May 21, 2003

NEW YORK STATE BAR ASSOCIATION TAX SECTION SUMMARY REPORT ON THE PROVISIONS OF RECENT SENATE BILLS THAT WOULD CODIFY THE ECONOMIC SUBSTANCE DOCTRINE[1]

This Report sets forth comments of the New York State Bar Association Tax Section on the "Clarification of Economic Substance" provisions of the Jobs and Growth Reconciliation Tax Act of 2003, as reported by the Senate Finance Committee on May 8, 2003, and passed by the Senate on May 16, 2003, [2] and the nearly identical provisions of the CARE ACT of 2003, passed by the Senate on April 9, 2003[3] (the "Acts"). We set forth our views in summary fashion, [4] and focus on providing examples, attached as a separate appendix, of the reasons we believe codification of the economic substance doctrine is not an effective means of combatting abusive tax shelters. We also believe that many of the more targeted anti-abuse proposals now under consideration by

---

1 The principal draftsperson of this Report was Andrew P. Solomon, with substantial contributions from James M. Peaslee. Helpful comments were received from numerous members of the Executive Committee of the Tax Section, including Andrew N. Berg, Lewis R. Steinberg, David P. Hariton, Kimberly S. Blanchard, Dickson G. Brown, Peter C. Canellos, Samuel J. Dimon, Arthur A. Feder, Lawrence M. Garrett, Stuart J. Goldring, Robert A. Jacobs, Richard O. Loengard, Jr., Peter Miller, Deborah L. Paul, Yaron Z. Reich, Richard L. Reinhold, Seth L. Rosen, David M. Schizer, Michael L. Schler, David R. Sicular, Bryan C. Skarlatos, and Diana L. Wollman, some of whom do not agree with all of the conclusions and recommendations.

2 Title III, Subtitle A, Section 301. The final print of the Bill was not available at the time this Report was prepared.

3 Title VII, Subtitle A, Section 701, "Clarification of Economic Substance Doctrine", of the CARE Act of 2003, S.476, reported in S. Rpt No. 108-11, 108th Cong., 1st Sess. (February 27, 2003).

4 We commented at length on a similar proposal released February 7, 2000, by the Clinton Administration in connection with its Budget Proposal for the Fiscal Year 2001, Dep't of the Treasury, General Explanation of the Administration's Revenue Proposals at 126 (Feb. 2000). *See* NYSBA Tax Section Report on the Treasury's Proposal to Codify the Economic Substance Doctrine (July 24, 2000), 2000 TNT 146-25 (July 28, 2000).

the Congress would be more effective in preventing abusive transactions, and, in principle, support their adoption.[5]

I. Overview and Summary.

The New York State Bar Association Tax Section has long supported administrative and legislative efforts to deal with the proliferation of corporate and other tax shelters.[6] As set out in previous reports, the Tax Section has strongly recommended that the existing penalty regime for tax shelters be strengthened. In particular, we believe that, in appropriate circumstances, taxpayers should be subject to strict liability penalties for understatements of tax attributable to tax shelters (i.e., that there be no exception from penalties even if taxpayers have relied in good faith on opinions from lawyers or other tax advisors). The possibility of obtaining a "get-out-of-jail-free" opinion for a tax shelter—an opinion that insulates taxpayers from penalties if the shelter is successfully challenged by the IRS— has skewed the economic calculus often associated with a taxpayer's decision to enter into a tax shelter and has encouraged some professionals to

---

5 We have not had the opportunity to study the precise form in which some of these proposals have been presented, and therefore do not comment on some of the many technical issues that may arise if they are enacted.

6 *See*, e.g., NYSBA Tax Section, Report on Tax Shelter Legislation, No. 1019, August 27, 2002, 2002 TNT 167-25 (Aug. 28, 2002); Letter to the Hon. Max Baucus from Robert A. Jacobs dated Oct. 30, 2001, 2001 TNT 213-13 (Nov. 2, 2001); Letter to Pamela F. Olson and Honorable Charles O. Rossotti from Andrew Berg dated May 22, 2002, 2002 TNT 01-27 (May 24, 2002); Report on Temporary and Proposed Tax Shelter Regulations, Nov. 16, 2000, 2000 TNT 225-17; Report on Certain Tax Shelter Provisions, June 22, 1999, 1999 TNT 126-31 (July 1, 1999); Report on Corporate Tax Shelters, April 23, 1999, 83 Tax Notes 879 (May 10, 1999); NYSBA Tax Section Report No. 995 on Proposed Modifications to Circular 230 (July 25, 2001), 2001 TNT 149-41 (Aug. 2, 2001) (corrected).

give inappropriate, hypothetical or overly aggressive opinions. We therefore generally support the effort in the Acts to strengthen penalties.

We do not believe, however, that codifying the "economic substance" doctrine will be an effective vehicle to combat the tax shelter problem, and, in particular believe the codification provisions in the Acts will have unwarranted and unintended effects on legitimate transactions. As we discussed in our longer report of July 24, 2000,[7] the Tax Section generally opposes codification of the judicially created economic substance doctrine.

The core problem with the statute is that it does not accomplish what it sets out to do, which is to provide clear or clearer standards for separating legitimate transactions from abusive tax shelters. While it does of course provide a series of tests that must be met for a transaction to have economic substance, we believe that the drafters in many cases would agree that the statute should not be applied as it is written to all transactions having tax effects. The examples attached to this report clearly illustrate why this must be so. The problem then is to identify when the new statutory requirements must be met in a way that provides guidance to taxpayers, the IRS and the courts. However, we cannot find in the statue or legislative history workable tests for making the choice, short of a delegation to the IRS of the task of drawing the line. The IRS is unlikely to have an easier time than the Congressional drafters in coming up with standards to distinguish the good from the bad. We do not know what the IRS could do

---

7 NYSBA Tax Section, Report on Tax Shelter Legislation, No. 1019, August 27, 2002.

other than carve out areas that should be exempted wholesale from the statute or rewriting the substantive law in a number of areas. These tasks seem to be more legislative than the administrative. They would involve an unusual delegation of authority to the IRS and would be made more difficult by the lack of guidance on what the IRS is supposed to do. If the key to the statute is delegation, as it appears to be, we believe it is unfair, and very disruptive for legitimate transactions to make the statute effective pending the issuance of guidance by the IRS.

The legislative history of the statute never really explains what the problem is with current law. It has a description of the economic substance doctrine, and indicates that courts have been inconsistent in applying it. It focuses on whether economic substance and business purpose are conjunctive or disjunctive requirements and states that the law should be clarified to ensure that the test is conjunctive.[8] We do not think this change goes to the heart of the issue. As the legislative history indicates, economic substance and business purpose are two sides of the same coin. We doubt whether a court says that it is using a conjunctive or disjunctive test, without more, would affect the outcome in many cases. It would be very helpful in understanding the statute if the drafters could identify some concrete cases where the courts have gotten it wrong that would be changed by the legislation. In fact, with a few exceptions, the courts have been quite effective in applying the economic substance test to deny benefits in abusive transactions. A few questionable cases does not mean the doctrine is fundamentally

---

8 *See* Senate Finance Committee, Jobs and Growth Reconciliation Tax Act of 2003. Technical Explanation of the Provisions Approved by the Committee on May 8, 2003, 19-20 (May 2003)

flawed. Cases depend on their facts and the parties' litigation strategies. The courts will never decide all cases to the satisfaction of all observers, and that will also be true in applying any new legislation in this area.

We understand that the drafters believe the Compaq case[9] in particular was wrongly decided and intend to reverse it. The holding of that case turned on a narrow question arising in the foreign tax credit area whether earning "taxable income" provided a sufficient "profit" motive to establish that a transaction met the requirements of the economic substance doctrine. The results of the case have already been reversed by legislation limiting foreign tax credits, and the specific conclusion regarding "taxable income" versus "profits" is unlikely to be a decisive issue outside of the foreign tax credit area. If there are additional problems with the case that need to be addressed, they should be identified more clearly. If anything, the problem with the transaction was not the lack of a profit motive but the lack of economic risk. Responding to the case by placing a greater emphasis on a profit test, as the proposed codification would do, will affect legitimate transactions without necessarily affecting tax shelters.

II. Background.

As we have observed in our previous reports, 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

---

9 *Compaq Computer Corp* v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001). This intention, however, is nowhere made explicit in the statute or in the legislative history.

applying statutory language in a manner inconsistent with its purpose. This aspect of the doctrine was recently restated, for example, by the Tax Court in the *Saba Partnership* case:

> 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,* [968 F2d 1229 (DC Cir 1992)] at 1239.[10]

The origin of the economic substance doctrine generally can be traced to *Gregory* v. *Helvering*, in which 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.[11] They therefore held that the taxpayers could not obtain tax-free treatment of a spinoff-type restructuring that otherwise met the literal requirements of the reorganization provisions of that time. In words that often have been repeated, Judge Hand reasoned:

> 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 chooses, 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

---

10 *Saab Partnership* v. *Commissioner,* 359 T.C. Memo, para 105 (1999).

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

> 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 holding. 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." 69 F.2d at 810-11.

This doctrine has since been applied by the courts primarily to prevent taxpayers from entering into tax-motivated transactions to obtain tax benefits under circumstances where Congress did not intend for them to be available. Although Congress has given taxpayers the right to deduct expenses and losses, presumably Congress did not intend (except where the context requires a different conclusion) to grant deductions for payments that had "no substance or purpose" other than to obtain the deductions. Thus in *Goldstein* v. *Commissioner*,[12] 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 interest

[12] 364 F.2d 734 (2d Cir. 1966).

deduction needed to offset income derived from winning the Irish Sweepstakes. There was then no rule requiring that deductible interest expense be paid on indebtedness incurred to derive profit, but the court concluded that the deduction could nevertheless be disallowed because it was not what Congress had in mind when it drafted Code Section 163:

> 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.[13]

The economic substance doctrine currently does not deny taxpayers <u>every</u> tax benefit arising from a tax-motivated transaction that lacks business purpose and does not meaningfully change a taxpayer's economic position. Given its role as a doctrine of statutory interpretation, it denies tax benefits only if under the circumstances allowing the benefits would be contrary to the intent of the drafters. Thus, in *Cottage Saving Ass'n* v. *Commissioner*,[14] a taxpayer entered into a tax-motivated transaction (an exchange of economically similar mortgage portfolios) solely to accelerate the deduction of an otherwise unrealized economic loss. Notwithstanding that the transaction had no non-tax business purpose and did not meaningfully change the taxpayer's economic position, 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

---

13 *Id*. At 741

14 499 U.S. 554 (1991).

have envisioned a taxpayer deducting its loss under these circumstances. The timing of realization of gains and losses is to some extent arbitrary and within a taxpayer's discretion. The taxpayer's intentional realization of gains or losses from strictly tax-motivated transactions was therefore within the relevant statutory and regulatory intent.[15] Similarly in *Horn* v. *Commissioner*,[16] 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 for straddles undertaken by commodities dealers under Section 108(c) of the Deficit Reduction Act of 1984.

Although a finding that allowing a claimed tax benefit was not contemplated by the applicable provisions is a precondition for disallowance, that finding, standing alone, 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 positions."[17] As Judge Posner put it in

---

15 By contrast, in *ACM* v. *Commissioner*, 157 F.3d 231 (3d Cir. 1998), the taxpayer sought to obtain a tax benefit (deductible losses) under circumstances (the absence of any economic losses) where neither Congress not the Treasury intended to grant a loss deduction.

16 968 F.2d 1229 (D.C. Cir. 1992).

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

Yosha v. *Commissioner*,[18] in the course of affirming the Tax Court's disallowance of losses claimed in commodity straddles similar to those that led to the enactment of the straddle rules:

> 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 . . . [T]axpayers were entitled to take advantage of this curiously asymmetrical treatment of the different legs of a straddle before Congress eliminated the asymmetry. 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. . . . Straddles that involve no market risks are not economically substantial straddles and hedges; they are artifices created by accomplices in tax evasion, the brokers. And that is what the record discloses.

To summarize, 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 its disallows a tax benefits under the doctrine. First, the court finds that the taxpayer is seeking to obtain tax benefits in circumstances where Congress and/or the Treasury did not intend the benefits to be available. In other words, the tax benefits are ones that were not reasonably contemplated by the drafter of the relevant statute or regulation, but instead frustrate the relevant statutory or regulatory intent. Second, the court normally finds that the transaction lacked both business purpose and economic substance, based on

---

[18] 861 F.2d 444 (1998).

a finding that the transaction could have accomplished little more economically other than the alteration of the taxpayer's reported tax position.

III. <u>The Doctrine Needs to Be Flexible</u>

Currently, the economic substance and business purpose doctrines are rules of statutory interpretation—efforts to establish whether Congress intended that a provision of the Internal Revenue Code reach a particular result. As such, the doctrine is designed to separate abusive from non-abusive transactions. Whether abuse exists, however, cannot be determined apart from the facts of the particular case, the nature of the tax benefit sought, the legislative purpose in enacting the relevant provision of the Code, the way the provision relates as a structural matter to other relevant Code sections and the nature and extent of other relevant anti-abuse rules. Application of the rule needs to be sensitive to the nature of the provision of the Internal Revenue Code being construed. What is required by the doctrine to sustain tax-free reorganization treatment (a "business purpose," *Gregory* v. *Helvering*) is different and should be different from what is required to claim a deduction for personal interest (a meaningful non-tax effect, *Goldstein* v. *Commissioner*). We continue to believe courts are uniquely well suited to make these determinations and apply the correct standard in the particular situation before them.

Although decisions in particular cases may be questioned, on balance we believe that the courts are properly implementing the doctrine. In part, the apparent differences among courts in articulating the economic substance doctrine is linguistic and not substantive. In part, it is the variety of situations and laws (and not confusion about doctrine) that is reflected in the various judicial opinions that have been rendered in this area.

IV. The Jobs and Growth Reconciliation Tax and CARE Acts

The Acts seek to standardize the application of the economic substance doctrine for transactions other than personal transactions of individuals. With few exceptions,[19] a transaction would have economic substance only if a taxpayer established that (1) the transaction changes in a meaningful way (apart from Federal tax effects)[20] the taxpayer's economic position (2) the taxpayer has a substantial non-tax purpose for entering into the transaction,[21] and (3) the transaction is a reasonable means of accomplishing that purpose. The economic substance requirement cannot be satisfied, however, by reason of a transaction's having a potential for profit unless both (1) the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected tax benefits and (2) the reasonably expected pre-tax profit from the transaction exceeds a risk-free rate of return.[22] Finally,

---

19 The Acts apply special substance-over-form rules to certain financing transactions, and to artificial income and basis shifting transactions, with tax indifferent parties; and have a relaxed version of the economic substance rule for certain leases of tangible personal property.

20 If there are federal tax effects, foreign, state or local effects also are not relevant. This results in the peculiar situation that a transaction that has no effect other than reducing foreign (e.g., French) tax and increasing U.S. tax lacks economic substance.

21 Note that it appears that the objective of reducing foreign tax does not appear to be a legitimate non-tax purpose.

in determining pre-tax profit for this purpose, fees and foreign taxes are treated as expenses.

V. Problems with the Acts

The literal provisions of the Acts will have unwarranted and probably unintended effects on perfectly legitimate transactions. As the Acts specifically recognize for leasing transactions, not all legitimate transactions undertaken in order to make a profit will have **both** a pre-tax return greater than a risk-free return and a substantial non-tax business purpose. In addition, even if that test is met, the requirement that the means chosen to accomplish a particular business purpose be a "reasonable" means of accomplishing that purpose will introduce considerable uncertainty about common business transactions.

As written, the test would be applied to all sorts of transactions, not limited to those having recognized tax shelter indicia. Examples of non-tax shelter transactions that might fail under the test, but that most (if not all) tax practitioners would think perfectly legitimate, many of which have been approved by the IRS in rulings and

---

(... continued)

[22] The legislative history seems to imply that this limitation on potential for profit applies only in determining whether a transaction results in a meaningful change in the taxpayer's economic position, Senate Finance Committee Technical Explanation at 21. Nonetheless, literally and conceptually, the limitation would also seem to apply in determining whether the means used to accomplish a transaction undertaken for the purpose of making a profit was reasonable. If the objective is to make a profit, a means of making a profit would only be a reasonable means of making a profit if the means had the potential for making a profit. Similarly to prove that a taxpayer's purpose for undertaking a transaction actually was to make a profit, one generally would have to demonstrate that the transaction objectively had a potential for profit. In either case, the special rule for determining whether a transaction has a potential for profit would seem to apply.

other guidance, are listed in the attachment. These examples illustrate the basic problem — the economic substance doctrine is fundamentally an anti-abuse rule, and not all transactions that lack either a pre-tax return greater than a risk-free return or a substantial non-tax business purpose are abusive. It depends on the provision under consideration.

Some statutory credits and deductions are compensatory. They are designed to provide a tax benefit because the relevant class of income has otherwise been taxed. The inter-corporate dividends received deduction and the foreign tax credit are designed to limit the effects of double or triple taxation of income. It defeats the compensatory purpose of these allowances to require that inter-corporate dividends and income subject to foreign tax generate cash-on-cash returns greater than a risk free rate of return. Similarly, other credits and deductions, like the low-income housing credit and the energy credits, are designed to encourage or subsidize actions or investments that otherwise would be marginally profitable at best. In cases such as these, to require greater than a risk-free return on investment may defeat the effect of the subsidy and conflict with the Congressional purpose in granting the tax credit or deduction.

Finally, without extensive guidance—standards and/or numerous examples—it will often not be clear when a particular transaction is a reasonable means of accomplishing a particular result.

VI. Vague Phrases And Responsible Delegation

There is no easy fix for the problems identified in the examples. The key question is not what the test requires but when the test should be applied and to what aspects of any multi-faceted or multi-step transaction. Stating in the legislative history or even the legislation itself that the provision or the doctrine does not apply to transactions where the tax result is "clearly contemplated" by the tax law will do very little to help matters. Honest taxpayers will be confused and will clamor for guidance as to when a result is clearly contemplated by law. Aggressive promoters will seize on the phrase to claim that a result is clearly contemplated if it is the straightforward result of the technical application of the rules prescribed. Recall that the *ACM* case involved an attempt to apply the contingent installment sale basis recovery convention in a manner that was clearly set out in the regulations.

Leaving the matter for Treasury to interpret in regulations also is unlikely to be effective or fair. In the absence of extensive statutory or Congressional guidance (which neither the legislation or the legislative history provides), the legislation will cause significant uncertainty for honest taxpayers. Conversely, the very ambiguity of the requirements will encourage others to continue to interpret the tax law aggressively. Treasury will, of necessity, have to undertake an extensive regulatory project in crisis mode to reduce uncertainty and deter abuse. Draconian penalties will apply even in cases where taxpayers make good faith mistakes about the law. The prospect of these penalties will create a strong demand for guidance. This would be a mammoth effort that would require substantial resources. The effort would, in our view, divert resources from smaller, more targeted anti-abuse projects that we believe are likely to be more effective. The unacceptable alternative would be to leave common transactions subject to uncertainty for a long time.

The potential for significant disruption of legitimate economic activity can be seen, for example, in the reaction of the leasing industry to a small change, from the CARE Act to the Jobs and Economic Growth Tax Reconciliation Act, to the standard for determining when a lease has economic substance. In the legislative history of the provision delegating to the IRS the power to determine when a lease has "profit potential", there was a direction to IRS to apply the IRS guidelines for issuing advance rulings on leases in determining when a lease had "profit potential".[23] Unfortunately, almost no leases (good, bad or indifferent) currently conform to these guidelines. This hasty, ill-considered change, if not corrected, would materially limit the kinds of lease financing available (no leases with fixed-price lessee purchase options, for example) and increase the cost of capital for lessees. Yet, the leasing industry needs guidance, because lessors generally do not earn a cash-on-cash return (exclusive of tax benefits) greater than the risk-free rate of return. As the examples attached to this Report establish, however, leasing is not unique. Many industries and individuals face the same situation.

VII. Alternatives

The Tax Section continues to believe that strict liability penalties for tax deficiencies arising from tax shelters (however defined, recognizing that the definition will be both under and over inclusive) would be fairer, more effective and more administrable than codifying the economic substance doctrine. We note with approval that the pending legislation moves in the right direction in establishing a penalty regime

---

23 Senate Finance Committee Technical Explanation at 21.

having the potential to deter tax shelter abuse. Nonetheless, strict liability penalties are legitimate only if taxpayers have fair warning of what is prohibited. As proposed, the codification of the economic substance doctrine leaves so much uncertainty for taxpayers that we believe it would be unfair to impose strict liability penalties in these circumstances.

Second, instead of attempting to codify the amorphous and flexible rules of the economic substance doctrine, if Congress believes that aggressive tax advisers and taxpayers in structuring transactions are not giving proper weight to that doctrine or to other common law principles, or that (contrary to our view) courts have been unduly hesitant to apply common law rules, consideration should be given to adding a Code provisions along the following lines:

> "A literal application of any provision in this Title shall not be respected if such application would produce results that are inappropriate under the economic substance, business purpose, sham transaction, step-transaction or other common law principles as developed and interpreted by the courts."

As previously discussed, we believe that tax avoidance transactions are being structured principally not because of a lack of uniformity among the courts regarding the application of the economic substance doctrine, but rather because current law does not adequately disincentivize tax advisers and taxpayers from taking aggressive positions. A clear statement in the Code incorporating these doctrines by reference, coupled with enhanced disclosure and penalty regimes, would in our view be far more effective in curbing abuses, significantly less disruptive of legitimate, ordinary course transactions, and a more efficient use of regulatory resources than an attempt to codify the economic substance doctrine, leaving it to Treasury and the IRS to sort out the mess.

In addition, if properly drafted, the following substantive law changes would, in our preliminary view, which are included in the Acts, should help to limit tax shelter abuse[24]:

- A rule limiting the use by a corporation of built-in losses arising from the transfer in a Section 351 transaction of high-basis, low value property to the corporation
- A rule limiting the ability of a partnership to allocate a required reduction in the basis of partnership property to the stock of a partner held by the partnership.
- Repeal of the FASIT rules.
- Better coordination of the CFC and PFIC rules.
- A rule limiting the ability to generate losses by separating rights to income from property.
- A general anti-abuse rule limiting basis shifts involving tax-indifferent parties. The rule should apply in circumstances where the basis shift results from a plan having three elements: the creation of artificial basis through the allocation of income to a tax indifferent party, the use of that basis by a taxpayer, and distortion of the tax liability of the taxpayer.

VIII. Improvements

Although we oppose codification of the economic substance doctrine, we acknowledge the concern with tax shelters that underlies the proposed legislation. In light of that concern, we have outlined below certain changes which we feel would make

[24] We have not had the opportunity to study the precise form in which some of these proposals have been presented, and therefore do not comment on some of the many technical issues that may arise if they are implemented.

the provision more effective as a constraint on tax shelters while mitigating its adverse effect on planning for true business transactions.

- Profit Potential: The requirement that transactions have greater than a risk-free rate of return (after expenses and foreign taxes) should be eliminated and replaced, if at all, with a provision subjecting such transactions to greater scrutiny and/or a provision focusing on transactions without meaningful economic ***risk***.

- Effective Dates: The codification should be modified so as to apply only to those transactions (or classes of transactions) determined by the IRS to be properly within its scope, either by regulation or notice. This approach would enhance what we believe to be the IRS' most powerful anti-shelter weapon, the ability to "list" abusive transactions, by causing the listed transactions to be subject to special substantive scrutiny as well as tough disclosure and penalty rules. We believe this approach would have a serious impact on tax shelters. This would particularly be the case if the listing consequence applied even to transactions entered into prior to listing (with taxpayers having a right to avoid penalties by amending returns to forego the benefits of the shelter).[25] At the same time, it would minimize the impact on real transactions, especially if the legislative history makes it clear, with appropriate examples, that such transactions are not to be targeted. Once a transaction is "listed", the law should provide that a taxpayer would prevail in sustaining the tax benefits or other tax treatment claimed with respect to the listed transaction only if the benefits or treatment satisfied the economic substance test as codified or was "clearly contemplated" by the relevant statute in light of the history, purpose and structure of the rule being construed.

- Greater Guidance: The legislative history should be expanded to include examples of transactions and results that are clearly contemplated by the relevant statutory provisions and/or are not abusive. Treasury should be encouraged to expand this list. In particular, examples should illustrate reasonable means of accomplishing various business purposes. The legislative history should also clarify that the reasonable means requirement is to be applied to the transaction judged as a whole, and not to each particular step in a transaction. Parts of a transaction can only be assessed properly in light of the whole.

[25] We believe, however, that the new provision should not apply to transactions entered into prior to the effective date of the statutory change.