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Tax evasion abroad: Tip of the tax iceberg for compliance?

Apr 23 2012 George Michaels

The Commodity Futures Trading Commission recently brought a legal action against the Royal Bank of Canada (RBC) for committing fraud by executing a series of riskless transactions. It is not likely these transactions could get past the watchful eyes of the U.S. Internal Revenue Service, but can compliance officers in U.S. firms spot them?

In news accounts about the lawsuit, commentators indicate that the RBC 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 outside of the United States, the CFTC and Securities and Exchange Commission would be surprised by the iceberg hiding right at home.

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 been invoked frequently since then to deny tax shelters to individuals and legal entities trying to behave similarly to RBC. From the description provided by news accounts, the RBC technique seems to involve a hybrid of two techniques used in futures and options trading to create tax benefits by postponing capital gains – the tax straddle and the dividend farm.

Focusing on the latter technique, a dividend farm is when you go long and short two securities with similar risk profiles so as 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. It is desirable, then, 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 then penalize the entity for tax evasion if they felt there was an issue of deliberate cheating here, rather than just 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, and the effect on the parent entity was "riskless."

There are a number of ways to accomplish the deferment or avoidance of taxes by using futures, unit investment trusts (UITs), index options swaps and certain bonds. If the CFTC was involved, at least one of the securities must have been listed as futures. If dividends were also involved, the transactions involved were likely either actual stock positions, UITs, or some other electronic trust fund variation.

There are laws against those activities

Again, if a U.S. company tried to do this, there are three areas of the tax code that demonstrate this is unacceptable. The ESD is the most recent of these laws, but the actual text of the Bush Tax Cuts of 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 a diminished risk of loss. You cannot 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 1,256 gains (gains on futures) into qualified dividends.

Also, the IRS could go back to the Economic Recovery Tax Act (ERTA) of 1981 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 to avoid capital gains taxes. 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 can never work in the United States 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.

What compliance professionals can do

Transactions that involve complex derivatives that are done with no apparent economic substance should be suspicious. Of particular interest are trades done with derivatives where the counterparty is a subsidiary firm. These should be reported to the firm's chief compliance officer, and the CCO should be on the lookout for these red flags.

Also, keep in mind that even if the intent was to take risk, the IRS takes the position that if the transaction 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.

Ignorance is no excuse in the eyes of the IRS. Conspiracy to commit fraud is a serious offense. In the wake of Enron, compliance officers and CEOs should be wary of engaging in this kind of tax strategy.

Fortunately, there are some new tools out there that can help a business avoid being splashed across a national newspaper the next time the IRS goes out hunting.

The first step that compliance professionals must take is to research what technologies are out there that help address taxable adjustments. Secondly, they need to understand which tax shelter-laws pose the greatest risk of circumvention for them, based on the complexity and volume of the investments they are making. Finally, compliance professionals must remember that the IRS is using more sophisticated technology now than ever to detect and measure these transactions, so there is no such thing as a "riskless" one in the eyes of the IRS.

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