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This special report presents the committee report and statutory language for a mock bill, named the "Anti-Skunk Works Corporate Tax Shelter Act of 1999." The format follows a real committee report, with a description of current law, an explanation of the reasons for change, and an explanation of the statutory language. The statutory language of the mock bill follows the mock committee report.

Professor Johnson argues that corporate tax shelters have increased in recent years in part because of aggressive marketing by "skunk works" operations in the largest accounting, investment banking, and law firms, set up to create and market the shelters. The corporate tax base, he claims, is under assault by a large army of motivated, well-trained, and vicious professionals. Johnson would defend the corporate tax base with three separate strategies.

Title I of the bill enacts general antiabuse rules that codify and restate the equitable antiabuse doctrines already in the judge-made common law of taxation. Title II of the bill would create a number of procedures and penalties that would reinforce the self-assessing system under which corporations report tax accurately on their returns in the first place. Title III recommends a series of rifle shot reforms closing specific loopholes. Johnson argues that the difficulty of identifying, diagnosing, and curing the specific loopholes means that the specific rifle shot reforms are necessary but will not be sufficient.

Johnson adds: "Many of the ideas in this special report have an identifiable source other than me. Professor Alan Feld of Boston University is responsible for the idea of separating audit and tax shelter consulting functions. Professor Joseph Bankman of Stanford taught me about basis-replication shelters. Professor Steven Bank of Florida State taught me about divisive mergers. Professor Mark Gergen of Texas Law School taught me about FASITs and tranches. Professor Steve Johnson of Indiana University made helpful suggestions on registration and Professor Ira Shepard of Boston gave advice on life insurance. Professor Joseph Dodge of Texas, Professor Richard Westin of Kentucky, and Professor Linda Galler of Hofstra made helpful suggestions and corrections. I am deeply grateful for their help. I have taken the best of the suggestions from the American Bar Association Tax Section and New York State Bar reports on corporate tax shelters and reacted to them. The residual errors, notwithstanding all the good advice, arise in me."

Corporate tax shelters are the issue of the day. The Treasury has issued its White Paper asking for broad remedies.\(^1\) Practitioner groups give a surprising amount of support to the Treasury, at least to the extent of admitting there is a serious problem.\(^2\) Forbes

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2See, e.g. Statement of Harold R. Handler on behalf of New York State Bar Association before Committee on Finance, Doc 1999-15300 (83 original pages), 1999 TNT 82-29; James P. Holden, "Dealing With the Aggressive Tax Shelter Problem," 52 Tax Lawyer 369 (1999); Testimony of Stefan A. Tucker, on

(Footnote 2 continued on next page.)
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magazine put an article entitled “Hustling of X Rated Shelters” on its front cover, with graphics right out of 
mis noirs like “Chinatown” and “LA Confidential.” Forbes is the magazine of a staunchly anti-tax candidate 
for President. When even Forbes uses film noir images to convey the idea of deep and sinister plots by 
promoters of corporate tax shelters, we know that there is something ugly at the center of our tax system and 
that Congress is going to have to do something about it.

This special report proposes a bill, the Anti-Skunk Works Corporate Tax Act of 1999, that is directed at the 
corporate tax shelter problem. The format of this report copies real legislation. A mock committee report starts 
the report and the text of the proposed bill then follows.

General Reasons for the Act

The number of widely marketed, increasingly aggressive corporate tax shelters has grown significantly 
in the last decade. The Big 5 accounting firms, the international investment bankers, and the largest law 
firms have set up “skunk works” operations to create and market aggressive tax shelters. The shelter shops 
create and exploit fissures in a complicated tax system, with an energy and creativity that could not have been 
anticipated by the Congress that drafted the legislation. The current corporate culture says that loopholes 
must be invented and exploited without limitation until the IRS can stop it. The penalty structure is not 
draconian enough to induce accurate reporting of tax and the IRS is not very good at stopping the loopholes. 
The skunk works shops compete with each other with vigor and viciousness to push the tax shelters, turning 
small cracks into gaping holes in the tax base.

Aggressive shelters are kept as very confidential transactions. Since the shelters continue until dis- 
covered and stopped, confidentiality extends the life and value of the shelter. The legal and institutional 
protections of that confidentiality and limitations on IRS research have effectively prevented reliable statistics 
from becoming publicly available. Still, knowledgeable observers say that the pace of development and 
aggressiveness of the shelters has increased and that corporate receptiveness to tax avoidance has in- 
creased. A corporation with a big economic gain that wants cash and no tax will be inundated, at the asking, 
with proposals for avoiding tax from the competing skunk works operations.

Years of underfunding and demoralization of the IRS have also left the IRS unable to compete. IRS agents 
are undertrained, undervalued, undermotivated, and stretched too thin. The personal liability on agents 
seems to have turned them imbecilic. The IRS does not pay enough, in honor or dollars, to attract recruits who 
can understand the tax system that Congress has adopted. The disparity between well paid private tax 
lawyers and accountants and poorly paid, poorly motivated IRS agents is even worse for older agents. 
The IRS has trouble retaining its best. The IRS is understaffed with respect to the most important transactions, 
compared with the talent and resources devoted to the other side. The IRS can not compete with the big corpo-
rations in the warfare of full-scale litigation. A new, friendlier, pro-customer IRS is also not necessarily the 
best kind of agency to enforce compliance or to defend the tax base against the most vicious skunk works at-
tacks.

The American tax system relies on self-reporting under which taxpayers, with the most knowledge of 
the transactions and familiarity with records, report the tax due on tax returns. But the self-reporting system 
needs more support than it is getting from Congress. The incentives facing corporations now encourage 
corporations to purchase tax-avoidance shelters and underreport income. On average and over time, a corpo-
ration can now be confident that the purchase of a loophole and the underreporting of income will be 
more profitable than full and fair reporting of tax due. The self-reporting system that has been a pride of 
American law in the past has now been left in shambles.

Making the self-reporting system work again and defending the tax base will require a number of over-
lapping defenses. No single line of defense is sufficient. If a platoon wants to hold the perimeter against attack 
by overwhelming numbers, it needs to set up more than a single strand of barbed wire; it needs layer upon 
layer of defense. So too, defense of the corporate tax base and the self-reporting tax system requires a num-
ber of layers of defense.

The optimal tax system has a fair and broad tax base that allows the rates to be kept low for any given revenue. 
A poorly enforced tax system is a terrible tax system. It maximizes economic harm, for a given level of revenue, 
because it puts irrational exemptions next to overly high rates. It induces economic stupidities to avoid tax. A poorly 
Congress that has lost 

enforced tax system is a system that Congress has lost control of. It is not engineered or rational: it happens by 
accident solely by the luck of whether the taxpayer is caught or can sneak out of the tax.

A tax system that is poorly enforced also allows each corporate taxpayer to determine how much it wants to 
pay to the Internal Revenue Service under its own moral code or conscience, and a corporation should not 
be assumed to have a moral obligation to comply with tax laws. Corporations are non-moral entities with no 
moral obligation to uphold the integrity or fairness of the tax code. They have a strong incentive to beat the 
tax system by any means.

Tax law may be a game, but if it is a game, it is a game that the United States (us) must win:

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behalf of American Bar Association, Tax Section before Ways 
and Means Committee, March 10, 1999, Doc. 1999-9409 (2 
original pages), 1999 TNT 47-65; Statement of Lester D. Ezrati, 
on behalf of TEI before the Committee on Finance, April 27, 
1999, Doc. 1999-15322 (160 original pages), 1999 TNT 81-29; 
hearing reported on by Heidi Glenn, "Archer Sets His Sights 

 and Laura Saunders, “Hustling of X Rated Shelters,” id. at 198.

4See, e.g., Martin Sullivan, “Is Taxpayer Cheating Up or 
In this arms race between taxpayers eager to hold onto as much as they can and tax law eager to stop them, one should bet on the taxpayers. ... Like disobedient children taxpayers have a great deal of ingenuity, a natural bent for coming up with new and not-yet-forbidden ways of doing the sort of thing the rules seem to be trying to forbid. They also have a taste for doing just that. These talents and inclinations predictably outrun the rulemakers' ability to define prohibited behavior with precision. The legal system is, to some degree helpless.5

A helpless and defenseless federal government, however, with tattered shambles of a tax law is not an acceptable solution.

The Anti-Skunk Works Corporate Tax Shelter Act of 1999, explained here, has three titles collecting three very different kinds of defenses. Title I enacts "General Antiabuse Rules" (GAARS), directing that the words of the Internal Revenue Code be interpreted to reach substance and to avoid abuse. Title II has a series of procedural and penalty provisions supporting the self reporting system and giving the IRS a better chance of finding the shelters and enforcing the law. Title III has specific "rifles shots" changing substantive law to end specific abuses or specific shelters. The Titles are independent of each other: the rifle shot provisions make sense, even if nothing else is adopted.

Title I. Codification of General Antiavoidance Rules

Current law. There is a judge-made common law of tax, which has a number of equitable or antiabuse doctrines. The courts, for instance, determine tax due by looking through the form of a transaction to its substance. Under the sham transaction doctrine, they ignore transactions that have no significant effect on the taxpayer's economic or beneficial interest except for tax. Under the step transaction doctrine, they determine tax by looking at the whole transaction from start to finish, collapsing the intermedi steps into the whole. These and other equitable doctrines are an important part of the legal culture, giving the tax law flexibility and vigor to defend against abuse. The court-made doctrines, however, have never been systematically codified in statutory law. Congress has endorsed the antiabuse rules in committee reports and assumptions, but it has never explicitly endorsed them in the tax statute.

Reasons for change. The court-made equitable doctrines such as substance over form, sham transaction, and step transaction give the law a vigor that helps the law defend against aggressive misinterpretations of the statute to avoid tax.

It is sometimes assumed by the formalistic school of interpretation that the tax law must be clear and simple and that the taxpayer must benefit, and government must suffer, from any ambiguities or misinterpretations of the tax law. That attitude, however, sets unrealistically high standards of perfection for the language for the tax law, which no human product can meet. Tax law is not and never can be a perfect machine that will run by itself to defeat all the aggressive tax plans that would make the tax system worse. When the words are assaulted so energetically with so many resources, the English language and human understanding never reach the level of perfection that the formalistic school expects. Tax laws are made, moreover, not by engineers but by a Congress that represents a broad and diverse democracy. Loopholes can be created in any human tax system unless the system is defend and repaired. Shelters take razor-thin fuses of no material concern and turn them into gaping holes in the tax base. The current corporate shelters also commonly invent misinterpretations of the words, where no imperfection in fact exists in the law.

Given the imperfections of a human Congress and a human-drafted tax code, the judges and administrators who interpret law need to construe the law with good sense and wisdom. The faithful servant loyal to Congress will often need to make judgments appropriate to the facts as they develop when the facts could not or were not anticipated by the congressional drafters. Even Prussian generals in battle receiving mandatory orders from headquarters know that the facts on the ground sometimes trump or reshape the orders. Judges need to take responsibility for the just results of their interpretations and they need to eschew absurdities and inequities. Judges are not absolved from the harm that they do because Congress could have written up the intent somewhat better. Judges and administrators need to look to substance and interpret the words in context of the structure that Congress intended. Judges and administrators need to make interpretations that make the tax system work. Judges, like all human beings, sometimes make mistakes, and may overreach. But there is no formalistic machine that can replace human wisdom. Congress can always fix the big mistakes.

Our tax law tradition, in fact, rests on an assumption that courts will sometimes act as courts of equity to prevent absurdity and abuse. Every tax lawyer, interpreting the code, knows that a tax plan building a house of cards, constructed from mounds of legal paper and cutesy interpretation of the words, will fall. That tradition of looking to substance is a pride of American tax law tradition that needs to be reinforced. Congress needs to codify the common law equitable or antiabuse rules so as to give judges courage and encourage their use.

Congress has in the past praised the courts for "a commendable tendency to look through the mere form of the transaction into its substance."6 Congress needs

5William J. Stuntz, "Law and the Christian Story," 78 First Things 28 (December 1997) (The author begins the next paragraph saying "I am, of course, exaggerating. After all, the IRS does manage to collect a lot of taxes.").

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to absolve the courts from accusations of judicial activism when the courts reach for equitable results, loyal to the deeper intent of Congress. Codification of the equitable rules should also have the beneficial effect of requiring corporate tax opinion writers to come to grips with the antiabuse doctrines now in place. At the margin, codification may convince some corporations to eschew the more outlandish transactions that depend on reading words out of context or in an overly literal fashion, devoid of rational or equity.

Our trading partners in other countries are adopting “General Antiabuse Rules,” or “GAAR,” with penalties on abuses reaching as high as 100 percent of tax due. The rules are sometimes enacted to imitate the United States tradition of legal realism or to overcome an undue wooden literalism inherent in their local judicial tradition. The definition of abuse in the foreign GAARs is often very vague. German law commands, for instance, that “tax law cannot be circumvented by the abuse of legal constructions. In the case of an abuse, tax will be due as in the case of a legal arrangement adequate to the transactions.”

Our own proud domestic traditions of antiabuse doctrines provide a source of antiabuse rules that are far less vague. The doctrines leave considerable responsibility for interpretation to the judges who see the transaction on the ground after the facts, but many of the doctrines have a 70-year history of interpretation in the courts. The history of the doctrines tames the rules and means that they are not monsters or surprises.

Explanation of proposed section 7812 (codification and restatement of judicial antiabuse rules). Section 7812 of the proposed Anti-Skunk Works Corporate Tax Shelter Act of 1999 codifies a number of judicial or common sense rules that would apply to interpretations throughout the income tax law. Because the provisions are codification of common law or common sense, the effective date of the provisions is coterminous with the effective date of the Internal Revenue Code. The various subsections of new section 7812 are independent. Thus, for instance, the fact that the transaction does not generate tax benefits worth more than cost (so passing subsection (c)) does not mean that steps can not be collapsed (subsection (g)) or that the labels or form did not describe the substance (subsection (a)).

Subsection (a) of proposed section 7812 of the code provides that the amount of any item of gross income, deductions, or credits shall be determined according to the substance of a transaction and not its form. The subsection codifies the long tax law tradition, in effect since at least 1924, that substance governs over form. The doctrine means, for example, that the label put on a document by the taxpayer will not bind the Commissioner or the courts nor prevent them from categorizing the documents according to their true economic nature as determined by a proud and energetic federal tax law. Subsection (a), however, does not authorize a taxpayer to renounce the form set up by its own papers. The subsection, for instance, is not intended to allow a taxpayer to elect the lower tax from either following or renouncing one’s own legal forms.

Subsection (b) provides that transactions which have no significant effect on the taxpayer’s economic or beneficial interest except for tax shall be treated as sham transactions and ignored in the computation of taxable income. Subsection (b) codifies Knetsch v. Commissioner, 364 U.S. 361 (1960). Knetsch involved a scheme in which the taxpayer was said to “invest” $4 million in an insurance company for 2½ percent return by giving an IOU to the insurance company. The interest due on the IOU was higher than the fixed return, so that the taxpayer was guaranteed to lose money, except for tax. Because the investment and IOU were offsetting and the liability was non-recourse, however, there never was any $4 million of capital or resources committed to the project. Each party would point to the other as having the $4 million and no real $4 million was ever there: there was no pea under any of the walnuts. The Supreme Court properly said that the paper created no change in the taxpayer’s economic interest, except for tax, and denied the deductions because shams need not be respected for tax. Under Knetsch, Potemkin Villages, false fronts set up just for tax, do not bind the law. The taxpayer in Knetsch did pay cash for the excess of interest cost over return, and did pay fees in cash, respecting the form, but the real economic cash cost to the taxpayer was less than the value of the tax deductions. Realistically, the taxpayer was buying only tax deductions, at a bargain price.

Subsection (c) provides that notwithstanding any provision of the code, the net present value of tax benefits from a transaction as a whole shall not exceed the net present value of the taxpayer’s economic cost of the transaction. Subsection (c) codifies another restate-ment of the sham transaction doctrine, expressed by

[Weiss v. Starn, 265 U.S. 242 (1924)(saying that under income tax laws, “we must regard matters of substance and not form.”); Higgins v. Smith, 308 U.S. 473 (1940)(saying that if one or other factor in calculation of tax is unreal, it distorts the liability of the particular taxpayer to the detriment of the entire taxpayer group); Commissioner v. Court Holding Co., 324 U.S. 331 (1945)(saying that “to permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress); Basley v. Commissioner, 331 U.S. 737 (1947)(saying that the taxpayer changed symbols and forms in the transaction, but that the form of a transaction opens questions as to the proper application of a taxing statute: it does not close them).]


8Section 42 of the German General Tax Code, as quoted in Id.
In *Emmons v. Commissioner*, the court disallowed interest deductions (which do not need a profit motive nor business purpose) because the transaction was “designed to give deductions in an amount large enough to reduce...taxes in a sum greater than the net consideration or cost of the entire operation.” Having tax benefits greater than the entire cost of the transaction is the *reducio ad absurdum* for a transaction. Transactions with a cost less than the tax benefit have no economic meaning except for tax and no economic constraints except by the courts ripping away the tax benefits. Tax is not supposed to be a profit center.

Subsection (c) disallows tax benefits if tax savings would be more valuable than cost, but the subsection does not set up a negative precedent. It is not intended to imply that transactions that have a cost somewhat in excess of the value of the tax benefits are therefore valid. Generally speaking, a dollar deduction is allowed by the tax code only because the taxpayer has lost a full dollar of ability to pay tax. Transactions with a tax value slightly below the cost to the taxpayer might well still be shams or transactions with a substance differing from the labels the taxpayer has tried to apply. The closer that the cost is to the value of tax benefits and the farther the deducted amount is from false losses, however, the more questionable the transaction becomes.

Subsection (d) of new section 7812 provides that only bona fide losses are to be allowed and that substance and not mere form shall govern in determining the amount of a deductible loss. Subsection (d) is a codification of Treasury regulation section 1.165-1(b)(1977). The requirement that deductible losses must be bona fide would have been an alternative rationale to reach the same result reached in the recent tax shelter case of *ACM Partnership v. Commissioner*.

in which the taxpayer used artificial losses from a partnership, produced by allocating big artificial income to another, tax exempt partner. Enforcement of the long standing regulatory requirement that losses be real to the taxpayer partner and not artificial would have prevented the ACM tax shelter.

Subsection (e) states a presumption that Congress did not intend negative tax, that is, a computation of taxable income or credits in which the taxpayer’s internal rate of return from an investment is higher after tax than it was before tax. A tax shelter, best defined, is a transaction that saves the investor tax that would have otherwise been paid on consumed amounts or other outside income. A tax shelter has a higher rate of return because Uncle Sam tries to run a tax system than it would in the absence of a tax. When Congress adopts favorable treatment, it usually talks about reducing the burden of tax, so that unfettered free enterprise can produce goods efficiently. Negative taxes go beyond freedom from tax for the transaction into corporate welfare or subsidy. Such subsidies waste capital because they induce projects that provide a return that is less than the prevailing interest rates. To be legitimated by the democratic process, subsidies need to be judged by the competitive budget process applied to government spending.

The subsidy from negative tax from deductions, moreover, is upside down to the progressivity of the income tax system. A subsidy tries to get some good accomplished. If two taxpayers pay the same dollars toward the good, it does not make sense to subsidize the richer taxpayer more and the poorer taxpayer less. In an upside down subsidy, the very taxpayer that Congress has judged to be best able to bear tax is the taxpayer that gets the greatest benefit. Such negative tax, upside-down subsidies are presumably always an accident, a result of bad accounting or bad tax law, and not of rational engineering.

Subsection (f) of new section 7812 codifies the step transaction doctrine, under which steps are component parts of an overall plan are collapsed and tax effect is determined from the overall transaction. Under the step transaction doctrine, the courts view the “individual tax significance of each step [as] irrelevant...if the steps when viewed as a whole amount to a single taxable transaction.” ["Taxpayers,"] the courts have said, “cannot compel a court to characterize the transaction solely upon the basis of a concentration on one facet of it when the totality of circumstances determines its tax status.” ["A given result at the end of a straight path,” it is said, “is not made a different result because reached by following a deviant path.” The version of the step transaction doctrine that is codified is the “end-result test” under which steps can be collapsed even if the steps are not shams and have independent significance. As one review of the doctrine put it, there is “precious little collateral support” for the independent significance test and “the end result test is very much the order of the day.”

As codified, the step transaction doctrine is anti-abuse doctrine, applied in favor of the commissioner. Under ordinary circumstances, a taxpayer is not at liberty to redesign a transaction, papered in one way, because it later becomes more advantageous to ignore the steps, especially where another party to the transaction is respecting the negotiated form and gets an advantage from the form chosen. If taxpayers were allowed to disown its form, all flimsy tax planning

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1031 T.C. 26, 31 (1958)(disallowing interest deduction).
11157 F.3d 231, Doc 98-31128 (69 pages), 98 TNT 202-7 (3d Cir. 1998).
12Calvin Johnson, "What’s a Tax Shelter?" Tax Notes, Aug. 14, 1995, p. 879 at 883-884 (1995)(arguing that a tax shelter, best defined, is a transaction in which the return after tax is higher than the return before tax).
13*Crenshaw v. United States*, 450 F.2d 472, 476 (5th Cir. 1971)(transaction that was in form a distribution from a partnership was in substance a sale when all the steps were viewed).
14Id. at 477.
would generate a retroactive election, giving the
taxpayer the choice of either the paper or the substance
depending on which turns out to be better. By contrast,
the commissioner who did not bargain for the steps or
design the form of the transaction has liberty to attack
and collapse steps when the taxpayer itself cannot
renounce its own planned and drafted steps.

Subsection (g), finally, requires that the words of the
statute be interpreted to make sense in the context of the
policy, structure, and congressional intent underly-
ing the text. Words can easily be read out of context.
Language is a very fragile vessel in which the greater
meaning can be lost, especially in the hands of those
who would willfully misread the words. Law, however,
is more than words, just as chorelate is more than just
individual notes, and the words need to be read as part
of the overall scheme of the legislation.17 Binding law
does not consist of just a random or arbitrary set of
words: it needs a satisfying rationale to give it
legitimacy. Subsection (g) thus requires the courts and
administration to make sense of the system enacted by
Congress before being sure of the meaning of separate
words.

Section 7812, as a codification of current antiabuse
rules, does not overrule current cases. In Cottage
Savings v. Commissioner, 499 U.S. 554 (1991), and Frank
Lyons Co. v. United States, 435 U.S. 561 (1978), for
instance, the Supreme Court upheld tax deductions on
transaction that many consider indistinguishable from
Kentsch. In both Cottage Savings and Frank Lyons the
taxpayer entered into transactions to avoid tax and
received tax benefits which exceeded its net costs for
the transaction. In neither case were the pretax eco-
nomic changes material. In Cottage Savings, a fellow
federal agency, Federal Savings and Loan Insurance
Corporation (FSLIC), was using the Treasury Depart-
ment as a profit center to keep bankrupt savings and
loans associations afloat (when the greater duty would
undoubtedly have led FSLIC to close the savings and
loans immediately). Michael Graetz has defined a tax
shelter as “a deal done by very smart people that, ab-
sent tax considerations, would be very stupid,”18 and
both the Cottage Savings and the Frank Lyons transcac-
tions fit the description. Nonetheless, Cottage Savings
and Frank Lyons were taxpayer victories after full litiga-
tion through to the Supreme Court. Cottage Savings and
Frank Lyons may be less than proud branches of the
antiabuse law, but they are precedents that a codifica-
tion must take into account. Section 7812 draws its
legitimacy from common law and applies retroactively,
so it must take the common law decisions as they stand.
But tax judicial doctrine, like the common law general-
ly, can work its way pure. Where the lines of judicial
authority are in conflict, section 7812 is intended to
encourage growth of the better line of cases, which
insists that tax be grounded on substance and eco-

damics.

Section 7812 does not, however, adopt subjective
tests asking whether a corporation’s intent is to avoid
or evade tax. A corporation is an artificial entity that
literally has no mind with which to have an intent. A
corporation is also an economic animal organized to
maximize after tax profit as aggressively as the law
allows. Corporations have no moral commitment to the
tax system or to government revenue. If loopholes are
available, it can be presumed that the corporation will
take advantage of them. Thus, asking a corporation to
have a “good purpose” is moralistic cant that betrays
an absence of analysis of the law and incentives and a
vacuousness about how concrete cases are to come out.
A corporation’s seeking tax avoidance, however, does
not legitimize loopholes nor absolve the corporation
from compliance with the law or penalties. The fact
that corporations are nonmoral tax avoiders by nature
also implies that the penalties and incentives need to
make compliance with the tax law economically rational
for the law to have effect, without regard to the
subjective state of the corporation.

Explanation of proposed section 446(c) (purpose
of accounting is accurate description). Broad antiabuse
rules are added, not just with proposed section 7812,
but also in other more specific areas where abuses have
been especially threatening. Section 446 of the code
deals with broad tax accounting principles. Section
446(b) now provides, for instance, that taxpayer’s ac-
counting must clearly reflect income, in the judgment of
the Treasury. The Act adds a new subsection (c) mandating that the rules of tax accounting shall be
interpreted to result in deductions and income that
give the most accurate feasible description of the tax-
payer’s true economic income for the taxable year, ig-
noring artificial accounting entries and transactions
without economic substance. New subsection (c) tells
the courts to avoid “creative accounting” and artificial
accounting losses. Tax accounting is not just empty
figures, to be manipulated at will. The overall function
of accounting is to describe the taxpayer’s ability to
pay tax, as accurately as possible. Accounting has an
overall mission to reach accuracy, eschewing artificial
entries and recording that fails to reflect the substance.
Subsection (c) also provides that no taxpayer has a
right to creative or artificial accounting merely because
it would save tax. Saying that the mission of accounting
is accurate description should go without saying, ex-
cept that in times when creative accounting becomes
an acceptable tool in some circles, the fundamental
function of accounting needs to be reiterated. Since
section 446(c) codifies principles that have always been
aspirational and prescriptive for tax accounting, the
amendment applies retroactively.

Explanation of amendments to section 165 and 166
(losses and bad debts need to be real). The act amends
section 165(b) and section 166(b) to provide that the
amount of the deduction for a loss shall not exceed the
taxpayer’s bona fide loss of value from the transaction,
viewed as a whole. The Act brings into sections 165 and 166, Treasury regulation section 1.165-1(b)(1977), which has long provided that the amount of the deduction shall not exceed the taxpayer's bona fide loss of value from the transaction and that substance and not form shall govern in determining the amount of the loss.

Explanation of amendments to section 702 (clear reflection of income on the partner level). The Act adds a new subsection (d) to section 702, defining the taxable income of a partner, to require that a partner's deductions or capital losses clearly reflect the partner's income, viewing the partner in isolation from the partnership-level accounting. The intellectual foundation of subchapter K, dealing with partnerships, is that partnerships are transparent entities for tax purposes and that a taxpayer can achieve nothing by use of a partnership that it could not accomplish by outright ownership of the partnership's assets or activities. That foundation is commonly breached by tax planners who use the partnership to create or distill tax loopholes for easy marketing to the highest bracket partners where the loopholes will do the most damage to a sound tax base. The principle that partner losses must have substance at the partner level will be a shocking disruption of normal thinking for many aggressive tax planners who are used to thinking of partnership law as within the ambit of creative accounting and artificial losses.

Tax accounting, however, aspires to clearly reflect income, even for a partner. Losses that are available only because of the mechanism of the partnership format should not be available at all. Losses that are devoid of substance when viewing the partner alone need to be disallowed, even accounting at the partnership level passes challenge. Some errors, for example, that arise from accounting conventions or historical anomalies may be not material when computing partnership income in the ordinary course of its business on the partnership level and yet become unacceptable errors when refined, magnified, and purified for a partner so that they become material to the partner. As drafted, subsection (d) makes all of the general antiabuse rules apply at the partner level, as well as at the partnership level. Application of section 702(d) would be retroactive to transactions going on in this tax year.

Title II. Assault on the Skunk Works: Procedures and Penalties

Reasons for change. Title I of the act is a restatement and codification of the general antiabuse rules developed by the courts, but it will not alone be sufficient to control the current round of corporate tax shelters. Antiabuse rules are developed and applied in litigation. Full-scale litigation is a slow and expensive process, akin to full-scale war. Not one in a million potential tax disputes can or should ever end up in court, so that aggressive tax planners are willing to take their chances. The IRS will never be able to enforce remedies that require full-scale litigation to work.

Title II collects a series of remedies that might help. Section 201 would increase appropriations for the Treasury, specifically to study and combat corporate shelters. Section 202 tells the SEC to consider whether to separate auditing function, where the accountant is the policeman on the line, from the consulting function, where the accountant is seeking to minimize tax. Section 203 provides for the preregistration of certain corporate shelters so that the Treasury has a road map to meet and defeat shelters that are especially threatening to Treasury revenue. Section 204 supports the honest and accurate self-assessment of tax by taxpayers themselves by increasing the penalty when tax must be collected after audit.

Explanation of section 201 (appropriations). Congress knows too little about the tricks that make various tax shelters work to make an informed judgment as to how to fix them. With better information, Congress could design sounder more elegant tax systems that could better survive the assault by aggressive tax planning. At a minimum, with perfect knowledge, Congress could adopt a series of narrow amendments to patch holes quickly. Corporate tax shelters are confidential operations, however, hidden from the scrutiny of the Congress and the public. Hiding or camouflaging the operations means that they will survive longer and erase more revenue. Significant money is needed to comb the files of the skunk works operations to find out the shelter games that are being played just to understand how tax shelters work and to figure out how best to correct the errors that make shelters possible.

Section 201 of the act provides for a supplemental appropriation in the amount of $500 million to collect more information about tax shelters and study how the tax system can be made more shelter resistant. The supplemental appropriation can also be used to achieve better compliance with current law, for instance, to set up the registration of tax shelters provided in section 203 of the Act and to provide for improvement of the auditing and litigating against corporate shelters. The $500 million will be cost-effective for the Treasury, returning to the Treasury many times the appropriation, by way of enforcement and improvement of current law.

In general, this Anti-Skunk Works Act enacts specific changes in the law, but section 201, appropriations, is merely suggestive of what might be done. The Treasury might have a 100 percent audit rate for every
shelter currently proposed by skunk works operations, combing the files both to raise money and to achieve enough understanding of the phenomena to make intelligent proposals. There might be a joint tax force study of the shelters by the Congressional Budget Office, General Accounting Office, and the Treasury Department Office of Tax Policy. The tax force might collect empirical data about shelters, including by means of thorough IRS audit. Collection of data should be done to generate valid statistics that will help the Congress to understand the extent of corporate noncompliance in future years. Economists, social scientists, and lawyers all have expertise that can be brought to bear on the problem. The Department of Treasury should be instructed to hire the best available talent in economics, tax, law, statistics, and empirical research at fair market rates for the period needed to propose amendments to the law to defeat shelters that do not reflect income and that undermine the policy and structure of the tax law. The special appropriation should also be used for compliance with current law. Treasury needs to issue a series of Notices, Revenue Rulings, and Regulations aimed at specific abuses that can be defeated under current law. The IRS should also be hiring aggressive litigators, on a contingency basis, to ensure that enough energy and motivation is devoted to the cases for Treasury to win.

Explanation of section 202 (separating financial statement auditing and tax shelter advice). The traditional function of certified public accountants (CPAs) is solely to audit and review the financial statements provided by public corporations to investors on the public stock markets, as required by Securities and Exchange Commission (SEC) legislation. CPAs have traditionally been the SEC policemen, checking both the facts and application of accounting standards on the financial statements, with an exclusive loyalty to the investing public. In recent years, however, CPA firms have increasingly made money as general business consultants to the public companies they audit, providing advice, among other things, as to how to avoid tax or minimize adverse earnings effects of accounting standards.

The auditing function and consulting function conflict with each other. For auditing, the CPA must be skeptical adverse to the public company so as to enforce candid disclosure of unpleasant facts. The CPA must zealously stand to potential investors. For consulting, by contrast, the CPA firm is loyal to the company, even though that entails less than candid public disclosure of what it knows. Under current practices, the same CPA firm is serving as consigliere and anti-crime task force to the same Godfather at the same time and the system is not working very well.

Much of the conflict between audit and consulting function has no tax ramifications. It is the SEC auditing function that is getting undermined because the CPA, as consigliere, is insufficiently skeptical and insufficiently scathing and candid to the public. The conflict, however, affects aggressive tax shelters for two reasons. Auditing, first, gives the CPA firm access to public companies and an entry for marketing aggressive tax shelters. Without the audit access, the marketing of aggressive shelters would be more difficult. Compromise of the auditing function, secondly, also encourages corporate tax shelters because auditors are less aggressive in insisting on full and candid disclosure of the risks of the shelter to the public if the same CPA firm, in its consulting branch, made up and marketed the shelter.

Section 202 of the act thus mandates that the SEC study whether the problems of conflict between audit and consulting function requires that ownership of the auditing part of CPA firms be separated from ownership of the consulting parts. The act requires that the SEC report to the Treasury and the Congress on separating auditing and consulting function by January 3, 2000.

Registration of Tax Shelters (Section 203 of the Act).

Current law. Since 1984, "tax shelters," as variously defined, have had to be registered with the Internal Revenue Service no later than when the shelter is first offered to buyers. The general purpose of the registration requirement is to improve the vigor and efficiency of IRS compliance measures. The registration gives the IRS warning at the national level and a road map for how to plan better audits. In the Taxpayer Relief Act of 1997, Congress extended the registration requirement to confidential tax shelters involving fees of in excess of $100,000. The extension of registration, however, does not become effective till Treasury issues regulations and no final or proposed regulations have been promulgated as of yet.

The regulations will need to clarify the scope of the phrase "significant purpose to avoid or evade tax" which is one of the requirements for registration under the 1997 Act. Section 6111(d)(1)(A) defines shelter subject to registration, if the fee and confidentiality requirement were present, to include any structure with "a significant purpose to avoid or evade tax." All corporate tax planning reasonably falls within the plain meaning of the phrase, "to avoid or evade tax." The phrase, "avoid or evade" includes legal as well as illegal tax minimization. A corporation is a nonmoral entity organized to maximize post-tax profit. Tax rates are significant. Thus, while the regulations will need to give notice on the point, the phrase "with a significant purpose to avoid or evade tax" applies to all corporate transactions.

Reasons for change. The registration remedy can be expected to be a significant remedy against tax shelters, but the remedy is useless until it is put into effect. Regulations need to be issued immediately if not sooner. Delay is costing material amounts of revenue that the tax system can and should collect.

Explanation of 203(a)(1) (mandating issuance of regulations under the 1997 Act). Section 203(a) of the Act mandates that the Treasury issue regulations putting the 1997 registration requirements into effect for shelters first offered after August 15, 1999. The regula-

tions should provide that all corporate transactions fall within the definition of transactions with a significant purpose to avoid or evade tax, within the meaning of section 6111(d)(1)(A). Treasury may issue safe harbors, for which registration is not required and by notice or proposed regulations from time to time, but not necessarily before August 15, 1999.

Explanation of 203(a)(2) (requiring enriched registration for especially threatening shelters). The preregistration remedy adopted in section 6111 of the code can be augmented for corporate shelters that are especially threatening to federal revenue. The enriched registration for especially threatening transactions will help the IRS understand the transaction and identify shelters that can be defeated under current law or an amendment of current law. The purpose of the preregistration requirement is to improve the chances of the IRS's finding and defeating the shelter. The Act adds a new subsection (e) to section 6111. Especially threatening transactions are defined by new paragraph (e)(1) to include any arrangement in which the loss reported over the course of the transaction is expected or projected to exceed $10 million and in which the fees paid to lawyers, investment bankers, or accountants exceeds $1 million.

In the case of an especially threatening transaction, the information reported on the registration will include an executive summary description in two pages or less designed to alert the ordinary reader of the most important tax issues to the taxpayer. The most important tax issues are the issues with the most economic impact in net present value terms. The most important tax issues also include the ones with the lowest chance of success if challenged. The enriched preregistration for an especially threatening shelter shall include an opinion of counsel as to all material tax issues, as to whether the taxpayer's position on the tax issues are more likely than not to be sustained if challenged. In the event it is not the opinion of counsel that the taxpayer's position will be more likely than not to be sustained, that fact shall be highlighted in the summary. The enriched preregistration shall include a certificate signed by one or more corporate officers with detailed knowledge of the business or economic purposes or objectives of the transaction describing the due diligence performed to ascertain the accuracy of facts, assumptions, and factual conclusions assumed by the opinion of counsel and the accuracy of the facts, assumptions, and factual conclusions. If the actual facts vary materially from the facts, assumptions, and factual conclusions relied on by the opinion of counsel, the statement must describe such variances. The preregistration shall also include copies of any written material provided by a third party. The registration statement shall also include a full description of any express or implied agreement with any adviser or offeror as to fees payable that are contingent or subject to reimbursement and a full description of any express or implied express warranty with respect to the anticipated results from the tax shelter.

New subparagraph section 6111(e)(2)(F) also provides that materials related to a potentially threatening transaction shall not be privileged and shall be disclosed to the Internal Revenue Service on audit or in response to a subpoena for information whether in connection with specific liability for tax or for general research purposes. New subparagraph section 6111(e)(2)(D) requires the taxpayer shall retain copies of all e-mails, recorded statements, or notes of oral descriptions of the transactions for disclosure to the secretary or his delegate when called on, for example, under paragraph (F).

New paragraph (3) of section 6111(e) provides for aggregation rules to determine whether a transaction has projected or expected losses in excess of $10 million and professional fees in excess of $1 million. Where essentially the same idea is offered to two or more taxpayers by a promoter or related parties using essentially the same materials, the $10 million loss and $1 million fee tests are determined by aggregating the losses and fees collected from all such taxpayers.

Treasury Notices on Especially Threatening Transactions (Explanation of new section 7813). Among the advantages of preregistration of shelters is that Treasury can issue early notices shutting down questionable shelters. The Treasury can save significant revenue efficiently by announcing that it finds the shelter to be contrary to current law. It can also save significant revenue by announcing that it finds the shelter to be inconsistent with sound tax systems and that it intends to seek legislation with an effective date that coincides with the notice.

New section 7813 mandates that when it comes to attention of the secretary of the Treasury that the taxpayer's position in an especially threatening transaction is inconsistent with the policy, structure of the code, or intent of Congress when the tax provision was enacted, the secretary shall issue a notice. The notice may announce that in the judgment of the secretary of the Treasury the position is not available to the taxpayer under current law, that the Treasury will issue regulations or a ruling that the position is not available, and that it will contest the position on audit and prosecute the position to the full force of the law. The notice may instead or in addition announce that the Treasury will seek legislation to clarify or amend current law to ensure that the position does not prevail. If the position of the taxpayer is clearly inconsistent with the policy, structure of the code, or intent of Congress, the Treasury shall announce that the regulation, ruling, or audit and litigation position and legislation that it seeks shall be effective from the effective date of the original legislation. If the position of the taxpayer is inconsistent with the policy, structure of the code, or intent of Congress, but it is more likely than not that the taxpayer will prevail under current law, then the Treasury shall announce that the regulation, ruling, or audit and litigation position and legislation that it seeks shall have an effective date at the time of the notice. For Treasury to prevail as legislation, it must obviously convince the Congress of the wisdom of its position on both the merits and the effective date.

The secretary is directed to review tax shelter registration statements required by section 6111 and conduct a vigorous and educated investigation of the market for tax products, so as to issue notices as soon
as possible and if possible before a material amount of tax becomes at stake. The notice procedure with expedited effective dates is intended to be limited to transactions that are especially threatening because of their size, that is, to schemes in which the Treasury has a reasonable basis for projecting that the tax savings from the transaction would exceed $50 million assuming the taxpayer position is not challenged.

Incentive for Accurate Tax Return for Corporate Taxpayer.

Current law. Section 6662 of the code imposes a nondeductible civil penalty in the amount of 20 percent of a tax deficiency on a number of different circumstances. In general the 20 percent penalty is avoidable if there was substantial legal authority for the taxpayer’s position or if the taxpayer flags the position on its tax return, but the penalty is not avoidable by reason of substantial authority or disclosure, if a significant purpose of the transaction was to avoid or evade tax. Since corporations are non-moral entities organized in part to maximize after-tax profit for transactions and corporate and shareholder tax is significant, all corporate transactions presumably have a significant purpose to avoid or evade tax.

Reason for change. Corporations are organized to maximize the after-tax profit for their shareholders so they can never be expected to have moral constraints. A corporation has no loyalty to government revenue, to the integrity of the tax system, to the community, or to the United States, that is, to the U.S. or to us. Corporations have no moral component to back up obedience to law, so that if corporations are going to follow the law, it must be in the economic self-interest of the corporation and its shareholders to do so. Relying on moral suasion as to corporations is moral cant that misanalyzes the nature of the relationship between a corporation and the government. That does not imply that moral suasion and community norms should not be tried, only that they will not work.

Self-assessment of tax by voluntary tax returns is the most efficient and least intrusive mechanism by which to collect the necessary governmental revenue. Self-assessment is done by the party that planned the transaction who has full understanding of the facts and organizing motives. Auditing and litigation is time consuming and wasteful. A tax system that gives sufficient incentive to report tax accurately on the tax return can reduce audit and litigation significantly. As the Founders knew, “nothing can be more ruinous to a state or oppressive to individuals than a partial and dilatory collection of taxes.” The incentives thus need to be large enough to induce compliance with the tax law as Congress wrote it.

Accurate tax returns should be understood as those that report the amount that would be required had all issues gone to final judgment after full litigation, but without the full litigation. Unfortunately, “incentive” and “penalty” are necessarily both relative terms defined in relationship to each other. It is impossible to give an incentive to accurate reporting without there being a relative penalty to returns that are corrected after audit. The ideal tax system therefore penalizes added tax determined or paid after audit, so as to lessen the need for audit and litigation.

A neutral penalty on tax added after audit would be high enough to make it in the self interest of the corporation to report tax accurately on its return. Unfortunately, the level of penalty needed to be a neutral penalty depends on how likely it is for innocent errors to be corrected in favor of the government. Unfortunately, the chances of the government correctly detecting an inaccuracy are not all that high. For example, if there is a 50 percent chance of an audit, a 50 percent chance of the auditor identifying the transaction, a 50 percent chance of the auditor being able to articulate the issue well enough to convince the government lawyers to go forward, and a 50 percent chance of the IRS prevailing eventually after all litigation, then the chances of correction of the error are only 1/16th. The neutral penalty to induce an effort by a moral entity to try to be accurate would have to be an automatic penalty of 16 times the tax due for all payments of added tax after audit.\(^2\)


Commonly, the shelter magnifies, purifies, and markets a small error in the tax code, turning what might be an immaterial issue into a threat to core revenue.

Given the low level of audit, the advantages the taxpayer has over the IRS agent in terms of training, experience, and knowledge of the transaction, and the greater willingness of the taxpayer to devote litigation resources to important cases, the chances of the system correcting a reporting error are not high. Therefore, the neutral penalty necessary to support the self-assessment of tax is probably too high to be tolerable. A penalty of 16 times tax or 16,000 percent would be considered to be harsh, even though it is just the minimum penalty needed to support self-assessment by making accurate reports rational. In consideration of the political force of that point of view, a penalty of less than the neutral penalty will have to be accepted. If one could hypothesize that it is as likely as not that an error will be corrected by audit, then the neutral penalty to induce accurate reporting would be only 100 percent of actual tax. Even a 100 percent penalty, however inadequate, is unlikely to be popular with corporations.
**Commentary / Special Report**

**Explanation of 204 of the Act (Increasing the accuracy-related penalty for corporations to 100 percent).**
Section 204 of the Act amends section 6662 to add a new subsection (i) to provide that in the case of a corporate taxpayer, there will be added to the tax an amount equal to 100 percent of the underpayment. The penalty is automatic; creation of defenses for care or subjective innocence would lessen the likelihood of correction of errors and require that the level of tax to reach a neutral penalty, inducing accurate tax returns, would have to raised. As an addition to tax, the penalty is not deductible.

**Title III. Rifle Shot Changes to Substantive Law**

The corporate tax shelters coming out of the skunk works operations have exposed a number of unjustified loopholes. Commonly, the shelter magnifies, purifies, and markets a small error in the tax code, turning what might be an immaterial issue into a threat to core revenue. This title collects five specific reforms, all with sound theoretical support.

The effort of finding a narrow remedy for tax shelters is arduous. Shelters, first, are secret documents kept hidden if possible, from public scrutiny or debate. Information is undocumented or based on rumors and understandings. Shelters, secondly, are hard to diagnose. Commonly even for the shallowest shelters, consisting of nothing but paper, it is difficult to diagnose what were the errors that made the shelter possible or to explain why the nonsense differs from other transactions that do not cross the line. The shelters are a violation of the norms of taxation: corporations are paying very much less than 35 percent tax on their economic income; often they are achieving a negative tax that is tax savings only for each dollar of economic income. But the specific fault in the tax system is often very difficult to identify. Finally, once the fault is diagnosed, finding a remedy that corrects the fault, without killing the patient, is hard work. Patch remedies should not be penalties. Many candidates for this list of rifle-shot remedies had to be abandoned because the error could not be fixed with a soundly based narrow patch.

It will take massive resources to locate, diagnose, and remedy even the currently available tax shelters. There needs to be a coordination among audit, high quality analysis, and legislation, which Congress has in fact never been able to achieve. The difficulty of finding viable rifle shot corrections is part of the justification for section 201 of the Act giving Treasury a supplemental appropriation of $500 million. The battle against shelters will not be won with pixie dust spread across the field nor by sunshine soldiers. These five modest reforms proposed by Title III will not alone hold the field. It will take resources shifted to the front if the tax base is to be held.

The specific reforms recommended by Title III are not sufficient, but they are consistent with sound theory and necessary to the defense of the tax base.

1. **Ending Replication of Losses. Section 362 of the Code.**

   **Current law.** Under current law, a taxpayer with a large built-in tax loss on an asset can replicate the loss by contributing the asset to a corporation for stock in a transaction qualifying under section 351. Both section 358 of the code, determining shareholder basis, and section 362, determining the corporation’s basis, look to the contributing shareholder’s basis in the transferred asset before the transaction.

   A recent shelter, for example, involved a hedge fund with volatile investments, which could expect some of the investments to collapse in value. Assume, to illustrate the scheme, that the hedge fund has $100x basis in some assets having zero value. If the fund will join with a U.S. taxpayer to form a new corporation and the two own 80 percent of the new corporation, formation of the new corporation will qualify for nonrecognition under section 351. The new corporation’s basis in the asset will be $100x. The U.S. taxpayer, on its part, can put taxable investment or business activities into the new corporation and the $100x built-in loss on the hedge fund asset will shelter the activity or gain from tax. The hedge fund will receive stock for its asset, solely attributable to the value of the $100x tax loss, even when the asset has no pretax value. The hedge fund also does not need to give up its tax loss to give it away. Under section 358, the hedge fund will also have $100x basis in the stock it receives. The hedge fund has thus replicated the loss and can both give its loss to the new corporation and have it too.

   The replication of basis, moreover, can continue, indefinitely, for many tiers of subsidiaries. If the asset is contributed to a new subsidiary, which contributes it to a new subsidiary, which contributes it to a new subsidiary, a loss can be built into the stock of each subsidiary. The loss can be recognized 10 times or more by selling the stock of the various subsidiaries, each of which carries the built-in loss. Economically there has been only one loss, by the shareholder that made the original contribution. Alternatively, the hedge fund can use the stock of the new corporation it has formed as an asset to enter into another similar transaction with an unrelated corporation. The replication of loss allowed by section 362 and section 358 has no bounds.

   **Reasons for change.** The replication of high basis and loss, because section 358 and section 362 pull their basis from the same asset, allows abuse. A loss should be allowed to the shareholder in which the loss arose, but the shareholder should not be able to double the loss an infinite number of times, both keeping the loss and giving it to another taxpayer as well.

   **Explanation of provisions.** The Act provides that the corporation’s basis for contributed property, determined under section 362, in a contribution to a corporation governed by section 351 shall not exceed the fair market value of the property when contributed. The shareholder’s basis in shares received in return for an asset, determined under section 358, is not so limited. Thus if a shareholder transfers an asset with basis of $100x and value of zero to a corporation in a transaction qualifying under section 351, the shareholder will have a $100x basis in its stock received in return, but the corporation will have a zero basis in the contributed asset.

2. **Preventing ‘Divisive Mergers.’ Section 368(a)(1)(A) of the Code.**

   **Current law.** Under section 368(a)(1)(A) of the code, a “statutory merger” is a tax-free reorganization (the
“A” reorganization). Treasury regulation section 1.368-2(b)(1)(1998) provides that to be an A reorganization, the transaction must be a merger under state law. Under the deep norms of reorganization law, mergers are not divisive events by which assets are spread between two or more corporations, but rather consolidations or poolings in which assets are joined into fewer corporations.

Since 1989, Texas has defined “merger” to allow more than one corporation to survive or be created in the “merger.” A target corporation may transfer its assets, not to a single corporation into which it merges, but to any number of different transferee corporations with varied owners. The target corporation may also survive the “merger” holding some of its assets at the end. Texas Business Corporation Act, arts 1.02(18), 5.01. The new definition was enacted in 1989 to allow flexibility. The debate in Texas considered only creditors’ rights and dissenters’ rights. Curtis Huff, “The New Texas Business Corporation Act Merger Provisions,” 21 St. Mary’s L.J. 109, 110 n. 5 (1989). Tax issues were not part of the public discussion. Only Texas law allows “divisive mergers” with multiple transferees, but section 368(a)(1)(F)(the “PR” reorganization) allows a corporation from another state to reincorporate in Texas without tax.

Reasons for change. Some promoters have taken the position that a multiple transferee merger that qualifies under art 1.02(18) of the Texas Business Corporation Act qualifies as an A reorganization for federal tax law because it qualifies as a “merger” under state law.23 If the A reorganization encompasses such transfers, then it would be an end around a number of venerable restrictions aimed at preventing “mere sales” of selected properties of a target from qualifying as a tax-free reorganization. If a purchaser wants to buy only portfolio stock, or one of a number of businesses conducted by the target, for example, the target could transfer the assets to be purchased to the purchaser’s corporation, while keeping in a corporation controlled by the target shareholders, for instance, cash or assets the purchaser does not want. If no distributions are made (other than stock of a transferee corporation), the merger is said to be tax-free.

Such a divisive “merger,” however, instead of being a full and faithful marriage of two corporations, would be a selective or cherry picking sale of part of the assets of the target. The C reorganization (section 368(a)(1)(C) of the code) and the triangular reorganizations (section 368(a)(D) and (E)) require a transfer of “substantially all of the properties” of the target in order to prevent mere selective sales from qualifying as reorganizations. Section 355 allows a tax-free division of a corporation only on meeting of rigorous statutory antiabuse standards, and section 355(e) now requires a corporation to recognize corporate-level tax if one of the two divided parts of the corporation is sold to unrelated parties.

“Merger” is a word with real meaning of its own and the meaning does not cover divisions of a target’s assets or selection of some of its assets. A merger is a fusion between two corporations in which the target corporation transfers its assets to the surviving fusion corporation and goes out of existence by operation of law. Tax-free reorganizations, moreover, do not encompass “mere sales” of the assets of one corporation by another corporation.24 A “divisive merger” is an oxymoron, a self-contradiction in terms. A state law statute might encompass other transactions, even within its authorization of mergers, but only the fusion is a merger.

Explanation of the provision. The Act, section 303, amends section 368(a)(1)(A) of the code to provide that a merger is a transaction in which the transferor corporation transfers all of its assets to a single transferee corporation and goes out of existence and that a transaction having the effect of dividing the assets of any corporation is not a merger. The provision clarifies and endorses current law, so the effective date of the amendment is retroactive for all open cases.

Given the difficulty the IRS has in finding and litigating transactions, the Act makes proper adjustment for basis. Basis is an account that records the cumulative tax history of an asset to prevent the double taxation of amounts invested or previously taxed. Basis is increased by gain recognized with respect to an asset. Basis, however, should be increased only by real gain recognized by the taxpayer. There is thus no reason to adjust basis upward to prevent double taxation of gain when the taxpayer never recognizes the gain on its tax return nor reports tax on the gain. For a taxpayer who reported a multi-transferee transaction as if it were a merger, there will be no step up in basis unless the taxpayer has a final determination that the merger was not tax-free.


Current law. Life insurance owned by a corporation is an investment shell or format that gives the corporation a tax-exempt return. An insurance policy gets more valuable because of earnings posted to the owner’s account. The earnings increase the cash surrender value of the policy or covers the actuarial cost, that is, the insurance company’s risk of paying if the insured individual dies during the year. Under section 101, the payment of the policy is tax exempt to the corporation.

In recent years there have been a number of new limitations on deduction of interest on debt incurred

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24Treasury reg. section 1.368-2(a)(1998) (“reorganization” does not apply to mere purchases); Roebing v. Commissioner, 143 F.2d 810, 812-814 (3d Cir. 1944) (transaction that qualified as state law merger was sale not reorganization because target shareholder’s ended with no equity in surviving fusion corporation).
or continued to purchase or carry corporate owned life insurance. But there are also important exemptions from the disallowance of interest. If "systematic direct or indirect borrowing of the increases in cash surrender value is not contemplated," for instance, the corporation may deduct normal levels of interest incurred on debt with respect to life insurance on its key persons, for debt of up to $50,000 per key person. Section 264(a)(3)(4), (c), and (d).

Borrowing with respect to corporate-owned life insurance is commonly a paper transaction with no change in beneficial interest, except for tax. The investment and borrowing offset each other so that the capital becomes just offsetting paper and accounting entries. The IRS, for example, has recently ruled that loans from a life insurance company were "shams" under the doctrine of Knetsch v. United States, 364 U.S. 361 (1960). TAM 9812005. The scope of Knetsch is uncertain, but if it applies, no interest deductions are allowed.

Reasons for change. Deduction of interest costs incurred by a corporation because of corporate-owned life insurance is a corporate tax shelter. The life-insurance-policy format or vehicle generates tax exempt money. Matching the interest cost to the tax-exempt yield from the policy would require that the interest be treated as a reduction of the tax-exempt yield rather than a deduction. When deduction is in fact allowed of the interest cost of tax-exempt yield, then no source of corporate income can be subjected to tax. With the combination of interest deduction and exempt yield, then a corporation with business income of $10,000, "by the simple expedient of purchasing an exempt policy" with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. Deductible interest allows the exemption for life-insurance policies to be transported to any source of corporate income.

The combination of deduction of interest and exemption also yields a negative tax or subsidy, better for the transaction than zero tax. The subsidy allows a life-insurance company to give out a rate of return that is inferior to competing investments. Assume, for example, that going interest rates are 6 percent. That means that users of capital generally give a 6 percent return to get their share of scarce capital. Life insurance companies, however, need to give only 4 percent rate of return. The after tax cost of 6 percent interest at corporate rates of 35 percent is only 6 percent (1-35 percent) or 3.9 percent. The corporate borrower can borrow indefinitely, incurring 3.9 percent interest cost to carry a 4 percent return policy.

There is no justification for subsidies or negative tax of that level. The low rates of return allowed by the subsidy mean that life insurance companies become wasteful users of capital unable to keep up with going return rates. The Treasury loses corporate revenue just to subsidize the inefficiency. When the insurance com-
pany lends back the money, moreover, the vehicle is just an empty shell generating tax losses without any capital involved.

When a corporation has both an interest cost and a life insurance policy, the law needs to stack interest costs to match it first to tax-exempt income from life insurance policies. It is impossible administratively and wrong in theory to try to trace debt to specific investments. Corporate borrowing appears on a balance sheet as a claim on all assets, including intangibles not listed on the balance sheet. A taxpayer can avoid a tracing remedy just by immaterial differences in the order of borrowing or of investing. It is always the case, moreover, that a corporation could reduce its interest cost by reducing the life insurance it carries. The life insurance is according always the but-for cause of the interest cost.

An even simpler remedy with strong theoretical appeal is to end the section 101 exemption as to corporations and to tax the corporation on the earnings or build up in its policy as it occurs. Life insurance is a shell or investment vehicle that gives the corporation a source of tax-exempt or tax-deferred income, without any special social merit. The distinctions between an investment in debt or a bank account and an investment in an insurance policy are modest at best. The best surviving rationale for the exemption for life insurance for individuals is that it parallels section 1014, which forgives tax on gain on assets on death, but corporations do not qualify for section 1014. Giving favor to the insurance company just protects an inefficient guild. The Treasury’s revenue loss is absorbed by the inefficient. Insofar as disallowance of interest reaches the same result as direct taxation of insurance policy earnings, that is a correct result.

Explanation of the provision. The Act simplifies current law for business entities by adding a new subsection (e) to section 264 of the code to provide that any interest deduction shall be reduced by the amount of (1) any increase in the cash surrender value of any life insurance or annuity policy owned by the taxpayer, and (2) the actuarial cost of term life insurance for the insured person for the year. New section 264 stacks interest first to tax-exempt income. New subsection 264(e) applies to all business entities, because the balance sheet approach, looking at debt as a claim on the whole pool of the entities assets, is most familiar to business entities and because life insurance is just business to a business entity. The stacking remedy of new subsection (e) avoids complicated tracing remedies or remedies prorating interest according to all of a taxpayer’s stated and unstated assets. Interest that is disallowed under new (e)(1) because of increases in cash surrender value are added to the corporations’ basis in the policy, because the interest should be recognized against taxable sales proceeds if the policy is sold or redeemed before the death of the insured.


Current law. Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs) avoid the double corporate tax of section 11 because they are given a deduction at the corporate level for dividends

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distributed to their shareholders. REITs usually distribute all of their taxable income to shareholders and the shareholders who invest in REITs and RICs tend to be investors looking for a steady cash flow from their investments. REITs are commonly highly leveraged entities borrowing large amounts of money to buy large real estate projects, and using the projects as security for the loans. In Notice 97-21, 1997-11 IRB 6, however, the taxpayer created a “step down” preferred stock, structured in an attempt to achieve a deduction of principal. The step down preferred gave out very large payments over a fixed term, and then became a small claim on the REIT, trailing indefinitely into the future. In substance, the step down preferred was a loan to the REIT, repaid with fixed payments of principal and interest over the initial term. The long tail was added to give some appearance that the step down preferred was stock with an indefinite life, rather than debt with a fixed term. In Notice 97-21, the Treasury announced that it would treat the step down preferred as conduit financing under section 7701, and would not allow a deduction of the preferred principal.

Reasons for change. Notice 97-21 has a strong equitable foundation. Under the deep norms of the income tax, the principal of the borrowed amounts is not deductible. Principal owed is included in basis from which depreciation deductions are computed. Deduction of both depreciation and payments of principal would be a double deduction, which would free unrelated income from tax. For the double deduction to be useful, the REIT shareholders need to contribute some unrelated activity into the REIT that will generate some taxable income to shelter, but it is not difficult to put such an activity into the REIT once it is known that that the REIT will shelter the activity from tax.

The technical source of the notice to close the loophole — the conduit theory — was a surprise to the bar, however, and could not have been anticipated under routine procedures in the preparation of legal opinions. The conduit theory also relied on some facts that were an accident to the specifics of the step down preferred and could have been avoided with planning if the attack on the loophole had been known beforehand. There thus needs to be a stronger base for the Treasury’s position, created within the REIT statute itself.

Explanation of the section. It is surprisingly difficult to distinguish between interest and principal with a line that will survive the acid test of aggressive tax planning. The Act, section 304, would allow deductions of dividends, first, on common stock and, secondly, on preferred stock. On common stock, dividends that are allowed to be deduction under section 857 would have to be fully discretionary to the board of directors. The full-discretion requirement should prevent fixed term loans from qualifying from the deduction. The Act also allows preferred dividends, but the preferred dividends would need to give a perpetual coupon, not larger than is normal on preferred stock at the time the stock is issued. Many preferred stock issues in fact have mandatory redemption or retirement provisions, but with those provisions it is impossible to distinguish economically between debt and preferred stock or between principal and interest.

Regulated investment companies (RICs) operate off the same logic of a dividend deduction. RICs do not tend to be as highly leveraged as REITs but if the loophole of deduction of principal is available, RICs can take advantage of it with planning.

5. Making Residual and Ownership Interests of REMICs and FASITs Taxable. (Section 860A and Section 860H of the Code. Section 305 of the Act.)

Current law. Real Estate Mortgage Investment Trusts (REMICs) and Financial Asset Securitization Investments Trusts (FASITs) are entities acting as financial intermediaries in “securitization” of debt instruments. In “securitization” the REMIC, for instance, collects individual debts secured by home mortgages into a large asset pool and then issues debt-like “regular interests” to the marketplace secured by the pool. Investors buying regular interests have a security interest in the underlying pool amassed by the REMIC, and the security interest gives the promise inherent in the regular interest creditability in the market place. REMICs add value by smoothing out investor risks on any specific mortgage by collecting many securities into a diversified pool. They also add value by chopping up the pool into payment at different times or “tranches” and selling the tranches to different investors who need or can better tolerate their investment cash returns at different times. FASITs are like REMICs except that they collect pools, not just of home mortgages, but of any kind of debt obligation, including, for example, pools of credit card receipts or trade receivables.

The REMICs and FASITs avoid corporate tax because deductions for interest-like payments on regular interests offset almost all of the investment income of the REMIC or FASIT. In the ordinary case, however, regular interests would be characterized as equity and not debt, absent the REMIC and FASIT legislation, because the regular interests absorb as close to 100 percent of the net worth of the REMIC or FASIT as it is possible to come with projections about the future. The residual or ownership interest is paid after the regular interest, but typically the residual or ownership interest is as thin as it can be made, and provides no cushion of equity with a substantial net worth. REMICs and FASITs would also not qualify as partnerships absent special legislation because they are publicly traded. Under the terms of our tax system, only entities not traded on a public market are eligible for the subchapter S or partnership and other tax regimes avoiding the corporate tax. The value added by financial activities such as securitization is not different in kind from activities such as pig-iron making that are subject to corporate tax.

Reasons for change. The REMIC and then the FASIT legislation was a product of negotiation between Treasury and Wall Street. The Treasury was willing to forgo

corporate tax on securitization (the pooling of fixed interest securities for sale to investors with differing needs), — notwithstanding that securitization adds economic value as much as any active business does. In return, however, Treasury was given assurances that the FASITs or REMICs would not reduce or defer revenue the Treasury would otherwise collect on the underlying mortgages or indebtednesses.

A FASIT or REMIC that chops up pooled indebtedness into tranches or payments at different times would ordinarily make revenue disappear, if regular interests alone owned the entity. Long-term interest rates are systematically higher than short-term interest rates, because the inflation risks are higher over the long term. If a sponsor sells all of a pool of indebtedness to REMIC or FASIT investors wanting differing tranches, then the purchasers of the early tranches will accept a low interest rate (in the form of original issue discount) and purchasers of the late tranches will demand a high rate (also in the form of original issue discount). It follows that in early years, when short-term holders constitute a large fraction of the regular interest holders, the interest payable by the REMIC or FASIT to holders is low, compared to interest paid on the underlying pooled mortgages. In late years, the short-term tranches have disappeared and interest payable is high compared to interest on the underlying debt. That means that in early years the FASIT or REMIC would absorb taxable income and make it disappear because the mortgage payers are paying more interest than is taxable to regular interest holders as original issue discount. In later years, the FASIT or REMIC creates taxable income, because the interest payable is to holders of long-term tranches which have interest accruals higher than the interest on the underlying pooled mortgages. Given the time value of money, however, the later years are less valuable and important, so that overall chopping up the mortgages into tranches would lose revenue, measured in time value terms.

The agreement between Wall Street and the Treasury solved the problem of loss of revenue inherent in securitization and sale of tranches divided by time, by requiring that a FASIT or REMIC have a residual interest held only by a taxable corporation. The residual interest holder would pay tax on the interest that would otherwise disappear due to the chopping up of the underlying mortgages into tranches. Residual interests are known affectionately as "toxic waste dumps" on the Street because they have the ability, as in sales of tranches divided by time, to give taxable income but no cash for what may be 30-40 years. A sponsor selling the pool would have to pay a residual interest holder to accept the toxic waste residual interest, in the amount of the present value of the tax. But under the original understanding behind the FASIT and REMIC legislation, the sponsor's payment would measure not only the present value of the residual interest's tax, but also the present value of what the Treasury would lose if the residual interest did not pay the tax. Under the deal between Treasury and Wall Street the toxic waste interest must be held by a taxable corporation.

Wall Street breached the deal behind the REMIC and FASIT legislation, however, because most residual interests in REMICs and FASITs are held by nontaxable entities — Indian Tribes. Section 860E(e)(5) and section 860L(a)(2) try to require that the residual interest be held by taxable domestic corporation but most FASIT and REMIC residual interests are now held by Indian Tribes taking the position that they are both exempt from section 11 tax. The breach of the original understanding is system wide. Payment by the REMIC or FASIT sponsor to the holder of the toxic waste residual interest measures the expected present value of the tax that the residual interest holders will bear. The usual payment in the market place is zero, meaning that the usual expectation is that the residual interest will pay no tax to make up for the Treasury's loss. It may in fact be impossible to ensure that some outside party bears enough tax to make the Treasury whole in transactions like the sale by tranches.

Wall Street breached the deal behind the REMIC and FASIT legislation because most residual interests in REMICs and FASITs are held by nontaxable entities — Indian Tribes.

The breach of the original understanding by Wall Street teaches us that we should not rely on outside holders of residual or ownership interests to make the Treasury whole. The REMIC or FASIT itself needs to pay the tax that leaves the Treasury whole. A REMIC or FASIT has no net worth, considering the regular interests as if they were debt, but if tax is imposed on the entity then the tax can ultimately be collected from those interests that are shareholders under state law. Ultimately the sponsor who sets up the FASIT or REMIC and sells the pool of indebtedness will bear the tax.

Explanation of the section. The Act, section 305(a), amends section 860A and 860H to provide that REMICs and FASITs shall pay tax on the income of a residual interest (for REMICs) or ownership interest (the analogous interest for FASITs) at the highest rates of the section 11 corporate tax, now 35 percent. Regular interests would continue to be taxable as debt, even if they flunk the ordinary debt-equity standards because there is no back-up net worth cushion in the corporation. Qualifying the regular interest as debt, notwithstanding high leverage, will ordinarily mean that a FASIT or REMIC will bear little or no corporate tax because of the interest deductions on regular interests. The corporate tax will remain, then, only a back up to ensure that the FASIT or REMIC is not being used as "income sink" to wipe out or defer taxable income. In cases such as the tranche problem, the tax to leave the Treasury whole is a tax without a cash flow, so that there will be no distributions to the owners of the residual interest, which might be subject to double tax.

The double corporate and shareholder tax on the very thin residual or ownership interest will not ordinarily be material, however, given the high leverage created
by regular interests. The corporate tax on the residual interest appears to be the simplest, most straightforward way to ensure that REMICs and FASITs do not lose revenue. The corporate tax would start at the highest, now 35 percent, corporate tax rate, however, because the REMIC and FASIT regular interests and the public trading make these entities too big to be considered "small corporations" eligible for lower-than-35 percent corporate rates, under any reasonable perspective.

The Act also directs Treasury to issue regulations saying that an Indian Tribe is not an eligible holder of a residual (under section 860E(e)(5)) or ownership interest (under section 860L(a)(2)). The Internal Revenue Service may also issue revenue rulings making a corporation ineligible under section 860E(e)(5) and 860L(a)(2) if it was expected to pay tax at effective tax rates below 35 percent.

Because the holding of residual interest by a tax-exempt or low-effective-tax entity is a breach of the understanding and contract underlying the enactment of the legislation, the regulations will be retroactive to all open tax years. If, however, Treasury collects amounts equal to the net present value of 35 percent tax of the taxable income of the residual interest, from the holders of the residual or regular interests, from the entity or the sponsor, then the disqualification of the REMIC or FASIT will not be applied until after January 1, 2000. On disqualification of the FASIT or REMIC, the FASIT or REMIC will be a corporation subject to section 11 and it is expected that the regular interests will be treated as stock and bear the cost of tax due because of the ineligible holder of the residual interest and that the Treasury will pursue collection of the tax. The remedy is meant to ensure compliance with the original understanding that REMICs and FASITs would not erase tax that would otherwise be collected on the mortgage or indebtedness.

Statutory Language

H.R. ———, Anti-Skunk Works Corporate Tax Shelter Act of 1999

Sec. 1. Short Title.

This Act may be cited as the Anti-Skunk Works Corporate Tax Shelter Act of 1999.

Title I. Codification of General Antiavoidance Rules

Section 101(a). General Antiabuse Rules of Wide Application. Chapter 80, Subchapter A of the Internal Revenue Code shall be amended by adding a new section 7812, to read,

"Section 7812. General Antiavoidance Rules.

"(a) Substance over form. The determination of any item of gross income, deductions, or credits shall be made according to the substance of a transaction and not its form, except that taxpayers shall be bound by the form chosen.

"(b) Ignoring sham transactions. Transactions which have no significant effect on the taxpayer's economic or beneficial interest except for tax shall be treated as sham transactions and ignored in the computation of taxable income.

"(c) Tax is not a profit center. Notwithstanding any provision of the Code, the net present value of tax benefits from a transaction as a whole shall not exceed the net present value of the taxpayer's economic cost of the transaction as a whole.

"(d) Only bona fide loss. Only bona fide losses are allowable. Substance and not mere form shall govern in determining the amount of a deductible loss.

"(e) No negative tax. Taxable income and losses shall be computed presuming that Congress did not intend to make the taxpayer's economic position or rate of return from a transaction as a whole positive after tax and also better after tax than it was before tax.

"(f) Step transactions collapsed. Steps undertaken to accomplish a larger goal shall be ignored by the Commissioner and the taxation of the transaction shall be determined by looking to the transaction from beginning to end, ignoring the interim steps, when ignoring the separate steps results in a higher amount of tax than would result if the steps were respected.

"(g) Policy, structure, and intent govern. The text of the Internal Revenue Code shall be interpreted to reach results consistent with the policy, structure, and intent of Congress at the time that it enacted the provisions."

Section 101(b). Effective date. The effective date of new section 7812 shall be the effective date of the provision of the Internal Revenue Code of 1986 to which it relates.

Section 102(a). Greater purpose of tax accounting. Section 446 of the Code shall be amended by adding a new subsection (c)

"(c) No artificial accounting losses. The rules of tax accounting shall be interpreted to result in deductions and income that give the most accurate feasible description of the taxpayer's true economic income for the taxable year, ignoring artificial accounting entries and transactions without economic substance. No taxpayer right shall be implied or construed to give taxpayers erroneous or artificial accounting on the ground that it yields a lower tax amount."

and by renumbering current subsections (d), (e), and (f) as subsections (e), (f), and (g) respectively.

Sec. 102(b). Effective date. The effective date of section 446(c) shall be the effective date of the Internal Revenue Code of 1986.

Sec. 103(a). Section 165 and 166 of the Code are amended by repealing subsection (b) of each section and replacing it with the following language:

"(b) Amount of the deduction.

"(1) The deduction allowed by subsection (a) shall not exceed the adjusted basis of the property provided in section 1011.

"(2) The amount of the deduction shall not exceed the taxpayer's bona fide loss of value from the transaction, viewed as a whole. Economic
substance and not form shall govern in determining the amount of the deductible loss.”

Sec. 103(b). The effective date of amendments to section 165 and section 166 shall be the effective date of the Internal Revenue Code of 1986.

Sec. 104(a). No artificial partner tax losses. Section 702 of the Code, defining taxable items of a partner, shall be amended by adding a new subsection (d)

“(d) Substance required for losses. A partner’s tax deductions or losses shall be allowed only if they pass section 7812, providing for general antiabuse rules, and section 446(b) and (c) requiring that tax deductions clearly reflect income, at the partner level as well as at the partnership level.”

and current subsection (d) shall be renumbered as subsection (e).

Sec. 104(b). Effective date. Section 702(d) shall apply to all taxable years beginning on or after January 1, 1999.

Title II. Assault on the Skunk Works
Section 201. Appropriation.

The Department of Treasury shall be given a supplemental appropriation in the amount of $500,000,000 to effect the provisions of this Title II, for the setting up of registration of tax shelters, for a joint task force study of the shelters by the Congressional Budget Office, the General Accounting Office, and the Treasury Department Office of Tax Policy to make proposals for reform of the law to curtail them, for the construction of systems for the collection and creation of statistics to ascertain the seriousness of the corporate tax shelter problem, for the issuance of Notices, Revenue Rulings, and Regulations as to current law, for the audit of corporate tax shelters, for the hiring of outside counsel on a contingent basis for the litigation of tax shelter issues, and for the preparation of amendments to the Internal Revenue Code to defeat tax shelters that do not reflect income and that undermine the policy, structure, and intent of Congress. The Department of Treasury shall be instructed to hire the best available talent in accounting, tax, law, statistics and empirical research, and economics at fair market rates for the period needed.

Sec. 202. The Securities and Exchange Commission is instructed to study the problem of auditors acting as business and tax advisers, with a view to determining whether the auditing of financial statements required by the Securities and Exchange Act contributes to the marketing of tax shelters or if auditor sponsorship of tax shelters leads to less than candid descriptions of the risks to investors, and with a view to determining whether the ownership and management of firms certified to audit financial statements required by the Securities and Exchange Act should be separated from functions in which the auditor is attempting to further the tax or commercial interests of the audited firm by advice or preparation of documents. The Securities and Exchange Commission shall report to the Department of Treasury and Joint Committee on Taxation by January 3, 2000.

Sec. 203(a). Registration of corporate tax shelters

(1) Quick Effective Date for Registration. By August 15, 1999, the Department of Treasury shall issue proposed regulations effective as of August 15, 1999 to put into effect section 6111(d) of the Code as amended by the Taxpayer Relief Act of 1997, section 102, providing for the registration of confidential tax shelters involving fees in excess of $100,000. For the purposes of the proposed regulations, section 6111(d)(1)(A), defining shelter as a structure with a significant purpose to avoid or evade tax, shall be satisfied for any entity subject to tax under section 11. Treasury may issue safe harbors, for which registration is not required, by Notice or proposed regulations from time to time, but not necessarily before August 15, 1999.

(2) Amendment of Registration for Especially Threatening Shelters. Section 6111 of the Code shall be amended by adding a new subsection (e)

“(e) Especially threatening transactions.

“(1) Especially threatening transaction defined. For the purposes of this section, the term ‘tax shelter’ includes any scheme, plan, arrangement, entity, or transaction, in which the loss reported over the course of the transaction is expected or projected to exceed $10,000,000 in which the fees paid to lawyers, investment bankers, or accountants exceed $1,000,000.

“(2) Information to be provided. In the case of an especially threatening transaction, the information reported on the registration shall include

“(A) A summary description of the transaction in two pages or less designed to alert the ordinary reader of the most important tax issues to the taxpayer in terms of economic impact and lowest chance of success if challenged. An issue is not a most important issue if the taxpayer has an opinion of counsel that the tax benefits are more likely than not to be available on final judgment if challenged.

“(B) An opinion of counsel as to all material tax issues, as to whether the taxpayer’s position on the tax issues are more likely than not to be sustained if challenged. In the event it is not in the opinion of counsel that the taxpayer’s position will be more likely than not to be sustained, that fact shall be highlighted in the summary.

“(C) A certificate signed by one or more corporate officers with detailed knowledge of the business or economic purposes or objectives of the transaction describing the due diligence performed to ascertain the accuracy of facts, assumptions, and factual conclusions assumed by the opinion of counsel and the accuracy of the facts, assumptions, and factual conclusions. If the actual facts vary materially from the facts, assumptions, and factual conclusions, relied upon by the opinion of counsel, the statement must describe such variances.

“(D) Copies of any written material provided by a third party. The taxpayer shall retain copies of all e-mails, recorded
statements, or notes of oral descriptions of the transactions for disclosure to the Secretary or his delegate when called upon.

"(E) A full description of any express or implied agreement with any adviser or offeror as to fees payable that are contingent or subject to reimbursement and a full description of any express or implied express warranty with respect to the anticipated results from the tax shelter.

"(F) Materials related to a potentially threatening transaction, including all material described in paragraph (D) shall not be privileged and shall be disclosed to the Internal Revenue Service on audit or in response to a subpoena for information whether in connection with specific liability for tax or for general research purposes.

(3) Aggregation of offerees. Where essentially the same idea is offered to two or more taxpayers by a promoter or related parties using essentially the same materials, the determinations under paragraph (1) shall be made by aggregating the losses and fees collected from all such taxpayers."

and current subsection (c) of section 6111 of the Code shall be renumbered as subsection (f).

(3) Notice with respect to especially threatening transactions. Chapter 80, Subchapter A of the Internal Revenue Code shall be amended by adding a new section 7813:

"Section 7813. Treasury Notices on Especially Threatening Transactions.

(a) Treasury notice. When it comes to attention of the Secretary of the Treasury that the taxpayer's position in an especially threatening transaction is inconsistent with the policy, structure of the Code, or intent of Congress when the tax provision was enacted, the Secretary shall issue a Notice that

"(1) The position is not available to the taxpayer under current law, that the Secretary will issue Regulations or a Ruling that the position is not available, or that it will contest the position on audit and prosecute the position to the full force of the law, and/or

"(2) That the Secretary will seek legislation to clarify or amend current law to ensure that the position does not prevail.

(b) Effective date.

"(1) Clear inconsistency. If the position of the taxpayer is clearly inconsistent with the policy, structure of the Code, or intent of Congress, the Treasury shall announce that the Regulation, Ruling, or audit and litigation position and legislation that it seeks shall be effective from the effective date of the original legislation.

"(2) More likely than not available under current law. If the position of the taxpayer is inconsistent with the policy, structure of the Code, or intent of Congress, but it is more likely than not that the taxpayer would prevail under current law if challenged, the Treasury shall announce that the Regulation, Ruling, and legislation that it will seek shall have an effective date at the time of the Notice.

"(c) The Secretary shall review tax shelter registration statements required by section 6111, shall conduct vigorous and educated investigation of the market for tax products, so as to give notice if possible before a material amount of tax becomes at stake.

"(d) Especially threatening shelter defined. For the purposes of this section, the term 'especially threatening transaction' includes any scheme, plan, arrangement, entity, or transaction, in which the Treasury has a reasonable basis for projecting that the tax savings from the transaction would exceed $50,000,000 assuming the taxpayer position is not challenged.”

Sec. 203(b). Effective date. Section 6111(e) shall apply to any offering made after August 5, 1999, except that for an offering made in a fiscal year beginning in 1999, the registration statement may be filed with the tax return, including any extensions of time allowed. Section 7813 shall apply after August 5, 1999.

Sec. 204(a). Increasing the accuracy-related penalty for corporations to 100 percent to induce accurate reporting.

Section 6662 of the Code shall be amended by adding at its end a new subsection (i) to read,

(i) Corporate taxpayers. In the case of a corporate taxpayer, there will be added to the tax an amount equal to 100 percent of the underpayment.”

Sec. 204(b). Effective date. New section 6662(i) shall apply to tax returns filed after the enactment of this Act.

Title III. Rifle-Shot Antiabuse Rules

Section 301(a). Ending replication of losses. Subsection (a) of section 362 of the Code, defining corporate basis in contributed property, shall be amended by deleting the final period and adding,

“, but not greater than the fair market value of the property when contributed.”

Sec. 301(b). Effective date. The amendments of section 362(a) shall apply to all taxable years beginning on or after January 1, 1999.

Sec. 302(a). No such thing as a "Divisive Merger.” Section 368(a)(1)(A) of the Code shall be amended by adding at the end the following:

“A merger is a transaction in which the transferor corporation transfers all of its assets to a single transferee corporation and goes out of existence, even if other transactions are also described in the state statute governing mergers. Transactions having the effect of dividing any corporation are not mergers.”

Sec. 302(b)(1). Effective date. The amendment of section 368(a)(1)(A) shall apply to all transactions occurring after the effective date of the Revenue Act of 1934, except that as to mergers qualifying under state law as it existed as of the
The effective date of the Revenue Act of 1934, the effective date shall be May 5, 1999.

(b)(2). The basis of property shall not be increased by reason of a merger reported as a reorganization under section 368(a)(1)(A), notwithstanding section 303(a) of this Act, except as to the basis of taxpayers who have a final determination that the transaction does not qualify under section 368(a)(1)(A).

Sec. 303(a). Ending shelter from mismatched investments in corporate owned life insurance.

Section 264(a) of the Code shall be amended by adding a new paragraph (5) to read,

"(5) In the case of a corporate taxpayer, any interest paid or accrued on any indebtedness to the extent of

"(A) any increase in the cash surrender value of any life insurance or annuity policy owned by the taxpayer, and

"(B) the actuarial cost of term life insurance for the insured person for the year.

Any interest disallowed by paragraph (A) shall be added to the basis of the policy."

Sec. 303(b). The amendments to section 264 shall apply to interest paid or accrued after the effective date of this act.

Section 304(a). No deduction for repayment of principal. Sections 852 and 857 of the Code shall be amended by adding at the end a new subsection (f):

"(f) Prohibition of deduction of principal. No dividend deduction shall be allowed except on instruments in which

"(1) the dividend is fully discretionary to the board of directors when the dividend is declared, or

"(2) the dividend amount is constant and perpetual and does not exceed the fair market rental cost of capital on preferred stock."

Sec.304(b). Effective date. The amendments of sections 852 and 857 shall be effective on August 15, 1999.

Sec. 305(a)(1). Section 860A, relating to the taxation of REMICs shall be repealed and in its place shall be added a new Section 860A to read,

Sec. 860A. Taxation of a REMIC

"(a) General rule. A REMIC shall be treated as a corporation subject to the highest tax rate of section 11 with the residual interest representing its stock.

The taxable income of a REMIC shall be determined under the accrual method of accounting."

"(b) Regular interests. For the purpose of this title, a regular interest in a REMIC, if not otherwise debt, shall be treated as a debt instrument."

Sec. 305(a)(2). Section 860C(a) shall be repealed and in its place shall be added a new Section 860C(a) to read,

"(a) Taxability of residual interests. A residual interest of a REMIC shall be treated as stock, subject to tax at the highest tax rate of section 11."

Sec. 305(a)(3). Section 860H, relating to the taxation of FASITs shall be repealed and in its place shall be added a new Section 860H to read,

Sec. 860H. Taxation of a FASIT

"(a) General rule. A FASIT shall be treated as a corporation subject to the highest tax rate of section 11 with the ownership interest representing its stock.

The taxable income of a FASIT shall be determined under the accrual method of accounting."

"(b) Regular interests. For the purpose of this title, a regular interest in a FASIT, if not otherwise debt, shall be treated as a debt instrument."

Sec. 305(b). The Treasury Department is directed to issue regulations saying that an Indian Tribe is not an eligible holder of a residual interest (under section 860E(e)(5)) and that it an Indian Tribe is an ineligible holder (under section 860L(a)(2)). The Treasury may also issue regulations making a corporation ineligible under sections 860E(e)(5) and 860L(a)(2) if it was expected to pay tax at effective tax rates below 35 percent.

Section 305(c). Effective dates.

Section 305(c)(1). The effective date of section 305(a) shall be the effective date of the Act.

Section 305(c)(2). The effective date of section 305(b) shall be the effective date of the Internal Revenue Code of 1986, except that if Treasury collects tax equal to 35 percent of the taxable income of the holders of regular or residual interests of the REMIC or from regular or ownership interests of a FASIT, or from the sponsor of the FASIT or REMIC, then the disqualification of the REMIC or FASIT will not be applied until after January 1, 2000. On disqualification of the FASIT or REMIC, the FASIT or REMIC will be a corporation subject to section 11 and it is expected that the regular interests will be treated as stock and bear the cost of tax due because of the ineligible holder of the residual interest and that the Treasury will pursue collection of the tax.