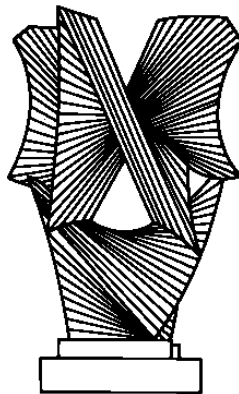


CHICAGO

JOHN M. OLIN LAW & ECONOMICS WORKING PAPER NO. 142
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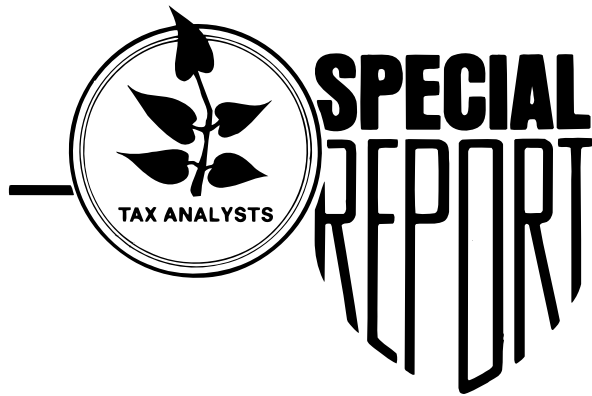
The Fifth Circuit Gets It Wrong in *Compaq v. Commissioner*

Daniel N. Shaviro and David A. Weisbach

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I. Introduction

Corporate tax shelters have received significant attention in the last few years. While the magnitude of potential problems is disputed, it is clear that the use of black letter rules, unconstrained by some sort of economic substance or business purpose requirement, could lead to the elimination of wholesale swathes of corporate income tax liability. There has also been dispute about the ability of the Internal Revenue Service to combat tax shelters without new tools, with some arguing that disclosure and reliance on current substantive law is sufficient. Unmistakably, however, any such ability of the IRS depends on courts to interpret the economic substance/business purpose doctrines to give the IRS a high probability of success when it finds transactions aimed purely at wholesale elimination of tax liability.

One reason the circuit courts performed so poorly in Compaq and IES is that they were confused by a relatively novel tax sheltering twist.

Several years ago, it seemed that courts were fulfilling this role. A series of decisions on a variety of shelters came out in favor of the government. This had much to do with the role of the Tax Court in the initial stages of the litigation, although appellate courts had been backing the Tax Court in some decisions. But lately there has been a run of taxpayer victories in the appellate courts. Most recently, *Compaq v. Commissioner*¹ placed the Fifth Circuit alongside the Eighth Circuit, in *IES v. Commissioner*,² by reversing the Tax Court and upholding a pair of purely tax-motivated cross-border dividend stripping transactions.

Whatever the broader merits of specialist as compared to generalist courts in tax matters, the recent performance of the generalist appeals courts in this area has frequently been appalling. They have too often failed to understand the doctrines they are applying,

¹2001 U.S. App. LEXIS 27297, 88 AFTR Par. 2001-5665, *Doc 2002-184* (14 original pages), 2002 TNT 1-5 (Dec. 28, 2001).

²253 F.3d 350, *Doc 2001-16769* (16 original pages), 2001 TNT 116-12 (8th Cir. 2001).

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This report argues that the recent decision of the Fifth Circuit in *Compaq v. Commissioner* is seriously misguided and may have adverse consequences for the tax system if not reversed either by the Supreme Court or legislatively. In particular, it criticizes the Fifth Circuit's discussion of the pre-tax profit and business purpose requirements, and argues that these requirements should be interpreted in light of the purpose that antiabuse doctrines serve, which is to filter out tax arbitrage transactions that appear likely to be socially undesirable.

Table of Contents

I. Introduction	511
II. A Quick Primer on Tax Shelters	512
A. Tax Shelters Using Losses	512
B. Tax Shelters Involving Foreign Tax Credits	513
III. The Lower Court Decisions	514
IV. Appellate Reversals of <i>Compaq</i> and <i>IES</i> ...	515
A. Pre-Tax Profit	515
B. Economic Risk	516
C. Genuine Multiparty Transaction	516
V. Possible Consequences of the Decisions ...	517

the rationales for those doctrines, or the consequences of taxpayer victories. The Fifth Circuit decision in *Compaq* makes this particularly clear. In this report, we analyze what is wrong with *Compaq* (and *IES*), what these decisions mean and their possible consequences, and what should be done legislatively if not (as we hope) reversed by the Supreme Court.

II. A Quick Primer on Tax Shelters

One reason the circuit courts performed so poorly in *Compaq* and *IES* is that they were confused by a relatively novel tax sheltering twist. Typically, tax shelters rely on arbitraging current deductions against deferred or excluded income, to create tax losses in excess of economic losses. These transactions have induced the development of anti-tax shelter doctrines that emphasize the potential for pre-tax economic profit (often lacking in these deals due to the need to compensate the promoter). In *Compaq* and *IES*, however, the game was to arbitrage phantom taxable income (from amounts paid as taxes to foreign governments) against foreign tax credits.

Given this modest innovation, sensible application of the pre-tax economic profit doctrine required some glimmer of comprehension of why it was developed, what purposes it serves, and what the different types of tax shelters have in common. This, however, was evidently too much to ask of the circuit court judges in *Compaq* and *IES*.

A. Tax Shelters Using Losses

Loss tax shelters typically rely on exclusion or deferral, enhanced by tax arbitrage, to create tax benefits that often are potentially unlimited. The classic case remains (after all these years) *Knetsch v. United States*,³ in which an individual purported to borrow \$4 million at a 3.5 percent interest rate so that he could invest this money, with the purported lender, at only a 2.5 percent return that was tax-deferred. He thereby arranged to earn \$100,000 per year at a cost of \$140,000 per year.

The transaction may initially remind one of the old joke where someone says he is in the business of making change, in the amount of five quarters for every dollar. "How can you stay in business doing that?" he is asked. "That's easy," he replies. "I make it up on volume." Knetsch, however, thought he had a better rationale than this for the deal. Deducting \$140,000 per year (with no offsetting current inclusion) would go well beyond merely making up his annual \$40,000 pre-tax loss (at least until the transaction unwound in an anticipated 30 years), in an era when marginal tax rates exceeded 90 percent.⁴ The Supreme Court, however, struck down the transaction as a sham, finding that it lacked economic substance and served no nontax business purpose, as evidenced by the lack of any

reasonable prospect of a pre-tax profit.⁵ Knetsch therefore ended up not even being permitted to deduct his out-of-pocket loss.⁶

One can easily see why this decision was important and meritorious, notwithstanding that the particular black letter rules at issue had been changed six years before the Supreme Court decision specifically to block *Knetsch*-type deals. Arbitrages of this sort are potentially unlimited. For example, Knetsch could just as easily have purported to borrow and invest \$40 million or for that matter \$4 billion, rather than just \$4 million, if he had needed more deductions. The circularity of the transaction ensured that it would not subject him to any downside economic risk, or alter market interest rates even if thousands of taxpayers did the same deal.

The application of antiabuse doctrines is not limited to "pure" tax arbitrages like *Knetsch*, where potential volume is unlimited since "the taxpayer essentially buys and sells [or borrows and lends] the same asset."⁷ Even regarding genuine financial assets issued by true third parties, the tax system may suffer if taxpayers face no constraint on stripping favorable tax attributes from the assets for use in arranging arbitrages. A well-known example where the doctrines applied to the purported purchase of a genuine third-party financial asset is *Goldstein v. Commissioner*.⁸ In *Goldstein*, the court treated a leveraged purchase of Treasury bonds as a sham because the transaction created a pre-tax loss and had no significant nontax motivation.

Antiabuse doctrines are needed to impede transactions like those in Knetsch and Goldstein because it is impossible for drafters of the tax law to anticipate each and every interaction of the various tax rules.

Antiabuse doctrines are needed to impede transactions like those in *Knetsch* and *Goldstein* because it is impossible for drafters of the tax law to anticipate each and every interaction of the various tax rules. Inevitably, there will be some unforeseen interaction of the tax rules so that, if one arranges one's affairs in just the

³It is worth noting that Knetsch's chance of earning a pre-tax profit was not actually zero. He had the right to keep on earning at 2.5 percent without continuing to borrow further amounts each year at 3.5 percent. Thus, if the prevailing market interest rate at which he could borrow had dropped sufficiently below 2.5 percent, he could have ended up profiting before-tax from the transaction. This possibility did not, however, sway either the Supreme Court or the two lower courts that heard the case to rule in Knetsch's favor.

⁴See *Knetsch v. United States*, 348 F.2d 932 (Ct. Cl. 1965), cert. denied 383 U.S. 957 (1966).

⁵C. Eugene Steuerle, *Taxes, Loans, and Inflation: How the Nation's Wealth Becomes Misallocated* 60 (Washington, D.C., Brookings Institution, 1985).

⁶364 F.2d 734 (2d Cir. 1966), cert. denied 385 U.S. 1005 (1967).

³364 U.S. 361 (1960).

⁴See Daniel N. Shaviro, "Knetsch v. United States and Judicial Doctrines Combating Tax Avoidance," forthcoming in Paul Caron (ed.), *Tax Stories* (2003).

right manner, magic happens. While these unforeseen interactions can be corrected once they are discovered, continual correction creates undue complexity and prevents policymakers from focusing on other issues. Moreover, if the corrections apply prospectively only, this approach creates a rush to market as taxpayers and promoters try to find new deals before they are shut down.

The antiabuse doctrines try to stop this vicious circle by interpreting the tax law so that odd interactions will not produce tax benefits, at least when taxpayers purposefully try to exploit them by arranging deals that lack any significant economic significance and nontax rationale. The doctrines thereby reduce the overall complexity of the tax law, free policymakers to focus on important issues, and reduce incentives on taxpayers and their advisers to seek out and develop new shelters.

A common complaint about antiabuse doctrines is that they treat similarly situated taxpayers differently. For example, the business purpose doctrine may result in treating the same set of events differently based on the purpose underlying their occurrence. However, this is entirely consistent with many other fields of law (think of the scienter requirement in securities law, the good faith requirement on contract law, and so forth). It also is good policy. Searching out and developing tax shelters is an entirely wasteful activity. Engaging in real business transactions is a useful activity. We have good reasons to distinguish these types of transactions. As Mark Gergen has put it, "you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it."⁹

Another common complaint about antiabuse doctrines is that they inhibit so-called legitimate tax planning. But we should always keep in mind that even the most mundane tax planning is not the same as, say, curing sick people, inventing a new product, or even driving a bus. Waving the flag of legitimacy does not turn tax planning into a productive activity, and if effective antiabuse doctrines sometimes cover more than we might ideally want, they do no real harm to the economy. Concerns about over-breadth should not prevent us from having effective antiabuse doctrines.¹⁰

A final crucial point about the antiabuse doctrines is that they must be interpreted, as they are best ration-

alized, in terms of what they are trying to accomplish. Why, one might ask, should we care how the taxpayers in a transaction allocate the economic risks among themselves? Why require a reasonable prospect of pre-tax profit when any economically rational taxpayer will only care about the after-tax return? And why strike down transactions where the expected pre-tax return is literally negative, but not those where it is negative in an opportunity cost sense (for example, because you buy municipal bonds that offer a lower pre-tax return than otherwise identical corporate bonds)?

The answer is that the doctrines do not seek to achieve logical precision, or to detect and reward moral purity. They are instead simply devices for roughly identifying a socially harmful set of transactions without attacking those that Congress plainly meant to encourage. The business purpose doctrine, the economic substance doctrine, and related antiabuse doctrines can be effective because taxpayers often refuse to do these tax-motivated deals if required to accept undesired economics, such as bearing significant downside risk. Similarly, the requirement of pre-tax profit is often effective because if you must pay a shelter promoter a fee but are otherwise trying to do nothing, you are almost bound to end up with a pre-tax loss.¹¹ Taxpayers engaging in real transactions accept downside risk, have a purpose, bear changes in their economic positions, and expect to make money. The doctrines are merely rough sorting devices and, at a minimum, should be interpreted to separate transactions designed purely at wholesale tax elimination from real business transactions. There is also no single "correct" antiabuse rule that can be codified into a mathematical formula that satisfies the tax lawyer's natural desire for tidiness. Instead, we use multiple, sometimes conflicting doctrines, to try to filter out the transactions that seem likely to be relatively bad.

B. Tax Shelters Involving Foreign Tax Credits

Historically, most tax shelters have involved the use of tax arbitrage to create losses that can be used to shelter other income from tax. However, shelters can work just as well (or perhaps even better when marginal rates are so far below the 90 percent level of the *Knetsch* era) by arbitraging credits, such as the foreign tax credit, against phantom taxable income, with the aim of sheltering other foreign-source income from U.S. tax.

To illustrate a basic tax planning opportunity associated with foreign tax credits, suppose a U.S. multinational that is excess-limit makes a new investment abroad, earning \$100 that does not qualify for deferral and paying \$35 of foreign tax. This is a wash from a U.S. tax standpoint, since the credit equals the U.S. tax liability on the pre-foreign-tax income. Suppose, how-

⁹Mark Gergen, "The Common Knowledge of Tax Abuse," 54 *SMU L. Rev.* 131, 140 (2001).

¹⁰Another common criticism of antiabuse doctrines is that they violate congressional intent by denying the treatment explicitly set forth by the statute. To the extent this argument holds (and we question its validity in any event), it merely shows the need for congressional action rather than that antiabuse doctrines should be abandoned. In addition, Congress has long legislated without protest against the background of antiabuse doctrines, going back at least to *Gregory v. Helvering*, 69 F.2d 809 (2nd Cir. 1934), *aff'd* 293 U.S. 465 (1935). Moreover, it would appear that in practice, Congress more commonly codifies than reverses the bottom-line result in antiabuse cases — as happened, for example, with respect to the transactions at issue in *Gregory*, *Knetsch*, and *Compaq*.

¹¹A pre-tax profit requirement may be ineffective, however, if the taxpayer builds a positive return into the deal by advancing money to the promoter at a below-market but positive interest rate. In effect, rather than paying the promoter \$X, the taxpayer accepts a market rate of return, minus \$X, on the associated loan.

ever, that the multinational could arrange instead to earn an extra \$1,000 from a foreign business partner or counterparty, with the entire \$1,000 then being taxed away by the foreign government. (The business partner or counterparty that paid it the extra \$1,000 might, for example, be informally controlled or secretly compensated by the government that got the money back in tax revenues.)

All of a sudden, the American company would be clearing the same \$65 in pre-tax cash as previously. However, it would also be reducing its U.S. tax bill by \$650 (the \$1,000 of foreign tax credits minus the \$350 U.S. tax on the extra phantom income created by not deducting the foreign taxes). Any sophisticated observer would realize that this was a tax arbitrage, fundamentally similar to *Knetsch* even though it arbitrated tax credits against phantom income rather than current deductions against deferred gain. As we will see, however, the Fifth Circuit in *Compaq* would completely misunderstand this. Look at the big enhancement to the pre-tax profit (it would evidently say) — obviously this is a business deal, not a tax deal!

The tax law has responded in various ways to this arbitrage potential. Consider, for example, section 901(i), denying the credit for taxes that are offset by a subsidy, whether paid to the taxpayer itself, a related party, or a transactional counterparty. Or consider the regulation limiting foreign tax credits for taxes that have in effect been specially allocated to the U.S. shareholders in a foreign corporation.¹²

Most recently, the IRS issued Notice 98-5,¹³ addressing various instances of “foreign tax credit abuse.” Example 1 in the Notice, its simplest illustration of an abusive transaction, is worth reviewing briefly. An expiring foreign copyright has one remaining payment due, in the amount of \$100, subject to a \$30 withholding tax. The day before this payment is due, an excess-limit American taxpayer buys the copyright for \$75. It thereby loses \$5 before U.S. tax, by reason of getting only \$70 back the next day. However, it also acquires \$30 of foreign tax credits, along with \$25 of phantom U.S. taxable income. The result, if it pays tax on the phantom income at the 35 percent corporate rate but can use all of the credits, is permanently to reduce its U.S. tax liability by \$21.25, without its really having had to do anything other than arrange a short-lived circle of cash flows.

For this transaction to work, the market price of the foreign copyright must not reflect the full value of the foreign tax credits to excess-limit U.S. taxpayers. (Otherwise, the copyright would sell for \$100 and the deal, even if it had zero transaction costs, would merely be an after-tax wash.) However, various taxable foreign assets are traded in markets where the marginal purchaser does not value U.S. foreign tax credits. All that this requires is that either tax-exempts or locals (who have no U.S. or other overseas tax liability to offset) be the key participants in a given market. Needless to say,

¹²Treas. reg. section 1.902-1(a)(9)(iv).

¹³1998-1 C.B. 334, *Doc 98-175 (16 pages)*, 97 TNT 247-3.

there are a lot more worldwide investment dollars held by persons in these categories than by excess-limit American multinationals.

If transactions like Example 1 from Notice 98-5 are allowed to work, foreign holders of taxable foreign assets throughout the world have the equivalent of a license to strip and sell the foreign tax credits off these assets. The stripped-off credits would go to excess-limit U.S. taxpayers, without requiring these taxpayers to burden themselves with the actual economics (such as downside risk) associated with the assets. Allowing this would certainly be a generous act on the part of the U.S. Treasury. It would amount to deputizing American taxpayers to circle the globe looking for foreign taxes for the Treasury to reimburse, up to the point where we effectively have a territorial system for taxing passive income. This is not, however, a policy that very many American taxpayers are likely to relish, apart from those doing the deals.

III. The Lower Court Decisions

The deals in *Compaq* and *IES* had a great deal in common with Example 1. Pursuant to the ministrations of Twenty-First Securities, the shelter promoter, the taxpayers engaged in pre-wired deals whereby they ostensibly bought foreign stock cum dividend and then promptly sold it ex dividend.¹⁴ The before and after-dividend prices differed only by the dividend net of withholding tax, rather than reflecting the value of foreign tax credits to excess-limit American taxpayers. Thus, ignoring transaction costs (such as Twenty-First's million-dollar fee), the taxpayers ended up with net taxable income — but also foreign tax credits — in the amount of the foreign withholding taxes paid on the dividends.¹⁵

In both *Compaq* and *IES*, the relevant lower court disallowed the claimed foreign tax credits (among other sanctions) on sham transaction grounds. In some respects, these decisions may not have been explained as lucidly as one might have liked. The Tax Court in *Compaq* strongly tipped its hand regarding its visceral dislike of the deals, perhaps without sufficiently explaining how its decision fit into the broader landscape of antiabuse doctrine. The district court in *IES* merely held the transaction to be a sham without further analysis.

The Tax Court did, however, forthrightly adopt the IRS view that the pre-tax profit requirement of existing antiabuse law be applied after deducting foreign taxes. This kept the test realistic in terms of how taxpayers evaluate tax-motivated foreign tax credit deals. (No sane taxpayer would participate in such a deal by

¹⁴More specifically, they bought American depository receipts (ADRs) that are used to trade foreign stock in United States exchanges with less regulatory inconvenience.

¹⁵Specifically, the entire pre-withholding tax dividend was taxable income, while the sale of the stock yielded a capital loss in the amount of the after-tax dividend. Given this capital loss and section 1211, only taxpayers with substantial capital gains to offset could benefit from the transaction.

reason of valuing the phantom income created by disregarding foreign taxes.) The Tax Court thereby preserved the ability of the pre-tax profit test to address deals that arbitrage foreign tax credits against phantom taxable income, to the same extent (be it great or small) that the test has for decades addressed deals that arbitrage current deductions against excluded or deferred income.

IV. Appellate Reversals of *Compaq* and *IES*

In holding for the taxpayer, the Eighth Circuit in *IES* and then the Fifth Circuit in *Compaq* made three main arguments, each of which we consider in turn.

A. Pre-Tax Profit

The main ground on which the circuit courts based their argument pertained to their view of pre-tax profit. They held that the United States must treat foreign taxes and domestic taxes the same way, so that in computing pre-tax profit, one ignores them both. Armed with this view of foreign taxes, the transaction appears profitable because *Compaq* is treated as receiving and making a profit on the foreign taxes withheld from the dividend.

The courts based their argument on *Old Colony Trust Company*,¹⁶ in which we learn that there is no difference between the income paid by an employer directly to an employee and that paid indirectly, such as to discharge the employee's tax or any other obligations. The withheld taxes were never received by *Compaq* or *IES*, but under *Old Colony*, this makes no difference.

The *Old Colony* principle, however, is totally irrelevant to *Compaq* and *IES*. The question is not whether gross dividends are includable in a shareholder's income notwithstanding that they include foreign taxes that have been withheld. Instead, the question is how we should interpret "pre-tax profit" for purposes of applying antiabuse doctrines that are aimed at impeding certain types of economically meaningless tax arbitrages that would otherwise work as money machines draining money from the U.S. Treasury. The courts' treatment of foreign taxes opens the door to arbitrages similar to those found in *Knetsch* and *Goldstein* and that the economic substance, pre-tax profit, and related doctrines are designed to prevent. It is not a reasonable reading of these doctrines because it guts their very purpose.

Moreover, there is no principle of tax law or good sportsmanship that requires treating foreign taxes the same as domestic taxes. From the taxpayer's perspective, which one they pay may be a matter of indifference. But from the U.S. perspective, we care immensely — foreign taxes are not the same as U.S. taxes. While the foreign tax credit and other elements of the international tax regime sometimes try to mitigate the differences between the two, in no way are they the same thing. The most they have in common is that they both happened to be taxes, but this is no reason that the pre-tax profit requirement has to treat them the

same. It is hard to make any sense of the Fifth Circuit's complaint that the IRS "consciously . . . stack[ed] the deck" against finding transactions profitable in Notice 98-5, by keeping U.S. taxes but not foreign taxes out of the pre-tax profit computation. Notice 98-5 treated foreign taxes differently from domestic taxes because, in the particular circumstances described in the notice, they were different — in economic incidence (since the U.S. taxpayer was not bearing them) as well as effect on the revenue interest of the U.S. government.

To be sure, there are many cases where a foreign transaction without a pre-tax profit (net of foreign taxes) is not a sham meriting disallowance. Suppose, for example, that a U.S. company borrows at 8 percent to make a genuine investment, over a significant period (say, a year), in a foreign bond or business opportunity that is expected (subject to the standard credit or business risks) to earn 10 percent before foreign tax and 7 percent after foreign tax. This, presumably, is not a sham, despite the lack of pre-tax profit as computed net of foreign tax. The taxpayer actually took an economic position in a deal that was not pre-wired or transitory like the supposed investment in *Compaq*. The taxpayer also bears the cost of the foreign tax, unlike *Compaq*. By contrast, the ADR trades were designed so that the payment of foreign taxes was economically irrelevant to the taxpayer. The taxpayer who borrows to make a real investment in foreign bonds therefore needs relief from double taxation, unlike *Compaq*.

All this shows, however, is the need to examine the overall facts and circumstances, rather than focusing excessively on a single indicator such as pre-tax profit. Borrowing at 8 percent to hold municipal bonds that pay at 6 percent is not inherently a sham transaction. And likewise, what made the transaction in *Goldstein* a sham was not just the expected pre-tax loss but the fact that the transaction reflected not "mixed motives" as between tax and nontax, but an absence of "purposive activity," taxes aside.¹⁷

Discussions of pre-tax profit, in some ways, are always surreal. The only meaningful number is after-tax profits. Perhaps this is why the courts got so confused. The pre-tax profit doctrine is not designed to measure some ultimate economic value. Instead, it is supposed to help sort socially harmful tax arbitrages from real business transactions, and it must be interpreted in this light. The courts failed to understand this and, as a

¹⁶279 U.S. 716 (1929).

¹⁷*Goldstein*, 364 F.2d at 741. Given the limited significance of the pre-tax profit test as merely an input into the inquiry into economic substance, we do not wish to be too doctrinaire about the "right" way to compute it. Thus, one could just as well say either (a) pre-tax profit is always computed net of foreign taxes, but a transaction will not be treated as a sham absent other indicia of its lacking economic substance, or (b) pre-tax profit is computed gross of foreign taxes except where there are other indicia of a lack of economic substance that indicate a need to compute it net of foreign taxes. Regardless of which approach one takes, it is important to remember the role of the test as one of a number of filtering devices designed to help taxpayers, the IRS, and the courts identify illegitimate transactions.

result, misapplied the doctrine to allow precisely what it is designed to prevent.

Whatever the unstated rationale, the Fifth Circuit effectively treated the intent to arbitrage phantom taxable income against foreign tax credits, to shelter other income from U.S. tax, as itself evidence of the requisite nontax business purpose. The tax planning therefore bizarrely validated itself, even though it was conceptually the same as arbitrating current deductions against deferred or excluded income for identical sheltering purposes, as in cases such as *Knetsch*.

What the courts in *Compaq* and *IES* had to say about economic risk was no less misguided than their discussion of pre-tax profit.

The Fifth Circuit closed its embarrassing critique of the IRS position on pre-tax profit by stating that in *Compaq* itself, “[a]lthough the United States lost \$2.7 million in tax revenues as a result of the transaction, that is only because the Netherlands gained \$3.4 million in tax revenues.” This is entirely mistaken. The Dutch were going to get their \$3.4 million whether *Compaq* engaged in the ADR transaction or not. They did not get the revenues “as a result of the transaction.” All that was at issue was whether the United States would in effect rebate the Dutch taxes. And it is hard to see why we should want to rebate foreign withholding taxes on dividends when no U.S. taxpayer has either held an economically significant position in the stock or borne the taxes economically.

B. Economic Risk

What the courts in *Compaq* and *IES* had to say about economic risk was no less misguided than their discussion of pre-tax profit. On the topic of risk, the decisions have two main themes. First, they turn prior antiabuse doctrine on its head, by treating the avoidance of risk, rather than the acceptance of risk, as the harbinger of nontax business purpose and consequent legitimacy. Thus, *IES*, in language that *Compaq* cites approvingly, states that the taxpayer’s “disinclination to accept any more risk than necessary . . . strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.”¹⁸

One pities poor Mr. Knetsch, who did not find a court perceptive enough to realize that he must have been engaged in a legitimate business deal because he borrowed the \$4 million nonrecourse. From a broader standpoint, of course the courts were right that it makes sense for taxpayers to limit risks that they do not want to bear. But this is a complete non sequitur with regard to how one should apply antiavoidance doctrines. The economic substance and business purpose requirements focus on economic risk — those the taxpayer bears, not those she manages to avoid — as

¹⁸*IES* at 355; *Compaq* at 15.

a filter and to deter pure paper-shuffling that serves solely to generate tax benefits.

The reading of the risk requirement in these cases gets it about as wrong as one can. They treat eliminating risk as a sign of legitimacy. Transactions can be completely pre-wired, and yet treated as exposing taxpayers to sufficient risk precisely because risk is eliminated. Both bearing risk and eliminating risk satisfy the doctrine, rendering it meaningless.

Second, the courts claimed that the taxpayers actually did bear risks that “were not by any means insignificant.” Supposedly, market prices could have changed in mid-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 differed from the pre-announced amount.¹⁹ For that matter, an asteroid might have struck the Earth in mid-transaction, making the transaction by no means risk-free.

In fact, the *Compaq* and *IES* transactions appear to have been complete shams. According to the expert report in *IES*, the purchase and sales prices in the transactions were pre-arranged.²⁰ Before the consummation of the first leg of the transaction (in which *IES* purchased ADRs from the counterparty cum-dividend), *IES* agreed to the terms of the second leg (in which *IES* sold the same ADRs to the counterparty ex-dividend). The Tax Court in *Compaq* similarly found that the transactions were “predetermined and designed . . . to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction.”²¹ The circuit courts ignored these facts. If they had not done so, however, they evidently would have viewed this pre-wiring as validating the transactions all the more, by demonstrating *IES*’s and *Compaq*’s good business sense.

C. Genuine Multiparty Transaction

The final ground on which the courts in *Compaq* and *IES* reversed the Tax Court was that the ADR transactions “had not been conducted by alter egos or by straw entities created by the taxpayer simply for the purpose of facilitating the transactions. Instead, ‘all of the parties involved were entities separate and apart from the taxpayer, doing legitimate business before . . . [the ADR trades] and (as far as we know) continuing such legitimate business after that time.’ Each individual ADR trade was an arm’s length transaction.”²²

This, of course, was equally true in *Knetsch*. The taxpayer in that case had no relationship to the life insurance company that sold him the deal. It presumably engaged in the life insurance business both before and afterwards. The government did not argue that the parties had agreed to anything but an arm’s length interest rate on either of the transaction’s two offsetting

¹⁹*Compaq* at 24. See also *IES* at 355.

²⁰See Affidavit of Defendant’s Expert Economist David J. Ross, in the district court record in *IES*.

²¹*Compaq*, 113 T.C. at 219.

²²*Compaq* at 15-16 (partly quoting *IES* at 356).

legs. And it agreed that the asset he purported to purchase had genuine legal existence under state law.

It is true that the use of alter egos and straw entities is sometimes an important element in sham transactions, and one that the courts will focus on.²³ But, since it is only one mechanism for sham, and entirely unnecessary to the construction of tax arbitrages that lack nontax significance, the Fifth and Eighth Circuits were not entitled to crow as they did about the absence of these mechanisms here.

V. Possible Consequences of the Decisions

We do not want to make too much of a pair of erroneous opinions by appellate courts. *Compaq* and *IES* might end up merely being added to the list of pro-taxpayer cases that appear in the string cites of legal briefs and judicial decisions. Moreover, at their narrowest, the decisions apply only to pre-1997 dividend strips. The loophole that allowed the transactions has been closed. What is more, transactions designed to transfer tax benefits to those who can make the best use of them are in a sense mundane, since they are done every day through leasing transactions, partnership special allocations, and the like.

Nonetheless, even under a narrow reading, *Compaq* and *IES* are bad news. They add to the vicious circle whereby taxpayers rush to exploit flaws in the law, leading to legislation designed to eliminate the flaws once exposed. The decisions strengthen incentives to discover the next shelter, in the hope that it will work until corrective legislation that is directly on point takes effect. Aggressive tax shelter promoters stay in business due to decisions like this. Even at their most narrow, *Compaq* and *IES* are abdications of the courts' responsibility in the tax system.

Moreover, the decisions are unlikely to be so limited. Section 901(k) applies only to dividends. As noted above, other types of payments that may be subject to foreign withholding taxes, such as royalties, leases, interest coupons, and other payments, can also be stripped. *Compaq* and *IES* open the door to a broad array of foreign tax credit planning. More generally in the foreign area, the decisions water down, if not eliminate, the pre-tax profit requirement, by measuring profits gross of foreign taxes. Money-losing transactions can thereby be treated as profitable, with the underlying tax arbitrage that they exploit to shelter other income absurdly validating the deals.

The decisions will also have consequences for domestic tax planning, particularly regarding the business purpose requirement and the risk component of the economic substance requirement. If treated as authoritative, *Compaq* and *IES* effectively eliminate the risk requirement from the law. They also treat what no sane person would have done absent taxes as having sufficient business purpose. These were purely tax-motivated transactions, manufactured by a promoter and sold to taxpayers who cared not a whit about the

nontax effects (except to ensure that they were negligible). The courts' versions of the risk and business purpose requirements could apply far outside foreign tax credits — for example, to purely domestic financial transactions and partnership transactions, both of which are fertile soil for shelters.

Finally, atmospheric matter. The perception that taxpayers can get away with money-losing deals that are completely pre-wired may cause a rush to market beyond the obvious trading of foreign tax credits.

What should be done? Perhaps the government should try to take the case to the Supreme Court. We have no confidence that the Supreme Court will do any better given its recent decision in *Gitlitz*,²⁴ but it might be worth the gamble. If the government does decide to try, we believe that *Compaq* is clearly worthy of *certiorari*. Apart from its freestanding importance, it is significantly at odds with the approach to corporate tax shelters taken by other circuits, such as the Third Circuit in *ACM*.

Compaq and IES show that disclosure alone is not sufficient to shut down tax shelters. If the deals work even when challenged and litigated, disclosure is nothing more than free publicity.

The courts' misguided and potentially dangerous view of pre-tax profit should not be allowed to stand. If the Supreme Court does not grant *certiorari* and reverse, then the IRS and Tax Court, in cases appealable to other circuits, should stick to their guns. Moreover, the Treasury should not hesitate to use its regulatory authority (as it suggested it would in Notice 98-5) to give added legal muscle to the IRS position on pre-tax profit in foreign tax credit deals. Finally, Congress should consider addressing this matter legislatively. Any such legislation should be retroactive, to prevent making this yet one more case in the vicious circle of shelters followed by prospective legislation followed by more shelters. Any claim that taxpayers did not have fair warning would be specious in light of Notice 98-5.

Compaq and *IES* also show that disclosure alone is not sufficient to shut down tax shelters. If the deals work even when challenged and litigated, disclosure is nothing more than free publicity. The view that it is sufficient requires taking a Panglossian view of likely judicial outcomes, and these cases may disabuse us of any such notion.

Although we are sympathetic to disclosure that helps IRS auditors to understand and trace transactions, what is needed as well is legislation enacting strong substantive antiabuse rules. We take no view here on the particular form of these rules. Treasury's proposed codification may have had flaws, and perhaps the doctrines should deliberately be left vague,

²³See, e.g., *Gregory v. Helvering*, *supra* note 10.

²⁴531 U.S. 206 (2001).

COMMENTARY / SPECIAL REPORT

like the common law. But at a minimum, the *Compaq* court's version of the risk requirement and pre-tax profit requirement should be overturned. Moreover, the legislation should require significant economic substance and a dominant business purpose for a transaction to be respected (in addition to clarifying

that pre-tax profit, to the extent relied on, is to be determined net of foreign taxes). This would be a change from current law, unlike prior proposed codifications of antiabuse doctrines that claimed to merely restate current law, but it is a change that is necessary.

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TNW1-01

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