July 24, 2000

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
REPORT ON THE TREASURY'S PROPOSAL TO CODIFY THE ECONOMIC SUBSTANCE DOCTRINE[1]

I. Overview

The purpose of this report is to comment on the Treasury's proposal to codify the economic substance doctrine, which is contained in the President's Fiscal Year 2001 Budget. This report is in furtherance of the Tax Section's Report on Corporate Tax Shelters, dated April 23, 1999 (our "Prior Report").[2] Part II below discusses the background of the Treasury's proposal and some initial reactions to it, including our own. Part III describes and analyzes the economic substance doctrine of case law insofar as it pertains to the Treasury's proposal. Part IV concludes that the Treasury's proposal does not accurately reflect the economic substance doctrine of case law and, more important, would not be effective as a substantive disallowance rule; at least read literally, it does not reliably distinguish abusive tax-motivated transactions and applies to a broader range of transactions than presumably was intended. Part V includes our specific recommendations and alternatives for better defining abusive tax-motivated transactions.

As we stated in our Prior Report, we believe that the corporate tax shelter phenomenon poses a serious problem for the tax system and that concrete steps should be taken

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1 The Report was prepared primarily by an ad hoc subcommittee of the NYSBA Tax Section consisting of Richard G. Cohen, David P. Hariton, Robert H. Scarborough, Michael L. Schler, and Robert T. Smith. David P. Hariton was the principal drafter. This Report, however, reflects the comments and views of a number of other members of the Tax Section's Executive Committee. In particular, comments were received from Andrew N. Berg, Kimberly S. Blanchard, Peter H. Blessing, Samuel J. Dimon, Peter L. Faber, Stuart J. Goldring, Harold R. Handler, Robert A. Jacobs, Richard O. Loengard, Donald C. Lubick, Charles M. Morgan, Yaron Z. Reich, Richard L. Reinhold and Andrew P. Solomon.

2 83 Tax Notes 879 (May 10, 1999).

to discourage corporate tax shelters and to increase the risks associated with entering into them. We therefore support new legislation directed specifically at deterring abusive corporate tax shelters. While we applaud—subject to our forthcoming comments—the Treasury's issuance of new regulations requiring the reporting, registration and listing of tax-motivated transactions, we do not think that these regulations will suffice on their own adequately to discourage corporate tax shelter activity.

In our Prior Report, therefore, we stated that Congress should support the Treasury by (a) adopting a "strict-liability" approach to the imposition of penalties for understatements arising from abusive tax-motivated transactions, and (b) increasing the amount of such penalties. We stated that legislation should provide that taxpayers cannot avoid such penalties based on a "reasonable cause and good faith exception" where the penalties arise from transactions that are successfully challenged under applicable substantive law and would not have been entered into but for the hope of avoiding taxes. Such measures must be complemented, however, by active and visible efforts on the part of the Commissioner to find and successfully challenge abusive tax-motivated transactions and assess the appropriate penalties. If (but only if) they are so complemented, we think such measures will (a) "shift the balance" towards a more conservative approach to tax planning, (b) discourage taxpayers from entering into abusive tax-motivated transactions, and (c) encourage taxpayers to consult sober counsel concerning the risk that the purported tax results of a proposed transaction will be successfully challenged.

We do not, however, have consensus supporting enactment at this time of any general rule designed to discourage corporate tax shelter activity by overriding otherwise applicable specific rules (a "substantive disallowance rule"). Some members of the Tax Section's Executive Committee ("Members") would support such enactment if it applied to a broader range of cases than the economic substance doctrine of case law, some if it applied to a narrower range of cases, and some if it applied to the same range of cases. Many Members, however, are opposed to any form of statutory substantive disallowance rule.[3]

We generally agree, however, that the substantive disallowance rule recently proposed by the Treasury Department (which it describes as a codification of the economic substance doctrine) does not serve its intended purpose, both because it does not adequately define abusive tax-motivated transactions and distinguish them from other transactions, and

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[3] Some Members believe that even an underinclusive "substantive disallowance rule" would be very constructive. They believe that a practitioner is more effective in dissuading a client from entering into an abusive tax-motivated transaction when he or she explains that the purported tax results are technically "disallowed" by a statutory rule (e.g., Section 482, 7701(f), 7701(l)) than when he or she merely states, as a matter of judgment, that a court might apply an ambiguous common law disallowance doctrine. And, in fact, such statutes often provide a clear basis on which purported tax benefits may be disallowed and therefore encourage the courts to find against the taxpayer if the matter is ultimately litigated. In any case, a statute like Section 482 of the Code can, even though it merely reiterates already extant legal concepts, develop into a "repository" of organized guidance and provide a clear basis for challenge and response.

Other Members are concerned, however, that the narrow breadth of application of such a provision might render the provision counterproductive. They fear that such a provision might encourage taxpayers to enter into abusive tax motivated transactions in cases where the new provision did not apply, and it would discourage courts from finding against such taxpayers. In light of such concerns, although we do not have a consensus supporting enactment of a substantive disallowance rule, we think that if such a rule were enacted it should clearly provide that it does not supplant case law doctrines, such as the "economic substance doctrine," the "step-transaction doctrine" or the "substance over form doctrine," and is not intended to discourage the courts from applying or expanding these doctrines. We likewise think it would be best not to describe such a rule as a "codification" of any of these doctrines, but rather to clarify that the rule is intended to apply in a narrower range of "core" cases.

Some Members believe, however, that there is literally "nothing to be gained" from a substantive disallowance rule that only applies to tax benefits that would have been disallowed in any case under a case law doctrine. If it is impossible to clearly define a set of tax-motivated transactions that goes beyond current case law, they would sooner abandon the effort to devise an objective definition of tax-motivated transactions and enact a broader "anti-abuse" rule. Such a rule might simply disallow any tax benefit that was "clearly not intended to be available under the relevant circumstances" and leave it to the courts to determine when the provision applied.

Other Members believe, on the other hand, that even a substantive disallowance rule that applies only in the narrowest of cases has the potential for being misunderstood, and misapplied, by taxpayers and IRS agents alike. They continue to think, as we suggested in our Prior Report, that such a rule has the potential to undermine more detailed and objective legal rules that have been crafted over the course of many years and that are better targeted to the specific transactions they address than any overarching substantive disallowance rule.

because it may not produce predictable and sensible results. We therefore suggest modifications to the Treasury's definition of problematic transactions so that it would better achieve its purpose, without necessarily endorsing use of the modified definition as the basis for any substantive disallowance rule.

We generally agree that such a definition should be designed to include transactions with two characteristics, and exclude other transactions. The first characteristic is that the transaction gives rise to purported tax results that would plainly not be desired by the drafters of the relevant statutes or regulations—in other words, results that are in some sense "abusive". This presumably must be determined by a judge or tax administrator, based on subjective considerations. No objective "formula" can serve to determine whether a transaction gives rise to abusive results. Our first difficulty with the Treasury's current proposal is that it appears to apply regardless of whether the transaction in question gives rise to abusive results. Thus, while this is presumably not intended, the Treasury's proposal might literally be read as disallowing tax-benefits that were (or might reasonably have been) contemplated.

The second characteristic is that the transaction is tax-motivated, in the sense that the transaction (considered as a whole) clearly would not have been entered into but for the desire to avoid taxes. This might be determined subjectively, but it can also be determined "objectively", by reference to objective facts, such as profit potential. The Treasury's current proposal offers such an objective test: whether the expected pre-tax profit from the transaction is insignificant in relation to the anticipated tax benefits. We think this fails adequately to distinguish abusive tax-motivated transactions, however, because there is no easily definable (let alone measurable) expected profit in many common transactions that generally would not be viewed as abusive (e.g., speculative derivatives positions, hedging transactions, mergers, restructurings, etc.).

We therefore suggest, without necessarily endorsing its use as the basis for a substantive disallowance rule, an alternative objective test. Our suggested alternative test would determine whether the transaction could not give rise to significant pre-tax profit under any reasonable scenario (i.e., has no real profit "potential"). We understand, in this regard, that the archetypical abusive tax-motivated transaction is designed virtually to eliminate economic risk (i.e., is fully hedged out), and that the potential for substantial profit is thus precluded by the desire to avoid material loss in that scenario. Thus, we think that a test based on profit potential (rather than expected profit) would serve to identify the most objectionable, purely tax-motivated transactions.

We recognize that our proposed objective definition of tax-motivated transactions might be viewed as underinclusive. It would not, for example, cover the aggressive structuring of a business transaction to avoid the tax otherwise arising from it (e.g., we do not intend to treat an aggressive "step" in the structuring of the sale of a business as a separate "transaction" for this purpose). Neither would it cover transactions that might be largely or primarily tax-motivated, but which have significant non-tax economic consequences.

We do not think it possible, however, to devise a sequence of abstract words that distinguishes abusive tax-motivated transactions from other transactions. An operative definition of "abusive tax-motivated transaction" must either be vague and broad, and therefore overinclusive, or narrow and targeted, and therefore underinclusive. As discussed more fully below, a potentially overinclusive definition should not be considered unless the only thing that turns on application of the definition is the imposition of additional penalties for taking a tax position that has already been found to be incorrect as a matter of law. If a tax position that would otherwise be correct can be incorrect solely because it arises from an "abusive tax-motivated transaction", then the operant definition of "abusive tax-motivated transaction" must for that purpose be narrow and targeted, and therefore underinclusive.

II. Background

In February of 1999, the Treasury Department included in its Fiscal Year 2000 Budget Proposals a proposal that Congress expand the scope of Section 269 of the Internal Revenue Code by adding a provision authorizing the Secretary to disallow any deduction, credit, exclusion or other allowance obtained in a "tax avoidance transaction". The Treasury proposed that a tax avoidance transaction be defined for this purpose as

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

The Treasury used the same definition of "tax avoidance transaction" for its proposal that Congress impose a 40% "strict liability" penalty on substantial understatements arising from any undisclosed "corporate tax shelter," where corporate tax shelter was defined as "any entity, plan or arrangement in which a direct or indirect corporate participant attempts to obtain a tax benefit in a 'tax avoidance transaction'."

The Treasury's proposal was not viewed at the time as a "codification" of the economic substance doctrine of common law. In our Prior Report, we strongly supported the Treasury's proposal that Congress impose strict liability penalties, at a higher rate, on substantial understatements arising from corporate tax shelters. We did not, however, support the Treasury's proposal to expand the scope of Section 269, because we were "not convinced that the proposal would prove 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."[4]

More specifically, we expressed concern about the administration of the proposed provision: about whether enforcement by IRS agents would be consistent with the intent of Treasury; about whether enforcement by Treasury would be consistent with the intent of Congress; and about whether taxpayers would have adequate guidance and certainty regarding the application of the provision to plan their affairs properly. We also felt that there

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4 Prior Report at 4.

was "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."[5]

We were, however, concerned that the Treasury's penalty proposals alone ultimately might not prove sufficient to discourage corporate tax shelter activity, and we conceded that a substantive disallowance provision might ultimately be necessary. We pledged ourselves, moreover, to "continue to work to attempt to develop substantive provisions to serve a similar role, and [we] have not permanently foreclosed the possibility of developing an appropriate and effective provision of the type proposed by the Administration."[6] With regard to what we might ultimately propose, we believed "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 the provision not have the effect of supplanting already existing useful authority directed at the inquiry conceptually relevant to the transaction at issue."[7]

On June 17th, 1999, Congressman Doggett introduced legislation in the House to curb tax abuses by disallowing tax benefits claimed to arise from transactions without substantial economic substance.[8] Congressman Doggett described this as a proposal to "codify" the economic substance doctrine of common law. On July 1, 1999, the Treasury Department

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5 Prior Report at 69-72.

6 Prior Report at 79.

7 Prior Report at 73.

8 The Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong., 1st Sess.

released a study entitled The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals (its "White Paper"). It continued to support its proposed expansion of Section 269, with one alteration described below. The Treasury likewise enunciated, however, a position that

> The centerpiece of the [proposed] substantive law change should be the codification of the economic substance doctrine first found in seminal case law such as Gregory v. Helvering and most recently utilized in ACM. The economic substance doctrine requires a comparison of the present values of expected pre-tax profits and expected tax benefits. This test was incorporated in the first part of the Administration's proposed definition of 'tax avoidance transaction'.[9]

The first part of the Administration's proposed definition, which treats a transaction as a tax-avoidance transaction unless the expected pretax profit from the transaction is significant in relation to its tax benefits, already resembled similar language in the bill introduced by Congressman Doggett. It was therefore not altered in the White Paper. The Treasury replaced the second part, the so-called "financing leg", of the definition, however, with the definition proposed by Congressman Doggett. More specifically, the Treasury replaced "certain transactions involving the improper elimination or significant reduction of tax on economic income" with "in the case of financing transactions, the deductions claimed by the taxpayer for any period are significantly in excess of the economic return realized by the person providing the capital." The Treasury's initial financing leg formulation had been widely criticized as too vague and broad. The Treasury described its replacement as a modification to make the proposed definition "more objective". "Concerns that the IRS might abuse its broader authority would be addressed by a more concrete definition of tax avoidance transaction. In addition, the tax attribute disallowance rule would apply by operation of law, rather than being subject to the discretion of the Secretary."[10]

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9 Treasury White Paper at xix.

10 Id.

On July 22, 1999, the Staff of the Joint Committee on Taxation released its Study of Present Law Interest and Penalty Provisions, which included an in-depth consideration of recent corporate tax shelter proposals. It released a similar study, Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters on November 10, 1999, in connection with hearings on corporate tax shelters that were held by the House Ways and Means Committee. The Chief of Staff of the Joint Committee testified again before the Senate Finance Committee in March of this year. The Joint Committee Staff, like the Tax Section, has generally been supportive of the Treasury's penalty proposals but not its proposal for a substantive disallowance rule. Its reasoning has been similar to ours. The Joint Committee Staff appears to believe that it would be difficult, if not impossible, to devise an objective definition of "corporate tax shelter" that separates abusive tax-motivated transactions from other transactions in an effective manner and on a consistent basis. Rather, drafters must choose between a definition of tax-avoidance transaction that is vague and broad, and therefore applies to many legitimate business transactions, and one that is relatively narrow, and therefore does not apply to many abusive tax-motivated transactions. The Joint Committee seems willing to support the former only if the sole consequence of concluding that a transaction is a corporate tax shelter is that the taxpayer incurs substantial understatement penalties if the taxpayer is wrong on the substantive merits, so that the definition of corporate tax shelter does <u>not</u> effectively override substantive law.

The Chief of Staff of the Joint Committee, Lindy Paull, reiterated this view in her testimony before the Senate Finance Committee earlier this year:

> Another important concern with enacting a substantive rule is the inherent difficulty of crafting a rule that is sensitive to the tax system's reliance on objective, rule-based criteria while at the same time does not impede legitimate business transactions. A substantive law change should be precise so as to target abusive transactions but not affect legitimate business transactions. The difficulty lies in crafting a definition of a "tax shelter." There can be significant disputes as to whether a particular transaction is a tax shelter. This is why the Joint Committee staff study identifies certain common characteristics of corporate tax shelter arrangements, referred to as "tax shelter indicators," which, if present in an arrangement, would result in an understatement penalty <u>only</u>

after a determination that the arrangement caused an understatement of the corporate participant's tax liability. It is not enough that the arrangement appears to be a tax shelter; there must be a determination that the tax treatment was improper and the taxpayer must have had less than a high level of confidence that the tax treatment was proper in order for a penalty to be imposed. This relieves much of the pressure of crafting a precise definition of a corporate tax shelter, which would exist if a substantive law change was adopted.[11]

In the Budget Proposal for the Fiscal Year 2001 that it introduced on February 7th of this year, the Treasury reintroduced its substantive disallowance proposal in substantially the same form as proposed in the White Paper. All reference to Section 269 of the Code were dropped, however, and the proposal was described as a proposal to "codify the economic substance doctrine." The proposal, as fully described by the Treasury, is as follows:

Proposal

> The proposal would codify and clarify the economic substance doctrine. The proposal would disallow tax benefits from any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the taxpayer from the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of the taxpayer from such transaction. With respect to financing transactions, tax benefits would be disallowed if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing. This articulation of the economic substance doctrine is incorporated in the definition of "tax avoidance transaction" found in the Administration's proposal to revise the substantial understatement penalty.
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> The proposal would not apply to disallow any claimed loss or deduction of a taxpayer that had economically been incurred by the taxpayer before the

11 Testimony of the Staff of the Joint Committee on Taxation Concerning Interest and Penalties and Corporate Tax Shelters Before the Senate Committee on Finance, at 22-23 (March 8, 2000) (emphasis added). We note that the Joint Committee Staff (in contrast to the Tax Section in our Prior Report) did not support strict liability; instead it favored an exception from penalties where the taxpayer had a high level of confidence that the asserted treatment was proper.

transaction was entered into. The proposal would apply to any transaction entered into in connection with a trade or business or activity engaged in for profit or for the production of income, whether or not by a corporation.

> The proposal would not alter or supplant any other existing judicial doctrine or anti-abuse rule.
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> The Secretary may prescribe regulations necessary to carry out the purposes of this proposal. The proposal would apply to transactions entered into on or after the date of first committee action.[12]

III. Case Law Economic Substance Doctrine

The business purpose and economic substance doctrines (hereafter, the "economic substance doctrine") are rules of statutory and regulatory interpretation devised by the courts to prevent taxpayers from interpreting statutory language in a manner that is inconsistent with its purpose and produces incongruous results. The doctrine was most recently restated, for example, by the Tax Court in Saba Partnership, a case involving facts similar to those of ACM:

> In this regard, it is important to recognize that the economic substance doctrine is not a judicially created exception to the general rule . . . as petitioner implies, but rather is a "canon of statutory interpretation that statutes should not be read to create absurd results.'" Horn v. Commissioner, supra at 1239.[13]

Many people trace the origin of the economic substance doctrine to Gregory v. Helvering, wherein first Learned Hand, writing for the Second Circuit, and then the Supreme Court, concluded that a tax-free "reorganization" did not contemplate a restructuring of assets in anticipation of their immediate sale.[14] They therefore held that the taxpayer could not obtain tax-free treatment of a spinoff-type restructuring that otherwise met the literal requirements of the reorganization provisions of that time (the requirement that a tax-free

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12 Department of the Treasury, General Explanation of the Administration's Revenue Proposals, at 126 (February 2000).

13 Saba Partnership v. Commissioner, 1999-359 T.C. Memo, para. 105 (1999).

14 Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935).

spinoff be "not essentially equivalent to a dividend" was not introduced until 1954). In words that have often been repeated, Judge Hand reasoned as follows:

> We agree with the Board and the taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. U.S. v. Isham, 17 Wall. 496, 506, 21 L.Ed. 728; Bullen v. Wisconsin, 240 U.S. 625, 630, 36 S.Ct. 473, 60 L.Ed. 830. Therefore, if what was done here was what was intended by section 112(i)(1)(B), it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was. Nevertheless, it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition. It is quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create. The purpose of the section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. Such transactions were not to be considered as "realizing" any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations."

This doctrine has since been applied by the courts primarily to prevent taxpayers from entering into tax-motivated transactions to obtain tax benefits (primarily deductions) under circumstances where Congress presumably did not intend for them to be available. The thought was that while Congress had given taxpayers the right to deduct expenses and losses, it presumably had not intended (except where it so stated explicitly) to grant deductions for payments that had "no substance or purpose" other than to obtain the deductions. Thus, in Goldstein v. Commissioner,[15] the Second Circuit disallowed a deduction for a large prepayment of interest because it arose from a transaction (a leveraged position in Treasuries) that was entered into solely to obtain the deduction. There was then no rule requiring that deductible interest expense be paid on indebtedness incurred to derive a profit, but the court concluded that the deduction could nevertheless be disallowed because it was not what Congress had in mind when it drafted Section 163 of the Code:

> . . . and notwithstanding Section 163(a)'s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction.[16]

The economic substance doctrine does not deny taxpayers every tax benefit arising from a tax-motivated transaction that lacks business purpose and economic substance. Given its role as a doctrine of statutory interpretation, it only denies tax benefits if their allowance in the circumstances would be contrary to the intent of the drafters. Thus, in Cottage Savings Ass'n v. Commissioner,[17] a taxpayer entered into a tax-motivated transaction (an exchange of economically similar bond portfolios) solely to accelerate the deduction of an otherwise unrealized economic loss. The Supreme Court refused to disallow the deduction because the drafters of the relevant provisions (Section 1001 of the Code and the regulations thereunder) might reasonably have envisioned a taxpayer deducting its loss under these circumstances. The timing of realization of gains and losses is to some extent arbitrary and turns, in any case, on the actions of the taxpayer. The taxpayer's intentional realization of gains or losses from strictly tax-motivated transactions was therefore within the relevant statutory and

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15 364 F.2d 734 (2d Cir. 1966).

16 Id. at 741.

17 499 U.S. 554 (1991).

regulatory intent.[18] Similarly, in Horn v. Commissioner,[19] the court refused to disallow deductions arising from abusive commodity straddles, even though the straddles obviously lacked both business purpose and economic substance (in that they were "devoid of any prospect of true gain or loss"), because Congress arguably had condoned such deductions under Section 108(c) of the Deficit Reduction Act of 1984, provided that they were taken by commodities dealers.

Although a finding that allowance of a claimed tax benefit was not contemplated by the applicable provisions is necessary to disallowance, such a finding is not sufficient. The economic substance doctrine is not a "general anti-abuse rule" that denies any tax benefit that was not intended to be available under the relevant circumstances. The economic substance doctrine has most commonly been applied to transactions that do not change economic consequences and thus "do not appreciably change the taxpayer's financial position,"[20] or to put it differently, to transactions that have "no objective economic consequences . . . . other than reduction of tax."[21] As Judge Posner put it in Yosha v. Commissioner,[22] which dealt with commodity straddles similar to those that led to the enactment of the straddle rules:

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18 By contrast, in ACM v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), the taxpayer sought to obtain a tax benefit (deductible losses) under circumstances (the absence of any economic losses) where neither Congress nor the Treasury intended to grant a loss. Likewise, the economic substance doctrine applied in Compaq Computer Corp. v. Commissioner, 113 T.C. 214 (1999), because the taxpayer sought to claim a tax benefit (a foreign tax credit) that Congress intended to grant in specified circumstance (the ownership by U.S. persons of foreign stocks) in the absence of those circumstances (i.e., foreign persons, rather than the taxpayer, owned the relevant stock during substantially all of the relevant dividend period).

19 968 F.2d 1229 (D.C. Cir. 1992).

20 Weller v. Commissioner, 270 F.2d 294, 297 (3rd Cir. 1959), cert. den. 364 U.S. 908 (1960).

21 Compaq, supra note 18.

22 861 F.2d 444 (1988).

Well, what is wrong with all this? . . . There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes. . . . Many transactions are largely or even entirely motivated by the desire to obtain a tax advantage. But there is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer such an advantage. . . . If Mrs. Gregory had won, either Congress would have had to amend the statute (which it did anyway, however) or there would have been a flurry of sterile reorganizations—reorganizations not only motivated solely by a desire to avoid taxes but having no consequences other than to avoid taxes.[23]

More recently, in ACM v. Commissioner, the Third Circuit observed:

While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. See, e.g., Gregory, 293 U.S. at 468-69, 55 S. Ct. at 267 ("if a reorganization in reality was effected . . . the ulterior purpose will be disregarded"); Northern Indiana Pub. Serv. Co., 115 F.3d at 512 (emphasizing that Gregory and its progeny "do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax related changes in economic position" regardless of "tax-avoidance motive" and refusing to disregard role of taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit); Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127-28 & n. 19 (2d Cir. 1956) (refusing to disregard tax effects of debenture issue which "affected . . . legal relations" between taxpayer and its corporate parent by financing subsidiary's acquisition of venture used to further its non-tax business interests). In analyzing both the objective and subjective aspects of ACM's transaction in this case where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual,

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23 Id. at 498.

objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations.[24]

Gregory v. Helvering[25] might be viewed as an exception, in that there were "objective non-tax consequences" to the underlying transaction considered as a whole. In Gregory, the taxpayer was the sole shareholder of a corporation that had agreed to a non-tax-motivated sale of one of its subsidiaries. The taxpayer's lawyers structured the transaction as a tax-free spinoff followed by a sale of the distributed corporation at the individual level, so as to avoid (a) the corporate-level gain on the appreciated subsidiary, under the so-called "General Utilities doctrine", and (b) part of the individual-level gain by shifting some of the taxpayer's outside stock basis to the stock of the distributed corporation prior to disposition. The IRS challenged the benefit of (b) above, but not of (a) above (it later challenged the benefit of (a) above in Commissioner v. Court Holding), and the courts upheld the Commissioner based on statutory interpretation—Congress apparently did not intend to allow tax-free treatment of a restructuring to accommodate a sale of assets.

In any case, taxpayers have often sought to defend themselves against the economic substance doctrine by asserting that they entered into the transaction in question for business reasons unrelated to taxation and the transaction had meaningful non-tax consequences. Where a particular transaction has involved a financial investment, the taxpayer has sometimes asserted that it entered into the transaction in hopes of deriving a profit. In response, the Commissioner has sought to establish the fact that the transaction was strictly tax-motivated by demonstrating that the transaction lacked any potential for profit apart from its tax consequences. The economic substance doctrine does not, however, require that a taxpayer have, or anticipate, a pre-tax profit from a transaction to derive a tax benefit; for as explained above, the economic substance doctrine seeks to interpret statutory rules rather than add new

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24 157 F.3d at 248 n.31. See also, Smith v. Commissioner, 937 F.2d 1089, 1096 (6th Cir. 1089) ("Under the law of this circuit, the proper test is 'whether the transaction has any practicable effects other than the creation of income tax losses.' ")

25 Supra note 14.

requirements to them. An examination of profit potential is but a "means" to the "end" of determining whether the claimed tax benefits arose from a real business transaction or from a transaction that had no purpose and effect other than altering the taxpayer's tax position.

Thus, in Goldstein the court recognized the taxpayer's assertion that the interest deduction did not require any profit motive.[26] Judge Friendly focused on the taxpayer's lack of profit potential primarily to establish that the taxpayer's leveraged position in Treasury securities was not, as the petitioner asserted, a "sophisticated speculative sortie into the market for government securities."[27] Similarly, in Sheldon v. Commissioner, the Court stated:

> We must bear in mind that neither an objective to make a profit nor the need for a trade or business, at least in 1981 and 1982, was a requirement for an interest deduction and are not the direct focus of our inquiry. We have analyzed the profit potential as part of the overall inquiry into whether these transactions had "purpose, substance, or utility apart from their anticipated tax consequences." . . . The principle of [Goldstein] would not, as petitioners suggest, permit deductions merely because a taxpayer had or experienced some de minimis gain. [Goldstein], to the contrary, holds that the transactions, in form, were real, but that they lacked substance. That test was not a profit objective test.[28]

Similarly, in ACM v. Commissioner, the Tax Court discussed the taxpayer's lack of profit potential primarily to counter the taxpayer's assertion that it entered into the transaction in question for legitimate business reasons:

> The theory of the LIBOR Note hedge was carefully developed in contemporaneous documents and argued in these proceedings. It forms the linchpin of practitioner's economic substance argument. It is, however,

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26 "Admittedly, the underlying purpose of Section 163(a) permitting the deduction of 'all interest paid or accrued within the taxable year on indebtedness' is difficult to articulate because this provision is extremely broad: there is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable, 4 Mertens, Law of Federal Income Taxation @ 26.01 (1960 ed.)." 364 F.2d at 741

27 Id. at 739.

28 94 T.C. 738, 767 (1990) (emphasis added).

false. . . . Neither ABN nor Colgate needed a hedge inside the partnership for the Colgate debt because both were effectively fully hedged outside the partnership—ABN through swaps and Colgate by virtue of being the issuer of the debt. Employing an additional hedging instrument within the partnership was not only redundant, but also flatly inconsistent with the manner in which both principals were otherwise managing their interests in the partnership. . . . The cash contributions that had to be invested "as quickly as possible" in Citicorp Notes yielding 8.78 percent in order for the partners to earn a reasonable return were already earning 8.75 percent in an ABN deposit account before the notes were acquired.[29]

In general, moreover, the courts have not concluded that a transaction is strictly tax-motivated merely because profit was unlikely, provided that there was still a meaningful opportunity for profit.[30] A transaction can have economic substance even if the taxpayer expects, on average, that the transaction will produce a loss, so long as the transaction realistically could produce a meaningful pre-tax profit and thus "has any practical effects other than the creation of income tax losses."[31]

Thus, in summary of what is set out above, the economic substance doctrine is a broad tool at the Commissioner's disposal to prevent taxpayers from reaping unintended tax benefits from tax-motivated transactions. Nevertheless, a court normally makes two findings before it disallows a tax benefit under the doctrine. First, the court finds that the taxpayer is seeking to obtain the tax benefits in question under circumstances where Congress and/or the Treasury did not intend for them to be available. In other words, the tax benefits are ones that were not reasonably contemplated by the drafters of the relevant statutes or regulations, but rather that run counter to, or frustrate, statutory or regulatory intent. Second, the court normally finds that the transaction lacked both business purpose and economic

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29 ACM v. Commissioner, 73 T.C.M (CCH) 2189, 2221, 2218 (1997).

30 See, e.g., Smith v. Commissioner, supra note 24 (upholding deductions for obviously tax-motivated investments in research and development of a new process for producing synthetic fuel, because the likelihood of success was "not insignificant.")

31 Jacobson v. Commissioner, 915 F.2d 832, 837 (2d Cir. 1990). See, Yosha, supra note 22.

substance, based on a finding that it could have accomplished little more than an alteration of the taxpayer's reported tax position.

IV. Analysis of the Treasury's Proposal

As a technical matter, we do not think the Treasury's proposal to "codify the economic substance doctrine" reflects the economic substance doctrine of existing case law. In particular, we do not think the economic substance doctrine denies tax benefits arising from a transaction merely because the taxpayer does not anticipate a pre-tax profit. That a taxpayer could not derive a pre-tax profit from a transaction under any reasonable scenario, however, may serve to establish the transaction lacked both business purpose and economic substance. Many financial transactions, however, such as, mergers, hedging transactions, speculative derivatives positions, restructurings, etc., do not involve any investment of equity capital, and thus there is no "expected" profit, or at least not one that admits of measurement under an objective formulation.

Moreover, the economic substance doctrine does not disallow tax benefits arising from transactions that do lack business purpose and economic substance unless the tax benefits in question were not intended to be available under the relevant circumstances. In other words, while it may be possible to use an "objective" test to define a "suspect class" of potentially abusive tax-motivated transactions, it remains necessary to make an essentially subjective determination of whether any given transaction is abusive.

In any case, regardless of how it relates to current common law concepts, we think that any proposed substantive disallowance rule should be designed to disallow tax benefits that (a) arise from primarily tax-motivated transactions, and (b) are "abusive", in the sense that they were not intended to be available under the circumstances in which they arise. We suspect that the Treasury's current proposal is intended to achieve that result. We are concerned, however, that it does not accomplish that result, at least when it is taken literally. Moreover, even if the Treasury proposal did follow case law, we do not think the Treasury should seek to follow case law doctrines in crafting a statutory substantive disallowance rule based on an "objective" definition. As we explain in Part I above, we believe that any such rule must be applied to a narrower range of cases than a subjective rule that is applied on a discretionary basis by the courts. Asserting that the former is intended to mimic the latter therefore works against both rules, encouraging an overly broad application of the former while discouraging application of the latter.

The Treasury's White Paper suggests that the Treasury clearly <u>does</u> seek to devise an "objective" test that would not require subjective determinations of when a transaction is primarily tax motivated and when a transaction gives rise to abusive results. Although an objective test has many advantages over a subjective test, devising an objective test that answers these kinds of questions satisfactorily is exceedingly difficult. The Treasury's current proposal relies on a "profit test" that is similar to the test it set forth in Notice 98-5 to determine when a cross-border transaction is entered into primarily to obtain foreign tax credits. While this kind of test may be useful for determining whether certain kinds of purported investment transactions are primarily tax motivated, it is less useful for determining whether business and financial transactions that are not investment transactions are primarily tax-motivated. Moreover, it is of no use in determining whether a given transaction, albeit strictly tax motivated, gives rise to unintended results.

A literal reading of the Treasury's proposal in its current form could result in far-reaching changes in substantive law, with consequences that have not been considered or discussed. Read literally, for example, the proposal could disallow dividends received deductions, foreign tax credits and other tax benefits arising from leveraged positions in domestic and foreign equities. Moreover, the proposal could disallow any tax benefit arising from a transaction that does not involve any investment of equity and is therefore not expected to produce any profit per se, such as a merger, a restructuring, or a "derivative" position in an interest rate, equity, commodity, yield curve, basis point or other swap, option, cap, collar or similar financial transactions.[32] Under the definition most recently provided by the Treasury Department in Treas. Reg. § 1.6011-IT, the term "tax benefit" includes "nonrecognition of gain", "exclusion from gross income", "and any other tax consequences that may reduce the taxpayer's federal income tax liability by affecting the timing, character or source of any item of income, gain, loss, deduction or credit."[33] Thus, a literal reading of the Treasury's current proposal could cause a tax-free merger to be taxable, a "collar" transaction to result in a "constructive sale", deductions for net payments under a swap to be disallowed, a long position in a forward contract to be treated as constructive ownership of the underlying equity, etc. For this purpose, moreover, a transaction could presumably include any single step that was undertaken as part of a non-tax-motivated series of business transactions in an effort to reduce the taxes that would otherwise arise from the transaction.

Moreover, it is not clear how to interpret "reasonably expected pre-tax profit" for purposes of applying the test. Consider investments such as venture capital, drilling for oil and gas, research and development of new technologies, etc. Investors in these activities clearly may expect to lose money in most cases, but are hoping for a ten- or hundred-fold profit in a small number of cases. Do these investors "expect" a profit, perhaps in the form of an equity risk premium? If so, how is it measured?

And while the introduction of a pre-tax profit requirement would have very broad potential application, it would still not be broad enough to discourage many of the tax-motivated transactions that are of principal concern to the Treasury Department. Without further modification, for example, a pre-tax profit requirement arguably would not serve to disallow the tax benefits arising from the contingent installment sale transaction described in ACM v. Commissioner if the taxpayer held on to its investment in LIBOR Notes long enough

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32 Many transactions in which a taxpayer does not invest capital, but merely assumes or avoids risk, do not have any expected objective pre-tax profit. After bid-ask spreads and transaction costs are taken into account, many such transactions are arguably expected to produce a loss.

33 Treas. Reg. §§ 1.6011-4T(b)(4)(ii) and 301.6111-2T(b)(1).

to derive a substantial profit from its investment in them.[34] In other words, it is not clear to us that there is any necessary relationship between profit, or lack thereof, and tax abuse.

V. Recommendations

As explained above, the Treasury's proposed "objective" definition of abusive transactions read literally applies in too broad a range of cases. It does not serve to separate out transactions that are primarily tax-motivated and that give rise to tax benefits that are not intended to be available under the circumstances in which they arise. We therefore believe the range of application of the Treasury's definition should be narrowed to better suit its purpose. Thus, we make the following recommendations for narrowing and refining the Treasury's substantive disallowance proposal.

It is important to note in reading this section of this report that we do not necessarily support enactment of the proposal, as we recommend that it be modified. As explained above, the Tax Section does not support enactment at this time of a substantive disallowance rule—even one based on the recommendations and definitions set out below; we do not have a consensus on this question. We present these recommendations in order to help advance the discussion of possible substantive disallowance rules by developing an alternative that we believe would be preferable to the Treasury proposal.

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34 The proposal provides that in determining whether or not a given transaction produces pre-tax profit that is significant in relation to its tax benefits, the anticipated pre-tax profits must be "discounted to present value". We assume, however, that the proposal is not intended to require that all projected cash flows must be discounted, and the projected yield on investment calculated, to determine the profit, if any, from the transaction; instead, we assume that the proposal is intended merely to require that the profit and tax benefits must be compared on a discounted basis, so that the test cannot be effectively avoided by projecting profit in the distant future. If our assumption were not correct, the proposed "expected pre-tax profit" test could not be coherently applied, because the yield on tax-advantaged assets, such as tax-exempt bonds, leases, investments by a corporation in stock of another corporation, etc., is substantially lower than the yield on taxable investments.

First, we recommend that notwithstanding that tax benefits arise from primarily tax-motivated transactions (determined either objectively or subjectively, as discussed below), they should nevertheless be allowed if they are "reasonably intended to be available under the circumstances in which they arise (based on a reasonable reading of the relevant statutes and regulations, considered in light of the purposes for which they were promulgated)." Some of us would prefer that this be stated the other way around—i.e., tax benefits should not be disallowed unless they are "not reasonably intended to be available under the circumstances in which they arise (based on a reasonable reading of the relevant statutes and regulations, considered in light of the purposes of which they were promulgated)." This formulation would in any case be intended to permit tax benefits such as depreciation deductions from leveraged leases, deductions for dividends received on leveraged investments in domestic stocks (that are not otherwise disallowed by Section 246A), etc. We do not think that permissible benefits should be limited, expressly or implicitly, however, by promulgation of a list, because it is too hard to foresee the potential applications of a substantive disallowance rule.

Second, we recommend that, if a substantive disallowance rule were to be enacted, tax benefits be potentially disallowed (i.e., disallowed if they are not intended to be available under the relevant circumstances) only if they arise from a transaction that is primarily tax motivated, considered as a whole. This could be defined either "objectively" or "subjectively". The advantage of an "objective" definition is that it is more precise, more uniformly interpreted and more easily relied upon. The disadvantage is that it is necessarily over- and underinclusive. In any case, an objective test would be intended to focus potential disallowance of tax benefits on a "suspect class" of primarily tax motivated transactions, rather than on a broader range of hedging, merger, restructuring and other business transactions.

The best objective test we have been able to devise would treat a transaction as primarily tax-motivated if it does not have a "reasonable possibility" of producing a pre-tax profit that is significant in relation to the transaction's reasonably expected net tax benefits. Derivatives positions (whether speculative or used as hedges), mergers, etc., presumably can produce a substantial profit in a range of reasonably likely scenarios; they have substantial profit potential–even though there is no "expected" profit that is measurable in any statistical, objective sense. By contrast, strictly tax-motivated transactions, such as those described in ACM and Compaq, are normally structured to assure that the taxpayer cannot suffer any meaningful economic loss, and it usually follows from this that the taxpayer cannot derive any meaningful economic gain. A slightly more subjective, but substantially equivalent, formulation of this objective test might treat a transaction as lacking in "economic substance" if it "does not change the taxpayer's economic position or circumstances" in a way that is meaningful in relation to the reasonably expected net tax benefits.

Alternatively, the Treasury could apply a "subjective" test to define the suspect class of tax-motivated transactions and simply state that potential disallowance applies to tax benefits arising from transactions that are "primarily" (or, alternatively, "almost entirely") "tax-motivated, considered as a whole." Naturally a court would have to interpret what it means for a transaction to be "primarily" tax-motivated, considered as a whole," and indeed, under this approach, the Secretary would not promulgate regulations further delineating the meaning of this term or otherwise seeking to turn it into an objective criterion. The posited subjective test would be more flexible than an objective test, and it could therefore apply to a broader array of potentially abusive cases, although the test would, of course, have the disadvantages typical of subjective test (including uncertainty and inconsistency of application).

We recommend (consistent with our reading of the Treasury's current proposal) that the "reasonable possibility of significant profit" test described above be applied by comparing the discounted present value of the possible pre-tax profit in some reasonably likely scenario to the discounted present value of the net tax benefits (so that taxpayers cannot avoid the test by referencing possible profit in the distant future). The calculation would not involve discounting possible cash flows from the transaction as a whole;[35] thus, it would be

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35 See supra note 34.

sufficient if the pre-tax profit in some realistic scenario, discounted to present value, is not insignificant in relation to the tax benefits.

The Treasury's current proposal contains a separate objective test for financing transactions, under which tax benefits would be potentially disallowed "if the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or return of the person providing the financing." We recommend retaining a separate test for financing transactions. We think the test should be modified, however, to disallow potential interest deductions arising from a financing transaction if the present value of the borrower's deductions is significantly in excess of the present value of the economic cost of the capital acquired.

As an initial matter, the Treasury's current proposed test seems slightly misdrafted, in the sense that the federal income tax benefit of a corporate interest deduction is only 35% of the yield (i.e., the interest income) from the loan, and the former can therefore never exceed the latter.

This is not the only problem with the proposed test, however. If we revise the test—to provide for disallowance where the present value of the amount of deductible interest exceeds the pre-tax profit or return of the person providing the financing--the provision may become overinclusive. Potential disallowance can turn on random extraneous and idiosyncratic factors, including the basis in the loan, the expenses incurred to make the loan, the taxes (including foreign taxes) paid on the income from the loan, etc. For example, the current proposal, read literally, might disallow a borrower's deductions for interest paid on publicly traded debt any time the debt was sold in the secondary market at a premium, since the return derived by the new lender would be less than the rate at which the borrower continued to deduct interest. We therefore recommend that this test be revised to compare the amount of deductible interest to the economic cost of the debt to the issuer of the debt.

We recognize that our recommended general test (focusing on profit potential) would not apply to some problematic transactions. It would not apply, for example, to aggressively structured business transactions, such as a disguised sale, a short-against-the-box transaction, a "mirror liquidation" or the purported avoidance of corporate level gain from the sale of the assets of a subsidiary through the use of an intervening Native American tribe. If the Treasury wishes to apply a substantive disallowance rule to a broader range of transactions, however, we think it should simply propose that Congress disallow any tax benefit that is "clearly not intended to be available under the relevant circumstances (based on a fair and logical reading of the relevant statutes and regulations, considered in light of the purposes for which they were promulgated)." Naturally, the meaning of this phrase in any particular case would have to be interpreted by the courts, and indeed, under this approach, the Secretary would not promulgate regulations further delineating the meaning of this term or otherwise seeking to turn it into an objective criterion.

As noted above in this report, however, we do not have a consensus favoring enactment of this (or any other) "general anti-abuse rule" or other statutory substantive disallowance rule at this time. The following points support reservations of a number of Members about enactment of such a rule:

First, the mere fact that a substantive disallowance rule or doctrine does not apply to a given transaction does not mean that the taxpayer "gets away with it". To the contrary, the taxpayer can lose on the substantive merits of its position—e.g., the taxpayer can simply be wrong, in the opinion of a court, that gain is avoided through the use of an intervening Native American tribe. Moreover, the taxpayer can (and given the current climate) probably will be subject to substantial penalties for understating its tax liability as a result of its aggressive position, if it loses under applicable substantive law (including common law doctrines). Our Prior Report supported increasing the amount of these penalties and imposing them without regard to (or without acceding to) the taxpayer's claim that its position was taken "with reasonable cause and in good faith".

Second, unlike understatement penalties, a substantive disallowance rule effectively changes the substantive law by denying tax benefits that would otherwise be available under a literal reading of the applicable statutory or regulatory provisions. As we noted in our Prior Report, the extension of a subjective disallowance rule to bona fide business transactions has a potential for undermining an otherwise reliable and objective system of determining tax liabilities.

We recognize that the IRS has limited resources and it is legitimately concerned with its ability to litigate a plethora of cases. The problem underlying this concern, however, is not that existing substantive law (including common law) is inadequate to allow courts to find in favor of the government in appropriate cases. Instead, the underlying problem is the risk-reward calculus faced by taxpayers considering entering into abusive transactions that are susceptible to successful challenge under existing law. This calculus can be affected by increasing penalties or making it more difficult to avoid them. If the problem is enforcement—not adequacy of existing substantive law—the solution is not changing substantive law through broad application of a substantive disallowance rule. For in the absence of adequate enforcement by the IRS, such a broad application will not have its intended result. A substantive disallowance rule—even a statutory rule—is <u>not</u> self-enforcing, because taxpayers seeking to "abuse" the tax law are likely to conclude that they are not subject to it. Assuming adequate enforcement of existing law, however, it is not clear what would be added by enacting a substantive disallowance rule. Is there really a significant set of cases involving abusive corporate tax shelters that taxpayers would win if litigated under current law, which they would lose under a new statutory substantive disallowance rule? And if the Service cannot identify and adequately litigate abusive shelters under existing law, would it be better able to do so if a new substantive disallowance rule were enacted? Not only is it unclear what would be gained by enactment of such a new rule, the rule might cloud current law and subject taxpayers that are not seeking to abuse the tax law to an increase in "discretionary" disallowances, and undermine the common law economic substance doctrine itself by diluting it to such a point as to render it meaningless and ineffective.