TAX SHELTERS AND STATUTORY INTERPRETATION: A MUCH NEEDED PURPOSIVE APPROACH

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Few are unaware that the federal Tax Code and the accompanying Treasury Regulations provide a detailed, complex (and lengthy) set of rules. It is hardly surprising (or new) that taxpayers attempt to avoid these rules to lower their taxes. Courts and lawmakers have long grappled to identify abusive transactions and strip taxpayers of the associated tax savings. The transactions have, however, changed dramatically over the last decade, making the task much more challenging. The rapid proliferation of aggressive and diverse tax shelters has created what many refer to as a "tax shelter war." In general, tax shelters refer to transactions carefully designed to fit within the letter of the law to derive benefits unintended by those sections. Courts, however, do not inquire directly into purpose when analyzing tax shelters. They instead rely on traditional anti-abuse tests. These tests are outdated and insufficient to curb current tax shelters. Even those that defend these tests admit that they supply neither a necessary nor sufficient basis for denying tax benefits. Scholars defend the usage of these tests believing a viable alternative to be lacking. This Article attempts to fill this gap and develops an alternative test, which inquires directly into the purposes of the tax laws to address abuse directly. After developing this test along with an extensive set of guidelines for analyzing tax provisions, the test is applied to three recent tax shelters to illustrate its advantages. Such a test is an essential weapon to compete in current and future tax shelter wars.

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I. INTRODUCTION

Few are unaware that the Internal Revenue Code and Treasury Regulations provide a detailed, complicated, and lengthy set of rules.[1] It is therefore hardly surprising (or new) that taxpayers attempt to avoid these rules to lower their taxes. Courts and lawmakers have long grappled to identify abusive transactions so taxpayers cannot benefit from the associated tax savings.[2] The transactions have changed dramatically over the last decade, however, making this task much more challenging.[3]

In general, tax shelters refer to transactions carefully designed to fit within the letter of various provisions of the Code and Regulations to derive benefits unintended by those sections.[4] Although there is no widely accepted definition of a "tax shelter," the ideal test would "catch" only those transactions yielding benefits unintended by the tax law.[5] This Article argues that the current tools used to identify tax shelters are insufficient, and a new test that looks directly at the purposes of the tax law is needed to compete in the current tax shelter wars. Specifically, I argue that courts should ask whether the results of the transactions (meaning the tax savings claimed) are within the purposes of the Code and regulatory sections that the transactions utilize. If the results are not, taxpayers should be denied the attendant benefits. If the results are within the purposes of the law, taxpayers are entitled to the benefits.

Part II discusses the current tax shelter landscape and how the traditional legislative and judicial tools used to curb past shelters are not working in the present environment. This Part first explains why law-

1. *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 236 (1999) ("We tax lawyers are alternatively amused and exasperated by the naive columnists and politicians who maintain that this complexity can be eliminated by changing tax systems."); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969).

2. George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 215–20 (2001).

3. Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1776 (1999).

4. *Id.*

5. *See, e.g.*, *id.* at 1775–95. Although recognizing that there is by no means an agreed upon definition of tax shelters, Bankman stated that "[t]he tax shelter, while supported by a literal reading of statute, regulation, or case law, produces a result that is inconsistent with commonly understood tax principles and is not supported by clearly defined legislative intent." *Id.* at 1777; *see also* David P. Hariton, *Tax Benefits, Tax Administration, and Legislative Intent*, 53 TAX LAW. 579, 583 (2000) ("The question a court must ask in deciding whether to disallow the resulting tax benefits . . . is whether those benefits frustrate the will of Congress."); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX L. REV. 325, 330 (2002) ("In fact, it seems impossible to define a tax shelter *except* in terms of congressional or regulatory intent. Whatever words are used, we instinctively compare the alleged results of a transaction (or a portion of a transaction) to the results we think 'should' arise under our understanding of the purpose of the Code and regulations. If we believe the tax result was intended by Congress or the regulations, we do not consider the transaction a tax shelter. If the transaction reaches a tax result that we consider 'too good to be true' under this analysis, we may think of the transaction as a tax shelter. Therefore, all tax shelters reach unintended tax results. Equivalently, a transaction that reaches intended results is not a tax shelter.").

makers cannot, and cannot be expected to, curb current shelters on their own. Often, abusive transactions make economic sense solely because of the large tax savings they were crafted to produce. Lawmakers can stop these transactions by denying taxpayers the benefits that made the transactions worthwhile in the first place. Importantly, however, legislative and regulatory reforms do not operate retroactively in the tax context. Thus, even if a reform is properly crafted to curb a particular abuse, taxpayers already engaged in the transactions will emerge unscathed and keep the associated benefits.[6] I refer to this as the retroactivity problem. Various features of the current tax shelter environment conspire to make the retroactivity problem quite serious, rendering legislative reform a dreadfully inadequate solution. But because courts *are* able to operate retroactively (by which I mean they can strip taxpayers of benefits that are gleaned from already executed transactions), their role is extremely important in the current tax shelter war.

Unfortunately, judicial tests traditionally employed in tax shelter cases are not up to this task. The types of transactions that should be targeted are transactions gleaning unintended results. Courts have not tackled this question directly. Instead, they have assumed inappropriate transactions can be identified by using traditional anti-abuse tests that do not consider the purposes of the laws. As discussed in Part II.C, the economic substance doctrine is perhaps the most notable of the traditional tests used by courts, as most current cases either use this test or employ one of its two prongs. The first prong asks whether there was any business purpose for the transaction other than tax avoidance. The second prong asks whether the taxpayer had any subjective motivation for the transaction other than gleaning tax benefits. This second inquiry is increasingly conducted by using the profit test, which questions whether there was any reasonable expectation of a profit before accounting for tax benefits.[7]

Finally, Part II discusses how these tests are inadequate when applied to current shelters. Most notably, the tests are both over- and under-inclusive, identifying non-abusive transactions (transactions that

6. *See, e.g.*, James S. Eustice, *Abusive Corporate Tax Shelters: Old "Brine" in New Bottles*, 55 TAX L. REV. 135, 147 (2002); Yin, *supra* note 2, at 215–18.

7. There are constant ruminations as to whether the economic substance doctrine will be codified. In September 2007 Joshua Odintz, tax counsel to the Senate Finance Committee majority, told the American Bar Association Section of Taxation's Tax Shelter Task Force that economic substance codification was coming. *See, e.g.*, Lee A. Sheppard, *Economic Substance Codification Coming*, TAX NOTES TODAY, Oct. 10, 2007, *available at* 2007 TNT 196-3 (LEXIS). The most recent draft suggests that the test will be conjunctive, requiring both an objective possibility of a pretax profit *and* a subjective business purpose. The drafters believe they are clarifying the existing common law doctrine as opposed to modifying it. *Id.* As a result, the analysis of the doctrine discussed below, which focuses on the courts' application of the business purpose doctrine, will not be affected in any significant way should codification occur in this form. *See id.* As of January 2008, government officials predicted that the doctrine would be codified in 2008. *See, e.g.*, Lee A. Sheppard & Jerimiah Coder, *Congress Will Pass Economic Substance Codification in 2008, Government Officials Predict*, TAX NOTES TODAY, Jan. 23, 2008, *available at* 2008 TNT 15-5 (LEXIS).

reach intended results) as tax shelters, and failing to identify clearly abusive shelters (transactions reaching unintended results). Further, the courts do not seem entirely unaware of these failings.[8] The inconsistent manner in which the tests are applied suggests that courts may be attempting to reach the results they deem sensible—that is, in accord with the purposes of the laws being exploited. Still, one cannot look at these complicated transactions that utilize complicated tax laws and eyeball whether the results are within the law's purposes. What is needed is a well-developed test that explicitly makes this inquiry. Part III proposes and develops such a test.

Importantly, most defenders of the traditional tests would agree they are neither necessary nor sufficient for identifying tax shelters.[9] What is disputed is how to fill this hole. Many feel that the current tests, although insufficient, are the best we can do and should be left alone.[10] This Article rejects that notion and offers an alternative test. Others recognize the missing piece to the traditional tests is an inquiry into whether the transactions circumvent the law, but offer that this inquiry is basically a matter of common knowledge.[11] This Article also rejects the notion that one can essentially eyeball purpose and provides a test to engage courts in the full and deliberate analysis into purpose that is needed.

Part III suggests that courts must look directly at the purposes of the provisions at issue to halt the proliferation of today's shelters. A close analysis of the purposes behind the provisions exploited by tax shelters often supplies a stronger basis for denying (or upholding) the claimed benefits without having to resort to the outdated anti-abuse tests. Part III proposes and develops a test for doing so and proposes that a transaction should be upheld if, considering the provisions of the Code and/or Regulations at issue and the materials related to their construction and development, the result of the transaction in question falls within one or more of the provisions' purposes.

Part III first sets forth the general framework for assessing the purposes of tax provisions. This test is tailored to the unique features of tax law and the novel contextual situation presented by current tax shelters. It therefore has certain attributes that might be objectionable in other contexts but are appropriate in this specialized area. For example, in addition to looking at the specific purposes of the provisions at issue in a transaction, I suggest courts should also consider the general principles of tax law. As this Part explains, general principles are fundamental con-

8. *See* Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 131–32 (2001).

9. *See, e.g.*, *id.* at 132; Hariton, *supra* note 1, at 244. Hariton, who is not a defender of the tests, notes that the economic substance doctrine may serve as a necessary but not sufficient condition. He argues that the essential question is whether the tax benefits "are beyond the scope of what the drafters of the relevant rules could reasonably have intended." *Id.* at 246.

10. *See, e.g.*, Gergen, *supra* note 8, at 131.

11. *See, e.g.*, *id.* at 132.

cepts that underlie the Code and Regulations as a whole. If the specific purposes of a law are unhelpful or cannot be ascertained, it is appropriate in some instances to consider these general principles to fill the gap or ambiguity that the transaction in question has exploited. Further, the test contemplates that certain types of legislative history, such as committee reports, be given more weight than they often are in other contexts. It is argued that the unique process of tax law codification makes it appropriate to consider these sources in determining the purpose of a tax law.

Of course, there are various types of tax provisions. Some provisions are part of the general structure of the Code while others are explicit deviations from that general structure. Further, tax laws can deviate from general principles in various ways. Part III.B identifies several types of provisions often used in tax shelters and discusses how the general framework provided in Part III.A should be specifically applied to these categories.

After fully developing the proposed test and explaining why objections commonly raised by scholars of statutory interpretation are far less compelling in this particularized context, Part IV is devoted to illustrating its application to three recent tax shelter transactions. This Part performs detailed and technical analyses, and not only clarifies the concepts discussed by applying the test to concrete examples, but also demonstrates the advantages of using the proposed test to analyze sophisticated transactions. Part V concludes.

II. THE NEED FOR A NEW APPROACH

To compete in current and future tax shelter wars, courts must look directly at the purposes of the laws being exploited rather than relying on the outdated anti-abuse tests discussed below. The starting point, then, is to define exactly what constitutes a "tax shelter." As this Part first discusses, this proves to be difficult and of constant debate. It is clear, however, that we need to strip taxpayers of unintended benefits. As a result, focusing on the purposes of the tax law gets directly at one of the few commonly agreed upon features of tax shelters.

Historically, the problem has not been approached in this manner. Instead, tax shelters have been curbed through legislation and judicial application of anti-abuse tests.[12] Although these methods failed to strike at the problem directly—i.e., they did not directly inquire into the purposes of the laws—it appears they managed to keep past shelters from spiraling out of control.[13] These methods are no longer sufficient to curb the proliferation of shelters, however.

12. *See infra* Part II.B–C.
13. *See infra* Part II.C.2.

Section B discusses how the current landscape of tax shelters has changed in such a manner as to render legislative reform extremely ill-equipped to deal with shelters. The failure of legislative reform to curb shelters makes judicial reform increasingly important. Section C illustrates how the traditional judicial tests are incapable of taking on current shelters. With legislative reform significantly weakened and current judicial tests performing inadequately, we need a new approach that directly asks whether the results of a transaction fall within the purposes of the law. This approach is developed in Part III.

A. Defining a Tax Shelter—Identifying the Problem

Because this Article develops an alternative method of identifying tax shelters, the first task is to provide the definition of a "tax shelter." Our ideal test will identify tax shelters and strip taxpayers of unintended benefits derived from these transactions. Thus, the definitional question asks: what exactly is it that our ideal test would catch?

Surprisingly, there is no widely accepted definition of a tax shelter, meaning there is no agreed upon definition of the type of transaction we are trying to stop.[14] It has been stated that "there seem to be as many answers to [the question of how to define a tax shelter] as there are individuals in a room to discuss [it]."[15] While there is no common consensus on how to define a tax shelter, there are several factors that are generally agreed upon. It is commonly agreed that tax shelters refer to transactions that are carefully designed to fit within the letter of the tax law to derive benefits that tax planners and taxpayers know are (or likely are) outside the purposes of the provisions on which they rely. Few (if any) would disagree that our target is aimed at, and limited to, transactions that produce unintended benefits.[16]

Although this does not seem to be a dramatic starting point, it helps shed light on why the definitional question has proven elusive. If the ideal test should target only transactions yielding unintended benefits, it should not touch transactions yielding intended benefits. Thus, it is not enough to target transactions that produce significant tax savings by taking advantage of the various deductions, credits, and other tax savings provided in the tax laws. They may very well reach intended results, wrongly stripping taxpayers of their benefits.

Consider the many tax preferences provided in the Code. Congress uses so-called tax preferences to stimulate what it determines to be desir-

14. *See, e.g.*, Schler, *supra* note 5, at 328 (stating that "[o]ne of the biggest problems in any discussion of tax shelters is that there is no established definition of the term"); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 232 (2002) (acknowledging that "[t]here is no a priori definition of shelters").

15. David P. Hariton, *How to Define 'Corporate Tax Shelter*,*'* 84 TAX NOTES 883, 883 (1999).

16. *See* sources cited *supra* note 5.

able economic behavior.[17] Tax preferences reduce taxes on income earned from certain activities to increase investment in those activities.[18] Whatever one thinks about the wisdom of using the Code to encourage certain behavior, tax savings gleaned through transactions that utilize these incentives, even arduously, to produce results that accord with the purposes of the preference are not the target of a properly devised tax shelter test. Instead, we need to target transactions that utilize "tax goodies"—preferences, credits, deductions, and losses—to reach unintended results. Examples that tread, and cross, this line will be discussed throughout this Article.

Courts do not focus directly on this goal and do not ask whether a transaction produces an unintended result. Instead, they rely on various tests that will be discussed in Section C. As will be shown, these tests are inadequate to deal with current shelters. In the past, the judicial tests did not play the pivotal role in curbing shelters that I argue they must today. Thus, the weaknesses in the judicial tests did not always create the threat that currently exists—a situation in which tax shelters burgeon at a pace that is dramatically faster than the pace with which lawmakers can identify and draft laws to stop them. Previous tax shelter wars did not spin out of control because the legislature could, more or less, curb shelters at an adequate rate by enacting provisions that would deny eligibility for the tax benefits that made the transactions worthwhile.[19] With legislative reform operating as a relatively effective solution, the problems with the judicial tests were not as concerning. As discussed below, however, the legislature cannot successfully curb *current* shelters, drastically increasing the importance of active and effective judicial intervention.

B. Lawmakers Cannot Handle This Problem Alone

Legislative reform is inadequate to deal with the current proliferation of tax shelters. With few, if any, exceptions, statutory and regulatory amendments do not operate retroactively in the tax area.[20] Both lawmakers and taxpayers become squeamish at the suggestion that tax amendments should reach back in time to strip taxpayers of benefits associated with a planned and executed transaction deemed undesirable after the fact. Therefore, while it need not be the case that tax legislation be limited to prospective application (and judgment is reserved as to the wisdom and, what many appear to believe, the inevitability of this limita-

17. *See, e.g.*, Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 502–03 (1989); Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 981 (1986) (discussing the various arguments for and against tax preferences).

18. Zelenak, *supra* note 17, at 503.

19. Richard C. Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, 91 TAX NOTES 115, 136 (2001).

20. Henry Ordower, *Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted*, 7 FLA. TAX REV. 259, 287 (2006).

tion), it is a current political reality and will be treated as such for purposes of this Article. Because statutory and regulatory amendments do not operate retroactively, if an amendment successfully curbs an abuse, it leaves past shelters employing the same abuse unscathed and taxpayers free to keep the spoils.[21] I will refer to this problem as the retroactivity problem.

Thus, the inadequacies of prospective legislative reform as a solution to the tax shelter problem can be measured with reference to these retained spoils. In other words, how much revenue do we stand to lose due to the retroactivity problem? There are several variables that affect the severity of the retroactivity problem.

First, the extent of the retroactivity problem depends on how easily the transactions can be foreseen. After all, if Congress or the Treasury can predict the abuse, they can prevent it before taxpayers take advantage. Lawmakers, however, cannot be expected to predict today's abusive transactions before they occur because the complexity and diversity of today's shelters prevent lawmakers from foreseeing the transactions.[22] As will be seen throughout this Article, some recent transactions are so stunningly complex as to inspire awe even amidst disapproval.[23] Lawmakers cannot be expected to divine these exotic concoctions and therefore must wait to discover these abuses after they occur. Once discovered, the most Congress or the Treasury can do is enact band-aid provisions to stop further abuses of this kind (sometimes doing more harm than good by providing unintended opportunities for new abuses).[24] Taxpayers who have already entered these transactions emerge unscathed, keeping their benefits while often moving on to the next device du jour.[25] This cat-and-mouse game has been termed prospective incre-

21. *See* Eustice, *supra* note 6, at 146–47; Yin, *supra* note 2, at 215–18.

22. *See* Bankman, *supra* note 3, at 1776 ("The new corporate tax shelter is much more sophisticated and complex than its 1980s predecessor."); Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951–52 (2005) ("Contemporary shelters are considerably more varied in design—and in the Code provisions they exploit—than were their predecessors.").

23. *See* Karen C. Burke, *Black & Decker's Contingent Liability Shelter: 'A Thing of Grace and Beauty'?*, 106 TAX NOTES 577, 577–78 (2005). Although her article explains why the *Coltec* shelter, which is discussed in Part IV.A, *infra*, should have been struck down, Burke's title refers to the Hon. William D. Quarles, Jr.'s description of the transaction and suggests the odd admiration we sometimes feel for these clever structures.

24. *See* Eustice, *supra* note 6, at 141.

> Even when Congress attempts to close down a perceived abuse, it frequently comes late to the rescue, reacts with excessive overkill, and then repents at leisure, if ever, only rarely returning to the scene of the accident. On the other hand, despite the frequency of statutory changes, many parts of the Code have lingered undisturbed for decades, and these provisions have long provided opportunities for creative tax planning.

Id.

25. *Id*. at 147 ("As soon as the Service kills one transaction, several new ones arise to take its place.").

mental reform[26] and illustrates how the retroactivity problem is very real indeed.[27]

The extent of the retroactivity problem also depends on how quickly lawmakers can identify and respond to abusive transactions that have already been devised. As this response time decreases, the number of taxpayers who can mimic the same transaction and benefit before legislation is enacted also decreases. Because lawmakers cannot predict abusive transactions, it becomes important that lawmakers respond to new shelters quickly. Lawmakers, however, are unable to do so. "The new corporate tax shelter[s] are more sophisticated and complex"[28] and "considerably more varied in design—and in the Code provisions they exploit—than were their predecessors."[29] These features make current tax shelters far more difficult to counteract with legislation than were earlier shelters.

Earlier tax shelter transactions were relatively homogeneous—employing the same general techniques and exploiting the same statutory and regulatory provisions to attain the same type of tax benefits.[30] As explained by Professors Chirelstein and Zelenak: "The pre-1986 shelters were all very much of a kind—virtually all involved the creation of artificial (noneconomic) losses for passive investors through the combination of tax preferences (most commonly accelerated depreciation) and interest expense deductions" on nonrecourse loans.[31] It is unnecessary to understand the details of these so-called passive real estate shelters to understand their relative significance with respect to prospective incremental reform.[32] Because the shelters were using the same basic scheme, lawmakers had a specific behavior to target, making statutory reform a feasible solution. In fact, although there is some controversy,

26. *See* Yin, *supra* note 2, at 216.

> [I]ncremental changes in the law intended to stem inefficient tax shelter activity may result instead in greater inefficiency and distortion. . . . The government first identifies a transaction or an outcome that it considers inappropriate and moves to prevent it through some change in the law. If, subsequent to the change, taxpayers still perceive the after-tax return from their desired outcome to be greater than the costs necessary to achieve that outcome, they may respond by attempting to circumvent the change in law.

Id.

27. *See* Chirelstein & Zelenak, *supra* note 22, at 1950.

28. *See* Bankman, *supra* note 3, at 1776.

29. Chirelstein & Zelenak, *supra* note 22, at 1951–52.

30. *See id*. at 1951.

31. *See id*. This is not to imply that there were no other shelters in the 1970s and 1980s. The emergence of commodity straddles, which allowed taxpayers to defer the recognition of prior capital gains, also took place before 1986 and was curbed by the Economic Tax Recovery Act of 1981, specifically I.R.C. §§ 501 and 502. *See, e.g.*, Richard W. Evans, Note, *The Tax-Straddle Cases*, 1982 Duke L.J. 114, 121–25 (describing the shelter and its tax advantages).

32. For those interested, however, there is much written on the subject. *See, e.g.*, Calvin Johnson, *University of Texas Professor Unveils Report on Passive Activity Regulations*, Tax Notes Today, Jan. 31, 1995, *available at* 90 TNT 9-32 (LEXIS) [hereinafter Johnson, *Passive Activity Regulations*]; Zelenak, *supra* note 17, at 509; Letter from Calvin Johnson, Arnold, White & Durkee Centennial Professor of Law, Univ. of Tex., to William F. Nelson, Chief Counsel, IRS (May 26, 1987), *reprinted in* 35 Tax Notes 1019 (1987) [hereinafter Johnson Letter].

many attribute the enactment of legislation meant to deal with these structures as "a major factor, if not the single most critical factor, in the curbing of tax shelter activity" in the 1970s and 1980s.[33]

Unfortunately, legislative action cannot be expected to correct the current onslaught of shelters in the same way that it did in the 1980s.[34] The rapid proliferation of shelters makes it inevitable that legislative responses will be too slow. The sheer complexity of each shelter ensures that solutions will be complicated, taking significant time to craft. Further, unlike earlier devises, the current breeds of shelters are diverse, exploiting a variety of provisions.[35] Rather than having a specific behavior to target, lawmakers are left with various, and often unrelated, abuses to juggle. As a result of this long response time, even if an amendment finally curbs a particular abuse,[36] it will leave all those taxpayers who managed to participate in these shelters during the lengthy time existing between the inception of the shelter and the amendment unaffected. To aggravate matters further, during this lag time new schemes (or variations on current schemes) will emerge.[37] Thus, by the time lawmakers have properly responded to a specific abuse, different transactions will have cropped up, making the process of prospective incremental reform dreadfully inadequate, if not futile.[38]

33. Yin, *supra* note 2, at 218–19; *see* I.R.C. § 469 (2006).

> The last tax shelter wars—involving the mass marketing of debt-financed tax shelters to upper-middle (and even middle-middle) income taxpayers in the 1970s and 1980s—ended abruptly in a sweeping government victory, as a result of the enactment of the passive loss rules of § 469 as part of the Tax Reform Act of 1986.

Chirelstein & Zelenak, *supra* note 22, at 1951. This is not to suggest that § 469 ended all abuses. Although this particular abuse has been curbed, so-called leveraged leases, transactions achieving similar effects to the individual real estate shelters discussed above, continue.

> Such a lease transaction generally involves three parties: a lessor, a lessee and a lender to the lessor. In general, these leases are net leases, the lease term covers a substantial part of the useful life of the leased property, and the lessee's payments to the lessor are sufficient to discharge the lessor's payments to the lender.

Rev. Proc. 75-21, 1971-1 C.B. 715.

So long as the parties adhere to Service guidelines, the lessor is able to transfer its investment credit to the lessee and maintain the interest and depreciation deductions to offset the received rental income. *See* Hariton, *supra* note 5, at 582 n.2. Commentators disagree, however, as to whether this transaction constitutes an abusive transaction. Hariton argues that leveraged leasing allows taxpayers to transfer incentivizing benefits to parties who can use them, thus furthering the purpose of granting the investment tax credit in the first place. *See id*. at 581–85; *see also* David P. Hariton, Commentary, *Response to "Old 'Brine' in New Bottles" (New Brine in Old Bottles)*, 55 TAX L. REV. 397, 402 (2002) (arguing that leveraged leases pass "legitimate tax benefits that have been conferred by Congress for investment in U.S. business property from one taxpayer to another (and arguably benefits Congress, since the relevant investment in U.S. business property otherwise might not take place"). *But see* Eustice, *supra* note 6, at 139 (referring to leveraged leasing as the "mother of all corporate tax windfalls").

34. *See* Eustice, *supra* note 6, at 147 ("Unlike the previous generation of tax shelter transactions, there appears to be no magic bullet, or stake-in-the-heart solution to the current problem.").

35. *See* sources cited *supra* note 22.

36. Sometimes the amendment, the purported solution, actually leads to more problems. *See supra* note 26.

37. *See* sources cited *supra* notes 24–25.

38. *See* Chirelstein & Zelenak, *supra* note 22, at 1950–51.

Finally, the magnitude of the retroactivity problem depends on the nature of the players—how prevalent are tax shelters and how aggressively are players willing to take part in them? The players in the new tax shelter battles are both enumerative and aggressive. Those who market current tax shelters—mainly investment banks and accounting firms—do so in a bullish manner because of the lucrative nature of the business.[39] They are also "much more aggressive in [their] interpretation of the tax law" than were their predecessors.[40] Further, while earlier shelters were marketed to high-wealth individuals, the market has moved to Fortune 500 companies and other wealthy corporations.[41] These taxpayers are generally willing to enter into transactions since they have "little to lose,"[42] so long as they are not subject to penalties, other than having to pay taxes they would have otherwise paid.[43] Finally, while it "is difficult to determine the size of this new tax shelter market. . . , [i]t is virtually certain . . . that annual investments in corporate tax shelters aggregate to tens of billions of dollars, and that the tax shelter market is growing at a breakneck speed."[44] In other words, the stakes of the retroactivity problem are high.

After considering these factors, it is clear that the retroactivity problem renders legislative reform a weak and entirely insufficient solution to combat the proliferation of current tax shelters. Courts, however, are able to operate retroactively because they can find already executed transactions abusive and strip taxpayers of tax benefits after the fact.[45] As a result, effective judicial intervention is essential. Discussing whether courts are best suited to have this retroactive power, or whether other branches or agencies would be better equipped to use it in this context is beyond the scope of this Article. Section C will discuss the tests that the courts use in analyzing tax shelters and argue that they are ineffective. Because courts, being able to operate retroactively, play an essential part in the current tax shelter war, this ineffectiveness is extremely problematic.

> The problem is that these targeted fixes are always made prospective only. As Congress closes one loophole, tax shelter designers find other glitches in the Code around which to build new shelters. Like the Dutch boy at the leaky dike, or Hercules attempting to conquer the Hydra by decapitation, or the man in the gospel parable who is rid of one devil only to be possessed by seven devils worse than the first, or Alice and the Red Queen running as fast as they can just to stay in the same place—the literary references go on and on—the government cannot win this game. . . . [T]he always-one-step-behind nature of this approach means that it can never be an adequate response to the proliferation of shelters.

Id.

39. *Id*. at 1939 ("The marketing of tax shelters by leading accounting and investment banking firms has developed into a perfect plague over the past decade.").

40. Bankman, *supra* note 3, at 1776.

41. *Id*.

42. Chirelstein & Zelenak, *supra* note 22, at 1940.

43. *Id*.

44. Bankman, *supra* note 3, at 1776.

45. *See infra* Part II.C.

C. The Judicial Tests Are Insufficient to Deal with the Problem

In the judicial setting, when the government believes a transaction is abusive, it contends that the transaction should not be respected for federal income tax purposes, and, therefore, the taxpayer should not be entitled to the tax benefits claimed. Courts have developed several tests to identify such transactions. If the transaction "fails" the test utilized, the court will uphold the government's position and disallow the benefits at issue.

Section C.1 discusses the main tests utilized in the tax shelter context: the economic substance doctrine, the business purpose test, and the profit test. These tests, however, do not act as sufficient screens to deal with today's shelters. Section C.2 will provide a sampling of the problems and inconsistencies that emerge when these tests are applied to today's complicated and varied shelters. This discussion will show the need for an alternative approach that makes a direct inquiry into statutory and regulatory purposes (as developed in Part III).

1. The Current Judicial Tests

The so-called economic substance doctrine is most often used to evaluate potentially abusive transactions.[46] Most courts utilize the doctrine, or one of its two prongs, to determine if a transaction is abusive. The first prong is objective, inquiring whether the transaction had any bona fide, non-tax economic effect.[47] Put another way, the test asks whether the transaction in question affected the taxpayer's economic position in any substantial way apart from the claimed tax benefits. To determine whether a transaction has a non-tax economic effect, the courts developed the now widely used profit test.[48] This test asks whether the transaction has a reasonable prospect of a pretax profit—that is, whether the taxpayer could have profited absent the tax benefits gleaned—after taking into account transaction costs.[49] The strongest version of the test was developed in a recent tax shelter case, *ACM Partnership v. Commissioner*.[50]

The second prong of the test is subjective, inquiring whether the taxpayer had any other purpose for entering the transaction other than tax avoidance (commonly referred to as the business purpose test).[51]

46. *See, e.g.*, Hariton, *supra* note 1, at 235.
47. *See* ACM P'ship v. Comm'r, 157 F.3d 231, 248 n.31 (3d Cir. 1998).
48. *See, e.g.*, *id.* at 253–54.
49. *See id.*
50. *Id.*; *see infra* text accompanying notes 105–08; *see also infra* Part IV.B.
51. For example, the Fourth Circuit applies a conjunctive test: A transaction is disregarded if (1) "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction" and (2) the "transaction has no economic substance because no reasonable possibility of a profit exists." Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006) (quoting Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985)). In contrast, the Federal Circuit

These tests, which obviously fail to directly address the question of whether the results of transactions fall outside the purposes of the tax laws, have many weaknesses that are illustrated in current cases.[52] Further, exploring these weaknesses is particularly necessary because of the increasingly significant role courts have in the current tax shelter environment. The next Section highlights some of these problems.

2. The Traditional Tests Do Not Adequately Deal with Current Shelters

The traditional tests—the business purpose test and the profit test—do not adequately identify tax shelters. This should not be surprising considering they fail to address the target directly. Some of the inconsistencies and oddities that result when these tests are applied are addressed below.

a. Profit Test

The strongest version of the profit test asks whether a transaction has a reasonable prospect of a pretax profit—that is, whether the taxpayer could have profited absent the tax benefits—after taking into account transaction costs.[53] Many problems have emerged as courts attempt to apply the profit test to potentially abusive transactions.[54]

i. Profit Test Is Both Over- and Under-Inclusive

The profit test is over-inclusive. When faithfully applied, the test erroneously identifies transactions that reach intended results as abusive. For example, the profit test might strike down transactions that utilize tax preferences to reach results intended by the law. As discussed in Part II.A, tax preferences reduce taxes on income earned from certain activities to increase investment in those activities.[55] In some instances, the preference is granted not only to provide an additional incentive to engage in a particular activity, but also to make otherwise unprofitable activities profitable. For example, § 45 grants a credit for the production

has used what appears to be something closer to a disjunctive test and has explicitly stated that it believes the Fourth Circuit's conjunctive test is discordant with Supreme Court precedent. *See* Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355 (Fed. Cir. 2006) ("While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.").

52. *See infra* Part II.C.2.

53. *ACM*, 157 F.3d at 257–63.

54. *See* David P. Hariton, *The* Compaq *Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong*, 94 TAX NOTES 501 (2002). Hariton has long argued that courts should abandon the profit test because "[t]he answer has nothing to do with whether the transaction lacks economic substance and nothing to do with whether the resulting tax benefits should be disallowed." *Id.* at 501. He continues, arguing that "the government's profit theory isn't wearing any clothes," as evidenced by recent tax shelter cases. *Id*.

55. *See, e.g.*, Zelenak, *supra* note 17; Zelinsky, *supra* note 17.

and sale of electricity produced from renewable resources.[56] Section 42 provides generous credits to those willing to invest in low-income housing projects.[57] These credits are meant to stimulate investment in activities lawmakers deem desirable. Absent additional incentives, these particular enterprises are often not profitable ventures,[58] and companies will therefore not enter into them. If the tax credits can provide tax savings that are larger than the losses the company expects to sustain on the ventures, the activity can nonetheless be stimulated. Thus, energy conservation and low-income housing credits are essential to encouraging the relevant activities.

These completely inoffensive transactions, however, are the quintessential transactions that the profit test would identify as abusive—transactions that are unprofitable before accounting for tax benefits. Thus, under the profit test, individuals engaging in these ventures would be stripped of their credits. This is an absurd result that would not occur in practice (i.e., the transaction would not be challenged by the government) because the result (the taxpayers' being able to use the credits) was the very thing the statute intended. It reveals, however, an extremely important weakness in the profit test. In difficult tax shelter cases, some of which will be discussed in Part IV, one cannot tell at a glance whether the results of these intricate transactions were intended. To make that determination, a reasoned and deliberate analysis of the purposes of the provisions at issue is required. Thus, the profit test, which does not inquire into purpose at all, may very well lead to the wrong result when applied to today's difficult cases.

The profit test is also under-inclusive, meaning that it fails to identify abusive transactions (transactions that glean unintended results). This occurs, quite simply, because transactions resulting in a pretax profit can still yield unintended results.[59] Cases tend to be very fact specific, inquir-

56. I.R.C. § 45 (2006).

57. *Id.* § 42.

58. *See* I.R.S. Priv. Ltr. Rul. 85-31-065 (May 9, 1985) (discussing the tax ramifications of a common low-income housing project that is not projected to be profitable for fifteen years); Katherine M. Breaks & Richard Blumenreich, *New Guidance on Partner Allocations of Wind Energy Production Tax Credits*, 108 J. TAX'N 95, 97 (2008).

59. Consider, for instance, one version of the so-called sale and leaseback transaction (otherwise known as a sale-in-lease-out transaction, or a SILO). A property owner (*O*) sells its property to a third party (*T*). *T* provides a down payment and mortgages the remainder of the property. *T* then leases the property back to the original owner. The rental payments are designed to be equivalent to *T*'s mortgage payments. The lease will also provide *O* with various repurchase options. The sales price will be equal to the original down payment and any remaining mortgage payments plus a specified compound interest rate. Thus, *T*'s pretax expected return is the specified compound rate minus transaction costs, a figure that will almost always be lower than *T*'s expected return on a "regular" real estate transaction. Since *T* is the "owner" of the property, however, she is entitled to take depreciation deductions against her other income, as well as any other deductions that might accompany ownership. It is the availability of these tax savings that make the deals worthwhile for *T*. *See* Frank Lyon Co. v. United States, 435 U.S. 561 (1978) (one of the most famous SILO cases). Another common related transaction is the so-called lease-in-lease-out transaction (LILO). *See* Rev. Proc. 2001-28, 2001-1 C.B. 1156 (setting forth guidelines as to whether LILOs will be respected for federal income tax

ing into whether the taxpayer is the true owner of the property such that she is entitled to these deductions, which turns on fact-specific inquiries into whether enough property rights have been transferred.[60] Some sale-in-lease-out transactions (SILOs) are found to be non-abusive, while in many other cases, the court finds that the taxpayer is not the true owner and is, therefore, not entitled to the claimed deductions.[61] The profit test, however, will *always* find that the taxpayer is entitled to the benefits, simply because there will always be *some* positive pretax profit after transaction costs. As a result, we need another test to create a sufficient screen that will not allow these abusive transactions to pass. Here, for instance, there should be an inquiry into the purpose of the various deductions being claimed and whether granting these deductions to the purported lessors (the taxpayers) are within those purposes.[62]

Thus, in some cases, the profit test casts too wide of a net and identifies innocuous transactions—transactions that reach intended results—as tax shelters, whereas in other cases, it acts as an insufficient filter and allows abusive transactions—transactions that reach unintended results—to slip by. Though these parameters could be reset correctly by looking directly at the purposes of the laws, this is not the only problem with the profit test. The definitional problems discussed below further illustrate that an alternative approach is needed.

ii. Definitional Problems Associated with the Profit Test

The profit test is also plagued with definitional problems. Most strikingly, it is not clear what qualifies as a sufficient "profit" to pass the profit test.[63] This leads to decisions that are potentially incorrect and also makes the test easy to manipulate. As courts confront complicated shelters, it becomes clear that other elements of the test are not easy to define. Struggling with these definitional points rather than confronting the purposive question directly leads to odd and inefficient decision making.

Although seemingly simple, there are many ways in which profit can be defined for purposes of the profit test. For instance, a positive profit might be all that is required.[64] While having the advantage of simplicity, this leads to the arbitrary result that a transaction having a one dollar

purposes); Rev. Proc. 75-21, 1975-1 C.B. 715 (general explanation of LILOs). An application of the profit test to this leasing transaction reveals the same problem that is revealed when it is applied to SILOs—i.e., that the test is both under- and over-inclusive. *See* Lee A. Sheppard, *Lease in, Lease out: Safe Harbor Leasing Revisited*, 81 Tax Notes 1167, 1168–69 (1998) (discussing the related LILO transaction).

60. *See, e.g.*, *Frank Lyon*, 435 U.S. at 576–81. For an excellent summary of various LILO cases, see *Mukerji v. Commissioner*, 87 T.C. 926 (1986).

61. *Compare Frank Lyon*, 435 U.S. 561, *with* Coleman v. Comm'r, 87 T.C. 178 (1986).

62. Commentators have very different opinions as to whether LILOs are abusive transactions. See *supra* note 33 for some various viewpoints.

63. *See, e.g.*, Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 Taxes 985, 987 (1981).

64. *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 253 (3d Cir. 1998).

pretax loss would fail the test while a transaction exploiting the law in the exact same way would pass if it has a one dollar pretax profit.[65]

Alternatively, something more could be required to qualify as "profit" under the test, such as a "reasonable" profit. This raises thorny questions of how such a requirement would be determined.[66] How does one determine what is "reasonable"? Should the profit be discounted to present value terms? If so, what discount factor would be used? Because of the inherent difficulties and resulting arbitrariness of defining a "reasonable" profit, courts have stuck with the requirement that any positive profit will suffice, leading to odd outcomes such as those mentioned.[67]

The fact that the profit test merely requires a positive pretax profit makes it ripe for manipulation. For example, taxpayers attempt to hide fees[68] or artificially create profits unrelated to the basic transaction[69] to make it appear as though they have passed the test. As a result, courts must engage in long, inefficient inquiries whereby they sift through the obfuscations of the transaction to reach its core components.

Defining the term "profit" is not the only definitional problem associated with the profit test. Recent cases have shown that interpreting the most basic terms of the test can be problematic, such as determining the definition of an "expense."[70] Meanwhile, as courts struggle with these definitional issues, they often fail to even consider the statutory or regulatory provisions the transactions exploit.[71]

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65. Warren, *supra* note 63, at 987.

66. *See id*.

67. *See id*. at 988 (arguing that the only possible solution is to require a mere dollar profit despite the very odd results it creates because to require something like a "reasonable" profit would be unacceptably arbitrary).

68. *See, e.g.*, Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 143–63 (D. Conn. 2004), *aff'd* 150 Fed. App'x 40 (2d Cir. 2005). In *Long Term Capital Holdings*, taxpayers—perhaps realizing that stuffing in income producing assets was too obvious—sought to hide fees instead. For example, the transactions included internal bonuses actually meant to compensate principals for their work on the transaction and legal fees structured as "consulting arrangements" in an attempt to make the arrangements seem less connected with the transaction in question. *Id*. at 163. There is no question that the fees were structured this way in contemplation of the test. Before the transactions had commenced, Long Term had discussed compensation with Babcock & Brown, the firm that aided them in the transaction, and specifically avoided cash fee arrangement. Long Term feared that "paying a cash fee could be construed as buying tax benefits which would raise questions about the economic substance of the transaction or Long Term's business purpose for it." *Id*. at 144.

69. The tendency to tack on profits to "pass" the profits test has been referred to as the "stuffing problem." Hariton, *supra* note 54, at 509.

> And even if there wasn't any profit in these transactions, you can be sure that there will be in the next 30 transactions that come before the courts, because adding in profit is like taking candy from a baby. All it requires is that the taxpayer add some net equity to the transaction so that it is effectively investing capital for a period of time.

Id. *But see* Mitchell Kane, Compaq *and* IES*: Putting the Tax Back into After-Tax Income*, 94 TAX NOTES 1215, 1215 (2002) (arguing that it will not be difficult to separate out the "stuffed in" assets).

70. Hariton, *supra* note 54, at 508.

71. *Id*.

Consider the recent case *Compaq Computer v. Commissioner*.[72] The taxpayer in *Compaq* devised a clever transaction executed for the sole purpose of acquiring foreign tax credits for foreign taxes it did not economically bear.[73] In general, taxpayers may take a dollar-for-dollar credit against their U.S. income tax for foreign taxes paid.[74] The basic notion behind the credit is to mitigate double taxation—that is, prevent taxpayers from having to pay taxes on the same income twice, once in a foreign jurisdiction and again in the United States.[75] If a taxpayer has not actually suffered an economic detriment by satisfying its foreign tax liability (as was the case in *Compaq*), however, the foreign tax credit is transformed into a windfall—allowing a taxpayer to have a dollar-for-dollar credit against her income tax at no cost.[76] Rather than discussing the meaning of the foreign tax credit provisions, the *Compaq* court wrestled with the question of whether foreign taxes should be considered expenses for purposes of the pretax profit analysis.[77] If foreign taxes were considered expenses, the taxpayer would not have a pretax profit and the tax benefits would be denied.[78] If, on the other hand, foreign taxes were not to be considered in the calculus, the taxpayer would retain the claimed benefits (i.e., the foreign tax credits).[79]

Compaq serves as an illustration of the inefficient decision making that can result from the profit test.[80] Courts harp on minutiae, such as whether a particular fee should or should not be counted in the pretax profit analysis, without ever mentioning the real problem behind the transactions—that they might fall outside the purposes of the laws.[81] Under the proposed test, developed in Part III, courts would focus on whether the result of the transaction (taking a foreign tax credit on taxes that the taxpayer did not economically bear) falls within the purposes of the foreign tax credit provisions.[82] Before proceeding to the proposed test, the next Section will show that the business purpose test (the second prong of the economic substance doctrine) is also inadequate to deal with current shelters.

72. 277 F.3d 778 (5th Cir. 2001).

73. *Id*. at 784. The complex manner in which Compaq acquired these credits will be discussed in Part IV.C.

74. *Id*. at 785.

75. *Id*. at 785–86; Norwest Corp. v. Comm'r, 69 F.3d 1404, 1407 (8th Cir. 1995).

76. *See Compaq*, 277 F.3d at 784–85.

77. *Id*. at 784–88.

78. *Id*. at 785–86.

79. *Id*.

80. *See id.* at 785–88.

81. *See id*. at 785–86.

82. Commentators often agree with this approach in the abstract but do not offer a mechanism by which to conduct the interpretive analysis. *See, e.g.*, Hariton, *supra* note 54, at 508–09. The proposed test will be applied to the *Compaq* transaction in Part IV.C.

b. The Business Purpose Test: Inconsistent Applications

The business purpose test asks whether the taxpayer had any other purpose for entering the transaction other than tax avoidance.[83] Applying the business purpose analysis, however, has proved troublesome and the courts' application of the doctrine is remarkably inconsistent.[84] This Section will discuss two of these inconsistencies. First, courts exhibit inconsistencies when defining the transaction that will be analyzed under the business purpose test. Further, courts sometimes require a strict purpose and other times allow flimsy purposes to suffice. Looking at cases illustrating these inconsistencies, one sees the court struggling to reach "sensible" results; specifically, results that seem to accord with the purposes of the laws. As discussed above, however, this cannot be done without a full and explicit analysis.

i. The Framing Question: How to Define the "Transaction"

When applying the business purpose test, courts often define the transaction in question differently, which can determine the outcome of the case. Sometimes courts find it sufficient for the transaction as a whole to have a non-tax business purpose (a test that is not extremely difficult for the taxpayer to pass).[85] In other cases, courts define the transaction narrowly, requiring the specific slice of the transaction that created the benefit to have a non-tax business purpose of its own.[86] This test is clearly more difficult to meet.

Consider two recent cases: *United Parcel Service v. Commissioner*[87] and *Coltec Industries v. United States*.[88] The taxpayer in *United Parcel Service*, UPS, is in the business of delivering parcels and, for a premium, insures sent parcels. UPS restructured its business so a foreign affiliate would provide the insurance and receive the income.[89] As a result, the income earned from insuring parcels was no longer subject to taxation in the United States. In deciding whether to uphold this result, the Ele-

83. IES Indus., Inc. v. United States, 253 F.3d 350, 353 (8th Cir. 2001).

84. *See, e.g.*, Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355–60 (Fed. Cir. 2006); United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1019–20 (11th Cir. 2001).

85. *See, e.g.*, Del Commercial Props., Inc. v. Comm'r, 251 F.3d 210 (D.C. Cir. 2001).

86. *See, e.g.*, Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 15 (2000).

> The economic substance doctrine requires that the events giving rise to a particular tax position must have objective economic substance, but does not tell us which of many interrelated events ought to be lumped together and measured for economic substance. In general, the greater the number of events lumped together, the greater the likelihood that a tax position will reflect changes in nontax attributes.

Id.; *see also* Bankman, *supra* note 3, at 1778 ("In practice, the term 'transaction' is underdefined, so that the effect of [applying the traditional tests] depends on what the 'transaction' is that is subject to scrutiny.").

87. 254 F.3d 1014.

88. 454 F.3d 1340.

89. *UPS*, 254 F.3d at 1014.

venth Circuit looked at the transaction as a whole and stated that a transaction has a business purpose "as long as it figures in a bona fide, profit-seeking business."[90] UPS clearly satisfied this test.

In *Coltec*, the taxpayer transferred its contingent asbestos liabilities, in addition to other property, to a newly formed corporation in a transaction that qualified for nontaxable treatment under § 351.[91] Coltec also transferred employees to manage the liabilities.[92] Coltec structured the transaction so it could take a high basis in the new stock and sell it at a large loss.[93] The company accomplished this by relying on a formalistic reading of the basis rules in § 351. In contrast to the Eleventh Circuit, the Federal Circuit defined the transaction narrowly, stating that it is improper to focus on the transaction as a whole in determining whether a business purpose exists, and, instead, "the transaction to be analyzed is the one that gave rise to the alleged tax benefit."[94] In slicing the transaction this way, the *Coltec* court held that it is inappropriate to focus on the business purpose of the newly formed corporation and therefore found Coltec's assertions that the new corporation would serve meaningful management functions to be irrelevant.[95]

The *UPS* transaction was upheld simply because an overall profit-seeking purpose existed for the transaction as a whole. Coltec, on the other hand, was required to show that it had a business purpose for transferring its liabilities to another corporation.[96] Once the transaction was defined narrowly, Coltec was unable to meet the test to the court's satisfaction.[97] It seems extremely unlikely UPS could have survived similar scrutiny—that is, UPS could not have proven that it had a non-tax purpose for transferring the insurance business abroad. Inconsistencies such as these create an odd and unpredictable body of law.

ii. What Is Business Purpose?

Courts have differed in defining business purpose itself, sometimes allowing somewhat flimsy purposes to suffice and other times stringently construing the requirement. Consider *Cottage Savings Ass'n v. Commissioner*[98] and *ACM Partnership v. Commissioner*.[99] In *Cottage Savings*, the taxpayer held a portfolio of mortgages whose value had declined substantially since it was acquired.[100] For the primary, if not sole, purpose of

90. *Id*. at 1019.
91. *Coltec*, 454 F.3d at 1345.
92. *See id.* at 1358.
93. *Id*. at 1345.
94. *Id*. at 1356.
95. *See id.* at 1358, 1360.
96. *Id*.
97. *Id*.
98. 499 U.S. 554 (1991).
99. 157 F.3d 231 (3d Cir. 1998).
100. *See Cottage*, 499 U.S. at 556.

obtaining a loss, the taxpayer exchanged its mortgage pool for another mortgage pool of equivalent value.[101] The Supreme Court focused on whether the taxpayer was entitled to realize its losses within the meaning of § 1001(a), which governs the timing of gain and loss recognition.[102] The Court found that the exchange constituted a "disposition of property" under § 1001(a), one of the events triggering gain and loss recognition.[103] The Court hardly addressed the economic substance of the transaction and implied it was enough that the losses were bona fide and the transaction was "conducted at arms length and actually transferred ownership."[104]

In *ACM*, the taxpayer also exchanged property of equivalent value to obtain a loss.[105] Here, the partnership (of which the taxpayer was a partner) acquired bank notes and sold the notes twenty-four days later for different notes of the same value.[106] The taxpayer carefully designed the transaction so it could take losses under a technical application of the regulations governing the sale.[107] Unlike the Supreme Court in *Cottage Savings*, the Third Circuit focused on whether the transaction had economic substance and carefully parsed through each of the taxpayer's asserted non-tax business purposes, finding none to be sufficient.[108]

The real difference between *UPS* and *Cottage Savings* on the one hand, and *Coltec* and *ACM* on the other, is that the taxpayers in the latter cases could only gain their benefits through a literal reliance on the Code and Regulations in a way that was very likely not intended. Thus, in *ACM*, rather than focusing on business purpose and how to distinguish the case from *Cottage Savings*, the court should have focused on whether the tax results gleaned (here, losses) fell within the purposes of the Regulations around which the *ACM* transaction was so carefully planned.[109]

It is possible that these inconsistent applications evidence an attempt by courts to adjust the old tests as they feel is needed to achieve "sensible results"—that is, results the courts believe to accord with the purposes of the provisions at issue.[110] In other words, courts may be

101. *Id*. at 557–58.
102. *See id*. at 554–55.
103. *Id*. at 567.
104. *Id*. at 568. In fact, the Commissioner appears to have argued only that the transaction lacked economic substance as a last resort. The argument was stated "in one sentence in a footnote in his brief." *Id*. at 567–68.
105. ACM P'ship v. Comm'r, 157 F.3d 231, 242–44 (3d Cir. 1998).
106. *Id*.
107. *Id*.
108. *Id*. at 254–60.
109. This will be addressed in Part IV.B.3, which applies the proposed test to the *ACM* transaction.
110. In *ACM*, the economic substance doctrine was used to strike down the transaction at issue. 157 F.3d at 260. Judge McKee's notorious dissent stated, "I can't help but suspect that the majority's conclusion to the contrary is, in its essence, something akin to a 'smell test.' If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.'" *Id*. at 265; *see also* Alexandra M. Walsh, Note, *Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism*, 53 STAN. L. REV. 1541, 1558 (2001) ("Accord-

reaching the right results, but for the wrong reasons. Importantly, however, one cannot know if the result is "right" until one discovers whether the benefits derived from the transactions fall outside the law's purposes—the very inquiry courts fail to make. At the same time, purpose cannot be eyeballed. Thus, courts must consider statutory purpose explicitly through a full analytical discourse. The tools for conducting this purposive analysis are developed in the next Part, which introduces a purposive test for tax shelters.

Before introducing this test, however, it is important to note that the judicial tests, as originally developed, were meant to be applied alongside a purposive inquiry. The current application of these tests thus represents a substantial deviation from that which was originally contemplated. If a purposive test is adopted, the current tests may still play a role in combating tax shelters, albeit one that is far more limited.

3. *The Traditional Tests, as Originally Designed, Are Consistent with a Purposive Inquiry*

Tellingly, when the concepts of business purpose, profit, and economic substance were first developed, they were inextricably bound to the question of purpose.[111] Thus, when judges, such as Judge Learned Hand, mentioned these concepts in early cases analyzing potentially abusive transactions, they did so with a specific, probing look at the purposes of the laws being exploited.[112]

In an early tax shelter case, *Goldstein v. Commissioner*,[113] the taxpayer borrowed money and invested the proceeds in what she knew would be a losing venture to reduce taxes on a large gambling winning. In the year the loan was commenced, the taxpayer deducted the entire amount of interest due both presently and in the future (as the law then allowed) against the winnings.[114] In future years, the taxpayer earned interest on the investment but had no offsetting interest expense.[115] Although the investments resulted in economic losses because the interest paid on the loan was more than the interest earned on the investment, the losses were more than offset by the tax savings from effectively spreading the gambling winnings over several years.[116] Thus, although the taxpayer's overall pretax income declined, her after-tax income increased. In *Goldstein*, the court considered the purpose of the Code provision allowing taxpayers to take deductions for interest paid on indeb-

ing to Judge McKee, though the majority might act as if it bases its conclusion on neutral application of an established legal test, in actuality it merely invokes the economic substance doctrine to legitimate the result it wants to achieve (i.e., to prevent the taxpayer from unfairly avoiding taxes).").

111. Helvering v. Gregory, 69 F.2d 809, 810–11 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
112. *Id*.
113. 364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965).
114. *Id*. at 736–37.
115. *Id*.
116. *Id*. at 739.

tedness.[117] After assessing this purpose, the court held that the provision required the taxpayer to have a business purpose for incurring the original indebtedness.[118] Finding this required purpose lacking, the court found that the taxpayer was not entitled to take the claimed interest deductions.[119]

Early courts asked whether taxpayers had a business purpose for entering a transaction only after determining that the Code or Regulations sections at issue required such a purpose.[120] Current courts short-circuit this indispensable step and often apply these tests without any reference to purpose at all.[121] One might view this as disintegration in judicial reasoning. On the other hand, courts might feel constrained, for various reasons, to operate within the confines of the now widely applied anti-abuse tests. I take no position as to the "fault" of the current state of affairs, and it is beyond the scope of this Article to surmise as to why courts might feel so constrained. The important point is the status quo is not working and we need an alternative test.

Finally, few would argue that the traditional tests provide necessary or sufficient conditions for identifying tax shelters.[122] There is also general agreement that the tests are inadequate filters, and the ultimate question is whether the resultant benefits are intended. Professor Gergen, who defends the tests, admits that after the traditional tests' application, "[t]here is always and finally a question of tax law."[123] There is considerable disagreement, however, on how to handle the failings of the traditional tests. Some commentators seem willing to accept these traditional tests as the best we can have, believing that there is no principled way to address the real question of purpose.[124] Others, sharing a similar skepticism, offer the unsatisfactory suggestion that the answer to the

117. *Id*. at 741.

118. *Id*. at 741–42.

119. *Id*. at 742.

120. *See, e.g.*, Arthur M. Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 61 YALE L.J. 14, 31 n.76 (1952).

121. *See Goldstein*, 364 F.2d at 741.

122. *See, e.g.*, Gergen, *supra* note 8, at 132. In his article, Professor Gergen defends the anti-abuse tests. *See id.* Hariton notes that the economic substance doctrine may serve as a necessary but not sufficient condition and that the essential question is whether the tax benefits "are beyond the scope of what the drafters of the relevant rules could reasonably have intended." Hariton, *supra* note 1, at 246.

123. Gergen, *supra* note 8, at 132.

124. Some scholars believe fervently that purpose cannot be determined in tax law. For example, Joseph Isenbergh made his viewpoint famous by stating that "there is no natural law of reverse triangular mergers." Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 879 (1982). Other scholars have expressed this sentiment as well. *See, e.g.*, Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 235, 240 (1999). Kleinbard also espouses this notion by asking, "[H]ow does one ask a model whether the benefits it dispenses were intentional? Models *do*; they do not *speak*." *Id.*; *see also* Gergen, *supra* note 8, at 139 (stating that "[i]n much of tax law, the quest for principle is Quixotic" as "tax law is not naturally or intrinsically principled"). As will be shown in Parts III and IV, which develop and apply a purposive test, these claims are overstated.

purposive question is simply customary or common knowledge.[125] I reject these notions.

Before proceeding, it should be noted that the need for an interpretive framework does not eliminate the possibility that a place remains for the traditional tests. Some situations may resemble that of *Goldstein*, where the transaction contradicted legislative purpose because it lacked economic substance, business purpose, and/or profit potential. In other words, courts might determine that, for instance, a taxpayer must have a business purpose to accord with the purpose of the law at issue. In these cases, the inquiry would circle back on itself.[126] This interpretive inquiry differs from the inquiry contemplated by the proposed test, which focuses on whether the results of transactions fall within the law's purposes, but may remain a viable method of analysis in some cases.

The following two Parts show there is a way to address the ultimate question of purpose, thus filling the gap that most recognize exists. Part III develops a test that inquires directly into the purposes of the tax law. This test is specifically tailored to the unique contextual situation of tax shelters. This alternative approach will, at the very least, serve as a needed supplement to the current tests, which we have seen fail, in varying respects, to capture the problem on their own. In many cases, however, the alternative approach will be more desirable.

III. A PURPOSIVE TEST FOR EVALUATING TAX SHELTERS

The need for a test that looks directly at the purposes of tax provisions and is tailored to the unique contextual features of tax shelter transactions should be clear. The "proposed test" accomplishes this by asking, considering the provisions of the Code and Regulations at issue, and the materials relevant to their construction and development, does the result of the transaction in question fall within any of the provisions' purposes? The proposed test focuses on the results of the transactions in question, which include any claimed benefits such as deductions, credits and losses. If the results of the transaction in question fall outside the law's purposes, the taxpayer will be denied the tax benefits.

This Part will show that a close analysis of the technical rules exploited by tax shelters will often supply a basis for denying the claimed

125. *See* Gergen, *supra* note 8, at 132.

126. *See* Bankman, *supra* note 86, at 11–12. Professor Bankman discusses the possible relationship between economic substance and statutory interpretation. *Id.* He notes that in some ways the doctrine can be seen as a method of statutory interpretation in and of itself—that is, the doctrine is derived from the text. *Id.* at 11. He notes, however, that in reality the relationship is "ambiguous" and concludes that "because the doctrine can be applied without formal discussion of text, intent, or purpose, its application is usually accompanied by, or entwined with, interpretation of the statute." *Id.* at 11–12. This intertwining, however, often leads the courts to spend most of their time on the economic substance doctrine, followed by inadequately developed statements regarding the meaning, intent, or purpose of statutory text. The proposed test provides a framework for conducting this needed analysis.

benefits (the results) without having to resort to the anti-abuse tests discussed above. This is especially true if general principles of tax law are used to fill the gaps and ambiguities of the Code. The proposed test is designed to deal specifically with the unique contextual situation of current tax shelters. Recall from Parts II.A and B some of the most significant features of these devises: current tax shelters are so sophisticated that lawmakers could not have possibly predicted nor contemplated these transactions at the time of drafting the provisions the shelters exploit.[127] Further, tax shelters are specifically designed to fit literally within the relevant provisions of the Code and Regulations, but to exploit gaps or ambiguities within these provisions to glean results that are outside of the law's purposes.[128] Finally, shelters are designed by savvy taxpayers and planners who know they are exploiting gaps or ambiguities in a way that circumvents the law's purposes.[129]

Section A of this Part sets forth a general framework for determining whether the tax benefits gleaned from exploiting these gaps and ambiguities do, in fact, cross the line. When confronted with a gap or ambiguity in a particular tax provision, courts should first consider the specific purposes of the Code and Regulations. If it is not clear what the provisions are meant to achieve, one should consider whether the gap or ambiguity might be resolved by looking at so-called general principles of tax law, which will be defined below. This Section also explains the importance of using certain types of legislative history to determine both specific and general purposes of tax provisions. Section B of this Part identifies several different types of tax provisions and provides guidelines for applying the general framework in Section A to each of these categories.

A. The General Framework

In determining the purposes of exploited laws, courts should first consider the specific purposes of the provisions. If specific purposes prove unhelpful, courts should consider whether general principles help fill the gap or ambiguity being exploited. Whether it makes sense to assume that general principles of tax law were meant to apply depends on the type of provision at issue. This Section discusses these steps and how they should be applied to several common types of provisions.

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127. *See supra* Part II.B.

128. *See* sources cited *supra* note 5.

129. *See, e.g.*, Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47, 51 (2001) ("While defining tax shelters may be difficult and while there are cases on the borderline, experienced tax professionals can usually readily distinguish tax shelters from real transactions.").

1. *Step 1: Consider the Specific Purposes*

When a gap or ambiguity in a provision is revealed through a potentially abusive transaction, courts should first look to the specific purpose(s) of the provision. Courts should ask if it is clear what the section is trying to achieve. This is often the case with tax provisions, as their structure and operation frequently speak for themselves.[130] One will often be able to determine purpose by looking at the Code or Regulations without going any further. Consider the following simple example, based on a 1939 case,[131] showing, among other things, that the motivation to exploit gaps and ambiguities in the Code is one that has stood the test of time.

> *Example 1*: Taxpayer *T* purchased a car for $1825. After five years, it had diminished in value to $220. In this same year, *T* was in a fender-bender that reduced her aging car's value to $190. Under a literal interpretation of the Code provisions governing loss deductions at the time, *T* was entitled to a deduction equal to the adjusted basis in the car less the value after the accident. Thus, *T* sought to deduct her original basis (which was also her "adjusted basis") of $1825 (the purchase price) less $190 (the value after the accident), for a deduction of $1635.

Although literally supported by the Code, this result is entirely discordant with the specific purpose of the law. The specific purpose of the casualty loss deduction is clearly to compensate taxpayers for the diminution in the value of personal property caused by certain events, such as an automobile accident. Here, *T*'s loss from the accident was $220 (the value at the time of the collision) less $190 (the value after the collision), for a loss of $30. A literal application of the Code, which would let *T* use her original basis in the calculation so that she could claim a loss far in excess of this amount, does not accomplish this purpose. *T* should only be entitled to a $30 deduction, a result that accords with the specific purpose of the statute. This result is now reflected in Treas. Reg. § 1.165-7(b)(3)(i).[132]

When courts can determine the specific purpose of the law, they should strip taxpayers of benefits that are discordant with those purposes. Of course, there will be instances in which the specific purposes of the statute or regulatory provision at issue are not clear. When this occurs, courts should turn to general principles of tax law.

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130. *See, e.g.*, Schler, *supra* note 5, at 333 (arguing that the reality is that congressional intent can often be determined, and tax practitioners, in no small part, make their livings by doing so). Thus, Schler states that inquiries into legislative intent often provide clear-cut answers. After all, the code provisions and their regulations do not exist in a vacuum—"the Code and regulations . . . have an overall structure" that aids considerably in ascertaining their underlying intent. *Id*.

131. This fact pattern is based on *Helvering v. Owens*, 305 U.S. 468 (1939), the result of which is now reflected in Treas. Reg. § 1.165-7(b)(1). *See* Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 497–98 (1995).

132. Treas. Reg. § 1.165-7(b)(3)(i) (1977).

2. *Step 2: If Specific Purposes Are Not Sufficient, Consider General Principles*

In addition to considering the specific purposes of the Code and regulatory provisions at issue, judges should account for general principles of tax law.[133] General principles of tax law refer to overarching theoretical constructs throughout the entire Code that are intended to be captured by its individual provisions.[134] One such principle is the concept that one's basis in an asset should reflect one's economic investment in that asset. Another example is the notion that "the same dollars should not be taxed to the same person more than once or deducted by the same person more than once."[135] Further, the so-called realization requirement, which generally holds that gain or loss should not be recognized until a qualifying event occurs (such as a sale), can also be considered a general principle of tax law.[136] Although there are deviations from these principles within the tax law, these general principles can sometimes be used to fill various gaps and ambiguities in the Code and Regulations. Section B sets forth a framework to determine whether it makes sense to construe whatever provisions are at issue to be in accord with these fundamental tenets.[137]

While these concepts may seem bold at first blush,[138] fundamental principles are commonly used to reach sensible results in tax cases.[139] Tax concepts are often extremely difficult to capture with palatable statutory phrases, making it essential that general principles be considered. Even what might seem to be the very simple concept of basis sometimes requires a look to general principles. Consider the following example.

133. Professor Lawrence Zelenak and Professor Deborah Geier have addressed the issue of what purposes should properly be considered when interpreting tax legislation in general. *See* Geier, *supra* note 131, at 493; Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623, 637 (1986). The views of these authors also translate well to the area of tax shelters.

134. Geier, *supra* note 131, at 497.

135. *Id*.

136. *See, e.g.*, WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 236 (12th ed. 2000).

137. *See* Geier, *supra* note 131, at 497 ("One component of statutory purpose in the income tax is the fundamental structure underlying the income tax. By 'structure,' I mean the theoretical construct that overarches the sum total of the entire Internal Revenue Code and is intended to be captured by it."); *see also* Zelenak, *supra* note 133, at 637. Zelenak advocates a "contextual, or whole statute, approach to the discovery of statutory meaning." *Id.* He continues, "It is generally accepted that particular words in a statute should not be read in isolation; rather, they must be understood in the context of the statute in which they appear." *Id*.

138. *See* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 1194–95 (1994). Hart and Sacks oppose this concept entirely and feel that even though the ultimate goal is to interpret statutes in accord with their original purpose, one cannot give meaning to the statute that the words will not bear (even if clearly discordant with that determined purpose). *Id.*

139. Deborah A. Geier, *Commentary: Textualism and Tax Cases*, 66 TEMP. L. REV. 445, 474 (1993) (arguing that in tax law even the most "ordinary terms—probably the best that Congress could have chosen—must sometimes assume a counterintuitive meaning in order to protect the structural integrity of the income tax").

> *Example 2*: Assume taxpayer *T* receives stock worth $500 as compensation for services rendered and therefore recognizes $500 of income upon receiving the stock. *T* sells the stock five years later for $600. Section 1012 defines the basis of property as "the cost of such property."[140] The Regulations provide that "cost is the amount paid for such property in cash or other property."[141] Because *T* did not pay anything for the stock (she did not provide money or other property), a literal interpretation of the Code and Regulations would give *T* a basis of $0 in the stock. As a result, she would have $600 in taxable income on the sale ($600 purchase price less $0 basis).

In the above example, even the very simple term "cost" cannot be construed in accordance with its most obvious meaning.[142] If it were, an absurd result would be reached: the double taxation of *T*'s income. Specifically, *T* would have paid tax on the original receipt of the stock when she received it as compensation and then would have paid tax again upon its sale. This violates the fundamental principle that taxpayers should not be taxed on the same dollars twice. As a result, although it is not within one's common conception of the word "cost," it is well established that, for purposes of determining basis, "cost" encompasses amounts included in taxable income. Thus, taxpayers increase their basis by the amount of money that was subject to tax to avoid double taxation. In this example, *T* would pay tax on $500 upon receiving the stock and take a $500 basis in the stock. Upon the sale, *T* would report $100 in income ($600 – $500), thereby reaching the correct result. Thus, it is sometimes clear that the purpose of various provisions is, among other things, to incorporate general principles of tax law. When this is the case, courts should disallow results falling outside of these purposes.

Scholars, such as Judge Posner, often object to the idea of using overarching principles to determine the purpose of particular provisions.[143] They argue, for instance, that courts should not look from one statutory section to another because political processes are at play in writing each statute.[144] Thus, the argument goes, it is "perilous for courts to use one statute to illuminate the meaning of another" because "the particular constellation of political pressures that produced the first statute"[145] may not have been at play in the enactment of the other. How-

140. I.R.C. § 1012 (2006). Professor Geier also discusses the nonliteral interpretation needed to make sense of the term "cost," albeit using different fact patterns. Geier, *supra* note 139, at 474–75.

141. Treas. Reg. § 1.1012-1(a) (1960).

142. Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estate & Gifts ¶ 41.2 (3d ed. 2000) ("The term 'cost,' which first entered the tax law in 1918, has never been defined by Congress, and ambiguities in its meaning have been resolved, if at all, only by administrative and judicial rulings." (citations omitted)).

143. *E.g.*, Richard A. Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. Chi. L. Rev. 263, 272–74 (1982).

144. *Id.* at 274.

145. *Id*.

ever justified such objections may be in general, they are far less compelling in the particularized context of tax law.

The provisions of the Code and Regulations are clearly interconnected and reflect a coherent structure with certain principles that are not subject to political pressures. For instance, the notions described above, such as what we wish to capture by the term basis and the idea that we should avoid double taxation and double deductions, underlie the general mechanisms at play in the Code and Regulations as a whole. These principles are not generally susceptible to alteration in individual sections based on political pressures.

Furthermore, using general principles is particularly appropriate when applying statutory or regulatory provisions to fact patterns not contemplated when the laws were enacted, particularly when the inadequacy of the language is due to inadvertence or mistake.[146] Tax shelters fit squarely within this description—almost all tax shelters take advantage of gaps and ambiguities lawmakers failed to recognize because they did not (and could not possibly) foresee the sophisticated contrivance that would be developed to exploit these gaps and ambiguities. The intuition is that in such circumstances, it makes sense to assume the purpose of the statute was to preserve the general theoretical construct of the income tax.

This Section provided a brief overview of the concept of general principles and highlighted the need to use these principles in appropriate cases to avoid absurd results. Of course, the example provided is simple, and complicated tax shelters will require more complex analyses. Such analyses are provided in Part IV. Further, general principles should be used in different manners depending on which type of provision is in question. This will be discussed in Section B of this Part.

3. Why Consider Specific Purposes Before General Principles?

Under the provided framework, courts should turn to general principles only if the specific purposes of the provisions cannot be determined or are not helpful. Why should we "prefer" specific purposes over general principles? The answer, quite simply, has to do with the nature of taxpayers and planners who engage in these shelters (and probably taxpayers in general). When possible, courts should decide cases in the narrowest manner possible. The broader the decision, the more leeway savvy players have to exploit it (something that they are clearly wont to do).

For instance, in a different context, Professor Zelenak noted the "unfortunate consequences"[147] that can occur when courts make decisions based on broad principles when they could have made their deci-

146. *See* Zelenak, *supra* note 133, at 657–58.
147. *Id.* at 644.

sions on narrower grounds. Consider the case of *Corn Products Refining Co. v. Commissioner*.[148] In this case, a farmer hedged his position in corn by purchasing corn futures.[149] The Code provided that capital assets do not include items of inventory.[150] The issue on appeal was whether the sale of the corn futures would result in ordinary income or capital gain.[151] In its decision, the Court articulated the broad principle that capital gains treatment was not intended to apply to profits made in the ordinary course of business and thereby held that the sale of corn futures would be subject to ordinary income treatment.[152] This case illustrates how broad principles can provide opportunities for subsequent manipulations.[153] The broad definition of "capital asset" articulated in *Corn Products* created an ambiguity with respect to some assets that may normally be capital but could produce income somehow linked to the taxpayer's business.[154] Latching onto this, taxpayers often inappropriately give themselves capital gain treatment for gains and ordinary income treatment for losses.[155] Instead of deciding the case broadly, the Court might have simply interpreted the term "inventory" to include inventory substitutes, resulting in a narrower decision that would have been far less prone to mischief.[156]

Although using general principles can be useful and sometimes necessary, courts should first explore whether the case can be resolved through use of specific purposes. This choice may arise more often than one might think. Recall *Example 1*. Remember that a literal interpretation of the Code would have allowed *T* to deduct her original basis (which was also her "adjusted basis") of $1825 (the purchase price) less $190 (the value after the accident), for a deduction of $1635. This result is discordant with the specific purpose of the casualty loss deduction, which is to compensate taxpayers for the diminution in value of personal property caused by unfortunate events. As a result, the taxpayer should only be entitled to a $30 deduction, the result that accords with the specific purpose of the statute (and that is now reflected in the Regulations).[157]

The case could also be decided with reference to general principles of tax law. The fact pattern implicates the fundamental principle that

148. 350 U.S. 46 (1955). Professor Zelenak uses this example to illustrate his point. Zelenak, *supra* note 133, at 644–47.

149. *Corn Prods.*, 350 U.S. at 51.

150. *Id.* at 51–52 (referring to I.R.C. § 117 (2006)).

151. *Id.* at 47.

152. *Id.* at 52–53.

153. For example, Zelenak notes that with this broad principle of capital asset, it is unclear when an asset is part of the ordinary course of business or not. Thus, taxpayers will roll the dice and give themselves capital gain treatment for gains and ordinary income treatment for losses. *See* Zelenak, *supra* note 133, at 645–46.

154. *Id*.

155. *Id*.

156. *Id*.

157. *See* Treas. Reg. § 1.165-7(b)(3)(i) (1977).

taxpayers are not entitled to take deductions for ordinary personal items—that is, they cannot deduct the diminution of value of personal assets. A literal application of the Code section on losses would allow the taxpayer to use her original basis in the calculation. This would allow the prohibited "personal deduction" through the backdoor because the loss deduction would include not only the difference between the value of the car before and after the accident ($220 – $190 = $30), but also the non-deductible decrease in value that occurred before the accident ($1825 – $220 = $1605). Clearly, the purpose of the loss deduction provision was simply to compensate the taxpayer for the loss she suffered as a result of the accident ($30), not to provide an effective override of the overarching concept that decreases in the value of personal items are nondeductible costs. Again, the correct result is to allow a $30 deduction ($220 (fair market value before the accident) – $190 (fair market value after the accident)).[158]

Although the use of both specific purposes and general principles reach the correct result, courts should use the former whenever possible. One should never underestimate the craftiness of taxpayers. The example provided above is quite simple, so it is not clear that the broader principle would create much opportunity for abuse. When dealing with the extremely complex shelters discussed in Part IV, however, it will be far less clear what unintended consequences might occur when defining the shelters in an unnecessarily broad manner.

4. *The Use of Legislative History to Determine Purpose*

In addition to the actual language of the Code and Regulations, there are other sources that can be utilized in determining the purposes of the law. Courts should attach more importance to legislative history in tax shelter cases than they generally do in other contexts. This weight is appropriate because of the general process of tax codification,[159] which renders certain types of legislative history especially useful in ascertaining a law's purposes, perhaps even more so than the actual text.[160]

"The noteworthy differences in the tax legislative process occur primarily in the committee stage."[161] The relevant tax committees consist of the Committee on Ways and Means in the House of Representatives and the Senate Committee on Finance. Unlike most legislative committees,[162] these tax committees rarely consider the actual language of a sta-

158. *See id.* § 1.165-7(b)(1)(i).

159. *See* Michael A. Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 Tex. L. Rev. 819, 833 (1991) (suggesting that tax codification is different from the codification process in other areas).

160. Most of my information regarding the legislative process has been garnered from Professor Livingston's excellent article. *See id.* Those interested in the process are encouraged to read his article in its entirety.

161. *Id*. at 833.

162. *Id*. at 833 n.58.

tute. "Instead, the staff presents members with a list of proposals in summary, '*conceptual*' form."[163] Committee members make decisions based on these summaries and only later does the *staff* reduce these decisions to actual statutory language.[164] After the committee members have made these conceptual decisions, nonpartisan specialists, such as the Joint Committee on Taxation (JCT), help draft the legislation.[165] The JCT is somewhat unique to the tax field.[166] It is a nonpartisan committee, consisting of senior members of the Ways and Means and Finance Committees.[167] Its nonpartisan staff includes lawyers, economists, and a smaller number of accountants.[168] This staff prepares the committee report during this drafting process.[169]

It is at this point that the drafts are presented to the full House and Senate floors.[170] When changes are made, they are also usually presented to staff in a conceptual manner.[171] The staff prepares the statutory materials and the conference reports.[172] While both are available to members of Congress, it is suggested that many simply read the conference reports, especially because of the highly technical nature of tax provisions and the limited amount of time members of Congress have to consider them.[173]

Importantly, members of Congress do not write the actual language of the tax statutes and might not even read the statutes before approving them.[174] Further, members of Congress are certainly not parsing through each word to make sure the statutory language perfectly captures the often complex concepts presented to staff and writers.[175] Instead, the congressional staff and writers craft the precise language pursuant to general directions from committee members.[176] This is relevant in the tax shelter area because most questions turn on the nuances of particular phrases. Dissecting the meaning of a word or phrase is not a rational way to ascertain the purposes of provisions, as the word or phrase is likely staff members' or the nonpartisan expert writers' attempt to capture the committee's conceptual wishes. This situation is only aggravated by the fact that

163. *Id.* at 833 (emphasis added).

164. Professor Livingston suggests that this process differs from the process conducted by other committees. *See id*. Even if this is not the case, it does not undermine the general point that legislative history ought to be given more weight, but it may suggest that the argument can be extended to other fields. This discussion is clearly beyond the scope of this Article, however.

165. *Id.* at 834.

166. *Id.* at 835.

167. *Id.*

168. *Id.* at 834 n.65.

169. *Id.* at 835.

170. *Id.*

171. *Id.* at 835–36.

172. *Id.*

173. *Id.* at 836.

174. *Id.* at 835–36.

175. *Id.*

176. *Id.*

it is extremely difficult to capture these often technical concepts into palatable statutory phrases. Recall the difficulties in *Example 2*, where interpreting the seemingly simple term "cost" to capture basis quickly leads to complications.[177] The committee reports prepared by the JCT or congressional staff during the drafting process often give a clear indication of the provisions' purposes and can serve as a valuable way to ascertain a statute's purpose.[178]

It is essential that the use of legislative history be limited to these types of reports that give a clear indication of "the underlying logic"[179] of a provision. Limiting the use of legislative history in this manner alleviates one of the common concerns that the legislative record is too diffuse, and often inconsistent, to be helpful. The concern is that decision makers will pick and choose from various (perhaps conflicting) reports to support their own positions, or the reports will lead to arbitrary findings.[180] If legislative history is confined to these reports, however, it will be used when, as often happens, there is a clear, coherent, and well-articulated statement of the purpose of the provision at issue. In Part IV, the *Black & Decker*[181] and *Coltec*[182] cases will provide examples where committee reports operate in this manner.

Another common objection to using legislative history is that all members of Congress approve statutory language but do not necessarily assent to the legislative history produced in enacting the law.[183] This argument makes little sense in the tax context, however, because members of Congress generally do not approve actual statutory language, and do not spend time carefully drafting each word.[184] Instead, members of Congress approve concepts.[185] Legislative history is the most obvious tool for identifying these concepts, which very well may not (and could not) have been adequately captured in the Code and Regulations. It is especially important in the context of tax shelters to fully understand these underlying concepts. In this context, the law is being applied to transactions that were not contemplated when the committee members formulated the tax concepts for staff members and writers to (try to) capture in statutory language.

177. *See supra* Part III.A.2.

178. *See, e.g.*, Richard A. Posner, *Statutory Interpretation—in the Classroom and in the Courtroom*, 50 U. Chi. L. Rev. 800, 818 (1983).

179. *See* Livingston, *supra* note 159, at 878.

180. *See generally id.* (discussing reasons for limiting the use of committee reports in determining legislative intent).

181. 436 F.3d 431 (4th Cir. 2006).

182. 454 F.3d 1340 (Fed. Cir. 2006).

183. *See, e.g.*, Reed Dickerson, *Statutory Interpretation: A Peek into the Mind and Will of a Legislature*, 50 Ind. L.J. 206, 223–24 (1975); Posner, *supra* note 143, at 274–75 (advancing a general argument against this traditional objection, and claiming that the terms of the deal are probably captured accurately in the legislative history, thus warranting that it be given at least some weight).

184. *See* Livingston, *supra* note 159, at 836.

185. *See id.*

5. *Purpose vs. Intent*

The choice to refer to the purposes of the provisions as opposed to the intent of the drafters is deliberate.[186] I do not wish to make too much of the distinction, but as it remains a viable dividing line among scholars of statutory interpretation, it seems important to address, albeit cursorily. It will suffice for purposes of this Article to explain (and drastically oversimplify) the difference as follows. An intent-based approach inquires into the intent of the drafters who enacted the laws in question.[187] Intent-based approaches force one to create the somewhat odd fiction of imagining a group of lawmakers (sometimes long perished) in an attempt to reconstruct their mindsets to apply "their" law to the fact pattern at hand.[188] My test does not harken back to the minds of drafters—that would be a particularly counterintuitive way to approach transactions that could not be contemplated at the time lawmakers enacted a particular provision. The proposed test thus differs from the test proposed by Professor Alan Gunn, which would strike down a transaction if it "yields a tax result that no sensible legislator would have approved of if the transaction had been called to the legislator's attention when the statute was drafted."[189]

A purposive approach, on the other hand, seeks to attribute a purpose to the law in question by looking at objective elements, such as the language of the statute and certain types of legislative history, to determine what the statute seeks to achieve.[190] The question is not what particular drafters sought to achieve, but what the statutory language and legislative history show the statute seeks to achieve.[191] After answering this question, courts should apply the law to fact patterns in a way that effectuates that purpose.[192] Statutory scholars have written much on this

186. I do not mean to imply that there is no existing debate as to whether a purpose-based or intent-based approach is superior. Purposivism, however, is a well-accepted approach, and some believe that it might be the most frequently used approach. For a summary of the debate regarding the two approaches, see William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990).

187. It is an understatement to say that this description simplifies the two approaches. For a discussion of the different versions of intentionalism, see *id*. at 326–32.

188. For one of the most famous criticisms of intentionalist approaches, see Max Radin, *Statutory Interpretation*, 43 HARV. L. REV. 863, 867–68 (1930).

189. Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 160 (2001). My reference to this test is meant to illustrate how an intent-based approach to tax shelters might look, not to criticize Professor Gunn, who recognizes in footnotes that he is being somewhat cavalier with the usage of intent and purpose. It should be noted, however, that Gunn's test seems to track (perhaps unintentionally) Judge Posner's approach of so-called imaginative reconstruction. Posner argues that "[t]he judge should try to think his way as best he can into the minds of the enacting legislators and imagine how they would have wanted the statute applied to the case at bar." Posner, *supra* note 178, at 817.

190. Radin, *supra* note 188, at 332–39.

191. *Id.* at 333.

192. There are, of course, many different versions of purpose-based approaches (as there are of intent-based approaches) and it would certainly go beyond the scope of this Article (and this author's expertise) to scratch the surface. For some of the variations, see, for example, HART & SACKS, *supra*

topic, and the nuances need not be captured here. The basic concepts set forth will be fleshed out in the ensuing discussions, and many examples will be provided.

6. *Summary of General Framework*

This Section has provided a general framework for determining the purposes of the Code and Regulations. When the result of a transaction falls outside those purposes, taxpayers should not be entitled to the tax benefits. In determining purpose, courts should first ask whether the specific purpose of the statute is clear. That is, is it clear what the statute is trying to accomplish? If the specific purpose is unclear or unhelpful, courts should then consider whether general principles of tax law should apply to elucidate the purpose of the provision. As discussed, specific types of legislative history should be used to help determine the purposes of the law.

There are, obviously, many different types of tax provisions, and the framework will apply differently to each category. The following Section identifies several types of provisions and outlines how they should be analyzed. These principles will also be applied in Part IV, which analyzes three current tax shelters.

B. *Applying the Framework to Different Types of Tax Provisions*

This Section identifies several types of provisions often used in tax shelters and discusses how courts should apply the proposed framework to fill the gaps and ambiguities exploited. This list is not exhaustive, nor is it the only way that provisions could be categorized. It provides, however, a useful starting point to which others might add. Further, as will be seen in Part IV, it provides helpful guidelines in analyzing complex shelters.

1. *Type 1: Provisions That Are Part of the General Structure of the Code*

The easiest cases involve transactions that exploit gaps and ambiguities in provisions that are part of the general structure of the Code. These are generally the most basic provisions of the Code, which can be viewed as establishing the default framework for taxing transactions. Such provisions would include, for instance, those governing basis[193] and § 1001, which determines the amount and timing of gain or loss recogni-

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note 138, at 102–13; Max Radin, *A Short Way with Statutes*, 56 HARV. L. REV. 388, 389 (1942). Admittedly, the authors are walking a fine semantical line in describing these two approaches. "Purpose" has quite appropriately been referred to as "a vague umbrella term for several distinct notions." Geier, *supra* note 131, at 496.

193. *See, e.g.*, I.R.C. §§ 1012, 1016 (2006).

tion.[194] Standard deductions and credits, such as the deduction for "ordinary and necessary business expenses,"[195] also fall within this category, as they simply allow taxpayers to make necessary adjustments to capture the general concept of income. In these instances, courts can assume that general principles of tax law apply to fill gaps and ambiguities. Put another way, it is the purpose of these provisions to accord with the general principles of tax law. Thus, when analyzing such provisions, courts should first consider the specific purpose of the statute. If the specific purpose is unhelpful or unclear, however, the court should move to general principles. The following examples show how general principles can fill gaps and ambiguities in provisions that are part of the general structure of the Code.

Recall *Example 2*, where taxpayer *T* received stock for compensation, thereby recognizing income upon its receipt.[196] Even though basis is simply defined as "cost," the general principle of basis dictates that *T* increase her basis by the amount of money upon which taxes were to be paid, even though this does not necessarily fit within the common definition of "cost." This adjustment is necessary so *T* will not pay taxes on the same dollars twice (another fundamental principle) when the stock is sold. Consider also the following example.

> *Example 3*: Assume taxpayer *T* sold *S* a painting for $1000. Assume also that *T*'s basis in the painting is $100. In year one, *S* took possession of the painting. Even though *T* was legally entitled to demand payment from *S* at that time, she failed to do so as a result of being a very absent-minded fellow. Instead, after five years, she finally collected the $1000 from *S*. *T* reported the income in year five.

Section 451(a) provides that "any item of gross income shall be included in the gross income for the taxable year in which *received* by the taxpayer."[197] Read literally, *T* would report the income in year five, when she has actually received the money. Section 451(a), however, is part of the general structure of the Code and seeks to accord with the general principle of realization[198]—that gain or loss should be recognized upon a specific event in which the taxpayer has a tangible increase or decrease in wealth, such as a sale or other disposition. Allowing *T* to wait until year five is discordant with this principle. To accord with the principle that § 451(a) seeks to achieve, *T* will recognize income in year one, when the income was first available to her. Even though *T* chose not to collect the money in year one (she had not actually received it), she had complete

194. *See, e.g.*, *id.* § 1001.
195. *See, e.g.*, *id.* § 162(a).
196. *See supra* Part III.A.2.
197. I.R.C. § 451(a) (2006) (emphasis added).
198. B. Douglas Bernheim & John Karl Scholz, Joint Econ. Comm., 106th Cong., Encouraging Personal Saving and Investment: Changing the Tax Treatment of Unrealized Capital Gains 2 (2000), http://www.house.gov/jec/tax/mutual/mutual.pdf.

legal right to it. Thus, at that time in year one, *T* had a clear increase in wealth, and it was entirely her choice to do nothing with it. This result is known as the constructive receipt doctrine and is now contained in Treas. Reg. § 1.451-2(a).[199] "The constructive receipt doctrine holds that income, although not actually reduced to the taxpayer's possession, is constructively received by the taxpayer during any year in which . . . it is available to him without 'substantial limitations or restrictions.'"[200]

These examples implicate sections that are part of the general structure of the Code. These are usually basic sections, which provide default rules for taxing transactions. As they are part of the general structure of the Code, it should be assumed that general principles apply. Although basic, tax shelters are sometimes built around such provisions. The transaction in *Compaq Computer Corp. v. Commissioner*,[201] for instance, utilizes such a provision.[202] The analysis will be different, though, for provisions that deviate from certain general principles. The next Section sets forth a framework to conduct this analysis.

2. *Type 2: Provisions That Deviate from Certain General Principles*

Many provisions deviate from general principles of tax law. Provisions may deviate in different manners, though, so it makes sense to consider these different types of provisions separately. The list of deviations provided here is not exhaustive, but it provides a strong starting point. This Section first discusses provisions that grant tax benefits for reasons apart from capturing the general concept of income. I call these provisions the "giveaway" provisions. In most cases, the specific purposes of giveaway provisions are clear, and the purpose for the deviation from general principles can be ascertained through the language and legislative history of the specific provisions.

Other provisions deviate from general principles in a more complicated way. This Section second deals with provisions that are compromises between accurate income capturing and administrative practicability. It is often more difficult to determine the specific purposes of these provisions, and general principles can only sometimes be used to fill the gaps. Courts must therefore determine how general principles can be used (if at all) to fill the gaps and ambiguities exploited by taxpayers. The essential question in these cases is whether, and to what extent, it is the purpose of the provision to accord with certain general principles.

199. Treas. Reg. § 1.451-2(a) (1979).
200. KLEIN ET AL., *supra* note 136, at 325 (citing Treas. Reg. § 1.451-2(a)).
201. 277 F.3d 778 (5th Cir. 2001).
202. *See infra* Part IV.C.

a. Deviation Type 1: Giveaways

Giveaway provisions deviate from general principles by allowing taxpayers to reduce their income in a way they could not under general principles.[203] These provisions set forth various requirements that must be met to qualify for the tax savings provided. In general, the specific purposes of these giveaway provisions are ascertainable, especially by using committee reports as a supplemental tool. As a result, with respect to this type of provision, courts will usually not need to consider general principles. Two main giveaways will be discussed.

i. Giveaways to Encourage Behavior

Giveaway provisions enacted to encourage behavior provide mechanisms whereby taxpayers qualify for tax savings if they engage in a particular activity. For example, the energy conservation credit grants a credit for the production and sale of electricity produced from renewable resources,[204] and the low-income housing credit provides generous credits to those willing to invest in low-income housing projects.[205] These provisions often have the purpose of encouraging a particular type of activity, which is generally apparent from the language of the provision. Legislative history will frequently be a useful supplemental tool because the purposes of the provisions are often stated clearly in committee reports. For instance, in discussing the reasons for permanently extending the low-income housing credit, the House Report states under "Reasons for Change" (the change being the permanent extension of the credit), "The committee believes the low income housing credit is a useful incentive for increasing the stock of affordable housing available to low-income individuals."[206] Thus, the report clearly states what that section means to accomplish. Because specific purposes should be used whenever possible,[207] it will frequently be unnecessary to consider general principles. Instead, the relevant question will be whether the utilization of the giveaways in a particular transaction advances the purpose of encouraging the identified type of behavior. Of course, taxpayers will sometimes concoct strange ways to make the most of these giveaways.

Consider the so-called accelerated depreciation preference.[208] This preference provides an Accelerated Cost Recovery System (ACRS) that allows taxpayers to take depreciation deductions on identified assets ex-

203. *See, e.g.*, I.R.C. § 45 (2006) (giveaway to encourage behavior); Victims of Terrorism Tax Relief Act, Pub. L. No. 107-134, 115 Stat. 2427 (2002) (codified in scattered sections of 26 U.S.C.) (giveaway to correct perceived unfairness).

204. I.R.C. § 45.

205. *Id*. § 42.

206. H.R. Rep. No. 103-111, at 843 (1993), *as reprinted in* 1993 U.S.S.C.A.N. 378, 612.

207. *See supra* Part III.A.1.

208. *See supra* text accompanying note 31.

ceeding their economic decline in value.[209] The purpose of ACRS is to encourage investment in these assets.[210] When ACRS is applied to a qualifying asset,[211] the taxpayer's taxable income is lower than her economic income with respect to that asset.

For example, assume taxpayer *T* purchased property for $100 million and earned $10 million in rental income from the property. Assume also that the property actually declined in value by $2 million, but *T* was entitled to an accelerated depreciation deduction of $5 million. As a result, *T* will have taxable income of $5 million ($10 million rental income – $5 million depreciation), even though her actual income is $8 million ($10 million rental income – $2 million actual depreciation). The $3 million in tax savings, however, is in line with the purpose of ACRS to encourage investment in the qualifying property.[212]

Those engaged in the now well-known passive real estate shelters used funds borrowed on a nonrecourse basis to purchase qualifying real estate property. By combining the interest deduction available on borrowed funds and the accelerated depreciation deduction available on the property, these shelters allowed the taxpayer to use the depreciation deduction to offset income completely unrelated to the real estate investment to which it is attached.[213] While this may be abusive, it is not because it flouts the purposes of the ACRS provisions. For purposes of analyzing the ACRS provisions, the question is whether claiming the accelerated deduction was outside the provisions' purpose to stimulate investment in the activity. It cannot be said that this is the case, however—the taxpayer made the desired investment in the property, regardless of

209. I.R.C. § 168 (2006).

210. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 75 (Comm. Print 1981) [hereinafter JOINT COMM. ON TAXATION].

211. I.R.C. § 168.

212. *See* JOINT COMM. ON TAXATION, *supra* note 210.

213. Assume *T* borrowed the $100 million on a nonrecourse basis and purchased property with those funds. Assume the interest rate on the loan was 8%. Because the money is borrowed on a nonrecourse basis, *T* will never be personally liable to repay any amount that exceeds the value of the property. Assume again that *T* earns $10 million in rental income from the property, the property actually declined in value by $2 million, and *T* is entitled to take an accelerated depreciation deduction of $5 million. Had *T* not used borrowed funds, she would again have taxable income of $5 million ($10 million rental income – $5 million depreciation), even though her actual income is $8 million ($10 million rental income – $2 million actual depreciation). These tax savings simply reflect the benefit of an ACRS. Because *T* used borrowed funds, however, *T* will pay $8 million in interest, resulting in $0 of actual income ($10 million rental income – $2 million actual depreciation – $8 million interest), and will have a $3 million tax loss ($10 million – $5 million accelerated depreciation deduction – $8 million). *T* will use this $3 million loss to offset other, completely unrelated income. *See* Zelenak, *supra* note 17, at 509. The case being described is a passive real estate shelter, a popular transaction in the 1970s and 1980s. *See* Johnson Letter, *supra* note 32 (stating that most of these cases can be "explained economically by the fact that the purchaser is paying for the property with play money, that is, nonrecourse liability to his seller that he cannot be expected to pay"); *see also* Johnson, *Passive Activity Regulations*, *supra* note 32. Johnson suggests that many of these loans were in fact abusive in and of themselves: "The most abusive shelters before 1986 took advantage of the law's presumption that an I.O.U. was as good as payment in gold. Confetti money and play money debts allowed taxpayers to get deductions from debts that represented trivial economic detriments, in present value terms." *Id.*

how she acquired the funds to do so and regardless of the type of income that the deduction ultimately offset.[214]

Passive real estate shelters were indeed deemed abusive and eventually addressed through legislation. The point of this exercise is not to imply that the legislation should not have been enacted, or that the transaction could not be found abusive on other grounds,[215] but simply to show how one would analyze the transaction with respect to the ACRS giveaway provision. In other words, the transaction may be abusive, but not because it flouts the purpose of the accelerated depreciation provisions.

ii. Giveaways to Correct Perceived Unfairness

Other giveaway provisions are best categorized as relief provisions designed to alleviate hardships. In some cases, Congress enacts provisions to aid particular groups suffering hardships for reasons independent of the Code. In 2002, for instance, victims of terrorist attacks were not required to include disaster relief payments that they otherwise would have been required to report as income.[216] This Section, however, will not focus on these types of relief provisions because they do not tend to be the focus of current tax shelters.

Instead, this Section will focus on relief provisions that deviate from general principles to grant relief from perceived hardships that result when the tax law is applied to certain situations. It will almost always be possible to ascertain the specific purposes of these provisions, making it unnecessary to consider general principles. In analyzing these provisions, courts should identify the situation the provision seeks to address and determine whether the taxpayer claiming the benefit falls within that situation. Courts should not attempt to determine "who" the provision was originally meant to benefit. Sometimes provisions are enacted simply to please a small, powerful lobbying group. A relief measure that was enacted "because of" such a group certainly does not mean that the benefits should be so limited.

Consider § 1301, which allows farmers to average income earned in one year over the prior three years.[217] General principles require taxpayers to recognize all income in the year in which it was earned.[218] The application of this general principle to farmers, however, created what

214. Zelenak, *supra* note 17, at 512 ("In each case, $100 [million] has been invested in an ACRS asset, and a system designed to encourage such investment should be as ready to grant a tax preference in one case as in the other.").

215. In fact, I believe a strong argument could be made that the taxpayer was not entitled to the interest deduction because her deduction falls outside the purposes of the provisions granting taxpayers interest deductions on indebtedness. The argument is that this type of nonrecourse indebtedness was not the type contemplated by the statute.

216. Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (2002).

217. *See* I.R.C. § 1301 (2006).

218. *See, e.g.*, *id*. § 32 (allowing an earned income tax credit per taxable year).

Congress perceived to be an unfair result. Because farming is dependent on many uncontrollable factors, there is great vacillation in earnings from one year to the next. Under general principles, a farmer may have several years of little to no income. In these years, that farmer will be unable to use most (if any) deductions, including business expenses. If, several years later, the farmer has an extremely profitable year, she is forced to pay tax on the large gains, but cannot deduct the many business expenses incurred over past years that finally produced the profitable crop.

Section 1301 seeks to ameliorate this effect.[219] Allowing farmers to average their income over the prior three years permits them to use past deductions and to spread the income recognized more evenly over the years they worked to earn it. The specific purpose of the statute—to relieve farmers from the unfair result caused by annual income reporting—is relatively clear from the language of § 1301.[220]

Additionally, committee reports often will be useful to further illuminate the purposes of these provisions, as they are for § 1301. Under "Reasons for Change," the House Report discussing § 1301 states, "Income from farming . . . can fluctuate significantly from year to year due to circumstances beyond the taxpayer's control. Allowing . . . farmers . . . an election to average their income over a period of years mitigates the adverse tax consequences that may result from fluctuating income levels."[221] There is no foreseeable reason to consider general principles when the specific purpose of the statute is clear.

Taxpayers will attempt to exploit these types of relief measures by trying to fit within the identified group, and they may even change their behavior to do so. The quintessential example of this is a lawyer who buys an orange grove, which she never visits, to reap the attendant benefits.[222] Thus, courts must ask whether this result—this taxpayer claiming the relief—is within the purposes of the provisions.

As discussed above, determining the purpose of relief provisions that require a deviation from general principles will often require courts to question whether the provision was meant to grant relief to a certain class of taxpayers or to those engaging in a particular type of activity. Though similar, these groups are not the same. The former entangles courts in strange inquiries regarding identity—e.g., is this the type of farmer to which the relief was meant to apply? Absent additional definitions[223] that would clarify the statute's purpose, specific inquiries into

219. *See* H.R. Rep. No. 106-467, pt. 1, at 90 (1999).

220. *See* I.R.C. § 1301.

221. H.R. Rep. No. 106-467, pt. 1, at 90.

222. *See, e.g.*, Steven A. Dean & Lawrence M. Solan, *Tax Shelters and the Code: Navigating Between Text and Intent*, 26 Va. Tax Rev. 879, 880–81 (2007).

223. Importantly, § 1301 has detailed definitions that make this clarification possible, including definitions of who is considered a "farmer" and what types of income is considered derived from a "farming business." *See* I.R.C. § 1301; Treas. Reg. § 1.1301-1 (as amended in 2008).

which exact individuals (or types of individuals) the provision was meant to benefit should be avoided. Otherwise, courts may find themselves identifying the lobbying groups responsible for legislation. Instead, courts should determine the type of activity or the type of situation that created the specific unfairness for which lawmakers drafted relief. Thus, absent additional definitions, the purpose of § 1301 is to grant relief for those engaged in the business of farming (an occupation that creates a tax "bunching" effect). Relief should not be limited to, say, small farmers or those making their livelihood solely through farming, even though that might be the type of farmer lawmakers originally had in mind.

Consider also the so-called dividends received deduction (DRD), which provides another example of provisions designed to correct perceived unfairness resulting from general application of the tax law. The DRD allows a corporation to take deductions equal to a large percentage of the dividends it receives from other corporations, drastically reducing, if not completely eliminating, its tax on such distributions.[224] The purpose of the rule is to ensure that corporate income is, roughly, taxed only once before being distributed to non-corporate shareholders.[225] This rule deviates from general principles because a corporation would normally pay tax on the entire dividend received, as the dividend would ordinarily count as income.[226] Application of this general tax principle, however, would create a "cascading effect" that lawmakers deemed unfair to non-corporate shareholders.[227] Thus, should a question arise as to whether a corporation should be entitled to the DRD, the proposed test would ask if granting the DRD to a particular corporate taxpayer corrects the situation that the provision is designed to address—"prevent[ing] the multiple taxation of income as it flows from the corporation that earns it to the ultimate noncorporate shareholder."[228]

Provisions such as the DRD and § 1301 seek to correct a perceived unfairness that results when general tax laws are applied to a specific situation.[229] In analyzing potentially abusive transactions, courts should ask whether the transactions fall within the situation that the provision seeks to address. The *Black & Decker*[230] and *Coltec*[231] transactions, discussed and analyzed in Part IV, involve this type of provision.

224. See I.R.C. §§ 243–246 (2006).

225. BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 5–48 (7th ed. 2006).

226. I.R.C. § 61(a)(7) (2006).

227. Rosanne Altshuler et al., *Understanding U.S. Corporate Tax Losses* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 14405, 2008), *available at* http://EconPapers.repec.org/RePEc:nbr:nberwo:14405.

228. H.R. REP. NO. 98-432, pt. 2, at 1180 (1984), *as reprinted in* 1984 U.S.S.C.A.N. 697, 852.

229. *Cf.* H.R. REP. NO. 106-467, pt. 1, at 90 (discussing unusual hardships on farmers that led to § 1301).

230. 436 F.3d 431, 433 (4th Cir. 2006).

231. 454 F.3d 1340, 1345 (Fed. Cir. 2006).

This Section has outlined the ways in which courts should analyze giveaway provisions to determine if a transaction's result (claiming the tax benefits) falls outside of the provisions' underlying purposes. The specific purposes of these provisions are often ascertainable, making it unnecessary to consider general principles. In contrast, the next Section discusses a different type of provision that requires general principles to play a more important role.

b. Deviation Type 2: Compromises Between Accurate Income Capturing and Administrative Practicality

Other provisions deviate from the general structure of the Code to balance the goal of taxing true income with the need to maintain administrative practicality.[232] It is often more difficult to determine the specific purposes of these statutes, but general principles can sometimes be used to fill the gaps. The essential question courts should ask is whether, and to what extent, it is the purpose of the provision to accord with certain general principles. Courts must keep in mind, though, that simply because a provision deviates from certain general principles does not mean that general principles are inapplicable. For instance, while a provision may deviate from *a* general principle, it may not do so completely. Further, that provision may not deviate from other general principles at all. As a result, courts must determine the nature of the deviation to answer the essential question posed above.

This Section explores two very different types of "compromise" provisions. Lawmakers must often craft provisions that deviate from general principles to (hopefully) make the tax process more administrable.[233] These provisions differ dramatically, however, in the way they achieve this goal. Some provisions deviate from general principles for purposes of convenience but do not abandon general principles altogether. In this class of provisions, general principles may be very helpful. Other provisions are nothing more than ad hoc compromises between accurate income capturing and administrative practicality. Here, general principles are essentially useless.

These two types of compromise provisions are located on opposite ends of a spectrum. While not always a clear-cut task, approximating a provision's placement on this spectrum provides a useful starting point for applying the proposed test to various transactions. An illustration of how to apply the guidelines provided below can be found in the analysis of the CINS transactions in Part IV.

232. Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 599 (1965).

233. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1148 (1974).

i. Deviations with Specific Purposes and Assumptions

Some provisions deviate from general principles for purposes of administrative convenience, but do not abandon general principles altogether.[234] Instead, these provisions seek to achieve results that reflect general principles while still accounting for administrative concerns.[235] Often, taxpayers will engage in transactions that benefit from these provisions but stray from the contemplated results. In these cases, courts should ask whether doing so has violated the purpose of the provision. If so, the taxpayer should not be entitled to the benefits.

For example, consider the treatment of loan proceeds in the Code. Loan proceeds are not included in gross income,[236] though they would obviously be included under a pure application of the general principle of realization, which seeks to impose tax when a specific event has occurred, resulting in a clear increase in a taxpayer's wealth.[237] The law deviates from this principle, however, as a matter of administrative convenience. To comply with realization principles, taxpayers would have to account for loan proceeds when received, and then deduct the same amount upon repayment. Because most loans are paid in full,[238] though, this double accounting is unnecessarily cumbersome, so the Code allows taxpayers to exclude loan proceeds from income when received.

Although the rule deviates from a pure application of general principles, its purpose is to accomplish a specific result that roughly accords with the realization principle while accounting for administrative concerns.[239] Specifically, because most taxpayers repay their loans,[240] the result is essentially the same if they do not report the loan or if they report the loan in one year and deduct the same amount upon repayment (i.e., the latter scenario also nets to zero). This desired result will be called the net result. Underlying the rule's purpose to achieve the net result is the assumption that the loan will be repaid—the purpose of the rule will not be fulfilled if this assumption proves false.[241] If, then, a taxpayer fails to repay the loan (in part or in full), she must report the loan proceeds (or the amount she did not repay) to achieve the net result. This repayment is known as recognizing "income from discharge of indebtedness" and is codified in § 61(a)(12).[242]

234. *See id.* (describing various degrees of compromise that are sometimes necessary to achieve practical administration).
235. *See id.*
236. *See, e.g.*, KLEIN ET AL., *supra* note 136, at 178.
237. *See supra* note 198 and accompanying text.
238. KLEIN ET AL., *supra* note 136, at 182.
239. This is not to imply that there are not other reasons behind the rule that loan proceeds do not have to be included. For example, taxing the receipt of loan proceeds "would impose a heavy front-end burden on debt financing of investment projects." *Id*.
240. *Id.*
241. *Id*.
242. I.R.C. § 61(a)(12) (2006).

Although this tax result is "not debatable,"[243] and thus presents a simpler situation than tax shelter cases, it illustrates an essential point: provisions may deviate from general principles for administrative convenience. Their purpose, however, may be to achieve a specific result that still reflects general principles. This result can often be achieved only by making assumptions. If these assumptions prove incorrect, thereby benefiting the taxpayer, courts should consider whether adjustments must be made to comply with the law's purpose, thereby stripping the taxpayer of the benefits. These principles are applied in Part IV.B, which analyzes the so-called CINS transactions.

ii. Deviations That Are Ad Hoc Compromises

On the other end of the spectrum lie provisions that are nothing more than ad hoc compromises between accurate income capturing and administrative convenience. These provisions are essentially formulaic. If the taxpayer complies with the "formula," she should get the benefits sought. General principles will not be useful in analyzing these provisions. To put it in the framework of the proposed test, it is the purpose of these provisions for taxpayers to enjoy the provided benefits so long as they strictly comply with the requirements provided. These requirements are often quite detailed and exact. Consider the following.

> *Example 4*: Assume *T* holds shares of stock *A* with a basis of \$100. Assume the stock is now only worth \$25. *T* does not want to get rid of the stock, but would like to recognize the loss in value now in order to deduct it against her current income. Taxpayers, however, do not recognize losses on the diminution in value of assets such as stock. Instead, under the realization principle, there must be an event, such as a sale or disposition. For the sole purpose of triggering a loss, *T* sells the stock, claims the loss, and immediately repurchases the stock so that she has the same ownership in stock *A* before and after the transaction.

Section 1001(a) sets forth the general principle of realization that losses on property will be recognized upon a sale or other disposition. Thus, under a literal application, *T* may take the loss.

To prevent this selective realization of losses, Congress enacted the so-called wash sale rules provided in § 1091.[244] This provision deviates from the general realization principle by providing additional conditions that a taxpayer who buys and repurchases "substantially identical stock or securities" (SISS) must comply with in order to claim losses.[245] These conditions are detailed and exact. For instance, the taxpayer may not take a loss on the sale of stock if they have purchased SISS "within a pe-

243. KLEIN ET AL., *supra* note 136, at 236.
244. I.R.C. § 1091 (2006).
245. *Id.* For an excellent discussion of these conditions see, for example, BITTKER & LOKKEN, *supra* note 141, § 44.8.

riod beginning 30 days before the date of such sale or disposition and ending 30 days after such date."[246] Further, "substantially identical stock or securities" are defined with great precision in the Regulations, which provide formulae for making the determination of what qualifies as SISS.[247] These detailed conditions evidence a purpose of rigid compliance—the taxpayer must comply with the provisions exactly to take the loss. If she does so, however, she can take the loss even if the results appear questionable. For instance, there is a detailed set of regulations setting forth circumstances under which two portfolios will be considered SSIS.[248] Compliance with these regulations allows taxpayers to dispose of one type of portfolio and immediately reacquire another that seems quite similar. If the taxpayer's transaction does not meet the prescribed criteria of the Regulations, she has no room to argue that she is nonetheless entitled to the loss. On the other hand, if her transaction fits the letter of the law, the government has no room to argue that the wash sale rules ought to apply anyway. Under the proposed test, taxpayers who comply literally with these provisions' requirements will be entitled to the benefits.

This Part has presented two types of compromise provisions that fall on opposite ends of a spectrum. When applying the proposed test to compromise provisions, the starting point is to determine where the provision falls on the spectrum. This Part also provides guidelines to analyze these provisions once this placement has been determined. These concepts will be applied in Part IV. Before proceeding, however, some anticipated objections should be recognized.

C. Anticipated Objections to the Proposed Test

Some will argue that the proposed test creates too much uncertainty, thus infringing on the taxpayer's supposed right to rely on the words of the Code.[249] Without further study, however, one should not overes-

246. I.R.C. § 1091(a).

247. *See, e.g.*, Treas. Reg. § 1.246-5(c) (1995) (outlining how to determine if baskets of stocks are substantially similar); *see* BITTKER & LOKKEN, *supra* note 141, ¶ 44.8.3.

248. Treas. Reg. § 1.246-5(c).

249. *See supra* note 124. I think it fair to assume, however, that these arguments are drastically overstated. There is more than ample evidence that interpreting statutory purpose is possible in light of the many cases in which it is successfully done. Further, there is no reason to believe that tax law is any different from other areas of law in terms of the ascertainability of purpose. The reality is that congressional intent can often be determined, and tax practitioners, in no small part, make their livings doing so. Schler, *supra* note 5, at 333. Inquiries into legislative intent often provide clear-cut answers. After all, the Code and Regulations do not exist in a vacuum. Instead, they "have an overall structure" that aids considerably in ascertaining their underlying intent. *Id*.

Furthermore, some scholars suggest that taxpayers' claims that they have a right to certainty are overstated, if not entirely unfounded. Moreover, it is not clear whether a taxpayer right to certainty even exists in tax law. Although Learned Hand stated in *Gregory v. Helvering* that there is no patriotic duty to minimize taxes, such a statement is a far cry from establishing a right to rely on the tax law. No authority supports the proposition that the right exists. Weisbach, *supra* note 14, at 221 ("[N]o moral or philosophical basis for the right to tax plan has yet been articulated. There is no constitutimate the level of uncertainty that will result from the proposed test. As discussed in Part II, the traditional anti-abuse tests are so fraught with problems that they themselves produce significant uncertainty.[250] Thus, the proposed test might actually create more certainty than the anti-abuse doctrines as they are currently applied.

Furthermore, in looking at the problem of certainty, one must remember the players involved. Those who exploit tax shelters are remarkably sophisticated parties, not simple folk falling into traps for the unwary. There is ample support in statutory interpretation scholarship for taking into account the nature of the audience when interpreting a statute.[251] Here, the players are quite aware they are pushing the limits of the Code and Regulations, and they also possess an in-depth understanding of the tax law. Notions that these players are somehow "caught by surprise" fail to take into account the nature of the players.[252]

Most importantly, maximum certainty does not necessarily (and likely does not) lead to optimal certainty because of the existence of other competing values, such as general welfare and the effect of the test on taxpayer behavior.[253] Certainty is not, in and of itself, a good to be maximized. Instead, the relevant inquiry is to find the optimal level of certainty—namely, the level of certainty that maximizes efficient behavior.[254] Considering the nature of the tax shelter war, a relatively high amount of uncertainty should be tolerated to stop aggressive tax shelter participants from continuing to proliferate these revenue-draining transactions.[255]

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tional right. There is not even an explicit statutory right. There is, in short, no basis for a right to tax plan other than statements made up out of thin air by a few judges using questionable theories of statutory interpretation.").

250. Admittedly, there are no studies to date that quantify the level of uncertainty produced by the traditional anti-abuse doctrines. *See* Weisbach, *supra* note 14, at 247–51.

251. *See, e.g.*, Zelenak, *supra* note 133, at 664.

252. *See also* Hariton, *supra* note 5, at 585. Hariton summarizes this situation nicely:

> [I]f a taxpayer applies rules that were designed to function in a specific context (*e.g.*, the passage of congressionally-sanctioned investment-related tax benefits from one taxpayer to another) to an entirely different context (*e.g.*, the creation of unintended tax benefits), the taxpayer is not necessarily entitled by law to the results that the rules appear to dictate. Regulatory and judicial authorities should respond to such a taxpayer not by bending or negating the rules, but rather by explaining that the rules have contextual limitations. After all, any taxpayer sophisticated enough to enter into a tax-motivated financial transaction does so with the guidance and advice of a tax lawyer, and a tax lawyer can be expected to have not merely the capacity to apply technical rules literally but also an understanding of the scope, purpose, and function of the rules and therefore the limits of their application.

Id.

253. Weisbach, *supra* note 14, at 249.

254. *Id*. at 247–51.

255. *See, e.g.*, Eustice, *supra* note 6, at 147.

> [T]he desire of tax practitioners for predictability, while unsurprising and even laudable, may eventually have to yield to a higher necessity—that these highly abusive transactions somehow have to be stopped, or at least seriously impeded, and if menacing ambiguity is the only way to do it, then do it we must. Such an eventual outcome, it should be noted, would be a self-inflicted wound.

Id. For completion, I should note that the so-called rule of lenity is also founded upon certainty concerns. This refers to the statutory principle that criminal statutes should be strictly construed in favor

Opponents may point to a general argument posited by many scholars of statutory interpretation that the room for judicial interpretation should diminish as a statute becomes increasingly complex and detailed.[256] Opponents may further contend that this argument is particularly applicable to tax law, which is notoriously complicated and detailed. As apt as this principle might be in most contexts, however, the unique features of the current tax shelter war dictate reconsideration.[257] As Professor Zelenak argues,

> It is possible . . . that complex statutes require nonliteral interpretations less often than simple statutes. But if this is so, it is not due to statutory complexity as such; rather, it is due to an inverse correlation between complexity and the number of fact patterns to which the statute must be applied that were not considered by the enacting Congress.[258]

In the tax shelter context, then, the traditional argument will frequently fail because tax shelters generally involve fact patterns that were not contemplated. In this context, the principle should be turned on its head. That is, "the more detailed the statutory [or regulatory] limitations, the more rigorous the courts' defense of that regime should be."[259] If Congress and the Treasury are clearly struggling to curtail a specific abuse, but taxpayers keep finding ways to fit within the cracks of the newly constructed wall, courts must confidently step in to preserve the purposes behind the provisions.[260]

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of the defendant and against the government or parties seeking to enforce the statutory penalties. NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 59:3 (6th ed. 2001).

My Article does not consider the rule of lenity as it is to be applied in the criminal context. I assume it to be irrelevant to the civil questions presented by tax shelter cases—namely the taxpayer's liability—and presently take no position on the criminal elements, such as penalties, that might come with flagrant abuses. For a discussion as to why this assumption might prove questionable, see generally Kristin E. Hickman, *Of Lenity,* Chevron*, and KPMG*, 26 VA. TAX REV. 905 (2007). Professor Hickman describes the courts' recent tendency to use the rule of lenity in civil cases and suggests that such application is entirely inappropriate to tax shelter cases.

256. Indeed, this proposition has historical support as well as support in the general literature regarding statutory interpretation. In the Board of Tax Appeals' opinion in *Gregory v. Commissioner*, the Board held for Mrs. Gregory because she had literally complied with the detailed reorganization provisions. 27 B.T.A. 223, 225 (1932). "A statute so meticulously drafted," the Board stated, "must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration." *Id.* Learned Hand, although reversing the decision, still agreed with the general notion "that as the articulation of a statute increases, the room for interpretation must contract." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

257. Eustice, *supra* note 6, at 158.

258. Zelenak, *supra* note 133, at 660.

259. Eustice, *supra* note 6, at 158.

260. For an alternative viewpoint, see Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality; Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001). Professor Aprill applies the general theories of statutory interpretation espoused in Professor Frederick Shauer's book *Playing by the Rules* to the tax shelter context. *Id.* at 14–22. Professor Shauer posits through "presumptive positivism" that literal application of the rules should serve as a starting, or default, point. FREDERICK SCHAUER, PLAYING BY THE RULES 12 (Clarendon Press 1991). Purposive application should be used when it is prudent to do so, a determination that can be made by considering the goals of certainty, reliance and predictability. *Id.* Aprill argues that Shauer's theory supports the general principles of statutory interpretation

IV. Applying the Proposed Test

The proposed test asks the following question: considering the provisions of the Code and Regulations at issue and the materials relevant to their construction and development, does the result of the transaction in question fall within any of the provisions' purposes? This Part applies this test, along with the framework and concepts developed in Part III, to three recent tax shelter transactions. This application will not only illustrate how the framework operates, but also show the feasibility of applying the proposed test to complex shelters. Finally, and most importantly, it will show that the proposed test will, in many circumstances, be superior to traditional anti-abuse tests. The proposed test can address tax shelters directly and produce a body of law that is consistent and avoids the inefficient decision making discussed in Part II.B.

A. The Black & Decker *and* Coltec *Cases*

In *Black & Decker*[261] and *Coltec*,[262] the taxpayers took advantage of ambiguities in the basis rules applying to § 351 transactions to claim extremely large losses. Section 351 provides a way for taxpayers to transfer money and property to a corporation in exchange for stock of that corporation without recognizing gain or loss on the exchange.[263] This transaction will be analyzed under the proposed test.

1. The Transactions

Black & Decker (B&D) and Coltec formed companies in transactions that easily qualified for nonrecognition treatment under § 351.[264] They transferred contingent liabilities and contributed large sums of money and other miscellaneous properties in exchange for stock of these newly created corporations (Newcos), while retaining the underlying businesses.[265] Soon after, the taxpayer-transferors sold the Newco stocks, claiming capital losses.[266] These losses were quite large as both B&D and Coltec claimed a basis in the Newco stocks equal to the money contributed, unreduced by the amount of contingent liabilities transferred to and assumed by, the Newcos.[267] The taxpayers then transferred over lia-

set forth in *Gregory v. Helvering* because as the level of detail present in the statute increases, the room for interpretation decreases. Aprill, *supra*, at 16.

261. 436 F.3d 431 (4th Cir. 2006).

262. 454 F.3d 1340 (Fed. Cir. 2006).

263. *See* I.R.C. § 351 (2006).

264. *Coltec*, 454 F.3d at 1343; *Black & Decker*, 436 F.3d at 433.

265. *Coltec*, 454 F.3d at 1343; *Black & Decker*, 436 F.3d at 432.

266. *Coltec*, 454 F.3d at 1344; *Black & Decker*, 436 F.3d at 432.

267. *Coltec*, 454 F.3d at 1345; *Black & Decker*, 436 F.3d at 433.

bilities severed from their businesses (naked liabilities) to generate capital losses from the sale of the Newco stocks.[268]

B&D (which had substantial capital gains to offset from selling three subsidiaries) borrowed $561 million and contributed the cash along with $560 million of contingent employee healthcare liabilities to Newco in exchange for stock, while keeping the remainder of the business.[269] Qualifying as a § 351 transaction, B&D claimed a basis of $561 million in the Newco stock (the cash unreduced by the liabilities) and sold it for a $560 million loss (the value of the corporation was $1 million: the $561 million of assets reduced by the $560 million in liabilities).[270]

The success of such schemes depends on a formalistic interpretation of the basis provisions governing § 351 transactions. Specifically, the schemes only "work" (i.e., generate large capital losses) if the basis taken in the Newco stocks does not have to be reduced by the contingent liabilities transferred, as is generally required.[271] This, in turn, depends on whether the liabilities qualify under the so-called deductible liability exception.[272]

In general, the basis of stock received in a § 351 transaction is determined under § 358(a)(1), which provides that the basis of stock received will be the basis of property surrendered reduced by: (i) the fair market value (FMV) of property received, (ii) the amount of money received, and (iii) any loss recognized; and increased by: (i) dividend amounts and (ii) gain recognized.[273] This formula gives the taxpayer a basis in her newly received stock that reflects the amount she invested in Newco, a result consistent with the general principles of basis.[274]

Section 358(d)(1) provides that the assumption of a liability shall be treated as money received, requiring the transferor to reduce its basis by the amount of the liability.[275] This also reflects general basis principles. Section 358(d)(2), however, states that § 358(d)(1) will not apply (i.e., basis need not be reduced by the liability) if the liability is one that would be excluded under § 357(c)(3);[276] that is, liabilities the payments of which would give rise to a deduction.[277] B&D and Coltec claimed that the transferred contingent liabilities qualified under this exception, allowing them to take high bases in the Newco stocks and generate high losses upon their sale.[278] The deductible liability exception is a deviation from

268. *Coltec*, 454 F.3d at 1343; *Black & Decker*, 436 F.3d at 433.
269. *Black & Decker*, 436 F.3d at 433.
270. *Id*.
271. *See id.* at 434–35.
272. *See id.* at 435–36.
273. I.R.C. § 358(a) (2006).
274. *See Black & Decker*, 436 F.3d at 435.
275. I.R.C. § 358(d)(1).
276. *Id.* § 358(d)(2).
277. *Id.* § 357(c)(3)(A)(i).
278. Coltec Indus., Inc. v. United States, 454 F.3d. 1340, 1347 (Fed. Cir. 2006); *Black & Decker*, 436 F.3d at 437–38.

the basis principles captured by the "default" provisions of § 358.[279] The proposed test, then, inquires into the purpose behind the deviation.

To understand the full implications of the transaction and the rationale for the deductible liability exception, the recognition rules governing § 351 transactions must be understood. Section 357(a) states the general rule that no gain or loss will be recognized on a § 351 exchange despite an assumption of liabilities.[280] Section 357(c) creates an exception: to the extent that the sum of the total liabilities exceeds the sum of the total adjusted basis of the property transferred, such excess will be considered gain.[281] Section 357(c)(2) carves out various liabilities that need not be included in this gain calculation—one such exception is liabilities, the payment of which would give rise to a deduction.[282] With this in mind, the case can be summarized as follows, using the numbers of *Black & Decker*.

	§ 357(c)(3) does not apply	§ 357(c)(3) applies
Value of Property Transferred	$561 million	$561 million
Liabilities Assumed	$560 million	$560 million
Gain Recognized	$0*	$0*
Basis in Newco Stock	$561 – $560 = $1 million	$561 million
Value of Newco Stock	Assets – liabilities = $1 million	$1 million
Gain/Loss on Sale of Stock	$1 million – $1 million = 0	$1 million – $561 million = $560 million loss

* There is no gain in either scenario because the liabilities do not exceed the property transferred as provided in § 351(c).

The Federal Circuit in *Coltec*[283] and the Fourth Circuit in *Black & Decker*[284] used the economic substance doctrine to analyze the transactions. For instance, the *Coltec* court held that the transaction that created a high basis must be disregarded for tax purposes under the economic substance doctrine because the transaction lacked a non-tax busi-

279. I.R.C. § 358.
280. *Id.* § 357(a).
281. *Id.* § 357(c).
282. *Id.* § 357(c)(2)–(3).
283. 454 F.3d at 1347.
284. 436 F.3d 431, 437–42 (4th Cir. 2006). *Black & Decker* was on appeal from the granting of a motion for summary judgment. The Fourth Circuit held that questions of fact existed regarding whether B&D had a reasonable expectation of a pretax profit, and the case was eventually settled by the IRS. *See* IRS Accepts Settlement Offer on Contingent Liability Tax Shelter, http://www.irs.gov/newsroom/article/0,,id=132350,00.html (last visited Mar. 3, 2009). For this reason, *Coltec*, which actually provides a final decision, is the case upon which this analysis focuses.

ness purpose.[285] In doing so, the court stated that "the transaction to be analyzed is the one that gave rise to the alleged tax benefit."[286] This illustrates one of the many inconsistencies courts have exhibited when applying traditional anti-abuse tests. As discussed in Part II, courts sometimes define the transaction narrowly, such as in *Coltec*, making it difficult to pass the business purpose test. Other times, and with no explanation as to the difference, courts define the transaction broadly, requiring only that the transaction as a whole have a business purpose.[287] In *Coltec*, with the transaction narrowly defined, the court held that it was inappropriate to focus on the management functions of Newco.[288] Specifically, the court recognized that transferring management activities to Newco so that it could handle the liabilities might have economic substance, but the court found this fact irrelevant.[289] Instead, the court was only interested in whether there was a business purpose for transferring the liabilities to Newco.[290] Coltec was unable to convince the court that such purposes existed for this sliver of the transaction.[291]

I take no position as to whether the transaction should be so narrowly defined—the traditional anti-abuse tests were the only manner available to analyze this device. The reasoning of the *Coltec* case, however, reveals one of the many inconsistencies of the anti-abuse tests. Application of the proposed test will produce a consistent body of law, making the need for the court's machinations unnecessary.

2. *Applying the Proposed Test*

The deductible liability exception is a deviation from the general basis principles captured in § 358.[292] The inquiry, then, focuses on the purposes behind that deviation. Section 358(d)(2) is a relief provision that seeks to correct unfairness resulting from the general application of the Code.[293] In analyzing such provisions under the proposed test, one should ascertain the specific situation addressed by the provision. As is often the case with these provisions, committee reports provide a clear answer in this case.

The deductible liability exception was created as a relief measure to prevent a "tax double whammy."[294] Without the exception, taxpayers transferring liabilities along with associated assets would lose the deduction they would have otherwise taken when the liability was paid. The

285. 454 F.3d at 1359–60.
286. *Id.* at 1356.
287. *See supra* Part II.C.2.a.i.
288. 454 F.3d at 1358.
289. *Id*.
290. *Id*.
291. *Id*.
292. I.R.C. § 358 (2006).
293. *Id*. This type of deviation was discussed in Part III.B.2.b.ii.
294. Black & Decker Corp. v. United States, 436 F.3d 431, 436 (4th Cir. 2006).

taxpayer would also have to reduce its basis in the underlying stock by the liability assumed, causing the taxpayer to recognize more gain upon sale of the stock. For instance, assume taxpayer *T* transfers her entire business in exchange for Newco stock in a transaction qualifying for nonrecognition under § 351. The business consists of $100 of property and $30 of accounts payable. If *T* does not transfer the business, she would be entitled to deduct the $30 accounts payable when paid. After the entire business is transferred, however, *T* is no longer eligible for that deduction (as it would now "belong" to Newco). In addition, in the absence of an exception, *T* is required to decrease her basis in the Newco stock by $30 (because assumed liabilities qualify as "money received" within the basis calculations outlined above). This reduction results in *T* recognizing an additional $30 gain when she sells the Newco stock. *T* is thus disadvantaged twice, by both losing her deduction and decreasing her basis, resulting in more gain when the stock is sold.

Congress undertook to correct this perceived unfairness by enacting the deductible liability exception.[295] In the Senate Report under "Reasons for Change," the report clearly states that the failure to exclude deductible liabilities in the gain and basis calculations "has in some cases resulted in unforeseen and unintended tax difficulties for certain . . . taxpayers *who incorporate a going business.*"[296] The report explains: "In general, liabilities the payment of which would give rise to a deduction include trade accounts payable and other liabilities (e.g., interest and taxes) *which relate to the transferred trade or business.*"[297] The report clearly sets forth the situation and unfairness the deductible liability exception addresses.

As discussed, in *Black & Decker* and *Coltec* the liabilities were transferred separately from the underlying businesses.[298] This is not the situation the deductible liability exception sought to address. The deductible liability exception was a relief measure meant to correct the perceived unfairness that occurred when general tax laws were applied to taxpayers who incorporated their entire business along with its associated liabilities. It was not meant to provide the taxpayer with a self-help mechanism whereby liabilities could be severed from a business, creating losses of unlimited magnitude.

Unlike many recent tax shelter cases, before looking at the economic substance of the *Black & Decker* and *Coltec* transactions, the courts considered the statutory arguments presented by the government, including arguments regarding the meaning of "deductible liabilities."[299] Still,

295. *See* S. REP. NO. 95-1263, at 183–84 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 6761, 6947.
296. *Id.* (emphasis added).
297. S. REP. NO. 96-498, at 62 (1979), *as reprinted in* 1980 U.S.C.C.A.N. 316, 372 (emphasis added).
298. *See supra* Part IV.A.1.
299. In *Black & Decker*, the court found that even on summary judgment, the taxpayer qualified for the deductible liability exception under the plain meaning of the statute. 436 F.3d at 437–38.

in finding that nothing in the Code required the taxpayers to reduce their basis by the contingent liabilities assumed (i.e., the taxpayers qualified for the exemption), the courts overemphasized the importance of the plain language of the Code and underemphasized the importance of legislative history.[300]

Both the Fourth Circuit and the Federal Circuit actually recognized that the "central purpose" of the deductible liability exception was "to protect taxpayers who transferred the assets of their business along with liabilities of their business."[301] After recognizing this purpose, however, both courts held that the taxpayer was entitled to the exception because the "plain language" did not express the limitation that liabilities must be transferred along with the underlying assets.[302] In other words, the courts placed all of the emphasis on the actual text of the Code and disregarded the clear purpose expressed in the committee report.

As discussed in Part III, certain types of legislative history, such as committee reports, should be used to determine the specific purposes of the Code when analyzing tax shelters. This is due, in large part, to the process of tax codification and the particularized context of tax shelters where, as here, the transaction was not contemplated. The phrase "liability the payments of which . . . would give rise to a deduction"[303] that appears in the statute was likely the attempt of staff attorneys or nonpartisan writers to capture the concept chosen by committee members. The desired concept behind the phrase is elucidated clearly in the committee report. Had the courts given the report appropriate weight, they would have easily reached the conclusion that transferring naked liabilities was not within the purposes of the deductible liability exception.[304]

With the specific purpose of the relief measure so defined, it is unnecessary to consider general principles of tax law. As discussed in Part III.A.3, courts should focus on specific purposes before looking at general principles because the latter method creates more opportunities for subsequent mischief by taxpayers who find ways to exploit the ambigui-

300. Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1347 (Fed. Cir. 2006); *Black & Decker*, 436 F.3d at 436–37.

301. *Coltec*, 454 F.3d at 1349.

> It is true that the central purpose of § 357(c)(3) was to protect taxpayers who transferred the assets of their business along with liabilities of their business (such as accounts payable) from having to recognize gain if the liabilities exceeded the assets. The theory was that the transferor corporation should not have to recognize gain when it had lost the tax deduction that would flow from payment of the liabilities.

Id. (citing S. Rep. No. 95-1263, at 184–85 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 6761, 6947–48); *see also Black & Decker*, 436 F.3d at 437 ("The prototypical transaction Congress had in mind in drafting § 357(c)(3) may well have been one in which a corporation exchanged liabilities as part of a transfer of an entire trade or business to a controlled subsidiary . . . .").

302. *See Coltec*, 454 F.3d at 1349; *Black & Decker*, 436 F.3d at 437.

303. I.R.C. § 357(c)(3) (2006).

304. For another analysis of these shelters, see Karen C. Burke, *Deconstructing* Black & Decker*'s Contingent Liability Shelter: A Statutory Analysis*, 108 Tax Notes 211 (2005).

ties of a broader holding.[305] Had the specific purpose of the relief measure not been ascertainable or helpful, a court applying the proposed test would then consider whether, and to what extent, it was the purpose of the provisions to accord with general principles. Commentators have advanced several other theories regarding the "true" problem behind the transactions that implicate general principles.[306] These alternative theories will be analyzed under the proposed test for purposes of illustration.

It has been argued the results of the transactions are inconsistent with general principles of basis that seek to capture one's investment in an asset; here, the Newco stock.[307] Some argue it is discordant with these principles for the value of the Newco stock to differ from the taxpayer's basis in that same stock immediately after the contribution of the transferred assets and liabilities.[308] Allowing the taxpayer's basis to stray in this manner allows a double loss. In *Black & Decker*, for instance, B&D took a $560 million loss on the sale of the stock. Later, when the liabilities are actually paid, B&D could take another $560 million deduction. Furthermore, B&D and Coltec were able to artificially accelerate their losses.[309] B&D and Coltec would have normally deducted the liabilities as they were paid. This deduction is in accord with general tax accounting principles, which allow taxpayers to deduct liabilities once the fact and the amount of the liability can be determined with reasonable certainty.[310] By selling their shares right after the transfer, B&D and Coltec were able to immediately deduct the entire contingent liability without satisfying this basic principle (neither the existence nor the amount of the liabilities were determined at the time B&D and Coltec sold their shares, thereby accelerating the deduction).

The transactions, however, cannot be labeled abusive under these theories because the provisions contemplate non-abusive situations in which all of these "problems" are present. In other words, the provisions

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305. *See supra* Part III (discussing *Corn Products*).

306. *See infra* Part IV.B.3.

307. *See* Chirelstein & Zelenak, *supra* note 22.

308. Professors Chirelstein and Zelenak make this very argument, stating:

> As a matter of tax logic, the basis of stock received in a § 351 incorporation cannot exceed the value of that stock—$1 million in *Black & Decker*—unless the value of the property transferred had declined in the hands of the transferor prior to the transfer. In the latter circumstance, the loss in value relative to the transferor's basis is properly recognized on a sale of the stock just as it would be on a sale of the property itself.

Id. at 1964.

309. *See* Lee A. Sheppard, *A More Intelligent Economic Substance Doctrine*, 112 TAX NOTES 325 (2006) (arguing that *B&D* and *Coltec* created an end run around the most basic principles of recognition and accounting principles, which seek to match income with associated deductions). "The tax law," she states, "is dead set against premature recognition of expense and loss, as indicated by section 461(h) and the all-events requirement." *Id*. Allowing the taxpayers to utilize the deductible liability exception permitted a "do-it-yourself reserve method," which created a mismatch of income and deductions, a principle at the heart of tax accounting rules. *Id.* Sheppard refers to the schemes of taxpayers like B&D and Coltec as self help reserve accounts that circumvent even the most basic principles of accounting rules and gain and loss recognition. *Id*.

310. I.R.C. § 461(h) (2006). This requirement is known as the "all events requirement."

exhibit a purpose to deviate from these fundamental principles in such a manner. For example, suppose *T*, a cash basis taxpayer, transfers her entire business, consisting of $100 property with a basis of $100 and $60 worth of accounts payable, in exchange for stock of Newco that satisfies § 351. *T* does not recognize any gain on this transaction (liabilities do not exceed the basis of the property, and even if they did, accounts payable are deductible liabilities and therefore subject to the exception). *T*'s basis in the stock is $100, unreduced by the liabilities due to the operation of the exception. The value of the stock, however, is $40 ($100 value of the property – $60 liabilities), meaning that the basis differs from the stock value. *T* could immediately sell the stock for a $60 loss, resulting in acceleration. When Newco pays the liability, it will also be entitled to a $60 deduction, thereby creating a double loss. Here, the taxpayer transferred her entire business to Newco. This transaction is clearly nonabusive and is exactly the sort of transaction to which § 351 applies.

Thus, arguments that the ultimate problem in the *B&D* and *Coltec* transactions is the existence of double losses coupled with the ability to accelerate those losses (which, in context of the proposed test, would implicate general principles) do not withstand scrutiny. Non-abusive transactions, such as that described above, were clearly contemplated by these provisions and yield these same effects.[311] It cannot, therefore, be said that it was the purpose of these provisions to accord with these general principles, making it inappropriate to strip B&D and Coltec of the tax savings for these reasons.

It is worth noting that *Black & Decker* and *Coltec* presented an additional twist to the double loss theory. In the hypothetical presented above, there was a double loss on the same dollars, once by the transferee and once by Newco. In *Black & Decker* and *Coltec*, however, it was unclear whether the Newcos would be entitled to the deduction when the liability was ultimately paid, or if B&D and Coltec would retain the deduction.[312] Generally, a liability is deductible by the party who owns the underlying business that gave rise to it.[313] Because B&D and Coltec transferred the liabilities but retained the underlying businesses, there was conflicting authority as to who had the right to the ultimate deduc-

311. David B. McGinty, *Economic Substance, Business Purpose, and Tax Avoidance in Section 351 Contingent Liability Transactions After* Black & Decker, Coltec*, and* Hercules, 36 CUMB. L. REV. 1, 1 (2005–2006).

312. In *Holdcroft Transportation Co. v. Commissioner*, the court held that the transferee (Newco) was not entitled to deduct transferred liabilities since the liabilities arose out of events occurring before the transfer of the underlying business. 153 F.2d 323, 325 (8th Cir. 1946). Yet there is some doubt as to whether the transferee was entitled to the deductions after the transfer (undertaken for valid business reasons) of all the assets and associated liabilities. Rev. Rul. 95-74, 1995-2 C.B. 36. For an excellent discussion of this issue, as well as the *Black & Decker* tax shelter in general, see Ethan Yale, *Reexamining* Black & Decker*'s Contingent Liability Tax Shelter*, 108 TAX NOTES 223 (2005).

313. *See* Yale, *supra* note 312, at 223–28.

tion.[314] If B&D and Coltec retained the deduction, there would be a double deduction on the same dollars *by the same taxpayer*, something the tax law certainly seeks to avoid.[315] It is fundamental to the Code that a taxpayer should not be able to deduct the same dollars twice.[316] Because the answer is unclear, and because the specific purpose of the statute is clear from legislative history, this theory is not pursued at length. Had it been necessary to turn to general principles, however, this may have been a viable theory to deny the benefits if it were determined that B&D and Coltec retained the deductions.

The deductible liability exception is a relief measure that corrects a specific unfairness created by application of the general tax laws. The committee report clearly states that the provisions are meant to prevent the hardships that result when taxpayers form a new corporation and transfer their liabilities along with the assets of their businesses. The taxpayers in *Black & Decker* and *Coltec* were not in this situation.[317] These cases present a situation in which the specific purposes of the provisions at issue are clear, making it unnecessary to consider general principles of tax law.

B. The CINS Transactions

The contingent installment sale transactions (CINS transactions) involve a different type of provision. Specifically, the CINS transactions involve a provision best characterized as a compromise between capturing true income and administrative feasibility.[318]

1. An Explanation of the Provisions at Issue

The CINS transactions were designed to take advantage of a "perceived flaw in the regulations governing the timing of recognition of gain from an installment sale."[319] The most famous of the CINS transactions was litigated in *ACM*.[320] An installment sale refers to a sale or disposition where the seller receives payments beyond the taxable year of the transaction.[321] In a basic installment sale, the payments and time periods for those payments are fixed.[322] To properly allocate gain and loss throughout the years of payment, the taxpayer uses the installment method provided in the Code. Under this method, the taxpayer recognizes

314. *See* Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1344–45 (Fed. Cir. 2006); Black & Decker Corp. v. United States, 436 F.3d 431, 433–34 (4th Cir. 2006).
315. *See* Geier, *supra* note 131, at 497.
316. *See, e.g.*, *id.*
317. *See Coltec*, 454 F.3d at 1349; *Black & Decker*, 436 F.3d at 438.
318. These types of provisions were discussed in Part III.B.2.b.
319. Hariton, *supra* note 1, at 262.
320. 157 F.3d 231 (3d Cir. 1998).
321. I.R.C. § 453(b) (2006).
322. *See ACM*, 157 F.3d at 244.

"that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price."[323] For instance, suppose taxpayer *T* sells property with a basis of $100 to *P*, who agrees to pay $50 in year one, $100 in year two, and $50 in year three. Using the formula provided, *T* would recognize gain as follows:

1. Basis	$100
2. Payment in Year One	$50
3. Payment in Year Two	$100
4. Payment in Year Three	$50
5. Total Contract Price (2 + 3 + 4)	$200
6. Gain (5 – 1)	$100
7. Gain Recognized in Year One (2 * 6/5)	$25
8. Gain Recognized in Year Two (3 * 6/5)	$50
9. Gain Recognized in Year Three (4 * 6/5)	$25

The purpose behind the installment method is to allocate the total gain that will be realized in proportion to the amount actually received in a particular year. This is in accord with the fundamental realization principle that strives to allocate gain as it accrues, for instance, at the time of a sale (as opposed to taxing accumulated increases in the value of assets while held).[324]

Matters are complicated, however, when contingencies are introduced. In some cases, the payments to be received in installment sales are not fixed. For instance, in *ACM*, the payments to be received were based on fluctuations in the London Interbank Offer Rate (LIBOR).[325] In these cases, one cannot determine the total amount of gain to be recognized (because the final contract price is unknown), making it impossible to use the general installment method described above.

Section 453(j)(2) extends the eligibility for installment sale reporting to installment sales with contingencies and provides that specific rules for dealing with such transactions will be provided in the Regulations.[326] The Regulations existing at the time of the *ACM* transaction provided for a method of allocating basis when the time periods for payments were fixed but the total contract price could not be determined (e.g., because the payments were not fixed).[327] The Regulations provided that in these circumstances, the taxpayer could allocate its basis equally among the years of payment and recognize gain or loss equal to the payment re-

323. I.R.C. § 453(c).

324. *See* Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution*, Macomber*, and Mark to Market*, 13 VA. TAX REV. 1, 56 (1993).

325. 157 F.3d at 234.

326. I.R.C. § 453(j)(2); S. REP. NO. 96-1000, at 5–6 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 4696, 4699–4701.

327. Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (as amended in 1994).

ceived less the allocated basis amount.[328] For example, assume that taxpayer *T* sells property with a basis of $100 to *S*. *S* agrees to pay *T* over the next three years. *S* will pay an amount equal to the value of a share of stock *X* on January 1 of the relevant payment year. Because the payments are not fixed, the total contract price cannot be determined. Therefore, under the regulations, *T* will allocate approximately $33 ($100/3) basis to each of the three years. Assume that the stock price in years one through three was $50, $100, and $50, respectively. Consider the following table.

Year	Payment	Basis Recovered	Gain Under Contingent Method	Gain if Payments Were Fixed*
One	$50	$33	$17	$25
Two	$100	$33	$67	$50
Three	$50	$33	$17	$25

* See earlier table.

The Senate Report referencing § 453(j)(2), prescribing the power to issue regulations to deal with contingent installment sales, states that "[i]n cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period."[329] The preamble to the Regulations recognized that the prescribed approach might result in what it called "rough justice"—that is, if "too much" gain is recognized in some years, then "too little" gain (or even losses) will result in other years, basically evening things out.[330] In the above scenario, had the payments been fixed and the general installment method been used, the $100 gain that resulted from the sale would have been allocated in proportion to the amount received. Using the contingent installment method, *T* recognized "too much" gain in year two. This "excessive" gain was, however, counterbalanced by lower gains in years one and three.

Importantly, the Treasury recognized that this ratable recovery method presented opportunities for abuse.[331] Specifically, taxpayers could take advantage of this method by intentionally back-loading contingent payments to defer taxes. Taxpayers take pains to defer taxes as long as possible to benefit from the time value of money.[332] Suppose, for example, *T* knew full well that the price of stock *X* was artificially depressed and was going to rise dramatically. Applying the regulation, *T* could en-

328. *Id.*
329. S. REP. NO. 96-1000, at 5–6.
330. 46 Fed. Reg. 10,709, 10,714, 10,716 (Feb. 4, 1981); *see also* Hariton, *supra* note 1, at 262–63.
331. The Treasury responded by introducing a provision intended to limit abuse. Temp. Treas. Reg. § 15a.453-1(c).
332. *See id.*

ter into the same contingent installment sale described above, and allocate her basis ratably over the years. *T* would recognize very little gain, or even losses, in early years because of the high basis allocation provided by the contingent installment sale method and could defer gain recognition until later years. To curb this predictable abuse, the Service was granted the discretion to require an alternative basis recovery method if it determined that the method described "substantially and inappropriately accelerate[d] . . . recovery of . . . basis."[333] Because taxpayers generally make every attempt to avoid accelerating gain recognition, the Regulations did not grant a similar power to reallocate if the normal method resulted in inappropriate deferral of basis (and thus acceleration of income).[334] Instead, the taxpayer, who would generally suffer under this scenario (as she would be recognizing too much gain in early years, thereby losing her time value of money), was given the power to petition the Service to use another method should she find himself in this situation.[335]

2. *The* ACM *Transaction*

The taxpayers in *ACM* concocted a way to use deferral to their advantage.[336] The taxpayer formed the ACM partnership with a foreign bank that was tax indifferent (i.e., not subject to U.S. tax).[337] The foreign bank contributed most of the capital and hence had a large share in the partnership totaling 82.6%.[338] The partnership used the money to purchase bank notes with a fixed interest rate. Almost immediately, the partnership sold the notes, valued at $175 million, for a $140 million upfront cash payment and LIBOR notes providing a stream of contingent payments over five years, with a net present value of $35 million.[339] Because a maximum selling price could not be determined (the stream of payments resulting from the LIBOR notes was unknown), ACM used the contingent installment sale method, and allocated its basis equally over five years.[340] Considering the large upfront payment and the relatively small payments to follow, this would have ordinarily resulted in the type of substantial acceleration that taxpayers seek to avoid.

In the first year, however, the large gain was allocated in proportion to partnership shares,[341] which meant the foreign bank (who did not care

333. *Id.* § 15a.453-1(c)(7)(v).
334. Hariton suggests that this denial is a "moment of stinginess." Hariton, *supra* note 1, at 262–63. This proposition seems dubious.
335. Temp. Treas. Reg. § 15a.453-1(c)(7).
336. 157 F.3d 231, 243–44 (3d Cir. 1998).
337. *Id.* at 233.
338. *Id.* at 239.
339. *Id*. at 240.
340. *Id.* at 246 n.28.
341. For instance, because the foreign bank had an 82.6% interest in the partnership, the bank was allocated that percentage of the gain.

about U.S. taxes) was allocated a great majority of the gain.[342] Soon afterwards, the foreign bank's interest was redeemed (as was always planned).[343] With relatively small LIBOR payments remaining and a relatively high basis allocation, the remaining years resulted in tax losses for the U.S. partners.[344] Thus,

> [t]he participation of [the] foreign partner that was impervious to tax considerations and that claimed most of the reported gains while allocating to [the U.S. partner] virtually all of the losses allowed . . . [the] U.S. partner to reap the benefits of the tax losses without sustaining the burdens of the offsetting tax gains.[345]

Naturally, the Service sought to disallow the losses and reallocate the gains, arguing that the transactions lacked economic substance.[346] In finding these transactions to be abusive, the *ACM* court engaged in lengthy and detailed inquiries into the economic substance of the transaction, the presence of a business purpose (or lack thereof) and the projected profitability of the venture.[347] First, the court found that the transactions lacked any objective economic effect.[348] Because the original bank notes were held for only twenty-four days, the court found the investment to be "fleeting and . . . inconsequential,"[349] without indicating what holding period would have made the investment consequential. Further, the court found that "the transactions . . . left ACM in the same position it had occupied before engaging in the offsetting acquisition and disposition of those notes."[350] ACM sold the notes at the same price for which it purchased them (and for which they, of course, continued to be valued after such a short time).[351] Next, the court considered and rejected each of the supposed non-tax business purposes ACM offered for the transactions.[352] Finally, the court found that ACM had no reasonable expectation of a pretax profit, noting, for instance, the investment in the LIBOR notes was "economically disadvantageous under the market conditions"

342. ACM reported $100.7 million of gain in the first year. The foreign bank was thus allocated 82.6% of that gain, which totaled $91.5 million. 157 F.3d at 239.

343. *Id.* at 242.

344. *Id.* at 245.

345. *Id*. at 252 n.40.

346. *Id.* at 244, 246 n.29.

347. *Id.* at 245–63.

348. *Id.* at 249–52.

349. *Id*. at 250.

350. *Id*.

351. *Id*. The court characterized the transaction as follows:

> Viewed according to their objective economic effects rather than their form, ACM's transactions involved only a fleeting and economically inconsequential investment in and offsetting divestment from the Citicorp notes. In the course of this brief interim investment, ACM passed $175 million of its available cash through the Citicorp notes before converting 80% of them, or $140 million, back into cash while using the remaining 20%, or $35 million, to acquire an amount of LIBOR notes that was identical, apart from transaction costs, to the amount of such notes that ACM could have acquired by investing its $35 million in cash directly into such assets.

Id.

352. *Id.* at 254–57.

existing at the time of the sale.[353] As a result, the court held that ACM was not entitled to its claimed losses.[354] Rather than engaging in these lengthy, fact-specific inquiries, the proposed test would have courts address the problem directly.

3. *Applying the Proposed Test*

With respect to *ACM*, the proposed test asks whether the results of the transaction (here, the large losses gleaned by the U.S. partners by frontloading payments) were within the purposes of the installment sale regulations. Analyzing the transaction in this manner addresses the real issue—namely, whether the tax benefits derived fell outside of the purposes of the law.[355]

Before proceeding, it should be noted that the Service likely believed it could not argue that the transaction flouted the purpose of the Regulations despite the fact that it was clear to everyone, including the taxpayers and their advisors, that the result they sought was inconsistent with the installment sale method. In other words, some might contend that the Service cannot argue against its own Regulations. The Treasury is presented with the same challenges as Congress in enacting provisions, and, like Congress, cannot be expected to predict future contrivances. It is not clear to this author why a taxpayer is any more entitled to a benefit outside the purposes of the Code than to one outside the purposes of the Regulations. This Article, however, does not undertake to resolve this issue and will assume that the court could properly consider whether the results of the *ACM* transaction fell outside the purposes of the installment sale regulations.

As discussed above, the general installment sale method accords with the general principle of realization, which taxes gains as they accrue.[356] As illustrated, however, the contingent installment sale method deviates from these general principles by providing a method in which

353. *Id*. at 257.

354. *Id*. at 260–62. To be precise, ACM was entitled to take the losses that it actually sustained on the sale (as opposed to the artificial losses generated through the literal application of the installment sale regulations), but these real losses were slight.

355. It should be noted that the court in *ACM* did touch upon issues of statutory and regulatory intent but only in an extremely brief and conclusory fashion. In a footnote, the court stated that although the installment sale regulations contemplated some distortion of income (as discussed above), they did not contemplate the recognition of non-bona fide losses. The court engaged in no further discussion and cited no further authority. *Id*. at 252 n.41. The court also dismissed the taxpayer's argument that applying the economic substance doctrine was inappropriate because §§ 1001 and 453 did not contemplate such a requirement. *Id*. at 253. The court pointed out that the court in *Goldstein v. Commissioner* had applied the doctrine even though the provision at issue there, § 163(a), did not specifically require it. The court in *ACM* did not discuss how the *Goldstein* court explicitly found that § 163(a) required it, nor did the court discuss why §§ 1001 and 453 incorporated an economic substance requirement. *Id*. These cursory comments regarding statutory intent highlight the need for a well-developed test that will lead to an adequate analysis.

356. *See supra* text accompanying note 324.

the gain recognized is not always equal to that which actually accrued.[357] This deviation was created not simply for administrative practicality, but for administrative necessity.[358] Because the payments, and thus the overall contract price, are not fixed in a CINS, it is impossible to allocate gains precisely as they accrue—that is, it is impossible to know how much basis "should" be allocated each year because one cannot determine what proportion of gain was recognized in that year. The Regulations fill in this unknown by providing that, in general, basis should be recovered ratably over time.[359] The Regulations also provide, however, that basis should be reallocated if certain distortions occur.[360]

Thus, the CINS provisions can be seen as a compromise between capturing real income and administrative considerations. (Recall that Part III.B.2.b provided a spectrum of such compromise provisions.) On one end of the spectrum are laws, such as the loan rules, that deviate from general principles for administrative convenience, but have a purpose to achieve a specific result that reflects general principles.[361] On the other end of the spectrum are provisions, such as the wash sale rules, that are essentially formulaic and meant to be applied in a literal, mechanic fashion.[362] Thus, the first task in applying the proposed test is to locate the CINS provisions on this spectrum.

At first glance, it might appear that the contingent installment method provides a formulaic test like the wash sale rules and thus, as ACM contended, "because its transactions on their face satisfied each requirement of the contingent installment sale provisions and regulations thereunder, it properly deducted the losses arising from its 'straightforward application' of these provisions."[363] In other words, the taxpayer would argue the CINS provisions provide a formula for allocating gain, and as long as taxpayers comply precisely with the provisions, no further inquiries should be made. The CINS provisions, however, do not fall on this end of the spectrum.

Because it is impossible to allocate gain or loss in strict compliance with the general principles of realization, the CINS method provides a "compromise." That compromise is to allocate basis ratably over time.[364] Even if the compromise does not create the perfect result where gain and loss were recognized exactly when accrued, it would create the "rough" justice discussed above. Thus, the CINS method seeks to accomplish a specific result as set forth in the preamble.[365] In this way, the CINS pro-

357. *See supra* text accompanying notes 326–30.
358. *See* Hariton, *supra* note 1, at 262.
359. *See* Temp. Treas. Reg. § 15a.453-1(c)(3)(i) (as amended in 1994).
360. *Id.* § 15a.453-1(c)(7)(i).
361. *See supra* text accompanying notes 239–42.
362. *See* BITTKER & LOKKEN, *supra* note 142, ¶ 44.8.1.
363. 157 F.3d 231, 245 (3d Cir. 1998).
364. *See supra* Part IV.B.1.
365. *See supra* note 330 and accompanying text.

visions are more along the lines of the loan rules, which fall at the other end of the compromise provision spectrum.[366] The fact that loan proceeds do not need to be recognized when received deviates from general realization principles because, absent this rule, they would be included. Although deviating, the rule seeks to achieve a specific result, called the net result.

Further, like the loan rules, the CINS provisions make certain assumptions in seeking to achieve the even result. Specifically, for ratable basis recovery to achieve the even result, it must be assumed that payments, although vacillating, will not do so substantially.[367] Recall from Part III that the loan rules assume that a taxpayer will repay her loan to achieve the intended net result. When this assumption proves false, the taxpayer will include unpaid loan amounts in her income, thus "setting things right." Although closer on the spectrum to laws like the loan rules, the CINS transactions are more complex than the simple loan rules example, in which any divergence from the underlying assumption that loans will be repaid is easily remedied by requiring taxpayers to recognize income from the discharge of indebtedness.[368]

The CINS transactions do not provide such a clear-cut case. Without more, there would be no way to determine how much divergence is too much. In other words, at what point does the result diverge so much from the intended result that it should be fixed to accord with the provision's purpose of achieving the even result? The Regulations provide the needed guidance.

The Regulations explicitly recognize and attempt to correct instances where the rules lead to substantial distortions by granting the Commissioner power to reallocate basis when these distortions occur.[369] The CINS transactions produce the very type of substantial distortion the reallocation provisions seek to correct. The fact that the Regulations failed to capture the exact method should make little difference (reallocation power was granted for substantial acceleration of basis but not for deferral of basis because lawmakers could not have contemplated that taxpayers would use deferral of basis to their advantage). The purpose of this reallocation power was to catch and correct instances where payments were so uneven (thus contravening the assumption that would achieve the even result) that gain was allocated in a way that strayed too far from the intended result. In these instances, the reallocation power allows the result to be "fixed," just as recognizing income from discharge of indebtedness "fixes" deviations from the assumptions underlying the loan rules. Thus, under the proposed test, the CINS taxpayers should be

366. For more specifics on this earlier argument, see *supra* Part III.B.2.b.i.
367. *See* Hariton, *supra* note 1, at 262.
368. *See supra* Part III.B.2.b.i.
369. Temp. Treas. Reg. § 15a.453-1(c)(4) (as amended in 1994).

denied the large claimed losses and be forced to reallocate their basis in a manner that does not cause a substantial distortion of the even effect.

C. *The* Compaq *Transaction*

The last transaction to be discussed deals with the foreign tax credit provisions. These provisions are probably best characterized as part of the general structure of the Code, as discussed in Part III.B.1.

1. The Transaction

Compaq Computer Corp. v. Commissioner[370] involved the utilization of a "dividend capture transaction," in which Compaq purchased and immediately resold American Depositary Receipts (ADRs). "An ADR is a trading unit, issued by a trust, that represents ownership of stock in a foreign corporation. . . . Foreign stocks are customarily traded on the U.S. exchanges using ADRs."[371] Specifically, Compaq purchased the ADRs "cum dividend" for $887.577 million[372] and immediately resold the ADRs "ex-dividend" for $868.412 million[373] to the same party from whom the interests were acquired.[374] The dividend amount was $22.546 million.[375] A 15% withholding tax of $3.382 million applied, however, so Compaq received a net dividend amount of $19.164 million.[376] The transaction costs totaled $1.486 million.[377] Thus, at the end of the day, Compaq lost $19.165 million on the sale of the stock, received a net dividend amount of $19.164 million, and paid $1.486 million in transaction costs.[378]

Compaq was required to pay U.S. tax on the entire dividend amount of $22.546 million.[379] After taking into account the loss on the sale and transaction costs, however, Compaq reported $1.895 million in income, yielding $640,000 in U.S. tax.[380] Compaq was also entitled to a $3.382 million foreign tax credit on the amount withheld, which it used to offset the tax on this transaction as well as on other capital gains.[381]

370. 277 F.3d 778, 779 (5th Cir. 2001), *rev'g* 113 T.C. 214 (1999).
371. *Id.*
372. *Compaq*, 113 T.C. at 217. This term means that the buyer has purchased a security with a declared dividend that has not yet been paid.
373. *Id.* This term means that the share has been sold but that the seller, as opposed to the buyer, is entitled to the dividend.
374. *Id.* Because of different settlement rules operating with respect to purchase and resale trades, the taxpayer was considered the record holder of the ADRs for purposes of receiving the dividend, even though it was no longer the owner of the stock on the distribution date.
375. *Id.* at 219.
376. *Id.*
377. *Id.* at 221.
378. *Id.* at 223.
379. *Id.* at 225.
380. *Id.* at 222.
381. *Id.*

The transaction made economic sense only because the price of the ADRs fell by $19.165 million as opposed to the entire dividend amount of $22.546 million, as would be expected.[382] This seemingly odd effect occurred because most taxpayers could not use the foreign tax credits. As a result, these taxpayers actually lost the $3.382 million withheld, so they would be willing to sell the ex-dividend stock for $19.165 million (the net dividend amount) less than the original price.[383] In contrast, Compaq did not actually lose the $3.382 million because it was able to take the dollar-for-dollar credit.[384] Thus, Compaq would have been willing to sell at the original price less $22.546 million.[385] Had this happened, the transaction would have been a wash—Compaq would have received a value of $22.546 million (net dividend amount plus the credit) and would have lost $22.546 million on the sale, making the transaction absurd, especially with transaction costs. But because the price fell only by the net dividend amount of $19.2 million (which is what the ADRs were worth to those who could not use the credits), Compaq actually came out $3.382 million ahead—it still received a value of $22.546 million but lost only $19.165 million.[386] In other words, as a result of this "market glitch," Compaq was able to "make up" what it lost in withheld taxes by selling at a price that was "too high" from its vantage point.

The transaction can be summarized as follows:

The Transaction	
1. Purchase Price	$887.577 million
2. Sale Price	$868.412 million
3. Loss on Sale (1 – 2)	$19.165 million
4. Transaction Costs	$1.486 million
5. Dividend Amount	$22.546 million
6. Withholding Tax	$3.382 million
7. Dividend Amount Received (5 – 6)	$19.164 million
Pre-Tax Profit Without Withholding Subtracted	
8. Dividend Amount	$22.546 million
9. Total Losses (3 + 4)	$20.651 million
10. Pre-Tax Profit	$1.895 million

382. George K. Yin, *The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches*, 55 TAX L. REV. 405, 407 (2002) ("These transactions were attractive to the taxpayers because the price of the stock interests did not fully capitalize the value to them of the foreign tax credits. Rather, the price was determined by owners who could not use such credits."). This situation is not especially unique. *See* Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in* Compaq v. Commissioner, 94 TAX NOTES 511, 514 (2002) ("All that this requires is that either tax-exempts or locals (who have no U.S. or other overseas tax liability to offset) be the key participants in a given market. Needless to say, there are a lot more worldwide investment dollars held by persons in these categories than by excess-limit American multinationals.").

383. Yin, *supra* note 382, at 407.

384. *Id.*

385. *Id.*

386. *Id.*

Pre-Tax Loss with Withholding Subtracted	
11. Dividend Amount	$22.546 million
12. Withholding Tax	$3.382 million
13. Net Dividend Amount (11 – 12)	$19.164 million
14. Total Loss (9)	$20.651 million
15. Pre-Tax Loss (13 – 14)	$1.487 million
Post-Tax Profit	
16. Net Dividend Amount (7)	$19.164 million
17. Total Losses (3 + 4)	$20.651 million
18. Pre-Tax Loss (16 – 17)	$1.487 million
19. U.S Tax on Dividend (5 * .35)	$7.66 million
20. Tax Benefit of Loss (17 * .35)	$7.021 million
21. Foreign Tax Credit	$3.382 million
22. Tax Savings (21 + 20 – 19)	$2.737 million
23. Post Tax Profit (22 – 15)	$1.25 million

The transaction is troubling to many because it seems that Compaq "did not pay anything for the portion of the dividend used to pay the foreign tax and, therefore, did not bear any of the economic cost of that tax."[387] Rather than focusing on this problem directly, however, courts and commentators utilized the profit test.[388] In doing so, it became clear that interpreting even the most basic elements of the profit test could become problematic when applied to the new, complicated generation of shelters. In *Compaq*, the question of how to account for foreign taxes in the calculation of pretax profit determined the entire outcome of the case and is the focus of scholarly debate to this date.[389] If foreign taxes were treated as expenses, the transaction would not yield a pretax profit, and the taxpayers would be denied the credits. If, on the other hand, the foreign taxes were not subtracted from the calculation, the taxpayers would retain the credits. The Tax Court chose the former option and the Fifth Circuit reversed, choosing the latter.[390]

Much of the extensive commentary and debate regarding the proper treatment of the *Compaq* transaction also focused on the profit test. Notably, Professors Daniel N. Shaviro and David A. Weisbach,[391] and

387. *Id.* at 407.

388. See the court's application of the profit test in *Compaq*. 277 F.3d 778, 781–88 (5th Cir. 2001).

389. *See, e.g.*, Hariton, *supra* note 54, at 502–09; Kane, *supra* note 69, at 1215–18; Shaviro & Weisbach, *supra* note 382, at 515–16.

390. To be precise, the Fifth Circuit held that the entire dividend amount should be used in the calculation of pre-tax profit because the payment of withholding taxes constituted income from the discharge of a liability under *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). The effect is the same, however, if the withholding taxes were not treated as expenses because under either scenario, the gross dividend amount, as opposed to the net dividend amount, is used, which yields a pretax profit. *Compaq*, 277 F.3d at 783.

391. Shaviro & Weisbach, *supra* note 382, at 515–16.

Professor Michael Knoll[392] offer different ways that the profit test ought to have been applied to deny Compaq the claimed foreign tax credits. To the extent that they defend the profit test as an adequate test, I disagree for the reasons stated in Part II. With respect to their particular analysis under the test, comment seems unnecessary as I do not believe the transaction can be properly analyzed with a look to profit alone. Other commentary provided by Professors Shaviro and Weisbach that has to do with applying the profit analysis is addressed below.

Rather than focusing on how to account for foreign tax expenses in the pretax profit analysis, courts and commentators should look at the purposes of the foreign tax credit regime. The next Section will apply the proposed test to do just that.

2. *Applying the Proposed Test*

The most generally understood policy of granting foreign tax credits is to mitigate double taxation and ensure that taxpayers do not have to pay tax twice on the same income, once in a foreign jurisdiction and once in the United States.[393] Compaq, however, "recouped" the withheld tax in the sense that the ADR sale price did not fall by the entire dividend amount.[394] Therefore, many have argued, Compaq was able to snatch a \$3.382 million tax credit for free.[395] Much of the literature regarding *Compaq* focuses on the fact that the dividend withholding amount "lost" by Compaq was "made up" on the sale of the ADRs because the price fell only by the net, as opposed to the gross, dividend amount.[396] For instance, Professors Shaviro and Weisbach argue that because of this pricing, "the payment of foreign taxes was economically irrelevant to the taxpayer" and that "it is hard to see why we should want to rebate foreign withholding taxes on dividends when no U.S. taxpayer has . . . borne the taxes economically."[397] This is indicative of two assumptions commentators seem too willing to make.

a. The First Assumption: An "Economic Bearance" Requirement

The first assumption is that failure to bear taxes economically is enough to deny foreign tax credits. This, once again, underscores the need for a deliberate analysis into the purposes of the provisions at issue. While one might feel it undesirable to grant credits to those who do not economically bear the underlying taxes, it does not mean that it falls out-

392. Michael S. Knoll, Compaq *Redux: Implicit Taxes and the Question of Pre-Tax Profit*, 28 VA. TAX REV. 821, 856–57 (2007).

393. S. REP. NO. 106-120, at 135 (1999).

394. *See* Yin, *supra* note 382, at 407–08.

395. *See, e.g.*, Shaviro & Weisbach, *supra* note 382; Yin, *supra* note 382, at 407–08.

396. *See, e.g.*, Shaviro & Weisbach, *supra* note 382, at 515; Yin, *supra* note 382, at 415.

397. *See* Shaviro & Weisbach, *supra* note 382, at 516.

side the purposes of the law. Moreover, it assumes that Compaq failed to "economically bear" the taxes because it made them up in the sale of the ADRs. One needs to inquire as to whether it is the purpose of the foreign tax credit regime to look at transactions holistically to determine when a tax is "economically irrelevant" to the taxpayer.

The proposed test asks the proper inquiry—whether the results achieved in *Compaq* fall within any of the purposes of the foreign tax credit provisions. The question is whether taking a foreign tax credit for withheld taxes on dividends when the amount of that credit was "recouped" because the market failed to fully capitalize the value of the foreign tax credit fell outside the purposes of the then-existing foreign tax credit regime. This can be broken down into two inquiries. First, is it outside the purposes of the foreign tax credit regime for the taxpayer to take credits on taxes that are not economically borne? And second, if so, did the results of the transaction fall outside this purpose—i.e., did the taxpayer fail to "economically bear" the taxes—because the taxpayer "made up" the foreign taxes withheld due to a market glitch?

Before proceeding to the analysis, note that the foreign tax credit provisions are probably best characterized as part of the general structure of the tax law, discussed in Part II.B. Like other common deductions and credits, these provisions allow taxpayers to make needed adjustments to capture the general concept of income. In ascertaining the purposes behind provisions of this type, we consider both the specific purposes of the law and general principles of tax law. Recall that when analyzing provisions that are part of the general structure of the Code, one should assume that general principles apply. That is, it is the purpose of these provisions to accord with general principles. Because this transaction does not flout any general principles of tax law, however, this Section will focus on the specific purposes of the foreign tax credit regime.

When one looks at the foreign tax credit regime, it is by no means clear, contrary to commentators' assumptions, that there is a purpose to restrict foreign tax credits to taxpayers who have economically borne them.[398] In fact, the regime strongly suggests quite the opposite. As is consistently stated in Senate and House Reports, "The purpose of the foreign tax credit generally is to eliminate the possibility of double taxation (once by the foreign jurisdiction and again by the United States) on the foreign source income of a U.S. person."[399] At first glance, it might seem to be an obvious corollary that taxpayers who have not borne the economic burden of the tax do not need protection from double taxation and therefore are not entitled to the credit. But this presumes a world where taxpayers can be separated with perfect precision—those who bear the economic burden and those who do not. In reality, it is quite

398. *See id.*
399. S. Rep. No. 106-120, at 135 (1999).

difficult to determine who actually bears the economic incidence of a tax, and the filter for those entitled to foreign tax credit will either be over-inclusive (granting credits to some who have not borne the tax) or under-inclusive (denying credits to some who have borne the tax). Senate and House Reports have further explained that reducing double taxation is essential to "make U.S. businesses more competitive, and create jobs in the United States."[400] Thus, the foreign tax credit regime is a protective mechanism meant to shield U.S. citizens from double taxation in order to advance important economic goals. This suggests that, if one were to choose, the purpose of the regime would be better fulfilled through over-inclusiveness than under-inclusiveness.

A closer look at the foreign tax credit regime provides more concrete evidence that taking a foreign tax credit on taxes not economically borne will not automatically fall outside the law's purposes. In fact, there are several places where an "economic burden" requirement might easily have been chosen as the requirement for foreign tax credit eligibility. Instead, lawmakers chose bright-line requirements that were easily administrable.

Consider the so-called technical taxpayer rule provided in Treas. Reg. § 1.901-2(f)(1), which affects a wide array of cross-border transactions.[401] This rule provides that the taxpayer liable for the tax, as opposed to the individual who actually pays the tax (i.e., suffers the economic detriment), is eligible for the credit.[402] Thus, the criterion for claiming the credit is legal liability as opposed to the incidence of an economic burden.

> It is generally understood that the policy rationale behind that "technical taxpayer" rule is the desire to have a simple, straightforward rule that can be readily administered by taxpayers and the IRS and that avoids the difficult and often nebulous inquiries as to where the incidence of tax falls as an economic matter.[403]

The technical taxpayer rule was rooted quite firmly in history before being included in the Regulations. As early as 1938, in *Biddle v. Commissioner*,[404] the Supreme Court of the United States found that, for purposes of determining who could claim the foreign tax credit, it was irrelevant who bore the actual economic burden.[405]

The rule's effect is illustrated through its application to the common cross-border loan arrangement known as a "gross-up loan."[406] In such an arrangement, a foreign borrower agrees to pay a U.S. lender a fixed in-

400. H.R. REP. NO. 108-548, pt. 1, at 190 (2004).
401. Treas. Reg. § 1.901-2(f)(1) (as amended in 2008).
402. *See id.*
403. Yaron Z. Reich, *The Allocation of Foreign Taxes Among Related Persons*, 107 TAX NOTES 1013, 1016 (2005).
404. 302 U.S. 573 (1938).
405. *Id.* at 581.
406. Reich, *supra* note 403.

terest amount and to pay the relevant withholding tax on that amount.[407] For example, if the agreed upon rate is 7%, the borrower will always pay the U.S. lender 7% and will also pay the relevant government whatever amount is due in withholding tax. This differs from ordinary loan arrangements where the U.S. lender is paid the interest amount less the amount withheld.[408] In the latter situation, the U.S. lender actually bears the economic burden of the tax (it receives less interest), and thus is entitled to a foreign tax credit on the withholding amount, effectively mitigating double taxation. Under the technical taxpayer rule, however, the U.S. lender is entitled to the foreign tax credit on the withholding amounts of gross-up loans as well—even though the borrower paid the tax, the U.S. lender is entitled to the full credit because it is the liable party.[409] This is just one of many instances where taxpayers take foreign tax credits where they may not have suffered the burden.

Consider also § 901(i), which provides that taxpayers will not be entitled to foreign tax credits on taxes for which the foreign taxing government has provided a subsidy to either the taxpayer or any party to the transaction.[410] This can result in taxpayers being denied credits for taxes that actually caused them detriment. Here, lawmakers again chose a bright-line rule rather than seeking to identify who bears the incidence of the tax.[411]

The effects of the "subsidy rule" are illustrated in *Continental Illinois Corp. v. Commissioner*.[412] In *Continental Illinois Corp*., a U.S. lender entered into a "gross-up" loan arrangement (such as that described above) with a Brazilian borrower.[413] In order to help its domestic taxpayers, the Brazilian government instituted a practice whereby Brazilian borrowers were eligible for rebates on taxes withheld on gross-up loan arrangements.[414]

The U.S. lender argued that it should not have to reduce its foreign tax credit because of the rebate.[415] Under the subsidy rule of § 901(i),

407. *Id.*
408. *Id.* at 1021.
409. *Id.* at 1017.
410. I.R.C. § 901(i) (2008).
411. Reich, *supra* note 403, at 1021.
412. 998 F.2d 513 (7th Cir. 1993).
413. *Id.* at 518.
414. *Id.* at 519.
415. While it might seem odd that a taxpayer argued to include more income, it is due to the simple fact that each dollar of income included is taxed at a 35% rate (so that is "costs" the taxpayer thirty-five cents) while each dollar of corresponding credit creates a dollar-for-dollar decrease in taxes (making it worth the entire dollar to the taxpayer). In fact, this is seen in many cases. *See, e.g.*, Riggs Nat'l Corp. v. Comm'r, 295 F.3d 16 (D.C. Cir. 2002). In *Riggs*, the U.S. lender entered into a gross-up loan with a Brazilian bank. Under Brazilian law, banks were normally exempt from the obligation to pay the withholding tax. In order to ensure the desired tax treatment, however, the U.S. lender received a formal ruling from the Brazilian government that it would make an exception in this case and require the bank in question to remit payments to them. After much controversy, the court finally felt obliged to allow the credit under the state of action doctrine. Because the Brazilian government had

however, the U.S. lender was forced to reduce its credit by the amount subsidized to the foreign borrower.[416] This was the case even though it was not at all clear that the U.S. lender's economic situation was at all affected by the rebate.[417] Specifically, before the rebating policy, the U.S. lender would receive the agreed upon interest rate and the Brazilian borrower would pay the government the relevant taxes.[418] The U.S. lender would then report the amount of taxes paid on its behalf as income and also take a foreign tax credit on that amount.[419] After the rebating policy, the U.S. lender would receive the same agreed upon interest rate, and the Brazilian borrower would pay the government the relevant taxes.[420] The only difference was that the Brazilian borrower would later receive a rebate for the taxes it paid on the U.S. lender's behalf.[421] Yet, rather than choosing a rule that required a reduction in foreign tax credits when subsidies or rebates actually affected the taxpayer's economic position, lawmakers again chose a bright-line rule: if the lender was given a rebate, the taxpayer would have to reduce its credit by that amount.[422]

Considering provisions such as these, one would be hard-pressed to claim that taking a foreign tax credit for taxes not economically borne falls outside the purposes of the law. This blanket statement obviously proves too much. This is significant because it reveals a common flaw present in much of the existing commentary arguing that Compaq should have been denied the claimed credits. Many of these arguments assume that Compaq's (alleged) failure to economically bear the taxes is enough to disqualify the taxpayer from claiming the foreign tax credits.[423] As this Section has shown, however, it is not. Thus, the correct result—and the result under the proposed test—would be to allow Compaq the foreign tax credit because the results of the transaction do not fall outside the purposes of the then-existing foreign tax credit regime.

issued a formal ruling, the court believed it would be against general principles of comity to disallow the credits.

416. *Cont'l Ill. Corp.*, 998 F.2d at 519–20.

417. In *Continental*, Judge Posner specifically noted: "It is by no means clear that the Brazilian tax rebate subsidized, in the sense of conferring an actual benefit upon, American net lenders like Continental. Indeed, insofar as the interest rate had been fixed in the loan contract before the rebate was instituted, only the borrowers benefited . . . ." *Id.* at 519 (citations omitted).

418. Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 Tax L. Rev. 227, 245 (1984).

419. *Id.* at 247.

420. *Id.* at 245–46.

421. *Cont'l Ill. Corp.*, 998 F.2d at 518.

422. In discussing the subsidy rule, Judge Posner wrote: "The IRS can hardly be faulted for having chosen a bright-line approach in preference to interminable investigation of the mysteries of public finance . . . ." *Id.* at 520.

423. *See, e.g.*, Shaviro & Weisbach, supra note 382, at 516.

b. The Second Assumption: A "No-Recoup" Requirement

As mentioned above, much of the commentary surrounding *Compaq* makes a second questionable and unsupported assumption. Specifically, after assuming that there is an "economic bearance" requirement, commentators assume that Compaq failed to meet that requirement because it made up the taxes on the sale of the ADRs. Because this Section has already shown that there is no general economic bearance requirement, it is unnecessary to address this at extreme length. It is worth noting, however, that the provisions discussed above—the technical taxpayer rule and the subsidy rule—hinge eligibility for the credit on criteria that are far easier to measure than an economic burden requirement.[424] The second assumption made by commentators implies that it is the purpose of the foreign tax credit regime to look holistically at a transaction to determine if the foreign taxes underlying the credit were "made up" in some manner—in *Compaq*, taxes were made up because of a market glitch.[425] Thus, commentators assume that we should not only focus on the tax, but also look at the other cash flows of the deal to see if the foreign tax was recouped anywhere within the transaction.[426]

This idea is unsupported. The clear choices of lawmakers to hinge foreign tax credit eligibility on bright-line rules rather than where the economic incidence of the tax falls belies this assumption. Both the technical taxpayer rule and the subsidy requirement evidence a clear choice to avoid the fuzzy inquiries that would result if we had to figure out where the economic incidence of a tax actually lies in each transaction. Consider again the transaction in *Continental Illinois Corp*.[427] Certainly, it would be theoretically possible to determine if the U.S. lender-taxpayers actually enjoyed any part of the subsidy received by the foreign borrowers. This would require, among other things, a lengthy inquiry into the terms and pricing of the loans. Nobody actually suggests that this should be done—i.e., that the blunter filter of the subsidy requirement should be replaced by a more precise yet remarkably more complicated inquiry. More importantly, lawmakers clearly chose against this more opaque requirement. Thus, commentators' willingness to argue that Compaq did not "bear" the underlying taxes because they were made up elsewhere—in the sales price of the ADRs—is not rooted in the purposes of the relevant laws.

This analysis has shown that the results of the Compaq transaction do not fall outside the purposes that can be derived from the foreign tax credit regime. In doing so, it also reveals that much of the commentary surrounding *Compaq* depends on unwarranted assumptions. Important-

424. Reich, *supra* note 403, at 1021.
425. *See* Shaviro & Weisbach, *supra* note 382, at 517.
426. Isenbergh, *supra* note 418, at 247.
427. 998 F.2d 513, 516–17 (7th Cir. 1993).

ly, however, this analysis does not look at whether a transaction should be treated differently because it is "prewired" to reach a specific tax result.[428] In other words, this Article does not address whether a transaction can be struck down for the sole reason that the taxpayer had a certain motive. What the analysis does show, however, is that once unwarranted assumptions are removed, it is not clear that cases arguing that Compaq should be denied the claimed credits depend on anything more than the fact that the taxpayer had an "improper" motive.[429] As Professors William A. Klein and Kirk J. Stark put it, "[O]ne might want to rely on the idea that the Compaq transaction should not be recognized for tax purposes because it was a contrivance . . . . But if that is the argument then it should be stated and addressed directly."[430] This Article will not further explore the wisdom of using motive as a criterion for denying tax benefits, except to agree with Professors Klein and Stark that doing so should (at the very least) be "somewhat disturbing" and something that "requires explicit recognition and justification."[431] Finally, this analysis does not address the transitory nature of Compaq's investment and whether this might have provided sufficient grounds for denying Compaq the foreign tax credits.[432]

Some might view the failure of the proposed test to identify the *Compaq* transaction as an abusive tax shelter as a failing in the test. This is not the case. One might not be pleased with what was done in *Compaq*. As shown, however, it cannot be said that the results fell outside the purposes of the law existing at the time of the transaction. As a result, I argue it is inappropriate to deny *Compaq* the claimed credits. The proposed test still serves a function for such transactions, however. As illustrated by the analysis of the *Compaq* transaction, the proposed test can serve a useful signaling function. For instance, the *Compaq* transaction can be accurately viewed as an extreme illustration of a broad prob-

428. Professors Shaviro and Weisbach seem to find the existence of a "bad" motive important. For instance, they present a cross-border transaction similar to *Compaq* that does not have a pre-tax profit, but that is profitable after one accounts for foreign tax credits and interest deductions. They argue that this transaction is "not a sham, despite the lack of pre-tax profit as computed net of foreign tax." The difference, they state, is that "[t]he taxpayer actually took an economic position in a deal that was not pre-wired or transitory like the supposed investment in Compaq." Shaviro & Weisbach, *supra* note 382, at 515.

429. *Id.*

430. William A. Klein & Kirk J. Stark, Compaq v. Commissioner—*Where Is the Tax Arbitrage?*, 94 TAX NOTES 1335, 1340 (2002).

431. *Id.* at 1339.

432. In *Compaq*, the parties stipulated that the taxpayers were legal owners of the stock despite the extremely transitory nature of that ownership. 277 F.3d 778, 781 (5th Cir. 2001). In the absence of this stipulation, the transaction might have been struck down by finding that Compaq never truly owned the stock (i.e., that there was never a true sale) and therefore was never entitled to the dividend or the accompanying tax benefits. I do not address the merits of this argument any further. In response to *Compaq*, § 901(k) was enacted and requires that stock be held for a minimum holding period before the owner will be eligible for the foreign tax credit. Like motive, if this is to be the sole reason for denying Compaq the claimed credits, it needs to be addressed directly and heartily.

lem present in the foreign tax credit regime.[433] If a transaction deemed undesirable passes the proposed test, it signals to lawmakers an area upon which they should focus.[434] The proposed test makes this possible by identifying transactions whose results fall outside the purposes of the Code, thus freeing lawmakers to allocate their time to provisions that really need revision (as opposed to provisions whose purpose is clear, but that taxpayers keep finding gaps and ambiguities to exploit).

V. CONCLUSION

The idea of looking at the purposes of the Code and Regulations to assess the validity of tax transactions may not appear remarkably novel. Courts have consistently failed, however, to conduct this needed analysis (and in rare cases where it has been done, it has been done inadequately). This Article provides a framework particularly suited to allow courts to effectively identify tax shelters and illustrates the application of the proposed test to three extremely sophisticated tax shelters.

The proposed test is superior to the traditional anti-abuse test in several ways. Most obviously, the proposed test has the advantage of asking the purposive question directly. The application of the test to the contingent liability shelters in *Black & Decker* and *Coltec* shows how clear statements of purpose expressed in reliable committee reports may be used to assess transactions in a clean and efficient fashion. Relying on the committee reports would have spared the courts from arbitrarily defining the transactions in a manner they "felt" would accord with the law's purposes, without conducting the needed inquiry into this complicated question. The proposed test would produce a consistent and reasoned body of law, rather than one riddled with the many definitional problems and inconsistencies of the anti-abuse tests discussed in Part II.

Analysis of the CINS transactions shows how a direct and reasoned look at the purposes of the installment sale regulations would have allowed courts to avoid the extremely fact-specific inquiries required under traditional anti-abuse tests. The need for these inquiries illustrates

433. Robert Peroni, Professor of Law, Univ. of Tex. School of Law, Commentary at the University of Minnesota Law School Tax Policy Conference: The Future of Tax Shelters (Oct. 27, 2006) (commenting upon the various ways in which commentators had fashioned the profit test to strike down *Compaq*). Noting them all to be clever, he went on to state that the tests failed to reach this real problem. *Id.* *See generally* Michael J. Graetz, Lecture, *Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies*, 54 TAX L. REV. 261, 261 (2001) (pointing out that the dollar-for-dollar credit, enacted in the 1900s to facilitate investment abroad, is remarkably outdated and in need of drastic revision). In fact, Graetz argues, due to the technical taxpayer rule, we have witnessed the odd situation of taxpayers fighting to claim more interest income, so that they can claim a foreign tax credit. *Id.* at 311. These odd situations make sense because the credit is dollar-for-dollar even though each additional dollar of income only costs thirty-five cents. *See, e.g.*, Cont'l Ill. Corp. v. Comm'r, 998 F.2d. 513 (7th Cir. 1993).

434. Professors Klein and Stark state that the "principal function" of the *Compaq* transaction "should be to draw our attention to the basic tax phenomenon of which it is a relatively small manifestation." Klein & Stark, *supra* note 430, at 1341.

another important advantage of the proposed test. Once a potentially abusive scheme is concocted, taxpayers will rush to mimic it. Under the traditional tests, courts have to consider each transaction on a case-by-case basis because the inquiries are fact specific. This allows for the absurd result that two transactions exploiting the same provisions in the same manner might be treated differently because only one yields a pre-tax profit. The proposed test would not produce such inconsistencies because it asks whether the results of these transactions fall within the purposes of the provisions they exploit. This question will be answered uniformly for each scheme.

Further, looking at the same scheme multiple times is inefficient. The proposed test would avoid this inefficiency. Once a determination is made as to whether the results of a particular type of transaction fall outside the purposes of the tax law, there is no need to consider each transaction separately.

The *Compaq* analysis illustrated the importance of engaging in a full and deliberate inquiry into the purposes of the laws that generate possibly abusive tax benefits. What this revealed in *Compaq* is that the results did not flout the purposes of the foreign tax credit regime, making it inappropriate to deny Compaq the claimed benefits.

The analysis also showed the overwillingness of commentators to assume the purposes of laws when analyzing transactions which appear abusive, resulting in flawed and misleading analyses. By engaging in the direct analysis required under the proposed test, these assumptions were stripped away. In some cases, once this was done, arguments claiming, for example, that Compaq should have been denied the claimed credits looked very different. Specifically, one begins to suspect that commentators' arguments relied on notions (such as the notion that improper motive is a sufficient condition for denying tax benefits) that were not explored at an appropriate depth, if they were addressed explicitly at all.

Finally, the *Compaq* analysis showed how the proposed test can serve a useful signaling function. The proposed test can identify areas upon which lawmakers need to focus (if troublesome transactions still fall within the law's purposes, it signals an underlying problem within the provisions as written), while freeing lawmakers of the need to constantly reform laws whose purposes are clear (because taxpayers will be denied benefits from transactions whose results flout these purposes).

As this Article illustrates, a test that inquires directly into the purposes of the tax law is needed to deal effectively with current tax shelters. This Article provides an extensive framework for doing so and illustrates that this framework is extremely feasible. Finally, this Article has shown that the test proposed has the potential to act as a powerful weapon in current and future tax shelter wars.