SMU Dedman School of Law

SMU Law Review

Volume 54 | Issue 1 Article 11

January 2001

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Recommended Citation

Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. Rev. 177 (2001)

https://scholar.smu.edu/smulr/vol54/iss1/11

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Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters

*Lawrence Zelenak**

IN two excellent contributions to this symposium, Alan Gunn and Ellen Aprill consider the merits of moving tax anti-avoidance doctrines from the judicial realm into some codified form (statutory or regulatory).[1] They have different views of the primary purpose of codification. To Gunn, the purpose is to introduce a new anti-avoidance doctrine, not to be found in the existing judge-made law.[2] To Aprill, the purpose is to shift from the courts to the IRS the discretionary power to identify tax avoidance transactions.[3] Codification of a general anti-avoidance rule (GAAR) is currently on the policy agenda because it is a central feature of the Treasury Department's anti-corporate tax shelter proposals.[4] Oddly enough, however, the Treasury proposal is clearly *not* designed to accomplish either the purpose identified by Gunn or the purpose identified by Aprill.[5] All this suggests that there is considerable confusion as to what is at stake in the debate over the Treasury proposal. The first part of this comment examines the purposes suggested by Gunn and Aprill for a GAAR, and other possible purposes more congruent with the design of the Treasury proposal. The conclusion is that, although a GAAR could affect judicial outcomes in some cases, it is easy to overstate its significance. It would probably not change judicial outcomes in most cases, and it could not possibly put an end to the proliferation of corporate tax shelters. The second part of this comment considers other reforms which might be more significant than a codified GAAR in controlling corporate tax shelters. It suggests that two approaches worthy of serious consideration are imposing criminal penalties on corporate officers who fail to comply with tax shelter disclosure requirements and enacting a corporate

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1. *See* Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons From the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159 (2001); Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001).
2. *See* Gunn, *supra* note 1, at 159.
3. *See* Aprill, *supra* note 1, at 18-19.
4. *See* DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 126 (Feb. 2000) [hereinafter 2001 REVENUE PROPOSALS]; DEPARTMENT OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 103-05 (July 1999) [hereinafter WHITE PAPER].
5. *See* 2001 REVENUE PROPOSALS, *supra* note 4, at 126.

tax schedular system analogous to the passive loss rules applicable to individual taxpayers.

I. POSSIBLE REASONS TO CODIFY ANTI-AVOIDANCE DOCTRINES

A. Because "Abuse" is a New Concept

According to Alan Gunn, the partnership anti-abuse regulations[6] go beyond the established judicial anti-avoidance doctrines by introducing the idea of "abuse:"

> A transaction can be abusive without running afoul of any of the traditional anti-avoidance doctrines; that is, it can have a business purpose and [economic] substance, its substance and form can coincide, and yet it yields *a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator's attention when the statute was drafted.* Flawed though they may be, the section 701 regulations give us a useful concept of "abuse," distinct from other anti-avoidance doctrines.[7]

Although Gunn does not discuss the current concern with curbing corporate tax shelters, presumably he would think the legislative enactment of a GAAR would appropriately extend the concept of abuse beyond the partnership context. I agree with Gunn that the concept he has identified is useful; the fact that a transaction is abusive in the sense described by Gunn should be reason enough for a court to refuse to allow tax benefits. In fact, Gunn deserves more credit than the drafters of the partnership regulations for clearly identifying the abuse concept. Although the regulations are titled "Anti-abuse rule," neither "abuse" nor "abusive" appears anywhere in the text of the regulations.[8] The preamble to the regulations, far from claiming any innovation, states that "the fundamental principles reflected in the regulation are *consistent* with the established legal doctrines."[9]

Despite my agreement with Gunn about the usefulness of the abuse concept, and my appreciation for the quality of his discussion of the concept, I do not think that the concept plays an important role in the current debate over the Treasury proposal. Whatever may be at stake in the GAAR fight, the issue does *not* seem to be the codification of abuse as a new and distinct anti-avoidance doctrine. The Treasury proposal applies only to a transaction which both (a) seeks to obtain a tax benefit not "clearly contemplated" by the applicable Code provision, *and* (b) lacks economic substance (in the sense that the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax bene-

6. Treas. Reg. § 1.701-2 (as amended in 1995).

7. Gunn, *supra* note 1, at 160 (emphasis added).

8. Treas. Reg. § 1.701-2.

9. T.D. 8588, 1995-1 C.B. 109, 112 (emphasis added). The preamble goes on to explain that any "uncertainty regarding the application of the regulation reflects the uncertainty that already exists in properly evaluating transactions under current law, including the proper application of existing legal doctrines." *Id.*

fits).[10] By contrast, a proposal intended to codify the abuse concept would consist of a narrower version of the first requirement (roughly speaking, the proposal would apply only to those tax benefits clearly not contemplated by the statute, rather than to all tax benefits not clearly contemplated), and nothing else. There would be no additional requirement that a transaction lack economic substance in order to be subject to the rule. None of this is to say that codification of Gunn's concept of abuse would be a bad idea; the point is simply that the Treasury proposal makes no attempt to codify that concept, so the fight over the proposal must be about something else.

I would also suggest, more speculatively, that Gunn may have overstated the difference between his concept of abusive transactions and the current state of judicial anti-avoidance doctrines. My interpretation is that the courts are working toward a concept very much like Gunn's, even without specific regulatory or statutory direction, and are likely to arrive there fairly soon. In support of that view, I offer the Third Circuit's opinion in *ACM Partnership v. Commissioner*.[11] In *ACM*, Colgate wanted a tax shelter for about $100 million of capital gain, which it realized on the sale of a subsidiary. It entered into an investment partnership with a foreign taxpayer. The partnership purchased private placement notes (the Citicorp notes) and sold them a few weeks later for $140 million cash and about $34 million of contingent payment installment notes (the LIBOR notes). The installment method regulations then in effect for contingent payment sales provided for allocating basis recovery evenly over the six years that payments were to be made on the notes.[12] Thus, the cash down payment was allocated only one-sixth of the basis despite representing over eighty percent of the amount realized. The result was a large artificial capital gain in the year of sale and corresponding artificial capital losses in later years. The capital gain was allocated to the tax-indifferent foreign partner and the capital losses in later years were allocated to Colgate (and carried back to the year with the large capital gain). The Third Circuit disallowed Colgate's claimed capital losses on the grounds that they lacked economic substance.[13]

Both the Citicorp notes and the LIBOR notes were genuine investments of capital and paid real economic returns in the form of interest. In addition, in the case of the Citicorp notes the yield was at the market rate. How, then, could the Third Circuit conclude there was no economic substance to the deal? It did so by applying a present value analysis under which the Citicorp notes bearing a market rate of return were considered an "economically inconsequential" no-profit investment.[14] The LIBOR notes, with an expected return below the market rate, were even

10. 2001 REVENUE PROPOSALS, *supra* note 4, at 124, 126.
11. 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).
12. *See* Treas. Reg. § 15(a).453-1(c)(3), 46 Fed. Reg. 10714 (Feb. 4, 1981).
13. *ACM*, 157 F.3d at 263.
14. *Id.* at 257.

worse; the court labeled them "economically disadvantageous."[15]

If we take the court at its word, the surprising result is that only investments with expected returns *above* the market rate of return have economic substance; any investment merely *at* the going rate is inconsequential and can be disregarded when necessary to deny inappropriate tax benefits. I read *ACM* as a *sub silentio* adoption of Gunn's concept of abuse as an independent anti-avoidance doctrine. If investing at the going rate of return can lack economic substance, then the economic substance requirement itself lacks substance. A creative court, faced with a transaction intended to achieve "a tax result that no sensible legislator would have approved of,"[16] will boldly declare the transaction lacks economic substance, no matter how much substance the transaction actually possesses. Eventually, courts will acknowledge that the economic substance analysis has become fictional, and abandon it in favor of a straightforward application of Gunn's approach.

My reading of *ACM*, however, is at odds with David Hariton's interpretation.[17] Far from seeing *ACM* as the beginning of the end for the requirement that a transaction lack economic substance in order to be subject to judicial anti-avoidance doctrines, Hariton believes *ACM* represents a principled development of the economic substance test.[18] According to Hariton, the economic substance doctrine disallows tax benefits of a transaction only if "the formalistic results are . . . disturbing enough to be overturned," *and* the transaction lacks economic substance.[19] Although Hariton acknowledges that most cases in which courts found insufficient economic substance involved debt-financed investments with little or no profit potential, he defines economic substance not with reference to profit potential but with reference to whether the transaction has meaningfully altered the taxpayer's economic position (apart from taxes).[20] Thus, "[A] complicated way of investing cash lacks economic substance—even though it obviously produces a profit—if it leaves the taxpayer in substantially the same position as if the cash had been left in the bank."[21]

Hariton, then, does not see *ACM* as an unacknowledged shift from the economic substance doctrine to an anti-abuse rule, which can apply even when a transaction has economic substance. To the contrary, he describes the judicial anti-avoidance doctrine as "permit[ting] taxpayers to retain even the most egregious tax benefits if they arise from transactions with meaningful economic consequences."[22] I disagree, but our disagreement

15. *Id.*
16. Gunn, *supra* note 1, at 160.
17. *See* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999).
18. *See id.* at 248-49, 262-68.
19. *Id.* at 235.
20. *Id.*
21. *Id.* at 235-36.
22. *Id.* at 235.

is really about what the courts are likely to do next, so only time will tell who is correct. What follows are the reasons for my prediction that the courts will first fictionalize, and eventually abandon, the economic substance test.

Until the recent spate of corporate tax shelters, abusive transactions overwhelmingly took the form of debt-financed investments.[23] A court could hold that a transaction lacked economic substance because it had little or no potential for profit, after taking into account the required interest payments on the debt. Tax practitioners and scholars generally believed that tax benefits would *not* be disallowed under the economic substance doctrine if a transaction had a significant potential for profit.[24] An innovative aspect of recent corporate tax shelters is that many of them—including the *ACM* transaction—are equity-financed and thus can easily produce a significant pre-tax profit. There was good reason, then, before the *ACM* opinion, to think that such shelters would survive an IRS challenge based on the economic substance doctrine. In support of the court's innovative interpretation of the doctrine in *ACM*, Hariton would argue that an equity investment in a tax shelter is equivalent to borrowing from oneself at a rate of interest equal to the return one would have earned on the alternative investment.[25] If borrowing from someone else at the market interest rate to invest at the market rate lacks substance (in the case of the traditional shelter), then borrowing from oneself at the market rate to invest at the market rate should also lack substance (in the case of the new corporate shelters).[26] Under this view, *ACM* can be interpreted not as a silent abandonment of the economic substance test but as a principled extension of the test to the new generation of equity-financed tax shelters. Courts will continue to require an absence of economic substance as a condition of disallowing tax shelter benefits, with the proviso that an equity investment at the market rate of return lacks economic substance.

Time may prove Hariton right, but I suspect courts will not stop where they are. It is one thing for a court in a traditional tax shelter case to hold that borrowing $100 at 10% in order to invest $100 at 10% in an identical debt instrument is a pointless exercise, which no one would engage in but for the hope of tax benefits. It is quite another thing for a court to hold in an equity shelter case that investing $100 of one's own money at 10% (the market interest rate) is a pointless exercise, which no one would engage in but for the hope of tax benefits. The difference, quite simply, is that the first statement is true and the second one is false. Hariton would respond that I have misstated the economic substance analysis for equity

23. *See, e.g.*, Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967).

24. *See, e.g.*, Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981), cited to this effect by Hariton, *supra* note 17, at 249 n.42.

25. *See* Hariton, *supra* note 17, at 249.

26. *See id.*

shelters. What is pointless (apart from taxes) is investing $100 in the shelter rather than in a non-shelter with the same pre-tax rate of return. But that is considerably less compelling than the pointlessness analysis of debt-financed shelters. The analysis for debt-financed shelters appeals to *actual* borrowing, whereas the analysis for equity shelters appeals to *hypothetical* alternative investments. The equity tax shelter analysis depends on debatable assumptions about what the taxpayer would have done with its money had it not invested in the shelter. Hariton suggests an investment can lack economic substance if it produces non-tax results no different from "if the cash had been left in the bank."[27] But how do we know the taxpayer would have kept the cash in the bank, but for the shelter? Even if there is no economic substance in investing cash in a tax shelter debt instrument paying a market rate of return when the alternative use of the money would have been an investment in a non-shelter debt instrument bearing the same (or higher) rate of return, there is certainly economic substance to the same tax shelter investment if the alternative use would have been the drilling of wildcat oil wells. Since the taxpayer, in fact, invested in the equity shelter, we can never know what it otherwise would have done with its money, and thus we can never tell whether the shelter had economic substance.[28]

In light of these difficulties with the idea that an investment at a market rate of return lacks economic substance, I suspect the courts will not find the current state of the law to be a convenient place to rest. Rather, they are likely to continue to undermine—and eventually abandon—absence of economic substance as a requirement for disallowing tax benefits from an abusive transaction. The closer the courts are to reaching that point, the less difference it makes whether Congress codifies Gunn's concept of an abusive transaction. In fact, enactment of the Treasury proposal might act as a brake on judicial abandonment of the economic substance test, since the proposal appears to be take the test more seriously than does the Third Circuit in *ACM*.[29]

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27. *Id.* at 235-36.

28. How the money was invested before the taxpayer purchased the shelter is not necessarily how the money would have been invested in the absence of the shelter, despite the Third Circuit's reliance on that factor in *ACM*. *See ACM*, 157 F.3d at 249.

29. The Treasury proposal bears a superficial similarity to *ACM*, since both call for present value analyses. The nature of the analyses are quite different, however. Under the Treasury proposal, economic substance would be absent if the present value of the reasonably expected pre-tax profit was insignificant in relation to the present value of the reasonably expected net tax benefits. 2001 Revenue Proposals, *supra* note 4, at 126. *ACM*, by contrast, views an investment as lacking economic substance if it does not have an expected pre-tax return higher than the discount rate. *ACM*, 157 F.3d at 257-60. Suppose, for example, the discount rate is 10% and the taxpayer invests $100 in a debt instrument paying $10 annual interest until maturity at the end of 10 years. Under the Treasury proposal, the present value of the reasonably expected pre-tax profit ($10 per year for 10 years) is a little more than $61; whether the investment had economic substance would depend on how $61 compared to the present value of the anticipated tax benefits. Under *ACM*, the fact that the investment does not have an expected return above the discount rate is the end of the economic substance portion of the analysis; the investment lacks economic substance.

B. Because It Will Give the IRS More Discretion

In her contribution to this symposium, Ellen Aprill suggests that what is really at stake in the codification debate is the allocation of authority between the courts and the IRS. With judicial doctrines, the discretion to decide when the justification underlying a statutory rule should "trump the language of [the] rule" lies with the court.[30] Aprill states, however, that "[c]odifying these judicial doctrines would empower administrative agents to decide themselves whether to follow the rule or to resort to its justification."[31] Regulatory and statutory anti-avoidance rules certainly *can* include grants of discretion to the IRS to determine when the rules apply. Both the partnership anti-abuse regulations and the President's Fiscal Year 2000 Budget Proposal took this approach.[32] This approach results in a significant transfer of authority from the courts to the IRS, because a court would be obligated to uphold the IRS' application of the anti-avoidance rule to a particular taxpayer as long as the IRS did not abuse its discretion, even if the court would otherwise have concluded the rule did not apply.[33] It is important to note, however, that this transfer of authority would accomplish little in terms of deterring corporate tax shelter activity. A typical corporation entering into a shelter does so in the hope that the shelter will escape IRS detection, not in the hope that the shelter will be upheld in court.[34] The transfer of discretion to the IRS would do nothing to increase the chances of shelter detection, and so would have little deterrent effect.

Aprill offers a thoughtful discussion of the advantages and disadvantages of such of shift of authority. Oversimplifying her nuanced analysis, the basic objection to the shift is that practitioners reasonably fear that the IRS—unlike the courts—will exercise its discretion with a systematic anti-taxpayer bias.[35] The responses to that objection are that the IRS has

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30. Aprill, *supra* note 1, at 18.

31. *Id.* at 20.

32. According to Treas. Reg. § 1.701-2(b), "[t]he Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K . . . ." The Fiscal Year 2000 Budget Proposal would have granted to the Secretary of the Treasury the authority to disallow a deduction, credit, exclusion, or other tax benefit obtained in a tax avoidance transaction. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2000 Revenue Proposals 95-96 (February 1999).

33. *See, e.g.*, Lucas v. Am. Code Co., 280 U.S. 445, 449 (1930) (stating that predecessor of I.R.C. § 446(b) conferred on the tax administrator "[m]uch latitude for discretion" in determining whether the taxpayer's accounting method clearly reflected income).

34. *See* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 Tax Notes 1775, 1776 (1999) ("Once the odds of audit are factored in, however, the cost benefit analysis leans decidedly in favor of the new corporate tax shelters.").

35. *See* Aprill, *supra* note 1, at 22. An anti-taxpayer bias would be in conflict with the IRS' "Statement of Principles of Internal Revenue Tax Administration," reprinted at the beginning of every cumulative bulletin, which declares, "[i]t is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is 'protecting the revenue.'" 1999-2 C.B. ii. Practitioners may be forgiven, however, if they are not convinced that every IRS employee has taken that admonition to heart.

a good track record of responsibly exercising similar grants of discretion,[36] and that even if there is some bias in the IRS' exercise of discretion this may be an appropriate counterbalance to the de facto discretion granted (by reason of the audit lottery) to tax lawyers subject to a *pro*-taxpayer bias.

The question of how much discretion the IRS should have in the application of a GAAR is interesting and important, but disagreement on that question cannot explain the current debate over the desirability of a statutory GAAR. When practitioner groups objected to the grant of discretion to the IRS in the Fiscal Year 2000 Budget Proposal,[37] the Treasury quickly announced (in a WHITE PAPER issued on July 1, 1999) a change in its position. It continued to support codification of the economic substance doctrine, but under its new position "the tax attribute disallowance rule would apply by operation of law, rather than being subject to the discretion of the Secretary."[38] Considering the general prolixity of the WHITE PAPER, its discussion of the about-face on the discretion issue is remarkably brief and conclusory. "[T]o address legitimate concerns regarding . . . the potential abuse of discretion," states the WHITE PAPER, a "self-executing" GAAR should be enacted, rather than the previously proposed grant of administrative discretion.[39] Beyond acknowledging the legitimacy of practitioners' concerns and noting the practical difference between the two approaches in terms of the degree of judicial deference afforded the IRS, the WHITE PAPER offers no discussion of the relative merits of the two approaches. In short, although the Treasury stuck to its guns (in the face of considerable practitioner opposition) in its support of a statutory GAAR, it gave up on the discretion issue without a fight.

As the Treasury's revised proposal demonstrates, a shift of power from the courts to the IRS is not a necessary element of a statutory GAAR.[40] Codification (either statutory or regulatory) of anti-avoidance doctrines may be necessary to accomplish a transfer of discretion from the courts to the IRS, but such a transfer is not a necessary element of codification,[41]

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36. *See* Aprill, *supra* note 1, at 22-23. The two major examples discussed by Aprill are the discretion granted by I.R.C. § 482 to allocate income and deduction items among related taxpayers, and the discretion the IRS has in deciding when the requirements of the tax-free corporate reorganization provisions have been satisfied.

37. For an excellent summary of the nature of the objections, see Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001). *See also* WHITE PAPER, *supra* note 4, at 102 (summarizing objections).

38. WHITE PAPER, *supra* note 4, at xix.

39. *Id.* at 103-04.

40. 2001 REVENUE PROPOSALS, *supra* note 4, at 126.

41. There is a faint suggestion in Aprill's article that a codified GAAR necessarily involves a grant of discretion to the IRS, even if the statute makes no mention of the fact. In her discussion of the dangers of IRS discretion, she cites comments of a practitioner group on the President's Fiscal Year 2001 Budget Proposal (which proposed a self-executing GAAR, without any explicit grant of discretion to the IRS), that "even a substantive disallowance rule . . . has the potential for being misunderstood and misapplied" by IRS employees. Aprill, *supra* note 1, at 15 (quoting New York State Bar Association Tax Sec-

and the current Treasury proposal does not call for any transfer. Thus the puzzle remains. If a codified GAAR is not about Gunn's concept of abusive transactions and if it is not about granting discretion to the IRS, what is the point? Answers to this question have been suggested; they are discussed below.

C. Codifying the Best of the Case Law

One advantage claimed by the White Paper for codification is that a statutory GAAR can adopt the *best* of the anti-avoidance case law. Under current law, according to the White Paper, "[s]elf-assessment is frustrated by conflicting, incoherent decisions and encourages the most aggressive taxpayers to pick and choose among the most favorable cases."[42] To a limited extent, the White Paper even names names, citing a Supreme Court opinion as an example of the "less developed, inconsistent decisions" to be rejected by codification.[43] It would be possible to write a GAAR which clearly rejects the reasoning of certain disfavored cases,[44] and it would even be possible to mention disfavored cases by name in the legislative history. There is some merit to this justification for a GAAR, but the Treasury overstates the probable significance and disregards the danger of unintended consequences.

The probable significance is overstated because the codified GAAR will still be a more-or-less vague standard (rather than a precise rule), with great latitude for judicial interpretation. Just as aggressive taxpayers can now pick and choose among uneven judicial interpretations of existing anti-avoidance doctrines, under codification taxpayers would be able to choose among the inevitable conflicting interpretations of the GAAR.[45] Depending on the details of the statutory language and the

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tion, *Report on the Treasury's Proposal to Codify Economic Substance Doctrine*, 2000 Tax Notes Today 146-25, at n.3 (July 28, 2000)). If the implication is that even a self-executing GAAR involves a special (albeit unstated) grant of discretion to the IRS, I disagree. The potential for IRS agents to misunderstand and misapply case law would seem to be at least as great as the potential to bungle a statutory GAAR. In any event, misunderstanding and misapplying the law is not what is ordinarily meant by the exercise of discretion.

42. White Paper, *supra* note 4, at 99.

43. *Id.* at 100 (citing Frank Lyon Co. v. United States, 435 U.S. 561 (1978)).

44. Obviously, a GAAR can be drafted with much more detailed provisions than those of the Treasury proposal. For an example, see H.R. 2255, 106th Cong. (1999).

Dana Trier has suggested that one benefit of codification would be the rejection of indications in some cases that the presence a subjective business purpose can serve to legitimate a tax shelter transaction, even when objective economic substance is lacking. Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, Taxes, March 2000, at 62, 83. Trier cites in the Tax Court's recent opinion in *Saba Partnership v. Commissioner*, 78 T.C.M. (CCH) 684 (1999), as an example of the approach which could be rejected by codification. I agree that this sort of tidying up of the common law is a potential benefit of codification, but the benefit will surely be of minor significance. It is not likely that, in the absence of statutory clean up, many courts would slice the analysis so fine as to find subjective business purpose when there is no objective economic substance.

45. The Treasury made a similar claim in the preamble to the partnership anti-abuse regulations. According to the preamble, the regulations would obviate the need for case-by-case judicial determinations of when anti-avoidance doctrines should apply. T.D. 8588,

committee reports, the range of judicial interpretations may be narrowed somewhat, but any difference is likely to be modest.

There is a significant risk of unintended consequences of a legislative attempt to influence the judicial application of anti-avoidance doctrines. As Martin Ginsburg has famously explained in his Law of Moses' Rod, "[e]very stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part."[46] Sooner or later, taxpayers will win some cases under the Treasury's proposed codification, which they would have lost without it. For example, as discussed above, *ACM* seems to be a significant judicial step away from requiring an absence of economic substance as a condition of disallowing tax benefits from an abusive transaction. The Treasury's proposal, however, clearly conditions application of the GAAR on a transaction's lack of economic substance (as specially defined). Because a stated purpose of the GAAR is to squelch judicial developments inconsistent with the statutory standard, the GAAR would put a speedy halt to a process which might otherwise result in judicial development of an anti-abuse rule (in the sense described by Alan Gunn).

D. "AND WE REALLY MEAN IT!"

In addition to tidying up the common law anti-avoidance doctrines, codification might serve to emphasize those doctrines in the minds of courts and taxpayers. Many courts take a statute more seriously than a doctrine embodied only in case law.[47] Again, there is something to this point, but not a great deal. Although Judge McKee exaggerated in his dissent in *ACM*, when he claimed that existing common law doctrines amount to nothing more than a "smell test,"[48] it is certainly true that courts inclined to apply existing anti-avoidance doctrines have great discretion to do so under current law. Conversely, courts that are disinclined to apply anti-avoidance doctrines would have great discretion not to do so even under codification.[49] Cases in which the judge's mind is so

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supra note 9, at 112. The claim is not quite so overstated in that context, because the partnership regulations give the IRS discretion in deciding when the regulations apply, thus narrowing the scope of judicial review. *See* Treas. Reg. § 1.701-2(b) (1995).

46. Martin Ginsburg, *The National Office Mission*, 27 TAX NOTES 99, 100 (1985).

47. *See, e.g.*, Calvin H. Johnson, *The Anti-Skunk Works Corporate Tax Shelter Act of 1999*, 84 TAX NOTES 443, 446 (1999) (codification would "absolve the courts from accusations of judicial activism" when they apply anti-avoidance doctrines); Aprill, *supra* note 1, at 19 (codification would "make the standard more salient" to judges); Bankman, *supra* note 34, at 1793 (codification would "embolden those judges who would otherwise be reluctant to rely on existing common law").

48. *ACM*, 187 F.3d, at 265. For two excellent articles responding to McKee, see Hariton, *supra* note 17, and Trier, *supra* note 44.

49. Under the Treasury's proposal, courts will have considerable discretion in determining the reasonably expected pre-tax profit, in determining whether those profits were "insignificant" relative to expected tax benefits, and in determining whether the tax benefits at issue were "clearly contemplated" by Congress. 2001 REVENUE PROPOSALS, *supra* note 4, at 124.

evenly balanced that codification will tip the balance are not likely to be numerous.

What about the effect of a GAAR on taxpayers' decisions whether to enter into dubious shelter transactions? The hope is that responsible tax practitioners would point to the GAAR in dissuading their clients from shelter transactions, and that clients who would not sit still to read a welter of case law would take the time to read the statute (and would be dissuaded).[50] As with the other justifications, there is something to this, but not much. Clients in a mood *not* to be dissuaded will decide (with the help of the shelter promoter) that their shelters are not within the scope of the vague and general terms of the statute.

II. SO WHAT TO DO?

The preceding discussion was not an argument against a GAAR as a weapon in the fight against corporate tax shelters; I am agnostic as to the wisdom of that course. A codified anti-avoidance rule would be of marginal benefit in some ways, and the expected benefit might or might not outweigh the risk of unintended consequences. The key word, however, is *marginal.* Any anti-tax shelter effort which is built around a GAAR is doomed to fail. If corporate shelters are to be brought under control, it will not be by a codification of anti-avoidance doctrines. This section discusses two possible approaches, which unlike a GAAR, offer some hope of controlling shelters—a serious threat of individual criminal liability for failure to comply with statutory tax shelter disclosure requirements, and a schedular system for corporations analogous to the passive loss rules of IRC § 469. There are serious problems with both approaches (mostly political with the former, mostly technical with the latter), and both may turn out to be dead ends. Unlike a focus on a GAAR, however, they at least offer some hope of success.

A. Criminal Penalties for Non-Disclosure

Even without a statutory GAAR, the IRS has been very successful under existing law in challenging corporate tax shelters in court.[51] The real corporate shelter problem is with the shelters which the IRS never finds, and hence never challenges. A risk-neutral corporation would decide to enter into a tax shelter transaction as long as the tax cost of not entering the shelter is greater than the expected cost of entering the shelter.[52] Suppose the question is whether to do a shelter transaction, which

50. *See* Bankman, *supra* note 34, at 1788 (concluding clients are more likely to read and understand a short statute than case law); Canellos, *supra* note 37, at 50 (finding that codification could serve the purpose of "arming conscientious tax advisors with a weapon to persuade clients to resist tax shelter promoters").

51. For successes, see *ACM*, 157 F.3d at 203; *Saba*, 78 T.C.M. at 684; Compaq Computer Corp. v. Comm'r, 113 T.C. 214 (1999).

52. A corporation might, of course, be risk-averse, especially with respect to penalties. As corporate tax departments are increasingly viewed as profit centers, however, risk aversion appears to be fading away. *See* Bankman, *supra* note 34, at 1784.

will eliminate $1 million of tax liability if it works. The cost of not doing the shelter, of course, is simply $1 million. Disregarding transaction costs,[53] the expected cost of doing the shelter is $1 million tax liability plus any applicable penalties (ordinarily the only relevant penalty would be the twenty percent substantial understatement penalty of IRC § 6662), discounted by the perceived chance that the shelter will not be detected and successfully challenged by the IRS. Expressing this as a formula, the taxpayer will enter into the shelter if $1 million > *x* ($1 million + $200,000), with *x* representing the odds, as perceived by the taxpayer, that the IRS will successfully challenge the shelter. With the current twenty percent penalty, the shelter will be attractive to a risk-neutral taxpayer as long as *x* is eighty-three percent or less. It would be unusual for *x* to be anywhere near that level. For the shelter to be detected and disallowed, (1) the IRS must audit the taxpayer, (2) the IRS agent must notice the shelter, (3) the agent must decide to disallow tax shelter benefits, (4) the disallowance must be upheld at higher levels of IRS internal review, and (5) the IRS must prevail in court. For many corporations, the first factor alone–the chances of not being audited–would be sufficient to place *x* below the crucial level. In 1997, for example, only thirty-five percent of corporations with assets of more than one-hundred million dollars were audited.[54]

The Administration has proposed increasing the substantial understatement penalty for corporate tax shelters to forty percent,[55] but even with a doubling of the penalty, shelters would still be attractive if *x* is seventy-one percent or less.[56] Assuming a twenty percent perceived chance of detection and successful challenge, which is probably a reasonable estimate for many corporate shelters (in the absence of disclosure), the penalty would have to be more than 400% before the shelter would fail the cost-benefit analysis of a risk-neutral corporation.[57] There is serious doubt whether even the proposed forty percent penalty is politically realistic; a 400% penalty is clearly out of the question.

All this suggests that efforts to increase *x* may prove more effective than efforts to increase penalties in the struggle to deter corporations from tax shelter transactions. If a taxpayer were required clearly to disclose the existence of a shelter to the IRS, then odds of detection and challenge (more precisely, the *perceived* odds of detection and challenge, which might be close to 100%) might be high enough to deter most corporations, even with a penalty of only forty percent or even twenty per-

53. Major transaction costs would include fees to the shelter promoter, legal and accounting fees, and the pre-tax loss (if any) inherent in the shelter transaction.

54. *See* WHITE PAPER, *supra* note 4, at 29 (citing IRS Annual Reports).

55. *See* 2001 REVENUE PROPOSALS, *supra* note 4, at 95.

56. The Treasury has also proposed a $100,000 penalty for a corporation's failure to disclose a tax shelter. *See id.* at 122-23. Because this penalty would be a flat amount (rather than a percentage of the underpayment), its effect on the critical level of *x* would be small for larger shelters.

57. Other commentators have made basically the same point. *See, e.g.*, Bankman, *supra* note 34, at 1792; Johnson, *supra* note 47, at 452.

cent. In fact, such a disclosure requirement already exists in the proposed and temporary regulations recently promulgated under IRC § 6011.[58] Under these regulations, a corporation, which has participated in a "reportable transaction" must attach a statement to its income tax return identifying and thoroughly describing the transaction.[59] Reportable transactions are defined broadly enough that few large tax shelters should escape the requirement.[60]

This does not mean, however, that corporations will now disclose all significant shelters. Instead, corporations are now faced with *three* options for cost-benefit analysis: no shelter transaction, a disclosed shelter, or an undisclosed shelter (in violation of the new regulations). No shelter may be preferable to a disclosed shelter, but an undisclosed shelter may be best of all–if an undisclosed shelter is likely to go undetected, and if the penalties for nondisclosure are mild. Through no fault of the Treasury or the IRS, the penalties for violation of the new regulations are very weak. The preamble to the regulations warns, "[i]n the event of an underpayment attributable to a reportable transaction, a taxpayer's failure to satisfy the disclosure requirements . . . may affect its exposure to penalties under sections 6662 [twenty percent penalty for substantial understatements] and 6663 [seventy-five percent penalty for fraud] of the Code."[61] The threat is not that the nondisclosure itself would be subject to penalty, but merely that "the nondisclosure could indicate that the taxpayer has not acted in 'good faith' with respect to the underpayment," so as to be eligible for the "reasonable cause" penalty escape hatch of I.R.C. § 6664(c).[62] The idea that disclosure could entitle the taxpayer to a good faith exception to the fraud penalty is silly; fraud and good faith are obviously incompatible, and the regulations interpreting I.R.C. § 6664(c) give no indication the reasonable cause escape hatch could ever apply to the fraud penalty.[63] In short, the only real risk of nondisclosure is exposure to the twenty percent substantial understatement penalty in the case of detection and successful challenge (an exposure which existed, incidentally, even before the promulgation of the new regulations). The tooth-

58. *See* T.D. 8877, 2000-11 I.R.B. 747.

59. Temp. Treas. Reg. § 1.6011-4T(c) (2000).

60. *See* Temp. Treas. Reg. § 1.6011-4T(b) (defining reportable transactions to include both "listed transactions" specifically described by published IRS guidance, and other transactions possessing at least two of six features typical of corporate tax shelters). Both prongs of the definition are subject to a "projected tax effect" test. A listed transaction is reportable only if it involves tax savings in excess of $1 million in a single year or $2 million in two or more years. Other transactions are reportable only if the expected tax savings are more than $5 million in a single year or more than $10 million in two or more years. *See id.*

61. T.D. 8877, *supra* note 58, at 747. The preamble also notes that "when a taxpayer verifies its return, which includes a declaration that the return is complete, a taxpayer affirms that it has accurately made all disclosures required by these temporary regulations." *Id.* This may be a subtle threat of criminal prosecution in extreme cases, although this degree of subtlety is likely to go unnoticed by many readers.

62. *Id.*

63. Treas. Reg. § 1.6664-4 (1991) (discussing the reasonable cause and good faith exception only in the context of I.R.C. § 6662).

lessness of the new regulations is not the fault of Treasury or the IRS; Congress conferred no authority to impose penalties for nondisclosure of this information.

A disclosure requirement could be an effective tool in counteracting corporate tax shelters, but only if violation of the requirement is not an attractive option. Since violation of the requirement will be difficult for the IRS to detect (for the same reasons that undisclosed shelters are difficult to detect), disregarding the disclosure requirement will generally be an attractive option unless the penalty for nondisclosure is severe. As noted above, an effective monetary penalty would have to be in the range of several hundred percent of the tax involved, and that seems politically out of the question. An alternative, which might be an effective deterrent even when the odds of detection of nondisclosure are quite low, is a credible threat of criminal sanctions on the individual(s) responsible for preparing the corporate tax return. There is a remote possibility that egregious violations of the new disclosure regulations could be subject to criminal prosecution even under existing I.R.C. § 7206 (relating to fraud and false statements),[64] but the threat would be much more credible if Congress were to enact a statute specifically criminalizing willful failures to comply with the corporate tax shelter disclosure rules.[65] At the same time, Congress could specifically criminalize failure by tax shelter promoters to comply with the registration and record-keeping requirements of I.R.C. §§ 6111 and 6112.[66]

Just as there is no political support for a monetary penalty for nondisclosure sufficient to serve as an effective deterrent, there may be no political support for criminal penalties. In that case, however, the entire approach of controlling shelters through disclosure requirements is hopeless. If criminal sanctions *are* politically feasible, the major technical problem will be constructing a definition of reportable transactions clear enough to support criminal liability for failure to disclose. On first reading, the new regulations appear to have achieved an impressive level of clarity in describing reportable transactions, although that impression awaits confirmation by experience. In any event, the level of precision

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64. In fact, the preamble to the new regulations under I.R.C. § 6011 appears to contain a veiled threat of prosecution under I.R.C. § 7206. *See supra* note 61 for a discussion. For another IRS threat of criminal prosecution in the tax shelter context, see Notice 2000-44, 2000-36 I.R.B. 255 (warning that concealing the amount of capital gains and losses by netting gains and losses from several transactions, and showing only the net amount of gain or loss on the return, may constitute a criminal offense).

65. A Treasury proposal would require disclosure of shelter transactions, and would make the officer signing the disclosure form "personally liable for misstatements on the form, with heightened penalties for fraud or gross negligence." 2001 REVENUE PROPOSALS, *supra* note 4, at 123. This seems to contemplate only civil penalties. More fundamentally, it penalizes corporate officers only for *bad* disclosure, when the real problem is *non*-disclosure.

66. Although I.R.C. §§ 6707 and 6708 already provide specific penalties for violation of the tax shelter promoter provisions, the penalties are civil only.

necessary to avoid unconstitutional vagueness is not particularly high,[67] especially if the criminal statute applies only to knowing violations of the disclosure requirement.[68]

A danger of criminal sanctions for nondisclosure is that taxpayers will *over*-disclose in response, thus swamping the IRS' ability to make use of disclosures. If everything is disclosed, then nothing is disclosed. This is a problem with any disclosure requirement, but the threat of criminal penalties makes it worse. Over-disclosure which would otherwise be an indefensible gaming of the system will be viewed more sympathetically if there is a plausible claim that it was done out of fear of prosecution. Perhaps over-disclosure can be kept to manageable levels by a combination of a very clear definition of reportable transactions and civil penalties for frivolous over-disclosure, but the problem is real.

In sum, there are both political and technical reasons why criminalizing non-disclosure may fail, but if it does fail then the entire deterrence approach to combating tax shelters–focused on the risk of detection and on penalties–is probably doomed.

B. A Silver Bullet?

The previous era of individual tax shelters was brought to a close not by litigation under anti-avoidance doctrines, not by penalties and disclosure requirements, and not by narrow legislation aimed at particularly troubling shelter techniques. Rather, the silver bullet that killed individual shelters was the enactment in 1986 of the passive loss rules.[69] The passive loss rules apply a schedular (or "basketing") approach, under which different types of activities are put in different tax baskets and losses in one basket cannot be used to offset income in other baskets.[70] In particular, losses from businesses in which a taxpayer does not materially participate cannot be used to shelter labor income, nonbusiness investment income (such as interest and dividends), and active business income.

The inevitable question is whether there is some analogue to the passive loss rules, which could kill corporate tax shelters as efficiently as those rules killed individual shelters. In a recent published discussion, a leading tax practitioner suggested that something similar to the passive loss rules might be the only answer to the corporate shelter problem.[71] In response to that suggestion, a leading government tax official remarked

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67. *See, e.g.*, Nash v. United States, 229 U.S. 373, 377 (1913) (remarking that "the law is full of instances where a man's fate depends on his estimating rightly, that is, as the jury subsequently estimates it, some matter of degree").

68. *See, e.g.*, Boyce Motor Lines v. United States, 342 U.S. 337 (1952) (holding that a statute is not vague to a defendant who knows he is violating the statute).

69. I.R.C. § 469 (1986).

70. *See generally* Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 Texas L. Rev. 499 (1989).

71. *See* Richard M. Lipton et al., *Corporate Tax Shelters Roundtable*, Taxes, March 2000, at 141, 144 (comments of Richard M. Lipton). For a similar suggestion, see Lee A.

that the Treasury had considered that approach, but had decided that it was unworkable. The problem with the analogy to the passive loss rules, he said, was that individual shelters were structurally so similar that a one-size-fits-all solution was possible, but that corporate shelters "all involve different areas of the code and they're different shapes and sizes so we would love to find a silver bullet one size fits all but these things are just too varied to try to get at."[72] The Treasury White Paper expresses the same conclusion in less colorful language.[73]

In the end, the Treasury's conclusion that a schedular system will not work for corporate shelters may be correct. In broad outline, it is simple enough to sketch the difficulties with the approach. It might be possible (although certainly it would not be easy) to define an active business basket and a portfolio basket for corporations, and to provide that losses in the portfolio basket could not shelter income in the active business basket. It is unclear, however, how successful this approach might be. In some cases, the income to be sheltered will itself be in the portfolio basket, and thus shelterable by a tax shelter loss in the portfolio basket.[74] In other cases, the income to be sheltered will be in the active business basket, but shelter promoters may be able to design a shelter which also goes into the active basket.[75] Despite these difficulties, the schedular approach seems worthy of further consideration. If (as seems likely) most income to be sheltered is from active businesses, and if (as also seems likely) active business shelters are much harder to design than portfolio shelters,[76] then a schedular system would seriously impede shelter activity, even if it did not succeed in shutting down all shelters.

The analogy to the passive loss rules is so appealing, that it would be a shame to give up on the schedular approach to corporate shelters without

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Sheppard, *Is There Constructive Thinking About Corporate Tax Shelters?*, 83 TAX NOTES 782, 784-85 (1999).

72. Lipton et al., *supra* note 71, at 144 (comments of Joseph Mikrut, U.S. Tax Legislative Counsel).

73. WHITE PAPER, *supra* note 4, at ¶ 113. In striking contrast, Lee Sheppard rather blithely concludes that designing an effective schedular system for corporations would be simplicity itself: "The definition for portfolio holdings could be simple, straightforward, and objective and could hook into existing provisions of the law." Sheppard, *supra* note 71, at 784. What is striking about both the WHITE PAPER and the Sheppard article are the certainty with which they express their opposite conclusions, and the lack of significant analysis in support of those conclusions.

74. *See, e.g.*, *Saba*, 78 T.C.M. at 688-89 (some of the income at which the shelter was aimed came from the sale of Brunswick's 36% interest in Nireco, a Japanese corporation); *Compaq*, 113 T.C., at 215 (shelter was intended to offset capital gain from the sale of stock of Conner Peripherals, a publicly traded corporation not affiliated with Compaq).

75. An individual cannot easily avoid the passive loss rules by generating active business tax shelter losses, because only a substantial investment of the individual's time will satisfy the material participation standard. *See* Treas. Reg. § 1.469-5T(a)(1) (1988) (material participation generally requires more than 500 hours of the taxpayer's time during the year). Other demands on an individual's time will usually make satisfying the material participation standard impractical. A corporation, of course, is not similarly constrained in its ability to conduct active businesses.

76. The greater difficulty comes largely from the likelihood that active business shelters–unlike portfolio shelters–will involve unacceptable levels of non-tax risk.

having made every effort to design a workable system. The White Paper suggests that the Treasury gave the approach serious consideration before abandoning it, but it describes the problems with the approach in only the briefest and vaguest of terms.[77] I would suggest that the Treasury issue a full report on the topic, describing in detail what it perceives to be the problems with the schedular approach, and soliciting assistance from sympathetic practitioners and academics in overcoming those difficulties. As bright and fertile as the minds of the Treasury undeniably are, once the issue receives a full public airing it is possible–not likely, but possible–that someone in practice or the academy will devise a solution which has eluded the Treasury. It seems worth a try.

III. CONCLUSION

I do not mean to oversell either criminal penalties for nondisclosure or a corporate tax schedular system as the solution to the problem of corporate shelters. Each approach involves very serious difficulties, both political and technical. Nevertheless, each has the potential to strike a serious–perhaps even fatal–blow to the corporate tax shelter industry. That is certainly more than can be said for codification of anti-avoidance doctrines, toothless disclosure requirements, and tinkering with the civil tax penalty structure.

77. WHITE PAPER, *supra* note 4, at 113.