Tax Evasion Overseas: Tip of the Tax Iceberg?

On April 3, the Wall Street Journal ran an article entitled CFTC Deals Out Royal Pain. The authors write that the Commodity Futures Trading Commission sued Royal Bank of Canada for committing fraud by executing a series of riskless transactions.

The authors indicate that the trades had some kind of nefarious purpose worthy of a criminal (fraud) suit. While the CFTC is empowered with overseeing commodities and futures trading, the tax enforcement in this instance really should fall under the jurisdiction of the Canadian government to protect Canadian taxpayers. Rather than focusing on tax evasion overseas, the CFTC and Securities and Exchange Commission would be surprised by the iceberg hiding along our shores.

If this had been a U.S. company executing a similar scheme, it would be addressed by the Economic Substance Doctrine (ESD) which was codified into law in 2010 as section 7701 of the tax code. This idea had been kicking around the tax courts for about 80 years and has frequently been invoked since then to deny tax shelters to individuals and legal entities trying to behave similarly to RBC. From the description provided by the WSJ, the RBC technique seems to involve a hybrid of a Tax Straddle (addressed in a G2 FinTech whitepaper published earlier this year) and a Dividend Farm.

A Dividend Farm is when you go long and short two securities with similar risk profiles to be able to convert ordinary income into qualified dividend income. Canada's tax rate on ordinary income is 29 percent plus an additional 10 percent to 19 percent 'provincial' tax – dividends are taxed at 19 percent. Therefore, it is desirable to convert one into the other. It seems clear that the Internal Revenue Service could have invoked either or both of these rules to disallow the preferential dividend treatment and furthermore penalize the entity for tax evasion should they feel that it was an issue of deliberate cheating rather than a misunderstanding.

The ESD states that if an entity executes transactions that have no net economic effect other than to avoid or defer taxes, the taxpayer must file their taxes as if they never executed those transactions. The RBC case clearly seems to demonstrate this, as the WSJ authors state that the effect on the parent entity was 'riskless.'

There are a number of ways to accomplish this using futures, Unit Investment Trusts, Index Options SWAPS and DDI bonds. If the CFTC was involved, at least one of the securities must have been listed futures. If dividends were also involved, the transactions involved were likely either actual stock positions or UITs (or some other ETF variation). Again, if a U.S. company tried to do this, there are already three areas of the tax code that clearly demonstrate this is unacceptable.

The ESD is the most recent of these laws, but the actual text of the Bush Tax Cuts in 2003 also would have clearly forbidden a U.S. entity from pulling off the same trick. The text specifically denies preferential dividend treatment when there is diminished risk of loss. You can't get much more diminished than 'riskless.' The IRS could have used this text in tax court to show that a U.S. entity cannot buy stocks and short futures to convert 1256 gains (gains on futures) into qualified dividends.

Also, the IRS could go back to the 1981 ERTA law to demonstrate that the super-entity was effectively engaging in a 'cash-and-carry' straddle. This kind of straddle is one of the many variations of the now-outlawed 'Tax Straddle,' which was popular in the 1960s and 1970s. This means that not only would the dividends have been denied qualification for preferential tax treatment, but the entity would also be wide open to huge taxable short term gains without being able to deduct their offsetting losses. This is a taxable disaster as far as the taxpayer is concerned.

The RBC strategy could never work in the U.S. as long as the IRS is keeping a watchful eye on trading strategies of this nature and their tax implications. The IRS is using increasingly sophisticated software each year to detect and shut down anything that even remotely resembles a riskless transaction.

Also, keep in mind that even if the intent was to take risk, the IRS takes the position that if it appears to be riskless, the tax shelter laws kick in and the deduction is denied. This now puts the onus on the taxpayer to not only behave properly but also to appear to behave properly.

Fortunately, there are some great new tools out there that can help your business avoid being splashed across the WSJ the next time the IRS goes out hunting. Good luck.

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