Tax Report #950

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200 • http://www.nysba.org

NYSBA

April 23, 1999

The Honorable Donald C. Lubick
Assistant Secretary
Department of the Treasury, Room 1000 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Secretary Lubick:

Enclosed is a copy of a report of the Tax Section of the New York State Bar Association dealing with certain of the proposals in the President's Fiscal Year 2000 Budget submitted to Congress on February 1, 1999 dealing with the phenomenon which has become known as corporate tax shelters. As you will see from this report, we believe that there are serious, and growing, problems with aggressive transactions designed principally to achieve a particular tax advantage. As a result, we strongly support the approach of the Administration in proposing an increase in accuracy relating penalties to encourage disclosure and to deter risk taking by taxpayers.

We believe that additional disclosure will be helpful in changing the odds of the audit lottery and, to the extent taxpayers actually report, to provide an early warning system to permit you to respond quickly to new developments. But as we indicate, more than disclosure, and increased audit scrutiny as well as diligent litigation, is required to address the insufficiency of the current law. As a result, we support the "strict liability" approach to the accuracy related tax shelter penalties by eliminating the "reasonable cause" exception for imposing such penalty for certain tax motivated tax transactions. As a consequence, corporate taxpayers would be forced to assume a real risk, far greater than the current risk of somewhat higher interest costs, upon entering into these transactions. Moreover, tax advisors would be encouraged to supply balanced and reasonable analysis rather than merely seeking "reasonable cause", as under current law.

While we clearly agree that it is important to continue to address the tax treatment of corporate tax shelters, we do not believe that the general substantive provision of denying tax benefits from corporate tax transactions which you propose should be adopted at this time. While we agree that a substantial amount of discretion must be granted to the Government in dealing substantively with aggressive tax motivated transactions, we do not support the general substantive anti-avoidance provision which you have proposed at this time. We believe that in most cases, the proposed provision would not prove to be as effective in distinguishing between legitimate tax planning and unwarranted tax motivated transaction as the existing body of authority which is potentially applicable to those transactions today.

It is clear to us that the critical element is to define these suspect transactions in a manner which distinguishes artificial transactions which are designed to produce a tax benefit only, from legitimate corporate tax planning which we believe is clearly appropriate. Our report includes a definition of the type of transaction which we believe should be subject to these penalties. We would be pleased to work with the Administration and Congress to clarify this approach.

We are also reviewing the other provisions which have been proposed with respect to corporate tax shelter transactions, and we expect to report on these proposals in the near future.

Very truly yours,

Harold R. Handler
Chair

cc: Joseph M. Mikrut
Tax Legislative Counsel

REPORT ON CORPORATE TAX SHELTERS OF NEW YORK STATE BAR ASSOCIATION TAX SECTION

The purpose of this Report is to comment on the principal corporate tax shelter provisions contained in the Administration's Revenue Proposals for the Fiscal Year 2000 Budget. The Report was prepared on behalf of the Tax Section of the New York State Bar Association by an Ad Hoc Committee of the Tax Section formed to address the Administration's corporate tax shelter proposals.[1]

We agree with the Administration that the corporate tax shelter phenomenon poses substantial issues for the tax system. We therefore believe that concrete steps should be taken to increase the risk associated with entering into corporate tax shelters, including the enactment of legislation directed specifically at deterring such transactions.

Whether or not new legislation is enacted at this time, we would emphasize that it is very important for the government to exploit fully all the powers it possesses to combat corporate tax shelters. In our experience, the government's recent victories in well-publicized court cases have had a perceptible impact on the willingness of corporate taxpayers to enter into these

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[1] The Ad Hoc Committee on Corporate Tax Shelters was composed of Harold R. Handler, Robert H. Scarborough, Robert A. Jacobs, Samuel J. Dimon, Dana L. Trier, Andrew N. Berg, Richard G. Cohen, Peter C. Canellos, Michael L. Schler, Steven C. Todrys, Richard L. Reinhold and David P. Hariton. Dana L. Trier was the principal drafter of the Report. Substantial contributions were made by all the members of the Ad Hoc Committee on Corporate Tax Shelters. Significant contributions were also made by Alex Raskolnikov, M. Carr Ferguson, Kathleen Ferrell and Kenneth Wear. Additional helpful comments were received from Richard O. Loengard, Charles Morgan, Sherwin Kamin, Eugene L. Vogel, Elliot Pisem, Joel Scharfstein, Andrew Solomon, Jodi J. Schwartz, J. Roger Mentz, Peter H. Blessing, James M. Peaslee, and Glen A. Kohl.

transactions, and the Treasury Department's aggressive exercise of its regulatory authority has also been helpful. It is important, however, to follow up on these actions with additional initiatives. Moreover, any new provisions adopted are unlikely to have a significant positive incremental effect without increasing substantially the guidance, audit, and litigation resources devoted to addressing corporate tax shelters.

In this Report, we focus on the two principal general corporate tax shelter provisions proposed by the Administration:

(1) the modification of the substantial understatement penalty for corporate tax shelters to apply those penalties on a strict-liability basis and to vary the penalty depending on whether the transaction was disclosed by the taxpayer to the Internal Revenue Service; and

(2) the general substantive provision proposed by the Administration that would deny tax benefits from corporate tax shelter transactions.[2]

After considering the very difficult issues raised by these proposals, our conclusions are, in brief summary, as follows. First, we strongly support the Administration's proposed approach to revising the accuracy-related penalties. In our view, even if substantially greater resources were devoted to attacking corporate tax shelters under current law, the structure of our current penalty system ultimately would not permit the adequate deterrence of corporate tax shelter activity. To address the insufficient deterrent effect of current law, we

[2] We are preparing a second report dealing with the other corporate tax shelter proposals made by the Administration, including the excise taxes imposed on professionals and promoters and with respect to recission benefits, the proposals relating to tax-indifferent parties, and the proposed inconsistent reporting provisions.

believe that it is important for Congress to adopt, as proposed by the Administration, a "strict-liability" approach to the accuracy-related penalties and to eliminate the reasonable cause exception to the imposition of the accuracy-related penalties with respect to certain tax-motivated transactions. Under a strict-liability regime, reliance on professional tax opinions would no longer have the effect of eliminating the penalty imposed on corporate taxpayers with respect to corporate tax shelter transactions. Consequently, as a result of enactment of such a regime, corporate taxpayers would be forced to incur a real risk from entering into such transactions, and would be induced to seek balanced, well reasoned tax advice concerning such transactions rather than tax opinions intended principally to serve as insurance against the imposition of penalties.

We also strongly support varying the amount of the accuracy-related penalty imposed with respect to a corporate tax shelter transaction depending upon whether the material facts concerning the transaction have been disclosed by the corporate taxpayer. Indeed, to many of us, the most important aspect of the Administration's penalty proposals is that relating to disclosure because increased disclosure will, we believe, both assist in the deterrence of these transactions, as well as flag troublesome transactions at an earlier stage.

A strict-liability approach to accuracy-related penalties may increase significantly the leverage of Internal Revenue Service agents in audits of corporate taxpayers involving transactions not properly viewed as corporate tax shelters. But because we believe that it is crucial to increase the risk associated with entering into corporate tax shelters, we have concluded that, on balance, it is acceptable to live with this effect of the Administration's proposal when the imposition of the penalty depends on the taxpayer's position ultimately not being sustained as a matter of current law.

It is also clear that a strict-liability penalty will put considerable pressure on the definition of the transactions subject to the penalty. After considerable analysis of this question, however, we are convinced that a definition can be formulated that would operate appropriately in the context of a penalty that is only applicable if the taxpayer's position is not legally sustainable, that is applied principally with respect to tax-motivated transactions, and that is reduced substantially if the taxpayer discloses the transaction in issue. We have included with this Report a preliminary attempt at revising the Administration's definition of the class of cases to which the strict-liability penalty is applicable.

Second, although we agree that it is also important to address the legal treatment of corporate tax shelter transactions, we do not believe that the Administration's proposed general substantive provision denying tax benefits from corporate shelter transactions should be adopted at this time. We agree that a substantial amount of discretion must be granted to the government under generally worded statutory and regulation provisions to deal substantively with aggressive tax-motivated transactions. In addition, we believe that in appropriate situations, the Treasury Department should exercise its regulatory authority with retroactive effect, as it has on occasion. We do not, however, support the general substantive anti-avoidance provision proposed by the Administration at this time because we are not convinced that the proposed provision would prove to be as effective a tool for distinguishing between legitimate tax planning and unwarranted artificial tax-motivated transactions as the existing body of judicial authorities and statutory and regulatory provisions potentially applicable to such transactions.

Nonetheless, a number of our members believe that the corporate tax shelter problem cannot be fully addressed without enactment of substantive provisions of the type proposed by the Administration in addition to the changes to the penalty structure that we support, and we have not permanently foreclosed the possibility that it will eventually prove necessary to enact a general substantive anti-avoidance provision of the type proposed by the Administration. We intend, therefore, to continue to work with the Administration and Congress to develop additional substantive tools to deal with corporate tax shelter transactions, including both provisions of the type proposed by the Administration and more targeted provisions. In this Report we suggest possible approaches to formulating such additional substantive provisions.

The overriding theme that emerges from our analysis of the Administration's proposals is the obvious one: there are no simple solutions to the problems posed by the corporate tax shelter phenomenon. Tax-sensitive corporate tax planning is inherent in our system, and it may be unlikely that any measures that are consistent with our system can be conceived that will entirely or even substantially eliminate the most undesirable form of that planning, corporate tax shelters. We believe, however, that through a combination of the enactment of a new penalty and disclosure regime, increased enforcement efforts and the development, over time, of new substantive tools, tangible progress can be made.

At the same time, we caution that Congress should proceed carefully in formulating legislative responses to the corporate tax shelter phenomenon. It is very difficult to draw lines between tax planning that should continue to be permitted and transactions that appropriately should be penalized, and it is important to craft legislation that will, in actual application, be effective. Moreover, the Administration's corporate tax shelter proposals ultimately raise significant issues about the nature of guidance that should be provided to taxpayers, the amount of discretion that should be granted to the administrative arm of our government in determining corporate tax policy, and the right of taxpayers to rely on the advice of their professional advisors.

Our Report will be divided into five parts: first, a general discussion of the nature and causes of the corporate tax shelter problem; second, an overview of the approach of the Administration to the policy problems posed by corporate tax shelters; third, an analysis of a range of well publicized corporate transactions with reference to the question whether such transactions would appropriately be the subject of corporate tax shelter legislation; fourth, a discussion of the proposed changes to the accuracy-related and other penalties; and fifth, our comments on the Administration's general substantive proposal denying tax benefits from corporate tax shelters.

I. Is There a Corporate Tax Shelter Problem and What Is It?

Our perception is that the number of widely-marketed, aggressive corporate tax shelter transactions has grown significantly in the last decade. We know of no reliable statistical study that would permit us precisely to quantify this growth in corporate tax shelters. Nevertheless, based on admittedly anecdotal evidence derived from our experience as tax professionals, we believe that the growth in such transactions has been quite substantial.

In our view, corporate tax shelters (properly identified) represent a major problem for our system. One obvious negative consequence of such transactions is the loss of tax revenue. It is inevitably difficult to quantify the precise amount of revenue lost due to corporate tax shelters, and it is obvious that a substantial amount of corporate tax revenue is being collected and will continue to be collected. Nonetheless, we believe that there is at least some significant number of transactions that most members of Congress would view as resulting in a substantial unintended loss of revenue. In many cases, the lack of rational justification for the significant tax benefits achieved together with the fact that no substantial business purpose or economic effect, other than the reduction of taxes, is served by the transactions would make it obvious to anyone that the revenue loss is unwarranted. An easy consensus would also likely be reached that the tax revenue lost in a somewhat smaller group of transactions that do, in significant respects, have business purpose and economic substance is clearly unjustified in terms of the purpose and structure of our income tax statute.

More important, in our view, are the significant collateral negative effects of the continued proliferation of corporate tax shelter transactions. In recent years, a number of our country's most respected tax professionals have expressed their dismay at the growth in number of corporate tax shelters, and conscientious practitioners are increasingly demoralized by what they perceive to be the degrading effect of such transactions on their profession. It is also clear that the perception of our tax system held by both corporate America and the general public has been altered, and that, as time goes on, such transactions breed a disrespect for the system which will ultimately have significant compliance consequences. Coping with aggressive tax planning has also obviously proven difficult for the Internal Revenue Service and Treasury Department, frequently fraying the relationship between the government and private sector. Moreover, the virtually annual amendments to the Code designed to address the most recently revealed tax schemes have been one cause of the almost intolerable complexity of our tax laws—a complexity that is, in turn, often exploited in designing new corporate tax shelters. Finally, as discussed later in this Report, we believe that the role of some tax professionals in these transactions has been problematic. As an association of tax professionals, we are particularly concerned with the growth of corporate tax shelters in this respect.

The corporate tax shelter phenomenon can perhaps be viewed as historically rooted in the tax shelter industry that developed in the late 1970s and early 1980s which marketed transactions principally to individuals. Aggressive tax planning has, of course, always been a feature of our system, and many of the classic judicial decisions in the tax law were responsive to such planning.[3] With the individual tax shelter industry that developed in the late 1970s and early 1980s, however, both the sophistication of financial engineering associated with such transactions[4] and the scope of the marketing of tax shelter products increased dramatically. Tax shelters for individuals were, to a significant extent, eliminated by Congress with the enactment of the passive loss rules in 1986. Aggressive, widely marketed tax-motivated transactions focusing on the reduction or elimination of corporate tax, however, survived the tax reform legislation of the 1980s, and in our experience the quantity of such transactions has grown substantially in this decade.

The number of corporate tax shelters has increased as part of an apparent broader growth in the role of aggressive corporate tax planning and tax-sensitive products generally. While we can only speculate as to the precise causes for this development, several factors seem to be at work simultaneously.

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[3] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Gregory v. Helvering, 293 U.S. 465 (1935); and Goldstein v. Comm'r, 364 F.2d 734 (2nd Cir. 1966).

[4] See, e.g., Peter C. Canellos & Edward D. Kleinbard, The Miracle of Compound Interest: Interest Deferral and Discount After 1982, 38 Tax L. Rev. 565 (1983).

First is the nature of our tax system itself. As experience with the last two decades of tax motivated financial engineering makes clear, our realization-based tax system inevitably stimulates an almost infinite variety of tax planning.[5] Moreover, in 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 tax cubby hole of debt or equity.[6] It is also clear that the repeal of the General Utilities doctrine in 1986 did not end the effort to avoid tax on the appreciation in corporate assets; indeed, General Utilities repeal may have spawned more aggressive tax planning. Finally, the presence of what the Administration has labeled "tax indifferent" parties and the willingness of such parties to participate in aggressive tax-motivated transactions has facilitated the exploitation of the flaws in our system.

Second, 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. This development can be seen as arising out of the greatly increased attention being paid to reported corporate earnings. In that financial environment,

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[5] See, e.g., David M. Schizer, Realization as Subsidy, 73 N.Y.U. L. Rev. 1549 (1998); David J. Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986).

[6] See, e.g., David S. Miller, Reconciling Policies and Practice in the Taxation of Financial Instruments, 77 Taxes 236 (1999); David P. Hariton, Distinguishing Between Equity and Debt in the New Financial Environment, 49 Tax L. Rev. 499 (1994); Edward D. Kleinbard, Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System, 69 Tex. L. Rev. 1319 (1991); and Randall K.C. Kau, Carving Up Assets and Liabilities—Integration or Bifurcation of Financial Products, 68 Taxes 1003 (1990).

structuring a transaction that results in either a tax deduction without a financial accounting charge or financial accounting revenue without the concomitant imposition of tax can be viewed as a real coup for the corporate manager. While, in our experience, the corporate cultures of corporations continue to vary widely in the way they approach aggressive corporate tax shelters, managing the effective tax rate on corporate income has, it appears, become one way that a substantial majority of corporations—even those that are more risk adverse—compete indirectly with respect to financial earnings results. In that context, it is inevitable that corporate tax managers will frequently be put under pressure to participate in aggressive tax-driven transactions by their financial colleagues, who are often considerably more irreverent about our tax laws.

Third, the sheer amount of talent and skill devoted to corporate tax planning has, because of an entirely rational perception of the considerable economic incentives at stake, grown dramatically, and the technical skill of tax professionals engaged in this enterprise has been married to modern, highly sophisticated financial engineering. Tax expertise is employed to find opportunities for tax savings, and sophisticated derivatives and other financial instruments are added to the mix to manage the real economic and business risks associated with creative tax-motivated transactions. The corporate tax planning enterprise now overlaps with a broader structured products industry.

Fourth, tax-oriented products have been widely and vigorously marketed, thus potentially increasing the actual impact of creative and aggressive tax planning schemes. Without ascribing "blame" for the phenomenon, one can reasonably observe that the greater involvement in aggressive corporate tax planning of large organizations such as investment banking firms, national accounting firms and multi-city law firms with substantial client bases has increased the scope of the marketing of tax-sensitive transactions. Moreover, trained tax planners have increasingly stepped beyond the role of passive providers of advice to clients who have engaged their services to become purveyors of tax "products" themselves. The widespread marketing of tax expertise and products has undoubtedly resulted in an increase in the actual number of tax-sensitive corporate transactions consummated, including corporate tax shelters.

Finally, the regulatory and enforcement arms of government face significant restraints in dealing with tax-motivated corporate transactions. A quick perusal of the 1999 "Business Plan" of the Treasury Department and Internal Revenue Service[7] reveals the enormous number of guidance projects demanding the government's attention. Audit resources also appear to be stretched thin,[8] decreasing the potential for detecting tax-motivated transactions. Litigating the issues involved in corporate tax shelters is inevitably a cumbersome, time consuming process that produces a definitive outcome only

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[7] See 1999 Priority Guidance Plan, Office of Tax Policy and Internal Revenue Service, reprinted in Tax Notes Today, 1999 T.N.T. 47-9.

[8] See, David C. Johnston, I.R.S. Figures Show Drop in Tax Audits for Big Companies, N.Y. Times, Apr. 12, 1999, at A10.

well after the type of transaction in question has long passed from the scene because of changes in the statute or regulations—a fact that has apparently sometimes lessened the government's enthusiasm for litigating today's tax scheme. Indeed, corporate taxpayers and their counsel often express the hope that a tax shelter transaction will be addressed by a change in law because they expect that it will make it less likely that their transaction will be attacked under current law. Moreover, under our penalty system, as long as the corporate taxpayer has reasonably relied on an opinion of counsel, the only downside to the taxpayer will likely be the payment of interest on the deficiency, which at the best acts as a blunt and insufficient penalty for being wrong. Thus, when a probability analysis is done and the chances of detection and ultimate unfavorable outcome are combined with the lack of predictable and substantial penalties for the failure of the position of the taxpayer to be sustained, a rational corporate taxpayer can often conclude that engaging in even a transaction highly questionable under current law is, financially, well worth the risk.

When this combination of factors are considered together, it is not surprising that there would be a growth in tax-motivated planning of a type that it is impossible for any system to accept passively. We do not mean to suggest that all large corporations are regularly entering into what Congress would view as corporate tax shelters, or even that we have specific evidence that a majority of such companies enter into these transactions. Based upon our collective experience, however, we are quite certain that a substantial number of large corporate taxpayers have been persuaded to participate in one or more of these transactions, and the incentives and impetus are there for the frequency of such transactions to increase substantially. Indeed, as more aggressive corporate taxpayers continue to exploit the tax law to increase after-tax earnings, other corporate taxpayers will undoubtedly feel greater pressure to engage in the same tax-driven transactions. The difficult question is how to distinguish corporate tax shelters that must be deterred in order to preserve the integrity of the tax system from legitimate sophisticated corporate tax planning that should be tolerated in the context of a complex, free economy.

For purposes of analysis, the policy problems raised by the corporate tax shelter problem can be divided into two types. The first policy problem can be viewed as procedural—the inadequacy of enforcement mechanisms and penalties to deter corporate tax shelter transactions with respect to which there is, in fact, a substantial risk of ultimately being legally overturned. The second, conceptually separate problem can be viewed as substantive—the problem of defining what current applicable law is in a manner that prevents the achievement of clearly unintended results.

The procedural problem is a reflection of a variety of factors—including the insufficiency of audit resources, the time and expense required to litigate tax cases and the improbability of application of penalties in the event of a negative outcome. Various provisions, including penalties specifically relating to tax shelters, have been adopted over the years to address this problem.[9]

The substantive law problem is a very difficult one because the nature of our tax system, the complexity of our economy and the enormous amount of talent and resources that have been devoted to tax planning inevitably spawn transactions and products that rely either on actual or arguable glitches in current law or the absence of authoritative guidance by the Treasury Department or the courts. Today's written law simply cannot address all the possible means of exploiting it. In fact, a relatively common phenomenon in recent years is for Congress to adopt legislation plugging a loophole in one context only to find tax planners soon exploiting the same basic idea in a different context. The Treasury Department has attempted to address this policy problem with generally worded regulations designed to respond to future tax avoidance schemes,[10] and Congress has granted targeted general regulatory authority to the Treasury Department for the same purpose,[11] which has on occasion been exercised with full or partial retroactive effect.[12]

In practice, of course, these two separate tax policy problems are often both at work with respect to a corporate tax shelter transaction. In many, if not

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[9] See, e.g., I.R.C. §§ 6111(d) and 6662(d)(2)(C).

[10] See, e.g., Treas. Reg. § 1.701-2(b) and Treas. Reg. § 1.1502-13.

[11] See, e.g., I.R.C. §§ 337(d); 7701(l).

[12] See, e.g., Notice 97-21, 1997-1 C.B. 407 and Notice 89-37, 1989-2 C.B. 679.

most, cases, it can be predicted that the government will, if it becomes aware of the transaction, ultimately change or at least clarify current law to address the technical underpinnings of a tax shelter transaction; in these cases, then, the real question faced by an aggressive corporate taxpayer is whether that change in, or clarification of, law will have retroactive effect and apply to its transaction. Thus, the taxpayer is, in effect, adding the probability of a change or clarification of the law retroactively applicable to its transaction to the other factors, such as probability of detection on audit and imposition of penalties, that it takes into account in assessing whether it is economically rational to enter into the corporate tax shelter transaction. Because of this interaction of the procedural and substantive uncertainties associated with corporate tax shelters, the corporate tax shelter problem has proven to be an intractable one despite the measures taken by Congress and the Treasury Department in recent years to address these transactions.

II. The Administration's Approach to the Corporate Tax Shelter Problem.

The Administration's proposals represent a radical new approach to both the procedural and substantive problems raised by corporate tax shelters. First, to address the procedural problem, the Administration proposes changes to the accuracy-related penalties applicable to corporate taxpayers as well as excise taxes and other penalties to be imposed with respect to the participation in corporate tax shelters of parties other than the taxpayer. These penalties, taken together, are designed to alter dramatically the incentives to the parties to enter into such transactions. Most fundamentally, the Administration proposes a strict-liability accuracy-related penalty for "corporate tax shelters" which would eliminate the ability of a corporate taxpayer to avoid penalties by invoking the reasonable cause exception to the imposition of penalties based on reliance on an opinion of counsel and which would vary in amount depending upon whether the corporate tax shelter transaction has been disclosed.

To address the substantive law problem, the Administration proposes a generally worded substantive anti-avoidance provision under which the Secretary would be authorized to disallow a tax benefit from a "corporate tax shelter." Under this provision no specific guidance is provided as to how the provision should be applied to specific future cases, and the provision can, as a legal matter, be applied by the Service and the courts without the promulgation of regulations subject to public comment. This provision, then, is intended to permit the government to attack corporate tax shelter transactions more nimbly without requiring the now constant legislative intervention of Congress or the targeted exercises of specific regulatory authority by the Treasury Department.

Both the procedural and substantive provisions proposed by the Administration would apply to a single, defined class of transactions, "corporate tax shelters." Corporate tax shelters would, under this unitary approach, be defined as transactions in which there is a "tax benefit" from a "tax avoidance transaction." Excepted from "tax benefit" for this purpose would be a tax advantage "clearly contemplated" by the applicable provisions. A "tax-avoidance" transaction would be defined to include any transaction in which the reasonably expected pre-tax profit determined on a present value basis of the transaction is insignificant relative to the expected net tax benefits. In addition, a tax avoidance transaction would also include transactions involving the "improper elimination or significant reduction of tax on economic income." It is understood that this last provision is directed at tax-motivated financings, but it also appears that such a provision could potentially apply to other business transactions, including tax-advantaged corporate dispositions of assets which arguably "improperly eliminate" the tax on economic income.

III. The Varieties of Corporate Tax Planning: What Are Corporate Tax Shelters?

Our views with respect to the Administration's proposals have been shaped by our experience with tax-motivated corporate planning in the last two decades, and the Administration's proposed approach to the corporate tax shelter problem ultimately must be evaluated against the backdrop of this experience. Therefore, prior to providing our specific comments on the Administration's proposals, we will discuss a number of the most well-known tax-sensitive transactions occurring during that period. We do not intend here to discuss these transactions in terms of the specific provisions proposed by the Administration. Rather, at this point, we will simply ask two basic questions: first, whether taxpayers entering into such transactions could appropriately be subjected to penalties in the event the tax treatment sought by the taxpayers in such transactions is not legally sustained, irrespective of whether the taxpayers had received a favorable opinion of counsel; and second, whether it would potentially be a constructive addition to the tax law for such planning to be the subject of a general substantive provision of the type proposed by the Administration.

The Loss Generator: The ACM Case and Similar Transactions.

We begin our analysis by considering a relatively pure case of corporate tax shelter transaction, what is sometimes called a "loss generator." This type of transaction has proliferated widely in recent years, and constitutes a large portion of the group of transactions that most people would view as "corporate tax shelters."

A pure loss generator, abstractly defined, has five characteristics. First, the loss or other deduction sought to be obtained by the taxpayer in the transaction is in no way inherent economically in its current position prior to entering into the transaction. In other words, the transaction does not have the effect of realizing an economic loss that has economically accrued to the taxpayer prior to entering into the transaction; rather the transaction itself "generates" the loss or other deduction in question. Second, at the core of the transaction is reliance on a legal rule under current law that, at least as it relates to the transaction in issue, produces an economically distortive loss or other deduction in the context of the transaction. In some cases, the correct technical interpretation of the legal "loophole" being exploited clearly leads to the result in question; in other cases, the relevant law is not so clear or has not yet been developed. Third, the principal purpose of entering into the transaction is to realize the tax benefits arising out of the application of the legal rule in question. Even though the parties will often attempt to articulate another ostensible purpose for the transaction, this "business purpose" frequently will have been conceived after the tax scheme has been formulated, and there is no real doubt that the transaction is being undertaken largely for tax purposes. Fourth, the transaction has a relatively insubstantial effect on the economic position of the taxpayer. In fact, although the transaction will usually have some actual or potential economic effect, a major purpose of the planning surrounding the arrangement will be to mitigate to a substantial extent the real risks to the parties. And, finally, in a typical case, no other U.S. taxpayer has a tax detriment associated with the transaction; the tax advantage to the taxpayer will not be associated with an offsetting tax cost to anyone else. Often this result is assured by the participation in the transaction of "tax indifferent parties," such as U.S. tax-exempts or foreign taxpayers not subject to taxation on income from the transaction.

A classic "loss generator" was involved in the ACM[13] and related cases recently successfully litigated by the government. A number of recent, widely-marketed corporate tax shelter transactions have the same basic characteristics, including transactions that are the subject of substantive changes proposed by the Administration.

The development of a loss generator often follows a common pattern in our experience. To begin with, a promoter or its tax advisor discovers a loophole

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[13] See ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998).

or economically irrational result under a current law or regulation. Often, as in ACM, this rule is actually a provision that potentially leads to overtaxation of a party at the inception of a transaction, followed by a reversal of that result later in the transaction. Then, the promoter and its tax advisor design a transaction to exploit the distorting tax rule which they believe has a reasonable prospect of achieving significant tax benefits under current law. In conceiving the tax scheme, the distorting result of the substantive tax provision in question is often exploited by insertion of a tax-indifferent party in the transaction to absorb the excess income generated early in the transaction, and the transaction is structured to permit the corporate taxpayer to benefit from the reversal of this result later in the transaction. After the transaction has been designed, it is marketed to a company known to have recently realized a large gain or otherwise to have an appetite for tax losses. Finally, after feedback from the corporate taxpayer, the transaction is massaged to become even less risky and less economically substantial, as the taxpayer makes it clear (if there were ever any doubt) that it is actually interested in the transaction only for the tax savings.

As noted above, there may be a strong technical basis for the tax treatment sought by the taxpayer under the specific provision being exploited in the loss generator; the question whether the taxpayer's interpretation of the installment sale regulation involved in ACM was correct, for example, was never reached by the courts. Moreover, at least in the case of the transactions at issue in ACM and related cases, the distorting impact of the legal rule in question should have been clear to the Treasury Department that promulgated the provision and announced that it intended to change it only after it became clear that transactions were being designed to exploit it.[14] The substantive underpinnings of other transactions that. broadly speaking, fall into this category could also have been addressed by regulations before the transactions proliferated.[15]

One might reasonably ask, then, why it is appropriate to deny corporate taxpayers the expected benefits from entering into such transactions. It might be argued that the tax benefits sought to be achieved by the taxpayers in these cases are simply the cost paid for the fact that the inevitable bluntness of our tax rules often leads to overtaxation in some cases and undertaxation in others, at least until the rules are refined.

The answer, as a general policy matter, seems to us to be that the inherent imperfections of our tax system demand that transactions such as these be deterred. Whether or not the Treasury Department should have promulgated the particular regulations at issue in ACM, our system will always contain tax rules that are flawed in some respect or under certain circumstances. Moreover, at any given time, the government will be behind the guidance curve with respect to some kind of financial instrument or business transaction. If taxpayers can exploit flawed rules or legal uncertainty by entering into transactions with no countervailing tax detriment to other U.S. taxpayers and with no substantial

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[14] See Notice 90-56, 1990-2 C.B. 344.

[15] I.R.C. §467; Committee Report on P.L. 98-369 (Conference Report) ("Regulations will also deal with the treatment of front-loaded (i.e. pre-paid) agreements.")

economic impact on the taxpayer's position, the system will be at the mercy of creative tax planners. There must be some friction in the system to save it from its frailties, and that "friction" is provided either by the tax detriment to other taxpayers involved in the transaction or a requirement that the transaction have business purpose and/or economic substance.[16]

Thus, there is a substantial consensus among the members of our group that, as a policy matter, this kind of highly artificial transaction is appropriately the subject of corporate tax shelter rules. The key questions are (i) whether such transactions can be defined with sufficient precision to distinguish these transactions from sophisticated corporate tax planning that should continue to be permitted under our system, and (ii) the nature of the rules (procedural and/or substantive) that should be enacted to attack such transactions.

A substantial body of tax common law already exists that addresses this type of tax-motivated transaction.[17] Moreover, to a significant extent, the Treasury Department has stretched its authority to address conduit arrangements to buttress its position under this tax common law.[18]

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[16] See, e.g., David P. Hariton, Sorting Out the Tangle of Economic Substance, __ Tax Law. __ (1999).

[17] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); ACM Partnership v. Comm'r, 157 F.3d 231 (3d Cir. 1998); Goldstein v. Comm'r, 364 F.2d 734 (2nd Cir. 1966); Sheldon v. Comm'r, 94 TC 738 (1990); See generally David P. Hariton, Sorting Out the Tangle of Economic Substance, __ Tax Law. __ (1999).

[18] See Prop. Treas. Reg. § 7701(l)-2.

The central characteristic of this case law and regulatory authority is that its application does not require a change in the underlying technical rule being exploited in the tax-motivated transaction. This characteristic can be very important to the government because significant complications may be encountered in attacking tax-motivated transactions in a timely manner under current law with the promulgation, on a retroactive basis, of a new, generally applicable, substantive regulation or statutory provision.[19]

Difficult questions of judgment, however, often are posed as to how this law and regulatory authority should be applied to specific cases. In particular, it will be difficult to determine in specific cases whether a transaction has sufficient substance to withstand attack[20] or whether a business purpose is required for the transaction to be upheld under current law.[21] For that reason, it will frequently not be at all clear that the taxpayer will lose in court if the transaction is challenged. One rational role, then, of corporate tax shelter legislation would be to strengthen the deterrence of such transactions by increasing the downside risk to the taxpayer of entering into such a transaction. A second possible role for corporate tax

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[19] See Notice 89-21, 1989-1 C.B. 651 relating to prepaid swaps. In order to deter tax-motivated transactions, this Notice was issued with retroactive effect even though the proper treatment of prepaid swaps might reasonably have been viewed as at least uncertain to all parties entering into such transactions.

[20] See Rev. Run. 99-14, 1999-13 I.R.C. 3.

[21] For example, with respect to a section 351 transaction. See Field Service Advice (Oct. 29, 1998), 1999 T.N.T. 25-64. See, also Carruth v. U.S., 688 F.Supp. 1129 (N.D. Tex. 1988), aff'd 865 F.2d 644 (5th Cir. 1989).

shelter legislation would be to clarify and rationalize the legal treatment of such cases.

Realizing Accrued Losses: Cottage Savings and Wash Sale Transactions.

While there is a general consensus that loss generators of the type involved in the ACM and related cases should be viewed as "corporate tax shelters," that consensus breaks down when one or more of the factual elements characteristic of a classic loss generator are changed. Consider, for example, a case involving a transaction designed to realize a loss that has economically accrued to the taxpayer prior to entering into the transaction.

This type of tax-motivated planning was at issue, for example, in the Cottage Savings case[22] decided by the Supreme Court in 1991. In that case, the taxpayer sold participation interests in 252 mortgages in which it had a built-in loss to other savings and loan associations, and simultaneously repurchased 305 similar mortgages from the same such savings and loans. Under the regulatory accounting rules promulgated by the Federal Home Loan Board the taxpayer was not required to report losses for the exchange because the exchange was for "substantially identical mortgages." Nonetheless, the taxpayer took a loss deduction for tax purposes on the grounds that the mortgages received in the exchange transactions were, in fact, "materially different" under the applicable tax law, the section 1001 regulations. The Supreme Court sustained the taxpayer's position.

[22] Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991).

Viewed from today's perspective, Cottage Savings is a fascinating study in tax legal process.[23] While expressing its deference to the Treasury Regulations under section 1001 as a reasonable regulatory interpretation of the statute,[24] the Supreme Court gave no particular heed to the Commissioner's application of those regulations to the facts in issue. Indeed, the Supreme Court specifically called into question the workability of the Commissioner's proposed interpretation:

> "...[t]he complexity of the Commissioner's approach ill serves the goal of administrative convenience that underlies the realization requirement. In order to apply the Commissioner's test in a principled fashion, the Commissioner and the taxpayer must identify the relevant market, establish whether there is an administrative agency whose views should be taken into account, and then assess how the relevant market participants and the agency would view the transaction. The Commissioner's failure to explain how these inquiries should be conducted calls into question the workability of the test."[25]

In some respects, the Cottage Savings transaction had the characteristics of a corporate tax shelter. The sole purpose for entering into the transaction was inarguably to achieve a tax deduction. Moreover, from the perspective of the corporate managers of the taxpayer's thrift business, the exchanges of diversified pools of mortgages with the same general characteristics resulted in no significant change in economic position. The lack of a substantial economic effect of the

[23] See Thomas L. Evans, The Realization Doctrine After Cottage Savings, 70 Taxes 897 (1992).

[24] See Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 555 (1991).

[25] Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 565-566 (1991).

transaction in this respect was reflected in a regulatory accounting treatment that differed from the tax treatment sought.

Nevertheless, many of us believe that this type of transaction is fundamentally different than a "loss generator," and should not be viewed by Congress as a "corporate tax shelter" subject to provisions of the type proposed by the Administration because the taxpayer did have an actual economic loss and its recognition for tax purposes was simply being accelerated by the transactions in issue. Because the realization of an already accrued loss was involved, the tax treatment sought by the taxpayer was more consistent with economic substance. The fact that the loss was not, prior to disposition of the mortgages, taken into account was a function of our realization-based system, which itself is grounded principally in administrative rather than general policy considerations.

It may be difficult, however, to be entirely persuaded that this distinction from the classic loss generator should be determinative. The selective realization of losses in our system has always been viewed as a policy concern.[26] For that reason, Congress has adopted the capital loss limitation and the wash sale rules.[27] The tax policy issue involved in cases like Cottage Savings may be of a lesser order than that involved in transactions that actually create deductions, but it is a cognizable tax policy nevertheless.

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[26] See Robert H. Scarborough, Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax, 48 Tax L. Rev. 677 (1993)

[27] See I.R.C. §§ 1091, 1211, 1212.

A more fundamental justification for distinguishing this type of case from the loss generators may be the existence of rules designed directly to deal with the question whether and when losses should be realized for tax purposes. In addition to the wash sale and other rules treating such transactions with respect to certain types of assets, the section 1001 Regulations at issue in Cottage Savings are intended, in general terms, to address this question, and a number of judicial decisions have interpreted the realization requirement over the years.[28] In Cottage Savings, the basic issue was simply how the relevant authorities should be interpreted.

Because the applicable law was itself directed at the conceptually relevant inquiry, the transaction involved in Cottage Savings cannot be viewed as a "tax trick" leading to clearly inappropriate results. Reasonable people (including the courts) could disagree with the Service as to the application of the relevant law. Moreover, while the transactions involved in Cottage Savings were the product of highly aggressive tax-motivated planning, that planning was not inconsistent with basic structure of current law. Thus, it is difficult for us to perceive this transaction as a corporate tax shelter of the type at which the Administration's proposals are directed, even though the transaction was motivated entirely by tax considerations.

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[28] See, e.g., Marr v. United States, 268 U.S. 536 (1925); Weiss v. Stearn, 265 U.S. 242 (1924); United States v. Phellis, 257 U.S. 156 (1921); and Eisner v. Macomber, 252 U.S. 189 (1920).

Other transactions of the same general type, however, may be viewed as raising more difficult issues with respect to the role of general anti-avoidance provisions. Assume that a corporate taxpayer owns a depreciated position in property, such as stock generally subject to the provisions of section 1091 wash sale rules, and the taxpayer sells that stock for the sole purpose of realizing a tax loss and simultaneously enters into a derivative position with another party that replicates the economics of the sold stock position. Assuming that neither the wash sale rules nor the section 1001 regulations technically apply to deny the loss from this transaction, should a general anti-avoidance provision potentially apply to this transaction?

This case illustrates one of the fundamental substantive problems raised with respect to tax-motivated transactions. As was true with respect to the investment company rules that were the subject of recent legislation,[29] the wash sale rules have not been updated to reflect modern financial instruments. One might reasonably predict, however, that if Congress did feel the need to revisit these provisions today, changes likely would be made to the wash sale rules to address the treatment of derivatives and other sophisticated modern financial instruments. Should the Treasury Department and Internal Revenue Service and ultimately the courts have the power pursuant to general anti-avoidance legislation to fill in the crevices in the absence of Congressional action?

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[29] See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1002 (1997).

We think not. It is true that the appropriate result may be obvious when an equity swap with respect to the stock disposed of is utilized to accomplish the economic result of a wash sale transaction. But the result will not be so clear in other cases, such as when, for example, the taxpayer enters into a swap or other transactions relating to a basket of stocks in the same industry (including the stock sold by the taxpayer).

Is it fair in that context to penalize the taxpayer before Congress modernizes the legislation or, indeed, before the Treasury Department issues comprehensive regulations that are subject to public comment? Another difficulty with granting that type of power—at least without significant guidance as to its use—is that it might be exercised in a significantly different way than Congress would want it to be. Is Congress willing to cede this great of role to the Treasury Department without guidance as to its use?

While this type of transaction is, in our view, not the type of "corporate tax shelter" transaction at which the Administration's proposals are appropriately directed, it may be acceptable for this type of transaction to be subject to penalties if the taxpayer loses under current law. In significant ways our perception of the appropriateness of applying the Administration's proposals to this type of transaction is affected by the prospect of applying <u>both</u> a rather vague substantive provision <u>and</u> a strict liability penalty. If the legality of such transactions were analyzed under current judicial authority and statutory provisions, however, the imposition of a penalty if the taxpayer loses becomes less troublesome; these are, after all, tax-motivated transactions without a substantial business purpose.

Tax-Sensitive Financings: MIPS; Reverse MIPS and Step-Down Preferred.

Difficult issues are also potentially raised by tax-sensitive transactions that do have a business purpose. One such type of transaction is a corporate financing. The treatment in our tax system of transactions such as these poses very difficult issues because a significant disparity in treatment results from transactions that often vary only in financially relatively insubstantial respects from each other.[30] Tax-advantaged corporate financings thus have stimulated significant controversy over a long period of time.[31]

As a recent example of such a controversy consider that engendered by so-called MIPS and other financing transactions designed, like the transactions involved in Cottage Savings, to achieve one treatment for tax purposes and a different treatment for financial accounting and/or regulatory purposes.[32] Although a large number of variations exist, all these transactions involve a pass-through entity (such as a trust, LLC or partnership) to which the corporate issuer

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[30] See Herwig J. Schlunk, Do We Really Need Nonqualified Preferred Stock? A Rethinking of the Taxation of Corporate Capital, 77 Taxes 64, 65 (1999) ("...the distinction the tax law attempts to draw is one without an objective basis.").

[31] See, e.g., Rev. Rul. 90-27, 1990-1 C.B. 50; Rev. Rul. 83-98, 1983-2 C.B. 40.

[32] See, e.g., Enron Corp., Prospectus Supplement, 3,000,000 Preferred Securities Enron Capital Resources L.P., 9% Cumulative Preferred Securities (July 28, 1994); Enron Corp., Prospectus Supplement, 8,000,000 Shares Enron Capital L.L.C. 8% Cumulative Guaranteed Monthly Income Preferred Shares (Nov. 8 1993).

issues debt (and perhaps other instruments) and which, in turn, issues "equity" instruments to the public.

In its simplest form, a MIPS financing transaction involves a debt instrument of varying length which is issued to the pass-through entity by the corporate issuer and which might or might not be extendible or convertible into the equity of the issuer. This type of transaction was the subject of Notice 94-47[33] in which the Treasury Department warned that, in the context of a financing transaction treated as equity for nontax purposes, it would scrutinize other aspects of the financing, including the length of the term of the corporate debt, and whether the debt is convertible or payable in equity.

That Notice, however, was only the beginning of what has become a protracted debate considering the treatment of these transactions. The Treasury Department proposed legislation addressing such transactions, which was rejected by Congress.[34] On audit, the Internal Revenue Service disallowed the deductions from at least one transaction.[35] In a recent technical advice memorandum,

[33] 1994-1 C.B. 357.

[34] See General Explanations of the Administration's Revenue Proposals, Dept. of Treas. (Feb. 1997).

[35] See Enron Corp. v. Comm'r, Tax Ct. Dkt. No. 6149-98, see also Lee A. Sheppard, IRS Attacks Enron MIPS, Tax Notes Today, 98 T.N.T. 104-4.

however, the debt treatment of such a transaction was upheld.[36] But at least some commentators continue to view such a transaction as a "corporate tax shelter."[37]

Would general anti-abuse provisions of the type proposed by the Administration perform a useful role in addressing this type of transaction? We are skeptical. There exists a long history of judicial and administrative consideration of debt-equity issues, and the Treasury Department has been given substantial regulatory authority under section 385 to deal with such questions. Moreover, one's views of such transactions will sometimes be affected by one's broader ideological orientation as to matters such as how important it is to buttress the two-tiered tax on corporate earnings. In that context, it may be difficult to justify imposing a substantial penalty on a corporate taxpayer for failing to get the structure absolutely right. It is even more difficult to imagine the role of a "super-section 269" provision in resolving whether, for example, twenty or thirty or fifty years should be the absolute limit on the term of a corporation's debt to achieve debt treatment for tax purposes, or whether or how much the financial accounting or regulatory treatment of an instrument should be taken into account for tax purposes.

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[36] See Tech. Adv. Mem. 199910046 (Nov. 16, 1998).

[37] See, e.g., Lee A. Sheppard, Giving and Taking on Corporate Tax Shelters, Tax Notes Today, 1999 T.N.T. 59-2.

Consider as another example the transaction considered in the companion to Notice 94-47. Notice 94-48.[38] That Notice involves a transaction sometimes referred to as "reverse-MIPS," in which a corporation creates a partnership to which it contributes cash in exchange for a partnership interest. The partnership issues debt to the public and uses the cash proceeds to buy preferred stock from the corporation. The tax position sought by the corporate taxpayer is that, as a partner in the partnership, it will achieve an interest deduction with respect to the debt, but will receive no income from the stock because the dividends are in effect being paid by it to itself. The Notice concludes that the overall substance of the transaction is the issuance of preferred stock and that the deduction relating to the debt should be disallowed.

We would agree that, in this case, the taxpayer clearly has gone over the line and entered into a transaction that should, for tax purposes, be treated as the issuance of equity. It appears unlikely, however, that a general substantive provision of the type proposed by the Administration would perform a constructive role in addressing this transaction legally. The Treasury Department already has available to it more targeted means of attacking this transaction, including the law of debt-equity and partnership anti-abuse rules. The basic point here is that, in substance, a debtor-creditor relationship was never created. Would the Service really be in jeopardy of losing such a case without a new super-section

[38] 1994-1 C.B. 357.

269? Would such a provision perform a constructive role in the legal analysis of the case?

As a final example of tax-sensitive corporate financings that raise issues relevant to the Administration's proposals, consider so-called "step-down" preferred stock. A basic historic feature of the tax treatment of distributions on stock has been what may be called the "dividend first" rule. Under that rule, payments in the form of state law dividends are treated as tax law dividends if made out of earnings and profits irrespective of whether, in economic effect, such distributions represent a return of capital. Thus, with respect to transactions in the form of a dividend rather than a redemption, there is no provision analogous to section 302 for characterizing the transaction according to its actual effect.

As a result of its analysis of certain financial products designed in the 1980s, the Treasury Department perceived the most obvious potential for tax avoidance inherent in the "dividend first" concept, and Congress enacted legislation designed to address this "loophole."[39] As so often happens under our tax system, however, because Congress did not address the basic problem—the treatment of the distribution as entirely a distribution of earnings—the potential for abuse in other contexts was left open. The result was the eventual design of transactions involving "step-down preferred" by REITs and foreign corporations

[39] See I.R.C. §1059(f)(2). This legislation was directed principally at the potential such transactions have for creating artificial capital losses.

that exploited the same conceptual problem.[40] These transactions were aggressively attacked by the Treasury Department, with retroactive effect, by issuance of a Notice[41] followed by Proposed Regulations under the authority of section 7701(l).[42]

We are separately commenting on the Proposed Regulations, and it is not our purpose here to discuss either the retroactive position taken by the Treasury Department in the Notice and Proposed Regulations or the substantive analysis applied to these transactions in the Proposed Regulations. We believe it is fair to say, however, that it is not entirely obvious that Congress had in mind transactions like step-down preferred when it enacted the anti-conduit rules embodied in section 7701(l).[43] Moreover, it appears quite clear that because the Proposed Regulations are issued under the anti-conduit statute, the drafters have been forced, again, not to address directly the basic conceptual problem—the dividend first rule.

We are in substantial agreement that these transactions are appropriately described as "corporate tax shelters," irrespective of whether such transactions are sustainable under current law. In the end, the reason for that conclusion is quite

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[40] These transactions relied on the dividend first rule to shelter the income of shareholders in the REIT or foreign corporations other than the step-down preferred holders because the income taxable to such parties was reduced by the "dividends" taxable to the holders of the step-down preferred, who were, of course, generally tax-indifferent parties.

[41] Notice 97-21, 1997-1 C.B. 651.

[42] See Prop. Treas. Reg. §1.7701(l).

[43] See H.R. Rep. No. 103-213, at 654-55 (1993); H.R. Rep. 103-111, at 727-29 (1993).

simple: it is overwhelmingly obvious that if Congress were made aware of these transactions it would seek to adopt legislation preventing taxpayers from achieving the desired tax results. The tax benefits to be achieved in these transactions, if upheld, result in substantial distortions of economic income. Moreover, although these transactions occur in the context of corporate financings and might be structured to have significant economic substance, the structures are, at bottom, artful attempts to exploit a loophole that Congress had already sought to close. It is also quite clear that current law is ill-suited to address transactions such as these that exploit an obvious glitch in the statute in the context of what otherwise can be viewed a real business transaction with significant economic substance. Thus, if general corporate tax shelter legislation could be formulated to deter transactions like these in the future, we would want to do it. The question is whether such legislation can be designed.

The Tax-Advantaged Disposition of Corporate Assets: Esmark, Viacom and Tax-Exempt Conduit Transactions.

Even more difficult issues are raised by aggressive corporate tax planning in the context of transactions involving the disposition of appreciated corporate assets. In these cases also there is clearly a business motivation for the transaction taken as a whole: the corporate tax planning involved thus principally affects the way the transaction is carried out, rather than whether the taxpayer would enter into the transaction in the first instance.

Consider first the Esmark case,[44] a classic case in the annals of corporate tax planning. The Mobil-Esmark transaction constituted a variant of a transaction with a long history in the tax law.[45] Esmark intended to restructure its business by disposing of its energy subsidiaries, including one, Vickers, which Mobil wanted to acquire. Rather than simply selling the stock of the Vickers subsidiary to Mobil, Esmark and Mobil structured a transaction to rely on then section 311(d)(2)(B), which provided an exception to the recognition of corporate level gain for the distribution in redemption of the stock of a subsidiary engaged in at least one business. Under this transaction, Mobil first acquired more than 50 percent of the Esmark pursuant to a public tender offer, and then under the terms of a prior agreement with Esmark exchanged that Esmark stock for all the Vickers stock held by Esmark.

The Internal Revenue Service attacked Esmark's tax treatment of the transaction based on both the application of step transaction principles and an interpretation of the relevant regulations. The Tax Court ruled for the taxpayer, however,[46] and the Tax Court's opinion was sustained on appeal.[47]

The Esmark case has been debated by tax practitioners ever since. Judge Cohen's opinion for the Tax Court emphasized that each step in the transaction

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[44] Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988).

[45] See e.g., Standard Linen Service, Inc. v. Comm'r, 33 T.C. 1 (1959), acq., 1960-2 C.B. 7.

[46] See Esmark, Inc. v. Comm'r, 90 T.C. 171 (1988).

[47] See Esmark, Inc. v. Comm'r, 886 F.2d 1318 (7th Cir. 1989).

had effect: Esmark disposed of the subsidiary stock; long outstanding corporate stock of Esmark was retired; former public shareholders of Esmark had cash; and Mobil owned the subsidiary stock. Given the actual economic effect of each step, Judge Cohen thought it inappropriate to re-sequence those steps under the step-transaction doctrine.[48] Those who criticize the decision, by contrast, tend to emphasize that Mobil's ownership of the stock was transitory and illusory because of its pre-existing agreement with Esmark.

The Esmark case is an example of aggressive planning that came very close to the line. But, in the context of the time, it is difficult to view it as abusive. The applicable statutory provision required no holding period with respect to Mobil's ownership of the Esmark stock, and whether such a holding period should be required was not, until after the transaction, addressed by Congress as part of what proved to be an ongoing consideration of the proper scope of the General Utilities doctrine. The question then came down to whether Mobil was ever the owner of the stock for tax purposes and thus the party that entered into the redemption transaction with Esmark, a question that could be and was decided under existing authorities within the established framework of current law. Thus, to us, this type of planning should not be viewed properly as a corporate tax shelter. Indeed, the application of a general anti-abuse rule could confuse the legal analysis of the case by diverting a court from useful case law developed over the years that addresses this type of transaction.

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[48] See Esmark, Inc. v. Comm'r, 90 T.C. 171, 198 (1988).

Similar issues were presented in this decade's analogue to Mobil-Esmark, the numerous Morris Trust and reverse Morris Trust transactions that exploited the exception to corporate level taxation for section 355 transactions. Under section 355 before the enactment of section 355(e), corporations were permitted to engage in spinoff transactions followed by the acquisition of one of the corporations resulting from the spinoff without the recognition of corporate level gain on the spinoff. This result was achievable so long as the shareholders of the distributing corporation continued to have equity interests in each entity resulting from the division or in the entity resulting from a merger with one of such entities.[49]

In the well-known Viacom transaction, the controlled corporation was subject to an immediate pre-planned acquisition, and the stock of former distributing corporation shareholders were, as part of the pre-agreed transaction, recapitalized into preferred stock. While the law at the time required, as it does now, that the distributing corporation control the subsidiary prior to the spinoff and that such stock be distributed in the transaction, there was no requirement that the shareholders maintain any specific control interest in the spunoff entity after the transaction unless the transaction was a reorganization under section 368(a)(1)(D). The Service ruled that the spinoff transaction was tax-free.[50]

[49] Rev. Rul. 75-406, 1975-2 CB 125.

[50] See Ltr. Rul. 9637043 (June 17, 1996).

As with the Esmark transaction, students of corporate tax will likely debate the merits of the Viacom ruling for years to come.[51] But, again, Congress had not yet at the time of the transaction re-examined the principal policy question—whether a planned disposition of control by the shareholders in a section 355 transaction should preclude tax-free treatment of the spinoff. Given that under longstanding current law there was no requirement of control by the stockholders after the distribution, a relatively narrow question was posed: was the stock owned by the distributing corporation before the transaction really distributed in the transaction or did the recapitalization of the controlled corporation occur prior to the distribution? In our view, although reasonable people can certainly disagree about the merits of the ruling, the type of planning involved in the Viacom transaction also does not appear to be properly the target of general corporate tax shelter legislation.[52] Rather, this transaction, like the transactions involved in Cottage Savings and Esmark, is one in which the taxpayer was, in effect, testing where the line should be drawn within the structure of current law.

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[51] See Lee Sheppard, IRS Rules In Favor of Viacom, Ignoring Its Own Guidance, 71 Tax Notes 1728 (1996); James M. Peaslee, The Viacom Ruling—Two Ships Passing In The Night, 72 Tax Notes 1435 (1996); Wessel et al, Corporate Distributions Under Section 355, pp. 187-195, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures & Restructurings, Vol. 7 (PLI 1998).

[52] A separate policy issue involved in the Viacom and similar transactions is the treatment of debt. Although we believe that this is the central policy issue raised by such transactions, Congress did not address it in enacting section 355(e). See Report on Section 355, N.Y. St. Bar Ass'n Tax Section (1997), reprinted in Tax Notes Today, 97 T.N.T. 132-36. This aspect of spinoff transactions also potentially raises interesting issues with respect to the scope of tax avoidance legislation.

Let us now consider a transaction that, viscerally at least, seems to be distinguishable from the Esmark and Viacom transactions. One publicly held C corporation (the "Acquirer") has agreed to buy another publicly held C corporation (the "Target") for cash. Assuming that the Target has no net operating losses, the most tax-efficient way for Acquirer to buy Target after the repeal of the General Utilities doctrine is in a stock purchase, with no attendant step up in basis in the corporate assets of Target. Acquirer, however, introduces Target to a U.S. tax-exempt ("Tax-Exempt"), and the parties structure a complicated transaction which begins with Target's stock being sold to Tax-Exempt, and ends a short time later with Target's assets in the hands of Acquirer. The purpose of the transaction is to permit Acquirer to take the position that it has a stepped-up basis for the Target assets without corporate level tax being imposed on the appreciation in Target's assets.

The Treasury Department had the clear regulatory authority to address this type of transaction. Eventually, that authority was exercised, in part at least, but without retroactive effect.[53]

On the face of it, the issues involved in this transaction are similar to those involved in the Esmark and Viacom transaction. One way of thinking about the issue is to ask when did the tax-favored transaction occur: did the Tax-Exempt own Target's stock prior to the transaction with Acquirer? Can this transaction really be distinguished from the Mobil-Esmark transaction in which the basic

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[53] See Treas. Reg. §1.337(d)-4.

issue was whether Mobil owned the Esmark stock when the redemption took place, and the Viacom transaction in which the narrow question was whether the subsidiary stock owned by the parent was actually distributed to the Viacom shareholders?

Two bases for distinction come to mind. The first is based on standard step transaction principles. In this case, unlike the Esmark and Viacom transactions, an unnecessary step (or series of steps) without a permanent effect on the economic position of the parties is being introduced: the only real role of the Tax-Exempt is to collect a fee (in the form of a mark-up) for the step-up in basis achieved by Acquirer.[54] Thus, Judge Cohen (and we) would find this case distinguishable from the Mobil-Esmark transaction. There does, however, exist arguably applicable legal authority for recognizing this type of conduit transaction for tax purposes.[55]

A more compelling distinction is a policy one. General Utilities repeal means nothing if it does not mean that a step-up in basis of corporate assets should not be achieved tax-free. Viewed in a policy context, then, this is clearly an objectionable transaction, and can be substantively distinguished from many of the cases in which conduit transactions have been upheld.

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[54] Rev. Rul. 80-221, 1980-2 C.B. 107.

[55] See Biggs v. Comm'r, 632 F.2d 1171 (5th Cir. 1980); Brauer v. Comm'r, 74 T.C. 1134 (1980); see also Tech Adv. Mem. 8738003 (May 22, 1987); Tech Adv. Mem. 8735007 (May 18, 1987); and Tech Adv. Mem. 8735006 (May 18, 1987).

Because it is so obvious that the intent of the income tax statute is being frustrated in a way that is highly artificial, we view this transaction as one type of transaction that could rationally be subject to corporate tax shelter legislation. Thus, such transactions could, in our view, reasonably be subject to a strict-liability penalty if found to be invalid under current law. It would also certainly be preferable from a systemic point of view for transactions such as these to be readily subject to attack substantively before regulations are issued and irrespective of whether the Treasury Department ultimately finds it appropriate for those regulations to have retroactive effect. The open question is whether general corporate tax shelter provisions of the type proposed by the Administration can actually be formulated that would have a constructive role to play in attacking a transaction such as this one that occurs in the context of a disposition of corporate assets.

While Congress might be tempted, because of the very difficult line drawing required with respect to transactions such as these, to give up on the task of crafting corporate tax shelter legislation to apply to tax-motivated corporate dispositions of assets, a significant gap would inarguably be left open in such legislation if Congress decided to do so. The conduit sales of businesses do, in our experience, comprise a relatively small percentage of corporate tax avoidance. A larger set of aggressive tax-motivated transactions, however, involve the disposition of substantial corporate holdings of portfolio stock. A now common spectacle is for a large corporation that has announced that it plans to dispose of such a large portfolio position in another company to be literally besieged by investment banks and promoters of various types with proposals relating to the disposition of such assets. While by no means all of such proposals will be abusive tax schemes or even tax-driven structures, many will be. Thus, while the difficulty of the task is considerable, the motivation for addressing corporate dispositions of assets should be high.

IV. Comments on the Administration's Penalty Proposals.

We now commence our detailed analysis of the Administration's proposals with an evaluation of the centerpiece of the Administration's attempt to deal with the procedural problem with respect to corporate tax shelters — the proposed modification of the accuracy-related penalties. Because we believe that it is very important both to shift the incentive structure with respect to tax-motivated transactions and to encourage greater disclosure, we support the Administration's proposed strict-liability approach to such penalties.

The principal issue concerning a strict-liability penalty provision with which we have grappled is whether the class of cases to which it is applied can be appropriately delimited. As suggested above, although we do not believe such transactions are "corporate tax shelters," we are willing to concede the application of penalty provisions to cases like the transaction in Cottage Savings because such transactions are principally tax-motivated and thus difficult to distinguish from other transactions which should be subject to penalties. In our perfect world, however, such a penalty provision would not apply, for example, to transactions like MIPs financings and Esmark, which we view as examples of corporate tax planning that is not inconsistent with our tax system, but would apply to cases such as loss generators, step-down preferred and corporate dispositions of assets through tax-exempt conduits, which we view as artificial, tax-motivated transactions that should be deterred. It may be impossible, however, to achieve this perfect world. In particular, it is difficult to distinguish between appropriate and inappropriate corporate tax planning in the context of corporate financings and dispositions of assets. For the reasons discussed below, however, we are not as concerned with imprecision of application in this context as we are with respect to the Administration's proposed general substantive provision, and are convinced that an appropriate description of the cases to which the provision is applicable ultimately can be designed.

Although we do not specifically discuss in this Report the penalties and excise taxes proposed by the Administration with respect to other parties involved in corporate tax shelter transactions, including tax advisors, promoters and tax-indifferent parties, we note here, that, in our view, the principal emphasis of revisions to the penalty structure should initially be placed on deterring corporate taxpayers themselves from entering into corporate tax shelters. If the appetite of corporate taxpayers for these transactions is substantially diminished, the participation of other parties will decline as well. Moreover, we find it very difficult, if not impossible, to determine standards for the application of such penalties that will not result in penalizing innocent behavior (of, for example, tax exempts who do not have any reason to understand the overall nature of the transaction in which they are participating). We agree with the Administration however, that important issues are raised by the role that parties other than the corporate taxpayers are playing in these transactions, and we hope to provide a number of suggested approaches for dealing with the issues relating to the role of such parties in our separate report on those provisions.

Description of Administration's Accuracy-Related Penalty Proposals.

The Administration would make four modifications of the accuracy-related penalty as it relates to corporate tax shelter transactions. First, and most fundamentally, the reasonable cause exception would not apply with respect to any corporate tax shelter. Thus, for example, reasonable reliance on the legal opinions of a professional tax advisor would no longer be relevant to whether the penalty is imposed on a corporate taxpayer.

Second, the penalty would vary substantially depending on whether the transaction in issue was disclosed. Disclosure for this purpose would have three elements: (a) disclosure (within 30 days of closing the transaction) to the National Office of the IRS appropriate documents describing the transaction; (b) the filing a statement with the corporation's return verifying that this statement had been filed; and (c) the provision of adequate disclosure on the corporation's tax returns as to the book/tax differences resulting from the corporate tax shelter for all taxable years in which the tax shelter transaction applies.

Third, a new definition, "corporate tax shelter," would apply for purposes of the penalty. As proposed by the Administration, the definition of "corporate tax shelter" utilized for penalty purposes would be the same as that applicable for general substantive purposes.

Finally, the rate of the penalty would be increased substantially for nondisclosed transactions to 40 percent. The rate would remain at 20 percent for disclosed transactions.

Each of these aspects of the accuracy-related penalty must be considered as it relates to the others. Thus, for example, the more certain one is that the definition of corporate tax shelter is appropriately drawn for purpose of applying the penalty, the more likely one is able to agree both to a strict-liability approach to the penalty and to higher penalties. Similarly, the more the taxpayer has it in his control to reduce the amount of penalty imposed through disclosure, the more likely one is able to agree to larger penalties for undisclosed transactions. As discussed further below, by appropriate coordination of the various parts of this proposal, we believe that it will be possible to develop an overall package that would be both reasonable and effective.

<u>Should the Reasonable Cause Exception Be Eliminated?</u>

The core question raised by this penalty proposal is whether a strict-liability approach should be adopted. We, not surprisingly, support the general notion that "a client is entitled to rely on the advice of his lawyer." For that reason, a number of the members of the Tax Section are troubled by a strict-liability approach to penalties. With some reluctance, however, we have concluded as a group that the time has come to eliminate any exception to the imposition of the substantial understatement penalty potentially based on the opinions of tax professionals rendered in corporate tax shelter transactions because we believe that this step is required to introduce a sufficient level of risk with respect to participation in corporate tax shelters.

We begin by noting that we do not believe that the sole or even principal problem here is a radical slippage in the professional standards of tax lawyers and accountants that can be addressed through disciplinary action against corporate tax advisors. To be sure, some of us are concerned about what we perceive to be an overly literal, technical approach applied by many tax advisors to the legal analysis of tax-driven transactions, a mode of analysis that perhaps leads such practitioners to underestimate the likelihood that a court will ultimately rule against a taxpayer in a highly-contrived tax-motivated transaction. Moreover, we all can relate stories of cases in which we thought the conduct of the tax professional involved was plainly unacceptable—cases in which, for example, the opinion writer purposely failed to address the important facts. Many of us are also concerned by the growing number of instances in which the professional authoring the tax opinion has a substantial, incentive-laden economic stake in the transaction being consummated, and perhaps legislation should be formulated specially treating such cases. Because, however, the application of standards of practice to individual cases inevitably involves difficult questions of judgment, we do not believe that the corporate tax shelter phenomenon can readily be addressed simply through enforcing professional standards and ethics more vigorously.

Thus, in our consideration of this question, we start with the assumption that, as a practical matter, most transactions that we (and likely the Congress) would view as clearly corporate tax shelters will be the subject of at least one "more likely than not" or stronger tax opinion rendered by a law firm or accounting firm. Technically, receipt of such an opinion does not alone preclude the imposition of a penalty on the corporate taxpayer under the reasonable cause exception of current law.[56] But the taxpayer's receipt of a favorable tax opinion will make it significantly more difficult for the Internal Revenue Service successfully to impose penalties, and the ultimate imposition of such a penalty will thus be highly uncertain.

The very nature of a "more likely than not" opinion, however, means that such opinions often will be relatively easy to obtain in a very large segment of the cases in which we believe a greater procedural disincentive to entering into the transaction is needed. There is often significant technical support for a corporate tax shelter, and much of the assessment of its prospects in court depends on judgments as to the applicability of relatively subtle, even vague, doctrines. As one reputable tax practitioner described his firm's attitude with respect to a transaction publicly identified by the Administration as a corporate tax shelter, "we thought it might work, or that it might not work." If even a relatively

[56] See Treas. Reg. § 1.6664-4(e)(3).

conservative practitioner whose firm will not give the opinion thinks a transaction "might work," there will be more than a few lawyers who will give the opinion. A transaction that has a forty to sixty percent chance of being upheld under current law can, nevertheless, be viewed as questionable enough in terms of broader tax policy that we should seek to deter taxpayers from entering into it. Thus, a penalty the imposition of which is affected by whether a favorable tax opinion can be rendered by a law or accounting firm will, by definition, not provide the additional deterrence needed with respect to corporate tax shelters.

Moreover, the current penalty structure places a premium on consulting those tax professionals who have already come to a favorable conclusion about the merits of a transaction. We are aware of experienced attorneys who counsel clients eager to enter into an aggressive transaction not to consult with them, lest the client lose the protection of the reasonable cause exception. We suspect that many others of us, whether we would acknowledge it to ourselves or not, feel subtle pressures to give favorable opinions in order to be "at the table," to continue to be involved with our clients' transactions, and ultimately to generate our fair share of revenues for our firms.

Finally, the current structure of penalties has, in our experience, often had a perverse impact on the discussion engaged in by corporations in considering whether to enter into such a transaction—what may be called the "tax dialogue." A dominant fact discussed in such situations simply becomes whether an opinion will be rendered or not. For corporate tax shelter transactions to be deterred, the tax dialogue must shift to a nuanced consideration of whether the tax benefits are likely to be sustained in court and whether the transaction is of the type with respect to which substantial penalties will be imposed if the tax treatment sought in the transaction is not, in fact, upheld. If penalties are applied with respect to highly aggressive tax-motivated transactions that are ultimately not sustained irrespective of whether an opinion is received, the emphasis of the tax dialogue will, we believe, tend to shift with respect to at least a significant number of these transactions, and a greater premium will be placed on receiving the most thoughtful and accurate legal advice, not the most aggressive. If audit and litigation resources are also increased, substantially greater deterrence will result: we, as tax professionals, will potentially become more important factors in persuading our clients not to enter into corporate tax shelter transactions.

One result of adopting a strict-liability penalty approach for corporate tax shelters is that penalties may sometimes apply in cases in which a strong tax opinion has been rendered by a client's long-time, trusted tax advisor after a careful and judicious consideration of all of the facts and applicable legal authority. Corporate cultures continue to vary widely, and by no means all of corporate America is playing the corporate tax shelter game to the hilt. Thus, an unfortunate result of adoption of a strict-liability penalty regime is that it will be applied in some cases in which taxpayers and their advisors are acting exactly as we would want them to in the context of our legal system.

We also view it as probable that Internal Revenue Service agents will from time to time assert application of a strict-liability penalty in cases in which a corporate tax shelter is clearly not involved. We must acknowledge, then, that, if a strict-liability approach is adopted with respect to the accuracy-related penalties, the leverage of Internal Revenue Service agents in audits of taxpayers will be increased even in cases that are not the target of the Administration's proposals. Because we are concerned about this effect of the enactment of the proposal legislation, we believe it to be quite important that the Internal Revenue Service take every step possible to assure a fair and even-handed administration of these penalties. We are not so naive, however, as to believe that no abuse of these strict-liability penalties will occur in the context of the vast Internal Revenue Service bureaucracy.

Nonetheless, in our view these negative consequences of adoption of a strict-liability regime are substantially outweighed by the necessity of increasing the deterrence of corporate tax shelters. The importance of these negative consequences is, we believe, lessened to a significant extent by the fact that the strict-liability penalty would most often be imposed with respect to a transaction that is in whole or part tax-motivated and only if the taxpayer's substantive position is not sustained. It is also important to us, as discussed below, that the amount of the penalty will be significantly reduced if the taxpayer discloses the transaction. Thus, on balance, we support the Administration's strict-liability approach.

We emphasize in this connection that we do not believe that merely increasing the audit and litigation efforts of the government with respect to corporate tax shelter transactions can, alone, adequately increase the deterrence of these transactions without also changing the penalty structure. The members of the Tax Section are virtually unanimous in their belief that substantially more guidance, audit and litigation resources must be devoted to addressing corporate tax shelter activity. But we do not believe that the additional deployment of resources will have a meaningful impact if the downside risk for aggressive corporate taxpayers is not also increased, which cannot be accomplished without a change in our penalty structure.

The Disclosure Rules.

We also strongly support the disclosure provisions of the Administration's penalty proposals. The significant reduction of the penalty for cases in which the taxpayer has disclosed a transaction will serve to ameliorate substantially the potential for over-breadth of the strict-liability penalty. At the same time, we expect, based on our experience, that the prospect of disclosure itself will deter many corporate taxpayers from entering into questionable transactions. As discussed earlier in this Report, an important part of the calculus of risk for many taxpayers considering aggressive transactions is the probability of detection. If avoiding the possible imposition of a high penalty requires that the corporate taxpayer disclose the transaction, that calculus will, in many cases, change.

We also view the disclosure provisions as potentially important tools in the government's effort to uncover corporate tax shelters. Considerable thought, however, must be given to the details of the required disclosure procedure; and for these provisions to have a productive impact, it will be necessary for the Internal Revenue Service and Treasury Department to make a major effort to analyze the data provided and to act upon it promptly. It will also be important to monitor the operation of the disclosure provisions to assure that overdisclosure is not defeating the purpose of the rules.

Our tentative thoughts on the required mode of disclosure are as follows. Disclosure should, as proposed by the Administration, be required within 30 days after entering into the transaction. Disclosure should be made on a one or two page form with space for the following: a brief description of transaction; an enumeration of key tax issues and the taxpayer's position with respect thereto; a specification of the aggregate amount of tax at issue; and an identification of all other filings made by the reporting party that raise issues substantially similar to those raised in the filing. Small transactions (e.g. involving tax of less than $1 million after aggregating all transactions raising similar issues) would not have to be disclosed to mitigate penalties. The taxpayer would only obtain penalty relief if the filing were complete and correct in all material respects and only with respect to the issues highlighted. Finally, we would suggest considering whether to consult with the SEC to determine whether it would be feasible to require specific footnote disclosure of the aggregate amount of tax covered by a taxpayer's filed disclosure statements as a way of attenuating the earnings benefit of such transactions.

It is also important for disclosed transactions to be highlighted in connection with the return filed by the taxpayer. We note in this connection that the Administration would require reconciliation of book/tax differences with respect to the corporate tax shelter in connection with the filing of returns. While we do not oppose requiring this reconciliation, the corporate tax shelter transaction should also be referred to clearly in filing the return even if there are no book/tax differences.

We have also given some consideration to whether there should be separate disclosure provisions addressing certain of the other issues raised by the Administration that would not necessarily be linked to the ultimate disposition of the case. Thus, for example, one approach to the problems posed by tax-indifferent parties would be special disclosure rules with respect to transactions involving such parties. Moreover, it might be separately required that promoters disclose corporate tax shelter transactions actually entered into by corporate taxpayers.

Transactions Subject to Strict-Liability Penalties.

Two different approaches could be taken to defining the class of cases subject to a strict-liability penalty regime. Under one approach, the class of cases would be defined relatively broadly and would clearly include many tax-sensitive transactions that are not appropriately viewed as "corporate tax shelters." Such an approach would emphasize the importance of disclosure, and one way of describing the class of cases to which such penalties would be applicable would be "disclosable transactions." If such an approach were adopted, the size of the penalties applicable might reasonably be, for example, 10 percent for disclosed transactions and 30 percent for undisclosed transactions.

Under the second approach, an attempt would be made in the definition of the transactions to direct the provision as much as possible at true corporate tax shelters or at the least clearly aggressive tax-motivated transactions. Thus, the class of cases to which the penalties are addressed could be viewed as "tax-avoidance transactions." Under such an approach, a higher rate of penalties would be reasonable, such as the 20 percent/40 percent structure proposed by the Administration, or even higher.

We perceive this second approach to be the type of penalty structure proposed by the Administration, and in this Report we focus on this approach. As noted above, however, the amount of the appropriate penalty under a strict-liability regime will ultimately depend in large part on the success of Congress in delimiting the class of cases to which the penalty is applied.

Under the Administration's proposal, a "corporate tax shelter" for purposes of the penalty provisions would be defined as any entity, plan or arrangement in which a direct or indirect corporate participant attempted to obtain a "tax benefit" in a "tax avoidance" transaction. Thus, the two key terms under the Administration's proposal are "tax avoidance transaction" and "tax benefit".

The Administration has defined two different kinds of "tax avoidance transactions." The first kind of "tax avoidance transaction" under the Administration's proposal is defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis) of the transaction is insignificant compared to the tax benefits achieved in such transaction. This definition would clearly appear to apply to transactions like loss generators and wash sale transactions. It is also noteworthy that the definition does not address separately either the subjective purpose of the taxpayer for entering into the transactions or the actual nontax economic effect of the transaction on its participants.

A definition of "tax avoidance transaction" based on an economic profit test is potentially both over inclusive and under inclusive. On the one hand, many relatively standard transactions could, when economic profit is viewed on a present value basis, be viewed as tax avoidance transactions, depending on how "insubstantial" is defined. In leveraged leases, for example, the principal source of "economic profit" will likely be the residual, which on a present value basis could have a relatively small value. We presume that some mechanism will be found for excepting standard leveraged leases from the penalty provisions.

On the other hand, the anticipated economic profit from an aggressive tax-motivated transaction may be increased by stuffing assets with a predictable return into the venture. Thus, for example, the theoretical potential for "profit" from a partnership transaction could be augmented significantly simply by adding to the partnership low risk assets that are, in fact, otherwise extraneous to the tax-motivated venture.

In order to assure the potential application of the penalty to cases that clearly are corporate tax shelters, we believe that this problem must be addressed. The legislative history could make clear, for example, that the profit from assets extraneous to the purpose of the transaction should not be taken into account. An alternative, which we suggest, would be to incorporate, in the alternative, a definition based on "the principal purpose" of the transaction.

The second category of "tax avoidance transaction" under the Administration's definition is vaguely described as being comprised of "certain transactions" involving the "improper elimination or significant reduction of tax on economic income". We are not sure precisely what further content will be given to this part of the definition, but we understand that, among other things, this definition would cover corporate financings with a perceived distortive tax effect.

Obviously, at least in its present form, this provision is very uncertain in application, and could apply in the minds of some to transactions such as MIPS financings and the Mobil-Esmark transaction which we do not view as corporate tax shelters. As discussed further below, we believe that it is important to provide more content with respect to this part of the definition.

A definitional problem that spans both parts of the Administration's definition of "tax avoidance" transaction is the question of the limits of the "transaction." For example, in the Esmark case, is the "transaction" the entire series of steps or is it each step — Mobil's purchase of the stock, the redemption, etc? Is the relevant transaction in the tax-exempt conduit case discussed in Part III the entire sale of the business or can it be viewed as simply the sale through the conduit? We believe this point must be clarified, as discussed further below.

A "tax benefit" for purposes of the Administration's penalty provision 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)."

This part of the corporate tax shelter definition proposed by the Administration would play a particularly important role in the context of a substantive provision addressing corporate tax shelters because there will be many transactions that are arguably "tax avoidance" transactions within the Administration's definition that should not properly be viewed as corporate tax shelters. A similar approach has been taken by the courts in the case law concerning tax avoidance transactions.[57] Because, by definition, a determination will have been made that the taxpayer's legal position should not be sustained, the role of such a provision in the penalty context is less substantial. Nonetheless, we

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[57] See Fox v. Comm'r, 82 T.C. 1001 (1984).

believe this aspect of the Administration's proposal may have an important role to play in the context of a penalty provision as well.

We note, in this connection, that even when there are specific statutory provisions applicable, there will often be quite difficult line drawing required to determine whether the "tax benefit" at issue is clearly contemplated. Consider, for example, corporate-owned life insurance ("COLI"). It would appear that the basic tax benefits afforded both by life insurance and leveraging were contemplated by the relevant statutory provisions: indeed, Congress in recent years has amended the statutory provisions in question in recent years with full knowledge of COLI. The more difficult question is whether the full extent of those benefits as provided by the most sophisticated COLI arrangements is "clearly" contemplated. Congress ultimately must decide whether a penalty should be imposed in such cases when a taxpayer has simply gone over the line .

A second question concerning this definition is whether it adequately deals with transactions like leveraged leasings which really are contemplated more directly by long-standing case law and rulings[58] than by specific "provisions." Perhaps it can be argued that in enacting accelerated depreciation or various credit provisions, Congress implicitly blessed leveraged leasing, but the probable success of that argument is not clear from this language. Although there might be some difficulty in drawing the line, it would seem to be appropriate to except

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[58] See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Rev. Proc. 75-21, 1975-2 C.B. 715; Rev. Rul. 55-540, 1955-2 C.B. 39.

relatively standard leveraged leases from the application of the penalty provisions. perhaps by including administrative pronouncements within the category of "contemplated" law.

Such a standard also may be difficult to apply even in cases in which there is no law on point. Consider, for example, contingent debt transactions during the long period for which there were no regulations determinative of how to treat these transactions. Was it "clearly contemplated" that the holder of such an instrument should not accrue income? If not, and the debt was issued by a U.S. company with net operating losses, should the transaction potentially be subject to the corporate tax shelter strict-liability penalties?

Finally, meeting the standard of "clearly contemplated" may be difficult for several of the transactions discussed in Part III of this Report that we believe should not be covered by general corporate tax shelter provisions. Was it "clearly contemplated", for example, that the taxpayer in the Cottage Savings case should receive the tax benefits sought from its mortgage pool exchange transactions? It might be difficult to make that argument. As we argue in Section III of the Report, the more important point is that there was law addressing the relevant question and the applicable tax law could reasonably be interpreted to apply to the transaction. Similarly, was the result achieved in the Viacom transaction clearly contemplated? Certainly it was at least arguably consistent with the structure of current law: it is substantially more difficult to argue, however, that Congress "clearly" contemplated this result of the evolution of corporate tax planning under section 355.

Although we believe, as discussed further below, that substantially greater guidance must be provided in defining the cases to which the penalty is applicable, we are ultimately willing to accept the possibility that the penalty will apply on occasion to cases such as these that we, in this Report, have argued should not be viewed as "corporate tax shelters." Because the planning in Cottage Savings was dominated by a tax motivation, we are not, in the end, troubled by the taxpayer being subject to penalties if it gets such a transaction wrong. Moreover, although one of the principal objectives of drafting of a definition provision should be to provide a judge (or the Internal Revenue Service) a basis for not applying penalties to cases like Esmark in which a taxpayer loses, it is not, in our view, a fatal flaw of such a provision if it is from time to time applied in such a case, which involves tax-motivated planning in which a taxpayer is testing where precisely the line should be drawn under current law.

A somewhat more significant problem is the potential application of the penalties to cases in which the reason the taxpayer has lost is due to a technical footfault or even negligence. Assume, for example, a taxpayer who has entered into a low income housing project, the benefits from which were disallowed because the property technically did not comply with the definition of the tax-favored property. It does not seem appropriate to apply a strict-liability penalty in such a case. This sort of case could be dealt with under the "contemplated benefit" rubric, with explanatory legislative history.

Even though the "contemplated benefit" potentially serves an important limiting role in a provision of this type, it is also important that this aspect of the provision not prevent its application to the targeted transactions. Thus, for example, it should be made clear that the benefit should be contemplated to be achieved in the context of a transaction like the taxpayer's and the fact that the distortive result (such as overtaxation in the early years, as in ACM) is technically provided by the provision in question is not enough. Legislative history should clarify the contemplated benefit concept in this and other respects.

In order to address a number of different concerns, we suggest that the Treasury Department and Congress consider several different types of changes to the Administration's definition. First, we suggest that such a definition be composed of two different parts: one directed principally at transactions like ACM and loss generators, that are, from beginning to end, tax-driven; and the second addressing transactions like corporate financings and dispositions of assets that have a significant tax-avoidance component, but a business purpose for the transaction as a whole. Second, we suggest that a transaction potentially fall into the first category either on the basis of the relationship of the present value of economic benefits to tax benefits being insignificant, as proposed by the Administration, or on the basis of "the principal purpose" of the transaction being tax avoidance. Third, to assist analysis, the term "overall transaction" would be used to indicate that the principal purpose and tax benefit tests are applied to the transaction as a whole, including related transactions. Fourth, in applying the principal purpose of tax avoidance test, certain factors, such as a fee arrangement contingent on tax benefits, would trigger a presumption that the transaction had "the principal purpose." Fifth, in applying the part of the definition relating to corporate financings and dispositions of assets, a non-exclusive list of factors would be provided that would be taken into account in determining whether the provision is applicable. Sixth, we would delete the word "clearly" and describe the exception to tax benefit in terms of "contemplated." Seventh, we would add administrative pronouncements (rulings, etc.) to the list of relevant provisions. Finally, the Treasury Department would be provided regulation authority to specify exceptions to the applicability of the penalty provisions. We include with this Report a first attempt at a provision incorporating these suggestions.

Level of Penalties.

We leave it to Congress to determine the appropriate level of penalties for both disclosed and nondisclosed transactions. As noted above, the overall appropriate level of penalties under a strict-liability approach will depend both on which of the two general approaches to this regime is adopted and on the success achieved in defining the transactions appropriately the subject of penalties. We suggest, however, the following general guidelines.

First, we believe it important that some minimum penalty be applicable even in the case of disclosed transactions. At a minimum, a penalty of 10 percent should be applied.

Second, in order to encourage disclosure, the penalty for disclosed transactions must be significantly lower than the penalty for undisclosed transactions. Thus, we would suggest that the 20 percent differential proposed by the Administration (20 percent versus 40 percent) is the minimum differential, and some of our members believe that a ratio of one to three or more is appropriate.

Third, the penalty applicable to undisclosed transactions should exceed the 20 percent rate of current law. While we believe that adoption of a strict-liability approach will have a significant deterrent impact on corporate tax shelter transactions, a significant number of corporate tax shelter transactions are undertaken today with no opinion. Thus, if additional deterrence is going to be provided for such transactions through changes to the penalty structure, a somewhat higher penalty than is applicable under current law must be adopted for undisclosed transactions.

We also have considered the question whether a corporate taxpayer should be subject to imposition of the strict-liability penalty in the event of the issuance of regulations (or other guidance with the same effect) after a transaction is entered into by the taxpayer. If the potential applicability of a statutory provision to a transaction is obvious, and the regulations in issue either simply interpret the plain language of the statute or implement the clearly articulated policy of Congress on a question, it might be appropriate to take into account such regulations in imposing the penalty. If, by contrast, regulation authority has been exercised on a retroactive basis under general provisions like sections 446 or 7701(l) or the proposed new section 269, it might be more difficult to justify imposing a strict liability penalty.

As a compromise approach with respect to this difficult type of case, we suggest that no penalty be applicable in such a case if the transaction has been appropriately disclosed by the taxpayer. We note, however, that this approach may have an impact on the manner in which Treasury's regulatory authority under general provisions is exercised.

In this regard we would emphasize that we believe a strict-liability penalty would have a substantial role to play even if it were never applied in cases in which regulatory authority were exercised with retroactive effect. In a sense, one role of the strict-liability penalty is to add a substantial additional element of deterrence to apply to cases in which the extreme measure of the issuance of retroactive regulations is not taken.

Additional Procedure Provisions.

In addition to the provisions proposed by the Administration, we suggest that the Treasury Department and Congress consider at least one other type of procedural provision. A number of our members believe that it could be very useful to permit the early litigation of corporate tax shelter cases by providing a procedure for segregation of such a case from the rest of a corporate taxpayer's return. As noted earlier in this Report, corporate tax shelter cases are often litigated (if they are litigated at all) well after the period the transactions in issue occurred. Moreover, the treatment of such transactions in audit is often affected substantially by the overall resolution of issues involving the taxpayer. A provision that required such cases to be segregated might permit such transactions to be more directly and quickly attacked.

V. The Substantive General Anti-Avoidance Provision.

We believe the enactment of strict-liability penalties applicable to corporate tax shelters and substantial incentives for disclosure will have a meaningful impact on the volume of corporate tax shelter activity, if combined with substantially increased enforcement efforts. We also believe, however, that the substantive policy problems that are at the heart of the corporate tax shelter phenomenon must be addressed in order to achieve fully the objective of substantially decreasing the level of corporate tax shelter activity.

In this regard, we agree with the Administration that it is important to continue to increase the legal risk associated with corporate tax shelter transactions. For that reason, we support the growing reliance on generally stated principles in regulations, the inclusion of anti-abuse provisions in newly promulgated regulations and newly enacted statutory provisions, and, from time to time, the promulgation of authority with retroactive effect. We are not, however, in a position to support the Administration's proposed amendments to section 269, although it remains an open question for us whether such a provision can be designed that would have a meaningful role to play with respect to corporate tax-avoidance transactions.

The Administration's Proposal.

Our views on the Administration's proposed expansion of section 269 of the Code are affected considerably by both the basic nature of the proposed provision and the nature of our tax laws. The provision proposed by the Administration has two characteristics that are not found together in existing authority. First, unlike the case with targeted regulatory authority such as section 337(d), for example, or section 1259(e), there will not be a substantial legislative background and history to new section 269 throwing light on how Congress views the relevant tax policy issues and how, to some significant extent, it perceives the Treasury Department's authority being exercised in the future with respect to specific types of transactions. Second, the provision can be applied without the exercise of regulation authority subject to public comment. Thus, it can, in practice, be applied by the Service and ultimately the courts without a systematic public exploration of the substantive issues at stake in relation to the rest of the Internal Revenue Code.

When considered with reference to our experience with aggressive corporate tax planning in the last two decades, a general substantive provision of this type gives rise to four different concerns. The first concern arises out of the fact that in practice agents or other Internal Revenue Service personnel will be asserting the substantive applicability of the provision in a broad range of cases without substantial guidance or control. We understand that the interpretation of such a provision could be subject to significant National Office coordination. Nonetheless, even though the issues were, in fact, ultimately reasonably resolved at the national level by the Internal Revenue Service, the experience with the treatment by the agents in the field of MIPS financings, for example, suggests to us that there would be at least some significant potential for mischief because of the extreme breadth of such a provision.

Second, because there will inevitably be very little guidance given by Congress as to the application of the provision to future cases, and the provision can be applied by the Service and Treasury Department without the exercise of regulation authority subject to public comment, the probability would be increased materially that the positions taken by the Internal Revenue Service and the Treasury Department could be substantially out of step with the views of Congress. The reaction of Congress, for example, to the Treasury Department's initiatives with respect to tax-motivated international planning suggests that this is a real possibility.[59]

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[59] Consider, for example, the controversy over the treatment of hybrid entities, for example, The Internal Revenue Service released first a Notice (Notice 98-11,1998-6 I.R.B. 18) and temporary regulations (63 F.R. 14669) relating to the use of hybrid entities in the international context. According to the Regulations' preamble, the Regulations are aimed at curing perceived abuses in the use of hybrid branches of controlled foreign corporations to circumvent the purposes of Subpart F. Just a week after the release of the temporary regulations, additional modifications to the Senate Finance Committee Chairman's Mark relating to the proposed restructuring of the Service and tax technical correction legislation were announced. Among other things, the proposed modifications included a moratorium on the implementation of temporary or final regulations with respect to Notice 98-11 until six months after the date of enactment of the (continued...)

Third and significantly more important to us, by its very nature the provision provides very little substantive guidance to taxpayers as to its future application. As we see the likely operation of the super-section 269 a provision, the law would develop in substantial part under the "clearly contemplated" standard. Take, for example, a simple case. Assume a corporate taxpayer with a subsidiary in a foreign country that begins incurring losses. The corporate taxpayer "checks the box" so that the losses can be offset against its income currently. Is this result "clearly contemplated." Perhaps it is, by analogy to other law under section 269.[60] Assume, alternatively, that a corporate taxpayer with an economic loss in its stock in a wholly-owned subsidiary, sells more than 20 percent of such stock to an independent third party and liquidates the subsidiary. What role would currently applicable law[61] have in addressing this transaction under a super-section 269?

To some extent this vagueness raises issues of taxpayer fairness; as noted in the discussion of wash sale planning in Part III of this Report, the perceived

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[59] (...continued)
legislation. In addition, the proposed modifications provided that it is the sense of the Senate Committee on Finance that the Department of the Treasury and the Service should withdraw Notice 98-11 and the regulations issued thereunder and that Congress, rather than Treasury or the Service, should determine the international tax policy issues presented with respect to the treatment of hybrid branch transactions under Subpart F. On the IRS's Unified Agenda for 1999 next action with respect to these regulations is listed as "undetermined." See Unified Agenda, 63 F.R. 62278 at 69.

[60] See Rev. Rul. 76-363, 1976-2 C.B. 90.

[61] See Comm'n v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945).

fairness of applying a strict-liability penalty regime can be affected by whether the taxpayer is subject to such a vaguely worded substantive provision.

A more important effect of this aspect of the proposed provision is that this vagueness in application may reduce substantially the effectiveness of the statute because taxpayers and their professional advisors will inevitably vary widely in their judgment as to whether there is any real possibility of the provision being applied to their cases. Again, we are concerned with the nature of the tax dialogue engaged in when considering a corporate tax shelter transaction. The more that the ultimate treatment of corporate tax shelter transactions depends on intuitive judgments about the applicability of a vaguely worded statute, the less likely it will have a deterrent effect.

Finally, and most important to us, we believe that there is a real danger that such a provision will actually hinder the development of law applicable to aggressive tax-motivated transactions by supplanting the law now potentially applicable to such transactions and requiring that new law develop under section 269 to make the required, highly nuanced distinctions between transactions. As discussed earlier in this Report, there is a considerable amount of existing legal authority addressing certain types of aggressive corporate tax planning. It could be self-defeating if a super-section 269 provision replaced such law and, in effect, a body of interpretative cases had to develop anew to address corporate tax planning. Is it really desirable for every future case like Cottage Savings to be addressed under a provision like the proposed super-section 269? Would it be anything more than an unconstructive diversion for such a provision to be applicable to cases like Esmark? Would such a provision do anything more than confuse the issues with respect to reverse MIPs?

Given these considerations, we believe that it is imperative that any new provision or provisions of the type proposed by the Administration have two characteristics. First, the role of such a provision should be relatively circumscribed. In this respect, we expect that our view of such a provision's role would not, in fact, vary significantly from the Treasury Department's view. Second, it is important that such provision not have the effect of supplanting already existing useful authority directed at the inquiry conceptually relevant to the transaction in issue.

In considering such a general substantive provision with respect to both criteria, it may be useful to delineate, based on our discussion in Part III of this Report, several different types of cases to which such a provision might apply. One type would be cases like the loss generators with the abstract characteristics described in our discussion of those cases. A second category would be cases like the conduit sale to a tax exempt party in which the plain purpose of statutory provisions that have been enacted by Congress is being contravened by the transaction, and Congress has provided regulatory anti-abuse authority to address transactions with such effect. Third would be cases like step-down preferred with respect to which there is no currently applicable statutory applying to the type of transaction in a given context, but it is very likely, based on the irrationality of the results achieved, as well as the existence of other law applying to the same type of transaction, that Congress would preclude the tax treatment sought by the taxpayers if it were aware of the transaction. A fourth category are cases like wash sale transactions to which a current provision clearly applies that does not have language addressing the transaction in issue even though the transaction is, in general terms, arguably inconsistent with the purpose of the applicable provisions. Finally are cases like MIPS financings or the Mobil-Esmark and Viacom transactions which involve real business transactions in a context in which the basic tax policy or substantive problem has not yet been definitively addressed by Congress, the Treasury Department or the courts.

When these categories of transactions are considered with reference to the criterion of circumscribing the role of the provision, we are, in general terms, most comfortable with granting to the Treasury Department, Internal Revenue Service and the courts the full discretion to apply a general substantive provision only to the first three types of cases (loss generators, conduit sales to tax exempts and step-down preferred), assuming they can be defined with relative clarity. In this context, our basic standard is whether we would be confident that Congress would clearly find the tax result achieved by the taxpayer unwarranted in the context of the transaction and the current structure of our tax laws. Based on our analysis in Parts III and IV of this Report, however, we do not believe that the scope of the provision proposed by the Administration could be so limited. It is not clear to us, for example, that such a statute would not apply in the context of Cottage Savings, Esmark or any number of similar cases.

Even assuming that the provision were easily limited to these three types of cases, we are not convinced that the Administration's provision would meet the second criterion of not supplanting more useful authority. It is not obvious to us, for example, that the proposed super-section 269 would add anything constructive to the treatment of loss generators, which are the most appropriate cases for application of such a provision, and such a provision could complicate the application of an already useful body of law.

Possible Alternative Approaches to General Anti-Avoidance Provisions.

A number of us are skeptical that any single general provision of the type proposed by the Administration can be formulated that will meaningfully address the substantive problems posed by corporate tax shelters. We do not, however, by any means foreclose the possibility of successfully developing such a workable provision or set of provisions. Although we, as a group, have not carefully considered any specific alternative to the Administration's proposal, we suggest here alternative approaches for future discussion and analysis.

One approach that we would suggest considering further would be more carefully to tailor the definition to address the different types of transactions identified in this Report. Thus, for example, one definition could be intended to deal specifically with "loss generators" and similar cases, a type of transaction that a number of our members find particularly offensive.

A multi-part definition could, for example, be employed for this type of relatively extreme type of transaction to specify the elements described in Section III above, including (i) the lack of an economically accrued loss of the taxpayer prior to entering into the transaction, (ii) a principal purpose of tax avoidance for the transaction, (iii) no significant business purpose of the taxpayer for entering into the transaction other than the reduction of tax and (iv) an insubstantial economic effect on the parties in relation to the tax benefit sought by the taxpayer and/or an insubstantial tax detriment to other parties in relation to the tax benefits sought to be achieved by the taxpayer. As to this type of transaction, a high standard would be applied with respect to "tax benefit" so that, to be exempt from the provision, the tax benefit sought would be required to be "clearly contemplated" to be realized in transactions like the transaction at issue by applicable statutory or regulation provisions, administrative authority or a substantial body of case law which had not been legislatively overturned. It may be difficult to formulate such a provision that is as effective as current law, but we do not foreclose the possibility of successfully doing so.

A second type of substantive provision could be developed to encompass transactions such as corporate financings which otherwise have a business purpose or economic effect and which are, by their very nature, difficult to analyze under general tax shelter legislation. As to this type of case, the burden might be shifted, however, in defining the applicable tax benefit. This part of the corporate tax shelter definition might apply if (i) there were a significant distortion in the timing of income or elimination of income or reduction of tax on income and (ii) such distortion in timing or reduction of tax on income were plainly contrary to the Congressional intent underlying statutory provisions or the purpose and structure of existing Treasury Regulations, taking into account provisions applicable to such transactions or provisions applicable to similar transactions. This type of provision might apply, for example, to the tax-exempt conduit transaction described above. The provision could be further targeted by reference to transactions subject to specific Code provisions such as section 707 (relating to partnership disguised sales) or section 1259 (relating to constructive sales).

Another type of provision that might be usefully considered would be a general grant of regulatory authority to the Treasury Department that would give the Treasury Department the right, in relatively extreme circumstances, to promulgate regulations to address transactions that exploit obvious loopholes that are plainly contrary to the intention or contemplation of Congress. As noted earlier in this Report, the Treasury Department is, to a significant, already employing section 7701(l) for this purpose today. The Congress might be uncomfortable with granting the Treasury Department such broad authority, but granting such explicit authority could easily be viewed as superior to the current situation in which the Treasury Department must address extreme cases such as step-down preferred in a manner that is not directed at the substantive problem.

Moreover, the fact that regulations must be issued with opportunity for public comment would, in practice, constrain the arbitrary exercise of this authority.

Each of these suggested approaches, of course, raises significant issues. We would, however, be pleased to work with Congress and the Treasury Department to discuss these and other types of provisions in the months ahead.

Broader Approaches.

In addition to considering general anti-avoidance provisions, it is obviously necessary to continue the hard work of rationalizing our substantive tax laws. Most, if not all, corporate tax shelters are rooted in distortions and flaws in that law, and significant parts of the weaknesses in our corporate tax laws can, in our view, be constructively addressed.

The substantive work that needs to be done can be seen as falling into two categories. At one level, we must continue to address those areas of that law that have been the source of much of the most aggressive corporate tax planning: partnerships, financial instruments, section 1032, etc. In our experience, much of the most aggressive corporate planning could be countered simply by further rationalization of the law in these and other areas.

At the same time, we must also continue to think more broadly. Unlike the case with individual tax shelters, there might not be one relatively simple (but blunt) solution, such as the passive loss rules. But our focus on the immediate problem of deterring corporate tax shelters should not divert us from a broader inquiry that would include consideration of a schedular system applicable to corporations, a general corporate cost of capital allowance, a mark-to-market regime for certain assets and other types of more fundamental changes to the system.

CONCLUSION

We view the Administration Proposals discussed in this Report as part of the beginning of what we hope will be a constructive dialogue with the government on how best to address the corporate tax shelter problem. We strongly support the Administration's accuracy-related penalty proposals, and believe that, with further refinement, such provision should be enacted by Congress. While we cannot support the general substantive provision proposed by the Administration at this time, we intend to continue to work to attempt to develop substantive provisions to serve a similar role, and have not permanently foreclosed the possibility of developing an appropriate and effective provision of the type proposed by the Administration. We also believe, however, that broader and more fundamental changes to our system must be considered.

Corporate Tax Avoidance Transaction

"A corporate tax avoidance transaction is any entity, plan or arrangement in which a direct or indirect corporate participant seeks to achieve a tax advantage other than a contemplated tax advantage and one of the following two requirements are met:

(1) either the principal purpose of the overall transaction is to achieve such tax advantage, or 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 overall transaction is insignificant relative to the reasonably expected value of the tax advantage sought to be achieved (based on net tax benefits in excess of tax liability from the transaction, determined on a present value basis); or

(2) the form of the entire transaction, or a material element of the entire transaction, is found to be dictated by an attempt to achieve such tax advantage and to have an immaterial relationship to the overall economic substance of the transaction when all the facts concerning the transaction are considered, including but not limited to the following:

(a) whether the transaction or a material element of the transaction involves a shifting of taxable income in excess of economic income from the taxpayer to a tax-indifferent party;

(b) whether a material element of the transaction is the limitation of the economic risk of the taxpayer or one or more of the parties whose role in the transaction is important to the achievement of the tax advantage;

(c) whether a principal purpose of the entire transaction is the achievement of the tax advantage; and

(d) such other factor that the Secretary shall, by the promulgation of regulations on a prospective basis, determine to be relevant to the determination of whether such a transaction constitutes a corporate tax avoidance transaction.

"A tax advantage for this purpose shall include: any significant difference between economic income, loss or expense and income, loss or expenses for U.S. federal income tax purposes; any significant deferral of U.S. taxable income; or any change in the character of income, loss or expense for U.S. federal income tax purposes."

"A contemplated tax advantage for this purpose shall include any 'tax advantage' contemplated by applicable provisions of the Code or Treasury Regulations (when considered together with other provisions of the Code or Regulations) or administrative pronouncements of the Internal Revenue Service."

"A tax-indifferent party for this purpose shall include a foreign resident not subject to U.S. taxation from the transaction, a Native American tribal organization, a tax-exempt organization (unless all or substantially all of the income of such organization from the transaction is subject to tax), a domestic corporation with net operating loss carry-forwards, a domestic taxpayer using a mark-to-market method of accounting or any other party defined as such by the Secretary pursuant to regulations; provided, however, that a tax-indifferent party for this purpose shall not include a foreign resident not subject to U.S. taxation from the transaction if it is determined, pursuant to regulations promulgated by the Secretary, that such foreign resident is subject to the imposition of a significant amount of tax on income from the transaction under the tax laws of a foreign country."

"The presence of any of the following shall create a rebuttable presumption that the principal purpose of the transaction is to achieve a tax advantage:

1. Fees paid to a promoter or tax advisor with respect to the transaction that are in whole, or significant part, contingent on the achievement of the tax advantage by the taxpayer;

2. A confidentiality agreement relating to the transaction; or

3. a tax indemnity or similar agreement for the benefit of the taxpayer other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction."

"The Secretary may by regulation enumerate transactions or classes of transactions to be excepted from the definition of corporate tax avoidance transaction hereunder."