The Tax Law Center NYU LAW

How some corporations manipulate losses using "Granite Trust" transactions to avoid tax

By: Duncan Hardell, Attorney Advisor and International Tax Specialist

We recently published a report highlighting a longstanding and common tax planning strategy that corporations use to minimize their taxes. This resource walks through the strategies at a simplified level for readers who are not tax lawyers and demonstrates the urgent need for enforcement by the IRS and new rules from Treasury and Congress.

What's the problem?

One common way corporations can reduce their tax liability is to offset their taxes with a loss. The general logic of the tax system is that a business can use a tax loss to reduce its current year's tax bill if: (1) that loss represents a true economic loss; and (2) there has been a change in the economic circumstances of the business that makes it appropriate for the business to recognize (i.e. use) the loss immediately. The idea is that there should not be a timing mismatch whereby taxpayers can just choose to accelerate losses to minimize their tax bill, while delaying taxes on profits. For most businesses, this is how the system works in practice. **But many large corporations, and especially multinationals, have found a way to play by a different set of rules.**

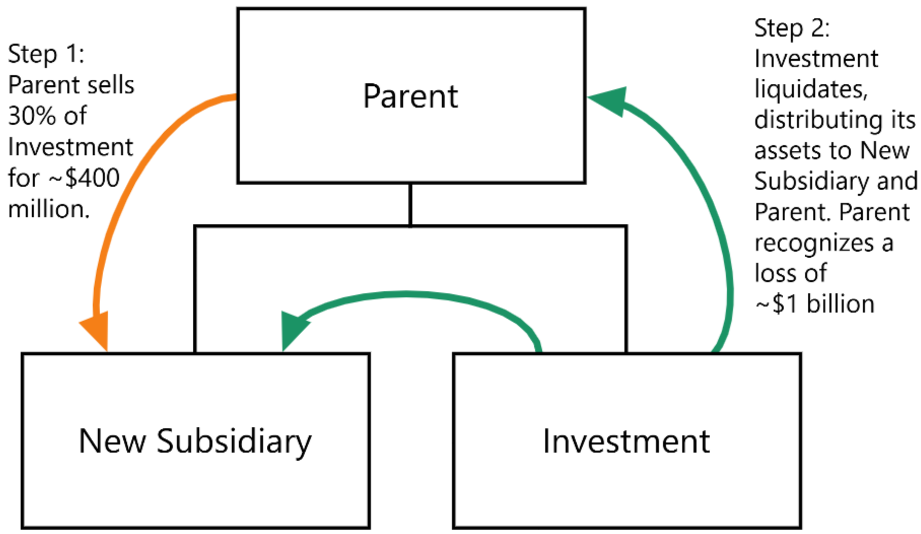
Corporations can get around the normal rules by using a common transaction that allows them to accelerate their use of losses without changing the economic circumstances of their businesses. This is achieved in a corporate group by liquidating (i.e. shutting down) an unprofitable entity, as long as the corporation first sells a portion of the unprofitable entity to another entity it owns. The economic/business consequences for the corporate group are almost always negligible, because all of the relevant assets remain under common ownership. But for tax purposes, **the transaction allows a corporation to immediately recognize its losses to reduce its tax bill**. This is a so-called "*Granite Trust* transaction," named after a decades-old court case blessing the beneficial tax consequences despite the IRS's arguments that the transaction lacks economic substance.

On top of this longstanding play to get around the normal timing rules for losses, some corporations have begun engaging in more aggressive and abusive *Granite Trust* transactions to try to generate excessive losses that do not match economic reality to avoid a much greater amount of tax. This approach exploits ambiguities in the rules governing transactions between two entities that have the same owner. **There are, however, several potential ways that the IRS, Treasury, and Congress can act to curb tax avoidance using *Granite Trust* transactions.**

What are the basic features of these transactions?

Example *Granite Trust* transaction

Parent purchased Investment for ~$2.8 billion but it's now worth ~$1.4 billion.



A *Granite Trust* transaction is a way to shelter income by forcing a loss on an unprofitable investment (with a so-called "built-in loss") and it is relatively easy to set up and execute. A corporate group only needs these three entities to undertake a *Granite Trust* transaction, and the underlying transaction is quite simple, with just two steps, a partial sale and then a liquidation. If the Parent skipped the sale, it wouldn't be able to get the tax benefit from the loss, but the sale "unlocks" the loss even though it's effectively just Parent selling to itself. ***Granite Trust*** **transactions are a common tool of tax planning and widely available to corporate businesses**. And as the example shows, **single transactions can easily generate upwards of a billion dollars in tax savings**.

When the Parent liquidates the Investment, it receives most of the Investment's assets directly, with the New Subsidiary receiving a small portion of these assets. But because the New Subsidiary is entirely owned by the Parent, the Parent can continue to benefit from and effectively use all the assets. The transaction therefore has no meaningful economic significance and is generally undertaken entirely as a way of accelerating loss recognition and minimizing the corporate group's taxes.

The more aggressive variant of a *Granite Trust* transaction, however, is much more complex and generally available only to large corporations that can afford the tax accountants and lawyers needed to carefully structure their transactions to maximize tax benefits. These aggressive variants also generally require the participation of multiple foreign corporations to maximize the tax benefits. **The tax benefits of this aggressive variant borders on the absurd by unfairly and uneconomically "super-charging" losses in ways that don't accurately reflect the economics of the business.**

OK, I'm ready for a taste of that complexity

The aggressive variant of *Granite Trust* takes advantage of a concept known as basis shifting. **Tax "basis" is how the tax system keeps track of the cost of an asset** (which can include physical property, IP, and stock in other corporations). Basis corresponds broadly to the value paid for the asset but can move up or down depending on whether further investments or improvements are made to the asset or whether certain deductions are permitted. **When an asset is sold or liquidated, tax gain or loss depends on the difference between the value of the money or other assets received and the seller's basis in the asset**. When one asset is exchanged for another asset, the tax rules will sometimes refer to the basis of the asset exchanged as a starting point for the basis of the asset received. Tax folks call this "carryover basis".

The aggressive variant of *Granite Trust* transactions takes advantage of the fact that the tax rules will generally view the Step 1 sale of the minority stake in the Investment as one of these exchanges. Specifically, the tax rules create a fiction that Parent received New Subsidiary stock in exchange for the shares of the Investment. That New Subsidiary stock has "carryover basis" in the hands of the Parent equal to the Parent's basis in the Investment shares it just sold. Complex tax rules result in those New Subsidiary shares immediately going away, so corporations take the position that the newly created but now orphaned basis in those fictional shares must go somewhere – and shift that basis to Parent's other shares in the Investment. It is this basis shift that makes the transaction so beneficial for corporations.

When the Investment liquidates, the Parent is treated as having paid extra for its shares in the Investment. This additional difference between the value of the assets received in the liquidation and **the shifted basis in those shares "super-charges" the Parent's loss on the liquidation, letting it substantially increase the amount of tax it can avoid. This transaction goes beyond simply accelerating loss recognition in the subsidiary and creates artificial, excessive loss recognition for the Parent.**

What should be done about this?

Our full report outlines various actions that can be taken to prevent or mitigate the tax advantages of these *Granite Trust* transactions. These include:

- **The IRS auditing existing transactions** and challenging the tax consequences
- **Treasury issuing new regulations** that explicitly address these transactions, in particular to unambiguously disallow the basis shifting used in aggressive transactions, and
- **Congress passing new laws** that require the tax benefits from *Granite Trust* transactions to be deferred until the relevant assets leave common ownership and control.