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Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals

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Summary

Several bills introduced in the 108th Congress have included revenue-raising provisions, particularly those aimed at tax shelters that are generally used by corporations. Anti-sheltering provisions were included in bills introduced by Representative Lloyd Doggett (whose current bill is H.R. 1555), in the Senate version of the 2003 tax cut (H.R. 2), in the Senate version of the Care Act (S. 476), and most recently in both the House (H.R. 2896) and Senate (S. 1637) reported versions of bills which eliminate the extraterritorial income provision (ETI)–which has been found to contravene World Trade Organization (WTO) restrictions on export subsidies–and provide other tax cuts and have been reported from their respective committees. The number and size of the revenue-raising provisions are much greater in S. 1637 ($56 billion over a 10-year period) than in the H.R. 2896 ($26 billion). The Senate bill is revenue neutral overall, while the House bill loses revenue over the period FY2004-FY2013.

Several types of revenue increases in S. 1637 and H.R. 2896 include (1) generic anti-shelter provisions (including increased penalties and, in the case of the Senate bill, changes in the economic substance doctrine), (2) provisions related to corporate inversions and expatriations, and the associated earnings stripping, (3) other provisions targeted at specific tax abuses, (4) provisions that involve explicit changes in tax policy, and (5) fees. Fees (basically customs fees), are actually the single largest revenue producers and account for about 30% of the gain in the Senate bill and 60% of the gain in the House bill.

The Senate bill's largest revenue raiser outside of customs fees is a codification and strengthening of the economic substance doctrine which is used to determine when an activity's tax benefits are denied because they are aimed solely at tax sheltering. This provision is one that has attracted relative controversy, with proponents arguing that is a crucial tool in the battle against corporate tax shelters and opponents suggesting it will not be effective and will adversely affect ordinary transactions.

Inversions occur when U.S. firms move the parent corporation abroad to reduce taxes, often accomplished by earnings stripping methods where domestic income is shifted abroad. The Senate bill has more stringent provisions directed to U.S. inverted firms; the House bill has generic earnings stripping provisions that apply to all U.S. subsidiaries of foreign parents.

A number of specific anti-shelter provisions are included in the bills, some of them arising from the investigation of the Enron failure or from other issues raised by failed firms. There are also some explicit tax policy changes which relate primarily to deferred compensation in the House bill, but touch on a variety of other areas in the Senate bill.

Contents

List of Tables

Anti-Tax-Shelter and Other Revenue-Raising Tax Proposals

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This report is an overview of the revenue raising provisions in H.R. 2896 and S. 1637. It includes a brief discussion of some of the larger revenue raising provisions, although the reader is directed to the Committee reports (108-393 for the House bill and 108-292 for the Senate) for more detailed descriptions.

The bills have numerous (and complex) provisions, many of which have minor consequences. To provide an overview, only provisions raising $100 million or more of revenue over 10 years will be discussed. **Tables 1** and **2** list these provisions in order of descending revenue gain. **Table 1**, containing the House provisions, lists 17 measures while **Table 2**, containing the Senate provisions, lists over twice as many measures.

To begin the discussion, it is helpful to organize the provisions into basic categories. The five categories (in the order in which they will be discussed) are (1) generic anti-shelter provisions, (2) provisions related to corporate inversions and expatriations, and the associated earnings stripping, (3) other provisions targeted at specific tax abuses, (4) provisions that involve explicit changes in tax policy, and (5) fees. Fees (basically customs fees) are actually the single largest revenue producers and account for about 30% of the gain in the Senate bill and 60% of the gain in the House bill.

Table 1: Revenue Raisers in H.R. 2896 Raising $100 million or more FY2004-FY2013, in Millions of Dollars

Provision	Revenue Gain
1. Extension of customs fees	16,916
2. Earnings Stripping	2,726
3. Tax Shelters: Penalties for Non-Reporting	1,559
4. Small property and casualty companies	1,179
5. Non-qualified deferred compensation	800
6. Corporate inversions	450
7. Mismatching of items with related corporations	444
8. Basis reduction for partnerships	364
9. Extension of IRS user fees	345
10. Individual expatriations	327
11. Extension of provision allowing DB plan transfers	298
12. Like-kind exchange for residences	171
13. Clarification of banking business	154
14. Estimated taxes on deemed asset sales	123
15. Exclusion of interest on overpayments	115
16. Prepayment of interest on underpayments	101
17, Limit on transfer of losses on REMIC residuals	100

Source: Joint Committee on Taxation, JCX-95-03, October 24, 2003.

Table 2: Revenue Raisers in S. 1637 Raising $100 million or more FY2004-FY2013 (In Millions of Dollars)

Provision	Revenue Gain
1. Extension of customs fees	17,139
2. Economic substance doctrine	13,322
3. Charitable contributions of patents	3,851
4. Intangibles, broader application of rules	3,291
5. Corporate inversions	2,747
6. Built in losses	1,800
7. Tax shelters: penalties for non-reporting	1,559
8. Qualification rules (tax exempt and casualty insurance)	1,273
9. Increase age limit for section 1(g)	1,180
10. Repeal rehabilitation credit, non-historic buildings	1,013
11. Private debt collection	973
12. Disallowance of interest on convertible debt	891
13. Lease term to include service contracts	864
14. Disallowance of partnership loss transfers	705
15. Establish specific class lives for utility grading costs	701
16. Individual expatriation (mark to market)	700
17. Lessors to tax exempt entities	519
18. Mismatching of items with related corporations	444
19. Extend IRS user fees	386
20. Basis reduction for partnership	368
21. Denial of deduction for punitive damages	333
22. Earnings stripping applied to Subchapter S and individuals	244
23. Straddle rules	230
24. Installment sale treatment	215
25. Denial of deduction for fines	191
25. Non-recognition of gain in liquidation	189
27. Like-kind sales of residences	171
28. Clarification of banking business	166
29. Estimated tax on deemed assets sales	123
30. Expanded authority to disallow benefits under Section 269	108
31. Modification of CFC/PFIC rules	106
32. Deposits to stop interest running on underpayments	101

Source: Report of the Committee on Finance, To Accompany S. 1637, Report 108-292.

General Anti-Shelter Provisions

The term "tax shelter" is not easily defined and the usage of the term varies. Sometimes it refers to any method of shielding income from tax including provisions that were explicitly adopted by Congress as incentives. Sometimes it refers to practices that meet the letter of the law (often by combining provisions in different parts of the tax code) but are unintended by the law. In some cases, they are activities that do not clearly meet the letter of the law. The provisions in the tax bills are largely aimed at what might be called "abusive" tax shelters – activities set up to take advantage of the strict letter of the law but whose purpose is to avoid taxes rather than engage in any meaningful economic activity, and whose benefits were not intended by Congress.

Tax shelters today are different from those that attracted attention in the 1970s, and the legislation enacted to address those shelters does not address today's shelters.[1] Most of the earlier tax shelters were in real estate or some other type of physical investment (oil and gas, farming) and involved limited partnership interests in highly leveraged assets which benefitted from both interest deductions and deductions for accelerated depreciation (or other deductions for costs). Before generic anti-shelter provisions directed at this type of shelter were enacted, a high income taxpayer could take deductions many times his actual investment as his claim to deductions (or his basis) included not only the amount financed by his cash investment but also any associated debt (for which he would not be personally at risk). These shelters were largely sold to high tax rate individuals. A series of law changes (slowing depreciation, lowering tax rates, and enacting limits on deductions through at-risk rules and passive loss restrictions) and economic changes (a decline in inflation and in interest rates) have made those shelters obsolete.

Today's tax shelters do not follow a consistent pattern and they are highly varied.[2] They are largely corporate shelters. Often, they do not involve investments in real assets but rather in financial instruments that are highly liquid, held for a short period of time, and structured to avoid risk. One paper discussing a court case referred to the underlying stock asset held by the company "which, under a charitable view of the facts, it owned for an hour."[3] This case was a dividend stripping case where a tax exempt entity owned stock in a foreign firm and could not use foreign tax credits; the entity arranged to sell a block of stock to a taxable firm just before the dividend was paid; the taxable firm then sold the stock at a loss (because it was worth the original price less the dividend) which wiped out the taxable income but left the firm with a foreign tax credit attached to the dividend.

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[1] For a discussion of old and new style tax shelters and their interaction with "at risk" rules, see James Whitmire and Bruce Lemons, "Putting Tax Shelters at Risk – Discussion and Proposal for Change," *Tax Notes*, Jan. 27, 2003, pp. 585-596.

[2] See Gerald R. Miller, "Corporate Tax Shelters and Economic Substance: An Analysis of the Problem and Its Common Law Solution," *Texas Tech Law Review*, vol. 34, 2003, pp. 1015-1069 for a discussion of some of the common features of tax shelters.

[3] Daniel Shaviro, "Economic Substance, Corporate Tax Shelters, and the COMPAQ Case," *Tax Notes*, July 10, 2000, p. 222.

The general objective of most tax shelters is to generate tax deductions, often by contriving to increase the basis of the taxpayer in assets, or to shift losses or deductions from tax indifferent parties (those not subject to U.S. tax such as foreign corporations or tax exempt organizations) to taxable parties. Tax shelters may take advantage of the flexibility allowed to partnerships in allocating income and assets, may take advantage of related parties that are incorporated abroad and not subject to current U.S. tax, may involve leasing arrangements to tax exempt organizations, and have even involved firms' buying life insurance on its rank and file employees (so-called "janitors" insurance).[4] Some of the shelters are put together by promoters who then sell them to firms, including prestigious accounting firms and financial institutions. (Some accounting firms have indicated that they have closed these operations.)[5]

Measuring the amount of revenue lost from tax shelters is difficult, although some data suggest that the loss is substantial. The role of tax shelters is especially difficult to monitor since these shelters may lead to mismeasurement of pre-tax profits and make their magnitude difficult to detect. Several studies comparing book and tax income have noted the widening gap between the two that cannot be explained by the traditional measures of depreciation, stock options, and foreign source income retained abroad. A study by Desai found $155 billion of unexplained discrepancies in 1998,[6] implying lost taxes that could be up to $54 billion (at a 35% tax rate). This amount could be lower because some firms are operating at a tax loss, some firms do not pay the top marginal tax rate, and some firms have unused credits. But the amount is significant.

Some of this gap between book and taxable income was due to intended tax benefits, and examining tax expenditures–which measure the revenue cost of explicit special tax deductions, exclusions, and credits not considered to be part of a normal income tax–may help to adjust for that effect. Our calculations suggest that about $23 billion of such a gap would be attributable to tax expenditures.[7] While there are

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[4] See CRS Report RS21498, *Corporate-Owned Life Insurance: Tax Issues*, by Don Richards, for a discussion.

[5] See Sheryl Stratton, "KPMG Skewered at Senate Shelter Hearing," *Tax Notes*, Nov. 24, 2003, pp. 942-946.

[6] Mehir Desai, "The Corporate Profit Base, Tax Sheltering Activity and the Changing Nature of Employee Compensation," National Bureau of Economic Research Working Paper 8866, April 2002.

[7] In the same year that Desai estimated the $155 billion gap, the projected tax expenditures for corporations were about $72 billion according to the Joint Committee on Taxation. Almost half of this amount ($33.5 billion) was due to accelerated depreciation, largely for equipment (and including expensing of research and development, or R&D, costs), which Desai accounted for. Another $1.2 billion was retained earnings of controlled foreign corporations, which he also accounted for. (These earnings are profits of subsidiaries of U.S. firms incorporated under the laws of foreign countries and not paid as dividends to the U.S. parent company). If one also eliminates $2.5 billion for tax deductions for charitable contributions which were probably deducted as a book expense, $4.2 billion lost because of graduated tax rates, and $7.6 billion of credits, the remaining tax expenditures account

(continued...)

many possible errors in calculating these effects, there nevertheless appears to be significant potential for a relatively large size of unintended corporate tax base reductions given the potential size of the book tax difference discovered by Desai. Of course, not all of these differences represent illegal, or even abusive, tax shelters. For example, there are certain types of preferred securities that are treated as debt for tax purposes but as equity for book purposes, whose treatment for tax purposes has been tested in court.

The general scope of this potential loss (i.e. a discrepancy of up to $54 billion reduced by $23 billion leaving a potential of $31 billion unaccounted for) accommodates estimates made by a Internal Revenue Service (IRS) contractor and reported in a GAO study that suggested a loss from abusive tax shelters of $13.6 to $17.3 billion for that same year.[8] This study also reports an IRS database covering the period 1989-2003 with a cumulative estimate of $85 billion. Additionally, the study explains the efforts that IRS has been making to address these abusive tax shelters, including listing specific transactions it found to be illegal and requiring disclosure.

Setting aside the explicit provisions adopted by Congress, tax sheltering activities raise two types of challenges for tax administration–and anti-shelter legislation addresses one or both of these issues. First, in order for the IRS to collect taxes avoided illegally, it is necessary to detect the tax shelters. Because of the complexity of these operations, the elements of the tax shelter may be buried in other deductions. IRS has engaged in an aggressive enforcement program against tax shelter operations, including requiring disclosure of shelters. The penalties for non-disclosure, included in both bills, are designed to provide more incentives to comply with disclosure rules. Secondly, when a tax activity technically meets the statute, it may nevertheless be disallowed in the courts under certain doctrines of common law. These doctrines include examining the activity to determine if it is a sham transaction, if it has no economic substance, and/or if it has no business purpose. A provision clarifying and codifying the economic substance doctrine is included in the Senate bill and is the largest revenue raiser after customs fees in that bill (although there is some uncertainty about the amount of revenue that might be raised).

Penalties for Non-Disclosure and Other Purposes

New initiatives and Treasury regulations require taxpayers to report information about certain categories of "reportable transactions" which include those that are similar to tax transactions already disallowed, those offered under conditions of confidentiality, those contingent on tax treatment, those generating losses of a certain size, those where tax treatment differs from book treatment, and those resulting in a significant tax credit while being held a short period of time. There are no specific penalties for not reporting these transactions, and both H.R. 2896 and S. 1637 impose

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[7](...continued)
for about $23 billion.

[8] *Internal Revenue Service: Challenges Remain in Combating Abusive Tax Shelters*, Statement of Michael Brostek, General Accounting Office, before the Senate Finance Committee, Tuesday, October 21, 2003.

a penalty on failure to provide required information on reportable transactions (items 3 in **Table 1** and 7 in **Table 2** respectively); this provision accounts for the bulk of the $1.6 billion in revenue gain from penalties, although there are some changes in other penalties. Some critics have objected to certain aspects of the penalty provisions, including the flat rate shelter disclosure penalty that applies regardless of whether the taxpayer's position is upheld and a new higher penalty on understatement that applies to transactions lacking economic substance in the Senate bill (because of uncertainty regarding the definition of economic substance).[9]

Economic Substance Doctrine

The provision in the Senate bill codifying the economic substance doctrine is the largest revenue raiser in the Senate bill after customs fees, accounting for $13.3 billion over 10 years.

As noted above, even when transactions meet the letter of the tax law, tax benefits may be disallowed by the courts if the activity is found to be a type of sham transaction; in the particular case of tax shelters the related issues of economic substance and/or business purpose are often used.[10] That is, if an activity does not have economic substance and/or there is no business purpose, the tax benefits are disallowed. The Senate bill recognizes these doctrines in the tax law itself and provides a number of specific guidelines. For example, if the court finds the economic substance doctrine to be relevant, the bill provides that the taxpayer must meet both the objective test of economic substance *and* the subjective test of having a non-tax business purpose to keep the tax benefit. Requiring both is referred to as a conjunctive rule, while requiring either is referred to as a disjunctive rule. The objective is to strengthen the rule and to bring more uniformity to court decisions. Some court cases have required both aspects to be met and others only one. The bill also sets out specific rules for determining when the taxpayer meets the economic substance test through demonstrating profit potential, by requiring that the return outside the tax benefits exceed the riskless rate of return; it also provides that the transactions must be a reasonable means of achieving the business purpose.

The purpose of the provision regarding economic substance (according to the Committee report) is:[11]

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[9] See letter written to Chairman William F. Thomas by Andrew Berg, Tax Section, New York State Bar Association, September 24, 2003, reprinted in Tax Notes, October 20, 2003, pp. 401-403. See also the letter to Chairman Thomas and Grassley on the economic substance doctrine dated August 5, 2003 posted on the Tax Executive's Institute web site, http://www.tei.org/codify03.html (visited December 16, 2003).

[10] For a general background on the economic substance doctrine see Joseph Bankman, "The Economic Substance Doctrine," *Southern California Law Review*, vol. 74, Nov. 2000, pp. 5-30; Miller, "Corporate Tax Shelters and Economic Substance," op. cit, and Martin J. McMahon, Jr. "Economic Substance, Purposive Activity, and Corporate Tax Shelters," *Tax Notes,* Feb. 25, 2002, pp. 1017-1026.

[11] Senate Report 108-192, to accompany S. 1637, p. 85.

> The Committee is concerned that many taxpayers are engaging in tax avoidance transactions that rely on the interaction of highly technical tax law provisions.

And the report goes on to add in a footnote:

> These transactions usually produce surprising results that were not contemplated by Congress. Whether these transactions are respected usually hinges on whether the transaction had sufficient economic substance. The Committee is concerned that in addressing these transactions the courts, in some cases, are reaching conclusions inconsistent with Congressional intent. In addition, the Committee is concerned that in determining whether a transaction has economic substance, taxpayers are subject to different legal standards based on the circuit in which the taxpayer is located. Thus, the Committee believes it is appropriate to clarify for the courts the appropriate standards to use in determining whether a transaction has economic substance.

There has been a great deal of controversy about the economic substance doctrine legislation. While the proposal is in the Senate bill, it is not in the House bill. It is opposed by Treasury officials in the current Bush administration. Many firms, practicing tax attorneys, and tax executives in businesses have objected to the provision, both individually and formally through organizations such as the Tax Executives Institute, the Tax Section of the American Bar Association and the Tax Section of the New York State Bar Association.[12]

At the same time, there is much support for the codification of the economic substance doctrine, in addition to the position taken by the Finance Committee. The Clinton administration supported the bill, and Chairman Thomas's 2002 bill in the 107th Congress (H.R. 5095) included an economic substance provision. There are a number of attorneys and law professors who have taken the view that codification of the economic substance doctrine, as in the Senate provision or with some modification is advisable and even necessary to stem the tide of tax shelters.[13]

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[12] Pamela Olson (at her nomination hearings for Assistant Secretary of Treasury for Tax Policy) commented on economic substance in answer to a question at a hearing; these comments are reported in Samuel C. Thompson Jr. and Robert Allen Clary 11, "Coming in from the Cold: The Case for ESD Codification" *Tax Notes*, May 26, 2003, pp. 1270-1274. See also, as noted above, the letter on the economic substance doctrine posted on the Tax Executive's Institute web site, http://www.tei.org/codify03.html (visited December 16) and the April 24 letter to Chairman Grassley and Ranking Member Baucus posted on the American Bar Association's Web site http://www.abanet.org/tax/home.html (visited December 16, 2003). See also New York State Bar Association Tax Section, "Economic Substance Codification," *Tax Notes*, June 23, 2003; Peter L. Faber, letter to the Chairman Thomas, reprinted as "Practitioner to Congress: Don't Try to Codify Economic Substance, *Tax Notes*, Oct. 21, 2002, pp. 423-424; James M. Peaslee, letter to the Finance Committee, reprinted as "More Thoughts on Proposed Economic Substance Clarification," *Tax Notes*, May 5, 2003, pp. 747-750, May 5, 2003.

[13] Lawrence M. Stone, Letter to Chairman Thomas, reprinted as "Congress Should Codify

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In general, the arguments for codification in these discussions and commentary include the need to take more aggressive action to stem the tide of tax shelter cases, since a stricter rule would change the cost-benefit calculus faced in this area and strengthen the position of the tax authorities. The argument is also made that in the face of aggressive tax sheltering, even compliant taxpayers will be pressured into these activities unless Congress (or the Supreme Court) takes action to clarify economic substance. Moreover, in addition to creating more conformity in court decisions, putting the doctrine into the code would allow the Treasury to write more detailed regulations.

The criticisms of the proposal include both criticisms of any codification of the economic substance doctrine, as well as the particular ones used in the provision. Pam Olson, answering a question at her nomination hearing as Assistant Secretary of Treasury for Tax Policy,[14] made the case against codification roughly as follows: such an approach is too wooden and rigid (not flexible enough), it will be both too broad (presumably covering unintended transactions) and too narrow (presumably leaving ways for individuals to get around the rules), and that it will increase complexity for the IRS and slow audits. In general, in the discussion by many of the critics several themes emerge. One is that the courts are the proper place to adjudicate complex technical issues. Another is that the legislation as written would also be applicable to perfectly common transactions that have long been occurring and whose benefits are intended by the Congress–even ordinary actions like electing Subchapter S (a small corporation electing to be taxed as a partnership) or incorporating a foreign branch operation (which allows deferral of U.S. tax on active income). Critics also argue that the new language will still have significant ambiguities that would require adjudication and that designers of shelters will simply devise new ways to get around the rules.

Supporters have written rejoinders, for example suggesting that too much flexibility is the underlying problem with tax shelters and that more rigid rules are needed, and that clearer rules would simplify IRS administration and enforcement. The rejoinders also argue that the claims about interference with ordinary accepted transactions are greatly exaggerated: the Committee report makes it clear that the intent is not to deny deliberate benefits bestowed by Congress, and that the legislation applies only to cases where the court decides economic substance is an issue. They also point out that the tax authorities would not press cases of this nature in any event.

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[13](...continued)
Economic Substance," in Tax *Notes*, November 18, 2002; Samuel C. Thompson Jr. and Robert Allen Clary 11, "Coming in from the Cold: The Case for ESD Codification" *Tax Notes*, May 26, 2003, pp. 1270-1274; Terrill A. Hyde and Glen Arlen Kohl, "The Shelter Problem is Too Serious Not to Change the Law," *Tax Notes*, July 7, 2003, Pp. 119-122; Lawrence Stone, "Economic Substance Codification: Naysayers Can Help Make it Work," *Tax Notes*, Aug. 4, 2003, pp. 730-731. A paper supporting the general notion is Martin J. McMahon, "Economic Substance, Purposive Activity, and Corporate Tax Shelters," op cit.

[14] Reported in Thompson and Clary, "Coming in from the Cold," op. cit.

Corporate Inversions, Earnings Stripping, and Expatriation

Anti-tax sheltering provisions include provisions that are directly related to an activity called corporate inversion and also provisions dealing with individual expatriates (individuals who change residence or renounce citizenship to avoid U.S. tax). The provisions discussed in this section are items 2, 6 and 10 in **Table 1** and items 5, 16 and 22 in **Table 2**.[15]

Corporate inversion occurs when a U.S. company sets up a foreign incorporated firm to become the parent corporation (and the current U.S. firm now becomes the subsidiary corporation). This inversion confers two related tax advantages: avoiding tax on foreign earnings and earnings stripping which allows a reduction of tax on domestic earnings.

First, any income earned abroad would be beyond the ambit of the U.S. tax system. Foreign subsidiaries of U.S. parent companies are subject to tax on certain types of passive income even if not paid back to the U.S. parent (this income is called Subpart F income), and the U.S. is stricter than many other countries in taxing this income. However, income of foreign subsidiaries of a foreign parent company (and the parent company's income) is not subject to this tax (even if the shareholders are U.S. citizens). Thus an inversion would permit a company to avoid the tax on passive earnings of foreign operations. (The tax on active earnings does not apply in any case until the income is repatriated as a dividend. Note also that the tax avoidance matters in countries that have no taxes or low taxes where foreign tax credits cannot be used to offset the additional U.S. tax).

The second advantage is that setting up the firm with a foreign parent allows more scope for reducing tax on U.S. source income by allowing the U.S. subsidiary to rely heavily on debt held by a foreign related company. Interest is deductible and while interest paid to a related foreign corporation is subject to a withholding tax, tax treaties often eliminate or greatly reduce that withholding tax. Some inversion operations are set up with three related firms: the U.S. firm, the new foreign parent firm in a country without a treaty, and another subsidiary in a country with a treaty to receive and transmit the interest payments. Reducing U.S. tax with debt or other deductible payments to related firms is referred to as "earnings stripping" and it is an issue not just with inverted firms, but with U.S. subsidiaries of foreign parent firms in general. Because of the potential for abuse, the current tax code has a restriction on deductibility of interest for thinly capitalized U.S. firms (with more than 60% of assets held in debt and with more than 50% of earnings paid in interest).

The tax benefits of inversions are limited by the possibility that stockholders will pay individual capital gains tax on the appreciation that occurred from the time they purchased the stock to the time of the inversion. However, increasingly large

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[15] See also CRS Report RL31444, *Firms That Incorporate Abroad for Tax Purposes: Corporate "Inversions" and "Expatriation,"* by David Brumbaugh for further discussion.

shares of stock are held in tax exempt form (e.g. pensions, IRAs) and the capital gains tax rate is relatively low (currently only 15%).

Individuals can also act to limit their tax liability by changing their citizenship to a low tax country.

The responses to these issues vary across bills. Under H.R. 2896 the general earnings stripping rules would be tightened (item 2 in **Table 1**) by dropping the asset share test (i.e. disallowing interest based only on the interest as a share of income) and lowering the interest share (to 25% for ordinary debt and 50% for guaranteed, or 30% overall). This provision, which has a broader scope than on firms with inversions, would raise much of the $3.5 billion revenue gain for 2004-2013 in this area – $2.726 billion. H.R. 2896 has some provisions focused directly on inversions as well (item 6) which would prevent use of foreign tax credits or net operating losses from offsetting taxes on inversion transactions (this and other items are grouped in item 5). It would also impose a 15% excise tax on stock options related to inversions. The limits on credits and loss offsets raise about $340 million and the stock option tax $78 million. There are also small gains from a provision to require reporting of mergers and acquisitions and to allocate items for reinsurance contracts.

The other significant revenue raiser in this group is a $327 million provision imposing taxes on expatriate individuals (item 10 in **Table 1**). U.S. citizens or residents are taxed on worldwide income (but are allowed a foreign tax credit for taxes paid on foreign source income); nonresidents who are not citizens are subject to a 30% withholding tax that may be lowered or eliminated through a tax treaty. Individuals who renounce citizenship or residency for the purpose of avoiding tax must pay tax on U.S. source income at ordinary tax rates, if they exceed certain thresholds with respect to tax liability in the past and assets. H.R. 2896 replaces this subjective determination of intent with an objective test based on prior taxes paid and assets.

S. 1637 focuses on inverted firms and does not alter the general earnings stripping rules. The inverted firms provisions (item 5 in **Table 2**) would tax inverted firms as if they were domestic firms if 80% of the new foreign parent is owned by former shareholders of the U.S. firm (for inversions occurring after March 20, 2002 and where the company had no existing substantial interest in the foreign country). For other inversions, a "toll" tax equal to the top corporate (or individual, in the case of a partnership) rate would be imposed (and could not be offset by foreign tax credits or carryover of net operating losses). For earnings stripping, S. 1637 has provisions that eliminate the asset test and reduce the interest share test to 25% but the bill applies these stricter rules only to inverted corporations. These provisions together account for $2.6 billion over FY2004-FY2013. In additional revenue provisions added to the bill, there is a 20% excise tax on stock options linked to the inversion and an extension of earnings stripping rules to Subchapter S corporations (corporations taxed as partnerships) and partnerships and strengthens them for inverted corporations. Individual expatriates would be taxed immediately under a mark to market rule (i.e. the individual must pay tax as if he or she had sold the asset).

Overall, the House bill focuses much more heavily on general revenues from tightening the earnings stripping rules for all corporations, and is less targeted to inverted companies, while the Senate bill has much stricter tax provisions for inversions and does not contain a general provision for earnings stripping. The Senate bill's provision for individual expatriates requires an immediate tax on accumulated gain from assets through a mark to market provision.

Specific Provisions Aimed at Shelters

This section discusses specific provisions that are aimed at practices that appear to require a legislative remedy but may still be thought of as tax shelters. They vary in the fundamentals, but as one can see from the following discussion, many of them involve transactions, sometimes between related parties, where one party is exempt from the U.S. tax and the other is not. Arrangements involve ways of reducing taxable income by increasing debt (since interest is deductible) as in the case of earnings stripping, increasing basis (the part of an asset's price that is exempt when the asset is sold), increasing other deductions, or excluding or reducing income. The following discussions are brief explanations; the reader is directed to the committee reports for more detailed information. They are arrayed from highest to lowest revenue gain.

The Senate bill also singled out certain provisions as relating to Enron – a report by the Joint Committee on Taxation investigating Enron uncovered some of the methods used to avoid taxes. When provisions fall into these categories, they will be noted.

Built in Losses

This largest of the provisions in this section in projected revenue gains ($1.8 billion) arose from the Enron investigation, and is only in the Senate bill. It addresses the situation when firms or other parties exchange assets for stock and control the corporation after the exchange; under current law this is a tax free transaction, that is, no gain or loss is recognized. If one party to the exchange is an exempt foreign entity and the asset has a loss (i.e. basis, that is, the amount deducted on sale, is above market value), and the U.S. corporation takes the foreign party's basis, the domestic taxable firm can benefit from this transaction (because when the asset is sold, a loss will be recognized). The proposal would require basis to be fair market value in these cases.

Property and Casualty Insurance Companies

This item is included in both bills (item 4 in **Table 1** and 8 in **Table 2**) and raises about $1.2 billion. It basically addresses a provision that has been in the tax law for a long time that allows tax exemptions for very small property and casualty companies. These firms are entirely tax exempt if they receive less than $350,000 in premiums. They are taxable only on investment income if premiums are less than $1 million. This provision had been used to exempt large amounts of investment income by setting up a firm with nominal premiums but huge investment reserves.[16] The new provision requires more than 50% of gross receipts from premiums to be eligible for these tax benefits; the House bill also raises the exemption level for firms that do qualify.

Disallowance of Interest on Convertible debt

This provision is also an Enron-related one, and is only in the Senate bill; it raises about $900 million. Under present law interest including original issue discount (the difference between issue cost and face value of a security on maturity, which is equivalent to interest paid at the end), cannot be deducted if it is contingent on the value of securities of the issuer or a related party (involving ownership of 50% or more). This provision applies the restrictions without regard to the 50% rule.

Lease term to Include Service Contracts

This provision, raising almost $800 million, is contained only in the Senate bill. To prevent tax exempt entities from transferring accelerated depreciation to taxable entities via leases, the useful life of property that is leased to tax exempt entities is a life that is the longest of the specified tax life or 125% of the lease term. Some attempts have been made to bypass this rule by using service contracts; this provision requires that the length of service contracts be included in determining lease term.

Disallowance of Partnership Loss Transfers

This $700 million provision is highly technical and contained only in the Senate bill. Many tax shelters are associated with partnerships, which have a lot of flexibility. This flexibility includes assigning basis to individual partners. Currently when property is distributed or a partnership interest transferred, the partnership is not required to make an adjustment to basis, and when property is distributed to other partners later, the basis adjustments may be made in a way that permits double recognition of losses or transfers of losses. This provision disallows that outcome.

Lessors to Tax Exempt Entities

This $500 million provision is only in the Senate bill. Leasing to tax exempt entities by taxable firms (who receive accelerated depreciation deductions) has figured heavily in a number of tax shelter arrangements. This provision limits deductions to income received from the lease, imposing a treatment much like the passive loss restrictions that apply to passive individual investors.

Mismatching of Items with Related Corporations

This provision, raising about $450 million, is included in both bills (item 7 in **Table 1** and Item 18 in **Table 2**). It corrects a circumstance where U.S. companies

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[16] This activity was described in David Cay Johnston, "From Tiny Insurers Big Tax Breaks," *New York Times*, April 1, 2003, Sect. C, p. 1

who are creditors do not include original issue discount on behalf of their foreign subsidiaries even though the deductions themselves are reflected in current income.

Basis Reduction for Partnerships

This $400 million provision came out of the Enron investigation and is included in both bills (item 8 in **Table 1** and item 20 in **Table 2**). It also arises from the flexibility allowed partnerships. When partners contribute assets to a partnership or the partnership distributes assets to a partner, there is no gain or loss realized. However, it may be necessary to adjust the basis of the asset (which determines how much of an asset is return on capital and exempt from taxes when the taxpayer does sell the property). For example, if a partner contributed a building for which he had paid $100,000 to the partnership, his basis in the partnership is $100,000, but if the partnership returns the building to him in a distribution and also pays him $20,000, then he has to reduce his basis to $80,000 so that when he sells the property, he will pay tax on the $20,000. The partnership may elect to adjust the basis of its assets in a corresponding manner and is required to group assets of a similar type in allocating basis. The grouping rules have permitted partnerships in such situations to reduce the basis of stock and increase the basis of physical assets, which is advantageous for corporate partners who do not include cash from the sale of stock in income but do include such gains on real assets.

Straddle Rules

This $230 million provision is only in the Senate bill. Straddles occur when individuals hold (generally two) assets that move in opposite directions (such as an option to buy, or call, along with an option to sell, or put, at a fixed price). If one of the assets is sold for a loss, current law allows the loss only in excess of the gain of the other asset, with unused loss carried over. Some stock positions are exempt from this treatment and there is some confusion regarding circumstances when the parts of the straddle are not identified.

The proposal makes a number of detailed changes in the straddle rule including repeal of the stock exemptions, providing that taxpayers identify the components of straddles, and changing the rule from a deferral of loss to a change in basis.

Installment Sales

This $215 million provision is only in the Senate bill. Under present law, individuals who sell property with payments to be received as installments only recognize gain when the payments are actually made. If the taxpayer also receives a readily tradable debt instrument from a corporation or government, this instrument is considered the payment and gain is taxed immediately. This provision extends this rule to debt issued by partnerships and individuals.

Non-Recognition of Gain in Liquidation

This provision is only in the Senate bill, and raises slightly under $200 million. U.S. subsidiaries of foreign parents pay U.S. corporate tax on their earnings and when they transfer profits to the foreign parent pay a withholding tax of 30% unless there is a tax treaty; there is a similar tax on the shifting of branch earnings abroad. However, if a subsidiary or branch is closing down (a liquidation) assets may be transferred tax free (if certain restrictions are met). There is a concern that firms may create U.S. holding companies to obtain the earnings of the domestic operation and then transfer them tax-free. This provision denies tax free treatment to a U.S. holding company that has been in existence less than five years.

Like Kind Exchanges for Residences

This provision raises $170 million and is in both bills (item 12 in **Table 1** and item 27 in **Table 2**). Under current law married couples can exclude $500,000 of gain ($250,000 for singles) when they sell their residence as long as they have lived in it for two of the past five years. This provision denies this exclusion if they acquired the house in a like kind exchange with no recognition of gain. For example, this provision would tax gain that arose from rental properties converted into residences.

Clarification of Banking Business

This provision is in both bills (item 12 in **Table 1** and item 28 in **Table 2**); it raises about $170 million. Under current law, income from foreign incorporated subsidiaries (other than earnings of certain types of passive assets) is not taxed until paid to the U.S. shareholder. However, investments of the foreign subsidiary in the United States are subject to tax (as they can be equivalent to a distribution). There are a series of exceptions to this rule, and one of them is for bank deposits. In a recent court case, payments to a shareholder for purposes of carrying on a department store credit card business were found to be banking by the courts; this provision bases the definition of banking on the taxpayer's being subject to banking regulations.

Estimated Tax on Deemed Asset Sales

This $120 million provision is in both bills (item 14 in **Table 1** and item 29 in **Table 2**). In some circumstances a company acquiring another company may elect to treat the transactions as a sale of assets by the acquired company rather than stock. Apparently some taxpayers have interpreted a related provision about estimated taxes to require no estimated tax payments; this provision provides that effects of an asset sale must be reflected in estimated tax payments.

Expanded Authority to Disallow Benefits under Section 269

This $100 million provision relates to the Enron investigation and is only in the Senate bill. Present law (Section 269) provides that a taxpayer who acquires control of another corporation cannot use the acquired firm's tax benefits if the acquisition was for the purposes of avoiding tax. This provision expands the scope of present law by not requiring that the acquisition of assets establishes control.

Modification of the CFC-PFIC Rules

This provision is related to the Enron investigation and raises about $100 million; it is only in the Senate bill. Under current law shareholders in controlled foreign corporations, or CFCs, are taxed currently on certain tax haven income (Subpart F income). There are also rules requiring current taxation of income of passive foreign investment companies (PFICs) that have most of their assets in a passive form. To prevent overlap, a CFC cannot also be treated as a PFIC and shareholders are not subject to the rules even if they are expected to pay no tax on Subpart F income. This provision would apply the PFIC rules in those cases.

Limit on Transfer of Losses in REMICs

This $100 million provision is only in the House bill and relates to the Enron investigation. Because of rules recognizing no gain or loss in a transfer of property for stock, Enron was able to use REMICs (real estate mortgage investment conduits, which are used to convert mortgages to securities) to duplicate losses. This provision limits the basis of certain interests in REMICs (residual interests, which are the remainder after subtracting regular interests that involve fixed payments) that are transferred to corporations to the fair market value in cases where the basis of a REMIC residual is greater than fair market value.

Tax Policy Changes

Many of the provisions listed thus for are in both the House and Senate bills; however, in the area of actual tax policy changes – items that change provisions of the income tax without seeming to be directed at a tax shelter abuse, the focus is quite different. The larger revenue raisers in the House bill are focused on deferred compensation, and, to a lesser degree, underpayments and overpayments of tax. The Senate bill, while including the underpayment provision, has several significant changes in tax provisions that are different from those in the House bill. Accordingly, in this section, we discuss first the House bill provisions and then the Senate bill provisions. In some cases these provisions actually provide benefits, and the revenue gain only reflects timing.

House Bill

The House Bill contains about $1.3 billion of tax increases resulting from tax policy changes, $800 million of which is due to the deferred compensation provision discussed immediately below.

Deferred Compensation.

The House bill contains two revisions to the treatment of deferred compensation (compensation that accrues to individuals but is not paid out to them)–items 5 and 11 in **Table 1**, respectively raising $800 million and $300 million. Non-qualified deferred compensation is taxable to an individual on a facts and circumstances basis designed to determine whether an individual has really obtained a right to the compensation. Firms had set up "rabbi trusts" (so called because the first case that came to the attention of the IRS was set up for a rabbi) where deferred compensation in the trust could be used to satisfy creditors if the firm became insolvent and this feature was used to justify not taxing the compensation currently. The bill eliminates this use of exposure of trust fund assets to creditors in the case of insolvency as a justification for not taxing deferred compensation.

This provision clearly involves a tax increase; the gain from this provision represents in part, therefore, a speeding up of tax payments, since at some point in the future, the taxes which would otherwise occur on deferred compensation will not materialize.

The second provision extends a current provision that allows firms to avoid plan disqualification (if made prior to termination) or penalties (if made on plan termination) when taking excess assets out of defined benefit pension plans, by transferring them to a retiree health benefits plan. The excise tax is 20% or 50%, depending on whether a replacement plan or certain benefit increases occur. The excise tax applies in addition to regular income tax on the withdrawal. When transfers are made, no deduction can be taken for the transfers or the expenditures they fund. If all the funds are not used currently, they revert and are subject to the 20% excise tax. This change involves providing a tax benefit, not a penalty. The provision is projected to raise revenue, however, presumably because of the increased transfers from the funds will pay for costs while not permitting a deduction and because a penalty is applied to unused funds. This provision would eventually lose revenue, however, by reducing the size of plans (and the eventual individual tax on pension recipients) or by reducing the amount of future contributions that must be made to fund benefits.

Overpayments and Underpayments of Tax.

The House bill includes two other policy changes that relate to tax administration and which raise revenue during the budget horizon – items 15 and 16 in **Table 1** (raising about $100 million each). The first is the elimination of taxes on interest accrued on overpayments of tax. This provision also establishes a benefit, and presumably results in a revenue gain because it increases the likelihood of overpayments, although it should lead to a long term loss. The other provision also provides a benefit and a speedup in collections by allowing more flexibility for taxpayers to prepay amounts to stop interest payments on tax underpayments; this gain would also be transitory.

Senate Bill

The Senate bill also contains the provision on underpayments (item 32, **Table 2**), but there are five other provisions that are permanent increases in most cases; altogether these provisions account for $11.6 billion in revenue, almost ten times the size of the provisions in the House bill. All references are to **Table 2**.

Charitable Contributions of Patents.

The largest revenue raiser ($3.9 billion) involves limiting deductions for charitable contributions of patents (item 3). Under certain circumstances, donors of property to charitable organizations are able to deduct the entire fair market value of an asset even though they have not been taxed on the gain. For certain other types of contributions, such as contributions to foundations or contributions of certain created property, they can only deduct the basis–what they paid for it or spent creating it. The Senate bill's provision, reflecting concerns that the fair market value of patents is not easily determined and may be inflated, limits the contribution to the basis. However, it also allows an exception to the general rule disallowing benefits for contributions of partial interests, by permitting the donor to receive a share of the royalties.

Intangibles.

The second provision involves the treatment of intangibles (item 4), raising $3.3 billion. Under current law acquired intangibles are deducted over a 15 year period –a compromise to prevent disputes and allocational issues across intangibles including some (such as good will) which were previously not deductible at all, and others (such as patient lists) that taxpayers had successfully made a case in court for deducting over shorter periods of time. In the Senate bill, two intangibles provisions would add organizational and certain start up costs (currently deductible over five years) and sports franchises (which had a variety of rules, including special rules for player contracts) to the 15 year category. The bill also permits the first $5,000 for organization and start-up costs to be deducted immediately.

Increase in Age Limit for section 1(g) ("Kiddie Tax").

A third provision (item 9), raising $1.2 billion, expands coverage of the "kiddie tax" that requires unearned income to be taxed at the parent's rate. The bill increases coverage from those under age 14 to those under age 18.

Repeal Rehabilitation Credit.

A fourth change (item 10) repeals the 10% credit for rehabilitation expenditures on buildings constructed before 1936, gaining $1 billion. No change is made in the 20% rehabilitation credit for historic buildings.

Private Debt Collection.

This provision (item 11) raising almost $1 billion authorizes the IRS to use private debt collection services.

Utility Grading Costs.

Utility assets (such as transmission or distribution lines) are placed in classes that allow them to be depreciated over 15 or 20 years. However, because certain regulations were never adopted, grading and preparing property for these lines is not assigned a class and by default is depreciated over seven years. This provision places the grading and land preparation costs for transmission and distribution lines into the same class as the assets themselves, raising about $700 million.

Corporate Governance Provisions: Denial of Deductions.

The Senate bill included several provisions on corporate governance that reflected concerns arising from the collapse of Enron and other firms. Two of the provisions raise revenues of about $330 million (item 21) and $190 million (item 25) respectively. The first would disallow firms' deductions for punitive damages (normally all settlements are considered a cost of doing business and are deductible). The second relates to deductions for fines. Taxpayers are not allowed to deduct the costs of fines. This provision clarifies that payments made to the government or at the direction of the government pursuant to an investigation, including those made to avoid further investigation, are not deductible unless they are determined to provide restitution.

Extensions of Fees

In both bills, the largest revenue raiser is the extension of customs fees (merchandising, passenger and conveyance processing fees), accounting for about $17 billion, accounting for about 60% of the revenue gain in the House bill and about 30% of the gain in the Senate bill. A fee extension with a smaller gain is the IRS user fee (item 9 in the House bill and item 19 in the Senate bill), which accounts for about $400 million.