Corporate Tax Shelters and Corporate Tax Management

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Introduction

A. Overview

This article expands on some of the themes presented to Tax Executives Institute’s Midyear Conference this past March, where I was privileged to have been asked to speak on the topic of “Evaluating Corporate Tax Shelters.” The first half of that presentation urged companies to adopt formal and rigorous internal protocols for reviewing tax-advantaged strategies. The heart of these protocols should be what I termed a “treaty” between a company’s Tax Department and its Chief Financial Officer, in which the Tax Department would undertake to work creatively to implement the Chief Financial Officer’s agenda (or at least fairly to quantify the attendant risks), and the Chief Financial Officer in turn would undertake to respect the integrity of the tax analytical process.

The second half of the presentation was directed to a critique of the President’s corporate tax shelter proposals, as unveiled in February of this year. In making its case for its corporate tax shelter proposals, the Administration repeatedly has stressed that it is responding, in part, to cries for help from corporate tax executives. Tax executives are described as hounded by tax shelter salespeople at every turn, and as pressured to accept those tax shelter transactions by senior management, who look only to the existence of an opinion from a brand-name tax advisor (supplied by the promoter) to validate the tax analysis. I have no doubt that this phenomenon is real, but I suggest that a company’s best long-term solution lies in the development of precisely those internal protocols—an internal treaty—of the type I outlined in the March presentation.

Nonetheless, advocates of corporate tax shelter reform argue that, in the absence of some form of governmental prodding, many companies are unlikely to overhaul their internal decision-making process. This article therefore focuses on the second of the two themes presented in March—the Administration’s corporate tax shelter proposals. The article then offers alternative suggestions for improving our corporate tax collection system, some of which, while possibly as unpopular as those advanced by the Administration, are intended to be more consistent with the underlying principles of our corporate tax system.

B. Summary

In my view, the Administration’s corporate tax shelter proposals miss the mark. Many have pointed out that the proposals are too vague to be amenable to practical application. More fundamentally, the proposals are flawed in that they confuse the corporate tax shelter phenomenon with the contemporary corporate tax collection problem.

What the Administration views as a corporate tax shelter problem is better portrayed as a natural outgrowth of an improvement in the efficiency of corporate management, as a result of which corporate income tax liabilities are treated, along with other business liabilities, as costs that respond to modern management techniques. Corporate tax shelters, I believe, are a demand-driven phenomenon, not a supply-side problem. Moreover, this trend is irreversible and will only intensify as corporate managerial arts become more sophisticated.

What, then, is to be done about the problem? Rather than attempting to moralize this issue and shame corporate participants in tax shelters, I think what is needed are practical rules that encourage the collection of the right amount of corporate income tax in the first instance. More substantively, the Treasury Department’s recent emphasis on overarching “standards” that would supplement our system of operative tax “rules” is ill advised. There is no natural law of corporate income taxation. In such circumstances, an emphasis on standards would significantly undermine our rule-based system by interjecting an unacceptably high degree of arbitrariness into the process, which would ultimately corrode the most important aspect of our corporate tax system—the sense of its underlying fairness.

Having made these points, I offer the following suggestions for improving the system:

- The quality of disclosure on corporate tax returns should be improved, to enable the Internal Revenue Ser-
vice to understand and analyze the complex issues that are embedded beneath the surface of every number on a corporate tax return. In addition, an “early warning system” should be developed for “tax shelter” items, under which contemporaneous disclosure would be required shortly after a transaction is consummated, to give tax policymakers the necessary data with which to respond to anomalies in the system. (This is the only use I would make of an expanded definition of “corporate tax shelter.”) The Treasury would need to respond promptly to this disclosure by issuing guidance (which might be retroactive, in some situations) dealing with the discrete issues posed by the particular transaction disclosed.

- A corporate taxpayer should not be allowed to rely on a tax adviser’s opinion to sustain a “reasonable cause” defense to the imposition of penalties, unless (a) the opinion is not rendered by a promoter (or adviser to a promoter) of the tax-advantaged product, (b) the opinion sets out all relevant facts of the transaction which a corporate officer certifies is accurate and (c) the tax adviser is not compensated on a basis of the percentage of the tax savings purportedly derived from the transaction.

- The present system contains inadequate incentives for corporate taxpayers, in response to uncertain tax rules, to overpay tax and subsequently claim a refund of tax with interest (thereby fully airing the underlying issue with the IRS). The interest charged on corporate underpayments of tax and the interest paid on corporate overpayments of tax therefore should be the same (or nearly so). In addition, the current rule for individual taxpayers should be applied to corporations, so that interest charged on corporate underpayments of tax generally would not be deductible for federal income tax purposes, while interest income received on overpayments would remain taxable.

The purpose of this rule would be to encourage corporate taxpayers to resolve difficult issues conservatively and to file for refunds. By forcing more issues to the surface for explicit resolution between the IRS and the taxpayer, the proposal is intended to help reverse current law’s perverse incentive for corporate taxpayers systematically to adopt aggressive interpretations of the rules. This agenda can succeed, however, only if the IRS and the Treasury have adequate resources to take on the additional burden. Hence, Congress should couple this proposal for reforming the rules for interest paid or received on tax overpayments/underpayments with the additional funding necessary to ensure that the system can handle the increase in explicit negotiations that the proposal is designed to promote.

C. The Administration’s Proposals

The Administration’s corporate tax shelter proposals have been the subject of extensive commentary, and no point would be served by producing another summary at this late date. It may be helpful, however, to restate the principal themes underlying the Administration’s statutory proposals.

The Administration’s general corporate tax shelter proposals consist of (i) the Administration’s so-called super-section 269 proposal, which would turn section 269 into a general anti-abuse provision, by giving the IRS the authority to disallow any losses, deductions, credits, or other tax benefits that arise from participating in a “corporate tax shelter,” and (ii) five other operative rules designed to discourage promoters of or participants in “corporate tax shelters” by imposing various strict liability penalties and excise taxes. These last five rules arguably would be largely redundant in a world of super-section 269, because it is difficult to imagine a corporate taxpayer knowingly entering into a transaction where all the favorable tax attributes flowing therefrom could simply be taken away by a determination that the transaction constituted a “corporate tax shelter.”

The heart of the Administration’s corporate tax shelter initiative, of course, is the proposed definition of “corporate tax shelter,” because that definition is shared by all the operative rules, and because that definition by itself determines the scope of super-section 269. The proposed definition looks to whether a corporation has “attempt[ed] to obtain a tax benefit in a tax avoidance transaction.” A “tax benefit” is any reduction, exclusion, avoidance or deferral in tax, unless that benefit is “clearly contemplated by the applicable [Code] provision.” A “tax avoidance transaction” is any transaction (i) “in which reasonably anticipated pre-tax profit . . . is insignificant relative to the reasonably expected net tax benefits,” or (ii) “that inappropriately eliminates or significantly reduces tax on economic income.”

This definition properly has been criticized as too vague to work evenhandedly in practical application. Moreover, the operative rules are clearly duplicative, and would, if actually all enacted, produce aggregate costs and penalties orders of magnitude greater than that imposed in civil fraud cases.

For purposes of this article, however, we need to concede that vagueness is a feature, not a bug, in the Administration’s proposals. The Administration’s avowed goal is to articulate a set of general principles of tax law that override any particular result inconsistent with them. As Assistant Secretary Donald C. Lubick has repeatedly stressed, the Administration views this debate as between “rules and standards,” by which I believe he means a debate between clear operative rules, on the one hand, and grand overarching principles to which all rules (even clear
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ones) ought to be subservient, on the other. Almost by definition, therefore, if these principles are going to apply to the whole range of economic activity reached by our income tax system, the principles must be phrased as vague aphorisms, particularly in contrast to the very specific rules that compose the Code today.

Thus, some irreducible element of vagueness must always be at the heart of proposals like those advanced by the Administration (although undoubtedly one can do better in this regard than the Administration's first attempt). Accordingly, this article puts aside all the well-founded practical objections that others have made to the Administration's proposals in general, and super-section 269 in particular, and instead addresses directly the Administration's underlying agenda.

The Issue: Corporate Tax Shelters or Corporate Tax Management?

It is an inconvenient truth in the current debate on corporate tax shelters that we collectively do not know very much about the nature or the extent of the corporate tax shelter problem. Senior U.S. Treasury policymakers, for example, have acknowledged that the evidence supporting their allegations of a rapid rise in corporate tax shelter activity is largely anecdotal, and some other observers have argued that the existing objective data in fact do not support the hypothesis that the corporate tax base is in danger of erosion.

It certainly is true that U.S. corporations are avid consumers of innovative tax-advantaged financing or transactional opportunities, but this is not a new phenomenon. In the early 1980s, the U.S. Treasury was so troubled by one innovative (and ultimately successful) financing structure that it took the unprecedented step of contacting a potential issuer — one of America’s largest companies — to urge it not to proceed with the transaction. During roughly the same time period, literally hundreds of stock-for-debt exchanges were consummated — transactions that essentially disappeared from American corporate finance practice following the elimination of its tax benefits in 1984.

Nonetheless, the President of Tax Executives Institute has testified before Congress that we do suffer from a corporate tax shelter problem; implicit in that testimony is the belief that the current problem is qualitatively different from the environment of 15 years ago. Other serious observers of corporate tax behavior agree. In such circumstances, our collective energies probably are better served thinking a bit more about what the nature of the problem is rather than debating whether a problem exists at all.

The current corporate problem in fact is fundamentally different from the individual "retail" tax shelter crisis of the late 1970s and first half of the 1980s for three reasons. First, to put matters bluntly, the retail tax shelters of years past were based, in a large preponderance of the cases, on outright noncompliance with the law: fictitious valuations, bogus nonrecourse debt, fanciful future income projections, and preposterous interpretations of the law as it then stood. By contrast, many of the corporate tax shelter transactions that trouble the Administration today do so precisely because they do work under current law (or at least work in the absence of the exercise by the Treasury of regulatory authority already granted to it).

The second difference between the current corporate tax shelter environment and the individual tax shelter mania of years past is that, in the latter case, one shelter was largely fungible with another. If lithographic fine art print deals were shut down, the market would quickly migrate to Christmas tree deals, because all the retail tax shelter offerings at heart served only one objective: to defer ordinary income and transmute it into long-term capital gains. By contrast, at their best the corporate transactions that trouble the Administration today respond to particular structural or business exigencies of a small subset of the corporate tax base, and are not universal panaceas suitable for all corporate taxpayers. The captive REIT liquidation idea, for example, was a clever strategy for a corporation that happened to have a captive REIT, but did not do very much for another corporation with excess foreign tax credit concerns. This suggests that global anti-shelter solutions might fairly be characterized as overreactions to what are unique solutions to specific problems of a relatively small number of corporations.

The final distinction between the corporate tax shelter problem today and the retail tax shelters of the past is that the latter deals in fact threatened to overwhelm the tax system, both through the generation of a crushing load of audits and Tax Court cases, and through the real prospect of massive noncompliance with the law, stemming from ignorance and naiveté (sometimes feigned), as well as the great likelihood of never being audited in the first place. The current corporate tax shelter problem poses few of these risks. The New York State Bar Association, for example, has pointed to the transaction pattern underlying the ACM case as an example of a classic "loss generator" transaction. In this sense, the transaction underlying ACM was the exception to my general theme, because the transaction could be argued to have had utility to any corporation with capital gain net income. As characterized by the New York State Bar Association, then, the ACM-type transaction arguably was analogous to the retail tax shelters of the past. But the ACM-type transaction apparently was executed by only 10 other corporations. One wonders whether our tax system is not resilient enough to handle this volume of litigation without senior tax policymakers declaring that the corporate tax system is in crisis.

More generally, the IRS typically audits every year virtually all of the corporations that engage in the kinds of transactions brought forward by the Administration. Similarly, every corporation’s tax calculations and provisions are reviewed each year by independent public accounting firms. As TEI members know, the tax function at each corporation is entrusted to substantial professional staffs, who struggle mightily to determine the correct answer for hundreds of novel questions every year. Whatever the corporate tax problems that we face today, they are not the result of the kind of massive noncompliance based on naiveté, ignorance, and the audit lottery that threatened the individual tax base some 15 years ago.

One fundamental problem with the current corporate tax shelter debate, then, is that the underlying corporate tax issue — notwithstanding the headlines of the popular

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press — really has very little to do with tax shelters, at least as the term is generally understood. Tax-shelter inspired solutions therefore will prove to be overbroad in many respects and possibly underinclusive in others.

Another unfortunate aspect of the Administration’s misframing of the debate in terms of corporate tax shelters is that the current discussion has taken on some of the flavor of a morality play, in which third-party developers of tax-advantaged financial structures are cast as the seducers of corporate innocents. It may be that retail tax shelter salespeople of years past presented opportunities to individual taxpayers that they could not discover on their own, and oversold those taxpayers on the underlying technical analyses that supported their schemes, but neither assertion is true of corporate taxpayers. First, corporations have large professional staffs who can (and in fact do) engage in the “shelter” discovery process. Indeed, in my personal experience it has now become commonplace for a sophisticated corporation to approach an investment bank with a self-developed tax-advantaged financing that the corporate client instructs the investment bank to execute. Second, regardless of where an idea is first developed, those same professional staffs are fully competent to analyze the proposals made to them. Corporate taxpayers do not need to be “protected” from the blandishments of tax shelter salespeople, and in many cases do not need those salespeople at all. Third, corporate taxpayers, not corporate tax shelter salespeople, ultimately control (and know the facts on which difficult legal judgments must rest, such as whether the taxpayer had a business purpose for a transaction. In short, corporate tax shelters, as the Administration conceives the concept, really do not require corporate tax shelter salespeople: Corporate taxpayers themselves are sophisticated enough to develop and implement these strategies on their own.

If tax shelters are not the real issue, then what is? In my view, the fundamental contemporary problem in the administration of our corporate tax system is the natural outcome of a two-decades long evolution in how corporate tax liabilities are perceived by corporate taxpayers themselves. My evidence is also anecdotal, but many others have pointed to the same phenomenon, which is simply that senior corporate managers now perceive a corporation’s tax liability, not as an inelastic and inevitable misfortune, but rather as a necessary cost that responds to aggressive management, just like other corporate expenses.18

One reason for the increased attention paid to the management of corporate tax liabilities is simply that the corporate tax base-widening exercise launched by the Tax Reform Act of 1986 has had precisely its intended effect, which was to make it much more difficult for corporations to avoid tax liability through straightforward strategies. The predictable natural corporate reaction to this base-widening, however, was not gladly to pay more tax, but rather to look harder for less obvious ways to mitigate that burden.

Another reason for the increased attention paid to the management of corporate tax liabilities is that, over the last two decades, corporate management skills have been progressively refined and successfully applied to a wide variety of previously difficult to control costs. There is no logical reason to expect that those same management techniques would not someday be brought to bear on corporate tax liabilities.

Corporations today aggressively manage a wide range of regulatory liabilities. For example, companies bring professional discipline to bear on their environmental liabilities, whether through implementing “greener” processes in the production process, environmental due diligence in corporate acquisitions, or legal challenges to overreach or unclear environmental regulations. The same phenomenon is true for pension liabilities, tort claims, and — I submit — tax liabilities.

The fundamental issue with which the tax system needs to grapple, then, is that modern corporate strategists perceive income tax liabilities as another cost of business that can and should be managed, like inventory costs or environmental regulations. The phenomenon, like the other examples just cited, is both inevitable and irreversible. Can anyone imagine, for example, that corporate America will ever revert to pre-1970 indolence toward inventory levels? Viewed from this perspective, Deputy Treasury Secretary Summers’s analogy of the corporate tax compliance problem to a baseball game in which every fan sees well if all sit in their seats, but each must stand if the fan in front chooses to stand, is both nostalgic and predictive: Once traditional free-market energetic corporate management is brought to bear on this or any other issue, it is inevitable that the result will be greater efficiency in individual corporate behavior, and less collective comfort.

The Administration’s corporate tax shelter initiative is misguided in this core sense, because it characterizes the problem narrowly as some corporate bad characters buying (and some equally reprehensible institutions selling) corporate tax reduction schemes. If the issue is broader (although less alluring) than that presented by the Administration, then the Administration’s emphasis, for example, on the selling of corporate tax schemes is nothing but a red herring. If selling corporate tax shelters is made a felony, but corporations are still committed to managing their tax liabilities with the same energy that they manage their inventory levels, then those who structure corporate tax-advantaged transactions simply will migrate in-house (as, in many cases, they already have) and Tax Executives Institute meetings will become a Casbah for the exchange of tax-savings strategies by all these in-house gurus.
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To summarize, corporate tax shelter activity today is a demand-driven phenomenon of a larger issue, not a supply-side problem by itself. Corporate tax shelters are symptoms of a larger issue — namely, the active management of corporate tax liabilities. Corporations that engage in the active management of their tax liabilities are knowledgeable, sophisticated, and regularly audited (both by the IRS and by independent accountants reviewing a company’s tax provisions), in sharp contradiction to the retail tax shelter market of the 1970s and 1980s. Such corporations consume external tax shelter proposals, but they also consume internal ideas and planning resources. We therefore need to look past Washington’s collective distaste for the individuals who market corporate tax shelters and, instead, focus on whether the corporate tax system as a whole is adequately designed to deal with the stress of its participants actively managing their liabilities to the system — particularly given that they themselves are the assessors of first resort.

Rules and Standards in Our Model-Based Corporate Tax System

A. Our Model-Based System of Taxation

One cannot fairly judge whether our corporate tax system is overstressed by the active management of corporate tax liabilities without considering the deep structure of that system. Fundamentally, our income tax law is a model-based system. That model seeks to describe and categorize all economic activity and objectively to calculate a tax liability from those economic inputs.

Our model-based approach to income taxation is so fundamental, and so ingrained, that we sometimes forget that it is not inevitable. We could, for example, articulate a few broad principles by statute and leave governmental assessors to determine each corporation’s income tax liability — my property taxes are determined in this manner — or alternatively taxpayer and assessor could sit down periodically to review that taxpayer’s accounts (or do so in advance, through quick and informal rulings) for the purpose of negotiating mutually acceptable tax liabilities arising from novel transactions.

But the United States has rejected such approaches in favor of a model that is intended to be comprehensive, objective, reliable, and transparent. We seek to make our model comprehensive by developing rules that address all the bewildering forms of commercial activity that make up our modern economy. We design our model to be objective by limiting the ability of taxpayers to create answers in a vacuum (though comprehensiveness) and by limiting the relevance of subjective states of mind: A “B” reorganization does not become a taxable sale because the target shareholder views herself as “selling out to Bigo.”

We insist that our model be reliable in that a taxpayer should obtain rational and repeatable answers when the taxpayer asks the model similar questions on different occasions. And finally, and perhaps most important, we demand that the model be transparent, in that each corporate taxpayer has confidence that other taxpayers engaged in similar business transactions will obtain similar tax liabilities when those taxpayers input their economic data into the model.

At its best, the resulting corporate tax systems is one that we can be proud of as demonstrably fair: Unlike other jurisdictions, we generally do not hear of corporate tax directors taking their finance company ruling requests to the St. Louis tax inspector, rather than the San Diego inspector, because St. Louis is known to be soft on debt-equity questions. Moreover, because our corporate tax model largely does satisfy these four objectives, we can rely on corporate self-assessment as the principal means of actually collecting the corporate income tax.

How does our model in fact operate to satisfy these four requirements? It does so, of course, like any other model — through operative rules. These rules ideally are crafted as generally as possible, consistent with the requirements of objectivity, reliability, and transparency, but in the end one cannot avoid the reality that our system at its heart is a large collection of rules — many inspired, no doubt, by a handful of common insights or biases about how the rules should treat various activities, but an enormous collection of rules nonetheless. We accept the concomitant complexity of our corporate income tax system as the price we must pay for a model that satisfies the four requirements of comprehensiveness, objectivity, reliability, and transparency.

Our rule-based tax system relies on a vigorous common law of taxation to make the model reasonably comprehensible and flexible. At its best, however, that common law serves as a handmaiden, not a sovereign, to our tax model.

Our rule-driven model relies on a common law of taxation for at least two purposes: first, as the finder of fact, and second, to give us a fair reading of the words of the statute. Most sham transaction, step transaction, and similar cases fall into the first category. In a typical sham transaction case, a court will hold that a purported trans-
of common law as a finder of fact); more meaningfully, the court may conclude that a transaction was so wholly devoid of business purpose that the purported facts of the transaction are not valid inputs into our tax model. The Third Circuit’s opinion in ACM, for example, boils down to a conclusion of ultimate fact in which the court held that Colgate ought not to be treated as the owner in fact of the Citicorp notes.

The second crucial role of a common law of taxation is to ensure, in effect, that the creators and users of the model that we call the Internal Revenue Code are speaking the same language, by which I mean that taxpayers are giving a fair reading to the words that compose each operative rule. One of the delights of the Code from a practitioner’s perspective is that, although the Code is a complex rule-driven model of economic activity, those rules are expressed in words, not mathematical abstractions. Courts frequently are compelled to remind us that these words are not infinitely elastic, but rather were chosen by legislators at a particular point in history and used in a particular context. The working definitions of those words for purposes of applying our tax model therefore must reflect those contextual constraints.

For example, most of us are so accustomed to hearing the phrase “tax-free reorganization” that we may not appreciate that, when the reorganization provisions of the Code were first enacted in 1921, Congress chose a term (“reorganization”) that had no tax gloss, but nonetheless had a contemporary commercial and legal meaning that Congress presumably sought to import into the tax system. Viewed from this perspective, Gregory v. Helvering is best seen, not as an abstract rumination on the need for a business purpose in all transactions accorded tax significance, but rather as an expression of what Congress intended the term “reorganization” to convey. The case is a sophisticated exercise in applied semiotics, not an abstract elevation of standards over rules. Similarly, the section 357 assumption of liability transactions that the Administration has recently attacked arguably are vulnerable to the criticism that, when Congress fashioned an operative rule that applied to an “assumption” of a liability, Congress intended the term “assumption” to imply that the assuming party in fact would pay the entire liability.

A vigorous common law of taxation thus is a vital part of our rule-based tax model. The common law tells us what the taxpayer’s facts actually are (i.e., identifies the correct inputs for the model), and informs us how to apply the words of the statute (i.e., explains the contextual operation of our word-based operative rules). Whether as a finding of fact or as an exercise in applied semiotics, we look to the common law to keep our rule-based model functioning (and comprehensible) in the real world, not to elevate abstract standards over those rules.

B. The Administration’s Proposals

The first weakness of the Administration’s corporate tax shelter proposals, described earlier in this article, is its moralistic fixation. The second, more fundamental, flaw is that the Administration, in its frustration with some anomalous results produced by the latest release of our tax system, proposes to undercut the objectivity, reliability, and transparency that in the end make our current model satisfyingly fair in practical application. As previously noted, Assistant Secretary Lubick is fond of saying that the current debate is about “rules versus standards.” Given the way the Administration has framed the debate, this statement is true, but in the end the imposition of a superstructure of “standards” (read: intuitions, biases, or inclinations) on top of our existing model, however well intended, inevitably can only corrode the rule-based model on which those standards rest.

Standards might replace rules if in fact there were a natural law of corporate income taxation — if Newton had been hit on the head by an Ur-Code rather than an apple or at least if we could agree on a natural morality of corporate taxation — if Moses had come down from the Mount with a third tablet proclaiming the 10 unalterable moral principles of corporate income measurement and tax. Alas, neither is true, which is why the Administration’s super-section 269 proposal strike so many observers as flawed from a principled as well as a practical perspective.

The Treasury’s definition of “corporate tax shelter,” for example, requires a determination whether a particular “tax benefit” was “clearly contemplated by all applicable Code provisions.” But how does one ask a model whether the benefits it dispenses were intentional? Models do; they do not speak. They are pure agents of action, without any self-consciousness; they cannot inform us when they feel abused. The captive REIT liquidation transactions relied on two Code provisions that were pellucidly clear; what additional meaningful evidence can anyone today adduce to say whether the result was intended? Surely it cannot be the rule going forward that all transactions not favorably described in legislative history are at risk of disallowance!

Similarly, one might be able to impose a “commensurate with economic income” standard on top of our current model-based Code if we all first could agree on what “economic income” is, and fashion a comprehensive and objective tax model that reflects that consistent view — but of course neither condition can be satisfied. How else can we explain the Treasury’s explicit insistence that (i) a convertible bond, (ii) an “exchangeable” bond (i.e., a bond convertible into stock of a corporation other than the issuer or an affiliate), and (iii) a bond and a separate call option on underlying stock, all three of which have the same cash payouts, nonetheless produce different quantities of ordinary income and capital gains (and in different time periods to boot)? And how do we explain Congress’s insistence that “conversion” transactions give rise to interest income but “reverse conversion” (the mirror image) transactions do not generate interest expense? The blunt reality is that our current tax model consistently follows contemporary economic theories, except when it does not, and the choice of when (or when not) to do so is driven by the whole range of historical, commercial, political, and practical considerations that in fact go into shaping our tax model.

Although the Administration’s proposals with respect to corporate tax shelters appear to be structurally similar to the existing partnership anti-abuse rules, the resemblance does not run very deep. In Treas. Reg. § 1.701-2(a),
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the Treasury provided relatively coherent guidelines by which taxpayers could evaluate whether a certain tax result comports with the intent of Subchapter K. More important, the 11 specific examples provided in the final regulations help taxpayers and the IRS alike to define the scope of the anti-abuse rules. Because of these examples, in particular, the partnership anti-abuse regulations can best be viewed as a kind of ex post facto legislative history to Subchapter K.

Notwithstanding the relative specificity provided by the extensive examples contained in the partnership anti-abuse regulations, those regulations have proven extremely controversial in practice. To replicate even that (controversial) degree of specificity, the Administration’s corporate tax shelter proposal presumably would require hundreds of thoughtful examples, which of course will not happen. The Administration’s proposed definition of “corporate tax shelter” thus will not serve the same role of ex post facto legislative history, and instead will be no more helpful to taxpayers than would a marine chart to a sailor without a compass.

The Administration also argues that the introduction of sovereign standards would not add additional uncertainty to the Code because the Code already embodies several such aphoristic principles. Experience suggests, however, that the Administration overstates the reach of those standards today.

Consider, for example, the clear reflection of income doctrine. The Code and relevant Treasury regulations offer only skeletal guidance on acceptable accounting methods for determining when an item is includible in income or deductible as an expense; it leaves the details largely to the discretion of the taxpayer, as reflected in how the taxpayer keeps its books. The premise of this minimalist approach no doubt was that taxpayers would employ commercially rational accounting principles for purposes of their non-tax books and records. The “clear reflection of income” principle serves to limit this otherwise uncircumscribed discretion to develop idiosyncratic accounting rules for the timing of income or deductions. The clear reflection of income doctrine thus typically is invoked to resolve a controversy that the tax model does not purport explicitly to address.

It is a large step from the clear reflection of income doctrine, which circumscribes a taxpayer’s discretion to invent commercially unrealistic accounting methods, to a proposal that would not merely fill in lacunae in the law, but override the straightforward application of that law. No one today argues, for example, that a bond-warrant unit does not clearly reflect income, even though a unit produces different income inclusions than does a convertible bond. Each result is prescribed by an explicit rule that answers the clear reflection of income question before it can rationally be asked, because that rule in fact specifies the income that a transaction within its scope generates each year. A taxpayer that follows that rule therefore definitionally is clearly reflecting income.

Going forward, by contrast, it may well matter whether one’s tax inspector is in St. Louis or in San Diego, because no two human beings can hope to apply vague principles like “commensurate with economic income” in a consistent matter. St. Louis, in fact, may decide that bond-warrant units must be taxed like convertible bonds, while San Diego insists that economics compels the conclusion that convertible bonds are bond-warrant units in disguise.

The Administration’s corporate tax shelter proposals are irremediably flawed precisely because they seek to rely on principles that, to the extent they are comprehensible, in fact are not universal, and because they seek to undo results obtained by a straightforward application of the enormous rule-based model that is our Internal Revenue Code. The Administration cannot accomplish its agenda without recourse to vague standards, but those standards in turn, if implemented on top of our rule-based system, will lead to precisely the result that we all collectively should fear the most: the collapse of our collective sense of the model’s fairness. Rules are frustrating to draft, tedious to learn, and always in need of repair, but in the end they serve to make a system that is reasonably comprehensive, objective, predictable, and transparent, and therefore that effectively can operate on a self-assessment basis.

Academics are fond of distinguishing between “loop-holes,” which are described as simple mistakes or ambiguities in the model that taxpayers exploit to their advantage, and “line-walking,” whereby taxpayers go to the edge of whatever activity is permitted by formal rules. Line-walking is said to be inherently troublesome, because the certainty created by clear rules invariably will be either “underinclusive as to purpose, overinclusive as to purpose, or both.” Treasury officials have repeatedly suggested that they find line-walking troublesome. Our corporate tax system, however, is itself an agglomeration of completely formal (and often arbitrary) rules. Does anyone believe, for example, that the heavens would tremble if target shareholders were allowed to receive a peppercorn of boot in a “B” reorganization? Moreover, that model is sometimes only casually connected to generally accepted economic principles.

In such circumstances, line-walking is inevitable, and we are best served by painting the lines in the most sensible place for the great majority of affected transactions. Particularly in a world of finite government resources, we should concentrate our energies on maintaining and improving the model, not in introducing new “standards” whose every application will lead to protracted wrangling, the outcome of which likely will not improve the quality of the tax system for most other taxpayers.

The foregoing argument is not meant to suggest that the current collection of rules embodied in the Internal Revenue Code is ideal, or that general principles can never be embodied in rule-based models. As the next section of this article makes clear, there is a great deal of work to be done to make our current rules more cohesive. Similarly, Occam’s Law teaches that we all are better served when rules are as simple and general in application as possible, consistent with the goals of objectivity, predictability, and transparency. The best way to embody general principles in a rule-driven model, however, is not through grandiose proclamations, but rather by applying those principles in formulating or revising individual rules. As one small example, if the Treasury wishes to further the overarching principle that income (in the tax sense) should follow eco-
nomic income, why has the Treasury proposed in its current corporate tax shelter package to impute hypothetical interest income to corporations that sell their stock forward, but has not proposed to impute interest expense to the forward purchasers in the same transaction?

**Doing the Right Thing**

The preceding discussion attempted to demonstrate two simple propositions. First, the contemporary corporate tax administration problem with which the Administration, academics, and private practitioners are grappling is not a corporate tax shelter crisis, but rather a wider issue of the natural consequences that follow from a view of corporate income taxes as a corporate liability to be managed like other liabilities. Second, the solution to that problem must be consistent with the deep structure of our income tax system, which at its heart is a comprehensive, objective, reliable, and transparent rule-driven model of economic activity. Having rejected the Administration’s proposals as too narrow (because they focus solely on corporate tax shelters sold through promoters) and as too broad (because they will corrode what is best about our current tax system — our belief in its fairness, because of its objectivity, reliability, and transparency), we turn to whether our system is designed to handle the stress of the active management of corporate tax liabilities by corporate taxpayers — Which are also the tax assessors of first resort — and, if not, what ought to be done about it.

There has simply been too much testimony from too many sources over the last few months to the effect that a problem does exist for me, at least, to reach any other conclusion. That testimony has largely been phrased in terms of corporate tax shelters, because that is how the Administration unfortunately has chosen to frame the debate, but all the points made to date apply with at least equal vigor (and in many cases make more sense) when adduced as evidence for the larger proposition that our system is not well designed to handle the active management of corporate tax liabilities.

Our principal goal thus is straightforward enough: to collect the right amount of tax from corporate taxpayers, not to shame buyers or sellers of tax corporate tax shelters, however defined. We need to ensure that, even in a world of active tax liability management, our system encourages corporate taxpayers to do the right thing, by which I mean that corporate tax returns should fairly and accurately self-assess corporate income tax liability in the first instance, and not take improper positions that absorb a disproportionate amount of audit or enforcement resources. Some specific suggestions are offered below.

At the same time, we should focus on a second, correlative goal, which is that our system must also encourage the Treasury to do the right thing. The Treasury and the IRS must provide timely and comprehensive guidance to enable taxpayers to apply the rules reliably and consistently. In this vein, the Treasury and the IRS must learn to resist asymmetrical, noneconomic rules in the guise of anti-abuse principles.

One of the ironies surrounding the Administration’s corporate tax shelter proposals is that those proposals fail the second of these two agendas. With super-section 269 in place, the current glacial pace of regulatory guidance likely will grind to a complete halt, as the Treasury relies more and more on its authority to do whatever it intuits from moment to moment as the right thing, rather than to undertake the hard work of developing clear guidance for taxpayers to apply through our rule-based tax system of self-assessment.

Deputy Secretary Summers offered the perfect metaphor for this second agenda when he compared the frustrations of working on the Code today to repairing the Brooklyn Bridge, where the painters no sooner finish at one end than they must begin anew at the other. Surely, such a Sisyphean undertaking is frustrating. But as a resident of New York City, I can report that Deputy Secretary Summers stopped his metaphor at the halfway point. The only alternative to never finishing is to stop trying, and the resulting deferred maintenance leads inexorably to infrastructure collapse. There is no royal road to maintaining a rule-based model that seeks accurately to describe and measure our complex and rapidly-evolving economy. The Treasury’s corporate tax shelter proposals (in particular, super-section 269) will not substitute for that necessary maintenance, but will corrode the underlying infrastructure surprisingly quickly.

Returning to the first goal, of ensuring that corporate tax returns are as accurate as possible in the first instance, we must acknowledge two fundamental issues. First, corporate tax returns are enormously complex, and IRS examiners will always be at a comparative disadvantage to corporate taxpayers in understanding not only the items on the return, but also the underlying analyses (the application of the model) through which those items were derived. Second, because of the deferred maintenance from which our Code already suffers, particularly in a period in which the economy is rapidly evolving, corporate tax managers are faced too often with a tax system — a model — that in fact does not answer their questions. Indeed, my experience has been that, for every unsavory tax-advantaged transaction that takes place, three or four commercially-driven transactions die, due to unacceptable tax uncertainties. This uncertainty is enormously frustrating to conscientious tax managers and their advisers, but also invites managers, when confronted with a difficult tax question and a range of plausible ad hoc answers drawn from analogies to other rules or from common sense, to opt for the most taxpayer-favorable resolution.

The first issue — the information disparity between taxpayers, on the one hand, and IRS examiners and Treasury policymakers, on the other — can be addressed in part by requiring better quality disclosure on the corporate tax return. Indeed, the one consensus that has emerged from the corporate tax shelter debate to date is that better disclosure (*not* duplicative disclosure) is both necessary and proper. The purpose of enhanced disclosure should be twofold: to enable important audit issues to be identified and aired, and to serve as an “early warning system” to flag those unusual transactions that exploit a previously underappreciated and material flaw in the tax model. Enhanced agent-friendly disclosure on the return might include, for example, a mandatory plain English reconciliation of the items comprising a taxpayer’s Schedule M.
In the case of a narrowly defined class of transactions that have a substantial tax component, disclosure ought to be required shortly after the transaction is consummated, to give tax policymakers the raw data they need to determine where our rule-based model is in immediate need of updating. Thus, I would address "corporate tax shelters" that plainly work under current law, but that really should not, by giving policymakers the information they need to change the model as quickly as possible, not by supersection 269-type standards. The definition of "corporate tax shelter" for this purpose (whatever it proves to be) will rightly be criticized as vague, but a vague standard whose purpose is only to elicit information does not pose the kind of corrosive threat to the tax system that a vague set of operative "standards" presents. My suggestion means that in some cases some early adopters will obtain anomalous tax benefits — subject, however, to the observation that it is not invariably the case that the model must be repaired only with prospective effect — but I would argue that the damaging effects of such occasional windfalls are much smaller to the system as a whole than the long-term pernicious effect of relying too heavily on unknowable "standards.

I would not impose disclosure requirements on "promoters," for three reasons. First, that disclosure will be duplicative of taxpayer disclosure, and not directly correlated to the ultimate object of interest to the IRS, which is the particular corporate tax return on which the item appears. Second, as mentioned previously, corporate taxpayers, not their promoters, ultimately are the persons with the best knowledge and control over their own facts, and the disclosure that one wants to encourage is intensely fact-specific. Third, any definition of "promoter" is likely to sweep in financial intermediaries and transactions that will overwhelm the disclosure system without advancing its objective — public underwritings of structured notes, for example.

Better disclosure on the return, and prompt transaction-based disclosure in appropriate cases, are necessary but not sufficient to assure that corporate taxpayers accurately apply the tax model to self-assess their corporate income tax liabilities. If one agrees that the current system is beginning to falter, then it must follow that we need to revisit the question of what substantive incentives exist for taxpayers to do the right thing in the first instance.

Incentives come in two forms: carrots and sticks. As applied to corporate tax collections, the carrot approach seems difficult to implement (a two-percent discount for returns that receive a "no change" at the conclusion of the audit?). We are left, therefore, with sticks — or interest and penalties as we politely call them.

In my experience, penalties are not routinely asserted against large-case corporate taxpayers. One reason is that IRS auditors and corporate taxpayers essentially have to get along if the audit process is to work at all. In this context, the proposed imposition of penalties is like a declaration of war, and affects every aspect of the relationship between the two sides. Another reason is that IRS agents are hesitant to impose penalties that are perceived to be too harsh because, to paraphrase the Mikado, most of us feel uncomfortable asserting penalties unless we believe that the punishment fits the crime. Finally, current law's penalty provisions can be rebutted through the reasonable cause exception, which in practice (although not in theory) is satisfied by the receipt of an opinion from virtually any outside tax adviser.

In general, I believe in the reasonable cause exception, but it is clear to me that the ethical standards surrounding tax opinions need substantial revamping. Assuming (as I believe should be the case) that opinions remain an important part of the reasonable cause defense, we need to ensure that the opinion process serves the needs of the tax systems as a whole. In that regard, the Treasury should use its authority to require that an opinion will not be taken into account for purposes of mounting a reasonable cause defense unless the opinion satisfies the following minimum criteria:

- The opinion is not rendered by the promoter of a tax-advantaged product or by a firm that is providing advice to the promoter in respect of that product;
- The opinion sets out all the relevant facts of the transaction, and a corporate officer certifies that the opinion's factual summary is true, complete, and accurate in all material respects; and
- The opinion-giver is not compensated on the basis of a percentage of the purported tax savings derived from the transaction that the opinion addresses.

These self-evident standards (which routinely appear to be violated in current practice) will materially improve the quality of the opinions rendered in some promoted transactions today.

Better opinion standards certainly are desirable, but by themselves they will change corporate behavior only at the margins. Moreover, it is not apparent to me that penalties are likely to be imposed more frequently in the future than they have in the past.

For all practical purposes, then, our only stick to assure that a corporation accurately self-assesses its corporate tax liability is that a deficiency that is conceded on audit bears interest at short-term Treasury rates plus 3 percent. Perversely, overpayments earn interest only at Treasuries plus 50 basis points. At the same time, the Treasury subsidizes 35 percent of every underpayment (and takes back 35 percent of every overpayment) through the corporate income tax system.

The combination of our rules for interest on corporate tax underpayments and overpayments encourages exactly the behavior that the Treasury should find most troublesome: a structural bias in favor of resolving every close question of law on the tax return against the government. The best way to see the problem is to conceptualize the resolution of every non-penalty tax law issue as an investment decision, in which a corporate tax manager can invest a potential tax savings in a refund claim, or in his company's business (subject to a retroactive claw-back if the corporation were to lose the issue on audit).

If, for example, you were a corporate tax manager, and had $100 to "invest" in a complex and ambiguous issue
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relating to the interpretation of a particular Treasury regulation, which would you do: (i) resolve the issue in favor of the government, thereby investing the $100 at a below-market rate of Treasuries plus 50 basis points, and file for a refund claim (thereby assuring that issue is fully aired before the IRS), or (ii) resolve the issue in favor of your corporation, put the $100 to work at a much higher return (say, Treasuries plus 200 basis points), and wait to see what transpired on audit, knowing that your downside risk (if the issue in fact ever were fully aired) would be a cost of 100 (deductible) basis points per year (the difference between the deficiency rate and the return earned on the cash savings)? The answer is self-evident, and in fact is mirrored in the behavior of corporations every day when they make practical decisions on how to resolve thousands of tax analytical questions, great and small.

There is another way. Individuals today earn the same interest rate on overpayments as they must pay on underpayments, but their underpayment interest expense is nondeductible. In effect, individuals today can be said to be subject to a small "strict liability" penalty on the entirety of any deficiency, by virtue of the nondeductibility of interest expense. If our goal is to encourage corporations to self-assess their tax liabilities accurately and fairly to the fisc, why is not this payoff pattern infinitely preferable to the current corporate system?

If we simply applied to corporations the interest rules now applicable to individuals, a corporate taxpayer's calculus of how to resolve difficult and ambiguous questions of law might well change, at least at the margin. For example, a corporate tax manager faced with the same $100 dilemma as considered above now would be asked to choose between (i) getting a fair return on the corporation's money, but fully airing the ambiguous issue to get its refund, or (ii) risking a substantially higher after-tax amount (in the form of nondeductible interest expense) if the issue were resolved in the taxpayer's favor on the return, but later disallowed. In many cases, the manager might choose the former strategy. The result would be a system in which there would be a clear, self-administering and "no fault" bias in the system encouraging corporations to bring some conservatism to bear on their application of our rule-based tax model to their particular facts.

Section 7462 of the Senate version (S.3209) of the Omnibus Budget Reconciliation Act of 1990 would have denied corporations a deduction for interest attributable to periods after 30 days after the earlier of the furnishing of a notice of proposed deficiency (commonly called a 30-day letter) or the furnishing of a statutory notice of deficiency issued pursuant to section 6212 (commonly called a 90-day letter). The House-Senate Conference rejected the proposal, and adopted instead current section 6621(c) (the rule that imposes an interest rate of Treasuries plus five percentage points for deficiencies after the earlier of the receipt of a 30-day letter or a 90-day letter). The proposal advanced here is different, in that it would maintain a uniform interest rate on corporate deficiencies, but make the entire amount nondeductible. The Senate proposal in 1990, like current section 6621(c), imposes a penalty for continuing to wrangle with the IRS after the first level of audit review (assuming, of course, one ultimately loses the issue). My proposal, by contrast, is not intended to encourage early settlement of issues that have been raised by an examiner, but instead to encourage corporate taxpayers to volunteer the existence of the issue in the first instance, by filing their returns on a conservative basis and seeking refunds.

For the same reason, this proposal rejects emphatically the idea that the Treasury should pay a materially lower interest rate on corporate tax overpayments than it receives on tax underpayments. It is true that the Treasury is a better credit risk than are domestic corporations, and it is also true that financial institutions do not borrow at the same rate at which they lend, but these discussions miss the point that the interest rates charged on tax overpayments and underpayments are not intended as an exercise in elementary banking, but rather are an opportunity to shape corporate behavior in a way that promotes the long-term interest of the fisc. So long as the "savings" rate offered on tax overpayments is not so high as to crowd out other corporate investment opportunities, it really does not matter that those rates are higher than those paid on Treasury notes. First, corporations typically deploy their cash in their operating business; if investing in Treasuries is an attractive use of a corporation's cash, most Chief Financial Officers will opt to repurchase shares instead. Second, the elimination of a subsidy on interest paid to the Treasury on underpayments (through tax deductions) will mitigate the cost to the Treasury of paying higher interest rates on tax overpayments. Finally, and most fundamentally, the corporate tax return behavioral change will be the Treasury's true return on its higher nominal interest cost.

The proposal made here for revamping the interest charges on corporate underpayments and overpayments would require significant work to develop into a full-blown statute, particularly with respect to interest "netting" and similar issues. For example, if the result of an audit examination in 2006 is to move a deduction from 2001 to 2002, most of us, I suspect, would feel uncomfortable with a result that contemplated the running of nondeductible interest expense for five years, and includable interest income for four years.

Similarly, the entire purpose of this proposal is to force more issues to the surface for explicit resolution between the IRS and the taxpayer. This agenda can succeed only if the dialogue that follows from a refund claim is prompt, professional and fair. The resources of both the IRS and the Treasury today are stretched too thin to take on this burden, or to issue the necessary quantum of regulatory and other guidance in the first instance. If this proposal were to be seriously considered, it therefore would need to be coupled with adequate congressional funding to enable the Government to conduct audits more promptly, to bring specialized resources to bear on complex questions, to issue more informal guidance to taxpayers, and, of course, to improve our rule-based model through an increased volume of formal guidance.
Notes

1 See Department of the Treasury, General Explanations of the Administration's Revenue Proposals 95-199 (February 1999).

2 See "A Better Tax Service and a Better Tax System," Remarks by Lawrence H. Summers, Deputy Secretary of the Treasury, before the Tax Executives Institute, as printed in the Treasury News on March 22, 1999, at 3 ("Members of the TEI, and others in the corporate community have come to us complaining, generically, of these developments and concerned about the growing pressure they feel themselves to be under to purchase such products in order to stay competitive with others. Many have asked for the help of the Treasury Department — help that we very much intend to provide.").


4 All citations to section numbers are to the Internal Revenue Code of 1986, as amended ("the Code"), and to the Treasury regulations promulgated thereunder.

5 Briefly, the Administration's proposals include the following operative provisions (beyond super-section 269). First, corporations determined to be participants in corporate tax shelters would be subject to a 40-percent strict liability penalty imposed on the portion of the underpayment attributable to the corporate tax shelter. This penalty would be reduced to 20 percent if the corporation adequately and timely disclosed the tax shelter transaction, but the corporation could not avoid the penalty in its entirety, even by a showing of reasonable cause and good faith. Second, any income derived from a tax shelter transaction by tax indifferent parties (e.g., foreign investors, Native American tribes, tax-exempt organizations, and corporations with expiring loss or credit carryforwards) would be subject to unrelated business income tax or surrogate taxes. Third, the participating corporation would be denied deductions for any fees paid for advice (from lawyers and investment bankers, for example) related to corporate tax shelters. Fourth, such advice would be subject to a 25-percent excise tax on any fees received in connection with corporate tax shelters. Finally, a 25-percent excise tax would be imposed on rebates, "unwind" provisions, or other tax benefit indemnities provided by the promoters of tax shelter transactions.

6 See, e.g., Statement of Lester D. Ezraty, on behalf of the Tax Executives Institute, Inc., before the Senate Finance Committee, April 27, 1999, at 3 ("In particular, we seek to explain our concerns about the proposals' lack of clarity (e.g., in defining the term 'corporate tax shelter'), their overall lack of proportionality, their possible interference with normal business transactions, and their potentially detrimental effect on tax administration.").

Statement of David Lifson, on behalf of the American Institute of Certified Public Accountants, before the House Committee on Ways and Means, Hearing on Revenue Provisions in the President's Fiscal Year 2000 Budget, March 10, 1999, at 10 ("Our primary concern with the Treasury proposals is the absence of a clear standard defining what is and what is not an abusive transaction, which would apply to most provisions of the tax law. The proposals modifying the substantial understatement penalty for corporate tax shelters and denying certain tax benefits to persons avoiding tax as a result of a tax avoidance transaction set forth a too-vague definition of abusive uses of the income tax laws that must be clarified. Anti-abuse legislation should be directed at transactions that are mere contrivances designed to subvert the tax law. The Treasury proposals move beyond the scope we think is appropriate to reach transactions that are described vaguely as 'the improper elimination or significant reduction of tax on economic income.' This criterion, whatever meaning is ascribed to it, is certain to capture transactions that would not be considered abusive by most and other transactions that have been undertaken for legitimate business purposes."); Statement of Kenneth J. Kies, PricewaterhouseCoopers, before the House Committee on Ways and Means, Hearing on Revenue Provisions in the President's Fiscal Year 2000 Budget, March 10, 1999, at 8 ("The imprecise definition of a corporate tax shelter transaction contained in... Treasury proposals would make it difficult for taxpayers and professional tax advisers to determine the circumstances under which this provision would be applicable.").

7 For example, if a corporate tax shelter were to generate $1,000 in deductions (a $35 tax benefit), $1,000 of income to a tax-exempt recipient, and $10 in fees to advisers who guarantee the availability of the tax deduction, the result would be the following (excluding interest charges):

\[
\begin{align*}
$35.00 & \text{Loss of anticipated tax benefit} \\
$14.00 & \text{40% penalty} \\
$35.00 & \text{Tax to tax-exempt investor} \\
$3.50 & \text{Loss of deductibility of fees} \\
$2.50 & \text{Excise tax} \\
$13.45 & \text{Excise tax on gross-up ($35.85 x 25\%)} \\
$103.45 & \text{Cost of lost tax benefit plus $68.45 in penalties.}
\end{align*}
\]

In sum, the aggregate effect of these rules would be that all affected taxpayers would pay (in addition to the lost benefit) nearly a 200-percent penalty (plus interest) on any tax shelter item that was disallowed. By contrast, the penalty in civil fraud cases is 75 percent. I.R.C. § 6663.

8 See Statement of Donald C. Lubick, Assistant Secretary (Tax Policy) of the Treasury, before the Senate Finance Committee, April 27, 1999, at 7 ("This is really no more than a debate on rules vs. standards."). See also Gann & Stroud, "The Recent Evolution of Antiabuse Rules," 66 Tax Notes 1189 (1995).

9 For example, Treasury Associate Legislative Counsel Paul Crispino reportedly told the National Tax Association's 29th spring symposium that, "while statistical evidence is 'inconclusive,' there is a substantial amount of anecdotal evidence that indicates a much larger and more aggressive shelter environment in recent years . . . ." Daily Tax Report, No. 90, May 11, 1999, at G-4.

10 See Statement of Kenneth J. Kies, supra note 6, at 2-3.


13 See Statement of Lester D. Ezraty, supra note 6, at 6 ("TEI is not among those who believe no problem exists.").

14 See, e.g., Statement of Stefan F. Tucker on behalf of the Section of Taxation, American Bar Association, before the Senate Finance Committee, April 27, 1999, at 4-6; Statement of David Lifson, supra note 6, at 12; NYSBA Report on Tax Shelter Proposals, at 879.

15 An example of the first category would be the strategy of liquidating a "captive REIT" under section 332 over an extended period of time (i.e., the combination of the "dividends-paid deduction" feature of REITs with section 332 distribution rules that allow the corporate parent to receive tax-free property from an 80-percent subsidiary). See, e.g., Letter Ruling No. 9609024 (March 1996). An example of the second category would be the step-down preferred stock transactions addressed in Notice 97-21, 1997-1 C.B. 407, and Prop. Reg. § 1.7701(b)-3.
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17 See Surdell, “ACM Partnership — A New Test for Corporate Tax Shelters?,” 75 Tax Notes 1380 (June 8, 1997) (“The court found that the ACM transaction was one of 11 similar transactions structured over a one-year period from 1989 to 1990 by Merrill’s Swap Group.”).

18 See, e.g., NYSBA Report on Tax Shelter Proposals, at 882 (“While, in our experience, the corporate cultures of corporations continue to vary widely in the way they approach aggressive corporate tax shelters, managing the effective tax rate on corporate income has, it appears, become one way that a substantial majority of corporations — even those who are more risk adverse [sic] — compete indirectly with respect to financial earnings results. In that context, it is inevitable that corporate tax managers will frequently be put under pressure to participate in aggressive tax-driven transactions by their financial colleagues, who are often considerably more irreverent about our tax laws.”); Shepard, “Colgate’s Corporate Tax Shelter Showdown,” 71 Tax Notes 1288 (June 3, 1996) (“Putting the best face on it, ‘opportunistic liability management’ means taking advantage of changes in the financial marketplace combined with changes in the state’s tax laws to minimize its taxes and its after tax cost of capital, opportunistic liability management starts to sound like a reason for going into tax shelters.”).


20 Admittedly, one does hear of such forums choosing activity in tax litigation, i.e., whether to litigate before a federal district court, the Court of Claims, or the Tax Court. Indeed, dissatisfaction with such a regime has resulted in repeated calls for reform of the system, an issue beyond the scope of this article.

21 For a rigorous economic framework in which to analyze the trade-offs between accuracy and fairness a vis a vis complexity and compliance costs in a tax system, see Kaplow, “Accuracy, Complexity and the Income Tax,” Harvard Law School and the National Bureau of Economic Research 77 (1998) (“With total compliance and administrative costs on the order of $75 billion annually, the question of the value of accurate income tax assessment, whether accomplished through more precise rules or more careful administration, is an important one.”).


23 See, e.g., Lipton, supra note 22.

24 See Hariton, supra note 22, at 242-45.

25 Ironically, of course, the closest most economists would come to agreeing on a natural law of corporate income taxation is that corporations should not in fact be separately subject to tax.

26 See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, at 3-75 (1999) (Fueling an ongoing debate with Professor Suryan regarding the tax expenditure budget, Bittker explained at the tax expenditure conference, by Professor Suryan’s words, that “the structural provisions necessary to implement the income tax on individual and corporate net income” can be identified and distinguished from ‘special tax provisions’ (or ‘tax subsidies’) embodying governmental financial assistance programs.’ The line between these two classes is not, however, easily drawn.”); Kaplow, supra note 21, at 79 (“Notably, the tax expenditure provisions are used to encourage various activities.”).


29 Treas. Reg. § 1.1273-2(h).

30 I.R.C. § 1258.

31 See Treas. Reg. § 1.701-2. The partnership anti-abuse regulations were issued in final form in Treasury Decision 8598 (Dec. 29, 1994).

32 Treas. Reg. § 1.701-2(a) provides, generally, that a partnership transaction is consistent with the intent of Subchapter K if: (i) the partnership is bona fide and the transaction is entered into for a substantial business purpose; (ii) the form of such transaction is respected under the substance-over-form principles; and (iii) the tax consequences to each partner of the partnership operations and transactions between the partner and the partnership must accurately reflect the partners’ economic agreement and clearly reflect the partner’s income (collectively, proper reflection of income). See Treas. Reg. § 1.701-2(a).

33 See Treas. Reg. § 1.701-2(d). For a detailed discussion of the examples, see Lipton, “IRS Improves Partnership Anti-Abuse Regs., But Major Problems Remain,” 82 Journal of Taxation 132 (March 1995). To ensure uniformity in application of these regulations, the IRS issued an Industry Specialization Program Coordinated Issue Paper on June 22, 1995, which requires auditors to contact partnership industry specialists, who in turn will coordinate with the National Office.


35 I.R.C. § 446(b).

36 I.R.C. § 446(a).

37 Thus, Notice 89-21, 1989-1 C.B. 651, relied on the clear reflection of income doctrine to conclude that a taxpayer’s accounting method must treat a lump-sum payment received in connection with a notional principal contract as amortizable over the life of that contract. At the time Notice 89-21 was published, essentially no guidance existed on the characterization of notional principal contracts for tax purposes. Notice 89-21 filled this statutory gap in this one application. Notice 89-21 was helpful, in the sense that it provided a sensible answer to one narrow question, but it also was controversial. First, the notice offered no principled explanation for the apparent conflict between its view of the clear reflection of income doctrine and the view of the same doctrine expressed by the Supreme Court in Schlude v. Commissioner, 372 U.S. 128 (1963). Second, to the extent that one could divine a distinction — namely, that financial instruments are different from services, and that notional principal contracts are more like traditional financial instruments than they are like services — Notice 89-21 did not (and, as a matter of statutory authority, could not) systematically implement that conclusion throughout the Code. The resulting tax law conflicts and uncertainties (which still linger in certain areas) were in large measure the natural outcome of that contemporary failure to fix the model itself to address comprehensively the tax characteristics of notional principal contracts.

38 See, e.g., Statement of David Lilson, supra note 6, at 11 (“We are also concerned that increased and multiple penalties, based on a loosely defined standard and with no abatement for reasonable cause, should not apply to taxpayers where differences of opinion are the norm, not the exception.”).

39 For a discussion of line-walking behavior in response to income tax rules, see M. Kelman, A Guide to Critical Legal Stud-
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ies, at 41-43 (1987); Hu, “Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm,” 138 U. Pa. L. Rev. 393, 396 (1989) (“Of course, as with any rule-based system, there will be an incentive to ‘walk the line’ to try to use the rules to one’s own advantage.”).

For example, speaking at the Federal Bar Association Tax Meeting, Treasury Assistant Secretary Donald C. Lubick noted that “a precise law would be a road map to avoidance.” See Hamilton & Bergin, “Corporate Tax Shelters: Is the Cure Worse Than the Disease?” 82 Tax Notes 1157 (March 15, 1999). See also Stratton, “Tax Shelter Guidance Might Be Out by May,” 82 Tax Notes 1733 (March 22, 1996).

See Helering v. Southwest Consolidated Corp., 315 U.S. 194, 198 (1942) (“Congress has provided that the assets of the transferor corporation must be acquired in exchange ‘solely’ for ‘voting stock’ of the transferee. ‘Solely’ leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement.”).

See Remarks by Lawrence H. Summers, supra note 2, at 4.


Another possible avenue to explore, first proposed by Peter Canellos, would be for the Treasury to work with the Securities Exchange Commission to require footnote disclosure in a public corporation’s financial statements of the taxpayer’s aggregate dollar amount of taxes saved through “corporate tax shelter” transactions. This proposal has two objectives: first, to ensure that audit resources are deployed wisely, and, second, to empower another party in interest (financial analysts) to ask pointed questions of a public corporation that has relied heavily on tax-intensive transactions to reduce its effective tax rate for financial statement purposes.

Id. at 174-84 (discussing the value of retroactive changes in law).

While others may be less sympathetic, I think it unfair to ask investment banks and other financial intermediaries to be put in the position of “ratting” on their clients when the bank, perhaps out of an excess of caution, wishes to submit a promotor disclosure statement in respect of a public underwriting that its issuer client vigorously contends is not a corporate tax shelter as to it, the taxpayer.

To take one closely observed recent example, penalties apparently were not asserted against the taxpayer in ACM Partnership v. Commissioner, 151 F.3d 231 (3d Cir. 1998), affg T.C. Memo 1997-115 (1997).

Treas. Reg. § 1.6664-4(c) contains a general facts-and-circumstances test for determining whether a taxpayer has reasonably relied in good faith on advice, including the opinion of a professional tax adviser concerning the treatment of the taxpayer under federal tax law. At a minimum, the tax opinion (i) must be based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances; (ii) must not be based on unreasonable factual or legal assumptions, including assumptions as to future events; and (iii) must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. Treas. Reg. § 1.6664-4(e)(2), which defines “reasonable cause,” in the context of corporate tax shelters, requires taxpayers to have (i) substantial authority for their tax treatment of an item and (ii) a reasonable belief that such treatment is “more likely than not” the proper treatment. Under Treas. Reg. § 1.6664-4(e)(2)(B)(2), taxpayers can satisfy this reasonable belief requirement by relying in good faith on the opinion of a professional tax adviser, provided such opinion meets the requirements of 1.6664-4(d)(3)(ii). In addition, Treas. Reg. § 1.6664-4(e)(2)(B)(2) provides that the tax adviser must conclude in such opinion that there is a greater than 50-percent likelihood that the tax treatment will be upheld if challenged by the IRS. Finally, Treas. Reg. § 1.6664-4(e)(3) states that a taxpayer will not have reasonable cause if (i) the tax shelter transaction at issue lacked a significant business purpose, (ii) the taxpayer claimed tax benefits that are unreasonable compared to the taxpayer’s investment in the tax shelter, or the taxpayer agreed with the promoter to keep the tax aspects of the shelter confidential.

Technically, Treas. Reg. § 1.6664-4 makes a legal opinion necessary but not sufficient. In practice, opinions have been widely perceived as necessary and sufficient. See, e.g., Statement of Stefan Tucker, supra note 14, at 4 (“We are particularly concerned about this phenomenon because it appears that the lynchpin of these transactions is the opinion of the professional tax adviser . . . . Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability. While some might dispute this as a legal conclusion, recent cases tend to support the absence of risk for penalties where favorable tax opinions have been given.”); Stratton & Sheppard, “ABA Tax Section Meeting: Administration’s Shelter Proposals Attacked Ad Nauseam,” 83 Tax Notes 780 (May 10, 1999) (Speaking at the American Bar Association Tax Section’s Spring meeting, Treasury Tax Legislative Counsel Mikruti “countered that as a practical matter, legal opinions protect a taxpayer from penalties, acknowledging that either the practice or the penalties need to be changed.”).


I.R.C. § 6621(a)(2). (Technically, the rate is measured by the short-term Applicable Federal Rate.) The rate jumps to Treasuries plus 5 percent, in effect, once a notice of proposed deficiency is issued. I.R.C. § 6621(c).

I.R.C. § 6621(a)(1).

Where corporate returns on investment are expected to exceed the deficiency rate, as is true in many recent life cases, a taxpayer in fact would enjoy a positive arbitrage.

Obviously, if a small differential is necessary to prevent distortion in corporate investment behavior, that small differential could be accommodated without materially affecting the proposal.

See House Ways and Means Committee Report, No. 426 (Dec. 7, 1985) (“The committee is concerned that these interest provisions are not modeled sufficiently closely on other interest rates in the economy; this may have distortive effects. First, the committee is concerned that both the interest rate taxpayers pay the Treasury and the rate the Treasury pays to taxpayers are the same rate. Few financial institutions, commercial operations or other entities, borrow and lend money at the same rate. Thus, either the rate taxpayers pay the Treasury or the rate the Treasury pays taxpayers is necessarily out of line with general interest rates in the economy. This distortion may cause taxpayers either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate. Consequently, the committee has approved a one-percent differential between these two interest rates.”).

The legislative history cited in the note 54 implies that in the past some corporate taxpayers used tax overpayments as a form of government-backed money-market investment with above-market yields. I am politely skeptical of the existence of the phenomenon, in light of the relative uncertainty (again, compared to an actual investment in Treasury securities or a money market fund) in the timing of processing a “redemption” request (i.e., the refund). Nonetheless, if the phenomenon is believed to be real, the proposal made in the text can address the problem by, for example, paying the current rate of Treasuries plus 50 basis points until the date a refund claim is filed, from which point forward the rate would jump to Treasuries plus 300 basis points.