



2001

# Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, A

Peter C. Canellos

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## Recommended Citation

Peter C. Canellos, *Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters, A*, 54 SMU L. Rev. 47 (2001)  
<https://scholar.smu.edu/smulr/vol54/iss1/5>

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# A TAX PRACTITIONER'S PERSPECTIVE ON SUBSTANCE, FORM AND BUSINESS PURPOSE IN STRUCTURING BUSINESS TRANSACTIONS AND IN TAX SHELTERS

*Peter C. Canellos\**

## TABLE OF CONTENTS

I. INTRODUCTION .....	47
II. REAL TRANSACTIONS VERSUS TAX SHELTERS ...	51
III. THE TAX BAR VERSUS THE TAX SHELTER BAR ..	55
IV. SUBSTANCE, FORM, AND PURPOSE IN THE REAL WORLD .....	57
A. DISREGARDING TRANSITORY ENTITIES AND CIRCULAR CASH FLOWS .....	58
B. BAUSCH & LOMB .....	60
C. STAPLED STOCK .....	61
D. MORRIS TRUST .....	63
V. SUBSTANCE, FORM, AND BUSINESS PURPOSE IN TAX SHELTERS .....	65
VI. CONCLUSION .....	68

## I. INTRODUCTION

**I**T requires no citations to establish what is obvious to tax professionals within and without the government: corporate tax shelters are proliferating, in both type and number, and their terms are becoming ever more audacious. The problem has a demand side: corporations are increasingly willing to treat taxes as a cost to be avoided, with the efficacy of avoidance increasingly being measured purely in monetary, probabilistic terms with only passing attention to ethical and public perception concerns. But it also has a supply side, with tax practitioners, who historically have had ethical concerns stemming from professional responsibility, increasingly under competitive pressure to satisfy clients.

Tax practitioners are regularly called upon to review tax shelter products—preplanned transactions, like that involved in *ACM Partnership v.*

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*Commissioner*,<sup>1</sup> with elaborately choreographed steps motivated by the prospect of capturing unintended (though sometimes plausible) and unreasonable tax benefits rather than a true business purpose. While the dollar volume of transactions is not readily ascertainable, its significance is evident in the fact that the major accounting and investment banking firms, as well as some law firms, maintain large departments staffed with highly compensated professionals who devote all their efforts to generating tax shelter products, an expensive exercise which they would not undertake if it were not lucrative. Since the revenues of these departments are based directly or indirectly on the expected tax savings (generally representing a small sharing in the present value thereof) large tax revenue losses can reasonably be projected. This conclusion is consistent with the experience of tax practitioners asked to review tax shelter schemes on behalf of corporate clients. It is a common experience to find, for example, that a corporation's disclosure of a planned or consummated divestiture results in a flood of competing offers to shelter the gain before or after it is realized.

Coupled with the proliferation of shelters is the increase in their audacity. Tax shelter promoters and their advisers, it is clear, are pitching transactions increasingly dependent on the audit lottery. "Do nothing and you pay the tax, do our deal you may not and if you're caught rely on an 'opinion' to deflect penalties" is the common refrain. An "opinion" in this context is a plausible, but shallow, reading of the tax law concluding that the shelter "should" work, which the promoter puts forward as a talisman against penalties. In the interest of efficiency, promoters regularly recycle old shelters that have been targeted by statutory, regulatory or interpretive changes by modifying some element of the transaction to avoid the literal terms of the change (narrowly read) while retaining the same discredited shelter objective. Impatience with this charade has finally led courts to sustain penalties and the I.R.S. to threaten criminal sanctions in egregious cases.<sup>2</sup>

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1. *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998).

2. Penalties were imposed in *United Parcel Service of America v. Commissioner*, 78 T.C.M. (CCH) 262 (1999), involving a shifting of insurance income to a foreign captive, and in a recent case involving corporate owned life insurance, *I.R.S. v. CM Holdings*, 254 B.R. 578 (D. Del. 2000). The I.R.S. raised the specter of criminal sanctions in connection with the third in a series of abusive transactions involving assumed liabilities. See I.R.S. Notice 2000-44, 2000-36 I.R.B. 255 (stating that a loss is allowable as a deduction only if it is bona fide and reflects actual economic consequences). The tax shelters at which Notice 2000-44 aims are based on the mismeasurement of assumed liabilities. In one variation, the taxpayer receives \$300x from a lender but the parties take the position that, because of the interest rate premium, the stated principal amount is only \$200x and the remaining \$100x is interest. These loan proceeds are then dropped into a partnership, which purchases assets worth \$300x. Taxpayer claims a basis in the partnership interest of \$100x, on the grounds that the partnership only assumed \$200x of liabilities. When the taxpayer sells its partnership interest for fair market value (a nominal amount because its balance sheet reveals a net worth close to zero), the sale generates a loss of \$100x. In a second variation, the taxpayer buys one call option and writes another offsetting it. Both the purchased and the written call options are then contributed to a partnership. Taxpayer, taking advantage of perceived uncertainty as to whether a written call option constitutes a liability, takes the

Much has been said and written of the tax shelter explosion.<sup>3</sup> Some of it deals with the demand side of the equation, some with supply. Government commentators and tax policy experts assert serious concerns based on immediate revenue loss and overall adverse impact on the tax system, its fairness and efficiency, and taxpayer compliance morality. Some other commentary is self-interested denial on the part of shelter promoters and their captive advisers, who rely upon the difficulties in measuring this "black box" phenomenon to support their argument that the problem is not extensive. A third voice, that of the highest levels of the tax practitioner community, represented most visibly by the New York State Bar Association Tax Section and the American Bar Association Section on Taxation, has been heard as well. These organizations are well suited to deal with, among other things, the professional and systemic responsibilities, duties and functions of tax advisers in the tax shelter context.

While differing somewhat as to specifics, these organizations have maintained a common aversion to the tax shelter phenomenon. This strongly felt and expressed sentiment reflects concern about the systemic effects of shelters and the pressures on conscientious advisers to support questionable deals. Less commonly recognized, this reaction also reflects tax shelters' implicit disparagement of the intellectual foundations of principled and creative tax practice. In such transactions, an elaborate series of formal steps is contrived to lead to an unreasonably beneficial tax result, usually resulting from some defect or ambiguity in the tax law. When a tax shelter is attacked by the I.R.S., the taxpayer relies on the form and the government makes the argument, in one variation or another, that the transaction should not generate the tax benefits attendant to its form because that form does not reflect its substance or because the transaction has no substance—*i.e.*, no business purpose. But the relationship between form and substance, and the respect to be accorded each,

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position that its basis in the acquired partnership interest is simply its basis in the purchased call option. This interpretation was rejected by the Tax Court in *Salina P'ship v. Comm'r*, 80 T.C.M. (CCH) 686 (2000). The artificially high basis generates a loss when the partnership interest is sold at its nominal fair market value. The I.R.S. referred to possible criminal penalties in discussing attempts to conceal the transaction by having a grantor trust hold the shelter and the underlying appreciated asset and then (improperly) netting the gain and loss of the grantor trust.

3. The tax shelter phenomenon has generated a wealth of tax literature. On the government side, the U.S. Treasury's White Paper on The Problem of Corporate Tax Shelters released July 1, 1999, and the Staff of Joint Comm. on Taxation, 106th Cong., 1st Sess., 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) 3 (Comm. Print 1999), as well as Comparison of Recommendations Relating to Corporate Tax Shelters Made by the Dept. of Treasury and the Staff of the Joint Comm. on Taxation (Comm. Print 2000) provide very useful summaries of tax shelters and anti-shelter proposals. Outstanding examples of the professional literature include Daniel N. Shaviro, *Economic Substance: Corporate Tax Shelters and the Compaq Case*, 88 TAX NOTES 221 (2000); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999); and Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 231 (1999).

also vitally concerns tax practitioners who are involved in real world transactions motivated by true business purposes.

The jurisprudence relating to tax shelters draws upon case law that often involved real world transactions with a business purpose, but also with a form that provided a tax benefit. There is, however, a stark contrast between the way in which practitioners and courts apply substantiality doctrines in tax shelter cases and real world cases. In real world cases, the analysis of the relationship between form and substance is nuanced. In tax shelters, promoters attempt to apply a patina of substance to a transaction that is formal and unreal. To the tax adviser in true business transactions, the existence of substance is a given and form is usually a friend to the extent it permits the tax planner to control the tax results of a given substantial transaction by employing one form rather than another. In such typical cases, the tax practitioner favors respect for form. But form can also be an enemy in that legal or other constraints may compel the use of a form for a real transaction that has adverse tax effects. In some of these cases, the tax law may allow, and the I.R.S. may acknowledge, a recharacterization of the transaction to reflect its substance and business purpose despite its form. By contrast, to the tax shelter promoter and its adviser, form is always a friend and substance always an enemy to be expiated. In a tax shelter, form is malleable because it needs to conform only to tax needs and not business objectives.

The common reaction of the key organizations representing tax professionals has been to focus on what they perceive to be the underlying weakness of tax shelter economics—the dependence on concealment and the audit lottery.<sup>4</sup> This would be accomplished by a requirement for prompt and discriminating disclosure of tax shelters, increased I.R.S. audit activity, penalties for shelters (heavier if not disclosed) which fail on the merits, and de-valuation of opinions as a means to deflect penalties (by creating strict liability for tax structures that fail).<sup>5</sup> More troublesome to many practitioners are proposals for a substantive disallowance provision that could trend in the direction of a general anti-avoidance rule. Such a provision would permit the I.R.S. to change the results that would otherwise flow from a transaction if it failed a test relating to its economic substance. Supporters of such a rule believe it will act as a deterrent both by improving the I.R.S.'s litigating position and arming conscientious tax advisers with a weapon to persuade clients to resist tax shelter promoters. In response, opponents contend that the types of shelters caught by the provision almost certainly would fail under current case law and that the

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4. See New York State Bar Association (Tax Section), Report on Corporate Tax Shelters of New York State Bar Association Tax Section, 83 TAX NOTES 879 (May 10, 1999); see also *Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget: Hearings Before the Senate Comm. on Finance*, 106th Cong. (1999) (statement of Stefan F. Tucker, on behalf of the Section of Taxation American Bar Association).

5. Thus, the NYSBA report recommends that penalties apply to shelters that fail in litigation whether or not opinions had been rendered, with heavier penalties for non-disclosed transactions. This approach would obviate, to some extent, the need to deal with opinion standards in corporate tax shelters.

plethora of recent anti-shelter decisions should sufficiently arm any conscientious adviser. In tax shelter cases, the case law doctrines are regularly applied to reject the tax benefit associated with form. Tax practitioners by and large, are comfortable that judges, in applying these doctrines, will be able to distinguish real transactions from artificial tax shelters. They may be less comfortable when a legislative solution is proposed to codify the anti-shelter case law because such an approach may fail to capture the subtlety and discrimination of the courts.

The difficulty of defining the class of transactions to be covered by a substantive disallowance rule has also been the focus of much attention. While showing a willingness to accept definitional over-inclusion in the disclosure-penalty regimes (in effect requiring disclosure of some transactions that might not be considered offensive shelters) so long as the efficacy of the scheme is not blunted by reams of disclosure, many professional advisers (represented, for example, by the NYSBA) have been much less willing to be vague, over-inclusive, or under-inclusive in a substantive business purpose codification.

Also cited, but less frequently analyzed, has been generalized concern on the part of these practitioner organizations with codifying, and in the process altering, the sophisticated judicially created body of law relating to the relationship of substance and form. Such a change could unpredictably alter the landscape for tax practitioners, who often rely on form but also at times (and sometimes with I.R.S. support) on substance to the extent it conflicts with form. It could also have the unintended effect of limiting the scope of the I.R.S.'s ability to challenge form on the basis of substance in cases not falling within the narrow scope of the statute and discouraging the I.R.S. from embracing substance when the form of the transaction would generate unreasonably adverse or beneficial results for taxpayers.

It is not the purpose of this article to deal yet again with the tax shelter phenomenon per se or the merits of various responses, a subject in any event admirably analyzed by recent literature. Rather, it probes the established tax bar's reaction to the tax shelter disease and proposed remedies, which in turn requires an understanding of the differences between (i) real transactions and tax shelters; (ii) the background, training and intellectual outlook of tax advisers involved in real transactions and those structuring tax shelters; and (iii) the role of substance versus form and business purpose in real transactions and in tax shelters.

## II. REAL TRANSACTIONS VERSUS TAX SHELTERS

Critics, some of them sincere and well meaning, of all attempts to rein in tax shelters often make the point that it is difficult to draw the line precisely between tax shelters and real business transactions. While defining tax shelters may be difficult and while there are cases on the borderline, experienced tax professionals can usually readily distinguish tax shelters from real transactions. Importantly, the courts have shown un-

commonly good judgment and common sense in distinguishing between the two classes. The distinction they draw is not narrowly based on a single test, such as a formulaic minimum return requirement, but rather the entirety of the transaction, including the way it was created and sold, the involvement of extraneous (usually tax-exempt) parties, shifting allocations, and the presence of unusual contrived steps.

It is this experience which provides a reasonable basis for the tax bar's conclusion that the problem can largely be solved by disclosure and penalty rules that focus attention on tax shelters and increase the costs of disallowance of shelter benefits. If this conclusion is sound, there is little need for (and adverse consequences would attend) taking the further step of expressly authorizing the I.R.S. to alter substantive tax rules, in shelter cases or otherwise. Many shelters are simply based on erroneous or distorted interpretations of law—often ignoring relevant provisions, misreading ambiguities, and almost always ignoring the underlying purpose of the law. Almost all are also at least disingenuous as to the purpose for entering into the transaction. It is the rare shelter that so cleverly exploits a provision of tax law as to afford proponents a relatively high degree of confidence that a court reviewing the transaction, in the light of its overall terms and motivations, would sustain the unreasonable result. Even in such a case, there is always the possibility of retroactive I.R.S. administrative attack under the many available statutory and regulatory authorizations and even quasi-retroactive legislative change.<sup>6</sup>

Distinguishing tax shelters from real transactions is often a frustrating exercise because tax shelters are usually designed to mimic real transactions. In this respect, tax shelters bear a relationship to real transactions analogous to the relationship between money laundering and banking. As in that analogy, rules designed to curb the abusive activity are a source of complexity in non-abusive cases. Without attempting to compete with the numerous proposed attempts to define corporate tax shelters, it is perhaps useful to compare real transactions (even aggressively structured ones) and tax shelters in terms of their origins, purposes, constituent parties, and common structural features.

Real transactions, most obviously, have as their origins and purpose making money in the short-run or the long-run by increasing revenues or reducing (non-tax) expenses. As a subset, business-based financings attempt to raise capital for the company's business. Taxes of course play a role in analyzing financings and other business transactions, but they do not provide the primary motivation for undertaking the transaction. Tax shelters by contrast exist principally to reduce taxes by generating tax benefits usually derived from losses or credits that reflect outlays, expenses, and negative economic items. The equity investment in a real

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6. For an administrative approach, see for example Notice 97-21, 1997-1 C.B. 407, retroactively attacking "step-down" preferred, a widely marketed transaction that threatened massive tax revenue losses. For a legislative response, see for example I.R.C. § 332(c) (1998) and its legislative history, dealing with liquidating REITs and RICs.

transaction is aimed at generating a sufficient economic return to exceed, on a risk-adjusted basis, the entity's cost of capital. The investment in a tax shelter is a fee paid for tax benefits. The investor either expects to lose it or expects a return with an economic yield that is below market on a risk-adjusted basis.<sup>7</sup> The economic return, if present, is often a carefully calibrated item designed to satisfy a perceived talismanic business purpose standard. The economic risk is likewise circumscribed so that, while predictable small losses may exist, large unpredictable losses do not.

Real transactions generally arise from commercial contacts, in-house corporate development and similar departments, business brokers and outside investment advisers. If not originated in-house, they are generally marketed to the sectors of corporate management dealing with acquisitions, divestitures, finance, corporate development, etc. They usually reflect a business or financing idea, not a tax-savings idea. Tax shelters are generally created by specialized tax professionals, usually but not always independent of the corporation in question. If developed outside the corporation they are generally marketed to the tax or finance department of the corporation, although in some high profile, large dollar cases the pitch is made to the highest management levels.<sup>8</sup>

Real transactions generally involve real parties in interest (*e.g.* buyer and seller) with financing parties supplying capital at market rates of return. Tax shelters often, probably most of the time, involve accommodation parties that are not U.S. taxpayers (*e.g.* foreign entities, tax-exempts, loss corporations) to whom income is deflected, often through a partnership or other non-taxed entity.

Real transactions, other than financings, are generally open-ended with undefined outcomes. Corporations expect them to generate returns that exceed the corporation's cost of capital but also expect a corresponding risk of loss. (Financings generally involve predictable outlays but generate proceeds whose investment is expected to generate open-ended returns, or at least returns that exceed (pre-tax) financing costs.) In contrast, tax shelters usually involve largely predictable outcomes in order to assure that the expected tax benefit will be available to offset a particular gain or income item. To achieve the predictable result, carefully scripted scenarios are usually followed. Indeed, it is the choreographed series of steps—typically foreign to the corporation's usual business, involving extraneous parties and often employed by other users of the same shelter type—that courts often seize upon in branding a transaction as a shelter.

Although in theory the line between a tax shelter and an aggressively structured real transaction may appear difficult to draw, in actuality the

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7. Investments in municipal bonds or leveraged leases might seem to fit this description but are distinguishable because the below-market economic returns reflect tax benefits intentionally and expressly conferred by Congress on the classes of persons claiming them.

8. This latter path was apparently pursued in peddling the shelters that led to ACM and related cases. See *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998).



distinction is generally rather easy to establish when the transaction involves most of the tax shelter elements described above. That is why it may be hard to define shelters legislatively (and the difficulty is compounded if the stakes are substantive disallowance as opposed to disclosures and penalties) but so easy for courts to determine whether an actual transaction is a shelter. Consider these variations on partnership transactions. In the first case, corporations A and B contribute businesses to a partnership, A receives 90% from the income from B's business, B 90% of A's, with the expectation of a redemption of A in year eight for B's business. In the second case, A contributes its business, B contributes cash, partnership borrows cash (recourse to A) and distributes it to A; expected redemption of A in year eight. The third case parallels case two but the redemption is for stock of a subsidiary holding high-basis investment assets. In the fourth, A and B contribute cash, assets are acquired and sold in a manner designed to generate an artificial tax gain which is allocated to B, a non-taxable entity; B is redeemed and A is left with an artificial loss. Most observers would treat the first and second as real business transactions, the third as an aggressive but real business transaction, and the fourth as a tax shelter.

The tax shelter stigma attaches most firmly and justifiably to transactions involving loss generation and/or tax-exempt accommodation parties to whom income is deflected or whose investment is used to generate a loss allocated to the shelter investor but without the tax consequences of debt incurrence. The *ACM* case, for example, drew precious few criticisms of the outcome, which seemed well deserved. As for step-down preferred, the severe I.R.S. reaction reflected both the abusive nature of the transaction (deflecting uneconomic amounts of income to tax-exempt holders with matching artificial deductions to taxpayers for the equivalent of principle amortization) and its massive revenue implications. This was in the context of a transaction that probably worked under then-existing rules but was too good to be true. The same could also be said of so-called liquidating REIT transactions.

Transactions involving income shifting within an affiliated group,<sup>9</sup> unwarranted interest deductions on corporate-owned life insurance<sup>10</sup> or foreign tax-credits on dividend-stripping transactions<sup>11</sup> exist in the hinterland between merely aggressive transactions and tax shelters, the border crossed as artificiality increases and tax benefits become more unreasonable. *Cottage Savings*-type transactions, resulting in recognition of true economic losses, have been sustained by the courts and would not generally be regarded as true tax shelters by practitioners.<sup>12</sup>

Financial products and their development fall into an interstitial class between real transactions and tax shelters. They admittedly often entail a

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9. See *United Parcel Serv., Inc. v. Comm'r*, 78 T.C.M. (CCH) 262 (1999).

10. See *Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254 (1999).

11. See *Compaq Computer Corp. v. Comm'r*, 113 T.C. 363 (1999).

12. See *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991).

great deal of tax motivation and their development sometimes more closely resembles that of shelters than real transactions in that tax planning, rather than a business plan, often generates the product. There are, however, significant differences between classic shelter activity and financial product innovation. In the first place, the tax benefits sought in financial products do not generally involve abuse of the tax system to the same degree as true shelters. Gross sheltering of unrelated income is typically not involved, and the deductions generated substantially comport with the investor's return. Deferring gain, deducting interest on instruments with equity elements, and exploiting the inconsistencies between U.S. and foreign systems are standard themes in tax planning and approach abuse only in extreme cases, like stepped-down preferred, where there is the risk of gross permanent avoidance of tax and not mere deferral. Indeed, it can be argued that some of these instruments rightly blunt the over-taxation of corporate earnings on equity as opposed to debt capital and others diminish the excess rigor of *General Utilities* repeal, especially as it relates to sales of portfolio stock investments. Moreover, financial product development is not nearly as dependent on concealment and the audit lottery. The instruments are often publicly traded and tax lectures regularly detail their inner workings.

### III. THE TAX BAR VERSUS THE TAX SHELTER BAR

Tax professionals are involved in planning real transactions and in facilitating tax shelters. The two types of practice are vastly different and the two categories of tax professional are equally distinct. In general and historically, individuals who plan real transactions are not involved in tax shelters, other than reviewing them for clients, and professionals who plan or facilitate tax shelters rarely participate in mainstream, high profile tax practice. The distinction has come under some pressure as of late, reflecting the demand of corporate clients' intent on minimizing taxes by virtually any means, as well as competitive concerns. But the fact remains that the two categories differ in approach, training, expertise, judgment, reputation, and status. The two types of practitioner differ most markedly in their attitude toward the issues of substance versus form and business purpose. An understanding of the differences between these two types of practice and two classes of practitioner are important to an understanding of the different roles that these doctrines play in real transactions as compared with tax shelters.

Tax practitioners involved in real transactions are called upon to cast a desired business transaction in a form that is most beneficial from a tax perspective. The basic business purpose is a given but there may be choices as to form. The choice of form may involve balancing business, legal, and financial constraints (including the desire for simple structures) against tax benefits. Often the form beneficial to the client may be detrimental to the counter-party. The process is interactive, interpersonal, and calls for negotiating as well as analytical skills.

Despite the increased specialization of the tax bar, transactional tax practice is more often than not the province of tax generalists versed in the many areas that may be implicated in particular transactions. They are as comfortable with "standards" as they are with "rules." The operating arena of such practitioners is generally the corporate law firm, although corporations (especially large ones) have in-house advisers as well.

Reputation greatly affects the effectiveness of such a tax practitioner. A practitioner's reputation will provide credibility in dealing with clients, opposing counsel, and the I.R.S. on audit and in connection with advance rulings. In many large corporate transactions (public spin-offs, for example) an advance I.R.S. ruling is often a practical prerequisite. Practitioners who have a reputation for knowledge and experience in real transactions are, needless to say, given a warmer reception than those who are less well known or are known for participating in tax shelter or other aggressive transactions.

Reputation and status are based on the practitioner's transactional experience but are reinforced by professional writing, lecturing, participation in tax discussion groups, and most importantly through active involvement in the high profile bar association tax sections, most prominently the New York State Bar Association and the A.B.A. These organizations play an important role in the development of the tax law, a fact widely acknowledged within and without government. The officer ranks of these organizations are almost exclusively reserved for members involved in real world tax practice, who have their colleagues' respect and who are actively involved in improving the tax law through writing, lecturing, etc. It is inconceivable that a practitioner who specialized in tax shelters would ever reach a position of responsibility in these organizations.

The tax shelter professional is a different breed, by experience, temperament, reputation, and calling. The differences reflect the wide gulf between real world tax and tax shelter practice. Instead of providing a tax structure for a real business transaction, the tax shelter adviser creates an artificial transaction to take advantage of a loophole. Such a transaction cannot be real—no one wanted to do the transaction before the loophole was discovered—it can only be made to appear real.

Tax shelter practitioners tend to be specialists rather than generalists and often suffer from the specialist's lack of judgment. They are comfortable with "rules" but not "standards." Within the product development departments of the entity that employs them, they ferret out lacunae in the tax law and then build transactions around them. The hard part is not finding the loophole (there are plenty around and most have been written up). Rather, it is cloaking the shelter in the mantle of a real transaction by incorporating the requisite economic return to satisfy a perceived "economic substance" minimum threshold. A second major task is to sell the idea to clients, through meetings and the preparation of a selling

memorandum. The latter has the appearance of a legal opinion, though it disclaims such status. It generally lays out the literalist arguments in favor of the shelter and claims that some implanted "business purpose" or economic return takes the transaction out of the category of tax shelters regularly disallowed by the courts.

No one really believes the selling memorandum. It is enough that the investor might reasonably believe it. If the investor wants the comfort of a legal opinion to deflect penalties it does not rely on the selling memorandum (which expressly disclaims such responsibility) but obtains the opinion from a law firm, usually one identified by the promoter as willing to give the requisite comfort. The firms rendering such opinions bridge the gap between real practice and shelter practice, with inevitable adverse reputational consequences, given their role as facilitators of often-abusive transactions. The investor's regular tax counsel may also be approached, although the prospect of a negative view, which could taint reliance claims, often discourages this approach.

In short, the real world and real world tax practice by and large bears scant resemblance to the tax shelter world and its tax practice. The differences are reflected in the manner in which both are impacted by business purpose and substance versus form doctrines.

#### IV. SUBSTANCE, FORM, AND PURPOSE IN THE REAL TAX WORLD

The many cases dealing with substance and form in real world transactions represent an extensive and pervasive body of law, unmatched by case law in other countries, most of which give far greater weight to form.<sup>13</sup> The usual cases involving I.R.S. attacks based on substance are familiar to all practitioners. It may be interesting and useful to focus instead on instances in which the I.R.S. has facilitated business transactions by permitting the taxpayer to re-characterize form to accord with substance and cases in which the I.R.S.'s view of substance has changed as the underlying stakes or structural features of the tax law have changed.

It is important to note the role that fundamental, structural principles of tax law play in applying substance-form and other recharacterization doctrines. Tax lawyers, the I.R.S., and the courts regularly appraise transactions in light of their consistency with such fundamental doctrines. These doctrines include: the creation of tax basis; the preservation of basis; the consequences of debt incurrence, satisfaction, and forgiveness; the realization concept and its limitations; the relative acceptability of deferral versus permanent avoidance; and the analysis of a transaction as a distribution or an exchange, at the shareholder and corporate levels. These rules change over time; witness the repeal of the *General Utilities* doctrine. With such repeal, the idea that corporate assets can leave cor-

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13. See Robert Thornton Smith, *Business Purpose: The Assault Upon the Citadel*, 53 TAX LAW. 1 (1999); Robert Thornton Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 TAX LAW. 137 (1990).

porate solution with a new tax basis is anathema. Whether stock of another corporation should be treated as such an asset is more problematic: the repeal of "mirror" liquidations in 1987 and limitations on *Morris Trust* transactions in 1997 suggest an affirmative answer but the continued tax-free status of spin-offs in general, coupled with the over-taxation that results when corporate stock sales are taxed without a step-up in the basis of the underlying assets, suggests the contrary.<sup>14</sup>

#### A. DISREGARDING TRANSITORY ENTITIES AND CIRCULAR CASH FLOWS

The notion that a transitory subsidiary or a circular flow of cash may be disregarded, for the benefit of the taxpayer as well as the government, is so well ingrained as to be taken for granted. It has largely been forgotten that the I.R.S. Revenue Rulings and Letter Rulings dealing with these issues played a fundamental role in the several phases of corporate acquisition activity since 1967.

The story begins with Revenue Ruling 67-448, which reads in its entirety as follows:

Where, pursuant to a plan of reorganization, a parent corporation, P, issues some of its voting shares to its new subsidiary, S, and S immediately merges into unrelated corporation, Y, with the result that the shareholders of Y receive shares of P and P receives 80 percent or more of the shares of Y, the substance of the transaction is an acquisition by P, in exchange solely for part of its voting stock, of stock of Y within the meaning of section 368(a)(1)(B) of the Internal Revenue Code of 1954.

Advice has been requested whether the transaction described below qualifies as a reorganization within the meaning of section 368(a)(1)(B) of the Internal Revenue Code of 1954.

Corporation P and Corporation Y, incorporated in the same state, are publicly owned corporations. Corporation P wanted to acquire the business of Corporation Y but could do so with an effective result only if the corporate entity of Y were continued intact due to the necessity of preserving its status as a regulated public utility. P also desired to eliminate the possibility of minority shareholders in the event less than all of the shareholders of Y agreed to the transaction. Since an outright acquisition of stock pursuant to a reorganization as defined in section 368(a)(1)(B) of the Code would not achieve this result, the plan of reorganization was consummated as follows: (a) P transferred shares of its voting stock to its newly formed subsidiary, S, in exchange for shares of S stock. (b) S (whose only asset consisted of a block of the voting stock of P) merged into Y in a transaction which qualified as a statutory merger under the applicable state law. (c) Pursuant to the plan of reorganization and by operation of

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14. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10223(a)-(c), 101 Stat. 1330 (codified as amended at I.R.C. §§ 337(d), 304(b)(4) and 355(b)(2)(D)); Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1012(a), 111 Stat. 788 (codified at I.R.C. § 355(e)).

state law, the S stock owned by P was converted into Y stock. At the same time the Y stock held by its shareholders was exchanged for the P stock received by Y on the merger of S into Y. The end result of these actions was that P acquired from the shareholders of Y in exchange for its own voting stock more than 95 percent of the stock of Y.

(d) Y shareholders owning less than five percent of the stock of Y dissented to the merger and had the right to receive the appraised 145 value of their shares paid solely from the assets of Y. No funds, or other property, have been or will be provided by P for this purpose.

Thus, upon the consummation of the plan of reorganization Y became a wholly owned subsidiary of P.

At the time of the transaction P had no plan or intention to liquidate Y or to merge it into any other corporation.

The transaction described above does not constitute a reorganization within the meaning of either section 368(a)(1)(A) or section 368(a)(1)(C) of the Code because no assets of Y were transferred to nor acquired by another corporation in the transaction but rather all assets (except for amounts paid to dissenting shareholders) were retained in the same corporate entity.

Section 368(a)(1)(B) of the Code provides in part that the term "reorganization" means the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

It is evident that the shortest route to the end result described above would have been achieved by a transfer of P voting stock directly to the shareholders of Y in exchange for their stock. This result is not negated because the transaction was cast in the form of a series of interrelated steps. The transitory existence of the new subsidiary, S, will be disregarded. The effect of all the steps taken in the series is that Y became a wholly owned subsidiary of P, and P transferred solely its voting stock to the former shareholders of Y.

Accordingly, the transaction will be treated as an acquisition by P, in exchange solely for part of its voting stock, of stock of Y in an amount constituting control (as defined in section 368(c) of the Code) of Y, which qualifies as a reorganization within the meaning of section 368(a)(1)(B) of the Code.<sup>15</sup>

The clarity, brevity, and elegance of this ruling are remarkable. To disregard the transitory subsidiary at taxpayer's behest seems so easy today but few advisers could have comfortably assumed this result in a major transaction absent the Revenue Ruling. Indeed, before the ruling was published, it would have been necessary to obtain a letter ruling to feel safe in this conclusion. Moreover, a contrary result could easily be reached: if the subsidiary's existence were not disregarded, the transaction could have been analyzed as an acquisition by Target of Subsidiary

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15. Rev. Rul. 67-448, 1967-2 C.B. 144.

(owning Acquiror stock) followed by a taxable distribution of Acquiror stock by Target. For what it is worth, foreign jurisdictions often have a difficult time dealing with reverse subsidiary mergers because they cannot take the leap of imagination to disregard an entity's existence. In Germany, in particular, it is only recently, and through elaborate mechanics, that it became possible to conclude safely that corporate and tax requirements are met in reverse mergers.

Revenue Ruling 67-448 played a key role in the stock-based takeovers of the 1970s, allowing Acquirors to force Target shareholders to take stock in a reorganization without transfer of Target assets and often without an Acquiror shareholder vote. While the subsequent enactment of Section 368(a)(2)(E) of the Code codified these results, Revenue Ruling 67-448's creative approach was extended to other areas, making viable other important transactional formats.

Revenue Ruling 73-427<sup>16</sup> treated exchanges in a reverse merger which did not qualify for reorganization treatment as taxable sales of shares (the consideration coming from Acquiror) not generating corporate level tax. Revenue Ruling 78-250,<sup>17</sup> held such a transaction to be a redemption where the cash paid to shareholders originated in Target. These rulings facilitated the cash takeovers and leveraged buyouts of the 1980s and 1990s. The use of reverse mergers to combine two public companies under a new holding company in a section 351 incorporation, in turn, played a vital role in cross-border combinations in which true merger treatment was not available under section 368(a)(1)(A).

This line of thinking was also extended to the foreign and partnership areas. Thus, in Revenue Ruling 78-397<sup>18</sup> and Revenue Ruling 83-142,<sup>19</sup> the I.R.S. disregarded a circular flow of cash, thus facilitating restructurings of foreign subsidiaries of U.S. corporations. Finally, in Revenue Ruling 66-264<sup>20</sup> the I.R.S. held that a partnership's sale of assets to a new partnership owned by some of its partners would be treated as a redemption of the non-continuing partners' interests, thus avoiding asset-level gain.

It is not too much to say that this series of rulings was responsible for facilitating trillions of dollars of corporate realignments in the late twentieth century, many of which would not have occurred or would have been made much more difficult if the I.R.S. had not been willing to embrace substance and ignore form.

#### B. BAUSCH & LOMB

In *Bausch & Lomb Optical Co. v. Comm'r*,<sup>21</sup> the Second Circuit ac-

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16. Rev. Rul. 73-427, 1973-2 C.B. 301.

17. Rev. Rul. 78-250, 1978-1 C.B. 83.

18. Rev. Rul. 78-397, 1978-2 C.B. 150.

19. Rev. Rul. 83-142, 1983-2 C.B. 68.

20. Rev. Rul. 66-264, 1966-2 C.B. 248.

21. 267 F.2d 75 (2d Cir. 1959).

cepted the I.R.S.'s argument that the acquisition of a corporation's assets by its corporate shareholder for the latter's stock did not qualify as a "C" reorganization (assets solely for voting stock) because the shareholder in fact acquired some of those assets for its historic ownership position in Target. This is actually a logical construction, in accord with the substance of the transaction, since the Acquiror could not really be said to acquire the portion of the Target's assets it already indirectly owned for its own stock, the issuance of stock to itself being a non-event. Indeed, this line of thinking remains important in the analysis of corporate inversions and partnership dealings in partner stock.<sup>22</sup>

Despite the inherent logic of the position, *Bausch & Lomb* created traps for the unwary, was easily avoided through planning (particularly, the use of subsidiaries), and served no real tax policy purpose. Accordingly, after forty years of living with this rule, the I.R.S. abandoned the doctrine.<sup>23</sup> In effect, form was allowed to govern rather than substance in this narrow area.

### C. STAPLED STOCK

The approach of the I.R.S. and the courts to stapled stock demonstrates pointedly the difficulties of determining the true substance of a transaction and the importance of context and consequences to this determination.

Stapled stock consists of interests in two entities bound together so that they may only be sold together. It raises the issue as to whether two theoretically separate items of property should be treated as one if indivisible, and if so whether a parent-subsidary or other relationship should be implied as the result. It has resonance in the inverse case of tracking stock, which is formally an interest in one entity but which "tracks" the economic performance of another, usually a subsidiary of the issuer. In stapled stock, two theoretically separate entities may be viewed as one because of linkage. In tracking stock, two classes of stock of a single entity may arguably be viewed as interests in two entities because the value of each derives from the income and assets of only one of the two.

The problem dates back to the decision of the Board of Tax Appeals, affirmed by the Second Circuit, in *DeCoppet v. Helvering*.<sup>24</sup> The issue in *DeCoppet* was whether a shareholder could take a worthless stock loss on stock of an insolvent investment company stapled (through a trust) to stock of a solvent bank.

The Board of Tax Appeals analyzed the matter as follows:

The petitioners say that they sustained a loss when the investment corporation dissolved without assets and its shares became worthless. We find it impossible to accept this view. Strictly speaking, in accor-

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22. See Peter C. Canellos, *Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores and McDermott*, 45 TAX LAW. 1 (1991).

23. See Treas. Reg. § 1.368-2(d) (1998).

24. 108 F.2d 787 (2d Cir. 1940).



dance with the conception which underlies the trust agreement of May 1, 1929, they were never the owners of investment corporation shares from the time of its organization until its dissolution. Their investment was always in shares of the bank, and indissolubly within that investment was embedded their more remote interest in the affairs of the investment corporation; and those affairs, conducted by the directors of the bank, might result in distribution to the trustees and in turn to them. In 1929 petitioners paid \$40 entirely to the bank and the bank was to use \$10 of it as a subscription for two shares of investment corporation stock to be issued to the trustees, who were the bank's directors. Aside from the New York law's requirement of a separate corporation, the affairs conducted in the name of the investment corporation were inseparable from those of the bank. They were conducted by the same persons, not because they happened to be holding positions as directors of both corporations, but because it was designed so and anything else was inherently impossible. The identity of a trustee was not in his person but in his position as a director or officer of the bank. Thus it was assured that there could be no conflict between the interests of the two. This unity was carried out in the identity of bank shareholders and trust beneficiaries; in distributive interests of the investment corporation, one being proportionate to the other; and in the evidence of both being shown by the same certificate. To all this was added the injunction that no holder might dispose of either alone; both must be held inseparably. This unitary conception was thoroughly adopted and adhered to by everyone at all times throughout the life of the enterprise at every stage and in every change in its course. . . . The conclusion which seems to us inevitable is that petitioners' investment must be regarded as existing in their bank stock and that their relation to the investment corporation and the trust was an inherent part of their ownership of bank shares, the ultimate disposition of which will reflect gain or loss upon the full basis of their cost.<sup>25</sup>

In *DeCoppet*, the I.R.S. prevailed in asserting that the substance of stapled stock was unity of investment where the issue was taking a loss on the stock of one of the stapled entities. In 1954, with the stakes changed, the I.R.S. shifted field. In Revenue Ruling 54-140, the I.R.S. concluded that stock held by a trustee for the benefit of shareholders of the parent, such beneficial interests being inseparable from the stock of the parent, nevertheless constituted a separate asset for tax purposes.<sup>26</sup> The I.R.S. relied on the fact that the shares were not subject to the bank's creditors, depositors, and other third party claimants.

This revised I.R.S. position in turn was exploited by taxpayers seeking to de-control foreign subsidiaries or corporations operating the properties of affiliated real estate investment trusts. Perhaps dubious about its ability to alter its position yet again, the I.R.S. instead left the field to Congress, which enacted section 269B of the Code in 1984.

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25. *DeCoppet v. Comm'r*, 38 B.T.A. 1381, 1392-94 (1938).

26. Rev. Rul. 54-140, 1954-1 C.B. 116.

Section 269B was enacted to deal with several different types of problems raised by stapled stock. In the foreign area, the major concern was with "de-controlling" transactions pursuant to which shares of a foreign subsidiary were distributed to the parent's shareholders and then "stapled" to the stock of the U.S. parent. The objective in such transactions was to remove the foreign subsidiary from the constraints applicable to controlled foreign corporations. In the second type of transaction, shares of a regulated investment company or real estate investment trust were stapled to shares in a corporation that conducted business which the Code does not permit of such an entity. In each case, Congress came to the conclusion that stapling was abusive in that it permitted shareholders to obtain the economic benefits of combined ownership (including common control without fiduciary duty constraints) while evading limitations which would apply to a parent/subsidiary structure. However, the underlying issues and tension remain in other areas that have not been the subject of legislation. These include the tax consequences of issuing tracking stock or so-called "dual-headed" transnational combinations in which two, in theory, separate entities bind their fates together through equalization and other contractual arrangements.

#### D. MORRIS TRUST

With the full repeal of *General Utilities* through the elimination of "mirror liquidations" in 1987,<sup>27</sup> spin-offs under section 355 of the Code became the last legitimate escape from (as opposed to deferral of) tax arising from dispositions of stock of another corporation. When coupled with the post-spin acquisition of Distributing or Controlled (generally, for technical tax reasons, Distributing) in a so-called *Morris Trust* transaction,<sup>28</sup> the result was a tax-efficient means of separating one corporation into two, one of which would be combined with an Acquiror. In the process, debt of the Target group was often realigned prior to the separation.

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27. See Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10223(a)-(c), 101 Stat. 1330 (codified as amended at I.R.C. §§ 337(d), 304(b)(4) and 355(b)(2)(D)).

28. See *Comm'r v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966) (holding that the distribution of stock of a newly formed subsidiary prior to a reorganization transaction in which parent was not the surviving corporation qualified as tax-free under § 355 of the Code); see also Rev. Rul. 70-434, 1970-2 C.B. 83 (assuming, but not explicitly deciding, that the distribution of the stock of a subsidiary followed by a tax-free acquisition of the parent qualified under § 355 of the Code); Rev. Rul. 78-251, 1978-1 C.B. 89 (concluding that a spin-off undertaken to facilitate a tax-free acquisition of parent could qualify under § 355 of the Code); Rev. Rul. 75-406, 1975-2 C.B. 125 (modified by Rev. Rul. 96-30, superceded by Rev. Rul. 98-27, 1998-1 C.B. 1159) (finding that the distribution of the stock of a subsidiary prior to its acquisition by an unrelated corporation, which acquisition was approved by the post-spin-off shareholders of subsidiary, qualified as tax-free under § 355 of the Code); Rev. Rul. 96-30, 1996-1 C.B. 36 (modifying Rev. Rul. 75-406, superceded by Rev. Rul. 98-27) (narrowing Rev. Rul. 75-406 to transactions in which there have been no negotiations to dispose of the stock of Controlled prior to the spin-off); Rev. Rul. 98-27, 1998-1 C.B. 1159 (superceding Rev. Rul. 75-406 and Rev. Rul. 96-30) (stating that the Service will not apply *Court Holding* or the step transaction doctrine to determine if the distributed corporation was a controlled corporation immediately before the § 355 distribution solely because of any post-distribution acquisition or restructuring).

Within limits, such realignment reflected the need to re-allocate consolidated debt, usually carried on the parent's balance sheet, though supported by both parent and subsidiary assets, into two tranches, each supported by one of the two entities. This was consistent with the philosophy underlying the allocation of interest expense now contained in sections 1.861-9T through 1.861-11T of the Regulations—*i.e.*, all of a group's assets support its parent's liabilities. Although it was theoretically possible to use debt realignment to affect a quasi-sale of the entity merging with Acquiror, in fact, the I.R.S. policed this issue closely by requiring applicants for rulings to demonstrate that Distributing and Controlled each wound up with an overall capitalization appropriate to its business. Moreover, unlike a sale, a distribution followed by a reorganization did not change the basis of corporate assets. Finally, imposing tax on such a transaction without a step-up in asset basis would create multiple levels of corporate tax.

Despite these arguments, the analogy to a tax-free sale caught the fancy of the Treasury and Congress, resulting in the enactment of section 355(e) of the Code in 1997. Despite its genesis in concerns over debt realignment, the provision ignores leverage entirely and instead taxes Distributing when the distribution is part of a plan or series of related transactions pursuant to which one or more persons acquire a fifty percent or greater interest in Distributing or Controlled. Acquisitions occurring within the four-year period commencing two years prior to the distribution are presumed part of a plan unless the presumption is rebutted. Highly criticized proposed regulations severely and unreasonably restrict the available means for rebutting the statutory presumption.

Section 355(e) is massive overkill, reaching transactions that in no way resemble sales. These include: (i) post-spin acquisitions not in fact part of a plan (if these were truly considered sales one would have to think the Target shareholders who sold between the time of distribution and merger "sale," and thus were deprived of the benefits of the "sale" were terribly disadvantaged and should sue); (ii) transactions without leverage shifting (if a "sale" by Distributing there are no proceeds); and (iii) acquisitions followed by pro-rata spins (which in no way resemble corporate sales because the spin will be made to all of Acquiror's shareholders, not just the former Target Shareholders).<sup>29</sup> Section 355(e) in its present unrefined form casts a pall on spins that is not justified by any valid tax policy. It shows the risk of legislating (or interpreting) by reference to the "substance" of a transaction when substance is divined by crude analogy—*i.e.*, is the distribution-merger really a "sale."

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29. I.R.C. § 355(e) (2000).

## V. SUBSTANCE, FORM, AND BUSINESS PURPOSE IN TAX SHELTERS

In the above-described real world transactions, the tax analysis attempts to divine the substance of the transaction to determine whether the form adopted properly reflects the substance. If so, the consequences expected to result from the form will in fact obtain. If not, the transaction may be recast with tax consequences appropriate to the substance and not the form. As noted, the re-characterization can benefit the government or taxpayers.

In tax shelters this refined analysis is secondary. The court's analysis focuses first on the bona-fides of the transaction. Courts have shown remarkable skill and persistence in pruning the (often intentionally) obfuscatory underbrush of complex tax shelters to determine whether they truly arose from business exigencies or attempts to generate unreasonable tax benefits. Since the contrived steps needed to structure a transaction benefiting from an arcane and uneconomic tax rule are usually abnormal, discerning the nature of the transaction is not that difficult once the transaction is understood in all its aspects. This is why tax shelters fail regularly in court. While the result may be couched in terms of lack of business purpose, promoters are foolish in believing (or persuading clients to believe) that the outcome turns on some requisite pre-tax profit. In shelters, by definition, the economics do not allow for substantial returns or actual equity investment, as would be appropriate to risk. The calibrated, modest returns are an obvious afterthought.

Once a judge sees the transaction as a shelter, a function of inferences that experienced judges are capable of making based on all the facts, the result is predictable—taxpayer loses. The Tax Court, in particular, seems to have accepted the view that the strain on the tax system would be unbearable if tax-motivated transactions had to be sustained merely because they manage to encapsulate an uneconomic tax rule, however clear by its terms. This result-oriented outlook resembles the approach of appellate courts, which often strive mightily not to reverse a criminal conviction on procedural grounds where guilt is clear. The shelter promoter who loses on a claim for unreasonable tax benefits despite good technical arguments based on arcane provisions and choreographed scenarios does not deserve or receive much sympathy. This attitude is evident in the scant concern for corporations that have had their tax shelter expectations undermined in a whole series of recent judicial decisions.

Nowhere is this judicial mindset more clearly displayed than in the landmark and much analyzed Tax Court decision in *ACM Partnership*.<sup>30</sup> Involved was one of a series of tax shelters sold by an investment banking firm in the late 1980s. These were designed to generate capital losses by a pre-arranged series of transactions affected through partnerships each in-

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30. *ACM P'ship v. Comm'r*, 73 T.C.M. (CCH) 2189 (1997).

volving a corporation seeking a loss, an investment bank and an offshore bank. They have all failed in court, under one or more theories of attack.

The facts of the case, illuminatingly revealed in Judge Laro's opinion, are highly complex but can essentially be summarized as follows:

(1) A corporation wished to shelter a capital gain which it had reported in 1988 in the sale of a subsidiary.<sup>31</sup>

(2) An investment banking firm proposed to the corporation a tax shelter designed to generate capital losses. The transaction, in essence, involved the purchase of an asset by a partnership whose partners were the corporation, a foreign bank, and the investment banker. The asset would then be sold for a large cash down payment and a series of contingent payments. Under applicable installment sale regulations, the partnership would unrealistically treat only a small portion of the asset's basis as attributable to the cash proceeds. This allocation generated a large (non-taxed) gain allocated to the foreign bank and left the installment notes with basis in excess of value. Through a pre-arranged series of redemptions and sales, this built-in loss was recognized and allocated to the corporation. A law firm gave the investment banker an opinion that the installment reporting basis allocation was appropriate.

(3) The corporation rejected the proposal because it lacked cash to invest and found the plan served no business purposes of the corporation, a fact that troubled its tax director.

(4) Thereupon, the transaction was modified to provide that the asset acquired was the corporation's own outstanding debt. With this change, the transaction was recast as a "Liability Management Partnership," purportedly offering the corporation certain advantages in restructuring its debt. To fine tune this rationale the transaction was further modified to insert an intermediate step, the purchase of Citicorp "private placement" notes pending the acquisition of the corporation's debt. The private placement notes were in turn promptly exchanged for cash and contingent payment "Libor" installment notes, purportedly to hedge interest rate exposure. Under the installment sale regulations, a large gain was recognized in the year of sale and allocated to the bank. The Libor notes were thereafter sold at a loss attributed to the corporation (the bank having been redeemed out of the partnership). The cash proceeds were invested in the corporation's debt.

Much effort and expense went into creating an appearance of business purpose, which looked solid enough on first impression but proved to be a thin veneer upon analysis. Judge Laro closely scrutinized the purported justification and found it false and disingenuous. His ire clearly comes through in the opinion:

Following our review of the record, with due regard to our view and perception of the witnesses, we do not find any economic substance

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31. Many corporate shelters involve the desire to avoid capital gains tax on dispositions, which are large non-recurring items the sheltering of which is, of course, very attractive.

in the section 453 investment strategy. We are convinced that tax avoidance was the reason for the partnership's purchase and sale of the Citicorp Notes. We do not suggest that a taxpayer refrain from using the tax laws to the taxpayer's advantage. In this case, however, the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created actually through the manipulation and abuse of the tax laws. A taxpayer is not entitled to recognize a phantom loss from a transaction that lacks economic substance.<sup>32</sup>

The court noted that the hedging and arbitrage justifications for the Citicorp Libor note acquisition were undercut by activities outside the partnership and that there were no reasonable prospects of a return to the corporation sufficient to offset the heavy transaction costs.

Judge Laro concluded as follows:

Each of the steps in the section 453 investment strategy was planned and arrangements commenced considerably in advance of execution. Before the negotiations to form ACM, Merrill had already begun negotiations to purchase the Citicorp Notes. Before their purchase, Merrill was negotiating for their disposition. By the time ACM acquired the LIBOR Notes, Merrill was arranging with Sparekassen the terms on which some of them would be sold. The contingent payment sale was scheduled to take place before the end of ACM's first taxable year in order to permit the partnership to spread its tax basis in the Citicorp Notes over 6 years instead of 5. The distribution and sale of the BFCE Notes was scheduled to occur before the end of Colgate's 1989 taxable year in order to offset Southampton's share of the contingent payment sale gain on Colgate's consolidated return. It was the understanding of the principals that Kannex would retire from the partnership by the fall of 1991 so that the LIBOR Notes could be sold in time for Colgate to carry back the taxable loss to its 1988 taxable year. No supervening market forces or other non-tax considerations disrupted the scheduled execution of these steps. If we stood at the top of the world and looked down on this transaction, we would see events unfolding during the year[s] \* \* \* about as they were contemplated . . .

But for the \$100 million of tax losses it generated for Colgate, the section 453 investment strategy would not have been consistent with rational economic behavior. The section 453 investment strategy lacked economic substance. It served no useful nontax purpose. Accordingly, the pertinent adjustments made by respondent to ACM's reported items of income and loss are sustained. [internal citations omitted]<sup>33</sup>

ACM offers the following lessons for shelter promoters:

(1) It doesn't help to have a good "gimmick." The installment sale basis argument in ACM was a very good gimmick, technically. It was not challenged by the court, and the I.R.S. never argued clear reflec-

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32. *ACM P'ship*, 73 T.C.M. (CCH) at 2215 (footnotes omitted).

33. *Id.* at 2228-29.

tion of income as a basis for disallowance. Despite the apparent clarity of the rule it relied upon, the investment banker and the corporation were not willing to simply rely on its terms but concocted a business purpose cover story.

(2) Cover stories, even complicated, well-crafted ones, will fail on close examination. Promoters cannot assume a judge will be unable or unwilling to perform the analysis required to undercut the cover story. If the judge makes that effort, it may be assumed he will be angry at the masquerade.

(3) Most shelter schemes require elaborate, pre-arranged scenarios. These are easily unveiled in litigation, further prejudicing the tribunal.

(4) The development and implementation of these schemes involves considerable costs that are passed on to the shelter buyer. These costs make it difficult to project positive pre-tax returns in investment in the shelter. But even if some pre-tax profit can be built in (e.g., through investment of excess equity by the shelter purchaser) there is no reasonable basis for concluding that the outcome would change because a judge would almost certainly determine that the essence of the transaction was the same—an orchestrated tax avoidance scheme.

(5) To justify its development cost, the promoter will wish to use the format on repeated occasions. Based on the discovery rulings in *ACM*, which allowed the I.R.S. to obtain lists of shelter investors and as further enhanced by recent tax shelter regulations,<sup>34</sup> the I.R.S. may be expected to find out about, and disclose in court, parallel transactions. This also undercuts the business purpose rationale and prejudices the court against the promoter. Moreover, parallel transactions improve the I.R.S. risk-reward ratio: in winning *ACM* the I.R.S. in effect won the other ten cases involving parallel investors, generating hundreds of millions in revenues for the government. Finally, numerous large transactions are difficult to conceal, and public disclosure of these schemes is usually the kiss of death. Notably, the *ACM* tax shelter blew up when it became the subject of widespread professional and journalistic comment, culminating in a newspaper article that disclosed the details of the transaction.<sup>35</sup>

## VI. CONCLUSION

The government obviously feels great frustration in combating abusive tax shelters. Shelters proliferate despite the government's recent sterling litigation record. With audacious schemes like "Son of Boss" the government is well justified in considering criminal sanctions. But cases like *ACM* make it clear that the fault is not primarily in the substantive law.

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34. See Treas. Reg. §§ 1.6011-4T, 301.6111-2T; see also, 26 C.F.R. pts. 1, 301 (modifying recent tax shelter regulations).

35. Randall Smith, *Collection Drives: IRS Battles Colgate over an Arcane Deal That Cuts Its Tax Bill*, WALL ST. J., May 3, 1996, at A1; see also Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, FORBES, Dec. 14, 1999, at 198.

Loss-generating shelters will almost always fail in litigation, for the reasons described above in the analysis of *ACM*. They involve all the classic abuse elements. First, there is the abuse of an uneconomic rule (the basis allocation in *ACM* for example). Second, there is the involvement of a passive tax-exempt party, functioning effectively as a lender (as the Tax Court determined in *ASA Investering's P'ship v. Comm'r*<sup>36</sup>) to which uneconomic amounts of income were deflected. Third, there are the shifting allocations bringing to the shelter-seeker the loss corresponding to the income allocated to the exempt party. Fourth, there are the contrived and pre-planned steps requisite to the strategy. Finally, there is the rather preposterous business purpose cover story.

Whether other transactions deserve the peremptory treatment accorded loss generators like *ACM* is largely a function of whether a court will perceive them to be abusive. "Abusive" in this context means a gross departure from sensible economic results and the fundamental tax principles underlying the Code. Step-down preferred is an interesting case. Consider the simplified variation in which a domestic corporation and an accommodation foreign or tax-exempt party each contribute \$1000 to a newly formed REIT, with the corporation taking back a common equity interest and the tax-exempt taking back a preferred interest. The preferred interest pays a very high dividend for the first ten years (allowing the tax-exempt to recover its capital and earn a return on its investment during that period), after which the dividend rate drops to almost zero. The REIT uses the \$2000 to make a qualifying investment in mortgage-backed securities issued by the domestic corporation, which generate just enough income to cover the dividend payments on the preferred interest. At the end of the ten year period, when the dividend rate is "stepped down," the tax-exempt party's preferred interest is redeemed for its (nominal) fair market value. In substance, the transaction resembles a ten-year self-amortizing loan. But during those ten years, the domestic corporation will have deducted all of the interest payments to the REIT—and neither the corporation nor its subsidiary REIT, having distributed the interest payments to the tax-exempt, will have reported any income associated with the transaction. Would a court regard this as a tainted shelter? On the one hand, it bears resemblance to a true financing on the part of the domestic corporation. On the other hand, it generates benefits so grossly excessive that it probably would be closely scrutinized. What happened in fact was probably just and fitting—the use of I.R.S. regulatory power on a retroactive basis seems appropriate and should not have surprised greedy participants. What a tax shelter regulatory scheme can add to the attack on such cases, as well as on other aggressively structured financial products, is an early warning disclosure system.

The key to deterrence for all classes of tax shelters is reporting and penalties. To fight what amounts to audit lottery and to nip schemes in

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36. 201 F.3d 505 (D.C. Cir. 2000).



the bud, airtight, focused, prompt and efficient disclosure rules are required. These in turn need the support of qualified and organized audit teams to review disclosure filings, as well as severe penalties (with no relief based on legal opinions) for failure to disclose and for losing on the merits. Given the track record in court, a tax director would need to have his head examined if he allowed his corporation to participate in a shelter that would have to be specifically disclosed and would bear heavy penalties if not sustained, irrespective of supporting legal opinions.

As the New York State Bar and others have maintained, the definition of tax shelters brought within the disclosure-penalty scheme should be broad.<sup>37</sup> An approach which targets the presence of one or more tax shelter indicia (or “filters”), along the lines of § 1.6011-4T of the Regulations, is probably better than one which focuses on a single factor such as the absence of expected pre-tax returns. As significant as the tax shelter definition is the disclosure mechanism. Of immense importance in this regard is the “listed transactions” provision of § 1.6011-4T of the Regulations, which requires tax shelter disclosure for transactions listed by the I.R.S. whether or not they would have to be disclosed under the general rules of that regulation and even if listing occurs after a return relating to the transaction has been filed. (The I.R.S. posted an initial list in Notice 2000-15.) The elegance of a listing procedure is that it remains a Sword of Damocles that may require disclosure of a type of transaction that comes to the attention of the I.R.S., even after the taxpayer has entered into it. Because of this factor, the basic tax shelter definition can be less sweeping, minimizing the risk of over-disclosure of deals which are not really shelters, protecting the I.R.S. and deterring shelters with the possibility of subsequent listing.

Indeed, a streamlined disclosure approach could be built *purely* around a listing procedure. Under this approach, the I.R.S. would have statutory authority to publish tax shelter lists similar to those under § 1.6011-4T of the Regulations. This authority would, necessarily, involve a tax shelter definition but that definition would be less critical because it would relate only to the authority to list, and would not be self-executing in terms of disclosures or penalties. (In essence, the definition would be designed to prevent the I.R.S. from overreaching by listing transactions which would not properly be regarded as tax shelters.) A taxpayer involved in a tax shelter which is listed would be required to make specific disclosure and would face heavy, no-fault penalties (not avoided by legal opinions) if the shelter were not sustained in litigation (heavier still if disclosure was not made). Because of the penalty aspect, it might be desirable to limit the retroactive nature of the penalty aspect of listing by having fully retroactive disclosure rules for listed transactions but imposing penalties only

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37. See New York State Bar Association (Tax Section), Report on Corporate Tax Shelters of New York State Bar Association Tax Section, *supra* note 4; Lee A. Sheppard, *News Analysis-Is there Constructive Thinking About Corporate Tax Shelters?*, 83 TAX NOTES 879 (May 10, 1999).

where the transaction is listed before the return is filed for the year in which shelter benefits are first claimed. Such a regime, coupled with the well recognized attitude of the courts, should be effective and preemptive in largely eliminating tax shelters. It is not intended by any means to deal with aggressive tax planning in real world transactions, which would be subject to attack under existing rules.

Much serious thinking has gone into defining tax shelters. However, the uncertainties and vagaries inherent in a tax shelter definition are much less troublesome where the issue is disclosure and penalties (especially where listing is a prerequisite to disclosure and penalties) rather than the override of substantive rules. In transactions that are at the margin, aggressive financial instruments for example, requiring disclosure does not seem burdensome to taxpayers and should be helpful to the government in providing early warning. By the same token, disclosure is less of a deterrent to non-abusive financial innovation since, in any event, these products tend to be widely discussed in public forums.

With the steps described above, given the judicial attitude, the tax shelter problem should subside. At the very least, disclosure and penalties should be given a chance to work before a substantive disallowance provision is adopted. The problems with such a provision are numerous. If aimed at tax shelters narrowly defined in terms of a lack of a pre-tax return, it will play into the hands of promoters who assert that the problem is only one of assuring a nominal cash return. Indeed, it could deter courts from applying a holistic approach to shelter definition that has proved devastatingly effective. The problem is not the lack of a minimum return; the problem is contriving an artificial transaction to generate unreasonable, unintended benefits whether or not there is some cash return.

A broad definition of tax shelter in a statutory substantive disallowance rule would only achieve what *ACM* and like cases already assure—namely that an abusive transaction will fail in court. At the same time, however, it is closely related to, and could morph into, a general anti-avoidance rule of the type recently adopted in a number of foreign countries.<sup>38</sup> Such a rule may make sense in countries that do not have a judicially-created body of substance-over-form authority. It makes little sense in the U.S. Substance versus form should remain a legal doctrine, invoked by the I.R.S. and taxpayers but interpreted and applied by the courts.

Who would favor a system in which the I.R.S. could unilaterally determine the substance of a transaction? Would it use that power to treat stapled stock as one property or two, or would the characterization vary with the consequences and change from time to time? Should the I.R.S. be able to treat tracking stock as subsidiary stock by fiat and would the

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38. Indeed, the Treasury Department White Paper, in dealing with "The Roads Not Taken," refers to general anti-avoidance rules in other countries, which the Paper characterizes as "general" anti-abuse rules as contrasted with the "specific" anti-abuse rules contained in Treasury Department Proposals.

characterization apply for all taxpayers and for all purposes? Should the I.R.S. determine that a spin-off is really a sale? Could it make these changes retroactively? The risks of such a change are too great, and the need for such a change as a tax shelter deterrent is insufficiently established, to justify such a step.