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Effective Responses to Aggressive Tax Planning

What Canada Can Learn from Other Jurisdictions

Instalment 6: The United States - Proposed Economic Substance Doctrine Codification

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This instalment is the sixth in a series that presents a detailed study on aggressive tax planning. It underpins the issuance of *Tax Paper No. 112* published in July 2009 by the Canadian Tax Foundation (CTF). As mentioned in the preface of the book in order to keep publishing costs reasonable and to avoid delaying its publication, the CTF has given us permission to publish this document in French and English on our Website.

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The Mission of the Research Chair in Taxation and Public Finance

The **Research Chair in Taxation and Public Finance** (RCTPF) was formed on April 15, 2003 via an unconditional grant from the Québec Government, to whom we are grateful. We are specifically thankfull to the Government for having given us total freedom in selecting topics we thought were important, thus expressing its confidence in the selection of our projects. In Québec, there are few official forums where practitioners, public-sector executives and researchers can discuss new issues in taxation and public finances. In addition, research in these fields generally focuses on a single discipline to the detriment of the multi-disciplinary aspect of relations between the state and its taxpayers. The **Research Chair in Taxation and Public Finance** was formed in response to these two realities. Its primary mission is to stimulate interdisciplinary research and training by bringing together professors and researchers interested in the political economy of taxation. For more information on the **Research Chair in Taxation and Public Finance**, visit its official Website at: http://www.usherbrooke.ca/adm/recherche/chairefiscalite/.

Gilles Larin holds the Research Chair in Taxation and Public Finance. Marie Jacques is a full professor at the Université de Sherbrooke. Robert Duong[1] was a research professional with the RCTPF when this study was produced.

We wish to express our gratitude for their observations and suggestions to Gaston Bédard, a consultant, and to readers who wished to remain anonymous. Of course, the opinions expressed herein are those of the authors, who assume full responsibility for the comments and interpretations in this study.

[1] Robert Duong, who is a lawyer, was a research associate with the Research Chair of Taxation and Public Finance at the University of Sherbrooke when this study was done. He is now working with the federal Department of Finance as a policy officer in the area of income tax. The views expressed in this publication are those of the authors and do not in any way represent the position of the Department of Finance of Canada. The material contained in this publication is not intended to be advice on any particular matter. No subscriber or other reader should act on the basis of any matter contained in this publication without considering appropriate professional advice. The publisher, and the authors and editors, expressly disclaim all and any liability to any person, whether a purchaser of this publication or not, in respect of anything and of the consequences of anything done or omitted to be done by any such person in reliance upon the contents of this publication.

Abstract

Instalment 6: The United States – Proposed Economic Substance Doctrine Codification

In 2005, the Research Chair in Taxation and Public Finance initiated studies on aggressive tax planning in light of concerns expressed by tax administrations, the courts, taxpayers and tax advisers ("**stakeholders**"). This project analyses the tools developed by some of Canada's major trading partners in response to aggressive tax planning schemes implemented by taxpayers and tax advisers.

This project aims to spark thinking among the various stakeholders in Canada by taking a comprehensive and pragmatic approach to several issues inherent in aggressive tax planning. In view of the scope of the subject, its complexity and the specific nature of the taxation systems of foreign jurisdictions, our study should be seen as a reflection on aggressive tax planning rather than an exhaustive analysis of each of the tools examined and all of the associated issues. This project was written over a more than a 2 year period. As the underlying logic was the key element we wished to convey, we wish to emplasise that these documents do not necessarily reprensent the state of tax legislation or jurisprudence.

As part of this project, the Chair held a symposium in 2006 on the risks inherent in aggressive tax planning for all stakeholders and published a discussion paper detailing the major issues of these schemes.

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal is to assess whether it would be worthwhile for Canada to develop one or more of these tools to safeguard its tax system. We are conducting this assessment bearing in mind the point of view of each of the stakeholders, according to generally recognized principles of tax administration.

This study consists of ten instalments detailing the study framework that guided our analysis of the tools developed in other jurisdictions and our study of each of the selected tools. Our conclusions were originaly destined to be the 10th instalment and propred solutions for Canada. However, it is not published here, because it was recast and augmented to become *Tax Paper* No. 112, published in July 2009 by the Canadian Tax Foundation: *Effective Responses to Aggressive Tax Planning – What Canada Can Learn from Other Jurisdictions*.

We refer the reader to instalment 1, "Study Framework", for an overview of our thinking throughout the instalments.

This instalment examines the proposed economic substance doctrine codification in the United States. While opinions differ in Canadian courts on the role of such a doctrine for the purposes of applying the general anti-avoidance rule (GAAR), the US courts have developed and applied this doctrine in order to rescind tax benefits stemming from abusive tax planning schemes. However, conflicts persist in the decisions of the US courts concerning the criteria governing the application of this doctrine. It is in this context that the American tax administration has formulated several proposed codifications of the doctrine.

In this instalment, we first describe the general context of the economic substance doctrine in the United States. We identify the key application details and the factors inherent in its application for each group of stakeholders, which in turn leads us to study the solutions that different codification proposals attempt to provide. We formulate in this instalment conclusions on the application of this tool in the United States.

In our view, the numerous attempts to codify the economic substance doctrine illustrate the doctrine's usefulness in establishing a dividing line between routine commercial transactions and transactions carried out for tax avoidance purposes. According to the Chair, the application by numerous US courts of the economic substance doctrine has enabled them to rescind tax benefits that the GAAR would not have withdrawn. Subject to the persistent uncertainty in the criteria governing the application of the economic substance doctrine in the United States, we believe that the introduction of its key principles for the purposes of the application of the GAAR would make it possible establish a less ambiguous demarcation between abusive tax planning schemes and legitimate transactions.

In light of the numerous attempts at codification, we are able to observe the difficulties inherent in the formulation of application criteria in respect of such a doctrine. The main problem is to define in a predictable, flexible manner what a taxpayer's level of anticipation of a profit in a transaction should be and the degree of economic risk below which a viable economic objective is discernable. An objective, impartial evaluation of the purposes that the taxpayer pursues according to generally recognized commercial standards and qualified according to the facts and circumstances would significantly mitigate the risks that groups of stakeholders arbitrarily evaluate the objectives that a taxpayer pursues. In our view, such an approach allows for the pragmatic reconciliation of the principles of predictability and flexibility in the application of tax law for the benefit of each group of stakeholders.

The penalty in the United States for under-stating tax payable stemming from a transaction carried out for tax avoidance purposes significantly increases the risks that an aggressive taxpayer runs. The application of a penalty when the taxpayer cannot reasonably believe according to the balance of probabilities that obtaining the tax benefits complies with the economic substance doctrine strikes a balance between the taxpayer's privilege of minimizing his tax payable and the integrity of the taxation system. However, bearing in mind the differences of opinion on the application of this doctrine and in the absence of precise, uniform parameters, the courts might be inclined to avoid imposing the penalty when a planning scheme is deemed, according to a literal interpretation, to comply with tax law.

In several cases, the American tax administration might ask the taxpayer to produce numerous documents to justify the aggressive tax planning scheme carried out. Given that the taxpayer might thus have to relinquish legal professional privilege to avoid this penalty, the tax administration must not apply it systematically or abusively in order to mainly collect information that is otherwise protected by privileges of confidentiality.

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1

General context

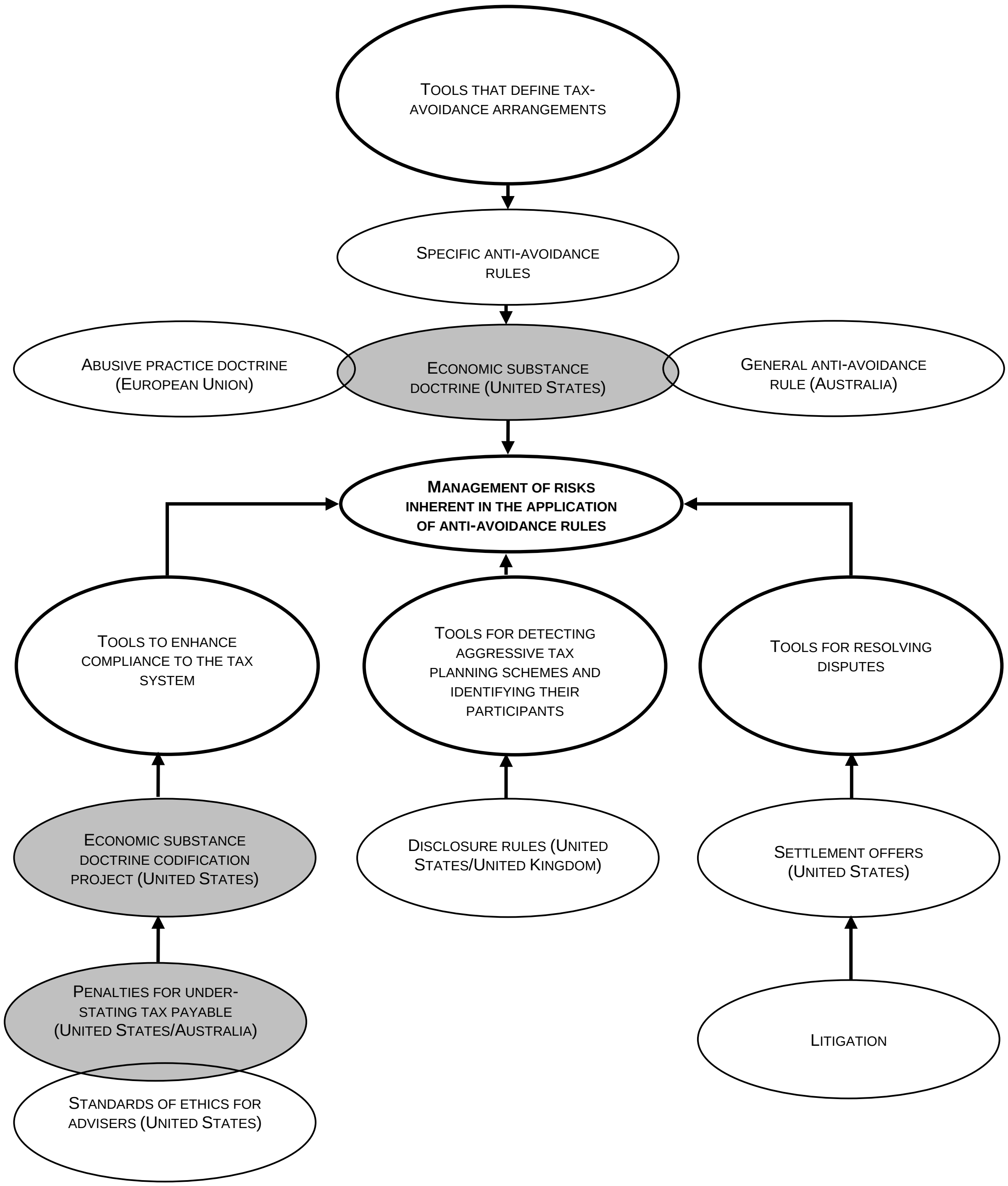
As indicated in instalment 1, “Study Framework,” of this study, the tax administration could adopt several tools to better delineate tax avoidance operations or heighten the risks that they imply for aggressive taxpayers and tax advisers. These tools can be grouped together according to the following spheres of intervention of the tax administration:

- tools aimed at defining tax avoidance arrangements;
- tools designed to enhance compliance to the tax system;
- tools centred on the detection of aggressive tax planning schemes and participants in such schemes;
- tools devoted to the settlement of disputes.

Chart 1.1 on the following page concisely illustrates the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted in the appropriate spheres of intervention. The tools covered by this study, i.e. the economic substance doctrine, the proposed codification of the doctrine, and the penalty of under-stating tax payable are highlighted by a grey screen in order to situate their role in the management by the American tax administration of the risks inherent in aggressive tax planning.

We refer the reader to instalment 5, entitled “The United States – General Context and Presentation of the American Broad-Spectrum Approach” for more detailed explanations of the American context.

CHART 1.1
SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING: SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS – ROLE OF THE ECONOMIC SUBSTANCE DOCTRINE IN THE UNITED STATES AND THE PENALTY FOR UNDER-STATING TAX PAYABLE



Our Chart.

2

Context of the proposed economic substance doctrine codification: the jurisprudence contains numerous forms of the doctrine

Under their self-assessment system, American taxpayers assume responsibility for accurately determining their tax payable. Taxpayers and their advisers might be tempted to organize their affairs to take advantage of disparities and inconsistencies in the tax law and the formulation of the general concepts used to determine their tax payable. If a grey area appears in the interpretation of the law, taxpayers and tax advisers might interpret the tax rules literally in order to claim tax benefits.

The American tax administration seeks to protect the integrity of the taxation system by prescribing specific anti-avoidance rules that rescind tax benefits stemming from transactions that the tax administration has pinpointed. It will also withdraw tax benefits that taxpayers claim because their planning schemes undermine the purposes that the tax rules pursue. The tax administration may also levy a penalty for under-stating tax payable that is basically equivalent to 20% of the amount of tax under-stated.

The American tax administration has not incorporated into its legislation a general anti-avoidance rule as Canada and Australia have done. The US Congress has contemplated this possibility on several occasions but has not until now acted on the proposals.

In the absence of such a rule and because American law contains its share of grey areas, American courts have often fallen back on principles of interpretation centred, in particular, on the economic substance of taxpayers' transactions. The proliferation in the United States of aggressive tax planning schemes, especially over the past 20 years, has increased recourse by American courts to an array of doctrines, several of which are similar. The courts often use them jointly in order to rescind tax benefits stemming from abusive tax avoidance transactions.

These interpretation doctrines include business purpose, sham, substance over form and step transactions.

The courts primarily base their decisions on the economic substance doctrine. Over the years, the courts have developed this doctrine, which plays a key role in the American tax administration's offensive against aggressive tax planning schemes.

Briefly, the economic substance doctrine can be described as a method of legislative interpretation pursuant to which the tax benefits that a taxpayer claims may be withdrawn if such benefits stem from one or more transactions that do not significantly alter his economic situation other than by reducing his tax burden. Under this doctrine, the courts may rescind the tax benefits that taxpayers claim stemming from transactions that do not genuinely change their economic situation.[2] In practice, it expressly or implicitly takes up the principles underlying the other doctrines mentioned earlier.

The economic substance doctrine seeks to avoid any literal interpretation of the law without taking into consideration its purposes. In the *Coltec* case, the Federal Circuit Appeal Court explained the raison d'être and scope of application of this tool:

> Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality. This principle has its roots in several Supreme Court cases. … The economic substance doctrine has also been repeatedly applied by our predecessor court. … The various tax treatises also recognize the doctrine's continued viability.
>
> The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.[3]
>
> [our extracts]

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[2] See the court decisions handed down in favour of taxpayers listed in Yoram Keinan, "The Economic Substance Doctrine – Past, Present and Future" (June 26, 2005) *Tax Management Memorandum 259* [Keinan, "Economic Substance"], pages 263-264.

[3] *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. App. 2006), 2006 U.S. App. LEXIS 24771 (Fed. Cir. App. 2006), (July 12, 2006) U.S. Court of Appeals for the Federal Circuit, 05-5111 [*Coltec* (Fed. Cir. App.)] cert. denied by the US Supreme Court: *Coltec Indus.* v. *United States*, 2007 U.S. LEXIS 2087 (U.S., 2007). Instalment 5 of Part II of this study summarizes this case.

The courts have not, however, uniformly applied the economic substance doctrine. They have recognized the tax benefits claimed by taxpayers stemming from aggressive tax planning when the taxpayer was able to establish:

- both that his economic situation was altered as a result of the transaction and that he was seeking to achieve a legitimate non-tax purpose;
- either that his economic situation was altered as a result of the transaction or that he was seeking to achieve a legitimate non-tax purpose;
- that in light of various factors, including the preceding components, a transaction had an economic impact on his situation beyond tax benefits.

Moreover, the courts have not uniformly applied the numerous criteria that they have developed to assess the economic substance of a transaction. In particular, they have applied the doctrine according to any of the following criteria:

- the impossibility for the taxpayer of making a profit through a transaction;
- the value of potential profits in a transaction were negligible in relation to the value of the tax benefits stemming from it, bearing in mind the economic risks to the taxpayer;
- the impossibility for a taxpayer to reasonably, objectively expect to make a pre-tax profit through a planning scheme.[4]

Consequently, the principles of interpretation that the courts apply to a transaction are somewhat vague.[5] As one court has already emphasized, the numerous forms of the economic

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[4] US, Joint Committee on Taxation, *Description of the Chairman's Modification to the Provisions of s. 1321, the "Telephone Excise Tax Repeal Act" of 2005 and s. 832, the "Taxpayer Protection and Assistance Act of 2005"* (JCX-28-06), June 28, 2006 [JCT, *Taxpayer Protection Act 2006*], pages 131-132. In respect of the proposed codification of the doctrine covered by the preceding document, see United States, Bill S. 1321 (rs), *Telephone Excise Tax Repeal and Taxpayer Protection and Assistance Act of 2006*, 109th Congress, September 15, 2006 [Senate Bill, *Taxpayer Protection Act 2006*], section 801.

[5] See the *Long Term Capital Holdings* v. *United States* case, 330 F. Supp. 2d.122, 2004 U.S. Dist. LEXIS 17159 (D. Conn. 2004) [*Long Term Capital Holdings* (D. Conn.)], decision upheld on appeal by 150 Fed. Appx. 40, U.S. App. LEXIS 20988 (Second Cir. 2005) [*Long Term Capital Holdings* (Second Cir.)] appealed solely in respect of the step transaction doctrine. This case illustrates the possibility of the courts' simultaneously applying several legal doctrines. The Court maintained at that time an assessment issued by the tax administration on the grounds that the planning schemes that the assessed taxpayers carried out were void of economic substance.

substance doctrine in the jurisprudence engender more unpredictability in the application of the law rather than enhancing its coherence and predictability:

> The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.[6]
>
> [our extracts]

Given the importance of the economic substance doctrine and the inconsistencies in its application, since 1999, the tax administration has repeatedly formulated a proposed codification to ensure more uniform application of it by all groups of stakeholders. The US Senate is proposing to establish in the law economic criteria that the courts must apply if they believe that compliance by a planning scheme with tax law must be evaluated according to this doctrine.[7]

The US Senate is of the opinion that a taxation system strictly based on rules adopted on an *ad hoc* basis is insufficient to target all forms of transactions carried out for tax avoidance purposes and cannot dissuade taxpayers from carrying them out. The Senate is proposing to codify the economic substance doctrine so that the tax law is applied according to its purposes in a more predictable, uniform manner. The Senate also believes that a system of penalties for under-stating tax payable must be appended to the doctrine in order to further dissuade taxpayers from engaging in abusive tax planning schemes:

> Recent tax avoidance transactions have relied upon the interaction of highly technical tax law provisions to produce tax consequences not contemplated by the Congress. When successful, taxpayers who engage in these transactions enlarge the tax gap by gaining unintended tax relief and by undermining overall respect for the tax system.
>
> *A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement tax rules with anti-tax avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved.* The Committee recognizes that IRS has achieved a number of recent successes in litigation. The Committee believes it is still

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The Court also concluded in a subsidiary manner that the planning schemes should be restated pursuant to the step transaction doctrine, which does not take into consideration the steps implemented solely for tax purposes.

6 *Collins* v. *Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988) [*Collins*].

7 For the latest proposed codification at the time of publication of this document, see United States, Bill S. 2242, *Heartland, Habitat, Harvest, and Horticulture Act of 2007*, 110th Congress, October 25, 2007 [Senate Bill, *Heartland Act 2007*], sections 511 to 513. For a previous proposal, see JCT, *Taxpayer Protection Act*, *supra* note 4.

> desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to assure such continued application of the doctrine and to improve its effectiveness at deterring unintended consequences. *The Committee believes that a stronger penalty imposed on understatements attributable to non-economic substance transactions is desirable in this connection, to deter taxpayers from entering such transactions and thus improve compliance*[8].
>
> [our extracts and italics]

The American tax administration is focusing more closely on codification proposals since it estimates that the codification of economic substance would enable it to collect additional revenues.[9] However, it is virtually impossible for the tax administration to evaluate with certainty the amount of such revenues. Over the past two years, the tax administration has published disparate assessments in this respect:

- In 2006, the Joint Committee on Taxation surmised that the codification of the economic substance doctrine and the attendant measures would enable the tax administration to collect roughly US$18 billion in taxes and penalties for the period 2007 to 2016.[10]
- In 2007, the US Senate estimated that the codification of the economic substance doctrine and the attendant measures would enable the tax administration to collect approximately US$10 billion for the period 2008 to 2017.[11]
- In 2007, the House of Representatives reckoned that the codification of the economic substance doctrine and the attendant measures would enable the tax administration to collect a total of US$3.59 billion over a period of ten years.[12]

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[8] United States, Senate Finance Committee, *Heartland, Habitat, Harvest, and Horticulture Act of 2007* (Report No. 110-206), October 26, 2007 [Senate Finance Committee, *Heartland Act Report*], page 114.

[9] See "Economic Substance Codification Seen More Likely in Next Congress" in (2007) 22:12 Tax Management Financial Planning 334 (anonymous author); Jeremiah Coder, Lee A. Sheppard, "Congress Will Pass Economic Substance Codification in 2008, Government Officials Predict" (2008) TNT 15-5 (23 janvier 2008).

[10] United States, Joint Committee on Taxation, *Estimated Revenue Effects of the Chairman's Modification to the Provisions Contained in S. 1321, the "Telephone Excise Tax Repeal Act of 2005", and S. 832, the "Taxpayer Protection and Assistance Act of 2005"* (JCX-29-06), June 28, 2006. The document contains, I particular, the following passage: "An overview of the current procedures used in the revenue estimating process is provided in Joint Committee on Taxation, Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation (JCX-1-05), February 2, 2005. The report provides a summary of the revenue estimating responsibilities of the Joint Committee staff; discusses requirements, constraints, and conventions of the revenue estimating process; and presents the estimating procedures and models used by the Joint Committee staff in preparing revenue estimates. The emphasis is solely on methodology and issues associated with the preparation of conventional revenue estimates of proposed changes to the Internal Revenue Code."

[11] United States, Senate Finance Committee, *Estimated Budget Effects of the "Heartland, Habitat, Harvest and Horticulture Act of 2007,"* October 26, 2007.

[12] United States, House of Representatives (Committee on Ways and Means), *H.R. 3970 Tax Reduction and Reform Act of 2007, Summary of Legislation* (October 29, 2007), online on the House of Representatives Website: <http://waysandmeans.house.gov/media/pdf/110/Summary%20for%20Distribution.pdf>. The draft legislation, tabled on October 25, 2007, is available online: <http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h3970ih.txt.pdf>.

The tax administration has never adopted the codification proposals because of differing opinions among groups of stakeholders on the application details proposed (some members of the tax administration are actually opposed to the codification proposals). Without codification, the three main currents of application of the economic substance doctrine will remain until the US Supreme Court seizes the opportunity to express an opinion on the precise nature of the application criterion or criteria of the economic substance doctrine.

As a judge of the United States Tax Court has emphasized, the courts must be able to apply the economic substance doctrine both to the simplest and most complex aggressive tax planning schemes. They could then flexibly reconcile the protection of the taxation system's integrity and the privilege of taxpayers to minimize their tax payable:

> To put into proper perspective both the desire of the taxpayer to reduce his taxes or avoid them altogether, and the need in behalf of the government to require that the tax law be respected and that all taxpayers pay their rightful share, we need a standard of analysis. The standard must be flexible and sophisticated enough to be able to evaluate the global, intricate, and even exotic transactions as well as the simplest business dealings. Economic substance is such a standard. By using economic substance as our standard of analysis, we can delve into the complexities of today's transactions, examining them from a similar perspective that Wall Street uses—economic analysis.[13]
>
> [our extracts]

To better situate the context surrounding the economic substance doctrine, the following subsections deal with the origin of the doctrine and its implementation principles and the application details of the penalty for under-stating tax payable.

2.1 Origin of the doctrine

Judge Hand explained the principles underlying several common law legal doctrines in the United States in the *Gregory* v*. Helvering* case.[14] This judicial decision is often deemed to be

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[13] See the Honorable David Laro (United States Tax Court), "Economic substance: a view from the Tax Court" in *The Tax Executive* (January-February 2000) 44 [Laro, "A view from the Tax Court"], page 46, online on the Tax Executive Institute Website: <http://www.tei.org/dman/Document.phx/Public/TTE%20Archive/2000/JAN-FEB%202000/Economic%20Substance%3A%20A%20View%20from%20the%20Tax%20Court?folderId=%2FPublic%2FTTEArchive%2F2000%2FJAN-FEB 2000&cmd=download>.

[14] *Gregory* v. *Helvering,* 69 F.2d 809 (Cir. Ct. App., 1934) [*Gregory* (Cir. Ct. App.)], ruling upheld by the US Supreme Court, 293 U.S. 465 (1935) [*Gregory* (Supreme Ct.)].

one of the judgements at the origin of the substance over form doctrine, the business purpose doctrine and the economic substance doctrine.

In this case, the courts refused to recognize a transaction through which a taxpayer sought to avoid the disadvantageous tax consequences that would have stemmed from the payment to him of a dividend by a company of which he was the sole shareholder. This company could realize a capital gain if it disposed of the shares that it held in another company. In order for the taxpayer to derive from this transaction an economic benefit, the company should have paid him a dividend.

To distribute the proceeds of the sale of the shares held by the company, the taxpayer decided instead to transfer the shares that the company held to a new company established solely for this purpose. This new company was then quickly dissolved and the taxpayer became the owner of the shares when the assets were distributed. The taxpayer subsequently sold these shares and declared a capital gain.

The taxpayer alleged that reorganization had occurred according to a provision in the US tax law then in force.[15] Under this provision, the transfer between companies of shares had no fiscal impact. The tax administration disagreed with this interpretation and rescinded the tax benefits claimed by the taxpayer.

Judge Learned Hand of the Circuit Court of Appeals concluded that the transaction appeared to comply with the wording of the legislative provision but declined to apply it since the concept of reorganization for the purposes of the provision implied the pursuit of a purpose linked to the taxpayer's business affairs and not the simple reduction of his tax burden. In his judgement, the judge stated the bases of the principle under which the courts may refuse to apply a legislative provision to a transaction even if it conforms to the provision's wording.

The Circuit Court of Appeals decided that the transfer between the companies of the shares did not in itself constitute, within the meaning of the applicable rule, a reorganization of the

[15] 26 USCA 2112(g).

taxpayer's commercial structure and that the taxpayer had not altered his position other than through a reduction in his tax burden. The taxpayer was unable to take advantage of the tax benefits stemming from a corporate reorganization because the court believed that the true nature of the taxpayer's planning scheme was not covered by the rule. The judge expressed himself in these terms in this regard:

> It does not follow that Congress meant to cover such a transaction. … *The meaning of a sentence may be more than that of the separate words*, as a melody is more than notes, *and no degree of particularity can ever obviate recourse to the setting, in which all appear, and which all collectively create*.
>
> *If what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was … [But] the purpose of the section is plain enough*; men engaged in enterprises … might wish to consolidate, or divide, to add to, or to subtract from, their holdings. Such transactions were not considered as realising any profit, because the collective interest still remained in solution. But *the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution … To dodge shareholder taxes is not one of the transactions contemplated as a corporate "reorganisation."* […] We cannot treat as inoperative the transfer of shares … The transfer passed title […] And the taxpayer became a shareholder of the transferee. *All these steps were real and their only defect was that they were not what the statute meant by reorganisation.*[16]
>
> [our extracts and italics]

The US Supreme Court upheld this ruling in these terms:

> *It is earnestly contended on behalf of the taxpayer that since every element required by [the statute] is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows.* It is quite true that if reorganization in reality was effected within the meaning of [the statute], the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his [or her] taxes, or altogether avoid them, by means which the law permits, cannot be doubted. ... *But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.* The reasoning of the court below [i.e., the reasoning of the Court of Appeals] in justification of a negative answer leaves little to be said.
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> *When [the statute] speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' ... of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose - a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation*

[16] *Gregory* (Cir. Ct. App.)*, supra* note 14, pages 810-811.

> *of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.* No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.
>
> *In these circumstances, the facts speak for themselves and are susceptible of but one interpretation.* The whole undertaking, though conducted according to the terms of [the statute], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. … *The transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.*[17]
>
> [our extracts and italics]

The application of this doctrine is more compatible with a teleological interpretation approach to legislative texts that focus on the purposes of the text, as opposed to a literal interpretation method. In the *Gregory* case, the US Supreme Court recognized the taxpayer's irrefutable right to minimize his tax burden, but specified that the applicable tax rules do not allow him to take advantage of tax benefits stemming from transactions that are devoid of commercial or corporate motivation. Under circumstances similar to those present in the *Gregory* case, the courts might then conclude that taxpayers may not claim tax benefits stemming from the transfer of assets that have no commercial purpose and that have no impact other than a reduction of tax on the taxpayer's cash flow.[18]

The US Supreme Court once again recognized the principles underlying the economic substance doctrine in the *Knetsch* case.[19] In this case, the majority justices of the Court ignored the tax benefits claimed by the taxpayer through a planning scheme in which he had deducted the interest that he alleged to have paid to reimburse a loan contracted for investment purposes.[20]

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17 *Gregory* (Supreme Ct.), *supra* note 14, pages 468-470.

18 *Higgins* v. *Smith*, 308 U.S. 473 (1940) [*Higgins*], page 476, US Supreme Court ruling.

19 *Knetsch* v. *United States*, 364 U.S. 361 (1960) [*Knetsch*], US Supreme Court ruling.

20 Briefly, the dissenting justices had granted the taxpayers the tax benefits although the planning scheme was devoid of economic substance, since the parties had in fact carried it out according to commercial practices in the insurance sector regulated by the laws of the United States. Their opinion is included in subsection 4.1.

The lower courts and the Supreme Court concluded that the objective pursued by the taxpayer was to reduce his tax. Notwithstanding this conclusion, the Supreme Court had to ascertain whether the taxpayer was entitled under the applicable rules to deduct the interest paid in the calculation of his income. A majority of Supreme Court justices concluded in light of the evidence that the taxpayer had not achieved anything substantial according to the requirements of the applicable rules and that the veritable essence of the transaction was solely to obtain a tax deduction. The following passage from the ruling clearly summarizes the Court's analysis the led to this conclusion:

> We first examine the transaction between Knetsch and the insurance company to determine whether it created an "indebtedness" within the meaning of 23 (b) of the 1939 Code and 163 (a) of the 1954 Code, or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction." As was said in Gregory v. Helvering, 293 U.S. 465, 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. ... But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."
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> When we examine "what was done" here, we see that Knetsch paid the insurance company $294,570 during the two taxable years involved and received $203,000 back in the form of "loans." What did Knetsch get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000, which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000. Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax …" … For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68. There may well be single-premium annuity arrangements with nontax substance which create an "indebtedness" for the purposes of 23 (b) of the 1939 Code and 163 (a) of the 1954 Code. But this one is a sham.[21]
>
> [our extracts]

The American tax authorities subsequently continued to attack transactions deemed to be abusive by systematically invoking the absence of economic substance. In 1978, Justice

[21] *Knetsch*, *supra* note 19, pages 365-367.

Blackmun of the US Supreme Court reiterated the importance of the economic substance of a transaction in the *Frank Lyon* case.[22]

Briefly, the Supreme Court had to determine whether the taxpayer could take advantage of a capital cost allowance in respect of a building acquired from a bank in conjunction with a sale-leaseback scheme. The bank wished to engage in banking operations in this building but various regulatory restrictions prevented it from obtaining a loan for this purpose. It proposed to the regulatory authorities the notion of a sale-leaseback, which the latter accepted, provided that a third party own the building. At the conclusion of complex negotiations conducted with several parties, the bank adopted the taxpayer's proposal.

The bank contracted with a financial institution a mortgage loan guaranteed by the building and the adjacent lot. The bank launched the construction of the building and transferred to the taxpayer each portion of the building as the construction progressed. Once the taxpayer had acquired the entire building, he granted a lease to the bank. At the same time, the taxpayer replaced the bank in respect of the lender under the terms of the mortgage loan and transferred to it his rights pursuant to the leases (conveyance of rents):

> Worthen initially hoped to finance, to build, and to own the proposed facility at a total cost of $9 million for the site, building, and adjoining parking deck. This was to be accomplished by selling $4 million in debentures and using the proceeds in the acquisition of the capital stock of a wholly owned real estate subsidiary. This subsidiary would have formal title and would raise the remaining $5 million by a conventional mortgage loan on the new premises. Worthen's plan, however, had to be abandoned for two significant reasons:
>
> 1. As a bank chartered under Arkansas law, Worthen legally could not pay more interest on any debentures it might issue than that then specified by Arkansas law. But the proposed obligations would not be marketable at that rate.
>
> 2. Applicable statutes or regulations of the Arkansas State Bank Department and the Federal Reserve System required Worthen, as a state bank subject to their supervision, to obtain prior permission for the investment in banking premises of any amount (including that placed in a real estate subsidiary) in excess of the bank's capital stock or of 40% of its capital stock and surplus. See Ark. Stat. Ann. 67-547.1 (Supp. 1977); 12 U.S.C. 371d (1976 ed.); 12 CFR 265.2 (f) (7) (1977). Worthen, accordingly, was advised by staff employees of the Federal Reserve System that they would not recommend approval of the plan by the System's Board of Governors.

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[22] *Frank Lyon* v. *United States*, 435 U.S. 561 (1978) [*Frank Lyon*], US Supreme Court ruling. Two of the nine justices sitting on the bench dissented: they would have rescinded the capital cost allowance claimed by the taxpayer in respect of a building that he owned on the grounds that he did not in practice possess the economic attributes inherent in ownership of the building. We will examine this dissenting opinion in subsection 2.5.1.

> Worthen therefore was forced to seek an alternative solution that would provide it with the use of the building, satisfy the state and federal regulators, and attract the necessary capital. In September 1967 it proposed a sale-and-leaseback arrangement. The State Bank Department and the Federal Reserve System approved this approach, but the Department required that Worthen possess an option to purchase the leased property at the end of the 15th year of the lease at a set price, and the federal regulator required that the building be owned by an independent third party.
>
> …
>
> Worthen then obtained a commitment from New York Life Insurance Company to provide $7,140,000 in permanent mortgage financing on the building, conditioned upon its approval of the titleholder. At this point Lyon entered the negotiations and it, too, made a proposal. … Lyon in November 1967 was approved as an acceptable borrower by First National City Bank for the construction financing, and by New York Life, as the permanent lender. In April 1968 the approvals of the state and federal regulators were received.
>
> In May 1968 Worthen, Lyon, City Bank, and New York Life executed complementary and interlocking agreements under which the building was sold by Worthen to Lyon as it was constructed, and Worthen leased the completed building back from Lyon[23].
>
> [our extracts]

Briefly, the financial details of the sale-leaseback scheme were as follows:

- During the first 25 years, the bank possessed the attributes and expenses inherent in the ownership of a building without being the legal owner of it.
- During the first 25 years of the lease, the planning scheme had no impact on the taxpayer's net financial position. The amount of the rent paid by the bank was equivalent to the mortgage payments that the taxpayer had to pay the financial institution on the bank's behalf.
- The bank could acquire the building after eleven years by assuming the portion of the accrued debt and $500,000 paid by the taxpayer for the construction of the building, at 6% interest. It was then possible for the bank to realize an economic gain stemming from the potential increase in the building's value.
- In the event of the almost total devaluation of the building, the taxpayer ran the risk of losing the capital initially invested if the bank did not exercise its option to acquire the building for an amount equivalent to this capital or if it failed to renew the lease after 25 years.[24]

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23 *Ibid.,* pages 563-565.

24 This summary essentially takes up again that of Bernard Wolfman, "Supreme Court in the Lyon's Den: A Failure of Judicial Process" (1980-81) 66 Cornell L. Rev. 1075, page 1080. Adapted by the authors.

The majority of the Supreme Court justices concluded that the taxpayer owned the building and could take advantage of a capital cost allowance. In light of an array of facts and circumstances, the Court concluded that the taxpayer truly possessed and to a sufficient degree the attributes of a building owner. Justice Blackmun asserted, on behalf of the majority, that the taxpayer's transactions had to have an economic substance separate from the benefit engendered by the tax savings that it allowed the taxpayer to achieve. The majority concluded that planning schemes had an economic substance separate from tax benefits. Justice Blackmun expressed this principle thus:

> Where … there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts. It suffices to say that, as here, a sale-and-leaseback, in and of itself, does not necessarily operate to deny a taxpayer's claim for deductions.[25]
>
> [our extracts]

All in all, the Supreme Court set forth the following principles pursuant to which the tax benefits that taxpayers claim may be rescinded if they are based on a literal interpretation of certain tax rules:

- In the *Gregory* case, the Court concluded that the applicable tax rules did not allow the taxpayer to take advantage of the tax benefits stemming from transactions that were devoid of commercial or corporate motivation.

- In the *Knetsch* case, it concluded in light of the evidence that the taxpayer had not accomplished anything substantial according to the requirements of the applicable rules and that the veritable essence of the transaction was solely to obtain a tax deduction.

- In the *Frank Lyon* case, the taxpayer's transactions had to have a separate economic substance from the benefit engendered by the tax savings that transactions allowed the taxpayer to achieve.

[25] *Ibid.,* pages 583-584.

The courts of first instance and the Appeal Courts have frequently applied the principles in the rulings of the US Supreme Court to planning schemes and tax rules, although they have not applied them consistently. The courts have applied the economic substance doctrine by means of three distinct approaches.

2.2 Application details of the doctrine

Under the economic substance doctrine, the courts examine the purposes pursued by the taxpayer in a planning scheme and the scheme's objective economic substance. This approach refers essentially to two separate legal doctrines, i.e. the business purpose doctrine and the substance over form doctrine.[26] A number of American courts refer to the approach formulated in the *Rice's Toyota* case.[27] Briefly, this doctrine comprises two sections to represent this duality. It can be stated thus:

> To treat a transaction as a sham, the court must find [(1)] that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and [(2)] that the transaction has no economic substance because no reasonable possibility of a profit exists. Whether under this test a particular transaction is a sham is an issue of fact[28].
>
> [our extracts]

To describe these two facets of the economic substance doctrine, we will refer to the "subjective section" and the "objective section."

2.2.1 Subjective section: pursuit of a non-tax purpose

Under this section, the courts ascertain whether the transactions that the taxpayer carries out have a rational link with a legitimate non-tax purpose, in light of his conduct and economic situation. The courts dwell on the taxpayers' intentions at the time that he decided to engage in the planning scheme and will, by and large, seek to pinpoint the presence of a commercial purpose. They will determine the economic substance of a transaction from the taxpayer's point

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26 See Donald L. Korb (Chief Counsel for the Internal Revenue Service), speech, "The Economic Substance Doctrine In The Current Tax Shelter Environment," 2005 University of Southern California Tax Institute, January 25, 2005 [Korb, *Economic Substance Doctrine*], page 6. Transcript available on the IRS Website: <http://www.irs.gov/pub/irs-utl/economic_substance_(1_25_05).pdf>.

27 *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F. 2d. 89 (4th Cir. 1985) [*Rice's Toyota* (Fourth Cir.)].

28 *Ibid.* note 27, pages 91-92, where reference is made, in particular, to passage in the ruling handed down by the court of first instance, in *Rice's Toyota World, Inc.* v. *Commissioner*, 81 T.C. 184 (1983) [*Rice's Toyota* (Tax Ct.)], page 209.

of view, according to a subjective analysis. One court, when it refers to the *Rice's Toyota* case, generally described the subjective section of the test as follows:

> The business purpose inquiry examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved. … The determination of whether the taxpayer had a legitimate business purpose in entering into the transaction involves a subjective analysis of the taxpayer's intent. *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989).[29]
>
> [our extracts]

2.2.2 Objective section: a planning scheme must have an impact on the taxpayer's economic situation

Under this section, the courts will determine based on objective indicators whether the taxpayers' economic position has improved or is likely to improve following the transaction. The courts then assess the economic substance of a transaction regardless of the taxpayers' tax-related motivation.

2.3 Differences of opinion in the courts in the application of the two sections

The American courts continue to date to express differing opinions on the application of the economic substance doctrine. Appeal courts, in particular, have quashed decisions handed down by courts of the first instance in favour of taxpayers on the grounds that the courts erred in the application of this doctrine.

Over the years, the courts have not uniformly applied the two sections of this doctrine.[30] It is possible to pinpoint three separate jurisprudential trends, i.e. the conjunctive approach, the disjunctive approach and the unitary approach.

For the purposes of this instalment, we are advocating an approach centred on the taxpayer's viewpoint since the taxpayer assumes the burden of proof before the courts: the conjunctive, disjunctive or unitary approaches refer to evidentiary elements that the taxpayer must establish

29 *Shriver* v. *Commissioner*, 899 F.2d 724 (8th Cir. 1990) [*Shriver*], page 726.

30 See *Collins*, *supra* note 6.

in order to satisfy the economic substance doctrine. We should, nonetheless, emphasize that these approaches are sometimes described in the tax literature from the viewpoint of the courts. In this perspective, the courts adopt a conjunctive approach if they rescind the tax benefits claimed by a taxpayer when the planning scheme does not satisfy both sections of the doctrine. From the same point of view, the courts adopt a disjunctive approach if they withdraw the tax benefits claimed by a taxpayer stemming from a planning scheme when the scheme does not satisfy either section. In the case of the unitary approach, the courts will determine whether the taxpayer establishes a relevant proof by means, among other things, of both sections of the doctrine.

2.3.1 The conjunctive approach: the taxpayer must establish that the planning scheme satisfies both sections of the doctrine

The courts that apply the doctrine according to a conjunctive approach demand that the taxpayer's transaction simultaneously satisfies both sections of the doctrine.[31] The taxpayer must, therefore, simultaneously demonstrate the pursuit of a non-tax commercial purpose and the presence of economic substance.

2.3.2 The disjunctive approach: the taxpayer must establish that the planning scheme satisfies either section of the doctrine

When the courts adopt a disjunctive approach, it is sufficient for the taxpayer to demonstrate either the pursuit of a commercial purpose or the adequate presence of economic substance in the planning scheme to warrant obtaining the tax benefits stemming therefrom.[32]

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[31] The courts have emphasized this approach in the *Illes* v. *Commissioner*, 982 F.2d 163, 165 (6th Cir. 1992), cert. denied by the US Supreme Court, 507 U.S. 984 (1993); *Pasternak* v. *Commissioner*, 990 F.2d 893 (6th Cir. 1993) [*Pasternak*], page 898; *United Parcel Service of America Inc.* v. *Commissioner*, 254 F.3d 1014 (11th Cir. 2001) [*UPS of America*], page 1018.

[32] *Rice's Toyota* (4th Cir.), *supra* note 27, page 91; *Black & Decker Corp.* v. *Commissioner*, 436 F.3d 431, 441 (4th Cir. 2006) [*Black & Decker* (4th Cir.)].

2.3.3 The unitary approach: the taxpayer must establish the economic substance of his planning scheme by means of the relevant proof bearing in mind the two sections taken together

Some courts are of the opinion that the substance of a transaction must not be determined by a compartmentalized analysis of one or the other section. Instead, they opine that the objective economic substance of a transaction and the taxpayer's business motivation are two related components that must be considered in order to determine the substance of a planning scheme.[33] This is the unitary approach, which allows for the more flexible application of the commercial purpose and economic substance criteria. The following passage from the judgement in the *ACM Partnership* case[34] clearly summarizes the latter approach:

> The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); accord Lerman, 939 F.2d at 53-54 (noting that sham transaction has been defined as a transaction that "has no business purpose or economic effect other than the creation of tax deductions" and holding that taxpayer was not entitled "to claim 'losses' when none in fact were sustained"). However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. Casebeer, 909 F.2d at 1363; accord James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990); Rose v. Commissioner, 868 F.2d 851, 854 (6th Cir. 1989).[35]
>
> [our extracts]

This approach has the advantage of flexibly, fairly taking into consideration all facets of planning schemes. Such flexibility enables the courts to apply the doctrine to increasingly complex planning schemes in which taxpayers must simultaneously combine numerous factors and parameters. The following excerpt from a speech given by the judge of the first instance in the *ACM Partnership* case illustrates this approach:

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33 *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir. 1988), cert. denied by the US Supreme Court, 488 U.S. 824 (1988); *Rose v. Commissioner*, 88 T.C. 386, 410-411 (1987) [*Rose* (T.C.)] confirmed by 868 F.2d 851, 854 (6th Cir. 1989) [*Rose* (6th Cir.)]; *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990) [*James*], pages 908-909; *Sacks v. Commissioner*, 69 F.3d. 982 (9th Cir. 1995) [*Sacks*], page 988; *ACM Partnership v. Commissioner*, (1997) T.C. Memo 1997-115 [*ACM Partnership* (T.C.)], ruling sustained on appeal by 157 F.3d 231, 247 (3rd Cir. 1998) [*ACM Partnership* (3rd Cir.)], cert. denied by the US Supreme Court, 526 U.S. 1017 (1999).

34 *ACM Partnership* (3rd Cir.), *ibid*.

35 *Ibid.,* page 247.

> Should economic substance be solely objective or should it be objective with some subjective aspects as well? The Fourth and Third Circuits, together with the Tax Court in ACM, say that it is permissible, even necessary, to examine the subjective as well as the objective aspects of a deal. This seems only fair. The test should not be rigid but elastic enough to allow for all of the proper evidence to be examined. After all, modern deals are very sophisticated and complex. We need to look at them from all angles. For instance, in ACM, the court was required to understand a myriad of sophisticated transactions, both inside and outside the partnership, and to evaluate the credibility of the claims made by the parties about the projected profitability of such complex transactions. By using the doctrine of economic substance, we have the means by which we can review, examine, and opine on whether the transactions have crossed the line from intelligent tax planning into the realm of improper tax avoidance.[36]
>
> [our extracts]

2.3.4 The US Supreme Court has still not taken the opportunity to resolve these different approaches

Court decisions in recent years have only exacerbated the unpredictability of the economic substance doctrine among stakeholders overall.[37] In the absence of a codification in the tax law of this tool, the US Supreme Court could play a leading role to resolve conflicts in the application of this doctrine and ensure that all stakeholders apply it more uniformly.

The court judgements in the *Coltec* and *Black & Decker* cases illustrate differences of opinion among the courts in the application of the economic substance doctrine. These cases dealt with a similar planning scheme, but the courts adopted a seemingly divergent approach. In the *Coltec* case, the taxpayer alleged that the Appeal Court should have applied the economic substance doctrine according to a disjunctive approach, following the example of the approach advocated by the Fourth Circuit Appeal Court in the *Black & Decker* case. However, the US Supreme Court refused to hear the *Coltec* case.[38]

In the *Coltec* case,[39] the United States Court of Appeals for the Federal Circuit concluded that the transactions in dispute complied with the terms of the specific rules in the tax code but were

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36 Laro, "A view from the Tax Court," *supra* note 13, page 46.

37 See Richard M. Lipton, "What Will Be the Impact of the Government's Economic Substance Victory in Coltec?" (2006) 105:3 Journal of Taxation 136 [Lipton, "Coltec"], page 140.

38 See Sean Pheils and Patrick Gay, "Supreme Court Denies Review of Coltec, Dow, Six Tax-Related Cases," 2007 TNT 35-1 (February 21, 2007).

39 *Supra* note 3.

devoid of economic substance. Consequently the Court of Appeals largely rescinded the tax benefits claimed by the taxpayer. The Court favoured an application of the economic substance doctrine according to a conjunctive approach. In this way, a taxpayer may only claim tax benefits stemming from a planning scheme if he is able to establish both the existence of a non-tax purpose and a change in his economic position, without regard for the taxpayer's subjective intention to minimize his tax payable.

In the opinion of the Court of Appeals in the *Coltec* case, the key principles of the economic substance doctrine that emerge from the American jurisprudence are indicated below:

- a taxpayer has the privilege to minimize his tax payable by engaging in tax planning but such planning must comply with the economic substance doctrine;
- the taxpayer who claims tax benefits assumes the burden of proof that the transactions sought to achieve an economic purpose;[40]
- the economic substance doctrine may apply if:
    - the transaction does not alter the taxpayer's economic position; or
    - the taxpayer is seeking solely to derive a tax benefit from a transaction;
- the economic substance of a transaction must be determined objectively rather than subjectively;
- the analysis must focus on the transaction that gives rise to the tax benefit. This transaction must be isolated from the other stages in the planning scheme in order to avoid a more general business purpose being invoked to justify tax avoidance through a broader examination of the facts.

On the other hand, the Court of Appeals that heard the *Black & Decker* case favoured an application of the economic substance doctrine according to a disjunctive approach. Under this approach, a taxpayer may claim a tax benefit as long as he objectively establishes that a transaction has altered his economic position or that he was seeking to realize a legitimate non-tax purpose.[41]

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40 Subsection 2.7 examines the taxpayer's burden of proof in respect of aggressive tax planning schemes.

41 See *Black & Decker* (4th Cir.), *supra* note 32, pages 15-18.

2.4 The courts differ in opinion on how to qualify the taxpayer's purposes and the relative weight of his subjective beliefs for the purposes of the doctrine

The judgement handed down by the Court of Appeals in the *ASA Investerings Partnership* case clearly delineated the importance of the subjective section. In the Court's opinion, this section makes it possible to establish a dividing line between legitimate transactions and tax avoidance. While this demarcation is vague, it is necessary to protect the taxation system's integrity and ensure fairness to all taxpayers, especially those who do not engage in abusive tax planning schemes, unlike other taxpayers placed in the same circumstances:

> We note that the "business purpose doctrine" is hazardous. It is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax. When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that that the business purpose is no more than a facade. But there is no clean line between the two. Yet the doctrine seems essential. A tax system of rather higher rates gives a multitude of clever individuals in the private sector powerful incentive to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance.[42]
>
> [our extracts and italics]

The American courts have not adopted a uniform stance on the criteria to be used to assess the economic substance of transactions, which engenders unpredictability concerning the eventual recognition by the courts of the validity of an aggressive tax planning scheme. This can also create unfairness between taxpayers when certain courts are more demanding than others.

American jurisprudence recognizes the privilege of taxpayers to structure their transactions in order to minimize their tax burden but refuses to recognize the tax consequences of transactions aimed solely at avoidance. The following passage from the *Boca Investerings Partnership* ruling illustrates this principle:

> The business purpose doctrine applied in *ASA Investerings* establishes that while taxpayers are allowed to structure their business purpose in such a way as to minimize their tax, these

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[42] *ASA Investerings Partnership, et al.* v. *Commissioner*, 201 F.3d 505, 513 (D.C. Cir. 2000) [*ASA Partnership*], page 513.

> transactions must have a legitimate non-tax avoidance business purpose to be recognised as legitimate for tax purposes.[43]
>
> [our extracts]

In the past, the courts took into consideration an array of factors to ascertain whether the taxpayer planned his affairs on solely fiscal grounds. In particular, the American courts have considered the following evidentiary elements to determine such intentions:[44]

- the possibility for the taxpayer to generate a profit from the planning scheme;
- the taxpayer's business and non-tax motivations;
- the prior assessment by the taxpayer and his advisers of the planning scheme, its characteristics and economic risks;
- the taxpayer's veritable capital investment;
- the links between the parties involved in the transaction, especially if they are operating at non-arm's length;
- the nature of the activities of the parties involved both before and after the planning scheme;
- the context in which the planning is carried out, including the degree of similarity between the scheme initially contemplated and the scheme carried out;
- the arguments used by advisers or promoters in marketing the tax shelter purchased by the taxpayers.[45]

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43 *Boca Investerings Partnership* v. *United States of America*, 314 F.3d 625, 631 (D.C. Cir. 2003) [Boca Investerings], which refers to *ASA Partnership, supra*.

44 See Korb, *Economic Substance Doctrine*, *supra* note 26.

45 *Goldstein* v. *Commissioner*, 364 F.2d 734 (2nd Cir. 1966) [*Goldstein*]; *Sacks*, *supra* note 33; *Winn-Dixie Inc.* v. *Commissioner*, 113 T.C. 254 (1999) [*Winn-Dixie* (Tax Ct.)], ruling upheld on appeal by *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313 (11th Cir. 2001) [*Winn-Dixie* (11th Cir.)], cert. denied by the US Supreme Court in 535 U.S. 986 (2002); *Rose*, *supra* note 33; *Casebeer* v. *Commissioner*, 909 F.2d 1360 (9th Cir. 1990); *Newman* v. *Commissioner*, 894 F.2d 560 (2nd Cir. 1990), page 563; *Salina P'ship* v. *Commissioner*, T.C. Memo 2000-352 (2000); *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989) [*Kirchman*]; *Nicole Rose Corp.* v. *Commissioner*, 117 T.C. 328 (2001) [*Nicole Rose Corp.* (Tax Ct.)] upheld on appeal by 320 F.3d 282 (2nd Cir. 2002) [*Nicole Rose Corp.* (2nd Cir.)]; *IES Industries, Inc.* v. *United States*, 253 F.3d 350 (8th Cir. 2001) [*IES Industries*], pages 355-356; James, *supra* note 33; *Pasternak*, *supra* note 31.

The American courts have decided that taxpayer's transactions had no business purpose in legal proceedings in which tax avoidance was clearly the taxpayer's sole motivation. Depending on the case, the evidence allowed the courts to conclude that these transactions would never have been carried out in the absence of the anticipated tax benefits.

By way of illustration, the courts have refused to consider complex transactions whose sole purpose was to generate capital losses applicable against earlier capital gains,[46] and complex transactions intended solely to create substantial tax deductions.[47]

A court might conclude that the taxpayer invested in a tax shelter solely for the purpose of obtaining pre-arranged tax benefits if the evidence shows that the taxpayer purchased the tax shelter while relying on promotional material centred exclusively on obtaining the anticipated tax benefits without any mention of the potential for non-tax profit.[48] Similarly, a court might conclude that the taxpayer is pursuing a purely tax goal if he has invested in a tax shelter that guarantees participants an economic gain stemming from tax savings, regardless of the commercial success of the tax shelter.[49] Failure by the parties to comply with the agreements negotiated at the outset, in particular when all stages in a planning scheme have not been carried out as initially agreed, also raises doubts about the taxpayer's business intentions and the substance of the transaction.[50]

In the application of the subjective section, one of the problems facing the courts is to ascertain the relative weight of a tax goal in relation to that of the other purposes that the taxpayer pursues in a planning scheme. The courts do not agree on the threshold beyond which the relative weight of a tax goal triggers the application of the economic substance doctrine. As the

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46 *ACM Partnership* (3rd Cir.), *supra* note 33.

47 *Sheldon* v. *Commissioner* 94 T.C. 738 [*Sheldon*], pages 766-767; *Rice's Toyota* (4th Cir.), *supra* note 27, page 92; *Hines v. Commissioner*, 912 F.2d 736 (4th Cir. 1990) [*Hines*], page 741; *Nicole Rose Corp.* (2nd Cir.), s*upra* note 45, page 284; *Winn-Dixie* (Tax Ct.), *supra* note 45, pages 287-288.

48 See *Kirchman*, *supra* note 45, pages 1489 and 1493; *In re CM Holdings, Inc.*, 301 F.3d 96 (3rd Cir. 2002) [*In re CM Holdings*], pages 102-103.

49 *Pasternak*, *supra* note 31, page 901: "Finally there is evidence that the 1981 transactions were marketed as tax shelters whose promised tax savings guaranteed economic gain to the participants, even if the co-tenancies failed to sell a single reproduction of their recordings."

50 See *Rose* (T.C.), *supra* note 33; see also *Merryman* v. *Commissioner*, 873 F.2d 879, 883 (5th Cir. 1989) [*Merryman*].

judge of the first instance in the *ACM Partnership* case emphasized in commenting on his ruling, the Tax Court never demanded that the tax goal be the principal or fundamental purpose of planning scheme in order to refuse to recognize its tax consequences.[51] The Court's stance in this case can be explained by the tendency for the courts to apply the economic substance doctrine according to the circumstances specific to each legal proceeding.

The unpredictability of the decisions handed down by the courts creates uncertainty among taxpayers, especially when they are pursuing numerous goals by means of a series of transactions. Once they have pinpointed certain transactions, some courts analyse each one of them separately while others analyse them as though they formed a whole.

As a matter of logic, grouping together several transactions increases the likelihood that a planning scheme will withstand the economic substance doctrine because certain of these transactions will seem to be motivated by business purposes or to have the effect of modifying the taxpayer's economic position. Aggressive taxpayers might take the risk of meticulously planning all of the transactions that allow them to obtain tax benefits in a manner that satisfies the subjective section of the doctrine. The courts do not specify how many interrelated events must be lumped together in order to measure the substance of a transaction. Transactions that have no other justification than the obtaining of tax benefits may, however, lead the courts to apply the economic substance doctrine. The following comment by Professor Joseph Bankman illustrates this notion:

> The economic substance doctrine requires that the events giving rise to a tax position must have objective economic substance, but does not tell us which of many interrelated events ought to be lumped together and measured for economic substance. In general, the greater the number of events lumped together, the greater the likelihood that a tax position will reflect changes in nontax attributes. In theory, by expanding or contracting the number of related events, a decisionmaker could reach virtually any result it wanted under the doctrine. In practice, some tax position will seem to correspond naturally with a discrete number of events or transactions. Moreover, courts have already put some flesh on this part of the doctrine by showing a willingness to lump together transactions connected to a taxpayer's ordinary business operations, but treat as discrete each element in tax shelters.[52]

[51] Laro, "A view from the Tax Court," *supra* note 13.

[52] Joseph Bankman, "The Economic Substance Doctrine" (2000) 74 S. Cal. L. Rev. 5 [Bankman, "Economic Substance"], page 15. The author stated this opinion based on the *Cottage Savings Ass'n* v. *Commissioner*, 499 U.S. 554 (1991) case, a ruling handed down by the US Supreme Court [*Cottage Savings*], and the *ACM Partnership* case (3rd Cir.), *supra* note 33.

The Court of Appeals for the Federal Circuit in the *Coltec* case was also of the opinion that the doctrine should be applied by isolating tax transactions from the other transactions in a planning scheme to avoid the purpose of the tax transactions' being masked by the presence of goals attributable to the other transactions:

> … the transaction to be analyzed is the one that gave rise to the alleged tax benefit. For example, in Basic Inc., … The court explained that if the business purpose of the ultimate sale could be used to justify the unnecessary inter-company transfer, then "all manner of intermediate transfers could lay claim to 'business purpose' simply by showing some factual connection, no matter how remote, to an otherwise legitimate transaction existing at the end of the line." Id. at 745. Similarly, in Ballagh … the Court of Claims focused on the purpose for the loan from the annuity company—not the purpose of the initial annuity contract, when evaluating the economic substance of the transaction. 331 F.2d at 878. So also the Fourth Circuit has stated that in economic substance cases, the focus is on "the specific transaction whose tax consequences are in dispute," Black & Decker, 436 F.3d at 441, and the Second Circuit has stated that "[t]he relevant inquiry is whether the transaction that generated the claimed deductions ... had economic substance," Nicole Rose Corp. v. Comm'r of Internal Revenue, 320 F.3d 282, 284 (2d Cir. 2002). See also ACM P'ship v. Comm'r of Internal Revenue, 157 F.3d 231, 260 & n.57 (3d Cir. 1998). These cases recognize that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).[53]
>
> [our extracts]

Nevertheless, when a taxpayer's transactions are linked to the normal operation of a business, certain decisions made by the courts lead us to believe that the latter may be willing to take into consideration the planning scheme overall. The American courts were more willing to lump together transactions concluded in conjunction with the taxpayer's normal business transactions. When a planning scheme is related to the taxpayer's business activities, the courts are more likely to conclude that the taxpayer is pursuing a business purpose and that the planning scheme has had an impact on his economic position.

The *Cottage Savings* case[54] illustrates this possibility. In this case, the taxpayer held a portfolio of mortgage loans receivable whose value had decreased because of an increase in interest rates. The taxpayer did not wish to dispose of the portfolio as doing so would create a book loss and threaten his ability to operate under certain banking regulations then in force. He thus

53 Coltec (Fed. Cir. App.), *supra* note 3.

54 *Cottage Savings*, *supra* note 52.

decided to engage in exchanges of mortgage loans receivable that allowed him to claim a tax loss without having to declare a book loss pursuant to banking regulations.

The characteristics of the mortgage loans receivable obtained at the time of the exchange were legally different from those initially held since they were granted by different borrowers on different properties. The mortgages that the taxpayer received at the time of the exchange were nevertheless economically identical to the mortgages that he exchanged. The tax administration rescinded the deduction of the tax loss that the taxpayer claimed and asserted that it was a fictitious loss since the exchange transactions were devoid of economic substance. The court recognized the tax loss and opined that the mortgages that the taxpayer had newly acquired were materially different since they conferred distinct rights on the taxpayer. When the court measured the economic consequences of these exchanges, it considered, in particular, that they were linked to the taxpayer's usual business arrangements.

Moreover, the courts were more inclined to analyse separately the operations related to an investment by the taxpayer in a tax shelter. In the *ACM Partnership* case,[55] the taxpayer established a general partnership that concluded a series of financial transactions whose ultimate objective was to generate tax losses to offset a previously realized capital gain. One of these operations involved the acquisition and disposal of the bonds of a corporation (Citicorp) in order to simulate the contingent instalment sale subject to the ratable base recovery rule governing the cost of an asset to the taxpayer.

The taxpayer cited the *Cottage Savings* case to convince the court to recognize the tax consequences of the capital loss stemming from the sale of the Citicorp bonds and alleged that the investment conferred on him rights that differed from those obtained when these bonds were exchanged for cash and London Interbank Offering Rate (LIBOR) notes.

The Court of Appeals of the Sixth Circuit refused to recognize the tax benefits of this transaction. In its opinion, the transaction was entirely unrelated to the business activities pursued by the taxpayer and the sole objective was to create an artificial loss by means of

[55] *ACM Partnership* (3rd Cir.), *supra* note 33.

inappropriate recourse to provisions in the tax law. The Court of Appeals decided that this transaction did not alter the taxpayer's economic position or his non-tax economic interests:

> Just as the taxpayer in Gregory engaged in offsetting transactions by creating a new corporation, transferring the stock to the corporation, transferring the stock back out of the corporation liquidating the corporation just as the taxpayers in Knetsch and Weller engaged in offsetting transactions by acquiring annuity policies and borrowing back virtually their entire value, and just as the taxpayers in Lerman and other property disposition cases engaged in inconsequential transactions by disposing of property while retaining the opportunity to acquire the same or virtually identical property at the same price, so ACM engaged in mutually offsetting transactions by acquiring Citicorp notes only to relinquish them a short time later under circumstances which assured that their principal value would remain unchanged and their interest yield would be virtually identical to the interest yield on the cash deposit which ACM used to acquire the Citicorp note.
>
> *Gregory* requires us to determine the tax consequences of a series of transactions based on what "actually occurred." 293 U.S. at 469, 55 S. Ct. at 267. Just as the *Gregory* Court found that the intervening creation and dissolution of a corporation and transfer of stock thereto and therefrom was a "mere device which put on the form of a corporate reorganization as a disguise for concealing its real character" which amounts to a mere "transfer ... of corporate shares to the [taxpayer]," *so we find that ACM's intervening acquisition and disposition of the Citicorp notes was a mere device to create the appearance of a contingent installment sale despite the transaction's actual character as an investment of $35 million in cash into a roughly equivalent amount of LIBOR notes. Thus, the acquisition and disposition of the qualifying private placement Citicorp notes*, based upon which ACM characterized its transactions as a contingent installment sale subject to the ratable basis recovery rule, *had no effect on ACM's net economic position or non-tax business interests and thus, as the Tax Court properly found, did not constitute an economically substantive transaction that may be respected for tax purposes*. *See Gregory,* 293 U.S. at 469-70, 55 S. Ct. at 267-68; *Knetsch,* 364 U.S. at 366; *Lerman,* 939 F. 2d 44; *Weller,* 270 F.2d at 297.
>
> …
>
> The distinctions between the exchange at issue in this case and the exchange before the Court in Cottage Savings predominate over any superficial similarities between the two transactions. The taxpayer in Cottage Savings had an economically substantive investment in assets which it had acquired a number of year earlier <u>in the course of its ordinary business operations</u> and which had declined in actual economic value by over $ 2 million from approximately $6.9 million to approximately $2.5 million from the time of acquisition to the time of disposition. See *Cottage Sav., 499 U.S. at 557-58, 111 S. Ct. at 1506*. The taxpayer's relinquishment of assets so altered in actual economic value over the course of a long-term investment stands in stark contrast to ACM's relinquishment of assets that it had acquired 24 days earlier under circumstances which assured that their principal value would remain constant and that their interest payments would not vary materially from those generated by ACM's cash deposits.
>
> *While the disposition in Cottage Savings and in this case appear similar in that the taxpayer exchanged the assets for other assets with the same net present value, beneath these similarity lies the more fundamental distinction of the disposition in Cottage Savings precipitated the realization of actual economic losses arising from a long-term economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment effectively*

> *returning ACM to the same economic position it had occupied before the note's acquisition 24 days earlier.*[56]
>
> [our extracts and italics]

Beyond the intentions that the taxpayer expressed, the qualification of the purposes that he pursued centres essentially on an objective proof that allows the courts to ascertain the reasonable nature of the taxpayer's fiscal projections. In the *Coltec*[57] and *Dow Chemical* cases,[58] the taxpayers alleged that they were pursuing business purposes to convince the courts that their transactions complied with the economic substance doctrine. However, the courts accorded preponderant weight to the subjective section of the economic substance doctrine. From this perspective, confirmation by the taxpayer of his intention to realize a business purpose alone would not suffice to warrant the tax benefits stemming from an aggressive tax planning scheme.

The *Jade Trading* case[59] illustrates the importance that the courts attach to the objective analysis of the purposes that taxpayers pursue in a planning scheme for the purposes of applying the economic substance doctrine. In this case, the taxpayers had claimed a substantial capital loss stemming from the disposal of their shares in a general partnership by means of a multi-stage aggressive tax planning scheme.

First, each taxpayer, through a general partnership, acquired a euro purchase option from a financial institution ("euro purchase option") and simultaneously granted a euro sales option to this financial institution. If the financial institution exercised the option, each taxpayer had to sell it a predetermined number of euros ("euro sale option").

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56 *ACM Partnership* (3rd Cir.), *supra* note 33, pages 250-252. Professor Joseph Bankman draw the following conclusion from the judgements in the *Cottage Savings* and *ACM Partnership* cases: "Thus, the swap in *Cottage Savings,* while economically insignificant in itself, was tied to ordinary business operations, and what was measured for substantial economic effect was not just the swap, but the business operation to which it was tied. The sale of Citicorp debt was not tied to business operations, and so it was considered in isolation for the purpose of economic effect." See Bankman, "Economic Substance," *supra* note 52, page 17.

57 *Supra* note 3.

58 *Dow Chemical Company* v. *United States of America*, 250 F. Supp. 2d 748 (E.D. Mich 2003), ruling quashed by 435 F.3d 594 (6th Cir. 2006) [*Dow Chemical* (6th Cir. 2006)], page 601, cert. denied, 2007 U.S. Lexis 2074 (Supreme Court of the United States, 2007).

59 *Jade Trading, LLC* v. *United States* (December 21, 2007), No. 03-2164T (U.S. Ct. Fed. Clms) [*Jade Trading*].

Overall, the capital of the euro purchase options and the euro sale options were identical, i.e. roughly €290 million. The price of the euro purchase option exercise was set at an exchange rate of €1.084 euro for US$1. This price was only one-thousandth of a point lower than the exchange rate of €1.085 established for the euro sale option exercise.

The purchase premium on the euro purchase option was set at US$15 million and was only marginally higher than the euro sale option. Each taxpayer thus paid the financial institution a sum corresponding to the difference between the cost of the euro purchase option and that of the euro sale option, i.e. US$150,000, plus transaction fees of approximately US$75,000.

The taxpayers subsequently transferred the purchase and sale options to a newly established general partnership in exchange for shares in the partnership. Within roughly 60 days, each taxpayer had withdrawn from the general partnership. The cost of their share in the general partnership had been established at approximately US$126,000. Each taxpayer received from the general partnership euros and the shares that the partnership held in another company of a value equivalent to the cost of their share in the general partnership.

From the taxpayers' standpoint, the tax cost of their shares in the general partnership was equivalent to the tax cost of the euro purchase option transferred to the general partnership. According to a technical interpretation of the tax rules, the assumption by the general partnership of the obligation to which the taxpayers were bound in respect of the financial institution under the euro sale option was not tantamount to assuming a debt. Consequently, the value of this obligation in no way reduced the tax cost of their share in the general partnership.

At the time of the disposal of the shares obtained through their withdrawal from the general partnership, each taxpayer claimed a capital loss of US$15 million. Because of the planning scheme, the tax cost of these shares was high since it corresponded to the each taxpayer's shares in the general partnership, although the fair market value of these shares was minimal. The capital loss realized reduced by an equivalent amount a US$40-million capital gain that each taxpayer realized beforehand.

The taxpayers carried out the planning scheme based on the opinion of their advisers. The tax advisers were of the opinion that the planning scheme complied with the tax law according to the balance of probabilities, based on a mechanical interpretation of the rules governing general partnerships and the relevant jurisprudence concerning the interpretation of these rules, the step transactions doctrine, the substance over form doctrine, and the economic substance doctrine.[60]

The United States Court of Federal Claims maintained the tax administration's notice of assessment by applying the economic substance doctrine in accordance with the principles spelled out in the *Coltec* case. According to the Court, the taxpayers could not reasonably, objectively anticipate a pre-tax profit from the planning scheme.

In light of evidence from expert economists, each taxpayer could not expect to make a net pre-tax profit bearing in mind the management fees and honoraria totalling over US$1 million paid to their financial and legal advisers. To obtain a return at least equivalent to all of the expenses incurred for the purposes of the planning scheme, each taxpayer would have had to anticipate a return at least 420 times higher than the total value of the expenses incurred. On balance, the taxpayers had invested roughly US$1 million to hope to benefit from a pre-tax profit of US$140,000.

Following the principles applied in the *Coltec* case, the United States Court of Federal Claims concluded, in particular, that the anticipation of a profit by the taxpayers in the planning scheme and the scheme's impact on their financial position should be evaluated objectively, regardless of the taxpayers' subjective opinions in this respect:

> Thus, a determination of the objective reality of contributing the spread transaction to Jade requires assessing the transaction itself – its reasonable possibility of profit and its effect on the Ervins' financial positions. The inquiry is not whether the Ervins believed the Jade transaction was a real investment capable of making a profit, but whether the Jade transaction in fact objectively was a real investment capable of making a profit and altering their financial positions.[61]
>
> [our extracts]

[60] Moreover, the advisers were of the opinion that the taxpayers were not liable to any penalty whatsoever for under-stating tax payable.

[61] *Supra* note 59, page 58 of the Court's judgement.

More specifically, this Court opined that the ruling of the US Court of Appeals for the Federal Circuit in the *Coltec* case had relegated the subjective analysis of the taxpayer's purposes to the background of an objective analysis of such purposes:

> The trial in this case was conducted before the Federal Circuit's opinion in Coltec was issued, and the record includes much evidence on the beliefs of the Ervin brothers that their activities in Jade could be profitable based upon Bergmann's sales pitch. In the context of assessing objective economic substance, Coltec has relegated this type of evidence to a back seat recognizing the taxpayer's "subjective motivation may be pertinent to the existence of a tax avoidance purpose." 454 F.3d at 1356. Rather, the lack of economic reality of the transaction itself is the primary consideration as this is sufficient to disregard the transaction.[62]
>
> [our extracts]

2.5 A lack of uniformity in the application by the courts of the objective section

The objective section of the doctrine requires the transaction concluded by the taxpayer to have economic substance that is distinct from its tax consequences.

The American courts have adopted several criteria to objectively measure a transaction's economic substance. By means of these criteria, the courts usually assess the economic substance of transactions bearing in mind the changes that occur in the taxpayers' economic position that are not attributable to tax savings. The different formulations of this approach have been summarized as follows in the *In re CM Holdings* case:[63]

> There are several different formulations of the objective portion of the economic substance inquiry. Knetsch voided a transaction because it "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." 364 U.S. at 366. (internal citations omitted). In United States v. Wexler we held that where a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." 31 F. 3d 117, 122 (3d Cir. 1994). In ACM Partnership we required a "net economic effect on the taxpayer's economic position." 157 F. 3d at 249. The main question these different formulations address is a simple one: absent the tax benefits, whether the transaction affected the taxpayer's financial position in any way.[64]
>
> [our extracts]

62 *Ibid.,* infrapaginal note 69 of the judgement.
63 *In re CM Holdings*, *supra* note 48.
64 *Ibid.* page 103.

Under this approach, the courts measure the impact of a transaction on the taxpayer's financial position. Thus, the American courts have often refused to recognize the tax consequences of the disposal of property that has had no impact on the taxpayer's net financial position either because the taxpayer concluded circular transactions or transactions that entailed no risk for him, or because the purposes of these transactions were of a purely fiscal nature.

In some instances, the courts have refused to recognize a transaction for tax purposes because the transaction did not lead to a substantial change in the taxpayer's net economic position. By way of illustration, the courts have refused to recognize losses related to the disposal of property that had no economic impact on the taxpayer's position either because the taxpayer had the possibility of repurchasing the property at the same price or because he had offset the economic risks stemming from such disposal through the purchase of identical property.[65]

However, in the *ACM Partnership* case,[66] the Court of Appeals specified that the courts will not rescind tax benefits stemming from a transaction that objectively alters the taxpayer's net economic position, his legal relations or non-tax business interests simply because the transaction was concluded for tax reasons.[67] By following a similar reasoning, certain American courts have more broadly applied the objective section of the economic substance doctrine and have decided that certain changes in the taxpayer's legal or business obligations were sufficient to satisfy this section. The creation of genuine, enforceable obligations between unrelated parties has, in particular, been deemed a sufficient economic effect in the *UPS of America* case:[68]

> The kind of "economic effects" required to entitle a transaction to respect in taxation include (sic) the creation of genuine obligations enforceable by an unrelated party. *See Frank Lyon Co.* 435 U.S. at 582-83, 98 S. Ct. at 1303 (refusing to deem a sale-leaseback a sham in part because the lessor had accepted a real, enforceable debt to an unrelated bank as part of the deal). The restructuring of UPS's excess-value business generated just such obligations.[69]

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65 *ACM Partnership* (3rd Cir.), *supra* note 33, page 249, which refers to the following judgements: *Lerman* v. *Commissioner*, 939 F2d 44, 48 (3rd Cir. 1991); *Merryman*, *supra* note 50; *Kirchman*, *supra* note 45, pages 1488, 1492-93; *Yosha* v. *Commissioner*, 861 F.2d 494, 501(7th Cir. 1989).

66 *Ibid*.

67 *Ibid.,* page 248: "Where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations."

68 *UPS of America*, *supra* note 31.

69 *Ibid.,* page 1018.

[our extracts]

However, uncertainty persists concerning:

- the nature of the change in the taxpayer's legal relations or economic position that will satisfy the objective section of the economic substance doctrine; and
- the way in which the degree of this change is measured.

2.5.1 The courts differ in opinion on the degree of the real impact that a planning scheme must have on the taxpayer's legal and economic relations

In light of the US Supreme Court's ruling in the *Frank Lyon* case, the courts might grant taxpayers tax benefits attributable to planning schemes that affect their economic position.[70] As this ruling illustrates, the judges hearing the same case may, however, differ in opinion on the application of the economic substance doctrine depending on whether they deem the planning scheme to significantly or negligibly affect the taxpayer's financial position. Opinions differed even among the US Supreme Court justices.

In the *Frank Lyon* case, seven of the nine Supreme Court justices concluded that the impact on the taxpayer of a sale-leaseback scheme was significant enough for the taxpayer to obtain a capital cost allowance in his capacity as the owner of a building:

> This Court, almost 50 years ago, observed that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed - the actual benefit for which the tax is paid." … In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. … In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," …, as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." … Nor is the parties' desire to achieve a particular tax result necessarily relevant. …
>
> …
>
> No matter how the transaction could have been devised otherwise, it remains a fact that as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon.

70 We refer the reader to subsection 2.1, which briefly reviews the facts of this case and the majority decision handed down.

> Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk.
>
> The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset. To the extent that Lyon has used its capital in this transaction, it is less able to obtain financing for other business needs.
>
> …
>
> As is clear from the facts, none of the parties to this sale-and-leaseback was the owner of the building in any simple sense. But it is equally clear that the facts focus upon Lyon as the one whose capital was committed to the building and as the party, therefore, that was entitled to claim depreciation for the consumption of that capital. The Government has based its contention that Worthen should be treated as the owner on the assumption that throughout the term of the lease Worthen was acquiring an equity in the property. In order to establish the presence of that growing equity, however, the Government is forced to speculate that one of the options will be exercised and that, if it is not, this is only because the rentals for the extended term are a bargain. We cannot indulge in such speculation in view of the District Court's clear finding to the contrary. We therefore conclude that it is Lyon's capital that is invested in the building according to the agreement of the parties, and it is Lyon that is entitled to depreciation deductions, under 167 of the 1954 Code, 26 U.S.C. 167. Cf. United States v. Chicago B. & Q. R. Co., 412 U.S. 401 (1973).[71]
>
> [our extracts]

Conversely, the two minority Supreme Court justices held the opposite view in keeping with the United States Court of Appeals for the Eighth Circuit that heard the same case. In the opinion of the minority justices, the taxpayer did not assume to a sufficient degree the economic attributes inherent in the ownership of a building in order to obtain a capital cost allowance. Briefly, they opined that the lessor of the building was its true owner since the lessor could decide to transfer or lease the building at its discretion, assumed the management of it and, above all, financially assumed the loss risks related to a devaluation of the building and the possibility of profits stemming from an increase in its value because of the financial details of the planning scheme. Below is a passage from the Supreme Court ruling that summarizes the Court of Appeals' decision and with which the minority justices concurred:

> The United States Court of Appeals for the Eighth Circuit … held that the Commissioner correctly determined that Lyon was not the true owner of the building and therefore was not entitled to the claimed deductions. It likened ownership for tax purposes to a "bundle of sticks" and undertook its own evaluation of the facts. It concluded, in agreement with the Government's contention, that Lyon "totes an empty bundle" of ownership sticks. Id., at 751. It stressed the following … (e) Worthen retained control over the ultimate disposition of the

[71] *Frank Lyon*, *supra* note 22, pages 572-573, 576-577, 581.

> building through its various options to repurchase and to renew the lease plus its ownership of the site. (f) Worthen enjoyed all benefits and bore all burdens incident to the operation and ownership of the building so that, in the Court of Appeals' view, the only economic advantages accruing to Lyon, in the event it were considered to be the true owner of the property, were income tax savings of approximately $1.5 million during the first 11 years of the arrangement. Id., at 752-753. The court concluded, id., at 753, that the transaction was "closely akin" to that in Helvering v. Lazarus & Co., 308 U.S. 252 (1939). "In sum, the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes. … The vice of the present lease is that all of [its] features have been employed in the same transaction with the cumulative effect of depriving [Lyon] of any significant ownership interest." 536 F.2d, at 754[72].
>
> [our extracts]

The courts have also had to decide in other cases whether the taxpayer could claim tax benefits stemming from a planning scheme that simply altered the legal position between the parties without having any impact on their respective economic positions. For example, in the *Long Term Capital Holdings* case,[73] the taxpayer's attorney alleged that it is possible to objectively conclude that a transaction has economic substance if and when it has the effect of altering the economic position and respective rights of the parties involved, regardless of the degree of such change. The attorney indicated by way of illustration the exchange of money or another consideration for the acquisition of an equity interest in a general partnership or indeed the acquisition by one of the partners of the equity interest of another partner.[74] The court of first instance rejected this approach and specified that it had been rejected in the *Gilman* case:[75]

> In Gilman, the Second Circuit affirmed the Tax Court's economic substance analysis, which was approached from "the standpoint of a prudent investor," Gilman, 933 F.3d at 147, an approach that finds "a transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits." Id. (quotations omitted). The Tax Court concluded that the sale/leaseback transaction under review lacked economic substance because, at the time the transaction was entered into, a prudent investor would have concluded that there was no chance to earn a non-tax based profit return in excess of the costs of the transaction. See id. The Second Circuit affirmed the approach, noting that "the most important element for economic substance" in the sale/leaseback transaction was the critical objective measurement demonstrating the taxpayer could not reasonably have expected to recoup his investment. Id. at 149. Importantly, the Second Circuit rejected the taxpayer's contentions that (1) the relevant standard for determining economic substance is whether the transaction

72 *Ibid.,* page 572.

73 See *Long Term Capital Holdings* (D. Conn.), *supra* note 5, ruling upheld on appeal by *Long Term Capital Holdings* (2nd Cir.), *supra* note 5.

74 *Long Term Capital Holdings* (D. Conn.), *ibid.,* pages 185-186.

75 *Gilman* v. *Commissioner*, 933 F.2d 143 (2nd Cir. 1991) [*Gilman*], pages 147-148.

> may cause any change in the economic positions of the parties (other than tax savings) and (2) that where a transaction changes the beneficial and economic rights of the parties it cannot be a sham. See id. at 147-48. Rather, the Second Circuit held that the Commissioner could properly focus on objective economic factors and "concern that [the taxpayer's] entry into the transaction was motivated by tax consequences and not by business or economic concerns," id. at 148, without having to prove or contend that the taxpayer did not become the owner of the computer equipment he purchased and subsequently leased.[76]
>
> [our extracts]

A taxpayer may thus not claim that a transaction has economic substance because its sole effect was to alter his rights. The approach emphasized in the *Long Term Capital Holdings* case consisted in assessing the economic substance of a transaction on the basis of its legitimate potential for profit. Based on the ruling in the *Gilman* case, the Connecticut District Court decided that the acquisition of an equity interest in a general partnership did not protect complex sale-leaseback and lease-stripping transactions from on analysis centred on economic substance.[77] Instead, it assessed the economic substance of these transactions from the viewpoint of a cautious investor. Following an analysis of the costs and potential return from the transactions, it concluded that the taxpayer had no reasonable prospect of making a non-tax profit from these transactions. Consequently, the court decided that the transactions had no economic substance separate from the tax benefits claimed by the taxpayer.[78]

The possibility that opinions differ at each level of court on the application of the economic substance doctrine increases the risks for taxpayers and the tax administration of being subject to an unfavourable decision over several years. The possibility that the judges substitute their ruling for that of their colleagues in the lower courts in a case constantly increases the risks of an arbitrary assessment of the economic substance of a planning scheme. Of all of the courts, the court of first instance that hears a case should normally be in a better position than the Court of Appeals or the US Supreme Court to analyse the facts and circumstances pertaining to a planning scheme in order to determine whether the economic substance doctrine applies to it.

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76 *Long Term Capital Holdings* (D. Conn.), *supra* note 5, pages 172-173, 185-186.
77 *Ibid.,* pages 185-186.
78 *Ibid.,* page 172.

2.5.2 Business standards allow for an assessment of the anticipation by the taxpayer of a profit in a flexible, reasonable manner, subject to differences of opinion concerning minimal profit thresholds

The courts frequently apply the subjective section of the economic substance doctrine by analysing the rationality of the taxpayer's anticipated profit in a planning scheme. The courts may conclude that a planning scheme is devoid of economic substance if the evidence objectively shows that the taxpayer could not reasonably expect to make a profit aside from the tax benefits stemming from the scheme.

In particular, the courts advocated this approach in the *Rice's Toyota* case and in several subsequent cases.[79]

In the *Rice's Toyota* case, the Court of Appeals evaluated the economic substance of a planning scheme involving the purchase by the taxpayer of a used computer partly financed by means of a secured note and partly by an unsecured note and the subsequent sale-leaseback of the asset in favour of the vendor. Bearing in mind the costs of the transaction, the court felt that the revenue that this planning scheme could generate and the insufficient residual value of the used computer allowed it to conclude that the taxpayer could not reasonably hope to generate a profit from this transaction.

This passage from the ruling proposed a formulation of the objective section of the economic substance doctrine that focuses solely on the potential for profit of the disputed transaction:

> The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits. *Rice's Toyota*, 81 T.C. at 203; see also *Bridges* v. *Commissioner,* 325 F. 2d 180, 184 (4th Cir. 1963).[80]
>
> [our extracts]

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[79] *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir.1989) [*Friedman*], page 793; *Shriver*, *supra* note 29, pages 725-726; *Hines*, *supra* note 47, pages 739-740; *Hunt v. Commissioner*, 938 F.2d 466 (4th Cir. 1991) [*Hunt*], page 472.

[80] See *Rice's Toyota, supra* note 27, page 94.

In the *Black & Decker* case,[81] the United States Court of Appeals for the Fourth District reconfirmed that the norm applicable pursuant to the objective section of the doctrine, at least within this circuit, was the evaluation of the reasonable nature of the taxpayer's anticipated profit as proposed in the *Rice's Toyota* case. In fact, the Court refused to abandon this norm[82] despite the taxpayer's argument that the courts should instead minutely analyse the transaction to establish the veritable economic consequences as suggested by the ruling handed down by a court in another circuit in the *United Parcel Serv. of America* case.[83]

If they apply this approach, the courts first analyse the conception and organization of the disputed transaction in order to assess the taxpayer's decision to conclude this transaction by means of the standards generally applicable to the type of transaction concluded by the taxpayer. The court will recognize that the transaction has a realistic potential for profit if it concludes that a sensible person would have deemed it reasonable to make this investment. This approach makes it possible to recognize that a risky transaction can be concluded in good faith in anticipation of a profit without the profit's materializing. In our view, this extract from the judgement handed down in the *Cherin* case[84] explains the foundation of this stance:

> A business transaction by its very nature must have economic substance, that is, a realistic potential for profit (James v. Commissioner, 87 T.C. at 924). The phrase "realistic potential for profit" does not mean that the transaction must make a profit or even that similar transactions generally are profitable. As we found in Abramson v. Commissioner, 86 T.C. 360 (1986), only an average of 1 film in 10 is successful; in wildcat oil drilling, the success rate based upon the number of wells drilled may be low. Realistic potential for profit is found, however, when the transaction is carefully conceived and planned in accordance with standards applicable to the particular industry, so that judged by those standards the hypothetical reasonable businessman would make the investment[85].
>
> [our extracts and italics]

Briefly, the American courts determine whether the taxpayer has acted as a cautious, diligent investor under the circumstances according to the standards applicable. The taxpayer's potential profit is measured in light of the relevant circumstances. The courts assess whether

81 *Black & Decker* (4th Cir.), *supra* note 32.

82 *Ibid.,* page 442.

83 *UPS of America*, *supra* note 31, page 1019.

84 *Cherin v. Commissioner*, 89 T.C. 986 (1987) [*Cherin*].

85 *Ibid*., note 84, pages 993-994. The ruling by the court of first instance in the *James* v. *Commissioner* case, 87 T.C. 905, to which the passage cited in the extract refers, was upheld on appeal: 899 F.2d 905 (10th Cir. 1990).

the taxpayer's transaction rationally allows the latter to achieve a business purpose. To this end, the taxpayer's anticipated profit must be established reasonably, excluding the tax benefits, and be proportional to the costs incurred to carry out the planning scheme. This passage from the *ACM Partnership* case illustrates these principles:

> Whether a transaction has economic substance is a factual determination. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950). Key to this determination is that *the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry.* Cherin v. Commissioner, 89 T.C. 986, 993-994 (1987). *A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs*. See Yosha v. Commissioner, 861 F.2d 494, 498 (7th Cir. 1988), affg. Glass v. Commissioner, 87 T.C. 1087 (1986)(explaining the teaching of Goldstein); cf. Seykota v. Commissioner, T.C. Memo. 1991-234, amended T.C. Memo. 1991-541. "[D]eliberately to incur an expense greater than the expected gain--to pay 4 percent for the chance to make 2 percent--is the antithesis of profit-motivated behavior; such a transaction lacks economic substance." Yosha v. Commissioner, supra at 498.[86]
>
> [our extracts and italics]

The courts also adopted this approach in the *Long Term Capital Holdings* case:

> As analysed above, the evidence of claimed reasonableness of the purported primary motivation, fees, is unpersuasive—a prudent investor would not have made the deal.
>
> …
>
> Moreover, the construction of an elaborate, time consuming, inefficient and expensive transaction with OTC for the purported purpose of generating fees itself points to Long Term's true motivation, tax avoidance. Taking fee-generating investment was LongTerm's core business and was regularly executed without either complex machinations related to OTC's or the attendant millions in transaction cost.[87]
>
> [our extracts]

Similarly, the United States Court of Federal Claims in the *Jade Trading* case concluded that the anticipation of a profit by the taxpayers who engaged in an aggressive tax planning scheme in this case was unreasonable considering the substantial fees that they had incurred compared with the pre-tax economic benefits that they could hope to obtain. The Court was of the opinion

86 *ACM Partnership* (T.C.), *supra* note 33, page 96 of the Court's ruling.
87 *Long Term Capital Holdings* (D. Conn.), *supra* note 73.

that a cautious, diligent investor who found himself in the same circumstances would never have carried out this planning scheme:

> The objective economic substance test requires that a taxpayer prove that a transaction had a "realistic financial benefit" beyond tax avoidance…
>
> …
>
> Several courts have analyzed economic substance objectively by viewing an investment transaction through the eyes of a "prudent investor" at the time of the transaction -- asking whether a prudent investor would engage in the transaction with a belief that profits could be earned…
>
> …
>
> The fact that the Ervins had to spend over $934,000 to obtain an investment return of $140,000, establishes that no reasonable investor would engage in such a transaction to earn a profit. As Dr. Kolbe testified, the Ervins' investment "was not even equivalent to buying a lottery ticket or placing a wager in a casino. Absent the tax motivation, there was no economically rational reason to undertake these transactions, and no economically rational investor would have done so." DX 505 at 20. To quote the Court in Long Term Capital Holdings, 330 F. Supp. 2d at 172, "at the time the transaction was entered into, a prudent investor would have concluded that there was no chance to earn a non-tax based profit return in excess of the costs of the transaction."[88]
>
> [our extracts]

In the ruling handed down in February 2006 in the *Black & Decker* case,[89] the United States Court of Appeals for the Fourth District issued a strong warning when it specified that pursuant to the objective section of the economic substance doctrine the judges must analyse the transaction whose tax consequences are the subject of the dispute according to the principles established in the *Rice's Toyota* case[90] rather than focus this analysis on the company's general business activities. It is thus not a question of analysing the taxpayer's usual business activities but instead of analysing the contentious transaction in order to ascertain the potential for deriving a profit from it. Here is the relevant passage from the judgement in the *Black & Decker* case that explains this legal position:

> The district court's approach to the objective prong strayed from our precedents. Although the district court quoted the pertinent language from *Rice's Toyota, see* 340 F. Supp. 2d at 623, it went on to assert: "A corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions." *Id*. at 623-24. In so reasoning, the district court

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88 See *Jade Trading*, *supra* note 59, pages 59 to 61 of the ruling published by the Court. Subsection 2.4 briefly reviews the facts surrounding this planning scheme.

89 *Black & Decker* (4th Cir.), *supra* note 32.

90 See *Rice's Toyota* (4th Cir.), *supra* note 27.

> mischaracterized the *Rice's Toyota* test, which focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute. "The second prong of the sham inquiry, the economic substance inquiry, requires an objective determination of whether a reasonable possibility of profit from *the transaction* existed apart from tax benefits." *Rice's Toyota*, 752 F.2d at 94 (emphasis added). Thus, many of the undisputed facts upon which the district court relied in concluding that Taxpayer was entitled to summary judgment - including the facts that BDHMI "maintained salaried employees" and paid health claims as they came due with BDHMI assets, 340 F. Supp. 2d at 624 - were simply not germane to the proper inquiry under the second prong of our circuit's sham transaction test.[91]
>
> [our extracts]

By applying business standards, the courts must ultimately decide whether the taxpayer's anticipation of a profit is sufficiently reasonable to grant him the tax benefits stemming from a planning scheme under the objective section of the economic substance doctrine. American jurisprudence is not, however, consistent as regards the profit threshold demanded to satisfy the objective section of the doctrine.

On the one hand, the courts have concluded on several occasions that it was sufficient for the taxpayer to demonstrate a potential for pre-tax profit in order to satisfy the objective section of the test without his having to demonstrate that the predetermined profit threshold was met.[92] The foundation of this position can, in our opinion, be explained by the extract from the judgement handed down in the *Cherin* case[93] cited earlier in this subsection.

On the other hand, certain taxpayers have been unable to take advantage of tax benefits stemming from risky transactions involving a potential profit because the court concluded that economic risks and the anticipated profit from such transactions were insufficient in relation to the tax benefits sought. In these cases, the court demanded instead that the taxpayer's anticipated profit be substantial.[94] By way of illustration, in the *ACM Partnership* case, the Court

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91 *Black & Decker* (4th Cir.), *supra* note 32, page 441.

92 JCT, *Taxpayer Protection Act*, *supra* note 4, pages 131-132, which cites *Rice's Toyota* (4th Cir.), *supra* note 27; *Compaq Computer Corporation* v. *Commissioner*, 277 F.3d 778 (5th Cir. 2001), page 781; *IES Industries*, *supra* note 45, page 354.

93 *Cherin*, *supra* note 84.

94 JCT, *Description of Codification 2005*, *supra* note 92, which cites, in particular, *Sheldon*, *supra* note 47, page 768.

of Appeals confirmed that a planning scheme is devoid of economic substance unless it has a perceptible, measurable impact on the taxpayer's economic position:

> In assessing the economic substance of a taxpayer's transactions, the courts have examined "whether the transaction has any practical economic effects other than the creation of income tax losses," Jacobson v. Commissioner, 915 F.2d 832, 837 (2d Cir. 1990) (citations and internal quotations omitted), and have refused to recognize the tax consequences of transactions that were devoid of "nontax substance" because they "did not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax." Knetsch v. United States, 364 U.S. 361, 366, 81 S.Ct. 130, 135 (1960).[95]

The key challenge facing the courts is to establish the minimum level of risk that a taxpayer must assume in order to take advantage of tax benefits stemming from an aggressive tax planning scheme.

The *IES Industries* case[96] illustrates the differences of opinion between taxpayers and the tax administration on this question. In this case, the taxpayer alleged that he could legitimately hope to derive a profit from the gross dividends paid on the securities held. Consequently, his investments were not solely motivated by tax considerations and he had acted prudently by minimizing the risks related to his investments. Moreover, the parties involved in the stock exchange transactions were entities separate from the taxpayer and operated legitimate businesses both before and after the conclusion of these transactions.[97]

The tax administration alleged that the stock transactions that the company effected were sham transactions because they did not entail any risk of loss. It doubted the taxpayer's veritable intentions since the latter sought to reduce the risks related to the transaction. The court dismissed this argument since the taxpayer is entitled to minimize the business risks to which he exposes himself:

> The risk may have been minimal, but that was in part because IES did its homework before engaging in the transactions.
>
> …

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[95] *ACM Partnership*, *supra* note 33.

[96] *IES Industries*, *supra* note 45.

[97] *Ibid.,* page 355, which refers, in particular, to a passage in US Supreme Court ruling in *United States* v. *Consumer Life Ins. Co*., 430 U.S. 725 (1977), page 737. Contracting with a third party is one of the factors that may lead the judges to conclude that the taxpayer has engaged in true business transactions pursuant to genuine obligations between the parties involved.

> We are not prepared to say that a transaction should be tagged as a sham for tax purposes merely because it does not involve excessive risk. IES's disinclination to accept more risk than necessary in these circumstances strikes us as an exercise of good business judgment consistent with a subjective intent to treat the ADR trades as money-making transactions.[98]
>
> [our extracts]

The *Hines* case[99] illustrates the courts' analysis when they must evaluate the possibilities for a taxpayer to derive a profit from an aggressive tax planning scheme. The court analysed the reasonable anticipation by the taxpayer of a profit in a transaction in which the latter borrowed money to purchase a computer with a view to leasing it. The court analysed the transaction by applying both sections of the doctrine stipulated in the *Rice's Toyota* case.[100]

The court refused to consider the taxpayer's subjective opinions because of objective evidence to the contrary: it applied the economic substance doctrine and first focused on the objective section of the doctrine.[101] The court concluded that the taxpayer had no reasonable expectation of a profit aside from the tax benefits. In fact, the evidence showed that the taxpayer and his advisers had structured the transaction in such a way as to generate bigger tax deductions than the initial investment and that they had shown no interest in the only two sources of potential revenue, i.e. the residual value of the computer and the possibility of leasing the computer upon the expiry of the lease. The following passage from the ruling in the *Hines* case[102] explains the importance that the courts attach to objective evidence in the application of the subjective section of the doctrine:

> Under the test in *Rice's Toyota*, however, a transaction with an expected loss may not be a sham if the taxpayer was motivated by some legitimate business reason other than to obtain tax benefits. In this case, *Hines claims that he subjectively believed, even if he was objectively wrong, that the investment would yield a profit aside from the tax benefits. The mere assertion of such a belief, particularly in the face of strong objective evidence that the taxpayer would incur a loss, cannot by itself establish that the transaction was not a sham. As we have noted, "the ultimate determination of whether an activity is engaged in for profit is to be made ... by reference to objective standards, taking into account all of the facts and circumstances of each case. A taxpayer's mere statement of intent is given less weight than*

98 *Ibid.,* page 355. Briefly, American Depository Receipts are securities negotiated publicly in US dollars, which represent the shares of foreign companies held in trust by an American bank: see page 351 of the foregoing ruling.

99 *Supra* note 47.

100 *Rice's Toyota* (4th Cir.), *supra* note 27.

101 *Hines*, *supra* note 47, page 739.

102 *Ibid*.

> *objective facts*." Faulconer v. Commissioner, 748 F. 2d 890, 894 (4th Cir. 1984). We have examined the record for some evidence that Hines in fact believed the investment would yield a profit, but we find nothing to support such an assertion.
>
> As in *Rice's Toyota*, Hines could have realized a profit on the investment only if he "could re-lease the computer ... or realize a substantial amount by its sale. ... *Residual value of the computer (either in selling or releasing) should therefore have been the crucial point of inquiry for a person with a business purpose of making a profit on this transaction*." *Rice's Toyota, 752 F. 2d. at 92. Neither Hines nor his advisors Morris and Sullivan claimed to have any expertise in the field of computer equipment leasing, nor did they make any independent inquiry into the market for used computer equipment.* They made no effort to obtain an appraisal or even to consult an expert. Sullivan, an accountant, admitted that he did not investigate the value of the computer equipment and that his role was mainly to run the numbers through Hines' tax returns. While Sullivan recommended the investment as profitable, "the record does not reveal that the accountant's opinion reflects anything more than the fact that the transaction, if successful, would generate large *tax deductions." Id.*[103]
>
> [our extracts and italics]

The true capital investment that the taxpayer makes in a transaction is one of the factors that the courts have considered to evaluate the taxpayer's intentions. If the operation is structured to allow a taxpayer to obtain tax benefits generated by an investment that exists only on paper and in respect of which he assumes no genuine business risk, it will be almost impossible for the taxpayer to show that he was not motivated solely by fiscal considerations. The following passage from the ruling in the *Sacks* case[104] clearly explains this factor's relevance:

> *In the ideal tax shelter from a taxpayer's point of view, but not the government's, the taxpayer shows a deductible expense on paper, without actually suffering any of the ordinary economic consequences of paying the money*. The simplest device for creating spurious loss of this kind is to borrow a large amount of money, buy something which immediately generates large paper losses, and avoid paying back the loan. That can be accomplished by inflated price and nonrecourse financing. Nonrecourse financing is a common indicator of a sham transaction. … *Loans which do not really have to be paid by the taxpayer enable him to pretend to pay an artificially high price and generate a correspondingly high tax credit and depreciation deduction, without the risk of really having to pay for what he has purportedly bought.*[105]
>
> [our extracts and italics]

Similarly, the courts will assess the level of economic risk that a taxpayer incurs in a planning scheme based on the contentious transaction, bearing in mind the transactions related to it.

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103 *Ibid.,* page 740. See also *Black & Decker* (4th Cir.), *supra* note 32, page 443.

104 *Sacks*, *supra* note 33.

105 *Ibid.,* pages 988-989.

In the *Coltec* case,[106] the US Court of Appeals for the Federal Circuit had to determine whether the economic substance doctrine applied to a planning scheme in which the taxpayers had carried out a series of transactions in order to deduct a capital loss in the calculation of their income. Essentially, the creation of this capital loss was first attributable to a transaction in which the taxpayer had transferred assets to a company in exchange for shares issued by the company, which assumed on behalf of the taxpayer an obligation of the latter that was subordinated to a future event. The taxpayer's purported objective was to minimize the risk of being subject to legal proceedings stemming from liability related to the use of asbestos in the course of its business activities.

The taxpayer subsequently transferred to two banks the shares received at the time of the transfer. The proceeds from the disposal were significantly less than their tax cost. For the purchasers, the fair market value of the company's shares had to be reduced to the present value of the subordinated obligation that the company assumed.

The US Court of Appeals for the Federal Circuit applied the economic substance doctrine to the planning scheme. In its opinion, the exchange of assets between the taxpayer and the company was indissociable from the subsequent sale by the taxpayer of the shares that he held in the company. The taxpayer did not objectively prove his alleged business purpose. Furthermore, the Court also took into consideration that the banks had devalued the value of the company's shares because of the possibility of its being subject to legal proceedings launched by third parties related to the subordinated obligation assumed:

> The government does not dispute that the transfer of management activities may have had economic substance. Government's Br. at 42. The transfer of management activities, however, is not the transaction at issue. Here, just as in Basic Inc., we must focus on the transaction that gave the taxpayer a high basis in the stock and thus gave rise to the alleged benefit upon sale. That transaction is Garrison's assumption of Garlock's asbestos liabilities in exchange for the $375 million note. Coltec admits that "Garrison received the Stemco note in exchange for assuming Garlock's asbestos liabilities." … It is this exchange that provided Garlock with the high basis in the Garrison stock, this exchange whose tax consequence is in dispute, and therefore it is this exchange on which we must focus.
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> …
>
> The transfer of the liabilities for the note could only strengthen Coltec's defense against veil-piercing if third parties would be obligated to pursue Garrison instead of Garlock. It is

[106] *Coltec* (Fed. Cir. App.), *supra* note 3.

> perfectly clear that the transaction had no such result. We are not aware of, nor has Coltec brought to our attention, any authority suggesting otherwise. …
>
> …
>
> Far from making Garrison more attractive to third party acquirers such as the banks here, the assumption of the asbestos liabilities made the Garrison stock less attractive. The banks were willing to acquire Garrison stock from Garlock only by establishing "separate subsidiaries to insulate their banking business from any potential veil-piercing claims" and they insisted on being indemnified by Coltec against veil-piercing claims. … The banks also insisted on keeping the entire transaction confidential.[107]
>
> [our extracts]

Similarly, the United States Court of Federal Claims in the *Jade Trading* case focused on the transaction from which stemmed the tax benefit claimed by the taxpayers, bearing in mind another transaction linked to it. The taxpayers had carried out a planning scheme involving euro purchase and sale options whose details and the sequence of acquisition and disposal were linked. The taxpayers alleged that they were entitled to minimize their financial risks by being involved both in the euro purchase and sale options. While the taxpayers may minimize their financial risks through aggressive tax planning schemes, the United States Court of Federal Claims concluded in this case that the two types of options were indissociable and must consequently be evaluated together for the purposes of applying the economic substance doctrine:

> Plaintiffs further argue that the spread transaction had economic substance because the euro option purchased from AIG and the euro option sold to AIG represented two distinct legal entitlements which should not be recast as one. Pls.' Post-Trial Br. at 2, 6, 41. In Plaintiffs' view, the sold euro option should be deemed a contingent obligation, not a liability, which would not affect partnership basis and permit the basis in the purchased call option to be inflated, yielding a large tax loss. Pls.' Post-Trial Br. at 50-51. However, the economic realities of the spread transaction contributed to Jade made it impossible to delink the options.
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> …
>
> Plaintiffs contend that longstanding precedent has rejected creative attempts by the IRS to collapse "roughly counterbalancing positions" such as vertical spread options, silver straddles, soybean straddles, mortgage swaps, sale/leasebacks, and other offsetting transactions. In so arguing Plaintiffs rely on six decisions in which courts refused to collapse such dual transactions, Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), Frank Lyon Co. v. United States, 435 U.S. 561 (1978), Valley Waste Mills v. Page, 115 F.2d 466 (5th Cir. 1940), Laureys v. Commissioner, 92 T.C. 101 (1989), Smith v. Commissioner, 78 T.C. 350 (1982), Maloney v.Commissioner, 25 T.C. 1219 (1956). However, these decisions are distinguishable from the instant case because the so-called counterbalancing

[107] *Ibid*, page 29 to 33.

> positions were legally distinct and clearly not inextricably linked as are the options comprising the spread transaction here. In contrast to the transactions in the Cottage Savings line of cases where transactions could not be collapsed because they were independent, the transactions here cannot be separated because they were totally dependent on one another from an economic and pragmatic standpoint[108].
>
> [our extracts]

In addition to the taxpayer's initial investment in a planning scheme and the risks inherent in such a scheme, the courts must measure the period during which the taxpayer may reasonably anticipate an economic profit in a planning scheme and the likelihood that the taxpayer will carry out the requisite transactions to obtain it. In the *Dow Chemical*[109] and *ACM Partnership* cases,[110] the courts assessed the profit that a taxpayer could anticipate by taking into consideration the net present value of the cash flows stemming from the planning scheme since the profit was only expected to materialize several years after the day on which the planning scheme was implemented.

To establish this value, the groups of stakeholders must determine the discount rate applicable depending on the circumstances surrounding a planning scheme. As the *Dow Chemical* case shows, the groups of stakeholders may, however, differ in opinion on the discount rate applicable depending on the facts and circumstances of the planning scheme.

Briefly, in this case, a company took out a life insurance policy on its employees with an insurer. The company was the beneficiary of the policy. At the same time, the company contracted an interest-bearing loan with the insurer in an amount corresponding to the present value of the insurance policy. The cash surrender value of the insurance policy was offered to the insurer as a guarantee. The company paid the insurance premiums from this loan except in certain years when, to do so, the taxpayer withdrew an advance on the accumulated cash value of the insurance policy through the return that the insurer obtained on the investment of surplus premiums.

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108 *Jade Trading*, *supra* note 59, pages 61 to 63 of the ruling published by the Court.
109 *Dow Chemical*, *supra* note 58.
110 *ACM Partnership* (3rd Cir.), *supra* note 33, page 259.

According to details of the transactions, the company incurred negative net cash flow during the first 17 or 18 years following the realization of the initial transactions. Subsequently, if the company injected additional funds over a period of 10 to 12 years, it could take advantage of surplus cash flow but only at the end of a period of 40 years following the implementation of the planning scheme. The company had not assumed any contractual obligation that compelled it to inject additional funds.

Pursuant to the tax rules applicable in this dispute, the death benefits paid under the life insurance policy are non-taxable in the hands of the beneficiary (including the portion of the benefits stemming from the return generated for the duration of the policy on surplus insurance premiums). The company did not have to include the amount borrowed in the calculation of its income, nor did it have to include in the calculation of its income the adjusted cost base of the insurance policy. Moreover, the company could deduct in the calculation of its income the amounts paid by way of interest on the loan contracted with the insurer.[111]

The tax administration applied the economic substance doctrine in order to rescind a deduction claimed by the taxpayer in the calculation of its income in respect of the amounts that the taxpayer paid pursuant to the loan.

The court of first instance sided substantially with the taxpayer and allowed it to deduct a large portion of the interest on the loan. Among other things, the court concluded that the taxpayer maintained a reasonable anticipation of a profit over a long period according to a post-tax discount rate established in a manner that conformed to applicable business standards bearing in mind the tax benefits allowed by the law. The tax administration contended that this discount rate must be applied before tax.

However, the United States Court of Appeals for the Sixth District quashed the ruling of the court of first instance since the majority judges concluded that it seemed highly improbable that the taxpayer would make the necessary additional investment to generate a long-term economic

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111 For a summary of the rules applicable in this case, including the changes to the tax rules that ultimately led to the impossibility of claiming a deduction on interest paid in such a context, see *Dow Chemical Company* v. *United States*, 250 F. Supp. 2d 748 (E.D. Mich 2003) [*Dow Chemical* (E.D. Mich.)].

profit. In his dissenting opinion, the minority judge sustained the ruling of the court of first instance and was, moreover, of the opinion that the discount rate that the taxpayer applied was reasonable according to business standards under the circumstances.

2.6 Predominance of the objective section over the subjective section

The weight accorded the subjective section of the test varies widely in the jurisprudence. Aside from the taxpayer's opinions and perceptions, the courts will examine whether the taxpayer could reasonably expect a profit in conjunction with a planning scheme, above all when the taxpayer's fiscal projects seem unreasonable in light of objective evidence.[112] When the courts adopt the same factor in the application of the subjective and objective sections of the test, they tend to attach greater importance to objective proof of the taxpayer's intention.[113] In this context, certain judges have refused to consider the taxpayer's subjective opinions when the objective proof does not corroborate the opinions.

In this perspective, if the taxpayer shows that the transactions were concluded in good faith for non-tax reasons such as compliance with a regulation or a law, e.g. the banking sector regulations,[114] or the restructuring of part of a company's business activities,[115] the courts will grant the taxpayers the right to claim the tax benefits under the subjective section of the doctrine.

As we emphasized in subsection 2.5.2, the courts will examine, in particular, whether the taxpayer could reasonably hope for a profit, above all when such predictions seem unreasonable in light of an objective proof and despite the taxpayer's subjective opinions. It is

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[112] In our opinion, the *Jade Trading* case, *supra* note 59, clearly illustrates this notion. In this case, the United States Court of Federal Claims opined that for the purposes of the application of the doctrine, the taxpayer's subjective opinion on the profits that might stem from a planning scheme was relegated to the background of subjective proof of the level of anticipation of a profit that the taxpayer could truly foresee. We refer the reader to the passages cited from this ruling in subsection 2.4.

[113] *Hunt*, *supra* note 79, page 472: "It is proper to draw from objective facts inferences regarding a subjective intent to profit." See also *Friedman*, *supra* note 79, page 792; *Faulconer* v. *Commissioner*, 748 F.2d 890, 894 (4th Cir. 1984) [*Faulconer*].

[114] *Frank Lyon*, *supra* note 22, pages 582-584.

[115] *UPS of America*, *supra* note 31, pages 1019-1020.

then to the taxpayer's advantage to prove that, according to the fiscal projections of a planning scheme, he could reasonably generate an economic profit in accordance with the business standards applicable under the circumstances and notwithstanding the tax benefits.

When the courts apply the criterion of the reasonable anticipation of a profit, it is imperative that the taxpayer prove that he was not seeking solely to reduce his tax burden. He must show that he was motivated by the opportunity to derive a profit from the planning scheme or that he had valid business reasons for concluding the scheme excluding tax savings.

If the taxpayer has shown no interest in potential non-tax sources of income stemming from his investment, the courts might conclude that he was not motivated a non-tax business purpose. It is reasonable to think that a taxpayer who genuinely pursues a business purpose has analysed the potential return on his investment before concluding the transaction. He must, therefore, be able to prove that he weighed the costs and risks inherent in the planned transactions as a cautious investor would have done. When the courts decide that a transaction must be evaluated according to the subjective section of the doctrine, they will examine whether the analysis that the taxpayer and his advisers conducted prior to the investment was thorough and rigorous.[116] This passage from the ruling in the *IES Industries* case illustrates this approach:

> The Shriver Court considered the district court's "subjective analysis of the taxpayer's intent" and the court's review of such factors as the depth and accuracy of the taxpayer's investigation into the investment. Id. To the extent the taxpayer's subjective intent is material, we too will consider factors that are arguably relevant to the inquiry. We do so, however, mindful of the fact that the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469, 79 L. Ed. 596, 55 S. Ct. 266 (1935). A taxpayer's subjective intent to avoid taxes thus will not by itself determine whether there was a business purpose to a transaction.[117]
>
> [our extracts]

The courts also reserve the right to assess the credibility of the taxpayer's contentions with respect to his anticipation of a profit by examining his prior conduct, above all when this anticipation centres on possible actions that are unusual for the taxpayer. In the *Knetsch*, *Frank Lyon* and *Dow Chemical* cases, the courts had to ascertain the likelihood of the taxpayers'

[116] *Shriver*, *supra* note 29, page 726; see also *IES Industries*, *supra* note 45, page 355.
[117] *IES Industries*, *supra* note 45, page 355.

carrying out certain transactions subsequent to the implementation of a planning scheme. These transactions were necessary for the taxpayers to realize an economic profit otherwise than by obtaining tax benefits. In majority decisions, the US Supreme Court in the *Knetsch* and *Frank Lyon* cases and the United States Court of Appeals for the Sixth Circuit in the *Dow Chemical* case opined that this likelihood was objectively limited in light of the facts and circumstances presented in the evidence.

More specifically, the court of first instance in the *Dow Chemical* case[118] allowed the taxpayer to deduct in the calculation of his income amounts paid as interest in conjunction with a planning scheme through which he took out a life insurance policy on his employees. For the purposes of the application of the economic substance doctrine, the judge concluded the taxpayer's anticipation of an economic profit was reasonable since he could generate a profit several years after the implementation of the planning scheme by subsequently injecting additional funds. This court deemed to be credible the taxpayer's intention to make the additional investment in a timely manner in order to maintain the long-term viability of the life insurance plan.

On appeal, the majority judges sided with the tax administration. All of the Court of Appeals judges noted that the courts may ascertain a taxpayer's potential profits by considering his possible actions in order to evaluate the economic substance of a transaction. Based on the US Supreme Court ruling in the *Knetsch* case, the majority judges did, however, dismiss the taxpayer's intention to make this additional investment, since it appeared highly unlikely in light of an objective assessment of the planning scheme. On the one hand, the Court noted that the taxpayer was not contractually obligated to make the additional investment and, on the other hand, that this investment was outside his normal field of operations:

> Courts may consider future profit contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct. Courts should be skeptical, however, when the asserted future profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money.[119]
>
> [our extracts]

118 *Dow Chemical* (6th Cir. 2006), *supra* note 58.
119 *Ibid*., page 601, commenting on *Knetsch, supra* note 19, pages 364 and 366.

In his *certiorari* brief filed with the US Supreme Court, the taxpayer in the *Dow Chemical* case was of the opinion that the Court of Appeals that had heard this case had erred by failing to properly take into account the likelihood of the taxpayer's possible investments. The taxpayer claimed that the courts must take into account these possibilities whether or not they are explicitly stipulated in the contracts concluded initially, without which the taxpayers would be deprived of opportunities to engage in legitimate commercial planning and long-term investments:

> At bottom the ruling below rests on an arbitrary irrebuttable presumption that taxpayers who enter into transactions requiring a substantial future investment can be counted on to actually make the investment only if they are contractually bound to do so. Nothing in the economic substance doctrine, let alone the Internal Revenue Code, supports a distinction between investments made at the beginning of the transaction and those made subsequently, or between those that are contractually stipulated and those that are planned in accordance with the taxpayer's business needs and financial incentives. The presumption embodied in the ruling below thus undermines principled application of the Internal Revenue Code. If permitted to stand, the presumption … will frustrate not only long-term financing transactions, but also many other legitimate business transactions that are not initially profitable but become so over time.[120]
>
> [our extracts]

2.7 Taxpayers must establish that their transactions comply with the economic substance doctrine according to the balance of probabilities

Generally speaking, taxpayers bear the burden of proof in tax matters. They must establish the relevant facts to prove that their planning schemes complied with the tax rules and the economic substance doctrine. The *US Internal Revenue Code* imposes on the taxpayer the burden of establishing credible proof in respect of the facts supporting the tax benefits that he is claiming.[121] From the standpoint of aggressive tax planning schemes, a taxpayer assumes a heavier burden of proof than is normally expected of him. This extract from the ruling of the United States Court of Appeals for the Federal Circuit in the *Coltec* case clearly illustrates this notion:

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[120] See *Petition for a Writ of Certioari*, *Dow Chemical Company* v. *United States* (No. 06-478), US Supreme Court, filed October 4, 2006, page 29. The Supreme Court refused to hear the taxpayer's appeal in this case (see *supra*, note 38).

[121] 26 U.S.C. § 7491.

> In describing the history of the economic substance doctrine, our predecessor court in Rothschild stated, "Gregory v. Helvering requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to a kind of transaction that would never occur absent the motive of tax avoidance. … Other circuits have similarly held that "[e]conomic substance is a prerequisite to the application of any Code provision allowing deductions [and therefore that] … [t]he taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible."[122]
>
> [our extracts]

When taxpayers are able to establish credible proof concerning the interpretation of these rules and facts, the tax administration must, in turn, justify the withdrawal of the tax benefits. Notwithstanding the sharing of the burden of proof, the courts will settle disputes from the standpoint of the application of the law and the economic substance doctrine according to the balance of probabilities.[123]

2.8 Aggressive taxpayers run the risk of paying a penalty for under-stating tax payable

2.8.1 Reasons for which the tax administration implemented a penalty for under-stating tax payable

Under a self-assessment system, American taxpayers assume responsibility for estimating their tax payable pursuant to the tax rules and the economic substance doctrine. To ensure the taxation system's integrity, the tax administration may audit the income tax returns produced by taxpayers to make sure that the amounts of tax estimated are accurate. The tax administration might conclude that certain taxpayers have under-stated their tax payable and issue them a new notice of assessment.

However, the tax administration is unable to verify the accuracy of all taxpayers' income tax returns. Moreover, it may be unable to pinpoint in a tax return indicators that point to tax avoidance if the taxpayer does not properly provide all of the information necessary that would

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[122] *Coltec* (Fed. Cir. App.), *supra* note 3, page 25 of the ruling published by the Court.

[123] By way of illustration, see *Santa Monica Pictures, LLC* v. *Commissioner of Internal Revenue*, T.C. Memo 2005-104 (May 11, 2005) [*Santa Monica Pictures*], pages 113-115. The taxpayers appealed this ruling before the Court of Appeals of the Second Circuit (No. 05-4491-ag).

enable the tax administration to determine whether a transaction complies with the economic substance doctrine.

Consequently, aggressive taxpayers might abusively take advantage of the tax rules to minimize their tax payable if they consider to be minimal both the likelihood of being subject to an audit by the tax administration and the financial consequences stemming from a new notice of assessment. Such financial consequences depend, by and large, on the interest that they must pay on the amount of tax payable and the penalties for under-stating tax payable.

To better protect the taxation system's integrity, the American tax administration has prescribed various penalties to which taxpayers may be subject should they fail, among other things, to produce an information return or to pay the amount of tax payable. The tax administration has prescribed these penalties to increase compliance by all taxpayers with the taxation system and to heighten the financial risks for those wishing to engage in aggressive tax planning schemes.

Generally speaking, the American tax administration attempts to reconcile the following principles in the application of tax penalties:

- Fairness – a penalty should be proportional to the severity of the taxpayer's conduct and be applied coherently and impartially by the tax administration, in light of the circumstances surrounding the incorrect conduct.
- Predictability – taxpayers should be aware of the nature of planning schemes covered by a penalty and the attendant sanctions.
- Efficiency – the sanction should be sufficiently rigorous to heighten more than minimally compliance by taxpayers with the taxation system. For example, the less risk there is for a taxpayer to be audited, the higher the penalty rate might be.
- Simplicity – the system's application procedures should be simple and flexible to ensure compliance with the principles mentioned earlier.[124]

These penalties include the penalty for under-stating the tax payable by the taxpayer. The tax administration may levy this penalty on a taxpayer, in particular when the amount of tax under-

[124] US, Department of Treasury (Office of Tax Policy), *Report to Congress on Penalty and Interest Provisions of the Internal Revenue Code* (October 1999) [Treasury, Report on Penalty and Interest Provisions], pages 35-40.

stated exceeds predetermined thresholds. This penalty corresponds to 20% of the amount of the tax under-stated, as determined by the tax administration according to its interpretation of the facts, the tax law and the jurisprudence.

2.8.2 General conditions of the penalty for under-stating tax payable

Pursuant to the *US Internal Revenue Code*, taxpayers must pay in addition to the amount of the withdrawn tax benefit and interest a penalty equivalent to 20% of the amount of the tax under-stated when the under-statement stems from negligence (penalty for negligence) as determined by the tax administration according to its interpretation of the facts, the tax law and the jurisprudence**.** Negligence is defined as failure by the taxpayer to take reasonable steps to comply with the tax rules.[125] The tax administration assumes the burden of establishing evidentiary elements to support *prima facie* the penalty imposed on the taxpayer ("burden of production").[126]

Taxpayers may avoid the penalty for negligence if they establish that they acted in good faith and displayed reasonable diligence in ensuring that they claimed tax benefits in accordance with the tax law.[127] The taxpayer must establish the relevant facts that allow him to avoid the penalty levied by the tax administration.[128]

The degree of diligence demanded of taxpayers varies according to the complexity of the aggressive tax planning scheme, the value of the tax benefits at stake and the taxpayers'

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[125] See 26 U.S.C. § 6662 for the penalty for negligence. In the *Long Term Capital Holdings* case, *supra* note 5, a Connecticut District Court (Second Circuit) provided the following explanations concerning the concept of negligence: "For purposes of this section, the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term "disregard" includes any careless, reckless, or intentional disregard."

[126] 26 U.S.C. § 7491(c). Taken literally, this rule only applies when the penalty is levied on an individual. However, for all intents and purposes, the tax administration must expect to show the courts that a penalty is applicable to any taxpayer in a given situation. We refer the reader to the *Long Term Capital Holdings* case (D. Conn.), *supra* note 5, for an analysis of the aforesaid article and the burden of proof concerning the penalty for under-stating tax payable.

[127] 26 U.S.C. § 6664.

[128] See *Gleason* v. *Commissioner of Internal Revenue*, T.C. Memo 2006-191: "The Commissioner satisfies this burden of production by "[coming] forward with sufficient evidence indicating that it is appropriate to impose the relevant penalty" but "need not introduce evidence regarding reasonable cause, substantial authority, or similar provisions." *Higbee* v. *Commissioner*, 116 T.C. 438, 446 (2001). Rather, "it is the taxpayer's responsibility to raise those issues." Id.

expertise in tax matters. Taxpayers usually assume responsibility for examining the facts relevant to a planning scheme geared to avoidance, depending on their level of expertise in this respect. Consequently, the more complex aggressive tax planning schemes are and the bigger the tax benefits, the greater the burden on taxpayers to employ the necessary means to ensure that the tax treatment being claimed complies with the tax law and the jurisprudence.

The courts will objectively evaluate the degree of diligence that the taxpayer displays to ensure compliance with the tax rules. Briefly, the courts will take into consideration:

- the nature of the planning scheme;
- the complexity of the tax questions in dispute;
- the taxpayers' expertise in tax matters;
- the steps that taxpayers have taken to ensure compliance with the tax rules;
- the disclosure by the taxpayer of his participation in a transaction prescribed by the tax administration pursuant to the disclosure rules.[129]

Taxpayers could avoid the penalty for negligence if the weight of the recognized legal and administrative sources in support of the tax benefits that they are claiming is substantial in relation to the sources supporting the tax administration's stance. The rules respecting penalties do not provide precise parameters to determine to what extent the weight of the recognized legal and administrative sources that favour the taxpayer are substantial. This weight is usually deemed to be substantial if the likelihood of the courts' accepting it stands at roughly 40%. If the taxpayers have properly disclosed in their tax returns or the prescribed form the facts that support the tax treatment demanded, they may avoid the penalty for negligence if the weight of the recognized legal and administrative sources in their favour is less than substantial. In the latter instance, the courts should accept the taxpayer's position if there is at least a 20% likelihood that the legal sources support this position.[130]

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[129] See *Long-Term Capital Holdings* (D. Conn.), *supra* note 5. See also Internal Revenue Service, Audit Technique Guide, "Accuracy-Related Penalties For Taxpayers Involved In Tax Shelter Transactions" (May 2004) [IRS, "Guide on Audit, Penalties and Tax Shelters"]. For an illustration of the application of these criteria by the tax administration, see Internal Revenue Service, Coordinated Issue Paper "Notice 2002-65 Tax Shelter," UIL 9300.22-00 (May 9, 2005).

[130] In this regard, taxpayers should usually produce a prescribed information return to provide the relevant information that is not otherwise properly disclosed in their tax return. The tax administration could prescribe a specific ad hoc disclosure method. See 26 C.F.R. § 1.6662-3(c); United States, Department of Treasury (Internal

According to the tax administration, the procedures governing the application of the penalty for negligence did not adequately protect the taxation system's integrity from the standpoint of the aggressive tax planning schemes implemented by taxpayers.[131] In particular, the reasonable position criterion centres on the notion that taxpayers and the tax administration are adversaries and, consequently, allows taxpayers to adopt an aggressive stance aimed more at establishing a litigating position than demonstrating compliance with the law. The tax administration maintains that aggressive taxpayers must be subject to a greater degree of diligence since it is unable to audit all tax returns.[132]

Consequently, the tax administration has adopted a penalty for substantially under-stating tax payable, which prescribes more rigorous diligence standards than the penalty for negligence. Taxpayers are subject to this penalty if the difference between the amount of tax they should have paid and the amount that they determined exceeds a set threshold, usually a percentage of the amount of tax under-stated.[133] However, the amount of tax under-stated must exceed the prescribed minimum threshold, which varies depending on whether the taxpayer is an individual or a company. This penalty seeks to heighten the financial risk that aggressive taxpayers bear.[134]

More specifically, the *US Internal Revenue Code* subjects taxpayers to a penalty for under-stating tax payable equivalent to 20% of the total amount of tax that the taxpayer under-stated as determined by the tax administration, when the amount of tax under-stated exceeds the following thresholds:

- Generally speaking, the amount the taxpayer has under-stated will be substantial if the amount of tax payable determined by the tax administration exceeds the amount stated

Revenue Service), *Disclosure Statement,* Form 8275 (Rev. 5-2001) and *Instructions for Form 8275 (Rev. February 2006, Use with the May 2001 Revision of Form 8275)*.

131 Treasury, *Report on Penalty and Interest Provisions*, *supra* note 124, pages 97-111.

132 *Ibid.*

133 Taxpayers must pay this penalty in addition to the interest that they had to pay on the amount of tax under-stated.

134 United States, Department of Treasury, *The Problem of Corporate Tax Shelters, Discussion, Analysis and Legislative Proposals* (July 1999) [Treasury, *Corporate Tax Shelters*], pages 64-66.

by the taxpayer by an amount corresponding to the greater of 10% of the tax determined by the tax administration or US$5,000.

- In the case of a company, an amount of tax under-stated will be substantial if the amount of tax determined by the tax administration exceeds the amount stated by the company by an amount corresponding to the lesser of 10% of the tax determined by the tax administration (or US$10,000 if this amount is greater) or US$10 million.[135] [fournir l'explication en note infrapaginale]

If the under-statement of tax payable by the taxpayer stems from a transaction one of whose significant purposes[136] is to obtain a tax benefit, the taxpayer may avoid part or all of the penalty if he demonstrates his good faith and establishes according to the balance of probabilities that he had reasonable grounds for believing that the tax treatment claimed in respect of this transaction complied with the tax law and the jurisprudence. As is true of the penalty for negligence, the courts will take into consideration all of the facts underlying the implementation of a planning scheme and will assess the degree of diligence that the taxpayer displayed under the circumstances.[137]

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135 26 U.S.C. § 6662.

136 Until it was amended in 1997, the penalty for under-stating tax payable applied to a transaction whose main purpose was tax avoidance. For the purposes of the penalty for under-stating tax payable, the tax administration adopted the criterion of "one of the significant purposes" in 1997 since the criterion of the main purpose in a transaction was harder to establish (a significant purpose appears to imply less weight than that attributable to the main purpose of a transaction). The statutory regulations governing the penalty for under-stating tax payable were not amended following the replacement of the "main purpose" criterion by the "one of the significant purposes" criterion, such that these regulations do not define the meaning of the latter criterion. The statutory regulations governing the disclosure rules nonetheless provide general indicators to determine whether one of the significant purposes of a transaction can be deemed to be tax avoidance. Pursuant to 31 C.F.R. § 301.6111-2(b)(3), a transaction will not have any significant purpose of a fiscal nature if it is carried out in accordance with standard commercial practices and the obtaining of tax benefits may be deemed to comply with the tax law. See John C. Gardener *et al*., "Amendments to Circular 230 (Part I)," (2006) 37:1 *The Tax Adviser* 24, 27-31.

137 For individuals, see 26 U.S.C. § 6662(d)(2)(C) and 26 C.F.R. § 1.6662-4(g). For companies, see 26 U.S.C. § 6664(c) and 26 C.F.R. §1-6662-4(g)(1)(iv) and §1-6664(f). Briefly, taxpayers could avoid a penalty for substantially under-stating tax payable in respect of a transaction one of whose significant purposes is tax avoidance regardless of their failure to adequately disclose their fiscal status on their tax return. Depending on the circumstances, failure to properly disclose their fiscal status might nonetheless be considered a lack of good faith on the part of the taxpayers and trigger the assessment of a penalty. Moreover, if the taxpayers do not produce an information return in respect of transactions that imply a risk of avoidance that are prescribed by the tax administration and the latter determines that they have under-stated the tax stemming from such transactions, the tax administration might apply a penalty of 30% of the amount of the tax under-stated instead of the 20% penalty usually applicable. The relationship between penalties for under-stating tax payable and transparency in the taxpayers' information returns in respect of aggressive tax planning schemes will be examined in instalment 8 devoted to the disclosure rules.

To minimize the risk of being subject to a penalty for under-stating tax payable, taxpayers may exercise a reasonable degree of diligence by seeking the opinion of tax advisers. When grey areas exist in the application of the tax law and the jurisprudence, taxpayers could avoid a penalty by relying on the opinion of a tax adviser who concludes according to the balance of probabilities that obtaining tax benefits complied with the tax law in force at the time that the benefits were claimed, bearing in mind the weight of each recognized source of legal or administrative interpretation.[138]

However, tax advisers must possess the expertise required to express a tax opinion. They must formulate an unequivocal conclusion in their opinion on the stance adopted by the taxpayer and take into account all of the relevant facts. They must not rely on unverified hypotheses that seem unreasonable.[139]

It is not usually incumbent upon taxpayers to obtain a second assessment of their advisers' opinion, unless they possess the necessary fiscal expertise.[140] However, taxpayers should not, in principle, rely on the tax opinion of the promoter of an aggressive tax planning scheme or on an adviser in respect of whom there is a conflict of interest.[141] Taxpayers might be unable to establish their good faith if they rely on a tax opinion issued by advisers who derive fees determined according to the value of the tax benefits claimed and, in addition, they share them with the auditors or third parties who have a pecuniary interest in the planning scheme. Such

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[138] 26 U.S.C. § 6662 and 26 C.F.R § 1.6662; 26 U.S.C. § 6664 and 26 C.F.R. § 1.6664. When aggressive tax planning schemes resemble certain transactions prescribed for the purposes of the disclosure rules, i.e. a transaction prescribed pursuant to the disclosure rules whose significant purpose is avoidance or on a transaction declared to be aggressive under the same rules, the taxpayers may present a defence centred on due diligence if, in particular, they have properly disclosed the relevant facts pertaining to the transaction, they have relied on recognized sources of interpretation and application of the law (substantial authority) to justify the tax treatment of the transaction, and they had reasonable grounds for believing that they could claim the tax benefits in accordance with the tax law and according to the balance of probabilities. See 26 U.S.C. § 6664(d).

[139] See *Long-Term Capital Holdings* (D. Conn.), *supra* note 5.

[140] *Ibid.*

[141] US, National Taxpayer Advocate, *2005 Annual Report to Congress* (December 31, 2005) [NTA, *2005 Report to Congress*], Volume 1, pages 514-518. See also *Klamath Strategic Investment Fund, LLC* v. *United States*, 472 F. Supp.2d 885 (E.D. Tex. 2007); (January 31, 2007), United States District Court, Eastern District of Texas (Texarkana Division), Civil Action No. 5:04-CV-278 [*Klamath*]. In this case, a Texas district court concluded that the taxpayers could trust the opinion of their tax advisers notwithstanding factors demonstrating the relationship that these advisers maintained with the promoters of the planning scheme that the taxpayer implemented, bearing in mind, among other things, that the opinion did not conform to ethical standards in tax matters. In this case, the taxpayers were unable to claim the tax benefits because the transaction was devoid of economic substance without, however, being subject to a penalty for under-stating tax payable. We refer the reader to instalment 7 devoted to ethical standards, in which the *Klamath* case is also analysed.

methods of remuneration could undermine the independence of the tax advisers who were to give an opinion on the planning scheme's compliance with the law.[142] The presence of confidentiality clauses governing the characteristics of a transaction elaborated by the advisers who have expressed an opinion in favour of the taxpayer might also undermine their impartiality.[143]

2.8.3 Impact of uncertainty surrounding the economic substance doctrine on the administration of the penalty for under-stating tax payable

Opinions differ in groups of stakeholders on the accuracy of the amount of tax stated by the taxpayer and, consequently, the administration of a penalty for under-stating tax payable and the amount of such a penalty because of current uncertainty surrounding the economic substance doctrine. In particular, opinions may differ among taxpayers, the tax administration and the courts on the amount of a penalty for under-stating tax payable if the application criteria respecting the economic substance doctrine are not clearly defined in the tax law. Thus, the tax administration might issue a new notice of assessment because the taxpayer under-stated his tax payable under a planning scheme devoid of economic substance. The courts might conclude, depending on the circumstances, that the taxpayers obtained the tax benefits in a manner that conforms to this doctrine.

The fairness of a penalty ultimately hinges on the possibility for taxpayers to avoid it because of uncertainty inherent in the tax rules and the economic substance doctrine. The courts may conclude unanimously pursuant to the economic substance doctrine that a taxpayer has under-stated his tax payable but may differ in opinion on the application to the taxpayer of a penalty. The courts may differ in opinion on the administration of the penalty for under-stating tax

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[142] For an illustration of the problems related to the tax advisers' independence, see the report produced by US, US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, entitled *The Role Of Professional Firms In The U.S. Tax Shelter Industry* (S. REPT. 109–54) Washington, DC, U.S. Government Printing Office, April 13, 2005, pages 68-71, 98-99. In one of the most aggressive cases mentioned, certain tax advisers sought to avoid being subject to the ethical standards of regional or federal professional corporations prohibiting recourse to contingent fees or sharing such fees with advisers engaged in a different profession.

[143] For an overview of the factors that the tax administration considers in order to determine whether a taxpayer has acted in good faith and displayed due diligence for the purposes of the penalty for under-stating tax playable, see the technical guide published by the Internal Revenue Service for its auditors [IRS, "Guide on Audit, Penalties and Tax Shelters"], *supra* note 129 dans Exhibit 7.

payable depending on the degree of diligence exercised by the taxpayer and his advisers both from the standpoint of the facts underlying an aggressive tax planning scheme and the application criteria respecting the tax law and the economic substance doctrine.[144]

The courts may maintain the levying by the tax administration of a penalty for under-stating tax payable on taxpayers who have carried out a tax planning scheme devoid of economic substance that other courts have already declared to be abusive.[145] However, each stakeholder may, in respect of each decision that might possibly apply to a given transaction, express interpretations considered to be reasonable of the facts then in question.[146] The possibility of a taxpayer's being liable for a penalty because of a transaction that was generally subject to unfavourable decisions depends on the degree of diligence that he displayed to establish a distinction between the circumstances surrounding his planning scheme and the facts underlying these unfavourable decisions.[147]

Moreover, the courts must decide to rescind or maintain a penalty for under-stating tax payable levied by the tax administration on taxpayers who have engaged in a planning scheme that complies with the tax rules according to a literal interpretation of these rules but devoid of economic substance that was not subject to an unfavourable decision at the time the planning scheme was carried out. In such a situation, the courts must then analyse the legislative, legal and administrative sources recognized by the tax code and all of the facts pertaining to a transaction to determine whether the taxpayers could reasonably believe according to the balance of probabilities that the transaction complied with the tax law.

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144 Sheldon I. Banott and Richard M. Lipton, "Debt vs. Equity: Courts Disagree on Understatement Penalty" (2006) 104:6 *Journal of Taxation* 378.

145 *Kooyers* v. *Commissoner of Internal Revenue*, T.C. Memo 2004-281.

146 See *Melnik* v. *Commissioner of Internal Revenue,* T.C. Memo 2006-25 (February 15, 2006): "We have previously held that a taxpayer's adoption of a "flagrant tax avoidance scheme" repeatedly rejected by the courts is patently negligent. … However, as petitioners point out, the implementation of a private annuity transaction using foreign entities has not been consistently rejected by the courts. Although this Court has subjected such transactions to strict scrutiny and has upheld only a few, the Court of Appeals for the Ninth Circuit has reversed this Court in several cases involving private annuity transactions, holding that, on the facts of those cases, the transactions had sufficient economic substance to be respected for Federal income tax purposes. … With this background in mind, we are unable to conclude that a private annuity transaction using foreign entities is a flagrant tax avoidance scheme that is per se negligent. Instead, we look to the evidence introduced by the parties to determine whether petitioners are liable for the section 6662 penalty."

147 *Long-Term Capital Holdings* (D. Conn.), *supra* note 5. In our opinion, this distinction might be established in certain cases solely in the wake of a thorough analysis of all of the documents submitted as evidence by the parties and, as the case may be, testimony to support a decision in order to properly grasp its scope.

More specifically, the courts must compare the weight of a technical interpretation of the tax rules that favour the obtaining by taxpayers of tax benefits and the weight of the economic substance doctrine pursuant to which the tax administration withdrew them.

For the purposes of the penalty for under-stating tax payable, the courts might attach predominant weight to a literal interpretation of the tax rules on which the taxpayer relies to claim the tax benefits. In the context of aggressive tax planning schemes, the courts must determine whether the taxpayers' technical interpretation of the tax rules may be considered plausible,[148] although this interpretation conflicts with the purposes of the law. The courts might attach predominant weight to a plausible interpretation of the tax rules in favour of taxpayers when the purposes of the tax law alleged by the tax administration do not clearly emerge from the text of the law. An interpretation might be deemed to be plausible if it is based on the terms of the tax rules in a reasonable manner although the courts may subsequently consider it to be wrong.

[148] See 26 C.F.R. §1.6664-4(f)(2)(i)(A) and §1.6662-4(d)(3)(i) ("There may be more than one substantial authority for more than one position with respect to the same item") and (ii) ("There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision".)

3

Description of the proposed codification

The tax administration has repeatedly proposed the codification of the economic substance doctrine to ensure that the courts apply it uniformly. Generally speaking, the same application details apply to these proposals. Thus, depending on the proposal, the courts must determine whether the taxpayer has engaged in tax planning in a manner that satisfies both sections of the economic substance doctrine. The courts will conclude, as the case may be, that the taxpayer could legitimately claim the tax benefits stemming from an aggressive tax planning scheme.

Two versions of the proposed codification submitted in 2007 differ from previous versions since their application details afford the courts greater flexibility. It would be possible to explain these modifications through extensive comments and suggestions from taxpayers, advisers and members of the tax administration to avoid the codification of the doctrine removing the flexibility that the courts enjoy in its application.

The following subsections briefly examine the highlights of the last two proposals to codify the economic substance doctrine, with particular emphasis on the characteristics of previous versions.[149]

3.1 The choice of applying the doctrine is left to the courts

When the courts decide that a tax planning scheme's compliance with the tax law must be assessed according to the economic substance doctrine, they must determine whether the taxpayer pursued a legitimate non-tax purpose and the planning scheme altered the taxpayer's economic position.

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[149] This section has been elaborated primarily in light of the latest US Senate codification proposal in the *Heartland Act* 2007 Senate Bill, *supra* note 7, bearing in mind certain facets of a proposed US Senate codification in 2006 in the *Taxpayer Protection Act 2006* Senate Bill, *supra* note 4.

Moreover, the codification of this tool does not prevent the courts from applying other legal doctrines, nor does it establish an order of priority among such doctrines.

3.2 Application details

The courts must simultaneously apply as many as three factors.[150] In the two most recent versions of the proposal submitted in 2007, the tax administration would demand of the courts that they determine whether a planning scheme significantly alters the taxpayer's economic position and whether the taxpayer pursued an essentially non-tax purpose in a planning scheme.

In earlier proposals, the tax administration expressly demanded that the courts determine whether there is a reasonable link between the planning scheme and the realization by the taxpayer of his non-tax purpose. It has not expressly adopted this application criterion in the two most recent codification proposals. The tax administration nonetheless acknowledges that the courts should not apply the economic substance doctrine to a planning scheme simply because the taxpayer chose the scheme essentially for tax reasons. In the explanatory notes accompanying these recent versions, the tax administration opines that the economic substance doctrine should not apply to routine commercial transactions that are recognized by the jurisprudence or an administrative practice.

We examine below each of these criteria.

3.2.1 A significant change in the taxpayer's economic position

The courts must determine whether the transaction has significantly altered the taxpayers' economic position. The proposal does not prescribe the method that a taxpayer must apply in order to establish that his economic position has thus been modified. However, he might resort to an evaluation of the transaction when it is implemented that demonstrates in a reasonable manner that the value of the pre-tax economic benefits stemming from the transaction is both:

[150] *Tax Relief Act of 2005*, S. 2020 (109th Congress, 1st session), article 511. See United States, Joint Committee on Taxation, *Description of The Chairman's Mark of The "Tax Relief Act of 2005"* (JCX 71-05), November 8, 2005, pages 92-98.

- substantial in comparison with the tax benefits; and
- higher than the return from an entirely risk-free financial investment.[151]

3.2.2 *Pursuit of a substantial non-tax purpose*

The courts must determine whether taxpayers have carried out a planning scheme in order to realize a substantial non-tax purpose.

3.2.3 *A reasonable link between the transaction and the realization of a non-tax purpose*

According to the versions prior to the two versions of the proposed codification submitted in 2007, the courts also had to determine whether the transaction represented for the taxpayer a reasonable manner in which to realize a substantial non-tax purpose. However, the tax administration did not adopt this criterion in the two versions submitted in 2007.[152]

3.3 Strict penalty for under-stating tax payable

Taxpayers who have under-stated their tax payable because of the implementation of a transaction devoid of economic substance would be liable to a strict penalty. The penalty rate proposed is 20% of the amount of tax under-stated if the taxpayer complied, as the case may be, with the disclosure rules. Otherwise, the penalty rate is 30%.[153]

Briefly, the amount to which the penalty applies corresponds to the product of the amount of the tax under-stated attributable to the transaction multiplied by the tax rate on the highest income according to the tax table applicable to the taxpayer.

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[151] The two codification proposals submitted in the fall of 2007 by the House of Representatives and the Senate do not demand that the taxpayer obtain a return greater than that from an entirely risk-free investment. Various stakeholders were of the opinion that this criterion was not sufficiently flexible for the courts to apply the doctrine fairly, depending on the circumstances. Subsection 4.8 examines the issues and discussions concerning this criterion.

[152] Taxpayers and tax advisers expressed concern about the possibility that the courts and the tax administration might arbitrarily reassess the taxpayers' transactions simply because they deem them to be unreasonable (see subsection 4.6).

[153] In the earlier proposals, this rate stood at 40%. The application of the penalty for under-stating tax payable according to the degree of compliance by taxpayers with the disclosure rules is discussed in instalment 8, devoted to the disclosure rules.

Contrary to the general penalty for under-stating tax payable and the penalty for transactions prescribed pursuant to the disclosure rules, the taxpayer could not avoid this penalty. He would nonetheless have an opportunity to submit his arguments to the tax administration before the latter imposes the penalty.[154]

[154] Senate Bill, *Heartland Act 2007*, *supra* note 7.

TABLE X.X
PROPOSED CODIFICATION OF THE ECONOMIC SUBSTANCE DOCTRINE
EXTRACTS FROM A VERSION SUBMITTED IN THE FALL OF 2007

CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE

(A) IN GENERAL.—In any case in which a court determines that the economic substance doctrine is relevant for purposes of this title to a transaction (or series of transactions), such transaction (or series of transactions) shall have economic substance only if the requirements of this paragraph are met.

(B) DEFINITION OF ECONOMIC SUBSTANCE. (i) IN GENERAL - A transaction has economic substance only if (I) the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer's economic position, and (II) […] the taxpayer has a substantial purpose (other than a Federal tax purpose) for entering into such transaction *****and the transaction is a reasonable means of accomplishing such purpose*****.

(ii) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—A transaction shall not be treated as having economic substance solely by reason of having a potential for profit unless the present value of the reasonably expected pre-Federal tax profit from the transaction is substantial in relation to the present value of the expected net Federal tax benefits that would be allowed if the transaction were respected, *****and the reasonably expected pretax profit from the transaction exceeds a risk-free rate of return*****.

(iii) SPECIAL RULES FOR DETERMINING WHETHER NON-FEDERAL TAX PURPOSE – For purposes of clause (i)(II) – (I) a purpose of achieving a financial accounting benefit shall not be taken into account in determining whether a transaction has a substantial purpose (other than a Federal tax purpose) if the origin of such financial accounting benefit is a reduction of Federal tax […]

(2) DEFINITIONS AND SPECIAL RULES:
(A) ECONOMIC SUBSTANCE DOCTRINE.—The term 'economic substance doctrine' means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.
(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, this subsection shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.
(C) OTHER PROVISIONS NOT AFFECTED.—Except as specifically provided in this subsection, the provisions of this subsection shall not be construed as altering or supplanting any other rule of law, and the requirements of this subsection shall be construed as being in addition to any such other rule of law or provisions of this title.

(4) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection. Such regulations may include exemptions from the application of this subsection.''.

Source: Extracts chosen by the authors drawn primarily from the US Senate version in the *Heartland Act 2007* Senate Bill*, supra* note 7. The extracts marked by asterisks are drawn from a previous US Senate version in the *Taxpayer Protection Act 2006* Senate Bill*, supra* note 4.

4

Observations on the proposed codification of the economic substance doctrine

In recent years, the courts have applied the economic substance doctrine to transactions whose application details complied, in a literal manner, with various tax rules. However, the courts of first instance and Courts of Appeal repeatedly expressed differing opinions on the application of this doctrine to the transactions in dispute. In recent rulings, the Courts of Appeal have quashed the decisions of the courts of first instance and have applied the economic substance doctrine in order to deny the tax benefits claimed by taxpayers.

In order to deny the tax benefits stemming from a planning scheme, the courts continue to express differing opinions on the need for taxpayers to establish both that they were pursuing a genuine non-tax purpose and that the planning scheme substantially altered their economic position. In addition to differing opinions on the application details of the economic substance doctrine, the courts may express differing opinions on the application of a penalty for under-stating tax payable. More specifically, they may rescind by virtue of the economic substance doctrine the tax benefits claimed by taxpayers without imposing a penalty for under-stating tax payable, inasmuch as the transaction might be deemed to comply with the tax law read in a literal manner.

The adoption of the proposed codification of the economic substance doctrine would enhance the predictability and uniformity of its application by all groups of stakeholders. However, the application methods of this tool must protect the integrity of the taxation system and strike the appropriate balance between the principles of predictability, flexibility and fairness in the enforcement of the tax law. The proposed codification arouses concern in respect of these principles both among taxpayers and tax advisers and certain members of the tax administration.

4.1 The courts play a key role in ensuring that the purposes of the tax law are achieved but within the confines of judicial power

In the *Coltec* case,[155] the US Court of Appeals for the Federal Circuit stated that the courts exercise their judicial power within their jurisdiction when they resort to the economic substance doctrine for the purposes of the application of the tax law. In the course of exercising this power, the courts may apply tax rules in light of the purposes of the law and not solely in a literal manner. Under the circumstances, the courts act within their field of jurisdiction without encroaching on legislative power:

> Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality. This principle has its roots in several Supreme Court cases. …
>
> The Supreme Court has explicitly held that when the judiciary goes beyond the literal language of a statute in order to give effect to its purpose, the separation of powers is not violated.[156]
>
> [our extracts]

As the judge in the court of first instance in the *ACM Partnership* case rightly emphasized, the role of the courts is confined to interpreting the tax law and applying it to the planning scheme in dispute through recourse to the interpretation doctrines. The elaboration of an anti-avoidance rule such as the proposed codification of the economic substance doctrine falls under the authority of the tax administration. As regards an earlier codification proposal, the judge nonetheless expressed the opinion that the criteria of such a proposal can only be clarified at the cost of extensive, complex litigation over a long period:

> The Treasury Proposal would regard a tax avoidance transaction as any transaction in which the reasonably expected pre-tax profits (determined on a present value basis and after taking into account foreign taxes and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits of such transaction.
>
> *Inasmuch as the economic substance test already is an established judicial doctrine, a question can be raised whether it is really necessary to have a new statutory economic substance test* or whether the existing judicial doctrine as discussed in *ACM* is adequate to resolve controversies. Other questions, such as how one defines “insignificant” or how one measures such term, remain open issues. …

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155 *Coltec* (Fed. Cir. App.), *supra* note 3.
156 *Ibid.*

> I take no position on these issues. *It is not the prerogative of the judiciary to propose new legislation or to discourage its enactment. The judiciary's responsibility is only to interpret the law*. But I do think that it is proper to examine existing law, including judicial doctrine when trying to decide if new law is required.
>
> *My concern is that new statutory language will produce new and often considerable litigation to clarify the law. This could take many years, if not decades.* We use significant judicial resources when trying to interpret new laws. Using *established* law in the context of today's complex deals, both the Tax Court and the Third Circuit were able to unravel the facts and circumstances of extremely sophisticated transactions to conclude that the transactions had no economic substance. Indeed, *there is no question that the judiciary has the ability to resolve tax controversies in complex litigation but one can question if prolonged trials with voluminous evidentiary records are an economical use of the court's time*.[157]
>
> [our extracts and italics]

It should be noted that the dissident US Supreme Court justices in the *Knetsch* case were of the opinion that the withdrawal by the tax administration of an interest deduction stemming from any planning scheme that is devoid of economic substance would establish a hazy demarcation between legitimate planning schemes and abusive ones carried out in situations different from those that are subject to dispute. In the opinion of these justices, it is incumbent upon the tax administration to establish such a demarcation in the law:

> Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. Will the Service that calls this transaction a "sham" today not press for collection of taxes arising out of the surrender of the annuity contract? I think it should, for I do not believe any part of the transaction was a "sham." *To disallow the "interest" deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative. Evils or abuses can be particularized by Congress.* We deal only with "interest" as commonly understood and as used across the board in myriad transactions. Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognize them tax-wise.[158]
>
> [our extracts and italics]

4.2 The proposed codification does not define the conditions under which the courts may decide to apply the economic substance doctrine

Differences of opinion persist between groups of stakeholders concerning the prerequisites for the application by the courts of this doctrine.

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[157] Laro, "A view from the Tax Court," *supra* note 13.

[158] *Knetsch*, *supra* note 19.

4.2.1 Application of the doctrine in addition to the applicable tax rules

Certain courts are of the opinion that the economic substance doctrine underpins each rule in the tax law. Consequently, a taxpayer may only claim tax benefits stemming from a planning scheme if the scheme complies with this doctrine:

> We can forgo examining the intersection of these statutory details, for pursuant to Gregory v. Helvering, 293 U.S. 465 (1935), and Knetsch v. United States, 364 U.S. 361 (1960), courts have looked beyond taxpayers' formal compliance with the Code and analyzed the fundamental substance of transactions. *Economic substance is a prerequisite to the application of any Code provision allowing deductions*. Lerman v. Commissioner, 939 F.2d 44, 52 (3d Cir. 1991). It is the Government's trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it "simply is not recognized for federal taxation purposes, for better or for worse." ACM Partnership v. Commissioner, 157 F.3d 231, 261 (3d Cir 1998) (Lerman 939 F.2d at 45). The rationale behind the Gregory and Knetsch line of cases is that courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings. The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance, and the deductions are permissible. National Starch and Chemical Corp. v. Commissioner, 918 F.2d 426, 429 (3d Cir. 1990).[159]
>
> [our extracts]

Similarly, the US Court of Appeals for the Federal Circuit in the *Coltec* case expressed the following opinion:

> Here, the economic substance doctrine is merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.[160]
>
> [our extracts]

In a subsequent judgment in the *Jade Trading* case, the United States Court of Federal Claims concluded, based on the Court of Appeals ruling in the *Coltec* case, that a planning scheme must satisfy both the technical details of the tax rules and the details of the economic substance doctrine in order for a taxpayer to claim tax benefits stemming from a planning scheme:

> Nonetheless, under Coltec, such compliance with the Code is insufficient in and of itself for Jade to reap the tax benefits claimed here. Coltec, 454 F.3d at 1355. Rather, the transaction must also meet the objective economic substance test.[161]

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[159] *In re CM Holdings*, *supra* note 48, cited in *Coltec* (Fed. Cir. App.), *supra* note 3.

[160] *Coltec* (Fed. Cir. App.), *supra* note 3.

[161] *Jade Trading*, *supra* note 59, page 54 of the ruling. Subsection 2.4 briefly examines the details of this case.

[our extracts]

4.2.2 Application when the applicable rules refer to it

Stakeholders are of the opinion that pursuant to the jurisprudence of the US Supreme Court, the courts must only apply the economic substance doctrine if the tax rules refer to it expressly or implicitly. Otherwise, the courts should not apply the doctrine to withdraw tax benefits claimed by taxpayers.[162]

If this latter approach were adopted, the tax administration and the courts could not apply the economic substance doctrine to deprive a taxpayer of tax benefits obtained pursuant to incentives incorporated into the tax law for certain types of investment in a targeted economic sector. In fact, the transaction concluded by the taxpayer would comply with the purposes of these measures. A taxpayer might thus claim tax benefits if the incentives in the law seek to encourage certain types of investment despite the absence of a pre-tax profit. The courts will decide in favour of the taxpayers if the latter have claimed tax benefits stemming from a planning scheme that conforms to the purposes of a tax rule even though it is devoid of economic reality.

The *Sacks* case[163] illustrates the latter principle. In this case, the taxpayers purchased solar heating units in order to lease them to homeowners. The profitability of the taxpayers' investment was clearly based on projected after-tax profits. The tax administration rescinded the deduction of the deprecation expenses and the tax credits claimed by the taxpayers on the equipment purchased, in particular because the purchase-lease transaction would not generate a pre-tax profit. The court rejected the tax administration's argument for the following reasons:

> If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses. H.R. Rep. No. 95-543, 95th Cong.

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162 Amandeep S. Grewal, "Economic Substance and the Supreme Court" (September 10, 2007) 116 *Tax Notes* 969 [Grewal, "Supreme Court"]. This position is similar to the one adopted by the Supreme Court of Canada in *Hypothèques Trustco Canada* v. *Canada*, [2005] 2 S.C.R. 601.

163 *Sacks*, *supra* note 33.

> 1st Sess., 1978 U.S.C.C.A.N. 7673, 7678 (stating that among the goals of the National Energy Act is that there be solar energy in more than 2 1/2 million homes by 1985).
>
> If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. *See* H.R. Rep. No. 496 at 8304. Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. *Cabell v. Markham,* 148 F.2d 737 (2d Cir. 1945) (L. Hand, J.).[164]
>
> [our extracts]

4.2.3 According to the tax administration, taxpayers may claim tax benefits from planning schemes that clearly comply with the purposes of the tax law even though they are devoid of economic substance

According to the Joint Committee on Taxation, the proposed codification in no way alters the conditions under which the courts have until now decided to apply the economic substance doctrine. The tax administration mentions in the explanatory notes accompanying one of the versions of the codification submitted in 2007 that the courts do not have to apply this doctrine when a taxpayer claims tax benefits stemming from planning schemes carried out in a manner that is clearly in keeping with the purposes of the applicable rules:

> If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. Thus, the provision does not change current law standards used by courts in determining *when* to utilize an economic substance analysis[165].
>
> [our extracts]

This explanation is similar to a proposal formulated in 2005 by the Joint Committee on Taxation. According to this proposal, a taxpayer whose tax benefits the tax administration has rejected *a priori* because of the application of the economic substance doctrine might nonetheless claim them if he can establish that the transactions clearly conform to the purposes pursued by all of

164 *Ibid.,* page 992.
165 Senate Finance Committee, *Heartland Act Report*, *supra* note 8, page 115.

the applicable tax rules.[166] This proposal resorts to the notion of abuse of the purposes of the tax law that underpins the general anti-avoidance rule in the *Income Tax Act* in Canada. The American tax administration is thus contemplating the adoption of the criterion of compliance with the purposes of the tax law read as a whole for the purposes of the application of the economic substance doctrine. However, this criterion is not one of those found in the versions of the codification proposal submitted in 2007.

4.3 The application of this doctrine allows for the withdrawal of tax benefits stemming from planning schemes although uncertainty persists concerning the purposes of the tax law

Members of the tax administration have already expressed the opinion that the application of specific rules allows the tax administration to rescind tax benefits that aggressive taxpayers may claim.[167] However, these rules are detailed, complex and sometimes inconsistent. By relying on a mechanical, literal interpretation of these rules, taxpayers could claim tax benefits in a manner that runs counter to the purposes of the tax law. Leaving aside the differences of opinion on the conditions for opening up the doctrine indicated in subsection 4.2, the application by the courts of this doctrine allows for the withdrawal of tax benefits although uncertainty persists concerning the purposes pursued by a specific rule or the tax law read as a whole.

The *Black & Decker*[168] and *Coltec* cases[169] illustrate what is at stake from the standpoint of the application of this tool. In these cases, the tax administration claimed that the purposes of the law did not allow the taxpayers to take advantage of tax benefits in conjunction with a technical application of various rules. The tax administration claimed that according to the explanatory notes one of the rules only covered a specific situation that did not obtain in the taxpayer's case. Furthermore, it maintained that the taxpayer could not obtain two deductions in respect of a

166 US, Joint Committee on Taxation, *Option to Improve Tax Compliance and Reform Tax Expenditures*, (JCS-02-05), January 27, 2005, pages 29-30.

167 Korb, *Economic Substance Doctrine, supra* note 26.

168 See *Black & Decker* (4th Cir.), *supra* note 32, pages 10 to 14.

169 *Ibid.,* pages 7-10. See also *Coltec* (Fed. Cir. App.), *supra* note 3. Instalment 1 of Part II of this study summarizes the latter case.

given amount and could not move forward the time when he could deduct this amount without his doing so being deemed abusive.

The Courts of Appeal that heard each of these two cases concluded that the purposes of the law alleged by the tax administration in no way emerge from the tax of the law. In the *Coltec* case, the US Court of Appeals for the Federal Circuit quashed virtually all of the tax benefits claimed by taxpayers by applying the economic substance doctrine. In the *Black & Decker* case, the United States Court of Appeals for the Fourth Circuit referred the case back to the court of first instance so that it could decide whether the economic substance doctrine should apply to the planning scheme in dispute. In the meantime, the US Court of Appeals for the Federal Circuit had handed down its judgement in favour of the tax administration in the *Coltec* case. In the end, the taxpayer in the *Black & Decker* case asked the court of first instance to adjourn the hearing of this case and reached an out-of-court settlement with the tax administration.[170]

4.4 The proposed codification fosters uniformity by requiring the taxpayer's planning scheme to satisfy both sections of the economic substance doctrine

The proposed codification requires the courts to apply the economic substance doctrine according to both the subjective and objective sections. This formulation corresponds to the conjunctive approach advocated, in particular, by the US Court of Appeals for the Federal Circuit in the *Coltec* case. Seen from that point of view, the proposed codification subscribes to the principle of uniformity in the application by the courts of the economic substance doctrine, since it rules out the unitary and disjunctive approaches that certain courts now apply. A conjunctive approach also enhances the taxation system's integrity since a taxpayer may not claim tax benefits simply because he is also pursuing business purposes in an aggressive tax planning scheme if his anticipated profit seems unreasonable in light of the commercial standards applicable under the circumstances.

170 See Sheryl Stratton, "Black & Decker to Settle; Bigger Contingent Liability Case on Horizon" (March 5, 2007), 2007 TNT 43-1, and the joint application formulated by the parties, as published in 2007 TNT 43-16.

4.5 Opinions differ among groups of stakeholders on how to reconcile the principles of uniformity and flexibility in the application of the doctrine

Certain professional organizations are of the opinion that it would be desirable to clarify the concepts that the courts apply, in particular from the standpoint of the factors aimed at defining the anticipation of profit.[171] They fear, especially, that depending on the proposal formulated, routine, legitimate commercial transactions will be deemed to be avoidance.[172] These organizations have voiced their disagreement with the proposed codification since it is not sufficiently flexible in relation to business standards and does not properly take into account changes in the economy.[173]

More specifically, these opponents believe that the case-by-case application by the courts of the economic substance doctrine allows for greater flexibility in the application of the tax rules. In the opinion of taxpayers and advisers, such flexibility enables the taxation system to adapt to changes in the economic environment.[174] They maintain that the tax administration is putting forward in its codification proposals criteria that are less flexible than those formulated until now by the courts. In their opinion, these criteria might prevent taxpayers from resorting to various commercial options to achieve legitimate purposes.

Moreover, certain members of the tax administration are of the opinion that an additional layer of strict, complex rules might prevent the tax administration from administering the taxation system in a flexible, efficient manner. In their view, the codification of this doctrine according to the versions proposed cannot establish an equitable demarcation between legitimate transactions and tax avoidance. Furthermore, the criteria proposed would slow down audits by

171 See the viewpoint expressed by the American Bar Association, Section of Taxation, in a letter addressed to the Senate Committee on Finance and the House Ways and Means Committee on January 4, 2006 entitled "Comments Regarding S. 2020: Tax Relief Act of 2005" [ABA, "Comments on S. 2020 (2005)], focusing, in particular, on the codification of the economic substance doctrine.

172 See Keinam, "Economic Substance," *supra* note 2.

173 For an overview and criticism of the viewpoint of opponents to the codification of the economic substance doctrine, see Samuel Thomson Jr., Director, Law Center, University of California, testimony given before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 9, 2006 [Thomson, Committee on Ways and Means].

174 See Keinam, "Economic Substance," *supra* note 2.

the tax administration since, in order to apply the doctrine, it would have to analyse a series of strict, restrictive criteria instead of applying those that it deems to be appropriate in light of the jurisprudence and according to the circumstances.[175]

The tax administration should respect the principle of predictability in the application of the tax rules while maintaining some degree of flexibility in order to apply them in different circumstances. The tax administration should define precise, flexible parameters in the law, including:

- the period of time within which a taxpayer may reasonably anticipate a profit for tax purposes;
- the measurement of the present value of the benefits of a transaction;
- the determination on an actuarial basis of the relative weight of the economic and tax benefits stemming from a transaction;
- the determination of the level of economic risk that a taxpayer must assume in a planning scheme in order to claim the tax benefits stemming from it.

It should be noted that the tax administration (Department of Treasury) may prescribe regulations to reassess an avoidance transaction involving several parties.[176] By virtue of this power, it could determine the tax consequences of the parties in a tax planning scheme as though the scheme were carried out between only two parties or between the number of parties that it deems appropriate. However, the tax administration has only rarely exercised this power. In these instances, it has reassessed the planning schemes according to the economic substance doctrine.[177] In addition, it has withdrawn a proposed regulation in light of court decisions in favour of the tax administration focusing on the planning scheme in question.[178]

[175] Thomson, *Committee on Ways and Means*, *supra* note 173.
[176] 26 U.S.C. § 7701(l).
[177] See Treasury, *Corporate Tax Shelters*, *supra* note 134, pages 44-45 and *Appendix A*.
[178] See Internal Revenue Service, “Withdrawal of Notice of Proposed Rulemaking,” RIN 1545-AU 19 (November 10, 2003).

4.6 The latitude available to the courts to assess the taxpayer's purposes in a planning scheme creates the risk that the courts will reassess it arbitrarily

The subjective section of the proposed codification requires that the non-tax purpose of the transaction be substantial. A court might deny a taxpayer the tax benefits claimed when, instead of the aggressive tax planning scheme that he carried out, the taxpayer could have concluded a transaction in a simpler manner that would be more compatible with his usual business activities.

Opinions may differ in groups of stakeholders on the manner in which the taxpayer's main purpose in a transaction is evaluated. For the purposes of the economic substance doctrine, the courts have subjectively or objectively evaluated the purposes that the taxpayer pursues. The weight accorded the subjective section of the doctrine varies considerably in the jurisprudence. When the courts adopt the same factor in the subjective and objective sections of the test, they tend to attach greater importance to objective proof of the taxpayer's intentions.[179] In this context, certain judges have refused to consider the taxpayer's subjective opinions when the objective proof failed to corroborate such opinions. Some courts have also expressed the opinion that the economic substance doctrine must be applied objectively according to the transaction's impact on the taxpayer's economic position and notwithstanding the taxpayer's subjective intention.[180]

To ascertain whether a taxpayer is pursuing an essential non-tax purpose, the courts have the latitude to apply any of the criteria that they have adopted in the past to apply the economic substance doctrine. In particular, the courts have taken into account the following factors to objectively assess the nature of the purposes that a taxpayer pursues in a planning scheme:

- the possibility for the taxpayer to derive a profit from a transaction;
- the existence of a veritable non-tax purpose that warrants the implementation of the transaction;

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[179] *Hunt v. Commissioner*, 938 F.2d 466, 472 (4th Cir. 1991): "It is proper to draw from objective facts inferences regarding a subjective intent to profit." See also *Friedman, supra* note 79; *Faulconer*, *supra 113*.

[180] See *Coltec* (Fed. Circ. App.)*, supra* note 3, pages 25-26 of the ruling published by the Court of Appeals; *Black & Decker* (4th Cir.), *supra* note 32, pages 15-18 of the decision published by the Court of Appeals.

- the actual financial investment by the taxpayer in the transaction.[181]

The comparison of the transaction concluded by the taxpayer with alternative transactions can lead the courts to pinpoint objectively the purposes that a taxpayer pursues in a transaction. The proposed codification does not define the characteristics of the transactions that the taxpayers might have contemplated to realize a non-tax purpose in the transaction carried out without obtaining the tax benefits that they claimed. In the absence of precise parameters, the courts and the tax administration will assess the reasonable nature of the transaction that the taxpayer has concluded, which opens the door to an arbitrary comparison by the tax administration and the courts of this transaction with alternative transactions.[182] Despite the absence in the most recent codification proposal of the section requiring an evaluation of the reasonable nature of the transaction carried out by the taxpayer,[183] we believe that the substantial purpose criterion implies that the courts and the tax administration will conduct such an evaluation.

From the standpoint of taxpayers and advisers, the evaluation by the courts and the tax administration of the reasonable nature of a transaction undermines the taxpayers' privilege to organize their affairs in order to achieve the purposes that they are pursuing.[184] This extract from the *certiorari* brief submitted by the taxpayer to the US Supreme Court in the *Coltec* case, in which the taxpayer requested that the Supreme Court reverse an unfavourable ruling handed down by the US Court of Appeals for the Federal Circuit, briefly sums up the taxpayers' concerns in this respect:

> The economic-substance doctrine is not a source of common-law power for a court to substitute its judicial sense of the economic benefits of corporate transactions for the goodfaith business judgment of experienced corporate officers and lawyers deeply conversant with asbestos liability, thereby depriving a taxpayer of benefits to which it is entitled by the plain terms of the Internal Revenue Code. Sham transactions generally involve transitory arrangements with no connection to the taxpayer's historic business and artificial losses with no economic corollary, *UPS*, 254 F.3d. at 1019-20; the economic-substance doctrine cannot be used against a taxpayer where (as here) the transaction "precipitated the realization of actual economic losses arising from a longterm, economically

181 See Korb, *Economic Substance Doctrine*, *supra* note 26. Subsection 3.3.1 presents an overview of the factors adopted by the courts to determine the presence of a tax-related purpose.

182 See the concerns voiced in this regard by the tax division of the New York State Bar Association in a letter dated April 12, 2007 sent to the US Senate Finance Committee.

183 See subsection 3.2.3.

184 See Keinam, "Economic Substance," *supra* note 2, pages 270-271.

> significant investment." *ACM*, 157 F.3d at 251 (citing *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554 (1991)); Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 17-18 (2000) (defending *Cottage Savings* exception to economic-substance doctrine for transactions "tied to ordinary business operations").[185]
>
> [our extracts]

In the explanatory notes accompanying the most recent proposed codification tabled by the US Senate, the tax administration (Joint Committee on Taxation) seeks to dispel taxpayers' and advisers' anxiety. Thus, the economic substance doctrine proposed would not apply to routine commercial transactions recognized by the jurisprudence or an administrative practice although the taxpayers chose a fiscally advantageous form of transaction:

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied. Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances. As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions can be a question of facts and circumstances. Also, the fact that a transaction does meet the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance[186].

In the tax administration's opinion, a taxpayer who engages in a transaction that is reasonably in keeping with the normal course of his activities is pursuing in principle a non-tax substantial purpose.[187] As the *Black & Decker* and *Coltec* cases show, the analysis must, above all, be centred on the transaction that gives rise to the tax benefit and, if need be, situate this transaction in the entire array of current activities carried out by the business.

Given the subjective nature of an evaluation of the taxpayer's intentions, the tax administration will continue to pay close attention to communications between taxpayers and their advisers

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185 See *Petition for a Writ of Certiorari*, *Coltec Industries Inc.* v. *United States* (No. 06-659) submitted by the taxpayer to the US Supreme Court on November 8, 2006, page 28.

186 Senate Finance Committee, *Heartland Act Report*, *supra* note 8, pages 115 and 116.

187 JCT, *Taxpayer Protection Act*, *supra* note 4, page 133.

that reveal the predominance of a tax-related purpose.[188] The courts must then contend with the application of the taxpayers' privilege of confidential communication when the latter communicate with their advisers in the application of the subjective section of the doctrine.[189]

4.7 The proposal resolves uncertainty over the minimal weight of the tax benefit that triggers the application of the doctrine to a planning scheme but does not prescribe how to measure it

Uncertainty persists in the jurisprudence concerning the relative weight of a tax purpose in a planning scheme that triggers the application of the economic substance doctrine and leads to the withdrawal of the taxpayer's tax benefits. The tax administration overcomes this uncertainty by requiring in the codification proposals that the economic substance doctrine apply when the relative weight of a tax purpose is substantial compared with any other purpose that a taxpayer pursues in conjunction with a planning scheme.

However, the proposal does not stipulate the parameters under which the courts might conclude that the taxpayer's substantial purpose in an aggressive tax planning scheme is of a non-tax nature. The stakeholders will argue, depending on their respective interests, that a substantial purpose is similar to the principal purpose in the transaction, to one of its significant purposes or its predominant purpose.[190] In the absence of additional parameters, the courts might express differing opinions on the nature of the taxpayer's essential purpose in a planning scheme, according to their interpretation of the facts and circumstances.

More specifically, the proposal does not specify whether the essential purpose that the taxpayer pursues must be pinpointed in light of the planning scheme overall or solely from the standpoint of the transaction that gives rise to the tax benefit that the taxpayer is claiming. The absence of precise parameters reflects the tax administration's desire to maintain the flexibility allowed the

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[188] Korb, *Economic Substance Doctrine*, *supra* note 26, page 14.

[189] Instalment 8 (publication pending) devoted to the disclosure rules in the United States examines the application of the privilege of confidential communication in the realm of aggressive tax planning schemes.

[190] See Lee A. Sheppard, "News Analysis: Drafting Economic Substance, Part 3," (February 28, 2005) 106 Tax Notes 1020, 2005 TNT 39-6 [Sheppard, *Drafting Economic Substance*].

courts in order to distinguish between a genuine commercial transaction and a transaction whose sole purpose is to obtain tax benefits.[191] The ruling handed down by the US Court of Appeals for the Federal Circuit in the *Coltec* case is in keeping with this notion: in the opinion of the Court of Appeals, the transaction that gives rise to the tax benefit must be isolated from the other stages in the planning scheme to avoid a general commercial purpose's justifying an avoidance transaction.

In our opinion, groups of stakeholders should measure the weight of a taxpayer's tax purpose in a planning scheme by applying the objective criteria used by the courts to measure the scheme's impact on the taxpayer's economic position.

4.8 Uncertainty over the criteria to be applied to measure significant changes in the taxpayer's economic position

Briefly, the different versions of the proposed codification adopt a requirement formulated by various courts whereby the taxpayer's economic position must be significantly altered in order for him to claim the tax benefits stemming from a planning scheme. The objective section of the proposed codification allows for reliance on proof based on the reasonable anticipation by the taxpayer of profit or other factors demonstrating a substantial change in the taxpayer's economic position. If the taxpayer invokes a potential profit, the proposed codification demands that he generate a minimum profit threshold. The present value of the potential pre-tax profit must be substantial in relation to the present value of the tax benefits stemming from the transaction. Consequently, it is insufficient to simply demonstrate the possibility of achieving a minimum profit.[192]

All in all, such a formulation implicitly seeks to ensure the application of the economic substance doctrine based on a measurement of the profit that the taxpayer anticipates from a transaction that takes into consideration the economic risk to which he is exposed.[193]

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[191] The proposed codification specifies that the tax benefits of an accounting nature that the taxpayer might obtain through a transaction are not non-tax purposes recognized for the purposes of the economic substance doctrine.

[192] Commissions, foreign tax payable and all other expenses incurred in conjunction with the transaction must be deducted to establish the taxpayer's potential profit.

[193] Sheppard, *Drafting Economic Substance*, *supra* note 190.

The application of the economic substance doctrine on such a basis enables the tax administration to achieve two objectives.

First, measurement of the taxpayer's "reasonable anticipation of a pre-tax profit" that depends on the return on an entirely risk-free investment makes it possible to better delimit tax avoidance transactions as opposed to the measurement of a simple potential profit. To satisfy the latter condition, a taxpayer would only have to objectively establish the existence of the simple possibility of deriving a minimal profit, although this anticipation seems unreasonable. Reliance on the criterion of the reasonable anticipation of a profit beyond the return on a risk-free investment thus increases the risk for taxpayers wishing to carry out a planning scheme solely to claim tax benefits.[194]

Next, when companies are involved in a planning scheme, a comparison of the economic benefits and the tax benefits stemming from a planning scheme makes it possible to properly pinpoint abusive tax planning schemes, as opposed to the comparison of the amount invested in a tax shelter with the tax benefits stemming from it. This latter comparison may be appropriate with regard to individuals who must usually contract a loan in order to invest in a tax shelter, since the ratio of the amount invested and the tax benefits generally proves to be disproportionate. However, companies could invest their funds in such a way as to dilute the tax benefits stemming from a transaction among other non-tax benefits.[195]

The versions of the proposed codification do not define any parameter to determine to what extent a taxpayer's economic position has been significantly altered by a given transaction. More specifically, they do not prescribe specific parameters to determine the degree of anticipation of a profit that a taxpayer must maintain to justify the tax benefits stemming from a planning scheme. In this respect, the groups of stakeholders differ in opinion on the minimum degree of anticipation of a profit and on the way to measure it.[196]

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[194] See Treasury, *Corporate Tax Shelters*, *supra* note 134, *Appendix C*. The tax administration presents there its reasoning concerning the application of a criterion of reasonable anticipation of a profit formulated in a previous proposal that is similar to the tool examined in this subsection.

[195] *Ibid,* note 134.

[196] See Keinam, "Economic Substance," *supra* note 2.

The absence of predetermined criteria allows the courts considerable leeway to determine whether a planning scheme has a significant impact on a taxpayer's economic position. Such latitude enables the courts to hand down fair decisions in respect of taxpayers according to the facts and circumstances of each planning scheme. On the other hand, the taxpayers must contend with the unpredictability of the courts' conclusions concerning their planning scheme's compliance with the economic substance doctrine.

The tax administration must attempt to reconcile the principles of integrity, predictability and flexibility in the application of the economic substance doctrine. Among other things, it is contending with the following difficulties:

- the setting of a minimum profitability threshold;
- the determination of a reasonable period of time within which the taxpayer can make an economic profit;
- the measurement of the present value of the benefits of a tax planning scheme;
- the measurement on an actuarial basis of the relative weight of the economic and tax benefits stemming from a planning scheme;
- the measurement of the degree of economic risk.

Opinions differ among groups of stakeholders on the taxpayer's minimum threshold of anticipation of profitability. It is impossible to define a threshold applicable to all taxpayers and planning schemes since the threshold varies according to the facts and circumstances pertaining to each taxpayer, the purposes that he is pursuing, and his business strategy. As we emphasized earlier, the versions of the proposed codification prior to those submitted in the fall of 2007 required the taxpayer's anticipated profit threshold to exceed the return on a risk-free investment. The tax administration's withdrawal of this latter criterion illustrates the difficulty of defining in a sufficiently flexible manner this minimum profitability threshold.

In our opinion, the tax administration should adopt a flexible application of the economic substance doctrine instead of adopting strict, inflexible criteria that remove from the equation the commercial and economic standards applicable depending on the circumstances. The following extract drawn from a speech given by the judge from the United States Tax Court in the *ACM* case illustrates the difficulty that the determination of a minimal anticipation of a profit poses:

> Inasmuch as the economic substance test already is an established judicial doctrine, a question can be raised whether it is really necessary to have a new statutory economic substance test or whether the existing judicial doctrine as discussed in *ACM* is adequate to resolve controversies. Other questions, such as how one defines "insignificant" or how one measures such term, remain open issues. For instance, does a certain percentage of pre-tax profits satisfy the test? Does that percentage apply to all industries and all taxpayers? Will the courts be placed in a position where they will have to determine what is an appropriate level of pre-tax profits industry by industry, and activity by activity? I do note that *ACM* did not require that the non-tax business purpose be the primary or principle [sic] purpose of the transaction. Moreover, the case did not conclude that pre-tax profits must exceed tax benefits in order to be sustained.[197]
>
> [our extracts]

More specifically, the odds are that opinions will differ among groups of stakeholders on the maximum period within which a taxpayer may maintain a reasonable anticipation of a profit. The *Dow Chemical* case[198] clearly illustrates differences of opinion between groups of stakeholders concerning the reasonable nature of a taxpayer's degree of anticipation of a profit when such profit depends on transactions that the taxpayer will have to carry out several years after the date of implementation of the transaction, especially if the taxpayer has not undertaken to carry them out according to the contractual details of the planning scheme and the taxpayer is unaccustomed to such transactions.

To determine the maximum period during which a taxpayer may reasonably anticipate a profit, the courts may adopt the perspective of a reasonable investor according to generally recognized business standards that are applicable to the taxpayer's activity sector.[199] As we emphasized in subsection 2.5.2, the courts might measure this anticipation of a profit according to the net present value of the economic profits stemming from a planning scheme. This value would vary depending on the discount rate applied by each assessor in light of the circumstances surrounding a given transaction. The courts might have recourse to a qualified, impartial expert to establish the present value of various benefits stemming from an aggressive tax planning scheme.[200]

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197 See Laro, "A view from the Tax Court," *supra* note 13, page 48.

198 *Dow Chemical*, *supra* note 58.

199 See Korb, *Economic Substance Doctrine*, *supra* note 26.

200 See Treasury, *Corporate Tax Shelters*, *supra* note 134, *Appendix C*. The tax administration presents its reasoning concerning the application of a criterion of reasonable anticipation of a profit formulated in a previous proposal that is similar to the tool examined in this subsection. We refer the reader to subsection 2.5.2, for

Uncertainty also persists over the net minimum present value of the non-tax benefits that a taxpayer must hope to obtain in a planning scheme in order to claim the tax benefits stemming from the scheme. In the absence of precise parameters in the tax law, the courts must establish as fairly as possible the minimum reference return in order to determine whether a taxpayer is maintaining a reasonable anticipation of a profit in conjunction with the planning scheme.[201]

While the versions of the proposed codification centre on the level of profit that a taxpayer may anticipate according to the economic risk that he assumes, they do not define the notion of economic risk. Aggressive taxpayers seek to take advantage of tax benefits by carrying out transactions in which they minimize or eliminate the economic risks that would otherwise stem from them.[202] In our opinion, clarification of the degree of economic risk recognized for tax purposes would make it possible, on the one hand, to ensure greater uniformity in the application by the courts of the economic substance doctrine and, on the other hand, to promote predictability and flexibility in the application of tax rules.

4.9 Taxpayers must always establish that their transactions comply with the economic substance doctrine according to the balance of probabilities

The proposed codification in no way changes the evidentiary rules pertaining to taxation. As we emphasized in subsection 2.7, taxpayers must prove that their planning scheme complies with the economic substance doctrine[203] and that the courts will settle disputes according to the balance of probabilities.

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additional information on questions pertaining to the application of the economic substance doctrine according to the net present value of a planning scheme.

201 *Ibid.,* pages 161-162.

202 See Sheppard, “Drafting Economic Substance,” *supra* note 190.

203 The US Court of Appeals for the Federal Circuit in the *Coltec* case reiterated this principle: see *Coltec* (Fed. Circ. App.), *supra* note 3.

4.10 Concern among taxpayers in respect of a strict penalty for under-stating tax payable

4.10.1 In the opinion of the tax administration, a strict penalty is necessary since taxpayers are able to avoid too easily the penalty for under-stating tax payable

As we noted in subsection 2.8, taxpayers are now subject to a penalty for under-stating tax payable equivalent to 20% of the amount of tax under-stated. They may avoid the penalty by proving that they applied the tax rules in a reasonable manner, especially if they have properly disclosed the relevant information in their tax return. As for aggressive tax planning schemes, taxpayers may avoid all or part of the penalty solely if they establish that they are acting in good faith and have displayed reasonable diligence to claim tax benefits in a manner that complies with the tax law and the economic substance doctrine, according to the balance of probabilities.

Under the proposed codification, taxpayers who apparently under-state their tax payable because of the application of the economic substance doctrine would be subject to a strict 20% or even 30% or 40% penalty if they have failed to fulfil their duty of disclosure in respect of certain transactions prescribed by the tax administration.[204] According to the proposal, the penalty would apply to the total amount of tax under-stated and would entirely unavoidable.

The tax administration has concluded that growing recourse by businesses to aggressive tax planning schemes might stem from the possibility of presenting a defence based on a reasonable application of the tax law. In the opinion of certain professional organizations, taxpayers might establish this defence based on tax opinions whose level of analysis is insufficiently detailed.[205] The tax administration also observed in some instances that taxpayers

[204] Briefly, taxpayers must produce an information return if they have implemented a transaction prescribed by the tax administration, in whose opinion the prescribed transactions imply risks of tax avoidance. Instalment 8 of Part II of this study, “Disclosure Rules,” examines these rules.

[205] Treasury, *Corporate Tax Shelters*, *supra* note 134, pages 85-93: “It is telling that two of the major organizations that represent tax professionals – the ABA and the NYSBA – point to a perceived deterioration in tax opinion writing standards as a facilitating cause in the availability of the reasonable cause exception and in the rise of corporate tax shelters, and have suggested remedies (described below) that are intended to narrow or, in the case of the NYSBA, even eliminate this escape hatch.”

were challenging the levying of penalties.[206] The application of a strict penalty would significantly increase the financial risks to taxpayers who implement aggressive tax planning schemes.[207]

However, professional organizations are of the opinion that it is unfair to assess a strict penalty stemming from the application of the economic substance doctrine. This injustice arises from the uncertainty surrounding the application of this doctrine. Various credible stakeholders could express differing, reasonable opinions on its application to a given tax planning scheme. In the opinion of these organizations, the taxpayers should be able to avoid the penalty if they have displayed reasonable diligence to ensure that their planning scheme complies with the tax law and the economic substance doctrine, according to the balance of probabilities.[208]

Professional organizations fear that the tax administration and the courts may uniformly assess a penalty for under-stating tax payable to all taxpayers if the penalty stands at 40%. Moreover, members of the tax administration are reluctant to apply the economic substance doctrine if

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206 Michael Brostek (Director Tax Issues, Internal Revenue Service), testimony before the US Senate Committee on Finance, *Internal Revenue Service: Challenges Remain in Combatting Abusive Tax Shelters*, (GAO-04-104T), October 21, 2003, pages 24-25. "Also designed to deter abusive tax shelters, accuracy-related penalties aim at investors who use abusive shelters to substantially undervalue true tax liability. Other penalties are for promoters who market shelters that aid and abet the understatement of tax liability or who fail to register shelters. IRS's Examination Returns Control System showed IRS assessing 21 investor penalties totaling about $73 million between July 1, 2002, and May 1, 2003, which taxpayers had not necessarily agreed to pay. During our review, Treasury included proposed legislation in the Administration's revenue proposals to strengthen the penalties that could be used in abusive shelter situations."

207 Briefly, taxpayers and tax advisers must produce an information return in respect of the details of the transactions prescribed by the tax administration because these transactions imply risks of tax avoidance. In the case of several of these transactions, uncertainty persists about the transactions that must be disclosed, especially when the tax administration relies on the economic substance doctrine to link a prescribed transaction to a risk of tax avoidance and also targets transactions similar to those that it has described. In such a context, the taxpayers run the risk of being subject to a 40% penalty. Instalment 8 examines the impact of the economic substance doctrine on the duty of disclosure of taxpayers and tax advisers in respect of aggressive tax planning schemes.

208 In the opinion of the National Taxpayer Advocate, the growing rate of rulings handed down by the courts in favour of the tax administration concerning the assessment of penalties for under-stating tax payable in general engenders uncertainty over the fair, uniform assessment of these penalties. In 57 rulings handed down by the courts on the assessment of the penalty for negligence by taxpayers between June 1, 2004 and May 31, 2005, the tax administration won in 39 cases (68%). In these rulings, the taxpayers had submitted insufficient proof to convince the courts to withdraw the penalty assessed. In the other cases, the courts rescinded the penalty when the taxpayers showed that they relied in good faith and in a reasonable manner on an opinion formulated by a tax adviser who possessed the appropriate level of expertise, in light of the entire array of relevant facts that the taxpayers submitted to him. The National Taxpayer Advocate is proposing that the tax administration analyse in greater detail the assessment of this penalty in order to ascertain its impact on voluntary compliance with the taxation system. See NTA, *2005 Report to Congress*, *supra* note 141, Volume 1, pages 514-518.

doing so leads to such a high strict penalty.[209] In our opinion, a penalty rate of 20% that a taxpayer can avoid depending on his degree of diligence has a sufficiently marked impact on his decision to carry out an aggressive tax planning scheme.[210]

At the same time as it is engaging in discussions on the codification of the economic substance doctrine and the attendant strict penalty, the tax administration is seeking to ensure more rigorous application by its auditors of the penalty for under-stating tax payable. The tax administration is of the opinion that the proliferation in businesses of aggressive tax planning schemes might stem primarily from the perception that the tax administration does not apply the penalty. It believes that its auditors have adopted in the past a relatively conciliatory attitude concerning its application to businesses. The tax administration is seeking to implement procedures to ensure that the auditors uniformly, fairly apply the penalty if the circumstances warrant doing so.[211]

4.10.2 The impossibility for a taxpayer to avoid a strict penalty seems unfair when he does not possess expertise in tax matters

Under the existing rules, the courts might withdraw the tax benefits claimed by taxpayers pursuant to the economic substance doctrine without, however, maintaining the penalty for under-stating tax payable if the taxpayers have claimed these tax benefits by virtue of a plausible technical interpretation of the tax rules. The courts will take into account the taxpayer's level of expertise in tax matters for the purposes of assessing the penalty. According to the

[209] See Lawrence M. Hill and Alexandra Minkovich, "Tax Policy Gone Wild: Harsh Penalties As Revenue Raisers," 2007 TNT 64-44. See also the viewpoint expressed by the Section of Taxation of the American Bar Association in ABA (Section of Taxation), "Comments on S. 2020 (2005)," *supra* note 171.

[210] For a discussion of the application details of the penalty for under-stating tax payable, see Treasury, *Corporate Tax Shelters*, *supra* note 134, pages 85-93.

[211] US, Treasury Inspector General for Tax Administration, *The Strategy to Reemphasize Penalties in Corporate Examinations Could Be Enhanced* (2005-30-123), August 2005. The tax administration observed that the auditors did not follow the procedures governing the assessment of penalties in 35 of the 45 income tax returns in the sample reviewed. These returns proposed notices of assessment of US$10,000 or more. Penalties for under-stating tax payable could have been assessed in 23 cases within this sample. Similar concerns were voiced when penalties for under-stating tax payable in cases involving potentially abusive recourse to trusts were examined: Treasury Inspector General for Tax Administration, *Significant Efforts Have Been Made to Combat Abusive Trusts, but Additional Improvements Are Needed to Ensure Fairness and Compliance Objectives Are Achieved* (2002-30-050), February 2002.

proposed codification, the taxpayer could not avoid the penalty when the tax administration decides to apply it.

A strict penalty seems unfair to taxpayers who do not possess expertise in tax matters. A taxpayer would have to pay a penalty even though he does not possess the level of expertise necessary to grasp the nuances and subtleties of a tax opinion on an aggressive tax planning scheme formulated by his advisers without the possibility of the courts' taking into consideration his level of expertise.

At present, the possibility of taxpayer's avoiding a penalty for under-stating tax payable in no way prevents the courts from maintaining a penalty levied by the tax administration on taxpayers who possess the tax expertise to fully grasp the risks inherent in an aggressive tax planning scheme. According to the jurisprudence, it is difficult for taxpayers who possess tax expertise to avoid the penalty for under-stating tax payable simply because they relied on the opinions of their advisers. Such taxpayers must disclose to their advisers all of the facts so that the advisers can diligently, impartially verify a transaction's compliance not only with the tax rules taken literally but also with the economic substance doctrine. In some cases, the courts have maintained the assessment of a penalty in respect of taxpayers who relied on an opinion in which the advisers concluded that the planning scheme complied with the tax rules taken literally but based on incomplete hypotheses submitted by the taxpayer on the transaction's economic substance.[212]

The courts may also maintain a penalty for under-stating tax payable levied on a taxpayer despite the latter's relying on his advisers' opinion and the advisers' taking into account the relevant jurisprudence for the purposes of the application of the tax rules. The Court of Appeals in the *Jade Trading* case maintained the penalty for under-stating tax payable because the relative weight of the recognized sources of interpretation in support of the economic substance doctrine in this case prevailed over the weight of the sources in support of the taxpayers' technical interpretation of the tax rules:

[212] See *Santa Monica Pictures, LLC* v. *Commissioner of Internal Revenue* and *Corona Film Finance Fund, LLC* v. *Commissioner of Internal Revenue*, T.C. Memo 2005-104 (May 11, 2005), appealed before the United States Court of Appeals for the Second Circuit (No. 05-4491-ag). See also the *Long-Term Capital Holdings* case, supra note 5.

> The taxpayer bears the burden of proving substantial authority. Norgaard v. Comm'r, 939 F.2d 874, 877-78 (9th Cir. 1999). Substantial authority for tax treatment exists "only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment." Treas. Reg. § 1.6662-4(d)(3)(i). Substantial authority is an "objective standard involving an analysis of the law and application of the law to relevant facts." Treas. Reg. § 1.6662-4(d)(2). "[T]he taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment." Treas. Reg. § 1.6662-4(d)(3)(i) (1998). Pertinent authorities for a substantial authority analysis include the Internal Revenue Code, other statutory provisions, regulations, revenue rulings, and court decisions, but not opinions rendered by tax professionals. Treas. Reg. § 1.6662-4(d)(3)(iii).
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> Plaintiffs argue that substantial authority existed for the tax treatment of the spread transaction based on Helmer. Plaintiffs are correct that at the time the spread transaction was executed, Helmer supported the premise that a sold call option would not constitute a liability under section 752 for purposes of calculating a partner's basis in its partnership interest. Indeed, recently in CEMCO the District Court for the Northern District of Illinois recognized that Helmer was good law […]
>
> The question of whether there was "substantial authority" for the positions taken by Jade here requires an examination of several legal theories. There was clearly authority under Helmer and its progeny for the proposition that contingent obligations were not liabilities within the meaning of section 752 of the Code. There was also some authority that the two legs of the spread transaction could be viewed separately, but the weight of both factual and legal authorities demonstrate that the options here could not be separated. More importantly, there is an overarching legal doctrine -- the economic substance doctrine -- which must be considered in evaluating whether Helmer was substantial authority for Jade's position. As the Federal Circuit in Coltec recognized, "[o]ver the last seventy years, the economic substance doctrine has required disregarding for tax purposes, transactions that comply with the literal terms of the tax code, but lack economic reality." 454 F.3d at 1352. The Federal Circuit traced the roots of this doctrine to Supreme Court cases and noted that the Federal Circuit's predecessor had repeatedly applied the doctrine over the years and that "various tax treatises also recognize the doctrine's continued viability." Id. At bottom, the fictional nature of the transaction and its lack of economic reality outweigh Helmer in the substantial authority assessment.
>
> Because this Court finds that, on balance, substantial authority did not exist for the tax treatment of the spread transaction in Jade, it is not necessary to analyze whether the taxpayers reasonably believed at the time the return was filed that the tax treatment of the spread transaction was "more likely than not the proper treatment." See Treas. Reg. § 1.6662-4(g)(1)(i)(B). As such, the alternative 20-percent substantial understatement penalties of section 6662(b)(2) were properly imposed by the Commissioner.[213]
>
> [our extracts]

Conversely, the courts concluded that taxpayers who do not possess the tax expertise required to grasp the scope of the tax rules and the economic substance doctrine might avoid a penalty for under-stating tax payable if the transaction carried out was devoid of economic substance but complied with the tax rules interpreted literally.

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213 See *Jade Trading*, *supra* note 59, pages 71 to 73 of the ruling published by the Court.

The *Klamath* case[214] illustrates the importance that the courts may attach to the weight of the economic substance doctrine in order to withdraw, on the one hand, the tax benefits claimed by the taxpayer in a transaction and, on the other hand, the penalty for under-stating tax payable.

In this case, a Texas District Court concluded that the taxpayers could claim the tax benefits stemming from a transaction that complied with the tax rules. However, it withdrew them by applying the economic substance doctrine. The Court was of the opinion that the taxpayers could neither maintain any reasonable anticipation of any profit whatsoever nor pursue a genuine business purpose.

The Court nonetheless withdrew the penalty for under-stating tax payable levied by the tax administration. In its opinion, the taxpayers could claim in good faith the tax benefits pursuant to the applicable rules of the jurisprudence, according to the balance of probabilities.[215]

The Court drew this conclusion in light, among other things, of a technical interpretation of the tax rules[216] and the technical report that the taxpayers produced on the depth of the analysis conducted by their advisers concerning the application of the law to the planning scheme. In its opinion, the taxpayers could claim the tax benefits pursuant to a technical interpretation of the tax rules in question. According to the technical report, the advisers had expressed an opinion that conformed to the standards of care stipulated in the ethical standards in tax matters.[217] The advisers had concluded that the taxpayers could claim the tax benefits from the standpoint of the tax law and the jurisprudence applicable at the time the opinion was expressed, according to the balance of probabilities.

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[214] See *Klamath*, *supra* note 141.

[215] *Ibid.,* pages 24-27.

[216] In its ruling, the Court provides a detailed technical analysis of its interpretation of the tax rules in dispute in this case.

[217] The ethnical standards prescribed by the tax administration, commonly known as *Circular 230*, as they were in force prior to June 21, 2005. Instalment 7 (publication pending) of Part II of this study on aggressive tax planning schemes examines these standards.

According to the technical report, the tax advisers could reasonably rely on the taxpayer's arguments and the documents that the financial advisers gave the taxpayers concerning the details of the planning scheme without having to conduct an independent analysis to ascertain the accuracy of such arguments. In light of these arguments and documents, the advisers would have suggested the possibility that the taxpayers were seeking to achieve a genuine purpose and that the planning scheme complied with the economic substance doctrine. However, the planning scheme was not implemented in accordance with these documents since the financial advisers agreed among themselves, without the taxpayers' knowing it, that the transaction had to be carried out otherwise in order to obtain the tax benefits.

According to the Court, the taxpayers could rely on the tax advisers' opinion bearing in mind that the latter had displayed diligence in accordance with the applicable ethical standards and that the taxpayers did not possess the requisite tax expertise that would allow them to pinpoint the facets that might undermine the credibility of their tax advisers' opinions.[218]

4.11 The taxpayers, their advisers and the tax administration must measure the likelihood of the courts' applying the doctrine and penalty for under-stating tax payable

Taxpayers will seek to minimize the risk that the tax administration and, as the case may be, the courts, withdraw the tax benefits stemming from an aggressive tax planning scheme that they have implemented because the scheme was devoid of economic substance.

4.11.1 Taxpayers can reduce such risk by relying on a tax opinion from their advisers inasmuch as they disclose to them all of the facts pertaining to their planning scheme

Taxpayers could consult their advisers to obtain an enlightened tax opinion on the likelihood of the planning scheme's complying with the tax law and the economic substance doctrine. Taxpayers who seek the services of tax advisers must disclose all of the facts relevant to the aggressive tax planning scheme contemplated. Otherwise, they could not avoid a penalty for

[218] For a criticism of the ruling handed down in the *Klamath* case, in particular the withdrawal of the penalty for under-stating tax payable, see Lee A. Sheppard, "What Does IRS BLIPS Victory Mean," 2007 TNT 30-5 (February 12, 2007).

under-stating tax payable if their advisers were unable to express an opinion on the relevant facts overall to determine whether a planning scheme complies with the economic substance doctrine.[219]

4.11.2 Obtaining an advance income tax ruling from the tax administration

To minimize their risks, taxpayers might submit to the American tax administration a request for an advance income tax ruling to obtain the assurance that the transaction complies with the tax law and the jurisprudence.[220] However, the tax administration might be unable to issue an advance ruling in respect of a transaction that presents a risk of tax avoidance, in particular if it doubted the business purposes that the taxpayer pursued in the transaction and the legitimacy of the transactions aimed at minimizing the taxpayer's tax payable.[221]

If they are unable to obtain an advance ruling, taxpayers should seek the opinion of tax advisers to ascertain the likelihood that the transaction contemplated complies with the tax law and the jurisprudence. Taxpayers might decide to implement an aggressive tax planning scheme if, in the opinion of their tax advisers, the scheme complies with the tax law and the jurisprudence, according to the balance of probabilities.

4.11.3 Contracting by taxpayers of an insurance policy

Faced with uncertainty surrounding the application of the tax law and the economic substance doctrine, taxpayers could contract an insurance policy with an insurance company to cover in whole or in part the amount of tax, interest and penalty that the tax administration might possibly levy. Insurance companies might, however, refuse to issue a policy to a taxpayer if the

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[219] See *InterTAN, Inc.* v. *Commissioner of Internal Revenue,* T.C. Memo 2004-1 (January 5, 2004), a ruling upheld in *InterTan, Inc.* v. *Commissioner of Internal Revenue,* Decision No. 04-60225 (United States Court of Appeals for the Fifth Circuit, December 8, 2004). For an analysis of this ruling, see Burgess J.W. Raby and William L. Raby, "How Taxpayers Can Void Their Penalty Protection Insurance," 2004 TNT 14-7.

[220] Insérer référence.

[221] See Department of Treasury (Internal Revenue Service), Rev. Proc. 2007-1, 2007-3 and 2004-4 published in I.R.B. 2007-1 (January 2, 2007). Briefly, taxpayers may submit to the Internal Revenue Service requests for letter rulings concerning the transactions that they plan to implement (such decisions are similar to the requests for advance rulings handed down by the Canada Revenue Agency).

transaction presents a high risk of avoidance, in particular if it is devoid of economic substance.[222]

4.11.4 Contracting by tax advisers of an insurance policy

Tax advisers will also contract an insurance policy to protect themselves against professional responsibility lawsuits that their clients may bring inasmuch as the clients have carried out an aggressive tax planning scheme based on a tax opinion concluding that this scheme complied with the tax law and the jurisprudence, according to the balance of probabilities.

As is true in the case of taxpayers, the insurance companies might, however, refuse to issue a policy to advisers in respect of opinions on planning schemes that present a high risk of avoidance, as a transaction devoid of economic substance. Consequently, disputes might arise over the insurable nature of the acts committed by the tax advisers in the context of aggressive tax planning schemes and over the amount covered by the insurance policy, which, moreover, might be significantly lower than the monetary damages sustained by their clients.[223]

4.12 The tax administration is only able to apply the economic substance doctrine and the penalty if the taxpayers produce the relevant information

To apply the economic substance doctrine and the penalty for under-stating tax payable, the tax administration must pinpoint in the taxpayers' tax returns indicators that might reveal that the taxpayers have engaged in an aggressive tax planning scheme devoid of economic substance.

> As discussed in Part V.A. with respect to disclosure, in order to assess a penalty, the IRS must discover the questionable transaction. Thus, issues of disclosure and penalties are interrelated. In addition, even if the taxpayer believes the IRS were to discover a

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[222] See Kyle D. Logue, "Tax Law Uncertainty And The Role Of Tax Insurance" (2005) 25 Va. Ta. Rev. 339. On page 393, the author provides a concrete illustration of risk management by the tax administration and by a taxpayer concerning compliance with the tax law and the jurisprudence by a corporate reorganization implemented by the taxpayer.

[223] For an observation in this respect, see Robert A. Rizzi, "Circular 230 and Current Opinion Practice: Two Years Later," (2007) 34: 1 Corporate Taxation 3, page 4. By way of illustration concerning disputes that may arise in respect of the details of professional insurance policies pertaining to aggressive tax planning schemes, see the settlement reached between taxpayers and tax advisers confirmed by the courts in *Denney* v. *Jenkens & Gilchrist*, United States District Court (Southern District of New York), Opinion & Order 03 Civ. 5460 (SAS), February 18, 2005 and *Denney* v. *Jenkens & Gilchrist*, (S. D. N. Y.), No. 03 Civ. 5460 (SAS), Joint Brief In Support of Motion for Preliminary Class Certification and Settlement Approval, April 28, 2004.

questionable transaction, the section 6662 penalty is an effective deterrent only if it can be applied to a substantial understatement. If there is a defect in the underlying substantive law such that the claimed tax benefits are not disallowed and concomitantly no understatement is created, the penalty alone will not be an effective deterrent[224].

[our extracts]

[224] Treasury, *Corporate Tax Shelters*, *supra* note 134, page 86.

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Conclusion

The *ad hoc* adoption of specific anti-avoidance rules enables the American tax administration to counter planning schemes only after it has pinpointed them and solely on a predictive basis. The concomitant application of general principles similar to those found in the economic substance doctrine and the tax rules represent for the tax administration a pragmatic approach in order to establish in a time-independent manner a clearer demarcation between legitimate transactions and tax avoidance.[225]

While the economic substance doctrine is, in principle, a tool of last resort for the tax administration applicable solely if the circumstances warrant it,[226] both the tax administration and the courts have frequently applied it in order to withdraw tax benefits stemming from transactions that nonetheless complied with the technical details of specific rules. For all intents and purposes, taxpayers and tax advisers must consider this doctrine as though it were a general anti-avoidance rule.

Following the example of Canada's general anti-avoidance rule (GAAR), the economic substance doctrine in the United States allows the tax administration and the courts to withdraw tax benefits stemming from transactions intended to achieve a tax-related purpose. The GAAR and the economic substance doctrine allow for the withdrawal of tax benefits stemming from planning schemes based on the tax rules interpreted literally but that undermine in an abusive manner the purposes of the law. Both in Canada and the United States, the purposes pursued by the tax law do not always emerge clearly either in the tax rules, the technical notes or other governmental sources of interpretation of the laws. However, the economic substance doctrine has enabled the American tax administration and the courts to rescind tax benefits that the

[225] Treasury, *Corporate Tax Shelters*, *supra* note 134, pages 33-34.
[226] See Korb, *Economic Substance Doctrine*, *supra* note 26.

taxpayer could, in our opinion, have obtained in Canada, notwithstanding the presence of the GAAR.

Following the example of the GAAR, the application in the United States of the economic substance doctrine centres, first and foremost, on the identification of a tax-related purpose in a planning scheme:

- Pursuant to the proposed codification, a taxpayer might claim the tax benefits stemming from an aggressive tax planning scheme if he establishes that the transaction allowed him to achieve a substantial, legitimate non-tax purpose and that it significantly altered his economic position.
- Under the GAAR, a taxpayer who carries out a planning scheme mainly for non-tax purposes may claim the tax benefits without the courts' having to determine whether the transaction abusively undermines the purposes of the tax law read as a whole.

As the American jurisprudence reveals, differences of opinion persist on how to pinpoint the presence of a legitimate purpose in a transaction and measure the relative weight of the different purposes that the taxpayer pursues. The courts have elaborated numerous criteria in order to pinpoint these purposes in the absence of parameters clearly established in the law.

The courts have generally endeavoured to ascertain the presence of such a purpose both according to a subjective analysis of the taxpayer's intentions and an objective analysis of the details of planning schemes. The identification of the purposes that a taxpayer pursues in a transaction centres on a factual analysis that may prove to be complex and lead the courts to hand down an arbitrary judgement concerning such purposes. The subjective section of the economic substance doctrine tends to lead to an analysis of documents that may be protected by the taxpayers' privilege of confidential communication. Disputes focusing on the application of privileges of confidential communication may delay by several years a court ruling on the application of the economic substance doctrine itself.

In this context, we are of the opinion that the courts should objectively apply the economic substance doctrine. We believe that the purposes that the taxpayer pursues should be evaluated subjectively only for the purposes of the penalty for under-stating tax payable.

Following the example of the US Court of Appeals for the Federal Circuit in the *Coltec* case, we subscribe to the objective approach that the American courts advocate in order to pinpoint the purposes that a taxpayer pursues in an aggressive tax planning scheme. An objective analysis of the purposes pursued in a planning scheme mitigates the difficulties inherent in judging the purposes claimed by a taxpayer. The stance adopted by the American courts in this respect strikes us as less equivocal than that of the Canadian courts concerning the manner in which the essential purpose of a transaction is identified. The business purpose doctrine is frequently criticized for unduly emphasizing the purposes that the taxpayer pursues, which leads to the conclusion that a planning scheme exists instead of focusing on the scheme's consequences. The economic substance doctrine responds to these misgivings since it often makes it possible to establish links between the taxpayer's purposes (the subjective section of the test) and the economic consequences of a planning scheme on the taxpayer's position (objective section of the test).[227]

The identification of the purposes that a taxpayer pursues in a planning scheme implies, for all intents and purposes, a comparison of such a scheme with an alternative scheme that would have allowed the taxpayer to achieve a legitimate purpose in accordance with the tax law. We believe that the objective identification of the taxpayer's essential purpose in a transaction according to generally recognized commercial standards, in particular in light of the economic profit and risks incurred, helps to establish a reasonable demarcation between transactions carried out to achieve a legitimate essential purpose and tax avoidance. Such an approach reconciles the principles of uniformity, predictability and flexibility.

The tax administration must then establish a measurement of anticipated profit that is at once sufficiently predictable and flexible for the purposes of the application by groups of stakeholders of the economic substance doctrine. The codification of the economic substance doctrine strikes us as relevant, since groups of stakeholders would then have to apply it objectively, in light of the changes to the taxpayers' economic position. To this end, this doctrine must essentially be formulated according to the parameters that make up the smallest common denominator of the transactions that run counter to the purposes of the tax law.

In certain previous versions of the proposed codification, the tax administration demanded that the courts determine whether the profit that a taxpayer anticipated seemed reasonable in light of

[227] Bankman, "Economic Substance," *supra* note 52, page 12.

the value of the tax and non-tax benefits and an entirely risk-free investment. The application of the economic substance doctrine according to an entirely risk-free investment implies, in our opinion, the risk of perceiving as tax avoidance legitimate transactions that comply with the law.

We believe that the courts must be able to apply the doctrine according to the each taxpayer's circumstances and a reasonable degree of economic risk to which the taxpayer exposes himself, within a maximum period during which the taxpayer may reasonably anticipate a profit. The tax administration should then establish the general parameters that the courts may apply depending on the circumstances to ascertain the reasonable nature of the taxpayers' anticipation of a profit, instead of establishing strict, precise criteria that do not reflect the reality of the taxpayers' economic and commercial environment. The courts could decide that recourse to analyses by experts is necessary to identify the economic changes to a taxpayer's position or the commercial standards applicable.

The existence of a penalty for under-stating tax payable significantly increases financial risks for aggressive taxpayers and, indirectly, increases the level of responsibility of tax advisers. However, we are of the opinion that taxpayers should have the possibility of avoiding a penalty for under-stating tax payable if they display reasonable diligence in the application of the tax law. In case of uncertainty concerning the application to a given planning scheme of the economic substance doctrine, the courts might hesitate to apply it if doing so led to the automatic assessment of a penalty that would be inappropriate under the circumstances. The withdrawal of tax benefits and the assessment of a penalty target two different objectives: one is intended to correctly determine the taxpayer's tax payable in a given situation; the other is designed to enhance compliance by the taxpayer concerned and all taxpayers.

For the sake of fairness, we believe that the tax administration should levy on a taxpayer a penalty for under-stating tax payable insofar as:

- the economic substance doctrine reconciles the principles of uniformity and predictability in its application;
- taxpayers may submit a reasonable diligence defence, in particular when they properly disclose the relevant information to the tax administration so that the latter can determine their tax consequences in an aggressive tax planning scheme;

- the taxpayers may lodge an appeal before a court of the tax administration's decision to assess the penalty in order to ensure that the tax administration applies it uniformly and non-abusively.

The rate of the penalty should then be established bearing in mind the principles of fairness, predictability, efficiency and simplicity. The taxpayers might be subject to a higher rate of the penalty for under-stating tax payable if they fail to properly disclose to the tax administration information concerning their tax consequences. By adopting such a strategy, the tax administration could achieve two objectives:

- it would be in a better position to pinpoint tax avoidance arrangements implemented by a taxpayer;
- it could identify more rapidly and efficiently transactions that present a risk of avoidance. If need be, it could also adopt specific rules to prevent other taxpayers from implementing these or similar transactions.

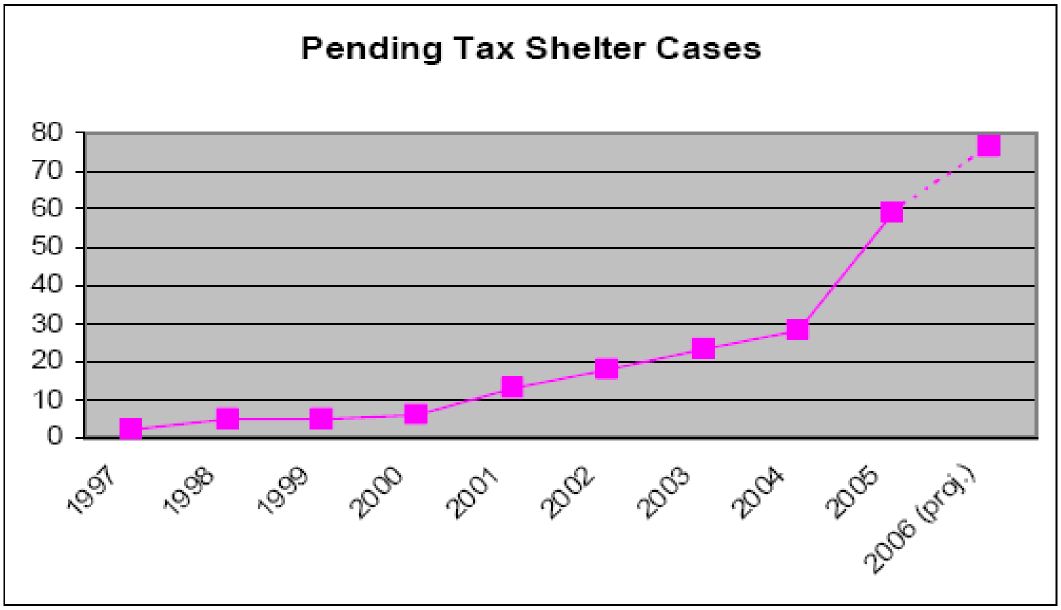
Because of the uncertainty inherent in the economic substance doctrine, the establishment of thresholds respecting the under-statement of tax payable that trigger the assessment of the penalty might strike a reasonable balance between the principle of fairness in the application of the tax rules and the protection of the taxation system's integrity. The fairness of a penalty depends on the level of the thresholds. A relative threshold established according to a percentage of the amount of tax under-stated by the taxpayer would ensure the fair assessment of a penalty. The establishment of fixed thresholds would, moreover, ensure that a penalty only applies when the amount of the tax under-stated is sufficiently high.

Since the penalty centres on the presence of a tax purpose in a planning scheme, the tax administration will attempt to collect information on the taxpayer's subjective intentions in a planning scheme, in particular based on opinions expressed or other communications between the taxpayer and his advisers. To avoid the penalty, the taxpayer might then be compelled to relinquish his privilege of confidential communication. For the sake of fairness, the tax administration must not apply this penalty systematically or abusively simply to collect information that is otherwise protected by the privilege of confidential communication. This penalty must then be applied according to the circumstances. In our opinion, the application of a penalty to a taxpayer who is only seeking to obtain a tax benefit by speculating on the enforcement of the tax law, including the economic substance doctrine, might be a reasonable infringement of the taxpayers' privilege of confidential communication.

The courts will, in all likelihood, hear a growing number of disputes between taxpayers and the tax administration concerning aggressive tax planning schemes. In recent years, the tax administration has won several cases, in particular through the application of the economic substance doctrine. According to Department of Justice data, in 2006 its tax division was involved in 68 categories of disputes involving over 200 medium-sized and big business. By late 2006, it was estimated that the number of categories of dispute would reach 76. As Chart 2 shows, that tax administration notes that the number of cases focusing on aggressive tax planning scheme has increased over the years despite its successes before the courts in respect of some of the most aggressive tax planning schemes.[228]

[228] Eileen J. O'Connor (Assistant Attorney General, Tax Division), testimony before the US Senate Committee on Finance, "Corporate and Partnership Enforcement Issues" (June 13, 2006). The value of the aggressive tax planning scheme in dispute is not indicated.

CHART 2
CATEGORIES OF DISPUTES BETWEEN THE TAX ADMINISTRATION AND TAXPAYERS IN THE REALM OF AGGRESSIVE TAX PLANNING SCHEMES, BY FISCAL YEAR
1997 TO 2006



Source: Table taken from "Statement of Eileen J. O'Conor Assistant Attorney General Tax Division Before the Committee on Finance United States Senate Concerning Corporate and Partnership Enforcement Issues" (June 13, 2006).

The scope of application of the economic substance doctrine and the penalty for under-stating tax payable and the attendant issues for each group of stakeholders engender significant repercussions on reliance by the tax administration on other tools that fall within each of its spheres of intervention. To broaden compliance by taxpayers and advisers with the taxation system, the tax administration has enacted ethical standards that advisers must apply when they express a tax opinion on aggressive tax planning schemes. It has adopted disclosure rules to broaden the identification of aggressive tax planning schemes carried out by taxpayers and their advisers. Moreover, the tax administration has issued settlement offers to taxpayers who have engaged in aggressive tax planning schemes in light of the possibility that the courts will decide in their favour.[229] The economic substance doctrine and the penalty for under-stating tax payable form the core of these tools.

The legislative branch of the tax administration has a duty to reformulate the law to incorporate this principle instead of leaving it to the courts to offset uncertainty over the foundations of the tax law that are inadequately expressed in the numerous rules. The courts play an extremely important role in the interpretation and enforcement of the tax law. The scope of their decisions must nonetheless be defined by the relevant facts and circumstances and the reasons that directly underpin their decisions. In our opinion, it is the legislative branch's role to enact a general anti-avoidance rule to mitigate as much uncertainty as possible for all groups of stakeholders in the application of the tax law. While uncertainty is inherent in human behaviour in general, including tax matters, we must attempt to establish in a sufficiently predictable manner a demarcation between legitimate transactions and those that might be deemed to be abusive.

Instalments 7, 8 and 9 focus on questions pertaining to the application of ethical standards in tax matters, disclosure rules and settlement offers, respectively.

[229] Richard M. Lipton, "Will *Black & Decker* Turn Out to Be a Pyrrhic Victory for the IRS?," (2006) 104:4 Journal of Taxation 200; Internal Revenue Service, "IRS Accepts Settlement Offer on Contingent Liability Tax Shelter," IR-2004-151 (December 16, 2004).

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