CORPORATE

1999-SE-007215

DRAFT 6/24/99

TREASURY REPORT ON CORPORATE TAX SHELTERS

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I. 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[1] 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.

- The New York State Bar Association, in testimony[2] 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.

- In the 1998 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."

- [Add TEI]

- A recent cover story in Forbes magazine[3] 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"

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[1] March 10, 1999

[2] April 27, 1999

[3] Janet Novack and Laura Saunders, "The Hustling of X Rated Shelters", *Forbes Magazine*, Dec. 14, 1998

strategies for tax avoidance that can save purchasers, but cost other US taxpayers from tens of millions, to hundreds of millions of dollars.

- **[Make stronger]** While corporate tax payments have been rising, taxes have not grown as fast as have corporate profits. Thus, 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.

- 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.

II. Evidence from recent shelters

A number of large aggressive tax shelters have been identified by the Treasury, and several types have been shut down by statute or regulation. Some of these deals involved tax reductions in the billions of dollars.

- **Corporate-owned life insurance** (COLI). In 1996 and 1997, two provisions were enacted to prevent the abuse for tax purposes of corporate-owned life insurance. Collectively, these two provisions were estimated by the Joint Tax Committee to raise over $18 billion over 10 years. As Ken Kies, former Chief of Staff of the Joint Committee on Taxation and current PriceWaterhouseCoopers partner 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.[4]"

- **Fast-pay** -

- **Liquidating REITs.** The Office of Tax Analysis estimated that legislation last year to eliminate liquidating REITs would save the tax system upwards of $30 billion over the next ten years.
- **LILO**. We have brought to light lease-in, lease-out transactions, or so-called "LILO" schemes. Like COLI, these transactions, through circular property and cash flows, offered participants millions in tax benefits with no

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[4] Federal Bar Association, 1996 Airlie House conference

real economic risk. The notion of a U.S. multinational leasing a town hall from a Swiss municipality and then immediately leasing it back to the municipality is, surely, odd on its face.

- 357(c).

III. Reasons for concern

Short-term revenue loss

- corporate tax shelters reduce the corporate tax base.

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 will have long-term consequences far more important than the short-term revenue loss we are experiencing.
- 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."

Complexity

- Piecemeal legislation ends up silting up the code and, almost by definition, calls into question the viability of common law tax doctrines. In the past few years alone, about 30 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 are better used in productive activities. Similarly, the Congress (particularly the tax-writing committees and their staffs), the Treasury, and the IRS must expend significant resources to address and combat these transactions.
- The ACM case alone cost the Federal Government over $ ____ million to litigate. (Should we mention there are __ cases involving similar shelter products).

- Peter Cobb, former Deputy Chief of Staff of the Joint Tax Committee: "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 --Yale Law Professor Michael Graetz recently defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid."[5] 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 virtually all economic risk.[6]

Inconsistent Financial Accounting and Tax Treatments -- In light of trends to treat corporate in-house tax departments as profit centers, and the pressure 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, most recent corporate tax shelters involving public companies, the financial accounting treatment of a shelter item has been inconsistent with its Federal income tax treatment. 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.

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 solely to absorb taxable income or otherwise deflect tax liability from the taxable party. Recent examples of shelter transactions that relied on the use of tax indifferent parties include the fast pay preferred stock transaction, the LILO transactions,

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[5]See Tom Herman, Tax Report, Wall St. J. at A-1 (Feb. 10, 1999).

[6] See e.g., ACM Partnership, * T.C.M. (CCH) * [discuss LIBOR notes]; Rev. Rul. 99-17, 1999-* I.R.B. * (discussing lease-in, lease-out transactions).

and the contingent installment sales transactions that were litigated in ACM and ASA.[7] See Appendix A.

Marketing Activity -- the typical tax shelter is designed today so that it 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 -- Like 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 Treasury 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 their "proprietary" advice. [add 1997 act]

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.**[Add size?]** 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 that are borne, in whole or substantial part, by the corporate beneficiary. For example, the transaction costs in ASA ($24,783,800) were approximately 26.5 percent of the purported tax savings (approximately $93,500,000).

V. Present Law Applicable to Shelters

Although the tax consequences of a particular business transaction are generally determined through the application of objective rules (primarily Code and regulatory provisions), certain standards may be invoked to challenge the technical tax results of a transactions where a literal application of the law to the facts produces tax results that are unreasonable or unwarranted.

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[7] Cite ASA and ACM.

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 rules limit the need for even more complicated rules that would otherwise be necessary to address uncovered fact situations. One commentator has declared that regulatory anti-abuse rules potentially are "a path toward a coherent solution" to the problem of tax shelters.[8]

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 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 organizations 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 any tax.

Judicial doctrines

- 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 the form."[9] 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

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[8] Airlie: David Hariton, <u>supra</u> note ___, at ___ ("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.")

[9] **[Cite Powlen }**

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."[10]

- 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 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,[11] 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."

    - The lack of a business purpose other than the creation of tax benefits was used to invalidate many of the individual tax shelters of the 1970's and 1980's.

- Economic substance - Under this doctrine, tax benefits may be denied if the tax benefits arise from a discreet set of transactions that do not meaningfully alter the taxpayer's economic position. **[elaborate -quote from Hariton?]**

VI. Legislative Proposals

In its FY 2000 budget, the Administration made several proposals intended to inhibit the growth of corporate tax shelters. These proposals focused on the following areas: (1) increased disclosure of corporate tax shelter activities, (2) increasing and modifying the penalty relating to the substantial understatement of income tax, (3) substantive changes to the 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., corporate participants, promoters and 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

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[10] Hariton, *Sorting Out the Tangle of Economic Substance,* **[cite], p.8.**

[11] 293 U.S. 465 (1935).

commented on the Administration's proposals and made proposals of their own in testimony filed with the tax-writing committees. The paper considers those comments and suggests refinements to the Administration's proposals based on those comments and the comments of others.

Increased 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 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. [cite Cal Johnson.]

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 with respect 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 and should not be overly burdensome to taxpayers.

- Administration's FY 2000 Budget. The penalty rate on substantial underpayments relating to corporate tax shelters would increase from 20 percent to 40 percent if the taxpayer does not adequately disclose the shelter. For this purpose, adequate disclosure 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) highlighting on Schedule M-1 of the tax returns the book/tax difference (if any) resulting from the corporate tax shelter.

- The budget also generally requires taxpayers to report tax items relating to a transaction with a tax indifferent party consistent with the form of their transaction, unless they disclose that they are reporting the item inconsistent with its form. 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 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 in connection with the offer of the tax shelter by a third party. One or more corporate officers with 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.

- AICPA. The AICPA strongly supports an effective disclosure mechanism. To be effective, disclosure must (1) provide taxpayers with an incentive to disclose transaction of interest to the IRS and (2) be in a form and at time to be useful 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 disclosure provisions.

- NYSBA. The NYSBA strongly supports the Administration's first disclosure proposal because they believe 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 (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. Also, SEC disclosure requirements could be modified to require financial statement disclosure of the aggregate amount of tax covered by the taxpayer's disclosure statements.

Taxpayer Penalties

- 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." The penalty would be reduced to 20 percent if, as discussed above, adequate disclosure is made. The penalty could not be avoided through reliance on a "more likely than not" opinion or belief (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. They also suggest 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 is upheld by a court).

- AICPA. The AICPA believes extraordinary sanctions (such as a 40-percent penalty) are appropriate only if the definition is sufficiently narrow so as to minimize the risk that the penalty would be proposed to hassle, harass, or otherwise encumber 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. The NYSBA proposes an approach similar to the Administration's budget proposal, suggesting that a penalty of at least 10 percent could be applied to corporate tax shelters for which the taxpayer provides disclosure and a penalty at least (and perhaps more) 20 percentage points higher would 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 penalties.

Disallow Tax Benefits of Corporate Tax Shelters As evidenced by the comments from the ABA, AICPA and NYSBA, corporate tax shelters are proliferating under the existing legal regime. 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 (e.g., sections 269, 446, 482, and 7701(l)) are limited to particular situations. Application of existing judicial doctrines has been uncertain which encourages the most aggressive taxpayers to pick and choose among the most favorable cases.

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. This approach has substantial defects. First, because it is not possible to identify and address all current and future sheltering transactions, it leaves us barely scratching the surface of the problem. 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 has not been definitively proscribed. Second, legislating on a piecemeal basis further complicates the Code. In the past few years alone, Congress has passed numerous provisions to prevent specific tax shelter abuses. Third, using a transactional approach to corporate tax shelters emboldens some promoters and participants to rush shelter products to market on the belief that any governmental reaction would be applied only on a prospective basis. Finally, litigation is costly and time consuming.

- <u>Administration's FY 2000 Budget</u>. 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. 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. 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).

- <u>ABA</u>. The ABA would clarify that, where the economic substance doctrine applies, the nontax considerations must be substantial (i.e., by more than a de minimis or nominal amount) 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 in order to determine the validity of the transaction for tax purposes.

- <u>AICPA</u>. The AICPA disagrees with the need to expand the Secretary's authority to expand the disallowance regimes of the Code.

- NYSBA. The NYSBA does not support a substantive change in the law as proposed by the Administration. However, they do support the inclusion of anti-abuse provisions in newly promulgated regulations and newly enacted statutes, sometimes with retroactive effect. In addition, the NYSBA suggests another alternative approach is to provide regulatory authority to address transactions that exploit obvious loopholes that are plainly contrary to the intention or contemplation of Congress.

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 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, quote the ABA

When Congress was concerned with the proliferation of individual tax shelters in the early 1980's, 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.

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 unforseen manner, it is appropriate to eliminate such status with respect to such use. 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 utilize this technique.

- 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. To ensure that a tax is paid, all corporate participants would be made jointly and severally liable for the tax. 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 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, recission clause, or insurance or other arrangement guaranteeing such benefits.

- <u>ABA</u>. 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 the rules applicable to tax return preparer penalties.

- <u>AICPA</u>. 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 it. The AICPA would not adopt the 25-percent excise tax on promoter or advisor fees 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. Finally, the AICPA suggests unspecified revisions to Circular 230, while acknowledging that certain parties (e.g., investment bankers) are not subject to these provisions.

- <u>NYSBA</u>. The NYSBA does not address the penalty excise taxes on other participants proposed by the Administration.on other participants. The NYSBA does acknowledge 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. <u>Refinement of Budget Proposals</u>

<u>Increased Disclosure</u>

The Treasury Deaprtment 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 was too vague for purposes of triggering a reporting requirement, disclosure would only be required if a transaction had [two] or more 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, etc. These filters are based on the objective characteristics identified by Treasury and others as common in many corporate tax shelters.

- Disclosure would be made on a short form separately filed with the National Office of the IRS within soon after the transaction is entered into and again with the tax return.

  -- The early warning will allow the IRS, Treasury 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 would be required again with the tax return to provide an examining IRS agent 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, a brief description of the transaction, and brief descriptions of the purported tax treatment and legal support thereof. Failure to meet the disclosure requirement would subject the taxpayer to a significant fixed-amount penalty (say, $100,000 each), regardless of whether the transaction in question is ultimately deemed to be a corporate tax shelter.

- The filing requirement would be an important component of the Administration's modified substantial understatement penalty, described below.

- To the extent this proposal requires taxpayers to disclose transactions subject to a confidentiality agreement, the section 6111 disclosure requirement for confidential corporate tax shelter arrangements could be modified or eliminated.

- Consideration should be given to the notion advanced by the ABA that 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 heightened penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights.

Taxpayer Penalties

- In lieu of strict liability, a strengthened reasonable cause standard could be offered to reduce or eliminate the substantial understatement penalty if 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 one version of potential modifications to the Administration's proposal regarding the substantial understatement penalty, the following sanctions could apply to transactions which may or may not meet the definition of corporate tax shelter and for which there is or is not disclosure:

  -- 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.

  -- 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 "more likely than not" probability of success on the merits.

  -- Transaction held to not 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.

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

Disallow Tax Benefits of Corporate Tax Shelters

The Treasury Department believes that the current state of the law presents a strong case that a substantive change is necessary to address corporate tax shelters. Such change should embody the adoption of objective standards rather than tinkering with 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 and most recently utilized in ACM Partnership v. Commissioner. Thus, the Treasury stands behind the first leg its original proposed definition of "tax avoidance transaction." This test requires a comparison of the present values of expected pre-tax profits and expected tax benefits.

- In order to address perceptions of vagueness, the second leg of the original proposed definition would be clarified and modified to apply to transactions that do lend themselves to a pre-tax profit comparison; most notably, financing transactions.

- Fears of abuse of discretion would be addressed by a more concrete definition of tax avoidance transaction. In addition, the tax attribute disallowance rule could apply automatically, rather than subject to use at the discretion of the Secretary.

- A model for this type of proposal 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, procedural and other safeguards could be installed to address fears of abuse of discretion. First, the IRS currently is restructuring among groups based on types of taxpayers, including large corporate taxpayers. The IRS personnel reviewing potential corporate tax shelters will be centralized in the new IRS' corporate tax shelter group. This centralization will facilitate training and coordination among agents, their supervisors and Chief Counsel. A corporate tax shelter tax force, modeled after current Industry Specialization Program and the individual tax shelter tax force of the 1970's and 1980's, could further centralize and streamline this issue. Proposed increased disclosure by taxpayers could facilitate this effort. Increased coordination by the IRS would increase consistency and efficiency in dealing with complex tax shelter issues.

- Additional legislative and regulatory steps could be taken to ensure proper and consistent resolution of corporate tax shelter issues. For example, an 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. 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 substantial underpayment 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.

<u>Consequences to Other Parties (e.g., promoters and advisors, and tax indifferent parties)</u>

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 believes there should be consideration to modify and clarify its 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 advisor and promoter fees operates in the same manner as a penalty. In this regard, consideration could be given to amending the current-law penalties to be more responsive to corporate tax shelters in lieu of such excise taxes.

Tax indifferent parties

- The Treasury believes there should be consideration to modify and clarify its 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 severable liability runs between the tax indifferent party and the corporate participant only.

II. INTRODUCTION

The Problem of Corporate Tax Shelters

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[12] 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.

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[12] March 10, 1999 **[need better cite?]**

- The New York State Bar Association, in testimony[13] 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.

- In the 1998 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."

- The Tax Executives Institute recently testified[14] 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 balanced and, further, that they do not add even more complexity to the already overburdened tax law."

- A recent cover story in Forbes magazine[15] was devoted to the "thriving industry of hustling corporate tax shelters." This 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 -- and cost US taxpayers -- anything from tens of millions, to hundreds of millions of dollars.

Some have argued that corporate tax shelters are not a significant problem because corporate tax revenues have been rising. As Professor Joe 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 to rise even faster..."[16] In fact, the evidence shows that corporate receipts have not grown as fast as have corporate profits; the effective tax rate, the ratio of tax to profits, has declined recently. Also, the ratio of book income to taxable income has risen fairly sharply in the last few years. Given that book-tax differences are a hallmark of corporate tax shelters, some of this increase may be due to tax shelter activity.

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[13] April 27, 1999

[14] *Ibid.*

[15] Janet Novack and Laura Saunders, "The Hustling of X Rated Shelters", *Forbes Magazine*, Dec. 14, 1998

[16] Cite Bankman letter. Interest rates have been falling also, which further contributes to higher corporate income. Thus, the countervailing economic effects have probably swamped the effect of corporate tax shelters.

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 far more important than the revenue losses we are experiencing. Also, corporate tax shelters reduce the corporate tax base. Finally, significant resources -- both in the private sector and the Government -- are currently being wasted on this uneconomic activity.[17] 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 committees and their staffs), the Treasury, 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, Treasury and the IRS have taken a number of actions to address specific corporate tax shelters. These include:

- Two provisions to prevent the abuse for tax purposes of corporate-owned life insurance. Collectively, these two provisions were estimated by the Joint Tax Committee to raise over $18 billion **[OTA estimate?]** over 10 years. As Ken Kies, former Joint Committee on Taxation and current PriceWaterhouseCoopers partner 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.[18]"

- The elimination of the ability to avoid corporate-level tax through the use of "liquidating REITs," which passed late last year. The Office of Tax Analysis estimated that legislation last year to eliminate this one tax shelter product alone would save the tax system upwards of $30 billion over the next ten years.

- The recent IRS ruling 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 risk.

- Both the Senate Finance Committee and the House Ways and Means Committee have passed legislation this year aimed at section 357(c) basis creation abuses, which has advanced in both chambers.

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[17] As Peter Cobb, former Deputy Chief of Staff of the Joint Tax Committee 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." **[Airlie House transcript]**

[18] Federal Bar Association, 1996 Airlie House conference

- proposed regulations addressing stepped-down preferred stock transactions;
- notice 98-5 dealing with foreign tax credit abuses;
- the Government's victories in two important corporate tax shelter cases -- ACM Partnership[19] and ASA Investerings Partnership.[20]

Addressing corporate tax shelters on a transaction-by-transaction, *ad hoc* basis, however, raises certain concerns. First, because it is not possible to identify and address all current and future sheltering transactions, it leaves us barely scratching the surface of the problem. As Deputy Treasury Secretary Larry Summers has 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."[21]

Second, legislating on a piecemeal basis further complicates the Code. In recent years, close to [thirty] provisions have been adopted responding to perceived abuses. Also, the proliferation of these shelters 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, using a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the belief that any reactive legislation would be applied only on a prospective basis.

Administration's FY 2000 Budget Proposals. The Administration believes that a common, [*antiseptic*] solution must be fashioned to the corporate tax shelter problem, as opposed to the current ad hoc, after-the-fact approach. This, however, 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. To some extent, defining "corporate tax shelter" is, as one commentator recently put it[22], "like defining 'moral behavior'. The definition in large part depends on whether one is talking to a salesman, a customer, one's client, opposing counsel, a judge, an IRS agent, or the mirror (in an empty room)."

The Treasury Department, nonetheless, has identified certain characteristics that are common to corporate tax shelters. For example, through hedges, circular cash flows, defeasements, and the like, corporate participants in a shelter often are insulated from any risk of economic loss or opportunity for economic gain with respect to the sheltering transaction. Thus, corporate tax shelters are transactions without significant economic substance, entered into principally to achieve a desired

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[19] [cite]

[20] [cite]

[21] Lawrence H. Summers, "A Better Tax Service and a Better Tax System," Tax Executives Institute, March 22, 1999

[22] ???

tax result. Other identified characteristics include: (1) inconsistent financial and tax accounting treatment; (2) presence of tax indifferent parties; (3) complexity; (4) unnecessary steps or novel experiences; (5) marketing activity; (6) high transaction costs; and (7) risk reduction arrangements.

In the Administration's Fiscal Year 2000 Budget, several generic remedies have been proposed to curb the growth of corporate tax shelters, focusing on these identified common characteristics. The Administration's proposals were 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."[23] As the ABA Tax Section suggested in its recent testimony before the House Ways and Means Committee, "all essential parties to a tax-driven transaction [must] have an incentive to make certain that the transaction is within the law."[24] The budget proposals included:

- A substantive law change that denies tax benefits in transactions without significant economic consequences relative to the tax benefits.
- Increased, strict liability penalties for substantial understatement where it is found that tax shelters have been used.
- Excise taxes on so-called "tax-indifferent" parties who facilitate tax shelters.
- A 25 percent excise tax on promoter and lawyer fees.
- New excise taxes on contingent fees, unwind provisions or tax indemnity clauses that make a positive ruling by the IRS a condition for the transaction itself.

The Treasury Department recognizes that this more general approach to corporate tax shelters raises certain concerns. Applying various substantive and procedural rules to a "corporate tax shelter" or a "tax avoidance transaction" requires definitions of such terms. Critics have suggested that the definitions in the Administration's Budget proposals are too broad or may create too much uncertainty and thus may inhibit otherwise legitimate transactions. [The Treasury Department does not intend to affect legitimate business transactions and looks forward to working with the tax-writing committees in refining the corporate tax shelter proposals. Some level of uncertainty, however, is unavoidable with respect to complex transactions. In addition, the definition of corporate tax shelter as used in the proposals is narrower and therefore less uncertain than other definitions and formulations used currently in the Code. Moreover, the proposed definition is similar to existing articulations of various judicial doctrines and may be viewed as largely enforcing the judicially-created concept of economic substance of current law. Finally, some amount of uncertainty may be

[23] ???

[24] ???

useful in discouraging taxpayers from venturing to the edge, thereby risking going over the edge, of established principles.

Since releasing the Budget in February, Treasury has had an 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 come to common understandings of the norms of appropriate behavior in this area. We also have analyzed the comments raised by others in testimony presented to the two tax-writing committees, as well as in recent articles. This White Paper on corporate tax shelters is intended to more fully discuss the reasoning underlying the Budget proposals relating to corporate tax shelters, provide an analysis of how the practitioner comments relate to this rationale, and provide refinements to the original Budget proposals in light of these comments and in keeping with the underlying rationale.

The original Administration proposals have focused on the following interrelated areas:

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

Practitioner comments have placed greater weight on some of these areas than others. For example, the ABA focuses on greater disclosure and the economic substance doctrine, the AICPA focuses on the weight of sanctions and the potential for abuse of discretion, and the NYSBA focuses on strict liability and distinguishing amongst types of corporate tax shelters. In light of these thoughtful comments, the Treasury Department proposes the following refinements to its proposals.

With respect to increasing disclosure:

9. Disclosure requirements would be based on objective criteria and would carry separate penalties.
10. The form and content of disclosure could be similar to that proposed by the ABA.
11. Disclosure could be a component of a reasonable cause exception to the substantial understatement penalty.

With respect to increasing and modifying the penalty relating to the substantial understatement of income tax:

1. In lieu of strict liability, a strengthened reasonable cause standard could be offered to reduce or eliminate the substantial understatement penalty if the taxpayer also properly disclosed the transaction in question. Under one version of potential modifications to the Administration's proposal regarding the substantial understatement penalty, the following sanctions could apply to transactions which may or may not meet the definition of corporate tax shelter and for which there is or is not disclosure:

-- 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.

-- 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 "more likely than not" probability of success on the merits.

-- Transaction held to not 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.

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

With respect to changing substantive law to disallow the use of tax benefits generated by a corporate tax shelter:

XIII. The second leg of the proposed definition of tax avoidance transactions would be modified to specifically apply to only financing transactions.

XIV. In order to address fears of abuse of discretion, the provision would be self-effectuating, rather than left to use at the discretion of the Secretary.

XV. Administrative and procedural safeguards would be put in place to insure prompt and consistent evaluation of corporate tax shelter challenges.

With respect to providing consequences to promoters and advisors and tax indifferent, accommodating parties.

- Excise taxes applicable to promoters and advisors would provide that only persons who perform services in furtherance of the corporate tax shelter would be subject to the proposal, and appropriate due process procedures for such parties would be extended with respect to an assessment.
- Consideration should be given to amending the current-law penalties to be more responsive to corporate tax shelters in lieu of such excise taxes.
- The proposal relating to the deductibility of promoter and advisor fees would be eliminated.
- The proposal relating to tax indifferent parties would 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 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.

We look forward to continuing the dialogue on this important tax policy issue with the tax-writing committees and other interested parties and are confident that further discussions will result in further refinements of these core proposals.

This Part II provides background information on corporate tax shelters, including a discussion of the goal and common characteristics of corporate tax shelters and the factors contributing to the growth of corporate tax shelters. This Part II also discusses the definition of a corporate tax shelter. Part III discusses factors that have contributed to the growth of corporate tax shelters. Part IV discusses the present law concerning tax shelter transactions, including historic Congressional and administrative responses to tax shelters and the development of judicial anti-avoidance doctrines. Part V discusses proposals put forth by the Administration in its FY 2000 Budget to limit the growth of corporate tax shelters, an analysis of comments from practitioner groups with respect to these proposals and proposed modifications to these proposals in light of these comments. Part VI discusses other potential responses to address corporate tax shelters. The Appendix provides descriptions of some recent corporate tax shelters.

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 source. As discussed in section 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.[25]

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[25] 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'g 69 F.2d 809, 810 (2d Cir. 1934) ("Anyone may so arrange his affairs 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.

Recently, corporate officers and directors appear to be paying even greater attention to shareholder concerns and reported corporate earnings.[26] This focus on increasing corporate earnings reportedly has caused many corporations to treat their in-house tax departments as profit centers.[27] 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.[28]

In light of this increased emphasis on keeping the corporation's effective tax rate low[29] -- to maximize shareholder value[30] -- and in line with that of competitors, more corporations are seeking to reduce their tax liability using tax-engineered transactions. Corporate tax shelters **[that work?]** 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.[31]

2. Methods of Reducing Corporate Income Tax Liabilities

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[26] 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) [herinafter NYSBA *Report*]; Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775 (June 21, 1999) [hereinafter Bankman].

[27] See also, Bankman, supra note 8, 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."); 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]. (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.")

[28] Janet Novack and Laura Saunders, The Hustling of X Rated Shelters, Forbes, December 14, 1998, at 198, 200 [hereinafter Forbes].

[29] The effective tax rate is the ratio of corporate tax liability to book income.

[30] A lower effective tax rate may lead to a higher stock price and more satisfied shareholders. **[cite recent Tax Notes article]**

[31] See discussion infra, at fns. ____.

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.[32] 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 exemption or a reduced rate of tax on the income to be derived from the shelter."[33] 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").[34] 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.[35]
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 attached hereto.

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, as described in Appendix A attached hereto.

[Retain?] As explained in Part **[II.C.]**, excess benefits shelters often are easier to identify and define than are exclusion shelters.

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.[36] Discontinuities exist in the tax law for several reasons. Most importantly, the Code does

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[32] See, e.g., Joint Committee on Taxation, Tax Reform Proposals: Tax Shelters and Minimum Tax, 2 (Aug. 7, 1985).

[33] Kenneth W. Gideon, Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters, 5 Va. Tax Rev. 825, 849 (1986)

[34] See NYSBA Report, supra note 8, 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 section IV(C) of this Report.

[35] NYSBA Report, supra note 8, at 884.

[36] See generally, Powlen and Tanden, supra note 5, at 1009 ("What are the fundamental aspects of the system that create the opportunity for tax shelters? First, our tax system, perhaps of

not measure economic income precisely.[37] 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."[38] Using this principle, taxpayers have been able to monetize the value in their assets (e.g., through borrowing),[39] or to lock-in appreciation with respect to their property,[40] 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.[41]

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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.").

[37] 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 (2d ed. 1989) and George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Col. L. Rev. 657, 660-63 (1985).

[38] NYSBA Report, supra note 8, at .

[39] See Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952) (borrowing against appreciated position is not a realization event).

[40] 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.

[41] NYSBA Report, supra note 8, 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.")

In addition, Congress has used the Code to provide tax benefits to induce taxpayers to 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.[42] However, at times, these provisions may be utilized to produce tax benefits in excess of those intended by Congress.[43]

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. **[Add Joe's changes - which I do not have]** Discontinuities can also arise from the existence of different tax treatments for the same transaction in different tax jurisdictions.[44]

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. **[Further explain/Cite ACM/Marty Ginsburg.]**

B. CHARACTERISTICS OF CORPORATE TAX SHELTERS

Corporate tax shelters "appear in the guises of Proteus,"[45] taking many different forms and utilizing many different structures. For this reason, a single, comprehensive definition of 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 experiences; (6) mass marketing; (7) confidentiality; (8) high transaction costs; and (9) risk reduction arrangements.[46]

1. Lack of Economic Substance

Yale Law Professor Michael Graetz recently defined a tax shelter as "a deal done by very smart people that, absent tax considerations, would be very stupid."[47] While somewhat tongue in cheek, this definition highlights one of the most important characteristics common to most corporate

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[42] Budget of the United States Government, Analytical Perspectives, 105 (Fiscal Year 2000).

[43] **Describe 172f abuse?.**

[44] See Notice 98-5, 1998-3 I.R.B. 49, Examples 4 and 5.

[45] See Testimony of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy), Before the Senate Finance Committee (April 27, 1999).

[46] It is important to that these characteristics, while common in corporate tax shelters, may be found in other transactions as well.

[47] See Tom Herman, Tax Report, Wall St. J. at A-1 (Feb. 10, 1999).

tax shelters -- the lack of significant pre-tax economic substance or risk to the participating parties. See section B of Part IV of this Report for a discussion of judicial doctrines that highlight this factor and section __ of Part V for a discussion of Treasury'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.[48] 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.[49]

A recent example of this is the so-called lease-in, lease-out (or "LILO") type of transaction.[50] In a typical LILO transaction, a U.S. taxpayer leases property from a foreign 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, the foreign municipality uses the majority of the front-loaded rental payments under the lease to fund deposit accounts 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. Treasury understands that in some lease-in, lease-out transactions, the claimed after-tax return could exceed 18 percent. Treasury 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.[51]

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[48] See, e.g., ACM Partnership, 73 T.C.M. 2189. The transaction at issue in ACM Partnership is discussed more fully in Appendix A of this Report.

[49] 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).

[50] For a more complete discussion of this transaction, see Appendix A of this Report.

[51] 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

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.[52] 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.[53]

2. Inconsistent Financial Accounting and Tax Treatments

In most recent corporate tax shelters involving public companies,[54] the financial accounting treatment of a shelter item has been inconsistent with its Federal income tax treatment.[55] 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 imposition0 of tax can be viewed as a real coup by the tax manager.[56]

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,[57] and the pressure to increase shareholder value and remain competitive. Corporate managers are placing greater emphasis on

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claimed tax benefits and could not, in and of itself, support a finding of economic substance).

[52] 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. See section C of this Part II for a discussion of these shelters.

[53] NYSBA Report, supra note 8, at 895.

[54] 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.

[55] 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.

[56] NYSBA Report, supra note 8, at 882.

[57] See the discussion in section A(1) of this Part II.

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.[58] According to one commentator:

> A chief executive officer is now evaluated in part on his company's effective tax rate. 'Things all have to do with effective tax rates,' says one lawyer. 'Companies can look at their competition and see their rate. Just a two point difference is a very big deal.'[59]

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.[60] 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 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."[61]

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.[62] Financial statement disclosure is limited to items

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[58] **[Joe** –Explain failure to reserve here -- 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. 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. Finally, a corporation may not fully reflect tax benefits 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. [Cites]

[59] See Bankman, supra note 5, at __.

[60] 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.

[61] Bankman, supra note 5, at 10.

[62] 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.

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.[63] 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 and ASA.[64]

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-advantaged status.[65] Tax indifferent parties include foreign persons, Native American tribal organizations, tax-exempt organizations (e.g., charitable organizations and pension plans), state and local governments, and domestic corporations with net operating losses or credit carryforwards that they do not expect to use to offset their own income.[66]

When taxpayers use different methods of accounting, the difference may be arbitraged to create a tax shelter. Recently, for example, taxpayers subject to mark-to-market accounting have been acting as accommodation parties in tax shelters.[67] This is because they are indifferent to the

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[63] 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.")

[64] ACM Partnership, 73 T.C.M. at 2189; and ASA, 76 T.C.M. at 325.

[65] In this connection, the shelters typically are structured so that the accommodation party bears little or no economic risk from the transaction.

[66] 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.

[67] 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.

realization principle and thus can enter into transactions with taxpayers subject to the realization principle to absorb gains of such taxpayers.

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.[68] 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.[69] 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

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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. The Administration, in its year 2000 budget, and Congressman Neal (D. Mass.) both have proposed legislation that would eliminate the purported conversion benefits from engaging in the derivatives transaction.**(Cite budget and Neal bill)**

[68] 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).

[69] Id.

investment without the unfavorable tax consequences.[70] Once inconsistencies are identified, they can be, and are, manipulated.[71]

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 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.'[72]

5. Unnecessary Steps or Novel Experiences

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.[73]

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[70] 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.").

[71] 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.").

[72] Bankman, supra note 5, at 1781.

[73] 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

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.[74] Similarly, in step-down preferred stock transactions, the use of the REIT structure was unnecessary to the corporate participant's business purpose of obtaining financing. Rather, the REIT structure was utilized solely to provide tax benefits that reduced the corporate participant's overall cost of borrowing.[75]

A common characteristic of the individual tax shelters of the 1970's and 1980's 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.**[OTA Stat?]** 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

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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.).

[74] 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, * T.C.M. at *.

[75] For a more complete discussion of this transaction, see Appendix___.

transactions. Thus, the fact a transaction is not "novel" for the taxpayer is not necessarily determinative of whether it is a corporate tax shelter.[76]

6. Mass 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 pitchmen who sold cattle and railcar tax shelters to individuals in the 1970s and 1980s.[77]

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.[78] Likewise, the fast-pay preferred stock tax shelter described in Notice 97-21 was marketed and sold by an investment bank to multiple corporations.[79] It has been reported that one Big Five accounting firm maintains two databases of about 1,000 "mass market" tax savings ideas.[80]

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

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[76] **[Should we cite liquidating REITs or something else?]**

[77] Forbes, supra note 5, at 200. See also, 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, 369 (Winter 1999) [hereinafter Holden]. (citing concern of many tax lawyers "with the recent proliferation of tax shelter products marketed to corporations").

[78] See ACM Partnership, 73 T.C.M. at 115 ("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).

[79] 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 (add); Bankman, supra note 5, 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.")

[80] Forbes, supra note 3, at 202 **[Add quote]**

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

Like mass marketing, maintaining confidentiality of a tax shelter transaction helps to maximize the promoter's return from its shelter idea.[81]

> [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.[82]

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.[83]

Confidentiality serves another essential purpose for the promoter -- it protects the efficacy of the idea by preventing or delaying discovery of the idea by Treasury and the IRS. In part, out of concern that confidentiality agreements were hindering the ability of Treasury and the IRS to uncover

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[81] Calvin H. Johnson, Corporate Tax Shelters, 1997 and 1998, 80 Tax Notes 1603, 1609 (Sept. 28, 1998) ("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.").

[82] See Bankman, supra note 5, 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.

[83] See Bankman, supra note 5, 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.")

corporate tax shelters in a timely fashion, Congress expanded the tax shelter registration requirements in 1997 to cover "confidential" corporate tax shelters.[84] One of three conditions for registration is that "some promoter other than the taxpayer has a proprietary interest in the arrangement or can prohibit the taxpayer from disclosing the arrangement."[85] Treasury 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.[86] 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,[87] or other arrangements (e.g., requiring a prospective participant to use the law firm selected by the promoter),[88] to protect their proprietary interest and reduce the risk of detection.

8. High Transaction Costs

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[84] Section 6111(d). See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, 222-23 ("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 addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.").

[85] See Johnson, supra note 63, 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.

[86] See Bankman, supra note 5, at 1789 ("It would allow members of the tax bar to discuss shelters in public forum and in informal conversations with Treasury 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.")

[87] Forbes, supra note 3, at 208 ("Clients know that if they blab, they won't see the next hot deal.").

[88] 1997 Airlie House Transcript, supra note 9, at 98 (Ed 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.").

Corporate tax shelters carry unusually high transaction costs that are borne, in whole or substantial part, by the corporate beneficiary.[89] For example, in ACM Partnership, the reported transaction costs were approximately 14.7 percent of the purported tax savings (approximately $34 million).[90] Similarly, the reported transaction costs in ASA ($24,783,800) were approximately 26.5 percent of the purported tax savings (approximately $93,500,000).[91] 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.[92]

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.[93] If no tax savings are realized, the promoter gets nothing. Although tax return preparers are precluded from charging a contingent fee in connection with the preparation of a return,[94] there is generally no

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[89] See, e.g., ACM Partnership, 73 T.C.M. 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.").

[90] Add cite]

[91] See ASA, 76 T.C.M. at 332.

[92] 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.")

[93] In one recent deal observed by Treasury, 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.").

[94] 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

prohibition on charging contingent fees in connection with providing tax planning advice. 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. **[Can we use step-down as an example?].**

[Summarize insurance memo]

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 uneconomic investments have been increasing for several reasons, at the same time that the costs have been coming down. Thus, it is unsurprising 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 are likely to continue to erode the corporate tax base in the future.

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

The Changing Benefit-Cost Calculus of Corporate Tax Shelters

The principal benefit of a corporate tax shelter is tax savings. The Tax Reform Act of 1986 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 11 cents less in 1987 than it was in 1986.[95] The same act also eliminated a host of tax preferences, most notably the investment tax credit. On balance, the base broadening more than offset the rate reduction, meaning that the *average* tax rate of corporate income increased, even though

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claims for refund.)

[95] Subsequent legislation raised the maximum corporate tax rate to 35 percent.

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

Perhaps more important, a myriad of factors have reduced the cost of corporate tax shelters. Most notably,

- Tax and financial advisers have become much more sophisticated about engineering transactions to avoid tax—which means that the cost of such strategies has been declining.

- The supply of tax shelter experts has increased, producing competitive pressures to lower the cost and expanding the array of sheltering schemes.

- The cost of producing tax shelters has decreased because of the growing complexity in the tax law, which creates more discontinuities that savvy tax planners can exploit.

- Corporate executives and tax departments have become less averse to participating in tax shelters (the "psychic cost" of tax avoidance has decreased).

- Rates of audit on corporations have decreased markedly, reducing the probability that aggressive tax schemes might be found to be illegitimate.

a. Greater incentive to tax shelter

The Tax Reform Act of 1986 (1986 Act) increased the benefit arising from tax shelters by eliminating tax credits and scaling back deductions. The 1986 Act repealed the investment tax credit and reduced the benefits of accelerated depreciation, and thereby eliminated two popular ways to reduce corporate taxes. These changes, indeed, 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[96]. The 1986 Act appears to have succeeded in this regard, as corporate tax payments increased sharply in the late 1980s [97].

Immediately following the passage of the 1986 Act, many observers raised concerns about the excessive use of debt as a tax shield, perhaps as a substitute for accelerated capital cost recovery allowances. That concern has abated for several reasons. Leveraged buyouts, commonly thought to

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[96] See McIntyre, Robert S. and Robert Folen. "Corporate Income Taxes in the Reagan Years; A Study of Three Years of Legalized Tax Avoidance." Washington DC: Citizens for Tax Justice 1984; McIntyre, Robert S. and Dean C. Tipps . "The Failure of Corporate Tax Incentives. A study of three years of growing loopholes and lagging investment." Washington DC: Citizens for Tax Justice 1985; McIntyre, Robert S, and David Wilhelm. "Corporate Taxpayers & Corporate Freeloaders: Four years of continuing, legalized tax avoidance by America's largest corporations, 1981-84." Washington DC: Citizens for Tax Justice 1985:

[97] See NIPA, table 1.16.

be an important vehicle for increases in corporate leverage during the 1980s, have all but disappeared, and much of the debt they created has been paid down (**citations**). 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[98].

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 these changes, firms have a stronger incentive to look elsewhere in the tax code in search of techniques for reducing their taxes.

b. Increased financial sophistication

The supply and price of corporate tax shelters depends on the supply of financially sophisticated tax experts and the availability and cost of complex technology to implement complex transactions. Anecdotal evidence, at least, suggests a significant increase in the number and sophistication of tax shelters engineers.

The increase in the power of computing technology and availability of sophisticated software is well documented. 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 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[99]. Employees who move from one firm to another take their knowledge and expertise with them and disseminate it. Business schools have been offering increasing sophisticated finance programs, teaching cutting-edge mathematical techniques and advanced computer technologies.

c. Increased supply of tax shelter specialists

By clamping down on individual tax shelters, the 1986 Act may have boosted the supply of corporate tax shelter specialists. The 1986 Act addressed individual 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 many accounts, it was quite successful in reducing individual tax shelters[100]. 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

[98] Ibid.
[99] See Romer on technology transfers?????
[100] See Samwick, 1995.

source of income 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.

d. Changing attitudes towards tax shelters

The individual tax shelter and tax evasion boom of the late 1970s and early 1980s is attributed in part to the widespread perception that the US tax code had become unfair [101]. The same thing 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[102]. In such an environment, corporations may be willing to take more aggressive tax positions because they believe that their competitors have an explicit or manufactured tax break. Indeed, as discussed in Part II.A.2.–., the officers of one corporations may examine the published financial statements of a competitor in order to try to determine their relative tax positions.

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 [103]. Taxpayer resentment of the U.S. tax system may have been fueled by the real 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 [104]. Other taxpayers and practitioners may feel that because the Congress and the Treasury 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 these seemingly unfair provisions[105].

Some commentators have argued that corporations increasingly view their tax departments as profit centers, rather than as general administrative support facilities[106]. This has put pressure on corporate financial officers to generate tax saving through tax shelters.

Some investors consider effective tax rates as a performance measure, separate from after-tax profits. As a result, 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.

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[101] See Meyer, Richard. "Running for Shelter: Tax Shelters and the American Economy." Public Citizens Tax Reform Research Group. (TRYING TO FIND OUT WHEN PUBLISHED)

[102] See Slemrod, Joel and Jon Bakija. "Taxing Ourselves: A Citizen's Guide to the Great Debate Over Tax Reform." The MIT Press, Cambridge: MA, 1996. Pg. 5.

[103] See Bankman, "The New Market for Corporate Tax Shelters," Forbes article, others.

[104] See Hyperlexis.

[105] See Weisbach.

[106] See Bankman, "The New Market for Corporate Tax Shelters," Forbes article.

e. Reduced audit risk from aggressive tax shelters

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 these companies were audited (IRS Annual Reports, various years). A reduction in the probability of being audited may make taxpayers more likely to take aggressive tax positions.

The dramatic decline in audit rates is somewhat misleading because companies have grown in size due to inflation and real economic growth. A $100 million company in 1980 would be much larger than a $100 million company in 1997. Since at any point in time audit rates are higher for larger companies than they are for smaller companies, a portion of the apparent decline in the audit rate for large companies may be illusory. The overall audit rate for corporate tax returns declined from 2.9 percent in 1992 to 2.0 percent in 1998, suggesting a decline in enforcement intensity.[107] The number of audits declined over the same time interval.

It also is worth noting that the audit rate is an imprecise guide to enforcement activity. For example, audits can be more or less comprehensive and done by more or less competent examiners. Thus, changes in the audit rate over time might not necessarily reflect real changes in tax enforcement.

f. Other factors

Various other factors have spurred the proliferation of corporate tax shelters. Increased complexity in the tax code creates more of the discontinuities that spawn tax shelters. A global marketplace for both products and capital creates opportunities that would not exist in a more autarkic environment. And finally, the merger boom of the 1980s and 1990s may have created some new avenues for tax shelter activity.

(1) 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 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.[108] As discussed in detail in Part II.A.2., some corporate tax

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[107] Jeremy Holmes, "TRAC Says IRS Data Show Decline in Audit, Fraud Prosecution Activities," *Daily Tax Report*, April 12, 1999, p. gg-6.

[108] For examples, see notice 98-5, 1998-3 I.R.B. 49.

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.

(2) Globalization

Several commentators have cited the increasing sophistication and internationalization of financial markets as a partial explanation[109]. Many tax shelters that have come to light involve complicated financial transactions, sometime involving foreign parties **(examples include ACM, fast-pay preferred stock, lease-leaseback, basis shifting involving foreign corporations)**. Such transactions may have been facilitated by technological advance in financial product development, and by the globalization of world capital markets.

(3) The Merger booms of the 1980s and 1990s

In the middle and late 1980s, the US 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 (M&A Almanac, 1992). After falling in the early 1990s, merger and acquisition activity has rebounded to reach new heights. In 1997 merger activity involving US companies totaled $791 billion, over 300 percent larger than in 1993 (M&A Almanac, 1998). These merger booms, while unlikely to be tax driven may have created tax planning opportunities[110]. Moreover, sales of companies may have generated significant capital gains, and consequently created a demand for capital losses. Indeed, some highly publicized corporate shelters (e.g., the ACM/Colgate case) apparently were motivated by a desire to generate losses to offset gains realized upon the sale of a business.

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. For one reason, at the same time that we believe tax shelters have proliferated, the economy has been booming, causing taxable corporate income to increase. Interest rates have been falling also, which further contributes to higher corporate

[109] See Forbes, Powlen and Tanden, Bankman.

[110] See Auerbach, Alan 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; Ibid. "Taxes and the Merger Decision: An Empirical Analysis." NBER Working Paper No. 1855, Cambridge MA: National Bureau of Economic Research, March 1986.

income. Thus, the countervailing economic effects have probably swamped the effect of corporate tax shelters.

As already discussed, experts in the field are convinced based on their own experience that corporate tax shelters are very significant. Forbes magazine conjectured that corporate tax shelters might cost the U.S. Treasury $10 billion annually, and that this number is growing dramatically. 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. Treasury 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 1998 Tax and Trade Relief Extension Act of 1998.

a. Increasing Discrepancy between Book Income and Taxable Income

As discussed elsewhere in this report, one feature of many tax shelters is that they reduce taxes without reducing book income. 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. For example, the ratio of (pre-tax) book income to income subject to tax 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.

While the recent increase in the discrepancy between book income and taxable income may be related to the growth of tax shelters, other factors also may have played a role. 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 the book/tax discrepancy. Furthermore, while the recent increase in the book/tax income ratio is large, the discrepancy has shown substantial volatility in the past: *e.g.*, in 1989 the ratio was 1.23, fell to 1.08 in 1990, jumped up to 1.20 in 1991, and fell again to 1.09 in 1991. **(More might be said on this, as the M-1 has more data which might be used to look at the reasons for the growth of the book/tax discrepancy. The M1 data also might be used identify firms which might have increased their tax shelter activity, as the book/tax discrepancy varies widely across firms.)**

It is also worth noting that the very large book/tax discrepancy in 1995 and 1996 is only partially mirrored in a reduced (book) effective tax rate. The ratio of taxes (per book) to pre-tax book income fell to about 17 percent in 1995 and 1996, from an average of about 19 percent in the 1990-1994 period. This reduction is much less dramatic than the change in the book/tax income discrepancy, and suggests that taxes during those years were more consistent with recent historical experience than was taxable income.

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-in to 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 then 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."[111]

Second, a system of rules backed up by standards can more accurately measure income a system of rules alone. 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 recharcterize 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

[111] Stanley Surrey, "Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail," 34 Law and Contemporary Problems 673 (1969).

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 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 in order 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 achieve either deferral or exclusion of income. In the past, Congress and the Treasury have responded by either amending the provisions or creating a system to overlay the provisions in order 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[112] and cumulative deferred taxes are accounted for in a liability account known as a deferred tax reserve.[113]

Deferral can arise in a number of ways. Some provisions of the Code and regulations specifically sanction deferral (for example, 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 LILO 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

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[112] 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 later year).

[113] See supra note ___.

interest income on short-term obligations, thereby matching in time their accrued interest income with accrued interest expense.

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, income from the discharge of indebtedness of insolvent or bankrupt taxpayers, 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).[114] 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 in order 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).

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[114] 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.).

A foreign source loss, on the other hand, may not be of much value 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.[115]

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 in order 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.[116]

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 by Congress. These 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 in

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[115] For an example of this type of conversion in the context of a corporate tax shelter, <u>see</u> Appendix A.

[116] For a more complete discussion of this type of arbitrage, <u>see</u> discussion of tax indifferent parties <u>supra</u> at section II(B)(3) of this Report.

order to deduct the amount of the dividend paid to the lender of the short stock and report only a small 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.[117]

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.[118] One commentator has declared that anti-abuse rules potentially are "a path toward a coherent solution" to the problem of tax shelters.[119]

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.[120] 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.[121]

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.[122] These regulations were issued in response to an increasing number of transactions that attempted to use the rules of subchapter K in an unintended manner.[123] Some of these transactions attempted to use a partnership to circumvent provisions of the Code outside of subchapter K. Others purported to create tax

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[117] 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.

[118] **Cite Weisbach**

[119] 1997 Airlie House Transcript, supra note ___, at ___ (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.")

[120] Treas. Reg. § 1.701-2.

[121] Treas. Reg. § 1.1275-2(g).

[122] T.D. 8588 (Dec. 29, 1994), amended by T.D. 8592 (Apr. 12, 1995).

[123] See PS-27-94 (May 12, 1994), reprinted at 1994-1 C.B. 832, 833.

advantages that were inconsistent with the substance of the transaction.[124] 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,"[125] 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,[126] 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.[127] 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.[128]

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.[129]

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.[130]

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[124] 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).

[125] Treas. Reg. § 1.701-2(a).

[126] For a detailed discussion of these doctrines, see infra section IV(A)(2) (clear reflection of income), section IV(B)(1)(substance over form), and section IV(B)(2)(business purpose).

[127] Id.

[128] Id. **[Any examples?]**

[129] Treas. Reg. § 1.701-2(b).

[130] Treas. Reg. § 1.701-2(e)(1).

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.[131]

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 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.[132] Because even more complicated rules would be required to address every conceivable (and unanticipated) fact pattern, the regulations contain a series of general anti-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."[133] 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. . ."[134]

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[131] Announcement 94-87, 1994-27 I.R.B. 124.

[132] See, e.g., Treas. Reg. §§1.1502-13 (intercompany transactions), 1.1502-20 (loss disallowance), 1.1502-32 (investment adjustments), and 1.1502-90T through 99T (application of section 382).

[133] CO-11-91, 1994-1 C.B. 724.

[134] T.D. 8597, 1995-2 C.B. 147.

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.[135]

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.[136] **[Do we want to keep this -- no more detail]** It remains unclear how courts will construe the various consolidated return anti-abuse rules, and the extent to which the rules will have an *in terrorem* effect in discouraging aggressive tax strategies.

3. Statutory Grants of Broad Authority

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[135] 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 . . .").

[136] See Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985), acq. 1986-2 C.B. 1. In Woods Investment, the court stated

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

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 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. This grant of authority was "deemed advisable" when Congress sanctioned the cash method of accounting as an alternative to the accrual method of accounting.[137] This authority is not limited to a taxpayer's overall method of accounting, but rather applies to any method of accounting for an item.[138] For example, section 446(b) authority has been exercised to clearly reflect income with respect to certain derivative transactions.[139]

The courts have long acknowledged that Congress vested the Secretary with broad discretion in determining whether a particular method of accounting clearly reflects income.[140] The Secretary's determination is entitled to more than the usual presumption of correctness.[141] Accordingly, the Secretary's interpretation of the clear reflection of income standard should not be interfered with unless clearly unlawful or plainly arbitrary,[142] 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

[137] H.R. Rep. No. 64-922, at 4 (1916). The legislative history of the 1924 Act explained the 's clear reflection of income authority as follows: "Authority is granted to the Secretary 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 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 ___ (1924).

[138] Treas. Reg. § 1.446-1(a)(1).

[139] 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.

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

[141] RLC Indus., 98 T.C. at 491; RECO Indus., Inc. v. Commissioner, 83 T.C. 912, 920 (1984); Pennsylvania Steel Products & Equip. Co. v. Commissioner, 78 T.C. 1029, 1044 (1982).

[142] 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)).

determined on a case-by-case basis.[143] 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.[144]

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.[145]

b. *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."[146]

c. *Section 7701(l).* Congress enacted section 7701(l) in 1993, which gave the Secretary authority to prescribe regulations recharacterizing any multiple party financing transaction as a transaction directly among any two or more parties when such recharacterization is appropriate to

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[143] See Pacific Enterprises & Subs. v. Commissioner, 101 T.C. 1, 13 (1993); RLC Indus. Co., 98 T.C. at 489.

[144] Ford Motor Co., v. Commissioner, 102 T.C. 87 (1994), aff'd, 71 F.3d 209 (6th 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 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.

[145] 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 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.)

[146] H.R. Rep. No. 70-2, at 16-17 (1928).

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 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."[147]

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.[148] 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.[149]

In accordance with this broad grant of regulatory authority, Treasury has already used section 7701(l) to address specific types of multiple-party financing transactions that permit taxpayers to avoid tax. For example, Treasury 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.[150] 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 cost recovery or rental expenses) related

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[147] H.R. Conf. Rep. 103-213, at 654 (1993).

[148] 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 the 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. See 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).

[149] 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.").

[150] Treas. Reg. § 1.881-3. **[Explain?]**

to that income.[151] Most recently, proposed regulations were issued to address fast-pay preferred stock (discussed more fully in Appendix __), 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.[152]

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 that, 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. **[Rework?]** What is less clear is whether the taxpayer crossed the line of propriety in selecting the less-heavily taxed route.

1. <u>Substance Over Form Doctrine</u>

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.[153]

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[151] Prop. Reg. § 1.7701(l)-2 (addressing "obligation shifting transactions" such as lease stripping transactions)

[152] Notice 97-21, 1997-1 C.B. 407; Prop. Reg. § 1.7701-3 (recharacterizing fast-pay stock transactions).

[153] 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. <u>See, e.g.</u>, Rev. Rul. 74-27, 1974-1 C.B. 24. In this case, the formal tax result is based on the substance of the underlying transactions, not its formal documentation.

> 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. [154]

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."[155] For example, a taxpayer cannot label what is, in essence, equity as debt and thereby secure an interest deduction.[156] 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."[157]

The substance over form doctrine has its roots in Gregory v. Helvering.[158] 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 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.

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[154] Joseph Isenbergh, Musings on Form and Substance and Form in Taxation, 49 Chi. L. Rev. 859, 866 (1982).

[155] Powlen & Tanden, supra note ___, at 1013.

[156] Notice 94-48, 1994-1 C.B. 357 (reverse MIPS).

[157] Hariton, supra note, at 239. 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.

[158] 293 U.S. 465 (1935).

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[159] and Litton Industries, Inc. v. Commissioner.[160] 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.[161] 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 upheld the transaction as the parties had structured it.[162] Litton, Esmark,[163] 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."[164]

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[159] 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971).

[160] 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(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 (7th 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, "The 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 fn. ___, at 240.

[161] I.R.C. § 243.

[162] See also, Uniroyal, Inc., v. Commissioner, 66 T.C.M. 2690 (1993).

[163] See discussion of Esmark in fn 136 supra.

[164] 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

Recently, however, in ASA Investerings Partnership v. Commissioner,[165] the substance over form doctrine was applied to invalidate the same loss generation tax shelter that was at issue in ACM.[166] 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.[167]

While it is difficult to discern a common thread to the substance-over-form decisions, it appears that application of the doctrine depends upon whether the court believes that the taxpayer would otherwise be able to achieve an unreasonable and unwarranted tax benefit. In cases where courts have found for the Government, there is usually strong language in the opinion that indicates the court's displeasure with the taxpayer's purported tax results. For example, in Waterman, where the IRS succeeded in recharacterizing a pre-sale dividend as additional consideration from the subsequent sale, the court openly worried that to hold otherwise would open a "new horizon of tax avoidance opportunities."[168]

In cases where the courts have held against the Government, by contrast, the courts have sometimes articulated an underlying view that the taxpayer's tax benefits were not unreasonable or unwarranted. In Esmark, for example, the Tax Court refused to recharacterize a multi-step transaction on substance-over-form grounds in part because the transaction was designed to fall within the remaining portion of the then-existing General Utilities doctrine.[169] In other words, given Congress's failure to fully repeal General Utilities for the taxpayer's transaction, the result the taxpayer sought was not so unreasonable or unwarranted as to justify the application of the substance-over-form doctrine.

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be easier for taxpayers to overcome than at any time in the past").

[165] 76 T.C.M. (CCH) 325 (1998).

[166] **Cite discussion of ACM**

[167] 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 fn ___, 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.

[168] 430 F.2d at 1195.

[169] 90 T.C. 171, 200 (1988), aff'd per unpublished order, 886 F.2d 1318 (7th Cir. 1989).

b. *Step Transaction Doctrine*. The step transaction doctrine is a relatively common application of the substance-over-form doctrine.[170] 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 of the steps more accurately reflects the underlying substance.[171] The seminal case on the business purpose doctrine, Gregory, is also an example of the step transaction doctrine.[172]

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.[173] 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.[174] The binding commitment test has not been widely adopted by courts, probably because it is a very restrictive view of the step transaction doctrine.[175] 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.[176] Because the end result test focuses on the parties' intent, it has

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[170] 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."

[171] Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 4.3.5 (3d ed. 1999). See generally, Randolph Paul & Philip Zimet, Step Transactions, in Selected Studies in Federal Taxation, 200 (2d Series, 1938); 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.

[172] See discussion supra at note134.

[173] See, e.g., Penrod v. Commissioner, 88 T.C. 1415 (1987).

[174] 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." 391 U.S. at 96. Cf. Redding v. Comissioner, 630 F.2d 1169 (7th 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).

[175] See Rosenberg, supra note __, at 406-07; Martin D. Ginsburg and Jack S. Levin, MERGERS, ACQUISITIONS, AND BUYOUTS § 608.1 (Mar. 1998 ed.).

[176] 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 (5th Cir. 1954); Atchinson,

been criticized for being vague and difficult to apply consistently.[177] 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."[178] The mutual interdependence test has been described as, alternatively, "more popular than either binding commitment or [end result],"[179] and "merely a variation of the end result test."[180]

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.[181] 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.[182]

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.[183] **[Elaborate -- any shelter applications]**

Topeka & Santa Fe R.R. Co. v. United States, 443 F2d 147, 151 (10th Cir. 1971); Associated Wholesale Groceries, Inc. v. United States, 927 F2d 1517, 1523 (10th Cir. 1991). See also Sheldon Banoff, The End Result Test, * Taxes * (19**).

177 See Rosenberg, supra note __, at 407-08.

178 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 __, at 254.

179 Rosenberg, supra notes __, at 409.

180 Ginsburg & Levin, supra note __, at § 608.1.

181 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 and Levin, supra note ___, at § 608.1 ("[n]otwithstanding 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").

182 Ginsburg and Levin, supra note ___, § 608.1. **[Should we add that Ginsburg and Levin believe that the cts look to intent, temporal proximity and business purpose to determine application of the s-t doctrine.}**

183 See generally, Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.61[3] (6th ed. 1997); Ginsburg & Levin, supra note __, § 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.[184] 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.[185] 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."[186] 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.[187]

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 the same transaction.[188] For example, in Danielson, the taxpayers had agreed to a cash sale of their

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[184] **[Fn 65 of Kies testimony cites Higgins and quotes Morris for this proposition].** 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]).

[185] Estate of Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961).

[186] Danielson v. Commissioner, 378 F.2d 771, 775 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

[187] 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.).

[188] 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 Robert Thornton Smith, Substance and Form: A Taxpayer's Right

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.[189] 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.[190] 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.[191]

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.

[Let's rework this]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.[192]

Concerns over whipsaw potential have also caused Congress to enact certain statutory provisions -- section 385(c) and section 1060(a)[193] -- that limit a taxpayer's ability to disavow the

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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).

[189] Danielson, 378 F.2d at 771.

[190] 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.

[191] 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).

[192] 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). **[We may want to elaborate on this and move it up in the discussion]**

[193] 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

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.[194]

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.[195] Like several of the other judicial doctrines, the origins of the business purpose doctrine are found in the Supreme Court's decision in Gregory v. Helvering.[196] 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

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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.")

[194] 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.").

[195] Bittker & Eustice, supra note __, ¶ 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 be.

Isenbergh, supra note ___, at 866.

[196] 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 F2d 740 (Ct. Cl. 1977) (requiring business purpose for payment of a dividend).

> 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.[197]

The business purpose doctrine also has been applied outside the corporate context. For example, in Goldstein v. Commissioner,[198] 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."[199]

The business purpose doctrine also was used to challenge the individual tax shelters of the 1970's and 1980's. 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, in some instances, the basis for their invalidation was the absence of any business purpose or economic substance other than the creation of tax benefits.[200]

3. Economic substance doctrine.

The third, and final, way the IRS can subjectively 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 (1) the tax benefits arise from a discreet set of transactions that do not meaningfully alter the taxpayer's economic position, and (2) the tax benefits are unreasonable and unwarranted in light of the objective rules that give rise to them.[201]

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

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[197] 293 U.S. at 469.

[198] 364 F.2d 734 (2d Cir 1966), cert. denied, 385 U.S. 1005 (1967).

[199] 364 F.2d at 741.

[200] See, e.g., Sochin v. Commissioner, 834 F.2d 351 (9th Cir. 1988); Lukens v. Commissioner, 945 F.2d 92 (5th Cir. 1991).

[201] One commentator has argued that the test 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." Hariton, supra note ___, at 235 (1999).

preserving the taxpayer's purported tax benefits. For example, in Goldstein v. Commissioner,[202] 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."[203]

Similarly, in Sheldon v. Commissioner,[204] 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 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,[205] 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" 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.

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[202] Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966).

[203] 364 F.2d at 741.

[204] 94 T.C. 738 (1990).

[205] 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).

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,[206] the taxpayer purchased privately-placed debt instrument 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."[207] 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 economics 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 position it had occupied before engaging in the offsetting acquisition and disposition of those notes.[208]

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 3 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.[209]

[Do we retain - cite Hariton?]Although the cases that discuss the economic substance doctrine focus primarily on the potential for significant net economic consequences, the requirement that the purported tax benefits be unreasonable or unwarranted must also be met. Perhaps this requirement is not often discussed because it is so clear from the facts that the tax benefits are unwarranted. For example, in ACM itself, the tax benefit from the near-simultaneous purchase and sale is so clearly unwarranted there is little need to discuss it. In other cases, however, this requirement appears to play a more significant role. For example, in Horn & Horn v.

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[206] 157 F.3d 231 (3d Cir. 1998).
[207] 157 F.3d at 250.
[208] 157 F.3d at ___.
[209] 94 T.C. at 769.

Commissioner,[210] the taxpayer, a commodities dealer, had sustained losses from commodities straddles similar to the straddles at issue in the London Metal Exchange cases. On appeal, the D.C. Circuit Court reversed the Tax Court's disallowance on economic substance grounds because, in the view of the Court, it was unclear whether the tax benefits sought by the taxpayer were unwarranted: "Barring constitutional infirmity, Congress undoubtably has the power to grant beneficial tax treatment to economically meaningless behavior, if indeed that is what has happened here."[211]

The requirement that the tax benefits be unreasonable or unwarranted also helps explain the taxpayer victories in Cottage Savings Association v. Commissioner[212] and Northern Indiana Public Service Co. v. Commissioner.[213] In both of these cases, the taxpayer entered into transactions that lacked significant economic consequence in order to obtain a tax benefit. In Cottage Savings, the taxpayer exchanged a pool of depreciated mortgages for a pool of economically identical mortgages in order to recognize a loss. In NIPSCO, the taxpayer inserted a Netherlands Antilles finance company into a cross-border lending transaction to avoid a withholding tax. Despite the lack of meaningful economic consequences from these transactions, the courts refused to apply the economic substance doctrine to disallow the benefits. While commentators can, and do, argue about exactly why the courts did this, the fact remains that in both cases a strong argument can be made that the results of the transactions are not unreasonable or unwarranted. **[Do we keep?]**In Cottage, the Federal Home Loan Bank Board had specifically condoned tax-motivated mortgage swaps. In NIPSCO, an argument could be made that the Commissioner approved of "self-help" methods of avoiding the withholding tax through Netherlands Antilles subsidiaries and, given this approval, it was unfair to single out this particular transaction.

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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[210] 968 F.2d 1129 (D.C. Cir. 1992).
[211] 968 F.2d at 1137-38.
[212] 499 U.S. 554 (1991).
[213] 115 F.3d 506 (7th Cir. 1997).

Several elements were common to the tax benefits derived in many of these tax shelters.[1] 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 Federal Government effectively was granting the taxpayer an interest-free loan. Second was the conversion of ordinary income to capital gains or some other form of tax-favored income. 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 leverage, which allowed taxpayers to recognize significant tax benefits without committing their own funds. The investments made with the borrowed funds often resulted in deductions against ordinary income, and the interest paid on the indebtedness was deductible against ordinary income as well. Income from these investments was subject to tax only when realized (which frequently was on disposition) and often at reduced capital gains rates. Finally, overvaluation of property 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.[2] The first step (albeit a small one) in the assault on tax shelters came in the Tax Reform Act of 1969.[3] 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.[4] 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,[5] the at-risk rules were extended to a broader array of activities (although still not real estate) and to closely-held corporations. The Economic Recovery Tax Act of

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[1] See generally Jt. Comm. on Tax'n, Tax Reform Proposals: Tax Shelters and Minimum Tax (Aug. 7, 1985).

[2] See generally Caplin, Tax Shelter Disputes and Litigation with the Internal Revenue Service - 1987 Style, 6 Va. Tax Rev. 709 (1987).

[3] Pub. L. No. 91-172, 83 Stat. 487.

[4] Pub. L. No. 94-455, 90 Stat. 1520.

[5] Pub. L. No. 95-600, 92 Stat. 2763.

1981[6] 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)[7] 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[8] 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, Treasury was given authority to bring disciplinary actions against appraisers who appear before the IRS or Treasury.

While significant progress had been made in the tax shelter battle by this time, the Tax Reform Act of 1986[9] 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.

[Rework or eliminate] While the numerous actions of Congress, taken together, were largely effective in shutting down the tax shelter industry of that day, the corporate tax shelters of today are a very different animal. Corporate tax shelters take many forms and are accomplished by exploiting many different provisions of the Code. The limitation on passive losses in 1986 wiped out a significant portion of the tax shelters being marketed at that time because a common factor in most

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6 Pub. L. No. 97-34, 95 Stat. 172.

7 Pub. L. No. 97-248, 96 Stat. 324.

8 Pub. L. No. 98-369, 98 Stat. 494.

9 Pub. L. No. 99-514, 100 Stat. 2085.

of the shelters was that the investors did not materially participate in the business underlying the investment. There is no similar common theme with respect to today's corporate tax shelters. In addition, because corporate tax shelters exploit so many different parts of the Code, an attack that focuses on modifying the substantive provisions that are being exploited would be fruitless. Accordingly, different remedies must be explored in order to effectively combat corporate tax shelters in today's market.

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

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.

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.[10]

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.[11] 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.[12] 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.[13] 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.[14] Section 6112 requires, in certain

[10] See Jt. Comm. on Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 475 ("1984 Blue Book") (Dec. 31, 1984)
[11] Section 6111(a)(1).
[12] Section 6111(a)(2).
[13] Section 6111(b)(1).
[14] Section 6111(b)(2).

cases, that organizers or sellers of "potentially abusive tax shelters" maintain lists of investors.[15] 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.[16] 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.[17] 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.[18] 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.[19]

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 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.[20]

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[15] 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. 861, 98th Cong., 2d Sess. 977 (June 23, 1984).

[16] Section 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. Section 6111(c)(2), (3).

[17] 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 ___, 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 ___, at 477-79.

[18] Section 6111(c)(4).

[19] Section 6112(b).

[20] Section 6111(e). The legislative history states in this regard that "[I]n 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 ___, at 477.

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).[21] 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.[22] 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.

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 to examine every return."[23] 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.[24] 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

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[21] Section 6707(a)(2) (as enacted).

[22] Section 6707(b). The penalty for failure to include the identification number on a return could be abated for reasonable cause.

[23] S. Rep. No. 169 [cite]. 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 ___, at 475.

[24] Id.

numerous investors in a shelter for whom lists had to be maintained or identification numbers furnished.

Accuracy-related penalty. Prior to 1982, penalties existed for negligent and fraudulent understatements of tax.[25] The expectation of nonfraudulent and nonnegligent reporting positions had its analog in ABA Formal Opinion 314 (1965), which imposed a 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.[26] Congress responded initially with a series of technical changes to the existing penalties.[27] 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.[28]

As originally enacted in Code 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).[29] 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.[30] 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.[31] A tax shelter was

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[25] Sections 6653(a) and (b) of the Internal Revenue Code of 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.

[26] See Jt. Comm. on Tax'n., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 216 (Dec. 31, 1982) ("1982 Blue Book"); J. Kurtz and Panel, "Questionable Positions," 32 Tax Law. 13 (1978).

[27] 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.

[28] See 1982 Blue Book, supra note ___, at 216.

[29] Section 6661(a), (b).

[30] Section 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 ___, at 216-17.

[31] 1982 Blue Book, supra note ___, at 217.

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."[32] 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.[33] The Secretary was authorized to waive the penalty upon a showing by the taxpayer of reasonable cause and good faith.[34] Further toughening of penalties occurred in the Tax Reform Act of 1984[35] and the Tax Reform Act of 1986.[36] 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.[37] 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 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.[38] 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

[32] Section 6661(b)(2)(C)(ii)(as enacted)(emphasis added). Regulations subsequently defined "the principal purpose" to mean a purpose that "exceeds any other purpose." Reg. section 1.6662-4(g)(2).

[33] Section 6661(b)(2)C)(i).

[34] Section 6661(c).

[35] 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 Code section 6660.

[36] The fraud penalty was increased to 75 percent and valuation penalties were broadened to encompass pension matters with the addition of Code 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."

[37] 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 the 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 the penalties."

[38] However, a 40 percent penalty applies under section 6662(h) in the case of certain "gross valuation misstatements."

6664(c) applicable to all accuracy-related penalties and to the fraud penalty.[39] As enacted in 1989, section 6662 retained the rules of its predecessor statute with respect to tax shelter items.

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.[40] Consequently, the section 6700 penalty is imposed on to organizers or sellers of interests in partnerships or other arrangements who made statements regarding the allowability of tax benefits that the person knew (or had reason to know) were false or fraudulent.[41]

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[42] to be false or fraudulent as to any material matter. Because many of these shelters involve

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[39] 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. 247, 101st Cong., 1st Sess. 1392-93.

[40] 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. 494, 97th Cong., 2d Sess. 266, 268 (1982).

[41] 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 ___ at 211.

[42] 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. Comm.) Rep. No. 760, 97th Cong. 2d Sess. 572 (Aug. 17, 1982). Several courts have held that the "know or has reason to know" standard does not require scienter, i.e., specific intent.

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.[43]

Also, in 1982 Congress enacted the aiding and abetting penalty of section 6701.[44] 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.[45] Some courts have held that the standard of knowledge under section 6701 requires actual knowledge, rather than willful blindness.[46]

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.[47] 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

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United States v. Campbell, 897 F.2d 1317 (5th Cir. 1990); United States v. Kaun, 827 F.2d 1144 (7th Cir. 19987). 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., United States v. Buttorf, 761 F.2d 1056 (5th Cir. 1985); United States v. Estate Preservation Services, 83 A.F.T.R.2d para. 99-769 (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. Estate Preservation Services, supra.

[43] S. Rep. No. 494, 97th Cong., 2d Sess. 267 (1982).

[44] 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 ___, at 220.

[45] Section 6701(c).

[46] Mattingly v. Commissioner, 924 F.2d 785 (8th Cir. 1991); Gard v. United States, 92-1 U.S.T.C. (CCH) para. 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 ___, at 221.

[47] 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.

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.[48] The aiding and abetting penalty may be imposed in relation to no more 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.[49]

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.[50] 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.[51]

Standards of Practice. The Treasury Department promulgates regulations governing practice before the IRS, referred to as Circular 230.[52] 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.[53]

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 opinions.[54] These standards were patterned after ABA Formal Opinion 346 (1982) and were directed toward the types

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[48] Section 6700(a). This provision was added by the Omnibus Budget Reconciliation Act of 1989.

[49] Section 6701(b)(3).

[50] 1982 Blue Book, supra note ___, at 213.

[51] The injunction may enjoin the conduct subject to penalty or "any other activity subject to penalty under section 6700 or 6701." Section 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., United States v. Campbell, 897 F.2d at 1323.

[52] Circular 230 is found at Part 10 of Title 31 of the Code of Federal Regulations..

[53] 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.

[54] Section 10.33. Circular 230 also contains standards for return preparers. See section 10.34.

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.[55] 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.[56] Practitioners must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.[57] 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.[58]

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.[59] A favorable 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.[60]

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,

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[55] 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 ___, at ___.

[56] 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.

[57] Section 10.33(a)(2).

[58] 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.

[59] Sections 10.33(a)(4) and (5).

[60] Section 10.33(a)(5)(i).

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.[61]

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.[62] 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.

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.[63] Once an abusive tax shelter was identified and investigated, the IRS would undertake procedures to (i) freeze the refunds of investors; (ii) request injunctive relief under section 7408; (iii) assert penalties under section 6700 (relating to a penalty for promoting abusive tax shelters); or (iv) issue pre-filing notification letters to investors.[64]

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[61] Section 10.51(j).

[62] IR 85-49 (May 17, 1985).

[63] I.R.M., Audit, 42(17)1, MT 4200-574 (Nov. 22, 1989) (Tax Shelter Program -- General).

[64] 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, § 6.01. 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, § 3.02 ("Returns in which pre-filing notification letters have been issued for the current or prior year will automatically be selected for review.").

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.[65] To accomplish this, the IRS determined that it had to identify and investigate abusive tax shelter promotions before the affected tax returns were filed.[66] 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.[67]

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.

2. 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.[68] 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

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[65] 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).

[66] Rev. Proc. 83-78, 1983-2 C.B. 595, modified, 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. Sections 6700 and 7408.

[67] 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.

[68] Section 6111(d).

promoter fees may exceed $100,000 in the aggregate.[69] 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.[70] In certain cases, persons other than the promoter are required to register the corporate tax shelter.[71] 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.[72]

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.[73] The ability 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.[74]

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.[75]

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

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[69] Section 6111(d)(1).

[70] Section 6111(d)(2).

[71] See section 6111(d)(3).

[72] Section 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.

[73] P.L. No. 103-465, ___ Stat. ___.

[74] 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. 826, 103d Cong., 2d Sess. 198 (1994).

[75] Johnson, supra note ___, 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. Section 6662(d)(2)(B).

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.[76] 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.[77] 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 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.[78] 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.[79] 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.[80]

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.[81]

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, there does not appear to be single proposal that adequately could 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.

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[76] Treas. Reg. section 1.6664-4(e)(1).
[77] Treas. Reg. section 1.6664-4(e)(2)(i)(A).
[78] Treas. Reg. section 1.6664-4(e)(2)(i)(B).
[79] Id.
[80] Treas. Reg. section 1.6664-4(e)(2)(i).
[81] Treas. Reg. section 1.6664-4(e)(4).

However, like the individual tax shelter problem of the 1980's, 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 in the rules or sanctions themselves.[82] 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.[83] 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 paper. 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.[84] Third, Treasury 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."[85] Equally, 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.[86] Fourth, the corporate sector appears to be placing a premium on tax savings and managing effective tax rates.[87] 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.[88] 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."[89]

This section of the paper describes and discusses the Administration's major legislative proposals that have been put forth by the Administration in its FY 2000 Budget and are intended to restrict the growth of corporate tax shelters.[90] This section also summarizes and analyzes comments

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[82] See, e.g., Kies at .
[83] See, e.g., NYSBA Report at 881-83 and ABA at 4-6.
[84] See, e.g., NYSBA Report at , Holden
[85] See, NYSBA at 882-3.
[86] The <u>ACM Partnership</u> litigation, for example, took several years and cost the IRS several million dollars.
[87] Cite Holden, NYSBA
[88] Cite Forbes article
[89] ABA Testimony at p. 6.
[90] Department of the Treasury, General Explanation of the Administration's Revenue Proposals at 95-105 (February 1999) (hereinafter Treasury Explanation).

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) in testimony filed with the tax-writing committees.[91] Provisions similar to the Administration's proposals and reflections of the bar groups' comments can be found in H.R. 2255, the "Abusive Tax Shelter Shutdown Act of 1999," also discussed in relevant part herein.[92]

The corporate tax shelter 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 consequences to all the parties to the transaction (e.g., corporate participants, promoters and advisors, and tax indifferent, accommodating parties). It should be noted that each of these areas are interdependent with one another and upon the definition of corporate tax shelter. For example, a clear, narrow definition of corporate tax shelter would support the imposition of significant strict-liability penalties upon transactions that meet the definition. Strict liability may not be appropriate where the definition is less clear. In such instances, reliance upon other deterring factors, such as disclosure, may be warranted. Similarly, 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. The relationships between, and the relative importance of, each of these four areas is discussed below.

A. Obtain Greater Disclosure of Corporate Tax Shelters

1. In general

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. 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

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[91] This white paper 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 white paper, the Treasury Department has considered all comments submitted by interested parties, even if not cited herein.

[92] H.R. 2255 was introduced by Messrs. Doggett, Stark, Hinchey and Tierney on June 17, 1999.

not to reveal questionable transactions to the IRS and, under current law, there are no mechanisms that adequately reverse this incentive. 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.[93] In fact, the 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 some taxpayers.

Disclosure can take several forms. 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. 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 enter into by, a number of taxpayers, disclosure could be required when the transaction is contemplated or entered into. Such "early warning" disclosure could be made by the participating corporation or the promoter.[94] In order to be effective, disclosure should be 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. The risk of overdisclosure may inhibit the ability of the IRS to sift through the reported transactions for those with shelter characteristics. 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.

Notwithstanding any defects in the current registration rules, statutory rules mandating disclosure are essential if the Treasury and 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 Treasury 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.[95] A related concern is that detection during the course of an audit by revenue agents is hampered by

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[93] See, e.g., Cal Johnson.

[94] See, e.g., the section 6111 registration requirements.

[95] Cites

resource and time constraints and the complexity of the transactions.[96] There appears to be a relatively uniform consensus among commentators that adequate disclosure requirements are an essential response to corporate tax shelter activity.[97]

2. Administration Proposals

The Administration's FY 2000 Budget contains several proposals that are designed to increase disclosure of corporate tax shelters.[98] 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 such the disclosure described in (1) had been made, and (3) providing increased disclosure on Schedule M-1 of the tax returns highlighting the book/tax difference (if any) resulting from the corporate tax shelter for the taxable years in which such differences exist.[99]

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 could be required to disclose the inconsistency on their returns.[100] Disclosure would permit the Treasury 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

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[96] Cites. 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, at p. [ ]. 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.

[97] Cites

[98] Treasury Explanation at 95.

[99] A separate proposal could be developed that would require greater disclosure through an expanded Schedule M could require corporate taxpayers to disclose and explain on a statement attached to their returns the nature of any book-tax adjustment with respect to any item reported on a tax return (or refund claim) that differs significantly from its book treatment. To keep the scope of the provision narrowly targeted at large corporations, the proposal could apply only if the book-tax adjustment exceeded $1 million. The penalty for failing to disclosure could run anywhere from 25 percent to 100 percent of the amount of any deduction or exclusion claimed with respect to such an item.

[100] 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.

regulations, or pursuing litigation) to prevent taxpayers from claiming such benefits. The disclosure requirement would not affect the requirement that taxpayers file their returns in accordance with existing law. Thus, for example, if the weight of authority supported treating a transaction in accordance with its substance, rather than its form, the taxpayer would be required to report the transaction in accordance with its substance (or face penalties). In this case, under the disclosure requirement, the taxpayer would also be require to disclose that it was taking a position inconsistent with the form of the transaction. The disclosure requirement would also not affect the application of the Danielson and strong proof rules under existing law.[101] Nor would the disclosure rule have any effect on the ability of the IRS to assert substance over form principles in order to recharacterize a taxpayer's transaction. Appropriate exceptions could be provided from the disclosure rules for transactions that have historically involved taxpayers taking positions inconsistent with the form[102] and transactions for which the Treasury and IRS explicitly require taxpayers to report the substance of the transaction.

3. Commentaries

Many of the ABA proposals relate to disclosure.[103] 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 Form 1120 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."[104] If the answer is "yes," specific information

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[101] Accordingly, if a taxpayer residing in a Danielson jurisdiction enters into a transaction in which the form and substance do not coincide and the transaction implicates the policies underlying the Danielson rule, the taxpayer would be required to offer proof that "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." Danielson, 378 F.2d at 775.

[102] 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. United States, 421 F.2d 442 (5th Cir. 1970) and Union Planters National Bank of Memphis v. United States, 426 F.2d 115 (6th Cir. 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. United States, 435 U.S. 561 (1978).

[103] (footnote citing Steph: "discl' discl' discl") from Daily Tax Reporter of 4/28/99.

[104] 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.

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 facts 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.[105]

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 penalty rate for tax shelters for which there is disclosure compliance.[106]

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 transaction of interest to the IRS and (2) be in a form and at time to be useful the IRS. The AICPA believes that approach used in Form 8275 " " 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. 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, 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.[107]

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[105] These reporting requirements can be found in section 4 of H.R. 2255, relating to decreases in the substantial understatement penalty applicable to noneconomic tax attributes.

[106] ABA at 9-10.

[107] AICPA at 19-20.

The NYSBA strongly supports the disclosure provisions of the Administration's penalty proposals 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.[108]

4. <u>Analysis and Possible Modifications to Administration Proposals</u>

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 usable by the government. Consistent with the views expressed by the ABA, AICPA and NYSBA, the Treasury 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 centers on the information being sought and requires short answers.

In addition, in order to address comments that the definition of corporate tax shelter is too vague for purposes of triggering a reporting requirement, certain "filters" would be developed so that a corporation need not disclose a transaction unless it met certain parameters, 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 all or 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; involvement with a tax indifferent party; advisor fees in excess of a certain amount or contingent fees; a confidentiality agreement, a difference between the form and the substance of the transaction, etc.

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. 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 and

[108] NYSBA Report at 894.

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 heightened penalties for fraud or gross negligence and the officer would be accorded appropriate due process rights.

The Treasury believes that two forms of disclosure are necessary.[109] First, 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, Treasury 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 so as not to waste the resources of the examining IRS agent in the field in attempting to discover and determine the nature of a sheltering transaction.

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. To the extent this proposal requires taxpayers to disclose transactions subject to a confidentiality agreement, the section 6111 disclosure requirement for confidential corporate tax shelter arrangements could be modified or eliminated.[110]

The Treasury Department continues to believe that taxpayers should be encouraged to disclose transactions that are reported differently from their form.[111] The Treasury proposal included in the

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[109] 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.

[110] 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.

[111] Alternatively, to discourage corporate taxpayers from entering into transactions where the substance is different from the form, corporate taxpayers could be precluded in all cases from taking positions that are inconsistent with the forms of their transactions. This alternative would preclude opportunities for arbitrage and whipsaw, but could impose significant burdens on taxpayers and the IRS because taxpayers would be prohibited from taking positions consistent with the substance of

Budget does not intend to overturn the axiom of tax law that, with certain limited exceptions, a transaction should be reported pursuant to its substance rather than its form. Rather, the proposal seeks to elicit disclosure of those transactions that may warrant additional scrutiny. However, it is recognized that if the sanction for failing to disclose the divergence from form is significant or if the form of the transaction produces more significant tax benefits than does its substance, a taxpayer may simply report a transaction according to its form and hope that the IRS does not discover the issue. The Treasury Department seeks to modify its original proposal and to strike the proper balance in this area. For example, options include using "substance versus form" as one of the filters for which disclosure is required or placing an additional relevant question on the tax return (whether or not the transaction was with a tax indifferent party).

B. <u>Modify Substantial Underpayment Penalty</u>

The imposition of a significant penalty traditionally is one method to deter persons, including taxpayers, from engaging in inappropriate behavior. As discussed in Part IV.C. above, 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 a substantial understatement of income tax.[112] 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 principal purpose* of the transaction was the avoidance or evasion of Federal income tax.

An issue closely associated with the substantial understatement penalty is the ways taxpayers can avoid the penalty. Section 6664© provides that the penalty shall not apply to any portion of an underpayment where there was reasonable cause for, and the taxpayer acted in good faith with respect to, the tax treatment of such portion. In this regard, the legislative history of the Uruguay Round Agreements Act of 1994 states that a determination by a taxpayer or a professional tax advisor that the substantial authority and more likely than not standards are satisfied will be an important factor in assessing whether the reasonable cause exception applies, but it will not be enough, by itself, to establish that the reasonable cause exception does apply. The legislative history states that reliance on the opinion of a professional tax advisor may be unreasonable where the advisor makes inappropriate legal or factual assumptions, does not address all relevant issues, or inappropriately

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the transaction, as is required in some cases under existing law. Accordingly, this alternative is not recommended

[112] The penalty is increased to 40 percent under section 6662(h) for certain gross valuation misstatements.

relies on representations or agreements to take certain actions made by the taxpayer or other parties.

Consistent with the legislative intent to tighten the exception to the penalty, regulations issued under section 6664 provide that, to escape the penalty, the corporate taxpayer must establish (1) that there was substantial authority for the position taken, (2) that the taxpayer had a reasonable belief that the position had a greater than 50 percent of being sustained if challenged (based either on the corporation's own research or the opinion of a tax professional), and (3) legal justification for the position taken. The regulations further provide that even if these three factors are present, relief will be denied if the corporation's participation in the tax shelter lacked significant business purpose, if the tax benefits claimed were unreasonable in relation to the investment, or if the corporate taxpayer agreed with the promoter to protect the confidentiality of the arrangement.[113]

As evidenced by the recent rise of corporate tax shelters despite of the current statutory and regulatory provisions described above, it is apparent that the current 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,[114] (3) the penalty is too easily avoided by reason of the reasonable cause exception, or (4) penalties alone are not a sufficient deterrent.[115] Anecdotal and other information seemingly refute the first two hypotheses. Several tax practitioners and corporate tax executives informally have told the Treasury Department that the likelihood of *any* liability for a significant penalty is likely to deter a corporate tax shelter transaction and, in their view, 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. Many commentaries criticizing the Administration's corporate tax shelter proposals focus on the severity of the penalties and the fear that the IRS will attempt to impose them in a wide variety of instances.[116] Thus, there is a strong belief by some that the IRS can and will use its authority to assess penalties. Whether all taxpayers and their advisors share this view is not clear, as some commentators believe that the government faces significant restraints in combating tax-motivated transactions.[117]

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[113] Treas. Reg. section 1.6664-4(e).

[114] As discussed above 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. Others 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.

[115] Whether penalties alone are sufficient as a deterrent is discussed below with respect to substantive changes.

[116] See, TEI at 11, AICPA at 16 and NYSBA Report at 893.

[117] NYSBA, Report at 882-3, citing the number of guidance projects on the 1999 Priority Guidance Plan of the Office of Tax Policy and the IRS, the perception that audit resources are "stretched thin" and the litigation process is cumbersome, time consuming and not adequate to address on-going problems.

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 prominent institutions 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 even eliminate this escape hatch.

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, consideration should be given to changes in substantive law to ensure that the appropriate understatement of tax is created.

2. 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 and causing a substantial understatement of tax.[118] 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.")[119] For this purpose, corporate tax shelter would be defined as any entity, plan, or arrangement (to be determined 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.[120] (See the discussion below for the definition of tax avoidance transaction.)

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

1. Commentaries

The ABA proposals primarily focus on disclosure. However, they acknowledge that an expanded penalty structure may be necessary in order to provide the appropriate incentives and disincentives for certain types of behavior and the ABA make some suggestions regarding the

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[118] 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.

[119] H.R. 2255 would make similar amendments to section 6662 with respect to tax benefits disallowed from certain noneconomic transactions.

[120] Treasury Explanation at 95.

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 increased disclosure apply to "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 top 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 with respect to a large tax shelter (whether or not the tax benefits from shelter are upheld by a court).[121]

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 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) 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.[122]

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 could 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 (which, mathematically it must, if one assumes at 10-percent minimum penalty and a differential of at least 20 percentage points).[123]

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 a 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 penalty 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 strict-liability penalty would be imposed even if the IRS and Treasury were to issue favorable regulations or other guidance with respect to a transaction unless the taxpayer disclosed the transaction.[124]

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[121] ABA at 9-10.

[122] AICPA at 15-17.

[123] NYSBA Report at 897.

[124] NYSBA Report at 894-97.

2. Analysis of Administration Proposals

The most intense focus of recent commentary on the Administration's budget proposals in the corporate tax shelter arena has occurred with respect to the substantial understatement penalty. Criticism of this proposal can be summarized as the following: (1) the penalty is too onerous, (2) the definition of corporate tax shelter is too broad or vague, and (3) elimination of the reasonable cause exception is unwarranted. This focus is both unsurprising and curious. It is unsurprising because it reinforces the perception that this penalty represents an integral piece in the arsenal of effective deterrents to aggressive tax planning and that assurances, generally on the basis of an opinion, of "penalty insurance" are important to corporate investors. Even aggressive corporations disposed to take the risk of a failed transaction and concomitant loss of tax benefits appear less inclined to expose the corporation to a substantial understatement penalty, whether for reasons of adverse publicity, shareholder or management reaction, the economic cost, or other reasons. The strength of the reaction by some to the "strict liability" approach of the Administration's budget proposal, as discussed in detail below is curious in that the current penalty can be said to impose a virtually similar stringent standard, with the added disadvantage of potentially being applicable to a broad range of corporate transactions with a "significant purpose" of tax avoidance.

a. Severity and breadth of the proposed expanded penalty

Many critics cite of Administration's proposal to double the 20-percent rate of current-law section 6662 cite the fact that the proposed 40-percent rate, when combined with the other proposals that disallow tax benefits and various 25-percent excise taxes as imposing a potential penalty rate that approaches the 75-percent penalty for fraud.[125] 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.[126] 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 (fees, recission agreements, etc.) that generally would be less than the amount upon which the substantial underpayment penalty applies.[127] In addition, the incidence of some of these excise taxes rests on parties other than the corporate participant. Finally, current-law section 6662 provides a 40-percent penalty in sufficiently egregious cases.

[125] See, TEI at 11 and AICPA at 15-16.

[126] Similarly, if an individual is found to have improperly embezzled funds, the mere restoration of his ill-gotten gains generally is not considered to be a sufficient sanction for such activity.

[127] 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.

Complaints about the level of penalties for corporate tax shelters really centers on the perceived broadness or vagueness of the definition of corporate tax shelter. It is indisputable that larger penalties may be more acceptable if taxpayers are have more certainty as to the target of penalty. 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 below. However, it must be noted that current-law section 6662 applies a 20-percent penalty upon corporate tax shelters that have as "a significant purpose" the avoidance or evasion of tax. The "a significant purpose" standard was added by the Taxpayer Relief Act of 1997. Prior to the 1997 Act, a "the principal purpose" standard applied. "The principal purpose" 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. Commentators on the 1997 Act change have suggested that the current definition of corporate tax shelter is broad enough to cover almost all corporate tax planning, including clearly non-abusive planning.[128] In comparison, the Administration's proposal can be reasonable interpreted as providing a narrower, more objective definition of corporate tax shelter than is provided under current law.[129]

B. Elimination of the reasonable cause exception

The regulations under the reasonable cause standard of Code section 6664(c), interpreted literally, do not provide penalty insurance 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, notwithstanding satisfaction of the authority and belief components of the reasonable cause exception to the penalty. Given present law, the intense adverse reaction to the Administration's proposal strongly suggests that the current standard is effectively discounted either on the basis of opinions that the transaction is more likely than not to be sustained and/or based on a perceived low likelihood of detection, audit and litigation by the IRS.[130] In addition, notwithstanding the regulatory standards, 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.

[128] Cite: Cal Johnson/Holden/ others?

[129] Another criticism of the Administration's corporate tax shelter proposals is that the Administration has not used the current tools available to it. As support, they cite the lack of regulations under 1997 Act changes to section 6662. Cite: Kies. Mr. Kies was chief of staff of the Joint Committee on Taxation during 1997. This analysis ignores the fact that the 1997 Act changes to section 6662 applied to transactions entered into after August 5, 1997 and was self-effecting. That is, the provision applies as drafted by Congress and is not dependent upon the issuance of enabling regulations. If the "a significant purpose" standard is a broad as reasonably interpreted by some, one may wonder why tax shelter activity persists after August 5, 1997.

[130] Cites

Some commentators have acknowledged the strict standard embodied in the current regulations.[131] It has been asserted that the IRS simply must enforce the penalty with the necessary vigor.[132] Others, however, have recommended elimination of the reasonable cause exception consistent with the Administration's budget proposal.[133]

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. To employ an analogy used by one recent commentator:[134]

> 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.

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 sophisticated corporate taxpayers who can be expected to come to an independent judgment about the validity of a transaction and the attendant risks if the transaction is challenged. Moreover, the role of the advisor as "policeman" comes under considerable pressure when considered in the context of large corporate taxpayers managing effective tax rates and large firm promoters, both of whom are well able to shop for advisors. Practitioners may be placed in the unenviable position of either turning away existing or prospective corporate clients or subjecting themselves to the pressures of those seeking an aggressive opinion. 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.[135]

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[131] Cite Holden

[132] Find cite

[133] NYSBA Report at 892-94.

[134] Cite Johnson

[135] Cite generally to NYSBA on these points and others re tax dialogue, etc.

If the role of the tax advisor as "policeman" of the tax system cannot adequately withstand these pressures, then the focus of the penalty structure must be on deterring corporate taxpayers themselves 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. However, if the risk is to be real, it also should be targeted to the offense. This necessarily highlights the issue of the definition of a corporate tax shelter to which the penalty will apply. The current definition of a tax shelter in the substantial understatement penalty provisions is broad and, as previously stated, potentially encompasses most types of corporate planning. With elimination of a reasonable cause exception, it is appropriate to consider a narrower definition of the offensive conduct. Concern has been expressed, however, that if there is no reasonable cause exception, the definition necessarily will be subject to attack such that the definition may not be viable in the long run.[136] An inherent tradeoff exists in crafting a penalty that will act as an adequate deterrent but will not penalize legitimate planning or foster nonreliance on advisors, even if ultimately the claimed tax benefits are not upheld. The critical question is whether the risk of suppression of some degree of otherwise legitimate planning must be taken in order to suppress overly aggressive planning. If overly aggressive planning were an activity on the margins engaged in by a few corporate taxpayers, this tradeoff probably should err on the side of conservatism. But in an environment where large investment banks, accounting firms and law firms have institutionalized the development and marketing of tax shelters, the risks may be rightly calibrated in the other direction.

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 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 regime are substantially outweighed by the necessity of increasing the deterrence of corporate tax shelters

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. This historic reluctance to mitigate the penalty on the basis of adequate disclosure reflects concern that [finish after reviewing legislative history]. However, because of the importance of disclosure in aiding detection, it may be appropriate to provide some relief if disclosure is made.

V. Proposed Modifications to Administration Proposals

The Treasury Department believes that an increased substantial understatement penalty should apply to corporate tax shelters in order to discourage their use and thus proposed to double the

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[136] Presently, those pressures probably are deflected to tax practitioners and their opinions.

current-law rate to 40 percent. In order to encourage disclosure, the penalty rate would be reduced if the taxpayer files the appropriate disclosures. In the original budget proposal, the Treasury Department provided that the rate could not be further reduced below 20 percent or eliminated by a showing of reasonable cause.

The Treasury Department believes that the substantial understatement penalty imposed on understatements of tax created by corporate tax shelters should be greater than the penalty imposed on understatements created by other causes in order to discourage the use of corporate tax shelters. This view is shared by the ABA, the NYSBA and others.

Although one may rhetorically question whether there is ever any reasonable cause for entering into a corporate tax shelter transaction, many commentators have criticized the proposed elimination of 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 their opposition to the proposal.[137] The Treasury Department believes that these comments merit some consideration. Specifically, consideration could be given to reducing or eliminating the substantial understatement penalty where the taxpayer properly discloses the transaction (as discussed 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 reasonable cause, these requirements would be codified to heighten visibility and strengthened to the extent necessary.[138]

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 of potential modifications to the Administration's proposal regarding the substantial understatement penalty, 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 "more likely than not" probability of success on the merits.

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[137] Cite: TEI/AICPA/others? Conversely, other commentators, notable the NYSBA, support elimination of the reasonable cause exception for corporate tax shelters.

[138] See, ABA at 4-6, NYSBA at 892-94, and Holden at .

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

C. Expand Authority of Secretary to Disallow Tax Benefits of Corporate Tax Shelters

I. In general

The income tax effects of a transaction generally are governed by a set of objective statutorily or regulatory. 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 (sec. 269), to require the computation of the income of a taxpayer in a manner that clearly reflects the taxpayer's income (sec. 446), to reallocate tax attributes among parties in order to prevent the evasion of tax or to clearly reflect the income of the parties (sec. 482), and to recharacterize multiple party financing transactions (sec. 7701(l)). In addition, the IRS has challenged questionable transactions under a variety of common law doctrines. At times, courts have rejected the Service's challenge, preferring to allow the operation of the applicable objective rules. Other courts, in ruling upon these matters, have upheld the Service'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 from court to court. Some courts will apply a standard to one fact pattern, but not another similar pattern.[139] Different courts may apply different standards to almost identical facts.[140] Finally, different courts have applied the same standards differently, have used the same labels for different standards, or have applied one standard but labeled it as another.[141] Because these common law standards inherently are more subjective and difficult to apply than are mechanical tax rules and have been applied unevenly by the courts, a great deal of confusion exists as to when and to what extent these standards apply, how they apply, and how taxpayers may rebut their assertions.

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,

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[139] See, e.g., the discussion on Part IV.B. relating to the different conclusions the courts reached in Waterman Steamship and Litton cases, and the Gregory and Esmark cases.

[140] See, e.g., the discussion on Part IV.B. as to the different theories that different Tax Court judges used to disallow tax benefits derived from identical transactions in ACM Partnership and ASA Investorings.

[141] Cite Hariton.

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 confusing 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 properly report taxable income. Self-assessment is frustrated by conflicting, incoherent decisions and encourages the most aggressive taxpayers to pick and choose among the most favorable cases.

The current state of the law presents a strong case that a substantive 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 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, objective standards could be developed to supplement or replace judicial doctrines, the self-assessment system could be enhanced and inappropriate results limited. However, as discussed in Part IV, the development of an objective standard appears to be an oxymoron of sorts. Nevertheless, some common law doctrines are more objective than others. For example, the economic substance doctrine as espoused in certain cases and rulings[142]–which weighs the pre-tax profit from a transaction with the expected tax benefits–is more objective than other doctrines that seek to divine the intent of the taxpayer in entering into the transaction.

II. 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.[143]

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,

[142] Cite: LILO ruling, ACM, Knetsch

[143] Treasury Explanation at 97.

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).

III. Commentaries

The ABA does not propose to adopt, *per se*, the disallowance provision of the Administration's budget. Rather, the ABA would clarify that, where the economic substance doctrine applies, the nontax considerations must be substantial (i.e., by more than a de minimis or nominal amount) 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 seemingly overrules 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.[144]

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 section IV.B., involves the weighing of potential tax benefits with potential 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 transaction 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 make such determinations.

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[144] ABA at 5-6 and 11.

The AICPA disagrees with the need to expand the Secretary's authority to expand the disallowance regimes of the Code.[145]

The NYSBA does not support a substantive change in the law as proposed by the Administration, but they do support the inclusion of anti-abuse provisions in newly promulgated regulations and newly enacted statutes, sometimes with retroactive effect.[146]

However, if a substantive provision were to be adopted, the NYSBA suggests that consideration be given to determine whether a general anti-abuse provisions could be applied separately to different categories of transactions, namely (1) "loss generators,"[147] and (2) corporate financing transactions in which there is a significant distortion in the timing of income or the elimination or reduction of tax that is plainly contrary to Congressional intent. In addition, the NYSBA suggests another alternative approach is to provide regulatory authority to address transactions that exploit obvious loopholes that are plainly contrary to the intention or contemplation of Congress.[148]

IV. Analysis of Administration Proposals

a. Why a substantive change in law is necessary

Many, if not most, current corporate tax shelters "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. In the view of some, a recent example of a "works, but shouldn't" transaction is the liquidating REIT transaction wherein the interest income from a pool of mortgages 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.[149] Policymakers decided that the most effective way to address these transactions was through legislation that modified the applicable objective mechanical rules of the Code.[150]

Continued reliance upon this type of piecemeal strategy for corporate tax shelters may prove ultimately to be self-defeating, as (1) policymakers do not have the knowledge, expertise and time

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[145] AICPA at16.

[146] NYSBA Report at 880.

[147] As discussed in Part II. A., "loss generators" generally are transactions entered into to create or access a tax attribute that the taxpayer does not ordinarily itself possess.

[148] NYSBA at 899-900.

[149] See the Appendix for a detailed description of the transaction.

[150] Section — of the P.L. - , the "Omnibus Tax and Trade Act of 1999." Legislative history and this paper provide no inference as to whether these transactions "work" under prior law.

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 rewards taxpayers and promoters who rush to complete transactions before the effective date of any reactive legislation; and (4) the approach results in further misuse and neglect of common law tax doctrines.

In order 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.[151] This argument ignores that fact that corporate tax shelters thrive today despite the presumptive applicability of these doctrines. Several reasons can be offered on why these common law doctrines currently fail the tax system. 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 less favorable (the "least common denominator" factor).

In any event, the Treasury Department believes that a change in the substantive law is necessary in order to address corporate tax shelters. The Treasury 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, but that 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 in order to attain the desired result. The Treasury Department 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. The Treasury Department believes that these perceptions are misplaced and the proposed definition of tax avoidance transaction relies on more objective standards than are contained in much of case law. Following is a discussion of the elements of Treasury's proposed definition.

As discussed in Part II.B, a significant characteristic of a corporate tax shelter is the existence of tax benefits that are vastly disproportionate relative to the economic benefits of the transaction. 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

[151] Kies at

derived from the transaction.[152] While the incorporation of this characteristic into the definition of corporate tax shelter could take many forms, the Treasury believes, for the reasons discussed below, that a balancing or weighing of reasonably expected profit against reasonably expected tax benefits is the best, most objective approach.

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.[153] 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.[154] 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 makes is rational and is consistent with the judicial doctrines that focus on determining whether there is any practical economic effects other than tax savings.[155] In tax

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[152] The comparison test is analogous to the "economic substance" (objective) leg of the sham transaction doctrine. See Part IV.B. In that context, however, there is no true comparison of the profit and tax benefits. Rather, the search is for any realistic possibility of profit. See Rice Toyota, 752 F.2d at 91; Sochin, 843 F.2d at 354. If such profit is found, and is not de minimis, then the economic substance leg of the sham transaction doctrine could be satisfied. See Sheldon, 94 T.C. at 768; 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.").

[153] 1998- IRB .

[154] 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.

[155] See, e.g., ACM Partnership, 157 F.3d at 248 ("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.'"); Sochin, 843 F.2d at 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, 868 F.2d at 853 ("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"); 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) ("[T]he avoidance of taxes hardly qualifies as 'the production or collection of income' under the

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.[156]

The Treasury 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.[157] 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.[158] 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.[159] 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."[160] 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.[161] 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 considered unreasonable.[162] Courts generally have interpreted this test as requiring an

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statute, either literally or by any implication that is supported by any relevant legislative history.").

[156] See Friendship Dairies, Inc., 90 T.C. at 1063-67 (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 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).

[157] As explained in section * of Part *, courts have applied a number of different test 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.

[158] See note *, supra (rice Toyota, etc).

[159] Section 183(a).

[160] S. Rep. No. 552, 91st Cong., 1st Sess., reprinted in U.S. Code Cong. & Admin. News 1645, 2027, 2133-34 (1969).

[161] Treas. Reg. section 1.183-2(a).

[162] 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

inquiry into whether the taxpayer has an actual and honest profit objective.[163] 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.[164] Second, permitting corporate taxpayers to enter into transactions with unreasonable expectations of profit would permit corporations to engage in transactions solely for tax benefits.[165]

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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. Section 1.183-2(b) of the Treasury regulations.

[163] 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). See also Peat Oil and Gas Associates, 100 T.C. at 280-83 (Swift, J., concurring). 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. Section 1.183-2(a) of the Treasury regulations. See also Brannen v. Commissioner, 78 T.C. 471, 500, 506-07 (1982). 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 Associates, 100 T.C. at 279-286 (Swift, J., concurring), 287-293 (Ruwe, J., concurring).

[164] 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)). As discussed in *, 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 Associates, 100 T.C. at 276.

[165] See Saviano v. Commissioner, 765 F.2d 643, 654 (1985) ("The 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

The Treasury 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.[166] 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.[167]

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.[168] A present value comparison best comports with economic realty.[169] Although a present value analysis requires a projection of expected 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.[170] The reluctance of

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accordingly. That is what we have done in this case and that is what taxpayers should expect in the future.").

[166] As discussed in Part II.B., the corporation's investment is rarely subject to a significant risk of loss.

[167] See, e.g., Sheldon, 94 T.C. 768.

[168] 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.").

[169] See Brealy & Meyers, Principles of Corporate Finance 66, 85 (2d ed. 1984) (stating that "wise investments 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).

[170] 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 court stated that "We 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

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.[171] 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.[172] The benefits of the relative test outweigh its 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.

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the normal tax applications to their actions."), aff'g per curiam 74 T.C. 705 (1980). 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.

[171] Cf. Treas. Reg. section 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.).

[172] 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 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 Associates. v. Commissioner, 100 T.C. 271, 285-86 (1993) (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.").

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.[173] Under the sham transaction doctrine, courts typically have not balanced profit against tax benefits.[174] Rather, courts have looked to whether the taxpayer had any realistic possibility of profit. In making this determination, however, courts have generally ignore profit that is insubstantial or de minimis.[175]

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.[176] 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.[177] For example, in ACM Partnership, in analyzing the taxpayer's potential for profit,

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[173] Cf. Treas. Reg. section 1.446-3(g)(6) Examples (3) and (4) (giving rough guideposts as to when a swap with significant nonperiodic payments may be recharacterized as two separate transactions).

[174] 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.")

[175] 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."); ACM Partnership, 157 F.3d at 249 ("Likewise, 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 transaction costs associated with marketing private placement notes to third parties."). 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).

[176] The scope of the transaction is important for determining the profit arising from the transaction as well as the applicable transaction costs.

[177] See, e.g., James v. Commissioner, 899 F.2d 905, 910 (10th Cir. 1990) ("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)"); 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]."), aff'g sub. nom. Smith v. Commissioner, 91 T.C. 733 (1988); Peat Oil and Gas Associates, 100 T.C. 271, 276

the courts focused on the purchase and sale of the ceratin 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.[178]

The proposed definition of tax avoidance transaction also includes transactions that result in the "improper elimination or significant reduction of tax on economic income." This latter 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. 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.[179] In this instance, and others,[180] a comparative profits test may be inapposite. Corporate taxpayers, however, should not be not 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.

("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."), aff'd sum. nom., Ferguson v. Commissioner, 29 F.3d 98 (2d Cir. 1994). As stated in note *, supra, the Sixth Circuit in Smith defined the transaction in question by considering the practical economic effects of parties unrelated to the litigants. Smith v. Commissioner, 937 F.2d 1089, 1096 (6th Cir. 1991) ("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 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.").

[178] ACM Partnership, 157 F.3d 231, 257-59 (rejecting ACM's claim that the Tax Court failed to account for Colgate's increased partnership interest in determining the profitability of the Citicorp notes transaction by noting that any additional profit attributable to Colgate's increase partnership interest resulted from Colgate's purchase of Kannex's interest in the partnership).

[179] Of course, a financing may have nexus to a larger transaction that has a profits component.

[180] Other situations where profit may not be relevant could include cases involving employee compensation and liquidations or dispositions of businesses.

Most of the comments that have labeled the Administration's proposed definition of corporate tax shelter as vague have focused on this second part of the definition. Some of these comments imply that this second leg 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.[181] Thus, they cannot judge the scope of the transaction.

Some have suggested modifications to the second leg of the Administration's proposed definition of corporate tax shelter to address this concern. The NYSBA suggests 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.[182] To the extent that the second leg of the proposed Treasury definition of tax avoidance transaction is intended to be limited to transactions for which the first leg is not readily applicable, and these transactions can be characterized in some fashion (e.g., as a financing), then such characterization can be imported into the definition to provide greater clarity.

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.) Thus, tax benefits that would normally meet the definition, such as the low-income housing credit[183] and deductions generated by standard leveraged leases,[184] would not be subject to disallowance.

There have been many comments on the definition of corporate tax shelter and tax avoidance transaction, whether in the context of a substantive change in the law, enhanced disclosure

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[181] Some have suggested substituting a "clear reflection of income" standard for this part of the definition.

[182] NYSBA Report at 899-900. The provision would also apply to dispositions of assets.

[183] See, for example, section 1.6662-4(g)(2)(ii) for lists of tax benefits explicitly provided by the Code.

[184] 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- C.B.). This is not to say, however, that all leveraged leasing transactions are not tax avoidance transactions (see, Rice's Toyota World, and Rev. Rul. 99-17 , 1999- I.R.B. (regarding lease-in, lease-out transactions)).

requirements or increased penalties. Critics often characterize the definitions in the Administration's proposal as either too vague or too broad.

Vagueness is inherent in any standard. In a sense, a corporate tax shelter could be defined as a transaction that "works, 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.[185] The first part of the Treasury definition, relating to the weighing of tax benefits to pre-tax economic income, is no more vague than the body of common law doctrines nor does it represent broader concepts than those espoused in sections 269, 446, 482 or 7701(l). The standard is intended to be an objective standard derived from the economic substance doctrine as espoused in a coherent body of case law[186] to the exclusion of less developed, inconsistent decisions.[187] 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.[188]

Variants of the economic substance standard has been proposed by others. As discussed above, the ABA would codify the economic substance doctrine and provide that where it applies, the nontax considerations must be substantial in relation to the claimed tax benefits.[189] However, the ABA would not provide in what instances the economic substance doctrine should apply only and would not mandate a present value analysis. Thus, the principal changes to current law that would be made by the ABA proposal would be to elevate the economic substance doctrine to a statutory provision and to overturn decisions that provide that de minims or insubstantial profit is enough to sustain tax benefits.[190]

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.[191] They suggest three possible approaches. 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

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[185] 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. cite?

[186] cite: Knetsch, ACM, anything else we like and Hariton article.

[187] cite: Horn, Frank B. Lyon?

[188] cite: hariton, others?

[189] ABA at 10-11.

[190] cite: Horn, Frank B. Lyon

[191] NYSBA at 899-900.

fit such a description are section 357© transactions and ACM Partnership-type transactions.[192] 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 many respects, a definition built on these elements is similar to those proposed by the Administration and the ABA.

The 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.[193] 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[194] would be resolved under the Administration's tax avoidance definition. TheCottage 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 mortgages. 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 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

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[192] In section 357© transactions, the taxpayer purportedly is able to create excessive basis in assets by having a tax indifferent party contribute an asset legally, but not realistically or economically, subject to multiple or excessive liabilities to a domestic corporation. Legislation currently pending in the Congress would end these abuses. cite.

In ACM Partnership transactions, a domestic corporation formed a partnership with a tax indifferent party. The principal asset of the partnership was a contingent payment installment note created for purposes of the tax shelter. Taxpayers took the position that the taxable income from note could be front-loaded and allocated to the tax indifferent party, leaving basis recovery and significant tax deductions to the domestic corporation. cite.

[193] 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."

[194] 499 U.S. 554 (1991).

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 could be modified to address these concerns.

H.R. 2255 contains elements of the economic substance doctrine of the Administration's and ABA's proposals and reflects comments from the NYSBA. 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 certain specified tax benefits.[195] 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.

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 it in ways substantially similar to the Administration's proposal and the ABA and NYSBA commentary. H.R. 2255 would adopt the NYSBA recommendation that a specific rule for financing transactions be substituted for the second part of the Administration's definition of tax avoidance transaction (the improper elimination of tax on economic income). 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

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[195] 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)

of the disallowance rules to taxpayers other than corporations are features of H.R. 2255 not found in the Administration's proposal.[196]

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.[197] The commentators fear that an examining agent may raise the specter that a transaction is a tax avoidance transaction, that, if sustained will give rise to tax benefit disallowance, a significant understatement of tax and the related penalties and other sanctions. 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 concede the shelter issue for concessions on other issues by the taxpayer. Other commentators recognize this possibility, but support the Administration proposals nonetheless.[198]

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 transaction. However, in order to address legitimate concerns regarding the vagueness of the and the potential abuse of discretion, the Treasury 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, the Treasury proposes to substitute its "improper elimination of tax" test with a test more focused on financing transactions in a manner similar to that of H.R. 2255 and suggestions of the NYSBA.

Second, there are several safeguards that could be instituted with respect to the concern that the original Administration proposal presented a the potential for the abuse of discretion. Many of these concerns 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.[199] Because the Administration's

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[196] But see, TEI testimony at p. 15 suggesting that any anti-shelter provisions should apply equally to corporate and noncorporate entities.

[197] AICPA at 16 and TEI at 11.

[198] NYSBA at 894.

[199] Cite Rossotti book.

tax shelter proposals generally apply to corporate transactions,[200] the IRS personnel reviewing potential corporate tax shelters will be centralized in the IRS' new corporate tax shelter group. This centralization will facilitate training and coordination among agents, their supervisors and Chief Counsel. A corporate tax shelter tax force, modeled after current Industry Specialization Program and the individual tax shelter tax force of the 1970's and 1980's, could further centralize and streamline this issue. Proposed increased disclosure by taxpayers could facilitate this effort. Increased coordination by the IRS would increase consistency and efficiency in dealing with complex tax shelter issues.[201]

Additional legislative and regulatory steps could be taken to 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[202] and the in proposed revenue procedure for automatic accounting method changes.[203] 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 is H.R. 2255 is self-executing. The difference between the two approaches is that should an issue 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.[204]

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[200] See, however, the comment by TEI that any proposals that are adopted into law should also apply to taxpayers other than corporations.

[201] Several commentators have discussed the need that in order to be effective, any corporate tax shelter provisions must be supported by proper enforcement on the part of government. See, e.g, ABA at 11.

[202] Regulation section 1.702- .

[203] Proposed Rev. Proc. 98-31, 98- C.B. ,. It should be noted that some of the commentators that have expressed a view that the Administration's corporate tax shelter proposals grant IRS field agents too much discretion have protested that proposed Rev. Proc. 98-31 denied agents of the same discretion with respect to changes in accounting method.. See, e.g., TEI /AICPA/ABA comments on this procedure.

[204] See, e.g., the deference shown to the Secretary when he uses his authority under section 446 to challenge a method of accounting as not clearly reflecting income.

Finally, similar to H.R. 2255 and in response to some commentators, the proposed substantive change of law would apply to all business activities of taxpayers, including those that engage in business in a non-corporate form.

D. Provide Disincentives for All Participating Parties

1. In general

As discussed in Part II.B., there are many parties that may participant in, and benefit from, a corporate tax shelter. 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. First and most obvious of the parties participating in corporate tax shelters are the corporations whose tax liabilities are being reduced or eliminated.[205] As discussed in this section, several remedies and sanctions–involving loss of tax benefits, penalties, and disclosure requirements–have been enacted and proposed with respect to the corporate participants.

a. Promoters and advisors

Less obvious are remedies and sanctions that can and should be imposed on other participants. For example, 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 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

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[205] As discussed with respect to comments submitted by the ABA, sanctions or remedies imposed upon the corporate participant can be extended to personal liability to responsible corporate officers. ABA at 9.

accounting opinion with respect to the extraordinary shelter transaction),[206] or may be the result of competition among advisors. In any event, providing corporate tax shelter advise purportedly is a lucrative business, with total professional fees often approaching one-third 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[207] and under circumstances where knowledgeable advice was not sought by the promoter.[208]

Although today's corporate tax shelters also may involve promoters, opinions rendered by practitioners associated with the promoter, and various degrees of marketing,[209] it nevertheless is doubtful that current-law penalties can be brought to bear with any real force. As discussed elsewhere

[206] NYSBA Report at 893.

[207] See, e.g., Buttorf, 761 F.2d at [ ] (injunctive relief appropriate against actions "denounced as wrongful by positive, public law"); Campbell, 897 F.2d at 1321 (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)

[208] See, e.g., Buttorf, 761 F.2d at [ ] ("[T]he 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 package were false and misleading."); Estate Preservation Services, (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.").

[209] Cite to Forbes article

in this paper, corporate tax shelters take advantageous 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

The operation of several 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 on income that is sourced in the United States. 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.[210] 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.[211] The withholding tax may be reduced by an applicable treaty.[212] 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).[213] States, municipalities or political subdivisions thereof are not subject to Federal income tax.[214] Native American Indian tribes, and wholly owned tribal corporations organized under Federal law, also are generally not subject to Federal income tax.[215]

As discussed in Part II.B., tax indifferent parties often are interposed into corporate tax shelter transactions in order 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.

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[210] Sections 871(b) and 882.

[211] Sections 871(a) and 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.

[212] In addition, there are a number of statutory exclusions. For example, so-called "portfolio interest" is not subject to the 30 percent withholding tax. Sections 871(h) and 881(c).

[213] Section 501(a) (exemption from tax), (b) (tax on UBIT).

[214] Section 115.

[215] 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.

A tax indifferent party has a special status conferred upon them by operation of statute or treaty. To the extent such person is using this status in an inappropriate or unforseen manner, it is appropriate to eliminate such status with respect to such use. 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 utilize this technique. 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.[216]

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.[217] 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, advisor, and tax indifferent parties must be at least accompanied by significant sanctions on the corporate participant as well.

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.[218] To ensure that a tax is paid, all corporate participants could be made jointly and severally liable for the tax.[219] Joint and several liability could also avoid peripheral issues concerning the potential of the proposal to override treaties or to impose a tax on a separate sovereign nation. 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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[216] See e.g., sections 269 and 382.

[217] Although such a scenario is unlikely in the current environment.

[218] Treasury Explanation at 104.

[219] 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[220] and (2) the total tax benefits anticipated from a corporate tax shelter transaction, to the extent such benefits are subject to an unwind agreement, recission clause, or insurance or other arrangement guaranteeing such benefits, levied upon the corporate participant.[221] Finally, the budget proposals would disallow deductions for promoter and advisor fees associated with a corporate tax shelter and would include such disallowance in the section 6662 substantial understatement penalty.[222]

2. 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.[223]

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 propose 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.[224]

The AICPA agrees that present law should be changed to insure 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 of tax indifferent parties, but offer no specific proposal as to how this issue would be best addressed.[225]

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

[220] Treasury Explanation at 99.
[221] Id. at 100.
[222] Id. at 99.
[223] ABA at 10.
[224] Id.
[225] AICPA at 14.

direct penalties on promoters and advisors, with adequate due process provided. In particular, they propose that current-law section 6700, 6701 and 6703 be revise 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.[226]

The NYSBA acknowledge 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.[227] 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 transaction.[228]

3. 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 believes that it in order to more pervasively 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 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 an excise tax upon the fees derived by such persons from the corporate tax shelter transaction. The Treasury proposes to modify and clarify its 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,[229] and (2) providing appropriate due process procedures for such parties with respect to an assessment.

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[226] Id. at 20-21

[227] NYSBA Report at 882-85.

[228] New York State Bar Association Tax Section, Report on Certain Tax Shelter Provisions (June 22, 1999).

[229] Thus, a tax professional who advised a client that a transaction was not supportable under current law or who cautioned not to enter into the transaction would not be subject to the excise tax with respect to fees charged for such advice.

The Treasury Department recognizes that the proposed excise taxes on advisor and promoter fees operates in the same manner as a penalty. In this regard, consideration could be given to amending the penalties described in sections 6700, 6701 and 6703 to be more responsive to corporate tax shelters.[230]

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 believes that the other sanctions proposed with respect to the corporate participant are sufficient, the Treasury 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, recission agreement, or insurance or similar arrangement. Treasury 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 proposes to eliminate this proposal. However, the Treasury proposes that the existence of an unwind provision, recission agreement, or insurance or similar arrangement should be one of the "filters" that triggers disclosure.

Finally, the Treasury 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 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

A. INTRODUCTION

[230] As described in Part IV.C., sections 6700, 6701 and 6703 were enacted in response to the individual tax shelters of the 1970's and 1980's and have little applicability to corporate tax shelters today.

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.[231] 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.[232] Second, it is extremely difficult, and perhaps impossible, to design a tax system that measures income perfectly.[233] 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.[234] 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.[235] Alternatively, as was done with respect to individual tax shelters in the 1980's, the symptoms could be dealt with. 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. **[Do we want to add something on comparison to our approach -- these are more invasive?]** This section discuss alternatives for addressing corporate tax shelters, including options that we considered but did not propose, approaches [anti-abuse rules] adopted in other countries, and improving the targeted response system.

A. THE ROADS NOT TAKEN

1. Fundamental Tax Reform or Integration

This paper is focused on curbing corporate tax shelters within the Federal income tax system. Treasury 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 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.[236]

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231 S. Rep. No. 313, 99th Cong., 2d Sess. 714, reprinted in 1986-3 (v.3) C.B. 714.

232 Id. at 715.

233 Id.

234 Id.

235 See, e.g., NYSBA testimony at p. .

236 **JCT Restructuring Pamphlet; Cite Hariton on tax reform from his econ substance piece.**

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 other consumption-based taxes. There have also been calls for replacing the income tax with a sales tax or, in some cases, a value added tax (VAT). With respect to publicly traded corporations, some have argued for replacing the corporate income tax with an annual tax on shareholders measured by the market value of the corporation's stock.

In 1992, Treasury issued a report on the integration of the individual and corporate tax systems.[237] 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.[238] The report examines in detail several different integration prototypes to stimulate debate on the desirability of integration.

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, in order 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.[239]

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 burden.[240] 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."[241] While acknowledging that tax preferences provide incentives for worthy goals, Congress believed that such preferences become counterproductive

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[237] Department of the Treasury, Integration of The Individual and Corporate Tax Systems (January 1992).

[238] Id. at *.

[239] Cite JCT pamphlet

[240] S. Rep. No. 552, 91st Cong., 1st Sess., 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.").

[241] S. Rep. No. 313, 99th Cong., 2d Sess., reprinted in 1986-3 (v.3) C.B. 1, 518.

when taxpayers are allowed to use them to avoid virtually all tax liability.[242] 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.[243] 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.[244] 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.[245] For years after 1989, the book income preference was replaced with an adjustment relying on the corporation's adjusted earnings and profits.[246]

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[242] 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.

[243] Id. at 520.

[244] 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.

[245] Section 56(f) (repealed). In the Revenue Reconciliation Act of 1990, paragraph (f) of section 56 was repealed. Section 11801(a)(3) of the Revenue Reconciliation Act of 1990, Pub. Law No. 101-508. (cite LH). See also Joint Committee on Taxation, General Explanantion of the Tax Reform Act of 1986 1, 434 (May 4, 1987) ("Congress concluded that it was particulatly 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 fairnenss of the tax system.").

[246] Section 56(c) and (g). Joint Committee on Taxation, General Explanantion of the Tax Reform Act of 1986 1, 435 (May 4, 1987) ("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.").

As discussed in Section II(B)(2) of this Report, most corporate tax shelters seek to reduce the effective tax rate of the corporation.[247] 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.[248] Adjustments also would be necessary to, among other things, 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.[249]

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 **[unclear how?]** and would allow sheltering to some extent.[250]

[We may want to drop this par.] 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.[251] 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. The observance of these concepts and rules is determined by certified public accountants and by regulatory bodies such as the

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[247] That is, they reduce the taxes paid by the corporation without a commensurate reduction in the book earnings of the corporation.

[248] Congress created a priority system for determining the applicable financial statement that would be used to determine book income. See S. Rep. No.313, 99th Cong., 2d Sess., reprinted in 1986-3 (v.3) C.B. 1, 530 ("The 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.").

[249] Id. at 532-35.

[250] Cite JCT pamphlet.

[251] Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises (FASB, 1978).

Securities and Exchange Commission. 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.[252] Tax accounting rules are determined by Congress, the Treasury, and the courts. As a result of differences between income tax laws and financial accounting standards relating to, among other things, the recognition and measurement of income and loss, the determination of taxable and financial income in a given year or with respect to a given transaction are different. Some of the differences are temporary, meaning that the difference will eventually be reversed, and others are permanent. For financial accounting purposes, temporary differences are reflected in the corporation's balance sheet as a deferred tax liability or asset.[253]]

3. Scheduler 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, deductions for capital losses are generally limited to the extent that there are not offsetting capital gains.[254] Similarly, foreign tax credits may be used to reduce tax on foreign source income but not U.S. source income.[255] Individuals may deduct investment expenses only to the extent of investment income,[256] losses from wagering are allowed only to the extent of gains from wagering,[257] 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.[258]

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")

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252 [cite Thor Power].

253 Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes (FASB, 1992).

254 Section 1211. In the case of a corporation, net capital losses are not deductible but generally may be carried back 3 years and carried forward 5 years. Section 1212(a). In the case of an individual, a net capital loss of up to $3,000 is deductible against ordinary income. Section 1211(b).

255 Section 904. In addition to an overall limitation on foreign tax credits, separate limitations apply to discrete categories of income. Section 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. source income on low-taxed foreign source income (generally passive income).

256 Section 163(d).

257 section 165(d).

258 Section 469(a).

merely to produce tax benefits to offset income from other transactions. Such an approach, however, would not affect so-called "exclusion transactions."[259]

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 shelters would require a definition and identification of the offending transactions. if this could be done easily, more appropriate sanctions could be devised.

C. ANTI-AVOIDANCE RULES OF OTHER COUNTRIES

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[260] 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."[261] As discussed in section IV(__) of the Report, 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 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.

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[259] See section II(A)(2) of this Report for a description of "excess benefit" shelters and "exclusion" shelters.

[260] A General Anti-avoidance Rule for Direct Taxes: Consultative Document (1998).

[261] Id. at section 6.1.1.

If the tax law is highly 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.[262]

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.[263]

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.[264] Whether the taxpayer met the provisions of the chosen provision would be interpreted under the formalistic standards of the Duke of Westminster case.[265] 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 applied, then section 260 could not.

Dissatisfied with section 260, the Australian government introduced a new rule, effective in 1981. Part IV A of the Income Tax Assessment Act provides that courts must look to the purpose or object of the statute when interpreting it.[266] The government may recast the tax effects of a transaction. Part IV A may be applied even where specific anti-avoidance provisions apply, but those provision must be applied first. The legislation provides that Part IV A will apply if the

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[262] See, e.g., the Australian experience with judicial interpretation of section 260 of the Income Tax Assessment Act, discussed infra.

[263] **Add a formal cite here.**

[264] See, e.g., W.P. Keighery Pty Ltd v. FCT (1957) 100 C.L.R. 66.

[265] For a discussion of this case, see text accompanying footnote ___, infra.

[266] **Add a formal cite here.**

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).

In FCT v. Spotless Services Ltd,[267] the Australian High Court handed the government a significant victory in a Part IV A case, 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. **[Elaborate on this case]**

The High Court also confirmed that the formalistic standards under Duke of Westminster have no relevance in applying Part IV A.

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.[268]

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.[269]

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[267] (1996) 96 ATC 4663.

[268] Tax Reform: Not a New Tax, a New System 150 (1998) **(citations omitted???)**. See also Schedule 8, Taxation Laws Amendment Bill (No. 3) 1998, which would introduce 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.

[269] See Brian Arnold and James Wilson **[check cite]**, The General Anti-Avoidance Rule, 36 Can. Tax J. 829 (1988). See also Stubart 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 (David Ward, Tax Avoidance: Judicial and

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.[270] 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."[271]

When the Act came into force, Revenue Canada issued several pieces of public guidance identifying how it will act in specific circumstances.[272] 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."[273]

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

Legislative Approaches in Other Jurisdictions, in Report of Proceedings of the Fortieth Tax Conference, 1988 Conference Report (Canadian Tax Foundation, 1989).

[270] Brian Arnold, The Canadian General Anti-Avoidance Rule, [1996] Brit. Tax Rev. 541.

[271] Section 245 Income Tax Act, RSC 1952, c. 148. The Canadian Department of Finance explained :

> 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).

[272] See, e.g., IC88-2, General Anti-Avoidance Rule (October 21, 1988).

[273] Id. ¶ 2.

in audit cases as well as its interpretation in advance rulings.[274] While criticized for not releasing its deliberations to the public,[275] the 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.[276] Revenue Canada is attempting to streamline the process by identifying frequently-arising issues which local Revenue Canada officials would then be given authority to reassess without a referral to the GAAR Committee.[277]

Despite dire predictions from the tax bar, the GAAR appears not to have dramatically altered tax administration in Canada. Revenue Canada has 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.[278] 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.[279] 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 not 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.[280] Absent such provisions, however, U.K. courts have traditionally narrowly interpreted the tax law, looking to discern the plain meaning of the statute and then determining whether the form

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[274] 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.

[275] Arthur Drache, Seven-Year-Old Law Still a Puzzle, Sec. 2, page 30, The Financial Post (June 18, 1996). See also, 1996 Report of the Auditor General of Canada, Chapter 11, in which the Auditor General suggested that Revenue Canada's local offices were equally in the dark as to the GAAR Committee's reasoning (at 11.40-11.41).

[276] 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 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 (November 17, 1998).

[277] R. Couzin, Business Operations In Canada A-76(1) (1997-98).

[278] See generally Brian J. Arnold, Revenue Canada: 2, Taxpayer: 0, Regarding GAAR, [xx] Tax Notes International 1427 (May 5, 1997).

[279] John R. Owen, Statutory Interpretation and the General Anti-Avoidance Rule: A Practitioner's Perspective, 46 Can. Tax J. 233, 266-73 (1998).

[280] See, Masters, Is There a Need for General Anti-Avoidance Legislation in the United Kingdom, [1996] Brit. Tax Rev. 647.

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 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.[281]

English Courts have also generally been unwilling to consider questions of motive. In Bradford v. Pickles,[282] 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.[283]

In recent years, English courts have proved more willing to expand judicial anti-avoidance doctrines, absent specific statutory endorsement. For example, the House of Lords in cases in the 1980s such as Craven v. White[284] (step transaction applied when steps are preordained and practically certain to happen) and in the 1990s in McGuckian v. CIR[285] (conform with the purpose of the statute) have broken what was has been widely perceived as new ground. **[can we elaborate here?]**

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.[286] First, judicial anti-avoidance doctrines give rise to

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[281] Commissioners of Inland Revenue v. Duke of Westminster, [1936] AC 1 (HL) (19 Tax Cases at 524).

[282] Bradford Corporation v. Pickles, [1895] AC 587 (HL).

[283] Id at 594.

[284] [1989] AC 398 (HL)

[285] [1997] Simons Tax Cases 888.

[286] Tax Law review Committee, Tax Avoidance (1997, Institute for Fiscal Affairs).

considerable taxpayer uncertainty (more so than even a general statutory anti-abuse rule). Second, such a doctrine operates retrospectively **[is there any more discussion of this point?]** and offers no clear framework within which it will operate. 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.[287]

Practitioners and others have raised serious concerns about the introduction of a GAAR.[288] According to recent reports, "[I]t appears, following the 1999 budget, that the U.K. government does not intend to introduce a GAAR immediately... [but] has certainly not foreclosed the possibility of doing so in the future."[289]

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[290]

According to one commentator, four factors are necessary for the application of this provision:

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[287] Id. at *xii*.

[288] See, e.g., Peter Wyman, U.K. Proposed GAAR May Be Counterproductive, 17 Tax Notes International 1160 (October 19, 1998); Adam Blakemore, U.K. Tax Institute Highlights GAAR's Hidden Dangers, 17 Tax Notes International 1891 (December 14, 1998).

[289] George Hardy, U.K. Chancellor Releases 1999 Budget, 18 Tax Notes International 1019 (March 15, 1999).

[290] General Tax Code, section 42.

(1) 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.

(2) There is an abuse of the legal arrangements in that there are no economic or other significant reasons which would justify the legal arrangement adopted by the taxpayer or the legal arrangement used by the taxpayer is inappropriate given the economic purposes it claims to seek to achieve in the transaction

(3) The purpose is to save or avoid tax

(4) There is an intent to circumvent the tax laws.[291]

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 Bundesfinanzhof (German Tax Court) held as insupportable in law, a Ministry of Finance decree based on section 42 which sought to restrict thin capitalization.[292]

b. *France*. France has a provision in the Book of Fiscal Procedures 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 lower registration duties or disguising either a realization of a transfer of profits or income or permitting the avoidance, either in whole or in part, or payment of turnover taxes on the transactions carried out pursuant to the contract or agreement, are not valid against the tax authorities . . .[293]

Taxpayers may request an advance ruling that Art. L64 does not apply. A taxpayer will be protected if it acts in reliance either upon a favorable ruling, or upon the absence of a reply within six months of requesting a ruling.[294] 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

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[291] Jorg-Dietrich Kramer, Abuse of Law by Tax Saving Devices, 1991/92 Intertax 96 at 100 (date).

[292] David Ward, Abuse of Tax Treaties 397 at 408 (in Alpert and van Raad eds, Essays on International Taxation: To Sidney I. Roberts, 1993)

[293] Book of Fiscal Procedures, Art. L64.

[294] Sandler and Fuks eds., The International Guide to Advance Rulings, France-17 (IBFD 1997)

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.[295]

It appears that the Courts have interpreted this provision fairly narrowly. Recent case law has 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 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.[296]

In both Germany and France, it appears that the revenue authorities have met with some success bringing cases under these sections.

D. 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, Treasury staff worked with Hill staff to develop legislation that eliminates the tax benefits of the transaction. Similarly, in response to the lease stripping tax shelters and the step-down 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'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, at a procedural level, the Treasury Department could considered proposing legislation requiring taxpayers that engaged in certain forms of tax-motivated activity to register or otherwise disclose their actions to the Service.[297] Third, the Treasury and IRS could use retroactive forms of guidance more frequently.

This third 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 the case of corporate tax shelters--transactions that were specifically designed to exploit a provision of the law--the government is not required to respect this purported reliance interest. In 1997, Congress granted the Treasury Department the authority to depart

[295] Claude Gambier and Jean-Yves Mercier, Taxes in France 163-4 (date)
[296] Id. at 163.
[297] [FN about ineffectiveness of current tax shelter registration].

from the prospective approach and issue retroactive regulations to "prevent abuse."[298] Although the Treasury Department has not yet exercised this grant of authority, the Treasury Department could do so in the future.

Finally, 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.[299] More recently, the Treasury Department has grandfathered only the portion of the transaction occurring before the effective date.[300] This approach, if applied consistently to targeted legislative and regulatory response should eliminate the economic incentive to enter into a transaction before the guidance is issued.

E. PROCEDURAL CHANGES

I. 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 tax code, international operations, and well-paid advisors to avoid paying their fair share of taxes.

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:

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[298] [FN to 7805(b)(3)]

[299] [FN to WSJ article on step-down]

[300] [FN to Notice 97-21 regarding fast-pay].

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. Consider modification of 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. Consider modification of 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. Consider tightening 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 sectionb 6664 reasonable cause exception as described in Part V, consideration should be given to the following actions.

1. Consider modification of 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. Consider modification of 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 promoted or marketed.

4. Appropriate funds to hire outside litigators for key shelter cases similar to Department of Justice practice in anti-trust cases.

5. Assert penalties where appropriate and make referrals to the Director of Practice where appropriate.

6. Use section 7408 injunctive action where appropriate.

APPENDIX -- DESCRIPTION OF CERTAIN CORPORATE TAX SHELTERS

EXCLUSION TRANSACTIONS

LIQUIDATING REITS TRANSACTION

As part of the Tax and Trade Relief and Extension Act of 1998 (the "1998 Trade Act"), Congress enacted section 332(c) of the Code in order to eliminate a corporate tax shelter known as the "liquidating REIT" transaction. The liquidating REIT transaction involved the use of a real estate investment trust (a "REIT") that was closely held 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.

Under the liquidating REIT structure, 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).

The REIT distributed dividends equal to its REIT taxable income and thus avoided paying tax by virtue of the dividends paid deduction available to REITs. The corporate shareholders (as well as other non-tax-exempt shareholders) were subject to tax on dividends paid prior to the liquidation period since the dividends received deduction is not available with respect to dividends paid by a REIT.

The benefit to the corporate shareholder came during the period 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 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, 1993. Interest income earned by the REIT and paid out in the form of dividends in 1993 and 1994 were taxable not taxable to the REIT but were taxable to the parent bank. 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. 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. Effective for distributions after May 21, 1998, 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.

BASIS SHIFT TRANSACTION (SECTION 357(c) TRANSACTION)

In general, if a parent corporation transfers assets to its subsidiary and the basis of those assets is less than the amount of liabilities assumed and "subject to" liabilities, gain is recognized by the parent corporation and the subsidiary steps up the basis in the transferred assets by the amount of such gain. Where a liability is secured by multiple assets, the tax treatment is unclear under current law whether a transfer of one asset, where the transferor remains liable, is a transfer subject to the liability for purposes of section 357(c). Taxpayers have exploited certain ambiguities to engage in transfers that effect a basis step-up in assets with no corresponding tax paid. If a non-U.S. taxpaying transferor (e.g., a tax-exempt corporation, a foreign transferor) transfers an asset that partially secures a line of credit, taxpayers have taken the position that gain would be computed under section 357(c) by treating the entire liability as an amount realized and the transferee's basis in the asset would be increased accordingly, although no economic appreciation would have occurred. Alternatively, under this interpretation, if a transferor transfers the assets securing a single liability to several different subsidiaries, taxpayers have taken the position that each asset has a basis increased by the entire liability.

For example, a foreign parent that has three U.S. subsidiaries and three assets subject to a single lien or mortgage of $100 separately transfers to each subsidiary one asset subject to the same liability. Although each transfer is a taxable transaction under section 357(c) because the amount of the liability exceeds the bases of the assets transferred, the transferor, typically a foreign corporation or tax-exempt entity, pays no tax. The $100 liability is used to step up the basis of each of the assets separately because they are all "subject to" the liability. Taxpayers take the position that the same liability is used to produce a step up for three separate transactions because each asset is technically subject to the whole $100 liability. The bill prevents a corporation from "creating"additional basis in its assets by transferring assets to a controlled subsidiary in exchange for stock and having the transferee assume a liability or receive assets "subject to" a liability. Under present law, a corporate transferor may recognize gain if the liabilities assumed exceed the basis of assets transferred. If the transferor recognizes gain, the corporate transferee's basis in the transferred assets is increased.

Where a recourse liability is secured by multiple assets, the tax treatment is unclear under present law whether a transfer of one asset where the transferor remains liable is a transfer "subject to" the liability. For example, if a foreign transferor transfers an asset that partially secures a line of credit, taxpayers have taken the position that gain would be computed by treating the entire liability as an amount realized and the transferee's basis in the asset would be increased accordingly. The foreign transferor is indifferent to the amount of gain for U.S. tax purposes because it is not subject to U.S. tax. Alternatively, under this interpretation, if a transferor transfers the assets securing a single liability to several different subsidiaries, taxpayers have taken the position that each asset has a basis increased by the entire liability. Similar issues arise with respect to nonrecourse liabilities.

The Treasury Department proposed changes in the FY '99 and FY 2000 budgets to address this abusive transaction that is being marketed aggressively by accounting firms, law firms and investment banks. Representative Archer introduced a bill addressing Treasury's concerns with an effective date of October 19, 1998. Versions of this bill have passed the Senate and the House of Representatives without becoming law. The changes made by the legislation will result in tax consequences that reflect the true economics of these transaction. In addition to curbing a prevalent abuse, the legislation gives taxpayers the certainty to engage in legitimate transactions.

The bill would eliminate the distinction between the assumption of a liability and the acquisition of an asset subject to a liability. Instead, unless the facts and circumstances indicate that the transferee is not expected to satisfy the liability, a recourse liability shall be treated as assumed to the extent the transferee has agreed to satisfy such liability (whether or not the transferor has been relieved on such liability). With a limited exception, nonrecourse liabilities shall be treated as having been assumed by the transferee of any asset subject to such liability. In addition, the bill imposes limitations on the transferee corporation's basis in property it receives

APPENDIX -- DESCRIPTION OF SELECTED CORPORATE TAX SHELTERS.

INCOME EXCLUSION EXAMPLE:

LIQUIDATING REIT TRANSACTION

Summary

The liquidating REIT transaction provides a tax benefit through exclusion. In the basic transaction, a corporation forms a captive real estate investment trust (REIT); contributes income-producing assets to the REIT such as mortgages; 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 used to interact with the tax rules governing corporate liquidations, the corporate taxpayer could avoid tax on the income-producing 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 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 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).

The REIT distributed dividends equal to its REIT taxable income and thus avoided paying tax by virtue of the dividends paid deduction available to REITs. The corporate shareholders (as well as other non-tax-exempt shareholders) were subject to tax on dividends paid prior to the liquidation period since the dividends received deduction is not available with respect to dividends paid by a REIT.

The benefit to the corporate shareholder came during the period 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 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, 1993. Interest income earned by the REIT and paid out in the form of dividends in 1993 and 1994 were taxable not taxable to the REIT but were taxable to the parent bank. 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. 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. Effective for distributions after May 21, 1998, 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.

BASIS SHIFT TRANSACTION (SECTION 357(c) TRANSACTION)

Summary

Section 357(c) basis shift transactions provide a tax benefit through exclusion. In one form of this 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 staffs of the tax-writing committee of Congress have worked on legislation that would deny the purported tax benefits of these transactions. Last year, Representative Archer dropped a bill addressing these transactions and holding October 19, 1998, as the effective date. Versions of this bill have passed both Houses. The Treasury Department expects that this provision will be signed into law in the near future.

Detailed discussion

In general, if a parent corporation transfers an asset to a subsidiary and the parent's basis in the asset is less than the amount of liabilities assumed by the subsidiary in the transaction, section 357(c) requires that the parent must recognize this difference as gain and that the subsidiary must step-up its basis in the asset by the amount of this gain. A similar rule applies where the subsidiary 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 corporations 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 parent (transferor) is a tax-indifferent person (e.g., a tax-exempt corporation or foreign corporation) and the subsidiary (transferee) is a U.S. corporation, this interpretation results in the subsidiary taking an overstated basis in its assets without a corresponding tax being paid by the tax-indifferent party.

For example, consider a foreign parent that has three U.S. subsidiaries and three low-basis assets subject to a single $100 liability. If the foreign parent separately transfers to each subsidiary one asset subject to the same liability, the each subsidiary may step-up the basis of each 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 Treasury Department 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. Last year, Representative Archer dropped a bill addressing these transactions and holding October 19, 1998, as the effective date. Versions of this bill have passed both Houses. The Treasury Department expects that this provision will be signed into law in the near future.

FAST PAY STOCK TRANSACTION

Summary

The fast-pay stock transaction, also known as the step-down preferred transaction, provides a tax benefit through exclusion. The transaction was designed 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 to tax-indifferent participants.

In early 1997, the IRS published a notice indicating that the Service and the Treasury expected to publish regulations that would recharacterize the transaction in a manner that eliminated the tax benefit. On January 6, 1999, the IRS and Treasury published proposed regulations recharacterizing the transactions, effective for tax years ending after February 26, 1997.

The Treasury Department estimates that this transaction, had it not been promptly addressed, would have reduced the corporate tax base by approximately $XX billion over a ten-year period.

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 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 a small fraction of its issue price. As a 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 §332 liquidation, the sponsor's economic income from the transaction would permanently escape tax. (Footnote: The liquidating REIT proposal, discussed at ________, would not have altered this permanent exclusion.)

In response to fast-pay transactions, the IRS and Treasury 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 Treasury 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 recast, 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 recast ensures that the sponsor is taxed on its economic income from the transaction.

DEFERRAL EXAMPLE:

LEASE-IN, LEASE-OUT (LILO)

Summary

The lease-in, lease-out (LILO) transaction provides a tax benefit through deferral. In the basic LILO transaction, a U.S. corporation leases long-lived property from a tax-indifferent party (under a Headlease) 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 Internal Revenue Service published a revenue ruling stating its position that many 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 1999. In addition, the IRS and Treasury 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 _____, 1999.

Although it is too soon to determine the size and scope of the LILO marketplace, the Treasury Department estimates that ....

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 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 Internal Revenue Service published a revenue ruling stating its position that many LILO transactions lack economic substance and therefore do not produce the intended tax benefits. In addition, the IRS and Treasury 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 _____, 1999.

ARBITRAGE TRANSACTION:

CORPORATE-OWNED LIFE INSURANCE

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, 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 is 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.

Treasury and the IRS responded to this particular corporate tax shelter through litigation and through proposed legislation. After 1996, the IRS issued Technical Advice Memoranda disallowing interest deductions claimed by corporations that invested in leveraged COLI plans. In 1997, Treasury 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% or greater shareholders in the business.

BOLI. In general, debt comprises over 90 percent of a bank's total assets, and the bank deducts interest expenses incurred with respect to this debt. In 1986, Congress disallowed interest deductions allocable to banks' investments in tax-exempt bonds, to preclude banks from claiming tax arbitrage benefits from investments in tax-exempt bonds. Today, banks invest in cash value life insurance contracts, which also generate tax-exempt investment returns, but which are not subject to the same tax arbitrage rules as investments in tax-exempt bonds.

Investments in bank owned life insurance ("BOLI") are usually structured so that the bank pays a single "premium." This "premium," less any fees charged by the insurance company, becomes the "account value" of the cash value life insurance contract. The insurance company invests the bank's account value in investment funds selected by the bank. In some cases, the bank directs the insurance company to invest the assets in an investment fund managed by the bank or its affiliates, all of the returns (net of the insurance company's fees) in these investment funds are credited to the bank's account value, and assets in these investment funds are not subject to claims of other creditors of the insurance company. The investment income on this account value is never taxed if the bank holds the cash value life insurance contract until the insured person dies and does not withdraw amounts from the account value before that time. The insured person is typically an employee, whose heirs usually have rights to none or a de minimis portion of the amount paid to the bank (the "death benefit") when the employee dies. The "death benefit" for the typical insurance contract consists largely of the tax-exempt savings account, which gradually increases to 100 percent of the total "death benefit" as the insured person ages.

Economically, the bank's "premium payments" on these cash value life insurance are derived from debt to the same extent that the bank's total assets consist of debt. Thus, throughout the duration of this cash value life insurance contract (often 20 or more years), the bank deducts interest on debt used to fund approximately 90 percent of the premiums on these contracts, but does not pay tax on the investment income generated by its investment of the debt proceeds in the cash value life insurance contracts.

This same strategy also is used by many other leveraged businesses, not just banks, to obtain tax arbitrage benefits.

CONVERSION TRANSACTIONS

CONVERSION OF SOURCE

U.S. taxpayers generally have an incentive to produce items of income or gain that are foreign source and produce deductions or losses that are 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 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. However, a U.S. source loss is valuable to the U.S. taxpayer since it reduces its U.S. taxable income. Some taxpayers attempt to convert what should properly be characterized as a foreign source loss into a U.S. source loss.

Regulations were issued earlier this year under section 865(j) that relate to the allocation of loss recognized on the disposition of stock and other personal property. The regulations contain various anti-abuse provisions designed to prevent the creation of U.S. source loss that properly should be allocated against foreign source income. The following is an example from the regulations that illustrates the application of one aspect of the anti-abuse rules:

Facts. On January 1, 2000, P, a domestic corporation, owns all of the stock of N1, a controlled foreign corporation, which owns all of the stock of N2, a controlled foreign corporation. N1's basis in the stock of N2 exceeds its fair market value, and any loss recognized by N1 on the sale of N2 would be allocated to reduce foreign source passive limitation earnings and profits of N1. In contemplation of the sale of N2 to an unrelated purchaser, P causes N1 to liquidate with principal purposes of recognizing the loss on the N2 stock and allocating the loss against U.S. source income. P sells the N2 stock and P recognizes a loss.

Loss allocation. Because one of the principal purposes of the liquidation was to transfer the stock to P in order to change the allocation of the built-in loss on the N2 stock, the loss is allocated against P's foreign source passive limitation income.

There are numerous other ways to create a U.S. source loss in a manner that is inconsistent with the purposes of the Code which regulations under section 865(j) are unable to adequately address. The Administration's built-in loss proposal included in the Budget Proposal would address certain others of these types of transactions.

TREASURY CLEARANCE SHEET

NO. ____________

Date 06/25/1999

MEMORANDM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____________

FROM:
THROUGH:
SUBJECT: CORPORATE TAX SHELTERS REPORT

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt
☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E &
☐ Savings Bonds
☐ Other ____________

NAME (Please Print)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Jon Talisman	JT	6·25	DO/XL	622-0140
REVIEWERS				
Linda Robertson	"Don't hold up" per Sara Lamm - NCC 6/30		DO/L	622-1900
Neal Wolin			DO/GC	622-0027
Howard Schloss	OK per M Smith NCC 6/30		DO/PA	622-2910
Neal Comstock			DO/SE	622-0064
Don Lubick			DO/X	622-0050
OK per John Talisman				

SPECIAL INSTRUCTIONS Comments by noon, 6/29

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

Please log and file

cleared by Neal W.

Linda R.

Howard S.

per NCC

7/1/99