IRS Setbacks in Court Rekindle Debate About Need for Tax-Shelter Legislation

By Tom Herman
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Several courtroom defeats suffered by the Internal Revenue Service in recent months are rekindling debate about the need for new legislation to combat corporate tax shelters.

At stake are billions of dollars. Advocates of new legislation say the IRS's recent losses will embolden corporate executives, prompting them to embrace more types of exotic shelters.

The latest courtroom defeat came late last month when a federal appeals court ruled in favor of a complex tax maneuver used by **Compaq Computer** Corp. Other government setbacks include tax cases involving **United Parcel Service** Inc., **American Home Products** Corp. and a company that now is a unit of **Alliant Energy** Corp.

New-legislation advocates say Congress needs to draw brighter lines between legitimate transactions and outrageous "shelters" with no real business purpose other than to dodge taxes. But drawing those lines has proved enormously difficult in the past and business groups fear any new congressional attempts might overreach, torpedoing legitimate transactions. What's more, critics of new legislation note that the government also has won several major corporate tax-shelter battles, including cases involving **Colgate-Palmolive** Co., **Winn-Dixie Stores** Inc. and AlliedSignal, which combined with **Honeywell International** Inc. in 1999.

The Bush administration isn't expected to propose any new antishelter legislation in the president's budget to be released in early February. Mark Weinberger, assistant Treasury secretary for tax policy, has emphasized vigorous IRS enforcement on a case-by-case basis and new government rules—as opposed to new legislation—to flatten egregious shelters. Late last month, the IRS also agreed to waive the customary penalties if businesses disclose tax shelters and other "questionable items" by April 23.

"There's often a very fine line between taking a legitimate position to reduce your taxes and crossing over that line into a gray or illegal area," Mr. Weinberger says. "You can't legislate away every difficult factual issue."

But one judge's idea of a sham can be another judge's idea of a legitimate tax-saving technique. "It's very difficult to draw the line with an objective definition," says David Hariton, a tax partner at Sullivan & Cromwell in New York. "Courts will always have to decide what is and is not a tax shelter."

In the case of Compaq, the computer maker bought and sold American deposi-

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tory receipts, or ADRs, of **Royal Dutch Petroleum** Co., generating foreign tax credits for Compaq. (ADRs trade in U.S. markets but represent shares of foreign companies.) The Tax Court, based in Washington, said the maneuver lacked "economic substance." The U.S. appeals court for the Fifth Circuit disagreed.

Congress later passed legislation curtailing the type of tactic used by Compaq and others. Still, Timothy J. McCormally, executive director of Tax Executives Institute, a Washington-based corporate tax group, called the appeals-court decision in the Compaq case "significant" because it marks the fourth time in recent months that the IRS's "assault on tax shelters has been rebuffed." The Compaq decision and other recent cases signal that "it is not enough to assert that the company structured a transaction to minimize its tax liability," he says.

decision, adding: "We always believed our position was sound and within the law and would ultimately prevail in the courts."

Fighting tax shelters was a hallmark of the Treasury Department during the Clinton administration. The administration proposed legislation that officials said would have made it tougher for many types of transactions with no real business purpose to pass muster. That legislation also was designed to encourage greater disclosure by companies and increased penalties on offenders. "Combating abusive tax shelters is perhaps the biggest challenge facing our tax administration system today," then-Treasury Secretary Lawrence Summers said late in 2000.

But how to define a shelter? Perhaps the most widely quoted definition is a quip by Yale Law Professor Michael Graetz: "A deal done by very smart people that, absent