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## Losing the Audit Lottery: Corporate Tax Shelters and Judicial Doctrine

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## NOTE

### LOSING THE AUDIT LOTTERY: CORPORATE TAX SHELTERS AND JUDICIAL DOCTRINE

*by Elena Eracleous\**

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#### INTRODUCTION

Marketing tax shelters to corporations has become a large and growing industry.<sup>1</sup> Corporate tax shelters generally operate by

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1. See Stefan F. Tucker, Statement of Stefan F. Tucker on behalf of the A.B.A. Section of Taxation before the Subcommittee on Oversight of the U.S.

exploiting discontinuities in the tax law, which treat certain types of economic activity more favorably than other types.<sup>2</sup> These strategies for tax avoidance can save corporations enormous sums of money by limiting their liabilities. This, however, may come at the expense of the federal tax base and other U.S. taxpayers.<sup>3</sup> The government finds the growth of corporate tax shelters troublesome for reasons beyond the loss of potential revenue in that these activities engender disrespect for the tax system, and cause the Internal Revenue Service (the "IRS") to waste a significant amount of resources in combating this problem.<sup>4</sup>

The overall situation is described as an "audit lottery," in which corporations engage in tax avoidance transactions, betting that they will avoid IRS scrutiny; there is much to gain if they win and relatively little to lose if they do not.<sup>5</sup> Even if the IRS eventually disallows a "sham" transaction and levies additional taxes, the offending corporation benefits in the interim from the investment use of the withheld funds. Determined to halt this kind of abuse, the IRS has intensified its efforts to "identify and find ways to stop transactions which have no real business purpose

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House of Representatives on the Subject of Revenue Provisions in the President's FY2000 Budget, 99 Tax Notes Today 47-65 (Mar. 10, 1999) (LEXIS, FEDTAX library, TNT file) ("We have witnessed with growing alarm the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than reduction of Federal income taxes."); Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, Forbes, Dec. 14, 1998 at 198 (describing the marketing of tax shelters as a "thriving industry that has received scant public notice . . .").

2. See Dep't of the Treas., *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*, July 1, 1999, reprinted in *Treasury White Paper on Corporate Tax Shelters*, 99 Tax Notes Today 127-12, 127-13 (July 2, 1999) (LEXIS, FEDTAX library, TNT file) [hereinafter *Problem of Corporate Tax Shelters*] (discussing the reasons for some of the discontinuities in the tax law).

3. See Novack & Saunders, *supra* note 1, at 202-03 (reporting that Joseph Bankman, a Stanford Law School professor estimated that the new corporate tax shelters save corporations up to \$10 billion per year in tax breaks).

4. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 9 (discussing the reasons to be concerned about corporate tax shelters).

5. See *id.* at para. 193 (citing statement of IRS Commissioner Charles Rossotti).

other than tax savings.”<sup>6</sup>

Congress has provided targeted responses that attempt to abolish specific shelters as they come to light;<sup>7</sup> however, the judicially formulated “economic substance doctrine,” in combination with the “business purpose doctrine,” is emerging as the preferred standard for evaluating the legitimacy of a purported business transaction that functions as a corporate tax shelter.<sup>8</sup> Preference for this common law doctrine is reflected in a recently issued Treasury proposal<sup>9</sup> which advises Congress that changes to the substantive law, such as codifying the economic substance doctrine, are needed to warn corporations about how market transactions will be scrutinized.<sup>10</sup> The Treasury addressed this, as well as other generic remedies concerning corporate tax shelters made by the Clinton Administration, in its Fiscal Year 2000 Budget designed to curb the growth of corporate tax shelters.<sup>11</sup>

The Treasury proposal comes on the heels of several major IRS legal victories.<sup>12</sup> One recent IRS challenge, decided by Tax Court Chief Judge Mary Ann Cohen, resulted in the case of

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6. Tom Herman, *Tax Report*, Wall St. J., Oct. 27, 1999, at A1.

7. See, e.g., I.R.C. § 901(k) (1994 & Supp. V 1999) (requiring a holding period before corporations can take a foreign tax credit).

8. See, e.g., David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235 (1999) (advocating proper use of the economic substance doctrine).

9. *Problem of Corporate Tax Shelters*, *supra* note 2.

10. *Id.* at para. 32 (proposing “codification of the economic substance doctrine” as the “centerpiece” of a change to the substantive law regarding corporate tax shelters).

11. See *id.* at paras. 31–35 (summarizing Treasury Department “refinements” of the Administration’s proposals). The Administration’s proposal focused on: “(1) increasing disclosure of corporate tax shelter activities, (2) increasing and modifying the penalty relating to the substantial understatement of income tax, (3) changing substantive law to disallow the use of tax benefits generated by a corporate tax shelter, and (4) providing consequences to all the parties to the transaction.” *Id.*

12. See, e.g., Novack & Saunders, *supra* note 1, at 208 (noting that recently companies such as “AlliedSignal, Colgate-Palmolive and Laidlaw have lost court decisions involving aggressive tax shelters”); Owen Ullman, *IRS Hurts Corporate Schemes*, USA Today, April 17, 2000, at 1A (reporting that the Tax Court recently labeled Winn-Dixie Stores’ 1993 corporate-owned life-insurance program “a sham for tax purposes”).

*Compaq Computer Corp.* ("Compaq") v. *Commissioner*.<sup>13</sup> In this case, the IRS scrutinized a corporate tax shelter in the international area, and avoided the tax benefits of a dividend-stripping transaction designed to yield a foreign tax credit for Compaq.<sup>14</sup> The Tax Court upheld the IRS' challenge, disallowing Compaq's foreign tax credit for withholding taxes paid to the Netherlands on dividends received, and finding that the American Depository Receipt ("ADR") transaction at issue was solely tax-motivated.<sup>15</sup> Following the Third Circuit's decision in *ACM Partnership v. Commissioner*,<sup>16</sup> the Tax Court reached its decision using the economic substance and business purpose doctrines to analyze Compaq's ADR transaction.<sup>17</sup> These two doctrines have been used in a variety of circumstances to discern the legitimacy of market transactions.<sup>18</sup>

*Compaq* was decided<sup>19</sup> in September 1999, approximately two months after the Treasury's proposal was released. Although the Tax Court made no specific reference to it, its analysis in *Compaq* reflects many of the policies advocated in the Treasury's proposal, particularly in respect to the use of the economic substance and business purpose doctrines in identifying corporate tax shelters. The case therefore provides a useful example by which these policies can be evaluated.

*Compaq* illustrates several of the weaknesses in applying the economic substance and business purpose doctrines to specific transactions. One weakness is the uncertainty of how much economic substance a transaction must have in relation to the tax benefits to withstand judicial scrutiny. *Compaq* left undefined the

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13. 1999 U.S. Tax Ct. LEXIS 44 (Sept. 21, 1999).

14. See *id.* at 4-14 (stating findings of fact).

15. See *id.* at \*13. An ADR is a trading unit issued by a trust, representing ownership of stock in a foreign corporation deposited with the trust. Foreign stocks are commonly traded through ADRs on U.S. stock exchanges. *Id.* at \*7.

16. 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

17. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44 at \*13-28.

18. See *infra* Part I.A-B (discussing development of the economic substance and business purpose doctrines).

19. The Tax Court's holding in *Compaq* was issued in an opinion to be "incorporated into the decision of the case when all other issues are resolved." *Compaq*, 1999 U.S. Tax Ct. LEXIS 44 at \*1.

level of risk and profit elements that a transaction needs to withstand judicial scrutiny. A second weakness arises when the economic substance doctrine is used to challenge transactions that have been specifically addressed by Congress. Judicial intent to enlarge the scope of the doctrine to combat corporate tax shelters may, if uncoded and therefore unchecked, undermine existing statutory safeguards. If the Tax Court applies the economic substance doctrine broadly, corporations will be hesitant to engage even in those transactions that meet U.S. Tax Code ("Code" or "tax code") specifications. Once it is codified, the doctrine could have a chilling effect on legitimate market transactions.

This note evaluates the application of the economic substance and business purpose doctrines to corporate tax shelters through a discussion of *Compaq*, and in light of the Treasury's proposed codification of these doctrines. Part I focuses on the development of the common law doctrines as well as statutory and administrative law addressing tax shelters. A brief overview is given of the Treasury's proposal to combat corporate tax shelters. Part II reviews the facts of *Compaq* and the Tax Court's analysis. Part III offers a critique of the Tax Court's analysis and discusses its significance in light of the Treasury's report on corporate tax shelters. Part IV concludes that, while the economic substance and business purpose doctrines can effectively combat corporate tax shelters, the Tax Court's case-by-case approach is likely to cause a chilling effect on legitimate market transactions. This note recommends that Congress codify the economic substance and business purpose doctrines as proposed by the Treasury, but with due regard for their vulnerabilities as discussed herein.

## I. LEGAL RESPONSES TO CORPORATE TAX SHELTERS

Courts have developed and reinterpreted various common law doctrines to address tax benefits resulting from transactions that are designed to exploit discontinuities in the Code. Two doctrines frequently used are referred to as the "economic substance" and "business purpose" doctrines. Under the economic substance doctrine, tax benefits may be denied if they "arise from a discrete set of transactions that do not meaningfully alter the taxpayer's

economic position.”<sup>20</sup> The business purpose doctrine requires that a taxpayer have a valid business reason for engaging in the transaction other than avoiding federal taxes.<sup>21</sup> In addition, Congress has passed statutory responses aimed at curtailing perceived abuses. For instance, Congress enacted I.R.C. § 901(k), requiring that taxpayers comply with a holding period before they are eligible to take a foreign tax credit.<sup>22</sup> Congress also issued I.R.C. § 6662, which imposes an accuracy-related penalty upon negligent taxpayers for negligently or substantially understating tax liabilities beyond the amount of the understatement and interest due.<sup>23</sup> Against this background, the Treasury issued the above-mentioned proposal to Congress addressing the problem of corporate tax shelters.<sup>24</sup>

#### A. Economic Substance Doctrine

The economic substance doctrine derives from a 1935 case, *Gregory v. Helvering*,<sup>25</sup> and was recently applied to corporate tax shelters in *ACM Partnership v. Commissioner*.<sup>26</sup> The economic substance doctrine compares the taxpayer’s potential to earn a pre-tax profit with the transaction’s anticipated tax benefits.<sup>27</sup> Other major decisions applying the economic substance doctrine include *Goldstein v. Commissioner*,<sup>28</sup> *Sheldon v. Commissioner*,<sup>29</sup> and the recent *Compaq v. Commissioner*.<sup>30</sup> The doctrine essentially allows the IRS to deny tax benefits if the economic substance of a transaction is insignificant relative to the tax benefits obtained.<sup>31</sup>

In *Goldstein*, the Tax Court denied the taxpayer’s interest

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20. *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 21.

21. *See id.*

22. *See* I.R.C. § 901(k).

23. *See* I.R.C. § 6662 (1994 & Supp. III 1997).

24. *See Problem of Corporate Tax Shelters*, *supra* note 2.

25. 293 U.S. 465 (1935).

26. 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

27. *See Problem of Corporate Tax Shelters*, *supra* note 2, at para. 21.

28. 364 F.2d 734 (2d Cir. 1966), *aff’g* 44 T.C. 284 (1965).

29. 94 T.C. 738 (1990).

30. 1999 U.S. Tax Ct. LEXIS 44.

31. *See id.* at \*15.

deduction when the taxpayer attempted to use a Treasury Bill transaction to shelter her sweepstakes winnings.<sup>32</sup> The scheme sought to exploit the difference in tax treatment between borrowing transactions involving prepaid interest and lending transactions with no prepaid interest.<sup>33</sup> The taxpayer planned to secure a large interest deduction by borrowing money to purchase Treasury Bills, and then prepaying much of the interest within the same year.<sup>34</sup> The effect of the economic loss would be reversed in later years by interest income and gain on the Treasury Bills.<sup>35</sup> After analyzing the economic value of the Treasury Bills and loan, the Tax Court denied the taxpayer's deduction, finding that the taxpayer had entered into the transaction as a "sham" to produce a tax benefit, and that the loan by the bank constituted an investment in Treasury Bills rather than economic exposure to the taxpayer.<sup>36</sup> The decision was affirmed by the Second Circuit Court of Appeals.<sup>37</sup>

In *Sheldon*, the economic substance doctrine was used to disallow the tax benefits resulting from a leveraged purchase of debt instruments.<sup>38</sup> The taxpayer bought Treasury bills that matured shortly after the end of the tax year, and funded the purchase by borrowing against the Treasury Bills.<sup>39</sup> The majority of the interest deduction on the borrowings was accrued in the first year, while the taxpayer deferred the offsetting interest income from the Treasury Bills until the second year.<sup>40</sup> Similar to the transaction in *Goldstein*, the borrowing and lending transactions in *Sheldon* economically offset each other, leaving little economic consequence.<sup>41</sup> The Tax Court in *Sheldon* denied the taxpayer's deduction because the transactions had no significant economic

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32. 44 T.C. at 285-87.

33. *See id.* at 286-87.

34. *See id.* at 287.

35. *See id.* at 292-94.

36. *See id.* at 298-99.

37. *Goldstein v. Commissioner*, 364 F.2d 734 (1966).

38. 94 T.C. at 759-69.

39. *See id.* at 743-45.

40. *See id.* at 745.

41. *See Sheldon*, 94 T.C. 738, 744-53; *supra* notes 32-35 and accompanying text (discussing the *Goldstein* transaction).



consequences other than the creation of tax benefits.<sup>42</sup> It also noted that the potential for small net economic effects could not support a finding for economic substance.<sup>43</sup> According to the Tax Court, the potential for gain was “nominal” and “insignificant” when compared to the claimed deduction.<sup>44</sup>

Recently, in *ACM Partnership*,<sup>45</sup> the economic substance doctrine was applied to deny a taxpayer the tax benefits from a near-simultaneous purchase and sale of property.<sup>46</sup> In a complex transaction, the taxpayer purchased privately placed debt instruments and sold them twenty-four days later for consideration equal to their purchase price.<sup>47</sup> Viewed together, the purchase and sale “had only nominal, incidental effects on ACM’s net economic position.”<sup>48</sup> Despite these minimal economic effects, the taxpayer claimed the transaction had a large tax effect that resulted when the installment sale rules were applied.<sup>49</sup> The Third Circuit affirmed the portion of the Tax Court’s decision that held the taxpayer was not entitled to deduct losses resulting from this aspect of the transaction because it lacked a meaningful economic consequence other than the creation of tax benefits.<sup>50</sup> The transaction’s economic substance was considered in light of the size

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42. See *id.* at 762.

43. See *id.* at 767.

44. *Id.* at 768.

45. 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) [hereinafter *ACM Partnership II*].

46. See *id.* at 263 (affirming the Tax Court’s application of the economic substance doctrine and its resulting decision to eliminate ACM’s capital gains and losses).

47. See *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 2214 (1997) [hereinafter *ACM Partnership I*].

48. *ACM Partnership II*, 157 F.3d at 250.

49. See *ACM Partnership I*, 73 T.C.M. (CCH) at 2191. Generally, recovery of basis and gain recognition occurs in the year of sale. The installment sale rules defer recovery of basis in the securities sold until each year in which a payment on the note is received and gain is recognized to the extent a payment exceeds the basis.

50. See *ACM Partnership II*, 157 F.3d at 263. The Court of Appeals did, however, allow deductions for “actual economic losses” that were “economically substantive.” *Id.*

of the tax benefit claimed.<sup>51</sup> As the Tax Court noted, the briefly owned debt instruments provided a yield that was only three basis points higher than a yield that could have been obtained by simply leaving the taxpayer's money on deposit.<sup>52</sup> The key inquiry is whether the taxpayer could have made any economic profit on the transaction, and as a factual matter, whether the taxpayer engaged in the transaction in a manner consistent with its stated business purpose.<sup>53</sup>

### B. Business Purpose Doctrine

The Supreme Court articulated the basics of the business purpose doctrine in *Gregory v. Helvering*<sup>54</sup> as follows:

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 tax motive, was the thing which the statute intended.<sup>55</sup>

Under *Gregory*, for a transaction to be valid, a business purpose for engaging in the transaction must exist apart from merely creating tax benefits.

In *ACM Partnership*, this inquiry required that the transaction "be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and . . . economic situation."<sup>56</sup> The business purpose doctrine considers whether the taxpayer acts in a "realistic and legitimate business fashion," by thoroughly weighing a questionable transaction before undertaking it.<sup>57</sup> In *Goldstein*, the Seventh Circuit held against the taxpayer because the borrowing transaction had "no substance of purpose aside from the

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51. See *id.* at 254-63.

52. 73 T.C.M. (CCH) at 2220.

53. See *id.* at 2223.

54. 293 U.S. 465 (1935).

55. *Id.* at 469 (citations omitted).

56. *ACM Partnership I*, 73 T.C.M. (CCH) at 2217. See *supra* notes 46-52 (reviewing factual background of the case).

57. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*23 (citing *UPS of Am. v. Commissioner*, 78 T.C.M. (CCH) 262 (1999)).

taxpayer's desire to obtain the tax benefit of an interest deduction."<sup>58</sup>

C. Statutory Responses to Perceived Abuses

Congress has attempted to abolish some specific tax shelters by statute.<sup>59</sup> It enacted I.R.C. § 901(k) to prevent taxpayers from abusing dividend-stripping transactions, by requiring taxpayers to undergo a predetermined period of risk before they can qualify for foreign tax credits.<sup>60</sup> I.R.C. § 901(k) requires the recipient of a dividend to hold the stock (or ADR) for at least sixteen days during a thirty-day period as a prerequisite to claiming a foreign tax credit for foreign taxes withheld at the source on foreign dividends.<sup>61</sup> For some preferred stock dividends, the stock must be held for forty-six or ninety-days.<sup>62</sup> If these holding requirements are not met, the taxpayer may not claim a foreign tax credit against payable taxes.<sup>63</sup>

Congress has also sought to deter taxpayers from engaging in inappropriate behavior by imposing penalties. I.R.C. § 6662(a) imposes an accuracy-related penalty equal to 20% of an underpayment of federal income tax when the underpayment is attributable to one or more of the following:

- (1) Negligence or disregard of rules or regulations;
- (2) Any substantial understatement of income tax;
- (3) Any substantial misstatement valuation under Chapter 1 [of the Code];

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58. 364 F.2d at 741-42. *See supra* notes 32-37 (reviewing facts of *Goldstein*).

59. *See Problem of Corporate Tax Shelters, supra* note 2, at para. 8 (providing examples of tax shelters shut down by statute).

60. *See* Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions* § 2.03(3)(a) (1997). A classic example of a dividend-stripping transaction is when a corporation buys stock just before a dividend is payable, then sells the stock once the dividend is received. The desired tax effect of such a transaction is to incur a capital loss on the sale of the stock.

61. *See* I.R.C. § 901(k)(1).

62. *See id.* § 901(k)(3).

63. *See id.* Alternatively, if the foreign tax credit is denied under the holding rules, the taxpayer may claim a deduction for foreign taxes paid if certain other requirements are met. *See id.* § 901(k)(7).

- (4) Any substantial overstatement of pension liabilities;
- (5) Any substantial estate or gift tax valuation understatement.<sup>64</sup>

The Code defines "negligence" as "the failure to make a reasonable attempt to comply with Code provisions, or the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances."<sup>65</sup> The penalty's enactment was motivated by Congress's concern that "an increasing part of the compliance gap is attributable to taxpayers playing the 'audit lottery'" by engaging in tax shelter activity.<sup>66</sup>

#### D. IRS Response to Foreign Tax Credit Abuses

In 1997, the IRS launched its own attack on what it considered to be abusive transactions designed to take advantage of foreign tax credits. It issued Notice 98-5,<sup>67</sup> declaring its intention to issue new amendments to regulations for the purpose of cracking down on schemes concocted solely to manufacture qualifying foreign tax credits.<sup>68</sup> The amendments are intended primarily to prevent U.S.-based multinational corporations from generating excess limitations by sheltering "low-taxed foreign-source income." from U.S. tax.<sup>69</sup> Although the amendments have not been issued, in March 2000 the IRS adopted the Notice 98-5 definition of "abusive arrangements" as transactions subject to the registration and disclosure requirements of the new temporary regulations discussed below in Part I.F.<sup>70</sup>

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64. *Id.* § 6662(a)-(b).

65. *Id.* § 6662(c).

66. *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 193. Without a penalty, the taxpayer merely has to pay the tax understatement plus interest. Meanwhile, the taxpayer had use of the withheld funds.

67. I.R.S. Notice 98-5, 1998-1 C.B. 334, *reprinted in IRS Targets Abusive Foreign Tax Credit Schemes*, 97 Tax Notes Today 247-3 (Dec. 24, 1997) (LEXIS, FEDTAX Library, TNT File).

68. *See id.* at para. 1 (announcing that the Treasury Dept. and the IRS will address "abusive tax-motivated transactions" involving foreign tax credits by issuing new regulations and applying "other principles of existing law").

69. *See id.* at para. 1.

70. *See* I.R.S. Notice 2000-15, 2000-12 I.R.B. 826, § 4 (stating that

### E. Treasury Proposal on the Problem of Corporate Tax Shelters

The Treasury supported an Administration proposal to change the substantive law to deny corporations the benefit of savings generated by tax shelters.<sup>78</sup> To accomplish this goal, the Treasury

78. *See id.* at para. 22.

recommended that Congress codify the economic substance doctrine as statutory law.<sup>79</sup> The Administration's proposal would also grant the Secretary of the Treasury "authority to disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction."<sup>80</sup>

The Treasury proposed a two-part definition of a "tax avoidance transaction."<sup>81</sup> The first part incorporates the economic substance doctrine, comparing the potential for pretax profits and expected tax benefits of the transaction.<sup>82</sup> The second part covers "transactions involving the improper elimination or significant reduction of tax on economic income,"<sup>83</sup> and is meant to apply to transactions that lack a determinable pretax profit, mainly financing transactions.<sup>84</sup>

The Treasury also backed the Administration's proposal that Congress construct sanctions that penalize all parties involved in a tax avoidance transaction, including the promoters.<sup>85</sup> The Treasury reasoned that the most direct way to curtail the economic incentive of persons marketing corporate tax shelters is to levy a penalty tax upon promoters' fees.<sup>86</sup> This penalty is meant to ensure that "[a]ll essential parties to a tax-driven transaction . . . have an incentive to make certain that the transaction is within the law."<sup>87</sup>

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79. See *id.* at para. 32 ("The centerpiece of the substantive law change should be the codification of the economic substance doctrine . . .").

80. *Id.* at para. 263.

81. See *id.* at para. 266.

82. See *id.* at para. 264. The definition would include:

any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction.

*Id.* "Tax benefits" are defined as "a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund," except for "those benefits that are clearly contemplated by the applicable [IRC] provision." *Id.* at para. 265.

83. *Id.*

84. See *id.* at para. 267.

85. See *id.* at para. 22.

86. See *id.* at para. 313.

87. Stefan F. Tucker, Statement of Stefan F. Tucker on behalf of the A.B.A. Section of Taxation before the Subcommittee on Oversight of the U.S. House of

Alternatively, the Treasury suggested that Congress could amend the penalties described in I.R.C. §§ 6700, 6701, and 6703 to address the heightened marketing activity of promoters.<sup>88</sup>

The Treasury further proposed that Congress raise and modify the I.R.C. § 6662 penalty attached to a substantial underpayment of income tax.<sup>89</sup> Despite amendments made in 1994, the penalty has not been an effective method to prevent the illegal corporate activity.<sup>90</sup> The Treasury stated that the current penalty regime does not effectively deter corporate tax shelter activity because:

(1) the penalty rate is too low (2) taxpayers do not believe the IRS will assess the penalty (3) the penalty is too easily avoided by reason of the reasonable cause exception or (4) penalties alone are not a sufficient deterrent.<sup>91</sup>

Accordingly, the Treasury proposed that Congress raise the I.R.C. § 6662 penalty from 20% to 40% of the underpayment.<sup>92</sup>

#### *F. Temporary Regulations Requiring Disclosure of Tax Shelters*

In a major administrative step against the growth of corporate tax shelters, the Treasury also issued new temporary regulations that require promoters and taxpayers to disclose and register potential tax shelters,<sup>93</sup> and force promoters to maintain a list of

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Representatives on the Subject of Revenue Provisions in the President's FY2000 Budget, 99 Tax Notes Today 47-65, para. 41 (Mar. 10, 1999) (LEXIS, FEDTAX library, TNT file). See also *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 297 ("[T]he potential for remedies or sanctions on all participating parties will multiply the number of eyes that will scrutinize a transaction for its integrity.").

88. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 314.

89. See *id.* at para. 22. See also *supra* notes 64-66 (describing the accuracy-related penalty).

90. See *id.* at para. 238.

91. *Id.*

92. See *id.* at para. 242.

93. See Temp. Treas. Reg. 1.6011-4T (as amended in 2000) (requiring certain corporate taxpayers to file a tax shelter disclosure statement with their income tax return); Temp. Treas. Reg. 3011.6111-2T (as amended in 2000) (requiring registration of confidential corporate tax shelters).

clients for IRS inspection.<sup>94</sup> Under the regulations, taxpayers should disclose once they engage in a transaction that has attributes typical of abusive tax shelters.<sup>95</sup> Promoters should disclose once they begin promoting tax shelters.<sup>96</sup> The Treasury hopes these temporary regulations will make it easier for the IRS to detect abusive tax shelters.<sup>97</sup> Furthermore, awareness that promoters have to maintain lists should deter corporations from investing in suspect tax schemes.<sup>98</sup>

To make administering these temporary regulations easier, the IRS opened a new central office, designed to improve coordination between IRS officials and corporations.<sup>99</sup> The IRS staffed this office with examiners specializing in recognizing illegal tax shelters.<sup>100</sup> The new IRS office is intended to enhance the government's ability to recognize tax avoidance transactions and improve its response time for attacking corporate tax shelters.<sup>101</sup> Moreover, corporations doubtful about the merits of a contemplated transaction may consult IRS specialists in advance for advice.<sup>102</sup>

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94. See Temp. Treas. Reg. 301.6112-1T (as amended in 2000) (requiring maintenance of lists of investors in potentially abusive tax shelters).

95. See Temp. Treas. Reg. 1.6011-4T(a)-(c). See also John D. McKinnon, *U.S. Sets Tax-Shelter Disclosure Requirements*, Wall St. J., Feb. 29, 2000, at A2 ("Taxpayers will be required to disclose shelters when the underlying transaction involves at least two of six criteria that officials say are typical of tax shelters, including: sheltering of at least \$5 million; fees to the promoter of \$100,000 or more; and use of a "straw man" that doesn't gain any tax benefit.").

96. See Temp. Treas. Reg. 1.6011-4T(d) (2000).

97. See *Corporate Tax Shelter Registration*, 65 Fed. Reg. 11,215, 11,215 (2000) (to be codified at 26 C.F.R. §§ 301, 602) (stating Congress' intent to provide the Treasury with earlier warning of potential violation of Federal tax law).

98. See McKinnon, *supra* note 95, at A2.

99. See John D. McKinnon, *IRS, Reorganizing, to Sharpen Fight Against Abusive Corporate Tax Shelters*, Wall St. J., Feb. 3, 2000, at A4 (reporting that the IRS is establishing a new office "to better coordinate the network of examiners and specialists responsible for uncovering and closing down illegal tax schemes . . .").

100. See *id.*

101. See *id.* (noting that the new office "is expected to develop a sort of field guide to tax shelters for examiners").

102. See *id.* (reporting that the main purpose of the office is to give corporations guidance on "what constitutes an abusive tax shelter").



## II. COMPAQ COMPUTER CORP. V. COMMISSIONER

Compaq's transaction involved ADRs traded on the New York Stock Exchange's floor. Initially, the ADR transaction did not seem unusual because it is quite common; many investors participate in similar transactions daily. The IRS, however, charged that Compaq's transaction was actually a strategy deliberately designed to achieve a specific tax benefit.<sup>103</sup> The Tax Court found that the transaction was solely tax motivated, thus precluding Compaq's claim to a foreign tax credit for withholding taxes paid to the Netherlands on dividends received.<sup>104</sup>

A. Factual Background

In 1992, Compaq incurred a large capital gain when it sold its stock in Conner Peripherals, Inc. ("Connor Peripherals"), a publicly traded, nonaffiliated computer company.<sup>105</sup> The next month, Twenty-First Securities Corporation ("Twenty-First"), an investment firm, approached Compaq and offered a few strategies to take advantage of Compaq's capital gain.<sup>106</sup> A month later, representatives of Compaq and Twenty-First met to discuss the strategies.<sup>107</sup> The day after the meeting, Compaq notified Twenty-First of its decision to engage in an ADR transaction.<sup>108</sup> This particular ADR transaction involved the purchase of ADRs before the dividend record date, *cum dividend*,<sup>109</sup> followed by an immediate resale of the same ADRs *ex dividend*.<sup>110</sup>

Under a prearranged plan, Compaq purchased Royal Dutch

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103. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*13-14 (noting the IRS position that the "ADR transaction had no objective economic consequences or business purpose other than reduction of taxes.").

104. See *id.* at 23-24.

105. See *id.* at \*4.

106. See *id.* at \*4-5.

107. See *id.* at \*6.

108. See *id.* at \*7.

109. See *id.* at \*5. A *cum dividend* is "a purchase or sale of a share of stock or an ADR share with the purchaser entitled to a declared dividend." *Id.*

110. See *id.* An *ex dividend* is "the purchase or sale of stock or an ADR share without the entitlement to a declared dividend." *Id.*

Petroleum ADRs from Arthur Gallagher & Company ("Gallagher") on the floor of the New York Stock Exchange.<sup>111</sup> Compaq then immediately resold the ADRs back to Gallagher.<sup>112</sup> The prices paid were predetermined.<sup>113</sup> Compaq and Gallagher engaged in 23 of these transactions in just slightly over an hour.<sup>114</sup> As a result of the transaction, Compaq became the holder of record when dividends were declared.<sup>115</sup> The dividend caused the market value of the ADRs to fall after the record date. Consequently, Compaq claimed a capital loss that was offset against its previously realized capital gain.<sup>116</sup> The dividends paid were subject to a 15% withholding tax in the Netherlands.<sup>117</sup> Compaq simply received the dividend net of the withholding tax and then claimed a foreign tax credit for the amount withheld.<sup>118</sup>

Compaq's trades were performed as "cross-trades" which traders on the floor could wholly or partially break up by bidding or offering a better price.<sup>119</sup> The Tax Court, however, found that because the cross-trades were valued at the market price, other parties had no incentive to break up the transaction.<sup>120</sup> Compaq had no specific knowledge concerning Royal Dutch,<sup>121</sup> and did not consult a tax advisor before entering into the transactions.<sup>122</sup>

Compaq argued that the transactions had economic substance because a reasonable opportunity for a "pretax profit" existed if the IRS took into account the gross amount of the dividend.<sup>123</sup> If both the foreign tax and the foreign tax credit were excluded from the calculation, Compaq would similarly have earned a pretax profit. Compaq argued that "the reduction in income tax received

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111. *See id.* at \*8-9.

112. *See id.* at \*9.

113. *See id.* at \*8.

114. *See id.* at \*9.

115. *See id.* at \*11.

116. *See id.* at \*12-13.

117. *See id.* at \*12.

118. *See id.* at \*12-13.

119. *See id.* at \*9-10. New York Stock Exchange rules permit certain cross-trade transactions to be broken up by other traders. *See id.*

120. *See id.*

121. *See id.* at \*7.

122. *See id.* at \*28.

123. *Id.* at \*15-18.

by the United States was not the result of a reduction in income tax paid by Compaq.”<sup>124</sup> Compaq also argued that the transaction satisfied its business purpose of short-term investments undertaken to make a profit apart from the tax savings.<sup>125</sup> Additionally, Compaq argued that the economic substance doctrine is not applicable to the foreign tax credit regime.<sup>126</sup> Therefore, Compaq reasoned, the ADR transaction did not warrant judicial scrutiny under the doctrine.<sup>127</sup>

The IRS disagreed with Compaq and used the economic substance and business purpose doctrines to deny Compaq’s use of a foreign tax credit.<sup>128</sup> The IRS disallowed Compaq’s foreign tax credit because it found that the ADR transaction had no objective economic consequences or a business purpose other than to reduce taxes.<sup>129</sup> Accordingly, the IRS determined that Compaq was liable for a 20% penalty on its tax underpayment pursuant to I.R.C. § 6662(a).<sup>130</sup>

The Tax Court ruled in the IRS’s favor, upholding its application of the economic substance and business purpose doctrines.<sup>131</sup> The court summarized its conclusion as follows:

Every aspect of [Compaq’s] ADR transaction was deliberately predetermined and designed by [Compaq] and Twenty-First to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction. [Compaq] had no reasonable possibility of a profit from the ADR transaction without the anticipated Federal income tax consequences.<sup>132</sup>

In addition to disallowing Compaq’s foreign tax credit, the court also upheld the IRS’ application of the 20% accuracy-related

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124. *Id.* at \*17.

125. *See id.* at \*23.

126. *See id.* at \*24.

127. *See id.*

128. *See id.* at \*22–25.

129. *See id.* at \*13.

130. *See id.* at \*26. *See also supra* notes 64–66 (explaining the accuracy-related penalty under IRC § 6662).

131. *See id.* at \*24.

132. *Id.* at 13.

penalty on the grounds of negligence.<sup>133</sup>

B. Tax Court's Use of the Economic Substance Doctrine

The Tax Court first considered whether Compaq's purchase and resale of the ADRs had economic substance.<sup>134</sup> Under this line of analysis, the transaction must have an objective economic consequence or business purpose other than to reduce taxes.<sup>135</sup> The court stated that only transactions with economic substance—compelled or encouraged by business or regulatory realities imbued with tax-independent considerations and not shaped solely by tax-avoidance features—will be respected.<sup>136</sup> It distinguished cases where taxpayers were “closing out a real economic loss in order to minimize taxes or arranging a contemplated business transaction in a tax-advantaged manner” from cases where they “enter[ed] into a prearranged loss transaction designed solely for the reduction of taxes on unrelated income.”<sup>137</sup> It cited *ACM Partnership* as within the latter category.<sup>138</sup>

1. Potential For a Pretax Profit

Having stated the principles underlying the economic substance doctrine, the Tax Court applied those principles to the ADR transaction.<sup>139</sup> When analyzing the fairness of allowing Compaq to take the foreign credit resulting from this ADR transaction, the court focused on the transaction's U.S. tax consequences rather than taking a worldwide perspective.<sup>140</sup>

First, the court reviewed Compaq's arguments claiming that the transaction had economic substance.<sup>141</sup> Compaq tried to justify

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133. See *id.* at \*28.

134. See *id.* at \*3.

135. See *id.* at \*13–14.

136. See *id.* at \*14.

137. *Id.*

138. See *id.* at \*14–15.

139. See *id.* at \*19–24.

140. See *id.* at \*19–20 (using the net dividend received to calculate the pretax profit).

141. See *id.* at \*15–19.

its ADR transaction by stating that it enjoyed neither a tax reduction nor tax benefit from the transaction.<sup>142</sup> Compaq argued that its taxable income increased by approximately \$1.9 million—\$22,546,800 of dividend income less a \$20,652,816 capital loss—due to arbitrage of the Royal Dutch ADRs.<sup>143</sup> Furthermore, Compaq's worldwide tax liability increased by more than \$640,000—its estimated U.S. income tax based on \$1.9 million in income.<sup>144</sup> Compaq argued that this increase in income taxes occurred because Compaq realized a net profit on the transaction.<sup>145</sup> The court countered Compaq's argument, stating that if it followed Compaq's logic, the company would have paid \$4 million in worldwide income taxes on \$1.9 million profit.<sup>146</sup>

Additionally, Compaq asserted that the ADR transaction had economic substance because a reasonable opportunity for pretax profit existed.<sup>147</sup> In response, the court stated that cases using pretax profit refer "to profit independent of tax savings, *i.e.*, economic profit."<sup>148</sup> The court concluded that Compaq "used tax reporting strategies to give the illusion of profit, while simultaneously claiming a tax credit in an amount (nearly \$3.4 million) that far exceeds the U.S. tax (of \$640,000) attributed to the alleged profit, and thus is available to offset tax on unrelated transactions."<sup>149</sup> It determined that Compaq, by reporting the gross

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142. *See id.* at \*16.

143. *See id.*

144. *See id.*

145. *See id.* Compaq calculated its net profit on the ADR transaction as follows:

ADR purchase trades	(\$887,577,129)
ADR sale trades	<u>868,412,129</u>
Net cash from transaction	(\$19,165,000)
Royal Dutch Dividend	22,545,800
<u>Transaction costs</u>	<u>(1,485,685)</u>
PRETAX PROFIT	\$1,895,115

*See id.*

146. *See id.* at \*18 (taking into account Compaq's estimated \$640,000 U.S. income tax and \$3.4 million tax credit).

147. *See id.* at \*18.

148. *Id.*

149. *Id.* at \*18-19. *Compaq* was decided before the enactment of I.R.C. § 904(d), which places limitations on using foreign tax credits used to offset unrelated income. *See I.R.C. § 904(d) as amended by Pub L. No. 106-170, Title*

amount of the dividend when only the net amount was received, fabricated a \$1.9 million profit as a predicate for a \$3.4 million tax credit.<sup>150</sup> Viewing the transaction this way, the economic substance of the transaction was insignificant compared to the tax benefits obtained.<sup>151</sup>

The Tax Court considered the withholding tax in testing the economic substance of the transaction, and demonstrated that Compaq would incur an economic loss from the transaction but for the foreign tax credit.<sup>152</sup> The capital loss from the ADR transaction provided a tax benefit when capital gains existed, and consequently the foreign tax credit had leverage on which to work.<sup>153</sup> The Court concluded that the cash flow deficit arising from the transaction was predetermined and tightly controlled to “capture” a foreign tax credit.<sup>154</sup> Thus, in this sense, Compaq “was acquiring a foreign tax credit, not substantive ownership of Royal Dutch ADR[s].”<sup>155</sup>

## 2. Market Risks

To test whether Compaq’s ADR transaction had business substance, the court considered the extent to which Compaq exposed itself to market risks.<sup>156</sup> After considering the specific facts and circumstances embodied in this ADR transaction, the Court concluded that the transactions were not economically substantial, partly based on its finding that the transaction was devoid of market risks, and thus a tax artifice.<sup>157</sup> Compaq argued that economic risks were associated with the ADR transaction.<sup>158</sup> The Court found, however, that the ADR transaction, as designed,

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V, § 501, Dec. 17, 1999, 113 Stat. 1860.

150. *See id.* at \*19.

151. *See id.* (comparing the \$3.4 million tax credit to Compaq’s alleged \$1.9 million profit). Notably, Compaq indirectly paid the withholding tax when it received the dividend net of the withheld tax.

152. *See id.* at \*19–20.

153. *See id.* at \*21 (stating that the loss was prearranged to take advantage of a foreign tax credit).

154. *See id.* at \*20–21.

155. *Id.* at \*21.

156. *See id.* at \*21–22.

157. *See id.*

158. *See id.* at \*21.

could only result in a capital loss for Compaq.<sup>159</sup>

In reaching its conclusion, the Court emphasized the circumstances surrounding the ADR transaction.<sup>160</sup> It pointed out that none of Compaq's representatives conducted an analysis or investigation of the economic risks Compaq claimed surrounded the transaction.<sup>161</sup> The facts showed that the purchase and resale prices were predetermined by Twenty-First (the investment firm), and that the floor brokers did not have the authority to deviate from the predetermined prices even if price changes occurred, and "there was virtually no risk of price fluctuation."<sup>162</sup> The parties used special next-day settlement terms and traded large blocks of ADRs to minimize the risk that third parties would break up the cross-trades.<sup>163</sup> Moreover, because the cross-trades were at market price, the risk that other traders might break up the trades was eliminated.<sup>164</sup> Consequently, "[n]one of the outgoing cash-flow resulted from risks."<sup>165</sup> Accordingly, the Court concluded that the transaction was predetermined and deliberately designed by Compaq and Twenty-First to yield a specific result.<sup>166</sup> This analysis is consistent with the other decisions applying the economic substance in focusing on transactions that limit the economic consequences to the taxpayer while preserving the taxpayer's purported tax benefits.<sup>167</sup>

### 3. I.R.C. § 901(k) as a Counter to the Economic Substance Doctrine

Compaq argued that the economic substance doctrine was inapplicable to the ADR transaction because the foreign tax credit

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159. See *id.* at \*21–22 (stating that tax-motivated trading patterns generally indicate a lack of economic substance).

160. See *id.* at \*22.

161. See *id.* at \*21.

162. *Id.* at \*22.

163. See *id.*

164. See *id.*

165. *Id.*

166. See *id.*

167. See *supra* notes 31–53 (discussing the economic substance doctrine as applied in *Goldstein v. Commissioner*, 364 F.2d 734 (1966), *Sheldon v. Commissioner*, 94 T.C. 738 (1990), and *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert denied*, 526 U.S. 1017 (1999)).

regime set forth Congress' intent regarding allowable foreign tax credits.<sup>168</sup> Compaq maintained that Congress intended by its enactment of I.R.C. § 901(k)<sup>169</sup> to prevent only those foreign tax credits that failed to meet its requirements, and preclude application of an "additional economic substance requirement."<sup>170</sup> Compaq asserted that the effect of Congress' action was to bar the use of the economic substance doctrine in factual circumstances such as those at issue in the case.<sup>171</sup>

The court examined the background of the foreign tax credit, noting that its purpose was to prevent double taxation and to facilitate international transactions.<sup>172</sup> Relying on its finding that no *bona fide* business purpose arose in this case, the court reasoned that Congress did not intend to encourage or permit a transaction that was "merely a manipulation of the foreign tax credit to achieve U.S. tax savings."<sup>173</sup>

Moreover, the Court held that I.R.C. § 901(k) had no effect on its conclusion because it was enacted five years after the transaction at issue.<sup>174</sup> To support this finding, the court relied on a Senate Finance Committee report indicating that "[n]o inference [was] intended as to the treatment under present law of tax-motivated transactions intended to transfer foreign tax credit benefits."<sup>175</sup>

### C. Business Purpose Doctrine

Compaq stated that it entered into the ADR transaction for the business purpose of making a profit on a short-term investment in addition to the tax savings.<sup>176</sup> According to the Tax Court, the

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168. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*24.

169. I.R.C. § 901(k). This statute was enacted as part of the Taxpayer Relief Act of 1997. Pub. L. No. 105-34, Title X, § 1053(a), 111 Stat. 941.

170. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*25.

171. See *id.*

172. See *id.* at \*24-26.

173. *Id.*

174. See *id.* at \*26.

175. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*25 (quoting S. Rep. No. 105-33, at 177 (1997)).

176. See *id.* at \*23.



business purpose requirement of the economic substance inquiry requires that the transaction be rationally related to a plausible nontax economic benefit.<sup>177</sup> This inquiry required the court to consider whether Compaq conducted itself in a “realistic and legitimate business fashion,” analyzing the ADR transaction’s viability at the moment Compaq decided to proceed with it.<sup>178</sup>

The Court found that the undisputed facts undermined Compaq’s business purpose argument.<sup>179</sup> The Court pointed out that Twenty-First marketed the ADR to Compaq as a device to partially shield the capital gain it realized on its sale of Conner Peripherals stock.<sup>180</sup> In addition, the Court found that Compaq’s evaluation of the ADR transaction was “less than businesslike,” involving minimal investigation and analysis into the proposed investment relative to its scale.<sup>181</sup> On the basis of Compaq’s conduct in contemplating the transaction, the Tax Court concluded that Compaq “had no business purpose for the purchase and sale of Royal Dutch ADRs apart from obtaining a Federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain.”<sup>182</sup>

#### D. Application of the Accuracy-Related Penalty

After concluding that the ADR transaction was tax-motivated, the Court examined whether the accuracy-related penalty pursuant to I.R.C. § 6662(a) was properly applied.<sup>183</sup> The IRS had imposed the penalty because Compaq “negligently disregarded the economic substance of the ADR transaction . . . .”<sup>184</sup> Compaq had

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177. See *id.* at \*22 (citing *ACM Partnership I*).

178. See *id.* at \*23.

179. See *id.* at \*23–24.

180. See *id.* at \*23.

181. *Id.* (noting that the agent who entered into the ADR transaction on Compaq’s behalf, although “a well-educated, experienced, and financially sophisticated businessman,” chose to commit Compaq to a multimillion-dollar transaction based solely on “one meeting with Twenty-First and his call to a Twenty-First reference.”). *Id.*

182. *Id.* at \*13.

183. See *id.* at \*26–29.

184. *Id.* at \*27.

the burden of proving that the IRS's determination was erroneous.<sup>185</sup> To meet this burden, Compaq was required to show that it acted "with reasonable cause and in good faith" under the relevant facts and circumstances.<sup>186</sup> Thus, the key question was Compaq's reasonableness in deciding it was entitled to the foreign tax credits at issue.<sup>187</sup> Compaq argued that its return position was reasonable since the economic substance doctrine as applied to the ADR transaction is "inherently imprecise," and use of the economic substance doctrine to disallow a foreign tax credit raised an issue of first impression.<sup>188</sup>

The Court concluded that Compaq was liable for the accuracy-related penalty because Compaq, employing sophisticated professionals with investment experience, should have been alerted to the questionable economic nature of the ADR transaction.<sup>189</sup> These professionals failed to investigate the basic details of the transaction, such as "the corporation Compaq was investing in, the parties Compaq was doing business with, or even the cash-flow implications of the transaction."<sup>190</sup> Additionally, Compaq did not offer evidence that it satisfied the "reasonable and ordinarily prudent person" standard, or that it even relied on the advice of its tax department or counsel.<sup>191</sup> No communications were submitted into evidence to show that Compaq considered the validity of the tax return position when the return was prepared and filed.<sup>192</sup> Accordingly, the Court determined that Compaq failed to carry its burden of showing the existence of reasonable cause or good faith in taking the position that it was entitled to a foreign tax credit.<sup>193</sup>

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185. See *id.* at \*26-27 (citations omitted).

186. See *id.* at \*27 (citing I.R.C. § 6664(c)(1) (1994)).

187. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*27. The most important factor in this inquiry is the extent of the taxpayer's effort to assess the proper tax liability for the year. See *id.*; see also Treas. Reg. § 1.6664-4(b)(1) (as amended in 1998).

188. See *Id.* at \*28.

189. See *id.* (stating that the sophisticated executives, evaluating the transaction, "failed to take even the most rudimentary steps to investigate the *bona fide* economic aspects of the ADR transaction.").

190. See *Id.*

191. See *Id.*

192. See *id.* at \*28-29.

193. See *id.* at \*29 (finding that Compaq was negligent).

## III. IMPLICATIONS OF COMPAQ ON THE TREASURY PROPOSAL

*Compaq* was decided approximately two months after the July 1, 1999 release of the Treasury report addressing the problem of corporate tax shelters, in which it proposed that Congress change the "substantive law to disallow the use of tax benefits generated by a corporate tax shelter."<sup>194</sup> The Treasury proposed that Congress codify the economic substance doctrine to provide corporations with clearer guidance on how to analyze market transactions.<sup>195</sup> *Compaq* provides a useful and timely insight into how the economic substance and business purpose doctrines would be applied if codified by Congress. For example, the court in *Compaq* focused on the ADR transaction's lack of pretax profit, which was also emphasized by the Treasury in its proposed definition of "tax avoidance transaction."<sup>196</sup> The Report also stated that the definition of "corporate tax shelter" must test the taxpayer's expected tax benefits and the expected economic consequences from the transaction.<sup>197</sup> The Treasury suggested that codifying these common law doctrines would give taxpayers useful principles to evaluate the propriety of corporate tax shelter transactions.<sup>198</sup>

As discussed below, the main challenge has been to find a way to forewarn corporations of the specific characteristics of questionable transactions, without inhibiting legitimate transactions. Weaknesses in *Compaq*'s opinion, stemming from the Tax Court's use of the economic substance and business purpose doctrines, shed light on the soundness of the Treasury's

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194. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 22.

195. See *id.*

196. See *supra* Part II.B.1. (discussing the *Compaq* Court's analysis of the ADR transaction's pre-tax profit); *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 264 (defining a tax avoidance transaction as one in which "the reasonably expected pre-tax profit . . . is insignificant relative to the reasonably expected net tax benefits.").

197. See *id.* at para. 282.

198. See *id.* at para. 279-80 (noting that taxpayers have tended to disregard the doctrines by distinguishing the facts of their own transactions from those facts governing current case law). The Report queries, "[W]hat good is a significant understatement penalty if there is not understatement?" *Id.*

strategy to use a codified definition of “tax avoidance” to effectively combat tax shelters. Attacks against corporate tax shelters have primarily been hindered by (1) an inability to define what factors constitute a lack of economic substance, and (2) an inability to apply these factors to fact-specific transactions. Critics against codifying these common law doctrines, focusing mainly on the vagueness of most proposed definitions, illustrate how difficult it is to define what constitutes a “tax avoidance” transaction.<sup>159</sup> *Compaq* helps evaluate the strengths and weaknesses of the Treasury’s proposed statutory amendment.

### A. Calculating a Transaction’s Economic Substance

#### 1. Adopting the ACM Partnership Analysis

*Compaq* illustrates the principle that a transaction motivated solely by tax avoidance and lacking a nontax business purpose will not stand in court.<sup>200</sup> In *Compaq*, the Tax Court employed an economic and legal analysis akin to the one undertaken in the *ACM Partnership* case.<sup>201</sup> In each case, the Court denied the corporation the purported tax benefits of the transaction. This occurred even though the facts suggest that *Compaq* undertook a more apparent tax shelter than *ACM Partnership* did.<sup>202</sup>

*Compaq*’s fate was sealed once the Court adopted the Third Circuit’s analysis of the economic substance and business purpose doctrines outlined in *ACM Partnership*.<sup>203</sup> In line with this analysis,

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199. See *id.* at para. 275 (noting that the Administration’s proposal to grant the Secretary the authority to disallow certain tax benefits derived from tax avoidance transactions has been widely criticized).

200. See *supra* Parts II.A.–B. (reviewing the *Compaq* court’s application of the economic substance doctrine).

201. See *supra* notes 46–53 and accompanying text (describing the development of the economic substance doctrine in the *ACM* case).

202. See *supra* notes 180–182 and accompanying text (describing the *Compaq* ADR transaction as motivated solely by the expectation of tax benefit and devoid of any other business purpose).

203. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*22 (citing *ACM Partnership I* in adopting the economic substance and business purpose doctrines).

the *Compaq* court compared the tax benefit from the transaction to the alleged amount of economic profit that would be derived from the ADR transaction, finding that Compaq had no opportunity to earn a nontax economic profit on the purchase and sale of the ADR transaction.<sup>204</sup> Compaq's claimed \$3.4 million foreign tax credit, however, far exceeded Compaq's declared U.S. income tax of \$640,000 assessable on the transaction.<sup>205</sup> Thus, the court concluded that Compaq fabricated a \$1.9 million profit as a predicate for a \$3.4 million tax credit.<sup>206</sup> Interestingly, the Court did not give any weight to the fact that the \$3.4 million tax had actually been indirectly paid by Compaq, that is, paid by Royal Dutch on behalf of Compaq.<sup>207</sup> Rather, it focused on the strategy used by Compaq to acquire a foreign tax credit—tax savings beneficial to Compaq in the United States.<sup>208</sup>

## 2. Lack of Economic Risks

The Court also focused on the lack of any market risks surrounding the transaction that would give the ADR transaction economic substance.<sup>209</sup> Seeking to offset its large capital gain, Compaq specifically engaged in an ADR transaction lacking market risks and structured it to guarantee a capital loss generating the benefit of a foreign tax credit.<sup>210</sup> Consequently, the transaction was a tax artifice because it did not involve any market risks.<sup>211</sup>

Unfortunately, the Court did not define how much economic risk is needed before a transaction is respected for tax purposes. For instance, would the Court have reached a different conclusion if the prices of the cross-trades were priced off market rather than

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204. *See id.* at \*18-19.

205. *See id.* at \*19.

206. *See supra* notes 148-51.

207. *See Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*19. The Court makes no reference to the effect of the \$3.4 million withholding tax. *See id.*

208. *See supra* notes 153-55 (discussing the court's finding that the ADR transaction was predetermined to yield a specific result for tax savings).

209. *See supra* Part II.C.2. (discussing the *Compaq* court's analysis of market risks in the ADR transaction).

210. *See id.*

211. *See id.*

at market price?<sup>212</sup> If Compaq held the Royal Dutch ADRs for a longer period of time while still gaining a foreign tax credit, would the Court then have viewed Compaq as acquiring substantive ownership?<sup>213</sup> The Court's analysis of the ADR transaction was very fact-oriented. No bright line was given to mark the degree of economic risk needed for an ADR transaction to withstand scrutiny under the economic substance doctrine.<sup>214</sup>

### B. Uncovering a Transaction's Business Purpose

#### 1. Lack of Investigation

After completing the economic substance inquiry, the court examined whether the ADR transaction was rationally related to, and plausible in light of, Compaq's stated short-term investment business plan.<sup>215</sup> Again, the court focused on the objective facts of the ADR transaction to conclude that Compaq's conduct in choosing the transaction was inconsistent with a legitimate investment strategy.<sup>216</sup> The court inferred by Compaq's lack of investigation under the circumstances that the transaction was motivated solely by the tax benefits and no other business purpose existed.<sup>217</sup>

The court's business purpose analysis focused on whether Compaq thoroughly considered the ramifications of the ADR

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212. See *supra* note 164 and accompanying text (noting the pricing of the cross-trades at issue in *Compaq* and its significance to the case).

213. See *supra* notes 111–14 and accompanying text (reviewing the fact that Compaq bought and resold the Royal Dutch ADRs within the space of an hour). See also *supra* notes 154–55 and accompanying text (quoting the *Compaq* court's opinion that Compaq sought to acquire a foreign tax credit rather than substantive ownership of the stock).

214. *Id.* at \*23 (stating that the objective facts belie Compaq's assertion of a business purpose). The court concluded that Compaq was motivated by the expected tax benefits of the ADR transaction, without explicitly stating what facts would have allowed the transaction to withstand judicial scrutiny. *Id.* at \*24.

215. See *supra* Part II.C. (discussing the *Compaq* court's application of the business purpose doctrine).

216. *Id.*

217. *Id.*

transaction.<sup>218</sup> Unfortunately, the Court did not define how much investigation is needed before a corporation can safely engage in a transaction.<sup>219</sup> For example, in “day trading,” investments in stocks are usually not preceded by an investigation of the underlying corporation. How much investigation is required for a taxpayer to claim tax benefits from market trading? Or was the fact that Compaq used the stock exchange to engage in a “predetermined strategy” the basis for the court’s conclusion?<sup>220</sup>

## 2. Marketing Transactions

The *Compaq* court strongly emphasized the fact that Twenty-First (the investment firm) marketed the ADR transaction to Compaq “for the purpose of partially shielding a capital gain” previously realized by Compaq.<sup>221</sup> The letter soliciting Compaq’s business stated that Twenty-First had “uncovered a number of strategies that take advantage of a capital gain.”<sup>222</sup> In addition, the ADR transaction was predetermined and controlled by Twenty-First to generate the tax benefits for Compaq, while the transaction fee was nearly \$1 million.<sup>223</sup> Again, Compaq’s alleged pretax economic profit was only \$1.9 million.<sup>224</sup> In the Court’s opinion, this supported the conclusion that no true investment motive for engaging in the ADR transaction existed.<sup>225</sup>

The frequent appearance of letters similar to the one Twenty-First sent to Compaq evidence a thriving industry of marketing corporate tax shelters.<sup>226</sup> Corporations are motivated solely by the

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218. See *id.* at \*23.

219. See *id.* The Court found Compaq’s evaluation of the ADR transaction “less than businesslike,” yet it provided no examples to clarify what are legitimate, “businesslike” transactions. See *id.*

220. See *id.* \*20–21 (stating that the ADR transaction was “predetermined” and tightly controlled to “capture” a foreign tax credit).

221. *Id.* at \*23.

222. *Id.* at \*5.

223. See *id.* at \*13.

224. See *id.* at \*11, 16.

225. See *id.* at \*23–24. (concluding that the record indicated that Compaq was motivated by the tax benefits).

226. See Novack & Saunders, *supra* note 1 at 198 (discussing similar letters sent by an accounting firm to corporations).

tax benefits these transactions promise to generate.<sup>227</sup> While most corporations rely on advisers to help minimize their taxes, schemes shaped solely by tax avoidance form a different *genre*, a development which has not gone unnoticed by the courts.<sup>228</sup> These schemes are often pitched as “products” to corporations facing pressure to lower their effective tax rates, and have little if any economic justification apart from tax savings.<sup>229</sup> In *Compaq*, Twenty-First’s role in implementing the ADR transaction strategy was a strong indicator to the court that the transaction was solely motivated by tax considerations.<sup>230</sup>

Corporations should be wary of transactions marketed as tax saving ideas because the IRS is likely to take that fact into account in determining their viability. Furthermore, a penalty for engaging in these transactions may be assessed on the grounds that they are not reasonably valid under the law.<sup>231</sup> Before engaging in market transactions, a corporation should at least consult with legal counsel.<sup>232</sup> However, legal advice does not guarantee protection; corporations can still be denied tax benefits even when they have obtained legal advice.<sup>233</sup>

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227. See *id.* (quoting a tax executive stating that companies “are taking provisions in the code intended to serve a normal, useful purpose and exploiting them in a manner that has no economic justification except tax savings.”).

228. See *id.* at \*14 (stressing the difference between “(1) closing out a real economic loss in order to minimize taxes or arranging a contemplated business transaction in a tax-advantaged manner and (2) entering into a prearranged loss transaction designed solely for the reduction of taxes on unrelated income.”).

229. See, e.g., Novack & Saunders, *supra* note 1, at 203 (discussing the marketing of products that utilize “special and unique strategies . . . [that] can save a client . . . hundreds of millions in tax”). These transactions superficially follow all tax code provisions but are not meant to have any economic justification besides tax savings. *Id.* at 206.

230. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*24 (noting that Twenty-First marketed the ADR transaction as a tax shelter in holding that Compaq was motivated by tax benefits rather than an investment purpose).

231. See *id.* at \*29 (concluding that Compaq was negligent in claiming the foreign tax credit and upholding the accuracy-related penalty under I.R.C. § 6662).

232. See *id.* at \*28 (considering lack of reliance on counsel in its determination of Compaq’s “negligen[t] disregard [of] the economic substance of the ADR transaction . . .”).

233. See, e.g., *ACM Partnership I*, 73 T.C.M. (CCH) 2189-90, 2199 (holding



C. Avoiding the Accuracy-Related Penalty

A taxpayer engaging in a transaction lacking economic substance and a business purpose may have to pay an accuracy-related penalty under I.R.C. § 6662.<sup>234</sup> The *Compaq* court upheld the penalty in part because Compaq's sophisticated executives failed to take "even the most rudimentary steps to investigate the bona fide economic aspects of the ADR transaction."<sup>235</sup> In addition, Compaq did not offer evidence that it satisfied the "reasonable and ordinarily prudent person" standard required under § 6662, or that it relied on the advice of its tax department or other counsel.<sup>236</sup> Compaq also failed to investigate the details of the ADR transaction or its cash flow implications, procedures regularly employed by Compaq's treasury department.<sup>237</sup>

How much of an investigation would prevent the imposition of the penalty? Would Compaq have escaped the penalty if a cash flow had been prepared with the same consequence?<sup>238</sup> Or was its tax position inherently unreasonable, thus warranting imposition of the penalty?<sup>239</sup> The Court's opinion seems to suggest that Compaq could have avoided the 20% penalty if it had sought legal advice regarding the ADR transaction.<sup>240</sup> Perhaps the Court believed that, if notified, Compaq's tax department or tax counsel

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that the ADR transaction lacked economic substance even though the parties consulted with legal counsel).

234. See *supra* notes 64-66 and accompanying text (describing the accuracy-related penalty).

235. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*28; see *supra* Part II.D. (discussing the court's application of the accuracy-related penalty).

236. See *supra* notes 183-93 and accompanying text (reviewing the court's findings on the issue of negligence).

237. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*7 (stating the finding of fact that "cash-flow was generally important to petitioner's investment decisions . . .").

238. See *id.* at \*28 (noting Compaq's failure to take "the most rudimentary steps to investigate the bona fide economic aspects of the ADR transaction" as evidence of its negligence).

239. See *id.* at \*28 (holding that there was no reasonable cause for Compaq's return position for the ADR transaction).

240. See *id.* ("Petitioner offered no evidence that it satisfied the 'reasonable and ordinarily prudent person' standard or relied on the advice of its tax department or counsel.").

would have policed the use of corporate tax shelters by rendering an unfavorable opinion of the ADR transaction.

Before obtaining legal advice, a corporation may be deterred from engaging in a seemingly legitimate transaction, fearing the consequences if the IRS invalidates the transaction. When the IRS discovers tax shelters that follow the letter of the law, however, they are unlikely to impose penalties.<sup>241</sup> For this reason, shelter promoters try to obtain legal opinions validating the legitimacy of their products.<sup>242</sup> Presumably, this protects corporations from penalties should a transaction fall apart. It has been suggested that shelter promoters can easily obtain favorable opinions from outside tax counsel, albeit for sizable fees.<sup>243</sup>

#### D. Conflicting Statutory Law

The economic substance and business purpose doctrines may conflict with statutory laws that address abusive transactions. A corporation may engage in a transaction that seems legitimate and follows all statutory requirements, yet have its transaction invalidated due to an inequity perceived by a reviewing authority. Because there are no specific guidelines or tests explaining these common law doctrines, corporations are uncertain whether these doctrines will be applied to particular transactions.

##### 1. I.R.C. § 901(k)

There is concern that the IRS will invalidate transactions that meet the literal requirements of the tax code. A question arose in

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241. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 240 (“[M]any commentators note that the substantial underpayment penalty is not an effective method to address current corporate tax shelter activity because the reasonable cause exception . . . has become an almost fool-proof escape hatch from the penalty regime.”).

242. See Novack & Saunders, *supra* note 1, at 199 (reporting that some prestigious law firms “are raking in huge fees writing opinions to justify [tax shelters].”).

243. See *id.* at 202 (“Because the [economic substance] doctrine is so fuzzy and most deals arguably follow the letter of the law, shelter promoters can easily obtain legal opinions asserting that these products are likely to work.”).

*Compaq* regarding whether the Court could invalidate a transaction that met the requirements of I.R.C. § 901(k), which sets forth the minimum time period during which a taxpayer must be exposed to the risk of market fluctuations before becoming entitled to a foreign tax credit.<sup>244</sup> *Compaq* essentially argued that a taxpayer should be able to obtain the benefit of a foreign tax credit if he or she meets the statutory requirements.<sup>245</sup> Yet, many tax shelters follow the tax code's technical requirements, structuring transactions to generate benefits while lacking market risk.<sup>246</sup>

Corporate taxpayers may seek to structure transactions to meet the literal requirements of I.R.C. § 901(k) to limit their market exposure. For example, a corporation may enter transactions hedging against currency and general market risk through options, "which generally move in a similar pattern to the target security if the currency and market risks are factored out," and can be used to hedge most of the remaining risk.<sup>247</sup> However, hedges add transaction costs that will likely invoke scrutiny under the economic substance doctrine, even if they are not labeled as an interest in substantially similar or related property.<sup>248</sup>

The IRS generally combats these schemes by invoking the economic substance and business purpose doctrines as defined in *Gregory v. Helvering*<sup>249</sup> and its progeny.<sup>250</sup> A court would most likely void a hedging transaction as described above that meets the literal requirements of I.R.C. § 901(k) but has no economic justification except for tax savings. The court in *Compaq* found that § 901 (k) was not intended to preclude application of then-

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244. See *supra* notes 59–63 and accompanying text (outlining the provisions of I.R.C. § 901(k)).

245. See *supra* notes 168–71 and accompanying text.

246. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 276 ("Many, if not most, current corporate tax shelters 'might work' under the applicable objective mechanical rules of the Code, but 'shouldn't work' under" principles of common law or tax policy).; Novack & Saunders, *supra* note 1, at 202 ("[M]ost deals arguably follow the letter of the law . . .").

247. See Burgess J.W. Raby & William L. Raby, *Economic Substance Needed for Foreign Tax Credit*, reprinted in 1999 Tax Notes Today 194-28 (Oct. 7, 1999) (LEXIS, FEDTAX library, TNT file), at para. 21.

248. See *id.*

249. 293 U.S. 465 (1935).

250. See *supra* Part I.A.–B.

existing legal doctrines to transactions involving foreign tax credits.<sup>251</sup> Consequently, transactions passing the requirements of I.R.C. § 901(k) must also survive judicial scrutiny under the economic substance doctrine. Even when a corporation complies with statutes targeting specific tax abuses, it needs further assurance that the transaction has economic substance.

## 2. I.R.S. Notice 98-5

The Tax Court's opinion in *Compaq* is consistent with the position the IRS took in Notice 98-5,<sup>252</sup> which targets foreign tax credit transactions in which the expected economic profit is slight small compared to the value of the credit.<sup>253</sup> The court described Compaq's "fictional" economic profit of \$1.9 million on the ADR transaction as a "predicate for a \$3.4 million tax credit," echoing the comparison approach of Notice 98-5.<sup>254</sup> Furthermore, the court's statement that the foreign tax credit regime is meant to "prevent double taxation and facilitate [bona fide] international business transactions"<sup>255</sup> enunciates the central theme of Notice 98-5: that it is meant to relieve unfair tax consequences of investing abroad rather than provide a tax incentive for such activity.<sup>256</sup> Finally, it follows Notice 98-5's general approach in not precluding the application of other law, such as common law doctrines, to corporate tax shelters exploiting foreign tax credits.<sup>257</sup>

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251. See *supra* notes 174-75 (discussing the court's reliance on a Senate report stating that "no inference [was] intended" in respect to the application of other law to foreign tax credit transactions).

252. I.R.S. Notice 98-5, 1998-1 C.B. 334, reprinted in *IRS Targets Abusive Foreign Tax Credit Schemes*, 97 Tax Notes Today 247-3 (Dec. 24, 1997) (LEXIS, FEDTAX Library, TNT File).

253. See *supra* Part I.D.

254. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*19.

255. *Id.* at \*24.

256. See I.R.S. Notice 98-5, *supra* note 252, at para. 4, 7 ("[T]he foreign tax credit was enacted to preserve neutrality between U.S. and foreign investment by providing relief from double taxation . . . . No statutory purpose is served by permitting credits for taxes generated in abusive transactions designed to reduce residual U.S. tax on low-taxed foreign-source income.").

257. See *id.* at para. 30 (declaring that the regulations to be issued "will not limit the application of other principles of existing law to determine the proper

The difficulty with this approach is that it eschews any sort of clear test to help corporations decide whether they should proceed with foreign investments that will consequently generate foreign tax credits. Applying the economic substance doctrine to transactions which yield foreign tax credits ignores the technical approach already present in the Code. Specifically, it ignores the fact that under the existing I.R.C. § 904(d) basket limitations, U.S. corporations have already been forced to accumulate unused foreign tax credits.<sup>258</sup>

While *Compaq* suggests that obtaining advice for tax counsel may prevent imposition of the accuracy-related penalty in a transaction that comes under attack,<sup>259</sup> it does not assure that the tax benefits will not be denied by the IRS.<sup>260</sup> The potential reversal of tax credits may deter some U.S. corporations from engaging in legitimate foreign investments. To achieve the foreign tax credit's intended purpose, a proposed solution to corporate tax avoidance must ameliorate this problem and address the current situation of companies paying foreign taxes that are of no benefit to them.<sup>261</sup>

### 3. Tax Treaties

The *Compaq* opinion did not discuss the tax credit provisions of the U.S.-Netherlands income tax treaty<sup>262</sup> in effect for 1992.<sup>263</sup>

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tax consequences of the structures or transactions addressed in the regulations.”)

258. See Raby & Raby, *supra* note 247, at para. 24 (commenting that those who favor the approach of Notice 98-5 “conveniently ignore the highly technical approach to [foreign tax credits] that has created the situation where U.S. corporations have huge amounts of unused [credits].”).

259. *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*28 (finding that *Compaq*’s conduct was negligent in part because there was no evidence that it relied on the advice of its tax counsel).

260. See *ACM Partnership I*, 73 T.C.M. (CCH) 2189-90, 2199 (denying tax benefits of the subject transaction even though the taxpayer consulted with legal counsel).

261. See Raby & Raby, *supra* note 247, at para. 24.

262. Convention Between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, Apr. 29, 1948, U.S.-Neth., 62 Stat. 1757, *amended by* United States-Netherlands Supplementary Income Tax Convention, Dec. 30, 1965, U.S.-Neth., T.I.A.S. No. 6051, *repealed by* Convention Between the United States and the Kingdom of the

Article XIX, paragraph (2) of that treaty provides:

The United States shall allow to a citizen, resident or corporation of the United States as a credit against its [U.S. Federal income tax] the appropriate amount of taxes paid to the Netherlands. Such appropriate amount shall be based upon the amount of tax paid to the Netherlands on income from sources within the Netherlands but shall not exceed that portion of the United States tax which taxable income from sources within the Netherlands bears to the entire taxable income.<sup>264</sup>

Compaq could have plausibly argued that these provisions allowed it to take a credit for the withholding tax, regardless of whether the foreign tax credit was available under U.S. law.

That argument, however, is vulnerable to attack under the "congressional intent" rationale the *Compaq* court used to justify applying the economic substance doctrine despite I.R.C. § 901(k).<sup>265</sup> The U.S.-Netherlands Treaty was originally designed to facilitate international trade and investment by lessening tax barriers that inhibit the international flow of goods and services.<sup>266</sup> Given the

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Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992, U.S.-Neth., S. Treaty Doc. No. 103-6 (1992), *amended by* Protocol Amending the Convention Between the United States and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Oct. 13, 1993, U.S.-Neth., S. Treaty Doc. No. 103-19 (1993) [hereinafter U.S.-Netherlands Treaty].

263. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*12 (mentioning only the withholding tax provision in the treaty).

264. U.S.-Netherlands Treaty, *supra* note 262, art. XIX, para. 2, 62 Stat. at 1761.

265. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*24. The Court looked at the history and purpose of the foreign tax credit. It concluded that the foreign tax credit does not apply to a taxpayer manipulating the Code solely to avoid paying U.S. taxes. *Id.*

266. See William J. Clinton, *Tax Convention with the Netherlands: Letter of Transmittal*, May 12, 1993, 1993 WL 761650, \*1 (transmitting for the advice and consent of the Senate to ratification the Convention Between the United States and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on Dec. 18, 1992).

specific facts in *Compaq*, the court probably would have found that denying a credit for the withholding tax would not hamper international trade since its ADR purchase and resale trades all occurred within one hour, for no business purpose beyond gaining a tax benefit on U.S. taxable income.<sup>267</sup> The *Compaq* court might take the position that the income tax treaty, like § 901(k), was not designed to insulate “sham” transactions, and disallow the foreign tax credit accordingly, despite the fact that the Netherlands tax was actually paid.<sup>268</sup>

Compaq could have raised a policy argument based on the U.S.-Netherlands Treaty to justify its foreign tax credit. The Executive Branch of the United States, in its power to conduct foreign relations, has the exclusive authority to negotiate treaties.<sup>269</sup> These treaties have the same force as federal law,<sup>270</sup> and in the case of a conflict with statutory law, the one adopted later in time prevails.<sup>271</sup> Individual states are not relieved of U.S. treaty obligations, and failure to comply with a treaty results in a violation of international law.<sup>272</sup> Even if done unwittingly, breaching or acting against a treaty may terminate or partially terminate the treaty.<sup>273</sup>

The Compaq court's decision is therefore controversial because it denied a benefit provided for in an income tax treaty. The court surely weighed the implications of denying a credit based on taxes actually indirectly paid to the Netherlands government. Aside from the general constitutional and international law implications, I.R.C. § 7852(d) states that neither a

267. See *Compaq*, 1999 U.S. Tax Ct. LEXIS 44, at \*24 (concluding that there was no bona fide business purpose implicated by the ADR transaction).

268. Cf. *id.* (declining to limit application of the economic substance doctrine on the basis that it was not Congress' intent in enacting I.R.C. § 901(k) to allow non-bona fide transactions that manipulate the foreign tax credit regime).

269. See U.S. Const., art. II, § 2, cl. 2; Restatement (Third) of Foreign Relations Law of the U.S. § 302 cmt. d. (1986) [hereinafter Restatement].

270. See Restatement, *supra* note 269, § 115 cmt. a.

271. *See id.* § 115.

272. See *id.* § 207; Vienna Convention on the Law of Treaties, May 23, 1969, art. XXVII.

273. See Restatement, *supra* note 269, § 321 cmt. b.

treaty provision nor a tax provision has preferential status.<sup>274</sup> Moreover, I.R.C. § 894(a) provides that Code provisions should be applied "with due regard to any treaty obligation of the United States."<sup>275</sup> On the other hand, the U.S. policy position is that tax treaties should not restrict the scope of worldwide income taxation in the state of residence any more than is necessary to avoid international double taxation.<sup>276</sup> It is unclear whether the IRS's accuracy-related penalty would have been upheld if Compaq had claimed that it relied on the income tax treaty before taking a foreign tax credit.<sup>277</sup> Given the facts in *Compaq*, the Court probably would have denied the foreign tax credit regardless of whether Compaq claimed reliance on the U.S.-Netherlands Treaty, since the credit was intentionally generated to serve as a shelter for U.S. taxes.<sup>278</sup>

#### CONCLUSION

The Tax Court's analysis in *Compaq* embodied many of the policies the Treasury Department put forth in its proposal. The major parallel was its analysis of the lack of economic substance of the ADR transaction engaged in by Compaq, but within that the court's focus on the presence of promotion or marketing efforts, as well as high transaction costs, is particularly noteworthy. One can expect these principles to become reinforced by codification of the economic substance doctrine.

If *Compaq* is an indication of things to come, it is a useful demonstration of weaknesses in the Treasury's proposed new

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274. I.R.C. § 7852(d) (1994).

275. I.R.C. § 894(a) (1994 & Supp. IV 1998).

276. See, e.g., Warren Christopher, *Tax Convention with the Netherlands: Letter of Submittal*, April 23, 1993, 1993 WL 761650, \*1-3 (submitting to the Senate the Convention Between the United States and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on Dec. 18, 1992).

277. See *supra* notes 191-92 (reviewing the *Compaq* court's finding that no evidence was offered to carry Compaq's burden of proof that its return position was reasonable and in good faith).

278. 1999 U.S. Tax Ct. LEXIS 44, at \*24 (stating that Compaq manipulated the foreign tax credit to achieve U.S. tax savings).



approach. The major problem with the economic substance doctrine is that its application is intensely fact-driven, and does not establish clear guidelines for appropriate behavior. In particular, the economic substance doctrine by itself indicate what kinds of profit and loss are relevant to the analysis. For example, in *Compaq*, the Netherlands tax of \$3.4 million withheld on Compaq's ADR dividend was reasonably viewed as a predicate to a U.S. foreign tax credit, although it was also an actual transaction cost. It remains unclear, however, what kind of transaction costs should be characterized as investment losses rather than justifications for tax benefits. Similarly, the complete lack of market risks in the ADR transaction was obvious from its facts, but *Compaq* leaves unanswered what degree of risk the economic substance doctrine demands. On the other hand, *Compaq* did ensure that facts indicating the presence of promotion and marketing efforts of a suspect transaction will remain highly relevant to whether it satisfies the business purpose requirement of the economic substance doctrine.

The second major difficulty with the economic substance doctrine is that it may complicate more targeted corporate tax shelter legislation. Where this is the case, it is a legitimate question whether Congress intended common law doctrine to apply. The *Compaq* court was able to apply specific congressional guidance in dealing with I.R.C. § 901(k), but it also proclaimed as a broad principle that Congress had not intended to permit transactions that manipulate the foreign tax credit to achieve tax savings. This suggests that the Tax Court has broad discretion in using the economic substance doctrine to scrutinize transactions where a statute also applies. The court should have considered whether this discretion could have allowed the doctrine to prevail over tax treaties, such as the U.S.-Netherlands income tax treaty, which seems to protect the foreign tax credit Compaq claimed.

Applying the economic substance doctrine in circumstances where statutory law applies may help reach just results, but it may also chill legitimate transactions. Targeted legislative attacks on tax shelter transactions, such as I.R.C. § 901(k), are meant to create "bright lines" that corporations can use to avoid liability. As *Compaq* demonstrates, the letter of the law can be twisted to create a tax shelter that was not contemplated by the applicable

statutes. The Tax Court's approach, however, which parallels the IRS's Notice 98-5, appears to go beyond how Congress intended to treat foreign tax credits. U.S. corporations may be discouraged by this decision from engaging in international transactions if they are denied the use of foreign tax credits. Given the increase in economic globalization, clear guidance should be provided to allow U.S. corporations to invest abroad and to effectively compete in an emerging global market.

Corporations therefore face the possibility that transactions not specifically prohibited in advance by the Code will nevertheless be voided upon further review. They are also confronted with the prospect of being sanctioned with an accuracy-related penalty. While *Compaq* suggests that reliance on legal advice may prevent the IRS from imposing an accuracy-related penalty, it does not ensure that the IRS will not initiate a proceeding to the tax benefits. Even if they receive favorable opinions, some U.S. corporations may be deterred from engaging in genuine foreign investments. Furthermore, by placing the applicable statutory guidelines in doubt, more widespread use of the economic substance doctrine may make it more difficult to obtain favorable legal opinions.

Overall, however, transactions like the one in *Compaq* present a compelling case that the substantive tax law must be changed to address corporate tax shelters. Until the Code is changed, corporations will continue to exploit discontinuities in the tax law to achieve tax savings to reach their primary goal—maximizing shareholder value.<sup>279</sup> To date, most attacks on corporate tax shelters have been targeted at specific transactions on an *ad hoc* basis.<sup>280</sup> As the Treasury Proposal notes, this type of case-by-case review simply encourages taxpayers to move from specifically prohibited transactions to others whose treatment has not yet been contested.<sup>281</sup> Moreover, the government spends an enormous amount of its resources attempting to address these activities: the

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279. See *Problem of Corporate Tax Shelters*, *supra* note 2, at para. 45.

280. See *id.* at para. 1 (describing the current state of the law as using an "after-the-fact, *ad hoc* approach.").

281. See *id.* at para. 40.

*ACM Partnership*<sup>282</sup> case alone cost the Federal government over \$2 million to litigate.<sup>283</sup>

A definition of "tax avoidance" that incorporates the economic substance doctrine is possible because this doctrine is already used by the Tax Court, and is familiar to corporations. Although corporate tax shelter cases are fact-intensive and reliance on a flexible definition of "tax avoidance" might leave corporations questioning which transactions will be respected for tax purposes, the IRS's past attempts to curb corporate tax shelters using detailed rules have not succeeded.<sup>284</sup> Therefore, Congress should codify the economic substance doctrine, but with due regard for some of the uncertainties and weaknesses it contains.

As the Treasury's tax legislative counsel, Joseph Mikrut, stated, "Legislation is needed to require taxpayers to apply economic-substance principles before the fact, rather than playing the audit lottery."<sup>285</sup> Compaq's executives lost the audit lottery and their corporation was hit with an accuracy-related penalty. The question now is, after codifying the economic substance doctrine, how many more corporations will continue to gamble in the audit lottery, with the jackpot being millions of dollars in reduced federal taxes?

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282. 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

283. *See id.* at para. 9 (commenting on the federal government's non-economic use of resources).

284. *See, e.g.,* Novack & Saunders, *supra* note 1, at 208 ("[T]he IRS' past efforts to curb tax shelters with detailed rules haven't slowed down the hustlers and have often given them openings.").

285. Tom Herman, *Tax Report*, Wall St. J., Oct. 27, 1999, at A1.