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Risk, Return, and Objective Economic Substance

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RISK, RETURN, AND OBJECTIVE ECONOMIC SUBSTANCE

Charlene D. Luke*

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I. INTRODUCTION

The economic substance doctrine is a judicial method used to evaluate transactions suspected of being nothing more than elaborate (and illicit) tax avoidance. The doctrine was developed in the court system, and its precise requirements are continually evolving. Generally, the test consists of a subjective inquiry into whether a taxpayer had a nontax purpose for entering the suspect transaction and an objective inquiry into whether the transaction accomplished anything beyond tax effects.¹ These inquiries frequently focus on the economic profit available in the transaction because taxpayers often assert a profit motive as their nontax reason for entering the suspect

¹ The subjective inquiry is sometimes treated as a separate test, known as the business purpose test. Not all courts require the taxpayer to meet both subjective and objective inquiries. See Joint Committee on Taxation, *JCT Describes Chairman's Modification of Phone Tax Repeal and Taxpayer Protection Bills*, 2006 TNT 125-14 (June 29, 2006). This article does not address whether the economic substance doctrine should include both inquiries.

transaction. Economic profit is determined by looking to the pre-tax landscape.

The use of pre-tax analysis reflects the idea that a genuine economic transaction will yield a higher return before taxes than after taxes. This article suggests that although this idea has intuitive appeal and provides some indication of economic substance, exclusive use of the pre-tax viewpoint is fundamentally flawed. This article reviews the problems associated with the pre-tax viewpoint and proposes an alternative framework for testing objective economic substance.²

Under the proposed framework, the after-tax return on the suspect transaction would be compared to the return available on an economically equivalent market transaction. If the after-tax return on the suspect transaction were substantially similar to the return available on a comparable transaction, the taxpayer would satisfy the objective economic substance inquiry. If, however, the taxpayer's after-tax return on the suspect transaction were substantially higher than the return on economically comparable market transactions, the suspect transaction would be presumed to fail the objective economic substance inquiry.

When a transaction fails the comparables inquiry, the taxpayer would still be able to rebut the presumption that the transaction lacks economic substance by demonstrating that the additional return more likely than not arose because she was part of a naturally occurring tax clientele for the transaction. A "tax clientele" is a group whose members have a preference for a particular asset or transaction because their tax bracket affords them an extra return that the investor setting the price of the asset is unable to attain. This rebuttal takes the form of the taxpayer demonstrating membership in a natural tax clientele because Congress presumably sanctions (and even encourages) the formation of broad tax clienteles through the progressive rate system. For example, in the case of tax-exempt bonds, high tax bracket taxpayers will be able to earn a higher return than on a comparable taxable bond if the price on both assets is set by a taxpayer in a lower bracket.³

If the comparables test could not be performed because of the

² This article does not address the subjective motive inquiry. This article also does not take a position as to whether the doctrine should be codified. For a discussion regarding textualist attacks on the doctrine and the advisability of its being codified, see Brian Galle, *Interpretive Theory and Tax Regulation*, 26 VA. TAX REV. 357 (2006).

³ See *infra* notes 57–63 and accompanying text (providing an example of tax-exempt and taxable bonds).

absence of a suitable comparable, the court would turn to a factor-based inquiry into whether the after-tax result more likely than not resulted from economic opportunity other than tax arbitrage.⁴ Relevant factors in this determination would include analysis of any imperfect comparables, the ease with which other taxpayers could have entered into the transaction, the presence or absence of a known tax-shelter promoter, the dependence of the after-tax return on particular tax attributes of the taxpayer or counterparty, the timing and circumstances surrounding the creation of those tax attributes, and the extent of risk and pre-tax profit.⁵

This article will review the problems associated with the pre-tax viewpoint and propose an alternative method for testing objective economic substance. In particular, Part II will provide an overview of the economic substance doctrine and discuss the assumptions about this doctrine that underlie the proposed method. Part III will critique the current pre-tax approach to an objective inquiry into profit. Part IV will detail the proposed objective economic substance framework. Part V will consider how the proposed framework might have been applied to two cases — *Compaq Computer Corp. v. Commissioner* and *Black & Decker Corp. v. United States*. Part VI states the article's conclusion.

II. OBJECTIVE ECONOMIC SUBSTANCE

This Part will briefly describe the economic substance doctrine and also outline the background assumptions regarding when the doctrine should be applied and what work the objective prong of the doctrine should perform. These assumptions are working assumptions;

⁴ See William A. Klein & Kirk J. Stark, *Compaq v. Commissioner — Where Is the Tax Arbitrage?*, 94 TAX NOTES 1335, 1335–36 (Mar. 11, 2002) (defining classic tax arbitrage as arising “from the differential tax treatment of an individual taxpayer’s cash flows”); see also Daniel N. Shaviro, *The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance*, in TAX STORIES 314, 314–15 (Paul Caron ed., 2003) (distinguishing between economic and tax arbitrage). The use of a post-tax perspective in economic substance has been raised in Mitchell Kane, *Compaq and IES: Putting the Tax Back into After-Tax Income*, 94 TAX NOTES 1215, 1217 (Mar. 4, 2002).

⁵ See Klein & Stark, *supra* note 4, at 1335–36 (listing similar factors in the context of the *Compaq* decision); Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 734 (2007) (discussing factors related to the relationship between taxpayer and other parties, including how “the presence of certain types of parties may be a red flag suggesting the possibility of abuse”).

an in-depth defense of them is beyond the scope of this article.

In general, the economic substance doctrine is applied to transactions when a taxpayer has technically met statutory and regulatory requirements but has met these requirements in such a way that the specific result of the transaction or series of transactions is unlikely to have been foreseen by Congress or regulators. The precise structure of the economic substance doctrine is not settled, and enumeration of the doctrine's many variations is beyond the scope of this article.⁶ Generally, however, the doctrine consists of both a subjective and an objective prong. The subjective prong is satisfied if the taxpayer had a nontax business or investment purpose for entering into the transaction.⁷ The objective prong looks to whether the transaction accomplished anything beyond generating the claimed tax benefits.⁸ This article focuses on the objective prong of the economic substance doctrine.

The objective and subjective inquiries of the economic substance doctrine often dovetail. Thus, for example, a taxpayer who asserts that she entered a suspect transaction in order to earn a pre-tax profit would satisfy the objective prong by demonstrating the reasonableness of attaining that goal.⁹ The courts have not reached a consensus as to the weight each prong should be given. Some courts require taxpayers to satisfy both prongs, whereas in other courts taxpayers need only satisfy one prong in order for the transaction to survive scrutiny.¹⁰ This article does not take a position as to the weight the courts should give the two prongs.

The economic substance doctrine is only one of several tests developed in the courts for the purpose of scrutinizing claimed tax benefits. Each of these tests fills a slightly different — though

⁶ See PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION* 1326–29 (5th ed. 2004) (reviewing background of economic substance doctrine); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 7–27 (2000) (overview of economic substance doctrine); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 241–53 (1999) (discussing the “history and scope” of the economic substance doctrine); Yoram Keinan, *The Economic Substance Doctrine*, 508 TAX MGMT. PORTFOLIO (BNA) A37–A57 (2006) (overview of the many variations on the doctrine); Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 TAXES 985 (1981).

⁷ See Keinan, *supra* note 6, at A44.

⁸ See *id.* at A43–A44.

⁹ See, e.g., *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 787 (5th Cir. 2001).

¹⁰ See Keinan, *supra* note 6, at A42–A43.

occasionally overlapping — niche in the world of tax litigation. Although the subjective and objective prongs together form the economic substance doctrine, these two prongs fill distinct roles. The objective economic substance prong is closely related to the sham transaction doctrine and to the more generalized “substance-over-form” approach. These two tests inform this article’s working assumptions about the boundaries and content of the objective economic substance test.

The sham transaction doctrine¹¹ is applied when a taxpayer claims tax benefits based on having taken certain steps but, as a factual matter, the taxpayer did not actually complete those steps. In the case of financial transactions, it can be difficult to tell whether a transaction was real or fictional. Financial assets may exist only as book entries, and transactions may involve offsets or pairoffs at the dealer level, which can be more difficult to verify than transactions taking place at the primary market level.¹² In such a situation, the court will look to industry custom in discerning whether a transaction factually took place.¹³ If a court makes a finding of factual sham, the transaction is completely disregarded, along with its attendant tax benefits.

The more generalized substance-over-form approach applies to transactions that have factually occurred but about which there is concern over whether the transaction has been mislabeled. If the court finds that mislabeling has occurred, the tax consequences of the transaction are adjusted to match the substance of the transaction. The substance of the transaction is often determined with reference to how closely the suspect transaction tracks similarly labeled market transactions.

¹¹ Courts occasionally use the term “sham” when discussing the economic substance doctrine, and vice versa. *See, e.g.,* *Black & Decker Corp. v. United States*, 436 F.3d 431, 440 (4th Cir. 2006); *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) (describing test for sham transaction as consisting of a subjective business purpose factor and an economic substance factor); *see also* Hariton, *supra* note 6 (noting the “unfortunate habit” in the Third Circuit of “calling the economic substance doctrine the ‘sham’ doctrine”).

¹² *See* *Sheldon v. Commissioner*, 94 T.C. 738, 740–41 (1990) (describing book-entry form and dealer pairoffs for Treasury bills). The Tax Court specifically considers whether the dealers involved were objectively capable of handling the size of the transaction, whether the transaction was prearranged to deliver a particular level of loss, and whether the margin deposits required from the taxpayer were consistent with the size of the transaction. *Id.* at 754.

¹³ *See id.* at 753–54 (looking to industry custom to decide whether “purported T-Bill purchases and repos were fictitious”).

For example, the substance-over-form approach is frequently invoked by the government to scrutinize transactions between a closely-held corporation and its shareholders.¹⁴ A profitable corporation might pay a large amount of rent to its landlord — who also happens to be the corporation's sole shareholder. A court reviewing this transaction would make a factual determination as to whether a portion of the "rent" was in substance a corporate distribution to the shareholder. Evidence about the fair rental value of the property would be highly relevant to the court's inquiry.¹⁵ If the court finds that the rent charged by the shareholder significantly exceeds the amount that would have been charged in the same market by an unrelated party, the shareholder would likely be required to include the excess amount as dividend income,¹⁶ and the corporation would forgo its "rental" deduction for the excess portion of the rent charged.

General substance-over-form tends to be applied when two mutually exclusive categories are readily identifiable — for example, dividend versus rent,¹⁷ owner versus lessee,¹⁸ debt versus equity,¹⁹ or partner versus creditor.²⁰ The presence of a specific alternative provides an anchor to a court's inquiry into the substance of a particular transaction and guidance to the taxpayers in their business transactions. To be sure, considerable uncertainty and controversy can surround the questions of how best to assign a particular transaction

¹⁴ See LEANDRA LEDERMAN, UNDERSTANDING CORPORATE TAXATION 117 (2d ed. 2006) (describing problem of mislabeling of distributions to shareholders of closely held corporations). Taxpayers may also invoke the substance-over-form doctrine. See, e.g., *Selfe v. United States*, 778 F.2d 769, 774 (11th Cir. 1985) ("[N]othing in the Internal Revenue Code or our decisions suggests that the factors used to determine the substantive character of a taxpayer's interest in a corporation are available only to the government.").

¹⁵ Anjanette T. Frias, *Dividends — Cash & Property*, 764-3d TAX MGMT. PORTFOLIO (BNA) A-19-A-35 (2006) (analyzing various rent cases and concluding that "[e]vidence that rental payments do not exceed the fair rental value of the property should negate the appearance of a constructive dividend").

¹⁶ The excess would have to be included as a dividend to the extent of corporate earnings and profits. I.R.C. §§ 301, 316.

¹⁷ See, e.g., *58th St. Plaza Theatre, Inc. v. Commissioner*, 195 F.2d 724 (2d Cir. 1952).

¹⁸ See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

¹⁹ See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968).

²⁰ See *ASA Investorings v. Commissioner*, 201 F.3d 505, 513-16 (D.C. Cir. 2000) (agreeing with the Tax Court that foreign bank was a creditor rather than a partner in a complex transaction designed to generate losses to the taxpayer).

or taxpayer²¹ and whether certain categories should be respected as distinct categories.²² In spite of these concerns, the use of general substance-over-form principles is widely accepted as a necessary component of the tax system.²³

The more controversial objective economic substance test tends to be applied when the transaction actually happened but there is no obvious alternative label applicable to the transaction. That is, the transaction is sufficiently complex or novel that the analysis requires more than making a choice between two readily recognizable tax categories. Instead, courts frame the objective economic test as a choice between the existence and nonexistence of the transaction for tax purposes. In other words (and putting to one side the possible effects of the subjective inquiry) the court determines whether the transaction should be ignored even though it factually took place. In general, this determination hinges on whether the transaction accomplished anything beyond tax effects.

In answering this open-ended question, courts frequently turn to analysis of the profit potential — exclusive of tax benefits — of the transaction. Part III takes up the profit potential test in greater detail. As will be discussed in that Part, the appeal of using pre-tax profit

²¹ See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 371 (1971) (discussing and critiquing the “jungle of criteria by which the courts have attempted to distinguish debt from equity”); Bernard Wolfman, *The Supreme Court in the Lyon’s Den: A Failure of Judicial Process*, 66 CORNELL L. REV. 1075, 1075–76 (1980-81) (discussing Supreme Court’s “misperception of some of the facts” in *Frank Lyon* and arguing that proper consideration of these facts would have led the Court to conclude that the “lessee” was the true owner and the taxpayer was not entitled to depreciation deductions).

²² See Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A “Revolutionary” Approach to Ownership*, 47 TAX L. REV. 725, 726 (1992) (discussing problems with tax law “insist[ing] that there is a single ‘owner’ of ‘the property’ at any given time”); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991) (discussing the difficulty of taxing debt-equity hybrids because of the tax system approach of “describing a finite number of idealized transactions and attaching to each a set of operative rules — what might be termed a set of tax cubbyholes”).

²³ See Martin J. McMahon, Jr., *Business Purpose, Economic Substance, and Corporate Tax Shelters: Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195, 197 (2001) (describing substance-over-form as a “venerable doctrine[]” and one which is also found to be “quite respectable and properly applied” by taxpayers when the approach operates in their favor).

relates to the idea that individuals who are engaging in genuine economic transactions will be focused on a transaction's return before taxes.²⁴ This assumption, however, fails to take into account the extent to which individuals make decisions based on their particularized tax circumstances and the effect that strategic taxpayer behavior has on the price of transactions.

In addition, use of a tax-exclusive viewpoint requires that courts consider not only actual pre-tax profit but pre-tax profit potential and risk. Attempts to identify pre-tax profit potential provide taxpayers with the opportunity to argue (and build-in) multiple alternate endings. As a result of these concerns, the amount of pre-tax profit necessary to save a transaction has not been settled. Various court cases and recent economic substance codification proposals suggest several different methods of harnessing inquiries into profit potential and specifying the required amount of pre-tax profit. Yet, as discussed in Part III.A, disagreement persists over the question of how best to assess profit potential and risk.

As discussed above, the presence of obvious binary categories frequently leads the court to use a general substance-over-form approach and, in conjunction, to undertake a simple comparables analysis. Courts, however, generally invoke the objective economic substance prong for more complex or novel transactions. As a result, current judicial formulations of economic substance generally do not involve the use of comparables analysis. This article suggests that it is possible to use a comparables analysis when answering the question whether a complex suspect transaction accomplishes anything beyond tax effects. Although the pre-tax profit approach to objective economic substance does work in certain circumstances, a comparables approach may yield a more certain and less controversial framework for determining the presence of objective economic substance. Part IV proposes and details a comparables approach to the problem of determining objective economic substance. The proposed approach relies on generally accepted ideas about the standard relationship between risk and reward.

Even though the proposed comparables approach brings the objective economic substance test closer to the more general substance-over-form approach,²⁵ this article does not propose a

²⁴ Cf. Shaviro, *supra* note 4, at 317 (“[T]he key to a potentially appealing tax shelter is that it reduce your taxable income by much more than it reduces your pre-tax economic income.”).

²⁵ Some courts have described objective economic substance as incorporating

change to the consequences of failing the objective economic test. (Again, this article puts aside the question of how taxpayer motivation should affect the final outcome.) While the consequences of failing the test may seem harsh, the test itself is not overly restrictive. The taxpayer need only show that the transaction accomplished something beyond tax effects — that it was not a substantive sham. As described in Part IV, the approach proposed in this article allows the suspect transaction's after-tax results to be assessed against a range of comparables. Only if the taxpayer fails to find a comparable with a return similar to the suspect transaction (assuming the government has an adequate comparable) will the transaction be presumed to fail the objective economic substance test. Furthermore, this presumption is rebuttable.

Since the consequences of failing the objective economic substance test can be severe, this article accepts, as a working assumption, that the objective economic substance test should be invoked only when more direct approaches to assessing a suspect transaction do not work. Thus, statutory tests and the general substance-over-form test should be applied in preference to the objective economic substance test.²⁶ Further, congressionally-sanctioned tax benefits obtained through standard channels should not be scrutinized under objective economic substance.²⁷ To take a simple (and obvious) situation, the deduction of qualified home mortgage interest by the resident home owner is a congressionally

the general substance-over-form approach. *See infra* note 106 and accompanying text.

²⁶ The choice to use the economic substance doctrine over other tools is a topic that has generated significant debate. *See, e.g.*, Bankman, *supra* note 6, at 5–7 (describing controversy over the use of common law doctrines in general and economic substance in particular); Pamela F. Olson, *Now That You've Caught the Bus, What Are You Going To Do With It?*, 60 TAX LAW. 567, 574 (2007) (“Rather than a careful analysis of the relevant statutory or regulatory provisions, it [economic substance] allows the tax administrator to attack every transaction it finds offensive The tax administrator may miss compelling statutory or regulatory arguments that would have produced a decision for the government . . .”).

²⁷ *See* Bankman, *supra* note 6, at 13 (“The primary limitation on the objective economic substance doctrine . . . [is that it] cannot apply where a sensible reading of text, legislative intent, and purpose suggest it should not apply.”); *see also* David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29, 31 (2006) (“The tax benefits arising from such a transaction [lacking economic substance] should not be disallowed unless they are clearly inconsistent with tax policy and congressional intent.”); Warren, *supra* note 6, at 990 (“[W]here Congress has enacted an incentive . . . it can be argued that application of the requirement of a pretax profit would interfere with the Congressional goal, perhaps even creating perverse results.”).

intended tax benefit obtained by the taxpayer in the normal way²⁸ and would not be susceptible to an objective economic substance attack.

To be sure, taxpayers fighting the application of economic substance to their transaction will argue that their claimed tax benefit has congressional approval because the taxpayers will have formally met the technical requirements for obtaining the benefit.²⁹ Thus, while the economic substance doctrine should not be invoked in the case of obviously intended tax benefits, it is appropriate to invoke economic substance to test transactions when the taxpayer has taken a less obvious path to a claimed tax benefit.³⁰

III. PRE-TAX PROFIT

Inquiring into pre-tax profit has become a primary method of approaching objective economic substance, yet difficult questions remain about how best to assess profit potential and the weight it should be given in the analysis. This Part discusses in greater detail the problems inherent in any pre-tax profit inquiry.

A. *Weighing Potentialities*

Use of the pre-tax profit viewpoint requires courts to consider not only actual pre-tax profit but pre-tax profit potential. Taxpayers investing for nontax motives may suffer genuine economic loss, whether because of general market downturns or transaction-specific losses. Thus, an analysis of profit potential must take into account the possibility of genuine loss — and lack of an actual pre-tax profit is not conclusive evidence that a taxpayer objectively lacked a pre-tax profit motive.³¹ The taxpayer may simply have lost on a genuine economic gamble.

While an inquiry into pre-tax profit potential protects against denying deductions for genuine losses, it also provides taxpayers with

²⁸ I.R.C. § 163(h)(3).

²⁹ See McMahon, *supra* note 23, at 196 (“[P]rominent tax lawyers . . . decry the application of judicial doctrines in derogation of what they perceive to be the unambiguous results produced by the interaction of multiple sections of the Code and regulations to a complicated fact pattern . . .”).

³⁰ *Cf. id.* at 197 (“The all too true aphorism . . . — ‘Substance controls over form, except, of course, in those cases in which form controls’ — really does accurately describe the rule.”).

³¹ *Cf. Hariton, supra* note 6, at 236 (“Taking a naked position in commodities has economic substance . . . even if it is likely to produce a loss.”).

the opportunity to present multiple accounts of the transaction and to build in remote contingencies or small profit amounts.³² For example, a complex transaction essentially guaranteed to generate a loss might integrate a bet about the direction of a particular interest rate or value of a financial asset. In court, the taxpayer will argue that such a bet saves the entire transaction from failing objective economic substance.³³ Government litigators will, of course, be on the watch for such ancillary profit-potential hooks and will argue that the court should disregard them. Some courts have, however, been drawn in by such profit-potential hooks, particularly when the taxpayer has emphasized elements of market risk. For example, in *Compaq Computer Corp. v. Commissioner*, discussed in greater detail in Part V.A, the Fifth Circuit gave some weight to the fact that part of the disputed transaction occurred through the New York Stock Exchange.³⁴ The court reasoned that this made the transaction more genuine since the setting meant that someone could have stepped into the middle of the transaction and altered its outcome.³⁵

Closely related to the problem of taxpayer-engineered, profit-potential hooks is the question of how much profit potential is required in order to imbue a transaction with economic substance. Taxpayers will argue that the presence of an actual pre-tax profit, however nominal, conclusively demonstrates the objective reasonableness of their subjective profit expectation.³⁶ Various courts and other government actors have made an effort to limit the degree of speculation taxpayers may engage in about profit potential and to quantify the amount of profit potential required. Two interrelated approaches to these problems have been proposed.

³² See *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 284 (1999) (taxpayer argued that profit was possible in corporate owned life insurance transaction “if some catastrophe were to occur that would produce large, unexpected death benefits”); Hariton, *supra* note 6, at 249 (“[W]here a tax-motivated transaction takes the form of an investment, the taxpayer can always contribute enough net equity to assure that there will be significant net profit . . .”).

³³ See, e.g., *Sheldon v. Commissioner*, 94 T.C. 738, 765–68 (1990) (describing transactions in which taxpayers argued profit potential based on possibility of appreciation in Treasury bills and explaining that the “fact that they [the transactions] permitted open positions for limited periods of time was . . . to formulate the appearance of potential for gain or loss”).

³⁴ *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001).

³⁵ *Id.* at 787.

³⁶ See, e.g., *Sheldon*, 94 T.C. at 767 (explaining that the *Goldstein* case “would not, as petitioners suggest, permit deductions merely because a taxpayer had or experienced some de minimis gain”).

The first approach is to require that the expected pre-tax profit bear a reasonable relationship to the expected tax benefits.³⁷ The Tax Court, for example, refused to give weight to a profit potential that it considered “infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions.”³⁸ The second approach is to require that the reasonably anticipated pre-tax profit exceed some minimum amount — generally, the rate on no- or low-risk investments.³⁹ Setting the minimum profit potential to a low- or no-risk return is akin to using a comparables approach. The underlying rationale is that if the suspect transaction has no more profit potential than a risk-free investment, the taxpayer must have entered into the suspect transaction to gain a tax arbitrage advantage. Otherwise, the taxpayer would have simply invested directly in the risk-free asset.⁴⁰

These approaches do restrict the range of possible alternate configurations available to a taxpayer and provide some guidance as to the amount of required pre-tax profit potential. Yet these approaches have inherent weaknesses apart from their failure to account for implicit taxes and the formation of tax clienteles.⁴¹ First,

³⁷ See, e.g., *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 94 (4th Cir. 1985).

³⁸ *Sheldon*, 94 T.C. at 768.

³⁹ See Bankman, *supra* note 6, at 24–25 (discussing implementation of various hurdle rate approaches — including the possibility of looking to the pre-tax return earned on other investments assets in the taxpayer's portfolio).

Recent codification proposals included both approaches: “[T]he profit potential must exceed a risk-free rate of return” and “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.” Joint Committee on Taxation, *supra* note 1.

⁴⁰ See Bankman, *supra* note 6, at 25 (“[T]he decision to use a combination of Citicorp debt, LIBOR notes, and hedges to obtain the return and risk characteristics offered by government debt serves no business purpose: The taxpayer could have gotten that same return with lower transaction costs had it simply . . . invest[ed] in government debt.”).

The Internal Revenue Code (Code) elsewhere does make use of a low-risk return in restricting tax benefits. Section 382 limits the amount of income that can be offset by losses incurred by a corporation prior to an ownership change. The income amount is limited to the value of the stock of the old corporation multiplied by a long-term tax-exempt rate. I.R.C. §§ 382(b)(1), (e)(1), (f).

⁴¹ Professor Warren has summarized well the “inherent dilemma” of using pre-tax profit:

The requirement of a pretax profit . . . involves an inherent dilemma

the comparison of pre-tax profit to tax benefits introduces a new avenue for speculation — expected net tax benefits. While the actual tax benefits would likely serve as strong evidence of the anticipated tax benefits, taxpayers could be afforded some opportunity to argue that they reasonably anticipated much lower tax benefits. Second, reasonable expectation tests appear susceptible to becoming inextricably linked to the taxpayer's subjective motive, which may further dispose a court to allow speculation about contingencies — perhaps to ensure a fair result given the implication of criminality or moral turpitude attaching to the taxpayer's conduct when the tax shelter⁴² label is applied.⁴³

Finally, requiring a specific level of return will likely trigger arguments asserting that such a requirement in effect gives the government power to direct taxpayer investment and that the minimum return requirement could cause taxpayers inefficiently to take on extra risk in order to ensure that the return on a transaction

because either the tax effect of a transaction turns on the presence of some positive, but trivial, pretax profit or, if more than a trivial pretax profit is necessary, there is no logical limitation on the amount of such profit required, short of what the market would command in such transactions if no tax benefits were involved. The first branch of the dilemma — that the pretax profit need only be positive — is arbitrary because a very small economic profit will validate a transaction that may be dominated by tax considerations, whereas a very small economic loss will invalidate the same transaction. But the second branch of the dilemma — requirement of a full market return — is logically incoherent because it ignores the fact that the capital markets will take preferential tax treatment into account in setting relative prices. . . . Finally, any intermediate position — such as requiring a 'reasonable' pretax return, somewhere between a trivial amount and a full market return — is unsatisfying because choice of the intermediate position is also necessarily arbitrary.

Warren, *supra* note 6, at 987.

⁴² The term "tax shelter" is here used descriptively only to indicate a transaction that a court has disregarded or likely would disregard through application of one of the standard anti-tax shelter tools (e.g., sham transaction, economic substance doctrine, etc.). The article does not address the normative question of which transactions should be labeled "tax shelters," except indirectly through arguing that this article's proposed framework identifies transactions that lack objective economic substance. See JOEL SLEMMOD & JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 280 (3d ed. 2004) (discussing lack of consensus on the definition of the term "tax shelter").

⁴³ Cf. David Cay Johnston, *Comment on Joseph Bankman's 'The Tax Shelter Battle,'* in *THE CRISIS IN TAX ADMINISTRATION* 28, 28 ("If you are going to talk about tax shelters, and about taxes in this country, you cannot lose sight of [the] moral component.").

clears the minimum profit potential hurdle.⁴⁴ Of course, there have also been some subtle (and not-so-subtle) suggestions that sophisticated taxpayers would still find it easy to add pre-tax profit to a particular transaction⁴⁵ and “then hedge out of the associated risks in ways that could not readily be identified.”⁴⁶ While it may be overly optimistic to imagine that taxpayers and their attorneys would ever — even grudgingly — agree to a particular formulation of economic substance, it does not follow that such criticisms should be automatically dismissed.

Such criticisms may indicate a failure to balance properly certainty and uncertainty in the current mix of pre-tax profit proposals. The desirability of a particular mix of certainty (rules) and uncertainty (standards) has generated a substantial body of scholarship.⁴⁷ A short, simplified version will suffice here: too much certainty and narrowness, and taxpayers might simply be able to work around the new rule or even find ways to use the rule to bootstrap a new shelter;⁴⁸ too much uncertainty and breadth, and taxpayers may decide to treat the new standard as meaningless.⁴⁹ The balance

⁴⁴ Cf. Hariton, *supra* note 27, at 48 (“If the price of entering into a tax shelter is that the taxpayer must take on unique economic risk that is substantial in relation to the tax benefits in question, we can rely on the fact that relatively few taxpayers will be willing to expose themselves to such risk merely to claim questionable tax benefits. But if the price of entering into a tax shelter is merely that the taxpayer must safely invest capital at the same time, then we shall see many such shelters, for investing capital is something that corporations and wealthy taxpayers do in the ordinary course.”).

⁴⁵ See Hariton, *supra* note 6 (“[W]here a tax-motivated transaction takes the form of an investment, the taxpayer can always contribute enough net equity to assure that there will be significant net profit . . .”); see also Kane, *supra* note 4 (discussing Hariton’s statements).

⁴⁶ Hariton, *supra* note 27, at 49.

⁴⁷ See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953 (1995); David A. Weisbach, *Comment on Joseph Bankman’s ‘The Tax Shelter Battle,’* in THE CRISIS IN TAX ADMINISTRATION 30, 35–37 (Henry J. Aaron & Joel Slemrod, eds. 2004); David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860 (1999).

⁴⁸ See Martin D. Ginsburg, *Making Tax Law Through Judicial Process*, A.B.A. J., Mar. 1984, at 74, 76 (“Every stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part.”).

⁴⁹ See Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1953 (2005) (proposing disallowance rules in order to create an approach that avoids “both the problem of

between certainty and uncertainty will also have ramifications at the government level. Flexibility in the tools used to combat tax shelters is critical, yet government actors should be able to deploy such tools more efficiently if they can better predict outcomes.

The persistence and volume of the complaints about the economic substance doctrine and codification proposals suggest that the balance of rules and standards is not quite right in current formulations of the doctrine. A frequent taxpayer criticism of attempts to codify economic substance is that the doctrine over-deters and creates uncertainty because of its potential to jeopardize congressionally intended benefits. Use of the pre-tax viewpoint may, however, create a setting in which taxpayer obfuscation flourishes and government actors feel compelled to try economic substance in case it works. The proposed alternate framework for determining objective economic substance shifts initial inquiries into profit and risk to a more rule-oriented test. The comparables method also helps sidestep the problem of the government requiring a specific, expected profit amount while still using risk to restrain tax shelters.⁵⁰ Although the proposed framework begins with a brighter-line approach, it then moves to an approach that is more open-ended and factor-based.⁵¹

B. After-Tax World

A more fundamental problem with the pre-tax landscape is the assumption that the economics of a transaction are readily separable from its tax components. The initial appeal of quantifying pre-tax profit seems to stem from the idea that an individual who is engaging

shelters escaping because the law gives courts the flexibility to let them escape, and the problem that narrowly-targeted legislative responses are always one step behind the tax shelter industry"); Hariton, *supra* note 6, at 238 ("Most practitioners believe . . . that there is a need for some sort of balancing between rules and standards and that a judicious sprinkling of standards throughout a fundamentally objective set of statutes and regulations is a beneficial palliative.").

⁵⁰ Cf. Shaviro, *supra* note 4, at 317 ("Why implicitly encourage and reward such risk-taking, by causing it to immunize tax benefits against legal challenge . . . ? The reason . . . resembles that for placing the cookie jar in a kindergarten classroom on a high shelf. We don't actually mean to encourage the five-year-olds to start stacking up boxes and standing on chairs Rather, we simply figure that this way fewer of them are likely to reach it when the teacher is not looking.").

⁵¹ A similar format — a bright-line rule coupled with a more open-ended inquiry — is used by administrative authorities to combat wraparound insurance tax shelters. See Charlene D. Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 144–45 (2005).

in a genuine economic transaction should be focused on its pre-tax profit possibility.⁵² Acceptance of this idea leads to the intuition that financial assets and transactions are priced without regard to individual tax consequences and that, therefore, pre-tax profit is a good indicator of economic profit and the genuineness of a transaction. This intuition, however, runs counter to principles of tax capitalization and efficient markets.

The terms “implicit tax” and “tax capitalization” are used to denote price changes that occur as the market takes explicit tax rates into account.⁵³ Implicit taxes (or implicit tax subsidies) arise in response to a tax benefit (or tax detriment)⁵⁴ conferred by Congress on a particular type of transaction or investment product. An implicit tax is not paid directly to Congress but is instead captured by another party to the transaction.⁵⁵ Tax clienteles then form as some investors are able to earn inframarginal returns on implicitly taxed transactions and assets.⁵⁶

Tax-exempt municipal bonds provide the paradigmatic case of implicit tax and tax clienteles.⁵⁷ Assume that a city wants to raise \$10 million by issuing tax-exempt bonds. To simplify the example further, assume that a taxable bond with the same level of risk as the tax-exempt bond offers a fixed 10% return.⁵⁸ Taxpayers in the 35%

⁵² Cf. Shaviro, *supra* note 4, at 317 (“[T]he key to a potentially appealing tax shelter is that it reduce your taxable income by much more than it reduces your pre-tax economic income.”).

⁵³ David A. Weisbach, *Implications of Implicit Taxes*, 52 SMU L. REV. 373, 374 (1999) (“Implicit taxes are misnamed. Implicit taxes (or implicit subsidies) are not taxes in the sense of the confiscation of resources by the government. They are simply asset price adjustments in response to a tax benefit or detriment.”).

⁵⁴ See MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH* 125 & n.4 (3d ed. 2005) (describing positive and negative implicit taxes); Weisbach, *supra* note 53.

⁵⁵ See SCHOLES ET AL., *supra* note 54, at 131.

⁵⁶ See *id.* at 130; see also *infra* notes 62–63 and accompanying text (discussing tax clientele formation).

⁵⁷ See Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 SMU L. REV. 339 (1999); Michael S. Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-tax Profit*, 26 VA. TAX REV. 821, 834–35 (2007) (discussing municipal bond interest rate as example of implicit taxation); Shaviro, *supra* note 4; Weisbach, *supra* note 53; see also Calvin H. Johnson, *Inefficiency Does Not Drive Out Inequity: Market Equilibrium and Tax Shelters*, 71 TAX NOTES 377, 381–85 (Apr. 15, 1996) (describing tax capitalization).

⁵⁸ Under market conditions, the return on both the corporate and tax-exempt bond would vary until an equilibrium point was reached.

bracket will be indifferent as between the tax-exempt bonds and risk-adjusted taxable bonds only if the return on the tax-exempt bonds is at least 6.5%.⁵⁹ 35% bracket taxpayers may not, however, be the investors setting the price (i.e., not the marginal investors). For example, the city may need to set the rate at 7% in order to raise the entire \$10 million. At that interest rate, the 30% bracket taxpayers would be the investors at the margin because they will be indifferent as between the taxable bonds and the tax-exempt bonds.⁶⁰ The difference between the interest payable on the taxable bond and the tax-exempt bonds is the implicit tax.⁶¹

The implicit tax will be the same for all taxpayers. In contrast, explicit tax rates vary across rate brackets. This rate-bracket difference will create preferences (tax clienteles) for particular investments.⁶² In the previous example, 35% bracket taxpayers will prefer the tax-exempt bonds to the risk-adjusted taxable bonds. Even after taking into account the implicit tax on the tax-exempt bonds, these taxpayers will still come out ahead by choosing the tax-exempt bonds over the risk-adjusted taxable bonds. The 35% bracket taxpayers are the tax clientele for the tax-exempt bonds; in other words, they are inframarginal rather than marginal investors with respect to the bonds.

Various assumptions inform this theoretical model of implicit tax and tax clientele formation. The central assumption, of course, is that taxes are incorporated into asset prices; this assumption requires the absence of potential impediments to price adjustment — impediments such as irrational investors, information asymmetries, government strictures, or market frictions.⁶³ Further, quantifying the implicit tax

⁵⁹ A \$100 after-tax investment in municipal bonds at 6.5% would yield \$106.50. A \$100 after-tax investment in 10% interest corporate bonds would also yield \$106.50 ($\$10 \times 35\% = \3.50 ; $\$10 - \$3.50 = \$6.50$).

⁶⁰ A \$100 after-tax investment in 10% taxable bonds would yield \$107 rather than \$106.50 ($\$10 \times 30\% = \3 ; $\$10 - \$3 = \$7$).

⁶¹ The implicit tax can be described in other ways as well. See Knoll, *supra* note 57, at 833–34 (“There are three alternative ways to quantify the implicit tax on the municipal bond. First, the implicit tax on the bond could be described as the increase in the issue price of the bond Second, the implicit tax can be described as the decrease in the payment on the bond at maturity Third, the implicit tax can be described as a reduction in the interest rate paid by the municipal bond All three methods are alternative, but equivalent, methods of describing the same phenomenon.”).

⁶² See SCHOLES ET AL., *supra* note 54, at 130 (“Taxpayers in the same tax brackets are attracted to investments that are taxed similarly.”).

⁶³ See, e.g., ZVI BODIE ET AL., INVESTMENTS 135–444 (6th ed. 2005); SCHOLES ET

requires a comparison between the asset and a risk-adjusted benchmark asset. Unless the benchmark asset and the test asset have the same risk level, the implicit tax cannot be accurately determined.⁶⁴ To make the necessary risk adjustment, the riskiness of the test asset and benchmark asset would need to be established using a pricing model, such as the capital asset pricing model (CAPM).⁶⁵ Choosing one pricing model over another may dramatically alter the amount of implicit tax measured.

A voluminous body of theoretical and empirical literature has developed surrounding each of these points;⁶⁶ even a short survey of this literature is beyond the scope of this article. The literature generally suggests that the broad, theoretical framework behind the implicit tax and the formation of tax clienteles is reasonably sound, although refinements regularly occur as ongoing empirical work either supports or fails to support various details.⁶⁷ As a practical matter, in spite of the controversy in economics literature, sophisticated tax planners have seemingly incorporated the idea of tax capitalization into their tax planning strategies by using (or engineering) the presence of implicit taxes or subsidies and tax clienteles into the transaction to confound the courts' application of economic substance.⁶⁸

AL., *supra* note 54; Douglas A. Shackelford & Terry Shevlin, *Empirical Tax Research in Accounting*, 31 J. ACCT. & ECON. 321, 346–59 (2001).

Professor Calvin Johnson has argued that full tax capitalization does not occur and “should also not be expected ever to happen . . . because the supply of alternative tax shuns is too large to be absorbed by the demand from maximum tax bracket investors.” Johnson, *supra* note 57, at 383.

⁶⁴ SCHOLES ET AL., *supra* note 54, at 127–30.

⁶⁵ *Id.* at 127–30.

⁶⁶ See, e.g., BODIE ET AL., *supra* note 63, at 281–445 (reviewing pricing models, market efficiency, behavioral finance, and empirical evidence); SCHOLES ET AL., *supra* note 54, at 131–32.

⁶⁷ See, e.g., BODIE ET AL., *supra* note 63, at 415 (“Many of the implications of these models [CAPM and arbitrage pricing theory] already have been accepted in widely varying applications.”); SCHOLES ET AL., *supra* note 54, at 131–32.

⁶⁸ Some indirect evidence of this point is the substantial space devoted to discussing implicit taxes, tax clienteles, and arbitrage strategies making use of these phenomena in *Taxes and Business Strategy: A Planning Approach*, a book co-authored by Nobel prize-winner (and tax shelter strategist) Myron S. Scholes. SCHOLES ET AL., *supra* note 54; see *Long Term Capital Holdings v. United States*, 330 F. Supp. 2d 122, 128, 129 & n.6 (D. Conn. 2004) (using economic substance to deny tax benefits to LTCH, one of whose founders was Myron Scholes), *aff'd*, 150 F. App'x 40 (2d Cir. 2005); see also Lee A. Sheppard, *LTCM Case: What They Won't Do for Money, Part 2*, 2004 TNT 173-5 (Sept. 7, 2004) (describing Myron Scholes's

Various tax scholars have called attention to the courts' failure to account for implicit taxes.⁶⁹ This failure could result in either too high or too low a measure of pre-tax profit potential. Under-detection of profit would occur if the taxpayer invested in a tax-favored asset. For example, the profit potential on the 7% tax-exempt bond described above does not reveal the pre-implicit tax return which is 10% — the same pre-tax return as that on the benchmark, taxable bond. On the other hand, failure to consider implicit tax subsidies results in over-detection of pre-tax profit potential.⁷⁰

For example, consider a hypothetical bond that is more highly taxed relative to the 10% yield, risk-adjusted benchmark. Assume that the marginal investor is a 30% bracket taxpayer and that a 10% tax surcharge is imposed on the highly taxed bond. For this investor, the after-tax return on the benchmark asset is 7%. In order to obtain the same after-tax yield on the highly taxed bond, the bond would need to yield $11\frac{2}{3}\%$ ⁷¹ — an implicit tax subsidy of $1\frac{2}{3}\%$. If both implicit and explicit taxes are taken into account, the pre-tax yield on the highly taxed bond is 10%.⁷² The clientele for transactions or assets carrying implicit tax subsidies will be taxpayers with lower tax brackets than the marginal investors. For example, a 25% bracket taxpayer would earn slightly more on the highly taxed bond than she would on the benchmark. If investing \$100, a 25% bracket taxpayer would earn \$7.50 after-tax on the benchmark asset and \$7.58 (rounded) on the bond carrying the 10% tax surcharge.

Any pre-tax inquiry will also fail to analyze the formation of tax clienteles. Such knowledge may help sift difficult cases. For example, a transaction that seemingly generates an insubstantial pre-tax return should be deemed to satisfy objective economic substance if the taxpayer's after-tax return is substantial and the difference between the pre- and post-tax results arises because the taxpayer's rate bracket places her in a position to attain inframarginal returns. In other words, clienteles formed as a result of the statutory rate brackets (including

involvement in the Long Term Capital Holdings shelter litigation).

⁶⁹ See generally Crane, *supra* note 57; Knoll, *supra* note 57; Shaviro, *supra* note 4; Weisbach, *supra* note 53.

⁷⁰ This is essentially what occurred in the *Compaq* transaction. See *infra* notes 138–139 and accompanying text; see also Knoll, *supra* note 57, at 839 (explaining that after taking an implicit tax subsidy into account “[t]he transactions in Compaq and IES Industries do not generate pre-tax profits”).

⁷¹ $X - 0.3X - 0.1X = 0.07$; solving for X yields 0.11667.

⁷² See, e.g., Knoll, *supra* note 57, at 836–37; see also Shackelford & Shevlin, *supra* note 63.

statutory exemptions from U.S. tax) should be considered to have been intended by Congress. As discussed in the next Part, my proposal builds on this conclusion.

IV. PROPOSED OBJECTIVE ECONOMIC SUBSTANCE INQUIRY

The objective substance framework proposed in this article consists of three components.⁷³ First, the suspect transaction would be subject to a comparables test. The transaction would be deemed to satisfy the objective substance inquiry if the transaction survived scrutiny under the comparables test. Second, if the transaction fails the comparables test, the burden would be on the taxpayer to show that the nonstandard return was more likely than not the result of a naturally occurring tax clientele. Finally, if no suitable comparable were found, preventing application of the comparables test, a more open-ended inquiry into other characteristics of the transaction would

⁷³ My proposal shares common elements with three other proposed reforms to the profits inquiry.

Michael Knoll has recommended that the economic substance doctrine be applied with a pre-implicit tax, pre-explicit tax profit standard in order to sharpen court analysis of profit potential on economic substance. While his article is written with *Compaq* in mind, his basic point about the failures of the current state of the pre-tax inquiry is of more general applicability. Knoll, *supra* note 57. This would require quantifying the amount or rate of the implicit tax (or implicit subsidy) — though such a task would be less difficult for shelters designed to use implicit taxes to generate the appearance of pre-tax profits. This is essentially what happened in *Compaq* and *IES*. See *id.* at 847–51.

Mitchell Kane appears to be the only other commentator who has advocated use of a post-tax profit test. His proposal is brief, and is tied primarily to his analysis of the *Compaq* case. He looks not only to what the taxpayer receives, after taxes, but also to what the government loses, after taxes: “I would propose that in transactions involving the acquisition of assets that will produce income subject to foreign withholding tax, the economic substance test should be applied not merely by comparing the pre-tax and after-tax profit of the taxpayer but also by determining whether there is any after-tax profit from the transaction in excess of the hit taken by the Treasury.” Kane, *supra* note 4.

Joseph Bankman has discussed the possibility of a comparables approach, though in the context of a pre-tax inquiry: “One plausible rule would be to require only the bare minimum present value expected return required by similarly situated taxpayers for investments with similar risk characteristics. The rule could be made less ambiguous by eliminating the ‘similarly situated’ requirement. In that case, a taxpayer could justify its position so long as it could show that some taxpayers, somewhere, would have found the pretax return it had received to be attractive.” Bankman, *supra* note 6, at 23–24. He notes the difficulty in making such a comparison pre-tax because of the problem of implicit taxes. See *id.* at 24.

apply.

These components are examined in greater detail below and are followed by a consideration of potential objections to the proposal and a discussion of how the adoption of the proposal could affect tax shelter litigation.

A. Comparables Test

1. Overview

The economic concept informing the proposed comparables test is the “law of one price” — the idea “that if two assets are equivalent in all economically relevant respects, then they should have the same market price.”⁷⁴ The literature on implicit taxes and tax clienteles adds the proviso that “the same market price” works only if the two assets are compared (1) before all taxes, including implicit taxes and implicit tax subsidies, or (2) after all taxes as measured from the viewpoint of the price-setting investors — that is, the marginal investors.

For example, in a competitive market, a tax-exempt bond and an economically equivalent taxable corporate bond will have the same return before all taxes and will also have the same return for the marginal investor when compared after-tax. If the marginal investor is in the 30% rate bracket, then an equilibrium point could be reached when the tax-exempt bond yields 7% and the taxable corporate bond yields 10%. If the return on this tax-exempt bond is determined before the implicit 3% tax, its return would be 10% — the same as that on the corporate bond. After-tax, both investments would yield 7% to the individual in the 30% tax bracket.

As this example illustrates, use of an after-tax comparison automatically takes into account implicit taxes and subsidies. In addition, risk is incorporated into the proposed comparables test through the requirement of comparing the suspect transaction to an economically equivalent market transaction. Thus, the proposed comparables test makes use of risk and return to determine economic substance but it avoids the problem of setting an absolute minimum level of return or risk.⁷⁵ The proposed comparables test, however, makes only a rough cut, risk-adjusted comparison between the suspect transaction and a market transaction.⁷⁶ It does not address the

⁷⁴ BODIE ET AL., *supra* note 63, at 349.

⁷⁵ See generally Joint Committee on Taxation, *supra* note 1.

⁷⁶ BODIE ET AL., *supra* note 63, at 866. This is somewhat analogous to risk

problem of inframarginal returns resulting solely from the progressive rate structure.

To return to the example of the tax-exempt and taxable bond, an investor in the 35% tax bracket would have different after-tax returns on the two assets — 7% on the tax-exempt bond and 6.5% on the taxable bond. This additional return — the inframarginal return — is available solely because of this investor's marginal tax bracket. As previously indicated,⁷⁷ an important assumption underlying the proposed framework is that Congress intends taxpayers to obtain inframarginal returns naturally arising from the progressive rate bracket structure. Thus, if the suspect transaction has an after-tax return that is substantially higher than the range available on comparable transactions, the taxpayer would have the opportunity to overcome the presumption that the transaction lacked objective economic substance. The taxpayer would need to show that the discrepancy was the result of the taxpayer being the member of a naturally forming tax clientele. This would take the form of a more open-ended inquiry into the transaction, as described in Part IV.B.2.

If the suspect transaction yields a return that is substantially similar to the comparable transaction, the taxpayer would satisfy the proposed objective inquiry without further government contest. Here, the underlying assumption is that a rational taxpayer would not bother with a tax shelter earning an after-tax return that is no better than that available on an economically equivalent market transaction⁷⁸ — particularly when the risks of tax litigation are considered. Yet, even if the suspect transaction survives the comparables test, it may nevertheless be, colloquially speaking, a “tax shelter.” For example, before entering into a suspect transaction, a taxpayer might reasonably believe based on promoter representations that the return on the transaction will substantially exceed the return on an

adjustments made to assess the performance of portfolio managers:

The simplest and most popular way to adjust returns for portfolio risk is to compare rates of return with those of other investment funds with similar risk characteristics. For example, high-yield bond portfolios are grouped into one “universe” Then the . . . average returns of each fund within the universe are ordered, and each portfolio manager receives a percentile ranking depending on relative performance with the comparison universe.

Id.

⁷⁷ See *supra* Part III.B (final paragraph).

⁷⁸ See *supra* notes 39–40 and accompanying text (discussing similar rationale underlying minimum profit potential hurdles).

economically comparable market transaction. Nonetheless, under the proposed test the suspect transaction would survive the objective economic substance inquiry if it in fact yields an after-tax return in line with that available on the comparable transaction. Such a result may raise equity and efficiency concerns since relatively few taxpayers have the luxury of engaging in the tax shelter game and all actions in this game trigger some level of deadweight cost.⁷⁹

Yet, it is also problematic to use objective economic substance to halt transactions that end up looking like market transactions. Objective economic substance, even as it is currently framed by the courts, is about distinguishing between transactions that actually affect the taxpayer's economic position from those that only do so through tax effects.⁸⁰ While beyond the scope of this article, the subjective inquiry of the economic substance doctrine might mitigate concern about equity and efficiency. In addition, the economic substance doctrine is far from being the only government tool available to litigate against suspect transactions.⁸¹

2. Fact-Finding Tasks

Courts must act carefully in defining comparables and making comparisons. The factfinder will need to locate the boundaries of the suspect transaction (including the problems of financing and hedging), calculate the after-tax return on the suspect transaction, decide on a range of economically equivalent comparables, and determine whether the after-tax return on the suspect transaction substantially outstrips that available on the comparables range.

a. Transaction Boundaries

Under the current pre-tax profit inquiry, courts must already determine transaction boundaries; the proposed test would not alter the current approach to this assessment. In determining transaction boundaries, courts generally take into account factors such as

⁷⁹ See, e.g., SLEMRD & BAKIJA, *supra* note 42, at 280 (describing tax shelter efforts as “economically wasteful”).

⁸⁰ See, e.g., Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001) (observing that the economic substance doctrine “has few bright lines, but ‘it is clear that transactions whose sole function is to produce tax deductions are substantive shams’”).

⁸¹ See Hariton, *supra* note 6, at 237–41 (describing various means through which suspect transactions may be challenged).

chronology, formal and informal agreements, and relationships among the parties.⁸² Financing and hedging arrangements that are directly implicated by such factors should be considered part of the suspect transaction.⁸³ Hedging and financing unrelated to the transaction should not be taken into account, although these agreements may well have some bearing on the actual risks and profitability of the suspect transaction.

Tracing debt and hedging to a particular transaction can be particularly difficult since debt is essentially fungible and hedging may be difficult to find. At the same time, however, pre-packaged tax shelters frequently come with suggestions and directions on financing and hedging.⁸⁴ While such packaging may grow in sophistication, a direct link between the suspect transaction and particular financing or hedging would still be present — if perhaps difficult to detect. If, however, a taxpayer finances or hedges outside a pre-packaged shelter or crafts its own shelter entirely, drawing transaction boundaries may well prove impossible. As a result, “home-grown” shelters will be less susceptible to resolution under the comparables approach.⁸⁵ This is, however, also true for current formulations of the objective economic substance inquiry.

b. After-Tax Calculation

The after-tax return must be determined both for the suspect transaction and any comparables. In making the after-tax calculation for the suspect transaction, the taxpayer’s claimed tax treatment would be used. The marginal tax rate selected for testing the comparables would be the taxpayer’s marginal rate bracket determined without regard to the claimed tax benefits of the suspect transaction. For example, if the suspect transaction generated \$1001 of losses and the last dollar moves the taxpayer from a 35% rate bracket to a 30% rate, the taxpayer will have saved \$350.30 in taxes since she will avoid the 35% rate on \$1000 of income and 30% rate on \$1 of income. The after-tax return on the comparables would also need to be calculated at these rates and in the same proportion in order to

⁸² See Keinan, *supra* note 6, at A-83.

⁸³ See, e.g., *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 279 (1999) (“[T]he overall transaction, of which the debt is a part, must have economic substance before interest can be deducted.”), *aff’d*, 254 F.3d 1313 (11th Cir. 2001).

⁸⁴ The two case studies discussed in Part V both were structured with pre-planned financing and risk hedging.

⁸⁵ With thanks to Marty McMahon for suggestion of this term.

yield an equivalent comparison.

For transactions that take place across multiple tax years, an averaging method would need to be selected. Consistent application of a calculation methodology is perhaps more important than the particular method chosen. One possible method is a time-weighted, arithmetic average of the after-tax rate of return.⁸⁶ Such a method should work especially well for tax avoidance transactions of short duration.⁸⁷ Under this method, the after-tax return is calculated for each tax year (the standard tax period) and converted into a rate of return against the investment base. The rates for each year are added together then divided by the number of years.⁸⁸ This is, however, just one possible calculation method; the characteristics of the suspect transaction should be taken into account when choosing a method.

The problems of debt and transaction costs remain to be considered. The after-tax rate of return depends on how the investment base is defined. It is proposed that the investment base should include related financing.⁸⁹ Failure to include financing would distort the comparison between the rate on the suspect transaction and that on the comparables. Including debt in the investment base is also consistent with the general incorporation of debt into the calculation of tax basis.⁹⁰ High transaction costs (i.e., promoter fees) are another feature of the tax avoidance landscape and should also be taken into account in determining the after-tax return.⁹¹ Often, the taxpayer will have deducted the fees or capitalized them into the transaction so that the claimed tax consequences automatically

⁸⁶ BODIE ET AL., *supra* note 63, at 862–63 (describing calculations for time-weighted, arithmetic average returns).

⁸⁷ Many tax shelters are likely to be of short duration since transactions of longer duration are more likely to carry with them greater risk and thus are less attractive.

⁸⁸ To give a simple example, assume that an investment of \$100 yields after-tax \$10 in the Year 1 and \$8 in Year 2, and the after-tax rates of return are 10% and 8% for Year 1 and Year 2, respectively. The arithmetic average is 9% — 18% divided by 2 years.

⁸⁹ See *supra* Part IV.A.2.a (discussion of the difficulty in tracing related financing).

⁹⁰ See, e.g., *Crane v. Commissioner*, 331 U.S. 1, 3–11 (1947) (basis equal to amount of debt); see also *Johnson*, *supra* note 57, at 378 (“[D]ebt should be included in basis unless there is a good reason for it not to be.”).

⁹¹ Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 609 (2007) (“A tax shelter promoter who develops a new scheme that is likely to work can earn large fees . . .”).

include adjustments for transaction fees.⁹² The after-tax return on a comparable would need to be adjusted to account for the standard transaction costs associated with the selected comparable.

The presence of unrecognized gains and losses presents additional, more difficult, measurement problems. These measurement problems may be further complicated if the transaction has been unwound by the taxpayer or audited by Internal Revenue Service (Service) agents before its completion. In such a situation, future returns may also need to be considered. In many cases, incorporating future returns may not be difficult since multiple-year tax avoidance techniques are frequently characterized by stable cash flows and relatively remote contingencies.⁹³

c. Market Comparables

The word “market” is used to signify that the comparable is available through a reasonably efficient market about which information is reasonably accessible. This definition is motivated by two considerations. First, in order to exploit the identity of returns on economically equivalent transactions or assets, the market must be relatively well functioning. Second, in order to make the comparison, sufficient access to information about the market must be available.

Economic equivalence would be determined by matching up factors that contribute to expected and actual rates of return.⁹⁴ The precise identity and weight of the factors that contribute to return variance is the subject of much ongoing scholarship,⁹⁵ potentially making economic equivalence seem a problematic method to deny tax benefits. In spite of similar concerns, however, controversial economic models are routinely used in the financial world, for example, in rating portfolio manager performance.⁹⁶ In addition, the universe of comparables for a transaction suspected of being a tax shelter may frequently look most similar to the low-risk world of simple debt transactions (with perhaps some remote opportunity of an equity-type

⁹² See *infra* note 135 (describing how fees were capitalized into the *Compaq* transaction).

⁹³ See, e.g., *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 262 (1999) (detailing projections on corporate-owned life insurance policies), *aff'd*, 254 F.3d 1313 (11th Cir. 2001).

⁹⁴ See BODIE ET AL., *supra* note 63.

⁹⁵ See, e.g., *id.* at 415–44 (reviewing empirical evidence testing capital asset pricing model (CAPM) and other pricing models).

⁹⁶ *Id.* at 415; see also *supra* note 74 (describing technique).

gain at the end, included in order to confuse courts). The factors that determine interest rates on simple debt are not especially complicated or controversial (e.g., loan term, credit considerations, market interest rates, and inflationary expectations), and public information about interest rates is readily available. Even when dealing with more complex debt securities, the factors that contribute to variance in yield to maturity are fairly well settled.⁹⁷

Current tax rules in other areas provide some additional support for a switch to a comparables approach to economic substance. For example, comparables are utilized in setting the terms of advance pricing agreements entered into by taxpayers with the Service and in litigating transfer pricing cases.⁹⁸ In addition, when deciding general substance-over-form cases, courts frequently give consideration to how parties would have operated if they had been negotiating at arm's length.⁹⁹ As discussed in Part II above, the comparables method proposed in this article is essentially an extension of this approach, though it operates by selecting a range of market benchmarks against which to assess the suspect transaction.

B. Factor-Based Inquiries

1. Rebutting the Presumption Triggered by Comparables Test Failure

After failure of the comparables test, a taxpayer would have the opportunity to rebut the resulting presumption that her suspect transaction lacked objective economic substance. The taxpayer would need to present evidence that the higher-than-market return was related to a standard tax clientele arising by normal operation of the progressive rate bracket system. The two principal questions would be (1) the extent to which the high return arose as a result of a tax bracket differential and (2) the extent to which the tax bracket differential was naturally occurring.

Discerning whether the return arose as a result of tax bracket

⁹⁷ See BODIE ET AL., *supra* note 63, at 520–23.

⁹⁸ Advanced pricing agreements are negotiated under authority granted under section 482. Through these negotiations, taxpayers are able to establish in advance that payments for transfers between commonly controlled entities will be respected. See John P. Warner, *Transfer Pricing: Introductory Materials*, 886 TAX MGMT. PORTFOLIO (BNA) (2007).

⁹⁹ See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968) (using arm's length transaction as factor to measure the "economic reality" of a payment from shareholder to corporation).

differential would require an examination of the tax profiles of the counterparties in the transaction. For purposes of illustration, consider again the tax-exempt and taxable bonds examples previously described.¹⁰⁰ Assume that the suspect transaction is investment in a 7% tax-exempt bond and that the comparable is a taxable, 10% bond. After taxes, a 35% tax bracket individual would earn more (7%) on the tax-exempt bond than on the taxable bond (6.5%). Even if the tax-exempt return were considered a “substantial” departure from the comparable, this individual would be able to demonstrate that this increased return arose naturally because of the difference between her tax bracket and that of the price-setting investors.

The phrase “naturally occurring” is admittedly ambiguous. Courts would look generally to whether the differential was pre-engineered in some way or whether the transaction would have yielded the same benefit to anyone in the same tax bracket as the challenged taxpayer. Relevant facts would include, for example, the presence of a promoter and the relationship between the counterparties and the taxpayer.

2. Lack of Suitable Comparable

In the event that a suitable market comparable is not available, courts would turn to a more open-ended inquiry into the suspect transaction. This inquiry would focus on whether the claimed after-tax result more likely than not arose from economic circumstances other than tax manipulation. Thus, the initial focus would remain on the after-tax result claimed by the taxpayer.¹⁰¹

This factor-based inquiry would begin with an assessment of any comparables previously suggested by the parties. Although the suggested comparables would already have been determined by the court to be unsuitable for the purpose of applying the presumption of the comparables test, they may still provide some indication of the likelihood that the claimed benefits arose in an economically meaningful way. Where a suitable market comparable is not available, consideration would be given to the factors that would go into determining price as between parties operating at arm’s length.¹⁰²

¹⁰⁰ See *supra* notes 57–63, 74–77 and accompanying text.

¹⁰¹ This inquiry is similar to Mitchell Kane’s overall proposal. See *supra* note 73; see also Hariton, *supra* note 6 (“The issue is not whether the transactions in question had tax-independent purposes, but rather whether they had tax-independent consequences, and whether those consequences were significant enough to rise to the level of economic substance.”).

¹⁰² See *infra* Part V.B (using such an approach to assess the *Black & Decker*

Other relevant evidence would include: the presence of nontax, market frictions or asymmetries; the ease with which other taxpayers could have entered into the transaction; the presence or absence of a known tax-shelter promoter; the degree of dependence of the after-tax return on particular tax attributes of the taxpayer or counterparty; the timing and circumstances surrounding the creation of those tax attributes; the degree of leverage and the taxpayer's out-of-pocket investment; the level of transaction risk; and the pre-tax profit potential.

While most of these factors are self-explanatory, the presence of pre-tax profit requires additional explanation since its inclusion may seem to threaten a return to the problems discussed in Part III. In the proposed inquiry, however, pre-tax profit is but one of several considerations. In addition, the pre-tax profit (actual and potential) should be compared to the post-tax return. The comparison would focus on whether the two measures bear a more-or-less standard relationship to each other. For example, taxes generally cause gain transactions to become less profitable rather than more so. Similarly, if the taxpayer claims to have simply lost on a highly speculative transaction and takes a deduction, the post-tax loss should be smaller than the pre-tax loss. In addition, if the pre-tax profit return (actual or potential) is equivalent to the return available on a low- or no-risk asset, the question should be asked whether it was objectively rational for the investor to enter the suspect transaction rather than simply invest directly in low-risk assets.

C. Framework Effects

This Part briefly addresses potential concerns and questions that may be raised by the proposed framework.

1. After-Tax Approach

A potential taxpayer concern is that the framework operates by looking at suspect transactions with the benefit of hindsight.¹⁰³ The

transaction).

¹⁰³ In its use of hindsight, the proposed framework is similar to the tax shelter reform proposal put forward by Professor Marvin A. Chirelstein and Professor Lawrence A. Zelenak, *supra* note 49. They write that “[t]he most promising approach” to dealing with contemporary shelters “is to create a hindsight rule, one that emphasizes outcomes, actual or readily foreseeable.” *Id.* at 1952. Their proposed method would, however, eliminate the economic substance doctrine altogether and

framework is not, however, a fully ex post process since the selection of a comparable will take into account the risks embedded in the suspect transaction. Still, current approaches to objective economic substance contain more emphasis on ex ante elements.

As a general matter, the tax system is applied to transactions as they actually occur — often to the benefit of taxpayers. For example, individuals are taxed on the income they actually earn, not on the income stream they would earn if utilizing their full earning potential; and the realization requirement allows taxpayers to wait to recognize gain on an asset until the sale or exchange of that asset. Since the tax law usually focuses on actual results, arguably, the question should be whether there is sufficient justification for the current approach to profit in the objective economic substance inquiry. The concern over the use of hindsight in evaluating tax avoidance schemes appears to relate directly to the consequences if the scheme is found to be illegitimate. In other words, because disallowance is a harsh measure, taxpayers want full consideration given to the various potentialities of the transaction.

As discussed in Part III.A, full consideration of every possible outcome would present a significant problem to courts and would provide taxpayers with the opportunity to confuse the true nature of the transaction. The proposed framework contains various safeguards to prevent disallowance of nonabusive transactions. Taxpayers would be able to present evidence on a range of comparables and would have the opportunity to address a failure on the comparables test. Finally, as discussed in Part II, the framework would be applied only to transactions in which the taxpayer took a nonobvious route to benefits and after other evaluative tools had been found lacking.

would instead contain just two rules: (1) deductions would only be allowed “for losses substantially in excess of any measurable reduction to the taxpayer’s net worth” and (2) no deduction or exclusion would “be allowed through the allocation of noneconomic income to a tax-indifferent party.” *Id.*

The framework proposed in this article assumes that the economic substance doctrine in some form or another is here to stay. Although an in-depth discussion of whether the economic substance doctrine should be retained is beyond the scope of this article, this article does take the position that the objective economic substance doctrine in its current formulations has yet to reach the optimal blend of “rule” and “standard.” *Supra* notes 47–50 and accompanying text.

For a more developed discussion of the proposal by Professors Chirelstein and Zelenak, see Professor Galle’s article, *supra* note 2, at 364–66.

2. Taxpayer Sophistication

As discussed in Parts III.B and IV, the proposed comparables test requires reliance on economic assumptions about competitive markets and tax capitalization. Taxpayers may be concerned that these assumptions are not sufficiently free from controversy so as to justify their use in a tax litigation tool. As previously discussed, however, these economic assumptions are used with frequency in the financial world (and sometimes used to craft tax shelters). This concern is also mitigated by the general profile of the taxpayers involved in transactions sufficiently problematic to be investigated under economic substance. Such taxpayers tend to be wealthy and highly sophisticated (or at least have access to highly sophisticated advisers). These taxpayers would likely be able to make a meaningful response as to the appropriateness of a particular comparable suggested by the government.

The sophistication of the taxpayers involved in tax avoidance schemes also raises the question of tax shelter evolution should the proposed framework be adopted. At least two changes to the construction of tax avoidance techniques seem likely. First, taxpayers would turn their attention to methods for satisfying the comparables inquiry. This might be accomplished by a more careful blurring of transaction boundaries and protracted factual battles over after-tax return calculations and selection of appropriate comparables. Attempts might be made to pre-select (or possibly even create) a comparable and build enough parallel points into the suspect transaction so as to create a ready-made argument for a favorable outcome under the objective inquiry. Courts and administrative agency personnel would need to watch for these or similar developments. Agency personnel might have to change the scope of audits (or reportable transaction requirements)¹⁰⁴ to uncover such tactics, and some concepts, such as the definition of transaction, might need to be narrowed.

This article has largely stayed away from discussion of the subjective prong of the economic substance doctrine and will do so again here except to observe that the proposed framework's second likely effect on tax shelter construction is that taxpayers would claim subjective motivations that helped them argue against particular comparables and bolster claims under the factor-based inquiry.

¹⁰⁴ See Code sections 6011, 6111, and 6112, and the regulations relating to these provisions.

Taxpayers might, for example, assert that they entered into the suspect transaction because they found a unique, golden economic opportunity for which no comparable would be available.

Apart from spurring possible changes to tax shelter construction methods, under the proposed framework, taxpayers may also make different information requests from would-be tax promoters. Instead of asking how much a particular transaction would save the taxpayer in taxes, they might shift to asking how much they can expect to earn after taxes are paid and how that return compares to the return available on more common, less suspect transactions. Such a comparison may (though this is perhaps wishful thinking) cause some taxpayers to reflect more seriously on whether entering into a tax shelter is really worth it.

3. Adoption of Framework

An additional question is the extent to which courts could adopt the proposed framework in the absence of congressional or administrative authority. In some jurisdictions, the economic substance doctrine may be stated ambiguously enough for lower courts to adopt the proposed approach.¹⁰⁵ Because the proposed framework is tied to the general substance-over-form test, there may be further room for courts to adopt a comparables approach. In fact, two court decisions have already incorporated a general substance-over-form test into their objective economic substance decisions.¹⁰⁶ At the appellate level, the Supreme Court's offerings on economic substance are so thin as to provide almost no direction.¹⁰⁷ As a result,

¹⁰⁵ See Kane, *supra* note 4 (suggesting that language in *Rice's Toyota World* could be used to support an approach comparing pre- and post-tax results); see also *Rice's Toyota World v. Commissioner*, 81 T.C. 184, 203 (1983) (analyzing the transaction in terms of a "realistic opportunity for economic profit").

¹⁰⁶ *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction."); *Johnson v. United States*, 32 Fed. Cl. 709, 717 (1995) ("The determination of whether a transaction has economic substance is essentially a two part analysis: (1) whether the substance of the transaction is reflected in its form, and (2) whether the transaction had a reasonable objective possibility of providing a profit aside from tax benefits.").

¹⁰⁷ Cf. Amandeep S. Grewal, *Economic Substance & The Supreme Court*, 116 TAX NOTES 969 (Sept. 10, 2007) ("[T]he lower courts' creation of an economic substance doctrine contradicts Supreme Court precedent, has caused deep circuit

courts would have some room to add the proposed approach to objective economic substance, although in some jurisdictions, appellate courts would have to refine or even directly overturn prior approaches of their own making.

V. CASE STUDIES

This part analyzes two tax avoidance cases for purposes of illustrating how a post-tax inquiry would operate. The first case is *Compaq Computer Corp. v. Commissioner*, a case that has generated a great deal of discussion.¹⁰⁸ This case provides an example of a pre-packaged transaction that would likely fail the comparables inquiry. The second case is the more recent *Black & Decker Corp. v. United States*.¹⁰⁹ It is an example of a situation where it may be necessary to apply the factor-based inquiry because no suitable comparable is available.

A. Compaq v. Commissioner

1. Transaction Details

The *Compaq* case¹¹⁰ involved a relatively simple transaction, and one that Congress responded to by enacting a statutory fix.¹¹¹ In July

splits, and is inconsistent with well-settled rules of statutory interpretation.”).

Some portions of the Supreme Court’s (infamous) opinion in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), might be stretched to support a comparables method — for example, the Court’s emphasis on the “competitive situation” and “multiple-party transaction.” *Id.* at 582–83. For discussion of *Frank Lyon*, see Wolfman, *supra* note 29.

¹⁰⁸ *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), *rev’d*, 277 F.3d 778 (5th Cir. 2001); *see, e.g.*, Hariton, *supra* note 6, 273 (“I am not sure Compaq is getting away with *enough* in this transaction for a court to disallow the results for lack of economic substance”); David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong*, 2002 TNT 19-30 (Jan. 29, 2002); Kane, *supra* note 4; Klein & Stark, *supra* note 4; Knoll, *supra* note 57; Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters and the Compaq Case*, 88 TAX NOTES 221 (July 10, 2000); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 26 TAX NOTES INT’L 191 (Apr. 15, 2002).

¹⁰⁹ *Black & Decker Corp. v. United States*, 436 F.3d 431, 433 (4th Cir. 2006).

¹¹⁰ *Compaq*, 113 T.C. 214. The *IES* case is essentially similar. *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), *rev’g* No. C97-206, 1999 WL 973538 (N.D. Iowa Sept. 22, 1999).

¹¹¹ Section 901(k) was added by the Taxpayer Relief Act of 1997 to restrict the dividend stripping technique used by *Compaq*. Taxpayer Relief Act of 1997, Pub. L.

1992, Compaq recognized \$231.7 million of long-term capital gain on an unrelated transaction.¹¹² (Numbers in the main text are rounded to the nearest \$100,000 unless otherwise noted.) Twenty-First Securities Corporation (Twenty-First) contacted Compaq and proposed a transaction that would generate capital losses to offset that gain.¹¹³ Compaq spent minimal time and effort reviewing the transaction details before agreeing to Twenty-First's proposal.¹¹⁴ The transaction consisted of three steps: (1) purchase of American Depository Receipts (ADRs)¹¹⁵ in the Royal Dutch Petroleum Company (Royal Dutch), a Netherlands corporation, when the ADRs were trading with dividend; (2) re-sale of the ADRs *ex dividend*; and (3) collection of the dividend.

No. 105-34, § 1053(a), 111 Stat. 788, 941–43. Generally, the foreign tax credit is available for foreign taxes withheld on dividends only if the dividend recipient held the underlying stock for at least 16 days during the “31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend.” I.R.C. § 901(k)(1)(A)(i).

One purpose of this rule is to require taxpayers to assume the risks of ownership before becoming eligible for the tax benefits tied to being the stock owner on the record date. In addition, the increase and decrease in stock price caused by the declaration of the dividend and passing of the ex dividend date will be significantly less pronounced as result of this enforced holding period.

¹¹² *Compaq*, 113 T.C. at 215.

¹¹³ *Id.* The Tax Court describes this company as “an investment firm specializing in arbitrage transactions.” *Id.*

¹¹⁴ *Id.* at 216–17. On September 15, 1992, the assistant treasurer — James J. Tempesta — of Compaq met with representatives from Twenty-First “[i]n a meeting that lasted approximately an hour.” *Id.* at 216. Two transactions were proposed — one called the “Dividend Reinvestment Arbitrage Program,” the other making use of American Depository Receipts (ADR). *Id.* at 215. On September 16, 1992 — the same day the transaction was completed — Compaq notified Twenty-First that it would go forward with the ADR transaction. The research was minimal: “Tempesta did not perform a cash-flow analysis before agreeing to take part in the ADR transaction. Rather, Tempesta’s investigation of Twenty-First and the ADR transaction, in general, was limited to telephoning a reference provided by Twenty-First and reviewing a spreadsheet provided by Jacoby [of Twenty-First] that analyzed the transaction.” *Id.* at 216. As to the Royal Dutch ADRs purchased, “Tempesta’s research . . . was limited to reading in the Wall Street Journal that Royal Dutch declared a dividend and to observing the various market prices of Royal Dutch ADR’s.” *Id.* at 217.

¹¹⁵ “An ADR . . . is a trading unit issued by a trust, which represents ownership of stock in a foreign corporation that is deposited with the trust. ADR’s are the customary form of trading foreign stocks on U.S. stock exchanges . . .” *Id.* at 215.

a. Purchase of ADRs

Compaq purchased 10 million Royal Dutch ADRs on September 16, 1992, through twenty-three separate transactions that occurred over the course of an hour.¹¹⁶ Each sale was carried out with “next day” settlement terms.¹¹⁷ Thus, closing would take place on September 17, 1992.¹¹⁸ The floor brokers executing the trades were instructed to complete a trade “only if the prices selected were within the range of the current market prices.”¹¹⁹ Each purchase (and re-sale) was done pursuant to the rules of the New York stock exchange¹²⁰ and none of the trades were broken up.¹²¹ The seller of the ADRs — a company called Arthur J. Gallagher and Company (Gallagher) — was also a client of Twenty-First.¹²² Compaq did not know the identity of the seller.¹²³

The aggregate purchase price for the ADRs was \$887.6 million. Compaq claimed a tax basis of \$888.5 million as a result of capitalizing certain fees. In this case, the “blended price per share equaled the actual market price plus the net dividend.”¹²⁴ The Netherlands withheld a 15% tax on the gross dividend. Thus, the price paid by Compaq was equal to market price plus 85% of the gross dividend. Compaq’s purchase price indicates that the seller was unable to use the U.S. foreign tax credit to offset the Netherlands withholding tax. In other words, the seller, Gallagher, was indifferent as between (1) keeping the stock, receiving the gross dividend, and paying the

¹¹⁶ *Id.* at 217.

¹¹⁷ *Id.*

¹¹⁸ These terms were pursuant to NYSE rule 64. *Id.*

¹¹⁹ *Id.*

¹²⁰ The specific rule was NYSE rule 76, which “required an open out-cry for each cross-trade, and NYSE rule 72 allowed other traders on the floor or the ‘specialist’ responsible for making the cross-trades to break up the transaction by taking all or part of the trade.” *Id.* at 218.

¹²¹ *Id.* (“[F]or cross-trades priced at the market price, there was no incentive to break up the transaction.”).

¹²² *Id.* at 217 (“Gallagher had been a client of Twenty-First since 1985 and participated in various investment strategies developed by Twenty-First over the years.”). In the *IES* case, the court described the sellers of the ADRs as “tax-exempt entities, such as pension funds. However, such entities were exempt only from U.S. taxes; they still were required to pay the 15% foreign tax on any ADR dividends collected. Because they owed no U.S. tax, they could not benefit from the foreign tax credit.” *IES Industries, Inc. v. United States*, 253 F.3d 350, 352 (8th Cir. 2001).

¹²³ *Compaq*, 113 T.C. at 217.

¹²⁴ *Id.*

Netherlands withholding tax and (2) selling the stock for market price plus 85% of the gross dividend.¹²⁵ If persons able to use the U.S. tax credit had set the price, the price would have approached the market price plus the gross dividend. Thus, Compaq's purchase price carried with it an implicit tax subsidy.

On the September 17th settlement date, Gallagher's account with Bear Stearns & Co. (Bear Stearns)¹²⁶ was credited with the purchase price, net of Securities and Exchange Commission fees (SEC fees).¹²⁷ Compaq paid the purchase price with money loaned to it through its margin account with Bear Stearns. Compaq opened this margin account on September 17, 1992, and transferred to it \$20.6 million.¹²⁸

b. Re-sale of ADRs

Each of the twenty-three separate purchases Compaq made from Gallagher was accompanied by a re-sale of the same ADRs back to Gallagher, but with the settlement specified to occur on September 21, 1992 — 5 days after the September 16 agreement on terms. Compaq sold the ADRs for a price of \$868.4 million, before adjustments for commissions and fees.¹²⁹ With adjustments for fees, Compaq reported an amount realized for the sale of \$867.9 million, yielding a reported capital loss of \$20.7 million.¹³⁰

¹²⁵ See also *IES*, 253 F.3d at 352 (“The purchase price of the securities was equal to market price plus 85% of the ADRs’ expected gross dividends, that is, the same amount the ADR lender would have received after foreign tax was withheld had it been the record owner entitled to payment of the dividends.”).

¹²⁶ For decades Bear Stearns was “a leading global investment banking, securities trading and brokerage firm.” Bear Stearns, http://www.bearstearns.com/sitewide/our_firm/index.htm (last visited Apr. 11, 2008). The “guiding principles” of “respect, integrity, meritocracy, innovation and a commitment to philanthropy . . . serve as [the] blueprint for the way that [they] do business.” *Id.* In March 2008, the Federal Reserve intervened to prevent the collapse of Bear Stearns and facilitate a takeover by JP Morgan Chase. See Edmund L. Andrews, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1.

¹²⁷ These fees totaled \$29,586. *Compaq*, 113 T.C. at 218. Gallagher was reimbursed for these fees; it is not clear why they were reimbursed or who reimbursed the company. *Id.*

¹²⁸ *Id.* On September 18, Compaq also transferred \$16,866,571. This amount was transferred back to it on the same day. This transfer/re-transfer was done to satisfy margin requirements — basically “to demonstrate [Compaq’s] financial ability to pay.” *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 219. Probably not coincidentally, the reported capital loss is only \$820 more than the deposit made by Compaq to its Bear Stearns account. *Id.*

c. Dividend

The dividend declared by Royal Dutch was payable to those who were shareholders of record on September 18, 1992.¹³¹ As a shareholder of record for that date, Compaq was entitled to a \$22.5 million dividend on its 10 million Royal Dutch shares.¹³² The Netherlands withheld \$3.4 million in taxes. When Royal Dutch paid the dividend on October 2, 1992, it deposited a net dividend of \$19.2 million into Compaq's margin account at Bear Stearns.¹³³ The pre-tax, gross economic loss (loss on sale plus fees) experienced by Compaq was \$20.7 million — \$1.5 million larger than the net dividend and \$1.9 million smaller than the gross dividend. Compaq claimed that the proper comparison was between this economic loss and the gross dividend for an expected and received pre-tax profit of \$1.9 million.

d. Fees

The court lists three fees paid by Compaq (rounded to the nearest \$1000): (1) SEC fees of \$29,000; (2) commissions to Twenty-First of \$999,000; and (3) \$458,000 interest paid to Bear Stearns on the borrowing through the margin account of the purchase price of the ADRs.¹³⁴ The total transaction costs were approximately \$1.5 million. All of these costs were capitalized into Compaq's basis in the ADRs

As explained below, the allocation of fees by Compaq as between basis and amount realized appears suspect. The pre-fee adjusted loss was \$19,165,000 (\$868,412,129 re-sell price minus \$887,577,129 purchase price). It appears that the adjustments to basis and amount realized were done so as to maximize the basis amount and thereby increase the capital loss for tax purposes. If the \$1,485,685 fees detailed by the court are added to that loss, the total economic cost is \$20,650,685 — or \$1311 less than the amount deposited by Compaq to its Bear Stearns account. The court opinions do not state whether Compaq received or paid a difference check to close out the Bear Stearns account.

The pre-fee-adjusted economic loss of \$19,165,000 is \$1070 more than the net dividend amount of \$19,163,930. Twenty-First lowered its original commission from \$1,000,000 to \$998,929 — a difference of \$1071 — in order “to offset computational errors in calculating some of the purchase trades.” *Id.* at 218–19 (the precise amount of the reduction in fees was \$1070.55). The intent clearly was to match precisely the net dividend and the pre-fee adjusted capital loss — that is, Compaq intended to pay a purchase price for the ADRs precisely equal to the market price plus 85% of the gross dividend.

¹³¹ *Id.* at 219.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* at 218. In addition, a \$37 margin write-off credit was specified. *Id.*

or in the amount realized on the re-sale.¹³⁵

2. Pre-Tax, Post-Tax

In court, Compaq argued that it had a pre-tax profit objective and that, in fact, the transaction had generated a pre-tax profit of approximately \$1.9 million — the difference between the gross dividend and its economic loss. The discussion by both the Tax Court and the Fifth Circuit largely focused on whether pre-tax profit should be measured by comparing the economic loss to the net dividend or the gross dividend.¹³⁶ The Tax Court rejected Compaq's approach while the Fifth Circuit agreed that the gross dividend was the appropriate measure. The Fifth Circuit also placed some emphasis on the trades having occurred pursuant to exchange rules and through an open market process.¹³⁷ The Fifth Circuit reversed the Tax Court and upheld the transaction.

If the courts had decided this case by looking at the return before both explicit taxes and the implicit tax subsidy, the transaction would

¹³⁵ *Id.* at 221. The method of allocating these fees as between basis and amount realized is unclear given the numbers the court provides. Compaq reported its adjusted basis in the ADRs as being \$888,535,869 — \$958,740 larger than the purchase price of \$887,577,129. Compaq reported its amount realized on the sale as \$867,883,053 — \$529,076 smaller than the sale price of \$868,412,129. These two adjustments add up to \$1,487,816, which is \$2131 larger than the total transaction costs reported. While the numbers are not entirely reconciled, what does seem sufficiently clear is that, roughly, two-thirds of the costs were capitalized into basis and, roughly, one-third into amount realized, which would have increased the capital loss.

¹³⁶ *Id.* at 222; *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 782 (5th Cir. 2001); *see also* MCDANIEL, *supra* note 6, at 1332 (pointing out that the Fifth Circuit ignored the fact that “the transactions would not have been undertaken absent the U.S. and Netherlands tax considerations that both created the potential for before-tax profit and made realization of an after-tax profit possible”).

¹³⁷ The court explained as follows:

Although . . . the parties attempted to minimize the risks incident to the transaction, those risks did exist and were not by any means insignificant. The transaction occurred on a public market, not in an environment controlled by Compaq or its agents. The market prices of the ADRs could have changed during the course of the transaction . . . ; any of the individual trades could have been broken up or, for that matter, could have been executed incorrectly, and the dividend might not have been paid or might have been paid in an amount different from that anticipated by Compaq.

Compaq, 277 F.3d at 787.

have been found to yield an obvious pre-tax loss.¹³⁸ Although *Compaq* presents a case in which quantifying the implicit subsidy was fairly straightforward, in other transactions, quantifying implicit taxes may be more difficult. The proposed framework uses a more indirect approach to dealing with implicit taxes by focusing on after-tax results and utilizing comparables.¹³⁹

Under the framework proposed in this article, Compaq's after-tax return first would be computed. Compaq reported a \$20.7 million capital loss, which at a uniform 34% rate¹⁴⁰ would yield \$7 million of tax savings. Although Compaq would have to pay tax of \$7.7 million to the U.S. government and \$3.4 million to the Netherlands on the gross dividend of \$22.5 million, it would receive a \$3.4 million foreign tax credit¹⁴¹ for the taxes paid to the Netherlands. Thus, the total post-tax return amount was \$1.1 million.¹⁴² Compaq only invested \$20.7 million (at most) of its own money. While it may seem appropriate to compute the rate of post-tax return on this amount,¹⁴³ in order to make a rate comparison between Compaq's suspect transaction and economically equivalent transactions, the investment base should be the \$887.6 million ADR purchase price (even though most of this was borrowed).¹⁴⁴ With the larger base, the total after-tax return is approximately 0.124%, but this is the return over a five-day period. If Compaq continued to earn the same rate over a year-long period, the annual return would have been approximately 9%.

¹³⁸ Knoll, *supra* note 57, at 839.

¹³⁹ See *supra* Part IV.A.

¹⁴⁰ The top corporate tax rate in 1992 was 34%. See *Citizens Federal Bank v. United States*, 66 Fed. Cl. 179, 203 (2005). Although the corporate tax rate schedule is progressive, the benefit of the lower rate brackets is eliminated after the corporation surpasses certain amounts of income. In 1992, income between \$100,000 and \$335,000 was subject to what was essentially a 39% rate. See also JEFFREY L. KWALL, *THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS* 22 (Foundation Press 2005) (describing phaseout of tax benefits from lower corporate tax brackets).

¹⁴¹ There was apparently no dispute that this was the correct amount of the tax credit under the formal rules on tax credits. See *Compaq*, 277 F.3d 778.

¹⁴² \$7 million tax saving on capital loss + \$22.5 million dividend + \$3.4 million tax credit - \$7.7 million U.S. tax on dividend - \$3.4 million Netherlands tax on dividend - \$20.7 million capital loss. (This accepts Compaq's capitalization of expenses into amount realized and tax basis.)

¹⁴³ Which would be an approximately 5% return in five days (387.9% return annualized).

¹⁴⁴ See *supra* notes 89–90 and accompanying text (explaining inclusion of debt in the investment base).

The only variables in this transaction for Compaq were the extraordinarily remote possibility that an unrelated third party would break up the cross-sales and that Gallagher would default on its obligation to re-purchase. If Gallagher had defaulted, Compaq could have mitigated any losses by finding another buyer for the publicly traded ADRs (though by then the dividend-related loss may have vanished). While Compaq (and possibly the Fifth Circuit) would disagree, the possibility was so remote as to be safely ignored when approaching the problem of locating an economically equivalent market comparable.

A highly plausible framing of the substantive economic relationship is that Compaq extended a collateralized, short-term loan to Gallagher — or, in more technical terms, that Compaq entered into a reverse repurchase agreement (reverse repo).¹⁴⁵ In a reverse repo, a buyer/lender purchases securities for cash from a seller/borrower.¹⁴⁶ The parties agree that at the end of some stated time period — frequently a matter of days or weeks — the seller/borrower will buy the securities back from the original buyer/lender at a set price reflecting an interest component (the repo rate).¹⁴⁷ Reverse repos carry some risk of default, which increases with the length of time the transaction is held open. The value of collateral mitigates this risk and affects the overall return.

Treasury securities are commonly used as collateral, and data on repo rates for nontreasury securities is difficult to obtain. One substitute is the “general collateral rate,” which is the term used for the highest repo rate available at a particular time on treasuries.¹⁴⁸ “The overnight general collateral rate is commonly near the federal funds rate.”¹⁴⁹ For the time period at issue in Compaq, the overnight federal funds rate was an annualized return of between 3.07% and

¹⁴⁵ Aspects of the transaction are anomalous for a reverse repo. The payment method on the transaction was somewhat unusual. Generally, the interest component is paid by the buyer/lender selling the securities back at a higher price than that originally paid. Here, Compaq sold the ADRs back at a lower price and was instead compensated through receipt of the dividend. Usually dividends accruing on the subject of a reverse repo are paid over to the original seller (which would be Gallagher).

¹⁴⁶ See Darrell Duffie, *Special Repo Rates*, 51 J. FIN. 493, 497 (1996).

¹⁴⁷ See *Sheldon v. Commissioner*, 94 T.C. 738, 742 (1990) (describing repo transaction).

¹⁴⁸ See Duffie, *supra* note 146, at 498.

¹⁴⁹ See *id.* at 499.

3.28%.¹⁵⁰ Applying a 34% tax rate would give a range of 2.02% to 2.16%. The five-day term would increase the return, but it is doubtful that any increase would bring it into substantial proximity to Compaq's annualized 9% after-tax return.¹⁵¹

Under the proposed comparables test, Compaq's transaction would be presumed to fail the objective inquiry. Compaq would then be afforded the opportunity to rebut this presumption by showing that the return was the result of Compaq being a member of a naturally occurring tax clientele for these ADRs. Professors Klein and Stark have previously articulated the argument that Compaq may have engaged in simple, clientele-based arbitrage.¹⁵² They note that the rule at issue in *Compaq* was one tied to the arbitrary decision to tax dividends to the owner on the record date.¹⁵³ According to professors Klein and Stark:

[This] rule permitted U.S. taxpayers to profit, with minimal risk, from a form of tax arbitrage between two taxpayers with different tax characteristics. . . . The *Compaq* arbitrage opportunity seems to have arisen because the two parties valued the dividend differently. . . . Indeed, any investor subject to any tax rate should find the *Compaq* transaction attractive, as long as it is allowed to deduct the capital loss that arises from the sale of the stock ex-dividend.¹⁵⁴

Professors Klein and Stark also discussed factors weighing against this possibility, including the prearranged nature of the Compaq transaction, the "purchase" of the transaction through a tax shelter promoter, and the use of one of the promoter's clients as the

¹⁵⁰ The Federal Reserve Board, H15 Selected Interest Rates, <http://www.federalreserve.gov/datadownload/Build.aspx?rel=H15> (choose "Series Type": "Selected Interest Rates"; then choose "Instrument": "Federal Funds"; then choose "Maturity": "Overnight"; then choose "Frequency": "Weekly"; then choose "Add to package"; follow "Go to Format"; select "September 1992" as date; download data) (last visited Feb. 24, 2008).

¹⁵¹ To add another point of comparison, during this same time period, the bank prime loan rate was 6% annualized. See The Federal Reserve Board, H15 Selected Interest Rates, <http://www.federalreserve.gov/datadownload/Build.aspx?rel=H15> (follow steps in footnote 139, except choose "Instrument": "Bank prime loan") (last visited Feb. 24, 2008).

¹⁵² Klein & Stark, *supra* note 4, at 1335–36.

¹⁵³ *Id.* at 1339.

¹⁵⁴ *Id.* at 1339–40.

counterparty.¹⁵⁵ In addition, Compaq's payment precisely matched the ADR market price plus the net dividend. The preciseness of the match provides some evidence that Compaq could not have simply gone into the market without the pre-packaging and received the same deal. These factors weigh heavily against the transaction arising from a naturally occurring tax clientele opportunity. Of course, Compaq did not know that the counterparty would be the same on both the purchase and the re-sale of the ADRs, and it may not have viewed the transaction as in substance a "reverse repurchase agreement." Although possibly unaware of the details of the transaction, Compaq's ignorance points more toward failure of objective economic substance than otherwise. At a minimum, Compaq certainly knew it had left the details of the transaction in the hands of a promoter of tax avoidance shelters.

B. *Black & Decker v. United States*

1. Transaction

The tax avoidance technique at issue in *Black & Decker Corp. v. United States* is elegant in its simplicity.¹⁵⁶ *Black & Decker*¹⁵⁷ provided medical and dental benefits to "thousands" of employees and retirees.¹⁵⁸ *Black & Decker*'s monetary obligation for benefit claims could not be ascertained with absolute certainty since the amount would depend on the health of the employees and retirees.¹⁵⁹ The estimated obligation had a net present value of \$560 million.¹⁶⁰ Presumably, this estimate was reached using standard actuarial tools. The accuracy of the estimate would also have been enhanced by the

¹⁵⁵ *Id.*

¹⁵⁶ *Black & Decker Corp. v. United States*, 436 F.3d 431, 433 (4th Cir. 2006); see Ethan Yale, *Reexamining Black & Decker's Contingent Liability Tax Shelter*, 108 TAX NOTES 223, 223 (July 11, 2005) (describing the shelter as "surprisingly simple"). I owe thanks to Marty McMahon for suggesting *Black & Decker* as an additional case to analyze under my proposal.

The transaction in *Black & Decker* is similar to the one at issue in *Coltec Industries v. United States*, 62 Fed. Cl. 716 (2004), *rev'd*, 454 F.3d 1340 (Fed. Cir. 2006).

¹⁵⁷ "Black & Decker" is used throughout to denote The Black & Decker Corporation as well as "its domestic direct and indirect subsidiaries." *Black & Decker*, 436 F.3d at 433.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

relatively large pool of people insured. Black & Decker owned all the common stock of Black & Decker Healthcare Management, Inc. (BDHMI).¹⁶¹

The tax avoidance transaction required two phases. The first phase took place on November 25, 1998.¹⁶² On this date, Black & Decker¹⁶³ transferred \$561 million in cash to BDHMI in exchange for BDHMI preferred stock and BDHMI's assumption of Black & Decker's contingent medical liabilities. BDHMI's "assumption of liability did not constitute either a legal defeasance . . . or a novation and consequently, [Black & Decker] continued to be primarily liable" on the claims.¹⁶⁴ Black & Decker took a \$561 million tax basis in the stock it received by relying on various statutory authorities relating to this exchange.¹⁶⁵

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ In addition to the parent corporation, a Canadian subsidiary transferred cash and received preferred stock in the exchange. *Id.*

¹⁶⁴ *Id.* (quoting record and omitting alterations made to that record).

¹⁶⁵ Black & Decker's transaction was governed by section 351, which provides for a tax-free exchange of property for stock if the property transferor (or group of property transferors) has control of the transferee corporation immediately following the exchange. I.R.C. § 351(a). If the transferor receives cash or other property in addition to the stock, receipt of this "boot" will require the transferor to recognize some income for tax purposes. I.R.C. § 351(b). Generally, if the transferee corporation assumes liabilities of the transferor, such assumption is not treated as boot. I.R.C. § 357(a). Such amount of the debt assumption must generally, however, reduce the transferor's tax basis in the stock received. I.R.C. §§ 358(a)(1)(A)(ii), (d)(1). But reduction is not required if the liability assumed would have given rise to a deduction if the liability had been retained and paid by the transferor. I.R.C. §§ 357(c)(3), 358(d)(2); see Rev. Rul. 95-74, 1995-2 C.B. 36 (no reduction required in case of contingent liability assumed that would have given rise to basis if retained by the transferor); see also Douglas A. Kahn & Dale A. Oesterle, *A Definition of "Liabilities" in Internal Revenue Code Section 357 and 358(d)*, 73 MICH. L. REV. 461 (1975).

Black & Decker took a \$561 million basis by transferring \$561 million of cash to the corporation. Black & Decker asserted that assumption of the debt by BDHMI did not trigger gain recognition and did not require basis reduction since had Black & Decker retained the liabilities it would have received a deduction for their payment.

In October 1999, Congress halted the transaction by adding section 358(h). Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 309(a), 114 Stat. 2763, 2763A-638. Section 358(h) applies to a section 351 transaction if (1) a transferor receives stock whose value is less than its basis, as calculated under the generally applicable rules and (2) the transferee corporation assumes liabilities that are not treated as "money" for purposes of section 358(d) (e.g., contingent liabilities). In such a case, the transferor is required to reduce its basis (but not below fair market value)

On December 29, 1998, Black & Decker sold the preferred stock received in the exchange for \$1 million. The purchaser was “an unrelated third-party trust benefiting a former [Black & Decker] executive.”¹⁶⁶ Black & Decker reported a \$560 million capital loss from this transaction, which it used to offset capital gains from unrelated transactions from the same year, as well as to reduce taxes from other years.¹⁶⁷ BDHMI would pay the obligations and then claim a tax deduction for the payment. To the extent BDHMI could not use the deduction, it could be carried forward (and back) as a net operating loss. The effect would be a potential doubling¹⁶⁸ of the deduction for the payment of the claims and the conversion of an ordinary loss to a capital loss for Black & Decker.¹⁶⁹

Black & Decker was following a generic pattern used by “most of the major accounting firms.”¹⁷⁰ This generic pattern is particularly problematic because it relied on a fairly straightforward application of statutory and administrative authorities (later amended to halt the transaction).¹⁷¹ A couple of additional facts in the Black & Decker case, however, lessen the difficulty of getting at the transaction. First, Black & Decker had borrowed the \$561 million cash transferred to BDHMI from “its banks for thirty days.”¹⁷² Second, on the same day Black & Decker sold its preferred stock, it also borrowed \$564 million from BDHMI.¹⁷³ The installment payments on this financing were “designed to provide BDHMI sufficient funds to pay the benefits liabilities as they came due.”¹⁷⁴

These financing steps are susceptible to a simple substance-over-form approach. Two obvious questions are whether Black & Decker,

in the stock received by the amount of liabilities assumed. I.R.C. § 358(h)(1). This rule does not apply if the assets or business associated with the liabilities is also transferred. I.R.C. § 358(h)(2). In the contingent liability shelter, only the contingent liabilities were transferred and not the assets or business generating the income related to the liabilities.

¹⁶⁶ *Black & Decker*, 436 F.3d at 433.

¹⁶⁷ *Id.*

¹⁶⁸ Section 351 generally operates to provide a doubling of tax gains and losses — one level occurring at the shareholder level and the other at the corporate level.

¹⁶⁹ Apparently, Black & Decker would eventually add BDHMI back to its consolidated group and use the NOLs itself. Yale, *supra* note 156.

¹⁷⁰ *Id.*

¹⁷¹ See *supra* note 165 (describing the statutory argument).

¹⁷² *Black & Decker*, 436 F.3d at 433.

¹⁷³ *Id.*

¹⁷⁴ *Id.*

as a matter of substance, transferred property (cash) to BDHMI and whether BDHMI, as a matter of substance, took over payment on the liabilities. The government does not seem to have used a more general substance-over-form attack in the *Black & Decker* litigation¹⁷⁵ — presumably because it wished to get at the generic shelter type.¹⁷⁶ The financing details of *Black & Decker*, however, raise the possibility that similar cash circles appeared in other iterations of the same contingency liability technique.

2. After-Tax Inquiry

Economic substance may not be necessary to successfully attack the contingency liability shelter. This Part explores, for the sake of illustration, how such an attack might be structured under the proposed objective economic substance framework. This Part considers both the *Black & Decker* transaction and the generic shelter. In both cases, the proposed objective economic substance method could be used to disallow the tax benefits sought. Additionally, although a comparable transaction is suggested in both cases, the market for that comparable is such that the more open-ended factor based inquiry is likely necessary.

a. *Black & Decker Contingent Liabilities Transaction*

Even after the transaction with BDHMI occurred, Black & Decker in substance continued to self-insure the contingent liabilities. In other words, Black & Decker did not experience any actual relief from risk by paying BDHMI (and by implication, BDHMI acted as an economic nonentity). Black & Decker transferred the present value of the estimated liability to the subsidiary, but Black & Decker borrowed that same amount back from the subsidiary and then apparently made loan payments designed to match the expected payouts on the contingent liabilities that BDHMI assumed.¹⁷⁷ Further, Black &

¹⁷⁵ See Lee A. Sheppard, *Drafting Economic Substance, Part 3*, 106 TAX NOTES 1020, 1024 (Feb. 28, 2005) (“[T]he taxpayers’ assertions that the transfer of liabilities was effective went unchallenged by the government.”).

¹⁷⁶ Hints of a more general substance-over-form approach appear in Notice 2001-17, which identified the contingent liability maneuver as a listed transaction subject to the tax shelter registration regulations. I.R.S. Notice 2001-17, 2001-1 C.B. 730. The notice gives as one disallowance approach “that the transfer of the asset to the transferee corporation is not, in substance, a transfer of property in exchange for stock within the meaning of § 352” *Id.*

¹⁷⁷ *Black & Decker*, 436 F.3d at 433.

Decker retained primary liability on the contingent liabilities. Even if Black & Decker had some indemnity claim against BDHMI, it would be of little value since the only items inside BDHMI were the contingent liabilities and its loan to Black & Decker. If Black & Decker had retained the liabilities outright, it would not have been able to deduct the contingent liabilities until payment.¹⁷⁸ Thus, the only effect of the transaction was to substantially reduce Black & Decker's after-tax cost of carrying these liabilities, since Black & Decker did not part with the risks associated with them.

Arguably, this is sufficient to deny Black & Decker the benefits of the transaction without engaging in the factor-based inquiry. Retention of responsibility on these types of claims is considered self-insurance.¹⁷⁹ Self-insurance is a fairly common practice, and information on the after-tax cost of doing so may be available. It seems certain that by reducing its costs through its transactions with BDHMI, Black & Decker received a return (through cost reduction) substantially higher than that available in standard self-insurance arrangements. Further, since Black & Decker was dealing only with a controlled entity, the possibility of rebutting the presumption of failure through showing a natural tax clientele is remote.

Since, however, the idea of a market in self-insurance is somewhat contradictory and since public information on those costs may be difficult to obtain, the more general, factor-based test is examined.¹⁸⁰ Various factors strongly suggest that nothing occurred except tax manipulation (indeed, on the subjective inquiry, Black & Decker essentially conceded this was the case).¹⁸¹ The proposed self-insurance comparable points in that direction, and Black & Decker relied on a package transaction marketed by accounting firms. Black & Decker created and controlled the subsidiary used in the transaction. The subsidiary was sold to a party who, though technically unrelated, was

¹⁷⁸ See William B. Barker, *Federal Income Taxation & Captive Insurance*, 6 VA. TAX REV. 267, 280 (1986) (“[S]ums set aside are not business ‘expenses,’ since the taxpayer retains a proprietary interest in the fund and the ‘payments’ are merely a reserve for future contingent liabilities. This follows even when the funds are transferred to and administered by an independent agent or insurance company.”).

¹⁷⁹ The term “self-insurance” is a misnomer because retention of liability means that the taxpayer has not acquired insurance. That is, the taxpayer has not shifted risk away from itself. See *id.* (“[T]here [is] no risk transfer in a self-insurance plan . . .”).

¹⁸⁰ See *supra* Part IV.B.2 (describing test).

¹⁸¹ *Black & Decker*, 436 F.3d at 441 (noting that Black & Decker conceded tax motive for purposes of motion for summary judgment).

controlled by an individual closely affiliated with Black & Decker.¹⁸² In short, the proposed re-design of the objective profit inquiry could be used to disallow the claimed tax benefits of the transaction.

b. Generic Contingent Liabilities Shelter

Service Notice 2001-17 on contingent liabilities suggests that the transaction is in substance “simply a payment to the transferee for its assumption of a liability.”¹⁸³ Such a payment also suggests another plausible comparable transaction. A business with a contingent liability may legitimately wish to hedge against the risks inherent in carrying that liability, and paying a fixed sum to a third party in exchange for relief from the liability would create such a hedge.¹⁸⁴ Though hedging transactions are common, it may be difficult to obtain information about specific terms — including the after-tax position of the parties. Even so, the principal arm’s length determinants of price are reasonably ascertainable, and such an examination suggests disallowance of the contingency liability transaction.

Parties dealing at arm’s length would first determine the expected cost of the contingent liability. The liability-assuming party would, however, be unlikely to accept a payment exactly equal to the expected cost. That is, the liability-assuming party would require some additional inducement (a risk premium), the amount of which would depend on the distribution of the possible outcomes.¹⁸⁵ For example, a contingent liability with a 50% probability of a \$101 payment and a 50% probability of a \$99 payment yields an expected cost of \$100. The expected cost would also be \$100 if there were a 20% probability of a \$400 payment and an 80% probability of a \$25 payment. But the liability-assuming party would almost certainly require a larger inducement in the latter case than in the former.

The cash transferred to the subsidiary in the generic contingent liability transaction was likely quite close to the estimated present value of the contingent liabilities. Such a small additional payment may indicate a price that is far lower than that which would be

¹⁸² See Lederman, *supra* note 5 (“A close relationship that does not fall within the related-party rules can provide opportunities to coordinate on tax reduction.”).

¹⁸³ Notice 2001-17, 2001-1 C.B. 730. In 2002, the government created a settlement initiative for purposes of dealing with the many taxpayers who entered into variations of this transaction. Rev. Proc. 2002-67, 2002-2 C.B. 733.

¹⁸⁴ Such a payment would not be immediately deductible but would have to be capitalized.

¹⁸⁵ See BODIE ET AL., *supra* note 63, at 142–44 (describing risk premiums).

charged by a third party operating at arm's length. In the *Black & Decker* transaction, for example, only \$1 million was paid over and above the estimated \$560 million present value cost of the liabilities. \$1 million is only 0.18% of \$560 million. The court opinions do not provide information as to the possible outcomes accounted for in the \$560 million estimated present value of the liabilities, and generally, such information may be difficult to obtain. Thus, it is not known whether this amount was reasonable given the contingency risks. Still, one wonders whether an unrelated third party would take on these liabilities for such a small inducement. (Of course, as argued above, BDHMI did not actually take over the liabilities.) The tax position of Black & Decker seems to underscore, rather than lessen, the insufficiency of this payment. Black & Decker's position that it could soon deduct the payment would likely have given a third party the ability to extract a higher payment in the form of implicit taxes (although this would also depend on the third party's tax treatment and rate bracket).

Further analysis under the factor-based inquiry would depend largely on how a particular iteration was carried out. It seems likely, however, that shelter indicia similar to those present in *Black & Decker* would also be present in other companies' attempts to use the transaction.

VI. CONCLUSION

Tax agencies have been regularly criticized for being indiscriminate in their use of the economic substance doctrine.¹⁸⁶ While some of this overuse may be the result of overreaching, it is also genuinely difficult to know in advance whether the doctrine will work against a particular transaction. The proposed framework would add an initial, brighter-line approach to the question of whether a given transaction has objective economic substance. The after-tax viewpoint automatically accounts for any implicit taxes. Providing the taxpayer the opportunity to rebut a presumption of failure helps avoid tarnishing a naturally occurring tax clientele with the tax shelter brush. Even if a suitable, economically equivalent market comparable is not available, the initial focus on locating such a comparable should better anchor the inquiry into objective economic substance. The

¹⁸⁶ See Joseph Bankman, *The Tax Shelter Battle*, in *THE CRISIS IN TAX ADMINISTRATION* 9, 18–19 (Henry J. Aaron & Joel Slemrod, eds. 2004) (“[I]t might be wiser to rely more on arguments that are more narrowly focused.”).

proposed framework still, however, requires considerable discretion and extensive fact-finding, and thus leaves plenty of space for “wrong” decisions — but also for government adaptation to tax avoidance innovations.