

July 25, 2000

Jonathan Talisman, Esq.  
Acting Assistant Secretary (Tax Policy)  
Treasury Department, Room 1330 MT  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

Re: Proposal To Codify Economic Substance Doctrine

Dear Mr. Talisman:

I am pleased to enclose a report of the New York State Bar Association Tax Section<sup>1</sup> commenting on a proposal in the President's Fiscal Year 2001 Budget to codify the economic substance doctrine. In general, the proposal would disallow tax benefits from any transaction in which the "reasonably expected" pre-tax profit is insignificant relative to the tax benefits. The proposal is intended to address the Administration's concerns about the proliferation of abusive corporate tax shelters.

The proposal presents the basic question whether a statutory substantive disallowance rule—a general rule that overrides otherwise applicable technical rules—is the right way to discourage abusive corporate tax shelters. Although we share the Treasury Department's concern about the serious problems presented by the corporate tax shelter phenomenon, and although we are on record as

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<sup>1</sup> The principal drafter of the enclosed report was David P. Hariton, co-chair of the Section's Committee on Tax Policy.

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supporting legislative responses, we have not previously supported enactment of substantive disallowance rules. We do not at this time have a consensus for changing that position. Instead, we continue to support changes to penalty and disclosure rules.

The report describes a range of views on the advisability of enacting substantive disallowance rules. Some members of the Section who participated in preparing the enclosed report are generally opposed to enactment of any substantive disallowance provisions, but they differ in the reasons for their reservations. Other members believe that some form of substantive disallowance rule is necessary and should be enacted to deal with abusive corporate tax shelters, particularly if stricter penalty and disclosure rules are not enacted.

Even if one concludes that a substantive disallowance rule should be enacted, however, the issue remains whether the particular rule in the Budget proposal is the right approach. We have several concerns about the proposal, which are described in the enclosed report.

First, we are concerned that the proposal, at least read literally, could apply in some situations to disallow tax benefits that are contemplated by applicable statutory rules. We think that any proposed substantive disallowance rule should be designed to disallow only tax benefits that were not intended to be available in the circumstances in which they arise.

Second, we are concerned about the proposed test's reliance on "expected" pre-tax profit. Taxpayers entering into many business and financial transactions—including both transactions that may be abusive in some sense and those that clearly are not—do not have an expected profit that is susceptible to objective measurement. Many transactions have a range of possible outcomes. We have concerns about any test that would purport to measure the expected profit of such transactions, either by determining which one of the possible outcomes

was "expected", or by measuring the statistical probability of each possible outcome and then weighting the profits associated with each outcome accordingly. Any such test may be inadministrable, and it also may not serve to distinguish abusive from nonabusive transactions in a sensible way.

In addition to setting forth concerns about how the proposed test would work in practice, the enclosed report discusses the common law economic substance doctrine, and it concludes that the proposal does not in fact codify that doctrine. The courts have not applied the doctrine as a mechanical test. Instead they have used the economic substance doctrine as a flexible tool of statutory construction to deny unintended results, and they have recognized that it may be applied only to deny benefits not contemplated by drafters of applicable rules. Furthermore, the case law, in contrast to the Budget proposal, has applied a test based on *potential* for pre-tax profit; profit potential may be quite different from *expected* profit.

In order to advance discussion of possible forms that a substantive disallowance rule might take, we not only set forth concerns about the Treasury proposal, but we also recommend an alternative for consideration. The alternative to the Treasury proposal we suggest in our report focuses—like the case law—on profit potential rather than on expected profit. We believe that this alternative test would serve to identify the most abusive transactions, because they generally are structured to be devoid of meaningful potential for significant pre-tax profit (as well as loss, other than transactions costs) and not to change materially the taxpayer's economic position. In our report, however, we acknowledge that this test may be underinclusive, and that some transactions that might be viewed as abusive would pass it.

The alternative suggested here, like the Treasury proposal, would apply a separate test to financing transactions. The alternative would compare deductible amounts (not tax benefits) to the taxpayer's

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economic cost (rather than to the return of the person providing financing).

The Tax Section does not advocate enactment of the alternative described in the enclosed report; we do not have a consensus for enactment of any substantive disallowance rule at this time. We suggest only that *if* a substantive disallowance rule based on economic substance were to be enacted, this alternative would be preferable to the Treasury proposal.

I want to emphasize in closing that the Tax Section continues to share the Treasury's concern about abusive corporate tax shelters, and that we are continuing to review possible measures to deal with them. As part of our review, we expect to submit in the near future a report commenting on possible revisions to Circular 230 and a second report on recent proposed Treasury regulations dealing with disclosure and registration of corporate tax shelters.

Please let me know if we can be of further assistance in consideration of the issues addressed in the enclosed report.

Sincerely,

Robert H. Scarborough

Enclosure

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Identical letter to: The Hon. Bill Archer  
Chair  
House Ways & Means Committee

The Hon. William V. Roth, Jr.  
Chair  
Senate Finance Committee

cc: Eric Solomon, Esq.  
Acting Deputy Assistant Secretary (Tax Policy)

Joseph M. Mikrut, Esq.  
Tax Legislative Counsel