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"It's Not a Lie if You Believe It": Tax Shelters and the Economic Substance Doctrine

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**“IT’S NOT A LIE IF YOU BELIEVE IT”: TAX SHELTERS AND THE
ECONOMIC SUBSTANCE DOCTRINE**

Daniel J. Glassman ***

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** *Editor’s Note:* This Note won the Gertrude Brick Prize for the best Note in Fall 2005.

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I. INTRODUCTION

In an episode of *Seinfeld*,¹ Jerry was confronted with the requirement of taking a polygraph test after denying, to a woman police-officer whom he was dating, that he watched the television show *Melrose Place*.² Deeply concerned about his pending polygraph examination, he turned to George Costanza, his friend who Jerry felt had the unique ability to deceive a lie detector.³ After George counseled Jerry as to the difficulty of deception, Jerry was ready to leave for the test, resigned to his fate.⁴ Then George offered these final words of advice: "Jerry, just remember, it's not a lie if you believe it."⁵ Although that episode of *Seinfeld* was simply attempting to entertain us by showing one particular character's attitude toward the truth, what we as a society find humorous very often reflects society's underlying attitude.

The example from *Seinfeld* illustrates American society's growing view that in many cases the ends justify the means, even if that involves creative interpretations of the truth. Regardless of whether one is a supporter or opponent of former President Bill Clinton, most would agree that the low

1. See *Seinfeld* Summary, http://www.tv.com/seinfeld/show/112/summary.html&full_summary=1 ("This is a show about nothing; however, for a show about nothing, this show has many complex plots, sub-plots, is very well written and put together. So much so that until the public caught onto the series, the television critics were responsible for helping to keep it alive. The critics further went on and made the series victorious in every category it was eligible for in the 1st Annual American Television Awards. *Seinfeld* has also won a few Emmy Awards, the George Foster Peabody Award for 1992 and many more.") (last visited Jan. 2006).

2. *Seinfeld: The Beard* (NBC television broadcast, Feb. 9, 1995).

3. *Id.*

4. *Id.*

5. *Id.*

point of his presidency was when, during testimony via videotape before a federal grand jury, he quibbled over the meanings of the words "sex" and "alone," and, alas, when he answered one question with the response of "that depends on what your definition of 'is' is."⁶ While many supporters made the legitimate argument that Clinton's private personal conduct should not be considered an impeachable offense, Clinton took the position that he had done nothing wrong because his answers were "legally accurate."⁷ The near uniform support among fellow Democrats⁸ and the President's maintenance of strong approval ratings from the public⁹ demonstrated that society's attitude was that the end results justify creative interpretation of facts and occurrences to fit the desired ends.

Many, including the IRS, have argued that corporations and wealthy individual taxpayers should not have the ability to use "loopholes" in the tax law to reduce their tax liability in ways "unintended" by Congress.¹⁰ They argue that it is unethical for accountants and tax attorneys to design or create transactions that have no economic effect and simply generate "paper" losses, expenses, or credits with the purpose of reducing a client's tax liability.¹¹ Frequently in the case of corporate taxpayers, courts and commentators use phrases such as "no business purpose" when they describe these transactions.¹² What they fail to consider is that from the

6. The Office of Independent Counsel, *Referral to the United States House of Representatives* (Sept. 9, 1998), available at <http://judiciary.house.gov/Legacy/2toc.htm>.

7. *Id.*

8. James Bennet, *Impeachment: The President—Clinton Impeached; President Digs In*, N.Y. TIMES, Dec. 20, 1998, at A1.

9. Adam Nagourney, *Impeachment: The Polls; Public Support For The President, And For Closure, Emerges Unshaken*, N.Y. TIMES, Dec. 21, 1998, at A23.

10. Throughout this Note, the references to loopholes and the intent of Congress will be contained inside quotation marks. This is because I have significant problems with the widespread use of these terms. What is meant by congressional intent? Is it the thoughts of the lawyer on the committee staff who drafted the language? The thoughts of the lobbyist who influenced him to include certain provisions? Certainly it cannot be the thoughts of the members of Congress themselves. I would be willing to place a large wager that if it were a requirement for a member of Congress to have read the bill in order to be allowed to vote on it, no tax legislation would muster a quorum. The tax laws passed by Congress are just collections of words, usually brought together with "syntactical correctness." See Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947). As discussed at length throughout this Note, some of the words are vague and subjective, necessarily relying on courts to determine the economic substance of transactions. Other Code sections contain language with bright-line rules and precise language. In the latter situation, there is no need to consider intent. When the words are clear, the intent is what is meant by the plain meaning of the words. The language used throughout the Internal Revenue Code often creates exceptions to clear-cut rules where the drafters desired. If a section contains a clear-cut rule without an exception, then there is no exception to that rule.

11. See generally Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 105 TAX NOTES 201 (2004) (arguing that greed has led tax professionals to push improper tax shelters).

12. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 252-54 (discussing the requirement that

perspective of the corporation, income taxes are an expense, no different than wages, rent, or interest. When a corporate officer chooses to engage in a transaction where the company can reduce an expense by incurring transaction costs far less than the amount saved, that decision is not based on anything learned in an MBA program. It is just plain common sense.

Often corporations and the wealthy are easy targets for complaints about tax “loopholes.” Politicians are able to score points with voters by expressing outrage at the corporations and wealthy individuals that “abuse” the laws that the politicians wrote by following the rules in a way that decreases their tax liability. When budget deficits are continuing to increase and the public desires for government spending to increase at the same time, corporations become easy targets for what some view as an abuse of the tax system. Since the enactment of the income tax in 1913, courts have used a variety of substance over form rules to restrict the ability of corporations and individuals to “shelter” income.¹³ Now some members of Congress want to make these judicially created doctrines part of the tax code itself.¹⁴ These proposals, along with the judicially-developed doctrines, essentially would allow the government to say, regarding the tax code, that the existing rules do not apply when the IRS and some sympathetic judges do not like the “smell”¹⁵ of what the taxpayer is trying to achieve.

This is not a Note about politics or ethics. This is a Note about tax law and the tax consequences of highly complex, real transactions entered into by corporations and wealthy individuals in an effort to reduce their income taxes.¹⁶ But the overall attitude society has regarding

transactions have a business purpose apart from taxes).

13. See *infra* Part III.

14. Allen Kenney, *Korb Speculates On Codification Of Economic Substance Doctrine*, 105 TAX NOTES 932 (2004) (discussing the codification of the economic substance doctrine part of the Senate version of the American Jobs Creation Act of 2004; the provision was not part of the final version of the bill).

15. See *ACM P’ship v. Comm’r*, 157 F.3d 231, 265 (3d. Cir. 1998) (McKee, J., dissenting). In a case further discussed in Part IV.A, the majority held that despite meeting all the technical requirements of the law, the taxpayers were not entitled to the tax treatment under the law because the transactions lacked economic substance or were a sham. *Id.* at 245-48. Judge McKee dissented and stated that disallowing gains and losses that clearly met the realization requirements of the statute, I.R.C. § 1001 (2000), amounted to the court applying a “smell test” and disallowing the losses because the taxpayer was attempting to “pull the wool over [the Commissioner’s] eyes.” *Id.* at 265.

16. In many instances the corporation will be forced to argue in court that there are some actual substantive economic effects from these transactions in order to have the transactions respected for tax purposes. This does not mean that these transactions were designed and created for any purpose other than reduction of one’s tax liability. It only means that the transactions in some way impact the economic positions of the parties to the transaction. For taxpayers or their attorneys to argue that there was a profit motive behind these transactions aside from favorable tax

playing games with the truth and reality affects the perception of how far tax practitioners can go in aggressively structuring (or, more cynically, creating) transactions solely for their “unintended” tax consequences.¹⁷ The line between aggressive, yet permissible, tax planning and improper, and sometimes criminal, tax evasion, like many lines in the law, is not at all clear or even straight. There are often things far away from that line that are unquestionably permissible or undoubtedly illegal.¹⁸ The problems come in the cases that fall closest to the line. In those instances, honest and honorable professionals can disagree about the correct result that comes

implications would take real chutzpah.

17. Many of the articles that condemn tax shelters and the lawyers and accountants who devise them discuss how tax professionals should not seek out technical anomalies in the interaction of various Code sections to create transactions that would never have occurred absent the tax consequences. *See generally* Pollack & Soled, *supra* note 11, at 203-04 (arguing that, motivated by prospects of extremely high fees, tax professionals act improperly by pushing improper tax avoidance techniques). It is interesting that the people who attribute the problems with corporate tax shelters to unethical tax lawyers advocate a system with fewer clear rules that relies more on subjective determinations made by the very lawyers and accountants whose ethical shortcomings created the problem with the bright-line rules. I am not arguing that it is a good thing that we, as a society, accept, in large part, finding ways around rules. I am, however, realistic about the nature of people. “If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary.” THE FEDERALIST NO. 51 (James Madison). The bright-line rules are necessary to prevent endless litigation and subjective characterization of transactions by taxpayers. To paraphrase what Donald Rumsfeld would probably say: You write the tax law for the world you have, not the world you would want or wish to have. *Cf.* William Kristol, *The Defense Secretary We Have*, WASH. POST, Dec. 15, 2004, at A33.

18. The IRS puts out a list of tax scams that are frequently peddled by scam artists. These claims, which any tax professional would regard as frivolous, include the following: “[T]hat the Sixteenth Amendment concerning congressional power to lay and collect income taxes was never ratified; that wages are not income; that filing a return and paying taxes are merely voluntary; and that being required to file Form 1040 violates the Fifth Amendment right against self-incrimination or the Fourth Amendment right to privacy.” *See* INTERNAL REVENUE SERV., IRS ANNOUNCES THE 2005 DIRTY DOZEN (Feb. 28, 2005), *available at* <http://www.irs.gov/newsroom/article/0,,id=136337,00.html>. Certain tax minimization techniques, however, are widely used and perfectly acceptable. For example, individual taxpayers who use the cash method of accounting often pay two years of state property tax in one year to allow themselves to aggregate their itemized deductions into one year so it will exceed the standard deduction. Additionally, there are always some tax strategies that are just plain humorous for tax professionals who spend their lives reading the Internal Revenue Code. For example, a taxpayer inquired about claiming a casualty loss deduction when the funeral home lost his deceased wife’s ashes, and the now famous case of the stripper, who after being denied a deduction for breast implants as a medical expense, was allowed to deduct the cost of the surgery as an unreimbursed business expense. *See* Leslie Haggin Geary, *Most Absurd Tax Claims: From Breast Implants To Cremated Ashes, Taxpayers Try Anything To Score New Deductions*, CNNMoney.com, Jan. 20, 2003, http://money.cnn.com/2003/01/29/pf/taxes/q_absurdmoves/. My questions to the court in the case are: Shouldn’t breast implants be considered capital expenditures with a useful life exceeding one year and therefore be capitalized and depreciated? And, would the stripper be required to allocate the cost between the business use and personal use in computing the allowable deduction?

from applying the rules embodied in the Internal Revenue Code and Treasury Regulations, which often contain a combination of objective rules and subjective standards.

In this Note, I will argue that the economic substance doctrine is unnecessary as either a judicially created common law standard or as a part of the Internal Revenue Code. I will show how many tax law provisions depend on a court determining the economic substance of transactions to apply the plain meaning of the statute. In the instances raised by certain recent cases, where the Code and Regulations clearly allow taxpayers benefits that were not contemplated by Congress or the IRS when the provisions were enacted, it is the place of Congress and the IRS, not the courts, to close the “loopholes.”

Abandoning the economic substance doctrine would not allow taxpayers to characterize their transactions in whatever way they choose. The characterization would still be governed by applying the facts and circumstances of a transaction to the statute. It would, however, prevent the government from changing the rules after the game has been played. I am not arguing that economic substance has no role to play in tax law. Nor am I arguing that the current version of the Internal Revenue Code strikes the proper balance between subjective standards and objective rules. In a tax system that is a mixture of standards and bright line rules, there will always be situations where substance governs and other where form governs; and it will always be true that substance “controls over form, except, of course, in those cases in which form controls.”¹⁹ My argument in this Note is that the plain language of the statutes enacted by Congress, not the opinion of judges on what the correct rule *should* be, determines whether the substance or form of a transaction controls its tax treatment. All taxpayers should be able to rely on the rules that are written to plan, and even create, transactions with predictable tax consequences. A corporation does not forfeit its right to due process simply because it is profitable and large enough to make it cost effective to hire bright tax advisors to devise ways within the system of laws enacted by Congress to reduce the corporation’s tax liability.

Part II of this Note briefly discusses the complex nature of the tax law and how many transactions that are labeled tax shelters rely on the tax treatment the IRS sought for nonrecourse debt. Part III traces the development of the economic substance doctrine. Parts IV & V look at recent cases decided by the courts under the economic substance doctrine

19. Martin J. McMahon, Jr., *Business Purpose, Economic Substance, and Corporate Tax Shelters: Random Thoughts On Applying Judicial Doctrines To Interpret The Internal Revenue Code*, 54 SMUL. REV. 195, 195 (2001) (stating that “[t]his immutable law of federal taxation lies at the heart of the ongoing controversy about the proper role of several long-standing judicial doctrines for interpreting and applying the Internal Revenue Code”).

(the inconsistent results demonstrate Judge McKee was correct in stating that the courts apply the economic substance doctrine as a “smell test”²⁰). Part VI examines the shelter that was part of the recent scandal involving KPMG’s tax practice and describes how the shelter fails to deliver the claimed tax result even without any consideration of the economic substance doctrine. Part VII argues that changing the rules after the game is played is inappropriate and that many tax rules depend on ascertaining the economic substance of transactions to properly apply the law; therefore, the economic substance doctrine is either inappropriate or redundant.

II. TAX COMPLEXITY: THE GOVERNMENT’S ARGUMENT FOR SUBSTANCE OVER FORM IS SIMILAR TO THE CHILD WHO MURDERS HIS PARENTS AND PLEADS FOR LENIENCY BECAUSE HE IS AN ORPHAN

A. *Governments That Live in Glass Houses Shouldn’t Throw Stones*

The Internal Revenue Code²¹ consists of the rules enacted by Congress, pursuant to its authority to tax income under the Sixteenth Amendment to the United States Constitution.²² In certain instances, Congress has granted the Treasury Department the power to enforce certain provisions by promulgating regulations to guide how the Code is to be implemented.²³ Together the Code and Treasury Regulations promulgated pursuant to specific Code provisions make up the enacted rules that govern the computation and imposition of federal income taxes.

Complexity in the tax code is far from a novelty.²⁴ The complexity in

20. See *supra* note 15.

21. I.R.C. §§ 1-9833 (2005).

22. U.S. CONST. amend XVI (“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”).

23. I.R.C. § 7805(a) (2000). See, e.g., I.R.C. § 79(c) (2000) (“For purposes of this section and section 6052, the cost of group-term insurance on the life of an employee provided during any period shall be determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) *prescribed by regulations by the Secretary.*”) (emphasis added). The IRS also issues interpretive regulations that are not pursuant to any specific Code provision. These regulations contain the interpretation of the IRS of a particular Code provision.

24. In 1947, Second Circuit Judge Learned Hand explained his view of the tax law by stating:

[T]he words of [the Internal Revenue Code] merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed purpose, which it is my duty to extract, but which is within my power,

the tax law can be attributed to many different causes. Some of the complexity is the result, as Judge Hand stated, of Congress attempting to close loopholes.²⁵ Other areas of complexity are the result of poor drafting²⁶ or attempting to put mathematical formulas into words.²⁷ The other cause of complexity in the tax law is the reality that the economic and financial world is complex. The concept of income is not as simple as the Sixteenth Amendment would have you believe. Some degree of complexity is necessary in the rules to fairly and consistently compute a measure of income in a world with complex corporate ownership structures, global corporations with trading partners on nearly every continent, and numerous financial instruments with differing forms.²⁸

The complex nature of the laws that determine the amount people are

if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

Hand, *supra* note 10, at 169.

25. *Id.* For examples of loophole-closing provisions, see I.R.C. § 1(h)(11)(B)(iii) (2004) (preventing “dividend arbitrage” opportunities that are created by taxing dividends at lower rates than short-term capital gains), I.R.C. § 183 (2000) (limiting deductions on hobby activities that are “not engaged in for profit” and creating a presumption of when profit motive exists), I.R.C. § 267 (2004) (disallowing deduction from and loss recognition on transactions involving related taxpayers), and I.R.C. § 469 (2004) (limiting the use of losses from passive activities in which the taxpayer does not materially participate to only being allowed to offset income from other passive activities and defining rental activities to be passive).

26. *See, e.g.*, Treas. Reg. § 1.71-1T(c)(A-18) (1984) (“The second situation is where the payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years.”).

27. *See, e.g.*, I.R.C. § 1(h)(1)(B) (2004).

28. Just as the tax authorities have been debating the economic substance doctrine, the accounting profession has been debating moving from “rule-based” accounting standards to “principle-based” accounting standards. The argument for moving to “principle-based” standards is similar to the argument for applying the economic substance doctrine: “Rule-based” standards lead to structuring transactions to get the desired treatment in a way that obfuscates the true intent of the rule. The counter-argument is similar to the argument against the economic substance doctrine: The uncertainty surrounding the treatment of transactions would chill productive behavior and create reported results based on individuals’ (in the case of the economic substance doctrine, courts’) subjective interpretation of the transaction. For a detailed report on the “principle-based” standard issue, see SEC. AND EXCH. COMM’N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003), available at <http://www.sec.gov/news/studies/principlesbasedstand.htm>.

required to pay in taxes creates numerous opportunities for tax professionals, who have, as Judge Hand stated, expended "inordinate [amounts] of time" studying tax law to structure transactions in a tax efficient way.²⁹ Few people, if any, would say structuring business transactions in a tax efficient way is improper.³⁰ The complexity and the bright-line objective tests inherent in the tax law, the increasing complexity in the features allowed in financial instruments and business organizations, and the expansion of a globally interdependent economy have allowed tax planners to devise transactions to exploit that complexity and interdependence in ways that manufacture a tax loss without a true economic loss.³¹

29. Hand, *supra* note 10, at 169.

30. For example, government officials, academics, and professionals generally agree where one party wants to "sell" his current property and "reinvest" the proceeds in a new investment property, it is acceptable to use an intermediary to structure the real estate transaction when the other party does not want to exchange properties, but wants to sell for cash. A tax professional, David Hariton, who has written numerous articles on the economic substance doctrine, justifies the use of otherwise economically meaningless straw men in these types of situations because, as he argues, if the tax-advantaged way of carrying out the transaction were not available, what would be left is not a more direct transaction, but no transaction at all. David P. Hariton, *Sorting Out The Tangle of Economic Substance*, 52 TAX LAW. 235, 236 (1999) ("Finally, a more complex, tax-advantaged way of executing a transaction should not lack economic substance if the transaction itself has economic substance").

31. Even though Hariton acknowledges, "[a]fter all, form, not substance, determines tax liabilities under a realization-based income tax," Hariton goes on to argue:

It is precisely because of our commitment to this relatively objective system that we are loathe to overturn the "technical" results which arise from the application of complex rules to complex business transactions. The taxpayer, we believe, is entitled to rely on the rules and the answers to which those rules give rise. She should not be denied beneficial tax results which she stumbles upon, or even seeks out, in the course of her legitimate business dealings, even if those results are obviously unanticipated, unintended or downright undesirable.

Nevertheless, given that it is the taxpayer, not the Commissioner, who chooses the form of the relevant business transactions, there must be at least some limits on the taxpayer's ability to enter into transactions which give rise to tax benefits under the rules as they currently exist—otherwise the fisc is not likely to collect very much tax on capital. No agency can foresee, let alone draft, rules to govern coherently every conceivable permutation of facts and circumstances in an increasingly complex business world. The consequences of our failure to maintain such limits, therefore, will be: (1) an increasingly defensive set of rules—niggardly, complex and narrow of spirit—designed with a view to potential abusers, real and imagined; (2) an increasingly inequitable allocation of tax liabilities, with relative benefits inuring to bigger taxpayers that are able and willing to enter into costly tax-motivated transactions; and (3) primarily as a result of (2), an erosion of confidence in what is functionally a self-enforced honor system of determining tax liabilities.

B. *Be Careful What You Wish For*

If many of the complex rules that afford tax planners the opportunities to create beneficial tax consequences devoid of economic impact are the result of implementation of rules designed to prevent abusive transactions from vague and subjective rules, then it cannot be appropriate to ignore the objective rule when the government subjectively views it as being abused. In fact, in many instances, tax shelters rely on a position advocated by the government a long time ago. Over time, changes in economic conditions and thoughtful reflection by tax lawyers and accountants turned the government's apparent victory in *Crane v. Commissioner*³² into a sword that allowed taxpayers to create tax losses with no real economic loss.

Beulah Crane inherited an apartment building from her late husband in 1932.³³ At the time she inherited the building, it was encumbered by a mortgage in an amount approximately equal to the value of the building.³⁴ She entered into an agreement with the bank whereby she would continue to manage and rent out the apartments and remit the net rental proceeds (after expenses) to the bank without assuming the debt of her late husband.³⁵ Over the period that she continued to operate the apartment building, she reported the rent received as gross income and deducted expenses for interest, taxes, and depreciation of the building.³⁶ The amount of the net rentals was not sufficient to cover the interest charges on the outstanding balance and over time the amount of interest in arrears on the loan grew to over \$15,000.³⁷ With the bank threatening to foreclose on the property, Crane found a buyer who was willing to pay her \$2,500 for the property subject to the mortgage.³⁸

Crane argued that because at the time she inherited the property the amount of the mortgage was equal to the value of the property, she inherited equity in the building of zero that had a zero basis to her.³⁹ She claimed to have sold that equity for \$2,500 and realized a gain of \$2,500.⁴⁰

Id. at 235, 237.

32. 331 U.S. 1 (1947).

33. *Id.* at 3.

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 3-4. Crane agreed to a sales price of \$3,000, but agreed to pay \$500 of transaction costs, so she received \$2,500. *Id.* The buyer did not assume the mortgage, but took the property subject to the mortgage. *Id.*

39. *Id.* Crane did, however, take depreciation deductions during the time she managed the building. This is inconsistent with her position that she had a zero basis when she inherited the property. *Id.* at 3 n.2.

40. *Id.* at 3-4.

The Commissioner argued that Crane realized an amount equal to the amount of actual cash she received plus the amount of debt the property was subject to and had a basis in the property of its fair market value at the time of her husband's death decreased by depreciation allowed as deductions to her.⁴¹ The Court, in what many tax lawyers believe is the most important tax case ever decided, agreed with the government and held that the amount realized on a sale of property includes relief from debt even if the seller was not personally liable for the debt.⁴²

Although not explicitly stated in the case, the rule in *Crane* created a corollary that purchasers of property who use nonrecourse debt to purchase the property receive a basis that includes the amount of debt used in the purchase. This implicit rule from *Crane* was stated explicitly in *Parker v. Delaney*.⁴³ This rule, allowing taxpayers to receive a full cost basis for property acquired using nonrecourse debt, was responsible for many of the tax shelter activities in the early 1980s, and it often plays some role in the corporate tax shelter controversies of today. Obtaining a basis for assets purchased solely from the use of nonrecourse debt provides an opportunity for taxpayers to use that basis to create losses without any risk of an economic loss because the taxpayers are not individually responsible for paying back the debt.⁴⁴ In certain types of transactions, the creditor can

41. *Id.* at 4-5.

42. *Id.* at 13-15.

43. 186 F.2d 455, 457 (1st Cir. 1950). Note the wording of the court:

During the years of his operation of them he took deductions for depreciation on a cost basis equal to the amount of the first mortgage liens. In this court he expressly disclaims any contention that [the buildings'] value for depreciation purposes was less than those liens. These mortgages represented the prices paid, or the consideration, for the properties. The properties became subject to these liens and appellant considered them as the cost in deducting depreciation. Nothing appears to the contrary and we must, as did the court below, accept these figures of cost used by appellant. Indeed we do not understand him to dispute this treatment of the cost question.

Id.

44. In the early 1980s, there was a growing use of partnerships to create tax losses by purchasing assets at inflated prices using nonrecourse debt. This is what in large part led to the downfall of the savings and loan industry which made many of these nonrecourse loans. The partnerships would purchase assets at inflated prices using nonrecourse financing. The assets would generate depreciation deductions that exceeded the profits of renting out or other use of the property and created net losses to the partnership. The losses would then be passed through to the individual partners and used to offset other sources of income. Eventually the taxpayer would walk away from the project and fail to report the gain that should have been recognized when the lender took over the property because the partnership could not meet its payment obligations. For a discussion of this, see Pollack & Soled, *supra* note 11, at 202 & n.7 (citing Bernard Wolfman, *The Supreme Court in the Lyon's Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075 (1981); Daniel
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also be assured of no economic loss because the creditor is also the seller of the property subject to the debt.⁴⁵

The problem inherent with giving basis for assets purchased with nonrecourse debt, while apparent to some, did not become fully ascertained until the Supreme Court was confronted with the situation where the amount of the nonrecourse liability exceeded the market value of the property, the issue the Court declined to address in *Crane*.⁴⁶ The Supreme Court was confronted with that issue in *Commissioner v. Tufts*.⁴⁷ In *Tufts*, a partnership acquired a building using nonrecourse financing.⁴⁸ After an economic downturn, the partnership was unable to continue to make the required payments under the nonrecourse mortgage and the lender threatened to foreclose on the property.⁴⁹ The partnership found a buyer for the property who agreed to pay it a nominal amount and take the building subject to the nonrecourse mortgage.⁵⁰ At the time of the sale, however, the amount of the nonrecourse mortgage exceeded the partnership's basis in the building, and that basis exceeded the fair market value of the building.⁵¹

Each partner reported the sale on his individual return and "indicated" that a partnership loss had been sustained, but no partner claimed a deduction for his share of the loss (excess of adjusted basis over fair market value at the time of sale) on his individual return.⁵² The Commissioner determined that the amount realized on the sale was equal to the amount outstanding on the nonrecourse mortgage and the partnership realized a gain since the amount of the mortgage exceeded the partnership's adjusted basis in the property.⁵³ The Court agreed with the Commissioner and reasoned that *Crane* applied even if the market value of the property was less than the amount of the mortgage.⁵⁴ The Court concluded that since the partners were allowed depreciation deductions as a result of the basis created by the acquisition of the building with non-

N. Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 TAX. L. REV. 401 (1988)).

45. See *infra* Part VI for discussion of the FLIPS and related tax shelters.

46. *Crane*, 331 U.S. at 14 n.37 ("Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.").

47. 461 U.S. 300 (1983).

48. *Id.* at 302.

49. *Id.* at 303, 305.

50. *Id.* at 303.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* at 307.

recourse debt, the full amount of the debt must be included in the amount realized on disposition.⁵⁵

Justice O'Connor, in her concurring opinion, agreed with the majority that the ruling in *Crane* required the inclusion in the amount realized of the full amount of debt assumed.⁵⁶ O'Connor, however, stated that there was merit in the position offered by Professor Wayne Barnett, as *amicus curiae*, that the transaction should be treated as two separate transactions involving both a disposition of property at a loss and also a discharge of indebtedness income for the excess of the amount of the nonrecourse liability over the fair market value of the property at disposition.⁵⁷ O'Connor acknowledged that the majority opinion reached the correct result because of the great body of case law and promulgated treasury regulations that interpreted I.R.C. § 1001 to require that relief from debt, even nonrecourse debt, is included in the amount realized on disposition of property.⁵⁸

O'Connor's concurring opinion suggests, however, that had she been confronted with a "clean slate," without any established precedent on the issue, she may have reached a completely different result from *Crane*.⁵⁹ Both the majority opinion and O'Connor's concurring opinion acknowledge that the interpretation of the law sought by the Commissioner in *Crane*, supported in many cases litigated by the Commissioner over time—and promulgated in Treasury regulations allowing taxpayers to receive a basis for property acquired through nonrecourse financing—is a discretionary interpretation that could be reversed by Congress through amendments to the Code or by the Treasury with changes to the regulations.⁶⁰

55. *Id.* at 307-08.

56. *Id.* at 317 (O'Connor, J., concurring).

57. *Id.* at 317-20; *see id.* at 310 n.11 (majority opinion) ("Professor Wayne G. Barnett, as *amicus* in the present case, argues that the liability and property portions of the transaction should be accounted for separately. Under his view, there was a transfer of the property for \$1.4 million, and there was a cancellation of the \$1.85 million obligation for a payment of \$1.4 million. The former resulted in a capital loss of \$50,000, and the latter in the realization of \$450,000 of ordinary income. Taxation of the ordinary income might be deferred under § 108 by a reduction of respondents' bases in their partnership interests.").

58. *Id.* at 319-20 (O'Connor, J., concurring).

59. *Id.* at 317-18 ("*Crane* established that a taxpayer could treat property as entirely his own, in spite of the 'coinvestment' provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any way tie nonrecourse debt to the cost of property or to the proceeds upon disposition.").

60. *See id.* at 308 n.5 (majority opinion) ("The Commissioner might have adopted the theory, implicit in *Crane*'s contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually

The Court's opinion in *Tufts* illustrates that much of the complexity inherent in the tax law is the result of both complex economic transactions and choices made by both Congress and the Treasury Department (including the IRS) that create the rules for determining taxpayers' taxable income. Lawmakers (Congress and the Treasury) have the choice when they create the rules whether they want the rules to be objective or subjective. There are costs and benefits associated with each. In the case of nonrecourse debt used to acquire property, the rulemakers chose an objective rule: Nonrecourse debt is included in the cost basis of acquiring property and relief from nonrecourse debt is included in the amount realized on disposition of property.⁶¹ The use of an objective rule reduces uncertainty and decreases the likelihood of litigation. An objective rule, however, also provides an opportunity for clever planning that uses "loopholes" in the rules to the advantage of certain taxpayers.⁶²

Congress was, and still is, free to legislate a reversal of the rule and corollary from *Crane*. It could choose to amend §§ 1001 and 1012 of the Code to respecting nonrecourse debt as part of the cost basis of acquiring an asset only when the buyer has made an economic investment in the property either by contributing capital to use as a down payment or by using recourse debt that creates personal liability to finance a portion of the property.⁶³ This would ensure that taxpayers did not receive basis when they didn't commit any capital. Such a decision also would put taxpayers on notice of the requirements of the law before the transaction, and the risks associated with uncertainty from a subjective rule would have to be factored into the taxpayer's decision. For whatever reason, Congress has chosen not to exercise its power to alter the rule from *Crane*.⁶⁴

increase his interest in the property while decreasing that of the mortgagee."); *id.* at 317-18 (O'Connor, J., concurring).

61. Treas. Reg. § 1.1001-2 (1980).

62. The use of the objective rule in the case of nonrecourse debt allowed some of the tax shelters in the 1980s. *See generally* Pollack & Soled, *supra* note 11 (discussing the transactions that used nonrecourse debt to create tax losses without any economic loss). Oddly enough, to counteract the tax shelters that were created by taking advantage of the rule allowing taxpayers to obtain a basis in assets acquired with nonrecourse loans, Congress, instead of choosing to convert the rule regarding basis and amount realized to a subjective rule based on the economic substance of the transaction (whether the borrower truly purchased the property or whether it was a coinvestment between the borrower and lender), decided to create an overall subjective rule restricting deduction of losses from activities in which the taxpayer does not "materially participate." *See* I.R.C. § 469 (2004); Pollack & Soled, *supra* note 11, at 202.

63. In such a situation the degree of subjectivity would also be up to Congress. Congress could choose to use a vague term, such as a "significant investment" in which the buyer assumes part of the risks of a decrease in value, or a specific term, such as "20% of the fair market value of the building."

64. It is possible that Congress agrees with the treatment of nonrecourse debt created by *Crane* and *Tufts*. On the other hand, it is possible that those who benefit from those rules were

This somewhat lengthy discussion about the *Crane* and *Tufts* decisions demonstrates that the technical “loopholes” that are decried by proponents of the substance over form doctrines are the result of choices made by Congress and the IRS. Just as taxpayers must live with the consequences of the forms of transactions they have chosen, the government should have to live with the consequences of the laws it enacts and the rulings it seeks. And just as taxpayers can learn from their past mistakes, Congress and the IRS can correct the technical “loopholes” they do not like through amendments to the Code or regulations⁶⁵ and can learn from past mistakes in drafting future language of tax rules.

III. DEVELOPMENT OF THE ECONOMIC SUBSTANCE DOCTRINE: HEADS THE GOVERNMENT WINS, TAILS THE TAXPAYER LOSES

Helvering v. Gregory,⁶⁶ the case that “popularized”⁶⁷ the economic substance doctrine, began with a statement that should have made the taxpayer smile: “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose the pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”⁶⁸ Despite this clear statement by the court that appeared to indicate that taxpayers were free to engage in transactions that gave them beneficial tax consequences, the court held the taxpayer was not entitled to tax treatment afforded by the statute because “Congress [had not] meant [for the statute] to cover such a transaction.”⁶⁹ *Gregory* concerned a taxpayer who was the sole shareholder of a corporation that had a subsidiary that the corporation wanted to sell to an unrelated party.⁷⁰ If the corporation had sold the stock of the subsidiary and then distributed the proceeds to the shareholder, the corporation would have been taxed on the gain on disposal of the stock and the shareholder would have been taxed on the distribution of a dividend.⁷¹

To prevent the double taxation of the gain, the corporation could have distributed the stock of the subsidiary to the shareholder who would have been taxed on the distribution as a dividend and received a basis equal to

successful in lobbying Congress not to override them.

65. The IRS can eliminate “loopholes” through changing regulations only when the “loopholes” were created through regulations. The IRS cannot alter the provisions of the Code through regulations, but it may issue interpretive regulations that are persuasive authority as to the meaning of certain Code provisions.

66. 69 F.2d 809 (2d Cir. 1934), *aff’d*, 293 U.S. 465 (1935).

67. Hariton, *supra* note 30, at 241.

68. *Gregory*, 69 F.2d at 810.

69. *Id.*

70. Hariton, *supra* note 30, at 241.

71. *Id.* at 241-42.

the fair market value of the stock.⁷² Under the then-valid *General Utilities* doctrine,⁷³ the corporation would not have recognized any gain on the distribution of appreciated property.⁷⁴ The shareholder would then sell the stock of the subsidiary to the unrelated party.⁷⁵ Mrs. Gregory's tax planners, however, came up with an even better solution.⁷⁶ They arranged what was the equivalent for that time of a "tax-free spinoff" of the subsidiary by creating a new corporation and transferring to the new corporation all of the stock of the subsidiary while the new corporation simultaneously issued all of its stock to Mrs. Gregory.⁷⁷ The new corporation was soon liquidated with its only asset, the stock of the subsidiary, distributed to its sole shareholder, Mrs. Gregory.⁷⁸ Mrs. Gregory only recognized part of the gain inherent in the subsidiary's stock on receipt of the stock because part of her basis in the stock of the parent company was allowed to be transferred to be her basis in the stock of the new corporation upon the reorganization.⁷⁹

The Commissioner sought to apply the step-transaction doctrine and disregard the formation of the new corporation.⁸⁰ Although the Second Circuit stated the transaction could not be ignored, it ultimately reached the same result as the Commissioner by recharacterizing the distribution in liquidation of the new corporation.⁸¹ The United States Supreme Court affirmed the decision of the Second Circuit.⁸² Even though the language in the statute was clear and no one contested whether the language was applicable to the facts, both the Second Circuit and the Supreme Court disregarded the statute because in the Courts' subjective opinions, the transaction was not what Congress had intended when drafting the statute.⁸³

The decisions in *Gregory* were seriously flawed. Even those who support application of the economic substance doctrine are troubled by the

72. *Id.*

73. *See Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935); PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION OF CORPORATIONS* 202-04 (2d ed. 1999). The *General Utilities* doctrine has been overruled by congressional action and now corporations are required to recognize gain upon the distribution of appreciated property to shareholders. *See* I.R.C. § 311(b) (2000).

74. Hariton, *supra* note 30, at 242.

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

81. *Id.* at 811.

82. *Gregory v. Helvering*, 293 U.S. 465 (1935).

83. Hariton, *supra* note 30, at 243.

application of the doctrine to the facts in *Gregory*.⁸⁴ In the case, it was not disputed that the corporation had the right to distribute the appreciated property to its shareholder without recognizing gain.⁸⁵ The only issues were whether the shareholder could defer recognition of part of the gain by transferring some of her basis in the stock of the parent to the stock of the new corporation formed in the "reorganization" and change the character from ordinary dividend income to capital gain.⁸⁶ This is the exact situation Hariton described when he stated that proper application of the economic substance doctrine would not overturn the results of simply a "tax-advantaged way of executing a transaction."⁸⁷ In *Gregory*, there were substantial changes in the economic positions of both the shareholder and the corporation. A transfer in the ownership of a subsidiary corporation occurred. The use of a newly formed corporation to have the transfer be characterized as a reorganization was simply a more tax efficient way of distributing the property.

Nevertheless, "Judge Hand disallowed the results of Mrs. Gregory's spinoff because he did not like them, and he made no bones about it."⁸⁸ Although Hariton called this "a refreshingly honest approach,"⁸⁹ it is not the appropriate role for a judge to disregard the clear language of a statute because he disagrees with the result.⁹⁰ In *Gregory*, Judge Hand as well as

84. See *id.* at 243-44 ("[T]here are some serious problems with the *Gregory* decision . . . Judge Hand's statutory analysis was a bit self-serving.").

85. *Id.* at 244.

86. It is not clear from the court opinions if, based on the law at the time, there was any preference given to capital gains as opposed to ordinary income. See *id.*

87. Hariton, *supra* note 30, at 236.

88. *Id.* at 245.

89. *Id.*

90. See *Bank One Chi., N.A. v. Midwest Bank & Trust Co.*, 516 U.S. 264, 279 (1996) (Scalia, J., concurring in part and concurring in the judgment). Justice Scalia said:

The law is what the law says, and we should content ourselves with reading it rather than psychoanalyzing those who enacted it. Moreover, even if subjective intent rather than textually expressed intent were the touchstone, it is a fiction of Jack-and-the-Beanstalk proportions to assume that more than a handful of those Senators and Members of the House who voted for the final version of the Expedited Funds Availability Act, and the President who signed it, were, when they took those actions, aware of the drafting evolution that the Court describes; and if they were, that their actions in voting for or signing the final bill show that they had the same "intent" which that evolution suggests was in the minds of the drafters.

Id. (citations omitted). In *Gregory*, the language in the statute was clear:

The provisions of the section, so far as they are pertinent to the question here presented, follow: "Sec. 112 (g) Distribution of Stock on Reorganization. If there

the Supreme Court did not find that the statute required a transaction to have economic substance to make the statute applicable.⁹¹ The opinions attempted to psychoanalyze what was in the mind of Congress instead of simply applying the statute as written to the facts of the case. By introducing this subjectivity into the application of the law, the decision in *Gregory* is partly responsible for the lack of consistency in recent cases where the government has invoked the economic substance doctrine.⁹²

is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock of securities shall be recognized. . . .

'(i) Definition of Reorganization. As used in this section . . .

'(1) The term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. . . .

Gregory v. Helvering, 293 U.S. 465, 468 (1935) (format in original).

The law enacted by Congress was clear and applied to the facts in *Gregory*. The courts disregarded it because they attempted to characterize subjectively the "intended" result Congress would have desired.

91. Much of the discussion in both the Second Circuit's and Supreme Court's opinions relating to the transaction refer to how the transaction did not meet the economic meaning of the term "reorganization." See *id.* at 469-70; *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934). While that may be entirely true, it is also entirely irrelevant. In the statute before the court, Congress specifically defined what the term reorganization meant for purposes of that Code section. Therefore, since the transaction met the definition of reorganization under the statute, it makes no difference that it was not a reorganization in the economic sense. In many classes in business schools in colleges and universities, the instructions to exams generally include a directive to assume a 360-day year so that allocations based upon months can be made evenly. Just as business school professors can, through words written on a paper, speed up the revolution of the Earth around the sun, Congress can, through words enacted as part of the Internal Revenue Code, alter the meaning of words from their ordinary economic meaning.

92. There are numerous other cases affirming judicial use of the economic substance doctrine to overrule the results of cases where the taxpayer would receive tax benefits that the court subjectively viewed the taxpayer did not deserve. Even when the Code allowed deductions for personal interest (interest on personal debt, not only residential and gain-seeking debt), the court disallowed deductions for prepaid interest on a loan in which the proceeds were used to purchase treasury securities. *Goldstein v. Comm'r*, 364 F.2d 734, 739 (2d Cir. 1966). The taxpayer had engaged in the transaction as a way to allow her to offset some of her income from winning a sweepstakes and essentially allow her to average her income over a number of years to avoid high marginal tax rates. See Hariton, *supra* note 30, at 246-49. The court, instead of recognizing that Congress's decision to allow deduction of prepaid interest could result in taxpayers having the ability to use that rule to average income, disallowed the result because there was no economic substance in borrowing money to buy short-term treasury securities. *Id.*

IV. THE WINDS BLOW THE STENCH OF CORPORATE TAX SHELTERS THROUGH THE COURTROOM: AMAZINGLY THE GOVERNMENT WINS SOME CASES WITH THE "HEADS THE GOVERNMENT WINS, TAILS THE TAXPAYER LOSES" RULE

The government has experienced some success in litigating cases involving corporate "tax shelters" by invoking the economic substance doctrine and convincing courts, including district courts, the Tax Court, and the courts of appeals, to disregard the technical result of applying the statute when the corporation engaged in actual transactions that lacked economic substance. Even though the transactions actually occurred and the treatment the taxpayer sought indisputably fell within the plain meaning of the technical Code or Regulation provisions the taxpayer sought to invoke, the courts applied the economic substance doctrine and reversed the results of the statute because they subjectively viewed the result as improper. As these cases were decided, there was no push to codify or enhance the economic substance doctrine because the subjective views of the courts matched the subjective views of those who were opposed to corporate use of technical Code provisions to reduce the corporation's tax liability. What the reasoning from these opinions indicates is that the courts substitute their view of what the law *should* be and how the tax law *should* operate for what the statute actually says.

A. ACM Partnership v. Commissioner⁹³

In 1988, Colgate Palmolive Company realized and recognized over \$100 million in long-term capital gains attributable to the sale of a subsidiary.⁹⁴ In 1989, a representative from Merrill Lynch approached Colgate and proposed a way to use an offshore partnership to generate capital losses that could be carried back and used to offset the gain recognized in 1988.⁹⁵ Initially, Colgate's officers would not enter into the arrangement out of concern that the IRS would challenge it under the economic substance doctrine.⁹⁶ After receiving an opinion from a law firm that the plan would work to generate the sought-after capital losses and modifying Merrill Lynch's initial plan to incorporate Colgate's repurchase of its own outstanding debt into the partnership's purpose, Colgate agreed to enter into the arrangement.⁹⁷

The plan to generate capital losses started with Colgate, Merrill Lynch,

93. 157 F.3d 231 (3d Cir. 1998).

94. *Id.* at 233.

95. *Id.* See also I.R.C. § 1212(a) (2004) (allowing corporations to carry back capital losses three years if it sustains losses in any year that exceed its gains).

96. *ACM*, 157 F.3d at 234.

97. *Id.* at 234-35, 239.

and a foreign bank all forming subsidiaries.⁹⁸ The subsidiaries formed a partnership and contributed capital in the total amount of \$205 million.⁹⁹ The partnership used the \$205 million to purchase Citicorp notes.¹⁰⁰ Shortly after purchasing the Citicorp notes, the partnership sold \$175 million worth of the notes to two foreign banks for cash totaling \$140 million and contingent future payments based on the LIBOR index rate worth slightly over \$34 million.¹⁰¹

Since the future payments were tied to the LIBOR rate, the amount could not be ascertained with certainty and therefore the regulations promulgated by the Treasury Department regarding contingent installment sales applied.¹⁰² The regulations required that the basis in the property sold would be allocated to the years in which payment may be received.¹⁰³ Since the contingent notes received by the partnership would make payments over a five-year period, the partnership had the possibility of receiving payments (including the up-front cash payment) over a period of six years.¹⁰⁴ Therefore, only one-sixth of the \$175 million basis was allocated to 1989.¹⁰⁵ Therefore, the partnership reported a capital gain of around \$110 million in 1989.¹⁰⁶ This gain was allocated to each of the partners in proportion to its share of the partnership.¹⁰⁷ The allocation of partnership gain resulted in Colgate's subsidiary reporting gain from its

98. *Id.* at 238-39. *See also* Hariton, *supra* note 30, at 262-66. The subsidiaries established by Colgate and Merrill Lynch were both incorporated in the United States, while the subsidiary formed by the foreign bank was formed in a tax haven where it would not be subject to income tax. *ACM*, 157 F.3d at 233.

99. *ACM*, 157 F.3d at 239. The subsidiary of the foreign bank contributed \$169.4 million and held an 82.6% share of the partnership. *Id.* The subsidiary of Colgate contributed \$35 million and held a 17.1% share. *Id.* The subsidiary of Merrill Lynch contributed \$0.6 million and held a 0.3% share. *Id.*

100. *Id.* The notes paid interest monthly and were floating rate notes based on the LIBOR rate. The interest rate would change each month depending on movements in the index (LIBOR) to which the note was pegged. *Id.* At the time the partnership purchased the notes, the notes were yielding a rate 0.03% higher than the partnership was earning on its deposit account in the foreign bank that was the parent of the partner with the largest share (at that time) of the partnership. *Id.*

101. *Id.* at 240.

102. *Id.* at 242.

103. *Id.* The regulation in question stated: "In general. When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments." Temp. Treas. Reg. § 15a.453-1(c)(3)(I) (as amended in 1994).

104. *ACM*, 157 F.3d at 242.

105. *Id.*

106. *Id.*

107. *Id.*

interest in the partnership of almost \$19 million.¹⁰⁸ Of course, the subsidiary of the foreign bank that was organized in a jurisdiction without an income tax was allocated over \$90 million of the gain.¹⁰⁹

The partnership used the cash proceeds from the sale to repurchase outstanding Colgate debt.¹¹⁰ The partnership then redeemed the interest of the subsidiary of the foreign bank.¹¹¹ The partnership, after the subsidiary of the foreign bank had been redeemed, sold its remaining contingent installment note and recognized a nearly \$85 million loss.¹¹² At that point, the Colgate subsidiary controlled 99.7% of the partnership and was allocated 99.7% of the loss.¹¹³ Since Colgate's subsidiary now had majority ownership of the partnership, it consolidated the partnership's financial statements into its own and effectively cancelled its outstanding debt.¹¹⁴ Colgate filed an amended return to carry back its allocated loss to offset any remaining gain from the sale of one of its subsidiaries in the prior year.¹¹⁵

The Commissioner adjusted the partnership's reported gains and losses and eliminated the partnership's gain on receipt of the cash part of the contingent installment sale, redetermined the partnership's basis in the contingent notes, and disallowed the loss from the sale of the final contingent note.¹¹⁶ The Tax Court upheld the Commissioner's adjustments, holding that the transactions "were 'created artificially'" solely to create tax benefits and the partnership "[was] 'not entitled to recognize a phantom loss from a transaction that lacks economic substance.'"¹¹⁷ The Third Circuit affirmed the Tax Court's ruling disallowing the loss from the

108. *Id.* Colgate did not actually want to have to pay tax on its allocated portion of the gain, so the partnership distributed one of the contingent notes that had a significantly higher basis than its market value and Colgate sold that note before the end of its tax year. *Id.* at 243. Therefore, even though Colgate's subsidiary was allocated over \$19 million in gain from the partnership, the loss on the sale of the note offset that gain and generated a net capital loss of over \$13 million for the subsidiary. *Id.*

109. *Id.* at 242.

110. *Id.* at 241.

111. *Id.* at 242.

112. *Id.* at 243-44.

113. *Id.* at 244.

114. *Id.* at 241.

115. *See id.* at 244; I.R.C. § 1212(a) (2004).

116. *ACM*, 157 F.3d at 244. It is interesting that neither the Third Circuit opinion nor the Tax Court's lengthy opinion state what Code section, Regulation, or matter of tax law justifies allocating the full \$140 million in basis to the cash receipts. Presumably, it is based on ignoring the ratable basis rules required by I.R.C. § 453(j)(2) (2004) and Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (as amended in 1994) and then treating the sale as resulting in no gain or loss and applying I.R.C. § 453(c) (2004).

117. *ACM*, 157 F.3d at 244-45 (quoting *ACM v. Commissioner*, 73 T.C.M. (CCH) 2189, 2215

(1997)).

transactions despite finding that the partnerships' transactions, "at least in form, satisfied each requirement of the . . . ratable basis recovery rule."¹¹⁸

The partnership argued, based on the Supreme Court's holding in *Cottage Savings Association v. Commissioner*,¹¹⁹ that the courts were required to respect the tax loss generated by the transactions because the loss had actually been realized since the sale resulted in the exchange of assets for other assets that were "materially different."¹²⁰ The majority in *ACM* distinguished *Cottage Savings* because in *Cottage Savings* the loss represented an actual economic loss based on a real long-term investment.¹²¹ The partnership's loss in *ACM*, on the other hand, was created with no real investment or risk and by using the technical rules of the ratable basis recovery regulation.¹²² The majority held that the Treasury's ratable basis recovery regulation only provides the technical "method" for reporting otherwise "deductible"¹²³ losses.¹²⁴

118. *Id.* at 246. The court reversed the Tax Court's ruling that the partnership was not allowed to deduct approximately \$6 million of loss that was attributable to the decline in value of the securities held prior to the ultimate sale. That loss was an actual loss and was not artificially created by, what the majority found to be, an improper use of the ratable basis recovery regulations. The court found that even though the investment plan as a whole lacked economic substance, there were actual economic losses that were "separable from the sham aspects of the underlying transaction." *Id.* at 260-62.

119. 499 U.S. 554 (1991). In *Cottage Savings*, the Supreme Court was confronted with the issue of whether a loss had been realized, when two taxpayers swapped portfolios of mortgages they each owned in order to realize a loss because the value of the mortgages had decreased in value due to an increase in interest rates. *See ACM*, 157 F.3d at 251. The taxpayers sold each other the other's mortgage portfolio in order to realize what would have been an otherwise unrealized decline in value. *Id.* The Supreme Court ruled that because the different mortgages represented "legally distinct entitlements," the exchange of those entitlements represented a realization event and allowed the taxpayers to deduct the losses. *Id.* Neither the majority nor the dissent in *Cottage Savings* addressed the issue of economic substance partly because the decrease in value did actually represent an economic loss to the taxpayers even though the transaction realizing the loss (the exchange of one portfolio of mortgages for the other) had no economic substance. *See Hariton*, *supra* note 30, at 254-57. The focus of the Supreme Court's opinion was on realization that did not depend on whether the transaction had economic substance. *Id.* at 256-57. As Hariton noted, the nature of whether a loss was realized does not depend on whether the transaction had economic substance. *Id.* at 254-55. The rules regarding realization are technical and not in any way based upon economic substance. *Id.* If whether a loss was realized depended on whether the transaction had economic substance, then many of the nonrecognition rules disallowing recognition of realized gains and losses would be unnecessary. *Id.*

120. *ACM*, 157 F.3d at 251.

121. *Id.* at 251-52.

122. *Id.* The *ACM* court noted that in *Cottage Savings* the Supreme Court stated that the deductibility of a loss was "allowable only where the taxpayer has sustained a 'bona fide' loss as determined by its 'substance and not mere form.'" *Id.* at 252 (quoting *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554, 567-68 (1991)).

123. When the court uses the term "deductible," it means a genuine economic loss. The majority does not consider that whether or not a loss from a sale or exchange of property is a "loss"

The decision in *ACM* was not unanimous; Judge McKee filed a dissenting opinion.¹²⁵ While acknowledging that the majority opinion was “finely crafted,” the dissent pointed out that the economic substance doctrine should not play a role when the rules regarding realization and recognition of gains and losses are clear and unambiguous.¹²⁶ Judge McKee believed that once the court determined that the loss had been realized under § 1001, the “inquiry should [have] proceed[ed] no further.”¹²⁷ Judge McKee stated that he believed the Supreme Court’s decision in *Cottage Savings* should lead to a decision in favor of *ACM* and attempted to distinguish *Gregory*, the Supreme Court case that established the economic substance doctrine, because *Gregory* did not involve an issue about loss realization like *ACM* did.¹²⁸

In his dissent, Judge McKee reached the right result but for the wrong reason. He was clearly correct when he stated that the majority’s conclusion was based on “something akin to a ‘smell test’” because the majority subjectively believed that the taxpayer should not be allowed to engage in a transaction to “put one over on the Commissioner.”¹²⁹ He was correct when he stated that the court’s responsibility in applying the tax code is to conduct an inquiry that is “cerebral, not visceral.”¹³⁰ But Judge McKee was not correct when he attempted to distinguish *Gregory* and stated that the judicially developed economic substance doctrine is not applicable to the facts in *ACM*.¹³¹ The majority’s decision was incorrect

for purposes of the income tax laws is determined by section 1001 of the Code. I.R.C. § 1001(a) (2000) provides: “[T]he loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.” I.R.C. § 1001(c) (2000) provides: “Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.” The Code, therefore, defines when a loss has been realized and recognized from the sale or exchange of property.

124. *ACM*, 157 F.3d at 252.

125. *Id.* at 263-65 (McKee, J., dissenting).

126. *Id.* See *supra* note 122.

127. *ACM*, 157 F.3d at 265 (McKee, J., dissenting).

128. *Id.* at 263-64.

129. *Id.* at 265.

130. *Id.*

131. *Id.* at 263-64. One could conceivably argue whether the transaction objectively lacked economic substance. Even the majority agreed that part of the loss was a genuine loss with economic substance and reversed the part of the Tax Court decision regarding the deductibility of the portion of the partnership’s loss that was caused by adverse changes in interest rates and fluctuations in the market value of the contingent notes prior to the partnership’s ultimate sale of the notes. *Id.* at 260-63 (majority opinion). See also *infra* note 133 and accompanying text. Even though the partnership realized a \$6 million actual substantive economic loss on the transaction, it is likely that since the loss was caused by changes in interest rates, the partners were able to effectively hedge, outside of the partnership, any real economic risk to which they exposed themselves. See Hariton, *supra* note 30, at 264. Even ignoring the likelihood of the economic risk being hedged, the fact that a small economic loss resulted from the transaction did not mean the

not because *Gregory* did not apply,¹³² but rather because *Gregory* represented an improper exercise of judicial activism.¹³³

B. Long Term Capital Holdings v. United States¹³⁴

Long Term Capital Partners (LTCP) arguably could be considered the most famous, and possibly infamous, hedge fund in history.¹³⁵ LTCP was managed by some of the most prominent figures in the fields of finance and economics¹³⁶ as a hedge fund that managed, for a substantial fee,¹³⁷ investments for wealthy individuals.¹³⁸ The hedge fund ultimately collapsed in 1998 as a result of the fund being too highly leveraged and ultimately defaulting on its loans in a way that threatened to cause a collapse in the United States banking system.¹³⁹ The downfall of LTCP is only tangentially related to the dispute with the IRS over the tax treatment it sought for particular transactions in which it engaged in order to generate losses to offset the principals' gains from their own holdings in Long Term Capital.¹⁴⁰

overall transaction had economic substance. *See id.* at 236. However, no one could argue with a straight face that this transaction was anything but a clever way to use an arbitrary rule enacted by the government to the advantage of the taxpayer. Even with the partnership repurchasing outstanding Colgate debt, the transaction involving the asset swap for contingent notes had no business purpose. *Id.*

132. In both *ACM* and *Gregory*, the relevant statutory sections were clear and had no subjective economic standards for a court to apply. In *Gregory*, there was a clear definition of "reorganization for a court to apply." *See supra* notes 90-91 and accompanying text. In *ACM*, there was a clear definition of loss on sale or exchange and a clear regulation existed for allocating the basis to the proceeds from the sale or exchange. *See* I.R.C. § 1001(a) (2000); I.R.C. § 453(j)(2) (2004); Cottage Savings Ass'n v. Comm'r, 499 U.S. 554, 567-68 (1991); Temp. Treas. Reg. § 15a.453-1(c)(3)(I) (as amended in 1994).

133. *ACM*, 157 F.3d at 265 (McKee, J., dissenting) ("To the extent that the Commissioner is offended by these transactions he should address Congress and/or the rulemaking process, and not the Courts."). In addition, Judge McKee also noted that the Commissioner did promulgate a new regulation to prevent partnerships from using this type of transaction to generate losses in the future. *Id.* at 265 n.2.

134. 330 F. Supp. 2d 122 (D. Conn. 2004), *aff'd*, 2005 U.S. App. LEXIS 20988 (2d Cir. Sept. 27, 2005).

135. Mark H. Leeds & Jeffrey L. Rubinger, *When Common Sense Failed: Tax Planning After Long Term Capital*, 105 TAX NOTES 237, 237 (2005).

136. *Long Term Capital*, 330 F. Supp. 2d at 128-29. The list of principals included some of the most well-respected professors of finance and economics at the nation's most elite universities and included two Nobel Laureates in the field of economics. *See id.* at 124 nn.3-4 & 6.

137. LTCP charged its investors annual management fees of 2% of fund assets plus 25% of the fund's gross return after the 2% of asset management fee. *Id.* at 130.

138. *Id.* at 129-31.

139. *See* Leeds & Rubinger, *supra* note 135, at 237 (stating that the Federal Reserve Bank of New York had to intervene to prevent a "systemic collapse").

The specific transactions in question in *Long Term Capital* involved a series of transactions between numerous parties. For the sake of brevity, I will only summarize the transactions and will not go through a detailed explanation of the technical steps of the transactions.¹⁴¹ The basic objective of the plan was to capitalize on the difference between the tax treatment given to prepayments of leases in the United States and the United Kingdom.¹⁴² In the United States, lease prepayments are taxed upon receipt, while in the United Kingdom, income from leases is accrued as earned throughout the lease.¹⁴³ The key to get the tax benefits sought by the architects of the plan¹⁴⁴ was to have an entity that was organized in the U.K. sublease computer hardware already leased to end users and then sublease it to a U.S. partnership.¹⁴⁵ The U.S. partnership would then borrow money to prepay its sublease obligation to the U.K. entity.¹⁴⁶ The U.K. entity, subject to U.K. taxes and not U.S. taxes, would recognize no income on the prepayment.¹⁴⁷ Even though it was not subject to U.S. tax liability, it would recognize income for U.S. tax purposes and therefore have a full tax basis in the cash it received from the prepayments.¹⁴⁸ The U.K. entity would then "strip"¹⁴⁹ away the sublease revenues from the lease payments and transfer to a newly formed subsidiary of a U.S. corporation the assets acquired with the cash paid by the U.S. partnership for the prepayment of rent (a U.S. Treasury Bill) and the obligation to

of the partners' liability to the government after the court disallowed the tax treatment LTCP sought for the transactions. Long Term argued that since the disallowed loss would have increased the partners' share of partnership income in 1997 and also increased their basis in their share of the partnership, when LTCP collapsed in 1998, the higher basis would have simply resulted in a larger loss when the partnership collapsed. Therefore, LTCP argued that the only thing the partners' owed the government was the interest on the money for one year. See Alvin C. Warren, Jr., *Understanding Long Term Capital*, 106 TAX NOTES 681, 694 (2005).

141. For a detailed discussion of the steps in the transactions, see Warren, *supra* note 140.

142. *Long Term Capital*, 330 F. Supp. 2d at 132; see also Warren, *supra* note 140, at 682.

143. See Leeds & Rubinger, *supra* note 135, at 238-39.

144. This was not a transaction devised by the principals of LTCP. It was a "tax product" created by a business investment-consulting firm and later "sold" to LTCP. *Id.* at 241.

145. *Long Term Capital*, 330 F. Supp. 2d at 132-34. In reality, the transactions in dispute involved two different types of transactions, CHIPS and TRIPS. *Id.* at 132. The CHIPS transactions involved the leases described in the text, while the TRIPS transactions involved the sale and leaseback of trucks owned by Walmart. *Id.* at 132-35. In both transactions the tax issues were identical so the differences are ignored in this Note.

146. *Id.* at 134; see also Warren, *supra* note 140, at 682.

147. *Long Term Capital*, 330 F. Supp. 2d at 134; see also Warren, *supra* note 140, at 682.

148. *Long Term Capital*, 330 F. Supp. 2d at 135-36; see also Warren, *supra* note 140, at 682-83.

149. By "strip," the authors generally mean separate to the extent that the nontaxable entity (for U.S. tax purposes) recognizes all of the income from the lease and transfers the proceeds and the remaining lease liability (future deductions) to a U.S. taxpayer. Warren, *supra* note 140, at 682-83.

make the sublease payments in exchange for preferred stock of the subsidiary.¹⁵⁰ The U.K. entity would then form a partnership with LTCP and contribute its preferred stock in the subsidiary, which had negligible value and a high basis, as part of its contribution to the partnership.¹⁵¹ Essentially, the plan allowed the U.K. entity to receive payments that would have been taxable (in the U.S., not the U.K.), creating a U.S. tax basis in the cash received as a prepayment and also allowing the U.S. subsidiary to deduct the payments it made on the lease obligations it assumed with no corresponding inclusion for any lease revenue. Also, the basis created for the U.K. entity was later “sold” to LTCP through the partnership between LTCP and the U.K. entity.¹⁵²

Although the district court¹⁵³ case only dealt with the transactions between the U.K. entity and LTCP, the transaction actually created double deductions for the “phantom” loss: first, the U.S. subsidiary received deductions for lease payments made out of the assets it received during its formation; and second, LTCP received a loss deduction for a capital loss based on the sale of the subsidiary’s preferred stock with the U.K. entity’s inflated basis carried over when the U.K. entity formed the partnership with LTCP.¹⁵⁴ The district court upheld the Commissioner’s deficiency and imposition of penalties based on the economic substance and step-transaction doctrines.¹⁵⁵ The imposition of penalties on the taxpayer despite the taxpayer’s receipt of an opinion letter from a reputable law firm demonstrated that opinion letters would no longer prevent the imposition of penalties.¹⁵⁶ The district court’s opinion was affirmed by the Second Circuit Court of Appeals.¹⁵⁷

Even though the transactions and purported tax effects in LTCP are troubling, especially the ability to generate the double deduction of a non-

150. *Id.* at 682-84.

151. *Id.* at 685.

152. *See Leeds & Rubinger, supra* note 135, at 241.

153. Warren hypothesizes that the reason LTCP paid the deficiency and chose to litigate the matter in district court was because taxpayers were having little success in the Tax Court in cases involving corporate tax shelters challenged by the IRS under the economic substance doctrine. Further, LTCP hoped that a district court judge would be unable to “master the intricacies of . . . a transaction executed by leaders in the world of finance.” Warren, *supra* note 140, at 686.

154. Many commentators were most concerned about the transaction’s ability to create double deductions from a “phantom” loss. *See, e.g., id.* at 684-85. Even if courts were to allow the transactions to be given tax effect, the implementation of I.R.C. § 362(e), which prevents importing losses into a corporation, would preclude the double deduction, but not a single deduction, of the phantom loss.

155. *Long Term Capital*, 330 F. Supp. 2d at 170-71.

156. *See Leeds & Rubinger, supra* note 135, at 243-44 (providing advice to both taxpayers and practitioners regarding the risks involved in planning aggressive tax avoidance transactions).

157. *Long Term Capital Holdings v. United States*, No. 04-5687, 2005 U.S. App. LEXIS 20988 (2d Cir. Sept. 27, 2005) (per curiam).

economic loss, it is not at all clear that the same outcome that the court reached could not have also been attained by applying other provisions of the tax law without resorting to the economic substance doctrine. Even if the same result could not have been achieved under other provisions of the law, it does not follow that it is appropriate for a court to disregard the results of applying the law to the facts just because it disagrees with the result.

First, with regard to the subsidiary's ability to deduct the lease payments it makes after incorporation, Congress has recognized the problems that could be created by such transactions and implemented amendments to the Code to prevent the importation of built-in losses to a corporation when the transferor was an entity that was not subject to U.S. tax.¹⁵⁸ It certainly would be logical to conclude that if Congress felt that it needed to enact an additional subsection to prevent these types of transactions, that the Code, as it existed before the enactment of the subsection, *did not prohibit* such an importation of a built-in loss. Despite the possible smell of such a transaction, it is not the job of any court to decide what the tax law should be. It is only a job of the courts to apply the law to a given set of facts.

Second, the court, if it desired, could have reached the exact same result if it applied the corporate formation rules strictly against the U.K. entity. The capital loss that LTCP attempted to create with its partnership with the U.K. entity depended on the U.K. entity receiving a basis in the preferred stock of the subsidiary that far exceeded its market value. This result could only have occurred if the U.K. entity could argue that in the § 351 transaction where it transferred assets subject to the lease payment obligation to the subsidiary in exchange for the preferred stock, that its basis in the preferred stock was not reduced under § 358(d) by the subsidiary's assumption of its lease payment obligation. The only way the basis would not be reduced by the assumption of the liability is provided in § 358(d)(2).¹⁵⁹ Section 358(d)(2) states that the basis will not be reduced by liabilities "the payment of which . . . would give rise to a deduction."¹⁶⁰ The lease liabilities of the U.K. entity would not have given rise to a deduction for the U.K. entity if it had paid the liabilities because either: 1) the U.K. entity was not subject to United States taxes; or 2) the payment of the lease liability would have been directly allocable to a class of income (the prepayment revenue) that was wholly exempt (by virtue of

158. I.R.C. § 362(e)(1) (2005). This provision was enacted in 2004 by Congress and "applies principally to transfers by foreign shareholders to U.S. corporations." MCDANIELET AL., *supra* note 73, at 5.

159. I.R.C. § 358(d)(2) (2002).

160. *Id.*; I.R.C. § 357(c)(3)(A)(I) (2000); *see also* Warren, *supra* note 140, at 683.

the U.K. entity's foreign status) from U.S. income taxes.¹⁶¹

C. *Conclusions from the Cases in Which the Government Has Prevailed on Economic Substance Grounds*

After examining the opinions in the cases in which the government, by applying the economic substance doctrine, prevailed in disallowing the tax treatment sought by corporations for certain transactions, one could conclude that the application of the doctrine is either unnecessary or inappropriate. The court's application of the economic substance doctrine in *ACM* was an inappropriate activist exercise of judicial power to change the law because the court did not like the result. The court's application of the economic substance doctrine in *Long Term Capital* was unnecessary because proper application of the tax code as it was written would not have resulted in LTCP receiving the inflated basis in the preferred stock that they claimed. Even with regard to the aspects of the *Long Term Capital* transaction that were not part of the *Long Term Capital* court opinion¹⁶² and would not have been prevented by application of the tax law in force at the relevant time, Congress's addition of rules to the Code to prevent such results demonstrates that the proper venue for changing the rules that create "loopholes" for corporations is Congress, not the courts.

So if, as I argue, it is the role of the legislative or regulatory processes to close "loopholes" in the tax laws that create the opportunities for corporations to generate artificial losses (and not to do so retroactively), how exactly could those processes address transactions similar to those in *ACM*? First, the IRS could modify the pro-rata basis recovery regulations to not apply to transactions where the future payments are determined with reference to a widely-traded index such as LIBOR.¹⁶³ Second, Congress could implement a new Code provision in the partnership tax sections that require a partnership to recapture gains allocated to entities that are not subject to U.S. taxation before it may allocate any losses to U.S. taxpayers. Such a provision would address a wide array of transactions that create

161. I.R.C. § 265(a)(1) (2004) disallows the deduction of "[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle."

162. The deductibility of the lease payments by the subsidiary was not at issue in *Long Term Capital* because it had no impact on LTCP.

163. See *supra* notes 100, 112 and accompanying text. The regulations could also devise a system where taxpayers are required to use various valuation models to value the contingent payments and adjust the ratable basis recovery if the result of applying a straight ratable basis recovery would result in a recognition of gain or loss that was more than a certain percentage (say 20%) deviation from the estimated gross profit or loss on the sale using the estimated value of the contingent payments.

artificial losses for U.S. taxpayers by creating transactions that generate large, but offsetting gains and losses and allocate the gains to entities not subject to U.S. taxation and the losses to U.S. taxpayers.¹⁶⁴ Either action would not change the result of cases decided under the old rules, but would prevent similar transactions from working in the future.

V. THE WINDS BLOW THE STENCH OF CORPORATE TAX SHELTERS AWAY FROM THE COURTROOM: THE TAXPAYERS PREVAIL IN LITIGATING CORPORATE TAX SHELTERS

The lawyers for the IRS have learned the problem with advocating a rule that depends on the subjective interpretation of the judge or judges who hear the case: Sometimes the judges do not share the same subjective outrage as the IRS. The cases discussed in this section rule in favor of the taxpayer in cases involving transactions that were, at least substantially and most likely entirely, motivated by obtaining tax benefits. In these cases, the courts did not rule that the economic substance doctrine was inapplicable or an inappropriate exercise of judicial power.¹⁶⁵ Instead, the courts of appeals found that the transactions in question had economic substance and reversed decisions of the lower courts that disallowed the corporations' desired tax treatment.¹⁶⁶ These decisions reach the correct result, but the stated reasons for those results, that the transactions had economic substance, is wrong. The results are right because the tax law provisions that create the results do not require that there be economic substance to the transactions.

164. Just as Congress made the determination that the loss generating activity of the 1970s and 1980s justified enacting the passive loss limitations, see *supra* note 62 and accompanying text, whether the use of foreign entities to create artificial losses is a problem large enough to justify enacting a new provision that would have compliance costs and the possibility to ensnare legitimate activities is a decision that is best left to Congress.

165. Presumably, based on Supreme Court cases like *Gregory* and others, the Courts of Appeals would not be able to hold that the economic substance doctrine is an illegal use of judicial power. Therefore, the judges who disagree with this type of judicial legislating are forced into a position where they must distinguish the facts of the case to find that there is economic substance to the transaction.

166. Compare *Compaq Computer v. Comm'r*, 277 F.3d 778 (5th Cir. 2001), with *IES Indus. v. United States*, 253 F.3d 350 (8th Cir. 2001), and *United Parcel Serv. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001).

A. IES Industries v. United States¹⁶⁷ and Compaq Computer v. Commissioner¹⁶⁸

U.S. taxpayers are entitled to receive a tax credit on their U.S. income taxes for the amount they pay in foreign income taxes.¹⁶⁹ Most foreign countries, like the United States, tax dividends received by the taxpayer as income.¹⁷⁰ Because the financial markets are more efficient than the United States Congress, the existence of the foreign tax credit combined with the way capital markets treat dividends on a stock that are to be received by the holder of stock created the opportunity for corporations to exploit a “loophole” in the tax code. If a corporation had capital gain income that could be offset with capital losses, it could use the disparity between the efficient way financial markets treated dividends to be received to obtain the benefits of the foreign tax credit without any economic cost of actually having a decrease in wealth by paying the foreign tax.

There are three relevant dates in terms of a company declaring and paying dividends. These dates are: 1) the date of declaration, which is when the company’s board of directors announces that the company will pay a dividend; 2) the date of record (ex-dividend), which is when it is determined who is entitled to receive the dividend; and 3) the date of payment, which is when the dividend is actually paid. Because of the way the mechanics of these transactions work, it is possible for stockholders to own the stock for a very short period of time and still obtain the right to receive the dividend if they owned the stock at the moment it went ex-dividend. Because the financial markets are fairly efficient at valuing securities, the prices in these markets generally adjust at the point the stock goes ex-dividend to reflect the reality that anyone who buys the stock after that point will not be entitled to receive the next dividend. Additionally, the financial markets adjust the price of the stock based on the after-tax cost of the dividend because that is the true cost of buying after the ex-dividend date.¹⁷¹

167. 253 F.3d 350 (8th Cir. 2001).

168. 277 F.3d 778 (5th Cir. 2001).

169. I.R.C. §§ 901-903 (2005). A tax credit reduces a taxpayer’s tax liability dollar-for-dollar by the amount of a credit. By contrast, a tax deduction reduces a taxpayer’s taxable income and only reduces his tax liability by the amount of the deduction times the taxpayer’s marginal tax rate.

170. Since 2003, the United States has taxed dividends to individuals at the same preferential rate as long-term capital gains under I.R.C. § 1(h)(11) (2004). Also, in the United States, corporations are entitled to a dividends-received deduction under I.R.C. § 246 (2004) for between 70% and 100% of the dividends they receive from U.S. corporations.

171. For example, if a stock was trading for \$50 a share after the company declared a \$1 per share dividend and the tax rate on dividends was 25%, up until the point when the stock went ex-dividend it would continue to trade at \$50 per share. The \$50 per share price represents the combined price of the share of stock and the \$1 per share dividend. Since we know that dividends are taxed at a rate of 25%, then the after-tax value of the dividend is \$0.75. Therefore, the share of

In *IES* and *Compaq*, the taxpayers bought shares of foreign stocks immediately before they went ex-dividend and sold them immediately after they went ex-dividend.¹⁷² The taxpayers in these transactions sold the stock back to the party they bought it from at a price that represented the price they bought it for less the after-tax value of the dividend.¹⁷³ They therefore realized a capital loss that could be used to offset capital gain income in either the current year or prior years to which the companies could carry back the capital loss.¹⁷⁴ Since the companies owned the stock at the moment it went ex-dividend, they were entitled to receive the dividend and, additionally, they received the after-tax amount of the dividend because the foreign taxes on the dividend income were withheld from the payment.¹⁷⁵ Aside from transaction costs that the companies had to pay, the amount of cash the companies received from the dividends (after the foreign taxes were withheld) exactly equaled the amount of cash¹⁷⁶ the companies lost on the buying and selling transactions.¹⁷⁷

For their U.S. tax returns the companies reported the gross amount of dividend income and reported capital losses for the differences in the price at which they bought and sold the stock and included most of the transaction costs in the capital loss as either part of the basis of the stock acquired or as a reduction of the amount realized on the sale.¹⁷⁸ The companies also claimed a foreign tax credit in the amount of the taxes on the dividend paid to the foreign government.¹⁷⁹ The IRS challenged the tax treatment from the transactions and assessed deficiencies against the companies.¹⁸⁰ *IES* paid the deficiency and sued for a refund in district court, while *Compaq* challenged the Commissioner's assessment of the deficiency in the Tax Court.¹⁸¹ In both lower court proceedings, the courts disallowed the use of the foreign tax credit on the grounds that the transaction lacked any economic substance or potential for profit apart

stock without the dividend is worth \$49.25. The efficient financial market will adjust the price of the stock to \$49.25 immediately upon the stock going ex-dividend to reflect the value of the stock without the next dividend.

172. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 351-52.

173. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352.

174. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352.

175. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352.

176. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352. The companies did not actually use their own cash for the transactions. They bought the foreign stock using margin loans from the investment firm that facilitated the transactions. *Compaq*, 277 F.3d at 780. Presumably, the payment of interest on the margin loan was part of the "fee" to the investment firm for devising the transaction.

177. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352.

178. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 352-53.

179. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 353.

180. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 353.

181. *Compaq*, 277 F.3d at 780; *IES*, 253 F.3d at 353.

from tax consequences.¹⁸²

The Courts of Appeals, in both *IES* and *Compaq*, found that the lower courts erred in finding that the economic substance doctrine precluded the companies from obtaining the benefit of the foreign tax credit.¹⁸³ The appeals courts stated that it was erroneous for the lower courts to conduct the analysis of whether there was a potential for profit on the transactions without considering the gross amount of the dividend received and ignoring the foreign tax paid on it.¹⁸⁴ What the courts failed to consider, however, is that the financial markets had already taken the tax into consideration when it determined the price the companies would have to pay to buy the stock before the ex-dividend point.¹⁸⁵ Because of the efficiency of the financial markets, there are no arbitrage opportunities with regard to ex-dividend dates except for opportunities created by the tax code and different status given to different entities.¹⁸⁶

The appellate courts in *IES* and *Compaq* reached the correct result, but for the wrong reason. If the economic substance doctrine was an appropriate inquiry for courts to engage in to reverse the clear language of the tax code, then it definitely should be applicable to the transactions in *IES* and *Compaq*. But it is not the role of the courts to determine when the foreign tax credit should apply; it is the role of the courts to determine if the foreign tax credit applies under the rules enacted by Congress. If a provision of law is being used by taxpayers in a way Congress believes is inappropriate, it is the responsibility of Congress to enact rules to prevent the inappropriate use of the law. After this type of transaction came to light, Congress acted and implemented § 901(k) of the Internal Revenue Code to restrict the ability of taxpayers to use, as a foreign tax credit, taxes paid on foreign dividend income on stock investments that have not been

182. *IES Indus. v. United States*, No. C97-206, 1999 WL 973538, at *2 (N.D. Iowa Sept. 22, 1999); *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 214 (T.C. 1999).

183. *Compaq*, 277 F.3d at 784-85; *IES*, 253 F.3d at 354.

184. *Compaq*, 277 F.3d at 784-85; *IES*, 253 F.3d at 354.

185. A better way of looking at the transactions to determine whether there was any economic substance would be to look at the cash flows from the transaction. It would appear that aside from the U.S. tax effects, the only cash inflow would be the after-tax value of the dividend, and the cash outflows would include the after-tax value of the dividend (the loss on buy/sell transaction) and transaction costs.

186. The entities from whom the U.S. companies bought the foreign stocks were foreign entities that would have had to pay the same tax on the dividend as the U.S. companies had to pay. The foreign entities, however, would not have obtained any benefit by paying the tax as the U.S. companies did with the foreign tax credit. Therefore, the foreign entities were indifferent to having the U.S. companies pay their taxes and give them the after-tax value of the dividend they would have received in the form of gain on the transaction. Plus, the foreign entities probably got a little extra compensation for assisting with the transaction and to offset any possible tax cost of realizing a gain on the transactions.

held for certain minimum holding periods.¹⁸⁷ It is absurd to think the tax law meant the same thing before and after the enactment of § 901(k).

In the *IES* and *Compaq* cases, the taxpayers certainly got away with “put[ting] one over on the Commissioner.”¹⁸⁸ In fact, they were also able to put one over on panels each comprised of three circuit court judges. But as Judge McKee noted in his dissent in *ACM*, it is the role of Congress and the Treasury, not the courts, to address shortcomings in the tax law.¹⁸⁹ Surprisingly enough, in this instance, Congress acted and enacted § 901(k) to prevent taxpayers from obtaining an improper tax benefit that was created by a shortcoming in the tax law.

B. United Parcel Service v. Commissioner¹⁹⁰

It generally would not be a prudent business strategy for a company to voluntarily give away a profitable segment of its business for nothing. If, however, the company or its owners could be assured of getting back substantially all of the profits that it has given away and avoid tax on the profits at the same time, then it seems like a fairly good idea. The factual situation in the *UPS* case is, while slightly more complicated, practically identical to this standard.

UPS is a well-known shipping company that engages in package delivery services worldwide.¹⁹¹ UPS has a policy that if a package is lost in transit, UPS reimburses customers for the value of the package, but only up to an amount of \$100.¹⁹² If customers want their shipments insured for an amount in excess of \$100, then the customer is required to pay an extra

187. See Hariton, *supra* note 30, at 272-73. Hariton, a supporter of the economic substance doctrine, argues that he is “not sure [that] Compaq is getting away with enough in this transaction for a court to disallow the results for lack of economic substance.” *Id.* I.R.C. § 901(k)(1)(A) (2005) provides:

In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if—

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Id.

188. See *supra* notes 126, 129 and accompanying text.

189. See *supra* note 130 and accompanying text.

190. 254 F.3d 1014 (11th Cir. 2001).

191. *Id.* at 1016.

192. *Id.*

charge based on the declared value of the package.¹⁹³ Since UPS faced additional exposure in these excess-value packages, it took special efforts to “safeguard and track” the excess-value shipments.¹⁹⁴ As a result of these extra measures, the amounts it received from these ‘excess-value charges’ far exceeded the amounts it was required to pay on claims for lost packages where customers had purchased the excess coverage.¹⁹⁵

For a number of years, UPS reported the amount received as excess-value charges as revenue and claimed deductions for the expenses of paying out claims.¹⁹⁶ Then, one of the company’s insurance brokers suggested that it could avoid paying taxes on the profits from this segment of its business if UPS (presumably through him) restructured its “excess-value” business as “insurance provided by an overseas affiliate.”¹⁹⁷ UPS created a subsidiary in Bermuda and distributed the shares of the subsidiary to its shareholders in a taxable dividend.¹⁹⁸ UPS then purchased an insurance policy for the benefit of its customers from a domestic insurance company.¹⁹⁹ The domestic insurance company then entered into a reinsurance contract with the former subsidiary of UPS.²⁰⁰

UPS continued to administer the program, collect the charges, and pay the claims.²⁰¹ The only difference was that UPS would remit the portion of the charges not paid out as claims to the domestic insurance company which would then, after taking a small percentage for facilitating the transaction, remit the balance to the Bermuda entity on the reinsurance policy.²⁰² For tax purposes, UPS didn’t report the revenue it collected or deduct the payments it made to settle claims.²⁰³ The IRS assessed a deficiency by claiming that the excess value charges were properly includable in the gross income of UPS.²⁰⁴ UPS challenged the deficiency

193. *Id.*

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.* At the time of these actions, UPS was not a publicly traded company and most shareholders were employees of the company. *Id.* Also, it is likely that the Bermuda subsidiary did not require a large amount of capital since it served no purpose other than to receive income, and therefore the taxable status of the distribution to the shareholders was insignificant. *Id.*

199. *Id.*

200. *Id.* Although the case opinion does not mention it, it is likely that the domestic insurance company had a contractual obligation to enter the reinsurance contract with the former UPS subsidiary. Without such an obligation, the insurance company could have kept the profits with virtually no risk on the insurance contract.

201. *Id.* at 1016-17.

202. *Id.* at 1017.

203. *Id.* UPS did, however, deduct the fees and commissions it paid to the domestic insurance company. *Id.*

204. *Id.*

in the Tax Court, but the Tax Court upheld the IRS determination.²⁰⁵ The Eleventh Circuit, noting that it was not clear whether the Tax Court applied the assignment of income doctrine or the economic substance doctrine, the assignment of income doctrine's "kissing cousin," reversed the Tax Court and held that the transaction had enough economic substance to be recognized for tax purposes.²⁰⁶

The opinion noted that for purposes of applying the economic substance doctrine in the Eleventh Circuit, the only factor to consider is whether the transactions had any real economic effects.²⁰⁷ The court found that despite the long-standing profitability of the excess-value business, UPS transferred and the domestic insurance company accepted some risk of loss (even if that risk was miniscule) associated with insuring excess-value shipments.²⁰⁸ The court further stated that it was irrelevant that the domestic insurance company reinsured the policy with the Bermuda company that was created by UPS and distributed to UPS shareholders.²⁰⁹ Judge Ryskamp dissented and stated that the Tax Court had sufficient grounds to conclude that the transaction lacked economic substance.²¹⁰

Of all the cases discussed in this Note, *UPS* is probably the one that comes closest to the line where the corporate taxpayer should be able to obtain the tax treatment it desired. Perhaps this is because the transaction at issue did not involve any of the complicated non-recognition or arbitrary basis rules from the Code or Regulations. The transaction involved no more than the application of basic income tax principles concerning the recognition of income and the deductibility of expenses. In both the Tax Court and the Eleventh Circuit, the Government argued that the result *UPS* sought should not be allowed because the lack of economic substance to the transactions justified courts in disallowing the result that would apply from an objective application of the law.²¹¹ The

205. *Id.*; *United Parcel Serv. v. Comm'r*, 78 T.C.M. 262 (RIA 1999) (providing a calculation of deficiency determination).

206. *UPS*, 254 F.3d at 1016-17.

207. *Id.* at 1017 (citing *Kirchman v. Comm'r*, 862 F.2d 1486, 1490 (11th Cir. 1989)). The court stated that the Eleventh Circuit standard varied in that it did not accept the typical two-part test for economic substance that required both a determination that the transaction lacked economic substance and had a tax-avoidance purpose. *Id.* at 1018 n.2 (comparing the standard used in many circuits with *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91-92 (4th Cir. 1985)).

208. *UPS*, 254 F.3d at 1018-19.

209. *Id.* at 1019 ("But even if we overlook the reality of the risk and treat National Union as a conduit for transmission of the excess-value payments from UPS to OPL, there remains the fact that OPL is an independently taxable entity that is not under UPS's control. UPS really did lose the stream of income it had earlier reaped from excess-value charges.").

210. *Id.* at 1020-22 (Ryskamp, J., dissenting) ("In sum, UPS failed to show any legitimate business reason for giving up nearly \$100 million in EVC income in 1984.").

211. For a discussion of the facts of the transaction, see *supra* notes 194-99 and accompanying

IRS should have argued that a correct application of the tax code, as written by Congress and *interpreted* by the courts, required UPS to include the amount collected as excess-value charges in its gross income.

UPS involved nothing more than a question concerning assignment of income²¹² and potentially (depending on how the assignment of income question was answered) whether the expense of buying the insurance policy from the domestic insurance company was deductible as an ordinary and necessary business expense.²¹³ Section 61 includes as income everything that Congress is empowered to tax under the Sixteenth Amendment.²¹⁴ For any given tax year,²¹⁵ gross income includes all “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”²¹⁶ Courts developed the assignment of income doctrine to prevent taxpayers from avoiding tax liability by shifting income they had earned to another party in order to circumvent the realization component of *Glenshaw Glass*.²¹⁷ The basic principle of the

212. I.R.C. § 61(a) (2004) includes in gross income all income from whatever source derived unless a specific Code provision excludes it.

213. I.R.C. § 162(a) (2004) allows as a deduction “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”

214. U.S. CONST. amend. XVI. Prior to adoption of the Sixteenth Amendment Congress only had the power to impose taxes based on population. U.S. CONST. art. I, § 2, cl. 3.

215. In addition to determining what constitutes income for tax purposes, a decision had to be made about adopting either an annual or transactional accounting system for determining and reporting taxes. See STEVEN J. WILLIS, *ERROR CORRECTION, ACCOUNTING, AND THE TIME VALUE OF MONEY* (CD-ROM, 2001). Congress chose to enact an annual system of accounting in lieu of a transactional system. See I.R.C. §§ 441, 451, 461 (2005).

216. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Under *Glenshaw Glass*, all realized accessions to wealth (unless excluded by Congress) are included in gross income. *Id.* at 429. Congress has allowed certain items to be deducted from gross income in arriving at the income that is taxed. See I.R.C. §§ 162, 165, 212 (2004). With many deductions (particularly those allowed under § 212), however, there are significant impediments to obtaining the benefit of those deductions. See I.R.C. §§ 63, 67 (2000) (limiting deductions under § 212 as itemized deductions and allowing deductions only to the extent that the aggregate exceeds 2% of adjusted gross income). The deductions allowed under § 212 are also subject to being disallowed in computing a taxpayer’s alternative minimum tax. See I.R.C. §§ 55-58 (2003). Furthermore, the Court has held that deductions depend “upon legislative grace” and therefore to be allowed to deduct an expense, a taxpayer must be able to “point to an applicable statute and show that he comes within its terms.” *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); see also *Deputy v. du Pont*, 308 U.S. 488, 493 (1940) (stating that “allowance of deductions . . . does not turn on general equitable considerations”).

217. See *Lucas v. Earl*, 281 U.S. 111, 115 (1930) (holding that the income belongs to the person who earns it and the fruits of one’s labor cannot be “attributed to a different tree from that on which they grew”). In *Lucas*, a husband entered into a contract with his wife agreeing that any property either may have acquired (including earnings from salaries) would be treated and considered as property owned in joint tenancy. *Id.* at 113-14. The Court held that the entirety of the husband’s salary and earnings should be taxed as his income and stated that the absence of any motive to reduce taxes was irrelevant. *Id.* at 114-15; see also *Helvering v. Horst*, 311 U.S. 112, 114, 36

assignment of income doctrine is that income is taxed to the taxpayer who earned the income even if the right to receive the income never vests in the earner because the earner assigned that right to another before the transaction was complete. Although typically applied to assignments of income within families to prevent a high-bracket taxpayer shifting income to a low-bracket taxpayer,²¹⁸ the assignment of income doctrine is simply an interpretation of § 61 that includes all income in gross income.²¹⁹

If the issue in *UPS* had been framed as an issue of assignment of income, it is likely that a court, properly applying the doctrine, would find that UPS was the taxpayer that earned the revenue and therefore even the pre-arranged insurance contract could not prevent UPS from being required to recognize the income. The only way a court could find that the income should not be taxed to UPS would be to hold that UPS was merely acting as the agent for the insurance company.²²⁰ Since UPS continued to operate the business the same way—collecting the funds and remitting only the amount remaining after the claims had been paid to the insurance company, and did not hold itself out to be acting as an agent for the insurance company—it is unlikely a court would find a true agency relationship.

If a court concluded that the assignment of income doctrine required that UPS include the amount received as gross income, the court would then have to decide whether UPS was allowed to deduct the amount it paid to the insurance company as an ordinary and necessary business expense.²²¹ UPS had paid out all of its profits on a segment of its business to insure a risk that they had effectively mitigated through efficient business processes.²²² Whether such an expense was “ordinary and necessary” would depend on the court’s analysis of the facts. As Justice Cardozo pointed out about the deduction for ordinary and necessary business expenses: “One struggles in vain for any verbal formula that will

120 (1940) (holding that a father earned interest income even though he gave bond coupons to his son because the father retained ownership of the bond).

218. *Lucas and Horst* both involved cases where the income was diverted from one family member to another in a gratuitous transfer. By contrast, in the case of a contingency fee, the transaction is a result of an arm’s length commercial transaction with a legitimate business purpose.

219. The assignment of income doctrine has also been applied to many nonfamily situations. *See, e.g., Comm’r v. Banks*, 125 S. Ct. 826, 828-29 (2005) (holding that a client who received money from a settlement of a lawsuit in which the client’s attorney retained a portion of the settlement as a contingent fee had to include the entire amount of the settlement in gross income even if the deduction for attorney’s fees was disallowed by application of the alternative minimum tax).

220. *See Comm’r v. Bollinger*, 485 U.S. 340, 340-41 (1988); *Nat’l Carbide Corp. v. Comm’r*, 336 U.S. 422, 437 (1949) (stating the factors that are used to determine whether a true corporate agency relationship exists for tax purposes).

221. *See supra* notes 190-95 and accompanying text.

222. *See supra* note 206.

supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."²²³

The *UPS* case demonstrates that given the factual circumstances of the tax shelter *UPS* attempted to implement, economic substance was highly relevant because substance is relevant to the *interpretation* of §§ 61 and 162. However, the economic substance doctrine, which affords courts the subjective power to disregard the results when the court believes the results are improper, was not an appropriate analysis of the case. As stated above, *UPS* comes extremely close to the line between clever tax planning that works and too clever planning under a vague provision of a statute that fails. But regardless of what side of the line the court decides the transaction belongs, the proper analysis follows an application of §§ 61 and 162, not the economic substance doctrine.

VI. THE IRS FLIPS OUT OVER FLIPS

As can be seen from a comparison of the cases in the previous two sections, the decisions of the various courts in cases involving the application of the economic substance doctrine and other provisions of the tax law to corporate tax shelters are inconsistent.²²⁴ A large part of that inconsistency can be attributed to the subjectivity needed to employ the doctrine. Nevertheless, the inconsistent decisions create difficulties for professionals trying to plan transactions for clients and create the opportunity for a discussion of a certain type of tax shelter before any court has rendered a decision on the merits of the plan.

A recent investigation by the IRS revealed that the Big Four accounting firms were all engaged in selling similar highly aggressive tax shelters to wealthy individuals to create capital losses to offset large capital gains generally realized from selling closely-held businesses.²²⁵ In September 2005, the IRS announced that it had reached a settlement with KPMG in which KPMG agreed to pay a \$456 million fine to avoid criminal prosecution of the firm.²²⁶ Although no court has ever ruled that the

223. *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

224. The Tax Court has been fairly consistent in applying the doctrine to disallow the tax shelter results. The Courts of Appeals, however, have been highly inconsistent as illustrated in Parts IV and V, *supra*.

225. Calvin H. Johnson, *Tales From The KPMG Skunk Works: The Basis-Shift Or Defective-Redemption Shelter*, 108 TAX NOTES 431, 431 (2005). See generally SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, S. REP. NO. 109-54 (2005) (describing the role of public accounting firms in marketing tax shelters).

226. News Release, Internal Revenue Serv., KPMG to Pay \$456 Million for Criminal Violations (Aug. 29, 2005), available at <http://www.irs.gov/newsroom/article/0,,id=146999,00.html>. In

transaction fails to qualify for the tax treatment KPMG “sold” to clients, the IRS has aggressively challenged the transactions.²²⁷

KPMG and the other major accounting firms sold shelters based on similar provisions of the tax law and similar transactions under various acronyms.²²⁸ One of KPMG’s shelters was called FLIP, for Foreign Leveraged Investment Program (FLIPS).²²⁹ The purpose of the FLIPS shelter was to create capital losses for taxpayers who had capital gains that they “needed” to offset.²³⁰ Under FLIPS, KPMG would create an entity in the Cayman Islands that was not subject to any taxation.²³¹ The entity would then engage in a transaction where the entity borrowed the amount of the desired loss on a nonrecourse basis from a foreign bank and then bought shares of stock in the same foreign bank with the proceeds.²³² The Cayman Islands entity received a cost basis of the full value of the stock.²³³ The U.S. taxpayer who bought the shelter would buy a small number of shares in the foreign bank and acquire out-of-the-money options to buy a majority interest in the Cayman Islands entity.²³⁴ Then a few months later the bank would redeem all of the stock of the Cayman entity and simultaneously the U.S. taxpayer would purchase from the foreign bank out-of-the-money options on the exact number of shares that the Cayman entity had owned and redeemed.²³⁵

The goal of all of those transactions was to have the redemption of

that same news release, the IRS announced that it would pursue criminal conspiracy and tax fraud charges against nine individuals, including many former partners at KPMG, a tax lawyer involved in providing opinion letters to the taxpayers involved in the transactions, and investment bankers that orchestrated the transactions. *Id.*

227. Professor Calvin H. Johnson of the University of Texas School of Law has written that the fact that over 80% of taxpayers that bought KPMG’s or similar tax shelters have settled with the IRS on not very favorable terms indicates that it is unlikely the purported results of the shelters are legitimate. Johnson, *supra* note 225, at 441-42. It is important to note that Professor Johnson is serving as an expert witness for taxpayers who bought the shelter in lawsuits against KPMG. *Id.* at 431.

228. *Id.* at 433.

229. *Id.*

230. *Id.* at 434.

231. *Id.*

232. *Id.* at 434-35. In reality the money never left the bank, but the shares were actually issued and the debt recorded on the bank’s books. The IRS, however, did not contend that the transaction never took place, only that it either did not or should not generate the tax benefits claimed by KPMG and the U.S. taxpayers. *Id.* The Cayman Islands entity received a cost basis of the full value of the stock. *Id.*

233. *Id.* at 435.

234. Johnson, *supra* note 225, at 434. The U.S. taxpayer acquiring the options on the Cayman entity served two purposes. First it established a connection between the U.S. taxpayer and the Cayman entity, which was necessary for the plan to work. Second, it served as a way for the U.S. taxpayer to pay KPMG the fee for its shelter. *See id.*

235. *Id.* at 435.

shares by the foreign bank fail to qualify as a redemption under § 302(b) of the Code.²³⁶ If the redemption failed to qualify as a redemption under § 302(b), then § 302(d) required that the distribution of property (which would be equal to the full amount of the nonrecourse loan) be treated under § 301 as a dividend instead of a sale or exchange.²³⁷ The argument in support of the shelter is that the options purchased by the U.S. taxpayer were treated the same as actual shares by § 318(a)(4), and under § 318(a)(3) the shares attributed to the U.S. taxpayer are re-attributed to the Cayman entity because of the U.S. taxpayer's ownership of options in the Cayman entity.²³⁸ Since the options in the foreign bank and the redemption of the Cayman entity's shares occurred simultaneously, both before and after the redemption, the Cayman entity had no reduction at all, let alone a "meaningful reduction,"²³⁹ in its proportionate interest of the company.²⁴⁰ Therefore, according to the shelter, the distribution was "essentially equivalent to a dividend" and did not meet any mathematical standard of § 302(b).²⁴¹

236. *Id.* at 434-35. I.R.C. § 302(b) (2005) provides that a distribution from a corporation to a shareholder will only receive sale or exchange treatment as a redemption if one of the following four conditions is met:

- (1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
- (2) Substantially disproportionate redemption of stock.—
 - (A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.
 - ...
- (3) Termination of shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.
- (4) ...

Id.

237. I.R.C. § 302(b) (2005); I.R.C. §§ 302(d), 301 (2005); Johnson, *supra* note 225, at 434-35.

238. Johnson, *supra* note 225, at 435-36.

239. United States v. Davis, 397 U.S. 301, 313 (1970).

240. Johnson, *supra* note 225, at 435.

241. *Id.* In his article, Professor Johnson argues that the transaction whereby the U.S. taxpayer acquires the options that are attributed to the Cayman entity is not what is meant by retaining the same proportion before and after the transaction in *Davis*. *Id.* at 436. Johnson argues that what is relevant is what he calls "recapture," whether the interest stays the same after the redemption by virtue of the remaining shares the taxpayer owned before the redemption and continued to own after the redemption. For example, a taxpayer who owns all 100 shares of a corporation continues to own 100% after the redemption of eighty of his shares. On the other hand, a taxpayer who owned 1,000 out of 10,000 of outstanding shares, has a meaningful reduction in his interest when he redeems 500 of his shares because his interest drops from 10% (1,000/10,000) to 5.26% (500/9,500) (that example would also qualify as a redemption under 302(b)(2)). *Id.* at 436-37. Although not clear in

If the redemption was to be treated as a dividend, the Cayman entity would have to recognize dividend income for the full amount, but it would not affect the entity at all because the Cayman entity was not subject to any income tax.²⁴² Since the distribution was not treated as a redemption under § 302, the Cayman entity's basis in the stock that it no longer owned was not used to offset amounts received in the distribution.²⁴³ The FLIPS shelter worked on the idea that the Cayman entity's unused basis in the stock migrated from the Cayman Islands over the Caribbean Sea and into the basis of the U.S. taxpayer's small number of shares of the foreign bank.²⁴⁴

Professor Johnson attacks the FLIPS shelter on a number of technical and economic substance grounds. Even without considering the economic substance doctrine, the transactions in question don't generate the claimed result.²⁴⁵ The main technical problem with the shelter was that it relied on

dividend" test set forth in *Davis*. But the fact that *Davis* described one situation where the distribution was not essentially equivalent to a dividend does not mean that is the only situation where a distribution is not essentially equivalent to a dividend. For instance, the technical problem Professor Johnson found could be "fixed" by the U.S. taxpayer buying an extraordinarily large number of out-of-the-money worthless options on stock of the foreign bank long before the Cayman entity was redeemed and that would get it past the *Davis* recapture rule. The fact that the transaction may meet any mathematical test is irrelevant when the Code provision provides an economic substance-based standard. "Not essentially equivalent to a dividend," *see supra* note 236, is a vague standard that requires a court to examine whether the transaction is essentially equivalent to a dividend. It is likely not a good idea to base a tax shelter on a subjective provision of the law.

242. Johnson, *supra* note 225, at 435-36.

243. *Id.* at 436.

244. *Id.* See Treas. Reg. § 1.302-2(c) (1997) ("In any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed . . . Example (2). H and W, husband and wife, each own half of the stock of Corporation X. All of the stock was purchased by H for \$100,000 cash. In 1950 H gave one-half of the stock to W, the stock transferred having a value in excess of \$50,000. In 1955 all of the stock of H is redeemed for \$150,000, and it is determined that the distribution to H in redemption of his shares constitutes the distribution of a dividend. Immediately after the transaction, W holds the remaining stock of Corporation X with a basis of \$100,000."). Partly as a result of these types of transactions, the Treasury has issued proposed regulations that would replace the basis-shifting regulations and require that the taxpayer retain the basis as a separate item to be deducted at a later date. See Prop. Treas. Reg. § 1.302-5, 67 Fed. Reg. 64331 (Oct. 18, 2002).

245. One of KPMG's problems could stem from the fact that the KPMG tax partners who devised and sold FLIPS did not even believe the claims were legitimate. Johnson, *supra* note 225, at 432. Johnson noted one piece of evidence that came to light at Senate hearings on the tax shelter industry was the following exchange of emails between two KPMG partners:

Partner 1: I do believe the time has come to s**t and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles . . . and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? My own

vague, economic substance-based code provisions to generate the desired results. As Professor Johnson noted in his article, the regulation that FLIPS relied on to transfer the basis to the U.S. taxpayer stated that “proper adjustment” should be made to the basis of other stock. But even assuming that KPMG’s interpretation of the basis-shifting regulation was correct, the first link in the chain failed. Despite the Supreme Court’s holding in *Davis* (which involved completely different factual circumstances), no reasonable person would conclude that the transactions between the foreign bank and the Cayman entity were “essentially equivalent to a dividend.” Since § 302(b)(1) uses vague and subjective language, there is no bright-line rule (such as the ratable basis recovery rule in *ACM*) to manipulate. When the statute uses vague language, there is no need for an economic substance doctrine because applying the statute as written requires courts to look at the substance of the transaction and to consider that “[life] in all its fullness must supply the answer to the riddle.”²⁴⁶

It is hard to say whether the criminal penalties sought by the government in the *KPMG* case are appropriate.²⁴⁷ While the transaction seems laughable,²⁴⁸ there was legal precedent from the United States Supreme Court and Treasury regulations that arguably supports the position taken by KPMG.²⁴⁹ It certainly appears clear that KPMG did not

recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit.

Partner 2: I think [the expression is] s**t OR get off the pot. I vote for s**t.

Id.

246. *Welch v. Helvering*, 209 U.S. 111, 115 (1933).

247. See Press Release, United States Attorney S. Dist. of N.Y., Nineteen Individuals Charged In Superseding Indictment Filed In Criminal Tax Case Related To KPMG Tax Shelters (Oct. 17, 2005), available at <http://www.usdoj.gov/usao/nys/Press%20Releases/October%2005/KPMG%20Superseding%20Indictment%20PR.pdf#search=United%20States%20%26%20Jeffrey%20Stein%20%26%20indictment>. But see Robert Weisberg & David Mills, *A Very Strange Indictment*, WALL ST. J., Oct. 12, 2005, at A16. Even if the KPMG partners who marketed the shelter to clients knew that the claimed results were highly dubious, that alone is not sufficient to create criminal liability. *Id.* Additionally, it appears as though the prosecutors were unusually aggressive in pursuing the criminal case before any court had ever ruled on the merits of the underlying transaction. Jonathan Weil, *Nine Are Charged in KPMG Case on Tax Shelters*, WALL ST. J., Aug. 30, 2005, at C1; Editorial, *KPMG in Wonderland*, WALL ST. J., Oct. 6, 2005, at A14 (commenting that the government’s aggressive use of criminal prosecutions against KPMG partners before litigating the merits of the transactions may be the result of “several recent IRS setbacks” in court).

248. But in reality many distinctions in tax law are laughable. For example, between 2001 and 2004, a taxpayer could deduct the full \$65,000 cost of a Cadillac Escalade used in his business because it weighed over 6,000 pounds, but the taxpayer that used a \$20,000 Chevy Malibu was severely limited in his depreciation deductions. I.R.C. §§ 179, 280F (2004).

249. See *United States v. Davis*, 397 U.S. 301, 313 (1970); Treas. Reg. § 1.302-2(c) (1997). <https://scholarship.law.ufl.edu/flr/vol58/iss3/4>

even feel that the transaction had a reasonable chance of success if challenged and therefore it is clear that civil tax penalties are appropriate.²⁵⁰

VII. THE SKY IS NOT FALLING AND IF IT WERE FALLING, THE ECONOMIC SUBSTANCE DOCTRINE WOULDN'T SAVE US!

Regardless of whether criminal tax charges are warranted against the individuals who developed and marketed FLIPS, the fact that it occurred was the result of the failure of control within a few organizations and improper actions by a few individuals. It was not a failure of the law as written. The FLIPS shelter (if ever litigated) would fail because the result sought by KPMG only would occur if someone disregarded a couple of subsections of the tax code and removed some words from the regulations; it wouldn't fail because a judge would decide to disregard the law under the economic substance doctrine. When there is a string of bank robberies or murders in a community, there isn't a rush to enact new laws against bank robbery and murder. It seems, however, that whenever there is any white-collar criminal activity that attracts public attention, the most immediate reaction is to push for new laws to prohibit the type of behavior that already violates the law.²⁵¹

The attention given to cases of high-profile corporate tax shelters has created the same type of push.²⁵² Many commentators and politicians view codification of the economic substance doctrine as an integral part of winning the "war" on tax shelters. Some commentators, most tax professional organizations from both the legal and accounting professions, and, notably, the United States Treasury Department oppose codification of the doctrine.²⁵³ Some alternatives to codification of the economic

250. Johnson, *supra* note 225, at 440-42.

251. After Enron and other well-known corporate scandals, Congress rushed to pass the Sarbanes-Oxley Act. While some of the reforms in Sarbanes-Oxley may be excellent ideas, Enron and the other scandals did not occur because the corporate laws in this country were inadequate. Those scandals occurred because a few individuals decided to break the rules for their own personal benefit. While the new law may make it more challenging to commit corporate fraud, it is only a matter of time before we have the next round of corporate scandals.

252. But how has the current law failed? In each case discussed in this Note, the government learned of the transaction and had the opportunity to litigate the issues in court. The law worked exactly as it should have worked. And even though the decisions by some courts may be questionable and there can be differing views on the degree to which courts should follow the literal language in the tax code and Regulations, the system of required disclosures allows the IRS to challenge questionable transactions and initiate amendments to the Regulations or propose Code changes to Congress to prevent future use of the "loopholes" with which the IRS disagrees.

253. Sheryl Stratton, *Officials Gauge Government Success In War On Shelters*, 106 TAX NOTES 883 (2005). See also Donald L. Korb, *Korb Gives Speech on Economic Substance Doctrine*, TAX NOTES TODAY, Jan. 25, 2005, at 16. Although Korb stated that the economic substance

substance doctrine include increasing disclosure requirements, increasing civil penalties for misstatements, and the always popular, but not going to happen in a million years, meaningful tax reform.

In reality, the only thing that codification of the economic substance doctrine would do is mute the criticisms of strict constructionists, such as myself. Such a codification that expressly made economic substance a part of every provision of the Code would refute any argument that the decisions changing the results from tax shelter transactions were the result of activist judges disregarding the statute.²⁵⁴ But even though such a codification would legitimize judicial use of the doctrine, it would represent an abdication of Congress's responsibility to create a tax law that fairly distributes the tax burden among the taxpayers.²⁵⁵ If the tax law improperly favors corporations, then it is the role of the political process through the election of members of Congress to mandate that change. It is improper for the people who enact the laws to attempt to pass responsibility onto the businesses and tax advisors who plan around the rules written by Congress. If Congress writes a bad law, members of Congress should be the ones to fix what was bad in the law they wrote.

While slightly different economic substance standards have developed between the various circuits, all the circuits have adopted the doctrine and apply it to corporate transactions.²⁵⁶ Commentators object to the results in cases such as *Compaq*, *IES*, and *UPS* because the courts found economic substance where the commentators thought the courts should not, not because the courts did not apply the economic substance doctrine. Those who argue against those decisions simply disagree with the subjective determination of the courts that the transactions had economic substance apart from the tax effects. Codification of the doctrine would not force courts to find a lack of economic substance to the *Compaq*, *IES*, and *UPS*

doctrine plays an "important role" in the tax system and should be available for the IRS to use as an argument in tax shelter cases, he opposed codification and its use as a "general anti-abuse" measure and indicated that when the government has technical grounds to challenge a transaction, the use of economic substance as an argument should only be as a secondary or tertiary argument. *See id.*

254. It would be an interesting argument if application of such a provision, what I refer to as the "heads the government wins, tails the taxpayer loses" law, would survive a constitutional challenge on grounds that such a subjective law denies taxpayers proper notice of the tax law in a manner that deprives the taxpayer of due process. For a discussion of cases involving gift-leaseback transactions, see Karen Nelson Moore, *The Sham Transaction Doctrine: An Outmoded And Unnecessary Approach To Combating Tax Avoidance*, 41 FLA. L. REV. 659, 703-07 (1989).

255. *See* *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001) (exploring that fairness and equity in the tax law are the responsibility of Congress).

256. *Compare* *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91-92 (4th Cir. 1985) (requiring tax avoidance purpose in addition to lack of economic substance), *with* *Kirchman v. Comm'r*, 862 F.2d 1486, 1492 (11th Cir. 1989) (refusing to consider subjective intent when transaction lacks economic effect).

transactions unless the law went further than the current judicially-applied doctrine and refused to give effect to a whole range of tax planning transactions.²⁵⁷ To most in the tax world, however, planning transactions to minimize taxes is a legitimate activity.²⁵⁸

The conclusion that tax planning and structuring transactions to take advantage of provisions of the tax law is a legitimate activity does not mean that there is not any downside to a system that allows such planning. The backbone of our system of taxation is the idea of self-reporting of income for both individuals and corporations. An extremely strong argument for preventing corporate tax loopholes is that the ability of certain taxpayers to reap improper tax benefits by cleverly exploiting technical provisions of the tax code creates a lack of respect for the system and a willingness to cheat among the rest of the taxpayers who are not in a position to garner the same benefit of tax planning.²⁵⁹ But that is a reason to make the law better, not to enact a catchall override that prevents taxpayers from making decisions based on the rules as written.

Most everyone agrees that it is infeasible and unwise to have a tax system based solely on bright-line rules.²⁶⁰ Most also agree that it is unwise to have a system based solely on subjective determinations.

257. For an argument in favor of outlawing a range of tax planning strategies because such activities produce external costs that are borne by society and not the individuals who engage in the planning, see David A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. REV. 73, 80 (2001).

258. See *supra* note 18 and accompanying text.

259. See Steven J. Willis, *Masks, Magic, And Games: The Use of Tax Law as a Policy Tool*, 4 AM. J. TAX POL'Y 41 (1985). One of the types of transactions that Professor Willis argues breeds that type of contempt for the system, as well as the belief that the tax law can be easily manipulated, is the gift-leaseback transaction. See *id.* at 65-70. In such a situation a taxpayer who owns a piece of fully depreciated property initially gives the property to a person to whom the taxpayer wishes to divert income and then immediately leases the property back. See *id.* Although the formalities for such a transaction vary from circuit to circuit, it is generally a way to allow taxpayers to shift income from a high-bracket taxpayer to a low-bracket taxpayer. Willis argues that taxpayers, upon hearing this advice from tax planners, think it is "magic" and that as a society, such transactions breed contempt for the tax law. *Id.* The example Willis uses in his article involves a dentist giving a piece of equipment to his child and leasing it back. *Id.* The objection to such a transaction, however, is not that the transaction lacks economic substance because one could easily design a situation where two dentists who are friends give each other's children identical pieces of equipment and then the children lease it to the other dentist. Although that may require moving the equipment from one office to another, those transactions would have to have economic substance because the actual pieces of equipment used in each business have changed. The problem with such a transaction is that the taxpayer is getting to take deductions on property which he has already fully depreciated. See *id.* This is because taxpayers may dispose of depreciated property by gift without being required to recapture excess depreciation under § 1245. See *id.* Such a transaction (or at least the tax benefit of such a transaction) could be prevented by removing the exemption from recapture for gifts.

260. Weisbach, *supra* note 257, at 79.

Therefore, the system should have some mix of subjective, “life in all its fullness” standards, and some concrete bright-line rules. This Note was not designed to state how to determine the appropriate balance, but it is interesting to note that many of the bright-line rules were implemented to prevent subjective abuse of the system. What I have set out to demonstrate is that when the results of application of the rule produce undesirable results, the appropriate course of action is to change the rule for the future, not disregard the rule in the present.

Some authors have made it seem like tax shelters and tax planning are the greatest threats this country faces and that these transactions threaten the ability of government to function.²⁶¹ I think those doomsday concerns are overstated. In this Note, I examined essentially five types of tax shelter transactions: *ACM*, *Longterm Capital*, *Compaq/IES*, *UPS*, and *FLIPS*. Of those five transactions, I believe only two, *ACM* and *Compaq/IES*, would have been allowed in a world without the economic substance doctrine.²⁶² The results in *ACM* could have easily been changed for future transactions by changing the ratable basis regulations, while Congress changed the results from *Compaq/IES* type transactions with the enactment of § 901(k).²⁶³ *UPS*, although allowed by the Eleventh Circuit under the economic substance doctrine, would not necessarily have been allowed under traditional application of tax law principles. Finally, the results sought by the taxpayers in *Longterm Capital* and the *FLIPS* shelter would be disallowed by clear application of the code sections in question.²⁶⁴

VIII. CONCLUSION

I once saw a bumper sticker regarding the debate over school prayer that said: “As Long as There Are Tests—There Will Be Prayer In Public Schools.” The same could be said about tax law. As long as there are taxes, people will find ways to reduce their tax liability. With bright-line rules, people plan transactions to exploit technical problems with the rules. If instead of clear rules, the tax law were comprised of subjective standards, people would attempt to characterize their activities in tax-favorable ways. Some argue that the best way to stop the transactions they believe are inappropriate is to give the courts the equitable power to disregard the law when the transaction smells bad. But just as justice is blind, it also should have no olfactory sense. Corporations, like

261. See generally Weisbach, *supra* note 257 (referring to the “boom” in the tax shelter industry and advocating a broad substantive disallowance rule involving tax motivated transactions and financial products).

262. *ACM* was disallowed by the Third Circuit. See *supra* Part IV.A. *Compaq/IES* was affirmed by the Fifth and Eight Circuits, respectively. See *supra* Part V.A.

263. See *supra* Parts IV.A, V.A.

264. See *supra* Parts IV.B, V.

individuals, are entitled to rely on the law as drafted and plan their affairs accordingly. Even though some people—for example, KPMG with FLIPS—take the “it’s not a lie if you believe it” theory of the truth too far beyond what the law allows, those who design transactions that fall within the technical provisions of the law are entitled to rely on the rules of the game that existed at the start of the game. Taxpayers are not free to characterize compensation as gifts to avoid tax or characterize an equity investment as debt because of a better tax treatment, but when Congress has seen fit, whether correctly or incorrectly, to create a clear, unambiguous rule, the taxpayers should be able to rely on the notion that the rule will be honored. For too long courts have exercised various “smell”²⁶⁵ tests to determine whether substance or form should control the tax treatment of certain transactions. I hope we can progress to a system where substance controls when the statute makes substance control, and form controls when the statute makes form control.

265. See *supra* note 15.

