

# **The Problem of Corporate Tax Shelters**

**Discussion, Analysis and Legislative Proposals**



**Department of the Treasury**  
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## PURPOSE

The proliferation of corporate tax shelters presents an unacceptable and growing level of tax avoidance behavior. Over the past several years, Congress and the Administration repeatedly have provided targeted responses to specific shelters as they have come to light. The Administration believes that a generic solution to curb the growth of corporate tax shelters must be fashioned, as opposed to the current after-the-fact, *ad hoc* approach. This, admittedly, is not an easy task. Unlike the individual tax shelters of the 1970s and 1980s, corporate tax shelters may take several forms and do not rely on any single Code section or regulation. For this reason, they are hard to define.

Nonetheless, the Administration in its Fiscal Year 2000 Budget proposed several generic remedies, focused on certain identified common characteristics, to curb the growth of corporate tax shelters. As Deputy Secretary Lawrence Summers recently stated, the Administration's proposals are intended to "change the dynamics on both the supply and demand side of this 'market' - making it a less attractive one for all participants - 'merchants' of abusive tax shelters, their customers, and those who facilitate the transactions."<sup>1</sup>

The Treasury Department recognizes that this more generic approach to corporate tax shelters raises certain concerns. In particular, critics have suggested that the definition of "tax avoidance transaction," upon which many of the Administration's Budget proposals rely, is too broad or may create too much uncertainty and thus may inhibit otherwise legitimate transactions. The Treasury Department has never intended to inhibit legitimate business transactions.

Since the release of the Administration's Budget in February, the Treasury Department has had intensive and extensive dialogue with practitioner groups -- the tax bar, the accounting profession, and corporate tax executives -- to hear their comments and their criticisms and hopefully to develop common understandings of the norms of appropriate behavior in this area. The Treasury Department has also analyzed the comments raised by others in testimony presented to the two tax-writing committees, as well as in recent articles by practitioners and academics. This report on corporate tax shelters is intended to discuss more fully the reasoning underlying the Budget proposals relating to corporate tax shelters, to provide an analysis of how the practitioner comments relate to this rationale, and to provide refinements to the original Budget proposals in light of these comments and in keeping with the underlying rationale.

We look forward to continuing to work closely with the tax-writing committees and other interested parties to adopt proposals that effectively cultivate a "culture of compliance in which corporate tax shelters are more seldom created,"<sup>2</sup> without inhibiting legitimate business transactions.

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<sup>1</sup> Lawrence H. Summers, "A Better Tax Service and a Better Tax System," Tax Executives Institute, March 22, 1999.

<sup>2</sup> Id.

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## EXECUTIVE SUMMARY

### I. Proliferation of Tax Shelters

There is widespread agreement and concern among tax professionals that the corporate tax shelter problem is large and growing.

- The American Bar Association, in an appearance before the House Ways and Means Committee, noted its "growing alarm [at] the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than the reduction of Federal income taxes," and its concern at the "blatant, yet secretive marketing" of such products.<sup>1</sup>
- The New York State Bar Association, in testimony before the Senate Finance Committee, stated: "We believe that there are serious, and growing, problems with aggressive, sophisticated and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage . . . There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience leads us to believe that it is likely to be quite significant."<sup>2</sup>
- In the 1999 Erwin N. Griswold Lecture before the American College of Tax Counsel, former ABA Tax Section president James Holden stated: "Many of us have been concerned with the recent proliferation of tax shelter products marketed to corporations...the marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on."<sup>3</sup>

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<sup>1</sup> Statement of Stefan F. Tucker, on behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, March 10, 1999, at 5 [hereinafter ABA Ways and Means].

<sup>2</sup> Statement of Harold R. Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance, April 27, 1999, at 1 [hereinafter NYSBA].

<sup>3</sup> James P. Holden, 1999 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Dealing with the Aggressive Corporate Tax Shelter Problem, 52 Tax Lawyer 369 (Winter 1999).

- The Tax Executives Institute recently testified before the Senate Finance Committee, that: “TEI is not among those who believe no problem exists. But the problem confronting the tax system is not simple, and care must be taken to ensure that the solutions are measured and balanced and, further, that they do not add even more complexity to the already overburdened tax law.”<sup>4</sup>
- A recent cover story in Forbes magazine was devoted to the "thriving industry of hustling corporate tax shelters."<sup>5</sup> This article quoted a partner in a major accounting firm who described the development and highly selective marketing of "black box" strategies for tax avoidance that can save its purchasers from tens of millions to hundreds of millions of dollars at the expense of other U.S. taxpayers.

While corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. One hallmark of corporate tax shelters is a reduction in taxable income with no concomitant reduction in book income. The ratio of book income to taxable income has risen fairly sharply in the last few years. Some of this decline may be due to tax shelter activity.

## **II. Evidence from Recent Shelters**

A number of large aggressive corporate tax shelters have been identified by the Congress, the Treasury Department, and the IRS. As a result, several types have been shut down by statute or administrative action. As more fully discussed in Appendix A, some of these shelters involved tax reductions in the billions of dollars.

- **Corporate-owned life insurance (COLI).** In 1996 and 1997, two provisions were enacted to prevent the tax abuse of corporate-owned life insurance. Collectively, these two provisions were estimated by the Joint Committee on Taxation to raise over \$18 billion over 10 years. As the then Chief of Staff of the Joint Committee on Taxation stated: "When you have a corporation wiring out a billion dollars of premium in the morning and then borrowing it back by wire in the afternoon and instantly creating with each

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<sup>4</sup> Statement of Lester D. Ezrati, on behalf of the Tax Executives Institute, before the Committee on Finance, April 27, 1999, at 6.

<sup>5</sup> Janet Novack and Laura Saunders, The Hustling of X Rated Shelters, Forbes, Dec. 14, 1998 at 198, 203.

year another \$35 million of perpetual tax savings, that's a problem.... I think we were looking at a potential for a substantial erosion of the corporate tax base if something hadn't been done.”<sup>6</sup>

- **Fast-pay.** Early in 1997, the Treasury Department became aware of several issuances of fast-pay preferred stock, a financing transaction that purportedly allowed taxpayers to deduct both principal and interest. It was reported that one investment bank alone created nearly \$8 billion of investments in a few months. The Treasury Department and the IRS shut down the scheme with a notice and proposed regulations.
- **Liquidating REITs.** This transaction allowed banks and other financial institutions to purportedly create a permanent tax exclusion for certain interest income through the confluence of two incongruent Code sections. The Treasury Department's Office of Tax Analysis estimated that legislation enacted last year to eliminate the use of liquidating real estate investment trusts (REITs) would save the tax system approximately \$34 billion over the next ten years.
- **LILO.** Through circular property and cash flows, lease-in, lease-out transactions, or so-called “LILO” schemes, like COLI, offered participants hundreds of millions of dollars in tax benefits with no meaningful economic substance.
- **357(c).** On June 25, 1999, President Clinton signed a bill that eliminates the ability of taxpayers to exploit the concept of “subject to” a liability when transferring property in order to "create" bases in assets far in excess of the assets' value.

### **III. Reasons for Concern**

There are several reasons to be concerned about the proliferation of corporate tax shelters. These concerns range from the short-term revenue loss to the tax system, to the potentially more troubling long-term effects on our voluntary income tax system.

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<sup>6</sup> Kenneth Kies, Transcript of Federal Bar Association's Fourth Invitational Biennial Conference on the Tax Legislative Process, reprinted in 97 Tax Notes Today 21-38 (January 31, 1997) [hereinafter 1997 Airlie House Transcript].

### **Short-term revenue loss**

- Corporate tax shelters reduce the corporate tax base, raising the tax burden on other taxpayers.

### **Disrespect for the system**

- Corporate tax shelters breed disrespect for the tax system -- both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a "race to the bottom." If unabated, this could have long-term consequences to our voluntary tax system far more important than the short-term revenue loss we are experiencing.
- The New York State Bar Association recently noted the "corrosive effect" of tax shelters: "The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions."<sup>7</sup>

### **Complexity**

- Piecemeal legislative remedies complicate the Code and call into question the viability of common law tax doctrines. In the past few years alone, nearly 30 narrow statutory provisions have been adopted responding to perceived abuses.

### **Uneconomic use of resources**

- Significant resources, both in the private sector and the Government, are currently being wasted on this uneconomic activity. Private sector resources used to create, implement and defend complex sheltering transactions could be better used in productive activities. Similarly, the Congress (particularly the tax-writing committees and their staffs), the Treasury Department, and the IRS must expend significant resources to address and combat these transactions.

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<sup>7</sup> NYSBA, supra note 2, at 2.

- The ACM Partnership v. Commissioner<sup>8</sup> case alone cost the Federal Government over \$ 2 million to litigate. In addition, there are a number of docketed cases involving almost identical shelter products.
- Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation recently stated: “You can’t underestimate how many of America’s greatest minds are being devoted to what economists would all say is totally useless economic activity.”

#### **IV. Characteristics of Corporate Tax Shelters**

Because corporate tax shelters take many different forms and utilize many different structures, they are difficult to define with a single formulation. A number of common characteristics, however, can be identified that are useful in crafting an approach to solving the corporate tax shelter problem.

**Lack of economic substance** -- Professor Michael Graetz recently defined a tax shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid.”<sup>9</sup> This definition highlights one of the most important characteristics common to most corporate tax shelters -- the lack of any significant economic substance or risk to the participating parties. Through hedges, circular cash flows, defeasements and the like, the participant in a shelter is insulated from any significant economic risk.

**Inconsistent financial accounting and tax treatments** -- There is a current trend among public companies to treat corporate in-house tax departments as profit centers that strive to keep the corporation’s effective tax rate (i.e., the ratio of corporate tax liability to book income) low and in line with that of competitors. Accordingly, in most recent corporate tax shelters involving public companies, the financial accounting treatment of the shelter item has been inconsistent with the claimed Federal income tax treatment.

**Tax-indifferent parties** -- Many recent shelters have relied on the use of “tax-indifferent” parties -- such as foreign or tax-exempt entities -- who participate in the transaction in exchange for a fee to absorb taxable income or otherwise deflect tax liability from the taxable party.

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<sup>8</sup> ACM Partnership v. Commissioner 73 T.C.M. (CCH) 2189, aff’d in part, rev’d in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

<sup>9</sup>See Tom Herman, Tax Report, Wall St. J. at A-1 (Feb. 10, 1999).



**Marketing activity** -- Promoters often design tax shelters so that they can be replicated multiple times for use by different participants, rather than to address the tax planning issues of a single taxpayer. This allows the shelter “product” to be marketed and sold to many different corporate participants, thereby maximizing the promoter’s return from its shelter idea.

**Confidentiality** -- Similar to marketing, maintaining confidentiality of a tax shelter transaction helps to maximize the promoter’s return from its shelter idea -- it prevents expropriation by others and it protects the efficacy of the idea by preventing or delaying discovery of the idea by the Treasury Department and the IRS. In the past, promoters have required prospective participants to sign a non-disclosure agreement that provides for million dollar payments for any disclosure of the “proprietary” advice. The 1997 Act addressed this feature to some extent.<sup>10</sup>

**Contingent or refundable fees and rescission or insurance arrangements**--Corporate tax shelters often involve contingent or refundable fees in order to reduce the cost and risk of the shelter to the participants. In a contingent fee arrangement, the promoter’s fee depends on the level of tax savings realized by the corporate participant. Some corporate tax shelters also involve insurance or rescission arrangements. Like contingent or refundable fees, insurance or rescission arrangements reduce the cost and risk of the shelter to the participants.

**High transaction costs** -- Corporate tax shelters carry unusually high transaction costs. For example, the transaction costs in the ASA<sup>11</sup> case (\$24,783,800) were approximately 26.5 percent of the purported tax savings (approximately \$93,500,000).

## **V. Present Law Applicable to Shelters**

The tax consequences of a particular business transaction generally are determined through the application of mechanical rules (primarily Code and regulatory provisions). However, certain standards under current law may be invoked to challenge the legitimacy of a transaction where a literal application of the mechanical rules to the facts produces technical tax results that are unreasonable or unwarranted. In addition, certain procedural provisions generally enacted in response to the individual tax shelters of the 1970s and 1980s apply.

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<sup>10</sup> See section 6111(d); see also Section II.A.2. of the Report.

<sup>11</sup> ASA Investerings Partnership v. Commissioner, 76 T.C.M. (CCH) 325 (1998).

**Anti-abuse rules** -- In connection with a highly complex statutory or regulatory regime, the Treasury Department has issued several broad-based regulatory anti-abuse rules intended to prevent manipulation of the mechanical rules in a manner that circumvents the overall purposes of the regime. These anti-abuse rules limit the need for even more complicated mechanical rules that would otherwise be necessary to address particular fact patterns. One commentator has declared that regulatory anti-abuse rules potentially are “a path towards a coherent solution” to the problem of tax shelters.<sup>12</sup>

**Statutory grants of broad authority** -- Congress has enacted several general provisions granting the Secretary of the Treasury broad authority to reallocate income and deductions to require the proper reflection of income. These grants of broad authority were considered necessary by Congress to empower the Secretary to curb inappropriate activities. These include:

- section 269, which grants authority to disallow certain acquired losses;
- section 446, which prescribes a change of method of accounting if necessary to clearly reflect income;
- section 482, which grants authority to reallocate income, deductions etc., between related entities if necessary to prevent evasion of tax or clearly to reflect income; and
- section 7701(l), which grants authority to prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of tax.

**Judicial doctrines** -- Courts have created, developed and re-interpreted various broad common law doctrines to address unreasonable or unwarranted tax benefits, including:

- Substance-over-form -- Under the substance-over-form doctrine, the IRS and the courts may recharacterize a transaction in accordance with its substance, if “the substance of the transaction is demonstrably contrary to

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<sup>12</sup> David Hariton, 1997 Airlie House Transcript, supra note 6. (“I think the anti-abuse rules are a terrific accomplishment of the Administration’s first four years. A day doesn’t go by without my telling somebody that they can’t do that because of the swap anti-abuse rule, the OID anti-abuse rule, or whatever.”)

the form.”<sup>13</sup> For example, a taxpayer cannot label what is, in essence, equity as debt and thereby secure an interest deduction. As one commentator recently has written, “standards must govern the factual characterization of relationships and arrangements to some extent, and the Commissioner must have the ability to challenge the taxpayer’s description of the relevant facts -- otherwise the taxpayer’s advantage would be insurmountable.”<sup>14</sup>

- Step transaction doctrine -- The step transaction doctrine is a relatively common application of the substance-over-form doctrine. Under the doctrine, formally separate steps may be treated as one transaction for tax purposes (rather than giving tax effect to each separate step), if integration more accurately reflects the underlying substance.
- Business purpose -- The business purpose doctrine requires that a taxpayer have a business reason -- other than the avoidance of federal taxes -- for undertaking a transaction or series of transactions. In the Supreme Court’s decision in Gregory v. Helvering,<sup>15</sup> the Court articulated the doctrine: “The legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from tax motive, was the thing which the statute intended.”<sup>16</sup>
- Economic substance -- Under this doctrine, tax benefits may be denied if the tax benefits arise from a discrete set of transactions that do not meaningfully alter the taxpayer’s economic position. The economic substance doctrine can be applied by comparing the taxpayer’s pre-tax profit to its tax benefits from a transaction. Many commentators believe

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<sup>13</sup> Michael S. Powlen and Raj Tanden, Corporate Tax Shelters or Plus Ca Change, plus C’est la Meme Chose, 431 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (PLI) 1003, 1013 (1998).

<sup>14</sup> David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Lawyer 235, 239 (Winter 1999) [hereinafter Hariton].

<sup>15</sup> Gregory v. Helvering, 293 U.S. 465 (1935).

<sup>16</sup> 293 U.S. at 469.

that the economic substance doctrine is the superior standard to evaluate the legitimacy of a purported business transaction for a variety of reasons.<sup>17</sup>

## **VI. Legislative Proposals**

In its FY 2000 Budget, the Administration made several proposals designed to inhibit the growth of corporate tax shelters. These proposals focused on the following areas:

- (1) increasing disclosure of corporate tax shelter activities,
- (2) increasing and modifying the penalty relating to the substantial understatement of income tax,
- (3) changing substantive law to disallow the use of tax benefits generated by a corporate tax shelter, and
- (4) providing consequences to all the parties to the transaction (e.g., promoters, advisors, and tax-indifferent, accommodating parties).

The American Bar Association (ABA), American Institute of Certified Public Accountants (AICPA), and the New York State Bar Association (NYSBA) have commented on the Administration's proposals and made proposals of their own in testimony filed with the tax-writing committees.<sup>18</sup> This Report considers those comments and suggests refinements to the Administration's proposals based on those comments and the comments of others.

### **Increasing Disclosure**

Greater disclosure of corporate tax shelters would aid the IRS in identifying corporate tax shelters and would therefore lead to better enforcement by the IRS. Also, greater disclosure likely would discourage corporations from entering into questionable

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<sup>17</sup> See, e.g., Hariton, supra note 14, at 235.

<sup>18</sup> See ABA Ways and Means, supra note 1; Statement of Stefan F. Tucker, on behalf of the Section of Taxation, American Bar Association, before the Committee on Finance, April 27, 1999; Statement of David A. Lifson, on behalf of the Tax Division, American Institute of Certified Public Accountants, before the Committee on Finance, April 27, 1999; NYSBA, supra note 2; New York State Bar Ass'n Tax Section, Report on Corporate Tax Shelters of New York State Bar Association Tax Section, 83 Tax Notes 879 (May 10, 1999); and New York State Bar Ass'n Tax Section, Report on Certain Tax Shelter Provisions (June 22, 1999).

transactions. The probability of discovery by the IRS should enter into a corporation's cost/benefit analysis of whether to enter into a corporate tax shelter.

In order to be effective, disclosure must be both timely and sufficient. In order to facilitate examination of a particular taxpayer's return with respect to a questionable transaction, the transaction should be prominently disclosed on the return. Moreover, because corporate tax returns may not be examined for a number of years after they are filed, an "early warning" system should be required to alert the IRS to tax shelter "products" that may be promoted to, or entered into by, a number of taxpayers. Disclosure should be limited to the factual and legal essence of the transaction to avoid being overly burdensome to taxpayers.

- Administration's FY 2000 Budget. The penalty rate on substantial underpayments of income tax attributable to corporate tax shelters would be increased from 20 percent to 40 percent if the taxpayer does not adequately disclose the shelter. For this purpose, adequate disclosure would mean (1) filing appropriate documents describing the tax shelter transaction with the National Office of the IRS within 30 days of the closing of the transaction, (2) attaching a statement with the corporation's return verifying that the disclosure described in (1) had been made, and (3) highlighting on the tax returns any book/tax differences resulting from the corporate tax shelter.
- The Budget also generally would deny tax benefits from transactions where taxpayers report tax items relating to a transaction with a tax-indifferent party inconsistent with the form of their transaction, unless they disclose that they are reporting the item inconsistent with its form (i.e., in accordance with the transaction's substance). The proposal is designed to restrict the ability of corporate taxpayers to arbitrage tax and regulatory laws (and in some cases whipsaw the Government) by entering into transactions where the substance of the transaction is inconsistent with its form and to permit the Treasury Department and the IRS to consider whether the claimed tax benefits flowing from the transaction should be allowed.
- ABA. The ABA believes that many corporate tax shelters and supporting opinions are based upon dubious factual settings. Thus, they would require clear disclosure on the return of various matters regarding the true nature and economic objectives of certain "large tax shelters," including (1) a detailed description of the facts, assumptions of facts and factual conclusions; (2) a description of the due diligence to ascertain the accuracy of these matters; and (3) copies of written materials provided by a third

party in connection with the promotion of the tax shelter. One or more corporate officers with a detailed knowledge of the transaction would be required to attest that the facts, assumptions of facts and factual conclusions relied upon in reporting the transaction are true and correct to the best of the signer's knowledge and belief.

- AICPA. The AICPA strongly supports an effective disclosure mechanism. To be effective, disclosure must (1) provide taxpayers with an incentive to disclose transactions of interest to the IRS and (2) be in a form and at a time to be useful to the IRS. The AICPA also supports requiring corporate officers or representatives to aver to the appropriate facts, assumptions, or conclusions with respect to a transaction. Any new disclosure requirements should be coordinated with section 6111 and other current-law disclosure provisions.
- NYSBA. The NYSBA strongly supports the Administration's disclosure proposal relating to the substantial understatement penalty because it believes the prospect of disclosure will deter taxpayers from entering into questionable transactions and will help the IRS uncover corporate tax shelters. According to the NYSBA, disclosure should be made within 30 days after entering into certain large transactions and again with the filing of the return, on a short form to avoid the problem of overdisclosure.

### **Taxpayer Penalties**

In order to serve as an adequate deterrent, the risk of penalty for corporations that participate in corporate tax shelters must be real. The penalty also must be sufficient to affect the cost/benefit analysis that a corporation considers when entering into a tax shelter transaction.

- Administration's FY 2000 Budget. The substantial understatement penalty would be increased from 20 percent to 40 percent for a substantial understatement of tax resulting from a transaction meeting the definition of a "corporate tax shelter." However, the penalty would be reduced to 20 percent if, as discussed above, adequate disclosure is made. The 40- or 20-percent penalty could not be avoided through the "reasonable cause" exception (i.e., the penalty would be subject to "strict liability.")
- ABA. While the ABA proposals focus primarily on disclosure, they acknowledge that an expanded penalty structure may be necessary in order to provide the appropriate incentives and disincentives for certain types of

behavior. Moreover, the ABA suggests that it may be appropriate to develop and impose new penalties upon taxpayers that fail to disclose required information with respect to a tax shelter (whether or not the tax shelter ultimately is invalidated by a court).

- AICPA. The AICPA believes extraordinary sanctions (such as a 40-percent penalty) are appropriate only if the definition of tax shelter is sufficiently narrow so as to minimize the risk that the penalty would be proposed to harass taxpayers with respect to non-abusive transactions. Sanctions should not apply to transactions that (1) were undertaken for reasons germane to the conduct of the corporation's business, (2) were expected to produce a pre-tax return that is reasonable in relation to the costs incurred, and (3) is reasonably consistent with the legislative purpose for which the provision was enacted. The AICPA disagrees with the application of a strict liability standard for corporate tax shelters, and does not suggest any changes to the current application of the reasonable cause standard.
- NYSBA. In an approach similar to the Administration's Budget proposal, the NYSBA proposes that a penalty of at least 10 percent should apply to corporate tax shelters for which the taxpayer provides disclosure and a penalty at least 20 percentage points higher (and perhaps more) should apply to undisclosed corporate tax shelters. Moreover, the NYSBA supports the elimination of the reasonable cause exception from the penalty, because they believe that most transactions that would reasonably be viewed as corporate tax shelters will be subject to at least one "more likely than not" or stronger tax opinion rendered by a law or accounting firm. While a favorable tax opinion does not technically provide "reasonable cause" by itself, the NYSBA notes that such an opinion makes it significantly more difficult for the IRS to impose current-law penalties.

### **Disallow Tax Benefits of Corporate Tax Shelters**

As evidenced by the comments from the ABA, AICPA, NYSBA, and others, corporate tax shelters are proliferating under the existing legal regime. This proliferation results, in part, because discontinuities in objective statutory or regulatory rules can lead to inappropriate results that have been exploited through corporate tax shelters. Current statutory anti-abuse provisions are limited to particular situations and are thus inapplicable to most current corporate tax shelters. Further, application of existing judicial doctrines has been inconsistent, which encourages the most aggressive taxpayers to pick and choose among the most favorable court opinions.

The current piecemeal approach to addressing corporate tax shelters has proven untenable, as (1) policymakers do not have the knowledge, expertise and time to continually address these transactions; (2) adding more mechanical rules to the Code adds to complexity, unintended results, and potential fodder for new shelters; (3) the approach may reward taxpayers and promoters who rush to complete transactions before the anticipated prospective effective date of any reactive legislation; and (4) the approach results in further misuse and neglect of common law tax doctrines. Thus, the Treasury Department believes that a change in the substantive law is necessary in order to curb the growth of corporate tax shelters. While increased disclosure and changes to the penalty regime are necessary to escalate issues and change the cost/benefit analysis of entering into corporate tax shelters, these remedies are not enough if taxpayers continue to believe that they will prevail on the underlying substantive issue. Stated another way, a significant understatement penalty will have little deterrent effect if there is no understatement.

- Administration's FY 2000 Budget. The Secretary of the Treasury would be granted the authority to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction. The term "tax avoidance transaction" would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis). In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income. The proposal would not apply to any tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code).
- ABA. The ABA would clarify that, where the economic substance doctrine applies, the nontax considerations must be substantial (i.e., more than de minimis or nominal) in relation to the potential tax benefits. According to the ABA, many current corporate tax shelters rely upon literal interpretations of mechanical rules of the Code but are not supportable under common law principles. Thus, the ABA seeks to make the economic substance doctrine more transparent by calling upon Congress to adopt statutorily the standard enunciated in the best of the case law. This approach is similar to the first prong of the Administration's budget proposal -- weighing potential tax benefits against potential economic



income from a transaction to determine the validity of the transaction for tax purposes.

- AICPA. The AICPA disagrees with the need to expand the Secretary's authority to expand the disallowance regimes of the Code, and would provide safe harbors with respect to any corporate tax shelter definition.
- NYSBA. The NYSBA does not currently support a change in the substantive law as proposed by the Administration, although they do not rule out the eventual need for such a proposal. While not endorsing a change in substantive law, the NYSBA believes that definitions of corporate tax shelters could be developed by analyzing the different types of transactions that are troubling from a tax policy perspective and tailoring the definition thereby. For example, they suggest that one possible approach would focus on "loss generators;" that is, transactions lacking in pre-tax economic substance that are designed to create a tax benefit that the corporation would not itself possess absent the transaction. They also suggest that a separate substantive provision could be developed to encompass corporate financings that otherwise have economic effect but are difficult to analyze under general tax shelter legislation.

### **Consequences to Other Parties (e.g., promoters and advisors, and tax-indifferent parties)**

Proposals to deter the use of corporate tax shelters should provide sanctions or remedies on other parties that participate in, and benefit from, a corporate tax shelter. These remedies or sanctions would reduce or eliminate the economic incentives for parties that facilitate sheltering transactions, thus discouraging those transactions. As the ABA stated in its recent testimony: "All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law."<sup>19</sup>

When Congress was concerned with the proliferation of individual tax shelters in the early 1980s, it enacted several penalty and disclosure provisions that applied to advisors and promoters. These provisions were tailored to the types of "cookie-cutter" tax shelter products then being developed. Similar provisions should be enacted tailored to corporate tax shelters.

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<sup>19</sup> ABA Ways and Means, supra note 1, at 7.

A tax-indifferent party often has a special tax status conferred upon it by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforeseen manner, the system should not condone such use. Imposing a tax on the income allocated to tax-indifferent parties could deter the inappropriate rental of their special tax status, limiting their participation in corporate tax shelters, and thus reducing other taxpayers' use of shelters that utilize this technique.

- Administration's FY 2000 Budget Any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable to such person. To ensure that a tax is paid, all corporate participants would be made jointly and severally liable for the tax. Thus, to the extent that the tax-indifferent person is immune from U.S. tax, the tax otherwise owed would be collected from other participants who are subject to U.S. tax. For purposes of the proposal, a "tax-indifferent person" would include a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with a loss or credit carryforward that is more than three years old.
- The Budget also proposes to impose a 25-percent excise tax upon (1) the fees earned by promoters and advisors with respect to a corporate tax shelter transaction and (2) the total tax benefits anticipated from a corporate tax shelter transaction, to the extent such benefits are subject to an unwind agreement, rescission clause, or insurance or other arrangement guaranteeing such benefits. In addition, the Budget proposes to disallow the deduction for promoter and advisor fees with respect to a corporate tax shelter transaction.
- ABA. In recognition of the role that promoters, tax advisors and tax-indifferent parties play in corporate tax shelters, the ABA proposes that if the substantial understatement penalty applies to a taxpayer with respect to a tax shelter, the penalty should also be imposed on outside advisors, promoters and tax-indifferent parties that actively participated in the tax shelter. Special procedural rules would be provided to assure due process to such parties, similar to current-law rules applicable to tax return preparer penalties.
- AICPA. The AICPA believes that all parties to a tax shelter transaction should have an incentive to ensure the soundness of the transaction. They favor the Administration's recommendation that Congress address exploitation of the tax system by the use of tax-indifferent parties, but offer no specific proposal for addressing this issue. The AICPA does not support

the 25-percent excise tax on promoter or advisor fees contained in the Administration's budget. Rather, they prefer to impose direct penalties on promoters and advisors, with adequate due process provided. In particular, they propose that current-law sections 6700, 6701 and 6703 be revised to be more effective tools with respect to promoters and advisors. Finally, the AICPA suggests unspecified revisions to Circular 230 (which governs practice before the IRS), while acknowledging that certain parties (e.g., investment bankers) are not subject to these provisions.

- NYSBA. The NYSBA does not propose sanctions on tax shelter participants other than the corporate taxpayer itself. The NYSBA believes that penalizing additional parties, while probably producing some marginal increase in deterrence, creates significant complexity, coordination issues and potential for unfairness. However, the NYSBA acknowledges that the growth of corporate tax shelters can be attributed, at least in part, to certain tax advisors and promoters (primarily, national accounting firms, multi-city law firms and major investment banks) that have significant planning resources, mass-marketing capabilities, and extensive client lists.

## **VII. Refinement of Budget Proposals**

### **Increased Disclosure**

The Treasury Department and almost all commentators believe that disclosure is an important component of proposals to address corporate tax shelters.

- In response to concerns that the definition of corporate tax shelter is too vague for purposes of triggering a reporting requirement, the Treasury Department would modify the disclosure requirement of the Administration's proposal. Disclosure would only be required if a transaction has some combination of the following characteristics: a book/tax difference in excess of a certain amount; a recission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits; involvement with a tax-indifferent party; advisor fees in excess of a certain amount or contingent fees; a confidentiality agreement; the offering of the transaction to multiple parties; a difference between the form of a transaction and the way it is reported, etc. These filters are based on the objective characteristics identified by the Treasury Department and others as common in many corporate tax shelters.

- Disclosure would be made by the taxpayer on a short form filed with the National Office of the IRS soon after the transaction is offered or entered into (either by the promoter or the corporation) and again with the corporation's income tax return.
- The early warning will allow the IRS, the Treasury Department and, to the extent necessary, the Congress sufficient time to react to and stop the spread of the latest type of corporate tax shelter.
- Disclosure with the tax return will provide an examining IRS agent with information necessary to discover and determine the nature of a sheltering transaction.
- The form would require the taxpayer to describe which of the filters apply to the transaction, and a brief description of certain information relating to the transaction, as proposed by the ABA. Failure to meet the disclosure requirement would subject the taxpayer to a significant fixed-amount penalty (\$100,000 for each failure), regardless of whether the transaction in question is ultimately determined to be a corporate tax shelter.
- As proposed by the ABA and AICPA, the form would be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction for which disclosure is required. Such officer should be made personally liable for misstatements on the form, with appropriate penalties for fraud or gross negligence.
- The disclosure requirement would be an important component of the Treasury Department's modified substantial understatement penalty proposal, described below.
- As the AICPA suggests, because this proposal requires taxpayers to disclose transactions subject to a confidentiality agreement, the section 6111(d) disclosure requirement for confidential corporate tax shelter arrangements would be modified or eliminated.
- Promoters would be required to make similar disclosures no later than 30 days after the first offering of the tax shelter.
- The Treasury Department continues to believe that taxpayers should be encouraged to disclose transactions that are reported differently from their form. The original proposal included in the Budget would be modified to

provide that any transaction over a certain threshold amount (say, with tax benefits over \$1 million) for which the taxpayer does not follow its form must be separately disclosed on the taxpayer's return. Exceptions would be provided for certain transactions that have historically involved taxpayers taking positions inconsistent with their forms.

### **Taxpayer Penalties**

- The Treasury still believes that the penalty structure set forth in the Administration's FY 2000 Budget is appropriate. However, consideration could be given to providing a strengthened reasonable cause standard that would cause the substantial understatement penalty to be reduced or eliminated, in situations where the taxpayer also properly disclosed the transaction in question. This limited exception would encourage disclosure and would alleviate some taxpayer concerns with respect to the definition of corporate tax shelter. Under this version, the following sanctions could apply to substantial understatements of income tax attributable to corporate tax shelter transactions:
  - If there was no disclosure by taxpayer, the resulting underpayment would be subject to the increased 40-percent penalty, with additional fixed-amount penalties for failure to disclose.
  - If there was disclosure by taxpayer, the resulting underpayment would be subject to the 20-percent penalty, unless the taxpayer met the strengthened reasonable cause standard, in which case the penalty could be avoided.

### **Disallow Tax Benefits of Corporate Tax Shelters**

As stated above, the Treasury Department believes that a substantive change is necessary to address corporate tax shelters. Such change should embody the adoption of coherent standards rather than narrow, mechanical rules.

- The centerpiece of the substantive law change should be the codification of the economic substance doctrine first found in seminal case law such as

Gregory v. Helvering<sup>20</sup> and most recently utilized in ACM.<sup>21</sup> The economic substance doctrine requires a comparison of the present values of expected pre-tax profits and expected tax benefits. This test was incorporated in the first part of the Administration's proposed definition of "tax avoidance transaction." Thus, the Treasury Department retains the first part of the Administration's original proposed definition of "tax avoidance transaction."

- The second part of the original proposed definition would be modified to be more objective. It would apply to transactions that do not lend themselves to a pre-tax profit comparison; most notably, financing transactions.
- Concerns that the IRS might abuse its broader authority would be addressed by a more concrete definition of tax avoidance transaction. In addition, the tax attribute disallowance rule would apply by operation of law, rather than being subject to the discretion of the Secretary.
- A model for the type of proposal discussed in the above three paragraphs can be found in H.R. 2255, the "Abusive Tax Shelter Shutdown Act of 1999," introduced by Messrs. Doggett, Stark, Hinchey and Tierney on June 17, 1999.
- In addition, legislative, regulatory, and administrative steps could be taken to ensure consistent resolution of corporate tax shelter issues and to address concerns that the IRS might abuse its broader authority.

-- As part of the IRS's restructuring, IRS personnel reviewing potential corporate tax shelters will be centralized in the new IRS corporate group. This centralization will facilitate training and coordination among agents, their supervisors and Chief Counsel. Increased coordination by the IRS would increase consistency and efficiency in dealing with complex tax shelter issues.

-- A corporate tax shelter task force, modeled after the current Industry Specialization Program and the Abusive Tax Shelter

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<sup>20</sup> Gregory v. Helvering, 293 U.S. 465 (1935).

<sup>21</sup> ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

Detection Team formed for the individual tax shelters of the 1970s and 1980s, could further centralize and streamline tax shelter review activity. Increased disclosure by taxpayers also could facilitate this effort.

-- Procedural and other safeguards could be installed. For example, a corporate tax shelter issue raised by an examining agent could be automatically referred to the National Office of the IRS for further review or resolution.

-- Special rules also could be developed that would allow a taxpayer to receive an expedited ruling from the National Office of the IRS as to whether a contemplated transaction constituted a corporate tax shelter for purposes of the substantial underpayment penalty.

### **Consequences to Other Parties (e.g., promoters and advisors, and tax-indifferent parties)**

#### **Promoters and advisors**

- With respect to promoters and advisors, the Treasury Department believes that the most direct way to affect their economic incentives is to levy an excise tax upon the fees derived by such persons from the corporate tax shelter transaction. The Treasury Department would modify and clarify the Administration's proposal regarding such excise taxes by (1) providing that only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal, and (2) providing appropriate due process procedures for such parties with respect to an assessment.
- The Treasury Department recognizes that the proposed excise taxes on promoter and advisor fees operates in the same manner as a penalty. In this regard, consideration could be given to amending the current-law penalties (that were enacted to address the individual tax shelters of the 1970s and 1980s) to be more responsive to corporate tax shelters in lieu of such excise taxes.
- The Treasury Department proposes to eliminate the Administration's original proposals that would (1) disallow deductions for promoter and advisor fees, and (2) impose a 25-percent excise tax on rescission agreements, unwind provisions, and insurance arrangements.

## **Tax-indifferent parties**

- The Treasury Department would modify and clarify the Administration's proposal regarding tax-indifferent parties by (1) providing appropriate due process procedures for such parties with respect to any assessment, (2) providing that only tax-indifferent parties that are trading on their tax exemption are subject to the proposal, and (3) clarifying that the joint and several liability runs between the tax-indifferent party and the corporate participant only.



## II. INTRODUCTION

*The Nature of the Problem.* The recent proliferation of corporate tax shelters poses a significant threat to our tax system. Many tax professionals have expressed their concern that the corporate tax shelter problem is large and growing.

- The American Bar Association, in an appearance before the House Ways and Means Committee, noted its "growing alarm [at] the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than the reduction of Federal income taxes," and its concern at the "blatant, yet secretive marketing" of such products.<sup>1</sup>
- The New York State Bar Association, in testimony before the Senate Finance Committee, stated: "We believe that there are serious, and growing, problems with aggressive, sophisticated and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage . . . There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience leads us to believe that it is likely to be quite significant."<sup>2</sup>
- In the 1999 Erwin N. Griswold Lecture before the American College of Tax Counsel, former ABA Tax Section president James Holden stated: "Many of us have been concerned with the recent proliferation of tax shelter products marketed to corporations...the marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on."<sup>3</sup>
- The Tax Executives Institute recently testified before the Senate Finance Committee: "TEI is not among those who believe no problem exists. But the problem confronting the tax system is not simple, and care must be taken to ensure that the solutions are measured and

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<sup>1</sup> Statement of Stefan F. Tucker, on behalf of the Section of Taxation, American Bar Association, before the Committee on Ways and Means, March 10, 1999, at 5 [hereinafter ABA Ways and Means].

<sup>2</sup> Statement of Harold R. Handler, on behalf of the Tax Section, New York State Bar Association, before the Committee on Finance, April 27, 1999, at 1 [hereinafter NYSBA].

<sup>3</sup> James P. Holden, 1999 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Dealing with the Aggressive Corporate Tax Shelter Problem, 52 Tax Lawyer 369 (1999) [hereinafter Holden].

balanced and, further, that they do not add even more complexity to the already overburdened tax law."<sup>4</sup>

- A recent cover story in Forbes magazine<sup>5</sup> was devoted to the “thriving industry of hustling corporate tax shelters.” This article quoted a partner in a major accounting firm describing the development and highly selective marketing of “black box” strategies for tax avoidance that can save its purchasers from tens of millions to hundreds of millions of dollars at the expense of other U.S. taxpayers.

Some have argued that corporate tax shelters are not a significant problem because corporate tax revenues have been rising. As Professor Joseph Bankman points out, however, this is not in and of itself “inconsistent with a burgeoning market in corporate tax shelters. In a boom economy, it is possible for tax revenues to rise, and tax savings from shelter usage to rise even faster...”<sup>6</sup> In fact, while corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. One hallmark of corporate tax shelters is a reduction in taxable income with no concomitant reduction in book income. The ratio of book income to taxable income has risen fairly sharply in the last few years. Similarly, the effective tax rate, the ratio of tax to profits, has declined during the 1990s. Some of this decline may be due to tax shelter activity.

*Reasons for Concern.* Corporate tax shelters breed disrespect for the tax system -- both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a “race to the bottom.” If unabated, this will have long-term consequences to our voluntary tax system far more important than the revenue losses we currently are experiencing in the corporate tax base. Also, significant resources -- both in the private sector and the Government -- are currently being wasted on this uneconomic activity.<sup>7</sup> Private sector resources used to create, implement and defend complex sheltering transactions are better used in productive activities. Similarly, the Congress (particularly the tax-writing

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<sup>4</sup> Statement of Lester D. Ezrati, on behalf of the Tax Executives Institute, before the Committee on Finance, April 27, 1999, at 6 [hereinafter TEI].

<sup>5</sup> Janet Novack and Laura Saunders, The Hustling of X Rated Shelters, Forbes, Dec. 14, 1998 at 198, 203 [hereinafter Forbes].

<sup>6</sup> Letter to the Editor from Joseph Bankman, 83 Tax Notes 1813 (June 21, 1999). See also Airlie House Transcript, intra note 9 (Kenneth Kies questioning those who claimed “the actual level of corporate receipts...tells us there is nothing to worry about.”)

<sup>7</sup> As Peter Cobb, former Deputy Chief of Staff of the Joint Committee on Taxation recently stated: “You can’t underestimate how many of America’s greatest minds right now are being devoted to what economists would all say is totally useless economic activity.”

committees and their staffs), the Treasury Department, and the IRS must expend significant resources to address and combat these transactions.

*The Need for Change.* To date, most attacks on corporate tax shelters have been targeted at specific transactions and have occurred on an *ad hoc*, after-the-fact basis -- through legislative proposals, administrative guidance, and litigation. In the past few years alone, Congress, the Treasury Department and the IRS have taken a number of actions to address specific corporate tax shelters. These include:

- Two provisions enacted in 1996 and 1997 to prevent the abuse for tax purposes of corporate-owned life insurance (COLI).<sup>8</sup> Collectively, these two provisions were estimated by the Joint Committee on Taxation to raise over \$18 billion over 10 years. As the then Chief of Staff of the Joint Committee on Taxation stated: "When you have a corporation wiring out a billion dollars of premium in the morning and then borrowing it back by wire in the afternoon and instantly creating with each year another \$35 million of perpetual tax savings, that's a problem.... I think we were looking at a potential for a substantial erosion of the corporate tax base if something hadn't been done."<sup>9</sup>
- Legislation enacted late last year to eliminate the ability of banks and other financial intermediaries to avoid corporate-level tax through the use of "liquidating REITs."<sup>10</sup> The Treasury Department's Office of Tax Analysis estimated that eliminating this one tax shelter product alone would save the tax system approximately \$34 billion over the next ten years.
- The recent IRS ruling<sup>11</sup> addressing so-called lease-in, lease-out transactions, or "LILO" schemes. Like COLI, these transactions, through circular property flows and cash flows, offered participants millions in tax benefits with no real economic substance or risk.
- Legislation signed into law June 25, 1999 aimed at section 357(c) basis creation abuses.<sup>12</sup> In these transactions, taxpayers exploited the concept of "subject to" a liability and

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<sup>8</sup> Pub. L. No. 104-191, § 501 (1996); Pub. L. No. 105-34, § 1084 (1997)

<sup>9</sup> Kenneth Kies, Transcript of Federal Bar Association's Fourth Invitational Biennial Conference on the Tax Legislative Process, reprinted in 97 Tax Notes Today 21-38 (Jan. 31, 1997) [hereinafter 1997 Airlie House Transcript].

<sup>10</sup> Pub. L. No. 105-277, § 3001(a) (1998).

<sup>11</sup> Rev. Rul. 99-14, 1994-14 I.R.B. 3.

<sup>12</sup> Pub. L. No. 106-\_\_\_\_, § 3001 (1999). The bills containing the amendment to section 357(c) are H.R. 435, 106<sup>th</sup> Cong. (1999) and S. 262, 106<sup>th</sup> Cong. (1999).

claimed increases in the bases of assets that resulted in bases far in excess of the assets' values.

- Proposed regulations<sup>13</sup> addressing fast-pay preferred stock transactions. These financing transactions purportedly allowed taxpayers to deduct both principal and interest. It was reported that one investment bank created nearly \$8 billion of investments in a few months.
- Notice 98-5<sup>14</sup> dealing with foreign tax credit abuses.
- The Government's victories in two important corporate tax shelter cases -- ACM Partnership v. Commissioner<sup>15</sup> and ASA Investering Partnership v. Commissioner.<sup>16</sup>

Addressing corporate tax shelters on a transaction-by-transaction, *ad hoc* basis, however, has substantial defects. First, because it is not possible to identify and address all (or even most) current and future sheltering transactions, this type of transaction-by-transaction approach is incomplete. There will always be transactions that are unidentified or not addressed by the legislation. As Deputy Treasury Secretary Lawrence H. Summers said: "One is reminded of painting the Brooklyn Bridge: no sooner is one section painted over, than another appears needing work. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions the treatment of which is less clear."<sup>17</sup>

Second, legislating on a piecemeal basis complicates the Code. In the past few years alone, Congress has passed numerous provisions to prevent specific tax shelter abuses.

Third, such a legislative strategy seemingly calls into question the viability of current rules and standards, particularly the common law tax doctrines such as sham transaction, business purpose, economic substance and substance-over-form. Finally, reliance on a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to

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<sup>13</sup> Prop. Reg. § 1.7701(l)-3.

<sup>14</sup> See Notice 98-5, 1998-3 I.R.B. 49.

<sup>15</sup> 73 T.C.M. (CCH) 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

<sup>16</sup> 76 T.C.M. (CCH) 325 (1998).

<sup>17</sup> Lawrence H. Summers, "A Better Tax Service and a Better Tax System," Tax Executives Institute, March 22, 1999.

rush shelter products to market on the assumption that any Governmental reaction would be applied only on a prospective basis.

This Report on corporate tax shelters is intended to provide an in-depth discussion of corporate tax shelters, including an analysis of the Administration's Budget proposals to address corporate tax shelters and recommendations for modification of those proposals, and a discussion of other proposals to limit the growth of corporate tax shelters. This Part II provides background information on corporate tax shelters, including a discussion of the goals and common characteristics of corporate tax shelters. Part III discusses the factors contributing to the growth of corporate tax shelters. Part IV discusses the present law concerning tax shelter transactions, including historic Congressional and Administrative substantive and procedural responses to tax shelters and the development of judicial anti-avoidance doctrines. Part V provides an analysis of the Administration's budget proposals and recommends modifications to the original proposals. Part VI discusses other proposals to limit the growth of corporate tax shelters, including options that we considered but did not propose, anti-abuse approaches adopted in other countries, and improving the targeted response system. Finally, the Report includes three Appendices. Appendix A describes some specific recent corporate tax shelters. Appendix B describes in detail the corporate tax shelter proposals in the Administration's FY 2000 Budget. Appendix C discusses in detail the proposed definition of corporate tax shelter.

## A. GOAL AND METHODOLOGIES OF CORPORATE TAX SHELTERS

Although corporate tax shelters take many forms, they all share a single goal -- the reduction of corporate income tax liability. To achieve this goal, participants engineer transactions that generate tax losses, exclude income from taxation, defer recognition of income into a later year, or convert income into a different, lower-taxed form. As discussed in Part II.A.3. below, these transactions typically rely on one or more discontinuities of the tax law. These discontinuities can arise in the basic structure of the Federal income tax system or in specific provisions of the Code and regulations. The development of sophisticated financial instruments, such as derivatives, has facilitated the exploitation of these tax law discontinuities.

### 1. Reducing Corporate Income Tax Liability

The primary goal of a corporation is to maximize shareholder value. As corporate earnings comprise the primary source of shareholder value, corporations continually seek to create or increase earnings. This can be done either by increasing revenues or decreasing costs. Because taxes represent one of a corporation's most significant costs, corporations seek to minimize their tax liability.<sup>18</sup>

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<sup>18</sup> Corporations are free to reduce their taxes as the law allows. See Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."), aff'd, 69 F.2d 809, 810 (2d Cir. 1934) ("Anyone may so arrange his affairs

Recently, corporate officers and directors appear to be paying even greater attention to shareholder concerns and reported corporate earnings.<sup>19</sup> This focus on increasing corporate earnings reportedly has caused many corporations to treat their in-house tax departments as profit centers.<sup>20</sup> According to one recent article:

With the encouragement from shelter hustlers, a new attitude is spreading: that the corporate tax department is a profit center all its own, and that a high effective tax rate is a sign of weakness. 'A potential client once said he would hire the firm if we could get their tax rate down, because it was higher than their competitors' and they were embarrassed,' says one accountant.<sup>21</sup>

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that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."). It should be noted that the taxpayer in Gregory lost in both the Second Circuit and the Supreme Court.

<sup>19</sup> See, e.g., New York State Bar Ass'n (Tax Section), Report on Corporate Tax Shelters of New York State Bar Association Tax Section, 83 Tax Notes 879 (May 10, 1999) [hereinafter NYSBA, Report]; Joseph Bankman, The New Market in Corporate Tax Shelters, 83 Tax Notes 1775 (June 21, 1999) [hereinafter Bankman].

<sup>20</sup> See also Bankman, supra note 19, at 1784 ("At the same time, perhaps part of a general trend of greater management responsiveness to shareholder concerns and returns, and perhaps due to greater management sophistication, tax departments are now looked at in some companies as profit centers."); 1997 Airlie House Transcript, supra note 9 (Don Longano stated that: "I think many corporate tax departments find themselves under a considerable amount of pressure to add value to the company... I don't think corporate tax departments generally get points for filing an accurate return or no typos. Most tax departments report not through the general counsel of the company, but through the CFO.").

<sup>21</sup> Forbes, supra note 5, at 200.

In light of this increased emphasis on keeping the corporation's effective tax rate low<sup>22</sup> -- to maximize shareholder value<sup>23</sup> -- and in line with that of competitors, more corporations are seeking to reduce their tax liability using tax-engineered transactions. Corporate tax shelters that are not successfully challenged by the IRS generally are very effective in reducing a corporation's effective tax rate. Of course, once a corporation uses a shelter to reduce its effective tax rate, there will be pressure to continue to engage in corporate tax shelters to maintain the reduced rate.<sup>24</sup>

## 2. Methods of Reducing Corporate Income Tax Liabilities

Corporate tax liabilities can be reduced if income is not taxed, is taxed at a later time, or is taxed at a rate lower than the prescribed rate for that category of income.<sup>25</sup> These classic hallmarks of tax shelters -- exclusion, deferral, and conversion -- are discussed in section A of Part IV of this Report.

Tax shelters take two forms to accomplish those goals: "(1) those that provide tax savings with respect to other, unrelated income of the shelter investor, and (2) those that provide

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<sup>22</sup> The effective tax rate is the ratio of corporate tax liability to book income. For purposes of determining a corporation's effective tax rate, a corporation's tax liability includes not only taxes currently payable, but deferred taxes as well. Thus, corporate tax shelters that create timing differences between book and taxable income lower the corporation's actual tax liability, but do not reduce the corporation's effective tax rate. Sophisticated users of financial statements can discern the benefits of a corporation's deferred taxes through an examination of other information in the financial statements reserve. In addition, tax benefits may be reflected in other areas of the corporation's income statement or balance sheet. For example, tax benefits related to leverage leases are reflected as part of the overall investment and not the tax reserves of the corporation. Permanent differences generally reduce a corporation's effective tax rate. However, a corporation may not fully reflect anticipated permanent tax benefits to be derived from a corporate tax shelter for fear that the benefits may not survive IRS scrutiny. In such cases, the corporation will establish a reserve against such benefits that can be reversed at a later time when it appears more likely that the benefits will be realized (e.g., when statute of limitations with respect to the year in question is closed or when the IRS has challenged similar benefits of other taxpayers but has lost in court).

<sup>23</sup> A lower effective tax rate may lead to a higher stock price and more satisfied shareholders. See Charles W. Swenson, Increasing Stock Market Value By Reducing Effective Tax Rates, 83 Tax Notes 1503 (June 7, 1999).

<sup>24</sup> See discussion infra, at notes 49-55.

<sup>25</sup> See, e.g., Jt. Comm. on Tax'n, Tax Reform Proposals: Tax Shelters and Minimum Tax, at 2 (Aug. 7, 1985).

exemption or a reduced rate of tax on the income to be derived from the shelter." <sup>26</sup> In the first category of corporate tax shelters are transactions that generate tax benefits in excess of the income generated by the shelter (an "excess benefits shelter" or so-called "loss generator"). <sup>27</sup> The excess benefits -- in the form of inflated basis, deductions, losses or credits -- can then be used to offset other income, thereby reducing the taxpayers' overall tax liability and effective tax rate. <sup>28</sup> There are several recent examples of excess benefits shelters, including so called "lease-in, lease-out" (LILO) transactions and section 357(c) transactions, both of which are described in Appendix A and have been shut down by legislative or regulatory action.

In the second category of transactions, income that should be taxed escapes taxation by exploiting an unintended discontinuity in the tax law ("exclusion shelters"). A recent example of an exclusion shelter is the liquidating REIT transaction, also described in Appendix A.

### 3. Exploiting Tax Law Discontinuities

Corporate tax shelters typically rely on some type of discontinuity in the tax law that treats certain types or amounts of economic activity more favorably than comparable types or amounts of activity.<sup>29</sup> Discontinuities exist in the tax law for several reasons. Most importantly, the Code

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<sup>26</sup> Kenneth W. Gideon, Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters, 5 Va. Tax Rev. 825, 849 (1986).

<sup>27</sup> See NYSBA, Report, supra note 19, at 884. The individual tax shelters of the 1970s and 1980s were usually of this type. Typically, in those shelters, individuals invested in limited partnerships that, through nonrecourse indebtedness and overvaluations of property, generated tax losses that could offset other income (often, earned income) of the individuals. For a more complete discussion of the individual tax shelters of the 1970s and 1980s, see Part IV(C) of this Report.

<sup>28</sup> NYSBA, Report, supra note 19, at 884.

<sup>29</sup> See generally Michael S. Powlen and Raj Tanden, Corporate Tax Shelters or Plus Ça Change, plus C'est la Meme Chose, 431 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (PLI) 1003, 1009 (1998) [hereinafter Powlen and Tanden] ("What are the fundamental aspects of the system that create the opportunity for tax shelters? First, our tax system, perhaps of necessity, incorporates certain basic principles that: (i) require arbitrary line drawing that can be manipulated, (ii) are generally not followed on an internally consistent basis, (iii) often exist simultaneously with antithetical principles, and (iv) ultimately do not give rise to authentically meaningful models of real income.").



does not measure economic income precisely.<sup>30</sup> Rather, the Code incorporates a number of simplifying conventions to address various concerns, such as liquidity, complexity (including valuation concerns), and administrability. These simplifying conventions, however, provide opportunities for manipulation and are a major source of tax shelter activity. For example, the realization principle alone has “inevitably stimulate[d] an almost infinite variety of tax planning.”<sup>31</sup> Using this principle, taxpayers have been able to monetize the value in their assets ( e.g., through borrowing),<sup>32</sup> or to lock-in appreciation with respect to their property,<sup>33</sup> without recognizing taxable gain. Other simplifying conventions include the annual accounting convention, historical cost, inventory methods, and other accounting methods.

There are several other discontinuities in the tax law that provide sheltering opportunities. For instance, the Code contains a number of distinctions that can be manipulated, such as the distinction between capital gains and ordinary income, and the distinction between debt and equity.<sup>34</sup> In addition, Congress has used the Code to provide tax benefits to induce taxpayers to

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<sup>30</sup> In an ideal income tax, all items of income or deduction would be measured and treated equally. Under the Haig-Simon definition of income, income is defined as the sum of the market value of rights exercised in consumption and the change in the value of the store of property rights between the beginning and the end of the period in question. Such a definition would lead to the accurate measure of income but has never been fully adopted in the Code. See Haig, The Concept of Income-Economic and Legal Aspects and H. Simons, Personal Income Taxation, discussed in Boris I. Bittker and Lawrence Lokken, 1 Federal Taxation of Income, Estates and Gifts, ¶3.1 (3d ed. 1999) and George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Col. L. Rev. 657, 660-63 (1985).

<sup>31</sup> NYSBA, Report, supra note 19, at 882.

<sup>32</sup> See Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (borrowing against appreciated position is not a realization event).

<sup>33</sup> For example, prior to the enactment of the Taxpayer Relief Act of 1997, a taxpayer holding an appreciated stock position could effectively sell the position without recognizing current taxable gain by entering into a short-against-the-box transaction or a similar economic transaction. Because the taxpayer had not sold the position, i.e., no realization event had occurred, taxable gain could be deferred to a future year (or could be avoided altogether if the taxpayer died holding the securities, as the basis of the stock would be stepped up to fair market value under section 1014). See, e.g., Rev. Rul. 73-524, 1973-2 C.B. 307. Section 1001(a) of the Tax Reform Act of 1997 adopted Section 1259, which requires gain recognition with respect to so-called “constructive sales transactions,” including short-against-the-box transactions.

<sup>34</sup> NYSBA, Report, supra note 19, at 882 (“[I]n the context of corporate tax planning, the unintegrated structure of the corporate tax system places a significant premium on fitting financial instruments into the optimal cubbyhole of debt or equity.”)

engage in certain socially desirable activities or to make certain investments. While provided through the tax system, these benefits (referred to as “tax expenditures”) are intended to achieve non-tax policy goals.<sup>35</sup> However, at times, these provisions may be utilized to produce tax benefits in excess of those intended by Congress.

Another form of discontinuity that can be manipulated to achieve unforeseen and unintended results is the existence of different tax regimes applicable to different types of taxpayers. The Code, for example, provides tax-exempt or tax-favored status for certain persons or organizations, and limits on the taxing powers of the United States provide exemptions for others. In addition, identical activities undertaken by different types of entities may result in different tax results.<sup>36</sup> Discontinuities can also arise from the existence of different tax treatments for the same transaction in different tax jurisdictions.<sup>37</sup> These different tax treatments can and have been arbitrated to produce corporate tax shelters.<sup>38</sup>

Finally, certain provisions of the Code and regulations have been designed with a bias toward accelerating taxable income. Ironically, over time, tax practitioners have developed techniques to exploit these rules to create corporate tax shelters.<sup>39</sup>

## B. CHARACTERISTICS OF CORPORATE TAX SHELTERS

Corporate tax shelters "appear in the guises of Proteus,"<sup>40</sup> taking many different forms and utilizing many different structures. For this reason, a single, comprehensive definition of

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<sup>35</sup> Budget of the United States Government, Analytical Perspectives, 105 (Fiscal Year 2000).

<sup>36</sup> Subchapter C corporations are subject to tax on their earnings. Subchapter S corporations and partnerships generally are not. Trusts are subject to a variety of tax rules. Real estate investment trusts (REITs) and regulated investment companies (RICs) are taxed as subchapter C corporations, but can reduce or eliminate their taxable income by making deductible distributions. Similarly, different tax rules apply to owners of these entities.

<sup>37</sup> See Notice 98-5, 1998-3 I.R.B. 49, Examples 4 and 5.

<sup>38</sup> See, e.g., the description of the fast pay stock transaction in Appendix A, which attempted to exploit differences with respect to the taxable status of parties, debt and equity, and forms of entity.

<sup>39</sup> See Appendix A for descriptions of the ACM transaction and the fast-pay stock transaction, both of which exploited rules designed to accelerate taxable income.

<sup>40</sup> See Testimony of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy), before the Senate Finance Committee (April 27, 1999).

corporate tax shelters is difficult to formulate. Nonetheless, a number of common characteristics of tax shelters can be identified, including: (1) lack of economic substance; (2) inconsistent financial and accounting treatment; (3) presence of tax-indifferent parties; (4) complexity; (5) unnecessary steps or novel investments; (6) promotion or marketing; (7) confidentiality; (8) high transaction costs; and (9) risk reduction arrangements.<sup>41</sup>

#### 1. Lack of Economic Substance

Professor Michael Graetz recently defined a tax shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid.”<sup>42</sup> While somewhat tongue in cheek, this definition highlights one of the most important characteristics common to most corporate tax shelters -- the lack of significant pre-tax economic substance or risk to the participating parties. See Part IV.B, of this Report for a discussion of judicial doctrines that highlight this factor and Part V.C for a discussion of the Administration’s proposals to limit corporate tax shelter activity.

Often, in corporate tax shelters, a corporate participant purportedly makes a significant investment. In most cases, however, this investment is illusory. Through hedges, circular cash flows, defeasements and similar devices, the participant in a shelter is insulated from virtually all economic risk.<sup>43</sup> Transactions with little or no economic risk typically generate little or no pre-tax return. As Professor Graetz notes, in light of the expectation of little or no pre-tax profit, no one rationally would participate in such transactions without significant tax benefits. After factoring in expected tax benefits, however, a negligible pre-tax profit is transformed into a significant after-tax return.<sup>44</sup>

A recent example of this is the so-called lease-in, lease-out (or “LILO”) type of transaction.<sup>45</sup> In a typical LILO transaction, a U.S. taxpayer leases property from a foreign

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<sup>41</sup> It is important to note that these characteristics, while common in corporate tax shelters, may be found in other transactions as well.

<sup>42</sup> See Tom Herman, Tax Report, Wall St. J. at A-1 (Feb. 10, 1999).

<sup>43</sup> See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), aff’d in part, rev’d in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999). The transaction at issue in ACM is discussed more fully in Appendix A of this Report.

<sup>44</sup> See, e.g., Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988) (leasing transaction lacked economic substance; court refused to treat investment tax credit as a substitute for or component of economic profit; in the absence of investment tax credit, taxpayer had no possibility of economic profit even under the taxpayer’s most optimistic assumptions concerning the residual value of the leased equipment).

<sup>45</sup> For a more complete discussion of this transaction, see Appendix A of this Report.

municipality (or other tax-exempt entity), and immediately subleases the property back to the original lessor. In addition to the circular property flows, the parties enter into other arrangements to eliminate any non-tax economics. For example, a U.S. corporation borrows funds to prepay its rental obligation to the foreign municipality that uses the majority of the prepayment to fund deposit accounts (in an affiliate of the U.S. corporation's lender) that economically defease its obligations to the U.S. taxpayer under the sublease and other arrangements. In light of the lack of any economic risk, the U.S. taxpayer receives only a negligible pre-tax economic return from the transaction. By engaging in the transaction, however, the U.S. taxpayer expects to receive substantial tax benefits because the transaction purportedly generates a stream of substantial net deductions in the early years of the transaction (that can be used to shelter other income) followed by net income inclusions many years later. The Treasury Department understands that in some lease-in, lease-out transactions, the claimed after-tax return could exceed 18 percent. The Treasury Department and the IRS recently issued a revenue ruling stating that these transactions lack economic substance and therefore do not generate the tax benefits they are alleged to create.<sup>46</sup>

Corporate tax shelters can arise even in transactions that produce more than a negligible amount of pre-tax economic profit. As discussed above, exclusion shelters are designed to reduce or eliminate corporate income tax on the pre-tax economic profit.<sup>47</sup> In addition, a taxpayer may attempt to disguise the tax avoidance nature of the transaction by placing high-grade, income-producing financial instruments in a corporate tax shelter.<sup>48</sup>

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<sup>46</sup> Rev. Rul. 99-14, 1999-14 I.R.B. 3. Other shelters have been held to lack economic substance because the reasonably expected pre-tax profit was insignificant relative to the claimed tax benefits. See Notice 98-5, 1998-3 I.R.B. 49. See also Sheldon v. Commissioner, 74 T.C. 738, 768-69 (1990) (in the context of an individual tax shelter, the court stated that the economic gain in question was "infinitesimally nominal" and "vastly insignificant" in relation to the claimed tax benefits and could not, in and of itself, support a finding of economic substance).

<sup>47</sup> In certain shelters, the corporate taxpayer may have a purpose other than profit for engaging in the transaction. For example, the transaction may be a financing, where the corporate taxpayer's purpose is to procure the lowest-cost financing possible.

<sup>48</sup> NYSBA, Report, supra note 19, at 895.

## 2. Inconsistent Financial Accounting and Tax Treatments

In most recent corporate tax shelters involving public companies,<sup>49</sup> the financial accounting treatment of a shelter item has been inconsistent with its Federal income tax treatment.<sup>50</sup> As the New York State Bar Association recently testified:

[A] significant segment of corporate America has, in recent years, appeared to place a larger premium on tax savings, particularly tax savings in transactions in which the tax treatment varies from the financial accounting treatment... [S]tructuring a transaction that results in either a deduction without a financial accounting charge or financial accounting revenue without the concomitant imposition of tax can be viewed as a real coup by the tax manager.<sup>51</sup>

The emergence of book-tax disparities as a hallmark of recent shelters is consistent with the trend to treat corporate in-house tax departments as profit centers,<sup>52</sup> and the pressure to increase shareholder value and remain competitive. Corporate managers are placing greater emphasis on keeping the corporation's effective tax rate ( *i.e.*, the ratio of corporate tax liability to book income) low and in line with that of competitors.

A successful shelter with a book-tax disparity is Elysium for a corporation; it not only reduces the corporation's tax liability, but also reduces its effective tax rate.<sup>53</sup> For example, assume a corporation subject to a 35-percent tax rate has both taxable income and book income of \$1,000. In this case, the corporation's pre-shelter effective tax rate is 35 percent (35 percent of \$1,000/\$1,000). If the corporation engages in a sheltering transaction that permanently

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<sup>49</sup> Private companies are less concerned with reported book earnings and thus may be more willing than public companies to engage in tax shelters that have favorable tax consequences but also have an impact on book earnings.

<sup>50</sup> This characteristic is consistent with the observation that corporate tax shelters generally do not have any underlying economic substance other than tax savings. If the transaction had economic substance, the result generally would be reported on the financial statements.

<sup>51</sup> NYSBA, Report, supra note 19, at 882.

<sup>52</sup> See the discussion in section A.1. of this Part II.

<sup>53</sup> It should be noted, however, that, by participating in corporate tax shelters that reduce the corporation's effective tax rate for one reporting period, the corporation may be under pressure to continue to engage in corporate tax shelters in order to meet market expectations of maintaining the low rate.

reduces its taxable income, but not its book income, by \$200, its effective tax rate becomes 28 percent (35 percent of \$800/\$1,000).

In contrast, a transaction that reduces both a corporation's taxable and book income lowers the corporation's tax liability, but does not affect its effective tax rate. More importantly, the corporation could fail to meet, as a result of the book loss, the earnings expectations of investors. Thus, as one commentator has noted, "many if not most executives will pass up an opportunity to reduce taxes if it also entails a reduction in reported earnings."<sup>54</sup>

Although some disclosure of book-tax disparities is required both for Federal income tax and GAAP purposes, the amount of detail required is limited and provides the IRS with little evidence concerning the existence of corporate tax shelters.<sup>55</sup> Financial statement disclosure is limited to items of materiality. Tax return disclosure is not limited to corporate tax shelters, but rather applies to all book-tax differences, of which there are many. Thus, book-tax differences attributable to shelters often remain hidden, and corporations have no incentive to expose the existence and nature of their shelters voluntarily.

### 3. Presence of Tax-indifferent Parties

Another significant characteristic found in many, but not all, corporate tax shelters is the participation of tax-indifferent parties.<sup>56</sup> Recent examples of shelter transactions that relied on the use of tax-indifferent parties include (as described more fully in Appendix A) the fast-pay preferred stock transactions, the LILO transactions, and the contingent installment sales transactions that were litigated in ACM<sup>57</sup> and ASA.<sup>58</sup>

Tax-indifferent parties are accommodation parties who are paid a fee or an above-market return on investment for the service of absorbing taxable income or otherwise "leasing" their tax-

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<sup>54</sup> Bankman, supra note 19, at 1780.

<sup>55</sup> This reconciliation is reported on schedule M-1 of Form 1120 and Part IV of Form 1120A and in the footnotes to financial statements filed with the Securities Exchange Commission.

<sup>56</sup> See Statement of Stefan F. Tucker, on behalf of the Section of Taxation American Bar Association, to Senate Finance Committee, April 27, 1999 [hereinafter ABA], at 4. ("The tax shelters that concern us generally have the following features ... one party to the transaction is frequently what the Treasury refers to as "tax indifferent.").

<sup>57</sup> 73 T.C.M. 2189.

<sup>58</sup> ASA Investering Partnership v. Commissioner, 76 T.C.M. (CCH) 325 (1998).

advantaged status.<sup>59</sup> Tax-indifferent parties include foreign persons, Native American tribal organizations, tax-exempt organizations ( e.g., charitable organizations and pension plans), and domestic corporations with net operating losses or credit carryforwards that they do not expect to use to offset their own income.<sup>60</sup>

When taxpayers use different methods of accounting, the difference may be arbitrated to create a tax shelter. Recently, for example, taxpayers subject to mark-to-market accounting have been acting as accommodation parties in tax shelters.<sup>61</sup> This is because they are indifferent to the realization principle and thus can enter into transactions with taxpayers subject to the realization principle to absorb gains of such taxpayers.

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<sup>59</sup> In this connection, the shelters typically are structured so that the accommodation party bears little or no economic risk from the transaction.

<sup>60</sup> Trafficking in losses has a long history. In 1943, Congress enacted the predecessor of section 269 to combat the sale of shell corporations with net operating loss carryovers. Unlike other tax-indifferent parties, the losses in question may be legitimate economic losses that the loss corporation may eventually be able to use to offset its own income. In this case, the sale of the losses accelerates their use and results in a timing benefit to the loss corporation. In contrast, if the loss corporation could never fully utilize its losses, the benefits arising from the sale would result in a permanent loss to the system.

<sup>61</sup> For example, in a recently publicized transaction, certain hedge fund investors have attempted to convert their short-term capital gains that flow through from the hedge fund into long-term capital gains by entering into a derivatives transaction with a mark-to-market taxpayer. See, e.g., E.S. Browning & Laura Jereski, Tax Plan Could Hurt Hedge Play, Wall St. J., Feb. 1, 1998, at C1. Under the arrangement, the mark-to-market taxpayer acquires a direct interest in the hedge fund (because it is indifferent to whether gains realized by the hedge fund are short-term or long-term) and agrees to pay an amount that replicates the return of the hedge fund to the investor. Because the derivative is not settled before one year after it is entered into, the transaction is intended to allow the hedge fund investor to defer income and to convert his hedge fund income into a long-term capital gain. Many investment banks, that create and promote corporate tax shelters, are required to be on the mark-to-market accounting method. Thus, these banks may play two roles (as promoters and as a tax-indifferent party) in a corporate tax shelter. The Administration, in its FY 2000 Budget, and Congressman Neal (D. Mass.) both have proposed legislation that would eliminate the purported conversion benefits from engaging in the derivatives transaction. See Department of the Treasury, General Explanation of the Administration's Revenue Proposals (February 1999) [hereinafter Treasury Explanation], at 122; and H.R. 1703, 106<sup>th</sup> Cong. (1999) (introduced May 5, 1999).

#### 4. Complexity

Corporate tax shelters typically involve exceedingly complex transactions and structures. This complexity arises from a number of sources. As discussed above, corporate tax shelters often require the completion of certain formalistic steps to claim the desired tax result. The use of certain entities or structures may be necessary to achieve the desired tax result or to facilitate the use of tax-indifferent parties. Other steps may be added to establish or buttress a claim of business purpose or economic substance.

Also, as alluded to above, corporate tax shelters often use innovative financial instruments to facilitate the exploitation of tax law inconsistencies. Financial innovation is growing rapidly and the tax law has not kept pace.<sup>62</sup> Many of the rules governing financial instruments were developed in the early part of the century to deal with the common financial instruments of the day, *i.e.*, plain vanilla stock, debt, and short-term options. New sophisticated financial products do not fit neatly into the existing regimes.<sup>63</sup> Consequently, taxpayers have been able to exploit the uncertainty regarding the taxation of these instruments to create, among other things, the economic equivalence of a traditional investment without the unfavorable tax consequences.<sup>64</sup> Once inconsistencies are identified, they can be, and are, manipulated.<sup>65</sup>

The use of a complex structure may also be used as a device to cloak the tax shelter transaction from detection. According to one commentator, some of this may be “psychological”:

A client may simply be unwilling to pay millions for a clever reading of the tax law -- even if the shelter around which the idea is built can save the client many times that fee... ‘You can have the greatest

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<sup>62</sup> See, *e.g.*, Edward D. Kleinbard, Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System, 69 *Tex. L. Rev.* 1319 (1991); Alvin C. Warren, Jr. Financial Contract Innovation and Income Tax Policy, 107 *Harv. L. Rev.* 460 (1993).

<sup>63</sup> *Id.*

<sup>64</sup> See, *e.g.*, Merton H. Miller, Financial Innovation: The Last Twenty Years and the Next, 21 *J. Fin. and Quantitative Analysis* 459, 461 (1986) (“The income tax system of virtually every country that is advanced enough to have one seeks to maintain. . . different rates of tax for different sources (and uses) of income. . . At the same time, modern finance theory assures us, as practitioners have long known, that securities can be used to transmute one form (or use or recipient) of income into another -- in particular, higher taxed forms to lower taxed ones.”) .

<sup>65</sup> See, *e.g.*, Michael S. Knoll, Financial Innovation, Tax Arbitrage, and Retrospective Taxation: The Problem With Passive Government Lending, 52 *Tax L. Rev.* 199 (1997) (“Many of these financial products were designed and marketed to exploit inconsistencies in the law, especially the tax law.”).



shelter in the world, and clients won't pay for it if it is too simple,' notes one promoter. 'I've rejected a lot of great ideas for that reason.'<sup>66</sup>

#### 5. Unnecessary Steps or Novel Investments

Corporate tax shelters may also involve (1) steps that are unnecessary to achieve the corporation's purported business purpose, or (2) property or transactions that the corporate participant either has little or no experience with, or with respect to which the participant lacks a bona fide business purpose.<sup>67</sup>

As discussed in Part IV.B., a taxpayer generally must evince a business purpose for entering into a transaction (or series of transactions) in order to sustain the claimed tax results. In many cases, however, certain steps are undertaken solely to obtain the desired tax benefits, and are not necessary for the taxpayer to achieve the purported business purpose. For example, in ACM, several steps were undertaken that were unnecessary to achieve the taxpayer's stated business purpose.<sup>68</sup> Similarly, in fast-pay preferred stock transactions, the use of the REIT structure was unnecessary to the corporate participant's business purpose of obtaining financing.

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<sup>66</sup> Bankman, supra note 19, at 1781.

<sup>67</sup> This latter characteristic of corporate tax shelters is similar to a characteristic prevalent in the tax shelters of the 1970s and 1980s: the failure to exercise normal due diligence prior to making an investment. See, e.g., Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988) (corporate taxpayer lacked a profit motive for engaging in a leasing transaction; taxpayer's knowledge of the computer industry was minimal and its evaluation of the leasing transaction in question was, in the court's words, "anything but business-like," because the taxpayer relied on questionable advice regarding the residual value of property); Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89 (5th Cir. 1985) (sale-leaseback of computer found to be a sham because the Tax Court found that the taxpayer, who knew virtually nothing about computers, did not seriously investigate whether the computer would have sufficient residual value at the end of the lease to enable the taxpayer to earn a profit on its purchase and seller-financed leaseback.); Rose v. Commissioner, 868 F.2d 851, 854 (6th Cir. 1989) (The purchase of "reproductions" of paintings found to be a sham, as the taxpayer failed to obtain any information on the commercial viability of the reproductions; rather, the taxpayer relied on the exaggerated claims of the promoter.).

<sup>68</sup> The partnership was purportedly formed to permit Colgate to repurchase its debt surreptitiously in an off-balance sheet transaction. The proffered reason for this was to avoid making Colgate a more attractive take-over target. As the court noted, the purchase and sale of the Citicorp notes were unnecessary to achieve this business purpose. The sale of these notes was necessary solely to achieve the claimed tax benefits. See ACM Partnership v. Commissioner, 73 T.C.M. at 2217-29.

Rather, the REIT structure was utilized solely to provide tax benefits that reduced the corporate participant's overall cost of borrowing.<sup>69</sup>

A common characteristic of the individual tax shelters of the 1970s and 1980s was that the shelter involved activities with respect to which the individual participant had little or no experience. These shelters often involved white-collar professionals trying to offset significant amounts of salary or other earned income with losses and credits from such diverse operations as jojoba bean farming, electricity-from-windmill operations, cattle or chicken feeding, and syndicated book and movie deals. Partially because of this characteristic, the Congressional response to individual tax shelters in 1986 was the enactment of the passive loss rules of section 469, which generally disallow losses and credits to be claimed against an individual's salary or other earned income if he or she does not materially participate in the activities generating the tax benefits.

Some corporate tax shelters may also involve new activities for the corporate participant. Many corporate tax shelters involve leasing transactions, novel financing arrangements, transactions with tax-indifferent parties, or the use of entities (e.g., REITs) that the corporate participant has not, in the past, been a party to or used. On the other hand, some corporate tax shelters involve activities that fall within the corporation's normal business operations. Many participants are publicly traded conglomerates that are involved in a host of diverse activities. In addition, many corporate tax shelters involve financing transactions and all business entities need to finance their activities. Tax-indifferent parties, particularly pension plans and foreign persons, are a major source of corporate finance.<sup>70</sup> Some corporations that are active in the trade or business of financial intermediation (e.g., banks or insurance companies) also participate in tax shelters involving financing transactions. Thus, the fact a transaction is not "novel" for the taxpayer is not necessarily determinative of whether it is a corporate tax shelter.<sup>71</sup>

#### 6. Promotion or Marketing

[T]ax advisors are no longer just devising specific strategies to deal with a client's tax needs as they arise, as in the past. Today's shelter hustlers parse the numerous weaknesses in the tax code and devise schemes that can be pitched as 'products' to corporate prospects. Then they sell them methodically and aggressively, using a powerful distribution network not unlike the armies of

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<sup>69</sup> For a more complete discussion of this transaction, see Appendix A.

<sup>70</sup> In 1998, governments, tax-exempt institutions, and foreign persons held 38.7 percent of U.S. corporate equities and 39.7 percent of net debt of nonfarm nonfinancial corporations. Flow of Funds Accounts for the United States, Annual Flows and Outstandings, June 11, 1999.

<sup>71</sup> For example, it is understood that many of the liquidating REIT transactions described in Appendix A of this Report were undertaken by financial institutions.

pitchmen who sold cattle and railcar tax shelters to individuals in the 1970s and 1980s.<sup>72</sup>

Many tax shelters are designed today so that they can be replicated multiple times for use by different participants, rather than to address the tax planning issues of a single taxpayer. This allows the shelter “product” to be marketed and sold to many different corporate participants, thereby maximizing the promoter’s return from its shelter idea. For example, the installment sales tax shelter addressed in the ACM and ASA cases was marketed by an investment bank to multiple corporations.<sup>73</sup> Likewise, the fast-pay preferred stock tax shelter described in Notice 97-21 was marketed and sold by an investment bank to multiple corporations.<sup>74</sup> It has been reported that one Big Five accounting firm maintains two databases of about 1,000 “mass market” tax savings ideas.<sup>75</sup>

There are various ways in which promoters become aware of corporations who have an appetite for shelter transactions. First, some corporations that generate significant profits are known to have an interest in transactions that reduce the tax liability on such profit. Second, promoters may work with corporations in other capacities, such as underwriters, legal advisors or auditors, and learn of events, such as the possible sale of a subsidiary for a significant gain, that would suggest a need for a corporate tax shelter. Using this knowledge, the advisors can communicate the needs of their clients to other members of the firm who may have expertise in designing corporate tax shelters.

In addition, new technologies have greatly increased the distribution and marketing of shelters. In the past, it may have taken weeks or months to distribute a corporate tax shelter nationwide; now it takes a matter of minutes.

## 7. Confidentiality

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<sup>72</sup> Forbes, supra note 5, at 200. See also Holden, supra note 3, at 369 (citing concern of many tax lawyers “with the recent proliferation of tax shelter products marketed to corporations”).

<sup>73</sup> See ACM Partnership, 73 T.C.M. at 2115 (“ACM is one of 11 partnerships. . . formed over a 1-year period from 1989-1990 by the Swap Group at Merrill Lynch & Co. Inc.”); see also Randall Smith, Collection Drive, Wall St. J., May 3, 1996, at A1 (stating that Merrill Lynch formed similar partnerships for several corporations in addition to Colgate).

<sup>74</sup> See Jacob M. Schlesinger & Anita Raghvan, U.S. Bars Certain Tax-Free Stock Deals, Cutting Off Billions in Planned Issues, Wall St. J., Feb. 28, 1997, at A4; Bankman, supra note 19, at 1781 (“Investments in step-down preferred were reported in excess of \$10 billion, generating well over \$100 million dollars of fees to Bear Stearns & Co. in a matter of months.”)

<sup>75</sup> Forbes, supra note 5, at 202.

Like marketing, maintaining confidentiality of a tax shelter transaction helps to maximize the promoter's return from its shelter idea.<sup>76</sup>

[A] promoter has no generally enforceable intellectual property rights in the idea around which the tax shelter is built. The idea may be expropriated, not only by the company shown a shelter, but by any other prospective purchaser that finds out about the shelter through the first company, or through the first company's advisors...Promoters attempt to limit this form of expropriation by requiring confidentiality agreements from prospective purchasers and their advisors.<sup>77</sup>

Before pitching prospective participants with their tax shelter idea, promoters may require a non-disclosure agreement that provides for million dollar payments for any disclosure of their "proprietary" advice. These arrangements limit, but do not preclude, the expropriation of the idea by other promoters.<sup>78</sup>

Confidentiality serves another essential purpose for the promoter -- it protects the efficacy of the idea by preventing or delaying discovery of the idea by the Treasury Department and the IRS. In part, out of concern that confidentiality agreements were hindering the ability of the Treasury Department and the IRS to uncover corporate tax shelters in a timely fashion, Congress expanded the tax shelter registration requirements in 1997 to cover "confidential" corporate tax shelters.<sup>79</sup> One of three conditions for registration is that "some promoter other than the taxpayer

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<sup>76</sup> Calvin H. Johnson, Corporate Tax Shelters, 1997 and 1998, 80 Tax Notes 1603, 1609 (Sept. 28, 1998) [hereinafter Johnson] ("The owner with a proprietary right to exclude others from free use of the idea will be able to charge a price for the idea and thus will have an incentive to improve or perfect the idea, and market it as to maximize the output from the idea.").

<sup>77</sup> See Bankman, supra note 19, at 1781. See also Kenneth W. Gideon, Assessing the Income Tax: Transparency, Simplicity, Fairness, Fourth Annual Laurence Neal Woodworth Memorial Lecture (Nov. 23, 1998) ("There is often a confidentiality letter to protect the 'proprietary' golden idea."), reprinted in Tax Law Works Best When the Rules are Clear, 98 TNT 225-71.

<sup>78</sup> See Bankman, supra note 19, at 1781 ("Notwithstanding confidentiality agreements..., the details of any successful tax shelter soon reach the promoter community,... with more than one promoter offering identical or at least similar shelters.").

<sup>79</sup> Section 6111(d). See Jt. Comm. on Tax'n, General Explanation of Tax Legislation Enacted in 1997, at 222-23 (1997) ("The Congress concluded that the provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In

has a proprietary interest in the arrangement or can prohibit the taxpayer from disclosing the arrangement.”<sup>80</sup> The Treasury Department understands from industry participants, as several commentators had predicted, that the result of the 1997 Act changes will be that promoters stop asking for confidentiality agreements in order to avoid the new registration requirements. This may help inhibit the growth of corporate tax shelters by allowing public information flow about corporate tax shelters and decreasing promoters’ ability to capitalize on “proprietary” shelters,<sup>81</sup> but it would not directly aid in detection and audit by the IRS.

It is unlikely, however, that limiting confidentiality agreements alone will greatly impact the corporate tax shelter market. In lieu of formal confidentiality agreements, many promoters already are relying on tacit understandings,<sup>82</sup> or other arrangements (e.g., requiring a prospective participant to use the law firm selected by the promoter),<sup>83</sup> to protect their proprietary interest and reduce the risk of detection.

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addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.”).

<sup>80</sup> See Johnson, supra note 76, at 1609. The other two conditions for registration under section 6111(d) are that the promoters may receive aggregate fees in excess of \$100,000 and the arrangement “has a significant purpose” of tax avoidance or evasion.

<sup>81</sup> See Bankman, supra note 19, at 1789 (“It would allow members of the tax bar to discuss shelters in public forum and in informal conversations with Treasury Department or legislative staff. The elimination of confidentiality would also make it slightly less profitable to devote resources to developing new shelters by decreasing the time it takes for a given shelter to come to the attention of a competitor.”).

<sup>82</sup> Forbes, supra note 5, at 208 (“Clients know that if they blab, they won’t see the next hot deal.”).

<sup>83</sup> 1997 Airlie House Transcript, supra note 9 (Edward Kleinbard stating that there are investment bankers who say “we won’t show the rest of the deal unless you agree to hire the law firm we’ve selected for you, or one of three law firms we’ve selected for you, and you can’t talk to anyone else.”).

## 8. High Transaction Costs

Corporate tax shelters carry unusually high transaction costs that are borne, in whole or substantial part, by the corporate beneficiary.<sup>84</sup> For example, the reported transaction costs in ASA (\$24,783,800) were approximately 26.5 percent of the purported tax savings (approximately \$93,500,000).<sup>85</sup> Transaction costs include fees paid to the promoter and the tax-indifferent party, fees for legal services (e.g., drafts of organizational documents and financial instruments, tax opinions), and other expenses incurred in connection with the shelter activity.<sup>86</sup>

## 9. Contingent or Refundable Fees and Rescission or Insurance Arrangements

Corporate tax shelters often involve contingent or refundable fees in order to reduce the cost and risk of the shelter to the participants. In a contingent fee arrangement, the promoter receives a portion, as much as one-half, of any tax savings realized by the corporate participant.<sup>87</sup> If no tax savings are realized, the promoter gets nothing. Although tax return preparers are

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<sup>84</sup> See, e.g., ACM, 73 T.C.M. at 2195 ("Colgate's management understood that most, if not all, of these [transaction] costs would be borne by Colgate because all the liability management and tax benefits of the partnership transactions would enure to Colgate. They believed that the costs, though high in absolute terms, were reasonable in relation to the benefits that Colgate expected to received from the partnership.").

<sup>85</sup> See ASA Investering Partnership v. Commissioner, 76 T.C.M. (CCH) 325, 332 (1998).

<sup>86</sup> See, e.g., ASA, 76 T.C.M. at 326 ("Merrill Lynch representatives further explained that the proposal was a package deal. Merrill Lynch would serve as the partnership's financial adviser and, for a \$7 million fee, recruit the foreign partner and arrange for the issuance and sale of the PPNs and LIBOR notes. To ensure a market for such issuance and sale, Merrill Lynch would structure and enter into the requisite swap transactions. Merrill Lynch would also serve as the partnership's financial intermediary, earning an additional \$1,060,000 to \$2,130,000 on the PPN sale and \$212,000 to \$425,000 on the LIBOR note sale. The foreign partner, for its participation in the transaction, would charge AlliedSignal the greater of \$2,850,000 or 75 basis points (b.p.) on funds advanced to the partnership. In addition, AlliedSignal would pay all of the partnership's expenses. Merrill Lynch estimated that AlliedSignal's total expenses for the entire venture would be between \$11,300,000 and \$12,600,000.").

<sup>87</sup> In one recent deal observed by the Treasury Department, prospective participants were offered a choice of fees, either an up-front payment of 25 percent of taxes saved, or a contingent fee of 50 percent of taxes saved, with no payment if the advice was overturned on audit. See also Forbes, supra note 5, at 202 ("Depending on the product and its originality PriceWaterhouseCoopers may ask customers for a contingency fee equal to 8 percent to 30 percent of their tax savings.").

precluded from charging a contingent fee in connection with the preparation of a return,<sup>88</sup> there is generally no prohibition on charging contingent fees in connection with providing tax planning advice.<sup>89</sup> Similarly, under a refundable fee arrangement, a promoter agrees to refund its fee to a corporate participant whose tax benefits are not realized because of IRS challenge or a change in the law.

Corporate tax shelters also may involve insurance or rescission arrangements. Like contingent or refundable fees, insurance or rescission arrangements reduce the cost and risk of the shelter to the participants. These arrangements provide the corporate participant with some measure of protection in the event the expected tax benefits do not materialize. In a clawback or rescission arrangement, the parties to the transaction agree to unwind the transaction if the purported tax benefits are not realized. Often, there is a so-called "trigger" event, such as a change in law or an IRS audit that is determined by an independent third party to constitute a significant risk to the tax benefits of the transaction. If the trigger event occurs, the transaction is unwound. The unwind may take the form of the liquidation of any entity formed for purposes of the tax shelter, the redemption of any securities issued pursuant to the shelter or the termination of any contractual agreements. In this way, the corporate participant is not burdened with any complex or costly financial or legal structures that were part of the design of the suddenly defunct tax shelter. For example, fast-pay preferred stock transactions provided for the tax-free unwind of the REIT structure through liquidation of the REIT.

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<sup>88</sup> See 31 C.F.R. sec. 10.28(b) (Standards of practice before the IRS prohibiting contingent fees for preparation of an original return, but not for preparing amended returns or claims for refund).

<sup>89</sup> But see AICPA Code of Professional Conduct Rule 302 (ET Section 302) which prohibits CPAs from providing attest services for clients for which they have provided certain services on a contingent fee basis.

### III. FACTORS CONTRIBUTING TO THE GROWTH OF CORPORATE TAX SHELTERS

Taxpayers will participate in corporate tax shelters if the benefits of doing so exceed the costs. The benefits of making such investments, which generally would be uneconomic but for their tax consequences, have been increasing for several reasons, at the same time that the costs have been coming down. Thus, it is not surprising that corporate tax shelters are more pervasive now than they have been in the past. Moreover, because those trends are likely to continue unabated barring legislative changes, tax shelters threaten to erode the corporate tax base further in the future.<sup>90</sup>

This part discusses qualitative factors that have contributed to the growth of corporate tax shelters and evaluates the evidence from tax returns and the experience of experts in the field.

#### A. THE CHANGING COST-BENEFIT CALCULUS OF CORPORATE TAX SHELTERS

##### 1. Greater Incentive to Use Tax Shelters

The principal benefit of a corporate tax shelter is tax savings. The Tax Reform Act of 1986 (1986 Act) reduced the attractiveness of tax shelters in one respect by lowering marginal tax rates from 46 percent to 34 percent. That rate reduction meant that a \$1.00 reduction in corporate taxable income was worth 12 cents less in 1988 than it was in 1986.<sup>91</sup> The 1986 Act also eliminated or reduced a host of corporate tax preferences, most notably accelerated depreciation and the investment tax credit. These changes were motivated, in part, by a perception that many large companies were paying little or no tax in the early 1980s, despite having substantial economic income.<sup>92</sup> On balance, the corporate base broadening more than offset the rate reduction, meaning that the *average* tax rate of corporate income increased, even

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<sup>90</sup> See, e.g., NYSBA, Report, supra note 19, at 883 (“Based on our collective experience, however, we are quite certain that a substantial number of large corporate taxpayers have been persuaded to participate in one or more of these [corporate tax shelter] transactions, and the incentives and impetus are there for the frequency of such transactions to increase substantially. Indeed, as more aggressive corporate taxpayers continue to exploit the tax law to increase after-tax earnings, other corporate taxpayers will undoubtedly feel greater pressure to engage in the same tax-driven transactions.”)

<sup>91</sup> The rate reduction was phased-in over two years. The maximum corporate tax rate was subsequently raised to 35 percent in 1993. I.R.C. § 11(b).

<sup>92</sup> See, e.g., Robert S. McIntyre and Robert Folen, Corporate Income Taxes in the Reagan Years: A Study of Three Years of Legalized Tax Avoidance, Citizens for Tax Justice (1984). The 1986 Act appears to have succeeded in this regard, as corporate tax payments increased sharply in the late 1980s. See National Income and Product Accounts, Volume 1, Table 1.16 (Apr. 1998) [hereinafter NIPA].



though *marginal* tax rates declined. Thus, shielding income from the corporate tax base was potentially more profitable after the 1986 Act than it was before.

The 1986 Act also repealed the General Utilities doctrine, which allowed corporations to avoid tax on appreciation in their assets upon a complete liquidation. This change “may have spawned more aggressive tax planning” to avoid the corporate-level tax on appreciation when corporate assets are disposed.<sup>93</sup>

Immediately following the passage of the 1986 Act, many observers raised concerns about the excessive use of debt as a tax shield, perhaps partly as a result of repeal of other tax shields, such as accelerated cost recovery allowances.<sup>94</sup> That concern has abated for several reasons. Leveraged buyouts (LBOs), commonly thought to be an important vehicle for increases in corporate leverage during the 1980s, have all but disappeared.<sup>95</sup> Net interest paid by nonfinancial corporations has become progressively less important in the 1990s. By 1997, it equaled only 14 percent of total capital income of nonfinancial corporations, down by 60 percent compared with a 35-percent share of capital income at the beginning of the decade.<sup>96</sup>

Part of the reduction in net interest may be due to the decline in the corporate statutory tax rate, a decline that reduced the tax benefit of the deduction for interest paid. Other factors, such as the fall in interest rates in the 1990s, undoubtedly have also been important. As a result of all those changes, firms have a stronger incentive to look elsewhere in the Code in search of techniques for reducing their taxes.

## 2. The Reduced Cost of Corporate Tax Shelters

A myriad of factors have reduced the cost of corporate tax shelters.<sup>97</sup>

a. *Increased financial sophistication.* Tax and financial advisers have become much more sophisticated about engineering transactions to avoid tax -- which means that the cost of

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<sup>93</sup> See NYSBA, Report, supra note 19, at 882.

<sup>94</sup> U.S. Treasury, Integration of Individual and Corporate Tax Systems: Taxing Business Income Once, Washington, D.C.: U.S. Government Printing Office, 1992, pp. 5-11 and pp. 115-116.

<sup>95</sup> In 1989, LBOs accounted for 27 percent of the value of mergers and acquisitions. By 1997, they were less than 1 percent of the total. Mergers and Acquisitions (May/June 1991) and (March/April 1998).

<sup>96</sup> See NIPA, supra note 92.

<sup>97</sup> NYSBA, Report, supra note 19, at 882-883.

such strategies has been declining. There is also a greater supply of financially sophisticated tax experts, as well as more readily available, lower-cost technologies to implement complicated transactions. According to the New York State Bar Association, "...the sheer amount of talent and skill devoted to corporate tax planning has, because of an entirely rational perception of the considerable economic incentives at stake, grown dramatically, and the technical skill of tax professionals engaged in this enterprise has been married to modern, highly sophisticated financial engineering."<sup>98</sup>

The increase in the power of computing technology and availability of sophisticated software is well-documented.<sup>99</sup> Financial markets have expanded dramatically, offering a mind-boggling array of products and creating the possibility to engineer new financial assets at very low cost. As discussed in Part II.B. of the Report, those products provide the engine for some sophisticated corporate tax shelters.

As in other technology-driven enterprises, the growth of the market for corporate tax shelters lowers the cost of implementing existing shelter schemes and of developing new ones, as participants in the market learn from their experiences. Employees who move from one firm to another take their knowledge and expertise with them and disseminate it. Business schools have been offering increasingly sophisticated finance programs, teaching cutting-edge mathematical techniques and advanced computer technologies. All these factors help breed corporate tax shelter development.

b. *Increased supply of tax shelter specialists.* The supply of tax shelter experts has increased, producing competitive pressures to lower the cost and expanding the array of sheltering schemes. By clamping down on individual tax shelters, the 1986 Act may have boosted the supply of corporate tax shelter specialists. As discussed more fully in Part IV.C. of the Report, the 1986 Act addressed individual tax shelters by reducing marginal tax rates, eliminating the investment tax credit, eliminating the tax preference for capital gains, and enacting the passive loss rules. By most accounts, it was quite successful in reducing individual tax shelters.<sup>100</sup> But the elimination of those tax shelters may have freed up a supply of knowledgeable and willing tax practitioners and shelter promoters, who have turned to corporate tax shelters as a source of employment in the 1990s. Thus, at the same time that the 1986 Act helped boost demand for corporate tax reductions, it created a supply of those who are expert in seeking out novel ways to reduce taxes.

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<sup>98</sup> NYSBA, Report, supra note 19, at 882.

<sup>99</sup> See, e.g., Powlen & Tanden, supra note 29, at 1009.

<sup>100</sup> See Andrew A. Samwick, Tax Shelters and Passive Losses after the Tax Reform Act of 1986, in Martin Feldstein and James M. Poterba, eds., Empirical Foundations of Household Taxation, National Bureau of Economic Research Project Report series, University of Chicago Press (1996), at 193-226.

c. *Changing attitudes toward tax shelters.* Some commentators explain the growth in corporate tax shelter activity as a reflection of more accepting attitudes of tax advisors and corporate executives towards aggressive tax planning.<sup>101</sup> Put another way, the psychic cost of participating in tax-engineered transactions to avoid tax appears to have decreased.

The individual tax shelter boom of the late 1970s and early 1980s is attributed in part to the widespread perception that the Code had become unfair.<sup>102</sup> This perception became self-fulfilling. As more individuals sheltered income from tax, those left paying tax at the higher marginal rates often felt that they were being treated unfairly and turned themselves to tax shelters.

A similar phenomenon may be happening now. Many reports in the popular press, and the results of many polls, suggest that taxpayers increasingly view the current tax system as unfair.<sup>103</sup> Taxpayer resentment of the U.S. tax system may be fueled by the complexity and perceived arbitrariness of the tax law. Some taxpayers and practitioners may feel that given the level of complexity of the Code and the seemingly limitless layering of rules, whatever is not proscribed is allowable. Other taxpayers and practitioners may feel that because the Congress and the Treasury Department enact and promulgate Code provisions and regulations that are “one-sided” or “anti-taxpayer,” the taxpayer is free to develop tax shelters that balance the effect of those seemingly unfair provisions.<sup>104</sup> In such an environment, some corporations may be more willing to take aggressive tax positions .

At the same time, as discussed more fully in Part II.A.2 of the Report, corporate officers are paying greater attention to the effect of taxes on their reported earnings. Corporations increasingly view their tax departments as profit centers, rather than as general administrative support facilities.<sup>105</sup> Effective tax rates may be viewed as a performance measure, separate from

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<sup>101</sup> See Bankman, supra note 19, at 1784; Forbes, supra note 5, at 198; NYSBA, Report, supra note 19.

<sup>102</sup> See Richard Meyer, Running for Shelter: Tax Shelters and the American Economy, Washington, D.C.: Public Citizen (February, 1985).

<sup>103</sup> See Joel Slemrod and Varsha Venkatesh, Public Attitudes About Taxation and the 2000 Presidential Campaign, 83 Tax Notes 1799 (June 21, 1999); and Joel Slemrod and Jon Bakija, Taxing Ourselves: A Citizen’s Guide to the Great Debate Over Tax Reform, The MIT Press, Cambridge: MA (1996), at 5.

<sup>104</sup> See David Weisbach, Formalism in the Tax Law, 66 Chi. L. Rev. \_\_\_\_ (1999) [hereinafter Weisbach].

<sup>105</sup> See Bankman, supra note 19, at 1784; Forbes, supra note 5, at 200.

after-tax profits. That has put pressure on corporate financial officers to generate tax savings through shelters.

Inevitably, all of this causes competitive pressures for new participants to enter the tax shelter market. Otherwise, they will be at a competitive disadvantage. Indeed, the officers of one corporation may examine the published financial statements of a competitor to try to determine their relative tax positions. In short, if one firm operates in a low-tax jurisdiction, takes advantage of a special tax provision, or engages in tax shelters, its competitors may feel compelled to follow suit.

d. *Reduced audit risk from aggressive tax shelters.* Taxpayers may be more likely to take aggressive tax positions because they perceive the risk of audit to be low. Audit rates for large corporations (those with assets greater than \$100 million) have fallen dramatically over the past several years. For example, in 1980, 77 percent of companies with assets above \$100 million were audited. By 1990, the audit rate for those companies had fallen to 59 percent, and in 1997 only 35 percent of those companies were audited.<sup>106</sup>

Part of this decline is due to the growth in the number of large companies, which occurs naturally because of real economic growth and inflation. Thus, a \$100 million company in 1980 would be much larger in real terms than a \$100 million company in 1997. But the overall audit rate for corporate tax returns also has declined, from 2.9 percent in 1992 to 2.0 percent in 1998, suggesting a decline in enforcement intensity.<sup>107</sup> The number of audits declined over the same time period. Although the audit rate is an imprecise guide to enforcement activity, corporate tax departments perceive that detection is less likely now than in the past.<sup>108</sup>

### 3. Other Factors

Various other factors have spurred the proliferation of corporate tax shelters. Increased complexity in the Code creates more of the discontinuities that spawn tax shelters. A global marketplace for both products and capital creates opportunities that would not exist without trade. And finally, the merger boom of the 1980s and 1990s may have created some new avenues for tax shelter activity.

a. *Complexity.* The more complex is the tax law, the more likely it is that aggressive taxpayers will be able to find and exploit discontinuities. Thus, a recent increase in complexity may have contributed to the boom in corporate tax shelters. Certain specific tax changes may be

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<sup>106</sup> IRS Annual Reports, various years.

<sup>107</sup> See Jeremy Holmes, TRAC Says IRS Data Show Decline in Audit, Fraud Prosecution Activities, Daily Tax Report (Apr. 12, 1999), at GG-6.

<sup>108</sup> NYSBA, Report, supra note 19, at 883.

identified as a likely cause of specific types of corporate tax shelters. For example, the 1986 Act included a complex set of restrictions on the use of foreign tax credits. Attempts to avoid these restrictions seem to be at the heart of certain types of tax shelters.<sup>109</sup> As discussed in detail in Appendix A, some corporate tax shelters have attempted to combine independent and seemingly unrelated Code provisions in a manner to produce an unintended result. Others use provisions intended only to accelerate taxable income to shift taxable income to tax-indifferent parties.

Moreover, efforts by Congress to rein in specific tax shelters often make the Code more complex, creating a vicious cycle. The legislative remedies themselves create the complexity that the next generation of tax shelters exploits, which leads to more complex responses, and so on.<sup>110</sup>

b. *Globalization and financial innovation.* Several commentators have cited the increasing sophistication and globalization of financial markets as a partial explanation.<sup>111</sup> Many tax shelters that have come to light involve complicated financial transactions, sometimes involving foreign parties (examples include ACM, fast-pay preferred stock, LILOs, and 357 basis shifting involving foreign corporations).<sup>112</sup> Such transactions may have been facilitated by technological advance in financial product development, and by the globalization of world capital markets. Globalization has increased the ability for taxpayers to arbitrage differences between tax systems of different countries through cross-border transactions.

c. *Merger booms of the 1980s and 1990s.* In the middle and late 1980s, the United States experienced a booming market in mergers and acquisitions. For example, in 1983, merger and acquisition activity involving U.S. companies totaled less than \$50 billion. By 1986, such transactions reached \$201 billion, and remained high throughout the 1980s.<sup>113</sup> After falling in the early 1990s, merger and acquisition activity has rebounded to reach new heights. In 1997, merger activity involving U.S. companies totaled \$791 billion, over 300 percent larger than in 1993.<sup>114</sup> Those merger booms, although unlikely to be tax driven, may create tax planning opportunities.<sup>115</sup>

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<sup>109</sup> See, e.g., Notice 98-5, 1998-3 I.R.B. 49.

<sup>110</sup> NYSBA, Report, *supra* note 19, at 881.

<sup>111</sup> See Forbes, *supra* note 5, at 200; Powlen and Tanden, *supra* note 29, at 1009; Bankman, *supra* note 19, at 1784.

<sup>112</sup> See Appendix A for a description of these transactions.

<sup>113</sup> M&A Almanac, 1992

<sup>114</sup> M&A Almanac, 1998

<sup>115</sup> See Alan Auerbach and David Reishus, The Effect of Taxation on the Merger Decision, NBER Working Paper No. 2192, Cambridge MA: National Bureau of Economic Research (March 1987); Taxes and the Merger Decision: An Empirical Analysis, NBER Working

For example, sales of companies may have generated significant capital gains, and consequently created a demand for capital losses. Indeed, some highly publicized corporate tax shelters ( e.g., the ACM case) apparently were motivated by a desire to generate losses to offset gains realized upon the sale of a business. In addition, legislation to eliminate popular, tax-saving techniques with respect to mergers and acquisitions may have led to increased emphasis on corporate tax shelters.<sup>116</sup>

## B. EVIDENCE OF GROWTH IN CORPORATE TAX SHELTERS

Quantitative evidence of corporate tax shelters is somewhat sketchy because corporations are not required to identify shelters. In fact, the whole point of tax shelters is to hide income from the tax authority. It is very hard to measure an absence of income. At the same time that we believe tax shelters have proliferated, the economy has been booming and interest rates have been falling, causing taxable corporate income to increase. At issue, however, is whether the rate of taxable income increase has kept pace with the growth in corporate profits.

As already discussed, experts in the field are convinced based on their own experience that corporate tax shelters are very significant. Forbes magazine and others have conjectured that corporate tax shelters might cost the U.S. Treasury \$10 billion annually, and that this number is growing dramatically.<sup>117</sup> The conjecture is based on unscientific evidence, but it reflects the widespread agreement that the tax shelter phenomenon is important and growing.

In specific cases, there is direct evidence of how corporate tax shelters can grow like wildfire. One corporate tax shelter, liquidating REITS, was virtually invisible in the data until 1996. Liquidating REITS generally involved the use of closely held mortgage REITS that were created solely to be liquidated within a year or two for tax reasons. The value of mortgages in closely held REITS soared by over 1,100 percent from 1995 to 1997, from \$9 billion in 1995 to \$111 billion in 1997, as word of the tax-sheltering technique spread rapidly. The Treasury Department estimated in 1998 that liquidating REITS reduced corporate tax receipts by \$0.5 billion in 1997, and were likely to reduce corporate tax receipts by over \$13 billion over the following five years. Based on more recent data, those estimates probably significantly understated the magnitude of the problem. The liquidating REIT tax shelter was closed as part of the Tax and Trade Relief Extension Act of 1998.

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Paper No. 1855, Cambridge MA: National Bureau of Economic Research (March 1986).

<sup>116</sup> Most notably in 1986, Congress repealed the General Utilities doctrine, which allowed taxpayers to receive a tax-free step-up in acquired assets. Most recently, Congress eliminated the use of the Morris Trust transaction, making it more difficult for a conglomerate to dispose of unwanted subsidiaries on a tax-free basis.

<sup>117</sup> See Forbes, supra note 5; Bankman, supra note 19; NYSBA, Report, supra note 19.

As discussed in Part II.A. of this Report, one feature of many tax shelters is that they reduce taxable income and taxes without reducing book income. It is very difficult to distinguish tax shelter activity from other activity that results in a book/tax difference. For example, to the extent that tax depreciation is accelerated relative to book depreciation, the substantial increase in investment over the past few years may have contributed to a discrepancy between book income and taxable income. Companies are able to “manage” their book income to send positive signals to their shareholders, and apparently are apt to do so.<sup>118</sup>

Nonetheless, the data reported on Schedule M-1 of Form 1120, “Reconciliation of Income Per Books with Income Per Return,” suggests that the difference between book income and taxable income has increased recently. The ratio of pre-tax book income to taxable income was 1.82 in 1995 and 1.86 in 1996, substantially above its average of 1.25 during the 1990-1994 period, and considerably higher than at any time since (at least) 1985.<sup>119</sup>

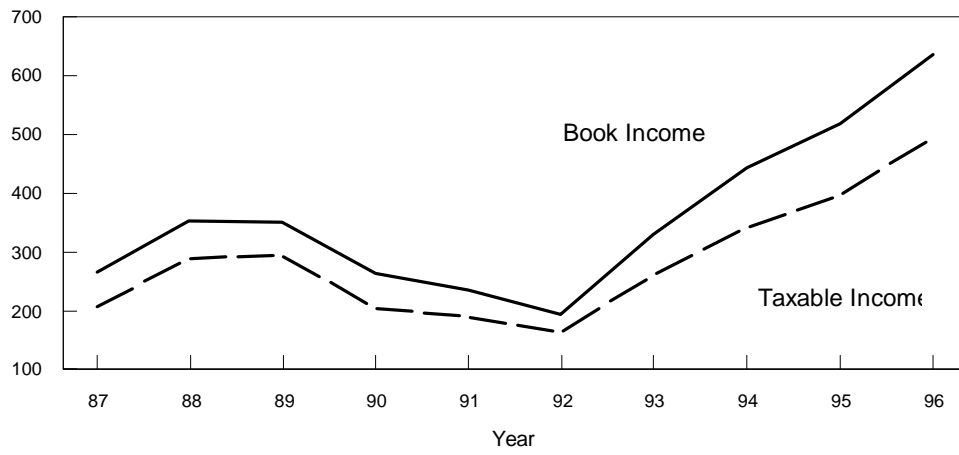
Figure 1 shows the discrepancy between book income and taxable income for corporations with assets over \$1 billion, in 1992 dollars. The difference has clearly been growing since 1992.

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<sup>118</sup> See Lillian F. Mills and Kaye J. Newberry, The Relation Between Reporting Incentives and Firms’ Book-Tax Earnings Conformity: Further Evidence of Earnings Management, unpublished working paper, University of Arizona (January 1999). See also Lillian F. Mills, Book-Tax Differences and Internal Revenue Service Adjustments, 36 *Journal of Accounting Research* 343-56 (Autumn 1998) (Mills finds evidence that the IRS is more likely to assert deficiencies on firms with large book-tax disparities, indicating that such disparities are correlated with aggressive tax planning).

<sup>119</sup> Note that this ratio is extremely volatile. For example, in 1989 it was 1.23, fell to 1.08 in 1990, jumped up to 1.20 in 1991, and fell again to 1.09 in 1991.

**Figure 1. Book Income vs. Taxable Income  
for Corporations With More Than \$1 Billion in Assets**  
(in Billions of 1992 Dollars)



Pre-tax book income is defined as after-tax book income plus federal taxes, as reported on lines 1 and 2 of Schedule M.



#### IV. PRESENT LAW CONCERNING TAX AVOIDANCE TRANSACTIONS

The system of determining income tax liabilities is generally rule based. The Code, the Regulations, and a host of administrative pronouncements provide detailed, voluminous rules that provide for the tax treatment of a great number of transactions. For the most part, this rule-based system is designed to be as comprehensive, objective, and transparent as possible.

Importantly, however, the system is not entirely rule-based. There are a set of standards--some explicitly built into the rules, some added by the courts--that overlay the rules. These standards, embodied in legislative and regulatory anti-abuse rules as well as judicially-created doctrines discussed below, serve several essential functions in our rule-based system. First, their mere existence allows the rules to be simpler and less complete than they otherwise would need to be. As Stanley Surrey observed some thirty years ago: “It is clear that [various anti-avoidance provisions in the law at that time] save the tax system from the far greater proliferation of detail than would be necessary if the tax avoider could succeed merely by bringing his scheme within the literal language of substantive provisions written to govern the everyday world.”<sup>120</sup>

Second, a system of rules backed up by standards can more accurately measure income than a system of rules alone.<sup>121</sup> When the rules by themselves produce results that are unintended or inappropriate, the application of a standard can defeat a literal interpretation of the rules, thereby providing a more reasonable result. For example, the business purpose requirement in corporate transactions performs this function, allowing the courts to disregard formalities and recharacterize transactions in certain cases.

Finally, standards reduce the level of certainty in the system as a whole. This reduction cuts both ways. In one sense, it acts as a powerful brake on the most egregious forms of tax-motivated activity. If the possible application of an overriding standard makes the tax consequences of a tax shelter uncertain, risk-averse taxpayers may not engage in the shelter. At the same time, however, too much uncertainty can inhibit or “chill” legitimate commercial transactions.

The standards that overlay the Code can be roughly grouped into three categories. First, under certain regulatory “anti-abuse” rules, the IRS may recharacterize the tax results of transactions that, while designed to meet the literal requirements of a particular Code or regulatory section, clearly frustrate the purpose of the relevant Code or regulatory section. Second, the Code provides various broad grants of authority to the Secretary to clearly reflect income and to prevent avoidance of tax. Finally, even in the absence of an explicit grant of authority in the Code or regulations, the tax benefits arising from a transaction may be disallowed

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<sup>120</sup> Stanley Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 Law & Contemp. Probs. 673 (1969).

<sup>121</sup> Weisbach, supra note 104.

under various judicial doctrines, including “substance-over-form,” “business purpose,” and “economic substance.”

## A. STATUTORY AND REGULATORY RESPONSES TO TAX SHELTERS

### 1. Specific Provisions Addressing Tax Shelter Transactions

Corporate taxpayers claim the benefits of certain provisions to achieve tax avoidance through the deferral, exclusion, or conversion of income, or through tax arbitrage. For example, through the use of inflated or excess deductions, losses, basis, and credits, taxpayers can exclude a significant amount of income. In the past, Congress and the Treasury Department have responded by either amending the provisions or creating a system to overlay the provisions to ensure that they may only be applied as intended.

a. *Deferral.* Deferral is the postponement of tax with respect to income that has economically accrued. Because the taxpayer must eventually pay the tax liability postponed through a deferral transaction, deferral generally provides the taxpayer with an interest-free loan from the Government. For GAAP purposes, deferred taxes are treated as an expense for the year in which the related income is reported for book purposes<sup>122</sup> and cumulative deferred taxes are accounted for in a liability account known as a deferred tax reserve.<sup>123</sup>

Deferral can arise in a number of ways. Some provisions of the Code and regulations specifically sanction deferral (e.g., the realization principle, the reorganization provisions and the cash method of accounting). Deferral also can arise from taxpayers’ manipulations of the tax law. For instance, taxpayers often attempt to structure transactions that accelerate deductions in the early years of the transaction (which can be used to shelter other income of the taxpayer), and defer the income until later years. A recent example of this type of transaction is the LIFO transaction, discussed more fully in Appendix A.

Section 1281 illustrates a Congressional response to deferral. Prior to the enactment of section 1281, taxpayers using an accrual method of accounting could purchase short-term obligations that mature shortly after the taxpayer’s tax year ends. If the taxpayer borrowed to fund the purchase, the taxpayer could accrue an interest deduction in the first year while deferring all of the economically offsetting interest income until it was received in the second year. Section 1281 was enacted in response to this problem, by requiring taxpayers that use an accrual method of accounting to accrue interest income on short-term obligations, thereby matching in time their accrued interest income with accrued interest expense.

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<sup>122</sup> For GAAP purposes, income tax expense includes both current tax expense (taxes actually paid to the government for the year) and deferred tax expense (taxes paid in a later year).

<sup>123</sup> See *supra* note 22.

b. *Exclusion.* Exclusion is the elimination of tax on economic income. Unlike deferral, exclusion results in permanent tax avoidance. In the case of corporate income, sanctioned exclusions from income are rare. Examples of exclusions applicable to businesses include the tax-free treatment of the proceeds from corporate-owned life insurance policies, the dividends-received deduction, percentage depletion, and lessee improvements that revert to lessors.

Obviously, corporate tax shelters that provide for the permanent exclusion of income are more beneficial than are shelters that provide for the deferral of income from both a cash flow standpoint (because the taxes are never paid) as well as for GAAP purposes (because deferred tax reserves need not be established).<sup>124</sup> Corporate tax shelters may be designed to provide the same benefits as exclusion by creating inflated deductions, basis, or other tax attributes the use of which shelter from tax otherwise taxable income (as discussed in subsection d., below). The liquidating REIT transaction is a recent example of an exclusion-based tax shelter, as discussed more fully in Appendix A.

c. *Conversion.* Conversion occurs when taxpayers are able to transmute one form or source of income into a tax-preferred form or source. For example, taxpayers may manipulate the different tax rules applicable to ordinary and capital items to convert income or loss from one form into another. Although there is no capital gains rate differential for corporations, corporations are subject to the capital loss limitation rules, and thus generally prefer income to be characterized as capital gain, and losses to be characterized as ordinary losses.

For example, prior to the enactment of section 1258 in 1993, taxpayers could agree to sell property forward for a fixed price. Although the gain from the sale related entirely to the time value of money (*i.e.*, was in the nature of interest income), the seller would claim that the gain from the sale was capital gain. Section 1258 precludes taxpayers from converting what is ordinary income into capital gain through the use of these types of financial transactions (that is, financial transactions generally consisting of two or more positions taken with regard to the same or similar property).

Conversion also occurs in connection with the source of income. In general, U.S. taxpayers have an incentive to characterize items of income or gain as foreign source and items of deduction or loss as U.S. source. A U.S. taxpayer can shelter foreign source income from a residual U.S. tax with foreign taxes paid on that income (or by cross-crediting foreign taxes paid with regard to other income in excess of the U.S. rate if such income is in the same category of income under section 904). A foreign source loss, on the other hand, may not be of much value

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<sup>124</sup> If a corporation enters into a tax shelter that it or its auditors believe may be challenged by the IRS, the corporation may establish a reserve for all or a part of such contingent tax liability. Such reserve may be reversed or reduced (*i.e.*, increase book income) when the corporation feels that such threat has subsided (*e.g.*, because the IRS did not challenge the issue, another taxpayer successfully litigated the issue, etc.).

to a U.S. taxpayer because it lowers the taxpayer's foreign tax credit limitation, which the taxpayer would like to maximize, thus offsetting some or all of the value the loss otherwise would have. A U.S. source loss, on the other hand, is valuable to the U.S. taxpayer since it reduces its U.S. taxable income. Consequently, some taxpayers attempt to convert what should properly be characterized as a foreign source loss into a U.S. source loss.<sup>125</sup>

d. *Arbitrage.* Structural discontinuities, such as those that arise from the existence of different tax treatments for the same transaction in different tax jurisdictions, can lead to arbitrage opportunities. For example, corporate taxpayers can take one position for U.S. tax purposes but another for foreign tax purposes to generate tax benefits under both sets of rules. Similar opportunities have been found by taking advantage of the use of entities that enjoy tax-exempt status or that employ different methods of accounting.<sup>126</sup>

Other arbitrage opportunities exist by using Code provisions in combinations to obtain a tax benefit from a transaction that may be uneconomic absent tax considerations. For example, assume that a taxpayer in the 30 percent marginal tax bracket can borrow \$10,000 at seven percent interest to buy bonds yielding five percent interest. On its face, this transaction is uneconomic because the taxpayer would appear to be losing \$200 a year (\$500 interest received less \$700 interest paid). However, if the interest on the five-percent bonds is tax exempt and the interest on the borrowing deductible, the taxpayer would be \$10 ahead (\$500 interest received less \$700 interest paid plus \$210 tax benefit from deductible interest). In this transaction, the taxpayer is arbitraging the tax-exempt status of the five-percent bonds and the tax-deductible status of the seven-percent borrowing to achieve a tax benefit. Congress has responded to such opportunities, for example, with the enactment of section 265, which disallows a deduction for interest payments on debt "incurred or continued to purchase or carry" tax-exempt obligations. (For a discussion of another recent tax shelter transaction structured to obtain such arbitrage, see the discussion of company-owned life insurance in Appendix A.)

Corporate taxpayers have also found tax arbitrage opportunities in transactions structured to take advantage of the exclusion provided by the dividends-received deduction ("DRD"). The DRD was designed to mitigate the taxation of corporate earnings distributed to another corporation. At times, however, taxpayers have applied the DRD rules in ways not contemplated, which have led to responses by Congress. For example, transactions have been structured to shift ownership of dividend-paying stock temporarily to a corporate taxpayer eligible for the DRD immediately before the dividend payment date. Also, transactions have been structured so that a corporate taxpayer holds both short and long positions in stock over the dividend payment date to deduct the amount of the dividend paid to the lender of the short stock and report only a small

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<sup>125</sup> For an example of this type of conversion in the context of a corporate tax shelter, see Appendix A.

<sup>126</sup> For a more complete discussion of this type of arbitrage, see discussion of tax-indifferent parties, supra, at Part II.B.3.

percentage of the dividend received on the long stock. Congress responded to these types of transactions by enacting section 246(c) in 1958 and strengthening it in 1984 and 1997 to prevent manipulation of the DRD rules when stock is held only for brief periods.<sup>127</sup>

## 2. Regulatory Anti-Abuse Rules

Recently, in connection with a highly complex statutory or regulatory regime that relies on mechanical rules, the Treasury Department has issued broad-based regulatory anti-abuse rules intended to prevent manipulation of the mechanical rules in a manner that circumvents the overall purposes of the regime. These rules are designed to affect a trend in transaction planning instead of targeting specific transactions. They also help limit the need for even more complicated rules that otherwise would be necessary to address all potential fact situations.<sup>128</sup> One commentator has declared that anti-abuse rules potentially are “a path towards a coherent solution” to the problem of tax shelters.<sup>129</sup>

For example, as a result of numerous transactions structured to take advantage of a literal reading of the partnership provisions of the Code and regulations, the Treasury Department promulgated final regulations providing for a partnership anti-abuse rule.<sup>130</sup> As another example, the final regulations providing rules for the timing and amount of original issue discount (OID) contain an anti-abuse rule that applies if a debt instrument is structured or engaged in with “a principal purpose” to achieve a result that is unreasonable in light of the purposes of the provisions.<sup>131</sup>

a. *Partnership anti-abuse rule.* On December 29, 1994, the Treasury Department issued final regulations providing an anti-abuse rule under subchapter K of the Code.<sup>132</sup> These regulations were issued in response to an increasing number of transactions that attempted to use

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<sup>127</sup> For example, under section 246(c), the DRD is denied if the stock is not held for more than forty-five days (or ninety days in the case of certain preferred stock), and the holding period is tolled if the taxpayer substantially diminished its risk of loss from holding the stock.

<sup>128</sup> See Weisbach, *supra* note 104.

<sup>129</sup> 1997 Airlie House Transcript, *supra* note 9 (David Hariton commented, “I think the anti-abuse rules are a terrific accomplishment of the Administration’s first four years. A day doesn’t go by without my telling somebody that they can’t do that because of the swap anti-abuse rule, the OID anti-abuse rule, or whatever.”).

<sup>130</sup> Treas. Reg. § 1.701-2.

<sup>131</sup> Treas. Reg. § 1.1275-2(g).

<sup>132</sup> T.D. 8588 (Dec. 29, 1994), amended by T.D. 8592 (Apr. 12, 1995).

the rules of subchapter K in an unintended manner.<sup>133</sup> Some of these transactions attempted to use a partnership to circumvent provisions of the Code outside of subchapter K. Others purported to create tax advantages that were inconsistent with the substance of the transaction.<sup>134</sup> Still other transactions relied on the literal language of rules in subchapter K to produce tax results that were inconsistent with the purposes of such rules.

The final regulations reconcile the purposes of subchapter K, which are “intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax,”<sup>135</sup> with the need to prevent taxpayers from taking advantage of this flexibility to achieve tax results that subchapter K was not intended to foster. The regulations incorporate established legal doctrines, such as business purpose, substance over form and clear reflection of income,<sup>136</sup> in combination with an analysis of the purposes of subchapter K.

The regulations begin by setting forth certain requirements that are implicit in the intent of subchapter K. These requirements are that (1) the partnership is bona fide and each partnership transaction has a substantial business purpose; (2) the form of each partnership transaction is respected under substance-over-form principles; and (3) the tax consequences under subchapter K generally must properly reflect the partners’ economic agreement and the partner’s income.<sup>137</sup> In recognition of the fact that certain provisions of subchapter K were adopted to promote administrative convenience and other policy objectives and thus, in some circumstances, tax results may not clearly reflect income, the regulations provide that the clear reflection of income requirement will be met if requirements (1) and (2) above are met and the tax results of the transaction were “clearly contemplated” by the subchapter K provision.<sup>138</sup>

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<sup>133</sup> See PS-27-94 (May 12, 1994), reprinted at 1994-1 C.B. 832, 833.

<sup>134</sup> See, e.g., Notice 94-48, 1994-1 C.B. 357 (partnership structure used to provide issuing corporation tax benefits of issuing debt even though corporation actually issues stock).

<sup>135</sup> Treas. Reg. § 1.701-2(a).

<sup>136</sup> For a detailed discussion of these doctrines, see infra Part IV.A.2. (clear reflection of income), Part IV.B.1. (substance over form), and Part IV.B.2.(business purpose).

<sup>137</sup> Treas. Reg. § 1.701-2(a).

<sup>138</sup> Treas. Reg. § 1.701-2(a)(3); see also Treas. Reg. § 1.701-2(d), Ex. 6 (relating to value equals basis rule in Treas. Reg. § 1.704-1(b)(2)(iii)(c)); Ex. 9 (relating to election under section 754 to adjust basis of partnership property); and Exs. 10 & 11 (relating to basis in distributed property under section 732).

The regulations follow with an operative rule, which provides that “if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partner’s aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K,” the transaction may be recast as appropriate to achieve tax results that are consistent with the intent of subchapter K.<sup>139</sup>

The regulations also contain a separate anti-abuse rule that relates to the abuse of entity treatment of a partnership to take advantage of other provisions of the Code. This rule generally provides that the Commissioner may treat a partnership as an aggregate of its partners when appropriate to carry out the purpose of any Code provision or regulation promulgated thereunder.<sup>140</sup>

In an effort to ensure that the regulations are applied only in appropriate situations, all issues affected by the regulation in an examination must be coordinated with both the Issue Specialist on the Partnership Industry Specialization Program team and the IRS National Office.<sup>141</sup>

b. *Original issue discount (OID) anti-abuse rule.* In general, the OID rules (sections 1271 through 1275 of the Code) provide for the calculation of accrued, but unpaid interest with respect to a debt instrument on an economic yield-to-maturity basis. Holders and issuers of OID instruments take OID into account on an accrual basis, regardless of the taxpayer’s overall method of accounting. The OID regulations contain a number of highly mechanical rules to calculate economic yield on a debt instrument. As a result, it is possible for taxpayers to structure transactions that literally meet the requirements of these mechanical rules but that produce results that are unreasonable in light of the broad principles underlying the OID provisions. To address these situations, the Treasury Department proposed in 1994, and finalized in 1996, the OID anti-abuse rule of §1.1275-2(g). This rule authorizes the Commissioner to apply or depart from the OID rules, as necessary, to prevent taxpayers from achieving results that are “unreasonable” in light of the purposes of the OID statutory provisions.

c. *Consolidated return anti-abuse rules.* The consolidated return regulations issued under the authority of section 1502 of the Code are characterized by a large number of highly complex mechanical rules.<sup>142</sup> Because even more complicated rules would be required to address every conceivable (and unanticipated) fact pattern, the regulations contain a series of general anti-

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<sup>139</sup> Treas. Reg. § 1.701-2(b).

<sup>140</sup> Treas. Reg. § 1.701-2(e)(1).

<sup>141</sup> Announcement 94-87, 1994-27 I.R.B. 124.

<sup>142</sup> See, e.g., Treas. Reg. §§1.1502-13 (intercompany transactions); 1.1502-20 (loss disallowance); 1.1502-32 (investment adjustments); 1.1502-90T through 99T (application of section 382).

abuse rules intended to act as a backstop to the detailed mechanical rules and to prevent use of the mechanical rules in a manner that contravenes the overall purposes of the regulations.

In explaining an anti-abuse rule under the intercompany transaction regulations, for example, the preamble to the proposed regulation states that “[t]he proposed regulation does not address every interaction with other consolidated return regulations and other rules of law. To ensure that the proposed regulations achieve neutrality . . . adjustments may be required.”<sup>143</sup> In explaining the retention of this rule despite criticism by some commentators, the preamble to the final regulation states that “. . . the anti-avoidance rule is necessary to prevent transactions that are designed to achieve results inconsistent with the purpose of the regulations. . . .”<sup>144</sup>

The typical consolidated return anti-abuse rule requires that adjustments must be made to carry out the purposes of the underlying regulation if a transaction is structured or undertaken with “a principal purpose” of avoiding those purposes.<sup>145</sup>

Prior to the promulgation of the anti-abuse rules, courts interpreted the consolidated return regulations literally, and would not allow the IRS to recast transactions that met the rules as drafted even if respecting such transactions led to inappropriate results.<sup>146</sup>

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<sup>143</sup> CO-11-91, 1994-1 C.B. 724.

<sup>144</sup> T.D. 8597, 1995-2 C.B. 147.

<sup>145</sup> See, e.g., Treas. Reg. §§1.1502-13(h) (“[i]f a transaction is engaged in or structured with ‘a principal purpose’ to avoid the purposes of this Section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this Section”); 1.1502-19(e) (“[i]f any person acts with ‘a principal purpose’ contrary to the purposes of this Section, to avoid the effect of the rules of this Section or apply the rules of this Section to avoid the effect of any other provision of the consolidated return regulations, adjustments must be made as necessary to carry out the purposes of this Section”); 1.1502-21T(c)(2)(iv) (“[t]he members composing a SRLY subgroup are not treated as a SRLY subgroup if any of them is formed, acquired, or availed of with ‘a principal purpose’ of avoiding the application of, or increasing any limitation under, this paragraph (c)”); see also Treas. Reg. §§ 1.1502-32(e), 1.1502-33(g), and 1.1502-76(b)(3) (all to similar effect). For other formulations of anti-abuse rules in the consolidated return regulations, see Treas. Reg. §§ 1.1502-17(c) (addressing activities acquired or engaged in with “the principal purpose” to avail the group of certain accounting methods); 1.1502-20(e) (addressing a taxpayer who “acts with a view to avoid the effect of the rules of this Section . . .”).

<sup>146</sup> See Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985), acq. 1986-2 C.B. 1. In this case, the Tax Court stated

[i]f respondent believes that his regulations and section 312(k)



3. Statutory Grants of Broad Authority

Congress has enacted several general provisions granting the Secretary of the Treasury broad authority to reallocate income and deductions to require the proper reflection of income. These grants of broad authority were considered necessary by Congress to empower the Secretary to curb inappropriate activities.

a. *Section 269.* Under section 269, if a person acquires (directly or indirectly) control of a corporation, or a corporation acquires (directly or indirectly) carryover basis property of a corporation not controlled (directly or indirectly) by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, the Secretary may disallow such tax benefit either in whole or in part to the extent necessary to eliminate such evasion or avoidance of income tax. For purposes of this rule, control means the ownership of 50 percent of the corporation's stock (by vote or value). The rule applies also in the case of a qualified stock purchase by one corporation of another corporation, in the event that the acquiring corporation does not elect to treat the stock purchase as an asset acquisition, and where the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date, the principal purpose of which is to secure the benefit of a deduction, credit, or other allowance. Section 269 was originally enacted in 1943 to deter the growing practice of purchasing loss corporations to serve as a shell to offset the profits of the purchasing corporation's businesses.

b. *Section 446.* If the Secretary determines that a taxpayer's regular method of accounting does not clearly reflect income, the Secretary may prescribe a method of accounting to be used in computing a taxpayer's taxable income that, in the Secretary's opinion, does clearly reflect income.<sup>147</sup> This authority is not limited to a taxpayer's overall method of accounting, but

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together cause petitioner to receive a 'double deduction,' then respondent should use his broad power to amend his regulation. Since respondent has not taken steps to amend his regulations, we believe his apparent reluctance to use his broad power in this area does not justify judicial interference in what is essentially a legislative and administrative matter.

Id. at 282.

<sup>147</sup> Treas. Reg. § 1.446-1(a)(1). The legislative history of the 1924 Act explained the clear reflection of income authority as follows:

[A]uthority is granted to the Commissioner to allow or require deductions and credits to be taken as of a year other than that in which 'paid' or 'accrued' when, in his opinion, it is necessary in

rather applies to any method of accounting for an item. For example, section 446(b) authority has been exercised to clearly reflect income with respect to certain derivative transactions.<sup>148</sup>

The courts have long acknowledged that Congress vested the Secretary with broad discretion in determining whether a particular method of accounting clearly reflects income.<sup>149</sup> The Secretary's determination is entitled to more than the usual presumption of correctness.<sup>150</sup> Accordingly, the Secretary's interpretation of the clear reflection of income standard should not be interfered with unless clearly unlawful or plainly arbitrary,<sup>151</sup> and thus found to be an abuse of discretion. The issue of whether a taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis.<sup>152</sup> The Tax Court recently clarified that the Secretary may set aside a taxpayer's method of accounting that is otherwise sanctioned by the Code or regulations where he determines that the method does not clearly reflect income.<sup>153</sup>

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order to clearly reflect income. ... The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

H.R. Rep. No. 68-179, at 10-11 (1924).

<sup>148</sup> Treas. Reg. § 1.446-3 prescribes the proper timing of income and loss arising from a swap transaction. The regulation arose as a result of taxpayers utilizing swaps to improperly accelerate taxable income. See Notice 89-21, 1989-1 C.B. 651.

<sup>149</sup> RLC Indus. Co. v. Commissioner, 98 T.C. 457, 491 (1992), aff'd, 58 F.3d 413 (9<sup>th</sup> Cir. 1995); Capitol Fed. Sav. & Loan Assoc. v. Commissioner, 96 T.C. 204, 209 (1991); Prabel v. Commissioner, 91 T.C. 1101, 1112 (1988), aff'd, 882 F.2d 820 (3<sup>rd</sup> Cir. 1989).

<sup>150</sup> RLC Indus., 98 T.C. at 491; RECO Indus., Inc. v. Commissioner, 83 T.C. 912, 920 (1984); Peninsula Steel Products & Equip. Co. v. Commissioner, 78 T.C. 1029, 1044 (1982).

<sup>151</sup> Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-533 (1979) (quoting Lucas v. American Code Co., 280 U.S. 445, 449 (1930) and Lucas v. Structural Steel Co., 281 U.S. 264, 271 (1930)).

<sup>152</sup> See Pacific Enterprises v. Commissioner, 101 T.C. 1, 13 (1993); RLC Indus. Co., 98 T.C. at 489.

<sup>153</sup> Ford Motor Co., v. Commissioner, 102 T.C. 87 (1994), aff'd, 71 F.3d 209 (6<sup>th</sup> Cir. 1995). In Ford, the taxpayer purchased single premium annuity contracts to fund a series of payments required under settlements with tort claimants. The cost of the annuity contracts did

One commentator on the corporate tax shelter problem suggests that the clear reflection of income authority should be used more frequently to address tax shelters that abuse specific authorized methods of accounting.<sup>154</sup>

c. *Section 482.* The Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among two or more organizations controlled by the same interests if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect income. Section 482 was enacted "...in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order to clearly reflect their true tax liability."<sup>155</sup>

d. *Section 7701(l).* Congress enacted section 7701(l) in 1993, which gave the Secretary authority to prescribe regulations recharacterizing any multi-party financing transaction as a transaction directly among any two or more parties when such recharacterization is appropriate to prevent avoidance of any tax. Section 7701(l) was considered necessary so that the Secretary could issue guidance consistent with the courts' focus on the substance of a

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not exceed the present value of the settlement obligations to the tort claimants. Ford claimed a deduction for the full amount of all future payments it was obligated to make to the tort claimants under the terms of the settlement agreements. Although Ford claimed that the deduction of the full amount was permitted under the all events test in the regulations, the Court found that Ford's method of accounting for its obligations under the settlement agreements did not clearly reflect income and that the Commissioner had not abused her discretion in requiring Ford to deduct only the cost of the annuity contracts. In its analysis, the Court stated that:

the statute does not limit the Commissioner's discretion under section 446(b) by the taxpayer's mere compliance with the methods of accounting generally permitted under section 446(c). To the contrary, section 446 provides that the use of an accounting method is conditioned upon the method clearly reflecting income 'in the opinion of the Secretary.' In short, the statute clearly provides that the taxpayers may use an accrual method so long as it clearly reflects income.

Id. at 99.

<sup>154</sup> See Lee A. Sheppard, What Should We Do About Corporate Tax Shelters?, 81 Tax Notes 1431, 1434 (December 14, 1998) (citing Judge Laro's observation in ACM Partnership that the IRS could have used its section 446(b) clear reflection of income authority to deny the benefits of the installment sale regulation to the taxpayer).

<sup>155</sup> H.R. Rep. No. 70-2, at 16-17 (1928).

transaction, which at times results in ignoring a party to a transaction "...as a mere conduit and imposing tax as if a single transaction had been carried out between the parties at the ends of the chain."<sup>156</sup>

Prior to the enactment of section 7701(l), the Tax Court and the IRS had recharacterized certain multiple-party financing transactions involving back-to-back loans as financing transactions between two of the parties.<sup>157</sup> Section 7701(l) was enacted, in part, to deal with the argument that these cases and rulings were limited to their facts ( *i.e.*, back-to-back financings without a spread). It is clear, however, that Congress intended that Section 7701(l) would apply to other complex, multi-party financing transactions, such as debt guarantees or equity investments, structured to avoid tax.<sup>158</sup>

In accordance with this broad grant of regulatory authority, the Treasury Department has already used section 7701(l) to address specific types of multiple-party financing transactions that permit taxpayers to avoid tax. For example, the Treasury Department promulgated regulations to prevent the use of an intermediary to avoid tax under section 881, which imposes tax on certain U.S. source income of a foreign corporation.<sup>159</sup> Also, proposed regulations under section 7701(l) have been issued to address lease stripping transactions, which are intended to allow one party to realize income from a lease or similar agreement and another party to report deductions (such as

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<sup>156</sup> H.R. Conf. Rep. No. 103-213, at 654 (1993).

<sup>157</sup> See, e.g., *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971). In *Aiken*, a domestic corporation (D) borrowed \$2,250,000 from a related person (F1), a resident of a country not having a treaty with the U.S., in exchange for a note bearing interest at four percent. F1 assigned D's note to a related party (F2), a resident in a country having a treaty with the U.S. that eliminated the 30-percent withholding tax on interest payments from a U.S. person to a treaty country resident, in exchange for nine notes in the aggregate amount of \$2,250,000 bearing interest at four percent. The Tax Court held that interest payments from D to F2 (which now held D's note) did not qualify for the treaty exclusion. Under the Court's reasoning, F2 did not receive the interest for its own account (*i.e.*, it did not have complete dominion and control over the interest) because it was "committed to pay out exactly what it collected, and it made no profit on the acquisition of [D's] note in exchange for its own." 56 T.C. at 934. In this case, F2 was "merely a conduit" for the passage of interest payments from D to F1. *Id.*; see also Rev. Rul. 84-152, 1984-2 C.B. 381, declared obsolete, Rev. Rul. 95-56, 1995-2 C.B. 322; Rev. Rul. 84-153, 1984-2 C.B. 383, declared obsolete, Rev. Rul. 95-56, 1995-2 C.B. 322; Rev. Rul. 87-89, 1987-2 C.B. 195, declared obsolete, Rev. Rul. 95-56, 1995-2 C.B. 322; Tech. Advice Mem. 9133004 (May 3, 1991).

<sup>158</sup> H.R. Rep. No. 103-111, at 729 (1993) ("The committee intends that the provision apply not solely to back-to-back loan transactions, but also to other financing transactions.").

<sup>159</sup> Treas. Reg. § 1.881-3.

cost recovery or rental expenses) related to that income.<sup>160</sup> Most recently, proposed regulations were issued to address fast-pay preferred stock (discussed more fully in Appendix A), which is designed to artificially allocate taxable income to a tax-exempt party thereby allowing the U.S. corporate participant in the transaction to avoid tax.<sup>161</sup>

## B. JUDICIAL RESPONSES TO TAX SHELTERS

Judicial anti-avoidance doctrines have been useful in curbing tax avoidance behavior. In this regard, the IRS has two primary means at its disposal: First, the IRS may argue that the objective facts of the transaction are not as the taxpayer has presented them. That is, the formal way in which the taxpayer has presented the facts belies their real substance and, as a result, the taxpayer is applying the wrong set of mechanical rules in reaching its purported tax consequences. Second, the IRS may argue that, while the facts are as the taxpayer has represented, the technical tax results produced by a literal application of the law to those facts are unreasonable and unwarranted, and therefore should not be respected. This second line of argument, which encompasses long-standing principles of business purpose and economic substance, is an important and essential gloss on our generally mechanical system of determining tax liabilities.

Application of these doctrines to a particular set of facts is often uncertain. Typically, in the cases in which the IRS has been successful, the IRS has argued that the taxpayer's transaction was in some sense artificial--that the taxpayer undertook the transaction in a particular way (even though economically equivalent avenues were available to the taxpayer) to achieve an unreasonable or unwarranted tax benefit. Often, it is clear that, if tax savings had not been an issue, the taxpayer would have used a more straight-forward (and more heavily-taxed) route.

### 1. Substance Over Form Doctrine

a. *In general.* As a practical matter, taxpayers, not the IRS, are in control of the facts. Taxpayers choose the transactions they undertake and, thereby, choose their tax consequences. Generally, the tax results arising from a transaction (or series of transactions) are obvious, uncontroverted, and based on the "form" of the transactions the taxpayer has chosen. In some rare (but important) cases, however, the "substance" of a particular transaction produces tax results that are inconsistent with its "form" as embodied in its underlying documentation.<sup>162</sup>

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<sup>160</sup> Prop. Reg. § 1.7701(l)-2 (addressing "obligation shifting transactions" such as lease stripping transactions).

<sup>161</sup> Notice 97-21, 1997-1 C.B. 407; Prop. Reg. § 1.7701-3 (recharacterizing fast-pay stock transactions).

<sup>162</sup> For example, under long-standing authorities, a "repo" of securities, although formally documented as a sale and repurchase, is treated for tax purposes as a secured borrowing. See, e.g., Rev. Rul. 74-27, 1974-1 C.B. 24. In this case, the formal tax result is based on the

From the beginning of taxation people have sought advantage in calling one thing another. To avoid a tax imposed on compensation, for example, people would call it a gift. The principle of following “substance” rather than “form” has always meant sweeping aside pretenses of this sort.<sup>163</sup>

Under the substance-over-form doctrine, the IRS and the courts may recharacterize a transaction in accordance with its substance, if “the substance of the transaction is demonstrably contrary to the form.”<sup>164</sup> For example, a taxpayer cannot label what is, in essence, equity as debt and thereby secure an interest deduction.<sup>165</sup> As one commentator recently has written, “[s]tandards must govern the factual characterization of relationships and arrangements to some extent, and the Commissioner must have the ability to challenge the taxpayer’s description of the relevant facts -- otherwise the taxpayer’s advantage would be insurmountable.”<sup>166</sup>

The substance-over-form doctrine has its roots in Gregory v. Helvering.<sup>167</sup> In that case, the taxpayer wanted to extract appreciated securities from her wholly-owned corporation in a manner that avoided taxation as a dividend. Accordingly, the distribution of securities was done in three steps (all within six days): (1) formation of a new subsidiary capitalized with the appreciated securities; (2) a spin-off of the new subsidiary to the taxpayer; and (3) liquidation of

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substance of the underlying transactions, not its formal documentation.

<sup>163</sup> Joseph Isenbergh, Musings on Form and Substance and Form in Taxation, 49 Chi. L. Rev. 859, 866 (1982) [hereinafter Isenbergh].

<sup>164</sup> Powlen & Tanden, supra note 29, at 1013.

<sup>165</sup> Notice 94-48, 1994-1 C.B. 357.

<sup>166</sup> David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Law, 235, 239 (1999) [hereinafter Hariton]. Although not really a limitation on the taxpayer’s ability to choose the facts, it is also clear that the IRS has the ability to dispute the facts themselves. In a number of cases (often referred to as “factual sham” cases), the IRS has succeeded in arguing that the facts as represented by the taxpayer did not, in fact, exist. A good example of a factual sham is Knetsch v. United States, 364 U.S. 361 (1960). In that case, the taxpayer sought to arbitrage the fact that income on a single-premium deferred annuity savings bond was includible in income only when paid, while interest on a borrowing to purchase the bond was currently deductible. The taxpayer purported to purchase a bond by borrowing the bulk of the purchase price from the seller of the bond. The Supreme Court held that the taxpayer could not claim the tax benefits of the purported transaction because the transaction itself never existed--it was a sham.

<sup>167</sup> 293 U.S. 465 (1935).

the new subsidiary (with the taxpayer receiving the appreciated securities as a liquidating distribution). Had the form of the transaction been respected, the taxpayer would have realized capital gain upon the liquidation of the subsidiary. The Court, however, did not respect the form of the transaction, but instead found that the transaction was in substance a dividend of appreciated securities, which was taxable as ordinary income to the taxpayer.

Application of the substance-over-form doctrine is highly subjective and fact dependent, and thus is uncertain. This uncertainty is demonstrated by a comparison of two cases with similar facts: Waterman Steamship Corp. v. Commissioner<sup>168</sup> and Litton Industries, Inc. v. Commissioner.<sup>169</sup> In Waterman, the Waterman Steamship Corporation declined an offer to sell its wholly-owned subsidiary for \$3.5 million because it would have realized a significant gain. (At the time, its basis in the stock of the subsidiary was \$700,000). Instead, prior to the sale, Waterman caused the subsidiary to distribute a \$2.8 million dividend in the form of a note. The dividend was tax-free to Waterman.<sup>170</sup> Waterman then sold the subsidiary for its reduced value of \$700,000, and reported no gain. Shortly thereafter, the new owner of the subsidiary lent it \$2.8 million, which the subsidiary used to pay off the note to Waterman. The Tax Court respected the transaction as the parties had structured it. The Court of Appeals for the Fifth Circuit reversed the Tax Court, and found that in substance the transaction should be treated as Waterman's sale of the subsidiary for \$3.5 million.

Litton involved a transaction almost identical to that in Waterman. It differed only in that there was no specific buyer for Litton's subsidiary at the time it paid the dividend note to Litton, and the sale of the subsidiary occurred about six months after the dividend. The Tax Court found these differences significant enough to decline to apply the substance-over-form doctrine, and

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<sup>168</sup> 430 F.2d 1185 (5<sup>th</sup> Cir. 1970), cert. denied, 401 U.S. 939 (1971).

<sup>169</sup> 89 T.C. 1086 (1987), acq. in result in part 1988-2 C.B. 1. As another example of the uncertain application of the substance-over-form doctrine, compare Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (holding that distributions of property to shareholders followed by their prearranged sale of the distributed property could be recharacterized as a sale directly by the distributing corporation), with Esmark v Commissioner, 90 T.C. 171 (1988), aff'd per unpublished order, 886 F.2d 1318 (7<sup>th</sup> Cir. 1989)(refusing to recharacterize Mobil's purchase of Esmark shares followed by a redemption of those shares in exchange for an appreciated asset as a sale of the appreciated asset by Mobil to Esmark). As one commentator puts it, "[t]he efforts to 'tease' out what the taxpayers did wrong in [the Court Holding line of cases] and distinguish them from what taxpayers did right in other cases have been wholly inscrutable." Hariton, supra note 166, at 240.

<sup>170</sup> I.R.C. § 243.

upheld the transaction as the parties had structured it. <sup>171</sup> Litton, Esmark,<sup>172</sup> and several other cases decided around the same time led some commentators to observe, perhaps prematurely, that the substance-over-form doctrine and other anti-avoidance doctrines were “moribund.”<sup>173</sup>

Recently, however, in ASA Investorings Partnership v. Commissioner,<sup>174</sup> the substance-over-form doctrine was applied to invalidate the same loss-generation tax shelter that was at issue in ACM.<sup>175</sup> In brief, the tax shelter involved a partnership that exploited the rules governing contingent installment sales in order to create a gain that could be allocated to a foreign partner (exempt from U.S. tax), and an offsetting loss that could be allocated to a U.S. partner. In ASA, the Tax Court invoked the substance-over-form doctrine to find that the foreign “partner” was actually a lender and reallocated the partnership’s gains to the U.S. partners.<sup>176</sup>

b. *Step transaction doctrine.* The step transaction doctrine is a relatively common application of the substance-over-form doctrine.<sup>177</sup> Under the doctrine, formally separate steps may be treated as one transaction for tax purposes (rather than giving tax effect to each separate

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<sup>171</sup> See also Uniroyal, Inc., v. Commissioner, 66 T.C.M. (CCH) 2690 (1993).

<sup>172</sup> See supra note 169 for a discussion of Esmark.

<sup>173</sup> Lee A. Sheppard, Colgate’s Corporate Tax Shelter Showdown, 71 Tax Notes 1284, 1284 (June 3, 1996); see also, Lee A. Sheppard, Substance Over Form in Subchapter C, 44 Tax Notes 642, 645 (August 7, 1989) (“After Esmark and other cases, the IRS is worried about the continuing viability of the substance over form doctrine.”); Robert W. Wood, Is the Step-Transaction Doctrine Still a Threat for Taxpayers?, 72 J. Tax’n 296 (1990) (“It seems safe to conclude that the step-transaction doctrine, and the related one of substance over form, may now be easier for taxpayers to overcome than at any time in the past.”).

<sup>174</sup> 76 T.C.M. (CCH) 325 (1998).

<sup>175</sup> See supra notes 212-214 and accompanying text for a discussion of ACM.

<sup>176</sup> 76 T.C.M. at 326 (“We must look to the substance of the transactions rather than the form. When the formalities are stripped away, ABN [the foreign “partner”] is in substance a lender.”(citation omitted)). At least one commentator has been highly critical of the Tax Court’s reliance in ASA on the substance-over-form doctrine, rather than the economic substance doctrine. See Hariton, supra note 166, at 58-59. Thus, under this commentator’s line of reasoning, ACM, which involved similar facts to those at issue in ASA, was more properly decided because it invoked the economic substance doctrine to disallow the purported losses.

<sup>177</sup> King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), stating that “the central purpose of the step transaction doctrine [is] to assure that the tax consequences turn on the substance of the transaction, rather than on its form.”



step), if integration of the steps more accurately reflects the underlying substance.<sup>178</sup> The seminal case on the business purpose doctrine, Gregory, is also an example of the step transaction doctrine.<sup>179</sup>

The courts have articulated three different tests for determining when to apply the step transaction doctrine: (1) the binding commitment test, (2) the end result test, and (3) the mutual interdependence test.<sup>180</sup> Under the binding commitment test, separate steps will be integrated only if, at the time of the first step, the taxpayer was under a binding commitment to proceed with later steps.<sup>181</sup> The binding commitment test has not been widely adopted by the courts, probably because it is a very restrictive view of the step transaction doctrine.<sup>182</sup> Under the end result test, separate steps will be combined into one transaction if the steps are part of a single scheme or plan intended from the outset to achieve a specific result.<sup>183</sup> Because the end result test focuses

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<sup>178</sup> See Bittker & Lokken, supra note 30, at ¶ 4.3.5. See also Randolph Paul & Philip Zimet, Step Transactions, in Selected Studies in Federal Taxation, 200 (2d Series, 1938) [hereinafter Paul & Zimet]; Seymour S. Mintz & William T. Plumb, Jr., Step Transactions in Corporate Reorganizations, 12 N.Y.U. Inst. on Fed. Tax'n. 247 (1954); Joshua D. Rosenberg, The Step Transaction Doctrine in Corporate Tax, 1986 N.Y.U. Inst. On Corp. Tax Plan. 280.

<sup>179</sup> See supra note 167.

<sup>180</sup> See, e.g., Penrod v. Commissioner, 88 T.C. 1415 (1987).

<sup>181</sup> The binding commitment test was first articulated by the Supreme Court in Commissioner v. Gordon, 391 U.S. 83 (1968). In Gordon, a corporation distributed 57 percent of the stock of its wholly-owned subsidiary to its shareholders, and notified its shareholders that it intended to distribute the remaining 43 percent within the next few years. Two years later, it distributed the remaining 43 percent. The taxpayer argued that the two distributions ought to be stepped together, and that therefore the overall transaction was a tax-free divisive reorganization under section 355. The Court rejected this argument, stating that "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later step." Id. at 96. Cf. Redding v. Commissioner, 630 F.2d 1169 (7<sup>th</sup> Cir. 1980), cert. denied, 450 U.S. 913 (1981) (court rejected taxpayer's argument that receipt and exercise of warrants were tax-free under section 355 under step-transaction analysis where more than 80 percent of subsidiary stock was issued to warrant-holders and underwriters within two weeks after warrants were issued).

<sup>182</sup> See Rosenberg, supra note 178, at 406-07; Martin D. Ginsburg and Jack S. Levin, Mergers, Acquisitions, and Buyouts, § 608.1 (Mar. 1998 ed.)[[hereinafter Ginsburg & Levin].

<sup>183</sup> See King Enterprises, Inc. v. United States, 418 F.2d 511, 517 (Ct. Cl. 1969); Kanawha Gas & Utils. Co. v. Commissioner, 214 F.2d 685, 691 (5<sup>th</sup> Cir. 1954); Atchinson, Topeka & Santa Fe R.R. Co. v. United States, 443 F.2d 147, 151 (10<sup>th</sup> Cir. 1971); Associated Wholesale Groceries, Inc. v. United States, 927 F.2d 1517, 1523 (10<sup>th</sup> Cir. 1991). See also

on the parties' intent, it has been criticized for being vague and difficult to apply consistently.<sup>184</sup> In the middle lies the mutual interdependence test, which inquires “whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”<sup>185</sup> The mutual interdependence test has been described as, alternatively, “more popular than either binding commitment or [end result],”<sup>186</sup> and “merely a variation of the end result test.”<sup>187</sup>

Whether a series of transactions will be stepped together is often uncertain. This is because it is difficult to discern a clear pattern in the application of the three tests.<sup>188</sup> As one treatise has stated,

The step transaction doctrine is an amorphous concept. Often, application of the doctrine hinges on whether a court finds that a particular series of transactions runs counter to a significant tax policy.<sup>189</sup>

Despite the somewhat inconsistent application of these three tests, the step transaction doctrine has been an effective anti-avoidance tool, particularly in the area of tax-free reorganizations and incorporations.<sup>190</sup>

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Stephen S. Bowen, The End Result Test, 72 Taxes 722 (1994).

<sup>184</sup> See Rosenberg, supra note 178, at 407-08.

<sup>185</sup> American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). See also Paul & Zimet, supra note 178, at 254.

<sup>186</sup> Rosenberg, supra note 178, at 409.

<sup>187</sup> Ginsburg & Levin, supra note 182, at § 608.1.

<sup>188</sup> See, e.g., Ronald H. Jensen, Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351, 11 Va. Tax Rev. 349, 359-67 (1991) (describing similar cases applying each of the three tests); Ginsburg & Levin, supra note 182, at § 608.1 (“Notwithstanding years of litigation and hundreds of cases, the exact contours of the step transaction doctrine, and even its proper formulation, are still the subject of intense debate.”).

<sup>189</sup> Ginsburg and Levin, supra note 182, at § 608.1.

<sup>190</sup> See generally Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.61[3] (6<sup>th</sup> ed. 1997)[hereinafter Bitker & Eustice]; Ginsburg & Levin, supra note 182, § 608.4.

c. *Taxpayer's ability to argue substance over form.* While it is clear that the IRS may seek to recharacterize a transaction in a manner consistent with its substance, a taxpayer's ability to do the same is limited.<sup>191</sup> To successfully argue that the substance of a transaction is controlling notwithstanding its form, taxpayers must meet a relatively high burden of proof and demonstrate that their actions show an honest and consistent respect for the substance of the transaction.<sup>192</sup> The level of proof required depends on the jurisdiction in which the taxpayer resides. Some jurisdictions follow the so-called "Danielson" rule: "A party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."<sup>193</sup> Other jurisdictions merely require strong proof (something more than a preponderance of the evidence but something less than the Danielson rule) that the substance of the transaction should be followed.<sup>194</sup>

Taxpayers are put to an exacting burden of proof when trying to recharacterize their transactions because of concerns over unjust enrichment, post-transactional tax planning, and the potential for the IRS to be whipsawed by the parties taking inconsistent positions with respect to

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<sup>191</sup> See, e.g., Higgins v. Smith, 308 U.S. 473, 477 (1940); U.S. v. Morris & E.R. Co., 135 F.2d 711, 713 (2d Cir. 1943), cert. denied, 320 U.S. 754 (1943). Under a related doctrine, when the form and substance of a transaction are consistent, the taxpayer may not argue that the tax consequences of the transaction should be determined by the tax consequences that would flow from an economically similar transaction in which the taxpayer did not engage. See Commissioner v. National Alfalfa Dehydrating & Mill & Co., 417 U.S. 134, 149 (1974) ("The Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." [citations omitted]).

<sup>192</sup> Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961).

<sup>193</sup> Danielson v. Commissioner, 378 F.2d 771, 775 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

<sup>194</sup> Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959) (applying the strong proof rule). See also Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986) (discussing both the strong proof and Danielson rules); Estate of Durkin v. Commissioner, 99 T.C. 561 (1992) (Tax Court indicates that, in order to satisfy the strong proof rule, a taxpayer must, at a minimum, establish that (i) the taxpayer reported the transaction in accordance with its substance, (ii) the taxpayer's reports and actions show an honest and consistent respect for the substance of the transaction, (iii) the taxpayer does not change its position upon challenge, and (iv) the parties are aware of the substance of the transaction and the taxpayer would not be unduly enriched at the other party's expense by relying upon the substance of the transaction).

the same transaction.<sup>195</sup> For example, in Danielson, the taxpayers had agreed to a cash sale of their common stock in a finance company. In connection with the sale, the taxpayers also agreed to enter into an agreement not to compete with the purchaser.<sup>196</sup> The terms of the sale allocated approximately 40 percent of the purchase price to the covenant not to compete and the remainder to the common stock.<sup>197</sup> In determining its offer for the stock and covenant, the purchaser took into account the tax benefits that it would receive from amortizing the amount allocated to the covenant not to compete. Notwithstanding the agreement, the sellers took the position that the entire purchase price was allocable to the common stock, and thus constituted proceeds from the sale of a capital asset. The IRS disallowed the taxpayers' capital gains treatment for the amount allocated to the covenant not to compete. The Tax Court disagreed, finding that the taxpayers had in effect produced strong proof that the covenant not to compete was not realistically bargained for by the parties and that the amount allocated in the agreement to the covenant was, in reality, part of the purchase price for the stock.<sup>198</sup>

On appeal, the IRS argued in Danielson that the taxpayer should not be permitted to attack its agreement, as the agreement spelled out the precise amount to be paid for a covenant not to compete, except in cases of fraud, duress, or undue influence. The Third Circuit agreed, finding that the prohibition on permitting one party to attack the agreement was necessary to prevent unjust enrichment (as the presumed tax consequences could have affected the determination of the purchase price, as it did in this case), would negate the reasonably predictable tax consequences of the agreement to the parties, and would cause administrative problems for the IRS in seeking to collect the proper amount of tax from the parties.

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<sup>195</sup> See, e.g., Danielson, 378 F.2d at 771; Insilco Corp. v. United States, 53 F.3d 95 (5th Cir. 1995) (taxpayer precluded from recharacterizing six years later a transaction originally structured as a sale). See also Michael Baillif, When (and Where) Does the Danielson Rule Limit Taxpayers Arguing 'Substance Over Form?', 82 J. Tax'n 362 (1995); Robert Thornton Smith, Substance and Form: A Taxpayer's Right to Assert the Priority of Substance, 44 Tax Law. 137, 144-46 (1990); William S. Blatt, Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form, 70 Or. L. Rev. 381 (1991).

<sup>196</sup> Danielson, 378 F.2d at 771.

<sup>197</sup> The amount that a purchaser pays to a seller for a covenant not to compete in connection with the sale of a business generally is ordinary income to the seller and is amortizable by the purchaser.

<sup>198</sup> Danielson v. Commissioner, 44 T.C. 549 (1965), vacated and remanded, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

The Danielson rule and the strong proof rule have been extended beyond allocations of purchase price and now apply to many different types of transactions. There have been a number of instances, however, where the courts have not applied these rules.<sup>199</sup>

Concerns over whipsaw potential have also caused Congress to enact certain statutory provisions -- section 385(c) and section 1060(a)<sup>200</sup> -- that limit a taxpayer's ability to disavow the form of its transaction. For example, under section 385(c), the characterization by a corporate issuer of an interest (at the time of issuance) as debt or equity is binding on the issuer and any holder of the interest, unless the holder discloses that it is treating the interest in a manner inconsistent with the issuer's characterization. At the time section 385(c) was enacted, Congress was concerned that issuers and holders may have been taking inconsistent positions with respect to the characterization of a corporate instrument as debt or equity.<sup>201</sup>

## 2. Business Purpose Doctrine

The business purpose doctrine requires that a taxpayer have a reason--other than the avoidance of federal taxes--for undertaking a transaction or series of transactions.<sup>202</sup> Like several

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<sup>199</sup> See, e.g., Strick Corp. v. United States, 714 F.2d 1194 (3d Cir. 1983) (limiting Danielson rule to cases where its underlying policy considerations are implicated).

<sup>200</sup> Section 1060(a) provides that if, in connection with an applicable asset acquisition, the transferor and transferee agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that the allocation (or fair market value) is not appropriate. See H.R. Rep. No. 101-881, at 350 (1990) (extending the existing reporting and allocation rules "may diminish some of the 'whipsaw' potential that results when the parties' allocations for tax reporting purposes are inconsistent").

<sup>201</sup> H.R. Rep. No. 102-716, at 3 (1992). See also 138 Cong. Rec. H7165-66 (daily ed. August 3, 1992) (statement of Rep. McGrath) ("[Section 385(c)] will help prevent an illegal tax avoidance scheme known among practitioners as the debt-equity whipsaw. Issuers of stock or bonds and the holders of those interest classify their interests differently to maximize tax advantages.").

<sup>202</sup> Bittker & Eustice, supra note 190, at ¶ 14.47[1]. One commentator has described the business purpose doctrine as follows:

In another class of cases what was done apparently falls within the statute, but results in a bad thing. . . . Many bad things, however, are precisely what they purport to be, and therefore cannot be swept aside as shams. Here the inclination of one who feels strongly is to invoke some more general feature of the law, for example the "intent" (or perhaps nowadays the "deep structure") of the statute, to conclude that the bad thing ought not to

of the other judicial doctrines, the origins of the business purpose doctrine are found in the Supreme Court's decision in Gregory v. Helvering.<sup>203</sup> In that case, the Court stated:

The legal right of the taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from tax motive, was the thing which the statute intended.<sup>204</sup>

The business purpose doctrine also has been applied outside the corporate context. For example, in Goldstein v. Commissioner,<sup>205</sup> Mrs. Goldstein, the winner of the Irish sweepstakes, attempted to shield some of her winnings from tax by borrowing \$945,000 at four percent annual interest and purchasing \$1 million in Treasury securities paying two percent annual interest. She prepaid interest of \$81,396 on the borrowing, and deducted this amount against her \$140,000 sweepstake winnings. The court disallowed the interest deduction on the grounds that the borrowing transaction had "no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction."<sup>206</sup>

The business purpose doctrine also was used to challenge the individual tax shelters of the 1970s and 1980s. These shelters typically took the form of partnerships that engaged in activities--such as real estate development or motion picture production--that generated net losses in their early years of operation. The partnerships' individual investors used their share of losses to shelter other, unrelated income. Although these shelters were attacked on a variety of grounds,

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be.

Isenbergh, supra note 163, at 866.

<sup>203</sup> 293 U.S. 465 (1935). The business purpose doctrine has since been made a requirement in a variety of corporate transactions, including divisive reorganizations, acquisitive reorganizations in general, tax-free incorporations, dividends, and the acquisition of control of a corporation. See, e.g., Basic Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977) (requiring business purpose for payment of a dividend).

<sup>204</sup> 293 U.S. at 469.

<sup>205</sup> 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

<sup>206</sup> Id. at 741.

the basis for their invalidation in some instances was the absence of any business purpose or economic substance other than the creation of tax benefits.<sup>207</sup>

### 3. Economic Substance Doctrine.

The third, and final, way the IRS can use non-statutory standards to challenge the tax benefits of a particular tax-advantaged transaction is through the application of the economic substance doctrine. This doctrine allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained.

A number of economic substance decisions have focused on the presence of offsetting obligations and circular cash flows that limit the economic consequences to the taxpayer while preserving the taxpayer's purported tax benefits. For example, in Goldstein v. Commissioner,<sup>208</sup> the taxpayer sought to exploit the different tax treatment for borrowing transactions involving prepaid interest and lending transactions that do not involve prepaid interest. By borrowing to purchase Treasury securities and by prepaying much of the interest on the borrowing, the taxpayer sought to secure a large interest deduction in the year of the borrowing. This deduction would be effectively reversed in later years by interest and gain on the Treasury securities. Aside from the purported tax benefits, the simultaneous lending and borrowing transactions produced little net economic consequence for the taxpayer. Despite the circular nature of the transactions, the court concluded that the transactions did, in fact, take place and therefore could not be ignored as "shams." The court nevertheless went on to hold against the taxpayer on the grounds that the transaction had "no substance or purpose aside from the taxpayer's desire to obtain a tax benefit."<sup>209</sup>

Similarly, in Sheldon v. Commissioner,<sup>210</sup> the economic substance doctrine was used to disallow the tax benefits resulting from the leveraged purchase of debt instruments. In Sheldon, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills. The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. As was the

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<sup>207</sup> See, e.g., Sochin v. Commissioner, 834 F.2d 351 (9th Cir. 1988), cert. denied, 488 U.S. 824 (1988); Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991).

<sup>208</sup> Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967).

<sup>209</sup> Id. at 741.

<sup>210</sup> 94 T.C. 738 (1990). See also Paul J. Donahue, The Rule of Sheldon v. Commissioner: Is It an Economically Efficient Evolution of the Sham Transaction Doctrine?, 13 Va. Tax Rev. 165 (1993).

case in Goldstein, the simultaneous borrowing and lending transactions economically offset, leaving the taxpayer with little real economic consequence from having entered into the transactions. In a reviewed decision, the Tax Court denied the taxpayer the purported tax benefits of the transactions because the transactions had no significant economic consequences other than the creation of tax benefits.

The economic substance doctrine has also been applied to disregard the tax benefits arising from dispositions of property where the disposition is part of a series of transactions that, taken together, do not meaningfully alter the taxpayers economic position. In the London Metal Exchange cases,<sup>211</sup> the taxpayers entered into a series of straddle and conversion transactions that were designed to create ordinary loss in the first year and capital gain in the second year. Because these transactions naturally offset each other (typically, a taxpayer would be both “long” and “short” on the same commodity at the same time), the transactions, while producing large “paper” gains and losses, produced minimal net economic consequences. For this reason, the transactions were found to lack economic substance.

More recently, the economic substance doctrine has been applied to deny a taxpayer the purported tax benefits from a near-simultaneous purchase and sale of property. In ACM Partnership v. Commissioner,<sup>212</sup> the taxpayer purchased privately-placed debt instruments and sold them 24 days later for consideration equal to their purchase price. Taken together, the purchase and sale “had only nominal, incidental effects on [the taxpayer’s] net economic position.”<sup>213</sup> The taxpayer claimed that despite the minimal net economic effect, the transaction had a large tax effect resulting from the application of the installment sale rules to the sale. The Tax Court held, and the Third Circuit affirmed, that because the transaction lacked any meaningful economic consequences other than the creation of tax benefits, the taxpayer was not entitled to the purported tax benefits of the transaction. As the Third Circuit opinion explained:

Viewed according to their objective economic effects rather than their form, [the taxpayer’s] transactions involved only a fleeting and economically inconsequential investment in and offsetting divestment from the [debt instruments]. . . . The transactions with respect to the [debt instruments] left the [taxpayer] in the same

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<sup>211</sup> The London Metals Exchange cases were heard in the Tax Court as a single case-- Glass v. Commissioner, 87 T.C. 1087 (1986). There were heard by several circuits on appeal. The appellate decisions include Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988), and Lerman v. Commissioner, 939 F.2d 44 (3d Cir. 1991), cert. denied, 502 U.S. 984 (1991).

<sup>212</sup> 73 T.C.M. (CCH) 2189 (1997), aff’d in part, rev’d in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct 1251 (1999). See also Steven M. Surdell, ACM Partnership: A New Test for Corporate Tax Shelters?, 75 Tax Notes 1377 (June 9, 1997).

<sup>213</sup> 157 F.3d at 250.



position it had occupied before engaging in the offsetting acquisition and disposition of those notes.<sup>214</sup>

Importantly, the determination of whether a transaction meaningfully alters the taxpayer's net economic position is a relative one. Economic substance must be measured in relation to the size of the tax benefit claimed. In ACM, for example, the court noted that briefly-owned debt instruments provided a yield that was only three basis points higher than the yield the taxpayer could have obtained by simply leaving its money on deposit. This "extra" return was clearly insignificant when compared to the size of the tax benefits at issue and, therefore, could not support a finding of economic substance. Similarly, in Sheldon, the court noted that the potential for small net economic consequences could not support a finding of economic substance. In the words of the court, the potential for gain was "nominal" and "insignificant" when considered in comparison to the claimed deductions.<sup>215</sup>

As is the case with other judicial anti-avoidance doctrines, predicting when the economic substance doctrine will be applied is difficult. One commentator has suggested that the test actually has three components: "(1) the benefits arise from a set of 'discrete' tax-motivated transactions; (2) these transactions do not meaningfully alter the taxpayer's net economic position; and, (3) most important, the tax benefits themselves are unreasonable and unwarranted in light of the objective rules which give rise to them."<sup>216</sup>

## C. PROCEDURAL APPROACHES

### 1. Tax Shelters of the 1970s and 1980s

This is not the first time that the tax system has been confronted with a significant assault in the form of tax shelters. In the 1970's and 1980's, there was an explosion of tax shelters that threatened not only the revenue of the fisc, but also general taxpayer confidence in the fairness and effectiveness of the tax system.

Unlike the corporate tax shelters of today, the tax shelters of the 1970's and 1980's were aimed primarily at high-tax bracket individuals. Many of these shelters were "cookie-cutter" deals that were mass-marketed to the taxpaying public. Often, these deals were accomplished using limited partnerships, which afforded the investors the benefits of limited liability and the ability to obtain tax benefits generated by the partnership without actively participating in the business of the entity.

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<sup>214</sup> Id.

<sup>215</sup> 94 T.C. at 769.

<sup>216</sup> Hariton, supra note 166, at 235 (1999).

Several elements were common to the tax benefits derived in many of these tax shelters.<sup>217</sup> First was the deferral of tax liability. This generally resulted from the acceleration of deductions in the early years of an investment with the bulk of the income from the investment coming in the later years. Under such an arrangement, the government effectively was granting the taxpayer an interest-free loan. Second was the conversion of ordinary income to capital gains. This could be achieved, for example, where a taxpayer took accelerated deductions against ordinary income with respect to an investment but was taxed at a reduced capital gains rate on the disposition of the property. Third was the use of nonrecourse leverage, which allowed taxpayers to recognize significant tax benefits (including interest deductions on the debt) without committing their own funds. Related to nonrecourse indebtedness were overvaluations of property that increased tax deductions and formed the basis of many of these early-era tax shelters.

Congress recognized the danger posed by these tax shelters and enacted various forms of legislation to combat the shelters.<sup>218</sup> The first step (albeit a small one) in the assault on tax shelters came in the Tax Reform Act of 1969.<sup>219</sup> There, Congress enacted a minimum tax on specified tax preference items, including excess investment interest, percentage depletion, long term capital gains, and other items.

The first comprehensive action against tax shelters came in the Tax Reform Act of 1976.<sup>220</sup> As part of this legislation, at-risk rules were enacted which limited loss deductions to a non-corporate taxpayer's actual investment with respect to certain activities (although, in a significant exception, the rules did not apply to real estate). In addition, deductibility of prepaid interest was required to be spread over the life of a loan, and a number of changes were made to the partnership provisions in order to limit syndication abuses. Finally, a number of additional provisions were added to curb abuses relating to (1) holding, producing, and distributing motion picture films, (2) certain types of farming, (3) equipment leasing, and (4) oil and gas exploration and exploitation.

In the Revenue Act of 1978,<sup>221</sup> the at-risk rules were extended to a broader array of activities (although still not real estate) and to closely-held corporations. The Economic

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<sup>217</sup> See generally Jt. Comm. on Tax'n, Tax Reform Proposals: Tax Shelters and Minimum Tax (Aug. 7, 1985).

<sup>218</sup> See generally Caplin, Tax Shelter Disputes and Litigation with the Internal Revenue Service: 1987 Style, 6 Va. Tax Rev. 709 (1987).

<sup>219</sup> Pub. L. No. 91-172, 83 Stat. 487.

<sup>220</sup> Pub. L. No. 94-455, 90 Stat. 1520.

<sup>221</sup> Pub. L. No. 95-600, 92 Stat. 2763.

Recovery Tax Act of 1981<sup>222</sup> extended the at-risk rules still further to the investment tax credit, strengthened rules regarding tax straddles, imposed a new penalty for valuation overstatements, and increased both the penalty for negligence and the interest rates that apply to tax deficiencies.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>223</sup> made a number of contributions to the battle against tax shelters. First, it replaced the minimum tax enacted in 1969 with an alternative minimum tax. The legislation also provided for penalties for substantial understatements of income tax and imposed harsher rules for tax shelters and for knowingly aiding third parties in understating income tax. The Act also authorized the imposition of heavy penalties on promoters for organizing or selling abusive tax shelters. Finally, in order to aid the IRS in attacking large tax shelters, centralized procedures for audits and litigation with respect to large partnerships were implemented so that the various procedural rules relating to such audits and litigation would apply at the partnership rather than the partner level.

The Deficit Reduction Act of 1984<sup>224</sup> contained numerous provisions aimed at tax shelters. For the first time, it became necessary to register tax shelters with the IRS, which was designed to help the IRS locate and evaluate tax shelters. Organizers and sellers of "potentially abusive tax shelters" also were required to maintain a list of investors in such shelters. Certain penalties were significantly strengthened, and rigorous standards for appraisals relating to charitable contributions of appreciated property were instituted. In addition, the Treasury Department was given authority to bring disciplinary actions against appraisers who appear before the IRS or the Treasury Department.

While significant progress had been made in the tax shelter battle by this time, the Tax Reform Act of 1986<sup>225</sup> was viewed by most as the death knell of the individual tax shelter industry that had grown up in the 1970's and 1980's. Among the provisions contained in this act were the following: (1) limitations on passive activity losses and credits, (2) application of the at-risk rules to real estate, (3) elimination of the investment tax credit, (4) less favorable depreciation deductions, (5) elimination of the capital gains preference, (6) adoption of uniform capitalization rules, (7) more restrictive limits on investment interest deductions, (8) denial of personal interest deductions (with an exception for home mortgage interest), and (9) a more rigorous alternative minimum tax for individuals and a new alternative minimum tax for corporations.

## 2. Procedural Provisions Aimed at the Tax Shelters of the 1970s and 1980s

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<sup>222</sup> Pub. L. No. 97-34, 95 Stat. 172.

<sup>223</sup> Pub. L. No. 97-248, 96 Stat. 324.

<sup>224</sup> Pub. L. No. 98-369, 98 Stat. 494.

<sup>225</sup> Pub. L. No. 99-514, 100 Stat. 2085.

The four principal procedural measures enacted by Congress to address the individual tax shelters of the 1970s and 1980s were: (1) tax shelter registration requirements, (2) the substantial understatement penalty, (3) a penalty for promotion of abusive tax shelters, and (4) a penalty for aiding and abetting the understatement of tax. These were intended to penalize taxpayers who entered into these shelter arrangements and the promoters of such shelters. In addition, the Treasury Department promulgated standards of practice for tax shelter opinions issued by tax practitioners. The IRS also took administrative measures to better coordinate the identification of tax shelters and promoters and the prosecution of tax shelter cases administratively and in the courts. These provisions provided new tools for the IRS in combating shelters but were directed toward the types of shelter arrangements then prevalent and the individuals who promoted them.

a. *Tax shelter registration requirements.* As part of the Deficit Reduction Act of 1984, Congress enacted Code sections 6111 and 6112 to require the registration of tax shelters and maintenance of lists of shelter investors. Prior to this time, there was no requirement that tax shelters register with the IRS. As a result, the IRS lacked complete and systematic information on which to base its decisions about which shelters should be audited.<sup>226</sup>

More specifically, section 6111 requires any tax shelter organizer to register a tax shelter with the Secretary no later than the day upon which the first offering for sale of interests in such shelter occurs.<sup>227</sup> The registration is to include (1) information identifying and describing the shelter, (2) information describing the tax benefits represented (or to be represented) to investors, and (3) any other information prescribed by the Secretary.<sup>228</sup> Any person who sells or transfers an interest in a tax shelter also is required to furnish each investor who purchased or otherwise acquired an interest in such shelter an identification number. The identification number is to be assigned by the Secretary.<sup>229</sup> This registration number is to be shown on the tax return of any person who claimed a deduction, credit or other tax benefit by reason of the registered tax shelter.<sup>230</sup> Section 6112 requires, in certain cases, that organizers or sellers of "potentially abusive

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<sup>226</sup> See Jt. Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 475 (1984) [hereinafter 1984 Blue Book].

<sup>227</sup> I.R.C. § 6111(a)(1).

<sup>228</sup> I.R.C. § 6111(a)(2).

<sup>229</sup> I.R.C. § 6111(b)(1).

<sup>230</sup> I.R.C. § 6111(b)(2).

tax shelters" maintain lists of investors.<sup>231</sup> The list is to be made available for inspection by the IRS upon request.

For purposes of section 6111, a "tax shelter" is defined to include any investment that meets two criteria. First, it must be reasonable to infer from representations made (or to be made) in connection with the offering for sale of interests in the investment that the tax shelter ratio for any investor at the close of any of the first five years after the investment is offered for sale is greater than two to one.<sup>232</sup> Second, the investment must be (1) required to be registered under a Federal or state law regulating certain types of securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or state agency regulating the offering of sale of securities, or (3) a substantial investment.<sup>233</sup> An investment is defined to be "substantial" if there are expected to be five or more investors and the aggregate amount that was offered for sale exceeds \$250,000.<sup>234</sup> For purposes of section 6112, a "potentially abusive tax shelter" is defined as any tax shelter under section 6111 for which registration is required or any entity, investment plan or arrangement or other plan or arrangement of a type determined by regulations as having potential or tax avoidance or evasion.<sup>235</sup>

A tax shelter "organizer" means the person principally responsible for organizing the shelter or, if there is no organizer under this definition, any other person who participated in the

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<sup>231</sup> Prior to enactment of this provision, when the IRS identified an abusive tax shelter, it would be able to identify taxpayers who invested in the shelter only through enforcement of summonses. See H.R. 98-861, at 977 (1984).

<sup>232</sup> I.R.C. § 6111(c)(1). The "tax shelter ratio" is defined as the aggregate amount of deductions and 350 percent of the credits represented to be potentially allowable for any year divided by the investment base. The "investment base" generally means the amount of money and adjusted basis of other property (reduced by liabilities to which the property is subject) contributed by the investor. I.R.C. § 6111(c)(2), (3).

<sup>233</sup> The legislative history states that the requirement that securities be registered with either the SEC or a state agency applied to many tax shelters. 1984 Blue Book, supra note 226, at 475. As a general rule, the legislative history's description of the tax shelter ratio and definition of a tax shelter reflects the salient features of many shelters of this era. See generally 1984 Blue Book, supra note 226, at 477-79.

<sup>234</sup> I.R.C. § 6111(c)(4).

<sup>235</sup> I.R.C. § 6112(b).

organization of the tax shelter or who participated in the sale or management of the investment at a time when the shelter was not registered.<sup>236</sup>

b. *Penalties for violation of registration requirements.* Violations of the registration requirements enacted in 1984 were made subject to penalty under Code sections 6707 and 6708. As originally enacted, failure to furnish information regarding, or to timely register, tax shelters, or filing false or incomplete information was subject to a penalty of the greater of (i) \$500 or (ii) the lesser of one percent of the aggregate amount invested in the shelter or \$10,000 ( *i.e.*, \$10,000 was the maximum penalty).<sup>237</sup> The \$10,000 limitation did not apply in the case of intentional disregard of the registration requirement. This penalty was modified by the Tax Reform Act of 1986 to be the greater of \$500 or one percent of the aggregate amount invested in the shelter (*i.e.*, the \$10,000 maximum was eliminated). A penalty also is imposed for failure to furnish a tax shelter identification number in the amount of \$100 for each such failure. Failure to include the identification number on a return was originally subject to a penalty of \$50 for each such failure, which amount was increased by the Tax Reform Act of 1986 to \$250.<sup>238</sup> Failure to maintain lists of investors in potentially abusive shelters is subject to a penalty of \$50 for each person with respect to which there was such failure, up to a maximum of \$50,000, which maximum was increased to \$100,000 by the Tax Reform Act of 1986.

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<sup>236</sup> I.R.C. § 6111(e). The legislative history states in this regard that

in many cases, the tax shelter organizer will be the tax shelter promoter. The tax shelter organizer need not, however, be the promoter or general partner. . . . If the person principally responsible for organizing the tax shelter fails to register the shelter as required, then any person who participates in the organization of the shelter must register the shelter. . . . Ordinarily, the rendition of professional advice by an unrelated attorney or accountant would not constitute the organization of a tax shelter. However, if, for example, the attorney's or accountant's fee is based, either in part or in whole, upon the number or value of units sold, the [IRS] might reasonably conclude that the attorney or accountant is an organizer, promoter, or seller of a tax shelter, since he participates in the entrepreneurial risk born by other promoters.

1984 Blue Book, *supra* note 226, at 477.

<sup>237</sup> I.R.C. § 6707(a)(2) (as enacted).

<sup>238</sup> I.R.C. § 6707(b). The penalty for failure to include the identification number on a return could be abated for reasonable cause.

The enactment of these registration provisions reflected Congressional concern that "promoters of and investors in syndicated investments and tax shelters [were] profiting from the inability of the Treasury Department to examine every return."<sup>239</sup> The requirement that promoters maintain lists of investors was enacted to "enable the Treasury to identify quickly all the participants in related tax shelter investments" and to ensure more uniform treatment of investors in similar schemes.<sup>240</sup> These provisions reflected and responded to the fact that these shelters were mass-marketed, often through partnerships, to individual investors and that it was time- and resource-intensive for the IRS to proceed against the investors individually. Moreover, the same promoter often marketed more than one shelter, and registration allowed the IRS to detect multiple marketings of similar shelters by the same individual promoter (or entities created by the promoter). Further, it was more efficient to handle the situations of individual investors in a single shelter simultaneously and uniformly. Lists of investors allowed the IRS to identify the participants for this purpose. Likewise, the definition of a tax shelter for purposes of this registration requirement reflected the fact that such shelters generally were promoted through offering materials, to multiple investors, through sale of interests in the shelter, and with tax benefits that exceeded by a multiple the investment in the shelter. Similarly, the penalties for failure to register or maintain lists of investors in potentially abusive shelters were not onerous in amount, but could accumulate if the aggregate investment was large or if there were numerous investors in a shelter for whom lists had to be maintained or identification numbers furnished.

c. *Accuracy-related penalty.* Prior to 1982, penalties existed for negligent and fraudulent understatements of tax.<sup>241</sup> The expectation of nonfraudulent and nonnegligent reporting positions had its analog in ABA Formal Opinion 314 (1965), which imposed a

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<sup>239</sup> S. Rep. No. 98-469, at 425 (1984). The legislative history goes on to state that promoters know that

even if a tax scheme they marketed was clearly faulty, some investors=incorrect returns would escape detection and many others would enjoy a substantial deferral of tax while the Treasury searched for their returns and coordinated its handling of similar cases. Also, Congress believed that registration will provide the [IRS] with basic information that will be useful in detecting trends in tax shelter promotions at an early date.

1984 Blue Book, supra note 226, at 475.

<sup>240</sup> Id.

<sup>241</sup> I.R.C. §§ 6653(a) & (b) (1954). The negligence penalty was 5 percent if an understatement was attributable to a careless, reckless, or intentional failure of the taxpayer to comply with the rules and regulations, while a 50 percent fraud penalty applied if an understatement was due to a knowingly false material representation by a taxpayer.

reasonable basis standard on attorneys advising clients regarding tax reporting positions. As the tax shelter market proliferated, however, confidence eroded that the reasonable basis standard, which essentially was a litigating position, served to adequately deter aggressive reporting positions.<sup>242</sup> Congress responded initially with a series of technical changes to the existing penalties.<sup>243</sup> In the TEFRA, however, Congress took a different approach and enacted the substantial understatement penalty. The thrust behind this penalty was Congressional concern that "an increasing part of the compliance gap is attributable to taxpayers playing the 'audit lottery.'" Taxpayers "were, generally, not exposed to any downside risk in taking questionable positions on their tax returns since resolution of the issue against the taxpayer required only payment of the tax that should have been paid in the first instance with interest to reflect the cost of the 'borrowing.'"<sup>244</sup>

As originally enacted in section 6661, the substantial understatement penalty applied a penalty of 10 percent to any underpayment attributable to an understatement of tax if the understatement exceeded the greater of 10 percent of the correct tax required to be shown on the return or \$5,000 (\$10,000 for corporations).<sup>245</sup> The penalty generally could be avoided either by adequately disclosing the relevant facts or by establishing that there was "substantial authority" for the taxpayer's position.<sup>246</sup> Special rules, however, applied to tax shelters because "Congress believed that taxpayers investing in tax shelters should be held to a higher standard of care in determining the tax treatment of items arising from the shelter or risk a significant penalty."<sup>247</sup> A

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<sup>242</sup> See Jt. Comm. on Tax'n, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 216 (1982) [hereinafter 1982 Blue Book]; J. Kurtz and Panel, Questionable Positions, 32 Tax Law. 13 (1978).

<sup>243</sup> In the Economic Recovery Tax Act of 1981, the negligence penalty was increased by adding a supplemental penalty of 50 percent of the interest attributable to the portion of a deficiency out of which the penalty arose. A negligence penalty also was added that presumptively applied to certain unreported straddles and a penalty that applied to individuals and certain corporations making valuation overstatements. The Tax Equity and Fiscal Responsibility Act of 1982 added a supplemental penalty to the fraud penalty similar to that adopted for the negligence penalty.

<sup>244</sup> See 1982 Blue Book, supra note 242, at 216.

<sup>245</sup> I.R.C. §§ 6661(a) & (b).

<sup>246</sup> I.R.C. § 6661(b)(2)(B). Congress did not believe a penalty was appropriate where substantial authority existed and taxpayers and the government reasonably differed over the tax laws, but did believe that a penalty was appropriate for undisclosed questionable positions. See 1982 Blue Book, supra note 242, at 216-17.

<sup>247</sup> 1982 Blue Book, supra note 242, at 217.



"tax shelter" was defined for this purpose as "a partnership or other entity, investment plan or arrangement, or any other plan or arrangement" if "the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax."<sup>248</sup> For a tax shelter item, adequate disclosure would not avoid the penalty and, in addition to substantial authority, the taxpayer was required to demonstrate a reasonable belief that the tax treatment of the item was "more likely than not" the proper treatment.<sup>249</sup> The Secretary was authorized to waive the penalty upon a showing by the taxpayer of reasonable cause and good faith.<sup>250</sup> Further toughening of penalties occurred in the Tax Reform Act of 1984<sup>251</sup> and the Tax Reform Act of 1986.<sup>252</sup> In particular, the substantial understatement penalty was increased to 20 percent, a level that was immediately raised to 25 percent by the Omnibus Budget Reconciliation Act of 1986.

A result of this legislative activity, however, was the existence of several separate (and potentially cumulative) accuracy-related penalties encompassing negligence, substantial understatement of tax, and various types of valuation overstatements or understatements.<sup>253</sup> The Improved Penalty Administration and Compliance Tax Act of 1989 consolidated these penalties into a single accuracy-related penalty under Code section 6662 for five different types of misconduct: (1) negligence or disregard of rules or regulations; (2) substantial understatement of income tax; (3) a substantial valuation misstatement for income tax purposes; (4) a substantial

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<sup>248</sup> I.R.C. § 6661(b)(2)(C)(ii)(as enacted)(emphasis added). Regulations subsequently defined "the principal purpose" to mean a purpose that "exceeds any other purpose." Treas. Reg. § 1.6662-4(g)(2).

<sup>249</sup> I.R.C. § 6661(b)(2)(C)(i).

<sup>250</sup> I.R.C. § 6661(c).

<sup>251</sup> The interest rate for tax motivated transactions was raised to 120 percent of the otherwise applicable rate and the valuation penalty was broadened through the addition of section 6660.

<sup>252</sup> The fraud penalty was increased to 75 percent and valuation penalties were broadened to encompass pension matters with the addition of section 6659A. The negligence penalty was extended to all taxes and the definition of negligence was changed to include "any failure to make a reasonable attempt to comply with the provisions of the Code."

<sup>253</sup> Thus, for example, a charitable deduction for donated property in excess of the property's value could subject a taxpayer to the negligence, substantial understatement and substantial overvaluation penalties for the same underpayment of tax. When Congress enacted major reform of the tax penalty regime in 1989, the legislative history indicated that "the number of different penalties that relate to accuracy of a tax return, as well as the potential for overlapping among many of these penalties, causes confusion among taxpayers and leads to difficulties in administering these penalties." H.R. Rep. No. 101-247, at 1288 (1989).

overstatement of pension liabilities; or (5) a substantial estate or gift valuation understatement. A single penalty of 20 percent was imposed on the portion of the underpayment attributable to the misconduct, and stacking of the penalties was eliminated.<sup>254</sup> The penalty for an understatement of tax attributable to fraud remained at 75 percent. Another reform was enactment of a single reasonable cause exception in section 6664(c) applicable to all accuracy-related penalties and to the fraud penalty.<sup>255</sup> As enacted in 1989, section 6662 retained the rules of its predecessor statute with respect to tax shelter items.

d. *Promotion of abusive shelters/aiding and abetting penalties.* In addition to the original substantial understatement penalty, two new civil penalties were enacted in 1982 that were directed specifically toward promoters and sellers of tax shelter transactions. These are (1) the penalty for promoting abusive tax shelters (Code section 6700) and (2) the penalty for aiding and abetting an understatement of tax (Code section 6701). In addition, Code section 7408 was enacted which provided authority for the Secretary of the Treasury to seek injunctions against tax shelter promoters. These penalties were directed toward the more egregious types of conduct engaged in by promoters in the 1970s and 1980s, *i.e.*, where the transaction was a sham, involved gross overvaluations, or otherwise involved false or fraudulent misrepresentations to potential investors of the purported tax benefits.

In 1982, Congress imposed a new penalty for promoting "abusive tax shelters" under section 6700. Consistent with the purpose underlying the registration requirements and the promoter penalty, this penalty was intended to attack tax shelters at their source, "the organizer and salesperson," rather than through enforcement actions against investors.<sup>256</sup> Consequently, the section 6700 penalty is imposed on to organizers or sellers of interests in partnerships or other

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<sup>254</sup> However, a 40-percent penalty applies under section 6662(h) in the case of certain "gross valuation misstatements."

<sup>255</sup> The legislative history states that the enactment of a single reasonable cause exception was intended to permit taxpayers to more readily understand the behavior that is required, to simplify administration of the penalties, to lead the IRS to consider fully whether imposition of the penalty is justified, and to provide greater scope for judicial review. H.R. Rep. No. 101-247, at 1392-93 (1989).

<sup>256</sup> Prior to enactment of section 6700, the Code contained no penalty provisions specifically directed toward promoters of abusive tax shelters and other abusive tax avoidance schemes. In appropriate cases, the promoter might be subject to civil or criminal penalties for false or fraudulent return preparation or willful attempts to evade tax. See S. Rep. No. 97-494, at 266 & 268 (1982).

arrangements who made statements regarding the allowability of tax benefits that the person knew (or had reason to know) were false or fraudulent.<sup>257</sup>

More specifically, the section 6700 penalty is imposed on (1) any organizer or participant in the sale of any interest in a partnership or other entity, investment plan or other arrangement who (2) makes or furnishes (or causes another person to make or furnish) a statement in connection with such organization or sale with respect to the purported tax benefits that the person knows or has reason to know<sup>258</sup> to be false or fraudulent as to any material matter. Because many of these shelters involve questionable valuations, the penalty also applies to the making or furnishing of a gross valuation overstatement (as defined in section 6700(b)) as to any material matter. Material matters are described in the legislative history as those matters which would have a substantial impact on the decision-making process of a reasonably prudent investor and include matters relevant to the availability of a tax benefit.<sup>259</sup>

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<sup>257</sup> The legislative history stated in this regard that "the promoter penalty was viewed as particularly equitable because the promoter, professional advisor or salesman of a tax shelter generally is more culpable than the purchaser who may have relied on their representations as to the tax consequences of the investment." 1982 Blue Book, supra note 242 , at 211.

<sup>258</sup> The legislative history clarifies that the addition of "has reason to know" is intended to permit the IRS to rely on objective evidence of the knowledge of the promoter or salesperson to prove that a false or fraudulent statement was deliberately furnished. H.R. Conf. Rep. No. 97-760, at 572 (1982). Several courts have held that the "know or has reason to know" standard i.e., specific intent. U.S. v. Campbell, 897 F.2d 1317 (5<sup>th</sup> Cir. 1990); U.S. v. Kaun, 827 F.2d 1144 (7<sup>th</sup> Cir. 1987). False statements of fact or statements regarding the purported tax benefits that are contrary to established law generally have been held to be false or fraudulent. See, e.g., U.S. v. Buttorf, 761 F.2d 1056 (5<sup>th</sup> Cir. 1985); United States v. Estate Preservation Services, 38 F. Supp.2d 846 (E.D. Ca. 1998). In determining whether the promoter knew or had reason to know of the false or fraudulent statement, relevant factors include the promoter's familiarity with the tax laws, level of sophistication and education, and whether the opinion of knowledgeable professionals was obtained. Id.

<sup>259</sup> S. Rep. No. 97-494, at 267 (1982).

Also, in 1982 Congress enacted the aiding and abetting penalty of section 6701.<sup>260</sup> This penalty applies to any person who aids or assists in, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws and who knows that such portion (if so used) would result in an understatement of the liability for tax of another person. The term "procures" is defined to include ordering or otherwise causing a subordinate to do an act and knowing of, and not preventing, the subordinate's participation in such act.<sup>261</sup> Some courts have held that the standard of knowledge under section 6701 requires actual knowledge, rather than willful blindness.<sup>262</sup>

Both the section 6700 abusive tax shelter penalty and the section 6701 aiding and abetting penalty are monetary penalties. The penalty for promoting an abusive tax shelter presently is the lesser of \$1,000 or 100 percent of the gross income derived from the activity.<sup>263</sup> The penalty for aiding and abetting is \$1,000 per document (\$10,000 for corporations). Reflecting the mass-marketing of cookie-cutter shelters in the 1970s and 1980s to high-bracket individuals, however, the penalties were framed such that multiple activities (e.g., sales) or misleading representations to more than one taxpayer can be separately penalized. Thus, the penalty for promotion of abusive shelters provides that activities with respect to each entity or arrangement or each sale are treated as separate activities.<sup>264</sup> The aiding and abetting penalty may be imposed in relation to no more

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<sup>260</sup> Prior to enactment of section 6701, there was no civil penalty for aiding and abetting in the preparation of false or fraudulent documents. A criminal penalty was provided for willfully aiding in the preparation or presentation of a false or fraudulent return or other document, punishable by a fine up to \$5,000 or 3 years imprisonment. Section 6701 was intended to be a civil penalty analogous to the preexisting criminal penalty for conduct that should be penalized but that was "not so abhorrent as to suggest criminal prosecution." 1982 Blue Book, supra note 242, at 220.

<sup>261</sup> I.R.C. § 6701(c).

<sup>262</sup> Mattingly v. Commissioner, 924 F.2d 785 (8<sup>th</sup> Cir. 1991); Gard v. United States, 92-1 U.S.T.C. (CCH) ¶ 50,159 (N.D. Ga. 1992). The legislative history states that knowledge was intended to limit the penalty to "cases involving willful attempts to accomplish an understatement of the tax liability of a third party." 1982 Blue Book, supra note 242, at 221.

<sup>263</sup> The penalty as originally enacted was the greater of \$1,000 or 10 percent of the gross income derived from the activity, which was modified by the Deficit Reduction Act of 1984 to be the greater of \$1,000 or 20 percent of the gross income derived from the activity. The current penalty amount was enacted in the Omnibus Budget Reconciliation Act of 1989.

<sup>264</sup> I.R.C. § 6700(a). This provision was added by the Omnibus Budget Reconciliation Act of 1989.

than one document per taxable period for each taxpayer for whom the promoter knew or had reason to know that use of a document prepared by the promoter would result in an understatement of tax liability.<sup>265</sup>

Apart from penalties for promoting abusive tax shelters or aiding and abetting understatements of tax, the 1982 Act also provided authority to the Secretary of the Treasury to seek injunctions against organizers or salespersons of shelters to prohibit them from further engaging in such conduct. Section 7408 was enacted to ensure "that the [IRS] can attack tax shelter schemes years before such challenges would be possible if the [IRS] were first required to audit investor tax returns."<sup>266</sup> Section 7408 authorizes a civil action in the name of the United States to be brought in federal district court enjoining any person from further engaging in conduct subject to penalty under sections 6700 or 6701. The action must be brought in a district court for the district in which the shelter promoter resides, has his or her principal place of business, or has engaged in the conduct subject to penalty. Injunctive relief may be awarded if the court finds that the promoter's conduct is subject to penalty under section 6700 or 6701 and that injunctive relief is appropriate to prevent recurrence of the conduct.<sup>267</sup>

e. *Standards of Practice.* The Treasury Department promulgates regulations governing practice before the IRS, referred to as Circular 230.<sup>268</sup> These standards cover "all matters connected with a presentation to the Internal Revenue Service" relating to a client's rights, privileges, or liabilities under the internal revenue laws. This includes the preparation and filing of documents, correspondence and communications with the IRS, and representing clients at conferences, hearings, and meetings.<sup>269</sup>

In response to the proliferation of tax shelters in the 1970s and 1980s, in 1985 the Treasury Department promulgated specific standards in Circular 230 relating to tax shelter

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<sup>265</sup> I.R.C. § 6701(b)(3).

<sup>266</sup> 1982 Blue Book, supra note 242, at 213.

<sup>267</sup> The injunction may enjoin the conduct subject to penalty or "any other activity subject to penalty under section 6700 or 6701." I.R.C. § 7408(b). Generally, where injunctions have been issued that reach beyond the specific conduct before the court, the injunction was applied to any tax avoidance scheme with characteristics similar to those of the particular scheme before the court. See, e.g., U.S. v. Campbell, 897 F.2d at 1323.

<sup>268</sup> Circular 230 is found at Part 10 of Title 31 of the Code of Federal Regulations.

<sup>269</sup> Section 10.2(e). Section 10.32, however, qualifies that the regulations should not be construed as authorizing persons not members of the bar to practice law.

opinions.<sup>270</sup> These standards were patterned after ABA Formal Opinion 346 (1982) and were directed toward the types of tax shelters prevalent in the 1970s and 1980s. As a consequence, the standards are directed specifically at tax shelter opinions that are designed to be included or described in tax shelter offering materials distributed to the public.<sup>271</sup> The standards require that the opinion renderer make inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable, and complete.<sup>272</sup> Practitioners must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.<sup>273</sup> The practitioner must ascertain that all material Federal tax issues have been considered and that all such issues which involve the reasonable possibility of a challenge by the IRS are fully and fairly addressed.<sup>274</sup>

The tax shelter opinion standard requires that the practitioner, where possible, render an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue, and on the material tax benefits in the aggregate, if there is a reasonable possibility of challenge by the IRS. Where such an opinion cannot be rendered, the opinion should fully describe the reasons for the inability to make such an evaluation.<sup>275</sup> A favorable

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<sup>270</sup> Section 10.33. Circular 230 also contains standards for return preparers. See section 10.34.

<sup>271</sup> Section 10.33(c)(3). One commentator has noted that, as a consequence, the standards are not easily adapted for application to practitioners who advise prospective purchasers in a one-to-one relationship. @ Holden, supra note 3, at 374.

<sup>272</sup> Section 10.33(a)(1). This subsection of Circular 230 also contains further refinements of the standards to be followed by practitioners in ascertaining facts, including valuations of property or financial projections.

<sup>273</sup> Section 10.33(a)(2).

<sup>274</sup> Section 10.33(a)(3). A material tax issue includes any Federal income or excise tax issue relating to a tax shelter that would make a significant contribution toward sheltering from Federal taxes income from other sources by providing deductions in excess of income from the tax shelter investment in any year, or tax credits available to offset tax liability in excess of the tax attributable to the tax shelter in any year. It also includes any other Federal income or excise tax issue that could have a significant impact (either beneficial or adverse) to a tax shelter investor under any reasonably foreseeable circumstance. It also includes the potential applicability of penalties, additions to tax, or interest charges that could be reasonably asserted. The determination of what is material is to be made by the practitioner in good faith based on information available at the time the offering materials are circulated.

<sup>275</sup> Sections 10.33(a)(4) & (5).

overall evaluation may not be rendered unless it is based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely than not will be realized if challenged by the IRS.<sup>276</sup>

Circular 230 is administered by the Director of Practice, who reports to the Commissioner of the IRS. The Director is empowered to provide for the conduct of disciplinary proceedings and to make inquiry with respect to matters under his jurisdiction. The Secretary of the Treasury has the power to disbar or suspend any person recognized to practice before the IRS who (1) is shown to be incompetent or disreputable, (2) refuses to comply with the rules and regulations in Circular 230, or (3) with intent to defraud willfully and knowingly deceives, misleads, or threatens a prospective client by oral or written solicitation. Circular 230 provides a number of examples of disreputable conduct, including (1) the giving of a false tax opinion, (2) knowingly, recklessly, or through incompetence, giving an opinion that is intentionally or recklessly misleading, or (3) a pattern of providing incompetent opinions on tax questions.<sup>277</sup>

After the tax shelter opinion standards were promulgated, the IRS announced that it planned strict enforcement of these standards where practitioners were connected with abusive tax shelters.<sup>278</sup> It stated that violations of the standards would be referred to the Director of Practice. Practitioners who would be considered for referral were those who had violated the requirements of section 10.33, against whom penalties for promoting abusive tax shelters had been assessed, who had been enjoined from promoting abusive tax shelters, who had been penalized for giving bad advice that created an understatement of tax, or who had not complied with the registration requirements. The IRS also stated that referrals would be made regardless of whether penalties were assessed if the situation indicated that the practitioner had failed to follow the rules of practice. As a practical matter, however, enforcement of these standards was largely preempted by the shutting down of shelter activity in the mid-1980s with passage of the passive loss rules.

### 3. Tax Shelter Program of the 1980's

In the early 1980's, the IRS established a program to identify, investigate, and address abusive tax shelters that coordinated a multitude of functions, including technical, examination, criminal investigation, and litigation. The primary goal of the program was to identify, examine, and investigate abusive tax shelters that utilized improper or extreme interpretations of the law or the facts to secure for the investors substantial tax benefits clearly disproportionate to the economic reality of the transaction.<sup>279</sup> Once an abusive tax shelter was identified and investigated,

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<sup>276</sup> Section 10.33(a)(5)(i).

<sup>277</sup> Section 10.51(j).

<sup>278</sup> IR 85-49 (May 17, 1985).

<sup>279</sup> I.R.M., Audit, 42(17)1, MT 4200-574 (Nov. 22, 1989) (Tax Shelter Program -- General).

the IRS would undertake procedures to (1) freeze the refunds of investors; (2) request injunctive relief under section 7408; (3) assert penalties under section 6700 (relating to a penalty for promoting abusive tax shelters); or (4) issue pre-filing notification letters to investors.<sup>280</sup>

The tax shelter program was initiated to ensure greater compliance with the tax laws and to maximize the use of the IRS's limited resources.<sup>281</sup> To accomplish this, the IRS determined that it had to identify and investigate abusive tax shelter promotions before the affected tax returns were filed.<sup>282</sup> Also, in the event that abusive tax shelters were not detected prior to the filing date of affected returns, the affected returns (*i.e.*, those claiming tax benefits from these shelters) had to be detected and identified before they were processed and refunds were issued.<sup>283</sup>

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<sup>280</sup> Under the direction of a District Director, pre-filing notification letters were sent to investors if there was evidence that the shelter assets were overvalued or if the promotional materials contained false or fraudulent statements concerning a material matter. Rev. Proc. 83-78, 1983-2 C.B. 595, at § 6.01, modified by, Rev. Proc. 84-84, 1984-2 C.B. 782. The pre-filing notification letters advised the investors that, based on a review of the shelter, the IRS believed that the purported tax benefits were not allowable. *Id.* at § 6.02. It also advised them of the consequences if they filed their tax returns claiming the shelter benefits and of the possibility of amending their returns if they had already filed them. *Id.* After the letters were issued, the District forwarded a list of the investors to the appropriate service centers so that the affected returns could be examined. *Id.* at § 7. See also Rev. Proc. 84-84, 1984-2 C.B. 782, at § 3.02 ("Returns in which pre-filing notification letters have been issued for the current or prior year will automatically be selected for review.").

<sup>281</sup> As of December 31, 1985, the inventory of tax shelter cases included approximately 413,665 returns under examination; approximately 31,072 cases in appeals; and approximately 30,000 cases docketed with the Tax Court. Robert R. Ruwe, Tax Shelter Outline, in Tax Shelter 1986 Style: The IRS Speaks (Law & Business, Inc., 1986).

<sup>282</sup> Rev. Proc. 83-78, 1983-2 C.B. 595, modified by Rev. Proc. 84-84, 1984-2 C.B. 782. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, permitted the IRS to attack abusive shelters at their source by authorizing injunctive relief and penalties against the promoters of such shelters. I.R.C. §§ 6700 & 7408.

<sup>283</sup> Rev. Proc. 84-84, 1984-2 C.B. 782. This revenue procedure arose because of concerns about an increase in abusive tax shelters that generated refunds for taxpayers. *Id.* at § 2.01. Paying out refunds attributable to losses, deductions, or credits when the available information indicated that those losses, deductions, or credits were attributable to an abusive tax shelter and were likely to be excessive imposed a heavy burden on the collection resources of the IRS. To meet this concern, the IRS developed procedures at the service centers to identify potential abusive tax shelter returns and certain claims for credit or refund during initial front-end processing before any refunds were paid.



These administrative efforts to detect and coordinate the IRS' handling of tax shelters included (1) establishing a coordinated body to review promotions identified by IRS personnel and select those for which litigation, penalties, injunctions or notices were appropriate; (2) establishing in each service center an abusive tax shelter "detection team" to analyze returns and other information to identify questionable shelters and make recommendations regarding further audit or prosecution; and (3) handling litigation through special teams in the U.S. Tax Court or U.S. district courts.

#### 4. Registration and Penalty Provisions Directed Toward Corporate Tax Shelters

In the last few years, Congress has modified the existing registration and substantial understatement penalty provisions to respond to the proliferation of corporate tax shelters. The Taxpayer Relief Act of 1997 extended the registration provisions to corporate tax shelters promoted under conditions of confidentiality.<sup>284</sup> This registration requirement is effective for tax shelter interests offered to potential participants after guidance is issued with respect to the registration requirement (which guidance has not yet been issued). Under this provision, certain arrangements are treated as tax shelters for a corporate participant, specifically: (1) where "a significant purpose" of the structure is tax avoidance or evasion, (2) which is offered under conditions of confidentiality, and (3) where promoter fees may exceed \$100,000 in the aggregate.<sup>285</sup> A promoter is defined as any person or any related person (within the meaning of section 267 or 707) who participates in the organization, management, or sale of the tax shelter.<sup>286</sup> In certain cases, persons other than the promoter are required to register the corporate tax shelter.<sup>287</sup> The amount of the penalty for failure to register or for registering false or incomplete information also was increased in the case of confidential arrangements. The penalty is the greater of 50 percent of the fees paid to all promoters of the tax shelter with respect to offerings made before the date such shelter is registered or \$10,000.<sup>288</sup>

Changes also were made to the substantial understatement penalty in the context of corporate tax shelters, beginning with the Uruguay Round Agreements Act of 1994.<sup>289</sup> The ability

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<sup>284</sup> I.R.C. § 6111(d).

<sup>285</sup> I.R.C. § 6111(d)(1).

<sup>286</sup> I.R.C. § 6111(d)(2).

<sup>287</sup> See I.R.C. § 6111(d)(3).

<sup>288</sup> I.R.C. § 6707(a)(3). A similar penalty is imposed on participants who are required to register the shelter but do not, but only to the extent of fees paid by that participant. The penalty is increased to 75 percent of fees paid in the case of an intentional failure or act.

<sup>289</sup> P.L. No. 103-465, 108 Stat. 4809.

of corporations to avoid the substantial understatement penalty for tax shelter items based on substantial authority and reasonable belief under section 6662 was eliminated. Instead, corporations could avoid the penalty for tax shelter items only if they established reasonable cause under section 6664(c). The legislative history of this provision indicates that it was intended to tighten the provisions applicable to corporate tax shelter items.<sup>290</sup>

Further, in the Taxpayer Relief Act of 1997, the definition of a "tax shelter" was broadened, to conform to the definition under the corporate tax shelter registration requirements of section 6111(d). A tax shelter was defined to include any plan or arrangement "a significant purpose" of which (rather than "the principal purpose") was the avoidance or evasion of tax. At least one commentator has asserted that the current law definition of a tax shelter as one having tax avoidance as a significant purpose potentially encompasses all types of corporate tax planning.<sup>291</sup>

Thus, under current law, a substantial understatement penalty of 20 percent can be imposed on any underpayment attributable to a corporate tax shelter item unless reasonable cause under section 6664(c) is demonstrated. A "tax shelter" is any partnership, entity, investment plan or other plan or arrangement "a significant purpose" of which is the avoidance or evasion of tax. Regulations issued under section 6664(c) provide that, with respect to tax shelter items of corporations, the determination of whether a corporate taxpayer acted with reasonable cause and in good faith must be made on the basis of all pertinent facts and circumstances.<sup>292</sup> The regulations set forth minimum requirements to establish reasonable cause. The corporate taxpayer must satisfy both an authority and belief requirement. The authority requirement is satisfied only if there is substantial authority for the tax treatment of the item.<sup>293</sup> The belief requirement is satisfied only if, based on all the facts and circumstances, the corporation reasonably believed at the time the return was filed that the tax treatment of the item is more likely than not the proper treatment. This latter requirement can be satisfied if the corporation either (1) analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably

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<sup>290</sup> The legislative history indicates Congressional concern that the substantial understatement penalty may not have been effective enough to deter corporations from entering into aggressive tax shelter transactions. "[T]he intent of the provision is that the standards applicable to corporate shelters be tightened; consequently, in no instance would this modification result in a penalty not being imposed where a penalty would be imposed under prior law." H.R. Rep. No. 103-826, at 198 (1994).

<sup>291</sup> Johnson, *supra* note 76, at 1604. The 1997 Act also provided that in no event would a corporation have a reasonable basis for the tax treatment of an item attributable to a multi-party financing if the treatment did not clearly reflect income. I.R.C. § 6662(d)(2)(B).

<sup>292</sup> Treas. Reg. § 1.6664-4(e)(1).

<sup>293</sup> Treas. Reg. § 1.6664-4(e)(2)(i)(A).

concludes in good faith that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged, or (2) reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged.<sup>294</sup> The regulations further provide that the belief requirement must be satisfied without taking into account the likelihood that the return will not be audited, that an issue will not be raised on audit, or that an issue will be settled.<sup>295</sup> If the authority and belief standards are satisfied, the corporation's legal justification may be taken into account to establish reasonable cause and good faith.<sup>296</sup>

The regulations further provide, however, that satisfaction of the minimum requirements is not necessarily dispositive of reasonable cause and good faith. Reasonable cause and good faith nonetheless may be found lacking if the taxpayer's participation in the tax shelter lacked significant business purpose, if the claimed tax benefits are unreasonable in comparison to the taxpayer's investment in the shelter, or if there is a confidentiality agreement between the taxpayer and the organizer or promoter.<sup>297</sup>

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<sup>294</sup> Treas. Reg. § 1.6664-4(e)(2)(i)(B).

<sup>295</sup> Id.

<sup>296</sup> Treas. Reg. § 1.6664-4(e)(2)(i).

<sup>297</sup> Treas. Reg. § 1.6664-4(e)(4).

## V. ANALYSIS OF ADMINISTRATION'S BUDGET PROPOSALS

Unlike the enactment of the passive loss rules by the 1986 Act in response to individual tax shelters, it does not appear that a single proposal could adequately address corporate tax shelters. As previously discussed in Part IV.C., the success of almost all individual tax shelters depended upon the “cookie-cutter” combination of limited liability of participants, overvaluations of property financed with nonrecourse indebtedness, and up-front accelerated ordinary income deductions followed by deferred capital gains. Corporate tax shelters, on the other hand, take a variety of forms and exploit anomalies in and among a variety of Code provisions.

However, like the individual tax shelter problem of the 1980s, legislation is necessary to address current corporate tax shelters, and in this regard, the Administration has put forth several proposals in its FY 2000 Budget. These proposals have generated a great deal of interest and commentary. Some commentators have asserted that any deficiency in current law is reflective of a need for greater enforcement of existing rules and sanctions rather than changes in the rules or sanctions themselves.<sup>298</sup> Conversely, others have asserted that the current regime requires further modification in light of the realities of today's marketplace and the correlative pressures brought to bear on the various parties engaged in corporate tax shelter activity.<sup>299</sup> The commentators, however, have almost uniformly recognized the existence of a serious and growing problem and their analysis of the underpinnings of the problem is substantially similar.

First, there appears to be a consensus that the corporate tax shelter transactions of concern have several common characteristics, as described in this Report. These characteristics are distinguishable in a number of respects from the salient characteristics typically found in the shelters of the 1970s and 1980s. Second, corporate tax shelters threaten the integrity of the tax system, due to lost revenue and other negative collateral effects including breeding of disrespect for the tax system and nonproductive use of resources.<sup>300</sup> Third, the Treasury Department and the IRS cannot handle this phenomenon solely through the issuance of regulations and notices; it is a perennial game of “catch up” in a realization-based system that spawns “an almost infinite variety of tax planning.”<sup>301</sup> Litigation is a time-consuming and resource-intensive process that produces a definitive outcome long after the transaction was accomplished and promoters have moved on to other products.<sup>302</sup> Fourth, the corporate sector appears to be placing a premium on tax savings

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<sup>298</sup> See, e.g., TEI, supra note 4, at 8-9.

<sup>299</sup> See, e.g., NYSBA, Report, supra note 19, at 881-83; ABA, supra note 56, at 4-6.

<sup>300</sup> See, e.g., NYSBA, Report, supra note 19, at 881; Holden, supra note 3, at 369.

<sup>301</sup> See NYSBA, Report, supra note 19, at 882-83.

<sup>302</sup> The litigation in ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999), for

and managing effective tax rates.<sup>303</sup> Fifth, tax practitioners are devoting significant resources to the development and marketing of products in response to this corporate emphasis, married to highly sophisticated financial engineering. Some of these products are mass marketed; others are marketed to a limited group of prospective investors.<sup>304</sup> Finally, in this environment, “the role of the opinion giver often disintegrates into the job of designing or blessing a factual setting to support applicability of the Code provisions that will arguably produce the desired benefit.”<sup>305</sup>

This Part of the Report discusses the legislative proposals put forth by the Administration in its FY 2000 Budget intended to restrict the growth of corporate tax shelters.<sup>306</sup> This Part also summarizes and analyzes comments on the Administration’s proposals by the American Bar Association (ABA), American Institute of Certified Public Accountants (AICPA), and the New York State Bar Association (NYSBA).<sup>307</sup> This analysis also examines the relevant provisions of H.R. 2255, the “Abusive Tax Shelter Shutdown Act of 1999,” provisions of which reflect portions of the Administration’s Budget proposals as well as comments made by the practitioner groups.<sup>308</sup> Finally, this Part of the Report provides potential modifications to the Administration’s original Budget proposals to address certain concerns raised by commentators.

To inhibit the growth of corporate tax shelters, the FY 2000 Budget proposals focus on the following areas: (1) increasing disclosure of corporate tax shelter activities, (2) increasing and modifying the penalty relating to the substantial understatement of income tax, (3) changing substantive law to disallow the use of tax benefits generated by a corporate tax shelter, and (4) providing incentives to all the parties to the transaction ( *i.e.*, corporate participants, promoters and advisors, and tax-indifferent, accommodating parties) to insure that it comports to established

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example, took several years and cost the IRS several million dollars.

<sup>303</sup> See Bankman, supra note 19, at 1784; NYSBA, Report, supra note 19, at 882.

<sup>304</sup> See Forbes, supra note 5, at 200 & 202.

<sup>305</sup> See ABA, supra note 56, at 6.

<sup>306</sup> Treasury Explanation, supra note 61, at 95-105. The descriptions of these proposals are reproduced in Appendix B.

<sup>307</sup> This Report focuses on the comments of these organizations because they not only provide an analysis of the relative strengths and weaknesses of the corporate tax shelter proposals put forth by the Administration in its FY 2000 budget, they also provide, to varying degrees, alternative or supplemental proposals of their own. In developing this Report, the Treasury Department has considered all comments submitted by interested parties, even if not cited herein.

<sup>308</sup> H.R. 2255, 106<sup>th</sup> Cong. (1999). This bill was introduced by Messrs. Doggett, Stark, Hinchey, and Tierney on June 17, 1999.

principles. It should be noted that each of these areas are interdependent with one another and upon the definition of corporate tax shelter. For example, increasing the substantial understatement penalty would not be an effective mechanism if there is a defect in the underlying substantive law such that the tax benefits claimed by a taxpayer are never disallowed and an understatement is never created. Thus, as discussed in detail below, a corresponding change of the substantive law is necessary. The relationships between, and the relative importance of, each of these four areas is discussed below.

#### A. INCREASING DISCLOSURE

Greater disclosure of corporate tax shelters would have two closely related ameliorative effects. First, it could lead to greater enforcement efforts by the IRS. Before the IRS can combat a corporate tax shelter, they must find it. As discussed in Part III.A., not all corporations are audited annually and those corporations that are frequently audited often have voluminous and complex tax returns. Because corporate tax shelters typically involve complex transactions and may generate deductions or credits that corporate taxpayers typically claim on a tax return, the existence of the shelter is not readily apparent from an initial examination of the corporation's tax return. As discussed in Part II.B., the reconciliation of book and taxable income on Schedule M-1 and published financial statements is not sufficiently detailed to expose corporate tax shelters. Clearly, sheltering taxpayers have incentives not to reveal questionable transactions to the IRS and, under current law, there are no mechanisms that adequately reverse these incentives. Indeed, disclosure cannot reduce the substantial understatement penalty with respect to a corporate tax shelter under section 6662 of current law.

Second, and more importantly, greater disclosure could discourage corporations from entering into questionable transactions. The probability of discovery by the IRS should enter into a corporation's cost/benefit analysis of whether to enter into a corporate tax shelter.<sup>309</sup> In fact, a corporation may develop and implement strategies to discourage the discovery of its tax shelter. For example, one part of the transaction may be undertaken by one entity in the affiliated group while another offsetting position that eliminates the economic substance of the transaction is undertaken by another member of the group. In addition, corporate tax shelters may be structured through partnerships, the procedural rules for which may inhibit discovery and assessment. An effective increase in the disclosure of corporate tax shelters will change the cost/benefit analysis of entering into such transactions and will deter the use of shelters by taxpayers.

##### 1. Administration Proposals

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<sup>309</sup> See, e.g., Johnson, supra note 76, at 1606-07.

The Administration's FY 2000 Budget contains two proposals that are designed to increase disclosure of corporate tax shelters.<sup>310</sup> First, under the proposed new substantial underpayment penalty relating to corporate tax shelters, a taxpayer may decrease the applicable penalty rate from the proposed 40 percent to 20 percent if, among other things, the taxpayer provides adequate disclosure of the shelter. For this purpose, adequate disclosure by a taxpayer seeking to reduce the penalty means (1) filing appropriate documents describing the tax shelter transaction with the National Office of the IRS within 30 days of the closing of the transaction, (2) attaching a statement with its return verifying that the disclosure described in (1) had been made, and (3) providing increased disclosure on Schedule M-1 of the tax return highlighting the book/tax difference (if any) resulting from the corporate tax shelter for the taxable years in which such differences exist.

Second, the Budget contains a proposal designed to curtail the ability of corporate taxpayers to arbitrage tax and regulatory laws (and in some cases whipsaw the Government) by entering into transactions where the substance of the transaction is inconsistent with its form. Corporate taxpayers would be denied the tax benefits from such transactions unless they disclosed that they were reporting consistent with the substance of the transaction on their returns.<sup>311</sup> By encouraging disclosure, the proposal would permit the Treasury Department and the IRS to consider whether the claimed tax benefits flowing from the transaction should be allowed and, if not, what actions to take (e.g., proposing legislation, promulgating regulations, or pursuing litigation) to prevent taxpayers from claiming such benefits. Appropriate exceptions would be provided from the disclosure rules for transactions that have historically involved taxpayers taking positions inconsistent with the form<sup>312</sup> and transactions for which the Treasury Department and IRS explicitly require taxpayers to report the substance of the transaction.

## 2. Commentaries

Many of the ABA proposals relate to disclosure. The ABA believes that many corporate tax shelters and supporting opinions are based upon dubious factual settings. Thus, they believe that there should be a clear disclosure of the true nature and economic impact of specified classes of transactions. Under the ABA approach, a question would be added to the corporate tax return

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<sup>310</sup> Treasury Explanation, supra note 61, at 95.

<sup>311</sup> To be effective, the disclosure would have to be made on a timely filed original Federal income tax return for the taxable year that includes the date the transaction is entered into.

<sup>312</sup> Such examples may include sale-repurchase and sale-leaseback transactions. For the treatment of sale-repurchase transactions, see generally American National Bank of Austin v. U.S., 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819 (1970) and Union Planters National Bank of Memphis v. U.S., 426 F.2d 115 (6th Cir. 1970), cert. denied, 400 U.S. 827 (1970). For the treatment of sale-leaseback transactions, see generally Helvering v. F.R. & Lazarus & Co., 308 U.S. 252 (1939) and Frank Lyon Co. v. U.S., 435 U.S. 561 (1978).

requiring the taxpayer to state whether any item on the return is attributable to an entity, plan, arrangement, or transaction that constitutes a “large tax shelter.”<sup>313</sup> The term “large tax shelter” would mean any tax shelter (as currently defined by section 6662(d)(2)(C)(iii)) involving more than \$10 million of tax benefits in which the potential business or economic benefit is “immaterial or insignificant” relative to the tax benefits that might result to the taxpayer from entering into the transaction. If the answer is “yes,” specific information describing the nature and business or economic objective of the transaction would be required with the return, including:

- (1) a detailed description of the facts, assumptions of fact and factual conclusions with respect to the business or economic purposes or objectives of the transaction that are relied upon in support of the return position;
- (2) a description of the due diligence to ascertain the accuracy of the above;
- (3) a statement signed by one or more corporate officers with detailed knowledge of the business or economic purposes or objectives of the transaction that the facts, assumptions of facts and factual conclusions relied upon in reporting the transaction are true and correct as of the date the return is filed to the best of the signer’s knowledge and belief, with any material differences explained;
- (4) copies of written materials provided in connection with the offer of the tax shelter by a third party;
- (5) a full description of any express or implied agreement or arrangement of any contingent or reimbursable fees with any advisor or any offeror with respect to the shelter; and
- (6) a full description of any express or implied warranty from any person with respect to the anticipated tax results from the shelter.<sup>314</sup>

The answers should be clear and accurate and not contain voluminous material that might obfuscate the true nature of the transaction. The statement provided by the corporate officer regarding the accuracy of the factual underpinnings of the transaction should impose personal accountability. Specific penalties for non-compliance are not provided. However, the ABA suggests an approach by which there would be a reduction of the penalty rate for tax shelters for which there is proper disclosure.<sup>315</sup>

The AICPA strongly supports an effective mechanism to advise the IRS of the essence of transactions reported on a return. In their view, to be effective, disclosure must (1) provide taxpayers with an incentive to disclose transactions of interest to the IRS and (2) be in a form and

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<sup>313</sup> See, the discussion in Part V.C., below, for a discussion of the use of a similar economic substance test in the Administration’s proposal.

<sup>314</sup> Cf. H.R. 2255, 106th Cong., § 4 (1999) (bill contains these same requirements; requirements relate to decreases in the substantial understatement penalty applicable to noneconomic tax attributes).

<sup>315</sup> ABA, supra note 56, at 9-10.



at a time to be useful to the IRS. The AICPA believes that the approach used in Form 8275 "Disclosure Statement" (for use in disclosing return positions for purposes of avoiding certain penalties, e.g., substantial understatement penalty) may be useful to ascertain the legal issues that may be involved in a controversy and solicit information with respect to contingent fees or warranties. Like the ABA, the AICPA also supports requiring corporate officers or representatives to aver to the appropriate facts, assumptions, or conclusions with respect to a transaction. The AICPA believes disclosure with the return should be sufficient but recognizes the value of earlier disclosure. Further, they believe disclosure alone is ineffective without adequate enforcement. Finally, the AICPA believes that any new disclosure requirements should be coordinated with the current-law requirements under section 6111 and other provisions.<sup>316</sup>

The NYSBA strongly supports the disclosure provision of the Administration's penalty proposals relating to the substantial understatement penalty because they believe the prospect of disclosure will deter taxpayers from entering into questionable transactions. In addition, the NYSBA views disclosure as a potentially important tool in the IRS's effort to uncover corporate tax shelters. According to the NYSBA, disclosure should (1) be made within 30 days after entering into the transaction and again with the filing of the return, (2) be made on a one or two page form to avoid the problem of overdisclosure, and (3) not apply to small transactions ( e.g., those involving tax of less than \$1 million). Disclosure should reveal a brief description of the transaction, an enumeration of the key tax issues and the taxpayer's position thereto, the amount of tax at issue, and an identification of all other filings made by the taxpayer that raise issues substantially similar to those raised by the filing. The NYSBA also suggests considering whether SEC disclosure requirements should be modified to require the footnotes of a taxpayer's financial statements to disclose the aggregate amount of tax covered by the taxpayer's disclosure statements.<sup>317</sup>

### 3. Analysis and Possible Modifications to Administration Proposals

As all the commentators agree, statutory rules mandating disclosure are essential if the Treasury Department and the IRS are to have the ability to detect and respond in a timely manner to aggressive transactions. One frequently cited impetus for aggressive planning is the assumption that the Treasury Department and the IRS will not be able to detect a fraction of the aggressive transactions that are being done and that any legislative or regulatory response will be prospective.<sup>318</sup> A related concern is that detection during the course of an audit by revenue agents

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<sup>316</sup> AICPA, supra note 316, at 19-20.

<sup>317</sup> NYSBA, Report, supra note 19, at 894.

<sup>318</sup> ABA, supra note 56, at 4.

is hampered by resource and time constraints and the complexity of the transactions.<sup>319</sup> There appears to be a relatively uniform consensus among commentators that adequate disclosure requirements are an essential (although not a necessarily a sole) response to corporate tax shelter activity.<sup>320</sup>

Disclosure can take several forms. To be effective, disclosure must be both timely and sufficient. To facilitate examination of a particular taxpayer's return with respect to a questionable transaction, the transaction should be prominently disclosed on the return. However, because corporate tax returns may not be examined for a number of years after they are filed, in order to alert the IRS with respect to tax shelter "products" that may be promoted to, or entered into by, a number of taxpayers, disclosure could be required soon after the transaction is promoted or completed. Such "early warning" disclosure could be made by the participating corporation or the promoter.<sup>321</sup> Disclosure will be more effective if it is limited to the factual and legal essence of the transaction. Disclosure of all items and documents with respect to a transaction may be misleading or may overwhelm the IRS such that it could not ascertain the substance of the transaction in a timely manner. Overdisclosure will inhibit the ability of the IRS to sift through the reported transactions for those with shelter characteristics. Thus, the required disclosure should be calibrated to avoid massive disclosures of routine corporate transactions among which are buried the transactions that should be scrutinized. Finally, disclosure should not be overly burdensome to taxpayers, particularly taxpayers not engaged in questionable transactions.

The Treasury Department continues to believe that disclosure is an important element in the effort to discourage the use of corporate tax shelters. In order to be effective, disclosure must be coupled with a sufficient penalty for the failure to disclose and must be in a form that is usable by the government. Consistent with the views expressed by the ABA, AICPA and NYSBA, the Treasury Department believes that the format of disclosure should be relatively short so as not to overburden both the IRS and taxpayers and should be limited to cases that cause the most concern. In this regard, a form could be developed that requires short answers, centering on the information being sought.

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<sup>319</sup> NYSBA, Report, supra note 19, at 883; Johnson, supra note 76, at 1606. One commentator has suggested that these audit constraints may operate with less force with respect to large corporate taxpayers, who are routinely audited under the IRS's Coordinated Examination Program. Holden, supra note 3, at 371 n.1. However, the IRS audits approximately 1600 large corporations under this program. The audits are complex and time consuming; often more than one tax year is included in a single audit cycle. Especially when constrained by the three-year statute of limitations, examining agents may encounter difficulty in identifying and analyzing the complex financial and structural arrangements that typify corporate tax shelters.

<sup>320</sup> See ABA, supra note 56, at 6-7; Bankman, supra note 19, at 1788-89.

<sup>321</sup> See, e.g., I.R.C. § 6111(a)(2) (registration requirements).

In addition, to address comments that the definition of corporate tax shelter is too vague for purposes of triggering a reporting requirement, the Budget proposal should be modified so that a corporation need not disclose a transaction unless it meets certain “filters,” regardless of whether the transaction meets the definition of corporate tax shelter. These filters would be based on the objective characteristics found in many corporate tax shelters, as discussed in Part II.B. For example, a taxpayer would have to disclose a transaction that had a combination of some of the following characteristics: a book/tax difference in excess of a certain amount; a recission clause, unwind provision, or insurance or similar arrangement for the anticipated tax benefits;<sup>322</sup> involvement with a tax-indifferent party; advisor fees in excess of a certain amount or contingent fees; a confidentiality agreement; the offering of the transaction to multiple corporations (if known); a difference between the form of a transaction and how it is reported, etc.

The Treasury Department believes that two forms of disclosure are necessary.<sup>323</sup> Disclosure would be made on a short form separately filed with the National Office of the IRS. Promoters would be required to file the form within 30 days of offering the tax shelter to a corporation.<sup>324</sup> Corporations entering into transactions that meet the filters described above would file the form by the due date of the tax return for taxable year for which the transaction is entered into (unless the corporation had actual knowledge that the promoter had filed with respect to the transaction) and would include the form in all tax returns to which the transaction applies. The form would require the taxpayer to provide a description of the filters that apply to the transaction and information similar to the information in the ABA disclosure proposal. The form should be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction for which disclosure is required. Such officer should be made personally liable for misstatements on the form, with appropriate penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights.

A filing nearly contemporaneous with the sheltering transaction should be made to the National Office of the IRS in order to provide the Government with an early warning of the types of transactions being promoted and implemented. This early warning will allow the IRS, the Treasury Department and, to the extent necessary, the Congress sufficient time to react to and stop the spread of the latest fad in the corporate tax shelter genre. In addition, disclosure must be made with the tax return to provide the examining IRS agent in the field the information necessary to discover and determine the nature of a sheltering transaction.

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<sup>322</sup> The proposal would not apply to customary representations and warranties found in transactions other than corporate tax shelters.

<sup>323</sup> H.R. 2255 also requires a dual filing to avoid the increased substantial understatement penalty -- once within 30 days of the transaction and again with the tax return.

<sup>324</sup> Different filters may be required for purposes of disclosure by promoters.

A dual filing requirement raises the issue that if the taxpayer inadvertently fails to meet the first requirement, some incentive must be provided to the taxpayer to still meet the second requirement. This can be done by independently subjecting both filing requirements to sanctions for failure to file. Failure to meet either requirement could subject the taxpayer to a significant penalty (say, \$100,000 each), with an additional penalty for failure to meet both requirements.

The filing requirement would be an important component of the Administration's modified substantial understatement penalty, described below. As the AICPA suggests, because this proposal requires taxpayers to disclose transactions subject to a confidentiality agreement, the section 6111 disclosure requirement for confidential corporate tax shelter arrangements would be modified or eliminated.<sup>325</sup>

The Treasury Department continues to believe that taxpayers should be encouraged to disclose transactions that are reported differently from their form. The original proposal included in the Budget would be modified to provide that any transaction<sup>326</sup> over a certain threshold amount (say, with tax benefits over \$1 million) for which the taxpayer does not follow its form must be separately disclosed on the taxpayer's return. Exceptions would be provided for certain transactions that have historically involved taxpayers taking positions inconsistent with their form. A significant penalty (say, \$100,000) would apply for each failure to disclose.

## B. MODIFY SUBSTANTIAL UNDERPAYMENT PENALTY

The imposition of a significant penalty traditionally is one method to deter persons, including taxpayers, from engaging in inappropriate behavior. As more fully discussed in Part IV.C., potentially the most significant penalty currently applicable to corporate tax shelters is the section 6662 accuracy-related penalty. Section 6662 imposes a 20-percent penalty on the portion of an underpayment attributable to, among other things, negligence or disregard of rules or regulations and any substantial understatement of income tax.<sup>327</sup> Special rules apply to tax shelter items. For this purpose, a tax shelter is defined as a partnership or other entity, investment plan or arrangement, or any other plan or arrangement if a *significant purpose* of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax. This provision was modified to its current form in 1997. Prior to 1997, an item was not a tax shelter item unless *the*

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<sup>325</sup> A significant criticism of the current-law registration rules is that the requirement of a confidentiality arrangement is overly limiting. Commentary on this requirement suggests that the response of purveyors of corporate tax shelters to its enactment in 1997 has simply been avoidance of confidentiality arrangements.

<sup>326</sup> Disclosure would be required whether or not the transaction was with a tax-indifferent party.

<sup>327</sup> The penalty is increased to 40 percent under section 6662(h) for certain gross valuation misstatements.

*principal purpose* of the transaction was the avoidance or evasion of Federal income tax. The effectiveness of the substantial understatement penalty is dependent on the ways taxpayers can avoid the penalty. As discussed in Part IV.C., recent changes to section 6664(c) were intended to limit the ability for corporate taxpayers to avail themselves of the reasonable cause exception to the penalty.

Given the recent growth of corporate tax shelters, it is apparent that the current statutory and regulatory penalty regime is not effective in deterring tax shelter activity. The inefficiency may result because (1) the penalty rate is too low, (2) taxpayers do not believe the IRS will assess the penalty,<sup>328</sup> (3) the penalty is too easily avoided by reason of the reasonable cause exception,<sup>329</sup> or (4) penalties alone are not a sufficient deterrent.<sup>330</sup> Anecdotal and other information seemingly refute the first hypothesis. Several tax practitioners and corporate tax executives informally have told the Treasury Department that the likelihood of liability for a significant penalty will deter a corporate tax shelter transaction and a 20-percent or greater penalty is significant. Thus, merely raising the section 6662 penalty rate, alone, likely will not have much effect upon corporate tax shelter activity.

As discussed in Part V.A. with respect to disclosure, in order to assess a penalty, the IRS must discover the questionable transaction. Thus, issues of disclosure and penalties are interrelated. In addition, even if the taxpayer believes the IRS were to discover a questionable transaction, the section 6662 penalty is an effective deterrent only if it can be applied to a substantial understatement. If there is a defect in the underlying substantive law such that the claimed tax benefits are not disallowed and concomitantly no understatement is created, the penalty alone will not be an effective deterrent.

In addition, many commentators note that the substantial underpayment penalty is not an effective method to address current corporate tax shelter activity because the reasonable cause exception, despite the amendments made in 1994, has become an almost fool-proof escape hatch from the penalty regime. It is telling that two of the major organizations that represent tax professionals --the ABA and the NYSBA-- point to a perceived deterioration in tax opinion writing standards as a facilitating cause in the availability of the reasonable cause exception and in the rise of corporate tax shelters, and have suggested remedies (described below) that are intended to narrow or, in the case of the NYSBA, even eliminate this escape hatch.

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<sup>328</sup> Some have commented that higher penalty rates may inhibit enforcement, as the IRS may be less willing to impose significant penalties in all but the most egregious cases.

<sup>329</sup> See generally NYSBA, *Report*, *supra* note 19, at 892-93.

<sup>330</sup> Whether penalties alone are sufficient as a deterrent is discussed below with respect to substantive changes.

Thus, it appears clear that any legislative response to corporate tax shelters that involves the substantial understatement penalty must address the related issues of disclosure and the reasonable cause exception. In addition, as discussed below, changes in substantive law should be made to ensure that the penalty can be applied appropriately.

1. Administration Proposals

The Administration's FY 2000 Budget proposals would increase the section 6662 penalty to 40 percent of the understatement resulting from a transaction meeting the definition of a corporate tax shelter<sup>331</sup> and causing a substantial understatement of tax.<sup>332</sup> The penalty would be reduced to 20 percent if, as discussed above, adequate disclosure also is made. The penalty could not be avoided through the reasonable cause exception of section 6664 ( *i.e.*, the penalty would be subject to "strict liability").<sup>333</sup>

The budget also contains several penalty-like sanctions in the form of excise taxes upon other participants in, and features of, corporate tax shelters. These proposals are discussed in Part V.D. below.

2. Commentaries

The ABA proposals primarily focus on disclosure. However, the ABA acknowledges that an expanded penalty structure may be necessary to provide the appropriate incentives and disincentives for certain types of behavior and makes some suggestions regarding the substantial understatement penalty. The ABA proposes that the current-law definition of corporate tax shelter of section 6662 (as modified in 1997) be retained, and that increased disclosure be required for "large tax shelters." For this purpose, a large tax shelter would be one that involves more than \$10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant to the tax benefits. The ABA also suggests that it may be appropriate to develop and impose new penalties upon taxpayers that fail to disclose required information

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<sup>331</sup> For this purpose, a corporate tax shelter would be defined as any entity, plan, or arrangement (to be determined based on all the facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. (See the discussion below for the definition of tax avoidance transaction.)

<sup>332</sup> A separate proposal in the Administration's Budget would modify application of the substantial understatement penalty to the lesser of \$10,000,000 or 10 percent of the tax required to be reported. This proposal would apply whether or not the understatement arose with respect to a corporate tax shelter.

<sup>333</sup> H.R. 2255 would make similar amendments to section 6662 with respect to tax benefits disallowed from certain noneconomic transactions.

with respect to a large tax shelter (whether or not the tax benefits from the shelter are upheld by a court).<sup>334</sup>

The AICPA does not formally propose a modification to the substantial understatement penalty and believes extraordinary sanctions (such as a 40-percent penalty) are appropriate only if the target is sufficiently narrow so as to minimize the risk that the penalty would be proposed to hassle, harass, or otherwise encumber taxpayers engaging in non-abusive transactions. In this regard, they would suggest that the sanctions, if any, not apply to transactions that (1) were undertaken for reasons germane to the conduct of the corporation's business, (2) were expected to produce a pre-tax return that is reasonable in relation to the costs incurred, and (3) are reasonably consistent with the legislative purpose for which the provision was enacted. The AICPA disagrees with the application of a strict liability standard for corporate tax shelters, and does not suggest any changes to the current application of the reasonable cause standard.<sup>335</sup>

The NYSBA would leave it to Congress to determine the appropriate level of penalties applicable to corporate tax shelters. They suggest that a penalty of at least 10 percent should be applied to corporate tax shelters for which the taxpayer provides disclosure and a penalty of at least 20 percentage points higher apply to undisclosed corporate tax shelters and that this latter penalty rate be greater than the current-law 20-percent rate.<sup>336</sup>

Moreover, the NYSBA supports the elimination of the reasonable cause exception from the penalty. The NYSBA assumes that most transactions that would reasonably be viewed as corporate tax shelters will be subject to at least one "more likely than not" or stronger tax opinion rendered by a law or accounting firm. They note that although a favorable tax opinion does not technically trigger the reasonable cause exception by itself, the receipt of such an opinion by the taxpayer makes it significantly more difficult for the IRS to impose penalties. The NYSBA is concerned that removal of the reasonable cause exception will increase the leverage of the IRS in audits and believes that it is important that the IRS administer the penalty in a fair and even-handed way. The penalty would be imposed even if the IRS and the Treasury Department were to issue favorable regulations or other guidance with respect to a transaction unless the taxpayer disclosed the transaction.<sup>337</sup>

### 3. Analysis of Administration Proposals

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<sup>334</sup> ABA, supra note 56, at 9-10.

<sup>335</sup> AICPA, supra note 316, at 15-17.

<sup>336</sup> NYSBA, Report, supra note 19, at 897.

<sup>337</sup> Id. at 894-97.

a. *Severity and breadth of the proposed expanded penalty.* Certain critics have argued that the Administration’s proposal to double the 20-percent rate of current-law section 6662 is too onerous. They claim that the proposed 40-percent rate, when combined with the other proposals that disallow tax benefits and impose various penalty excise taxes, causes the proposed corporate tax shelter penalty structure to approach the 75-percent penalty applicable to fraud under section 6663.<sup>338</sup> This analysis misstates the case in certain important respects. First, the disallowance of a tax benefit and the resulting 35-percent corporate tax thereon is not a penalty. Tax benefits are either allowable as a matter of law or they are not. The disallowance of an unwarranted tax benefit (with an appropriate interest charge for the time value of untimely paid taxes) merely puts the noncompliant taxpayer in the same financial position as a compliant taxpayer. It is the later imposition of a penalty that places the noncompliant taxpayer in a worse financial position than a compliant taxpayer. Second, the various 25-percent excise taxes would be applied to amounts (e.g., promoter fees) that generally would be less than the amount upon which the substantial underpayment penalty applies.<sup>339</sup> In addition, the liability of some of these excise taxes rests on parties other than the corporate participant. Finally, current-law section 6662 already provides a 40-percent penalty in sufficiently egregious cases.<sup>340</sup>

Complaints about the level of penalties for corporate tax shelters also appear to result from the perceived broadness or vagueness of the definition of corporate tax shelter. Larger penalties generally are more acceptable if taxpayers have greater certainty as to the intended target of the penalty.<sup>341</sup> The definition of corporate tax shelter in the Administration’s proposal largely turns on the definitions of “tax benefit” and “tax avoidance transaction” and is discussed in detail in Part V.C. below. It should be noted, however, that the current law definition of “tax shelter” under present-law section 6662 is generally thought to be far broader than the definition proposed by the Administration. It defines a “tax shelter” as any partnership, entity, plan or arrangement that has as “a significant purpose” the avoidance or evasion of tax.<sup>342</sup> Commentators on this 1997 Act change to section 6662 have suggested that the current-law definition of

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<sup>338</sup> See TEI, supra note 4, at 11; AICPA, supra note 316, at 15-16.

<sup>339</sup> The notable exception to this statement is a taxpayer that has a recission or other arrangement that covers 100 percent of its anticipated tax benefits from the tax shelter.

<sup>340</sup> A 40-percent penalty applies under section 6662(h) to certain gross valuation misstatements.

<sup>341</sup> See NYSBA, Report, supra note 19, at 892.

<sup>342</sup> The “a significant purpose” standard was added by the Taxpayer Relief Act of 1997. Prior to the 1997 Act, the applicable standard was “the principal purpose,” which generally is interpreted as the primary or most important purpose. “A significant purpose” generally is interpreted as a lesser standard and could include any important purpose.



corporate tax shelter is broad enough to cover almost all corporate tax planning, including clearly non-abusive planning.<sup>343</sup>

b. *Elimination of the reasonable cause exception.* Some have criticized the Administration's (and NYSBA's) proposed elimination of the "reasonable cause" exception with respect to corporate tax shelters. This is somewhat curious given that the current-law structure appears to impose a similarly stringent standard -- some commentators have written that, under a literal reading of the section 6664 regulations, it is difficult, if not impossible for a corporate tax shelter to satisfy the requirements for "reasonable cause" under the regulations, particularly for transactions that lack business purpose, have tax benefits that are unreasonable compared to the taxpayer's investment in the shelter, or that involve confidentiality arrangements. When that is combined with potentially being subject to a broader definition of "tax shelter" ( *i.e.*, transactions with "a significant purpose" of tax avoidance), countervailing factors must be operating currently to mitigate their deterrent effects. For example, some may believe that, if the transaction is backed by a "more likely than not" opinion, the IRS and courts will be disinclined to impose penalties regardless of the literal requirements of the regulations.

Thus, perhaps the strongest rationale for elimination of the reasonable cause exception lies in transparency, *i.e.*, dispelling any notion at the time the transaction is being evaluated by the taxpayer that a "more likely than not" opinion is a mechanism for penalty insurance. As the NYSBA recently stated:

The current structure of penalties has, in our experience, often had a perverse impact on the discussion engaged in by corporations in considering whether to enter into such a transaction - what may be called the "tax dialogue." A dominant fact discussed in such situations simply becomes whether an opinion will be rendered or not. For corporate tax shelter transactions to be deterred, the tax dialogue must shift to a nuanced consideration of whether the tax benefits are likely to be sustained in court and whether the

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<sup>343</sup> See Johnson, *supra* note 76, at 1604; Holden, *supra* note 3, at 371. Some have criticized the Administration for proposing changes to the current law penalties when the Administration has not used the current tools available to it. As an example, they cite the lack of regulations under the 1997 Act changes to section 6662. See Kenneth J. Kies, A Critical Look at the Administration's Corporate Tax Shelter Proposals, 83 Tax Notes 1463, 1465 (June 7, 1999) [hereinafter Kies]. This analysis ignores the fact that the 1997 Act changes to section 6662 (passed while Mr. Kies was chief of staff of the Joint Committee on Taxation) applied to transactions entered into after August 5, 1997 and was self-effectuating. That is, the provision applies as drafted by Congress and is not dependent upon the issuance of enabling regulations. If the standard of "a significant purpose" is as broad as reasonably interpreted by some, one must ask why tax shelter activity persists after August 5, 1997.

transaction is of the type with respect to where substantial penalties will be imposed if the tax treatment sought in the transaction is not, in fact, upheld.<sup>344</sup>

Stated differently, a reasonable cause exception is grounded in the notion that taxpayers should not be required to second-guess their tax advisors. This rationale relies, critically, on the advisor to act as the “policeman” of the tax system. Although sensible in the context of the shelters of the 1970s and 1980s involving individual taxpayers unsophisticated in the tax law, this rationale assumes less persuasive force in connection with large corporate taxpayers who can be expected to exercise an independent judgment about the validity of a transaction and the attendant risks if the transaction is challenged. This is particularly true in the context of corporate tax shelters where sophisticated corporate taxpayers are intent on managing their effective tax rates. Practitioners may be placed in the unenviable position of either turning away existing or prospective corporate clients, or writing an aggressive opinion to provide “penalty insurance.” Even if receipt of a favorable opinion does not technically preclude application of the substantial understatement penalty, receipt of such an opinion makes it significantly more difficult for the IRS to successfully assert the penalty which, in turn, makes its deterrent value less certain.<sup>345</sup>

Corporate taxpayers themselves must be deterred from entering into corporate tax shelters. This requires that such taxpayers perceive a real risk of penalty if the transaction ultimately is not upheld, one that is not perceived to be mitigated on the basis of a “more likely than not” opinion.

Another concern expressed by commentators is that elimination of the reasonable cause exception will vest too much discretion in IRS revenue agents to assert the penalty. However, as discussed in detail in Part V.C. below, it is possible to institute review procedures to mitigate this concern. Some amount of judgment will always be necessary in the assertion of penalties and, ultimately, the courts are the final arbiter. Even under present law, revenue agents must bring judgment to the task of evaluating the taxpayer’s assertion of reasonable cause. At least one commentator has concluded that “these negative consequences of adoption of a strict liability

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<sup>344</sup> NYSBA, Report, supra note 19, at 893. See also Johnson, supra note 76, at 1606. (“A 20 percent penalty imposed automatically if the corporation loses in a substantial tax case is a very good idea. The corporate behavior you want to encourage is reporting and paying over the amount of tax that is due as finally determined by a court. The behavior you want to discourage is reporting and paying over less than the amount that is ultimately determined to be due. Giving a corporation an immunity from penalty if it has a reasonable basis or substantial authority for its reporting position will mean that the corporation will not try hard enough to predict real outcomes of the case. Giving the corporation credit for reasonable basis or substantial authority is a bit like scoring football games by the number of good tries or reasonable efforts. Scoring by touchdowns accomplished seems to encourage each side to try harder.”).

<sup>345</sup> See generally NYSBA, Report, supra note 19, at 883.

regime are substantially outweighed by the necessity of increasing the deterrence of corporate tax shelters.”<sup>346</sup>

Another issue is the relationship of disclosure and the substantial understatement penalty. Under present law, disclosure is not a relief valve with respect to tax shelter items because participants in tax shelters were held “to a higher standard than ordinary taxpayers.”<sup>347</sup> However, because of the importance of disclosure in aiding detection, the Treasury Department believes it is appropriate to provide some relief if disclosure is made.

#### 4. Proposed Modifications to Administration Proposals

The Treasury Department continues to believe that the substantial understatement penalty imposed on understatements of tax attributable to corporate tax shelters should be greater than the penalty generally imposed on other understatements. This view is shared by the ABA, the NYSBA and others. Thus, to discourage the use of shelters, the Treasury Department would retain the Budget proposal to double the current-law substantial understatement penalty rate to 40 percent for corporate tax shelters. As in the Budget, to encourage disclosure, the penalty rate would be reduced to 20 percent if the taxpayer files the appropriate disclosures.

In the original Budget proposal, the Administration provided that the rate could not be further reduced below 20 percent or eliminated by a showing of reasonable cause. Although one may rhetorically question whether there ever is any reasonable cause for entering into a corporate tax shelter transaction, many commentators have criticized the proposed elimination of the reasonable cause exception for corporate tax shelters. These commentators cite the potentially vague definitions of corporate tax shelter and tax avoidance transaction, the allowance of a reasonable cause exception for other penalties, and basic fairness for opposing a “strict liability” penalty.<sup>348</sup> The Treasury Department still believes that the penalty structure set forth in the Administration’s FY 2000 Budget is appropriate. However, in light of the comments received, the Treasury Department believes that consideration should be given to reducing or eliminating the substantial understatement penalty where the taxpayer properly discloses the transaction (as discussed in Part V.A. above) and the taxpayer has a reasonable belief that it has a strong chance of sustaining its tax position. In addition, because many commentators believe that taxpayers are either ignoring or circumventing the requirements of section 1.6664-4 as to what constitutes

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<sup>346</sup> See id.

<sup>347</sup> 1982 Blue Book, supra note 242, at 218-19.

<sup>348</sup> See TEI, supra note 4, at 9-13; AICPA, supra note 316, at 15-17. Conversely, as discussed above, other commentators, notably the NYSBA, support elimination of the reasonable cause exception for corporate tax shelters. NYSBA, Report, supra note 19, at 880.

reasonable cause, these requirements would be codified to heighten visibility and strengthened to the extent necessary.<sup>349</sup>

Under the Treasury Department's modified approach, a strengthened reasonable cause standard could be used to reduce or eliminate the substantial understatement penalty if the taxpayer also properly disclosed the transaction in question, even if the transaction ultimately is deemed to be a corporate tax shelter. This limited exception would encourage disclosure and would alleviate some taxpayer concerns with respect to the definition of corporate tax shelter. Under one version, the following sanctions could apply to the following transactions which may or may not meet the definition of corporate tax shelter and for which there is or is not disclosure:

(1) Transaction held to be a corporate tax shelter, no disclosure by taxpayer: The resulting underpayment would be subject to the increased 40-percent penalty, with additional fixed-amount penalties for failure to disclose.

(2) Transaction held to be a corporate tax shelter, disclosure by taxpayer: The resulting underpayment would be subject to the 20-percent penalty, unless the taxpayer had a reasonable belief that it had a "strong" probability of success on the merits.

(3) Transaction held not to be a corporate tax shelter, no disclosure by taxpayer: The resulting underpayment would be subject to the current-law 20-percent penalty, subject to the current-law substantial authority exception, with additional fixed-amount penalties for failure to disclose.

(4) Transaction held not to be a corporate tax shelter, disclosure by taxpayer: The resulting underpayment would be subject to the current-law 20-percent penalty, unless the taxpayer met the current-law reasonable basis exception.

Finally, fears that the IRS may abuse the potential availability of increased substantial understatement penalties would be addressed by promulgating procedures that would enhance issue escalation and facilitate consistent and centralized resolution of such matters. Such procedures are discussed below in Part V.C.

## C. DISALLOW TAX BENEFITS OF CORPORATE TAX SHELTERS

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<sup>349</sup> See ABA, supra note 56, at 4-6; NYSBA, Report, supra note 19, at 892-94; Holden, supra note 3, at 373. For example, no reliance could be placed on an advisor's opinion if the transaction in question is subject to a confidentiality agreement, the advisor is compensated by a promoter, the advisor worked with a promoter in developing the transaction, the advisor is being compensated on a contingent or other non-traditional basis, the opinion does not satisfy the standards of Circular 230 and applicable professional ethics or practice standards, the opinion fails to identify all the material facts of the transaction, the opinion does not set out the due diligence performed by the advisor, the opinion does not identify or consider the application of judicial doctrines, the opinion assumes a business purpose, or other such qualifications.

The income tax effects of a transaction generally are governed by a set of objective statutory and regulatory rules. As discussed in Part IV.B., the Secretary has authority, in certain cases, to set aside these mechanical rules and disallow the use of tax attributes acquired in certain tax-motivated transactions (section 269), to require the computation of the income of a taxpayer in a manner that clearly reflects the taxpayer's income (section 446), to reallocate tax attributes among parties in order to prevent the evasion of tax or to clearly reflect the income of the parties (section 482), and to recharacterize multiple party financing transactions (section 7701(l)). In addition, the IRS has challenged questionable transactions under a variety of common law doctrines. At times, courts have rejected the IRS's challenge, preferring to allow the operation of the applicable mechanical rules. Other courts, in ruling upon these matters, have upheld the IRS's challenges and in doing so, have created, developed, and reinterpreted the concepts of sham transaction, substance over form, step transaction, business purpose, and economic substance. The application of these standards varies necessarily from court to court. Because the application of these common law standards is inherently subjective and courts have applied them unevenly, a great deal of uncertainty exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions.

The current state of the law presents a strong case that a substantive law change is necessary to address corporate tax shelters. Resolving these issues by legislation rather than court decisions has other advantages as well. Litigation is costly and time consuming. Often, by the time a judicial determination with respect to a transaction is made, Congress or the Treasury Department has changed the underlying operating rules, or the transaction is otherwise obsolete. This is particularly true of corporate tax shelters that traditionally have had short "shelf-lives," in part, to help avoid detection by the IRS. The promulgation of tax rules generally rests with the Congress in enacting statutory provisions and in the Secretary of the Treasury in issuing regulatory guidance. Unlike judicial decisions, both of these forums are subject to public scrutiny and comment and can be formulated to apply to a wide variety of fact patterns, rather than only the case at bar.

It is clear that amendments to the objective operating rules of the Code upon which existing shelters rely will not stop unidentified transactions (and may, in fact, provide a breeding ground for new shelters). To the extent coherent standards could be developed to supplement existing judicial doctrines, the self-assessment system would be enhanced and inappropriate results limited.

#### 1. Administration Proposals

The Administration's FY 2000 Budget would provide the Secretary of the Treasury the authority to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction.<sup>350</sup>

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<sup>350</sup> Treasury Explanation, supra note 61, at 97.

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (*i.e.*, tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund. However, the definition of tax benefit subject to disallowance would not include those benefits that are clearly contemplated by the applicable Code provision (taking into account the Congressional purpose for such provision and the interaction of the provision with other provisions of the Code.) Thus, tax benefits that would normally meet the definition, such as the low-income housing credit<sup>351</sup> and deductions generated by standard leveraged leases,<sup>352</sup> would not be subject to disallowance.

The proposed definition of tax avoidance transaction has two parts. The first part incorporates the economic substance doctrine found in case law.<sup>353</sup> The economic substance standard generally is thought to be the most objective of the common law doctrines, primarily because it does not rely on the taxpayer's intent.<sup>354</sup> In addition, the first part of the definition incorporates a significant characteristic of current excess-benefits corporate tax shelters -- the existence of tax benefits that are vastly disproportionate relative to the economic benefits of the transaction.<sup>355</sup>

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<sup>351</sup> See, e.g., Treas. Reg. § 1.6662-4(g)(2)(ii) (list of tax benefits explicitly provided by the Code). See also H.R. 2255, 106<sup>th</sup> Cong. (1999), which provides an explicit list of credits not subject to disallowance under the bill.

<sup>352</sup> The tax benefits generated by leveraged leasing activity requires careful analysis as to whether such benefits are clearly contemplated. Leveraged leasing has existed for decades primarily as a means of transferring tax benefits among parties. Both the Congress and the Administration have implicitly and explicitly allowed leveraged leases to stand undisturbed, subject to certain tolerances (see, e.g., Rev. Proc. 75-21, 1975-1 C.B. 367). This is not to say, however, that all leveraged leasing transactions are not tax avoidance transactions. See, e.g., Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89 (5<sup>th</sup> Cir. 1985); Rev. Rul. 99-17, 1999-14 I.R.B. 3.

<sup>353</sup> A detailed discussion of the first part of the proposed Administration definition can be found in Appendix C.

<sup>354</sup> See Hariton, supra note 166, at 241 & 252.

<sup>355</sup> See supra discussion in section II.B.

The second test is necessary to cover those transactions for which a comparison of profits to tax benefits would not be appropriate because of the lack of a determinable "profit." The most significant of these types of transactions are financing arrangements.

## 2. Commentaries

In general, the practitioner groups do not propose to adopt, *per se*, the disallowance provision of the Administration's budget. As discussed in detail below, only the ABA suggests a change to substantive law. However, the NYSBA makes several suggestions with respect to the definitions of "corporate tax shelter" or "tax avoidance transaction" upon which a substantive change may be based. The AICPA disagrees with the need to expand the Secretary's authority to expand the disallowance regimes of the Code and would provide safe harbors with respect to any corporate tax shelter definition.<sup>356</sup>

Rather than adopt the Administration's disallowance rule, the ABA would clarify that, where the economic substance doctrine applies, the nontax considerations must be substantial (*i.e.*, more than a *de minimis* or nominal) in relation to the potential tax benefits. The ABA provides this proposal in response to their belief that many current corporate tax shelters rely upon literal interpretations of mechanical rules of the Code but are not supportable under common law principles. In this regard, the ABA seeks to make the economic substance doctrine more visible by calling upon Congress to adopt it statutorily. In addition, the ABA proposal is intended to overrule interpretations of case law that would suggest that even a *de minimis* or insignificant amount of pre-tax profit is sufficient to give tax significance to a transaction.<sup>357</sup>

In many respects, this ABA proposal is similar to the Administration's budget proposal to change substantive law. Both proposals deal with the economic substance doctrine, which, as explained in Part IV.B., generally involves the weighing of expected tax benefits with expected pre-tax economic income from a transaction in order to determine the validity of the transaction for tax purposes. The Administration's proposal would elevate the standard to apply to all corporate tax avoidance transactions and would specifically provide how the doctrine would apply (*i.e.*, by using a present value analysis). Although not adopting a formalistic approach, the ABA would similarly provide that nontax considerations must be substantial in relation to the claimed tax benefits. However, the ABA would provide that the economic substance doctrine should apply only in cases where it currently applies and would not mandate a present value analysis. Presumably, the ABA would leave it to the courts to determine when and how to make such determinations.

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<sup>356</sup> AICPA, supra note 316, at 16.

<sup>357</sup> ABA, supra note 56, at 5-6 & 11.

The NYSBA, while not endorsing a change in substantive law, believes that definitions of corporate tax shelters could be developed by analyzing the different types of transactions that are troubling from a tax policy perspective and tailoring the definition thereby.<sup>358</sup> They suggest three possible approaches.<sup>359</sup> The first approach would focus on “loss generators” that is, transactions lacking in pre-tax economic substance that are designed to create a tax benefit that the corporation would not itself possess absent the transaction. Examples of recent corporate tax shelters that would fit such a description include section 357(c) transactions and ACM-type transactions.<sup>360</sup> The NYSBA suggests that the elements of “loss generator” definition could be: (1) the lack of an economically accrued loss of the taxpayer before entering into the transaction, (2) a principal purpose of tax avoidance, (3) no significant business purpose of the transaction other than tax savings, and (4) an insubstantial economic effect upon the parties in relation to the tax benefits. The definition would not apply to tax benefits that are “clearly contemplated” by applicable statutory or regulatory provisions, administrative authority or a substantial body of case law. In some respects, a definition built on these elements is similar to those proposed by the Administration and the ABA.

This NYSBA definition raises elements not found in the Administration and ABA definitions --accrued losses, motive and business purpose. As discussed above, the Administration’s proposed definition does not look to motive or business purpose, as these concepts are viewed as subjective and potentially subject to taxpayer manipulation.<sup>361</sup>

However, the Administration’s proposed definition is silent as to whether a tax avoidance transaction would encompass the use by a taxpayer of a tax attribute that it already possesses, but could not readily access but for some extraordinary transaction. Thus, it is unclear how the decision in Cottage Savings Association v. Commissioner<sup>362</sup> would be resolved under the

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<sup>358</sup> NYSBA, Report, supra note 19, at 899-900.

<sup>359</sup> Id. This section of the paper focuses on the first two approaches suggested by the NYSBA. The third approach -- providing the Treasury Department a grant of regulatory authority to address troubling transaction -- is not discussed herein because it does not have an analog to the Administration’s original proposed definition.

<sup>360</sup> See Appendix A for descriptions of these and other “loss generator” transactions.

<sup>361</sup> As one anonymous tax professional has commented, “If somewhere in the planning for a transaction you have to ask, ‘What is our business purpose?’, you know you have a tax shelter.”

<sup>362</sup> 499 U.S. 554 (1991). The Cottage Savings decision involved a thrift institution that sold interests in a pool of mortgages with built-in losses to other thrift institutions and, at the same time, acquired interests in substantially identical mortgages from the other institutions. The Supreme Court upheld the taxpayer’s deduction for a loss on the disposition of its mortgages even though its economic position had not changed because of the acquisition of the new



Administration's tax avoidance definition. In many respects, the Cottage Savings transaction has the characteristics of a corporate tax shelter: the transaction was tax motivated, it lacked significant economic substance, it created a book/tax difference and it skirted statutory tax rules designed to inhibit selective loss realization (particularly, the wash sale rules of section 1091). Others would not view the Cottage Savings transaction as a corporate tax shelter, primarily because the taxpayer simply was availing itself of tax losses it already had realized economically, but had not recognized for tax purposes. Whether one views the Cottage Savings case as abusive or not, any substantive legislative change could so clarify. Alternatively, if one is not sure whether or not this or similar transactions are abusive, a legislative change could be left to subsequent interpretation, with taxpayers and their advisors deciding which cases are appropriate and which are not. In any event, the issues presented by the Cottage Savings case and other "close calls" does not mean that a substantive legislative change should be abandoned. Rather, the definition should be tailored appropriately to address these concerns.

The adoption of the second NYSBA approach would address perceptions of vagueness in the second part of the Administration's proposed definition. They suggest that a separate substantive provision could be developed to encompass corporate financings that otherwise have economic effect but are difficult to analyze under general tax shelter legislation. In such cases, the purported tax benefits could be disallowed if there was (1) a significant distortion in the timing of income or the elimination or reduction of income or a reduction of tax on income and (2) such distortion, timing or elimination was plainly contrary to Congressional intent under applicable statutory provisions or the purpose or structure of existing Treasury regulations.<sup>363</sup>

### 3. Analysis of Administration Proposals

The criticisms of the Administration's proposal to grant the Secretary the authority to disallow certain tax benefits derived in a tax avoidance transaction can be summarized as follows: (1) a change in the substantive law is not necessary to address current tax shelters; (2) the proposed definition of tax avoidance transaction is too vague and (3) the proposal provides the IRS with significant authority that may be subject to abuse.<sup>364</sup> These issues, and an analysis of H.R. 2255, are provided below.

a. *Why a substantive change in law is necessary.* Many, if not most, current corporate tax shelters "might work" under the applicable objective mechanical rules of the Code, but "shouldn't work" under either the more subjective common law doctrines developed by the courts or under general notions of tax policy. A recent example of a "might work, but shouldn't"

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mortgages.

<sup>363</sup> NYSBA, Report, supra note 19, at 899-900. The provision would also apply to dispositions of assets.

<sup>364</sup> See AICPA, supra note 316, at 16; TEI, supra note 4, at 11.

transaction is the liquidating REIT transaction wherein the interest income from a pool of mortgages purportedly was permanently excluded from tax by a combination of the allowance of dividends paid deduction for liquidating distributions of REITs and the tax-free treatment of the receipt of such distributions by controlling REIT corporate shareholders.<sup>365</sup> Policymakers decided that the most effective way to address these transactions was through legislation that modified the applicable mechanical rules of the Code.

Continued reliance upon this type of piecemeal strategy for “works, but shouldn’t” transactions may prove ultimately to be self-defeating, as (1) policymakers do not have the knowledge, expertise and time to continually address these transactions; (2) adding more mechanical rules to the Code adds to complexity, unintended results, and potential fodder for new shelters; (3) the approach may reward taxpayers and promoters who rush to complete transactions before the anticipated prospective effective date of any reactive legislation; and (4) the approach results in further misuse and neglect of common law tax doctrines.

Corporate tax shelters flourish under the existing legal regime. As discussed in Part II.B., discontinuities in objective statutory or regulatory rules can lead to inappropriate results that have been exploited through corporate tax shelters. More general anti-abuse provisions ( e.g., sections 269, 446, 482, and 7701(l)) are limited to particular situations. Reliance upon the courts to police such transactions with common law tax standards has proved to be somewhat unsatisfactory. As discussed above, court decisions are often conflicting, creating confusion in an area of law that generally relies upon objective rules. An efficient tax system places great reliance on self-assessment, requiring taxpayers and their advisors to apply the law to report taxable income properly. Self-assessment is frustrated by conflicting, incoherent decisions and encourages the most aggressive taxpayers to pick and choose among the most favorable cases.

To properly address corporate tax shelters, a broader approach is necessary. Much of the discussion with respect to corporate tax shelters has centered upon the broader common law doctrines discussed in Part IV.B. Some have suggested that these tools are sufficient in order to address corporate tax shelters and no other substantive changes are necessary.<sup>366</sup> This argument ignores the fact that corporate tax shelters thrive today despite the presumptive applicability of these doctrines. Several reasons can be offered as to why these common law doctrines are ineffective in curbing tax shelters. First, taxpayers (and their advisors) may be simply ignoring the doctrines. Alternatively, taxpayers may be cognizant of the doctrines, but have decided that they do not apply because the facts of their transaction are distinguishable from the facts in the case. Finally, because judicial interpretations of these doctrines is uneven, taxpayers may be relying on decisions that are more favorable to the result they desire, while ignoring (or distinguishing) decisions that are less favorable (the “least common denominator” factor).

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<sup>365</sup> See Appendix A for a detailed description of the transaction.

<sup>366</sup> Kies, supra note 343, at 1478-79.

In any event, the Treasury Department believes that a change in the substantive law is necessary in order to address corporate tax shelters. While the Treasury Department believes that increased disclosure and changes to the penalty regime are necessary to escalate issues and change the cost/benefit analysis of entering into corporate tax shelters, these remedies are not enough if taxpayers continue to believe that they will prevail on the underlying substantive issue. Stated another way: what good is a significant understatement penalty if there is no understatement?

b. *Definition of tax avoidance transaction.* There are different ways to modify substantive law to attain the desired result. The Administration has proposed to disallow tax benefits derived from a tax avoidance transaction. Criticisms of this approach generally focus on the vagueness of the definition of tax avoidance transaction.<sup>367</sup> Vagueness is inherent in any standard. In a sense, a corporate tax shelter could be defined as a transaction that “might work, but shouldn’t,” is “too good to be true,” or doesn’t “pass the smell test.” These definitions represent visceral reactions to shelter transactions; are difficult to translate into legislative, regulatory or judicial language; and are truly subjective.<sup>368</sup> For the reasons described in this report, the Treasury Department believes that its proposed definition of tax avoidance transaction is more objective (than those contained in much of case law), and that perceptions of vagueness are overstated. However, as discussed below, modifications can be made to the definition to address certain causes of concern.

As described in detail above and in Appendix C, the first part of the Administration’s proposed definition is intended to be a coherent standard derived from the economic substance doctrine as espoused in a body of case law<sup>369</sup> to the exclusion of less developed, inconsistent decisions.<sup>370</sup> In addition, the definition incorporates a common characteristic of current corporate tax shelters -- the lack of economic substance relative to purported tax benefits. Any definition of corporate tax shelter should encompass this characteristic and, accordingly, take into account the taxpayer’s expected tax benefits and the expected economic consequences to be derived from the transaction. While the incorporation of this characteristic into the definition of corporate tax

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<sup>367</sup> See, e.g., TEI, supra note 4, at 9-10; AICPA, supra note 316, at 15.

<sup>368</sup> Some have suggested that courts in analyzing questionable transaction apply such visceral tests and then disallow the tax benefits under the rubric of one of the enumerated common law doctrines. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231, 265 (3d Cir. 1998) (McKee dissenting), cert. denied, 119 S.Ct. 1251 (1999).

<sup>369</sup> See Knetsch v. U.S., 364 U.S. 361 (1971); ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, aff’d in part, rev’d in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999). See generally Hariton, supra note 166.

<sup>370</sup> See Frank Lyon Co. v. U.S., 435 U.S. 561 (1978); Horn v. Commissioner, 968 F.2d 1289 (D.C. Cir. 1992).

shelter could take many forms, the Treasury Department believes that a balancing or weighing of reasonably expected profit against reasonably expected tax benefits is the best, most objective approach.

Most of the comments that have labeled the Administration's proposed definition of corporate tax shelter as vague have focused on the second part of the definition. Some of these comments imply that the second part of the definition is vague because it only applied to "certain," undefined transactions, and the phrase "improper elimination or significant reduction of tax" is not a standard used under current-law anti-abuse provisions or judicial doctrines.<sup>371</sup> Thus, they cannot judge the scope of the definition.

This second part of the Administration's proposed definition is intended to apply primarily to financing transactions. In straight financing arrangements, the borrower is not "making a profit" in an economic sense -- although the borrower may be reducing its costs relative to other forms of capital financing -- but rather is raising capital in order to enter into profit-making transactions.<sup>372</sup> In this instance, and others,<sup>373</sup> a comparative profits test may be inapposite. Corporate taxpayers, however, should not be free in these situations to enter into transactions that produce unintended and unreasonable tax results, and this branch of the definition of corporate tax shelter is intended to preclude corporate taxpayers from realizing such benefits. However, as described below, the second part of the Administration's proposal may be modified to be more objective, targeted and consistent with the economic substance standard of the first part of the proposed definition.

The disallowance of tax benefits generated by tax avoidance transactions would not apply to tax benefits that are clearly contemplated by the applicable Code provision (taking into account the Congressional purpose for such provision and the interaction of the provision with other provisions of the Code.) Some commentators have suggested that this exception to the proposed definition also is too vague because it is often difficult to discern Congressional intent.<sup>374</sup> Others believe this to be an important feature of any definition.<sup>375</sup>

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<sup>371</sup> Some have suggested substituting a "clear reflection of income" standard for this part of the definition.

<sup>372</sup> Of course, a financing may have nexus to a larger transaction that has a profits component.

<sup>373</sup> Other situations where profit may not be relevant could include cases involving employee compensation and liquidations or dispositions of businesses.

<sup>374</sup> See, e.g., TEI, *supra* note 4, at 10; AICPA, *supra* note 316, at 15.

<sup>375</sup> See, e.g., NYSBA, *Report*, *supra* note 19, at 896. See also, *supra*, Part IV.B. for a discussion of the use of a similar standard in the partnership anti-abuse regulation.

c. *Abuse of discretion.* Some commentators have criticized the Administration's proposed change to substantive law to disallow tax benefits arising in tax avoidance transactions as providing the IRS with significant authority that may be subject to abuse.<sup>376</sup> The commentators fear that an examining agent may raise the specter that a transaction is a tax avoidance transaction. The commentators fear that the issue will be raised, not because the agent believes the taxpayer engaged in a tax shelter, but because the agent wishes to use the shelter issue as leverage for concessions on other issues by the taxpayer. Other commentators recognize this possibility, but support the Administration proposals nonetheless.<sup>377</sup>

#### 4. Description and Analysis of H.R. 2255

H.R. 2255 contains several elements of the Administration's proposal to modify substantive law to disallow certain unwarranted tax benefits derived in corporate tax shelter transactions.<sup>378</sup> In addition, H.R. 2255 reflects comments made by the ABA and NYSBA. Specifically, with respect to a substantive change in the law, section 3 of the bill would amend section 7701 to provide for the disallowance of noneconomic tax attributes which would be defined as any deduction, loss or credit claimed from any transaction unless (1) the transaction changed in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position and (2) either (a) the present value of the reasonably expected potential income from the transaction (and the taxpayer's risk of loss from the transaction) are substantial in relationship to the present value of the tax benefits claimed or (b) in the case of financing transactions, the deductions claimed by the taxpayer for any period are not significantly in excess of the economic return realized by the person providing the capital. Disallowance would not apply to the realization of built-in losses or deductions that the taxpayer had economically borne prior to the transactions or to certain specified tax benefits.<sup>379</sup> Certain transactions that do give rise to meaningful book/tax differences or are entered into with tax-indifferent parties would be presumed to be noneconomic transactions.

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<sup>376</sup> See AICPA, supra note 316, at 16; TEI, supra note 4, at 11.

<sup>377</sup> See NYSBA, Report, supra note 19, at 894.

<sup>378</sup> As described supra in Part V.B., H.R. 2255 also contains provisions similar to the Administration's original Budget proposal to modify the substantial understatement penalty of section 6662.

<sup>379</sup> Specifically, the following tax benefits would not be subject to disallowance: the credit relating to producing fuel from nonconventional sources of section 29, the low-income housing credit of section 42, the credit relating to electricity produced from renewable resources of section 45, the credit relating to qualified zone academy bonds of section 1397E, and any other tax benefit as provided in regulations.

The disallowance of losses in H.R. 2255 is similar to the Administration's proposal, except that the disallowance under the bill would not turn on a finding by the Secretary. The test for noneconomic transactions relies on the economic substance doctrine and would apply the doctrine in ways substantially similar to the first part of the Administration's proposed definition of tax avoidance transaction.

H.R. 2255 would adopt the NYSBA recommendation that a specific rule be applied to financing transactions (in lieu of the more general second part of the Administration's original definition). However, H.R. 2255 applies a different rule to such transactions than that proposed by the NYSBA. Under H.R. 2255, deductions from a financing transaction would be disallowed if such benefits are significantly in excess of the economic return of the counterparty to the transaction. This rule of H.R. 2255, in essence, uses the economic substance test also found in the first part of the Administration's original proposed definition (and in the first part of the H.R. 2255 test), but applies it in a practical way to financing transactions. In this regard, H.R. 2255 is more objective than the second part of the Administration's original proposal and the NYSBA's suggested modification for financing transactions (which is similar to the "improper elimination of tax on economic income" test).

H.R. 2255 would resolve the Cottage Savings issue discussed above in a manner similar to that suggested by the NYSBA (*i.e.*, disallowance would not apply to built-in losses of the taxpayer). The Administration's proposal and the NYSBA suggestion would not apply to tax benefits that were contemplated by the Congress; H.R. 2255 would supply a definite list of certain exempt credits and allow other tax benefits to be exempt pursuant to regulations. The presumption that certain transactions are subject to disallowance and the application of the disallowance rules to taxpayers other than corporations are other features of H.R. 2255 not found in the Administration's original proposal.<sup>380</sup>

##### 5. Proposed Modifications to Administration Proposals

The Treasury Department continues to believe that a substantive change in the law is necessary to address corporate tax shelter transactions. However, in order to address legitimate concerns regarding the vagueness of the definition and the potential abuse of discretion, the Treasury Department proposes certain modifications.

First, the definition of tax avoidance transaction would remain a two-part definition, with the first part based on the economic substance doctrine as originally proposed. However, to more narrowly target the second part of the definition and to make it more consistent with the first part, the Treasury Department proposes to substitute its original "improper elimination of tax" test with a test focused specifically on financing transactions to that of H.R. 2255.

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<sup>380</sup> But see TEI, *supra* note 4, at 15; ABA, *supra* note 56, at 5 (suggesting that any anti-shelter provisions should apply equally to corporations and other taxpayers).

Many of the concerns regarding abuse of discretion will be addressed by a more concrete definition of tax avoidance transaction. In addition, procedural and other safeguards could be installed to address this issue. First, the IRS currently is restructuring among groups based on types of taxpayers. Because the Administration's tax shelter proposals generally apply to corporate transactions,<sup>381</sup> the IRS personnel reviewing potential corporate tax shelters will be centralized in the IRS' new corporate tax shelter group. Centralization will facilitate training and coordination among agents, their supervisors and Chief Counsel. Increased disclosure by taxpayers, as proposed in Part V.A., would facilitate coordinated review. A corporate tax shelter tax force, modeled after current Industry Specialization Program and the individual tax shelter tax forces of the 1970s and 1980s, could further centralize and streamline these efforts. Increased coordination by the IRS would increase consistency and efficiency in dealing with complex tax shelter issues.<sup>382</sup>

Additional legislative and regulatory steps could be taken to further ensure proper and consistent resolution of corporate tax shelter issues. For example, any corporate tax shelter issue raised by an examining agent could be automatically referred to the National Office of the IRS for further processing or resolution. Similar procedures currently are provided with respect to the partnership anti-abuse regulation<sup>383</sup> and in the proposed procedures for involuntary accounting method changes.<sup>384</sup> Special rules also could be developed that would allow a taxpayer to receive an expedited ruling from the National Office as to whether a contemplated transaction constituted a corporate tax shelter for purposes of the section 6662 penalty. Taxpayers currently have the opportunity to request private letter rulings with respect to the determination of the proper substantive tax treatment of a transaction. Due to the complex factual and legal nature of many corporate transactions, these rulings often cannot be provided on an expedited basis.

Finally, an approach similar to that of H.R. 2255 should be adopted to further address concerns of abuse of discretion. As described above, the Administration's proposed substantive rule vests authority in the Secretary to disallow unwarranted tax benefits; the substantive rule in H.R. 2255 is self-executing. The difference between the two approaches is that, should an issue

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<sup>381</sup> But see TEI, supra note 4, at 15 (any proposals that are adopted into law should also apply to taxpayers other than corporations).

<sup>382</sup> Several commentators have observed that to be effective, any corporate tax shelter provisions must be supported by proper enforcement on the part of government. See, e.g., ABA, supra note 56, at 11.

<sup>383</sup> Announcement 94-87, 1994-27 I.R.B. 124.

<sup>384</sup> Notice 98-31, 1998-23 C.B. 9.

go to court, a judge may grant greater deference to the Government's position under the Administration's approach than under an H.R. 2255 approach.<sup>385</sup>

Finally, similar to H.R. 2255 and in response to some commentators, the Treasury Department would modify the proposal such that any substantive change of law would apply to all business activities of taxpayers, including those that engage in business in non-corporate forms.

#### D. PROVIDING INCENTIVES FOR ALL PARTICIPANTS

##### 1. Introduction

As discussed in Part II.B., there are many parties that may participate in, and benefit from, a corporate tax shelter other than the corporate participant. Proposals to deter the use of corporate tax shelters could provide sanctions or remedies on these parties as a penalty for engaging in inappropriate behavior. More importantly, such remedies or sanctions would lessen or eliminate the economic incentives for these parties to participate in sheltering transactions, thus having a dampening effect on the transactions themselves to the extent they are facilitated by the participation of these parties. Finally, the potential for remedies or sanctions on all participating parties will multiply the number of eyes that will scrutinize a transaction for its integrity.

Different remedies or sanctions may be fashioned for different types of participating parties, requiring an identification of the parties and their respective roles in a corporate tax shelter. It should be noted that remedies or sanctions on participants other than the corporation itself will not, alone, put an end to corporate tax shelters. Not all corporate tax shelters use tax-indifferent parties. Likewise a corporate tax shelter can be devised and implemented by a corporation's in-house personnel without the aid of outside promoters or advisors.<sup>386</sup> Moreover, sanctions on tax advisors and promoters may merely raise the cost of the tax shelter transaction and does not totally eliminate the incentive to enter into the transaction. Thus, enactment of sanctions on promoters, advisors, and tax-indifferent parties must be at least accompanied by significant sanctions on the corporate participant as well.

a. *Promoters and advisors.* Many corporate tax shelters are designed and promoted by individuals that are not employees of the corporate participant. These individuals may be employed by investment banks, accounting firms, law firms or tax shelter boutiques whose primary activity is the development and promotion of tax shelter products. Other independent parties involved in a sheltering transaction include those who provide technical tax advice and analysis, those who provide tax opinions, those who prepare or review tax returns or financial

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<sup>385</sup> For instance, the Secretary generally is shown substantial deference when he uses his authority under section 446 to challenge a method of accounting as not clearly reflecting income. See *supra* Part IV.A. for a discussion of section 446.

<sup>386</sup> Such a scenario is unlikely, however, in the current environment.



statements, and those who help implement the tax shelter transaction ( e.g., by drafting transaction documents and entity charters, appraising property, underwriting financial instruments, etc.). Many of these promoters, advisors and implementers may come from firms with whom the corporate participant does not have ongoing relationships. This extraordinary relationship may be by design (as a traditional advisor may have superior knowledge of the corporation's historical business and thus may not be able to provide a clean legal or financial accounting opinion with respect to the extraordinary shelter transaction), <sup>387</sup> or may be the result of competition among advisors. In any event, providing corporate tax shelter advice purportedly is a lucrative business, with total professional fees often approaching one-third of the tax benefits anticipated from the transaction. These fees generally are deductible by the corporate participant and often are provided on a contingent basis based on a percentage of the anticipated or realized tax benefits.

Congress previously has addressed the role of promoters and advisors of tax shelters. The abusive shelter promotion and aiding and abetting penalties were enacted by TEFRA during the height of the individual tax shelter activity of the 1980s. Rightly, they focus on the promoter or salespersons hyping the shelter and other participants making representations as part of the offering materials because those shelters typically had many investors and it was more effective to target the promoter and associated individuals than to take enforcement action against each investor. The level of misconduct that is subject to penalty, however, is egregious misconduct of a variety not difficult for courts to discern, i.e., false or fraudulent statements or the preparation of documents that knowingly will result in an understatement of tax. These standards reflect a basic attribute of the tax shelter activity of the 1970s and 1980s, that is, that the typical investor was a high-bracket individual without any detailed knowledge of the tax laws and potentially susceptible to promotional claims that did not withstand close scrutiny by those skilled in the tax laws. Usually, the participant offering the opinion did so at the behest of the promoter and had no relationship to the investors in the shelter. Consequently, the penalties were intended to protect such third-party investors from the activities of such promoters and other participants. The cases that have been brought under these standards reflect their basic orientation toward these types of shelters, where the representations involved were plainly at odds with the economic substance of the transaction or established principles of tax law or economics <sup>388</sup> and under circumstances where knowledgeable advice was not sought by the promoter. <sup>389</sup>

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<sup>387</sup> NYSBA, Report, supra note 19, at 893.

<sup>388</sup> See, e.g., U.S. v. Buttorf, 761 F.2d 1056, 1063 (5<sup>th</sup> Cir. 1985) (injunctive relief appropriate against actions “denounced as wrongful by positive, public law”); U.S. v. Campbell, 897 F.2d 1317, 1321 (5<sup>th</sup> Cir. 1990) (debt without monetary correction for rapidly declining value of foreign currency “did not comport with standard commercial practice” and rendered notes virtually worthless compared to purported value).

<sup>389</sup> See, e.g., Buttorf, 761 F.2d at 1062 (“the fact that appellant counseled his clients not to seek separate opinions from lawyers or accountants” demonstrates “that appellant knew or had reason to know that his representations to his customers regarding the tax benefits of his trust

Although corporate tax shelters also may involve promoters, opinions rendered by practitioners associated with the promoter, and various degrees of marketing,<sup>390</sup> it is doubtful that current-law penalties can be brought to bear with any real force on today's shelters. As discussed elsewhere in this paper, corporate tax shelters take advantage of complex provisions of tax law and sophisticated financial instruments, rather than the more blatant overvaluations or other techniques used to generate noneconomic losses in the shelters of the 1970s and 1980s. Corporate tax shelter investors and their advisors are sophisticated and not apt to stray across the line into false or fraudulent representations.

b. *Tax-indifferent parties.* As discussed in Part II.B. of this Report and described in Appendix A, the operation of many corporate tax shelter transactions are dependent upon the participation of parties who are indifferent to tax consequences, e.g., foreign persons, tax-exempt organizations, Native American tribal organizations, and otherwise taxable persons with expiring tax attributes such as loss or credit carryovers. Foreign persons (nonresident aliens and foreign corporations) are subject to U.S. Federal income tax only on income that is sourced in the United States.<sup>391</sup> Tax-exempt organizations (including pension plans and charitable organizations) are subject to federal income tax only on income that is unrelated to the organization's exempt purpose (UBIT).<sup>392</sup> States, municipalities or political subdivisions thereof are not subject to

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package were false and misleading"); U.S. v. Estate Preservation Services, 38 F. Supp.2d 846, 854 (E.D. Cal. 1998) (promoter consulted with professionals but acknowledged that some of those professionals disagreed with him as to propriety of specific representations; promoter ignored those opinions and instead "associated with individuals who unquestioningly agreed to further his scheme").

<sup>390</sup> See Forbes, supra note 5, at 202.

<sup>391</sup> With respect to foreign persons who engage in a trade or business within the U.S., income that is effectively connected to such U.S. trade or business is subject to tax in the same manner and at the same rates as income of U.S. persons. I.R.C. §§ 871(b) & 882. Certain U.S. source income that is not effectively connected to a U.S. trade or business is subject to a 30-percent gross basis tax, collected through withholding. I.R.C. §§ 871(a) & 881(a). U.S. source income subject to the 30 percent withholding tax generally includes interest, dividends, rents, and other fixed or determinable annual or periodic income. In addition, there are a number of statutory exclusions. For example, so-called "portfolio interest" is not subject to the 30 percent withholding tax. I.R.C. §§ 871(h) & 881(c). The withholding tax may be reduced by an applicable treaty.

<sup>392</sup> I.R.C. §§ 501(a) (exemption from tax) & (b) (tax on UBIT).

Federal income tax.<sup>393</sup> Native American tribes, and wholly owned tribal corporations organized under Federal law, also are generally not subject to Federal income tax.<sup>394</sup>

As discussed in Part II.B., tax-indifferent parties often are interposed into corporate tax shelter transactions to absorb taxable income from the transaction, leaving offsetting deductions or losses to be used by a taxable corporate participant. The tax-indifferent party, in effect, rents its tax exemption to the corporation in exchange for an above-average return on investment.

A tax-indifferent party has a special status conferred upon it by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforeseen manner, the tax system should not condone it. Imposing a tax on the income allocated to tax-indifferent persons could be used to eliminate the inappropriate rental of their special tax status, eliminate their participation in corporate tax shelters, and thus eliminate the use of shelters that arbitrage their tax-preferred treatment. Trafficking of tax status also is inconsistent with the many provisions of the Code that seek to limit the trafficking of tax attributes, such as net operating losses.<sup>395</sup>

## 2. Administration proposals

Under the Administration's FY 2000 Budget proposal, any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable to such person.<sup>396</sup> To ensure that a tax is paid, all corporate participants would be made jointly and severally liable for the tax.<sup>397</sup> For purposes of the proposal, a tax-indifferent person would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with a loss or credit carryforward that is more than three years old. The proposal would characterize the income to achieve taxable status. For example, in the case of a tax-exempt organization, the income would be characterized as UBIT. In the case of a foreign taxpayers, any income not otherwise treated as U.S. source income would be treated as effectively connected income.

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<sup>393</sup> I.R.C. § 115.

<sup>394</sup> See, e.g., Rev. Rul. 94-65, 1994-2 C.B. 14; Rev. Rul. 94-16, 1994-1 C.B. 19; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 67-284, 1967-2 C.B. 55.

<sup>395</sup> See, e.g., I.R.C. §§ 269 & 382.

<sup>396</sup> Treasury Explanation, supra note 61, at 104.

<sup>397</sup> If corporate participants were not jointly and severally liable, the tax could be easily avoided. For example, the parties could organize a special purpose foreign entity to absorb the income and then liquidate to avoid the proposed penalty. In addition, the joint and several liability proposal would avoid questions concerning the limitations on the taxing jurisdiction of U.S.

The Budget also proposes to provide additional costs upon activities and services of other parties involved in corporate tax shelter transactions. These proposals would impose a 25-percent excise tax upon (1) the fees earned by promoters and advisors with respect to a corporate tax shelter transaction, levied upon the promoter or advisor<sup>398</sup> and (2) the total tax benefits anticipated from a corporate tax shelter transaction, to the extent such benefits are subject to an unwind agreement, rescission clause, or insurance or other arrangement guaranteeing such benefits, levied upon the corporate participant.<sup>399</sup> Finally, the Budget proposals would disallow deductions for promoter and advisor fees associated with a corporate tax shelter.<sup>400</sup>

### 3. Commentaries

The ABA believes that promoters and tax advisors have played a role in the proliferation of corporate tax shelters. They also recognize that one feature of many corporate tax shelters is the participation of a tax-indifferent party. In recognition of the role that these parties play in corporate tax shelters, the ABA proposes that if the substantial understatement penalty applies to a taxpayer with respect to a tax shelter, the penalty should also be imposed on outside advisors, promoters and tax-indifferent parties that actively participated in the tax shelter. These penalties would be set at levels commensurate with the fees and benefits such parties stood to realize if the transaction was successful. Special procedural rules would be provided to assure due process to such parties, similar to the rules applicable to tax return preparer penalties.<sup>401</sup>

The ABA would also expand the scope of potential participants subject to penalty with respect to corporate tax shelters to officers of the corporation who must attest to the disclosure requirements proposed by the ABA regarding the nature of the transaction. The ABA would impose personal accountability upon such officer for the accuracy of the factual underpinnings of the transaction. The nature of such penalty is not discussed.<sup>402</sup>

The AICPA agrees that present law should be changed to ensure that all parties to a tax shelter transaction have an incentive to ensure the soundness of the transaction. They favor the Administration's recommendation that Congress address exploitation of the tax system by the use

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<sup>398</sup> Treasury Explanation, supra note 61, at 99.

<sup>399</sup> Id. at 100.

<sup>400</sup> Id. at 99.

<sup>401</sup> ABA, supra note 56, at 10.

<sup>402</sup> Id.

of tax-indifferent parties, but offer no specific proposal as to how this issue would be best addressed.<sup>403</sup>

The AICPA would not adopt the 25-percent excise taxes or the disallowance of promoter or advisor fees that are contained in the Administration's budget. Rather, they would prefer to impose direct penalties on promoters and advisors, with adequate due process provided. In particular, they propose that current-law section 6700, 6701 and 6703 be revised to be a more effective tool with respect to promoters and advisors. They also propose to revise the burden of proof requirement of section 6703 in an unspecified manner and provide Tax Court jurisdiction over the assessment of these penalties. Finally, the AICPA suggests unspecified revisions to Circular 230, while acknowledging that certain parties ( e.g., investment bankers) are not subject to these provisions.<sup>404</sup>

The NYSBA acknowledges that the growth of corporate tax shelters can be attributed, at least in part, to certain tax advisors and promoters --primarily, national accounting firms, multi-city law firms and major investment banks-- that have significant planning resources, mass marketing capabilities, and extensive client lists.<sup>405</sup> However, the NYSBA does not support the penalties and excise taxes proposed by the Administration with respect to parties other than the corporate participant and believes the principal emphasis should initially be placed on deterring corporations themselves from entering into questionable transactions.<sup>406</sup>

#### 4. Analysis and Possible Modifications to Administration Proposals

The Treasury Department believes that the current "nothing ventured, nothing gained" attitude, coupled with little downside risk to many participants has, in part, led to the proliferation of corporate tax shelters. The Treasury Department believes that, to foster a "culture of compliance," it is important that all parties that facilitate a questionable transaction have a personal stake in determining the appropriateness of the transaction. In order to develop this personal stake, current law must be modified to change the financial incentives of participants in corporate tax shelter transactions.

The proposals in the Administration's Budget attempt to change these financial incentives. With respect to promoters and advisors, the Treasury Department believes that the most direct way to affect their economic incentives is to levy a penalty excise tax upon the fees derived by

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<sup>403</sup> AICPA, supra note 316, at 14.

<sup>404</sup> Id. at 20-21

<sup>405</sup> NYSBA, Report, supra note 19, at 882-85.

<sup>406</sup> New York State Bar Ass'n (Tax Section), Report on Certain Tax Shelter Provisions (June 22, 1999).

such persons from the corporate tax shelter transaction. The Treasury Department proposes to modify and clarify its proposal regarding such penalty excise taxes by (1) providing that only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal,<sup>407</sup> and (2) providing appropriate due process procedures for such parties with respect to an assessment.

The Treasury Department recognizes that the proposed excise taxes on advisor and promoter fees operates in the same manner as a penalty. Thus, as an alternative, consideration could be given to amending the penalties described in sections 6700, 6701 and 6703 to be more responsive to corporate tax shelters.<sup>408</sup>

Denying the deduction for costs of certain services effectively raises the cost of such services. Because this sanction is directly imposed on the corporate participant, it only has an indirect effect on promoters and advisors. In addition, unlike deductions generated by tax avoidance transactions, fees paid to outside promoters and advisors represent actual out-of-pocket costs to corporations. Because the Treasury Department believes that the other sanctions proposed with respect to the corporate participant are sufficient, the Treasury Department proposes to eliminate its original proposal regarding the deductibility of promoter and advisor fees.

As a further deterrent to certain services currently being provided to participants in corporate tax shelters, the Administration's original Budget proposed a 25-percent excise tax upon the tax benefits subject to an unwind provision, rescission agreement, or insurance or similar arrangement. The Treasury Department believes it is inappropriate for promoters and others to "guarantee" tax benefits arising from corporate tax shelters. However, because this sanction represents yet another burden on the corporate participant and would be difficult to administer, the Treasury Department proposes to eliminate this proposal. However, the Treasury Department proposes that the existence of an unwind provision, rescission agreement, or insurance or similar arrangement should a special type of "filter" that automatically triggers disclosure.

Finally, the Treasury Department remains concerned about the participation of tax-indifferent parties in corporate tax shelters. At a minimum, the Administration's original Budget proposal to tax income earned by such persons with respect to corporate tax shelters should be modified by (1) providing appropriate due process procedures for such parties with respect to any assessment, (2) providing that only tax-indifferent parties that are trading on their tax exemption

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<sup>407</sup> Thus, a tax professional who advised a client that a transaction was not supportable under current law or who cautioned a client not to enter into the transaction would not be subject to the penalty excise tax with respect to fees charged for such advice.

<sup>408</sup> As described in Part IV.C., sections 6700, 6701 and 6703 were enacted in response to the individual tax shelters of the 1970s and 1980s and have little applicability to corporate tax shelters today.

are subject to the proposal, and (3) clarifying that the joint and severable liability runs between the tax-indifferent party and the corporate participant only. In addition, because the proposal may be difficult to administer and may only represent an additional penalty on the corporate participant (because the tax-indifferent party is not subject to U.S. taxing jurisdiction), consideration should be given to further modifying the scope of the proposal. For example, the proposal could be only applicable to taxpayers that have a nexus to the United States.

## VI. ALTERNATIVE APPROACHES

In addressing the individual tax shelters of the 1970s and 1980s, Congress considered how best to prevent (or at least reduce) harmful and excessive tax sheltering.<sup>409</sup> Congress considered eliminating substantially all tax preferences from the Code but found that approach deficient for two reasons. First, the Code contains a number of provisions that were enacted to further some perceived beneficial social or economic goal and eliminating all tax preferences would necessarily restrict the use of the Code to further such goals.<sup>410</sup> Second, it is extremely difficult, and perhaps impossible, to design a tax system that measures income perfectly.<sup>411</sup> Congress recognized that, even if rules for the accurate measurement of income could be devised, such rules could result in significant administrative and compliance burdens.<sup>412</sup> Accordingly, Congress chose a more limited path: addressing the symptoms rather than the cause.

Existing corporate tax shelters could be limited if some of the basic principles and rules underlying the Federal income tax system that are contributing to the existence of such shelters are changed or modified.<sup>413</sup> Alternatively, as was done with respect to individual tax shelters in the 1980s, the symptoms could be addressed. For example, various limitations could be imposed on the amount of tax benefits a taxpayer could receive or use under the income tax. Examples of the latter type of limitation include the alternative minimum tax and the passive loss rules of section 469. Applying such rules in response to corporate tax shelter transactions casts a wide net—one that would catch both taxpayers that engage in sheltering transactions as well as those that do not. This section discusses alternatives for addressing corporate tax shelters, including options that we considered but did not propose, anti-abuse approaches adopted in other countries, and improving the targeted response system.

### A. THE ROADS NOT TAKEN

#### 1. Fundamental Tax Reform or Integration

This Report is focused on curbing corporate tax shelters within the Federal income tax system. The Treasury Department recognizes, however, that in light of the increased avoidance of corporate income taxes through the use of tax shelters, some may call for the replacement of the corporate income tax with a new tax regime, or integration of the corporate and individual

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<sup>409</sup> S. Rep. No. 99-313, at 714 (1986).

<sup>410</sup> Id. at 715.

<sup>411</sup> Id.

<sup>412</sup> Id.

<sup>413</sup> See, e.g., NYSBA, supra note 19, at 900.



income tax systems in order to eliminate corporate tax shelters once and for all. A detailed analysis of these approaches is beyond the scope of this paper. It is unlikely, however, that corporate tax shelters would end as a result of fundamental tax reform or integration.

Periodically, there are calls for fundamental tax reform to address, among other things, the complexity of the Federal income tax system. For example, some have argued for replacing the progressive rate structure with a flat rate, while others have argued for replacing the income tax base with consumption-based taxes, such as a sales tax or a value added tax (VAT).

In 1992, the Treasury Department issued a report on the integration of the individual and corporate tax systems.<sup>414</sup> The primary goal of integration would be to tax corporate income once and reduce or eliminate the economic distinctions arising under the current two-tiered system. The report examines in detail several different integration prototypes to stimulate debate on the desirability of integration. With respect to publicly traded corporations, some have argued for a form of integration that would replace the corporate income tax with an annual tax on shareholders measured by the market value of the corporation's stock.<sup>415</sup>

In the case of fundamental tax reform and integration, a corporation would still be required to determine a tax base, albeit under the new system, to determine its tax liability or the tax allocable to its shareholders. Under any system, corporations and their shareholders would continue to have an interest in minimizing their collective tax liabilities. For example, even if the corporate and individual income taxes were integrated, shareholders (and, correspondingly, corporations) would have an interest in postponing the payment of taxes attributable to corporate earnings. In addition, a fundamentally new tax regime would have sufficiently unclear or complex areas that could result in a significant avoidance of tax.<sup>416</sup>

## 2. Floor on Taxable Income

In 1969, Congress enacted the minimum tax to reduce the advantages derived from tax preferences and to make sure that those receiving such preferences also pay a share of the tax

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<sup>414</sup> Dept. of the Treas., Integration of The Individual and Corporate Tax Systems (January 1992).

<sup>415</sup> See, e.g., Bankman, A Market Value Based Corporate Income Tax, 68 Tax Notes 1347 (Sept. 11, 1997).

<sup>416</sup> See, e.g., Jt. Comm. on Tax'n, Impact on Manufacturing, Energy, and Natural Resources of Replacing the Federal Income Tax (1996) (discussing sources of complexity and potential manipulation in alternative tax systems).

burden.<sup>417</sup> In 1986, Congress replaced the add-on minimum tax for corporations with a new alternative minimum tax regime in order to "ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits."<sup>418</sup> While acknowledging that tax preferences provide incentives for worthy goals, Congress believed that such preferences become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability.<sup>419</sup> Congress determined that the goal of applying the minimum tax to all companies with substantial economic incomes could not be accomplished solely by compiling a list of specific items to be treated as preferences.<sup>420</sup> Rather, Congress believed that a book income preference adjustment, that would increase a corporation's alternative minimum taxable income if the corporation's reported book income for the year exceeded its alternative minimum taxable income, was necessary in order for the minimum tax regime to be successful.<sup>421</sup> Under the book income preference adjustment, the alternative minimum taxable income of a corporation was increased by 50 percent of the amount by which the adjusted net book income of the corporation exceeded the alternative minimum taxable income for the taxable year (determined without the book income adjustment and the alternative tax net operating loss deduction). This adjustment applied only for three years, from 1987 through 1989.<sup>422</sup> For years after 1989, the book income

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<sup>417</sup> S. Rep. No. 91-552 (1969), reprinted in 1969-3 C.B. 423, 495 ("The present treatment which permits individuals and corporations to escape tax on certain portions of their economic income results in an unfair distribution of the tax burden. This treatment results in large variations in the tax burdens placed on taxpayers who receive different kinds of income.").

<sup>418</sup> S. Rep. No. 99-313, at 518 (1986).

<sup>419</sup> Id. Congress also believed that the ability of high-income individuals and highly profitable corporations to pay little or no tax undermined respect for the tax system and was inherently unfair. Id.

<sup>420</sup> Id. at 520.

<sup>421</sup> Id. Given the conservatism of financial accounting (i.e., it is designed to err on the side of understating, rather than overstating income), "alternative minimum taxable income generally should not be lower than book income for any substantial period of time, absent tax preferences that have not been separately identified." Id. at n. 4.

<sup>422</sup> I.R.C. § 56(f) (repealed). See generally Jt. Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 434 (1987) [hereinafter 1986 Blue Book] ("Congress concluded that it was particularly appropriate to base minimum tax liability in part upon book income during the first three years after enactment of the Act, in order to ensure that the Act will succeed in restoring public confidence in the fairness of the tax system.").

preference was replaced with an adjustment relying on the corporation's adjusted earnings and profits.<sup>423</sup>

As discussed in Part II.B.2. of this Report, most corporate tax shelters seek to reduce the effective tax rate of the corporation.<sup>424</sup> A possible response to corporate tax shelters could include imposing book income as a floor on the corporation's taxable income. This would eliminate the book-tax disparity, and therefore would significantly limit the allure and benefit of corporate tax shelters to public corporations.

This approach, however, would add significant complexity. For instance, such an approach obviously would require a determination of the appropriate book income figure.<sup>425</sup>

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<sup>423</sup> I.R.C. §§ 56(c) & (g). According to the Joint Committee on Taxation,

For taxable years beginning after 1989, Congress concluded that the book income preference should be replaced by the use of a broad-based system that is specifically defined by the Internal Revenue Code. Congress intended that this system should generally be at least as broad as book income, as measured for financial reporting purposes, and should rely on income tax principles in order to facilitate its integration into the general minimum tax system. Congress concluded that the definition of earnings and profits applying for certain regular tax purposes . . . provided an appropriate starting point in this regard.

1986 Blue Book, supra note 422, at 435.

<sup>424</sup> That is, they reduce the taxes paid by the corporation without a commensurate reduction in the book earnings of the corporation.

<sup>425</sup> Congress created a priority system for determining the applicable financial statement that would be used to determine book income. The Senate Report provides that

[t]he taxpayer's applicable financial statement is the statement it provides for regulatory or credit purposes, for the purpose of reporting to shareholders or other owners, or for other substantial nontax purposes. In the case of a corporation that has more than one financial statement, rules of priority are provided for the determination of which statement is to be considered as the applicable financial statement for the purpose of determining net book income.").

S. Rep. No. 99-313, at 530 (1986)

Adjustments also would be necessary, among other things, to ensure that book income reflects the activities of those corporations included in a consolidated return (and conversely remove any corporations included in the financial statements but not the tax return) and to remove the effects of Federal income taxes.<sup>426</sup>

In addition, use of a book income floor in response to corporate tax shelters is overbroad. Such a provision would apply to all corporations, not just those entering into shelters. If applied at the same tax rate as the regular tax, a book income floor would negate the benefits Congress intended in enacting various tax preferences. If applied at a lower tax rate (as is the current alternative minimum tax), the provision would apply unevenly among corporations<sup>427</sup> and would allow sheltering to some extent.

Finally, broadly relying on financial accounting rules for tax purposes may prove unsatisfactory as financial accounting and tax accounting rules have different purposes and different sources. The objective of financial accounting is, among other things, to provide investors and creditors with some of the information useful in making rational investment, credit, and similar decisions.<sup>428</sup> Financial accounting is governed by broad concepts, such as conservatism and consistency, and by standards (generally accepted accounting principles, or GAAP) that are generally developed by the Financial Accounting Standards Board (FASB). The observance of these concepts and rules is determined by certified public accountants and by regulatory bodies such as the Securities and Exchange Commission (SEC). Their application may vary among companies, among industries, or depending upon the auditor. The objective of the Federal income tax is, among other things, to provide revenues for the operation of the government. Tax accounting rules are determined by Congress, the Treasury Department, and the courts. If the Congress were to re-enact a book income adjustment, it would be conceding the determination of a significant portion of the corporate tax base to bodies (the AICPA, FASB and SEC) other than itself.

### 3. Schedular or Basketing System

The Code contains a number of provisions designed to limit the ability of taxpayers to use tax benefits from one activity to offset income from an unrelated activity. For example,

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<sup>426</sup> Id. at 532-35.

<sup>427</sup> See Andrew B. Lyons, The Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects, in Economic Effects of the Corporate Alternative Minimum Tax, at 51-82 (Washington, D.C.: Am. Council for Capital Formation Ctr. for Policy Research 1991).

<sup>428</sup> Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises (FASB 1978).

deductions for capital losses are generally limited to the extent of capital gains.<sup>429</sup> Similarly, foreign tax credits may be used to reduce tax on foreign source income but not U.S. source income,<sup>430</sup> and are further basketed among categories of foreign source income. Individuals may deduct investment expenses only to the extent of investment income,<sup>431</sup> losses from wagering are allowed only to the extent of gains from wagering,<sup>432</sup> and, under the so-called “passive loss” rules, taxpayers who do not materially participate in a trade or business activity are limited in the amount of loss or credit arising from the activity that they may claim in any taxable year.<sup>433</sup>

These types of rules have been effective in limiting the use of tax benefits derived from one activity to shelter income from another activity. A similar limitation system could be developed to restrict the tax benefits a corporation derives from non-economic transactions. This would preclude taxpayers from engaging in transactions (so-called “excess benefit transactions” or “loss generators”) merely to produce tax benefits to offset income from other transactions. Such an approach, however, would not be effective with respect to so-called “exclusion transactions.”<sup>434</sup>

A broad basketing or schedular system limited to corporate tax shelters would be difficult to design, implement and enforce. Unlike individuals, corporations engage in a wide variety of activities and often grow and diversify into new activities. Because money is fungible, tracing tax benefits derived from financing transactions to taxable income from activities for which the financing is used (and vice versa) would be difficult. Limiting schedular taxation to corporate tax

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<sup>429</sup> I.R.C. § 1211. In the case of a corporation, net capital losses are not deductible but generally may be carried back three years and carried forward five years. I.R.C. § 1212(a). In the case of an individual, a net capital loss of up to \$3,000 is deductible against ordinary income. I.R.C. § 1211(b).

<sup>430</sup> I.R.C. § 904. In addition to an overall limitation on foreign tax credits, separate limitations apply to discrete categories of income. I.R.C. § 904(d). These “baskets” limit the use of foreign tax credits generated with respect to highly taxed foreign source income from being used to offset U.S. resident tax on low-taxed foreign source income (such as, passive income).

<sup>431</sup> I.R.C. § 163(d).

<sup>432</sup> I.R.C. § 165(d).

<sup>433</sup> I.R.C. § 469(a).

<sup>434</sup> See supra Part II.A.2. for a description of “excess benefit” shelters and “exclusion” shelters.

shelters would require a definition and identification of the offending transactions. If this could be done easily, more appropriate sanctions could be devised.<sup>435</sup>

## B. EXPERIENCES OF OTHER COUNTRIES WITH ANTI-ABUSE RULES

A number of foreign countries have adopted a general anti-avoidance rule (or “GAAR”) and others have considered a GAAR. A GAAR, as its name implies, is a general rather than a specific anti-abuse rule. Instead of seeking to prevent the abuse of any particular provision (through specific enumeration of prohibited transactions, or a more general power to prevent abuse of that provision), a GAAR states in general terms the circumstances in which transactions relating to any provision of the tax law can be overturned or recast by tax administrators and the courts. In many cases, the general principles employed by a GAAR are similar to the long-standing common law principles employed by the U.S. courts. Some employ several principles, failure to meet any one of which will trigger the GAAR, to those that only encompass one test (e.g., business purpose).

For example, the U.K. Inland Revenue consultative paper on a GAAR<sup>436</sup> identifies four elements that a GAAR might contain. It would: “require a scheme to be considered as a whole, rather than on a step-by-step basis;” apply this step transaction rule to steps “merely planned or expected,” not just those that are preordained; impose a recharacterization “based on the commercial substance of the transaction;” and “have regard to the purpose of the legislation.”<sup>437</sup> As discussed in Part IV. B., judicial doctrines involving step transaction, substance-over-form recasts of transactions, and purposive interpretation of the statute (where the language of the statute is ambiguous or silent) are well-established in U.S. tax jurisprudence.

It is difficult from the experiences of other countries to draw general conclusions about the efficacy of a GAAR, or its appropriateness for the United States, because tax systems and systems of jurisprudence differ from country-to-country. For example, a GAAR may have been introduced in some countries because courts felt unable to develop judicial anti-avoidance doctrines (similar to those that exist in the United States). The success of a GAAR also may depend on the extent to which the tax law is based on formalistic mechanical rules, and the extent to which legislative intent is clearly expressed in an accessible form. If the tax law is highly

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<sup>435</sup> 1997 Airlie House Transcript, *supra* note 9 (quoting Phil Wiesner: “I can live with the [partnership anti-abuse rules] because I view them like the difference between a root canal with novacaine versus a root canal without novacaine. There are worse things that could have been done...like extending the passive loss rules to corporations.”); *but see* Lee A. Sheppard, Is There Constructive Thinking About Corporate Tax Shelters?, 83 Tax Notes 782, 783-84 (May 10, 1999) (advocating a scheduler system).

<sup>436</sup> A General Anti-Avoidance Rule for Direct Taxes: Consultative Document (U.K. Inland Revenue 1998).

<sup>437</sup> *Id.* at § 6.1.1.

mechanical, and legislative intent is hard to discern, a “purposive” GAAR might have little effect. Furthermore, the efficacy of a GAAR may depend on the willingness of judges in a particular country to apply broad doctrines. If, historically, judges have narrowly interpreted the law based on “plain meaning,” or value the commercial certainty provided, for example, by strict construction, then a GAAR may also be narrowly interpreted in the judicial culture.<sup>438</sup>

1. Common Law Jurisdictions.

The major common law countries, with the notable exception of the United States, generally have followed the British practice of more narrowly interpreting tax laws, placing more importance on the legal form of the transaction, and ignoring motive. What follows is a brief examination of three common law countries and their experience (or lack thereof) with a GAAR: Australia, which has had a GAAR for several decades; Canada, which recently introduced a GAAR; and the United Kingdom, which has been considering a GAAR.

a. *Australia.* Australia has for many years had general anti-avoidance rules in its income tax legislation, but the history of their application has been mixed. Section 260 of the Income Tax Assessment Act of 1936 (reenacting a provision originally enacted in 1915), which was in force until 1981, provided that any contract, agreement or arrangement made with the purpose or effect of, inter alia, altering the incidence of any income tax or “defeating, evading or avoiding” any tax liability, would be absolutely void as against the government.<sup>439</sup>

The Australian courts, however, apparently proved very unwilling to apply the statute, and developed the “choice doctrine” which held that if the legislation provided two explicit choices, then section 260 could not be used to invalidate the taxpayer’s choice of the more tax efficient outcome.<sup>440</sup> Whether the taxpayer met the provisions of the chosen provision would be interpreted under the formalistic standards of the Duke of Westminster case.<sup>441</sup> The courts also interpreted the section as giving them no authority to recast transactions; only to completely void (or “annihilate”) them. Finally, if any specific anti-avoidance rule (however limited) applied, then section 260 could not.

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<sup>438</sup> See, e.g., Australia’s experience with judicial interpretation of section 260 of the Income Tax Assessment Act, discussed infra at text accompanying notes 444 - 441.

<sup>439</sup> Section 260, Income Tax Assessment Act 1936.

<sup>440</sup> See, e.g., Mullens & Ors v. FCofT (1976) 135 CLR 290; Slutzkin & Ors v. FCofT (1977) 140 CLR 314; Cridland v. FCofT (1977) 140 CLR 330.

<sup>441</sup> For a discussion of this case, see infra text accompanying notes 459-460.

Dissatisfied with section 260, the Australian government introduced a new rule, Part IV A of the Income Tax Assessment Act, effective in 1981.<sup>442</sup> Part IV A provides that courts must determine the objective of a tax avoidance scheme. The legislation provides that Part IV A will apply if the taxpayer obtains a tax benefit in connection with a scheme, the sole or “dominant” purpose of which is to obtain the tax benefit. In making this determination, the statute lists certain factors to be taken into account, including the manner in which the scheme was entered into or carried out, the form and substance of the scheme, the time at which the scheme was entered into and the length of the period during which the scheme was carried out, and the tax result that would be achieved by the scheme (absent application of Part IV A). If such motive is determined to exist, then the government may recast the tax effects of a transaction. Part IV A may be applied even where specific anti-avoidance provisions apply.<sup>443</sup>

In FCofT v. Spotless Services Ltd,<sup>444</sup> the Australian High Court considered Part IV A in relation to a scheme which involved earning interest in a favorable foreign low-tax jurisdiction at a rate that was lower than the comparable interest rate obtainable in Australia. Because the interest was claimed to be exempt from Australian taxation, this nevertheless resulted in a higher post-tax return than the income would have earned if deposited in Australia. The taxpayer argued that it was simply trying to maximize its post-tax return, which was a business motive rather than a tax avoidance motive. The lower courts agreed. However, the High Court handed the government a significant victory, holding that:

A person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.<sup>445</sup>

The High Court also confirmed that the formalistic standards under Duke of Westminster have no relevance in applying Part IV A.

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<sup>442</sup> After Part IV A was introduced, in cases on the former section 260, the Australian courts significantly limited the apparent scope of the “choice doctrine” and so expanded the potential effect of the former section. See, e.g., FCofT v. Gulland, Watson v. FCofT, Pincus v. FCofT (1985) 160 CLR 55 (consolidated cases).

<sup>443</sup> Sections 177A-177G, Income Tax Assessment Act 1936.

<sup>444</sup> (1996) 96 ATC 4663.

<sup>445</sup> Id. Judgment of Brennan CJ, Dawson, Toohey, Gaudron, Gummow and Kirby JJ.



However, even despite the greater apparent efficacy of Part IV A, the Australian government still believes that improvements can be made. As part of its current tax reform project, it has announced:

The Government will modernize the general anti-avoidance rules to ensure that they deal with existing and emerging risks. They will be broadened to include avoidance schemes involving the use of rebates, credits and losses.<sup>446</sup>

b. *Canada.* A recent example of a common law country introducing a GAAR for the first time is Canada. In 1988, Canada enacted a GAAR, in response to increasingly aggressive planning and the perceived unwillingness of Canadian courts to expand common law doctrines.<sup>447</sup>

The GAAR was first proposed in 1987. A white paper was issued, and a period of consultation followed during which the tax bar almost unanimously opposed the proposed provision.<sup>448</sup> Despite these objections, the Canadian Government moved forward with the proposal. Several changes were made, however, to reflect some of the comments that had been received. As passed (in section 245 of the Income Tax Act), the GAAR provides that tax benefits from a transaction may be denied “unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.” In order to provide “greater certainty,” however, the GAAR “does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.”<sup>449</sup>

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<sup>446</sup> Gov’t of Austl., Tax Reform: Not a New Tax, a New System 150 (1998). See also, e.g., Taxation Laws Amendment Act (No. 3) 1998, which introduced a new general anti-avoidance provision into Part IV A to target franking credit trading and dividend streaming schemes where one of the purposes of the scheme (other than an incidental purpose) is to obtain a franking credit benefit.

<sup>447</sup> See Brian Arnold & James Wilson, The General Anti-Avoidance Rule -- Part 1, 36 Can. Tax J. 829 (1988). See also Stuart Investments Ltd. v. The Queen [1984] CTC 294 (SCC). Other commentators, however, disagree. They argue that the Courts were going in the right direction, but the problem was lax enforcement. See, e.g., David Ward, Tax Avoidance: Judicial and Legislative Approaches in Other Jurisdictions, in Report of Proceedings of the 40th Tax Conf. (Can. Tax Found. 1989).

<sup>448</sup> Brian Arnold, The Canadian General Anti-Avoidance Rule, [1995] Brit. Tax Rev. 541.

<sup>449</sup> Section 245 Income Tax Act, RSC 1952, c. 148. The Canadian Department of Finance explained:

When the Act came into force, Revenue Canada issued several pieces of public guidance identifying how it would act in specific circumstances.<sup>450</sup> Revenue Canada also announced that it would issue advance rulings on the application of the GAAR which would be made available to the public. Furthermore, Revenue Canada announced that: “In order to ensure that the rule is applied in a consistent manner, proposed assessments involving the rule will be reviewed by Revenue Canada, Taxation Head Office.”<sup>451</sup>

This review function is fulfilled by the so-called “GAAR Committee” which is a formal interdepartmental committee comprised of senior officials from various offices of Revenue Canada as well as the Departments of Finance and Justice. It first met in 1992 when the audit of 1989 returns commenced. The GAAR Committee considers both the appropriate assertion of the GAAR in audit cases as well as its interpretation in advance rulings.<sup>452</sup> While criticized for not releasing its deliberations to the public,<sup>453</sup> the GAAR Committee has recommended that the GAAR not be applied in one-third of the cases sent to it by the rulings division and by district offices in relation to income tax audits.<sup>454</sup> Revenue Canada is attempting to streamline the process

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New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

Canadian Department of Finance, Explanatory Notes to Legislation Relating to Income Tax (1988).

<sup>450</sup> See, e.g., IC88-2, General Anti-Avoidance Rule (October 21, 1988).

<sup>451</sup> Id. at ¶ 2.

<sup>452</sup> 1998 Report of the Auditor General of Canada, Chapter 5. According to the report (at 5.29), the Committee meets weekly to review GAAR audit and advance ruling issues.

<sup>453</sup> Arthur Drache, Seven-Year-Old Law Still a Puzzle, Sec. 2, p. 30, The Financial Post (June 18, 1996). See also 1996 Report of the Auditor General of Canada, Ch. 11, at 11.40-11.41 (Auditor General suggested that Revenue Canada’s local offices were equally in the dark as to the GAAR Committee’s reasoning).

<sup>454</sup> By late 1998, 300 audit-generated cases had been referred to the GAAR Committee. The Committee determined that the GAAR did not apply in 100 cases. Application of the GAAR was recommended in 200 cases. Among the 200, 130 were reassessed and 45 subsequently

by identifying frequently-arising issues which local Revenue Canada officials would then be given authority to reassess without a referral to the GAAR Committee.<sup>455</sup>

Despite dire predictions from the tax bar, the GAAR appears not to have dramatically altered tax administration in Canada. Revenue Canada has, however, now brought a number of successful cases under the GAAR, and it seems clear that in a number of instances the courts would not have reached decisions favorable to the government, absent the GAAR.<sup>456</sup> Some commentators have suggested that the GAAR has led to new forms of statutory interpretation of tax laws. No longer is literalism or textualism ( *i.e.*, interpreting the provision in the context of the whole statute) being applied, so much as a purposive inquiry as to the intent of parliament.<sup>457</sup> More cases will need to be decided, however, before judicial treatment of the GAAR can be fully assessed.

c. *United Kingdom.* While the United Kingdom has never adopted a GAAR with respect to its income tax, general anti-abuse rules have been employed, at various times, in relation to certain specific types of tax ( *e.g.*, the excess profits tax). In applying these broad provisions, the courts have liberally exercised their powers to approve recasts of transactions by the Inland Revenue.<sup>458</sup> Absent such provisions, however, English courts have traditionally narrowly interpreted the tax law, looking to discern the plain meaning of the statute and then determining whether the form of the transaction comports with the language of the statute. In the leading case, *IRC v. Duke of Westminster*, Lord Russell of Killowen stated his “disfavour” for the notion that a court may recast a transaction in accordance with its substance:

I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it considers the substance of the transaction, the Court thinks that the case falls within the contemplation or spirit

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settled. Only 21 were taken to court, and 6 of those were subsequently withdrawn. Vivien Morgan, *Revenue Canada and Finance Round Table, 1998 Annual Tax Conference* (Special Report) Canadian Tax Highlights (Nov. 17, 1998).

<sup>455</sup> Robert Couzin, *Business Operations In Canada*, A-76(1) (1997-98).

<sup>456</sup> See generally Brian Arnold, *Revenue Canada: 2, Taxpayer: 0, Regarding GAAR*, 14 Tax Notes International 1427 (May 5, 1997).

<sup>457</sup> John Owen, *Statutory Interpretation and the General Anti-Avoidance Rule: A Practitioner's Perspective*, 46 Can. Tax J. 233, 266-73 (1998).

<sup>458</sup> See, Colin Masters, *Is There a Need for General Anti-Avoidance Legislation in the United Kingdom?*, [1996] Brit. Tax Rev. 647.

of the statute. The subject is not taxable by inference or by analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case. . . . If [this] doctrine means that you may brush aside deeds, disregard the legal rights and liabilities arising under a contract between parties, and decide the question of taxability or non-taxability upon the footing of the rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine.<sup>459</sup>

Lord Tomlin, further stated, in terms reminiscent of Judge Learned Hand, in Gregory:

Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow tax-payers may be of his ingenuity, he cannot be compelled to pay an increased tax.<sup>460</sup>

English Courts have also generally been unwilling to consider questions of motive. In Bradford v. Pickles, Lord Halsbury stated that:

If it was a lawful act, however ill the motive might be, he had a right to do it. If it was an unlawful act, however good his motive might be, he would have no right to do it.<sup>461</sup>

In recent years, English courts have, on occasion, proved more willing to expand judicial anti-avoidance doctrines without specific statutory endorsement. For example, the House of Lords in cases in the 1980s such as Furniss v. Dawson<sup>462</sup> (step transaction applied, and transaction

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<sup>459</sup> Commissioners of Inland Revenue v. Duke of Westminster, [1936] AC 1 (HL) (19 Tax Cases at 524).

<sup>460</sup> Id. at 19 Tax Cases 520.

<sup>461</sup> Bradford Corporation v. Pickles, [1895] AC 587 at 594 (HL).

<sup>462</sup> [1984] STC 153 (HL).

recast) and in the 1990s in McGuckian v. CIR<sup>463</sup> (“purposive” approach taken to statute) have broken what has been widely perceived as new ground. These cases move away from the Westminster doctrine towards an approach that pays more attention to the intent of the statute and the substance of the transaction than to the formalistic mechanics that were employed.<sup>464</sup>

Despite these cases (or perhaps because of them), the U.K. has initiated consideration of a GAAR. One factor which has influenced the government’s decision was a report by the Tax Law Review Committee in 1997 which concluded that “innovative judicial anti-avoidance techniques” are unsatisfactory, for two main reasons.<sup>465</sup> First, judicial anti-avoidance doctrines give rise to considerable taxpayer uncertainty (more so than even a general statutory anti-abuse rule). Second, such a doctrine operates retrospectively, as courts are declaring what the law has always been (rather than only applying prospectively as a statute, or regulatory guidance might), yet offers no clear framework within which it will operate or not. The Committee, therefore, concluded:

We consider that tax avoidance should be countered principally by legislation rather than by the further development of the current judicial anti-avoidance doctrine. A statutory rule can attempt to make good some of the limitations inherent in a judicial rule and provide a proper framework for the application of a general anti-avoidance rule.<sup>466</sup>

Practitioners and others have raised serious concerns about the introduction of a GAAR.<sup>467</sup> According to recent reports, it appears, following the 1999 budget, that the U.K. government does not intend to introduce a GAAR immediately. However, the government did not foreclose the possibility of doing so in the future.<sup>468</sup>

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<sup>463</sup> [1997] STC 888 (HL).

<sup>464</sup> This is not to say that there have not been setbacks for the Inland Revenue. Craven v. White, [1988] STC 476 (HL), for example, was regarded as a paring back of the principle of Furniss v. Dawson, as was Fitzwilliam v. IRC [1993] STC 502 (HL).

<sup>465</sup> Tax L. Rev. Comm., Tax Avoidance, xi-xii and 31-32, (1997, Inst. for Fiscal Affairs).

<sup>466</sup> Id. at xii.

<sup>467</sup> See, e.g., Peter Wyman, U.K. Proposed GAAR May Be Counterproductive, 17 Tax Notes Int. 1160 (Oct. 19, 1998); Adam Blakemore, U.K. Tax Institute Highlights GAAR’s Hidden Dangers, 17 Tax Notes Int. 1891 (Dec. 14, 1998).

<sup>468</sup> George Hardy, U.K. Chancellor Releases 1999 Budget, 18 Tax Notes Int. 1019 (Mar. 15, 1999).

## 2. Civil Law Jurisdictions.

A number of civil law jurisdictions have enacted GAARs in their civil codes; in other cases GAARs have been judicially constructed based upon the civil law doctrines of “abuse of rights” and *fraus legis* (“fraud on the law”).

a. *Germany.* In Germany, the Civil Code reflects the abuse of rights doctrine in a number of places and the Tax Code in particular provides:

The tax law cannot be circumvented through the abuse of structures available under the law. If such abuse occurs, tax will be due as if a legal structure had been used which is appropriate to the economic substance of the transaction.<sup>469</sup>

According to one commentator, four factors are necessary for the application of this provision. First, there is an attempt to circumvent the law by transactions that may not conflict with the literal language of the statute, but which do conflict with its purpose. Second, there is an abuse of the legal arrangements in that there are either (a) no economic or other significant reasons which would justify the legal arrangement adopted by the taxpayer, or (b) the legal arrangement used by the taxpayer is inappropriate given the economic purposes it claims to seek to achieve in the transaction. Third, the purpose is to save or avoid tax. Fourth, there is an intent to circumvent the tax laws.<sup>470</sup>

The tax authorities bear the burden of proving circumvention of the tax law under section 42. While the use of an unusual legal structure is not, as such, inappropriate, an objectively verifiable economic or other reason must exist to justify the use of such a structure. The choice of such a structure may be considered to be an indication of an intent to circumvent the law, and the Federal Tax Court has held that a presumption of circumvention exists if the taxpayer cannot show objectively verifiable economic or other reasons for use of the structure. Moreover, the Federal Tax Court has also held that a presumption of intent to circumvent the law exists where a taxpayer uses a structure that has repeatedly been held to be abusive or that has generally been held to establish intent to circumvent the law.<sup>471</sup>

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<sup>469</sup> Gen. Tax Code, § 42.

<sup>470</sup> Jorg-Dietrich Kramer, Abuse of Law by Tax Saving Devices, 2 Intertax 100 (Feb. 1991).

<sup>471</sup> Various categories of suspect structures have emerged in practice, including sales of shell corporations with expiring tax attributes, formation of offshore base or holding companies, interposition of certain partnership holding structures, agreements between family members or spouses, and arrangements for acceleration of expenses or deferral of income.

The German government has not always been successful in its attempt to apply section 42. For example, in one notable case decided in 1992, the Federal Tax Court held as insupportable in law, a Ministry of Finance decree based on section 42 which sought to restrict thin capitalization.<sup>472</sup>

b. *France.* France has a provision in the Book of Fiscal Procedures, Article L64, which provides that the tax authority is empowered to disregard certain transactions:

Acts which dissimulate the true nature of a contract or of an agreement under the appearance of provisions giving rise to (a) lower registration duties or (b) disguising either a realization or a transfer of profits or income or (c) permitting the avoidance, either in whole or in part, of payment of turnover taxes on the transactions carried out pursuant to the contract or agreement, are not valid against the tax authorities . . . .<sup>473</sup>

Taxpayers may request an advance ruling that Art. L64 does not apply. It is understood that this process is rarely used because as a technical matter the ruling only protects the taxpayer against assertion of abuse of law. It is not a ruling on the tax treatment of the transaction as such. A taxpayer will be protected against assertion of abuse of law if it acts in reliance either upon a favorable ruling, or upon the absence of a reply within six months of requesting a ruling.<sup>474</sup>

A taxpayer who receives an assessment which invokes Art. L64 may ask for the matter to be referred to a special Committee that considers the application of the anti-abuse rule ( i.e., a GAAR Committee). Once the Committee has rendered its decision, the burden of proof is on the party that the Committee held against. If no referral is made to the Committee, then the burden of proof in any court case is on the government.<sup>475</sup>

It appears that the Courts have interpreted this provision fairly narrowly. The courts have consistently held that Art. L64 may only be successfully invoked in two situations. Either the transaction is simply fictitious ( e.g., a sham), or the transaction is entered into exclusively with the

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<sup>472</sup> David Ward, Abuse of Tax Treaties, 397 at 408 (in Herbert Alpert and Kees van Raad, eds, Essays on International Taxation: To Sidney I. Roberts, 1993).

<sup>473</sup> Book of Fiscal Procedures, Art. L64.

<sup>474</sup> Daniel Sandler and Ephraim Fuks, eds., The International Guide to Advance Rulings, France-17 (IBFD 1997).

<sup>475</sup> Claude Gambier and Jean-Yves Mercier, Taxes in France 163-4 (1990).

motive to reduce, in whole or in part, the tax liability that the taxpayer would normally have had to pay having regard to his “actual situation and activity” if the acts had not been carried out.<sup>476</sup> The government has, thus, met with only mixed success.

### C. IMPROVING THE EXISTING “TARGETED RESPONSE” SYSTEM

Traditionally, the Treasury Department has responded to specific corporate tax shelters by proposing specific and targeted changes in the Code or regulations. For example, in response to the liquidating REIT shelter, the Treasury Department worked with the tax-writing staffs of Congress to develop legislation that eliminates the tax benefits of the transaction. Similarly, in response to the lease stripping tax shelters and the fast-pay preferred tax shelters, the IRS and Treasury Department initiated regulatory projects that recharacterized the transactions in a way that eliminated the purported tax benefits of the transactions. The Treasury Department can, and should, continue to address tax shelters and tax-motivated transactions by proposing these types of statutory and regulatory changes.

The Treasury Department can also take a number of steps to increase the effectiveness of these responses. First, the Treasury Department’s Office of Tax Policy and the IRS National Office can allocate additional employee time and other resources to detecting and responding to tax-shelter activity. Second, the Treasury Department and IRS could use retroactive forms of guidance more frequently.

This second point -- retroactive guidance -- deserves some elaboration. Legislative and regulatory responses by their very nature are generally prospective. When changing the rules, Congress (in the case of legislation) and the Treasury Department (in the case of regulations) generally make the changes prospective so that they do not inappropriately affect transactions that were entered into in reliance on the existing state of the law. In fact, in 1996, Congress generally limited the ability of the Treasury Department to issue regulations having retroactive effect in the Taxpayer Bill of Rights (“TBOR”) 2.<sup>477</sup> Section 1101 of TBOR 2 amended section 7805(b) of the Code to provide that temporary and proposed regulations must have an effective date no earlier than the date of publication in the Federal Register or the date on which any notice substantially describing the expected contents of the regulation is issued to the public.<sup>478</sup>

This limitation on the application of regulations retroactively (hereafter “retroactive regulations”) is subject to certain exceptions. Regulations filed or issued within 18 months of the

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<sup>476</sup> Id. at 163.

<sup>477</sup> Pub. L. No. 104-168, 110 Stat. 1452, 1468, § 1101. See Jt. Comm. on Tax’n, General Explanation of Tax Legislation Enacted in the 104th Congress, at 44 (1996) (“The Congress believed that it is generally inappropriate for Treasury to issue retroactive regulations.”).

<sup>478</sup> I.R.C. § 7805(b)(1).



enactment of the statutory provision to which the regulation relates, for example, are not subject to the limitation.<sup>479</sup> Similarly, the limitation does not apply to regulations promulgated to “prevent abuse.”<sup>480</sup> Although the Treasury Department has not yet exercised this grant of authority, the Treasury Department could do so in the future. A corporate tax shelter -- a transaction specifically designed to exploit a provision of the law in unintended ways -- is the quintessential example of a situation where retroactive regulations may be considered.

The ability to issue retroactive regulations is a significant tool the Treasury Department can use to address corporate tax shelters. Unlike the traditional approach of applying regulations on a prospective basis (hereafter “prospective regulations”), retroactive regulations effectively discourage the creation and implementation of new shelters. While generally effective at preventing the expansion of known shelters to new participants, prospective regulations do not discourage the creation and implementation of new shelters because, as noted in Part V, they encourage tax shelter promoters and participants to “rush to market” the latest abuses in order to avoid application of the prospective fix. Retroactive regulations do not suffer from this “rush to market” phenomenon. Of course, retroactive regulations suffer from a drawback not present in prospective regulations: they create uncertainty as to the ability of taxpayers to rely on existing law. This uncertainty, however, is limited to cases of abuse. As Congress recognized when it enacted section 7805(b)(3), the reliance interests of taxpayers engaging in abusive transactions is outweighed by the interests of the Treasury Department in preventing abusive transactions.

Finally, Congress and the Treasury Department could significantly curtail the “rush-to-market” attitude of many corporate tax shelter market participants by changing the way pre-effective date transactions are “grandfathered.” Traditionally, targeted legislative and regulatory responses to corporate tax shelters have “grandfathered” transactions that were entered into prior to the effective date of the statute or regulation. Reportedly, this has led to a rush to market in cases where the tax shelter community has become aware of planned legislative or regulatory action.<sup>481</sup> More recently, the Treasury Department has grandfathered only the portion of the transaction occurring before the effective date.<sup>482</sup> This approach, if applied consistently to targeted legislative and regulatory response should limit the economic incentive to enter into a transaction before the guidance is issued.

#### D. PROCEDURAL CHANGES

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<sup>479</sup> I.R.C. § 7805(b)(2).

<sup>480</sup> I.R.C. § 7805(b)(3).

<sup>481</sup> Anita Baghavan, Wall Street Concocts New Tax-Saving Play; Then It’s Fed’s Turn, Wall St. J., Nov. 6, 1997, at A1.

<sup>482</sup> Notice 97-21, 1997-1 C.B. 407.

## 1. Introduction

Apart from changes to the substantive tax law, deterrence of corporate tax shelters can be accomplished by proactive discouragement of the activity that generates such transaction or by enforcement mechanisms that raise the cost of such activity. These are not independent approaches. Enforcement mechanisms not only can raise the cost of a transaction; when effective they should deter its initiation. There are a number of practice guidelines, ethical rules and civil tax penalties that together or separately can operate to deter corporate tax shelters. Certain of these mechanisms were adopted or strengthened in the 1980s to deter the tax shelter activity then occurring. Some have been further modified in response to corporate tax shelter activity in the 1990s. In addition, new tax shelter registration requirements were recently enacted to deter the use of conditions of confidentiality and potentially to provide an additional tool of detection. Recently, the IRS also has achieved success in a few well-publicized litigations of corporate tax shelter transactions. Notwithstanding the foregoing, it is not apparent that corporate tax shelter activity has diminished to the point that it has ceased to impose an unacceptable drain on tax revenues or to foster the negative impression among taxpayers at large that corporate taxpayers are able through adroit use of the Code and well-paid advisors to avoid paying their fair share of taxes.

## 2. Additional Potential Responses

To successfully attack the problem of corporate tax avoidance transactions may require, as it did in the 1980s, a multi-prong approach dedicated to detection and penalization of such transactions. The following are a list of potential actions:

### a. *Standards of practice.*

1. Modify Circular 230 to expand the tax shelter opinion standard to include the types of corporate tax shelters currently being marketed, and to make clear that the opinion standards apply whether or not the shelter is marketed to the public.
2. Modify Circular 230 to expand the definition of practice to include tax advice on corporate tax shelters, whether or not reflected in a written opinion.
3. Modify Circular 230 to eliminate contingency fee arrangements and confidentiality arrangements with respect to tax shelters.
4. Institute policy similar to 1985 policy statement regarding referrals and enforcement of practice standards relating to tax shelters.
5. Encourage ABA and AICPA to consider whether additional guidelines should be issued with respect to corporate tax shelter advice.

6. Tighten the "more likely than not" standard for opinion letters to a "should" standard.

b. *Penalties.* In addition to the suggested changes to the section 6662 penalty and the section 6664 reasonable cause exception as described in Part V, consideration should be given to the following actions.

1. Modify the section 6701 aiding and abetting penalty to impose a lesser penalty for negligent aiding and abetting an understatement of tax liability. Consider a penalty based on amount of understatement rather than a monetary amount.

2. Modify the section 6700 promoter penalty to include making or furnishing a statement in connection with the organization or sale of a plan or arrangement that the promoter knows, or has reason to know, would be false, fraudulent, or misleading as to any material matter. Modify penalties such that false or fraudulent statements are penalized by loss of the greater of \$1,000 or 100 percent of the gross income derived (or to be derived) from such activity, with a reduced percentage for misleading statements.

3. Modify section 7408 injunction action to be limited to knowing aiding or abetting under section 6701 promoter penalty but to encompass misleading statements under section 6700 promoter penalty.

c. *Enforcement*

1. Create IRS task force dedicated to corporate tax shelter audits with appropriate training to assist revenue agents in identifying and analyzing corporate tax avoidance transactions. Coordinate audits with registration information filed pursuant to section 6111 to identify transactions and promoters.

2. Consider development of IRS trial teams dedicated to litigation of corporate tax shelters. Coordinate through IRS National Office selection of cases for litigation. Develop informational data base for use in audit and litigation of promoters.

3. Use summons authority aggressively to obtain lists of potential investors to whom tax avoidance transactions are promoted or marketed.

4. Assert penalties where appropriate and make referrals to the Director of Practice where appropriate.

5. Use section 7408 injunctive action where appropriate.

6. Consider legislation that addresses statute of limitations issues with respect to corporate tax shelters established in TEFRA partnerships.

7. Consider legislation that would extend section 7623-like rewards to corporate tax shelter informants.

## APPENDIX A-- DESCRIPTION OF SELECTED CORPORATE TAX SHELTERS<sup>483</sup>

### CONTINGENT INSTALLMENT SALE NOTE (ACM-TYPE) TRANSACTIONS: GENERATION OF A TAX BENEFIT THROUGH OVER-ALLOCATION OF TAXABLE INCOME TO TAX-INDIFFERENT PARTIES

#### Summary

The contingent installment note (CINS) transaction was designed to allow U.S. corporate taxpayers, through use of a tax-indifferent party, to have a high and overstated basis in a relatively liquid asset. When the U.S. corporate taxpayer sells the asset, a tax loss is generated that can be used to shelter other, unrelated income from tax. In particular, the transaction is designed to overallocate taxable income to a tax-indifferent participant in the transaction, resulting in a corresponding underallocation of taxable income to the U.S. corporate taxpayer.

The IRS successfully challenged the CINS transactions in court. In ACM Partnership v. Commissioner,<sup>484</sup> the tax benefits of the transaction were denied on economic substance grounds. In ASA Investering Partnership v. Commissioner,<sup>485</sup> the court recharacterized the transaction in a manner that eliminated the intended tax benefits of the transaction.

#### Detailed discussion

The CINS transaction exploits a mechanical provision in the contingent installment sale rules that accelerates taxable income. In the basic transaction, a U.S. taxpayer, a tax-indifferent party, and a promoter create a partnership. The partnership acquires privately-offered notes and, shortly thereafter, exchanges the notes for cash and contingent notes in a transaction designed to qualify as a contingent installment sale. Because the contingent installment sale rules limit the amount of basis that can be allocated to the first year of the sale, the cash consideration received in the first year produces significant amounts of gain in that year. (The parties, of course, expect that this gain will be “reversed” by losses in the later years.) Most of this gain is allocated to the tax-indifferent partner. Shortly after the gain has been allocated, the tax-indifferent partner is redeemed out of the partnership, leaving the U.S. taxpayer (and the promoter) to benefit from the expected losses in the later years.

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<sup>483</sup> The descriptions in this Appendix are for illustrative purposes only. No inference is intended regarding the proper tax treatment under present or prior law with respect to any transaction described herein.

<sup>484</sup> 73 T.C.M. (CCH) 2189 (1997), aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999).

<sup>485</sup> 76 T.C.M. (CCH) 325 (1998).

The following hypothetical transaction illustrates the intended tax benefits of the transaction: A tax-indifferent person, a U.S. taxpayer, and a promoter form a partnership. They contribute \$800, \$190, and \$10, respectively, for 80 percent, 19 percent, and 1 percent interests in the partnership. The partnership uses its \$1,000 to purchase privately-placed notes. Within days of the purchase, the partnership exchanges the notes for \$800 cash and \$200 worth of contingent notes. The contingent notes have a six-year term and provide for annual payments equal to LIBOR multiplied by a notional amount. Because the fair market value of the consideration received for the notes (\$800 + \$200) is equal to the price paid for the notes (\$1,000), the partnership has no economic gain from the transaction.

For tax purposes, however, the contingent installment sale creates gain in the first year. Under these rules, the partnership is required to allocate its \$1,000 basis pro-rata over the six-year term of the contingent notes. Thus, the partnership must allocate \$167 of basis to each of the six years. This flat allocation of basis results in significant gain in the first year. At a minimum, the gain in the first year will be \$633 (\$800 amount realized in cash less \$167 basis). (The amount of gain recognized in the first year will be higher to the extent a contingent payment is received.) This first-year gain is allocated in accordance with the partner's respective interests in the partnership; that is, 80 percent to the tax-indifferent party, 19 percent to the U.S. taxpayer, and 1 percent to the promoter. At the end of the first year, the partnership uses the \$800 cash on hand to redeem the partnership interest of the tax-indifferent party. The partnership is then left with an asset, the contingent note, worth somewhat less than \$200 in which it has a basis of \$833 (\$1,000 - \$167). Because its basis is higher than its fair market value, this asset will generate losses over the remaining five years of the note.

Shortly after the IRS discovered the CINS transactions,<sup>486</sup> the IRS published Notice 90-56<sup>487</sup> indicating that the contingent installment sale regulations would be amended and that the transactions would be closely scrutinized under principles of existing law such as the economic substance doctrine. Ultimately, the IRS successfully challenged the CINS transactions in court. In ACM, the tax benefits of the transaction were denied on economic substance grounds. In ASA, the court recharacterized the transaction in a manner that eliminated the intended tax benefits of the transaction.

#### **LIQUIDATING REIT TRANSACTIONS: EXCLUSION OF ECONOMIC INCOME FROM TAXABLE INCOME THROUGH TAX LAW "GLITCHES"**

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<sup>486</sup> See ACM Partnership, 73 T.C.M. at 2115 ("ACM is one of 11 partnerships. . . formed over a 1-year period from 1989-1990 by the Swap Group at Merrill Lynch & Co. Inc."); see also Randall Smith, Collection Drive, Wall St. J., May 3, 1996, at A1 (stating that Merrill Lynch formed similar partnerships for several corporations in addition to Colgate).

<sup>487</sup> 1990-2 C.B. 344.

## Summary

In the basic liquidating REIT transaction, a corporation forms a captive real estate investment trust (REIT); contributes income-producing assets ( e.g., mortgages) to the REIT; and, shortly thereafter, adopts a two-year plan of liquidation for the REIT. Because of a glitch in the way the tax rules governing REITs interacted with the tax rules governing corporate liquidations, the corporate taxpayer purported to avoid tax on all income produced by the assets held by the REIT during the liquidation period.

In 1998, the Treasury Department and the tax-writing staffs of Congress worked together on legislation to correct the glitch giving rise to these transactions. That legislation was enacted as part of the Tax and Trade Relief and Extension Act of 1998 (the "1998 Trade Act") and is effective for liquidating distributions occurring after May 21, 1998.

The Treasury Department estimates that this transaction, had it not been legislatively addressed, would have reduced the corporate tax base by approximately \$34 billion over a ten-year period.

## Detailed discussion

The liquidating REIT transaction involved the use of a real estate investment trust (a "REIT") that was closely held (i.e., at least 80 percent owned) by a corporate shareholder. The transaction was intended to allow the REIT and the corporate shareholder to avoid all federal income tax on earnings accrued by the REIT during the liquidation period of the REIT.

In the basic transaction, a corporation formed a subsidiary corporation that elected to be taxed as a REIT in its first taxable year. The parent corporation owned all of the common stock of the REIT, which represented virtually all of the economic interest in the REIT. In order to meet the 100 or more shareholder requirement for REITs, the REIT issued shares of a separate class of non-voting preferred stock to 99 other "friendly" shareholders (generally employees of the corporation). Sometime soon after formation, the REIT adopted a plan of liquidation.

Although REITs are generally taxable as corporations, unlike most other corporations REITs can reduce or eliminate their taxable income by making dividend distributions and claiming a dividends paid deduction. These dividend distributions generally are included in the taxable income of the REIT shareholder.

The benefit to the corporate shareholder in the liquidating REIT transactions arose after the REIT adopted a plan of liquidation. Section 562(b)(1)(B) provides that, in the case of a complete liquidation that occurs within 24 months after the adoption of a plan of liquidation, any distribution during such period made pursuant to such plan will, to the extent of earnings and profits, be treated as a dividend for purposes of computing the dividends paid deduction. Prior to the 1998 Trade Act, even where a liquidating distribution qualified for the dividends paid deduction, section 332 generally provided that a corporation receiving property in a complete liquidation of an 80-percent-owned subsidiary would not recognize gain or loss as a result of the distribution.

By virtue of these rules, taxpayers argued that both the REIT and the corporate shareholder could avoid recognizing taxable income with respect to all of the distributed earnings of the REIT during the two-year period ending with the REIT's complete liquidation. Some taxpayers even timed the REIT distributions so that the REIT effectively paid out three years of earnings during the two-year liquidation period.

Many of the liquidating REIT transactions were engaged in by financial institutions. The mortgage loans held by these institutions were qualifying REIT assets, and the placement of the passive mortgage loans in a separate REIT entity did not create significant operating disruptions for the institutions.

The following hypothetical example illustrates the intended tax results from the liquidating REIT transaction: A bank transferred a significant portfolio of mortgage loans to a closely-held REIT on January 1, 1995. For the taxable year ending December 31, 1995, the REIT avoided the payment of any dividends prior to the end of the year. On December 31, 1995, the REIT adopted a plan of liquidation and paid out all of its earnings for 1995 (*i.e.*, interest on the mortgage loans) in a "liquidating" distribution. The REIT also distributed the interest income earned on the mortgage loans as dividends to the parent bank in 1996 and 1997, with the last distribution being made on December 30, 1997 (the last day of the two-year liquidation period). Under these facts, taxpayers took the position that the REIT was entitled to a dividends paid deduction for all liquidating distributions (which include the REIT's earnings for 1995, 1996, and 1997), and the corporate shareholder avoided recognition of income upon receipt of all liquidating distributions under section 332. The end result of the example is that the bank did not pay any corporate-level income tax on interest income earned with respect to its mortgage loans for the 1995-1997 taxable years.

It was determined that if taxpayers were allowed to continue engaging in this transaction, the cost to the Federal government in lost tax revenues would be approximately \$34 billion over a ten-year period. The Treasury Department and the tax-writing staffs for Congress worked together to draft a bill to stop these transactions, and the bill, which added new section 332(c) to the Code, eventually was enacted as part of the 1998 Trade Act. Section 332(c) provides that where a REIT (or a regulated investment company) claims a dividends paid deduction with respect to a liquidating distribution, the corporate parent must include the distribution in income as a dividend. The legislative history of 1998 Trade Act states that no inference was intended regarding the treatment of these transactions under prior law. The provision was effective for distributions after May 21, 1998.



## **SECTION 357(c) BASIS-SHIFT TRANSACTIONS: GENERATION OF A TAX BENEFIT THROUGH ARTIFICIAL BASIS CREATION AND TAX-INDIFFERENT PARTY**

### Summary

Section 357(c) basis-shift transactions purport to provide a tax benefit primarily by importing tax attributes into the U.S. tax system in a costless manner. In one form of the transaction, a foreign taxpayer transfers to a wholly-owned U.S. subsidiary an asset that partially secures a liability. Through an aggressive reading of section 357(c) of the Code, the U.S. subsidiary takes the position that its basis in the asset must be increased by the entire amount of the secured liability, not just the portion of the liability that relates to the asset. In effect, the U.S. subsidiary takes an overstated basis in the asset. This overstated basis can later be used to shelter income from tax.

Over the past two years, the Treasury Department and the tax-writing staffs of Congress have worked on legislation that would deny the purported tax benefits of these transactions. This legislation was enacted as part of H.R. 435 on June 25, 1999, effective for transfers on or after October 19, 1998.

### Detailed discussion

In general, if a shareholder transfers an asset to a corporation and the shareholder's basis in the asset is less than the amount of liabilities assumed by the corporation in the transaction, section 357(c) requires that the shareholder must recognize this difference as gain and that the corporation may step-up its basis in the asset by the amount of this gain. A similar rule applies where the corporation does not assume the liabilities but, instead, takes the asset "subject to" the liabilities.

The section 357(c) basis-shift transaction exploits an ambiguity in the application of section 357(c) to transactions in which multiple assets are secured by a single liability. In these cases, it is unclear how the liability should be allocated among the assets if some, but not all, of the assets are contributed to a corporation in a transaction to which section 357(c) applies. In these cases, a number of taxpayers have interpreted section 357(c) as applying to the full amount of the liability assumed or taken subject to, even though the liability secures additional assets that were not part of the transfer. In cases where the transferor is a tax-indifferent person (e.g., a tax-exempt corporation or foreign corporation) and the transferee is a U.S. corporation, this interpretation results in the transferee corporation taking an overstated basis in its assets without a corresponding tax being paid by the tax-indifferent party. This excess basis may be recovered through depreciation deductions or may create a tax loss on the sale of the asset.

For example, consider a foreign parent that has three U.S. subsidiaries and three zero-basis assets subject to a single \$100 liability. If the foreign parent separately transfers to each subsidiary one asset subject to the same liability, each subsidiary may take the position that it can step-up the basis of its asset by the full \$100 amount of the liability on the theory that each asset is transferred "subject to" the entire liability.

In both the FY 1999 and FY 2000 budgets, the Administration proposed amending section 357(c) to clearly address this type of transaction. During 1998 and 1999, the Treasury Department worked with the staffs of the tax-writing committees on this proposal. Chairman Archer and Chairman Roth introduced similar bills addressing these transactions and setting October 19, 1998, as the effective date. The provision was enacted on June 25, 1999, as part of H.R. 435.

## **FAST-PAY STOCK TRANSACTION: DEDUCTING BOTH PRINCIPAL AND INTEREST THROUGH THE USE OF TAX-INDIFFERENT PARTIES**

### Summary

The fast-pay stock transaction, also known as the step-down preferred transaction, was intended to allow a U.S. taxpayer to avoid tax on substantial amounts of economic income by using a conduit entity (typically a REIT) whose income tax treatment artificially allocates the conduit entity's income during a period of years to tax-indifferent participants. The effect was purportedly to allow the U.S. taxpayers to deduct both principal and interest.

In early 1997, the Treasury Department became aware of these transactions and on February 27, 1997, the IRS and the Treasury Department published a notice indicating their intent to publish regulations that would recharacterize the transaction in a manner that eliminated the tax benefit. On January 6, 1999, the IRS and the Treasury Department published proposed regulations recharacterizing the transactions, effective for tax years ending after February 26, 1997.

### Detailed discussion

In early 1997, the Treasury Department became aware of certain corporate tax shelter transactions involving so-called "fast-pay stock," sometimes referred to as "step-down preferred stock." These transactions were designed to artificially allocate taxable income to a tax-exempt party (such as a foreign bank) thereby allowing the U.S. corporate participant in the transactions to avoid tax.

In the basic fast-pay transaction, a U.S. corporate sponsor (the "sponsor") forms a closely-held REIT with accommodating tax-exempt investors (the "exempt participants"). The REIT issues common stock to the sponsor and fast-pay stock to the exempt participants. The fast-pay stock is structured to have an above-market dividend rate for a fixed period of time, after which the dividend rate "steps down" to a de minimis rate. In addition, after the step down, the arrangement generally gives the sponsor (or the REIT) the right to redeem the fast-pay stock for its then-fair market value, a small fraction of its issue price. As an economic matter, the fast-pay stock performs much like self-amortizing debt: To the exempt participants, the high periodic dividend payments represent in part distributions of income and in part returns of capital.

For federal income tax purposes, by contrast, the periodic dividend payments on the fast-pay stock were entirely distributions of income. This mischaracterization of the dividends (entirely as income when economically a portion represented a return of capital) effectively allowed the REIT to overallocate its taxable income to the exempt participants. This overallocation resulted in a corresponding underallocation to the taxable sponsor. If the sponsor eventually sold its interest in the REIT, the underallocation would allow the sponsor to defer its economic income from the transaction to the time of the sale and convert its character from ordinary to capital gain. If the sponsor liquidated

the REIT in a section 332 liquidation, the sponsor's economic income from the transaction would permanently escape tax.<sup>488</sup>

The following hypothetical example illustrates the intended tax benefits of the transaction: A U.S. corporation forms a REIT by contributing \$1,000 in exchange for substantially all of its common stock. At the same time, a tax-indifferent party contributes \$1,000 in exchange for fast-pay stock that has a stated dividend rate of 14 percent. The REIT invests its \$2,000 in a 10-year, 7 percent, balloon payment mortgage. The mortgage provides for 10 annual payments of \$140 (7 percent x \$2,000) and a single payment of its \$2,000 principal at the end of the ten year term. The fast-pay stock provides for annual dividend distributions of \$140 (14 percent x \$1,000) for ten years. After the initial 10-year period, the dividend rate on the fast-pay stock steps down to 1 percent per year. At that time, the REIT has the ability to redeem the fast-pay stock for its then-fair market value of \$100. If the fast-pay stock is redeemed, the U.S. corporation that owns the corporation can then liquidate the REIT in a section 332 liquidation.

The U.S. corporation expects that it will realize a predictable economic benefit over the anticipated 10-year term of the transaction without ever incurring any tax liability for that benefit. In particular, the U.S. corporation anticipates that the dividends-paid deduction on the fast-pay stock will eliminate the REIT's income for the initial 10-year period. Immediately after this period, the U.S. corporation anticipates that the fast-pay stock will be redeemed for \$100 and that the REIT will then be liquidated in a section 332 liquidation. Upon the liquidation, the U.S. corporation will succeed to the \$1,900 cash on hand (\$2,000 cash on hand less the \$100 payment to redeem the fast-pay stock) without incurring a tax. Thus, the U.S. taxpayer will have realized a \$900 economic benefit (\$1,900 amount received less \$1,000 initial investment) over the 10-year term of the transaction without ever incurring a tax on it.

In response to fast-pay transactions, the IRS and the Treasury Department published Notice 97-21 on February 27, 1997. The Notice described the transactions in detail, explained how the purported tax benefits of the transactions did not reflect their economic substance, and promised regulations under section 7701(l) (conduit regulatory authority) that would recharacterize these transactions in accordance with their economic substance. On January 6, 1999, the IRS and the Treasury Department published proposed regulations under section 7701(l). The proposed regulations treat the fast-pay stock as if the stock were a security issued by the sponsor, instead of the REIT. Consistent with this recharacterization, the regulations treat the fast-pay distributions as if they were made by the REIT to the sponsor and then by the sponsor to the exempt participants. This recharacterization ensures that the sponsor is taxed on its economic income from the transaction.

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<sup>488</sup> The liquidating REIT proposal, discussed supra in this Appendix A, would not have altered this permanent exclusion.

## **LEASE-IN, LEASE-OUT (LILO): CREATING TAX DEFERRAL THROUGH IMPROPER TAX ACCOUNTING AND THE USE OF TAX-INDIFFERENT PARTIES**

### Summary

In the basic LILO transaction, a U.S. corporation leases long-lived property, such as a building, from a tax-indifferent party and immediately subleases the property back to the same counterparty. By exploiting a glitch in the tax accounting treatment for prepaid rent, the U.S. taxpayer purports to generate significant net deductions in the early years of the transaction that will be reversed in the later years of the transaction. Although the U.S. taxpayer is taxed on the proper amount of economic income over the entire term of the transaction, the mismatch of deductions early and income late results in a significant tax benefit. The value of this deferral benefit is the excess of the present value of the tax saved (through the early-year deductions) over the present value of the tax owed (as a result of the later-year income inclusions).

Earlier this year, the IRS and the Treasury Department published a revenue ruling stating that such LILO transactions lack economic substance and therefore do not produce the intended tax benefits. As a statement of existing law, the revenue ruling applies to LILO transactions that were completed prior to its release. In addition, the IRS and the Treasury Department finalized regulations that alter the way taxpayers must account for prepaid rents on a going-forward basis. These regulations effectively eliminate the tax benefits that were at the heart of the LILO transaction for leases entered into after May 18, 1999.

### Detailed discussion

The LILO transaction is deliberately designed to exploit a tax rule that mischaracterizes prepaid rent to produce significant tax benefits with little or no real business risk. Very simply, the U.S. taxpayer purports to lease a long-lived asset owned by a foreign municipality (under a “Headlease”). As part of the same transaction, the U.S. taxpayer immediately leases back the asset to the foreign municipality (under a “Sublease”) and grants the foreign municipality a fixed-price option to terminate the arrangement at the end of the Sublease term. Thus, at all times, the foreign municipality maintains title and possession of the asset.

The tax benefits of the transaction come from the unusual payment structure on the Headlease. The Headlease calls for the U.S. taxpayer to prepay its rental obligations. This prepayment purportedly generates significant net deductions in the early years of the arrangement that will be economically offset by significant net income in the final year of the arrangement. The early net deductions can be used to shelter unrelated income of the U.S. taxpayer.

Although only the Headlease is prepaid, the non-tax economics of the transaction are minimized through the use of deposit arrangements that economically defease virtually all cash flows from the transaction. At the inception of the transaction, the foreign municipality uses the majority of the rent prepayment to fund deposit accounts that economically defease its obligations under the Sublease and the fixed-payment option. Having defeased its obligations, the foreign municipality keeps the balance of the Headlease prepayment as its “fee” for participating in the transaction.

Earlier this year, the IRS and the Treasury Department published Revenue Ruling 99-14 stating that such LILO transactions lack economic substance and therefore do not produce the intended tax benefits. In addition, the IRS and the Treasury Department finalized regulations that alter the way taxpayers must account for prepaid rents on a going-forward basis. These regulations effectively eliminate the tax benefits that were at the heart of the LILO transaction for leases entered into after May 18, 1999.

## **CORPORATE-OWNED LIFE INSURANCE AND BANK-OWNED LIFE INSURANCE: GENERATION OF A TAX BENEFIT THROUGH ARBITRAGE**

### Summary

The leveraged purchase of corporate-owned life insurance (COLI) provides a tax benefit through arbitrage. Basically, leveraged COLI exploits or “arbitrages” the fact that interest on debt is deductible as it accrues while “inside build-up” on cash-value life insurance (the investment returns credited to the policy each year) are not includible. This mismatch (current deduction for the expense; deferral or exemption for the income) creates a valuable tax benefit.

In 1996 and 1997, the Treasury Department and the tax-writing staffs of Congress worked together on legislation that limits the ability of corporate taxpayers to deduct interest on debt used to carry COLI. The 1996 legislation eliminated the tax benefit from leveraged purchases of COLI on large numbers of insured lives where the debt was directly traceable to the purchase of the life insurance. The 1997 legislation eliminated the tax benefit from leveraged purchases of COLI where the insured lives were not employees of the corporation, regardless of whether the debt was traceable to the purchase of the life insurance.

### Detailed discussion

**COLI** In a basic leveraged COLI transaction, a corporation purchases a number of cash value life insurance policies on lives of employees and uses borrowed funds to pay some or all of the premiums. Because the anticipated inside build-up on the policy is offset in whole or part by the interest expense on the borrowing, there is little net non-tax benefit to the corporation from the policy. In fact, the primary benefit to the corporation from the transaction is the tax benefit created by the timing mismatch -- current deduction for the interest expense, and deferral or exclusion for the inside build-up.

Although Congress moved to limit a corporation’s interest deduction for indebtedness that was incurred to purchase or carry COLI in 1986, this legislation only limited interest deductions on borrowings that exceeded \$50,000 per insured life. After 1986, corporations invested in smaller COLI contracts that were designed to fit under the \$50,000 cap. The insured persons under these policies included many or all of the corporations’ employees. Thus, corporations made up in volume (more individual contracts) what they lost in size (smaller values per contract).

In 1996, Congress limited a corporation’s interest deduction on all debt that could be directly traced to an investment in COLI, with a limited exception for \$50,000 of indebtedness with respect to up to 20 policies.

In 1997, the Treasury Department and Congress learned that some businesses planned to invest in cash value life insurance policies on the lives of their customers, and to use general business indebtedness rather than traceable indebtedness to finance these investments. Congress responded by disallowing interest deductions on non-traceable indebtedness allocable to investments in cash value life insurance, to the extent that the policies did not insure the lives of the business’ employees.

Congress imposed no corresponding limits on the indirect financing of premium investments in policies that named employees as the insureds. Congress also imposed no dollar limit on the amount of nontraceable indebtedness allocable to investments in cash value life insurance on the lives of employees. With these remaining loopholes, banks and other highly leveraged businesses continued to invest in indirectly leveraged cash value life insurance contracts on the lives of their employees, and sales of bank owned life insurance (“BOLI”) soared.

The Treasury Department and the IRS also responded to this particular corporate tax shelter through litigation and through proposed legislation. After 1996, the IRS issued a technical advice memoranda disallowing interest deductions claimed by corporations that invested in leveraged COLI plans. In 1997, the Treasury Department testified in support of the proposed legislation to disallow interest deductions on nontraceable indebtedness of a business that invested in cash value life insurance, which was later enacted. In 1998 and 1999, the Administration’s budget included a proposal to extend this prorata disallowance rule to investments in cash value life insurance on the lives of employees and officers, other than 20 percent or greater shareholders in the business.



**APPENDIX B--PROPOSALS IN THE ADMINISTRATION'S FY 2000 BUDGET  
RELATING TO CORPORATE TAX SHELTERS**

**MODIFY SUBSTANTIAL UNDERSTATEMENT PENALTY FOR  
CORPORATE TAX SHELTERS**

**Current Law**

The substantial understatement penalty imposes a 20 percent penalty on any substantial understatement of tax. The penalty was modified in 1994 and 1997 to more effectively deter aggressive corporate tax shelters. The 1994 modification eliminated, with respect to corporate taxpayers, the exception to the substantial understatement penalty regarding tax shelter items for which the taxpayer had substantial authority and reasonably believed that its treatment was more likely than not the proper treatment. Instead, the substantial understatement penalty applied unless the taxpayer could demonstrate reasonable cause and acted in good faith with respect to the portion of the underpayment attributable to the tax shelter item (section 6664(c)). The legislative history stated that a determination by the taxpayer or a professional tax advisor that the substantial authority and more likely than not standards were satisfied would be an important factor, but not enough by itself, to establish that the reasonable cause exception applied. It was the intent of the provision that the standards applicable to corporate shelters be tightened. In 1997, the statutory definition of a tax shelter was modified to eliminate the requirement that the tax shelter have as "the principal purpose" the avoidance or evasion of Federal income tax and required that the tax shelter have only as "a significant purpose" the avoidance or evasion of tax.

**Reason for Change**

Despite the heightened substantial understatement penalty for corporate tax shelters, there continue to be a significant number of abusive tax shelter transactions involving corporate taxpayers. The more narrow reasonable cause exception for corporate tax shelters does not appear to adequately deter such transactions. Accordingly, the standards applicable to corporate tax shelters should be tightened.

**Proposal**

The proposal would increase the penalty applicable to a substantial understatement by corporate taxpayers from 20 percent to 40 percent for any item attributable to a corporate tax shelter. The penalty would be reduced to 20 percent if the corporate taxpayer (1) discloses to the National Office of the Internal Revenue Service within 30 days of the closing of the tax shelter transaction appropriate documents describing the transaction, (2) files a statement with its tax return verifying that such disclosure has been made, and (3) provides adequate disclosure on its tax returns as to the book/tax differences resulting from the corporate tax shelter item for the taxable years in which the tax shelter transaction applies. The reasonable cause exception of section 6664(c) would be eliminated for any item attributable to a corporate tax shelter.

For this purpose, a corporate tax shelter would be any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code).

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

The Secretary may prescribe regulations necessary to carry out the purposes of this provision.

The proposal would be effective for transactions occurring on or after the date of first committee action.

## **DENY CERTAIN TAX BENEFITS TO PERSONS AVOIDING INCOME TAX AS A RESULT OF TAX AVOIDANCE TRANSACTIONS**

### **Current Law**

Under section 269, if a person acquires (directly or indirectly) control of a corporation, or a corporation acquires (directly or indirectly) carryover basis property of a corporation not controlled (directly or indirectly) by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance, the Secretary may disallow such tax benefit either in whole or in part to the extent necessary to eliminate such evasion or avoidance of income tax. For purposes of this rule, control means the ownership of 50 percent of the corporation's stock (by vote or value). The rule applies also in the case of a qualified stock purchase by one corporation of another corporation, in the event that the acquiring corporation does not elect to treat the stock purchase as an asset acquisition, and where the acquired corporation is liquidated pursuant to a plan of liquidation adopted not more than two years after the acquisition date, the principal purpose of which is to secure the benefit of a deduction, credit, or other allowance.

Tax benefits also can be disallowed when those benefits are generated in transactions that lack economic substance and undermine the purposes of the Code. Sheldon v. Comm'r, 94 T.C. 738 (1990). The Treasury Department has exercised its general regulatory authority to promulgate anti-avoidance rules in specific contexts, including rules incorporating business purpose and economic substance standards. See, e.g., Treas. Reg. section 1.701-2; Notice 98-5, 1998-3 I.R.B. 3.

### **Reasons for Change**

The Administration is concerned about the proliferation of corporate tax shelter activity that allows a direct or indirect corporate participant to obtain a tax benefit that the participant otherwise did not possess in a tax avoidance transaction. The current law anti-avoidance provision may not be sufficient to address many current corporate tax shelter schemes. First, the provision only applies to the acquisition of control of a corporation or the acquisition of carryover basis property. In addition, although tax evasion or avoidance might be the most significant factor motivating an acquisition or liquidation, it is difficult from an administrative standpoint to contest a taxpayer's assertion that the transaction had another more significant purpose.

Furthermore, some taxpayers take aggressive positions that they are entitled to a tax benefit even in circumstances in which there is little or no expected pre-tax economic profit from a structure. The proposal would clarify that tax benefits arising from tax avoidance transactions would be disallowed. The Administration proposes to expand the anti-avoidance provision to better address the types of transactions that the Administration believes are abusive.

### **Proposal**

The proposal would expand the scope of the anti-avoidance rule by adding a provision authorizing the Secretary to disallow a deduction, credit, exclusion or other allowance obtained in a tax

avoidance transaction. For purposes of this proposal, tax avoidance transaction would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. No inference is intended regarding the treatment of such transactions under current law.

The proposal would apply to transactions entered into on or after the date of first committee action.

## **DENY DEDUCTIONS FOR CERTAIN TAX ADVICE AND IMPOSE AN EXCISE TAX ON CERTAIN FEES RECEIVED**

### **Current Law**

Buyers of corporate tax shelter advice generally may deduct the fees paid for such advice as an ordinary and necessary business expense.

### **Reasons for Change**

The Administration has become increasingly concerned with the prevalence of corporate tax shelters and thus wants to impose impediments to the purchase, promotion and sale of corporate tax shelters. Further, the Administration does not believe that payments made for the purchase and implementation of corporate tax shelter schemes should be treated as ordinary and necessary business expenses.

### **Proposal**

The proposal would deny a deduction to the corporate participant in a tax avoidance transaction for fees paid or incurred in connection with the purchase and implementation of corporate tax shelters and the rendering of tax advice related to corporate tax shelters. The proposal also would impose a 25 percent excise tax on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to the underwriting or other fees) and the rendering of tax advice related to corporate tax shelters. This proposal would not apply to expenses incurred with respect to representing the taxpayer before the IRS or a court. If a taxpayer claims a deduction that otherwise would be denied under this proposal, the amount of deduction could be subject to the Administration's proposed new substantial understatement penalty. For purposes of this proposal, "corporate tax shelter" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty.

The proposal would be effective for fees paid or incurred, and fees received, on or after the date of first committee action.

## **IMPOSE EXCISE TAX ON CERTAIN RESCISSION PROVISIONS AND PROVISIONS GUARANTEEING TAX BENEFITS**

### **Current Law**

Because taxpayers entering into corporate tax shelter transactions know that such transactions are risky, particularly because the expected tax benefits are not justified economically, purchasers of corporate tax shelters often --

(1) require a rescission clause that requires the seller of the shelter or a counterparty to unwind the transaction and make the taxpayer whole financially if there is a change in or clarification of law that interferes with the successful completion of the transaction,

(2) require a guarantee of tax benefits necessitated not by a change or misstatement of the facts but by a change in or clarification of the law (to distinguish this from a normal representation and warranty clause), or

(3) enter into insurance arrangements with third parties to guarantee the tax benefits.

The tax treatment of payments under these arrangements depends upon the nature of the payments.

### **Reasons for Change**

The Administration has become increasingly concerned with the prevalence of corporate tax shelters and is concerned that provisions that insulate the purchaser from risk encourage participation in tax shelter activity. The Administration wants to impose impediments to the purchase, promotion and sale of corporate tax shelters by taking away the benefit of provisions that insulate the purchaser from risk.

### **Proposal**

The proposal would impose on the corporate purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment under a tax benefit protection arrangement at the time the arrangement is entered into. For this purpose, a tax benefit protection arrangement would include a rescission clause, guarantee of tax benefits arrangement or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction). The maximum payment under the arrangement would be the aggregate amount the taxpayer would receive if the tax benefits were denied. For example, if a taxpayer purchases for \$100 protection against the risk that the tax benefits derived from a transaction will not be realized and the agreement values the tax benefits at \$10,000, the taxpayer would be subject to an excise tax of \$2,500, even if it is later determined that only \$5,000 of the tax benefits from the transaction were denied. For purposes of this proposal, "corporate tax shelter" would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty.

The Secretary would have regulatory authority to provide that arrangements entered into in connection with specified transactions are not subject to the proposal.

The proposal would apply to arrangements entered into on or after the date of first committee action.

## **PRECLUDE TAXPAYERS FROM TAKING TAX POSITIONS INCONSISTENT WITH THE FORM OF THEIR TRANSACTIONS**

### **Current Law**

In general, if a taxpayer enters into a transaction in which the economic substance and legal form of the transaction are different (and, thus, provide for different Federal income tax consequences), the taxpayer may take the position that, notwithstanding the form of the transaction, the substance is controlling for determining the Federal income tax consequences of the transaction. To successfully assert that the substance, and not the form, of the transaction controls the Federal income tax consequences, taxpayers must meet a relatively high standard of proof. Depending on the jurisdiction in which the taxpayer resides, the taxpayer will be required to show that the substance of the transaction is indeed different from its form through either proof that would alter the construction of the agreement or render it unenforceable (the so-called "Danielson rule") or strong proof (something more than a preponderance of the evidence and something less than the Danielson rule). See, e.g., Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959); Danielson v. Commissioner, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); Illinois Power Co. v. Commissioner, 87 T.C. 1417 (1986).

Under section 385(c), an issuer's characterization of an interest in a corporation as debt or equity is binding on the issuer and all holders of such interests, unless the holder discloses that it is treating the interest in a manner inconsistent with the issuer's characterization. Under section 1060(a), if, in connection with an applicable asset acquisition, the transferor and transferee agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that the allocation (or fair market value) is not appropriate.

### **Reasons for Change**

Because a taxpayer has control over the form of its transactions, it is appropriate to impose restrictions on the taxpayer's ability to argue against the form it has chosen. In addition, many taxpayers enter into transactions in which the substance is different from the form in order to arbitrage U.S. and foreign tax and regulatory laws. In transactions involving a taxable and tax-indifferent party, the taxable party may believe it has even greater freedom to disavow the form of the transaction because such recharacterization would have no effect upon the tax-indifferent party.

### **Proposal**

The proposal would generally provide that a corporate taxpayer would be precluded from taking any position (on any return or refund claim) that the Federal income tax treatment of a transaction is different from that dictated by its form if a tax-indifferent party has a direct or indirect interest in such transaction. This rule would not apply (i) if the taxpayer discloses the inconsistent position on a timely filed original Federal income tax return for the taxable year that includes the date the transaction is entered into; (ii) to the extent provided in regulations, if reporting the substance of the transaction more clearly reflects the income of the taxpayer; or (iii) to certain transactions (such as



publicly available securities lending and sale-repurchase transactions) identified in regulations. For this purpose, the form of a transaction is to be determined based on all facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A tax-indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.) The Secretary would have the authority to prescribe regulations to carry out the purposes of the rule, including regulations that would define the “form” of a transaction. Nothing in the proposal would prevent the Secretary from asserting the substance-over-form doctrine or imposing any applicable penalties. No inference is intended as to what extent a corporate taxpayer may disavow the form of its transactions under current law.

The proposal would be effective for transactions entered into on or after the date of first committee action.

## **TAX INCOME FROM CORPORATE TAX SHELTERS INVOLVING TAX-INDIFFERENT PARTIES**

### **Current Law**

The Federal income tax system has many participants who are indifferent to tax consequences, e.g., foreign persons, tax-exempt organizations, and Native American tribal organizations. Foreign persons are subject to U.S. Federal income tax on a net basis on income that is effectively connected to a U.S. trade or business (ECI) and on a gross basis on income that is fixed or determinable annual or periodic (FDAP). Tax-exempt organizations (including pension plans and charitable organizations) are subject to Federal income tax only on income that is unrelated (UBTI) to the organization's exempt purpose.

### **Reasons for Change**

Many corporate tax shelters involve a timing mismatch or separation of income or gains from losses or deductions that is exploited through the use of tax-indifferent parties. In these transactions, the tax-indifferent party absorbs the income or gain generated in the transaction, leaving the corresponding loss or deductions to the taxable corporate participants. Tax-indifferent parties often agree to engage in such transaction in exchange for an enhanced return on investment or for an accommodation fee. Corporate taxpayers should not be entitled to buy the special tax status of tax-indifferent parties. Imposing a tax on the income allocated to tax-indifferent parties should limit the sale of their special tax status and, thus, their participation in corporate tax shelters.

### **Proposal**

The proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to such party. The tax on the income allocable to the tax-indifferent party would be determined without regard to any statutory, regulatory, or treaty exclusion or exception. All other participants of the corporate tax shelter ( *i.e.*, any participant other than the tax-indifferent party in question) would be jointly and severally liable for the tax. For this purpose, a corporate tax shelter would be defined in the same manner as that provided in the Administration's proposed new substantial understatement penalty. A tax-indifferent party would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with expiring loss or credit carryforwards. (For this purpose, loss and credit carryforwards would generally be treated as expiring if the carryforward is more than 3 years old.)

In the case of a tax-exempt organization, the income would be characterized as UBTI. In the case of a domestic corporation with expiring loss or credit carryovers, tax would be computed without regard to such losses or credits. In the case of a foreign person, tax on the income or gain allocable to such person would first be determined without regard to any exclusion or exception (provided in a treaty or otherwise) and any such income or gain that is not U.S. source FDAP would be treated as ECI, regardless of its source. If the foreign person properly claimed the benefit of a treaty, however, the tax otherwise owing by such person would be collected from the other participants who are not exempt from U.S. tax. Similarly, in the case of a Native American tribal organization, the tax

on the income allocable to such person would be determined without regard to any exclusion or exception; however, the tax would be collected only from the participants who are not exempt from U.S. tax, rather than the tribal organization.

The proposal would be effective for transactions entered into on or after the date of first committee action.

## APPENDIX C -- PROPOSED DEFINITION OF TAX AVOIDANCE TRANSACTION

The first step in designing rules to limit corporate tax shelters is defining what they are. Since the beginning of the income tax, Congress and the Treasury Department have struggled with defining tax avoidance. As discussed in Part IV, the Code, regulations, and case law are replete with provisions and doctrines designed to limit tax avoidance transactions.<sup>489</sup>

Similarly, the Administration's FY 2000 Budget would provide the Secretary of the Treasury the authority to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction.

A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction are insignificant relative to the reasonably expected net tax benefits (*i.e.*, tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision ( taking into account the congressional purpose for such provision and the interaction of such provision with other provisions of the Code).

The Administration's proposal to change substantive law to disallow tax benefits claimed with respect to a tax avoidance transaction would supplement current authority possessed by the Secretary in current-law sections 269, 446, 482 and 7701(l).

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<sup>489</sup> See generally Powlen & Tanden, *supra* note 29. In this article, the authors solicit readers to play the

*tax shelter challenge*: (1) Blindfold yourself; (2) Pick up a volume of the Code; (3) Randomly open it to any page; (4) Take off the blindfold; (5) Read the provision to which you have turned. We give you three chances to do this and challenge you to find *one* of the three provisions that was not enacted in part to prevent tax shelter activity *and* is not a provision enabling an existing tax shelter (*i.e.*, is not Section 42, which enables low income housing tax credit tax shelters).

*Id.* at 1024 (emphasis in original).

The recommended definition is derived from a number of sources, with the principal influence being the common law standard of economic substance. The definition resembles the test applied in Notice 98-5.<sup>490</sup> In both Notice 98-5 and the proposed definition, the subjective motives of the taxpayer are not taken into account. Rather, the motives of the taxpayer are analyzed objectively based on whether the taxpayer reasonably expects an economic profit from the transaction in question. This is also consistent with the application of the sham transaction doctrine.<sup>491</sup> In addition, like Notice 98-5, in determining the amount of reasonably expected profit generated in a transaction, all transaction costs, including foreign taxes, are taken into account. Treating foreign taxes as an expense for this purpose is rational and is consistent with the judicial doctrines that focus on determining whether there is any practical economic effects other than tax savings.<sup>492</sup> In tax avoidance transactions, the inquiry focuses on whether a transaction has any practical economic effects apart from taxes. Thus, the transaction's economic profit absent U.S. tax effects must be calculated, *i.e.*, the U.S. tax effects must be ignored. All other economic costs must be taken into account since those costs determine whether, as an economic matter, a transaction had a potential for economic profit.<sup>493</sup>

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<sup>490</sup> 1998-3 I.R.B. 49.

<sup>491</sup> As discussed in Part IV.B., although the sham transaction doctrine has typically involved an analysis of both subjective and objective factors, in applying the subjective test of the doctrine, greater weight is given to what the taxpayer actually (objectively) did rather than what the taxpayer claims to have actually intended.

<sup>492</sup> See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998) ("In assessing the economic substance of a taxpayer's transactions, the courts have examined 'whether the transaction has any practical economic effects other than the creation of tax losses.'"), cert. denied, 119 S.Ct. 1251 (1999); Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988) (The court's traditional sham analysis is "whether the transaction had any practical economic effects other than the creation of income tax losses"); Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989) ("The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses."). Courts have defined profit, for purposes of the primary profits test of section 183, as "economic profit, independent of tax savings." See, e.g., Campbell v. Commissioner, 868 F.2d 833, 836 (6th Cir. 1989) ("'profit' means economic profit independent of tax consequences"), non acq. 1993-1 C.B. 1; Surloff v. Commissioner, 81 T.C. 210, 233 (1983) ("'profit' means economic profit, independent of tax savings," citing Shapiro v. Commissioner, 40 T.C. 34 (1963)); see also Shapiro v. Commissioner, 40 T.C. 34, 39-40 (1963) ("the avoidance of taxes hardly qualifies as 'the production or collection of income' under the statute, either literally or by any implication that is supported by any relevant legislative history").

<sup>493</sup> See Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054, 1063-67 (1988) (ignoring investment tax credit but taking into account all economic outlays, including the 10% of taxpayer's cost on which the credit was based, for purposes of economic substance analysis). In the context of non-sham transactions, courts have recognized that foreign withholding taxes are a

The Treasury Department decided against adopting a "potential" for profits test. As discussed in Part IV.B., in connection with determining whether a transaction has sufficient substance, apart from tax consequences, to be respected for tax purposes, the economic substance of the transaction must be examined.<sup>494</sup> An evaluation of economic substance is an objective inquiry into the economics of the transaction. Most relevant for this purpose is whether the transaction presents the taxpayer with the potential for economic profit.<sup>495</sup> In the case of an activity engaged in by an individual or an subchapter S corporation, no deduction attributable to such activity is allowed (except to the extent provided in section 183) if the activity is not engaged in for profit.<sup>496</sup> In applying this profits test, Congress intended that the focus be on "whether the activity is engaged in for profit rather than whether it is carried on with a reasonable expectation of profit."<sup>497</sup> Treasury regulations under section 183 define the test as requiring the taxpayer to have an "objective of making a profit," not a reasonable expectation of profit.<sup>498</sup> In determining whether such an objective exists, the regulations provide that a small chance of making a large profit may be sufficient, even if the expectation of a profit may be

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cost that affects profit. Continental Illinois Corp. v. Commissioner, 998 F.2d 513, 516 (7th Cir. 1993) (changes in the amount of withholding tax on interest payments affect the lender's rate of return when the lender bears the foreign tax), cert. denied, 510 U.S. 1041 (1994); Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765, 769 (1987) (same).

<sup>494</sup> As explained in section B of Part IV, courts have applied a number of different tests in determining whether a transaction has economic substance, with the most prominent test being an inquiry into whether the transaction has any practical economic effects other than the creation of tax benefit.

<sup>495</sup> See Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89, 91 (5<sup>th</sup> Cir. 1985); Sochin v. Commissioner, 843 F.2d 351, 354 (9<sup>th</sup> Cir. 1988), cert. denied, 488 U.S. 824 (1988). If such profit is found, and is not de minimis, then the economic substance leg of the sham transaction could be satisfied. See Sheldon v. Commissioner, 94 T.C. 738, 768 (1990); Estate of Thomas v. Commissioner, 84 T.C. 412, 440, n.52 (1985) ("Since the potential profit here was more than de minimis, we are satisfied that petitioners should prevail.").

<sup>496</sup> I.R.C. § 183(a).

<sup>497</sup> H.R. Rep. No. 91-172 (1969), reprinted in 1969 U.S.C.C.A.N. 1645; S. Rep. No. 91-552 (1969) reprinted in U.S.C.C.A.N. 2027 & 2133-34.

<sup>498</sup> Treas. Reg. § 1.183-2(a).

considered unreasonable.<sup>499</sup> Courts generally have interpreted this test as requiring an inquiry into whether the taxpayer has an actual and honest profit objective.<sup>500</sup>

A potential for profit test would likely prove inadequate in the context of corporate tax shelters. First, the test was developed to distinguish among activities of individuals. Corporations exist to make a profit. Thus, a corporation generally will be presumed to satisfy the potential for profit test even if its expectation of profit is unreasonable.<sup>501</sup> Second, permitting corporate taxpayers to enter into

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<sup>499</sup> Id. The determination of whether a taxpayer has an objective of making a profit is based on all facts and circumstances, with greater weight given to objective factors rather than the taxpayer's subjective intent. Relevant factors include: (i) the manner in which the taxpayer carries on the activity; (ii) the expertise of the taxpayer or his advisors; (iii) the time and effort expended by the taxpayer in carrying on the activity; (iv) the expectation that the asset used in the activity may appreciate in value; (v) the success of the taxpayer in carrying on other similar or dissimilar activities; (vi) the taxpayer's history of income or losses with respect to the activity; (vii) the amount of occasional profits, if any, which are earned; (viii) the financial status of the taxpayer; and (ix) whether there are elements of personal pleasure or recreation in carrying on the activity. Treas. Reg. § 1.183-2(b).

<sup>500</sup> See, e.g., Krause v. Commissioner, 99 T.C. 132, 168 (1992), aff'd sub nom., Hildebrand v. Commissioner, 28 F.3d 1024 (10th Cir. 1994), cert. denied, 513 U.S. 1078 (1995); Peat Oil and Gas Assoc. v. Commissioner, 100 T.C. 271, 280-83 (1993) (Swift, J., concurring), aff'd sub nom., Ferguson v. Commissioner, 29 F.3d 98 (2d Cir. 1994). Section 183 is an allowance, not a disallowance, provision. Expenses that are not deductible under sections 162 or 212 may still be deductible to the extent provided in section 183. Treas. Reg. § 1.183-2(a). See also Brannen v. Commissioner, 78 T.C. 471, 500, 506-07 (1982), aff'd, 722 F.2d 695 (11<sup>th</sup> Cir. 1984). Although sections 162 and 212 generally require an inquiry into the taxpayer's primary motive for entering into an activity, the courts have not generally applied this standard in cases involving section 183. See generally Peat Oil and Gas Assoc., 100 T.C. at 279-286 (Swift, J., concurring), 287-293 (Ruwe, J., concurring).

<sup>501</sup> See, e.g., Smith v. Commissioner, 937 F.2d 1089, 1096 (6th Cir. 1991) (under the profit objective test of section 183, "'a reasonable expectation of profit [subjectively] is not required;' rather we look to 'whether the taxpayer entered into the activity, or continued the activity, with the objective of making a profit . . . even though the expectation of profit might be considered unreasonable'" (quoting Bryant v. Commissioner, 928 F.2d 745, 750 (6th Cir. 1991)), cert. denied, 502 U.S. 1082 (1992). In order to compare the expected economic benefits of a transaction to the transaction's expected tax benefits, one must define the scope of the transaction. In Smith, the Sixth Circuit failed to limit the scope of the transaction with reference to the parties before the court. As the Tax Court noted in Peat Oil and Gas Associates, the Sixth Circuit "seemed to give the limited partners the benefit of the possibility that some 'practicable effects other than the creation of tax losses' might be realized by other persons associated with the venture." Peat Oil and Gas Assoc., 100 T.C. at 276.

transactions with unreasonable expectations of profit would permit corporations to engage in transactions solely for tax benefits.<sup>502</sup>

The Treasury Department decided to compare the reasonably expected profit of the transaction--rather than the taxpayer's investment in the transaction--to the reasonably expected tax benefits for two reasons. First, unlike individual tax shelters which typically involve nonrecourse borrowings because individual taxpayers generally do not have the funds available to invest in the shelter, corporate tax shelters typically involve a significant investment of funds by the corporate participant.<sup>503</sup> Hence, corporate taxpayers could easily avoid a test that compares the taxpayer's net investment in the tax shelter to the reasonably expected tax benefits by "stuffing" additional, but unnecessary investment into the transaction. Second, comparing profit to tax benefits is consistent with economic reality and existing case law.<sup>504</sup>

In comparing the expected economic benefits to the expected tax benefits, both factors should be discounted to the time at which the transaction is entered into.<sup>505</sup> A present value comparison best comports with economic reality.<sup>506</sup> Although a present value analysis requires a projection of expected

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<sup>502</sup> See Saviano v. Commissioner, 765 F.2d 643 (1985). In this case, the court stated

[t]he freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies . . . The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly. That is what we have done in this case and that is what taxpayers should expect in the future.

Id. at 654.

<sup>503</sup> As discussed in Part II.B., the corporation's investment is rarely subject to a significant risk of loss.

<sup>504</sup> See, e.g., Sheldon v. Commissioner, 94 T.C. 738, 768 (1990).

<sup>505</sup> Smith, 937 F.2d at 1096 (The determination of whether a transaction has any practicable economic effects other than the creation of income tax losses must be "conducted from the vantage point of the taxpayer at the time the transaction occurred, rather than with the benefit of hindsight").

<sup>506</sup> See Brealy & Meyers, Principles of Corporate Finance 66, 85 (2d ed. 1984) (stating that "wise investment decisions are based on the net present value rule"; a key feature of the net present value rule is its recognition that "a dollar today is worth more than a dollar tomorrow," and "any investment rule which does not recognize the time value of money cannot be sensible"(emphasis in original)).



values, such a projection is a necessary incident of any long-term project and, thus, should not impose any unreasonable burdens on taxpayers.

A determination of an accurate present value of economic benefits depends, in part, on the chosen discount rate. Courts have been reluctant to require a discounting of economic benefits because of a concern that the courts are not competent, in the absence of legislative guidance, to require that a particular return must be expected before a profit is recognizable.<sup>507</sup> The reluctance of courts to recognize what taxpayers have long recognized should not preclude the use of time value of money concepts in determining whether a transaction is a corporate tax shelter. For one thing, corporations engaging in tax avoidance transactions are sophisticated. Second, in the absence of a clear Congressional mandate, corporations should not be encouraged to enter into transactions that do not produce a positive net present value. The choice of the appropriate discount rate likely will depend on the facts and circumstances surrounding the transaction and the identity of the transaction participants.<sup>508</sup> In some cases, the discount rate may be the average cost of capital for the corporate participant. In other cases, the discount rate may be the applicable Federal rate, as defined in section 1274(d), commensurate with the expected term of the transaction. Certain presumptions may need to be developed to determine the appropriate discount rate or a range of acceptable discount rates.

A comparison of the expected economic benefit to expected tax benefits requires a weighing of relative benefits, which in some cases may be difficult.<sup>509</sup> The benefits of the relative test outweigh its

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<sup>507</sup> Estate of Thomas v. Commissioner, 84 T.C. 412, 440, n.52 (1985) ("Moreover, we do not feel competent, in the absence of legislative guidance, to require that a particular return must be expected before a 'profit' is recognizable, the necessary conclusion to be drawn if we were to discount residual value"); Hilton v. Commissioner, 671 F.2d 316 (9th Cir. 1983) (in commenting on the Tax Court's discounting of economic benefit, the Ninth Circuit Court of Appeals stated that "[w]e deem the six percent rate to be for illustrative purposes only. No suggestion of a minimum required rate of return is made. Taxpayers are allowed to make speculative investments without forfeiting the normal tax applications to their actions.") , cert. denied, 459 U.S. 907 (1982). Because tax benefits are typically front-loaded, discounting such benefits will have little effect. In contrast, because the economic benefits of a transaction are typically backloaded, discounting will have a significant effect on the relative value of such benefits.

<sup>508</sup> Cf. Treas. Reg. § 1.1275-4(b)(4)(I)(B) (in determining the comparable yield of a contingent debt instrument with one or more contingent payments not based on market information when the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest is not expected to have a substantial effect on their U.S. tax liability, the instrument's comparable yield is presumed to be the applicable Federal rate, based on the overall maturity of the debt instrument).

<sup>509</sup> Courts have been reluctant to apply a relative test because of the perceived inability to determine at what point tax benefits should be denied. See, e.g., Estate of Thomas, 84 T.C. at 440, n.52 ("Moreover, we do not feel competent, in the absence of legislative guidance, to require

detriments. Whether the reasonably expected pre-tax profit of a particular transaction is insubstantial relative to the reasonably expected tax benefits of the transaction is to be determined based on all of the relevant facts and circumstances. A more mechanical test would likely be too easily avoided. The experience with the original tax shelter registration requirements, which is based on a mechanical test, demonstrates the inherent limitations of mechanical tests. In addition, a bright line test invariably invites taxpayers to come right up to and, in time, stretch the line. The primary purpose in seeking to limit corporate tax shelters is to discourage corporate taxpayers from engaging in questionable transactions.

To assist taxpayers and courts in determining whether, in a particular case, the reasonably expected pre-tax profit is insubstantial relative to the reasonably expected tax benefits, certain presumptions may need to be developed to determine the outer range of unacceptable ratios.<sup>510</sup> Under the sham transaction doctrine, courts typically have not balanced profit against tax benefits.<sup>511</sup> Rather, courts have looked to whether the taxpayer had any realistic possibility of profit. In making this determination, however, courts have generally ignored profit that is insubstantial or *de minimis*.<sup>512</sup>

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that a particular return must be expected before a 'profit' is recognizable, the necessary conclusion to be drawn if we were to discount residual value."); Peat Oil and Gas Assoc., 100 T.C. at 285-86 (Swift, J., concurring) ("I would spare us, other courts, the IRS, and the tax bar, the task of evaluating whether, for example, a \$5,000 pre-tax profit when compared to \$20,000 of tax benefits provides a sufficient non-tax profit for one investor but not for another.").

<sup>510</sup> Cf. Treas. Reg. § 1.446-3(g)(6), Exs. (3) and (4) (giving rough guideposts as to when a swap with significant nonperiodic payments may be recharacterized as two separate transactions).

<sup>511</sup> But see Sheldon, 94 T.C. at 768 ("The potential for 'gain' here, however, is not the sole standard by which we judge, and in any event, is infinitesimally nominal and vastly insignificant when considered in comparison to the claimed deductions").

<sup>512</sup> See, e.g., Sheldon, 94 T.C. at 768 (sale-repurchase transactions lacked economic substance and a non-tax business purpose, notwithstanding the potential for a profit that the court characterized as "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions"). In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999), the court stated

[I]ikewise, the court found that the interest income generated by the notes could not have a material effect on ACM's financial position because the Citicorp notes paid interest at a rate that varied only nominally from the rate that ACM's cash contributions 'were already earning . . . in . . . deposit accounts before the notes were acquired,' resulting in only a \$3,500 difference in yield over the 24-day holding period, a difference which was obliterated by the

Relying on a comparison of reasonably expected pre-tax profit to reasonably expected tax benefits requires a consideration of the scope of the transaction at issue.<sup>513</sup> In a number of cases, courts have bifurcated a transaction to identify the portion of the transaction that results in the tax benefits at issue.<sup>514</sup> For example, in ACM Partnership, in analyzing the taxpayer's potential for profit, the courts

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transaction costs associated with marketing private placement notes to third parties.

Id. at 249; see also Hilton v. Commissioner, 74 T.C. 305, 353 n. 23 (1980) (suggesting the need for more than a de minimis amount of pre-tax profit), aff'd per curiam, 671 F.2d 316 (9th Cir. 1982), cert. denied, 459 U.S. 907 (1982).

<sup>513</sup> The scope of the transaction is important for determining the profit arising from the transaction as well as the applicable transaction costs.

<sup>514</sup> In James v. Commissioner, 899 F.2d 905 (10th Cir. 1990), the court stated

The only transactions at issue in this case are the purported sales by the Communications Group to the joint venture. These sales cannot be legitimized merely because they were on the periphery of some legitimate transactions. . . . The 'bifurcated transaction' approach does have a basis in established law, however. As the Fourth Circuit held in Rice's Toyota, 'a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded.' (citations omitted).

Id. at 910; see also Karr v. Commissioner, 924 F.2d 1018 (11th Cir. 1991) ("The activities of the other entities involved in exploiting the Koppelman process, however, cannot necessarily be attributed to POGA [the taxpayer]."); Peat Oil and Gas Assoc., 100 T.C. at 276 ("The Court of Appeals for the Sixth Circuit [in Smith] seemed to give the limited partners the benefit of the possibility that some 'practicable effects other than the creation of tax losses' might be realized by other persons associated with the venture."). As stated in note 500, supra, the Sixth Circuit in Smith defined the transaction in question by considering the practical economic effects of parties unrelated to the litigants. The court in Smith stated as follows:

The evidence presented at trial included the following: a report concluding that the Koppelman process was 'technically, environmentally, and economically feasible;' a showing that the taxpayers' obligations to SFA took the form of full recourse notes; financial analysis indicating that projected revenues would be sufficient to retire the partnership's notes to FTRD and SciTeck; and uncontradicted expert testimony stating that the Koppelman

focused on the purchase and sale of the certain notes--the events that directly lead to the tax benefits at issue. The courts did not take into account the profit that the taxpayer earned from the portion of the notes that were not sold .

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process did have a reasonable chance of generating profits. These investments were risky, to be sure, and the taxpayers were predictably concerned about saving taxes -- but the question is whether apart from the anticipated tax advantages, the taxpayers' investment was a sham. On the basis of the evidence present, it seems obvious to us that the investment was not a sham.

937 F.2d at 1096.