was projected to provide an annual deduction of $10 million and a tax savings of approximately $4 million a year.

So much for best-laid plans, XYZ discovered. A few years later, the IRS audited the transaction and disallowed the associated tax benefits, forcing XYZ to pay millions of dollars in taxes and interest. The company challenged the determination in federal court, but a U.S. District Court

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ruled in favor of the IRS. The court saw through the tax shelter's complexity and discovered that there was *no economic substance* to the transaction. XYZ vowed to appeal.

XYZ'S Corporate Values

XYZ's stated purpose is to create economic rewards for its shareholders. In short, it exists to make a profit. Reducing its federal income tax liability contributes to this goal, but this goal is at odds with XYZ's duty to properly calculate and pay its taxes. Every corporation's challenge is to satisfy its tax obligation while simultaneously minimizing the amount of tax paid in order to maximize profits. Therefore, the more aggressive a corporation is at minimizing taxes, the more its actions have the potential to be unethical or even illegal.

A core set of corporate values can serve as a guide to executives in such situations. XYZ has a set of integrated values that it claims are important and must be followed in achieving its mission. At least three of these stated values (reality, honesty, and integrity) should have provided valuable guidance to XYZ executives as they contemplated the particulars of the LILO structure. Let's examine each of these values in turn.

Reality. Rather than relying on wishes or unproven theories, managers at XYZ are expected to base their decisions on a careful consideration of facts. Two important facts should have been critical to those examining the LILO structure. First, the agreement existed on paper only and completely lacked any business purpose except that of avoiding taxes. The written contracts purported to lease assets in return for rent, but, in actuality, XYZ never took possession of the leased equipment or paid rent to use it.

Second, pursuant to IRC §162(a)(3), a deduction for rent isn't permitted unless rent is actually paid for use of an asset. Furthermore, the doctrine of economic substance elucidated by the U.S. Supreme Court provides that the tax benefits of a transaction aren't sanctioned under the law unless the transaction is undertaken for business purposes other than to merely avoid taxes. The LILO structure failed to meet either of these standards. It seems unlikely that *both* XYZ's internal tax experts and its external tax consultants would have overlooked these two important facts. Yet the transaction was approved.

Other circumstances may have held stronger influence. First, risk of IRS detection was low for a variety of reasons. The IRS was suffering from a limited staff, which reduced the number of tax audits its agents could conduct; transaction disclosure rules for tax reporting purposes were inadequate; and, as mentioned earlier, the tax shelter's complexity disguised its true nature. Second, several other financial institutions had already participated successfully in LILO transactions. Third, a "tax me if you can" culture seemed to prevail in the industry. Reliance upon corporate values should have guided the company past these influences, but "reality" didn't seem to intrude upon the decision to participate in the questionable tax shelter.

Honesty. XYZ also purports to conduct business in accordance with its stated value of "honesty" and that any action contrary to that value is dishonest and leads to failure. A quick review of the facts, however, demonstrates that XYZ executives did *not* act in accordance with the principle of honesty. They utilized a series of circular money movements to feign the payment of rent for the use of plastic manufacturing equipment, which the bank had absolutely no use for and got involved with for the sole purpose of obtaining tax benefits.

In addition, consider the nature of the U.S. federal income tax system. The IRS doesn't calculate each corporation's tax liability or send out bills in order to collect the amount owed. Instead, it trusts each corporation—and individuals as well—to take these actions on its own, voluntarily and based on existing law. By signing the tax return, a company executive declares that, under penalties of perjury, the return has been examined and to the best of his or her "knowledge and belief, it is true, correct, and complete." The signature is a declaration of honesty. A representative of XYZ signed the return purporting to have properly determined and paid the bank's taxes.

In the end, XYZ executives were guilty of performing the very act the company's values describe as contributing to failure: dishonesty.

The definition of honesty in *Webster's Dictionary* includes phrases such as "not disposed to lie, cheat, or steal," which implies freedom from fraud or deception. But, in fact, XYZ executives relied upon deception—including concealing the company's true identity—to secure their desired tax benefit. In the end, XYZ executives were guilty of performing the very act the company's values describe as contributing to failure: dishonesty.

Integrity. XYZ also professes to be an organization of "highest integrity," meaning that it won't compromise its core values for short-term benefits. Contrary to this, however, XYZ executives undermined the bank's stated values of reality and honesty when they engaged in the

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LILO structure, which ultimately did the company more harm than good. It lost all the tax benefits of the transaction and incurred interest on the delinquent taxes. Also wiped out were millions of dollars in fees to the foreign entity and its tax advisor. Finally, XYZ suffered enormous time and legal expense to unsuccessfully defend the transaction against the IRS, administratively and judicially.

Forcing a Higher Standard

In 1991, the U.S. Sentencing Commission enacted federal sentencing rules for organizations convicted of crimes. Since an organization itself can't be imprisoned, the rules imposed severe fines on those involved in or tolerating criminal activity within their ranks. The rules rewarded organizations that adopted ethical standards and compliance programs designed to prevent and detect crimes committed by corporate agents. These "rewards" came in the form of smaller fines, reduced sentences, and, in some cases, a lesser likelihood that prosecutors would initiate criminal proceedings. Not surprisingly, by the early 1990s more than 90% of all large corporations had adopted written ethical standards. Nevertheless, the decade that followed produced a number of corporate scandals, including those of Enron, WorldCom, and Tyco International, indicating that some companies adopted ethical rules merely for show to take advantage of government incentives without engendering real change in company culture.

Recognizing that you can't have a culture of compliance unless you also have a culture of ethics, in 2004 the federal government revised its sentencing guidelines in an attempt to create a new era of corporate compliance where organizations would focus on ethical behavior and being good corporate citizens. The new guidelines mandated the establishment of ethics codes and compliance programs that promote a culture of ethical conduct. (For more on this subject, see "The 2004 amendments to the federal sentencing guidelines and their implicit call for a symbiotic integration of business ethics" in the May 2006 issue of the *Fordham Journal of Corporate & Financial Law.*)

Also, in 2002 Congress enacted the Sarbanes-Oxley Act (SOX). SOX Section 406 specifically addresses the conduct of corporate executives and seeks to encourage better behavior and eliminate abuse. Companies are required to adopt a code of ethics applicable to senior financial officers that promotes compliance with governmental rules and regulations.

Obviously, the federal government has had to force corporate America into higher ethical standards through regulation. Sadly, though, new regulation becomes an unnecessary and unfair burden to honest executives, and it doesn't appear to reduce opportunities for abuse by less-than-honest corporate leaders. The ever-evolving tax shelter industry is a prime example of this phenomenon. For example, when the IRS shut down the LILO structure, shrewd tax practitioners quickly shifted to promoting SILO (sell-in/lease-out) transactions not prohibited under the new rules. As described by Jonathan Talisman, former Treasury Acting Assistant Secretary for Tax Policy, "Addressing tax shelters transaction-by-transaction is like attempting to slay the mythological 'Hydra.' You kill off one over here, and two or three more appear over there." It's therefore unlikely that regulation alone will alter the culture of tax abuse.

Moving Forward

A values-based code of conduct can be a valuable tool to a corporation, serving to guide its activities at the highest levels of the organization. Honest executives who respect and comply with a well-designed code can avoid the pitfalls of unethical activity and resist the temptation to participate in shady tax strategies. Senior executives who are free to ignore the corporate code of conduct will do so when it serves their purposes. For evidence of that, look no further than the case of XYZ Corporation and dozens of other companies.

Regardless of the existence of corporate codes of conduct or the government's efforts to regulate ethical behavior, the pattern of tax abuse can still thrive within an organization. Top-level executives need to commit themselves to act in accordance with the organization's ethical standards, like all other employees. A possible way to protect against the potential ethics failures of senior executives is to place oversight responsibility with the board of directors or a supervisory committee. For its actions to be truly effective, however, the oversight body *must* be given the power to take disciplinary action against the executive for ethics violations. As we've seen, if it doesn't, the government surely will. **SF**

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