[JOINT COMMITTEE PRINT]

APPENDIX II TO JCX-82-99:

DESCRIPTION AND ANALYSIS OF PRESENT-LAW TAX RULES AND RECENT PROPOSALS RELATING TO CORPORATE TAX SHELTERS

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of the

JOINT COMMITTEE ON TAXATION

November 10, 1999

JCX-84-99

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), contains a detailed description of the present-law corporate tax shelter provisions and a description and analysis of recent corporate tax shelter proposals. The tax shelter proposals that the Joint Committee staff analyzes are (1) the Department of the Treasury's corporate tax shelter proposals,[2] as amended by its "White Paper,"[3] (2) the *Abusive Tax Shelter Shutdown Act of 1999*,[4] and (3) the Joint Committee staff recommendations relating to corporate tax shelters.[5]

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Present-law Tax Rules and Recent Proposals Relating to Corporate Tax Shelters* (JCX-84-99), November 10, 1999.

[2] *General Explanations of the Administration's Revenue Proposals*, Department of the Treasury, February 1999.

[3] The *White Paper: The Problem of Corporate Tax Shelters (Discussion, Analysis and Legislative Proposals)*, Department of the Treasury, July 1999 ("White Paper").

[4] H.R. 2255, 106th Cong., 1st Sess. (June 17, 1999).

[5] Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999.

I. OVERVIEW

The Treasury Department, Congressman Doggett (on his own behalf and on the behalf of several members of Congress), and the Joint Committee staff each have independently developed proposals to address abusive tax shelter transactions.[6] These three proposals share certain common premises: tax shelter activity (particularly that engaged in by corporations) poses a serious threat to the efficacy of the tax system; the trend with respect to the level of corporate tax shelter activity is increasing; and present law does not adequately address this problem.

The three proposals under consideration each take different approaches for addressing the tax shelter problem. Each approach has its own merits and flaws. Although the Joint Committee staff believes that certain of these proposals may be more effective than others in addressing tax shelter activity, the Joint Committee staff further believes that many of the specific criticisms raised herein with respect to any particular proposal could be addressed as part of the legislative process.

The most important difference in approach among the three proposals is whether they would change substantive law. A major component of both the revised Treasury proposal and H.R. 2255 is that these proposals would change substantive law by generally codifying some form of an economic substance doctrine. The Joint Committee staff recommendations would not change substantive law. While a substantive law change may be an effective means for addressing tax abuse, it may be difficult under such a rule to distinguish legislatively between legitimate business activity and improper tax avoidance. All three proposals include enhanced penalty and disclosure regimes; enhanced penalties and disclosure, however, are the essence of the Joint Committee staff recommendations.

There are many other issues with respect to each corporate tax shelter proposal, some of which are discussed below. The fundamental question remains which approach is the most appropriate response given the extent of the corporate tax shelter problem on the one hand, and the need for certainty in the Code in order to avoid disrupting legitimate business activity on the other. The approaches under consideration range from a codification of a heightened economic substance doctrine such as that of H.R. 2255 (and to a lesser extent, the revised Treasury proposal) to enhancing the present-law penalty regime such as that of the Joint Committee staff

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[6] See the *General Explanations of the Administration's Revenue Proposals,* Department of the Treasury (February 1999), as revised by *The White Paper: The Problem of Corporate Tax Shelters (Discussion, Analysis and Legislative Proposals),* Department of the Treasury (July 1999) (the "revised Treasury proposal"); the *Abusive Tax Shelter Shutdown Act of 1999*, H.R. 2255, 106th Cong., 1st Sess.; and Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) (July 22, 1999) (the "Joint Committee staff recommendations").

recommendations. Once the determination of the approach is made, the Joint Committee staff believes the many of the other issues raised could be addressed through refinements to the proposals.

This pamphlet includes a description of present law relating to corporate tax shelters. It then includes a summary and detailed analysis of the revised Treasury proposal, H.R. 2255, and the Joint Committee staff recommendations.

II. PRESENT LAW RELATING TO CORPORATE TAX SHELTERS

A. Application of Present Law to Corporate Tax Shelters

Under present law, there is no clear, uniform standard as to what constitutes a corporate tax shelter; however, there are a number of statutory provisions and judicial doctrines that attempt to police corporate transactions in which a significant purpose is the avoidance or evasion of Federal income tax. Additionally, the Code itself defines corporate tax shelters in a variety of contexts.[7]

1. <u>Statutory provisions limiting tax benefits in connection with tax shelters</u>

a. <u>Section 269</u>

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the "Secretary") has the authority to disallow the resulting benefits. The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before the acquisition, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is <u>not</u> made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

Because "tax shelter" transactions sometimes involve securing the benefits of deductions, credits, or other allowances that would not have otherwise been available to the tax shelter participants, to the extent that the transaction involved is of the type described above, section 269 may apply to deny the anticipated tax benefits.

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[7] Section 6662(d)(2)(C)(iii) defines a tax shelter for purposes of the understatement penalty (see definition below); section 6111(a) imposes a registration requirement with respect to certain tax shelters (see definition below); section 461(i)(3) defines a tax shelter for purposes of certain tax accounting rules as (1) an enterprise (other than a C corporation), the interests in which have been offered for sale in an offering required to be registered with a Federal or State securities agency, (2) a syndicate (a partnership or other entity, other than a corporation that is not an S corporation, if more than 35 percent of the losses of the entity are allocable to limited partners or limited entrepreneurs), and (3) a tax shelter (as defined in section 6662(d)(2)(C)(iii)); section 448(d)(3) generally adopts the section 461(i)(3) definition of a tax shelter for purposes of limiting the application of the cash method of accounting.

b. Section 446

Section 446(b) provides that if a taxpayer's method of accounting does not clearly reflect income, taxable income shall be computed under the method that, in the opinion of the Secretary, does clearly reflect income. The Secretary has broad discretion to determine whether a method of accounting clearly reflects income.[8] As the Tax Court in ACM v. Commissioner observed, "a taxpayer's method of accounting does not clearly reflect income when it does not represent 'economic reality.'"[9] Thus, to the extent that a corporate tax shelter involves deferrals of income or acceleration of deductions or basis recovery, or otherwise involves methods of accounting, the Secretary may employ section 446 as a substantive means to modify the taxpayer's method of accounting in order to clearly reflect income.

c. Section 482

Section 482 provides that when two or more entities are controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among the entities in order to prevent the evasion of taxes or to reflect clearly the income of an entity. The Internal Revenue Service ("IRS") may assert section 482 as authority to counteract tax shelters that involve the misallocation of income among different business entities.

In order to apply section 482 with respect to corporate tax shelters, the transaction in question must involve transfers between or among "two or more entities . . . controlled . . . by the same interests . . . ."[10] However, the IRS has adopted a broad interpretation of what it means to be controlled for this purpose. Acting in concert to avoid taxes may cause two unrelated entities to be considered part of the same controlled group.[11]

Three recent Field Service Advice Memoranda addressing certain lease stripping transactions illustrate the IRS's use of section 482 as a substantive rule in connection with transactions for which the IRS also raised the sham transaction and economic substance doctrines

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[8] Thor Power Tool v. Commissioner, 439 U.S. 522, 531 (1979); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Ferrill v. Commissioner, 684 F.2d 261, 263 (3d Cir. 1982).

[9] ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, 2214 (1997) (dictum) (citing Prabel v. Commissioner, 882 F.2d 820, 826-27 (3d Cir. 1989)), aff'd in part and reversed in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 1999 U.S. LEXIS 1899 (Mar. 22, 1999).

[10] Sec. 482.

[11] Treas. Reg. sec. 1.482-1(i)(4).

(discussed below).[12] Hence, in certain circumstances section 482 may provide the IRS with a statutory mechanism for addressing corporate tax shelter activity.

d. Section 7701(*l*)

Section 7701(*l*) provides: "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent [the] avoidance of . . . tax . . . ." The subsection authorizes Treasury to prescribe regulations to deal generally with complicated, tax-motivated lending transactions that lack economic substance.[13] On January 6, 1999, the IRS proposed regulations pursuant to section 7701(*l*) to eliminate the abuse of "step down" or "fast pay" preferred stock (discussed in greater detail below).[14] Earlier, the IRS proposed regulations to deal with lease stripping transactions, which are intended to allow one party to realize income from a lease and another party to report depreciation deductions related to that income, and issued final regulations dealing with certain conduit financing arrangements.[15] Hence, the authority granted under section 7701(*l*) provides the IRS with yet another means to address certain corporate tax shelter arrangements involving financing transactions.

2. Judicial doctrines applicable to tax shelters

a. Overview

In addition to the statutory provisions discussed above, over the years the courts have developed several doctrines to deny certain tax-advantaged transactions their intended tax benefits. These doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. There is considerable overlap among the doctrines, and typically more than one doctrine is likely to apply to a transaction. Because of these ambiguities, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, the doctrines provide a useful tool under present law to police, at a minimum, the most egregious tax shelter abuses.[16]

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[12] Field Service Advice Memoranda 199920012 (May 21, 1999), 199914018 (Apr. 12, 1999), and 199909005 (Mar. 8, 1999).

[13] See, e.g., Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971).

[14] Prop. Treas. Reg. sec. 1.7701(*l*)-3.

[15] Prop. Treas. Reg. sec. 1.7701(*l*)-2; Treas. Reg. sec. 1.881-3.

[16] See, e.g., ACM v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997).

The Supreme Court has made it clear that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."[17] When a taxpayer, however, "crosses the line" such that what was done, apart from tax motive, was not the thing which the statute intended, the tax advantage should be denied.[18] The general doctrines used to deny such tax benefits are (1) the sham transaction doctrine, (2) the economic substance doctrine, (3) the business purpose doctrine, (4) the substance over form doctrine, and (5) the step transaction doctrine.[19]

b. Sham transaction doctrine

Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions"[20] and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent.

At a minimum, the sham transaction doctrine can be said to apply to a "sham in fact." For example, where a taxpayer purported to buy Treasury notes for a small down payment and a financing secured by the Treasury notes in order to generate favorable tax benefits, but neither the purchase nor the loan actually occurred, the court applied the sham transaction doctrine to deny the tax benefits.[21]

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[17] Gregory v. Helvering, 293 U.S. 465, 469 (1935), aff'g 69 F.2d 809 (2d Cir. 1934). In the lower court opinion with respect to this case, Judge Learned Hand stated this concept another way: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d at 810.

[18] Gregory, 293 U.S. at 469.

[19] The Gregory case is often cited as the seminal case with respect to several of these doctrines, especially the sham transaction, economic substance, and business purpose doctrines. For a general discussion of these doctrines, see Alvin C. Warren, Jr., The Requirement of Economic Profit in Tax Motivated Transactions, 59 Taxes 985 (1981), and David P. Hariton, Sorting Out the Tangle of Economic Substance, 52 Tax Law. 235 (1999).

Although many of the cases raising these doctrines deal with individual tax shelters, they also have applied in the corporate context. See, e.g., ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189; ASA Investerings v. Commissioner, 76 T.C.M. (CCH) 325 (1998).

[20] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds).

[21] See Goodstein v. Commissioner, 267 F.2d 127, 131 (1st Cir. 1959). In ASA Investerings, the Tax Court disallowed losses on the grounds that the taxpayer and the foreign bank in the transaction never actually entered into the purported partnership which was formed to

Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, if a transaction is entered into to generate loss for the taxpayer, and the taxpayer actually has risk with respect to the transaction, but that risk has been eliminated through a guarantee by a broker that the broker will bear the market risk and that the only consequences to the taxpayer will be the desired tax benefits, such transaction may be found to be "in substance" a sham.[22]

Finally, as discussed above, the delineation between this doctrine (particularly as applied to shams "in substance") and the "economic substance" and the "business purpose" doctrines (both discussed below) is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" notwithstanding that the purported activity did actually occur.[23]

c. Economic substance doctrine

(i) In general

The courts generally will deny claimed tax benefits where the transaction giving rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity did actually occur. The Tax Court recently described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[24]

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in Gregory v. Helvering.[25]

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effectuate the transaction, implicitly applying the sham transaction doctrine.

[22] See, e.g., Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (holding options straddles to be shams because the broker insured the clients against market risk).

[23] See United States v. Wexler, 31 F.3d 117, 124 (3d Cir. 1994). In Wexler, the promoter of a tax shelter was brought up on criminal fraud charges. In the jury instructions, the court blurred the distinction between sham transactions and transactions having no business purpose or lacking economic substance.

[24] ACM, 73 T.C.M. at 2215.

[25] 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934).

In Gregory, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

> [T]he 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 shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."[26]

Since the time of Gregory, several cases have denied tax benefits on the grounds that the subject transactions lacked economic substance.[27] The economic substance doctrine can apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential (i.e., where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.[28] In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine whether the transactions had "purpose, substance or utility apart from their anticipated tax consequences."[29]

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[26] Gregory, 69 F.2d at 811.

[27] See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance); Sheldon v. Commissioner, 94 T.C. 738 (1990) (holding that a marginally profitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance, and imposing penalties); Ginsburg v. Commissioner, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacks economic substance).

[28] See Goldstein v. Commissioner, 364 F.2d 734, 739-40 (2d Cir. 1966) (disallowing deduction even though taxpayer has a possibility of small gain or loss by owning T-bills); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[29] Goldstein, 364 F.2d at 740. Even this articulation of the economic substance doctrine will fall short in its application to some sets of facts. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. See, e.g., Cottage Savings v. Commissioner, 499 U.S. 554 (1991) (allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages); Doyle v. Commissioner, 286 F.2d 654 (7th Cir. 1961). In Doyle, the IRS argued that the taxpayer's use of a straddle to recognize loss on its stock without taking itself out of its

(ii) Modern application in corporate context

Four recent court cases illustrate the modern application of the economic substance doctrine in the corporate context. The four cases are ACM Partnership v. Commissioner,[30] United Parcel Service of America, Inc. v. Commissioner[31] ("UPS"), Compaq Computer Corp. v. Commissioner,[32] and Winn-Dixie Stores, Inc. v. Commissioner.[33]

(a) The *ACM* case

The ACM case involved an intricate plan designed to create losses where the offsetting gains would escape U.S. taxation. Colgate-Palmolive Company had reported a sizeable capital gain in 1988 (approximately $105 million) from its sale of a subsidiary. Colgate wanted to avoid or minimize paying Federal income tax on that gain.[34] The transaction at issue was designed for that purpose: i.e., to avoid ever paying tax on a realized gain.[35] The transaction originated with a proposal that Merrill Lynch presented to Colgate in 1989 involving the formation of a partnership with a foreign bank and utilization of special ratable basis recovery rules under the section 453 regulations in connection with the purchase and sale of short-term securities.

Under the proposed transaction, a partnership would be formed in which a foreign bank would hold a substantial interest. The partnership would buy short-term securities and shortly thereafter sell them for the same price. The consideration for the sale would be approximately 70 percent cash and the remaining amount in installment notes that would provide for six semiannual payments equal to a notional principal amount multiplied by the London Interbank Offering Rate ("LIBOR").[36] These installment notes would be considered as contingent and, therefore, would fall within the special ratable basis recovery rule under the section 453 regulations, which provide:

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ownership in the stock lacked economic substance; held: the transactions were at arm's length and, therefore, bona fide so that the losses were allowed under section 165.

[30] 157 F.3d 231 (3d Cir. 1998), aff'g 73 T.C.M. (CCH) 2189 (1997).

[31] 1999 Tax Ct. Memo LEXIS 304 (Aug. 1999).

[32] 113 T.C. No. 17 (Sept. 1999).

[33] 113 T.C. No. 21 (Oct. 19, 1999).

[34] ACM, 73 T.C.M. at 2191.

[35] See Richard M. Lipton, Tax Opinions for Corporate Tax Shelters, 148 J. Tax'n 331, 334 (1997).

[36] ACM, 73 T.C.M. at 2191.

> when a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.[37]

The result of the approach would be a large gain in the first year that would be allocated almost entirely to the foreign bank (with no U.S. tax consequences to the foreign bank). The foreign bank's interest in the partnership would then be redeemed. Losses would be created in subsequent years that would almost entirely be allocated to Colgate and which could be carried back to offset its capital gain from the sale of its subsidiary.

Colgate initially had reservations with respect to Merrill Lynch's proposal because it did not seem to serve Colgate's business purposes.[38] However, Colgate became interested in using the partnership to invest in its own debt in order to rebalance its debt portfolio.[39] Colgate's debt acquisition objectives were then incorporated into the tax reduction strategy.

To accomplish its goal, in November 1989, Colgate (through a subsidiary) formed a partnership ("ACM") with a subsidiary of ABN, N.V. (a foreign bank), and a subsidiary of Merrill Lynch. Each partner contributed cash. At the outset, ABN held an 82.6 percent interest in the partnership, Colgate held a 17.1 percent interest and Merrill Lynch a 0.3 percent interest. The total contributions to the partnership were $205 million.

At the end of November 1989, ACM paid $205 million to purchase floating-rate notes that were paying interest at a rate that was only three basis points above the rate the funds were already earning in deposit accounts. The interest rates on the floating-rate notes were scheduled to reset only once a month, and ACM had prearranged to dispose of the notes in a 24-day period encompassing only one interest rate adjustment and virtually guaranteeing that ACM would have no real exposure to interest rate or principal value fluctuations with respect to the notes.[40] Twenty-four days later, ACM sold $175 million of the floating-rate notes in exchange for $140 million in cash plus LIBOR notes worth an estimated $35 million.[41] Colgate alone bore virtually all of the approximately $5 million in transaction costs.

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[37] Temp. Treas. Reg. sec. 15A.453-1(c)(3)(i).

[38] ACM, 73 T.C.M. at 2191.

[39] Id. at 2192.

[40] ACM, 157 F.3d at 250 and n.35.

[41] In several transactions in December 1989, proceeds of the sale were used to purchase outstanding Colgate debt.

With respect to the $175 million of notes sold in 1989, pursuant to Temporary Regulation section 15A.453-1, ACM recovered only $29 million of its basis and therefore reported a $111 million capital gain, most of which was allocated to the foreign partner that was not subject to U.S. tax.[42]

In 1991, pursuant to a preconceived plan, Colgate purchased part of ABN's interest in ACM, and ACM redeemed the remainder of ABN's interest, leaving Colgate with a 99.7 percent interest. Subsequent to redeeming the foreign partner (and pursuant to the same plan), ACM sold the LIBOR notes for $11 million, recognizing a capital loss of $85 million under Temporary Regulation section 15A.453-1(c). Virtually all of this loss was allocated to Colgate. Hence, if given effect for tax purposes, the transaction would have generated a capital loss producing a tax refund for Colgate (after carryback to offset its capital gain from the sale of its subsidiary) and an offsetting capital gain that escaped U.S. taxation.

Both the Tax Court and the Court of Appeals for the Third Circuit held that the transaction lacked economic substance. The Third Circuit held that "both the objective analysis of the actual economic consequences of ACM's transactions and the subjective analysis of their intended purposes support the Tax Court's conclusion that ACM's transactions did not have sufficient economic substance to be respected for tax purposes."[43] The court observed that the economic substance doctrine can apply equally to "shams in substance" as "shams in fact" and that even when the purported activity in the transaction actually occurs, the transaction may be disregarded when (other than tax consequences) the transaction results in "no net change in the taxpayer's economic position."[44] In other words, as an objective matter, to be respected for tax purposes, a transaction must have practical economic effects other than the creation of tax losses.[45] The court found that there was "a lack of objective economic consequences arising from ACM's offsetting acquisition and virtually immediate disposition of the [floating-rate] notes. . . . we find that these transactions had only nominal, incidental effects on ACM's net economic position."[46]

The court stated that economic substance is a prerequisite to sustaining a transaction:

> In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss, which,

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[42] ACM, 73 T.C.M. at 2213.

[43] ACM, 157 F.3d at 248.

[44] Id. at 248.

[45] Id.

[46] Id. at 250.

> as the Tax Court found, is "not economically inherent in" the transaction. 73 T.C.M. at 2215. . . . Based on our review of the record regarding the objective economic consequences of ACM's short-swing, offsetting investment in and divestment from the [floating-rate] notes, we find ample support for the Tax Court's determination that ACM's transactions generated only "phantom losses" which cannot form the basis of a capital loss deduction under the Internal Revenue Code.[47]

Finally, in addition to finding that the transaction lacked objective economic substance, the court held that to be respected for tax purposes, a transaction must have, and the ACM transaction did not have, a subjective nontax objective. In short, the court held that a transaction must have sufficient objective economic substance and subjective business motive to be respected for tax purposes, and the ACM transaction lacked both.[48]

(b) The *UPS* case

The UPS case involved the determination of whether UPS should have reported as income certain premiums it collected from its customers. UPS charged these premiums, known as excess value charges ("EVCs"), to insure any package with a declared value of more than $100. Prior to 1984 (the tax year in question), UPS reported the EVCs as income, and claimed a deduction for the insurance claims it paid to customers.

In 1983, UPS formed an offshore subsidiary, Overseas Partners Ltd ("OPL"), a Bermuda corporation, and thereafter distributed the OPL stock to UPS's employee-shareholders. UPS also entered into an insurance arrangement with National Union Fire Insurance ("NUF"), an unrelated domestic insurer. Under the UPS-NUF insurance arrangement, UPS would collect and remit to NUF the EVCs (less any insurance losses paid). UPS also would administer all claims on behalf of NUF and be responsible for all bad debts or uncollectible items. In December 1983, NUF and OPL entered into a reinsurance contract whereby NUF was required to remit to OPL 100 percent of what NUF receives from UPS less (1) a commission (not to exceed $1 million) and (2) certain allowances to cover expenses. The reinsurance agreement could not be terminated by either party so long as the UPS-NUF insurance arrangement remained in effect; however, the termination of the UPS-NUF arrangement resulted in a simultaneous termination of the reinsurance contract.

For tax year 1984, UPS did not include the EVCs as income, nor did UPS claim a deduction for the amounts it remitted to NUF. Because OPL was not a controlled foreign

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[47] Id. at 252.

[48] The IRS has assessed deficiencies in two other cases involving similar facts. See ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305 (August 20, 1998) and Saba Partnership v. Commissioner, T.C. Memo. 1999-359 (October 27, 1999).

corporation,[49] the premium income earned by OPL was not subject to U.S. tax until the income was repatriated. Thus, if respected for tax purposes, the arrangement would have allowed UPS to defer paying tax on the income attributable to the EVCs.

The Tax Court concluded that the arrangement UPS had with NUF and OPL lacked economic substance and had no business purpose other than to confer tax-free benefits to UPS's and OPL's shareholders. Under the assignment of income doctrine, the income attributable to the EVCs properly belonged to UPS.[50] The court's conclusion was based in part on the fact that, under the arrangement, NUF bore no risk or exposure to loss.[51] Furthermore, UPS continued to perform the same functions and activities related to the EVCs, and bore the same economic risks, as it did prior to the arrangement. Thus, "[t]he difference between petitioner's EVC activity before and after January 1, 1984, was that after that date it remitted the excess of EVC revenues over claims paid, i.e., gross profit, to NUF, which, after subtracting relatively small fronting fees and expenses, paid the remainder to OPL, which was essentially owned by petitioner's shareholders."[52] UPS failed to prove that the arrangement was motivated by nontax business reasons or that it had economic substance; the court concluded that the arrangement was a sham transaction.[53]

(c) The *Compaq* case

The Compaq case involved a variation of what is commonly referred to as a "dividend strip" transaction. In such a transaction, a corporate purchaser acquires dividend-paying stock of a corporation immediately before the corporation declares a dividend. The purchase price reflects the value of the expected dividend (because the corporate purchaser is entitled to the dividend). Immediately following the declaration of the dividend, the corporate purchaser sells the dividend-paying stock for less than its purchase price (because the subsequent purchaser buys the stock "ex dividend," or without entitlement to the declared dividend). Though the corporate purchaser has ordinary income from the dividend and a capital loss from the stock sale, the tax

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[49] Because UPS was a privately-held corporation, the shareholders of OPL were essentially the same as the UPS shareholders. In addition, restrictions applied to the transfer of OPL stock.

[50] Because the court viewed the case as an assignment of income issue, it did not reach the issue of whether an allocation must be made under sections 482 or 845. UPS, 1999 Tax Ct. LEXIS 304 at *114, n.59.

[51] Id. at *65.

[52] Id. at *68.

[53] In addition to requiring UPS to pay tax on the income, the court denied UPS's claimed deduction for the amount it paid to the unrelated insurance company. The court also upheld the imposition of a negligence penalty, a substantial understatement penalty, and the increased interest rate applicable in tax motivated transactions.

consequences from the dividend income typically are offset by other aspects of the transaction and tax benefits can be created. In the Compaq case, the tax benefit was the availability of foreign tax credits.

Much like the taxpayer in the ACM case, the impetus for Compaq's investment was a desire to generate artificial losses to offset capital gain it had recognized earlier in the year.[54] To accomplish this, on September 16, 1992, Compaq instructed its broker to purchase 10 million shares of American Depository Receipts ("ADR") in Royal Dutch Petroleum[55] in 23 separate transactions (of approximately 450,000 ADRs) with special "next day" settlement terms. The broker was further instructed to sell the Royal Dutch Petroleum ADRs, and that each purchase and sale be completed before executing the next purchase trade. The sale transactions, however, used the standard five-day settlement period.

Due to the different settlement rules, while all 23 purchase and resale transactions were completed within one hour, Compaq was the shareholder of record of 10 million shares of Royal Dutch ADRs as of September 18, 1992, and thus became entitled to receive a dividend of $22,545,800. The dividend was subject to a 15 percent withholding rate under the United States-Netherlands Tax Treaty, resulting in a foreign tax payment of $3,382,050. Compaq claimed this amount as a foreign tax credit.

The Tax Court disallowed the foreign tax credit, finding that there was no business purpose for the transaction apart from obtaining the foreign tax credits effectively to offset the previously recognized capital gain.[56] The court's conclusion was based in part on the fact that, under a cash flow analysis, the taxpayer would have incurred a prearranged economic loss but for the tax credits. The court also cited the taxpayer's lack of due diligence and investigation as evidence of a lack of business purpose.[57]

(d) The *Winn-Dixie* case

The Winn-Dixie case considered whether Winn-Dixie was entitled to deduct interest expenses and program administrative fees associated with a leveraged corporate-owned life

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[54] In 1992, Compaq sold its stock holdings in another computer company and recognized long-term gain of $231 million.

[55] An American Depository Receipt, or ADR, is a trading unit issued by a trust, which represents ownership of stock in a foreign corporation that is held by the trust. On the domestic exchanges, ADRs are the customary form of public trading of equity interests in foreign corporations.

[56] The IRS has sustained assessed deficiencies in another case involving similar facts. See IES Indus., Inc. v. Commissioner, N.D. Iowa, No. C97-206 (Sept. 22, 1999).

[57] The court upheld the imposition of an accuracy-related penalty under section 6662 attributable to the taxpayer's negligence.

insurance ("COLI") program. Under the program, Winn-Dixie purchased life insurance policies on approximately 36,000 of its employees. In order to help fund the premiums required under the policies, Winn-Dixie systematically borrowed against the cash surrender value of such policies. The net pre-tax profit or loss of the program consisted of the cash surrender value of the policies plus any death benefits received, reduced by (1) the annual premiums paid, (2) the accrued interest on the policy loans, and (3) administration fees. The projections relating to the COLI program indicated that Winn-Dixie would sustain a pre-tax loss (but an after-tax profit) for every year the plan remained in effect (projected for 60 years). The cumulative 60-year projections indicated that Winn-Dixie would sustain an aggregate pre-tax loss of approximately $682 million but would also receive an aggregate after-tax profit in excess of $2 billion. The difference between the pre-tax and after-tax effects was attributable to the income tax savings that would result from deducting the interest and, to a lesser extent, the administrative fees.

For the tax year ending June 30, 1993 (the only tax year at issue in the case), Winn-Dixie claimed deductions of $3,735,544 for accrued interest on the COLI policy loans and $100,000 for fees related to the administration of the COLI policies. The IRS disallowed these deductions on the basis that the COLI program was tax motivated, unsupported by any independent business purpose, lacked economic substance, and a sham in substance.

Winn-Dixie argued that the policies conceivably could produce tax-independent benefits in the case where some catastrophe were to occur that would produce large, unexpected death benefits. The court felt that such a possibility was so improbable as to be unrealistic and therefore had no economic significance. The court noted that the insured persons were of various ages and lived in diverse locations, making the chances of a common catastrophe more remote.

Winn-Dixie argued that a lack of economic substance should not warrant disallowance of the interest deductions because such deductions were specifically sanctioned by Congress as indicated by the safe harbor test of section 264 and its related legislative history. This legislative history suggests that Congress condones interest deductibility on COLI products that satisfy the requirements of section 264. Winn-Dixie maintained that its COLI policies constituted life insurance contracts within the meaning of section 7702 and its pattern of borrowing from the policies satisfied the "four-of-seven test" of section 264(c)(1), and therefore, the related interest expense is deductible. While both the IRS and Winn-Dixie agreed that the COLI program met the "four-of-seven test," the court found that section 264 does not confer the right to a deduction but simply denies, disallows, or prohibits deductions that might otherwise be allowable under some other provision, such as section 163.

The court held that the transactions associated with Winn-Dixie's COLI program lacked both economic substance and business purpose (other than tax reduction). As a result, the interest accrued with respect to the COLI policy loans was not deductible interest within the meaning of section 163. The court applied a similar reasoning to deny a deduction for the COLI program administrative fees.

(iii) Special application: leasing transactions

A line of authorities has developed addressing economic substance (and, as discussed below, business purpose) specifically in connection with leasing transactions. The focus with respect to leasing transactions (particularly leveraged leases and sale-leaseback transactions) is who should be entitled to the benefits of tax ownership such as depreciation deductions.

The determination of tax ownership sometimes overlaps with the determinations of whether the transactions have economic substance and business purpose. The Supreme Court articulated the standard as follows: "where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."[58] The Fourth Circuit has interpreted Frank Lyon to require a two-prong analysis with respect to sale-leaseback transactions: namely, the court "must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."[59] In analyzing the economic substance of a leasing transaction, the Tax Court found that economic substance was not supported where the discounted present value of the future rental income and sale proceeds would be less than the present value of the amount expended by the investors.[60]

In addition to its application by the courts, economic substance is a component of the guidelines that were adopted in 1975 by the IRS for advance ruling purposes with respect to determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes.[61] The guidelines require that the lessor represent and demonstrate that it expects to receive a profit, apart from the value of or benefits obtained from tax deductions, allowances, credits, and other tax attributes arising from such transaction.

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[58] Frank Lyon Co. v. Commissioner, 435 U.S. 561, 583-84 (1978).

[59] Rice's Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985).

[60] Hilton v. Commissioner, 74 T.C. 305, 353 n.23 (1980), aff'd 671 F.2d 316, 317 (9th Cir. 1982). The Tax Court arrived at the present value using a six-percent discount rate found in the estate tax regulations for purposes of making actuarial valuations. Although affirmed on appeal, the Ninth Circuit observed that the six-percent rate was illustrative only and that no suggestion of a minimum required rate of return is intended. See also Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976). In Estate of Franklin, property was overvalued when acquired by the lessor, and the lessor had no reasonable expectation of a residual value, so the court held that the lessor had no depreciable investment in the property and the nonrecourse debt was not true debt.

[61] Rev. Proc. 75-21, 1975-1 C.B. 715.

d. Business purpose doctrine

Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham transaction and economic substance doctrines is the business purpose doctrine. Although numerous authorities apply this doctrine in the context of individuals or partnerships, as the discussion above with respect to ACM makes clear, the doctrine equally applies in the corporate context. Additionally, the doctrine is not limited to cases where the relevant statutory provisions by their terms require a business purpose or profit potential.[62]

In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance.[63] In essence, a transaction will only be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[64]

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful nontax purpose.[65] Finally, where appropriate, the court may bifurcate a transaction in which independent activities with nontax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction.[66] Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect to the particular tax-motivated activities.

e. Substance over form doctrine

The concept of the substance over form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. For instance, two transactions that

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[62] ACM, 157 F.3d at 253; Goldstein, 364 F.2d at 736; Wexler, 31 F.3d at 122.

[63] Rice's Toyota World, 752 F.2d at 91.

[64] Frank Lyon Co., 435 U.S. at 561. Cf. Esmark v. Commissioner, 90 T.C. 171, 198 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989) (not disregarding steps of a transaction where, for example, a tender offer was not a "'mere device' having no business purpose").

[65] See e.g., Rice's Toyota World, 752 F.2d at 89; ACM, 157 F.3d at 231; Peerless Indus. v. Commissioner, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[66] ACM, 157 F.3d at 256 n.48.

achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The Supreme Court has found that a "given result at the end of a straight path is not made a different result because reached by following a devious path."[67] However, many areas of income tax law are very formalistic and, therefore, it is often difficult for taxpayers and the courts to determine whether application of the doctrine is appropriate.

While tax cases have been decided both ways, the IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.[68] In National Alfalfa Dehydrating & Mill & Co., the Supreme Court ruled as follows:

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not.[69]

The IRS has published administrative guidance that applies the substance over form doctrine in a variety of contexts.[70] Taxpayers and tax practitioners apply these pronouncements, as well as certain favorable court cases, as an exception to the general rule that taxpayers are bound by their chosen form.

f. Step transaction doctrine

An extension of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such

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[67] Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

[68] Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); In the matter of: Insilco Corporation v. United States, 53 F.3d 95 (5th Cir. 1995).

[69] Commissioner v. National Alfalfa Dehydrating & Mill Co., 417 U.S. 134, 149 (1974). See also Higgens v. Smith, 308 U.S. 473, 477 (1940).

[70] See Rev. Rul. 78-397, 1978-2 C.B. 150, Rev. Rul. 83-142, 1983-2 C.B. 68, and Rev. Rul. 80-154, 1980-1 C.B. 68 (disregarding circular cash flows in transactions); Rev. Rul. 73-427, 1973-2 C.B. 301 (viewing a reverse subsidiary merger as a taxable stock purchase); Rev. Rul. 67-274, 1967-2 C.B. 141 (treating "B" reorganization followed by liquidation of acquired corporation as a "C" reorganization); Rev. Rul. 68-602, 1968-2 C.B. 135 (not respecting contribution of debt from a creditor-shareholder to a debtor-subsidiary for purposes of determining whether the subsidiary is eligible for tax-free liquidation).

steps are in substance integrated, interdependent, and focused toward a particular result."[71] The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end result test, (2) the interdependence test, and (3) the binding commitment test.

The end result test is the broadest of the three articulations. The end result test examines whether it is apparent that each of a series of steps are undertaken for the purpose of achieving the ultimate result.[72] The interdependence test attempts to prove that each of the steps were so interdependent that the completion of an individual step would have been meaningless without the completion of the remaining steps. The binding commitment test is the narrowest of the three articulations and looks to whether, at the time the first step is entered into, there is a legally binding commitment to complete the remaining steps.[73]

In determining whether to invoke the step transaction doctrine, the courts have looked to two primary factors: (1) the intent of the taxpayer,[74] and (2) the temporal proximity of the separate steps. If a taxpayer can provide evidence that at the time the first of a series of steps was undertaken, there was no plan or intention to effect the other steps, then the transactions should not be stepped together. An important factor that supports a taxpayer's lack of intent is found where subsequent steps are prompted by external, unexpected events that are beyond the taxpayer's control. Where there is no legally binding commitment to engage in subsequent steps after undertaking the initial transaction, the span of time between the events is an important measure in determining whether the transactions should be stepped together. A significant lapse of time between a series of transactions should prevent the application of the step transaction doctrine.[75]

The step transaction doctrine may not be invoked in all cases, irrespective of the taxpayer's intent or the temporal relationship of the separate steps. Aside from a case involving a legally binding agreement,[76] if each of a series of steps has independent economic significance, the transactions should not be stepped together.[77] Also, the courts have not permitted the application of the step transaction doctrine if its application would create steps that never actually

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[71] Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).

[72] King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).

[73] Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

[74] McDonalds Restaurants of Ill. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).

[75] Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989) (by implication); Martin D. Ginsburg et al., Mergers, Acquisitions, and Buyouts, para. 608.2.2 (Apr. 1999 edition).

[76] J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995).

[77] Reef Corporation v. Commissioner, 368 F.2d 125 (5th Cir. 1966); Rev. Rul. 79-250, 1979-2 C.B. 156, modified by Rev. Rul. 96-29, 1996-1 C.B. 50.

occurred.[78] This limitation is sometimes viewed as prohibiting the use of the step transaction doctrine where the alternative transaction has at least the same number of steps.[79] Another possible limiting factor to the application of the step transaction doctrine is when the steps in a series of transactions are separated by a real and meaningful shareholder vote to continue with the subsequent steps. While such a shareholder vote may be an indication of separate, unrelated steps, particularly when the corporation is publicly traded, it may not be determinative. Finally, as discussed above, the IRS and not the taxpayer generally has the ability to recharacterize a series of transactions under the step transaction doctrine.

3. Tax shelter penalties

a. Civil penalties relating to tax shelters

(i) Taxpayer penalties

Accuracy-related penalty (sec. 6662).--The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. In no event does a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation.

Special rules apply for "tax shelters." With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. For these purposes, section 6662(d)(2)(C)(iii) defines a tax shelter as (1) a partnership or other entity, (2) an investment plan or arrangement, or (3) any other

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[78] Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989); Walt Disney, Inc. v. Commissioner, 97 T.C. 221 (1991); Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973).

[79] West Coast Marketing Corporation v. Commissioner, 46 T.C. 32 (1966); Rev. Rul. 70-140, 1970-1 C.B. 73.

plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.

The understatement penalty generally is abated (even in the case of corporate tax shelters) in cases where the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[80] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service."[81]

Fraud penalty (sec. 6663).--The accuracy-related penalty under section 6662 discussed above does not apply to any underpayment of tax that is attributable to fraud. Rather, a penalty under section 6663 equal to 75 percent of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined fraud to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.[82]

(ii) Nontaxpayer penalties

Understatement of taxpayer's liability by income tax preparer (sec. 6694).--Section 6694 imposes a monetary penalty on income tax preparers for any understatement of tax liability on a tax return due to a position for which there was not a realistic possibility of success of being sustained on its merits, but only if (1) the return preparer knew (or reasonably should have known) of the position, and (2) the position was not adequately disclosed on the return or was frivolous.

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[80] Sec. 6664(c).

[81] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c). Although rare, from time to time accuracy related penalties have been asserted in the context of tax shelters generally. See, e.g., Sheldon v. Commissioner, 94 T.C. 738, 769-70 (1990). In the corporate context specifically, see, e.g., Leema Enterprises v. Commissioner, 77 T.C.M. (CCH) 1261 (1999)). Because of the lack of clarity of the various economic substance and business purpose doctrines, however, courts are often reluctant to impose penalties in corporate tax shelter cases. See, e.g., Peerless Indus. v. United States, 94-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

[82] Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied, 393 U.S. 1020 (1969); Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968); Jenkins v. United States, 313 F.2d 624 (5th Cir. 1963).

An "income tax preparer" means any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.[83]

The penalty is $250 with respect to each return, unless the preparer establishes that there was reasonable cause for the understatement and the preparer acted in good faith. The penalty amount is increased to $1,000 if any part of the understatement is due to the preparer's willful conduct, or reckless or intentional disregard of the rules and regulations.

Other assessable penalties with respect to the preparation of income tax returns for other persons (sec. 6695).--Section 6695 imposes a penalty on any income tax return preparer who, in connection with the preparation of an income tax return, fails to: (1) furnish the taxpayer with a completed copy of the tax return; (2) sign the tax return (if required to do so by regulations); (3) furnish the proper identification number with respect to the tax return; (4) retain a copy of the completed return or a list (with names and taxpayer identification numbers) of the taxpayers for whom a return was prepared; or (5) comply with certain due diligence requirements in determining a taxpayer's eligibility for the earned income credit. Section 6695 also prohibits an income tax preparer from endorsing or otherwise negotiating a refund check that is issued to the taxpayer. In most cases, the penalty is $50 for each failure, with a maximum penalty of $25,000 per category. The failure to comply with the due diligence requirements in determining eligibility for the earned income credit carries a $100 penalty for each failure.

Promoting abusive tax shelters (sec. 6700).--Section 6700 imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty equals $1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

[83] Sec. 7701(a)(36)(A).

Aiding and abetting understatement of tax liability (sec. 6701).--Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. The concept of aiding or abetting requires "direct involvement" in the preparation or presentation of a tax return or other tax-related document.[84]

Several definitions and special rules apply. The penalty applies to a person who orders (or otherwise causes) a subordinate to do an act, as well as a person who knows of, and does not attempt to prevent, participation by a subordinate in an act. A subordinate means any other person over whose activities the person subject to the penalty has direction, supervision, or control. The penalty applies whether or not the understatement is with the knowledge or consent of the persons responsible for the return or other document. By contrast, a person furnishing typing, reproducing, or other mechanical assistance is not subject to the penalty.

The penalty for aiding and abetting with respect to an individual's tax liability is $1,000; the penalty is $10,000 if the aiding and abetting is with respect to a corporation's tax liability. A person can only be subject to this penalty once with respect to a particular taxpayer per period. Courts have held that there is no statute of limitations for purposes of applying this penalty.[85]

Coordination rules apply such that a person who is subject to the aiding and abetting penalty is not also subject to the return preparer penalty (sec. 6694) or the promoter penalty (sec. 6700).[86]

Registration of tax shelters (sec. 6111).--Section 6111 requires an organizer of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered to potential users. A tax shelter for this purpose means any investment with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio[87] for any investor as of the close of any of the first five years ending after the date on which such

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[84] See Staff of the Joint Committee On Taxation, 97th Cong., General Explanation to the Tax Equity and Fiscal Responsibility Act of 1982, 220.

[85] Mullikin v. United States, 952 F.2d 920, 922-929 (6th Cir. 1991); see also Kraye v. United States, 93-1 U.S.T.C. (CCH) para. 50,047 (D.N.M. 1992).

[86] Sec. 6701(f)(2).

[87] The tax shelter ratio is, with respect to any year, the ratio which the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).[88]

In addition, certain arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax for a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the tax shelter promoter may receive fees in excess of $100,000 in the aggregate. An arrangement is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. The registration provision with respect to these arrangements is effective for offerings made after the date the Treasury Department issues guidance in connection with such arrangements. At the time of publication of this study, the requisite guidance has not yet been issued; accordingly, this provision is not yet effective.

Any tax shelter registration must include: (1) information identifying and describing the tax shelter, (2) information describing the tax benefits of the tax shelter represented (or to be represented) to investors, and (3) such other information as the Secretary may prescribe.

Under section 6707, the penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or $500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

b. Injunctive actions

(i) Action to enjoin income tax return preparers (sec. 7407)

Under section 7407, the Secretary may bring a civil action in district court to enjoin a tax return preparer from further engaging in conduct (1) described in section 6694 (the understatement of tax liability by a return preparer penalty, discussed above) or section 6695 (other assessable penalties with respect to the preparation of income tax returns, also discussed above), (2) misrepresenting his eligibility to practice or his experience or education, (3) guaranteeing the payment of any tax refund or allowance of any tax credit, or (4) engaging in any other fraudulent or deceptive conduct which substantially interferes with the proper

[88] Sec. 6111(c).

administration of the Internal Revenue laws. For repeat offenses, the court may enjoin the person from acting as an income tax preparer.

(ii) Action to enjoin promoters of abusive tax shelters (sec. 7408)

Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters, discussed above) or section 6701 (the penalties for aiding and abetting the understatement of tax liability, also discussed above). Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. These actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the penalty. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

The court may grant injunctive relief against any person if it finds (1) that the person has engaged in any conduct subject to the penalty, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct.[89] The IRS does not need to assess or collect the penalty prior to proceeding with an injunction.[90] In addition, case law has indicated that traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered, provided that the government has satisfied the statutory requirements.[91]

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[89] In addition to the specific injunction actions under sections 7407 and 7408, under section 7402(a), the United States is empowered to seek, and the United States District Court to grant, such decrees or orders, and processes (including injunctions) as may be necessary to enforce the internal revenue laws. The court also has full authority to act under its general equity jurisdiction and possesses the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief. For example, a court could enjoin particular conduct or enjoin all conduct subject to the penalty. In addition, the court could enjoin any action tending to impede the proper administration of the tax law or any action which violates criminal statutes. See e.g., United States v. Landsberger, 692 F.2d 501 (8th Cir. 1982).

[90] See S. Rep. No. 494, 97th Cong., 2nd Sess. 266-69 (1982).

[91] See United States v. Estate Preservation Serv., 38 F.Supp. 2d 846, 850 (E.D. Cal. 1998) (holding that because section 7408 expressly authorizes the issuance of an injunction, the traditional requirements for equitable relief need not be satisfied); see also United States v. H & L Schwarz, Inc., 1987 U.S. Dist. LEXIS 14478 (C.D. Cal. 1987), aff'd sub nom. Bond v. United States, 872 F.2d 898 (9th Cir. 1989); United States v. Music Masters, Ltd., 621 F.Supp. 1046 (W.D.N.C. 1985), aff'd sub nom., without published opinion, United States v. Masters, 816 F.2d 674 (4th Cir. 1987).

B. Standards of Tax Practice and Professional Conduct Regarding Tax Shelters

1. Circular 230 – Treasury regulations which govern practice before IRS

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before the IRS.[92] Similarly, an individual who is duly qualified to practice as a certified public accountant in a State may represent a person before the IRS.[93] Individuals not qualifying under either the attorney or the certified public accountant rules may represent a person before the IRS if they qualify either by passing an examination or by nature of their previous employment with the IRS.[94]

The Treasury Department is authorized to regulate the practice of representatives before the Treasury Department (which includes the IRS), and (after notice and opportunity for a proceeding) to suspend or disbar any representative from practice before the Treasury Department for a violation of such rules and regulations.[95] In accordance with this grant of authority, the Treasury Department has issued regulations that govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients (hereafter "practitioners") before the IRS.[96] These regulations are commonly referred to as Circular 230. The IRS Office of Director of Practice is responsible for the enforcement of Circular 230. Among other things, Circular 230 provides specific rules regarding standards for tax return advisors and preparers and specific rules regarding tax shelter opinions.[97]

2. State licensing authorities and professional organizations

Each State, by virtue of the State courts (for lawyers), or through a licensing board (for CPAs), regulates and disciplines practitioners who are authorized or licensed to practice in the State. Tax practitioners that fail to abide by their respective State requirements may be subject to disciplinary actions, such as disbarment, suspension, reprimand, or denial of license to practice within such State. In addition, professional organizations such as the American Bar Association ("ABA") and the American Institute of Certified Public Accountants ("AICPA") have

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[92] 5 U.S.C. sec. 500.

[93] Id.

[94] Circular 230, sec. 10.4.

[95] 31 U.S.C. sec. 330.

[96] The regulations are found in Title 31, Part 10 of the Code of Federal Regulations.

[97] See Circular 230, sec. 10.33, et. seq. For a more detailed discussion of the Circular 230 standards, see Joint Committee Study, supra note 5, at 199-203.

promulgated rules and/or guidelines concerning the standards of practice for their professional members.[98]

[98] See Joint Committee Study, supra note 5, at 203-06, for a more detailed discussion of the rules and guidance promulgated by the ABA and the AICPA.

III. THE ADMINISTRATION'S REVENUE PROPOSALS RELATING TO CORPORATE TAX SHELTERS AS MODIFIED BY THE WHITE PAPER

A. Description

The Administration's Fiscal Year 2000 Budget, as submitted to the Congress on February 1, 1999, included six provisions with general application to corporate tax shelter transactions.[99] The six provisions generally affect a class of transactions that fall within a new statutory definition of a corporate tax shelter. For this purpose, a "corporate tax shelter" would be defined as any entity, plan, or arrangement in which a corporate participant attempts to obtain a "tax benefit" in a "tax avoidance transaction." A "tax benefit" would be defined as any reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision. A "tax avoidance transaction" would be defined as any transaction (1) 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 of such transaction, or (2) any transaction that involves the improper elimination or significant reduction of tax on economic income.

The Treasury Department issued its White Paper approximately five months following the release of the Administration's Fiscal Year 2000 Budget. The White Paper is intended to provide refinements to the budget proposals in light of comments received by the Treasury Department subsequent to the release of the Fiscal Year 2000 Budget. Described below is the Joint Committee staff's understanding of the definitions and provisions that comprise the Treasury Department's revised proposal (i.e., the original general budget provisions as modified by the White Paper) ("revised Treasury proposal").

1. Definitions

The revised Treasury proposal modifies the second prong of the "tax avoidance transaction" definition (i.e., the improper elimination of tax on economic income). The revised definition thus would define a tax avoidance transaction as: (1) 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 such transaction; and (2) in the case of financing transactions, any transaction in which the deductions claimed by the taxpayer for any period are significantly in excess of the economic return realized by the person providing the capital.

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[99] The Administration's Fiscal Year 2000 Budget also included ten proposals that are designed to address specific transactions. These proposals are not the subject of this analysis.

2. New disclosure regime

The revised Treasury proposal would create a new disclosure regime for any transaction that has certain characteristics (referred to as "filters") regardless of whether the transaction meets the definition of a corporate tax shelter. Disclosure would be required if a transaction has some combination of the following characteristics: (1) a book/tax difference in excess of a certain amount; (2) involvement with a tax-indifferent party; (3) advisor fees in excess of a certain amount or contingent fees; (4) a confidentiality agreement; and (5) the offering of the transaction to multiple corporations (if known).

Under the new disclosure regime, disclosure would be made on a short form filed with the National Office of the IRS. For promoters, disclosure would be required within 30 days of offering a tax shelter to a corporation. For corporations entering into transactions that meet the requisite combination of "filters," the form would have to be filed with the National Office by the due date of the tax return for the taxable year in which the transaction is entered into. The form would also have to be included with the tax return. The form would have to be signed by a corporate officer who has, or should have, knowledge of the relevant facts. The officer would be personally liable for misstatements on the disclosure form. Any failure to file either form would result in a flat fine (e.g., $100,000).[100]

3. The substantial understatement penalty for corporate tax shelters

The revised Treasury proposal would make several modifications to the substantial understatement penalty. The penalty rate would be increased to 40 percent with respect to any item attributable to a corporate tax shelter. The 40 percent rate would be reduced to 20 percent if the corporation fulfilled certain disclosure requirements. The substantial understatement penalty would be eliminated altogether where a taxpayer discloses the transaction and satisfies a strengthened reasonable cause standard (i.e., the taxpayer had a reasonable belief that it has a strong chance of sustaining its tax position -- that is, it satisfies a "should" prevail standard). For purposes of the reasonable cause standard, Treas. Reg. sec. 1.6664-4 would be codified (and to some extent strengthened).

4. Deny certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions

The revised Treasury proposal would automatically disallow any tax benefit derived in a tax avoidance transaction.[101] The proposal also would apply to all business activities of taxpayers, including those that engage in business in non-corporate forms.

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[100] The section 6111 disclosure for confidential corporate tax shelter would be modified or eliminated.

[101] The original proposal, as described in the Administration's Fiscal Year 2000 Budget, would have granted the Secretary of the Treasury the discretion to disallow any tax benefit obtained in a tax avoidance transaction.

5. **Excise tax on certain fees for tax advice**

The revised Treasury proposal would impose an excise tax of 25 percent on fees received by promoters and advisors who perform services in furtherance of a corporate tax shelter.[102] Due process procedures also would be provided for such parties.

6. **Rescission provisions and provisions guaranteeing tax benefits**

The revised Treasury proposal would provide that the existence of an unwind provision, recission agreement, or insurance or similar arrangement would be a " special filter" automatically triggering disclosure.[103]

7. **Inconsistent tax positions with the form of the transaction**

The revised Treasury proposal would provide that any transaction over a certain threshold amount (e.g., with tax benefits over $1 million) for which a taxpayer does not follow its form would have to be separately disclosed.[104] Exceptions would be provided for certain transactions that have historically involved taxpayers taking positions inconsistent with their form. In addition, the rule would not apply if reporting the substance of the transaction more clearly reflects the income of the taxpayer (to the extent this exception is permitted in regulations). A flat penalty (e.g., $100,000) would apply for each failure to disclose.

8. **Tax income from corporate tax shelters involving tax-indifferent parties**

The revised Treasury proposal would provide that any income allocable to a tax-indifferent party with respect to a corporate tax shelter is taxable to the tax-indifferent party if it is trading on its tax exemption. Joint and several liability would exist between the tax-indifferent party and the corporate participant.[105] Consideration also would be given to applying the

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[102] The original proposal, as described in the Administration's Fiscal Year 2000 Budget, would have denied a deduction to a corporation for fees paid or incurred in connection with a corporate tax shelter, and would have imposed the excise tax on any fees paid or incurred in connection with a corporate tax shelter.

[103] The original proposal, as described in the Administration's Fiscal Year 2000 Budget, would have imposed an excise tax of 25 percent on the maximum amount that might be paid under a tax benefit protection agreement.

[104] The original proposal, as described in the Administration's Fiscal Year 2000 Budget, would have precluded a corporate taxpayer from taking an inconsistent position on a tax return if a tax-indifferent party has an interest in the transaction.

[105] The original proposal, as described in the Administration's Fiscal Year 2000 Budget, would have imposed a tax on any income allocable to a tax-indifferent party (regardless of whether it was trading on its tax exemption) with respect to a corporate tax shelter. In addition,

proposal only to taxpayers that have a nexus to the United States. In addition, appropriate due process procedures would be provided for parties subject to assessment.

B. Analysis

The revised Treasury proposal would address the corporate tax shelter problem through the adoption of a substantive rule that would disallow any tax benefit in a tax avoidance transaction. There are several issues that are raised in connection with a substantive law change that are discussed below. Such issues include, for example, (1) the level of uncertainty that a substantive rule (and the components of the rule) would create, (2) the application of the "clearly contemplated" exception to the proposal, and (3) the continued role of common law doctrines with respect to corporate tax shelters. In addition to the substantive rule, the revised Treasury proposal includes provisions that address the problem through an enhanced penalty regime and additional disclosure requirements.

These six provisions that comprise the revised Treasury proposal fall into two general categories: (1) provisions that would apply to the corporate participant in the tax shelter, and (2) provisions that would apply to other parties involved in tax shelter activities. The analysis begins with a discussion of the definitions that would apply to the revised Treasury proposal and then analyzes the specific provisions within each category.

1. Definitions

The revised Treasury proposal relies on a single definition of a "corporate tax shelter" that would be used in connection with: (1) the application of a proposed substantive rule, (2) the imposition of penalties, and (3) the requirement of certain disclosures with respect to the substantial understatement penalty.[106] A corporate tax shelter would be defined as an entity, plan or arrangement in which a corporate participant attempts to obtain a "tax benefit" in a "tax avoidance transaction." While a uniform definition may seem desirable, using the same definition for three different purposes may make it difficult to tailor the definition to accomplish each specific objective.

Because the revised Treasury proposal includes a substantive rule that would disallow tax benefits obtained in a corporate tax shelter transaction, the definition of a corporate tax shelter (and its various components) becomes critically important. Although the relevant definitions are important with respect to any corporate tax shelter proposal, the consequences of imprecision are less severe in connection with a proposal focused solely on an understatement penalty as opposed to a substantive disallowance provision.

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the joint and several liability would have existed with respect to all participants in the transaction.

[106] The new disclosure regime, described below, would not be limited to corporate tax shelters.

a. **Tax benefit**

The first element of the proposed definition of a corporate tax shelter is that the corporate participant must claim a "tax benefit." A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, though it would not include benefits that are "clearly contemplated" by the applicable Code provision.

As the only exception to the definition of a corporate tax shelter, the "clearly contemplated" exception would be the subject of much interpretation and disputes. The revised Treasury proposal offers little guidance regarding this exception: it states that the standard would be applied by taking into account the Congressional purpose for such a provision and the interaction of the provision with the other provisions of the Code.[107] This statement belies the uncertainty associated with whether a benefit was clearly contemplated by Congress.[108] One difficulty has to do with the fact that many tax shelter arrangements involve a combination of tax benefits, each of which may have been clearly contemplated, but not in tandem.

In the absence of a codified exception, the legislative history to tax provisions would assume a much greater role because it is where Congressional intent would most likely be explained. Legislative history generally does not describe all the transactions that could come within a newly-enacted provision. Whether a transaction is clearly contemplated would not be known with certainty and thus would be the subject of much post-enactment revisions. If the legislative history doesn't clearly reflect the intent of the proposal, the courts would be forced to decide what was contemplated by Congress.

One need only to look at the White Paper's articulation of the clearly contemplated exception to appreciate the uncertainty that such a standard would create. The White Paper cites standard leveraged leases as an example of a transaction whose tax benefits would be clearly contemplated.[109] The same analysis, however, implies that some leveraged leases may be tax avoidance transactions.[110]

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[107] White Paper, supra note 3 at 96.

[108] See also the discussion of H.R. 2255 and the Joint Committee staff recommendations with respect to the merits of a clearly contemplated exception and an enumerated list of exceptions.

[109] White Paper, supra note 3 at 96.

[110] The White Paper states that:

> The tax benefits generated by leveraged leasing activity requires careful analysis as to whether such benefits are clearly contemplated. Leveraged leasing has existed for decades primarily as a means of transferring tax benefits among parties. Both the Congress and the Administration have implicitly and explicitly allowed leveraged leases to stand undisturbed subject to certain tolerances

The White Paper's discussion regarding leveraged leases illustrates the difficulty in crafting a list of clearly contemplated tax benefits.[111] There could be concerns that such a list would exclude tax benefits that many would believe are "clearly contemplated"[112] and could create an inference with respect to benefits that are not included on the list. Conversely, the list could include benefits that many would believe were not clearly contemplated. The stakes are high -- designating a tax benefit as clearly contemplated has the effect of exempting the transaction from the revised Treasury proposal.

b. Tax avoidance transaction

The second aspect of the definition is that the tax benefit must be obtained in a "tax avoidance transaction." A tax avoidance transaction is any transaction that satisfies either a pre-tax profit test or a special test for financing arrangements.

Under the pre-tax profit test, a transaction would be a tax avoidance transaction if 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 such transaction. In transactions other than financing arrangements, the pre-tax profit test is the only test for determining whether a transaction is a corporate tax shelter.

Because the pre-tax profit test presumably relies on a cash-flow analysis, there may be some question regarding its application to transactions in which cash flow is not a critical element of the tax benefit. Arrangements that involve the inappropriate creation or duplication of tax basis in assets, for example, would be more difficult to analyze using a cash-flow model.[113] It may be difficult to apply a "profit" test to transactions such a mergers, acquisitions and hedging transactions, all of which may be legitimate business activity, but may not produce "profit."

It is similarly unclear how the pre-tax profit test would apply to transactions that involve the receipt of economic income that is excluded from taxable income ("exclusion transactions").

> (citation omitted). This is not to say, however, that all leveraged leasing transactions are not tax avoidance transactions.

(citing Rice's Toyota World) Id. at n.352.

[111] For a similar list under prior law, see Treas. Reg. sec. 1.6662-4(g)(2)(ii).

[112] For example, the list found in Treas. Reg. sec. 1.6662-4(g)(2)(ii) does not include claiming the low-income housing tax credit.

[113] See also the discussion of this issue below in connection with the Joint Committee staff recommendations (which incorporates the pre-tax profit test as a tax shelter indicator).

For example, in the "liquidating REIT" transaction, in which the real estate investment trust ("REIT") earns a market rate of return on its assets, the pre-tax profit from the transaction arguably could be significant in relation to the net tax benefit.[114]

A related concern involves the continued role of the common-law doctrines. The pre-tax profit test is a codification of the economic substance doctrine. While the economic substance doctrine may be the most objective of the common-law doctrines,[115] the exclusive reliance on the economic substance doctrine in non-financing arrangements implies that other common-law doctrines, such as the step-transaction and business purpose doctrines, may not apply to these transactions.[116] This could be problematic with respect to transactions that, for example, arguably pass the pre-tax profit test and yet lack any business purpose (such as a liquidating REIT transaction).[117] Some might question the wisdom of replacing a body of well-developed case law that may well be more tailored to specific factual situations. It seems likely that new judicial standards would evolve under the new definition of a corporate tax shelter but, at a minimum, much uncertainty is likely to exist as those standards develop.

Another concern is the appropriate discount rate for determining present value. The proposal offers no guidance as to the appropriate discount rate in connection with the pre-tax profit test. Differences of opinion may exist regarding the proper discount rate for a given transaction. Some argue that this test, in and of itself, may not provide a useful measure of corporate tax shelter activity, and could lead to a particularly harsh result in connection with a substantive disallowance rule. On the other hand, not mandating a discount rate gives taxpayers greater discretion to structure a transaction that would meet the pre-tax profit test.

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[114] Some argue that exclusion transactions should be beyond the reach of corporate tax shelter legislation in any event because of the difficulty in differentiating between exclusion transactions that involve legitimate tax planning and those that do not.

[115] The White Paper states that "the economic substance standard generally is thought to be the most objective of the common law doctrines, primarily because it does not rely on the taxpayer's intent." <u>White Paper</u>, <u>supra</u> note 3 at 97.

[116] In contrast, under both H.R. 2255 and the Joint Committee staff recommendations, the common-law doctrines would continue to apply in evaluating corporate tax shelter arrangements.

[117] Another example of a transaction that might not be caught by the pre-tax profit test (and thus would not be a tax shelter under the revised Treasury proposal) is the transaction described in the <u>UPS</u> case previously discussed. The arrangement in the <u>UPS</u> case (<u>i.e.</u>, the assignment of income by the taxpayer to a related foreign entity) arguably does not give rise to a tax benefit, and even if it does, the related income may be significant related to the tax benefit.

In the case of financing transactions,[118] the revised Treasury proposal would treat an arrangement as a corporate tax shelter if 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 original version of this test (as described in the Administration's Fiscal Year 2000 Budget), which would have covered any transaction "involving the improper elimination or significant reduction of tax on economic income," was viewed by some as too vague. Although perhaps too vague, one virtue of the original version was that it served as a backstop to catch arrangements that might not otherwise be caught by the pre-tax profit test. The "basis shift transactions" and "exclusion transactions" previously discussed, for example, would have been caught by the original version of this test; they would not be caught by the revised test (because they are not financing arrangements).

2. Corporations that participate in corporate tax shelters

a. New disclosure regime

The revised Treasury proposal recommends a new disclosure regime that would require certain disclosures with respect to any transaction that exhibits a combination (more likely two or more) of the following characteristics (referred to as "filters"): (1) a book/tax difference in excess of a certain amount; (2) involvement with a tax-indifferent party; (3) advisor fees in excess of a certain amount or contingent fees; (4) a confidentiality agreement; and (5) the offering of the transaction to multiple corporations (if known). In addition, special disclosure requirements would apply with respect to any transaction (regardless of whether it exhibits a combination of filters) if the transaction (1) includes an unwind provision, recission agreement, or insurance or similar arrangement, or (2) exceeds a certain threshold amount (e.g., with tax benefits over $1 million) and the taxpayer does not follow the form of the transaction. The disclosure requirements would apply to both promoters[119] and corporate participants. Any failure would result in a flat fine (e.g., $100,000).

The revised Treasury proposal envisions a multiple filing process. That is, if the arrangement meets the necessary combination of filters (or exhibits one of the special filters), the corporate participant would file a separate form with the IRS National Office by the due date of the tax return for the taxable year in which the transaction is entered into.[120] The corporate

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[118] The Treasury proposal adopts the aspect of H.R. 2255 relating to financing transactions. For a more detailed discussion regarding the financing transaction test, see the analysis of H.R. 2255 below.

[119] The promoter disclosure rules are analyzed below in connection with provisions that would affect other parties in tax shelters.

[120] The phrase "due date" presumably refers to the original due date of the tax return. Otherwise, disclosure might not occur for up to 21 months following the date of the transaction (and would be superfluous given the tax return disclosure requirement).

participant also would include the form in all tax returns to which the transaction applies. The form would require the taxpayer to provide a description of the filters that apply to the transaction and certain information regarding the business or economic objectives of the transaction.[121] The form would be signed by a corporate officer who has, or should have, knowledge of the factual underpinnings of the transaction. The corporate officer would be personally liable for misstatements on the form, with appropriate penalties for fraud or gross negligence. The officer would be accorded appropriate due process rights.

The requirement that the disclosure statement be signed by a corporate officer who has (or should have) knowledge of the facts sign the disclosure statement has the support of a number of professional organizations, including the ABA and the AICPA. Moreover, as described below, this requirement is a feature of both H.R. 2255 and the Joint Committee staff recommendations.[122] The attestation function is designed to ensure that the person who commits the corporation to engage in the transaction is also made aware of the tax risks associated with the arrangement.

A corporation would not have to comply with this disclosure requirement if it had actual knowledge that the promoter filed a disclosure statement with respect to the transaction.

[121] The required information would be similar to the information in the proposal presented by the ABA Tax Section. White Paper, supra note 3 at 85. Specifically, such information would include: (1) a detailed description of the facts, assumptions of facts and factual conclusions with respect to the business or economic purposes or objectives of the transaction that are relied upon in support of the return position; (2) a description of the due diligence to ascertain the accuracy of the above; (3) a statement signed by one or more corporate officers with detailed knowledge of the business or economic purposes or objectives of the transaction that the facts, assumptions of facts, and factual conclusions relied upon in reporting the transaction are true and correct as of the date the return is filed to the best of the signer's knowledge and belief (with material differences explained); (4) copies of written materials provided in connection with the offer of the tax shelter by a third party; (5) a full description of any express or implied agreement or arrangement of any contingent or reimbursable fees with any advisor or any offeror with respect to the shelter; and (6) a full description of any express or implied warranty from any person with respect to the anticipated tax results from the shelter. White Paper, supra note 3 at 82. H.R. 2255, described below, included the same items with respect to its disclosure requirement.

[122] Unlike the revised Treasury proposal, however, H.R. 2255 and the Joint Committee staff recommendations would not hold the corporate officer personally liable for misstatements on the form.

Some argue that requiring the attestation of a corporate officer, and making the officer personally liable for any misstatements, may give the IRS another issue to pursue in audit (i.e., was the attestation proper). Other commentators question the utility of the attestation function.[123]

Greater disclosure of corporate tax shelters should result in improved detection and enforcement by the IRS, as well as greater reluctance on the part of corporate participants to engage in tax shelter arrangements. But to be effective, the disclosure requirements should be refined so that they result in the disclosure of transactions that government officials should be aware of, while minimizing the burdens on taxpayers and the IRS regarding information that is irrelevant.

The disclosure regime could result in multiple disclosures with respect to a single transaction. For example, a promoter would be required to file a disclosure statement regarding a transaction within 30 days of its offering. The corporate participant presumably could not always rely on the promoter making the necessary disclosure, so it would file a disclosure statement by the due date of the return. The corporate participant also would include the filing as part of its tax return. Some may view these filings as excessive, and potentially providing the IRS with more information than it can process. On the other hand, the multiple disclosure requirements serve different functions. The initial filing is intended to serve as an "early warning" of the types of transactions being promoted in the event that a legislative or administrative response is warranted. The tax return disclosure is designed to alert an IRS agent as to the existence of the transaction and to provide the agent with the necessary information to evaluate the transaction.[124]

Depending on some of the unknown specifics regarding the revised Treasury proposal (such as the number of filters and the amount of book/tax difference), the proposed disclosure regime could require disclosure of transactions that would not meet the Treasury Department's definition of a corporate tax shelter. Conversely, transactions that otherwise might be thought of as tax shelters could avoid disclosure. For example, assuming that the existence of two filters is sufficient to mandate disclosure, the involvement of a tax-indifferent party coupled with a temporary book/tax difference would require disclosure of a transaction, even though the transaction may not meet the definition of a "tax avoidance transaction." Yet an exclusion transaction (which may be a tax-avoidance transaction) that creates a permanent book/tax difference but exhibits no other filter would not trigger disclosure. This concern is exacerbated

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123 See Sheppard, "News Analysis: Courts Combat Cross-Border Corporate Tax Shelters," 85 Tax Notes 137, 138 (Oct. 11, 1999) ("The behavior of Compaq's assistant treasurer has got to give one pause about the utility of enacting a law that requires a corporate financial officer to sign a sworn statement accompanying the tax return to the effect that all the asserted facts in the tax shelter transaction are just that, facts. . . .One gets the impression that the sort of financial officer who would deploy nearly a billion dollars of the company's money for use in a tax dodge without asking basic questions would also sign a tax return without asking questions.")

124 Some have suggested that the tax return disclosure need only provide the IRS with notice as to the existence of a transaction that needs further analysis. Any additional information could be sought by an IRS agent as part of an exam.

by the lack of guidance regarding how the new disclosure rules interact with the disclosure requirement for a reduced substantial understatement penalty. Specifically, it is unclear whether the new disclosure regime replaces, or is in addition to, the disclosure requirement with respect to the penalty. To the extent the new regime replaces the penalty disclosure requirements, the above concerns will continue to exist.

The White Paper suggests that the penalty for failing to file should be significant and suggests possibly $100,000 per failure. Some argue that there is merit to having an independent penalty for failure to disclose in order to encourage disclosure. In addition, to the extent that corporations are penalty averse, the size of the penalty should not matter -- the mere fact that a penalty would be imposed may be a sufficient deterrent. On the other hand, some might question the appropriateness of imposing a new disclosure penalty with respect to a transaction that is not a tax shelter. Again, this problem arises because the new disclosure regime relies on different criteria than the definition of a corporate tax shelter.

b. <u>Deny tax benefits resulting from tax avoidance transactions</u>

The revised Treasury proposal would disallow any tax benefit derived in a tax avoidance transaction (the "section 269 provision"). The section 269 provision is premised on the belief that, while increased disclosure and changes to the penalty regime are necessary elements to curb the use of corporate tax shelters, such changes are not enough if taxpayers continue to believe that they will prevail on the underlying substantive issues.[125] Moreover, the provision embodies a fundamental proposition; namely, that corporate taxpayers should not be able to claim tax benefits from non-economic transactions.

Opponents of the section 269 provision contend that any success achieved through a substantive law change comes at a significant cost -- the loss of the tax system's reliance on objectivity. A substantive rule that disallows tax benefits from a tax avoidance transaction could inject a new level of uncertainty into the tax law. A revenue agent's decision to assert the section 269 provision would require an analysis and understanding of both the definition of a corporate tax shelter and the clarity of the underlying provisions of the Code relied on by the taxpayer. A reality of a complex tax code is that there will be some ambiguities and glitches. Some have argued that rather than a substantive rule that strays from a rule-based model of taxation, the tax system may be better served with a more targeted and effective penalty structure.

Some argue that the section 269 provision could replace decades of well-developed, fact-specific case law with a multi-purpose general anti-abuse rule. Because of the difficulty in distinguishing between legitimate business activity and improper tax avoidance, each set of facts warrants individual attention, and the courts are best equipped at drawing the lines and setting the standards. Proponents of this theory further argue that a new standard is unnecessary and would be no more effective than present law. They further argue that these issues could be properly addressed by providing the IRS the resources to enforce existing law.

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[125] <u>White Paper</u>, <u>supra</u> note 3 at 101.

As previously discussed with respect to the definitions, the section 269 provision would place considerable pressure on the definition of a corporate tax shelter and its components. To the extent the definition is over-inclusive, tax benefits to which a taxpayer would be entitled under current law would automatically be disallowed; to the extent it is under-inclusive, the section 269 provision would not achieve the desired effect. Ambiguity in the definition could be viewed as providing IRS agents with too much discretion to formulate their own interpretations, and may result in increased litigation. This ambiguity also could result in the uneven application of the section 269 provision among similarly-situated taxpayers. Some IRS agents may apply the proposal with zeal; others may be overly cautious in its use.[126]

The revised Treasury proposal would expand the scope of the section 269 provision to apply to all business activities of taxpayers, including those that engage in business in non-corporate form. Thus, its focus is on all transactions that could be viewed as lacking economic substance. However, the new disclosure regime and the increased substantial understatement penalty appear only to apply to corporate taxpayers. The lack of coordination with other elements of the revised Treasury proposals may diminish the effectiveness of the section 269 provision with respect to non-corporate tax shelter transactions.

c. Substantial understatement penalty

The revised Treasury proposal would increase the substantial understatement penalty rate to 40 percent (from the current 20 percent rate) of the understatement resulting from a transaction meeting the definition of a corporate tax shelter and causing a substantial understatement of tax. The penalty rate would be reduced from 40 percent to 20 percent if certain specified disclosure requirements are satisfied. The penalty would be eliminated altogether where the taxpayer (1) discloses the transaction and (2) satisfies a strengthened reasonable cause standard -- that is, its position should prevail, and the taxpayer satisfies the codified and enhanced requirements of Treas. Reg. sec. 1.6664-4.[127]

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[126] Perhaps in recognition of this possibility, the proposal suggests that procedural and other safeguards could be implemented in connection with this proposal. These procedural changes could include (1) centralization of IRS personnel who would review corporate tax shelter transactions, (2) the creation of a corporate tax shelter task force, (3) an automatic referral of any corporate tax shelter issue to the IRS National Office, and (4) an expedited ruling process in the IRS National Office to evaluate whether a contemplated transaction constitutes a corporate tax shelter.

[127] Treas. Reg. sec. 1.6664-4(e) provides guidance regarding the application of the reasonable cause exception of section 6664(c) to corporate tax shelters. Under the regulations, in order to establish that a corporation acted with reasonable cause and in good faith with respect to a tax shelter item, the corporation must establish that, at a minimum, (1) its legal justification for the position is supported by substantial authority, and (2) it reasonably believed that the tax treatment of the item was more likely than not the proper treatment. The regulations further provide that these minimum tests are an important factor, but are not necessarily dispositive, in determining whether the corporation acted with reasonable cause and good faith. Other facts and

A 40-percent penalty may be viewed as too harsh, particularly if one accepts the premise that corporate taxpayers are penalty averse.[128] The inequity of a high penalty rate is exacerbated by the section 269 provision, which would operate to create an understatement to which the increased penalty rate would apply. On the other hand, the penalty rate must be sufficiently high to alter the cost-benefit analysis in a manner that would discourage corporate tax shelter activity. This would argue for a rate that is higher than the rate otherwise applicable to understatements of tax not associated with corporate tax shelters. In this regard, the proposed penalty structure for corporate tax shelters is consistent with the penalty structure that is used with respect to valuation misstatements.[129]

Some argue that to the extent an understatement results from a corporate tax shelter, a penalty should apply without regard to the "strengthened reasonable cause" exception – i.e., the penalty should be a "no-fault" penalty. This argument, however, suffers from again being dependent on the ability to precisely define corporate tax shelters in a way that would distinguish between legitimate business activity and improper tax avoidance. Even if an exception is warranted, however, the proposal's strengthened reasonable cause standard may not be the appropriate exception. In part, the Treasury Department suggests codifying the requirements in Treasury regulations as to what constitutes reasonable cause. The effect of codifying present law is unclear.[130] The White Paper also suggests possibly adopting a "should prevail" standard (apparently in lieu of a "more-likely-than-not" standard) for opinions that could be used to demonstrate reasonable cause.[131] Such a standard is inherently vague and will vary among opinion writers.[132]

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circumstances are taken into account.

[128] Under this rationale, the proposal's reduced 20-percent rate provides little actual incentive to disclose.

[129] A taxpayer whose underpayment of tax is attributable to a valuation misstatement is subject to a multi-tiered penalty structure: the rate is 20 percent if the valuation misstatement is "substantial;" the rate increases to 40 percent if the underpayment is attributable to a "gross misstatement."

[130] It appears that these regulations are not being enforced (at least in part) because of uncertainties regarding their application.

[131] White Paper, supra note 3 at 134.

[132] For example, some believe that the range of probability of success on the merits to which a "should" opinion relates can be from 52 percent to possibly 80 percent. The Joint Committee staff recommendations attempt to address this concern by specifying a percentage, 75 percent -- albeit recognizing that the determination of whether a transaction satisfies that percentage is still subjective. The importance of these subjective disparities is diminished in the Joint Committee staff recommendations through the adoption of an objective, "reasonable practitioner" standard.

As previously discussed in connection with the definitions, a narrower definition of a corporate tax shelter presents concerns with respect to the application of the proposed substantial understatement penalty. Because the penalty provision relies on the proposed definition of a corporate tax shelter, a narrowing of the definition translates into a reduced scope (and possible effectiveness) of the penalty. For example, the revised Treasury proposal presumably would eliminate the present-law special rules for tax shelters.[133] Additional clarifications are needed to understand the implications of this proposal on present-law section 6662.[134]

Even with respect to transactions that would meet the revised Treasury proposal's definition of a corporate tax shelter, the corporation nevertheless would avoid the imposition of an understatement penalty so long as the understatement is not "substantial" (i.e., in excess of 10 percent of the tax required to be shown on the tax return).[135] Thus, while the section 269 provision would disallow any tax benefits derived from a tax shelter, the corporation would avoid the imposition of a substantial understatement penalty if it can effectively manage its tax liability (by not exceeding the 10 percent threshold). For those corporations, a penalty would be imposed under section 6662 only if the corporation's underpayment is due to negligence. For larger corporations, retaining the substantial requirement would weaken the effectiveness of the revised Treasury proposal and eliminate much of the incentive for disclosure (other than the failure to file penalty).[136]

Another prerequisite to the imposition of the proposed section 6662 penalty is the existence of an underpayment of tax. A corporation could avoid the imposition of an

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[133] In other words, the Treasury provision would replace the "significant purpose" test of section 6662(d)(2)(C).

[134] The Treasury Department's Report to Congress on the Penalty and Interest Provisions in the Code, dated October 1999 ("Treasury Penalty and Interest Report"), includes some recommendations with respect to the section 6662 penalty that are relevant to this discussion. One recommendation would raise the present-law minimum accuracy standard for disclosed positions to require a "realistic possibility of success on the merits." Id. at 111. Another recommendation would change the "substantial" requirement to the lesser of $10 million or 10 percent of the tax required to be shown on the return. Id. at 109. A third recommendation is that "consideration be given to whether the negligence penalty should be confined to situations involving understatements below the monetary thresholds of the substantial understatement penalty to better harmonize the two penalties." Id. It is unclear whether these recommendations would apply to understatements that are attributable to corporate tax shelters.

[135] H.R. 2255 is similar to the revised Treasury proposal in this regard. The Joint Committee staff recommendations would eliminate the substantial requirement.

[136] As previously discussed in note 142, the Treasury Penalty and Interest Report proposes to change the "substantial" requirement to be the lesser of $10 million or 10 percent of the tax required to be shown on the return. It is unclear whether this recommendation would apply to understatements that are attributable to corporate tax shelters.

understatement penalty under the revised Treasury proposal if it avoids having an underpayment based on all items on its tax return (i.e., by overpaying the tax or offsetting the understatement with an overstatement of tax from other items). Depending on the specific facts, the revised Treasury proposal could have the effect of encouraging corporations to overpay their tax and not disclose the tax shelter, and subsequently file a refund claim with respect to the overpayment (assuming the tax shelter arrangement is not detected). Such an approach could eliminate any exposure to an understatement penalty but would have an economic cost (i.e., the opportunity cost with respect to the overpayment of tax). It also could limit the taxpayer's choice of forum.[137]

One uncertain aspect of the proposed section 6662 penalty proposal is what disclosure rules would apply to reduce (or eliminate) the penalty. As previously discussed, the new disclosure regime would require the corporate participant to disclose its involvement in any arrangement that exhibits a combination of certain enumerated filters without regard to whether the arrangement falls within the definition of a corporate tax shelter. It is unclear as to whether the new disclosure regime supercedes the disclosure rules under the proposed section 6662 penalty provision.[138]

3. Provisions affecting other parties involved in tax shelters

The revised Treasury proposal includes a series of provisions targeted to parties other than the taxpayer who participate in, and benefit from, a corporate tax shelter. These provisions are designed to lessen or eliminate the economic incentives for these parties to participate in corporate tax shelter transactions.[139]

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[137] H.R. 2255 is similar to the revised Treasury proposals in this regard. The Joint Committee staff recommendations would impose the section 6662 penalty to corporate tax shelters on a transaction basis. Thus, a corporate participant that has an understatement attributable to a corporate tax shelter would be liable for the section 6662 penalty even if the understatement does not result in an underpayment of tax.

[138] If the proposal retains a 30-day disclosure requirement (as provided in the Treasury Department's original disclosure rule in connection with the section 6662 penalty provision), another potential concern is whether the 30-day period is a sufficient time frame. The same concern arises in connection with H.R. 2255 and the Joint Committee staff recommendations.

[139] In its "Alternative Approaches" section, the White Paper lists a number of potential actions that, if taken, could affect other parties involved in corporate tax shelters. These actions include (1) modifying the Circular 230 standards to expand the tax shelter opinion standard and expand the definition of practice; (2) modifying the section 6701 aiding and abetting penalty to impose a lesser penalty for negligent aiding and abetting an understatement of tax liability; (3) modifying the section 6700 promoter penalty to include the making or furnishing of misleading statements in connection with the organization or sale of a plan, and increasing the penalty amount. Because these approaches appear not to have been adopted as part of the revised Treasury proposals, they have not been included in this analysis. It should be noted, however, that the Joint Committee staff recommendations, described below, include similar approaches.

a. Excise tax on certain fees

One provision would impose a 25-percent excise tax on those persons who perform services in furtherance of the corporate tax shelters. The scope of this provision is narrower than Treasury's original excise tax proposal, which would have disallowed deductions for promoter and advisor fees associated with corporate tax shelters.

The original provision was somewhat misdirected in that the tax could have been imposed (and the deductions could have been disallowed) with respect to fees paid to advisors who advised against engaging in the tax shelter arrangement. Limiting the excise tax to those persons who perform services "in furtherance of the corporate tax shelter" seems more consistent with the Treasury Department's policy objectives, though some will raise questions regarding the meaning of the quoted language.

Imposing an excise tax may be a way to lessen behavior that is viewed as undesirable. Excise taxes have been used in other areas of the tax law to deter specific types of activities that are disfavored (such as greenmail payments under section 5881). An excise tax provides a front-end disincentive to the development of corporate tax shelters by persons who are not parties to the transaction. What is unclear is what legal standing the person subject to the excise tax would have to enter in disputes between the corporate participant and the IRS as to the substance of the transaction, such as whether a transaction is or is not a corporate tax shelter. The revised Treasury proposal simply states that "appropriate due process procedures" would be provided with respect to an assessment. What these procedures might be and whether they can be administered is unclear.[140]

b. Tax income from corporate tax shelters involving tax-indifferent parties

The revised Treasury proposal would provide that any income attributable to a corporate tax shelter received by a tax-indifferent party that is trading on its tax exemption would be subject to tax (the "tax-indifferent proposal"). To ensure that a tax is paid, the corporate participant would be made jointly and severally liable for the tax.[141] Appropriate due process procedures would be provided with respect to any assessment.[142] For purposes of this provision,

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[140] Perhaps because of the uncertainties regarding the proposal, the White Paper states that, as an alternative, consideration could be given to amending the penalties described in sections 6700 (promoting abusive tax shelters), 6701 (penalties for aiding and abetting understatement of tax liability), and 6703 (rules applicable to penalties under sections 6700, 6701, and 6702) to be more responsive to corporate tax shelters. White Paper, supra note 3 at 113.

[141] To the extent that the corporate participant is liable for the tax, this provision could be viewed as affecting corporate participants, which were discussed in the previous section.

[142] The White Paper also suggests that consideration could be given to limiting the proposal to parties that have a nexus to the United States.

a tax-indifferent participant would be defined as a foreign person, a Native American tribal organization, a tax-exempt organization, and domestic corporations with a loss or credit carryforward that is more than three years old.

The tax-indifferent provision highlights one of the common features of modern corporate tax shelter arrangements, which is the involvement of a party that is indifferent with respect to the Federal income tax consequences of a particular transaction. Typically, the tax-indifferent party's involvement is structured to minimize (if not completely eliminate) the tax-indifferent party's exposure to any economic risk from the tax shelter. Imposing tax on income allocated to tax-indifferent parties could be expected to limit their participation in corporate tax shelter transactions. In addition, requiring the corporate participant to be jointly and severally liable for the tax would create further disincentives for participation in such transactions, as well as facilitating the collection of the tax.

The tax-indifferent provision uses the previously-discussed definition of corporate tax shelter. Thus, the proposal suffers from similar scope and definition issues. Moreover, while limiting the provision to a tax-indifferent party that "trades on its exemption" targets the provision to tax-indifferent parties that abuse their special tax status, the provision offers no guidance regarding how one "trades on its exemption."[143] Note that this standard is narrower than the relevant filter under the new disclosure regime (i.e., "the involvement of a tax-indifferent party").

A related concern regarding the definition of a tax-indifferent party is the inclusion of domestic corporations with loss or credit carryforwards of more than three years. Some might question the rationale for this definition, particularly in the case of losses or credits where Congress specifically provided a twenty-year carryforward period (e.g., net operating losses and business credits). It may seem inconsistent to exclude from the definition of a tax benefit those benefits that are clearly contemplated by Congress while at the same time limit a domestic corporation's use of its loss or credit carryforwards during the time period that Congress clearly contemplated its usage.

Perhaps more significant than the concerns with the definitions is the interaction of this provision with other aspects of the revised Treasury proposal -- specifically, the section 269 provision. The lack of coordination creates the impression that the two provisions could apply to a single transaction. In fact, the tax-indifferent provision will never apply in a situation in which the section 269 provision does not apply because both provisions depend on the same threshold inquiry -- whether there is a corporate tax shelter within the meaning of the proposal's general, multi-purpose definition. From a policy matter, therefore, the provision is superfluous; the section 269 provision alone is sufficient disincentive for these transactions. The additive nature of the two provisions, however, could result in disproportionate tax consequences. By way of example, assume that a corporate tax shelter involves a current deduction of $100 by a domestic corporation and a corresponding income inclusion of $100 by a tax-indifferent party (trading on

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[143] The original proposal would have applied to any tax-indifferent party, and the joint and several liability would have run to any party (other than the tax-indifferent party).

its tax-exempt status). Under the section 269 provision, the domestic corporation's $100 current deduction would be disallowed, resulting in $35 in additional tax. In addition, by virtue of the tax-indifferent provision, the domestic corporation would be jointly and severally liable for $35 in additional tax attributable to the tax-indifferent party. With the addition of the 40 percent penalty on the understatement, the sum of the tax and penalty would almost equal the original $100 deduction.

c. Disclosure by promoters

The new disclosure regime discussed above would impose different disclosure rules to promoters of tax shelters. Promoters would be required to file a disclosure form with the IRS National Office within 30 days of offering the tax shelter to a corporation.

The revised Treasury proposal does not provide any guidance regarding under what circumstances a promoter would be required to file, though the Treasury Department recognizes that the filters discussed above may not necessarily work with respect to promoters.[144] This lack of guidance makes it difficult to evaluate the effectiveness of the promoter disclosure requirement. Further guidance also would be appropriate concerning (1) the applicable penalties (including any personal liability for misstatements on the form) and (2) its coordination with the new disclosure regime for corporate participants. Since this disclosure can be a substitute for the early disclosure requirement by the corporate participant, the development of the details regarding this provision becomes even more important.

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[144] White Paper, supra note 3 at 85, n. 324.

IV. ABUSIVE TAX SHELTER SHUTDOWN ACT OF 1999

A. Description

The *Abusive Tax Shelter Shutdown Act of 1999*, H.R. 2255, was introduced on June 17, 1999 by Mr. Doggett (for himself, Mr. Stark, Mr. Hinchey, Mr. Tierney, Mr. Allen, Mr. Luther, Mr. Bonior, and Mr. Farr of California) with the purpose of eliminating abusive tax shelters by denying tax attributes claimed to arise from transactions that do not meet a heightened economic substance requirement and by repealing the provisions that permit legal opinions to be used to avoid penalties on tax underpayments resulting from transactions without significant economic substance.

H.R. 2255 provides a substantive rule under which a "noneconomic tax attribute" would not be allowed for purposes of determining an income tax liability. A "noneconomic tax attribute" would be any deduction, loss, or credit claimed to result from a transaction unless the transaction changes in a meaningful way the taxpayer's economic position and (1) the present value of the reasonably expected potential income from the transaction (and the taxpayer's risk of loss from the transaction) are substantial in relationship to the present value of the tax benefits claimed, or (2) in the case of certain financing transactions, the deductions claimed with respect to the transaction are not significantly in excess of the economic return realized by the lender. Thus, deductions, losses, and credits would be disallowed unless the underlying transaction has meaningful economic consequences.

Under H.R. 2255, certain transactions would give rise to a presumption of noneconomic tax attributes, resulting in such tax attributes being disallowed. Such a presumption would be created when the transaction that gives rise to the claimed tax benefits is not reflected to any meaningful extent on the taxpayer's books and records for financial reporting purposes. A presumption also would be created when the transaction results in an allocation of income or gain to a tax-indifferent participant which is substantially in excess of the tax-indifferent participant's economic income or gain from the transaction.

Certain special rules are provided. For example, H.R. 2255 generally would not apply to the realization of built-in losses. A special rule is provided that would require a transaction that is part of a series of related transactions to satisfy the economic consequences test both as a single transaction and as if the series of transactions were a single transaction. A similar rule would apply to multiple-step transactions. In a transaction that is an integral part of a taxpayer's trade or business and which is entered into in the normal course of that trade or business, the determination of the potential income from that transaction would be made by taking into account its relationship to the overall trade or business of the taxpayer.

H.R. 2255 enumerates certain benefits (such as the section 29 credit and the low-income housing credit) that would be deemed to satisfy the proposal's heightened economic substance test. The Treasury Secretary would be authorized to expand that list.

H.R. 2255 would apply to both corporations and individuals. In the case of individuals, the proposal would apply only to transactions entered into in connection with a trade or business or an activity engaged in for profit. Certain charitable transfers would be excepted from the proposal's scope. The proposal would not supplant common-law doctrines for addressing tax shelters.

In addition to the substantive rule that would disallow noneconomic tax attributes so as to create an understatement of tax, H.R. 2255 provides increased penalties applicable to tax shelter activity. Under the proposal, a penalty rate of 40 percent would apply to any understatement resulting from the disallowance of a noneconomic tax attribute under the proposal's provisions or under any common-law doctrine such as business purpose, substance over form, and the like. The enhanced penalty would not apply (and thus, only a 20-percent rate would apply) if certain disclosure requirements are satisfied. The disclosure requirements include disclosure within 30 days after the closing of the transaction as well as tax-return disclosure. The disclosure would be required to be signed, under penalties of perjury, by the senior financial officer of the corporation. Under H.R. 2255, there would be no exception to either the 40-percent penalty or the reduced 20-percent penalty.

B. Analysis

H.R. 2255 would address the corporate tax shelter problem primarily through the adoption of a substantive rule of law that would operate to disallow "noneconomic tax attributes," without regard to whether those attributes may be allowable under current law. Like the other proposals under consideration, H.R. 2255 is designed to and likely would result in a change in the cost-benefit analysis undertaken by corporations in connection with evaluating corporate tax shelter transactions. The substantive law approach would give a clear signal as to the Government's tolerance for tax shelter transaction behavior, and would likely earn the attention of corporations that engage in such activity. There are, however, several issues that are raised in connection with a substantive law approach in general, and H.R. 2255's substantive law approach specifically, which are discussed below. Such issues include, for example, (1) certain presumptions that will result in a disallowance if a transaction involves tax-indifferent parties or is not "reflected to any meaningful extent" for financial reporting purposes, and (2) the broad scope of the proposal in that it is not limited to corporations.

In addition to its substantive rule, H.R. 2255 includes an enhanced penalty regime that operates as a "no-fault" penalty. The proposal also includes a separate disclosure regime. The issues with respect to penalty and disclosure components of H.R. 2255 also are discussed below.

The analysis begins with a discussion of H.R. 2255's substantive rule. It discusses (1) the operation of the substantive rule, (2) the relevant definitions used in connection with the rule, (3) the rule's presumptions, (4) the scope of the substantive rule, and (5) exceptions to the substantive rule. The analysis then discusses the proposal's penalty regime and its disclosure regime. The analysis also briefly discusses H.R. 2255's approach of not penalizing non-taxpayer participants (such as advisors) in tax shelter activity.

1. Substantive Rule

a. Operation of the substantive rule

The proposal is designed to deter tax shelter transactions by substantively disallowing "noneconomic tax attributes." The proposal would overlay on the Code certain new heightened economic substance criteria that must be satisfied as a prerequisite to the allowance of any deduction, loss, or credit. In other words, as a starting point the proposal operates to disallow any deduction, loss or credit otherwise allowable under the Code. The proposal then describes the situations under which the deduction, loss or credit would be allowed.

At a minimum, the proposal requires that all transactions must change in a meaningful way the taxpayer's economic position. Thus, if the taxpayer cannot show that a transaction changed in a meaningful way its economic position, the deduction, loss or credit is automatically disallowed. If the transaction does change in a meaningful way the taxpayer's economic position, then the taxpayer also must be able to show that it is able to satisfy either an income test or a financing transaction test. If the taxpayer cannot satisfy either one of those tests, any deduction, loss, or credit associated with the transaction is disallowed, notwithstanding that the taxpayer may have changed in a meaningful way its economic position.

In general, the approach of a substantive rule could be an effective way to combat corporate tax shelters if the rule could specifically target the abusive transactions. Because of the difficulty in narrowly defining the targeted abuses, however, a substantive rule such as the one proposed arguably may be too broad in scope and, along with the use vague definitions, may create a risk of impeding legitimate business activity. Some contend that such a rule can be viewed as inconsistent with a rules-based, objective tax system and could hamper the taxpayer's ability to rely on specific provisions in the Code.

More specifically with respect to H.R. 2255, some argue that the proposal's substantive rule is a significant departure from present law. The proposal's heightened economic substance standard, which requires a "meaningful change in economic position" plus the satisfaction of an income test or financing transaction test, is a different and potentially higher standard than well-developed common-law standards..[145] This affirmative duty of satisfying these new standards would present an additional burden for every corporate transaction involving a deduction, loss, or credit.[146]

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[145] Thus, for example, a transaction that gave rise to an ordinary and necessary deduction satisfying the requirements of section 162 is automatically disallowed <u>unless</u> there has been a meaningful change in the taxpayer's economic position, and even then, the deduction is disallowed if the transaction does not satisfy the income test or, if applicable, the financing transaction test.

[146] Some commentators point out that if H.R. 2255's language is taken literally, the proposal would appear to treat most routine business transactions as corporate tax shelters. Possibly, this criticism could be addressed by retaining an economic substance standard but by

In addition, commentators observe that a substantive rule would create pressure with respect to all of the components and definitions in the rule (discussed below), such as what is a "meaningful" change in economic position as well as each element of the income test and financing transaction test. To the extent that any such component of the substantive rule is unclear, the proposal would undermine the taxpayer's ability to engage in legitimate business activity. On the other hand, some argue that because the proposal is structured to apply to transactions that have little or no economic substance, the proposal would not unduly interfere with legitimate business transactions. Again, this argument depends upon the proposal's success at drawing the line between legitimate business activity and improper tax avoidance.[147]

The proposal provides certain specific exceptions (discussed below). If a transaction does not satisfy one of these specific exceptions, there is no way to prevent the application of the substantive rule. Some view this aspect of the rule as too inflexible. In addition, some argue that to enact a substantive rule as a response to the corporate tax shelter problem may be over-reactive insofar as an enhanced penalty regime arguably has never been adequately tested in this regard.

b. <u>Relevant definitions</u>

Because H.R. 2255 involves a substantive rule that would disallow "noneconomic tax attributes," the definition of noneconomic tax attribute (and all the proposal's related definitions) is extremely important. Imprecision or ambiguity in the definitions could have implications for legitimate transactions not targeted by the proposal.[148] H.R. 2255 contains many operative terms that some view are not adequately defined. In addition, some of the terms and standards are new concepts. If the definitions or new concepts are too vague, some contend that the proposal will not provide the necessary guidance to the IRS to enable it to implement the standards.

(i) <u>Meaningful change in economic position</u>

Much uncertainty surrounds the circumstances under which a "transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position." "Meaningful" is an undefined, imprecise term. For example, does incorporating a

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reversing the presumption such that transactions are disallowed only upon a finding that a transaction <u>does not</u> change in a meaningful way the taxpayer's economic position.

[147] Some have argued that the proposal in essence could be viewed as attempting to provide a legislative definition of legitimate business activity for tax purposes. Namely, under the proposal, legitimate business activity would include only activity that satisfies the proposal's heightened economic substance criteria.

[148] As previously stated in connection with the discussion of the revised Treasury proposal, although the relevant definitions are important with respect to any corporate tax shelter proposal, the consequences of any imprecision are less severe (and, accordingly, the tolerance is greater) in connection with a proposal focused solely on understatement penalties as opposed to substantive disallowance.

portion of a business (i.e., a section 351 transaction) change in a meaningful way the taxpayer's economic position? The assets and liabilities are transferred to a new corporation, with new capitalization and new creditworthiness and perhaps different exposure. At the same time, the value of what the taxpayer had before the transfer is the same as the value of what the taxpayer had after the transfer. Similarly, a routine borrowing transaction (particularly if it is nonrecourse) arguably does not change a taxpayer's economic position, and if it does, it may be difficult to argue that the change was "meaningful," depending upon the meaning of that term and the facts of the transaction. It may be challenging to evaluate whether there is a meaningful change in economic position for purposes of H.R. 2255. Proponents of the proposal would argue that the term "meaningful" is intended to have a common sense definition that when applied to abusive transactions would not be difficult for the IRS and courts to apply.

(ii) Income test

In addition to showing that the transaction changes in a meaningful way the taxpayer's economic position, a taxpayer must be able to show that it satisfies an income test or a financing transaction test (discussed below). Under the income test, the present value of the reasonably expected potential income (and the taxpayer's risk of loss) from the transaction must be substantial in relationship to the present value of the benefits claimed. This test is similar to tests provided in the revised Treasury proposal and the Joint Committee staff recommendations. Some important differences exist, however. In the revised Treasury proposal and the Joint Committee staff recommendations, a transaction satisfies the definition of a corporate tax shelter if the present value of the reasonably expected pretax profit is "insignificant" relative to the present value of the reasonably expected net tax benefits. H.R. 2255, on the other hand, affirmatively requires that the expected income from the transaction be "substantial" in order to be outside of the disallowance rule. It is not clear what level of income is necessary to be considered "substantial" in this regard. Nonetheless, this at a minimum appears to be a higher threshold than merely not being "insignificant" in relation to the expected tax benefits. Some might argue that vagueness in this regard is acceptable because the appropriate level of income would depend on the facts.

Another potentially important distinction from the revised Treasury proposal and the Joint Committee staff recommendations is that H.R. 2255's test focuses on income, not profit. It is not clear why the test would focus on reasonably expected potential income. If in fact what is meant is net income, then the distinction is perhaps not important. Without further guidance, however, the test could mean gross income. Similarly, it is unclear whether the income referred to in the proposal would be pre-tax or after-tax. Additional guidance would be warranted in this regard.

In addition, no guidance is provided with respect to the application of the present value test or the determination of the reasonably expected potential income. Some might argue that it is sensible to permit the facts to dictate the appropriate discount rate, notwithstanding that such ambiguity could impede a taxpayer's ability to rely upon the rule, because the discount rate is inherently a fact-driven issue. On the other hand, dramatically different results could ensue, for example, depending upon the discount rate used to determine the present value. Considerable differences of opinion may exist with respect to the proper discount rate for a given transaction potentially resulting in a battle of experts. As well, not mandating a discount rate may give the taxpayer greater discretion to structure a transaction that would meet the income test.

An additional concern with the income test, which looks to present values and therefore would seem to depend upon a cash-flow analysis, is its application to non-cash-flow transactions. As discussed above in connection the revised Treasury proposal, arrangements that involve the inappropriate creation or duplication of tax basis in assets, for example, may be difficult to analyze using a cash-flow model. In addition, it may be difficult to apply the test to transactions such as mergers and acquisitions.

In the same vein as the substantial income requirement, H.R. 2255 requires that the risk of loss from the transaction also be substantial in relationship to the present value of the tax benefits claimed. H.R. 2255 provides that in determining whether there is a risk of loss from a transaction (and the amount thereof), potential loss of fees and other transaction expenses would be disregarded. The proposal therefore focuses on the risk of economic loss inherent in the transaction itself. It is not clear how this test would apply to business transactions that are designed to reduce a taxpayer's risk of loss, such as a hedging transaction for example.

(iii) <u>Financing transactions</u>

The proposal provides a special test with respect to any transaction which in substance is the borrowing of money or the acquisition of financial capital ("financing transactions"). In such cases, for related deductions to be allowed, the deductions claimed with respect to the transaction must not be "significantly in excess of the economic return for such period realized by the person lending the money or providing the financial capital." The separate rule arguably is necessary because financing transactions do not readily lend themselves to a profit or income test – there generally is no intention to profit or generate income through a financing transaction; therefore, a profit or income test is inapposite. The test focuses on shelter-type activities through which excess deductions may be claimed in a financing transaction.

The proposal essentially requires a matching of the deduction claimed by the borrower and the economic return of the lender. This matching arguably ensures that the tax attributes are economical and that the transaction is not a shelter. For example, a transaction that in substance is a financing transaction but is structured so that the borrower (or acquirer of financial capital) can deduct a portion of the repayment of principal would appear to result in a disallowance of such deductions under this proposal. The proposal establishes a ratio or comparison of deductions of the borrower to economic return of the lender, but does not provide any guidance as to when the rule might be satisfied.[149] It may be difficult for a borrower to evaluate the economic return of an unrelated lender. The lender's return generally is irrelevant to the borrower. Under H.R. 2255, the borrower would have an affirmative duty of establishing this ratio or comparison, or its deductions with respect to the borrowing would be automatically disallowed.

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[149] The comparison of the deduction to the economic return of the lender required under the proposal may be difficult in connection with contingent debt obligations.

(iv) Defining the transaction

Another important aspect of the application of the substantive rule is what constitutes a transaction to which the provision applies. In a loss-generating transaction that involves the transfer of assets, for example, does the expected profit include potential profit from the use of the asset? Will the transaction include the gains or losses from a subsequent sale of the assets by the transferee? The proposal to some extent addresses these concerns by providing that a transaction which is part of a series of related transactions would be treated as satisfying the requirements to avoid disallowance of noneconomic tax attributes only if (1) the transaction meets such requirements (i.e., has a meaningful change in economic position and satisfies the income test or the financing transaction test) standing alone, and (2) the series of related transactions, if treated as one transaction, would meet the requirements. The proposal also provides that a similar rule would apply to a multiple-step transaction with each step being treated as a separate but related transaction. The rule thus partially codifies the step-transaction doctrine, but also requires that each separate transaction have adequate economic substance when tested alone. These tests are designed to prevent taxpayers from bifurcating or combining transactions in order to subvert the rules. A question remains, however, as to when a transaction will be considered as part of a series of "related" transactions or a "multiple-step" transaction.

c. Presumptions

H.R. 2255 provides that certain transactions are presumed to give rise to noneconomic tax attributes and, thus, are automatically disallowed -- apparently without regard to the effect on the taxpayer's economic position and without regard to the income test or financing transaction test (described above). If a transaction meets the terms of a presumption, all deductions, losses, or credits claimed to result from the transaction would be disallowed. Thus, there will be great scrutiny of the terms and definitions under each presumption. The presumptions relate to (1) differences between reporting the transaction for tax purposes verses reporting the transaction for financial statement purposes ("book/tax differences"), and (2) allocation of income to a tax-indifferent party. The operation of these presumptions would represent an expansion of present law and would raise important policy concerns.

A significant concern with respect to these presumptions relates to the lack of guidance regarding how to overcome the presumption. By operation of the substantive rule, if a taxpayer was unable to show substantial potential income relative to the expected tax benefits, the deduction, loss or credit would be disallowed irrespective of this presumption. One could deduce, therefore, that demonstrating a substantial income potential would not be sufficient to overcome this presumption, otherwise the presumption would seem superfluous.

(i) Book/tax differences

Under H.R. 2255, when the payments, liabilities, or assets purport to create a loss (or other benefit) for tax purposes that are not reflected to any meaningful extent on the taxpayer's books and records for financial reporting purposes, the deduction, loss, or credit is disallowed, again regardless of whether the transaction meaningfully changes the taxpayer's economic position or satisfies the income test or financing transaction test. Some would argue that even if book/tax differences are an important factor in identifying tax shelter activity, a proposal that presumes a tax attribute is noneconomic because of such a difference puts too much weight on that factor and could cause inequitable results and affect legitimate business transactions.

There are several ambiguities inherent in this rule. It is unclear what it means for a loss to be "reflected" to a "meaningful extent" on the taxpayer's books and records. For example, would footnote disclosure be considered as reflecting an item to a meaningful extent? In a related issue, it is unclear whether timing differences would be addressed by this rule. In part, whether timing differences are covered by the rule would presumably turn on whether the item could be viewed as being reflected to a meaningful extent on the taxpayer's books and records. If timing differences are covered, this could bring a wide variety of transactions under the presumption.

In addition, financial reporting has different objectives than does reporting for Federal income tax purposes. H.R. 2255's lack of guidance regarding how one rebuts the book/tax presumption could result in a taxpayer having "noneconomic tax attributes" that are disallowed notwithstanding that the taxpayer's treatment for financial reporting purposes is consistent with generally accepted accounting principles.

(ii) <u>Tax-indifferent party</u>

The proposal provides that the fact that the transaction results in an allocation of income or gain to a tax-indifferent party which is substantially in excess of such party's economic income or gain from the transaction gives rise to a presumption that the deduction, loss, or credit is noneconomic and therefore disallowed. A tax-indifferent party is defined as a person who is exempt from income tax. In addition, a tax-indifferent party includes a party with respect to a transaction if, by reason of such person's method of accounting, the items taken into account with respect to the transaction have no substantial impact on such person's income tax liability.

The issue again arises as to how, if at all, this presumption can be rebutted. While the test accurately captures one clear indication of a tax shelter transaction, use of this characteristic to presumptively disallow tax attributes may seem unfair, particularly given the lack of guidance regarding the standard for rebuttal. The concern is that all transactions with a tax-indifferent party having the described economic disparity may not necessarily be abusive.

In addition, some would argue that the aspect of the definition of a tax-indifferent party that includes parties that are tax-indifferent with respect to a transaction because of their method of accounting (such as taxpayers using the mark-to-market method) is too broad and may unfairly penalize taxpayers that are using an otherwise sanctioned method of accounting. On the other hand, use of the mark-to-market method can create tax-indifference with respect to balanced positions. Such tax-indifference arguably should not be permitted to be exploited through otherwise noneconomic transactions.

d. Scope of the substantive rule

H.R. 2255's substantive rule generally has a broad scope in that it is not limited to corporate taxpayers, and it is in addition to rather than in lieu of common law anti-abuse doctrines. The proposal arguably is too narrow, however, in that it does not adequately address noneconomic transactions involving the exclusion of items of income from taxable income.

(i) Individuals

The proposal's reach is not limited to corporations that participate in tax shelter activities. A noneconomic tax attribute under the proposal can be any deduction, loss, or credit, irrespective of whether it is incurred by a corporation or an individual. With respect to individuals, however, the proposal provides that it applies only to transactions entered into in connection with a trade or business or activity engaged in for profit.

Although the proposal is limited to business or "for-profit" transactions, some would argue that it is inappropriate and perhaps unnecessary to apply a proposal, which has its genesis in corporate tax shelters, to individuals. While it is true that the system should not tolerate tax shelter activity, regardless of whether such activity involves an entity operating in corporate form, some dispute whether the marginal benefits from imposing such rules on individuals outweigh the relatively substantial compliance burdens, particularly given the complexities involved with interpreting the proposal's lexicon.[150]

(ii) Effect on common law

Unlike the revised Treasury proposal, H.R. 2255's substantive rule is in addition to and not in lieu of existing common law doctrines such as the economic substance doctrine, the business purpose doctrine, and the substance over form doctrine. The common law doctrines would still apply unaffected by the new proposed economic substance test and, as discussed below, could result in the application of enhanced penalties. Some argue that to the extent that the proposal is in effect codifying an economic substance doctrine, it should supplant common law so that, at a minimum, taxpayers can rely on one set of criteria in evaluating whether the tax benefits they are claiming might be subject to disallowance. They would claim that layering a new economic substance rule upon the various common law doctrines is an admission of the inadequacies of the proposed new rule and will only serve to add confusion to the Code.

On the other hand, some question the wisdom of replacing a body of well-developed case law (including Supreme Court authority) with a new standard that is not likely to address every type of transaction which arguably should be discouraged (as well as potentially impacting

[150] Although the application to individuals potentially is a significant issue with respect to H.R. 2255, the proposal easily could be limited to corporations. Even with respect to individuals, it appears that the proposal may be limited to tax shelters in connection with commercial-type activities.

transactions that should not be discouraged) and, therefore, would support the retention of the common law standards in addition to any proposed new standard.

(iii) Exclusion transactions

Absent from the scope of the transactions covered by the proposal are exclusion transactions. The proposal operates to disallow noneconomic tax attributes. Noneconomic tax attributes are limited to deductions, losses, or credits. Transactions that involve the receipt of economic income that is excluded from taxable income ("exclusion transactions"), would not be covered because they do not involve deductions, losses or credits. Some argue that such exclusion transactions generally are not "tax shelters," and it is difficult to differentiate between exclusion transactions that involve legitimate business activity and those that do not. At a minimum there is little consensus as to when exclusion transactions are inappropriate; accordingly, it is justifiable to omit exclusion transactions from the substantive rule. Proponents of this view also argue that because of the challenges posed by identifying inappropriate exclusion transactions, exclusion transactions should be held to a lower standard and/or a lighter sanction than other "tax shelter" transactions such as the creation of artificial losses, for example. H.R. 2255 arguably strikes this balance by not applying its new economic substance tests to exclusion transactions but by preserving the current common law economic substance doctrines which presumably could still apply to such exclusion transactions and, as discussed below, by applying an enhanced "no-fault" penalty regime to understatements attributable to such transactions.

On the other hand, like noneconomic deductions, losses, or credits, exclusion transactions can be thought of as transactions which should be discouraged.[151] For those that believe that exclusion transactions should be treated the same as deductions, losses and credits, H.R. 2255 could be modified to cover exclusion transactions.

e. Exceptions

The operation of the substantive rule under the proposal is automatic; there is no general exception to the rule such as an exception if "reasonable cause" can be shown. Some contend that this is a serious problem with the proposal, particularly if the scope of the proposal is too broad. Some specific exceptions are provided, as described below.[152]

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[151] See, for example, the discussion of liquidating REITs as an exclusion transaction in connection with the analysis of the revised Treasury proposal, above. For further example, it would seem that the transaction involved in the UPS case, discussed above, would not likely give rise to noneconomic tax attributes under H.R. 2255 because the transaction essentially was an exclusion transaction. Because the transaction lost under a common-law doctrine, however, as discussed below, an enhanced penalty would apply provided that a transaction resulted in a substantial understatement for the year.

[152] Some argue that it is better policy to describe the offensive transactions and disallow the tax benefits associated with those transactions rather than H.R. 2255's approach of treating all

(i) Enumerated list in lieu of general exception

In lieu of a general exception, H.R. 2255 enumerates a series of specific items that might run afoul of the substantive rule, but that would be deemed to give rise to economic returns and not tax benefits. These include the credit for producing fuel from a nonconventional source (section 29); the low-income housing credit (section 42); the credit relating to electricity produced from certain renewable energy sources (section 45); the credit for holders of qualified zone academy bonds (section 1397E) or any similar subsequently enacted program; and any other tax benefit specified in regulations.

Some observe that there would be considerable attention given to the proposal's list of specifically excepted transactions. To the extent that a transaction is not enumerated in that list, it runs the risk of its tax benefits being disallowed. Although there is regulatory authority to expand the list of specifically excepted transactions, at a minimum, there will be a lag time before such list is updated. The Treasury Department would be under considerable pressure to expand this list -- the stakes are high because inclusion on this list has the effect of exempting the transaction from the proposal's substantive rule. In addition, there are no assurances that legitimate transactions will necessarily ever be included in the list. For example, leveraged lease transactions that comply with case law and Rev. Proc. 75-21[153] could run afoul the proposal's income test. There is no exception for such transactions in the list, notwithstanding that Congress may have contemplated the deductions claimed in connection with a leveraged lease. Under a literal reading of the proposal, the deductions would be disallowed.[154] Such a result further illustrates the concern some have raised that the proposal could be overly broad.

Moreover, some would argue that it is inappropriate for the proposal to ignore whether there are legitimate, nontax business reasons for a transaction, and a general exception is necessary. For example, assume an oil company invests in a coal mine. The coal mine may have a very low return so that the oil company barely breaks even, if at all, on its investment. Nonetheless, the oil company desires to keep this investment as a type of hedge in the event of changes in the market (and prices) of oil that would cause coal to be a more economical alternative fuel source. Although the oil company has a legitimate business purpose for its investment, it is conceivable that the investment could give rise to "noneconomic" tax attributes under the proposal, and deductions (such as depletion) could be disallowed.

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transactions as offensive and then attempting to exclude a finite list of specifically enumerated "non-offensive" transactions.

[153] 1975-1 C.B. 715.

[154] As a further example, as previously noted with respect to the revised Treasury proposal, the enumerate list of tax benefits described in Treas. Reg. sec. 1.6662-4(g)(2)(ii) does not include the low-income housing tax credit. Although this item is included in H.R. 2255's list of exceptions, its omission from the Treasury regulations illustrates the difficulty in developing and maintaining such a list.

(ii) Built-in losses

The proposal would provide a separately stated exception for the realization of a built-in loss. Under the proposal, a built-in loss means any loss or deduction to the extent that such loss or deduction had economically been incurred before such transaction is entered into and to the extent that the loss was economically borne by the taxpayer. Thus, the loss on a sale of a building with a built-in loss, which might otherwise be a noneconomic tax attribute that would be disallowed under the proposal's substantive rule, would be allowed under this exception. It would seem that the mortgage swaps in Cottage Savings v. Commissioner[155] would be permitted because those losses had economically been incurred before the transaction was entered into and were economically borne by the taxpayer. On the other hand, loss trafficking in which a taxpayer who did not economically bear a built-in loss claims the loss apparently would not qualify for this exception.

(iii) Charitable contributions

The proposal would also provide an explicit exception (separately stated) for charitable contributions. Notwithstanding that deductions in connection with such contributions might otherwise be "noneconomic tax attributes" under the proposal, such deductions would not be disallowed under the general rule.

2. Increased Penalties

The proposal would increase the penalty under section 6662 with respect to an underpayment of tax attributable to negligence or any substantial understatement of income tax to the extent that such underpayment is attributable to (1) the disallowance of any noneconomic tax attribute under the proposal's substantive rule or (2) the disallowance of any other benefit because of common-law principles such as economic substance, business purpose, substance over form, or any other similar rule of law. The proposal would eliminate the reasonable cause exception (as well as the substantial authority and reasonable basis/disclosure exceptions) to the imposition of the penalty. Hence the penalty would be a "no-fault" penalty.

The "no-fault" nature of the proposed penalty raises some concerns. On one hand, a no-fault penalty could be an effective means for deterring undesirable corporate tax shelter behavior. Some argue that if a transaction is found to be a corporate tax shelter, then a substantial penalty should apply and there should be no exceptions. The concern with this approach, however, is that it depends heavily on the ability to precisely define corporate tax shelters (or, as the case may be, noneconomic tax attributes) in a way that will adequately distinguish between legitimate and abusive tax planning. In other words, to the extent that the proposal's substantive rule relies on definitions that are too broad, it might apply to disallow what otherwise might be legitimate business deductions. An understatement would result and a penalty would apply (assuming the other requirements of section 6662 are satisfied). In some circumstances, this arguably would

[155] 499 U.S. 554 (1991).

produce an inequitable result. Thus, some argue that a general exception to the penalty (even if the standard for such an exception is relatively high) is necessary.

Significantly, notwithstanding the "no-fault" nature of the penalty, like the revised Treasury proposal, there apparently must be a finding of negligence (within the meaning of section 6662(c)),[156] or a substantial understatement (within the meaning of section 6662(d)) in order for the penalty to apply.[157]

With respect to the penalty rate, some argue that a 40-percent penalty rate is too high, particularly to the extent that corporate taxpayers are penalty averse. The inequity created by this high penalty rate is exacerbated by the substantive rule that disallows noneconomic tax attributes and, thereby, potentially creates an understatement to which the enhanced penalty would apply.[158] On the other hand, the penalty rate should be sufficient to alter the cost-benefit analysis with respect to corporate tax shelter activity in a manner that would discourage such activity. This argument would support a rate that is higher than the rate otherwise applicable to understatements of tax not associated with corporate tax shelters.

3. Disclosure

a. Taxpayer disclosure

Under H.R. 2255, the increased penalties discussed above would not apply if certain disclosure requirements are satisfied. Many commentators believe that disclosure is a key to addressing effectively corporate tax shelters. As a general matter, therefore, the proposal's inclusion of a disclosure mechanism seems appropriate. A question exists, however, as to the effectiveness of the proposal's specific disclosure regime. Disclosure would prevent the 20 percent section 6662 penalty rate from increasing to 40 percent under the proposal's enhanced penalty regime (discussed above). Disclosure would not change the application of the substantive rule, and it would not function to eliminate completely an otherwise applicable penalty. Some argue that corporations are generally penalty averse and, as a result, a reduction in the potential penalty rate from 40 percent to 20 percent is not a sufficient incentive for a corporate taxpayer to disclose. This is especially true because by disclosing a transaction that the taxpayer believes may have noneconomic tax attributes (and therefore subject to the penalty) the taxpayer is also admitting that the deductions, losses, and credits claimed to result from the

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[156] Some corporate tax shelter transactions will result in negligence penalties. See Compaq Computer Corp. v. Commissioner, 113 T.C. No. 17 (Sept. 21, 1999).

[157] See the previous analysis of the revised Treasury proposal for a discussion of issues regarding substantial understatement and the need for an underpayment of tax.

[158] The penalty is imposed if there is a "noneconomic tax attribute," tracking the proposal's substantive rule. Some would argue that the penalty, therefore, just increases the pressure on the definitions and terms used to describe noneconomic tax attributes.

transaction are suspect and arguably should be disallowed under the proposal's substantive rule. In other words, disclosure arguably guarantees an understatement and a penalty.

In order to reduce the penalty from 40 percent to 20 percent, the proposal requires the taxpayer to comply with a 30-day disclosure and a tax-return disclosure. The 30-day disclosure provides an "early-warning" device enabling Treasury and the Congress to react in a more timely fashion to tax shelter activity. Further guidance is needed as to what that disclosure would entail. In addition, to the extent that the general definition of a noneconomic tax attribute is too broad, the proposal could be viewed as compelling disclosure of many legitimate transactions that will be of little value to the Treasury in seeking information relating to tax shelter activity.

Some also argue that a 30-day disclosure requirement is not practical. Situations could arise, for example, in which the tax department of a corporate taxpayer is involved in the planning stages of a transaction only at the latest phases before the deal is "closed." In some situations, the tax department may not even be aware of the transaction until after the fact. The relevant tax analysis may not be available until the taxpayer is in the process of preparing its tax return. Because 30-day disclosure is a requirement for reduction of the penalty rate, to the extent that a taxpayer cannot comply with that disclosure, there is no opportunity to reduce any potential penalty and, therefore, there is no incentive to comply with the tax-return disclosure. On the other hand, some have observed that the proposal could have the collateral benefit of encouraging earlier involvement of the tax department in such transactions.

With respect to the tax-return disclosure, very detailed specifications are provided. Included among those is a requirement that the senior financial officer sign, under penalty of perjury, a statement that the facts, assumptions, or factual conclusions relied upon in reporting the transaction are true and correct as of the date the return is filed, to the best of such officer's knowledge and belief. This requirement has the benefit of increasing the visibility of the tax shelter transaction within the corporation.[159]

The tax return disclosure would also require disclosure of items such as the facts and assumptions, due diligence performed, and third-party offering material. In addition, the proposal would require disclosure of any contingent fee arrangement or arrangement in which fees could be subject to reimbursement and any express or implied warranty with respect to the anticipated tax results from the transaction. These last two features may be common characteristics of corporate tax shelter transactions and disclosure of such features would seem to be consistent with uncovering such transactions.

The proposal does not state how the disclosure regime would be satisfied for noncorporate taxpayers.

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[159] The revised Treasury proposal and the Joint Committee staff recommendations have similar officer attestation requirements.

b. Promoter disclosure

H.R. 2255 does not provide for promoter disclosure. Some have argued that promoter disclosure is the most appropriate means for accomplishing early warning to Treasury with respect to corporate tax shelters. Both the revised Treasury proposal and the Joint Committee staff recommendations include promoter disclosure requirements.

4. Proposals affecting other parties involved in tax shelters

H.R. 2255 does not include any provisions targeted to parties, other than the taxpayer, who participate in, and benefit from, a corporate tax shelter, such as promoters and advisors. Proponents of this approach argue that taxpayers should bear responsibility for the consequences of their transactions and that, if the demand for tax shelters is removed, there will be little incentive to supply such transactions. In addition, although there are no specific penalties for advisors, the proposal arguably accomplishes the same effect by repealing the provision that permits legal opinions to be used to avoid penalties on tax underpayments resulting from tax shelters. On the other hand, some are of the view that those who encourage or assist in (and stand to benefit from) a taxpayer's shelter activity should bear some responsibility for their participation in that activity. Both the revised Treasury proposal and the Joint Committee staff recommendations include rules targeted at such other participants.

V. JOINT COMMITTEE STAFF RECOMMENDATIONS RELATING TO CORPORATE TAX SHELTERS

A. Description

The Joint Committee staff recommends that a meaningful penalty structure be established to discourage corporate taxpayers from entering into corporate tax shelter transactions. Thus, the Joint Committee staff has recommended modifications to penalties and the standards of practice as they relate to corporate tax shelters. The recommendations fall into two categories: (1) those that affect corporations that participate in tax shelters, and (2) those that affect other parties involved in corporate tax shelters. In addition, the Joint Committee staff makes a number of recommendations regarding new disclosure and registration obligations with respect to corporate tax shelters. In accordance with its findings, the Joint Committee staff recommends the following with respect to corporate tax shelters.

1. <u>Recommendations that affect corporations which participate in corporate tax shelters</u>

- Clarify the definition of a corporate tax shelter for purposes of the understatement penalty with the addition of several "tax shelter indicators." With respect to a corporate participant, a partnership, or other entity, plan, or arrangement will be considered to have a significant purpose of avoidance or evasion of Federal income tax if it is described by one (or more) of the following indicators:

    - The reasonably expected pre-tax profit from the arrangement is insignificant relative to the reasonably expected net tax benefits.

    - The arrangement involves a tax-indifferent participant, and the arrangement (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deductions, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.

    - The reasonably expected net tax benefits from the arrangement are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction.

    - The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is reasonably expected to create a "permanent difference" for U.S. financial reporting purposes under generally accepted accounting principles.

- The reasonably expected net tax benefits from the arrangement are significant, and the arrangement is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement.

- An entity, plan, or arrangement can still be a tax shelter even though it does not display any of the tax shelter indicators, provided that a significant purpose is the avoidance or evasion of Federal income tax.

- Modify the penalty so that, with respect to a corporate tax shelter, there would be no requirement that the understatement be substantial.

- Increase the understatement penalty rate from 20 percent to 40 percent for any understatement that is attributable to a corporate tax shelter. The IRS would not have the discretion to waive the understatement penalty in settlement negotiations or otherwise for corporate tax shelters.

- Provide that the 40-percent penalty could be completely abated (i.e., no penalty would apply) if the corporate taxpayer establishes that it satisfies certain abatement requirements. Foremost among the abatement requirements is that the corporate participant believes there is at least a 75-percent likelihood that the tax treatment would be sustained on the merits. Another requirement for complete abatement involves disclosure of certain information that is certified by the chief financial officer or another senior corporate officer with knowledge of the facts.

- Provide that the 40-percent penalty would be reduced to 20 percent if certain required disclosures are made, provided that the understatement is attributable to a position with respect to the tax shelter for which the corporate participant has substantial authority in support of such position.

- Require a corporate participant that must pay an understatement penalty of at least $1 million in connection with a corporate tax shelter to disclose such fact to its shareholders. The disclosure would include the amount of the penalty and the factual setting under which the penalty was imposed.

2. Recommendations that affect other parties involved in corporate tax shelters

- Increase the penalty for aiding and abetting with respect to an understatement of a corporate tax liability attributable to a corporate tax shelter from $10,000 to the greater of $100,000 or one-half the fees related to the transaction.

- Expand the scope of the aiding and abetting penalty to apply to any person who assists or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement penalty if (1) the person knew or had reason to believe that the corporate tax shelter could result in an understatement of tax, (2) the person opined or advised the corporate participant that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged, and (3) a reasonable tax practitioner would not have believed that there existed at least a 75-percent likelihood that the tax treatment would be sustained on the merits if challenged.

- Require the publication of the names of any person penalized under the aiding and abetting provision and an automatic referral of the person to the IRS Director of Practice.

- Clarify the U.S. government's authority to bring injunctive actions against persons who promote or aid and abet in connection with corporate tax shelters.

- Include the explicit statutory authorization for Circular 230 in Title 26 of the United States Code and authorize the imposition of monetary sanctions.

- Recommend that, with respect to corporate tax shelters, Treasury amend Circular 230 generally to (1) revise its definitions, (2) expand its scope, and (3) provide more meaningful enforcement measures (such as the imposition of monetary sanctions, automatic referral to the Director of Practice upon the imposition of any practitioner penalty, publication of the names of practitioners that receive letters of reprimand, and automatic notification to state licensing authorities of any disciplinary actions taken by the Director of Practice).

3. Disclosure and registration obligations

a. Corporate taxpayer disclosure

- 30-day disclosure.--Arrangements that are described by a tax shelter indicator and in which the expected net tax benefits are at least $1 million would be required to satisfy certain disclosure requirements within 30-days of entering into the arrangement.

  - The 30-day disclosure would include a summary of the relevant facts and assumptions, the expected net tax benefits, each tax shelter indicator that describes the arrangement, the analysis and legal rationale, the business purpose, and the existence of any contingent fee arrangements.

  - The chief financial officer or another senior corporate officer with knowledge of the facts would be required to certify, under penalties of perjury, that the disclosure statements are true, accurate, and complete.

- Tax-return disclosure.--Arrangements that are described by a tax shelter indicator (regardless of the amount of net tax benefits) would be required to satisfy certain tax-return disclosure requirements.

  - The tax-return disclosure would include a copy of any required 30-day disclosure.

- The tax-return disclosure also would identify which tax shelter indicators describe one or more arrangements reflected on the return.

b. Tax shelter registration

- Modify the present-law rules regarding the registration of corporate tax shelters by (1) deleting the confidentiality requirement, (2) increasing the fee threshold from $100,000 to $1 million, and (3) expanding the scope of the registration requirement to cover any corporate tax shelter that is reasonably expected to be presented to more than one participant.

- Require additional information reporting with respect to the registration of tax shelter arrangements that are described by a tax shelter indicator. The additional information would include the claimed tax treatment and summary of authorities, the tax shelter indicator(s) that describes the arrangement, and certain calculations relating to the arrangement.

B. Analysis

1. In general

The Joint Committee staff's recommended penalty regime is intended to have a deterrent effect on corporate tax shelter activity by raising the costs associated with engaging in such tax shelter activity (e.g., through monetary penalties, possible shareholder disclosure, and the like) and thereby discouraging taxpayers from participating in such activities.

A fundamental aspect of the Joint Committee staff recommendations is that they would never produce, in and of themselves, an understatement of tax liability: The recommendations do not contain a substantive rule that would operate to disallow tax benefits in a tax shelter transaction. Rather, the recommendations only would apply to impose penalties if an understatement is otherwise determined under existing tax laws (including common-law doctrines). It is presumed that, under present law, legitimate business transactions would not result in understatements of tax. Accordingly, such transactions would not be subject to a penalty under the recommendations. Where an aspect of the recommendations might otherwise be viewed as possibly vague or broad, such that a legitimate business transaction might be described as a tax shelter, the only direct implication of the recommendations would be a limited disclosure requirement of the transaction at issue.

Some commentators have suggested that the Joint Committee staff recommendations merely represent what is already present law with respect to corporate tax shelter penalties, and that the Treasury Department currently has the authority to prescribe regulations that could provide rules similar to the Joint Committee staff recommendations. Similarly, some maintain that the existing penalty rules should be given an appropriate opportunity to be applied and only then, evaluated as to their adequacy.

The Treasury Department, however, has yet to issue regulations regarding tax shelter registration under section 6111 and is unlikely to issue further guidance under section 6662. The lack of guidance may be, in part, a result of a lack of clear statutory guidance with respect to recent legislation regarding corporate tax shelters. As long as the Treasury Department is reluctant to issue regulations in this regard, the rules are ineffective and corporate tax shelter activity will likely continue unabated. The lack of guidance under present law also can create uncertainty for legitimate business activity. On the other hand, due to a lack of legislative guidance as to its authority, the Treasury Department conceivably could issue guidance that could be viewed as significantly more expansive than the Joint Committee staff recommendations. Additional Congressional guidance therefore would serve the purposes of (1) expediting the implementation of enforceable rules with respect to corporate tax shelters, (2) providing more certainty as to when certain activity potentially could be subject to penalties, and (3) ensuring that such rules are balanced and reasonable.

In addition to providing further legislative guidance with respect to corporate tax shelters, the Joint Committee staff recommendations would enhance the section 6662 penalties and the preparer and advisor penalties. Such changes are intended to increase the costs for taxpayers and for advisors who participate in corporate tax shelters, and hopefully would deter others from entering into such transactions.

2. Corporations that participate in corporate tax shelters

a. No change to substantive law

Some argue that in order for an anti-tax shelter regime to function properly, it must disallow unwarranted tax benefits, thereby producing related understatements of tax. Others respond that in order for such a regime to function properly and not impede legitimate business transactions, the definition of a corporate tax shelter should be narrow and only address the egregious cases. Because such a rule would create an automatic understatement with respect to arrangements described by the definition, good intent or the presence of a business purpose would become irrelevant and could not alter the disallowance of tax benefits. The Joint Committee staff is concerned that no tax shelter definition would adequately distinguish in every case between legitimate business activity and improper tax avoidance. Instead, the Joint Committee staff determined that it was appropriate to modify the existing tax shelter penalty regime in order to change the cost-benefit analysis, which the Joint Committee staff concluded is heavily skewed in favor of participating in corporate tax shelters. At the same time, the Joint Committee staff recommendations would not interfere with a taxpayer's ability to rely on a rules-based Code and would provide greater certainty as to when a transaction will be considered to be suspect, potentially subjecting it to increased penalties.

b. Definitions

Present law defines a tax shelter as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.[160] The Joint Committee staff recommendations would not modify this definition, but rather, would deem such a significant purpose to exist if an arrangement is described by at least one of five defined indicators.

The retention of the significant purpose test, in conjunction with the five indicators, may be redundant as the rule could be viewed as encompassing the very same transactions that would be described by the five indicators. In addition, the “significant purpose” standard is viewed by some as overly broad. A possible response to this concern would be to eliminate the significant purpose aspect of the rule.[161] On the other hand, the five indicators may be too narrow and may not encompass all the transactions that could meet the significant purpose standard.

Some commentators have suggested that certain arrangements should be exempt from the definition of a corporate tax shelter where the tax consequences were contemplated by Congress in enacting the provision upon which the taxpayer relies. On the other hand, it is often difficult to ascertain whether the tax results of a particular provision were specifically contemplated by Congress. In fact, many tax shelter transactions rely on separate Code provisions, where the results may have been independently contemplated by Congress, but where the interaction of such provisions was not. Because the Joint Committee staff recommendations would not automatically deny tax benefits, there is less pressure for a clearly contemplated exception. A tax benefit that is clearly contemplated should not result in an understatement of tax and accordingly no penalty would be assessed.

An alternative to a general clearly contemplated exception would be to provide a list of exempt transactions as in H.R. 2255, discussed above. Such a list could be viewed as increasing uncertainty by creating positive inferences with respect to arrangements that are on the list and negative inferences for arrangements that are absent from such list. Furthermore, it is unclear how to define precisely the criteria by which transactions would or would not qualify for inclusion on such a list. There would be considerable pressure on such a list because inclusion in the list would result in certainty that the transaction would not be subject to enhanced penalties.[162] Because the Joint Committee staff recommendations would not automatically deny tax benefits, however, it would seem that there is less of a need for a list of enumerated exceptions.

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[160] Sec. 6662(d)(2)(C)(iii).

[161] Thus, a tax shelter would then be described as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement only if it is described by at least one of the five indicators.

[162] See also the discussion of the revised Treasury proposal and H.R. 2255 with respect to the merits of a clearly contemplated exception and an enumerated list of excepted transactions, particularly in connection with a substantive rule.

There is an issue as to the need for disclosure of clearly contemplated transactions (which disclosure would be prudent under the recommendations in order to avoid any understatement penalty), and the potential compliance burdens such disclosure would create for legitimate business activity. The Joint Committee staff recommendations, therefore, include a list of items that are excepted from disclosure. Arguably, the pressure on this list and the issues with respect to the inferences such a list may create remain, though exclusion from such a disclosure list is less significant than exclusion from a list of exceptions from a substantive rule.[163]

In addition, there are issues with respect to each indicator that is a component of the recommended definition of a corporate tax shelter. Perhaps most importantly is whether the recommended definition (through its indicators) would describe legitimate business activity. It bears repeating that while the recommended definition of a corporate tax shelter may not be solely limited in every circumstance to inappropriate transactions, the recommendations would never, in and of themselves, produce an understatement of tax. Rather the recommendations would impose penalties on understatements otherwise arising pursuant to existing tax laws. Therefore, a legitimate business transaction that may be described by one of the tax shelter indicators provided in the recommendations but that also produces valid tax benefits in accordance with present law would not likely create an understatement under present law and no penalty could be imposed. A discussion of each tax shelter indicator and the issues related thereto follows.

(i) <u>Insignificant pre-tax profit relative to tax benefits</u>

An arrangement would be described by the first indicator when its reasonably expected pre-tax profits are insignificant relative to its reasonably expected net tax benefits. Some have pointed out that many business operations are established with the expectation that no profits will arise until many years in the future, as is often the case with respect to natural resource exploration or innovative technology development. While companies may operate for several years without earning positive cash flows, it is generally intended that they will ultimately be profitable.

To the extent possible and often in order to obtain financing, companies generally prepare multi-year cash flow projections. In evaluating whether a transaction would be described by this indicator, the Joint Committee staff intends that taxpayers and the IRS should utilize the same cash flow projections that were generated for other business reasons (<u>i.e.</u>, investment decisions, prospective investors, internal budgeting, external financing, and the like). The calculations

[163] For example, some have observed that the Joint Committee staff recommendations include tax-exempt interest as an item for which inclusion on the appropriate schedule of a corporation's tax return will be deemed to satisfy the recommended disclosure requirements. Such commentators have suggested that this treatment implies that an investment in tax-exempt bonds would be considered to be a tax shelter under the recommendations. No such inference is intended. The recommendations are designed to remove any uncertainty as to a reporting obligation with respect to such transactions by deeming disclosure to have been satisfied.

should include "out-year" cash flows and should consider possible cost savings and other economic changes that may result from the arrangement.[164] In addition, the IRS should not substitute its own business judgement for that of the taxpayer in determining whether an investment opportunity should have been undertaken. Similarly, it is intended that the IRS would not substitute the actual results of an investment for the estimates made at the time the investment decision was made, unless the facts and circumstances clearly indicate that such estimates were unreasonable at the time.

The Joint Committee staff recommendations do not assign a percentage or value to the term "insignificant."[165] Some commentators have expressed concerns with the uncertainty an imprecise measure such as "insignificant" can create and have argued that the use of such vague terms will preclude the recommendations from being objective. The Code presently uses the terms "insignificant" and "significant" in more than fifty provisions, and the regulations thereunder further expand their use. In some cases, the term is defined as a fixed percentage,[166] but in most cases the concepts are left as qualitative matters to be evaluated in the context of the particular facts and circumstances.[167] On the other hand, rules quantifying an acceptable minimum level of profit may encourage promoters to create tax shelter arrangements that are designed to achieve only such minimum amounts, but that nonetheless may be abusive transactions that should be discouraged.[168] As well, the imprecision is not as compelling with respect to the recommended indicator as it would be under a substantive rule, because the indicator would not cause (in and of itself) an understatement of tax upon which to assess a penalty. It is expected that the courts would analyze this standard in the same manner as other similar rules under present law -- a common sense application of the law to the specific facts and circumstances of the case.

For purposes of calculating the reasonably expected pre-tax profit, all taxes, other than Federal income taxes, would be taken into account as expenses in the period in which they are expected to be paid. This rule would require that foreign income taxes expected to be imposed in the arrangement would be treated as an expense in determining pre-tax profit. Some

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[164] Some have observed that reliance on reasonably expected cash flows calls into question the objectivity of the recommended indicator. Different "reasonable expectation" projections (including the probability assigned to each potential "out-year" cash flow) could cause dramatically different results under this indicator.

[165] Nor does the revised Treasury proposal discussed above.

[166] For example, section 1202(c)(3)(B) defines a significant redemption by reference to five percent of the aggregate value of a corporation's stock.

[167] For example, section 351(g)(3)(A) considers stock to be preferred only if, among other things, it does not participate in corporate growth to any significant extent.

[168] Some have suggested that in the absence of guidance, a practitioner "rule of thumb" ratio is likely to develop with respect to when a profit would be considered not insignificant.

commentators have expressed that a choice between investing in the United States and a foreign country, both subject to the same income tax rate in their respective jurisdictions, would be treated differently under this test. The pre-tax profit of the U.S. arrangement would be measured on its gross income while the gross foreign income would be reduced by any foreign taxes imposed, resulting in possible different determinations of what are otherwise similar transactions.

Certain arrangements (i.e., leveraged leases, like-kind exchanges, financing transactions, and tax-free reorganizations) arguably do not have as their main objective the production of quantifiable pre-tax profits. Other transactions are not traditional investments of money (e.g., acquisitions, financings, swaps, and hedging transactions), and under the Joint Committee staff recommendations could presumably be treated as described by this indicator because they may not produce any measurable "profit." Also raised as a concern are debt-financed, stock buy-back programs that would likely produce interest deductions (i.e., tax benefits) greater than the related reduction in dividend payments (i.e., negative pre-tax profit) otherwise due on the redeemed stock. On the other hand, the transactions described above should not be expected to produce understatements under present law, and even if an understatement might arise, taxpayers should be highly confident and therefore could satisfy the requirements for exemption from an understatement penalty.[169]

(ii) Involvement of tax-indifferent participant

An arrangement would be described by the second indicator if it involves a tax-indifferent participant and: (1) results in taxable income materially in excess of economic income to the tax-indifferent participant, (2) permits a corporate participant to characterize items of income, gain, loss, deduction, or credits in a more favorable manner than it otherwise could without the involvement of the tax-indifferent participant, or (3) results in a noneconomic increase, creation, multiplication, or shifting of basis for the benefit of the corporate participant, and results in the recognition of income or gain that is not subject to Federal income tax because the tax consequences are borne by the tax-indifferent participant.[170]

Some question the need for the second rule described above, believing that it would be subsumed within the first rule. Although there may be some overlap in the rules, the Joint Committee staff believes that the second rule is an important safety net for transactions in which the character of payments is important (and takes advantage of the tax-indifference of the counterparty), even if there is an argument that the tax-indifferent party's economic income is ultimately the same as its taxable income. For example, in a step-down preferred stock arrangement, the corporate taxpayer is able to claim a deduction for what amounts to repayment

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[169] It could still be argued that in order to ensure that penalties would not apply, disclosure would be required of even legitimate business transactions. This disclosure could be viewed as overly burdensome on taxpayers.

[170] The revised Treasury proposal and H.R. 2255 each have a tax-indifferent party provision but have details that differ from the Joint Committee staff recommendations.

of principal. On an annual basis, the transaction is likely to be described by the first rule (because the tax-indifferent party is receiving taxable income in excess of economic income). On an aggregate basis, however, the answer is less clear because the tax-indifferent party may be entitled to a capital loss (under U.S. principles) when the transaction closes. It is clear, however, that were the tax-indifferent party fully taxable, it would not engage in such a transaction because in early years it would essentially be taxed on a return of its investment. The corporate participant would be able to characterize its payments as deductions (including the repayments of principal), which is a more favorable manner than it otherwise would if it were dealing with a taxable party. The second rule, therefore, removes any ambiguity with respect to this type of transaction.[171]

Others have questioned whether evaluating transactions based on classes of taxpayers that possess Congressional exemptions from tax, including Native American tribal organizations and other tax-exempt organizations, essentially overrides their tax exempt status. At the same time, such parties are exempt from tax for policy reasons (e.g., societal good, charitable purpose, insufficient nexus to the United States, and similar policy reasons) that are wholly unrelated to engaging in transactions that basically serve to confer their special tax status to corporations for a fee. Thus, assessing tax shelter status arguably is not inconsistent with the policies underlying an entity's tax exempt status.

Another criticism of any tax-indifferent party rule is that a corporate participant in a transaction may not be aware that other parties to the transaction satisfy the tax-indifferent definition. While the lack of information could cause uncertainty with respect to corporations that engage in multi-party transactions, it seems unusual that taxpayers would not know certain fundamental information regarding their investment partners.

(iii) Existence of noncustomary tax indemnity

An arrangement would be described by the third indicator when its reasonably expected net tax benefits are significant, and the arrangement involves a tax indemnity or similar agreement for the benefit of the corporate participant other than a customary indemnity agreement in an acquisition or other business transaction entered into with a principal in the transaction. The Joint Committee staff recommendations would define a "tax indemnity or similar agreement" as an indemnity clause, a guarantee, insurance, or any other arrangement under which the corporate participant would be entitled to be recompensed in the event that it is

[171] Although some have argued that the first rule, which compares the tax-indifferent party's taxable income to its economic income, is sufficient and the more appropriate rule, that rule itself is not without issue. For example, a tax indifferent party arguably derives what would otherwise constitute taxable income that is materially in excess of economic income any time a tax-exempt or foreign person acquires a bond at a premium, because absent any section 171 amortization election (which the tax-exempt or foreign person will presumably not bother to make), stated taxable income exceeds the yield on the bond. It would seem that such examples are rare, and the rule could be clarified in a manner that would make it clear that it does not apply to such situations.

not entitled to all or any portion of the expected net tax benefits, or any other arrangement that has a similar economic effect. This definition would include, among other things, a promise by the promoter to refund all or a portion of its fees charged in the event that expected tax benefits are disallowed.

Commentators have questioned whether the definition of a customary indemnity agreement would include, among other things, (1) gross-ups for the imposition of cross-border withholding taxes, which appear in practically every cross-border swap or financing arrangement, (2) gross-ups for changes in the amount of the dividends received deduction, (3) gross-ups for changes in the amount of the depreciation deductions available to a lessor, (4) gross-ups for changes in the rate of foreign tax credits available in respect of cross-border financings, or (5) indemnifications for tax benefits in dividend stripping transactions. The determination of whether a customary agreement exists should be based on the applicable facts and circumstances associated with the arrangement at issue. Depending upon the particular circumstances in which they arose, the items described above may or may not constitute customary agreements. Although some suggest that a list of customary indemnities is needed for clarification, it is unlikely that a comprehensive list that would fit every situation could be adequately developed. This may create uncertainty for taxpayers and cause them to disclose transactions that may not have avoidance features.

An issue also exists as to the effectiveness of the provision. To the extent that tax shelter transactions increasingly include indemnity agreements, a question arises as to whether such agreements become "customary." It is unlikely, however, that such are of the type that is customary in an acquisition or business transaction. In addition, if such agreements are not with a principal in the transaction, but rather are with a promoter, the fact that they are customary should not matter. The agreement will still cause the transaction to be described by an indicator.

(iv) Permanent difference for U.S. financial reporting purposes

An arrangement would be described by the fourth indicator when its reasonably expected net tax benefits are significant and it is reasonably expected to create a permanent difference between tax and financial reporting (i.e., an amount that will be reflected for either tax or financial reporting purposes, but not both).

Not all permanent differences are indicative of tax shelter activity. However, permanent differences that arise in conjunction with significant net tax benefits (e.g., tax deductions or losses that will never produce financial reporting expenses or losses, and financial reporting income or gain recognition that will never be subject to taxation) should be disclosed in order to be identified and evaluated. Permanent differences that involve financial reporting deductions that will never produce tax expenses or losses, or taxable income or gains that will never be reported in the financial statements likely may not produce significant net tax benefits and, thus, would not be described by this indicator. Even when there are significant net tax benefits, however, exemptions from disclosure may be appropriate. For example, one commentator suggested that certain cases, such as incentive stock options that would never be deducted for financial reporting purposes, should be exempt from this definition (or at least from the disclosure requirement).[172]

Many cases exist in which a particular item of income, deduction, gain, or loss is treated differently for tax and financial reporting purposes, but only for a period of time until such temporary difference reverses itself (e.g., where an asset has a shorter tax depreciation life than the financial reporting depreciation life). Some commentators have pointed out that temporary differences between tax and financial reporting can be found in corporate tax shelter arrangements that produce significant tax benefits and should be included as part of this indicator. Such tax benefits generally involve either, or both, the acceleration of tax deductions before actual payment of an expense or the deferral of taxable income beyond the actual receipt of the revenue. However, these transactions would likely be described by the first indicator by virtue of its present value analysis. Furthermore, requiring special disclosure of most items from Form 1120, Schedule M-1 would be too burdensome for taxpayers and unadministrable by the IRS.

(v) Lack of additional economic risk

An arrangement would be described by the fifth indicator when its reasonably expected net tax benefits are significant and it is designed so that the corporate participant incurs little (if any) additional economic risk as a result of entering into the arrangement. For this purpose, an arrangement can be designed to limit a corporate participant's economic risk in a number of ways, including (but not limited to) the use of nonrecourse financing, guarantees, stop loss agreements, recission clauses, unwind clauses, hedged position, or other similar arrangements. This indicator would be broadly defined, encompassing the many different transactions that can be utilized to minimize or eliminate risk, including the use of derivative transactions.

Some commentators believe that the economic risk indicator overlaps in many cases with the pre-tax profit indicator and does not appear to function properly with respect to transactions containing economic returns with option-type payoffs. They question, for example, whether an out-of-the-money call option, which may be inexpensive and provide its holder with tax benefits when compared to owning the underlying property, would be described by this indicator. Some also argue that this indicator could describe all borrowings (because the lender, not the borrower, is the party taking the risk), hedging transactions, defeasance transactions, insurance transactions, and all transactions among members of an affiliated group (including all financing transactions, intercompany transactions, and arrangements regarding the repatriation of dividends). On the other hand, while certain of these transactions may, in fact, produce little (if any) additional economic risk, they would also have to produce significant tax benefits in order to be described by this indicator.

[172] A list of exemptions from this indicator, however, has similar problems as those previously discussed with respect to list of "clearly contemplated" items.

c. Consequence of understatement with respect to a corporate tax shelter

The Joint Committee staff recommendations would impose a new 40-percent corporate tax shelter understatement penalty. Under the recommendations, the IRS would not have the discretion, in settlement negotiations or otherwise, to waive such a penalty. The recommendations would apply to any understatement that is attributable to a corporate tax shelter.

An "understatement attributable to a corporate tax shelter," for this purpose, would mean the amount of tax required to be shown on a return for the taxable year with respect to the transaction that is a corporate tax shelter over the amount of the tax imposed which is shown on the return with respect to that transaction (reduced by any rebates with respect to that transaction). In other words, the tax shelter transaction would be viewed in isolation, and if the reporting of the transaction in isolation results in an understatement, then a penalty would be imposed, regardless of other items on the return for the taxable year and regardless of whether there was an overall "underpayment" of tax for the taxable year. The recommendations provide that the penalty would apply regardless of whether the understatement is "substantial" within the meaning of section 6662. Thus, the penalty would be imposed on the "first dollar" of understatement.

Although in certain circumstances the amount shown as tax by the taxpayer on its return may include a qualified amended return,[173] in no event would such an amended return that includes a corporate tax shelter transaction be treated as a qualified amended return with respect to that corporate tax shelter transaction unless it is filed prior to the time the taxpayer is first contacted by the IRS concerning an examination of the return (or a person described in section 6700(a), relating to the penalty for promoting abusive tax shelters, is first contacted by the IRS concerning an examination of an activity described in section 6700(a)). This is essentially the standard of Treas. Reg. sec. 1.6664-2(c)(3), without the exceptions made for Coordinated Examination Program taxpayers in Rev. Proc. 94-69.[174]

Under present law, taxpayers negotiate settlements with respect to both understatements of tax and penalties that could be imposed on any such understatements. One advantage of the Joint Committee staff recommendations that would eliminate the IRS ability to waive penalties is that all taxpayers would be treated identically, thus ensuring consistency.[175]

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[173] See Treas. Reg. sec. 1.6664-2(c).

[174] 1994-2 C.B. 804.

[175] In order to better ensure consistency with respect to corporate tax shelter audit activity, some have suggested that taxpayers should be afforded certain procedural safeguards. For example, taxpayers arguably should have the right, but not the obligation, to have corporate tax shelter issues reviewed by the IRS National Office. As discussed above, the White Paper suggests that such safeguards may be appropriate.

Some commentators believe that one way in which a corporate taxpayer could avoid penalties with respect to any item on its return would be to pay taxes with respect to that item, file a claim for refund that is denied, and commence litigation in District Court or Court of Federal Claims. Such actions could be viewed as distorting and undermining the traditional settlement process. On the other hand, the originally filed tax return should only reflect those items that the taxpayer reasonably believes is an accurate reflection of its tax position. Taxpayers should be free to petition the government through the refund claim procedures for tax refunds with respect to questionable transactions.[176]

d. <u>Abatement of penalty</u>

The Joint Committee staff recommendations would require that in order for a taxpayer to receive a complete abatement of a tax shelter penalty, among other things, the taxpayer must be highly confident that the arrangement would prevail on its merits if its tax treatment were challenged by the IRS. A taxpayer would be treated as "highly confident" only if a reasonable tax practitioner would believe that the arrangement at issue, at the time it was entered into and based on the then existing facts and law, had a least a 75 percent chance of being sustained on its merits (without considering risks of detection or negotiated settlements). If the taxpayer relies upon an opinion from a third party in forming its level of high confidence, such reliance must be reasonable. The term "abatement," for this purpose, means that the penalty would automatically not apply. No further administrative action (such as any "abatement proceeding") would be needed. Thus, if a corporate participant has satisfied each of the abatement requirements, the penalty that might otherwise apply to an understatement would not be imposed.

Some commentators maintain that an IRS agent or a court would be unlikely to disallow the tax benefits associated with a transaction while at the same time determine that a "reasonable tax practitioner" would have properly believed that at least a 75 percent chance of success on the merits existed. To do so could suggest that the agent or court was itself unreasonable in ruling against the taxpayer. Thus, the commentators believe that any time a corporate participant ultimately derives an understatement from a tax shelter arrangement, a penalty would be assessed despite the existence of a highly confident belief. It is intended that if the corporate participant relied on a third-party opinion letter for purposes of its high level of confidence, the agent or court should only be able to question whether such reliance was reasonable. Any question as to whether the opinion was accurate would be resolved as part of the aiding and abetting provisions, discussed below.[177]

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[176] Under this scenario, while no penalty may be owed, to the extent the strategy works, it (1) limits the taxpayer's choice of forum (<u>i.e.</u>, the Tax Court may no longer be an option), (2) potentially provides greater disclosure insofar as the taxpayer's aggressive position is highlighted on an amended return, and (3) provides the government with the revenue at issue while the dispute is pending.

[177] In a related matter, some have questioned whether the highly confident standard would require a taxpayer or its advisors to anticipate a change in law or regulations, which may apply retroactively. Again, the determination of whether the highly confident standard is

Some commentators have criticized the Joint Committee staff recommendations as requiring a threshold (i.e., 75 percent) that may be difficult to achieve because the tax laws are not perfectly clear in all respects. These commentators state that tax advisors would be reluctant to provide an opinion on a transaction that may be treated as a tax shelter under this recommendation because of this threshold, as well as the risk of incurring aiding and abetting penalties (as discussed below) if such opinion is found not to have met this threshold.

Integral with the increased standard required of taxpayers in order to completely abate the corporate tax shelter penalty, the Joint Committee staff has recommended new minimum tax return standards that would be applicable to all transactions, including tax shelters. First, the Joint Committee staff recommended that both taxpayers and tax preparers be held to the same standards. Second, the recommended minimum standards would be "more likely than not" in the case of undisclosed positions, and "substantial authority" in the case of disclosed positions. If non-tax shelter transactions are subject to these increased standards, it seems appropriate that the minimum standards with respect to corporate tax shelter transactions should accordingly be raised to an even higher level (i.e., 75 percent).[178]

Similarly, the Treasury Penalty and Interest Report proposed that both taxpayer and tax preparers with respect to non-tax shelter transactions should be subject to the same standards.[179] However, the Treasury Department proposed that the minimum standards be "substantial authority" in the case of undisclosed positions and "realistic possibility of success" in the case of disclosed positions, both of which represent a lower standard than the Joint Committee staff recommendations. H.R. 2255 does not propose any changes to the minimum standards with respect to non-tax shelter transactions.

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satisfied should be based on the facts and law that existed at the time the transaction was entered into. If a taxpayer or its advisor is on notice that the law applicable to a transaction will likely change, such change should be taken into account. This would equally hold true in connection with the aiding and abetting penalty discussed below.

[178] Some commentators have suggested that under present law, IRS agents are held to a low standard with respect to assertions raised against taxpayers. These commentators have suggested that the IRS should be held to a "substantial authority" standard of proof and that taxpayers should be able, where the IRS failed to meet such a standard, to sue for damages. Such claims could be limited to the legal costs associated with defending the tax shelter arrangement, perhaps not to exceed a maximum amount. (Section 7430 presently allows corporations to recover certain administrative and litigation costs incurred in connection with IRS administrative and court proceedings, subject to a net worth limitation.) On the other hand, others maintain that the IRS should be allowed a lower standard because they are at a disadvantage in ferreting out the details of a taxpayer's underlying tax information.

[179] See Treasury Penalty and Interest Report, supra note 142 at 107.

e. Disclosure

(i) Disclosure to shareholders

The Joint Committee staff recommendations provide that a corporate participant which must pay an understatement penalty with respect to a corporate tax shelter of at least $1 million be required to disclose the amount and the related explanation to its shareholders. Commentators have suggested that such a rule should be expanded to require that any accuracy-related or fraud penalties should be required to be disclosed to shareholders. On the other hand, while tax shelters and fraud may be reflective of corporate governance concerns, the accuracy-related penalty may not produce the same level of such concerns.

In addition, some have criticized this recommendation on the grounds that it continues what is a troubling precedent of tax-writing committees indirectly regulating securities disclosure laws. A further criticism is that a penalty structure which penalizes traditional tax planning, even when there exists a more than 50 percent chance of success, may imply that management has failed to properly perform its fiduciary responsibilities. In defense of the recommendation, others maintain that if management, with full knowledge of an increased penalty regime, would be willing to engage in transactions that have only a 51 percent chance of being sustained on their merits, and such transactions ultimately result in an understatement and corresponding penalty, then shareholders should have the right to know such facts in order to adequately evaluate management's fiduciary performance.

(ii) Taxpayer disclosure to the IRS

The Joint Committee staff recommendations require that a transaction that is reasonably expected to have net tax benefits of $1 million or more and that is described by an indicator be disclosed to the IRS within 30 days of the close of the transaction. In addition, any transaction described by an indicator (regardless of the $1 million threshold) must be disclosed on the corporate taxpayer's tax return. To the extent a transaction is properly disclosed (or satisfies certain exceptions to the disclosure requirement), the recommended corporate tax shelter penalty rate is reduced to 20 percent. Disclosure is also a prerequisite to elimination of the penalty when the "highly confident" standard is satisfied.

Some have argued that under the recommendations, a corporate taxpayer that engages in a transaction that has a more than 50 percent but less than 75 percent chance of succeeding on its merits may not have sufficient incentive to disclose such a transaction. Taxpayers with at least a 75 percent chance of success (and that satisfy the other aspects of the "highly confident" standard) would derive benefits from disclosure because such disclosure could, if other requirements are satisfied, eliminate any penalty if a tax understatement is found to exist. On the other hand, a taxpayer that engaged in a transaction with less than a 75 percent chance of success would only be able to reduce its understatement penalty rate from 40 percent to 20 percent through disclosure. Commentators suggest, however, that corporate taxpayers (or rather, their tax personnel) are so penalty averse that rather than incurring even a 20 percent penalty, the taxpayer would either choose not to engage in the transaction or to take their chances of avoiding detection under IRS audit procedures instead of disclosing, which would serve to highlight the matter. Under the Joint Committee staff recommendations, however, the potential costs of engaging in tax shelter activity would be higher than under present law. It is expected that taxpayers would abstain from the transaction instead of relying on the audit lottery. To the extent that is true, the insufficient incentive to disclose transactions that do not meet the highly confident standard may not be as significant of an issue as it might first appear.

Some commentators believe that the recommendations would require disclosure by any corporate taxpayer that participates in the transaction, even if the taxpayer does not obtain any tax benefits from the transaction (e.g., any bank that provides financing would be required to comply with these disclosure requirements). While the definition of a "corporate participant" may not be entirely clear, it was intended to encompass only those corporations that would derive tax benefits from the arrangement.

The recommendations provide that certain arrangements, to the extent provided by the Secretary in regulations, would be deemed to be disclosed for purposes of the tax shelter provisions. The IRS would be given discretion to expand the list of disclosure exceptions based on its experience in administering the rules and to take into account changes in the law. The issues with respect to such an enumerated list of exceptions are discussed above with respect to this recommendation. Similar issues are discussed in connection with the analysis of the revised Treasury proposal and H.R. 2255.

Some argue that the 30-day taxpayer disclosure would be too burdensome for taxpayers, representing in some respects a year-round filing requirement. The documentation related to many complicated transactions takes considerable time to collect and evaluate, and often cannot be done before the end of the year or even later in some cases. In addition, the tax department may not be involved in a business transaction until well after it closes. The sanction for failure to disclose under such circumstances would seem harsh: the taxpayer could receive no relief from potential penalties. Commentators have suggested that taxpayers should be expected to provide adequate disclosure with their tax return for the year. The promoter disclosure may provide a sufficient amount of early warning to the government for purposes of expediting needed legislative or regulatory action with respect to corporate tax shelters.

As part of the Joint Committee staff's 30-day disclosure recommendation, the corporate participant would be required to provide a summary of its rationale and analysis underlying the tax treatment of the reportable transaction, including the substantive authority relied upon to support such treatment. Some have questioned whether this requires a discussion of all potential theories that the IRS could use to attack the transaction. It is intended that taxpayers should only provide the rationale and analysis that was used in support of their claimed position.

In addition, the recommendation requires that the disclosure be certified, under penalties of perjury, by a senior corporate officer. This corporate officer attestation requirement (as well as the issues related thereto) is similar to the attestation requirement contained in the revised Treasury proposal and H.R. 2255, discussed above.

Some commentators are concerned about the consequences of a failure to disclose with respect to the Joint Committee staff recommendations. A failure to disclose a tax shelter arrangement (i.e., an arrangement that is described by at least one of the indicators) would not, in and of itself, cause the imposition of a penalty. The Joint Committee staff recommendations would never impose a penalty unless a tax shelter arrangement is determined to cause an understatement of tax under present law. If the claimed tax benefits are sustained on the merits, failure to disclose is irrelevant.[180]

3. Other parties involved in corporate tax shelters

The staff recommended to expand the penalty for aiding and abetting the understatement of tax liability under section 6701. Such penalty would apply to any person who aids or assists in, procures, or advises with respect to the creation, implementation, or reporting of a corporate tax shelter that results in an understatement of tax liability of a corporate participant, and: (1) the person to be penalized knew, or had reason to believe, that the corporate tax shelter (or any portion thereof) could result in an understatement of tax liability of the corporate participant; (2) the person opined, advised, represented, or otherwise indicated (whether express or implied) that, with respect to the tax treatment of the corporate tax shelter (or any portion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged; and (3) a reasonable tax practitioner would not have believed that, with respect to the tax treatment of the corporate tax shelter (or any portion thereof), there existed at least a 75-percent likelihood that its tax treatment would be sustained on its merits if challenged.

One interpretation of the reasonable tax practitioner standard is that a taxpayer would need the support of only one reasonable tax practitioner to agree that it meets the standard. At the same time, a tax return preparer apparently would be required to ensure that every reasonable tax practitioner would agree that the standard is satisfied. The intent of this rule is to be an objective standard and should not be construed as requiring a preparer to enlist the consensus of every reasonable tax practitioner.

Some commentators believe that an IRS agent or court, particularly after ruling against a taxpayer's claimed position, would be unlikely to conclude that a reasonable tax professional would have believed that the taxpayer had at least a 75-percent likelihood of success on the merits. To do so could suggest that the agent or court was itself unreasonable in ruling against the taxpayer. The standard is intended to be objective and it is anticipated that IRS agents and the courts would apply that standard fairly and would respect the fact that such opinions require many judgment calls.

On the other hand, some commentators have observed that it is not clear whether there is an obligation on behalf of the advisor to evaluate all the relevant facts and the purpose of the arrangement in the process of opining that there is at least a 75-percent likelihood of success on the merits. The Joint Committee staff recommendations make it clear that in order for a taxpayer

[180] The Joint Committee staff recommendations do not have a separate penalty for failure to disclose as under the revised Treasury proposal.

to rely on an opinion from a third party to form its level of high confidence, the facts and assumptions used to form the basis of that opinion must not materially differ from the actual facts and assumptions with respect to the arrangement, all facts and circumstances must be considered, and no unreasonable assumptions made. Commentators have suggested that it be made clear that such requirements also apply to the advisor.

Some have noted that the amount of non-taxpayer penalties that could be imposed under the Joint Committee staff's recommendations could well amount to more than 100 percent of the advisor's after-tax income attributable to the transaction because the understatement penalty is assessed on gross fees (and not net income from the transaction) charged to the corporate participant. This could be viewed as an excessive penalty. On the other hand, penalties are intended to be punitive in nature, thus discouraging the behavior upon which the penalty was assessed. Furthermore, a penalty that was based on the advisor's net income with respect to a tax shelter transaction would be very difficult for the IRS to determine, particularly when having to account for a portion of indirect costs.

The Joint Committee staff recommendations also include several modifications to Circular 230 to enhance its application with respect to corporate tax shelters and reflect the staff recommendations. One comment with respect to these modifications observed that the rendering of tax advice with respect to a corporate tax shelter transactions would constitute "practice before the IRS," without regard to whether the advisor was considered to be a tax return preparer with respect to the tax shelter matter. The Joint Committee staff recommendations contemplate a broader scope of Circular 230 in this regard.

The Joint Committee staff also recommends updating the Circular 230 standards for tax shelter opinions to be consistent with its general recommendations with respect to tax shelter advisors. A recent report of the ABA Section of Taxation similarly suggests strengthening Circular 230 with respect to the standards for tax shelter opinions, particularly opinions intended to provide the taxpayer with legal justification for the treatment of an item on its tax return.[181] Unlike the Joint Committee staff recommendations, however, the ABA Section of Taxation report does not go so far as to recommend increasing the required confidence level necessary for legal justification for claiming benefits with respect to a tax shelter.

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[181] ABA Section of Taxation, *Report To Amend 31 C.F.R. Part 10, Treasury Department Circular 230, To Deal With "More Likely Than Not" Opinions Relating to Tax Shelter Items of Corporations*, October 29, 1999.

VI. CONCLUSION

The revised Treasury proposal, H.R. 2255, and the Joint Committee staff recommendations provide a range of approaches for addressing the corporate tax shelter problem. H.R. 2255 would codify a heightened economic substance doctrine that would disallow tax attributes unless its criteria were satisfied, and contains certain presumptions that would automatically disallow certain tax benefits. The revised Treasury proposal also contains a substantive disallowance rule that relies on a somewhat more restricted codification of an economic substance doctrine. The Joint Committee staff recommendations do not contain a substantive rule. Rather, it relies on the application of common-law doctrines to determine an understatement attributable to a corporate tax shelter, provides guidance as to when penalties would apply to such an understatement, and enhances the penalty regime applicable to such understatements. H.R. 2255 and the revised Treasury proposal contain enhanced penalty regimes, and all three proposals contain a new disclosure regime.