April 24, 2003

The Honorable Charles E. Grassley
Chairman
Senate Finance Committee
United States Senate
219 Senate Dirksen Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Senate Finance Committee
United States Senate
219 Senate Dirksen Office Building
Washington, DC 20510

Re: S.476 – Proposed Codification of Economic Substance Doctrine

Dear Senators Grassley and Baucus:

On behalf of the American Bar Association Section of Taxation, I am enclosing comments on the proposed codification of the “economic substance doctrine” in Section 701 of “The CARE Act” (S.476). The comments were prepared by members of the Section’s Tax Shelter Task Force and represent the position of the Section. They were not, however, approved by either the House or Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

For the reasons outlined in the comments, we have serious reservations about attempts (however well-intentioned they may be) to codify the economic substance doctrine. To the extent that the Congress ultimately decides to take any action in this regard, it should in our view be limited to clarifying that when a court determines that the economic substance doctrine does apply, (i) the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits; and (ii) in evaluating the potential economic profit from the transaction, all costs associated with the transaction (including fees paid to promoters and advisers) should be taken into account.

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Representatives of the Section would be pleased to discuss these comments with you or members of your respective staffs. Please contact Bill Wilkins, the Section’s Vice Chair for Government Relations (at 202/663-6204), if that might be helpful.

Very truly yours,

[Signature]

Herbert N. Beller
Chair, Section of Taxation

Enclosures

cc: The Honorable William Thomas, Chairman, House Ways & Means Committee
    The Honorable Charles Rangel, Ranking Member, House Ways & Means Committee
    Mark A. Prater, Republican Chief Tax Counsel, Senate Finance Committee Staff
    Russell Sullivan, Democratic Chief Tax Counsel, Senate Finance Committee Staff
    Bob Winters, Republican Chief Tax Counsel, House Ways & Means Committee Staff
    John Buckley, Democratic Chief Counsel, House Ways & Means Committee Staff
    Mary Schmitt, Acting Chief of Staff, Joint Committee on Taxation
    Pamela F. Olson, Assistant Secretary, Tax Policy, Department of Treasury
    Gregory F. Jenner, Deputy Assistant Secretary, Tax Policy, Department of Treasury
    Helen M. Hubbard, Tax Legislative Counsel, Department of Treasury
American Bar Association  
Section of Taxation  
Comments on the Proposed Codification of the Economic Substance Doctrine

These comments, filed on behalf of the Section of Taxation of the American Bar Association, address the proposed codification of the “economic substance” doctrine. The comments were approved by the Section’s Council and represent the position of the Section. The comments have not, however, been reviewed or approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

As stated in our prior testimony before the Senate Finance Committee and the Ways & Means Committee, and in our written comments last year on the tax-shelter provisions of H.R. 5095, we oppose codification of the economic substance doctrine. We share the concerns of Congress regarding the robustness of the tax shelter phenomenon, and we commend the Finance Committee and the Ways & Means Committee for taking up and approving important provisions to combat shelters, including significant penalties for failure to disclose reportable transactions. We believe, however, that the proposed codification of the economic substance doctrine, though well intended, may have significant ramifications for bona fide business transactions that are far removed from the shelter transactions that are the intended target of the legislation.

The comments that follow are based on the codification of the economic substance doctrine as embodied in Section 701 of the CARE Act (S. 476), which passed
the Senate on April 9, 2003.\(^1\) As discussed more fully below, our comments include the following:

- While we continue to oppose codification of the economic substance doctrine, we continue to support a legislative clarification that when the doctrine applies, the nontax considerations in the transaction must be substantial relative to the potential tax benefits.

- The economic substance doctrine should continue to be flexible so that courts can use their discretion in determining whether the doctrine should apply in a given context. The statutory language should make clear that the legislation does not limit this traditional discretion of the courts.

- Codification of the doctrine is likely to encourage the IRS and the courts to focus on vague and subjective considerations rather than precise questions of statutory interpretation and Congressional purpose essential to the proper implementation of the tax laws.

- Codification of the doctrine is likely to do more harm than good in that well-advised taxpayers can imbue their transactions with enough economics to satisfy the proposed standard while codification will

\(^1\) The Section has previously submitted comments on other tax shelter-related provisions included in the legislation. See the June 4, 2002 letter from Richard M. Lipton to Senators Baucus and Grassley providing comments on the Tax Shelter Transparency Act (S. 2498) as introduced on May 9, 2002, and the September 9, 2002 letter from Herbert N. Beller to Congressman William M. Thomas regarding the tax shelter-related provisions of the American Competitiveness and Corporate Accountability Act (H.R. 5095) as introduced on July 11, 2002.
draw into question many well-accepted tax planning techniques having nothing to do with tax shelters.

- Expansion of the judicial economic substance doctrine by requiring that a transaction be a “reasonable means” of accomplishing the taxpayer’s business purpose has the potential for introducing significant uncertainty into the tax law, affecting many business transactions that have nothing to do with tax shelters.

**Discussion**

Section 701 of the CARE Act of 2003, S. 476, would add a new section 7701(m) to the Internal Revenue Code ("IRC") to “clarify and enhance” the economic substance doctrine in several respects.\(^2\) The proposal would explicitly make the economic substance test a two-part conjunctive test under which a transaction would be treated as having economic substance only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal and other tax consequences) the taxpayer’s economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.\(^3\) In essence, the proposal would clarify or expand the economic substance doctrine in essentially three ways: (1) it would make it clear that the change in economic position must be “meaningful” and not merely *de minimis*; (2) it would explicitly require that a taxpayer establish both a change in economic position

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\(^2\) The phrase “clarify and enhance” is not in the statutory language, but is used in the description of the proposed legislative change in Joint Committee on Taxation, *Description of the “CARE Act of 2003”* 75 (Feb. 3, 2003) (hereinafter the “JCT Description”).

\(^3\) Proposed IRC § 7701(m)(1)(B)(i).
a substantial non-tax business purpose; and (3) it would require that the transaction be a
“reasonable means” of accomplishing that purpose. The legislation also includes specific
requirements that must be satisfied in order for the form of certain transactions to be
respected, namely financing transactions and certain transactions involving tax-
indifferent parties.

As we have previously stated, both in written comments and Congressional testimony, we support legislation clarifying that when a court determines that the economic substance doctrine applies, the taxpayer must establish that the non-tax considerations in the transaction were substantial in relation to the potential tax benefits. We have similarly supported legislative clarification that in evaluating the potential economic profit of a transaction, all costs associated with the transaction, including fees paid to promoters and advisers, should be taken into account. To the extent that the legislation incorporates these concepts, we believe it will improve the state of the law. In other respects, however, we continue to oppose codification of the economic substance doctrine. Our comments here first deal with that fundamental point and then continue with comments on specific aspects of the proposal.

I. Codification Generally

The proposed codification of the economic substance doctrine appears to us to be undesirable for a number of reasons. Our comments in Part II on particular features of the proposal explain some of those reasons, but others are more fundamental.

First, the doctrine should continue to be flexible so that courts can use their discretion in determining whether the doctrine is applicable in any given context. Fundamentally, the determination of whether the doctrine applies in a given context
should be left to the courts because the doctrine is an aspect of statutory construction. The court must determine whether Congress intended the particular IRC section at issue to apply when the taxpayer literally satisfies its language but has done so in a way that may lack economic substance or business purpose. While the economic substance doctrine is often thought of as an anti-abuse doctrine, its origins are traceable to the landmark case of *Gregory v. Helvering*,\(^4\) in which the Supreme Court held — as a matter of statutory construction — that the taxpayer was not entitled to the tax benefits sought because she lacked a business purpose. Although the taxpayer’s transaction satisfied the literal words of the reorganization statute at issue, the Court concluded that Congress intended to limit the statute to situations in which business entities were being reorganized for purposes germane to the business. Similarly, the taxpayer in *Cottage Savings v. Commissioner*\(^5\) could recognize its losses — even though the transaction may have lacked economic substance or business purpose — because it undertook an exchange of the sort contemplated by the statute.

One concern raised by the proposed legislation is that it may be read as implying that the economic substance doctrine applies to every transaction. Indeed, the legislation contains a definition of the economic substance doctrine that appears to create such an inference:

“The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if

\(^{4}\) 293 U.S. 465 (1935), *aff’d* 69 F.2d 809 (2d Cir. 1934).

the transaction does not have economic substance or lacks a business purpose.”

The size of the revenue estimate associated with the proposal -- $11.5 billion -- has also led some to believe that it must be based on a universal application of the economic substance doctrine because it is so large. The Finance Committee report accompanying the legislation indicates, however, that the decision of whether the doctrine should apply will continue to rest with the courts. We believe it is critical that this intent be unambiguously reflected in the statute itself. Moreover, even if this change is made, we are concerned that the legislation may give rise to widespread challenges by the IRS to established and accepted planning techniques that have nothing to do with tax shelters. The proposed 40% penalty for transactions lacking economic substance significantly heightens our concern.

Just as the decision of whether the doctrine applies to a given transaction should be left to the courts, we think courts should similarly continue to have flexibility as to how the doctrine should apply in any particular context. For example, under current law a court may decide in the context of a specific IRC section that it is sufficient if a transaction meets either an economic substance test or a business purpose test. If the legislation is enacted, a court would not be free to interpret a statute as requiring one but not the other. A number of IRC provisions require a business purpose or profit motive but do not expressly require economic substance. How are these provisions to be interpreted if the legislation is enacted? For example, IRC § 355 requires a business purpose for a

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6 Proposed IRC § 7701(m)(3)(A).
tax-free spin-off. If the legislation is enacted, would a court also have to weigh the benefit of the tax savings from a tax-free distribution (as compared with a taxable disposition) against the expected profit or other intended economic benefits of the transaction in order to determine whether the transaction qualifies for tax-free treatment? We think that such an approach would be contrary to Congress’s intent in enacting IRC § 355 and that courts must retain the flexibility to interpret statutes without the artificial legislative constraint of a codified economic substance doctrine such as that contained in this legislation.

Second, we are concerned that codification of the doctrine will encourage the IRS and the courts to focus too much on vague and subjective considerations rather than precise questions of statutory interpretation and legislative purpose essential to the functioning of a statutory system. Judgments about the proper tax treatment of a transaction properly depend, in the first instance, on the application of statutes and fundamental principles of tax law. Even in the case of abusive transactions, judgments rarely depend on general questions about objective economic substance and/or subjective purpose. Some of the IRS's significant losses in recent tax shelter litigation may be due to excessive reliance on general economic substance arguments. For example, in *Salina Partnership v. Commissioner,*\(^7\) the IRS failed to sustain the economic substance and business purpose arguments to which it and the court gave priority, but won the case on the more technical argument that a short position should be treated as a partnership

\(^7\) T.C. Memo 2000-352.
liability in determining substitute basis. In *ACM Partnership v. Commissioner* and related cases, the IRS might have made a straightforward argument that the installment sales were not really “contingent” because the payments were made on a standard interest rate index. In *Compaq Computer Corp. v. Commissioner* and *IES Industries, Inc. v. United States*¹⁰, the IRS might have won had it argued that in substance the taxpayer was never the owner of the shares in question but had simply purchased the right to a dividend. And in *United Parcel Service (UPS) v. Commissioner*,¹¹ the IRS might have done better with a straightforward transfer pricing argument under IRC § 482.

Third, because the economic substance/business purpose doctrine deals only with extreme cases, we are concerned that codification of the economic substance doctrine will do more harm than good. Well-advised taxpayers can tailor their transactions so as to satisfy an economic substance standard. For example, had the taxpayers in *ACM Partnership* held the private placement notes that were used in the contingent installment sale for several months rather than a few days, and had they earned a meaningful economic profit on those notes, would the courts have been able to conclude that the transactions lacked economic substance and a business purpose? Would the IRS have had any basis for attacking the dividend-stripping transactions in *Compaq Computer* and *IES Industries* on economic substance grounds if the taxpayers had held the shares for several days (perhaps while minimizing risk through hedges)?

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¹⁰ 253 F.3d 350 (8th Cir. 2001), aff’g in part & rem’g in part 1999 U.S. Dist. LEXIS 22610 (1999).

¹¹ 254 F.3d 1014 (11th Cir. 2001), rev’g and rem’g, 78 TCM 262 (1999).
We therefore expect that revenue expectations associated with the proposal will go largely unfulfilled. While accomplishing little in the tax shelter area, however, codification of the economic substance doctrine is likely to draw into question a wide variety of previously well-accepted tax planning techniques that have nothing to do with tax shelters. The following discussion of our concerns about particular aspects of the legislative proposal gives a number of examples.

II. Specific Aspects of the Proposal

A. Business Purpose Test

By requiring both a meaningful change in economic position and a substantial non-tax business purpose, the proposed legislation would significantly expand the economic substance doctrine as applied by the courts. Many courts apply the rule of Rice’s Toyota World, Inc. v. Commissioner, 12 under which a transaction will be respected if it has either economic substance or a substantial business purpose. 13 Others have suggested that the two factors are really two different aspects of a single test. 14 While

12 752 F.2d 89 (4th Cir. 1985), aff’d 81 T.C. 184 (1984).

13 In practice, most courts focus first on objective economic substance. If a transaction lacks economic substance, it is easy for the court to conclude that it had no business purpose. Conversely, courts finding transactions to have economic substance generally find the transaction to have a business purpose as well.

14 See James v. Commissioner, 899 F.2d 905 (10th Cir. 1990), aff’d 87 T.C. 905 (1986); Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988), cert. denied, 488 U.S. 824 (1988); Thompson v. Commissioner, 631 F.2d 642 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981). The Joint Committee Description cites the Third Circuit’s decision in ACM Partnership as an example of a case treating the economic substance and business purpose prongs of the test as simply aspects of a single test, JCT Description at 74 n.121. Presumably, this is based on the statement in the opinion that: “these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a ‘rigid two-step analysis,’ but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.” However, in footnote 31, which ends the paragraph with the quoted language, the Third Circuit clearly states: “[I]t is also well established that where a transaction objectively affects the taxpayer’s net economic position, legal relations, (continued…)
some courts have stated that a transaction must have both economic substance and a business purpose to be respected,\textsuperscript{15} the only cases of which we are aware in which a court has found a transaction to possess economic substance but has disregarded it for tax purposes because of a lack of business purpose are those in which the relevant statutory provision implicitly or explicitly required a business purpose.\textsuperscript{16}

We have several significant concerns with a rule that would disallow the tax benefits of a transaction that effects a meaningful change in the taxpayer’s economic position because it lacks a substantial business purpose. Depending on how the words “the tax benefits … with respect to a transaction are not allowable” is interpreted, such a rule could be highly punitive. For example, in a leveraged transaction, the proposed rule could conceivably be interpreted to deny the taxpayer any interest deductions but to subject the taxpayer to tax on the gross income from the transaction. Further, the rule would appear to subject the taxpayer to tax on any true economic gains on the transaction or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.”

\textsuperscript{15} \textit{E.g.}, \textit{UPS v. Commissioner}, note 6 supra, where the Eleventh Circuit stated: “Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance.” Significantly, the Tax Court held against the taxpayer, but in so doing found that the taxpayer’s insurance arrangement had neither a business purpose nor economic substance. Hence, even had it not been reversed, the Tax Court’s decision in \textit{UPS} would not have been an example of a case in which a transaction’s tax benefits were disallowed for lack of business purpose even though it possessed economic substance.

\textsuperscript{16} \textit{Gregory v. Helvering}, supra note 3, may be viewed as such a case (although the transaction at issue there was recharacterized and not simply disregarded) because the courts concluded that implicit in the tax-free treatment for certain corporate reorganizations was the requirement that the reorganization be undertaken for corporate business reasons. The Joint Committee Description cites \textit{Pasternak v. Commissioner}, 990 F.2d 893, 898 (6th Cir. 1993), as an example of a case imposing a two-part test requiring both economic substance and a business purpose. JCT Description at 73 n.119. That case, however, imposes a two-part test only because the taxpayer there was an individual claiming an investment tax credit, and the statute explicitly provided that an individual was entitled to such a credit only on property used in a trade or business or held for the production of income. Further, the holding of the case does not support the existence of a two-part test because the court held that the transaction lacked economic substance, making moot the business purpose question.
while denying a deduction for even true economic losses. We suggest that if the proposed change goes forward, it be made clear in the statute that only the net tax benefits of a transaction are disallowed and that a taxpayer is permitted a deduction for any true economic losses.\(^{17}\)

Second, by substantially expanding the economic substance doctrine as applied by the courts, the proposed rule would undercut many well-accepted tax planning techniques having nothing to do with tax shelters. For example, under current law, it is clear that a taxpayer with a depreciated asset may choose to sell that asset solely to recognize the tax loss. Such a sale would typically effect a material change in the taxpayer’s economic position. Would the loss be denied under the proposed legislation in such a case but allowed to a taxpayer who also had a business motive for selling the asset? Similarly, would a taxpayer be allowed to drop an appreciated asset into a subsidiary in a “busted 351” transaction (involving a sale of preferred stock to a third party) in order to trigger a gain that would soak up a loss that was about to expire?\(^{18}\) At a minimum, the legislation should have an exception for any transaction whose purpose is to recognize a true economic gain or loss and that accomplishes a meaningful change in the taxpayer’s economic position.\(^{19}\)

\(^{17}\) The Third Circuit permitted the taxpayer a deduction for its actual economic losses in the ACM Partnership case, 157 F.3d at 260-263.

\(^{18}\) Cf. Chisholm v. Commissioner, 79 F.2d 14 (2d Cir.), cert. denied, 296 U.S. 641 (1935) (upholding transfer of appreciated shares to partnership so that it could sell them without tax).

\(^{19}\) Our position that a transaction should not be given effect for tax purposes unless it results in a meaningful change in the taxpayer’s economic position would allow the possibility of a court reaching a different result if the facts in Cottage Savings v. Commissioner, supra note 4, were considered under this standard. A court might determine, for example, that pools of loans sufficiently similar as to not require the recognition of the loss on the exchange for regulatory accounting purposes are not sufficiently different to (continued…)}
Such an exception, however, would not be sufficient to address all our concerns, for not all transactions that are largely tax-driven involve gain or loss recognition. Suppose that a corporation has been successful and decides to distribute a note to its sole shareholder for a portion of its retained earnings. Or suppose that the corporation decides to buy in some of its preferred stock for a subordinated note with similar terms. The sole purpose of the distribution is to convert some of the corporation’s equity capital to debt capital, which will allow it to receive interest deductions for interest as it accrues on the note. Such transactions have been upheld by the courts, but seemingly would not be permissible under the proposed rule. Similarly, the distribution by a corporation of a cash dividend to a corporate shareholder in anticipation of a sale (to convert taxable gain into an exempt or partially exempt dividend) or the drop-down of assets in connection with a spin-off would also appear potentially unacceptable.

Further, the scope of the rule is unclear because the notion of what constitutes a “transaction” is inherently ambiguous. Would the formation of a new subsidiary to merge into a target in a section 368(a)(2)(E) transaction be disregarded for lack of a non-tax business purpose? For another example, suppose that a corporate group acquires a target with multiple subsidiaries and thereafter restructures the combined group to achieve tax efficiencies. Often, at least some of the steps in such a restructuring be treated as causing a meaningful change in the taxpayer’s economic position. In most loss recognition trades, however, it would be clear that the taxpayer’s economic position changed in a meaningful way and in those cases the loss should not be disallowed for lack of business purpose.

20 Kraft Foods Company v. Commissioner, 232 F.2d 118 (2d Cir. 1956). Cases involving individuals, such as Pasternak, supra note 12, often involve statutes that explicitly impose a business purpose or similar requirement.

21 Such a transaction was found acceptable in, for example, Litton Industries, Inc. v. Commissioner, 89 T.C. 1086 (1987).
are purely tax-motivated. If the acquisition and restructuring is viewed as one transaction, then clearly it has a business purpose. But if each post-acquisition realignment step is viewed as a separate transaction, it might not have an independent business purpose. Does it matter whether the restructuring takes place before the acquisition, immediately after the acquisition or several months or years after the acquisition? The step transaction doctrine will not always produce sensible answers to these questions because some or all of the post-merger steps might not be sufficiently tied to the merger to be treated as steps in a single transaction but may nevertheless be sufficiently linked to the acquisition that they should not have to have an independent business purpose to be respected for tax purposes.

To take another example, suppose an owner of real estate wishes to dispose of an appreciated asset. The owner wants to defer paying the tax and so it arranges a typical three-party like-kind exchange. The owner has a business reason for wanting to dispose of the property (for which it has a buyer willing to pay cash) but perhaps no business reason for wanting to invest in a replacement property. One transaction or two? Given the well-established law governing like-kind exchanges, it seems easy to conclude that this should be viewed as a single transaction. What about a situation where a corporate taxpayer with appreciated subsidiary shares that it wants to dispose of first sells the assets within its group in order to trigger deemed dividends and basis adjustments that will minimize the gain recognized on the disposition of the shares to a third party?22 Here, it seems appropriate to characterize the transactions as steps in

the sale because the relevant statute intends to impute dividends only when the taxpayer maintains control. The examples illustrate the point that the concept of “transaction” as applied in the economic substance doctrine has no real meaning apart from particular circumstances and statutes.

In view of these considerations, if the proposed business purpose test is enacted, we think it is essential that the legislative history make it clear that all steps that are related to an overall transaction that has a business purpose should be treated as part of the overall transaction and not disregarded merely because the individual steps may be undertaken solely for tax reasons. On the other hand, if a business purpose test is to be included at all, we would endorse a statement that makes it clear that a tax-motivated transaction with no economic substance or business purpose should not be respected merely because it has been incorporated into an unrelated transaction which does have economic substance and a business purpose. For example, a tax-driven investment transaction in which a taxpayer has no reasonable possibility of making an economic profit should not be made acceptable merely by having the taxpayer invest an additional amount in other securities whose potential rate of return would move the combined rate of return on the two transactions to a rate in excess of a risk-free rate of return. Finally, we reiterate our suggestion above that the statutory language be revised to remove any implication that the economic substance doctrine applies to every transaction absent a specific exception.

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B. Reasonable Means

The proposed legislation would require that, in order to be treated as having economic substance, a transaction would have to be a “reasonable means” of accomplishing the taxpayer’s business purpose. The Joint Committee explanation of this proposal is a single sentence: “By requiring that a transaction be a “reasonable means” of accomplishing its non-tax purpose, the proposal broadens the ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.”24

We certainly agree with the sentiment expressed by the Joint Committee staff, but we believe that codifying a “reasonable means” test is both unnecessary and dangerous. The courts already have broad ability to characterize transactions for tax purposes, and in that process, they can and do bifurcate and amalgamate transactions. If the only effect of the proposed test were to reemphasize this ability, it would do no more harm than codification in general may do. On its face, however, a “reasonable means” test does far more than prevent the combination of an abusive with a legitimate transaction. Further, since the test is vague and entirely new, with no case law to indicate or limit its intended effect, the test’s effect is impossible for taxpayers or their advisors to predict.

To take a simple example, suppose a sole shareholder (S) of a small corporation (T) wants to sell his company to a larger corporation (P). He learns that if he

24 JCT Description at 76.
sells for cash (which P is willing to pay), he will pay tax on the gain on the sale, but if he accepts P shares he will have a tax-free reorganization and will defer his tax until he sells the P shares received. Is this a “reasonable means” for S to accomplish his business purpose? Does it matter whether S actually wants to own P shares? Does it matter whether S immediately puts a “collar” around the P shares to limit his downside and upside in the P shares? Does it matter if the value of the P shares is greater or less than the amount of cash P was willing to pay?

A more general concern is whether a taxpayer will be considered to have adopted a “reasonable means” of accomplishing a business purpose if the form of the transaction is less favorable on a pre-tax basis than a simpler form of the transaction, but more favorable on an after-tax basis. For example, suppose an individual shareholder (S) of a holding company (H) wants to liquidate H but chooses instead to merge H downstream into a larger company (C) in which H owns a minority interest. In so doing, S winds up with fewer shares of C than were held by H, but avoids paying the tax that would arise upon a complete liquidation of H. Assuming S had a legitimate business reason to get rid of H, is the downstream merger a reasonable means of accomplishing the goal? Does it matter how the value of the C shares S has to relinquish compares to the tax saved?

As another example, suppose T is the sole shareholder of an S corporation (S), and wishes to raise additional capital to expand the business. A C corporation (C) would like to invest in S, but this would cause a loss of S corporation status, so instead S and C form a partnership, which is a much more costly and time-consuming way of achieving the business goal than simply having the S corporation issue additional shares.
Is this a reasonable means of achieving the business objective? Presumably yes, because a specific example in the partnership anti-abuse regulations condones this use of a partnership, but similar cases without the benefit of a specific regulation example will be considerably less clear.

Not all cases are equally deserving of sympathy. Suppose taxpayer L with an expiring capital loss wants to sell a certain asset for unrelated and substantial business reasons. L’s basis in the asset is approximately equal to its fair market value. To use the asset sale as an opportunity to refresh the expiring capital loss, L engages in a contingent installment sale transaction similar to the one used in the ACM Partnership and similar cases. This generates a gain in the year of sale equal to approximately five-sixths of the sales proceeds and offsetting losses in subsequent years, but it exposes L to the risk of interest rate fluctuations while it holds the contingent installment note. Has L used a reasonable means to sell the asset?

One might say that the first three examples are reasonable because they are within the scope of what most practitioners normally think of as tax planning while the contingent installment sale transaction is unreasonable because it exploits a flaw in the installment sale regulations. But how is one to know on which side of the line the next transaction falls? We do not believe that the IRS, practitioners or the courts can apply the “reasonable means” standard in a predictable way to prevent “tax abuses” while permitting “tax planning.”

25 Reg. §1.701-2(d), Example 2.
26 ACM Partnership v. Commissioner, supra, note 7.
27 Although the IRS announced its intention to change the flawed regulation, Notice 90-56, 1990-2 C.B. 344, it has never done so.
We believe that a “reasonable means” test would introduce significant and undesirable uncertainties into the tax system and hence recommend that this feature of the proposed legislation be dropped if the codification legislation goes forward. If the test is retained, we would urge the staffs of the tax writing committees and of the Joint Committee on Taxation to provide numerous examples, both positive and negative, of the types of transactions that are and are not intended to be covered by the “reasonable means” test. Such examples should make it clear that well-established tax planning techniques, such as multiple-step merger and acquisition transactions, multiple-party like-kind exchanges, and pre- and post-merger restructurings continue to be acceptable.

C. Profit Potential

The legislation recognizes that taxpayers may rely on factors other than profit potential to demonstrate that a transaction has economic substance, but it provides that if a taxpayer does rely on the potential for profit, “the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.” This proposal goes beyond present law in that it evaluates the taxpayer’s “reasonably expected” pre-tax profit rather than the potential for profit. Measured by this standard, a short sale of a security arguably would have no economic substance because the market expectation of positive returns on stocks and bonds means that the reasonably expected rate of return on a short sale is negative. Thus, at a minimum, it should be clarified that “reasonably expected profit” should not be a simple weighted average of the profit that could be realized under all possible market scenarios but should encompass the case where the
taxpayer had a significant profit objective and there was a reasonable possibility that that objective could be achieved.

We also object to the provision in the bill that would require a taxpayer relying on profit potential to treat foreign taxes as an expense. At a minimum, the requirement seems to be an unnecessary reaction to the decisions in Compaq Computer and IES Industries. The taxpayers in those cases were allowed foreign tax credits for income from assets to which they took no material economic exposure. It has been widely observed, however, that the credits likely would have been disallowed on more technical grounds had the Government not chosen to litigate the cases on economic substance grounds. While it is true that the Treasury’s so-called technical taxpayer rule 28 theoretically makes it possible for persons who do not bear the economic burden of a foreign tax to claim credit for it, abuse is not as easy as the flawed result in those cases would make it appear. A taxpayer who has no material economic exposure to an asset generally is not the tax owner of income from the asset and not entitled to tax benefits associated with the income. 29 (Indeed, Congress already has enacted a holding period requirement that would make it impossible for taxpayers engaged in transactions like those in Compaq Computer and IES Industries to claim foreign tax credits. 30) More fundamentally, the requirement is incompatible with the basic structure of the foreign tax credit system. The system relieves international double taxation by allowing credit for foreign taxes to the extent they do not exceed the U.S. tax due on the same amount of

28 Treas. Reg. § 1.901-2(f).
30 IRC § 901(k).
taxable income. Taxable income is necessarily a pre-tax concept. Determining the amount of U.S. tax due after deducting foreign taxes therefore ensures a measure of double taxation. Undermining the foreign tax credit system in this way is not the best way to attack abuses of the system. Current law and more targeted reforms, such as holding period requirements like those enacted in IRC § 901(k), would seem to be more suitable responses.

It strikes us as inconsistent to treat foreign taxes as an expense while at the same time providing that the reduction of foreign taxes (as well as all other taxes) is to be ignored for purposes of determining whether a transaction has economic substance. Historically, a purpose of reducing taxes other than federal taxes (e.g., state, local or foreign taxes) generally has been respected as a business purpose, at least where the tax is not simply a state counterpart to the federal tax.\textsuperscript{31} The proposed legislation, however, may call into question a wide range of structures and transactions designed to reduce foreign taxes, as well as real property taxes, sales taxes, and the like, that currently are viewed as standard and perfectly legitimate business planning strategies. We urge that, if ultimately enacted, the statutory language and/or legislative history of the proposal be revised to make clear that this is not the intention—\textit{i.e.}, that such non-federal tax savings would be ignored for purposes of applying the economic substance doctrine only where such savings flow from, and are less substantial than, any associated federal tax savings.

\textsuperscript{31} See, e.g., Treas. Reg. § 1.355 – 2(b)(5), \textit{Example} (7) [greater tax reduction will flow from federal “S” corporation election for spin-off subsidiary than from state “S” election; purpose of reducing state tax not a sufficient corporate business purpose to qualify spin-off under section 355].
D. Financing Transactions

The proposed legislation provides that the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. While we generally support the principle that the deductions from a financing transaction should not exceed the economic cost of the financing, we suggest that a better way to test whether a taxpayer is claiming deductions greater than the economic cost of a financing is to question transactions in which the difference between the taxpayer’s pre-tax financing cost and after-tax financing cost is materially greater than the expected value of the deduction for the financing costs. In other words, we believe that the legislation would be improved if it called into question financing transactions in which the taxpayer’s after-tax financing cost is materially less than his pre-tax financing cost multiplied by 100% minus the taxpayer’s effective tax rate.