

A Note on Tax Shelters

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This article describes the ongoing legislative and administrative efforts to curtail tax shelters. It concludes that these efforts, which rely largely on disclosure requirements and penalties, cannot succeed as long as taxpayers continue to win many of the litigated shelter cases. It also concludes that the recent proposal of the Joint Committee on Taxation, to codify the economic substance doctrine, is unlikely to solve the problem. Although the proposal would have the salutary effect of preventing courts from deciding that the economic substance doctrine does not exist, courts would remain free to conclude that the doctrine is not applicable in particular situations, or to find that the doctrine is satisfied in highly dubious circumstances. Narrowly tailored legislative responses to particular types of shelters are also not adequate as a solution to the overall shelter problem; since the legislative fixes are prospective only, taxpayers merely move on to new types of shelters not yet legislated against. Accordingly, the article suggests a new approach to the shelter problem, based on the general disallowance of non-economic losses. This could be accomplished by either (1) the enactment of a Code provision flatly disallowing noneconomic losses, subject to an exception for noneconomic losses the deduction of which is clearly contemplated by Congress, or (2) a legislative grant of authority to the Treasury to promulgate regulations retroactively disallowing noneconomic losses, as necessary to prevent abuse.

The marketing of tax shelters by leading accounting and investment banking firms has developed into a perfect plague over the past decade. The aim in every case is to create a tax benefit in the form of a loss, expense or exclusion from gross income that has no economic corollary but is simply the consequence, or the hoped-for consequence, of rule manipulation. It is beyond doubt that such manipulations are contrary to Congressional intent, but that perception has not always been conclusive or even probative in the cases that have arisen.

Recent litigation between taxpayers and the government has had mixed results, with taxpayers winning in more than a few instances by persuading the courts that ‘rules are rules’¹

¹See, e.g., *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001); *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001); *TIFD III-E, Inc. v. United*

and that Congress alone, but not the courts, must patch the leaky tire if Congress thinks a patch is needed. To be sure, the government has also had some major victories.²

From the taxpayer's standpoint there is little to lose (apart from fees to the promoter) by investing in a tax-shelter scheme *provided* that the only consequence, if the scheme unravels, is payment of taxes that would have had to be paid anyway. So why not give it a try? The outlook would be a lot more chancy – often prohibitively so – if the taxpayer also had to confront the risk of civil penalties for understating his income, penalties that might, depending on circumstances, run as high as 75% of the tax due.³ In many cases, probably most, that danger would render the tax-shelter scheme unsalable. The solution to this irritating problem has been for the tax-shelter promoter to obtain and furnish to the taxpayer (at the taxpayer's expense) an opinion of independent tax counsel whose considered conclusions on the legal status of the tax-shelter are presumably entitled to respect. Usually running to forty or fifty pages of heavily cited legal analysis, such opinions almost invariably state that in the event of a challenge by the government the taxpayer's position is "more likely than not" to be upheld by the courts. The phrase "more likely than not" apparently means that there is at least a 51% chance of success in any future litigation, although, to be sure, by implication, there may also be a 49% chance of failure. But the effect of such an opinion – or so it is hoped – is to immunize the taxpayer from the danger of civil fraud penalties. If unlucky enough to be audited, the taxpayer can honestly assert that he sought the opinion of reputable counsel and was assured thereby that the tax-shelter scheme was consistent with the requirements of law.⁴

States, 342 F.Supp.2d 94 (D. Conn. 2004); *Black & Decker Corp. v. United States*, 340 F.Supp. 621 (N.D. Md. 2004); and *Coltec Industries, Inc. v. United States*, 62 Fed.Cl. 716 (2004).

²See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002); *ASA Investorings Partnership v. Commissioner*, 201 F.3d 505 (DC Cir. 2000), cert. denied, 532 U.S. 871 (2000); and *Long Term Capital Holdings v. United States*, 330 F.Supp.2d 122 (D. Conn. 2004).

³The 75% penalty is imposed on underpayments attributable to fraud. IRC § 6663. Section 6662 imposes a 20% penalty on an underpayment attributable to "any substantial understatement of tax," and section 6662A (added to the Code in 2004) imposes a 20% penalty on understatements of tax attributable to "listed" and "reportable" tax shelter transactions (with the penalty increased to 30% if the taxpayer did not adequately disclose the transaction on its return).

⁴ A "should" opinion is even better – at least it should be. "Tax law practitioners customarily use the wording of a legal opinion to convey their level of comfort that the legal conclusions contained therein are correct... Different comfort levels are customarily indicated with the language "more likely than not," "should," and "will." A "should" level opinion evinces a fairly high level of comfort that the legal conclusions follow as a matter of law from the factual representations and assumptions." *Long Term Capital Holdings*, supra note 2, at 144.

Some high-standing law firms have steadily declined to furnish such opinions; others, with bills to pay, have not.

The Treasury's very limited audit resources have made it difficult for the government to track tax shelter transactions, a problem to which Congress reacted in 2004 by adopting strict disclosure requirements buttressed by substantial penalties for non-compliance. The penalty provisions are aimed both at the taxpayer and at his or its 'material advisors,' the latter presumably including the firm or firms that act to implement the shelter plan.⁵

But disclosure is not a solution. As noted, the government has lost at least as many audited tax shelter cases as it has won. To date, Congress has been unable to formulate a substantive rule that would define "tax shelter" and simply deny the purported tax benefit in cases that come within that definition. Adoption of a statutory "economic substance" rule has been proposed and discussed at great length,⁶ but the tax bar has generally opposed that step on the ground that such a rule would throw doubt on legitimately planned transactions and create uncertainty where none exists or should exist.⁷

The taxpayers in *Long Term* paid their tax advisors \$500,000 for a set of "should" opinions ("more likely than not" opinions would presumably have cost less) but got socked with heavy civil penalties anyway.

⁵ Section 6707A penalizes taxpayers who fail to include on their returns information required information with respect to "listed" and "reportable" tax shelter transactions. For corporate taxpayers the penalty is \$200,000 for each undisclosed listed transaction, and \$50,000 for each reportable (but unlisted) transaction. For human beings, the penalty amounts are \$100,000 and \$10,000, respectively. Section 6111 requires tax shelter promoters to file information returns identifying and describing their tax shelters. There is a \$50,000 penalty for each failure to comply with § 6111. The penalty is increased to the greater of \$200,000 or 50% of the promoter's gross income derived from the shelter, in the case of listed transactions. Also, §6662A (supra, note 3) imposes a higher penalty on tax shelter understatements of tax liability in the case of undisclosed transactions. In a related regulatory development, in December 2004 Treasury amended its rules governing practice before the IRS, to impose stricter requirements on the writers of tax shelter opinion letters. Among other things, writers of opinion letters may not base their opinions on unreasonable factual assumptions or representations, and must make reasonable efforts to ascertain all relevant facts. Circular 230, 31 CFR § 10.35.

⁶The leading current proposal, which is discussed later in this essay, comes from the Staff of the Joint Committee on Taxation. Staff of the Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures 14-30 (JCS-02-05, 2005).

⁷For an example from a particularly vocal and influential member of the tax bar, see Kenneth J. Kies, A Critical Look at "Corporate Tax Shelter" Proposals, 83 Tax Notes 1463 (1999).

Our aim in this brief Note is to propose a straightforward and (as we think) uncomplicated statutory solution to the tax shelter problem, one that avoids the much-disputed ‘economic substance’ doctrine and that entails no intrusion on what practitioners would generally regard as legitimate and traditional tax planning. We offer a ‘model’ Code provision, together with Commentary, in our Appendix. This is discussed against the background of a current proposal by the Joint Committee on Taxation, which we think deficient in vital respects.

Hoping that non-specialists will find the topic accessible, we begin with an illustration of a shelter device taken from a recent decision by the Third Circuit Court of Appeals.

An Illustration

Tax shelter arrangements are inevitably complex and detailed – often by design. The fairly recent *ACM Partnership* case⁸ is a very suitable illustration of the species, one that non-specialists (we hope) can follow easily (or fairly easily). By way of background, the Internal Revenue Code has for many years contained an installment sale rule allowing sellers of investment property to report their gains in the years in which the installment payments are received rather than all at once at the date of sale. Assuming the amount of each installment payment is prescribed by the contract of sale, the seller simply allocates a portion of his cost to each payment in proportionate fashion. Perfectly simple. But suppose the installment payments are contingent on future events, so that the amounts to be received each year cannot be ascertained or even predicted at the time the sale takes place. At what rate should the seller’s cost be recovered? In the well-known (to tax practitioners) *Logan* case,⁹ the transaction involved the sale of a coal mine in exchange for royalty payments calculated with respect to the tonnage of coal to be mined each year. Finding that the present value of the royalty payments could not be ascertained, the Supreme Court took the easy way out by holding that the seller was entitled to recover her entire cost before reporting any gain from the sale. The effect was to defer the recognition of taxable gain well into the future, such deferral obviously being very much to the taxpayer’s advantage.

Dissatisfied with the result in *Logan*, Congress in 1980 authorized the Treasury to substitute ratable cost-recovery rules for the ‘front end’ cost-recovery procedure approved by the Court in *Logan*. Accordingly, in a case in which the payout period is fixed but the maximum amount to be paid is uncertain, the Regulations now require that the seller’s cost be allocated in equal amounts over the stated payment period.¹⁰ The result, presumably, is that the seller’s gain will be computed on a yearly basis instead of being deferred, with any unrecovered cost to be deducted in the year in which all payments are completed.

⁸Supra note 2.

⁹*Burnet v. Logan*, 283 U.S. 404 (1931).

¹⁰Treas. Reg. §15a.453-1(c)(3).

As described, the ratable cost-recovery rule seems a reasonable solution to the awkward contingent payment problem posed by the *Logan* case. But what the cited Regulations failed to anticipate was that so-called tax-planners would treat that rule as an invitation to create an avoidance scheme of the most egregious and transparent character. In the *ACM Partnership* case, the tax planning was done by one of the nation’s great financial institutions – Merrill Lynch, no less – and the taxpayer to which the avoidance scheme was sold was a major consumer products company, Colgate-Palmolive, maker of soap and toothpaste and other articles of personal hygiene.

Colgate had earlier realized a large taxable gain on the sale of a subsidiary. The object of the tax plan was to create a deductible “loss” that could be carried back and offset against that gain,¹¹ thus eliminating the tax otherwise due.

Briefly described (rounding all the numbers and omitting many details), the plan went like this:

1. Colgate and Merrill entered into an offshore partnership with a Dutch bank, Algemene Bank Nederland, to which the parties made the following capital contributions (in millions):

	<u>Capital Investment</u>	<u>Partnership Interest</u>
Dutch Bank	\$140	80%
Colgate	33	19%
Merrill Lynch	<u>2</u>	<u>1%</u>
Totals	\$175	100%

2. In the same year, the partnership

(A) bought \$175 of notes issued by Citicorp, and then *immediately*

(B) sold the Citicorp notes to other investors, receiving from the latter

(i) \$140 in cash, plus

(ii) Installment notes payable quarterly over the 5-year period following.

The dollar amount of each quarterly payment was not fixed, but would vary from quarter to quarter depending on the prevailing interest rate for short-term interbank loans – the so-called London Interbank Offering Rate, or LIBOR – a rate that changes slightly from day to day to reflect loan demand and other market conditions. Overall the notes were expected to generate \$35, but it could be a little more or it could be a little less depending on LIBOR over the 5-year term of the notes.

3. Shortly thereafter, the Dutch Bank received a cash distribution from the partnership equal to its original capital investment – \$140 – and was eliminated as a partner. Merrill Lynch also got back all but a few hundred thousand of its original capital investment. This left Colgate with a 99% interest in the partnership and Merrill Lynch with a 1% interest.

¹¹. IRC § 1212(a).

4. In the next year, the LIBOR notes were sold by the partnership for roughly \$35 in cash, following which the partnership in effect distributed virtually all of its assets to Colgate and Merrill, the sole remaining partners. Colgate got back just about the same amount it put in (less, of course, large fees paid to Merrill and the Dutch Bank), which is exactly what it expected.

Pointless? Completely – except for the anticipated tax consequences. The partnership treated the sale of the Citicorp notes as a contingent installment sale within the anti-*Logan* Regulations – the “contingency” being the quarterly fluctuations in LIBOR during the 5-year payout period. By reason of such fluctuations the payments to be received by the partnership would vary from quarter to quarter. Hence the total amount to be received over the entire 6-year period – the year of sale and the next 5 years – was uncertain, *i.e.*, “contingent” on the LIBOR from time to time prevailing.

Assuming (as the tax-planners intended) that the contingent installment sale rules applied, the partnership’s basis for the Citicorp notes would be recoverable ratably over the 6-year period in equal amounts of \$29.167 a year, *i.e.*, \$175 (cost of the Citicorp notes) divided by 6 years equals \$29.167. In the year of sale, therefore, the partnership had a gain of \$140 (cash received) less \$29.167, or about \$111. Only 19% of that gain, about \$20, was allocated to Colgate by reason of its 19% interest in the partnership, and \$1 to Merrill Lynch. The remainder, roughly \$90, was allocated to the Dutch Bank, which, being a foreign entity, paid no taxes to the United States.

In the following year when the LIBOR notes were sold, the partnership – now consisting of Colgate 99% and Merrill Lynch 1% – offset its entire remaining basis, about \$146 (\$175 - \$29.167), against the sale price of \$35. The result was a “loss” of about \$111, of which 99%, or \$110, was allocable to Colgate (and \$1 to Merrill). Taking into account the \$20 of gain that it realized in the first year when the cash payment of \$140 was received, Colgate had a net deductible loss of \$110 minus \$20 equals \$90 (million) to carry back against the taxable gain previously realized on the sale of its subsidiary. The “loss”, of course, was solely a function of the ratable cost-recovery rule, not of any actual market disaster.

In summary, the Dutch Bank gained \$90 and Colgate lost \$90. In fact, neither “partner” gained or lost anything. Same for Merrill Lynch.

Too good to be true? Yes, but just barely. Affirming the Tax Court, the Third Circuit in a 2-1 decision disallowed Colgate’s purported \$110 million loss (and eliminated its earlier \$20 million gain). The overall partnership arrangement – and in particular, the purchase and immediate resale of the Citicorp notes – lacked “economic substance,” in the Court’s view, and as a consequence, under settled law, must be disregarded for tax purposes. “In order to be deductible,” the Court observed, “a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax

accounting rule....”¹² The dissenting judge argued, more or less typically, that the loophole, if there was one, should be left for Congress to close.¹³

The majority opinion in *ACM* bears a close resemblance to the 1960 *Knetsch* decision, in which the Supreme Court disallowed phantom interest deductions under a sham annuity contract.¹⁴ There, as here, the absence of an economic or commercial purpose apart from tax-saving was fatal to the scheme. Undeterred, Colgate’s tax-planners thought it worthwhile to try the sham-transaction game again, largely in the hope of baffling the courts and the Service or (better yet) getting by without an audit. And they nearly did, losing a split decision by the luck of the judicial draw.

What all this shows is that despite decades of legislative, judicial and administrative effort to defend the system, the impulse to vandalize it remains alive and active in the minds of those for whom the income tax is an object of evasion and nothing else.

The Joint Committee Proposal

The *ACM Partnership* decision represented something of a high point in the government’s war against tax shelters and indeed led some commentators to suggest that the war had been won and that tax shelters, like smallpox, were a thing of the past. Writing in 2001, when the government’s appellate victory in *ACM* appeared to be the defining corporate tax shelter decision, one experienced commentator confidently predicted that “[l]oss-generating shelters will almost always fail in litigation.”¹⁵ Events, as it turned out, speedily proved the prediction wrong. By the end of 2001, the government’s twin appellate defeats in *Compaq* and *IES* had called that confidence into question,¹⁶ and three high-profile government defeats in 2004—*Black & Decker*, *Coltec*, and *TIFD III-E*¹⁷-- suggest it may be more likely that *taxpayers* will win the great majority of litigated cases than that the government will do so. Not only are

¹²157 F.3d at 252.

¹³ 157 F.3d at 263 (McKee, J., dissenting).

¹⁴ *Knetsch v. United States*, 364 U.S. 361 (1960).

¹⁵ Canellos, *Business Purpose, Economic Substance, and Corporate Tax Shelters: A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. Rev. 47, 69 (2001).

¹⁶Supra note 1.

¹⁷Supra note 1.

the courts finding the economic substance doctrine to be surprisingly easy to satisfy,¹⁸ there are even rumblings that the courts may deny the very existence of the doctrine. According to the Court of Federal Claims in *Coltec*, “[W]here a taxpayer has satisfied all statutory requirements established by Congress . . . the use of the ‘economic substance’ doctrine to trump ‘mere compliance with the Code’ would violate the separation of powers.”¹⁹ In support of this proposition, the court cites (among many other things) the Supreme Court’s 2000 dictum in *Gitlitz v. Commissioner*, in which the Court held that a result purportedly called for by the “plain text” of the Code was inescapable despite its apparent conflict with Congressional intent.²⁰ Although *Gitlitz* was not a tax shelter case, and the economic substance doctrine was not discussed in the opinion, when eight justices are so ready to accept unintended and illogical results because of poor statutory drafting, an eventual rejection of the economic substance doctrine by the Supreme Court is not unthinkable.

The 2004 legislative response to corporate tax shelters, with its focus on disclosure and penalties, was based on the assumption that the real problem with shelters is the audit lottery. If the taxpayer believes that a shelter is unlikely to survive litigation, then there is some combination of increased odds of detection and increased penalties that will persuade the taxpayer not to undertake the shelter. Obviously, even certainty of detection and massive penalties for shelter-generated understatements of tax liability will not deter shelter activity if the shelters will prevail on the merits in court.

In response to the new judicial coolness to the economic substance doctrine, there has been growing legislative interest in codifying the doctrine. In a recent publication, the Staff of the Joint Committee on Taxation (JCT) has proposed a Code amendment that attempts to tackle the shelter problem in express terms.²¹ Briefly summarized, the JCT amendment seeks to define the several circumstances in which a court *may* apply the “economic substance” test, and then undertakes to state what that test shall consist of. As a first step, the court must determine that

¹⁸A striking example, comes from the Eighth Circuit’s opinion in *IES*. A crucial issue under the judge-made economic substance doctrine is whether a transaction featured a reasonable prospect of being profitable, apart from tax benefits. The transaction in *IES* clearly offered no hope of significant profit aside from hoped-for United States income tax benefits. The Eighth Circuit decided, however, that the imposition of a foreign tax should be disregarded in analyzing the transaction’s profit potential, and with the foreign tax disregarded the transaction would be profitable. 253 F.3d at 354. The conclusion that foreign taxes do not count for purposes of economic substance analysis constitutes a highly *formalistic* approach to a doctrine which is supposed to about substance.

¹⁹61 Fed. Cl. at 756.

²⁰531 U.S. 206, 220 (2000).

²¹Staff of the Joint Committee on Taxation, *supra* note 6.

the “economic substance doctrine is relevant” in respect to an “applicable transaction.”²² If “relevant,” the requirement of economic substance is to be deemed satisfied by the taxpayer only if (A) the transaction changes the taxpayer’s economic position “in a meaningful way” apart from tax saving, and (B) the taxpayer has a “substantial nontax purpose” for entering into the transaction.²³ The two criteria are in the conjunctive, meaning that the taxpayer fails the “economic purpose” test (assuming that test is “relevant”) unless he satisfies both criteria.

There follows a list of six “applicable transactions.”²⁴ The listing is ingeniously designed to cover the known tax shelter universe not by describing tax shelter transactions in all their particular detail, as might be done in a discursive revenue ruling, but by reference to the *mechanisms* by which shelter devices customarily operate. For example, “applicable transactions” include “[a] transaction which is structured to result in a disparity between basis and fair market value which creates or increases a loss or reduces a gain,” a description that fits the *ACM* case described above. And since tax shelters usually entail a chain of legal moves designed to create the desired tax benefit, the JCT proposal wisely provides that “[t]he term ‘transaction’ includes a series of transactions.”²⁵ Presumably the reference is to a “series” of steps that are integrated or pre-wired and that are properly evaluated in their entirety.

In our view, though it is well-crafted and well-intended, the JCT proposal fails to address the major problem in the shelter field, which is, quite simply, the ambiguous and untrustworthy application of the ‘economic substance’ doctrine. The proposal says nothing about what it takes to cross the threshold of ‘relevance’, and indeed in the accompanying Discussion the JCT writers take pains to affirm that there is no intention to intrude on judicial discretion:

“The proposal only applies to cases in which a court determines that the economic substance doctrine is relevant. The proposal is not intended to change current law standards used by the courts in determining when to utilize an economic substance analysis, and does not require a court to make such a determination merely because of the presence of an applicable transaction. The proposal does not apply to cases in which the taxpayer establishes that the outcome of the transaction is clearly consistent with all applicable provisions of the Code and the purposes of such provision.”

The limitations or restrictions on the proposed statutory provision are thus expressed in rather urgent terms. We presume the aim is to assure that the economic substance doctrine will

²²Staff of the Joint Committee on Taxation, *supra* note 6, at 29.

²³*Id.*

²⁴*Id.*

²⁵*Id.* at 30.

not be extended improperly, whatever that means, or used in an excessively aggressive fashion by the Internal Revenue Service. Perhaps such caution is unavoidable. The consequence, however, may be to leave the doctrine in an uncertain status, vulnerable to chance judicial interpretation very much as it is today. Our guess – admittedly only a guess – is that the results reached by the courts over the past year or two, including the dissenting opinion in the *ACM* case, would be unchanged by adoption of the JCT proposal. In effect, the ‘relevance’ limitation frees the courts, at least those that are so disposed, to apply ‘rules’ in literal fashion, with the usual proviso that rules are made to be followed until Congress acts to change them.

A related observation on the JCT proposal is in order. Assuming ‘relevance,’ tax planners may be able to satisfy the proposed two-part test of economic substance by including *some* opportunity for gain in the shelter arrangement, even though the chance of such gain is small. The fact is that virtually every shelter arrangement does include an element of prospective gain, however unlikely. In the *ACM* case, described above, a sharp drop in the LIBOR would of course result in a sharp rise in the value of Colgate’s 5-year installment notes, leading to an investment gain as well as a tax benefit. In the offsetting currency option shelter cited below²⁶, a quick and unexpected change in the value of the dollar, yen or euro could likewise generate an investment gain for the taxpayer. The chance of gain is, as stated, remote in every case, and the odds *against* are much longer than the promised payoff should the gamble unexpectedly prove to be a winner. The bet is one that no sane and sensible investor would make apart from the hoped-for tax saving, but “success” is not quite out of the question.

How do the JCT “meaningful change” and “substantial nontax purpose” tests operate under these circumstances? Hard to say. The ‘meaningful change’ test, which is based on the objective economic facts of the arrangement rather than the taxpayer’s subjective intent, may well be satisfied. Making a bet, even a bad one, would seem to effect a meaningful change in the taxpayer’s financial circumstances. But even if able to satisfy the objective part of the twofold “economic substance” test, the taxpayer still confronts the *subjective* prong of the JCT criteria and a court may find that no serious investor, with large sums at stake, would make as bad a bet as this one. On the other hand, bad bets are made every day. And what if the taxpayer, pointing to the *possible* gain, states simply that “he felt lucky that day,” long odds and short payoff notwithstanding? Is that enough to satisfy the nontax business purpose test? It is if the court believes him (*i.e.*, falls for it), and some courts probably will. No doubt a similar argument was made in the *ACM* case. It lost, to be sure, but only by a 2-1 vote.

In summary, although codification would prevent a court from concluding that the doctrine does not exist, courts would remain free to conclude that the doctrine is not relevant in particular situations. And even when they did find the doctrine relevant, courts would remain free to find meaningful changes in economic positions and substantial nontax purposes in highly dubious circumstances. In only one of the recent government litigation losses did the court question the existence of the doctrine (and even in that case the court held that, assuming the

²⁶ *Infra*, note 67.

doctrine did exist, it was satisfied on the facts of the case²⁷). In all the other cases, the courts found that the doctrine did indeed exist, and was relevant, but that the tax shelters in question actually passed the doctrinal test.

If disclosure requirements and increased penalties will not administer a death blow to shelters, and if codification of the economic substance doctrine is also not enough, is there some other, more promising, approach lurking offstage? It is always possible, of course, to shut down particular shelter techniques by narrowly targeted legislation—as, for example, the enactment of section 901(k) did for foreign tax credit shelters, the enactment of section 358(h) did for contingent liability shelters, and the enactment of section 470 did for tax exempt entity leasing. The problem is that these targeted fixes are always made prospective only. As Congress closes one loophole, tax shelter designers find other glitches in the Code around which to build new shelters.²⁸ Like the Dutch boy at the leaky dike, or Hercules attempting to conquer the Hydra by decapitation, or the man in the gospel parable who is rid of one devil only to be possessed by “seven devils worse than the first,” or Alice and the Red Queen running as fast as they can just to stay in the same place—the literary references go on and on—the government cannot win this game. Some commentators have suggested that ad hoc legislation aimed at particular types of shelters should be the government’s primary weapon in the battle against shelters.²⁹ We believe, however, that the always-one-step-behind nature of this approach means it can never be an adequate response to the proliferation of shelters. As with enhanced disclosure and penalty regimes, and codification of the economic substance doctrine, we are not opposed to particular ad hoc prospective legislative responses to tax shelters, but we believe that something more is needed if the shelter dragon is to be slain.

A Simpler Rule

What is wanted is a silver bullet (or perhaps a broad spectrum antibiotic) which would kill a wide variety of tax shelters, and do so in such a way that the government would no longer always be playing “catch up”—a provision which would invalidate tax shelters *before* they are invented, and which would leave little to judicial discretion. There is a precedent for such a bullet. The last tax shelter wars—involving the mass marketing of debt-financed tax shelters to upper-middle (and even middle-middle) income taxpayers in the 1970s and 1980s—ended

²⁷*Coltec*, 62 Fed.Cl. at 754.

²⁸In fact, this dance—in which shelter promoters invent shelters, Congress shuts down the shelters prospectively, and the promoters invent new shelters—is essential to the tax shelter promotion industry. Without the constant need for new shelters to replace the invalidated old ones, corporations could simply take battle-tested old shelters “off the shelf.” Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775, 1782 (1999). Of course, the revenue loss would be tremendous, but no one would be able to make a living designing ingenious new shelters.

²⁹See, e.g., Sheppard, *supra* note 27.

abruptly in a sweeping government victory, as a result of the enactment of the passive loss rules of section 469 as part of the Tax Reform Act of 1986. For those (like us) who lived through those wars, it is natural to hope that some analogue to section 469 might be found, thereby putting an end to the new breed of shelters in one fell swoop. It is not immediately obvious, however, how that might be done. The pre-1986 shelters were all very much of a kind—virtually all involved the creation of artificial (noneconomic) losses for passive investors through the combination of tax preferences (most commonly accelerated depreciation) and interest expense deductions. The passive status of the taxpayers investing (so to speak) in the shelters was crucial, since no busy shelter-seeking doctor or lawyer was willing to devote any significant portion of his time to the business activities of his shelter. Because of these common shelter features, it was possible to kill them all with a single bullet—a rule that a taxpayer cannot deduct losses from an activity in which he does not “materially participate” against income from other sources (with “material participation” being defined to require, in most cases, at least 500 hours of the taxpayer’s time per year³⁰). The problem is in translating this success to the new shelters. Contemporary shelters are considerably more varied in design—and in the Code provisions they exploit—than were their predecessors.³¹ Moreover, there is no straightforward way to transport the elegant simplicity of the 500-hours-per-year participation requirement of section 469 from the old individual taxpayer shelter context to the new context of shelters used (primarily) by corporations. Some commentators (including one of us) have expressed a hope that there might be a workable analogue to section 469 applicable to corporate shelters, but they have not offered actual proposals.³² However, others—including the Treasury Department during the Clinton Administration—have believed the enterprise to be hopeless.³³

The most promising approach, we think, is to create a hindsight rule, one that emphasizes outcomes, actual or readily foreseeable, rather than “economic substance” or taxpayer motive. In that spirit, we propose the enactment of a Code provision that would flatly disallow non-economic losses and non-economic deferrals through the use of foreign (and other tax-indifferent) counterparties. Our aim is to render fruitless the manipulation of basis or other accounting rules in order to achieve a tax benefit that has no substantial economic corollary, as

³⁰Treas. Reg. § 1.469-5T(a)(1).

³¹Section 470, the legislative attack on tax exempt entity leasing enacted in 2004, is in fact closely modeled on section 469. The difference is that section 469 was sufficient to kill virtually the entire pre-1986 tax shelter industry, whereas section 470 addresses only one medium-sized corner of the corporate tax shelter phenomenon.

³² Lipton et al., *Corporate Tax Shelters Roundtable*, *Taxes*, March 2000, at 141, 144; Zelenak, 54 *SMU L. Rev.* 177, 191-93 (2001); Sheppard, *Is There Constructive Thinking About Corporate Tax Shelters?* 83 *Tax Notes* 782, 784 (1999).

³³Lipton, et al., *supra* note 36, at 144 (comments of Joseph Mikrut, U.S. Tax Legislative Counsel); Department of the Treasury, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* 113 (July 1999).

was attempted in the *ACM* case.

The rule that we propose is simply stated: (1) no deduction shall be allowed for losses substantially in excess of any measurable reduction in the taxpayer's net worth, and (2) no deduction or exclusion from gross income shall be allowed through the allocation of non-economic income to a tax-indifferent party (e.g., a foreign bank). Neither "economic substance" nor "motive to avoid tax" would have any role to play in the application of the proposed disallowance rules. The rules would operate by resort to arithmetic, not by resort to doctrinal analysis and not by consulting case-law precedent. Proposed statutory language and commentary (loosely in the style of a committee report, and relating the proposal to several recent cases) is included in the Appendix. In contrast with the JCT approach, our proposal takes the form of a substantive rule that losses within the scope of the proposal are not allowed—*not* that the losses are subject (at a court's discretion) to the economic substance doctrine, and that a court may disallow the loss if it concludes the transaction lacks economic substance, but rather that such losses are *simply not allowed*. This approach avoids both the problem of shelters escaping because the law gives courts the flexibility to let them escape, and the problem that narrowly targeted legislative responses are always one step behind the tax shelter industry. We are sure that the Staff of the Joint Committee fully recognizes the limitations of its own proposal, and made such a limited proposal because of its sense that Congress would not be amenable, in the short term, to any more forceful proposal.³⁴ We bow to the Staff's expertise in taking the pulse of Congress, but we also claim that our proposal—unlike any of the more frequently discussed anti-shelter proposals—has the potential to control corporate tax shelters with a level of effectiveness approaching that of section 469 against pre-1986 shelters.

A virtue (so we hope) of our proposal is that it would – in self-executing fashion – distinguish between traditional "tax planning" and "planning" that generates abusive tax shelters. As an example of the former, we need look no further than the famous and well-remembered *Gregory* case,³⁵ birthplace of the business purpose doctrine, of which a fact summary appears in

³⁴The Staff of the Joint Committee noted that broad anti-shelter legislation is commonly opposed on the grounds that "the legislative rule might inadvertently restrict the flexibility of the courts in resolving disputes on a case-by-base basis," and that "the rule might apply too broadly, and cause a court . . . to raise an 'economic substance' inquiry in common situations not previously involving the issue." Staff of the Joint Committee on Taxation, *supra* note 6, at 20-21. The Staff went on to explain that "[t]he proposal attempts to respond to such concerns by limiting its application only to certain types of transactions having the characteristics of tax shelters, and only if a court determines the economic substance doctrine is relevant." *Id.*

³⁵*Gregory v. Helvering*, 293 U.S. 465 (1935). Mrs. Gregory was the sole owner of United Mortgage Corporation, which owned highly appreciated investment assets. If she had caused United Mortgage to distribute the assets to her, the entire fair market value of the assets would have been taxed to her as a dividend. Instead, she caused United Mortgage to transfer the appreciated assets to newly-formed Averill Corporation, in exchange for all of Averill's stock,

the footnote. Adopting Learned Hand's classic opinion,³⁶ the Supreme Court held that the reorganization provisions of the Code include an unwritten "business purpose" requirement, and that the use of a transitory corporate entity to satisfy the literal requirements of the statute failed for lack of such a "purpose". The transaction in *Gregory* plainly did have an *economic* goal – namely, to distribute certain readily salable assets to Mrs. Gregory individually – but not one that met the business purpose condition which Hand found to be embedded in the Code's reorganization provisions. Practitioners are of course well aware that tax plans that build upon transitory relationships, or "steps," are vulnerable to attack by the IRS, and that they often fail, though not always.

At all events, the issue in what we have called a "traditional" context is, roughly speaking, whether a transaction that has been cast in a roundabout form, with a view to avoiding the tax that would be imposed if the transaction were carried out directly, will be given legal recognition or be recast at the Commissioner's insistence to produce a taxable result. In all such cases, the taxpayer does indeed have a respectable goal in view – to sell a business, distribute a dividend or exchange one property for another. The great question, then, is not whether the taxpayer sought to achieve a bona fide business or investment objective – he plainly did -- but whether the roundabout form adopted by his tax planners is legally valid and creditable under the statute. By and large, the outcome depends on whether the form chosen has substantive effect in all its elements or, instead, includes some transitory feature whose only function is to meet the terms of the statute in literal fashion.

Gregory is an instance of traditional "tax planning" – a failed instance, to be sure – but it obviously does not come within the class of tax shelters that would be affected by our disallowance proposal -- provided, as we intend, that the term "tax shelter" is understood to mean the creation of noneconomic tax benefits of the sort claimed in the *ACM* case. Traditional tax planning is most often aimed at avoiding the recognition of taxable gain or ordinary income. Our aim is to place that settled function of advice-giving to one side. Doctrinal limitations – "business purpose," "step transaction" – would continue to apply, however variably, where appropriate, but the *Gregory* case and its infinite progeny would fall outside the scope of our

and then to distribute all the Averill stock to her. Shortly after receiving the Averill stock, Mrs. Gregory obtained direct ownership of the appreciated assets through the complete liquidation of Averill. She then sold the assets. The transaction met the literal statutory requirements for a divisive corporate reorganization. If the form of the transaction were respected, Mrs. Gregory would have been able to recover a portion of her basis in her United Mortgage stock, and would have paid tax on her gain at favorable capital gains rates. After the dust had settled, however, the non-tax result of the series of transactions was indistinguishable from that of a simple dividend distribution of the appreciated assets from United Mortgage to Mrs. Gregory (followed by a sale of those assets by Mrs. Gregory), and the Supreme Court held that the transaction should be taxed according to its dividend substance, rather than its reorganization form.

³⁶*Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934).

disallowance rule. We therefore follow the JCT proposal in vesting in the Secretary specific authority to regulate, and thus to distinguish between shelter transactions – those that entail noneconomic losses and transactions with foreign counterparties – and transactions that may be regarded as a function (whether or not acceptable to the Commissioner) of traditional tax planning. As noted above, the JCT proposal imposes its “economic substance” condition on the taxpayer *only* if, as an initial matter, a court determines that the economic substance “doctrine” is relevant to the case at hand. That curious threshold feature (we assume, perhaps wrongly) is designed to prompt the court to distinguish between traditional tax planning and abusive shelter planning. If so, it goes well past its purpose, creating uncertainty where there should be none and leaving the shelter-planner free to pump just enough economic substance into his scheme to avoid the provision altogether.

Alternatives

We anticipate two principal objections to our proposal. The first is that as a rule of substantive law it would apply too broadly—that is, it would disallow noneconomic losses (and deductions and exclusions)³⁷ in situations where Congress, if it had considered the issue, would have considered the losses appropriately allowed. The second (and closely related) objection is that it would inhibit legitimate business planning by creating massive uncertainty as to its scope. We agree that Congress would not want to disallow every type of noneconomic loss, and that some mechanism is needed to separate the deductible wheat from the nondeductible chaff. Two basic mechanisms for accomplishing this come to mind, and we would be satisfied with either.

The first mechanism, which is reflected in the proposed statutory language in the Appendix, is to enact a self-executing disallowance provision—i.e., a provision which by its own terms disallows described losses, without the need for any implementing regulations or other administrative action—but to provide for appropriate exceptions. The statutory language we have proposed would leave the crafting of exceptions to Treasury, but we would not object to more direct legislative involvement in this area, which could take either or both of two forms. The first would be a general statement that the disallowance provision does not apply to noneconomic losses “clearly contemplated” by Congress.³⁸ This could be combined with an explicit grant of regulatory authority to promulgate a nonexclusive list of situations to which the “clearly contemplated” exception applies. Instead of, or in addition to, a general “clearly

³⁷The remainder of this discussion uses “noneconomic losses” as a shorthand covering both noneconomic losses and noneconomic deductions and exclusions in transactions with tax-indifferent parties.

³⁸To take two easy examples familiar to every law student who has taken the basic income tax course, the noneconomic loss created by the combination of tax-free imputed rental income and deductible home mortgage interest (see IRC § 163(h)(3)) is clearly contemplated by Congress, as is the charitable contribution deduction for appreciation never taxed to the donor (see IRC § 170(e)).

contemplated” provision, Congress could include in the statute (or perhaps in the legislative history) a list of situations in which noneconomic losses are not subject to disallowance. Although we ourselves would not undertake the daunting task of compiling such a list, we are confident that lobbyists would propose to the tax-writing committees every worthy candidate for inclusion. In fact, the main danger of a statutory list of exceptions is that lobbyists would persuade Congress to include inappropriate items on the list.

The second mechanism for separating the deductible wheat from the disallowed chaff would be the enactment of a non-self-executing anti-shelter provision. Rather than disallowing any noneconomic losses by its own terms, a statute of this sort would confer on the Treasury the authority to promulgate regulations disallowing any noneconomic losses (or deductions or exclusions arising in connection with transactions with tax indifferent parties) as necessary to prevent abuse. This reverses the presumption of the first mechanism. Under the first approach, all noneconomic losses are disallowed except as otherwise provided; under the second approach, noneconomic losses are disallowed only as specifically provided. If Congress were concerned that Treasury might be overly exuberant in its exercise of this authority, it could subject it to either or both of the limitations discussed in connection with the first mechanism—it could deny Treasury authority to disallow losses “clearly contemplated” by Congress, losses on a list of exceptions, or both. Since anti-shelter legislation will be effective only if it overcomes the always-one-step-behind problem, this approach would be effective only if it gave Treasury authority to apply its anti-shelter regulations retroactively.³⁹ It should be sufficient to authorize retroactivity to the date of the enactment of the legislation conferring the regulatory authority. With this regulatory authority in place, any taxpayer considering a tax shelter would have to take into account the possibility that it would be invalidated by regulations promulgated after the taxpayer had entered into the shelter. Moreover, the threat of retroactive invalidation would make it impossible for attorneys to issue favorable shelter opinion letters. If Treasury considered this Damoclean threat inappropriate with respect to particular transactions, it could promulgate regulations (or simply issue announcements) identifying situations in which it had decided it would definitely not issue loss disallowance regulations.

Only time will determine the political viability of a grant of retroactive regulatory anti-shelter authority, but a 1999 Report of the Tax Section of the New York State Bar Association (NYSBA) suggests that the elite tax bar, at least, might accept this approach to the shelter

³⁹Assuming Congress is willing to legislate broadly against tax shelters, we would not expect it to balk at granting Treasury authority to promulgate retroactive anti-shelter regulations. Despite its general antipathy to retroactive tax regulations, Congress currently permits tax regulations to “take effect or apply retroactively to prevent abuse.” IRC § 7805(b)(3). Under current law this would include, for example, regulations promulgated under IRC § 337(d) (authorizing regulations to ensure that *General Utilities* repeal is not circumvented), and IRC § 7701(l) (authorizing regulations to “prevent avoidance of any tax” through the use of multiple-party financing arrangements).

problem.⁴⁰ The Report was written in response to a set of anti-shelter proposals offered by the Clinton Treasury Department, including a proposal that Treasury be given authority exercisable on a case-by-case basis “to disallow a deduction, credit, exclusion or other allowance obtained in a tax avoidance transaction.”⁴¹ The NYSBA Tax Section strongly objected to this proposal, expressing concerns that the authority would be exercised by individual IRS officials “without substantial guidance or control,” and that positions taken by the IRS under this provision might be “substantially out of step with the views of Congress” because of the ability of the IRS to apply the provision “without the exercise of regulation authority subject to public comment.”⁴² By contrast, the Tax Section suggested that “a general grant of regulatory authority . . . to address transactions that exploit obvious loopholes that are plainly contrary to the intention or contemplation of Congress” could be “usefully considered.”⁴³ The Tax Section considered this approach superior to the Treasury’s proposal because the notice and comment requirement for regulations would “constrain the arbitrary exercise of this authority.”⁴⁴

No doubt a grant of regulatory authority of this sort would be challenged on constitutional grounds, both for its broad scope and for its retroactive effect. Although we leave a detailed discussion of the constitutional issue for another day, a quick review of the authorities suggest the grant would survive all constitutional challenges. The nondelegation doctrine would be the basis of a challenge based on the sweeping nature of the regulatory grant; the argument would be that the grant is “an unconstitutional delegation of the taxing power by Congress to the Executive Branch.”⁴⁵ The leading case on the application of the nondelegation doctrine in the tax arena is *Skinner v. Mid-America Pipeline Co.*, in which a taxpayer challenged a statutory grant of authority to the Secretary of Transportation to establish a schedule of “Pipeline safety

⁴⁰Tax Section of the New York State Bar Association, Comments on the Administration’s Corporate Tax Shelter Proposals, 83 Tax Notes 879 (1999).

⁴¹Department of the Treasury, General Explanations of the Administration’s Revenue Proposals 98 (Feb. 1999).

⁴²Tax Section of the New York State Bar Association, *supra* note 44, at 898.

⁴³*Id.* at 900. The Tax Section did not specify whether the contemplated authority would include authority to make the regulations retroactive, but the overall context of the Report strongly suggests that retroactivity was contemplated. Elsewhere in the Report the Tax Section described at some length the always-one-step-behind problem inherent in most of the existing approaches to combating shelters (*id.* at 882-84), and opined that retroactive regulations are sometimes appropriate under more targeted grants of authority to promulgate anti-abuse regulations (*id.* at 880).

⁴⁴*Id.*

⁴⁵*Skinner v. Mid-America Pipeline Co.*, 490 U.S. 212, 214 (1989).

user fees,” which gave the Secretary broad discretion in setting the fee schedule.⁴⁶ The Supreme Court began by noting that the nondelegation doctrine is ordinarily not very demanding, as illustrated by earlier cases such as one upholding a grant to a Price Administrator to set “fair and equitable” commodities prices,⁴⁷ and another upholding a grant of authority to the Federal Communications Commission to regulate broadcast licensing according to “public interest, convenience, or necessity.”⁴⁸ In general, noted the Court, it is enough that “Congress provides an administrative agency with standards guiding its actions such that a court could “ascertain whether the will of Congress has been obeyed.””⁴⁹ Mid-America Pipeline Co. argued, however, that the “user fees” were really taxes, and that a more demanding version of the nondelegation doctrine applied to taxation. A unanimous Supreme Court sharply disagreed: “Even if the user fees are a form of taxation, we hold that the delegation of discretionary authority under Congress’ taxing power is subject to no constitutional scrutiny greater than that we have applied to other nondelegation challenges.”⁵⁰ The Court concluded that the delegation to set user fees did not violate the Constitution, even if viewed as a delegation of the power to tax. Under the approach to the nondelegation doctrine used by the Court in *Skinner*, the proposed grant of anti-shelter regulatory authority seems clearly permissible.

The second constitutional issue is whether retroactive application of anti-shelter regulations might be invalid as an abuse of discretion or as a violation of the due process clause of the Fifth Amendment. (Although some courts analyze this issue in abuse of discretion terms, and some in due process terms, the choice of label seems to have no effect on the substance of the analysis.⁵¹) The dominant view is that retroactivity is a grounds for judicial invalidation only if the “regulation alters settled prior law or policy upon which the taxpayer justifiably relied and

⁴⁶The statute directed the Secretary to “establish a schedule of fees based on the usage, in reasonable relationship to volume-miles, miles, revenues, or an appropriate combination thereof, of natural gas and hazardous liquid pipelines.” 490 U.S. at 214, quoting the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, 100 Stat. 82, –, sec. 7005(a)(1).

⁴⁷*Yakus v. United States*, 321 U.S. 414, 420, 426-27 (1944).

⁴⁸*National Broadcasting Co. v. United States*, 319 U.S. 190, 194, 225-26 (1943).

⁴⁹490 U.S. at 219, quoting *Mistretta v. United States*, 488 U.S. 361, 379 (1989), in turn quoting *Yakus v. United States*, 312 U.S. 414, 426 (1944).

⁵⁰490 U.S. at 223.

⁵¹See, e.g., *Tate & Lyle, Inc. v. Commissioner*, 87 F.3d 99(3d Cir. 1996) (due process analysis); *Snap Drape, Inc. v. Commissioner*, 98 F.3d 194 (5th Cir. 1996) (abuse of discretion analysis, but relying heavily upon Supreme Court due process precedent); *A. Tarricone, Inc. v. United States*, 4 F.Supp. 2d 323 (SDNY 1998) (invoking both abuse of discretion and due process terminology); *CWT Farms, Inc. v. Commissioner*, 755 F.2d 790 (11th Cir. 1985), cert. denied, 477 U.S. 903 (1986) (abuse of discretion analysis).

if the change causes the taxpayer to suffer inordinate harm.”⁵² Applying this standard to uphold the application to events of 1985 of regulations issued in 1992, the Third Circuit stated that it was sufficient that “the taxpayer had adequate notice within a reasonable time [by October of 1986] that regulations would be forthcoming which *could* alter the tax treatment of its interest deductions.”⁵³ Similarly, the Southern District of New York upheld the retroactive application of an excise tax regulation where the law was unsettled prior to the issuance of the regulations: “[Taxpayer] cannot plausibly contend that the retroactive application of the new regulations altered settled law and expectations; to the contrary, it was always possible that [taxpayer] would be liable for the taxes at issue here.”⁵⁴ Any taxpayer entering into a tax shelter transaction featuring a noneconomic loss (or involving a tax-indifferent party) after the enactment of the grant to Treasury of regulatory anti-shelter authority would be on notice that the hoped-for tax benefits were subject to retroactive disallowance by regulation. To any claim of abuse of discretion or due process violation, Treasury could simply respond that the taxpayer always knew (or should have known) that “it was always possible” that the tax benefits would be retroactively disallowed, and that should be enough to uphold the retroactive application of the regulation.⁵⁵

It is our sense that not a great deal is at stake in the choice between these two approaches to separating the wheat from the chaff. Under either approach, there will be a period when the scope of the anti-shelter provision is less than perfectly clear—in one case because the exceptions to the self-executing rule have not yet been fully defined, and in the other case because the Treasury has not yet fully indicated how aggressively it will exercise its authority to disallow

⁵²CWT Farms, Inc., 755 F.2d at 802.

⁵³Tate & Lyle, 87 F.3d at 107-08 (emphasis added).

⁵⁴A. Tarricone, Inc., 4 F.Supp.2d, at 326.

⁵⁵There is authority, from the Fifth Circuit, indicating that a regulation retroactive to the enactment of the authorizing statute would survive due process and abuse of discretion challenge even in the presence of justified detrimental reliance. *Snap Drape, Inc. v. Commissioner*, supra note 55. On the authority of *United States v. Carlton*, 512 U.S. 26 (1994) (upholding against a due process challenge the retroactive application of an estate tax *statutory* provision), the Fifth Circuit applied a rational purpose standard. It held that matching the effective date of the retroactive regulation to the effective date of the statute to which it related was enough to satisfy the rationale purpose standard, despite the fact that the taxpayer reasonably relied on the existence of a contrary state of the law and the fact that the court considered retroactive application of the regulation to the taxpayer to be “inordinately harsh.” *Snap Drape, Inc.*, 98 F.3d at 203. The validity of retroactive regulations under the proposed anti-shelter legislation does not depend, however, on the *Snap Drape* analysis. Even assuming that due process and abuse of discretion analyses do protect reasonable reliance, taxpayers entering into tax shelters after the enactment of the legislation could not establish that they had reasonably assumed that retroactive anti-shelter regulations would not be applied to them.

losses retroactively. Under either approach, however, we would expect the uncertainty to dissipate fairly quickly, as Treasury issued additional guidance over time. To deal with the predictable complaints that either approach would introduce an unacceptably high level of uncertainty (at least in the short term), thus interfering with legitimate tax planning, Congress might accompany either approach with funding for an expanded advance ruling program. Any taxpayer contemplating a tax shelter investment could request an advance ruling that the hoped-for tax benefit was within the “clearly contemplated” exception (under the self-executing form of the proposal) or that it would not be retroactively disallowed (under the regulatory authority form of the proposal). If this approach—of providing predictability on a case-by-case basis through the advance ruling process—has proven generally satisfactory for corporate reorganizations, it should also be generally satisfactory for tax shelters. In reality, of course, this approach would call the bluff of those who complain about uncertainty but whose real interest is in being able to play the audit lottery without risk of penalty.

A final comment on two things our proposal does not do. First, the proposal does not address *Cottage Savings*-type situations, in which the taxpayer has clearly suffered an economic loss, and the question is whether events have occurred which make it appropriate to take that loss into account for tax purposes.⁵⁶ If these situations are understood as tax shelters at all,⁵⁷ they are a tiny part of the tax shelter universe, and excluding them from the scope of our proposal does not significantly reduce its effectiveness. Second, the noneconomic loss portion of the proposal would not reach a transaction in which the taxpayer manages to “stuff” enough taxable income into the transaction to avoid the generation of a tax loss. Suppose, for example, a taxpayer’s original shelter plan was a transaction which generated zero economic income and a \$1 million noneconomic tax loss. This plan would be subject to our proposal. But if the taxpayer were able to stuff into the same transaction \$1 million of income (i.e., \$1 million of both economic income and taxable income), the overall transaction would then feature \$1 million of economic income and zero taxable income. It could still be reasonably described as a shelter, but it would no longer feature a noneconomic loss, and so would not be subject to the first prong of our proposal. The proposal could be amended, of course, to extend to all transactions in which taxable income is lower than economic income, but that would put a huge number of transactions—perhaps a majority of all transactions—within the scope of the proposal. Among other things, expanding the proposal in this manner would raise the specter of a general imposition of tax on unrealized appreciation. Although we are concerned that the narrower scope of our proposal may leave room for some shelters to escape its reach, on balance we think the proposal would be reasonably effective, for two reasons. First, although some shelter-like transactions have avoided the production of losses through the income-stuffing technique, they have generally required the presence of tax-indifferent parties.⁵⁸ Thus, they would escape the first prong of our

⁵⁶*Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).

⁵⁷See Tax Section of the New York State Bar Association, *supra* note 44, at 886-88 (expressing doubt that transactions of this type should be understood as tax shelters).

⁵⁸See, e.g., TIFD III-E, *supra* note 1.

proposal only to be impaled on the second prong. Second, in many cases the problem of stuffing can be dealt with through appropriate determinations of the “transaction” to which the anti-shelter legislation applies. That is, if the taxpayer has no good non-tax reason for stuffing the income into the shelter transaction, then the transaction can and should be defined by excluding the stuffed income from its scope, with the result that the transaction produces a noneconomic loss after all.⁵⁹

Conclusion

For the reasons we have given, the ‘economic substance’ doctrine is simply too weak a barrier to protect the income tax from assault by abusive shelter planners. Recent court decisions prove that proposition beyond a doubt. New statutory disclosure rules and ethical practice restrictions are all to the good, but they do not bear directly on the legal question of what is and what is not acceptable tax planning. The JCT proposal is to be admired, as we have said, but its invocation of judicial discretion in determining whether the doctrine is or is not relevant in a given case is a serious, perhaps even a fatal weakness. Patchwork legislation aimed at particular shelter schemes is also to the good, but it is normally prospective in application, leaving those who have already taken steroids to enjoy their homerun records, even if sometimes contested, and of course having no application to new shelter ideas as they arise.

Our proposal discards ‘doctrine’ and strikes at abusive shelters in a direct fashion by stressing outcomes rather than intentions. The tax benefit sought by the shelter planner is simply made unavailable. If adopted, our proposal should make it impossible for law firms to issue favorable opinions on shelter schemes that would entail tax benefits in excess of economic loss, and should also put an end to shelter litigation.

Appendix

We propose a Code amendment in the following form:

Section XXX. Noneconomic losses and deferrals

(a) Noneconomic losses and deferrals.

(1) Noneconomic losses. No deduction shall be allowed for any loss claimed to have been incurred in connection with any transaction or series of transactions except to the

⁵⁹This defining of the scope of a transaction can be done by the IRS and the courts on a case-by-case basis, but it would also be an appropriate topic for regulations, as Treasury is able to identify particular genres of income-stuffing transactions.

extent that such loss reflects a measurable reduction in the taxpayer's net worth.

(2) Tax-indifferent parties. No deduction or exclusion from gross income shall be allowed in connection with any transaction or series of transactions structured to result in income to a tax-indifferent party for any period, which income is substantially in excess of the economic income of such tax-indifferent party for such period. The term "tax-indifferent party" means any person or entity not subject to tax imposed by subtitle A. A person shall be treated as a tax-indifferent party with respect to a transaction if the items taken into account with respect to a transaction have no substantial impact on such person's liability under subtitle A.

(b) The Secretary may by regulations exempt any transaction from the application of this Section.

Commentary:

(a)(1) Noneconomic losses. No deduction shall be allowed for any loss claimed to have been incurred in connection with any transaction or series of transactions except to the extent that such loss reflects a measurable reduction in the taxpayer's net worth.

The *ACM* transaction is an example of the kind of shelter-device this provision is intended to eliminate.⁶⁰ Another example – this one a notable taxpayer triumph – is provided by the District Court's ill-advised decision in *Black & Decker Corp. v. U.S.*⁶¹ Black & Decker, having realized significant capital gains on the earlier sale of various properties, was in the market for offsetting capital losses. As proposed and planned by its accounting firm, Black & Decker created a wholly owned subsidiary to which it transferred (i) \$560 million in *contingent* employee healthcare claims plus (ii) \$561 million in cold hard cash. It then sold the stock of the subsidiary to an "independent" third party for \$1 million. Asserting that its basis in the subsidiary's stock was equal to the cash transferred, \$561 million, Black & Decker sought to deduct a \$560 million capital loss. The Commissioner, arguing that Black & Decker's basis for the stock should be reduced to \$1 million by reason of the subsidiary's assumption of the contingent healthcare claims, disallowed the loss in full.

The Court held for the taxpayer. In general, IRC § 358(d) provides that the basis of stock received in a tax-free incorporation under IRC § 351(a) shall be reduced by the amount of any liability assumed by the corporate transferee. If applicable, the provision just cited would, as the government contended, result in a \$1 million basis for the subsidiary's stock in the hands of

⁶⁰*ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999). *ACM* is described in some detail, *infra* text accompanying notes 8 - 13.

⁶¹*Black & Decker Corp. v. United States*, 340 F.Supp.2d 621 (ND Md. 2004).

Black & Decker and, of course, no deductible loss when the stock was sold. For reasons too tedious to describe, the Court allowed itself to be persuaded that § 358(d) did not apply to contingent liabilities that would be deductible by the transferor if paid in the ordinary course of the transferor's business, as would be true of the employee healthcare claims. Accordingly, it found that the taxpayer's stock basis was equal to the cash transferred, \$561 million, unreduced by the \$560 million of liabilities assumed by the transferee-subsiary.

The decision is of course preposterous. As a matter of tax logic, the basis of stock received in a § 351 incorporation cannot exceed the value of that stock – \$1 million in *Black & Decker* -- unless the value of the property transferred had declined in the hands of the transferor prior to the transfer. In the latter circumstance, the loss in value relative to the transferor's basis is properly recognized on a sale of the stock just as it would be on a sale of the property itself.

But there was no such loss in value in *Black & Decker*; the cash transferred was obviously worth its face amount. The "loss" claimed by the taxpayer had no economic corollary but simply represented an unaccrued expense for which the taxpayer had received full value in the form of employee services. The Court proceeded blindly to apply the relevant Code provisions and in the end rewarded the taxpayer with an enormous undeserved tax benefit, leaving Congress to supply a legislative remedy.⁶²

Subsection (a)(1) of our proposal would knock out the *Black & Decker* shelter by restricting loss deductions to transactions by which a measurable reduction of taxpayer net worth is shown to have been realized. Other shelter devices that depend on artificial basis manipulation would likewise be eliminated. Lease-stripping transactions⁶³, offsetting straddles⁶⁴ and currency options⁶⁵, distributions of encumbered property⁶⁶ – all the subject of recent revenue rulings – would be rendered fruitless by subsection (a)(1) for the straightforward reason that none of these devices generates a measurable reduction in the taxpayer's net worth. Questions of "economic substance" or "taxpayer motive" would be irrelevant.

(a)(2) Tax-indifferent parties. No deduction or exclusion from gross income shall be allowed in connection with any transaction or series of transactions structured to result in

⁶²Section 358(h), which was added to the Code in 2000, clearly forecloses the possibility of successful *Black & Decker*-type shelters in the future. That provision did not exist, however, at the time of the *Black & Decker* transaction, and it was not made retroactively effective (following the usual practice with respect to ad hoc legislative responses to tax shelters).

⁶³ Notice 2003-55, 2003-2 CB 395.

⁶⁴ . Notice 2002-65, 2002-2 CB 690.

⁶⁵ . Notice 2000-44, 2 CB 255.

⁶⁶ . Notice 99-59, 1999-2 CB 761.

income to a tax-indifferent party for any period, which income is substantially in excess of the economic income of such tax-indifferent party for such period. The term “tax-indifferent party” means any person or entity not subject to tax imposed by subtitle A. A person shall be treated as a tax-indifferent party with respect to a transaction if the items taken into account with respect to a transaction have no substantial impact on such person’s liability under subtitle A.

The recently decided *TIFD III-E* case (better known as *Castle Harbour*) provides a suitable illustration.⁶⁷ In *Castle Harbour*, the taxpayer, General Electric Credit Corporation, transferred leased aircraft with a value of \$272 million to a newly formed partnership, Castle Harbour, LLC. The other partners, which transferred \$117 million of cash to the partnership, were a group of Dutch banks not subject to U.S. taxation. The aircraft had presumably been fully depreciated before the transfer. Exploiting the partnership allocation rules, the partnership agreement provided that 98% of the taxable income realized annually under the aircraft leases was to be allocated to the Dutch banks, just 2% to GECC. The banks, however, were entitled to annual distributions of net book income *only* – that is, gross rentals *less* book depreciation, the latter amount being derived from the value of the aircraft at date of transfer (\$272 million) rather than the basis of the aircraft in the hands of GECC, which presumably was zero. In the end the banks would get back their original cash investment of \$117 million plus a pre-calculated 9.1% return.

The effect of all this was to enable GECC to avoid an enormous tax burden – roughly \$62 million -- while shifting very little book income to the banks. “Put another way,” said the Court, “by [actually paying out] income less depreciation to tax-neutral parties, GECC was able to ‘re-depreciate’ the [aircraft] for tax purposes. The tax-neutrals absorbed the tax consequences of all the income allocated to them, but actually received only the income in excess of book depreciation. Thus, the full amount of book depreciation was available, pre-tax, to Castle Harbour [GECC, in effect] to use” in financing other business activities. Put yet another way, GECC obtained an interest-free loan from the United States Treasury in the amount of \$62 million, which was not a bad day’s work.

It is of course perfectly obvious that the annual distributions to the Dutch banks were simply a return of the banks’ capital investment in the partnership (plus 9.1% interest), although characterized as “income” under the partnership agreement. The banks were creditors in all but name, and the annual distribution of book income was nothing more than a “fast-pay” repayment of debt plus interest. Nevertheless, finding that the partnership had “economic substance” and that the banks took some risk, however modest, the District Court held for the taxpayer. The Court very well understood that the partnership enabled GECC to enjoy a massive tax saving, but it saw, or thought it saw, substantial non-tax advantages as well and in the end concluded that the scheme was “legally permissible” – at least until Congress should legislate otherwise.

⁶⁷TIFD III-E, Inc. v. U.S., 342 F.Supp.2d 94 (D. Conn. 2004).

Subsection (a)(2) of our proposed statute, which is drawn directly from the Joint Committee proposal, would put an end to *Castle Harbour*-type tax shelters by denying the domestic taxpayer, GECC, an exclusion for the excess of the “taxable income” annually allocated to the banks by the partnership agreement over the “book income” actually received. The effect would be to treat what the Court in *Castle Harbour* properly called “re-depreciation” as taxable to the domestic partner.

Subsection (a)(2) may overlap (a)(1) where there is both basis manipulation and a cooperating foreign counterparty – the currency option device mentioned above would be an instance – but the overlap would in every case be harmless. Once again, “economic substance” would be irrelevant under subsection (a)(2).

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