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en finances publiques

Effective Responses to Aggressive Tax Planning

What Canada Can Learn from Other Jurisdictions

Instalment 5: The United States - General Context and Presentation of the American Broad-Spectrum Approach

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

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UNIVERSITÉ DE SHERBROOKE

The Mission of the Research Chair in Taxation and Public Finance

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

Gilles Larin holds the RCTPF. Marie Jacques is a professor in the Département de fiscalité et sciences comptables, Faculté d'administration, Université de Sherbrooke. Robert Duong[1] was a research professional with the RCTPF when this study was produced.

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

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

Abstract

Instalment 5: The United States – General Context and Presentation of the American Broad-Spectrum Approach

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

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

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

This project is being pursued here by a study of the tools developed by Australia, United States, United Kingdom and European Union. Our goal was to assess whether it would be worthwhile for Canada to develop one or more of these tools to safeguard its tax system. The assessment was carried out taking into consideration the point of view of each group of stakeholders, according to generally recognized principles of tax administration.

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

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

This instalment examines the general context surrounding the anti-avoidance tools used in the United States that we have selected for the purposes of this study, i.e. the proposed economic substance doctrine codification, ethical standards, disclosure rules, and offers of settlement. We will then publish an instalment on each of these tools that presents their main methods of application and the issues raised for each group of stakeholders. Instalments 6 to 9 will thus focus on the application of the following tools that the American tax administration uses:

- the proposed economic substance doctrine codification (instalment 6);
- ethical standards for tax advisers (*Circular 230*) (instalment 7);
- disclosure rules (instalment 8);
- offers of settlement issued by the Internal Revenue Service (instalment 9).

Table of Contents

The Mission of the Research Chair in Taxation and Public Finance i

Abstract ii

1 General context 1

2 Illustration of the American approach in respect of one type of aggressive tax planning 8

2.1 Spheres of intervention of the American tax administration: § 351 Contingent Liability 9

2.2 Statement by the tax administration that an transaction is aggressive for the purposes of the disclosure rules: Notice 2001-17 “Contingent Liability Tax Shelter” 11

2.2.1 Details of the transaction 12
2.2.2 Application of the tax rules 13
2.2.3 The tax administration’s position 15
2.2.4 Duties of taxpayers and tax advisers 15

2.3 Settlement offer: *IR-2002-105* – “IRS Offers Tax Shelter Settlements for Limited Times” 16

2.4 Dispute: *Coltec Indus., Inc.* v. *United States* 18

2.4.1 Details of the planning scheme 18
2.4.2 Tax rules in question 19
2.4.3 The taxpayer’s claims 21
2.4.4 The tax administration’s claims 22
2.4.5 Decision of the court of first instance: literal application of the tax rules, without the application of the economic substance doctrine 23
2.4.6 Decision of the court of appeals: the literal application of the tax rules, with the application of the economic substance doctrine 23
2.4.7 Reaction of taxpayers involved in a similar dispute in the wake of the courts’ decisions in the Coltec case 25
2.4.8 The United States Supreme Court refused to hear the appeal lodged by the taxpayer in the Coltec case 25
2.4.9 The American tax administration is examining the advisability of codifying the economic substance doctrine in order to enhance its uniformity and predictability 25

Appendix 1: Overview of the American legal system in the realm of taxation 27

Bibliography 32

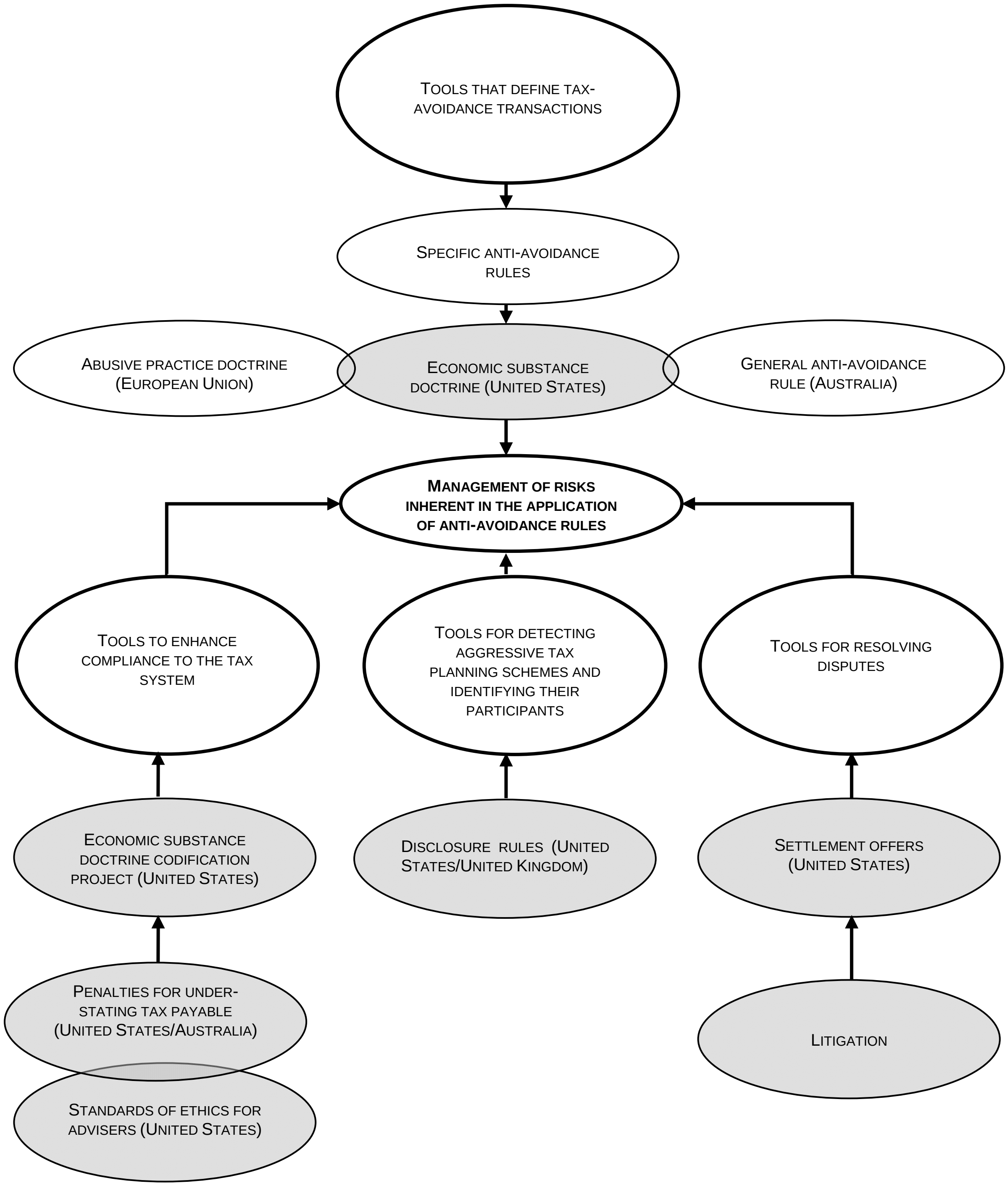
1 General context

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

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

Chart 1.1 below concisely illustrates the relation between these spheres of intervention in managing the risks inherent in aggressive tax planning. Each sphere of intervention is shown in the chart using a bold border. The foreign tools selected for the purposes of the study are inserted in the appropriate spheres of intervention. The American tools are highlighted by a grey screen in order to situate their role in the management by the American tax administration of the risks inherent in aggressive tax planning. These tools are the economic substance doctrine (including the penalty for under-stating tax payable), ethical standards, disclosure rules and offers of settlement that are covered in instalments 6, 7, 8 and 9, respectively.

CHART 1.1
SPHERES OF INTERVENTION OF THE TAX ADMINISTRATION REGARDING AGGRESSIVE TAX PLANNING: SELECTED TOOLS USED BY SOME OF OUR TRADING PARTNERS – UNITED STATES



Our Chart.

The American tax administration collected over US$2.5 trillion from taxpayers in the 2006 taxation year, including nearly US$49 billion by exercising its audit authority and power of enforcement of tax laws.[2] It seeks to collect additional revenues by offsetting the tax gap.[3]

Briefly, the tax gap represents the amount of tax that taxpayers should pay pursuant to tax laws but have not paid. The most recent data on the value of the tax gap in the United States apply to 2001. The tax administration estimates a tax gap for that year of US$345 billion. The tax gap attributable to under-stating by taxpayers of tax payable stands at US$286 billion, roughly 83% of the overall tax gap.[4]

The American tax administration intends to reduce the portion of the tax gap attributable to abusive tax planning schemes that lead to under-stating by taxpayers of tax payable. As of September 30, 2003, the tax administration estimated at US$85 billion the tax gap potentially attributable to such schemes. In relation to the tax gap for 2001, this amount represents approximately 30% of the tax gap attributable to under-stating tax payable:

> IRS has information that suggests the scope of abusive shelters totaled tens of billions of dollars over about a decade, but those estimates are based on limited data … as of September 30, 2003, an Office of Tax Shelter Analysis database included estimated potential tax losses of about $33 billion from investments in listed transactions … and another $52 billion in potential tax losses from nonlisted transactions with some characteristics of abusive shelters. This database contains information on promoters and investors and the amount of potential tax savings resulting from listed and nonlisted transactions… The estimated tax losses contained in the database cover a wide range of years from at least as far back as tax year 1989 and extending even to future tax years…[5]
>
> [our extracts]

The American taxation system recognizes the privilege of taxpayers to organize their affairs to minimize their tax payable. However, in the opinion of the tax administration and the courts, taxpayers may not exercise this privilege in an abusive manner. The tax administration deems

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2 United States, United States Government Accountability Office, *Financial Audit IRS's Fiscal Years 2006 and 2005 Financial Statements*, Report to the Secretary of the Treasury (GAO-07-136), November 2006 [GAO, *Financial Audit 2006*], page 17.

3 For additional information on the notion of the tax gap, please refer to instalment 1 of this study.

4 GAO, *Financial Audit 2006*, *supra* note 2 on pages 35-37.

5 United States, Michael Brostek (Director, Tax Issues), testimony, *Internal Revenue Service: Challenges Remain in Combatting Abusive Tax Shelters*, submitted to a public hearing of the U.S. Senate Committee on Finance under the theme "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?" (GAO-04-104T), Washington, DC, October 21, 2003 [Brostek, *Abusive Tax Shelters*], pages 10-15, transcript available on the US Senate Website: <http://finance.senate.gov/hearings/testimony/2003test/102103btest.pdf>.

abusive tax planning schemes to be planning carried out by a taxpayer primarily for the purpose of obtaining a tax benefit in a manner that complies with the law but that undermines it. The US Senate Subcommittee on Investigation of the Senate Homeland Security and Governmental Affairs explained abusive tax planning schemes in the following manner:

> In its broadest sense, the term ''tax shelter'' is a device used to reduce or eliminate the tax liability of the tax shelter user. This may encompass legitimate or illegitimate endeavors. While there is no one standard to determine the line between legitimate ''tax planning'' and ''*abusive tax shelters*,'' the latter *can be characterized as transactions in which a significant purpose is the avoidance* … of Federal, state or local tax *in a manner not intended by the law*.
>
> The abusive tax shelters investigated by the Subcommittee were complex transactions used by corporations or individuals to obtain substantial tax benefits in a manner never intended by the Federal tax code. *While some of these transactions may have complied with the literal language of specific tax provisions, they produced results that were unwarranted, unintended, or inconsistent with the overall structure or underlying policy of the Internal Revenue Code.* These transactions had *no economic substance or business purpose* other than to reduce taxes. Abusive tax shelters can be custom-designed for a single user or prepared as a generic tax product sold to multiple clients.[6]
>
> [our extracts and italics]

The US *Internal Revenue Code*[7] contains specific anti-avoidance rules to block transactions that are known to the tax administration when such rules are drafted. As for the grey areas of the *Internal Revenue Code,* the courts have elaborated interpretation doctrines in respect of tax rules, including the economic substance doctrine pertaining to transactions that technically comply with the law but whose outcome undermines its purposes. This doctrine makes it possible to overcome certain of these grey areas. However, the courts differ in their opinions on the application details.[8] To ensure that the courts administer this doctrine more uniformly, the tax administration has elaborated several pieces of draft legislation to clarify the doctrine's application details. However, such legislation had still not been adopted when this instalment was drafted.

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6 United States, Permanent Subcommittee on Investigations of The Committee on Homeland Security and Governmental Affairs, United States Senate, *The Role of Professional Firms in the U.S. Tax Shelter Industry* (S. REPT. 109–54), U.S. Government Printing Office: Washington, DC, April 13, 2005, page 1.

7 26 U.S.C.

8 This lack of uniformity stems, among other things, from the American legal system, in which taxpayers may appeal a notice of assessment before courts of first instance and appeal courts in several regional or jurisdictional circuits. Instalment 6 examines the economic substance document and explores the lack of uniformity in the doctrine's application. To help readers better grasp the context surrounding this doctrine, Appendix 1 of this instalment presents an overview of the American legal system from the standpoint of taxation.

The courts must resolve differences of opinion between taxpayers, their advisers and the tax administration on the administration of tax rules and legal doctrines. These disputes imply substantial amounts for each party. The taxes, interest and penalties at stake in disputes between the tax administration and taxpayers during the 2005 fiscal year stood at an estimated US$25 billion, including US$22.3 billion in disputes involving companies.[9]

According to a report from the Taxpayer Advocate Service,[10] disputes concerning penalties for under-stating tax payable ranked fourth among the ten principal questions settled by the courts during the period from June 1, 2004 to May 31, 2005. The decisions handed down by courts of first instance and appeal courts over the years, especially in the Black & Decker,[11] Coltec,[12] Castle Harbour,[13] Klamath[14] and Heinz[15] cases, vividly illustrate the differences of opinion between stakeholders on the application of tax rules and the economic substance doctrine to aggressive tax planning schemes.

In recent years, the American tax administration has adopted or bolstered anti-avoidance tools. It is seeking to reduce taxpayer and adviser interest in aggressive tax planning schemes. More specifically, it is seeking to heighten the financial risk for daring taxpayers and advisers by means of tools centred on compliance by tax planning with tax rules. The tax administration is relying on tools geared to compliance by taxpayers and their tax advisers with the taxation

9 United States, Internal Revenue Service, Internal Revenue Service Data Book 2005, Table 10 - Examination Coverage: Recommended and Average Recommended Additional Tax after Examination, by Type and Size of Return, Fiscal Year 2005 et Table 11 - Examination Coverage: Returns Examined with Unagreed Recommended Additional Tax after Examination, by Type and Size of Return, Fiscal Year 2005. Of the corporate tax returns that were subject to a new notice of assessment, the number of tax returns of corporations that were subject to a notice of objection accounted for only 9% of the latter.

10 Briefly, the Taxpayer Advocate Service is a division of the Internal Revenue Service that has a mandate to impartially help taxpayers who so desire in order, among other things, to regulate their tax problems that cannot be resolved through the usual channels, or to handle their recriminations concerning the functioning of the taxation system and formulate, if need be, recommendations to the tax administration. To obtain additional information, visit the Internal Revenue Service Website by clicking on the following hyperlink: <http://www.irs.gov/advocate/>.

11 *Black & Decker Corp.* v. *United States*, 436 F.3d 431 (Fourth Cir. 2006).

12 *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. 2006) [*Coltec*], *cert. denied*, 127 S.Ct. 1261 (2007).

13 *TIFD III-E, Inc.* v. *United States*, 459 F.3d 220 (2nd Cir. 2006), overturning the decision of the court of first instance that ruled in favour of the taxpayer in *TIFD III-E, Inc.* v. *United States*, 342 F.Supp.2d 94 (D. Conn. 2004). These decisions are commonly referred to by the name of the general partnership of which the taxpayer was a member (Castle Harbour Limited Liability Company).

14 Klamath Strategic Investment Fund, LLC v. United States, 472 F.Supp.2d 885 (E.D. Tex. 2007) [Klamath].

15 *H.J. Heinz Co.* v. *United States* (May 24, 2007), No. 03-2847T (Ct. Fed. Cl.); 76 Fed. Cl. 570 (2007) [*H. J. Heinz*].

system, the detection of aggressive tax planning schemes and participants in such schemes, and dispute settlement.

The tax administration endeavours to quickly pinpoint the income tax returns that present the highest risk of avoidance. It adapts its tools to promptly target aggressive tax planning schemes and participants in such schemes, in particular by means of the modification of disclosure rules and its participation in the Joint International Tax Shelter Information Center (JITSIC), along with the modernization of its information technologies.[16] These detection initiatives have led the tax administration to adopt specific anti-avoidance rules.[17]

The tax administration applies other tools to heighten the financial risk that aggressive taxpayers assume, in particular by increasing their level of diligence for the purposes of the penalty for under-stating tax payable. It has also strengthened the ethical standards applicable to tax advisers and offered aggressive taxpayers the possibility of settling out of court their disputes in order to recover the taxes and penalties that it could not have collected through its audit operations or that it would only have collected at the conclusion of unpredictable disputes in which it would have risked squandering fees in excess of the potential gains.

As Chart 1.1 above illustrates, the American tax administration has adopted tools that fall under each of the spheres of intervention pertaining to aggressive tax planning schemes, at the heart of which lies the application of the economic substance doctrine. This tool affords different groups of stakeholders considerable flexibility and makes it possible to strike a balance between the protection of the taxation system's integrity and the taxpayers' privilege to minimize their tax payable. On the other hand, the courts' failure to apply it uniformly undermines the principle of predictability both in the enforcement of tax law and in the administration of penalties, disclosure rules and settlement offers.

Reliance by the tax administration on this array of tools is helping to offset the tax gap through significant heightening of the risks that aggressive taxpayers and tax advisers assume. For the

[16] See GAO, *Financial Audit 2006*, *supra* note 2.

[17] Mention should be made in this respect of the rules that it plans to adopt to rescind tax benefits stemming from international planning schemes detected through its collaboration with the JITSIC: see United States, Internal Revenue Service, IR-2007-73, "IRS Issues Regulations on Transactions Designed to Artificially Create Foreign Tax Credits" (March 29, 2007).

latter, the tax administration's recourse to these tools in a possibly abusive manner does, however, present the risk of undermining the principles of simplicity and fairness in the enforcement of tax law.

To help the reader visualize the American tax administration's broad-spectrum approach, section 2 takes stock of the application under the approach of an array of tools to a specific type of aggressive tax planning scheme. Until instalments 6 to 9 are published, the reader will find in Part I an overview of the application details of each of the American tools. However, it should be emphasized that Part I was published on June 18, 2007 and has not been updated since its publication.

2

Illustration of the American approach in respect of one type of aggressive tax planning

This section concretely illustrates the American approach. It succinctly presents the application in tandem by the tax administration of different tools to control an aggressive tax planning scheme known as § 351 Contingent Liability. We believe that it is advisable to use this transaction to illustrate the approach favoured by the American tax administration, which consists in relying on an array of tools distributed throughout all of its spheres of intervention in order to curb such planning. The Coltec case is a perfect example of the American approach to aggressive tax planning schemes.

Having learned that taxpayers had engaged in this tax planning scheme, the tax administration imposed on them and on their tax advisers the obligation to submit detailed information pursuant to the disclosure rules. The tax administration had declared this planning scheme to be aggressive for the purposes of these rules because it deemed it to be devoid of economic substance. It made the taxpayers concerned a settlement offer, some of whom refused it.

The courts ultimately applied the economic substance doctrine in the Coltec case in order to rescind the tax benefits claimed by a taxpayer who had engaged in a planning scheme similar to the one covered by the disclosure rules. The taxpayer had appealed to the United States Supreme Court claiming that the Federal Circuit Appeal Court had erred in the application of this doctrine. According to the taxpayer, the application of this doctrine by the Appeal Court conflicted with decisions handed down by other circuits in the US judicial system. However, the Supreme Court refused to hear the taxpayer's appeal. The courts subsequently applied the economic substance doctrine according to the principles elaborated by the Federal Circuit Appeal Court in the Coltec case.[18]

[18] Instalment 6 focuses on the application by the courts of the economic substance doctrine. For subsequent decisions that applied this doctrine in light of the Coltec case, see, among others, *Klamath*, *supra* note 14; *H.J. Heinz*, *supra* note 15; *Jade Trading, LLC* v. *United States* (December 21), No. 03-2146T (Ct. Fed. Clms).

This section is divided into four parts:

- Subsection 2.1 reproduces Chart 1.1 adapted to § 351 Contingent Liability planning.
- Subsection 2.2 summarizes the tax administration's statement in which it explains the transaction in dispute in these cases for the purposes of the disclosure rules.
- Subsection 3.3 presents the outline of the settlement offer that the tax administration made to the taxpayers who engaged in this planning scheme.
- Subsection 2.4 summarizes the courts' decisions in the Coltec case.

In each of these subsections, we will focus solely on the tool under examination. In this way, we can better grasp the context and the manner in which the tax administration applies each of the tools at its disposal. An examination of these subsections in the order presented reveals that the American tax administration maintains a consistent position throughout its spheres of intervention.

2.1 Spheres of intervention of the American tax administration: § 351 Contingent Liability

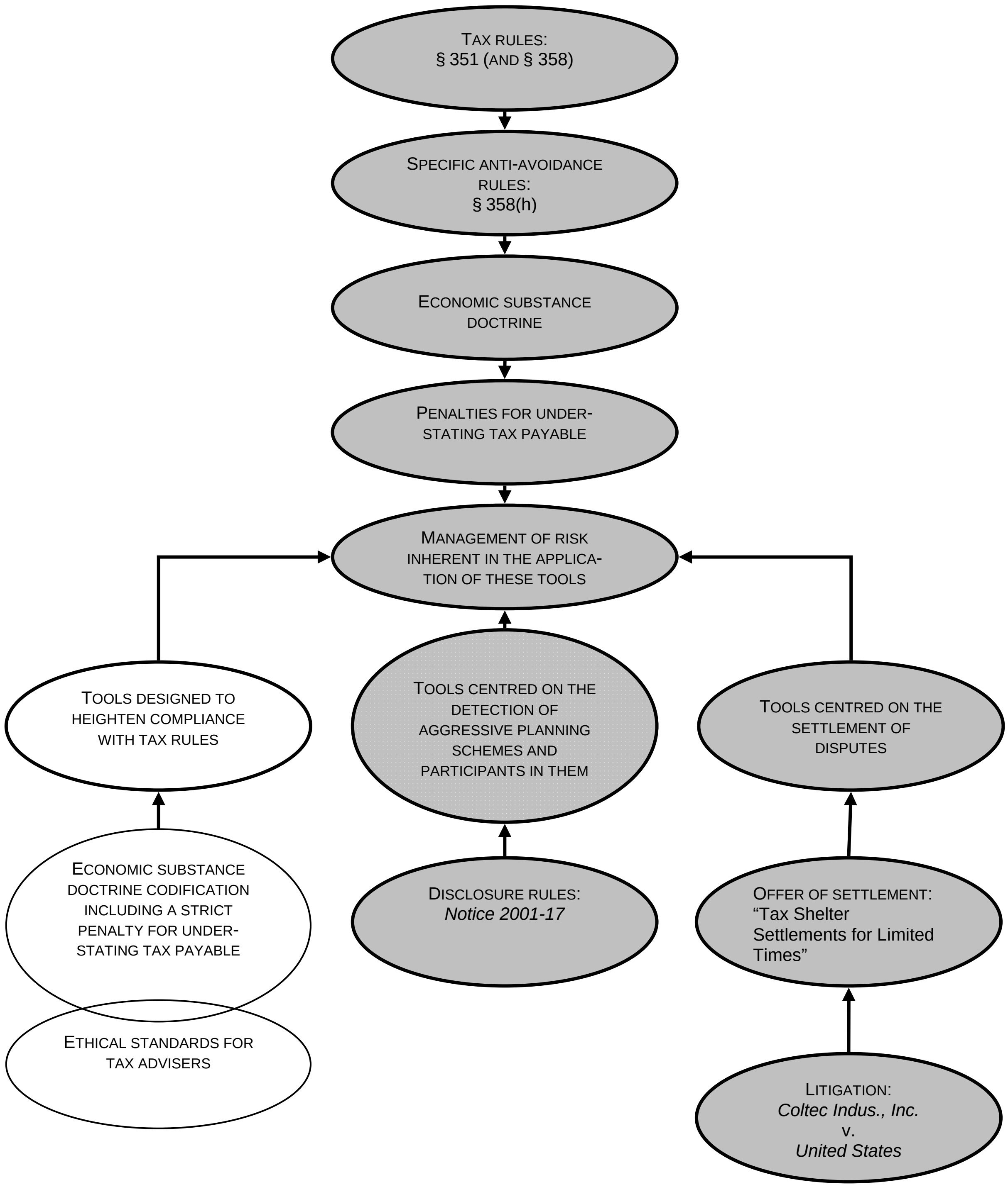
On the following page, under the heading Chart 2.1, we are reproducing Chart 1.1 with the necessary changes, in order to illustrate the American tax administration's intervention in respect of the § 351 Contingent Liability Transaction described in subsection 2.2. To block this transaction, the tax administration resorted to:

- the tax rules;
- the economic substance doctrine;
- the penalty for under-stating tax payable;
- the disclosure rules;
- the settlement offer; and
- litigation.[19]

[19] It should be noted that ethical standards were not the subject of litigation in the Coltec case. To our knowledge, the courts have not had referred to them a case directly involving ethical standards in the realm of aggressive tax planning schemes.

CHART 2.1

ILLUSTRATION OF INTERVENTION BY THE AMERICAN TAX ADMINISTRATION IN RESPECT OF TAXPAYERS WHO ENGAGED IN THE § 351 CONTINGENT LIABILITY TRANSACTION



Our Chart.

2.2 Statement by the tax administration that an transaction is aggressive for the purposes of the disclosure rules: Notice 2001-17 "Contingent Liability Tax Shelter"

Pursuant to the disclosure rules, taxpayers and tax advisers must file information returns when they participate in transactions pinpointed by the tax administration that, in its opinion, present a risk of abusive tax avoidance.[20] To this end, it may define the details of such a transaction in the rules of application of the US *Internal Revenue Code*. It may also compel taxpayers and tax advisers to file an information return concerning a transaction that it has declared to be aggressive by means of a public news release when it deems such a transaction to be devoid of economic substance.[21]

On January 18, 2001, the tax administration declared the § 351 Contingent Liability Transaction to be aggressive.[22] Essentially, it targeted a type of transaction subject to requests from tax advisers for taxpayers to engage in such transactions. Pursuant to this transaction, taxpayers could more rapidly crystallize a tax loss or even increase deductions in the calculation of their income. In its statement, the tax administration described the details of this transaction and its stance as regards the tax benefits claimed by taxpayers bearing in mind the application of the tax rules and the economic substance doctrine.

The tax administration was of the opinion that the taxpayers could not claim the tax benefits stemming from this transaction pursuant to the tax rules and the economic substance doctrine. Nonetheless, shortly before it declared this transaction to be aggressive on December 20, 2000, it deemed it appropriate to adopt a specific anti-avoidance rule in order to explicitly rescind the tax benefits stemming from this type of transaction. Briefly, this rule applies to a tax planning scheme carried out on or after October 18, 1999.[23] The tax administration thus wished to dispel any uncertainty concerning the possibility for taxpayers to claim tax benefits stemming from this type of transaction.

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[20] 26 U.S.C. § 6011; 26 C.F.R. § 1.6011-4(a), § 1.6111, § 1.6112.

[21] 26 C.F.R. § 1.6011-4(b)(2).

[22] United States, Internal Revenue Service, Notice 2001-17 "Contingent Liability Tax Shelter," 2001-9 I.R.B. (February 26, 2001).

[23] See *Community Renewal Tax Relief Act of 2000*, Pub. L. No. 106-554, *Appendix G*, § 309, 114 Stat. 2763, 114 Stat. 2763A-638 (codified as amended in 26 U.S.C. § 358(h)).

2.2.1 DETAILS OF THE TRANSACTION

The planning scheme in question allows a company to immediately deduct in the calculation of its income an amount corresponding to the present value of a subordinated obligation that has not yet materialized.

The assignor (Company A) disposes of an asset in favour of an assignee (Company B). For Company A, the tax cost[24] of the asset corresponds to its fair market value, usually a large amount.

By way of compensation, Company A receives shares of Company B's capital stock. Moreover, Company B assumes an obligation of Company A subordinated to a future event, e.g. a contractual obligation for environmental damage or benefits to be paid to employees under a deferred salary plan.

Under the rollover rules, the tax cost to Company A of Company B's shares is equivalent to the tax cost of the asset transferred by Company A. Generally speaking, the tax cost and the fair market value of the asset of which Company A disposed are only marginally higher than the present value of the subordinated obligation assumed by Company B. In point of fact, the actual value of Company B's shares received by Company A is minimal compared with the tax cost and the fair market value of the asset assigned.

Shortly after the exchange, Company A assigned to a third party the shares of Company B, from which the proceeds of disposition were markedly below their tax cost. For the third party, the fair market value of the shares of Company B underwent depreciation by an amount corresponding to the present value of the subordinated obligation assumed by the latter.

In the calculation of its income, Company A thus claimed a capital loss the amount of which corresponds to the present value of the subordinated obligation.

[24] For the sake of simplification, we are using the expression "tax cost" to reflect both the concept of the cost basis of an actual asset and that of the adjusted cost basis.

In the calculation of its business income, Company B may deduct the amounts that it pays to satisfy the subordinated obligation that it has assumed.

Through this transaction, Company A can immediately deduct in the calculation of its income an amount corresponding to the present value of the subordinated obligation that has not yet materialized.

2.2.2 APPLICATION OF THE TAX RULES

Generally speaking, a taxpayer ("assignor") who transfers an asset to another person ("assignee") realizes a gain corresponding to the difference between the proceeds of disposition of the asset and its tax cost.

However, the assignor does not realize any gain at the time of the sale if, briefly stated, he receives shares of the assignee's capital stock in full payment of the selling price of the asset and immediately controls the assignee after the exchange ("rollover rules"). These rules allow the assignor to carry out the exchange without tax effect bearing in mind that he does not receive any money at that time. The tax cost to the assignor of the assignee's shares then corresponds to the tax cost of the asset transferred.

Since the assignor does not monetize at that time the gain stemming from the disposal of the asset, the rollover rules allow him the possibility of carrying forward the taxation of the gain to the time when he disposes of the assignee's shares. The following passage from a decision handed down by the First Circuit Appeal Court concerning the application of the rollover rules clearly summarizes this principle:

> It is the purpose of Section 112(b)(5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture. As was said in American Compress & Warehouse Co. v. Bender, 5 Cir., 1934, 70 F.2d 655, 657, "The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continue to be beneficially interested in the transferred

> property and have dominion over it by virtue of their control of the new corporate owner of it."[25]
>
> [our extracts]

If the assignor receives a sum of money by way of compensation for the asset transferred, he must include the amount of the gain realized up to the equivalent of the sum of money received. The tax cost to the assignor of the assignee's shares is reduced by the portion of the sum of money that he received and that is not included in the taxable gain. The same rules apply if the assignor monetizes the gain stemming from the sale of the asset transferred by means other than a sum of money.

In the tax planning scheme that the tax administration declared to be aggressive, the taxpayers wished to take advantage of a technical application of the rollover rules:

- Briefly stated, the tax cost to Company A of Company B's shares corresponds to the tax cost of the asset that Company A transfers to Company B.

- The tax cost to Company A of Company B's shares must be deducted from any sum of money that Company B pays Company A or the value of any other asset that Company B transfers to Company A. An obligation of Company A that Company B assumes is equivalent to a sum of money that Company B pays.

- However, under certain circumstances, the assumption by Company B of the subordinated obligation of Company A is not equivalent to a sum of money. The value for Company A of the subordinated obligation does not reduce the tax cost of the shares of Company B.[26]

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[25] *Portland Oil Co.* v. *CIR*, 109 F.2d 479 (First Cir. 1940), page 488, *cert. denied* by the United States Supreme Court, 310 U.S. 650 (1940). This decision concerned the application of the rollover rules that preceded the rules in force, although the principles underlying these rules remained the same. For additional explanations concerning the application details of the rollover rules in the United States, see Boris I. Bittner and James S. Eustice, *Federal Income Taxation of Corporations and their Shareholders*, Seventh Edition, Volume 1 (Warren, Gorham & Lamont: Valhalla, NY, 2006), pages 3-4 to 3-6.

[26] The tax administration was referring to specific rules in the US tax code in its statement without providing additional explanations of these circumstances. Subsection 2.4.3 explains these rules in greater detail. Briefly, in the situation described in the tax administration's statement, the value of the subordinated obligation does not reduce the tax cost to Company A of Company B's shares if Company B may deduct in the calculation of its business income an amount that it pays to satisfy the subordinated obligation.

2.2.3 *THE TAX ADMINISTRATION'S POSITION*

When the tax administration declared this transaction to be aggressive, it noted that this type of transaction is equivalent to a transaction carried out for tax avoidance purposes and that it intended to reject the capital loss that Company A claimed for various reasons, including those indicated below:

- The parties did not implement the transaction to achieve a genuine commercial purpose and could not, therefore, take advantage of rollover rules.
- The exchange was not the equivalent of a rollover but instead a payment that Company A made to Company B in respect of the assumption of the subordinated obligation.
- The main purpose of the transaction was to avoid tax, not to achieve a genuine commercial purpose.
- Company A did not sustain a genuine capital loss.
- The capital loss could not be deducted pursuant to various specific rules.
- The transaction was devoid of economic substance.

The tax administration also intended, for various reasons, to deny Company B any deduction that the latter planned to claim in respect of an amount paid to satisfy the subordinated obligation, in particular because the amount paid was not equivalent to a current expenditure that was necessary in the normal course of Company B's business.

2.2.4 *DUTIES OF TAXPAYERS AND TAX ADVISERS*

Taxpayers who participate in a transaction identical or substantially similar to the one described above must file an information return in respect of the transaction carried out, on pain of sustaining the applicable penalties. Their tax advisers are also subject to the same obligations and are liable to penalties.

The tax administration may impose on the taxpayers who implemented this transaction a penalty for under-stating tax payable. It may also apply the penalties in the US *Internal Revenue*

Code applicable to tax advisers who have promoted this transaction or participated in claims for tax benefits made by taxpayers.

2.3 Settlement offer: *IR-2002-105* – "IRS Offers Tax Shelter Settlements for Limited Times"

On November 4, 2004, the Internal Revenue Service offered to settle with all of the taxpayers who engaged in the § 351 Contingent Liability Transaction.

Under this limited-time public offer, eligible taxpayers could conclude an agreement with the tax administration and thus avoid the tax administration's rescinding all of the tax benefits that they claimed and its levying the maximum penalty rate for under-stating tax payable.

In this way, both the tax administration and the taxpayers could better manage their respective risks arising from the possibility of the courts deciding in favour of the other party. In 2006, the courts decided in favour of the taxpayers concerning the technical application of the tax rules invoked to obtain the tax benefits claimed. However, the courts based their decision on the economic substance doctrine in order to rescind them.

Table 3.1 briefly summarizes the details of this settlement offer and outlines the results obtained by the tax administration.

TABLE 3.1

SETTLEMENT OFFER IN RESPECT OF THE § 351 CONTINGENT LIABILITY TRANSACTION

PERIOD OF THE OFFER	From October 4, 2002 to March 5, 2003.
DESCRIPTION	The offer was made to taxpayers who implemented the § 351 Contingent Liability Transaction that the tax administration declared aggressive pursuant to the disclosure rules.
ELIGIBILITY	The offer was made publicly to all eligible taxpayers whether or not the tax administration had identified them at the outset.
TAX	The amount of tax payable was calculated according to a percentage of the loss claimed. Generally speaking, the amount of the loss allowed under the terms of the offer could range from 50% to 90% of the loss claimed by the taxpayer.
INTEREST	The taxpayer had to pay all of the interest accrued on the amount of the under-stated tax.
PENALTY FOR UNDER-STATING TAX PAYABLE	The tax administration would not have levied any penalty on the taxpayer if the latter had disclosed his participation in the transaction pursuant to a previously proposed general settlement offer. The tax administration would not have levied any penalty if the taxpayer had agreed to deduct only 75% of the loss claimed. Otherwise, the tax administration could levy a penalty according to each participant's circumstances, under a mediation process.
PROCEDURE	The taxpayer had to submit to the tax administration a written request indicating his wish to accept by January 2, 2003 at the latest the settlement offer. The request had to include the prescribed information concerning the details of the transaction and the taxpayer's tax consequences.
NUMBER OF PARTICIPANTS	As of October 21, 2003, 62 of the 126 eligible participants had taken advantage of the offer.[27]
AMOUNTS COLLECTED BY THE IRS	In May 2003, the tax administration estimated that the offer had allowed it to collect $US2.8 billion in income tax.[28]
COURT DECISIONS	In favour of the tax administration: see *Coltec Indus., Inc.* v. *United States*, 454 F.3d 1340 (Fed. Cir. 2006); 2006 U.S. App. LEXIS 17351; cert. denied, 127 S.Ct. 1261 (2007).

Source: United States, Internal Revenue Service, IR-2002-105, "IRS Offers Tax Shelter Settlements for Limited Times" (November 4, 2002); Announcement 2002-110, "Extension of Application Period for Rev. Proc. 2002-67," 2002-50 I.R.B. (December 16, 2002), page 970.

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27 United States, Mark W. Everson (Commissioner of Internal Revenue), testimony given at a hearing of the US Senate under the theme "Tax Shelters: Who's Buying, Who's Selling, and What's the Government Doing About It?," Washington, DC, October 21, 2003, transcript available on the US Senate Website: <http://finance.senate.gov/hearings/testimony/2003test/102103etest.pdf>.

28 Brostek, *Abusive Tax Avoidance*, *supra* note 5, pages 18-19.

2.4 Dispute: *Coltec Indus., Inc.* v. *United States*

In the Coltec[29] case, the tax administration rescinded the tax benefits stemming from an aggressive tax planning scheme that enabled a taxpayer to deduct a substantial capital loss in order to reduce his tax payable. This transaction was similar to the § 351 Contingent Liability Transaction that the tax administration had declared aggressive for the purposes of the disclosure rules. The main details of the transaction were presented in subsection 2.2.

In the 1996 taxation year, the taxpayer realized a capital gain on the order of US$420 million. In order to substantially minimize the tax payable on this gain, the taxpayer carried out a tax planning scheme that resulted in a US$378.7 million capital loss in the calculation of his income. This loss stemmed from the sale by the taxpayer of shares that generated proceeds of disposition that were limited compared with the tax cost of the shares.

The taxpayer claimed that he could deduct this capital loss in accordance with the tax rules. The tax administration considerably reduced the loss because, on the one hand, the application of the tax rules overall prevented him from claiming it and, on the other hand, because the planning scheme overall was devoid of economic substance. The tax administration issued a new notice of assessment to the taxpayer demanding the payment of roughly US$83 million in tax. The taxpayer paid the amount of tax demanded and filed a motion for payment out of court with the United States Court of Federal Claims.

The Court of Federal Claims concluded that the taxpayer could claim the capital loss according to the tax rules and granted him the reimbursement of the tax that he had paid. However, the United States Court of Appeals for the Federal Circuit overruled the decision of the lower court by apply the economic substance doctrine in order to rescind the tax benefits stemming from the contentious tax planning scheme.

2.4.1 DETAILS OF THE PLANNING SCHEME

Briefly, the disputed planning scheme was carried out in three successive stages.

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[29] *Supra* note 12.

First, the taxpayer converted one of his subsidiaries into a special purpose entity (Subsidiary A), into which he injected roughly $US14 million in exchange for Subsidiary A's shares in order to provide it with the funds necessary to carry out the planning scheme.

Subsequently:

- Subsidiary A acquired from Subsidiary B, another subsidiary of the taxpayer, all outstanding shares of Subsidiary C, a subsidiary of Subsidiary B. Subsidiary C operated a business likely to be subject to civil lawsuits related to the use of asbestos in its operations. Subsidiary A had also acquired from Subsidiary B supplies, files and an insurance policy related to the use of asbestos and a promissory note issued by Subsidiary C whose value and tax cost for Subsidiary B was US$375 million;
- in compensation, Subsidiary A had issued to Subsidiary B shares of its capital stock, assumed the management of existing and possible civil lawsuits against Subsidiary B, and committed itself to financially compensating Subsidiary B for the damages that the latter would have to assume in a civil lawsuit pertaining to asbestos;
- according to the taxpayer, the amount of the promissory note transferred by Subsidiary B to Subsidiary A was equivalent to the present value of the commitment to compensate assumed by Subsidiary A.

Subsidiary B transferred the shares of Subsidiary A to two banks in exchange for US$500,000. Under the terms of this disposition, the taxpayer undertook to indemnify and hold harmless the banks for any amount that the latter would have to pay as damages in the event of lawsuits pertaining to asbestos launched against Subsidiary A.

In his consolidated income tax return, the taxpayer had deducted in the calculation of his income for 1996 a US$378.7-million capital loss resulting from the disposition by Subsidiary B of the shares of Subsidiary A in favour of the two banks.

2.4.2 TAX RULES IN QUESTION

The application of the rollover rules is the crux of the dispute.

Pursuant to 26 U.S.C. § 351, the disposition by an assignor to an assignee of an asset solely in exchange for shares of the assignee's capital stock usually occurs without tax effect when the assignor controls the assignee immediately after this exchange. The assignor does not have to include any amount as a capital gain stemming from the disposition of the asset in the calculation of his income. For the assignor, the tax cost of the shares acquired corresponds to the tax cost of the asset transferred.

When the assignor receives both the assignee's shares and a sum of money, he must include in the calculation of his income a gain in an amount not exceeding the value of the consideration other than in shares pursuant to 26 U.S.C. § 351(b). The amount of money that the assignor receives reduces the tax cost of his shares of the assignee's capital stock but the amount of the gain that the assignor realizes at the time of the exchange increases his tax cost for these shares pursuant to 26 U.S.C. § 358(a).

Instead of paying a sum of money to the assignor, the assignee may assume an obligation of the assignor in addition to issuing to him shares of his capital stock. Specific rules apply to determine the gain that the assignor realizes at the time of disposition of an asset in favour of the assignee and the tax cost for the assignor of his shares of the capital stock of the assignee.

These specific rules prescribe the circumstances under which the assumption by the assignee of an obligation of the assignor is equivalent to a sum of money. If such is the case, the assignor must include the amount of this obligation in the calculation of the gain stemming from the disposition of the asset to the assignee, the same as a sum of money. Moreover, the tax cost to the assignor of the assignee's shares must be lowered according to the amount of the obligation that the assignee assumes. This adjustment affects the calculation of the gain or loss that the assignor realizes when he disposes of these shares.

In the calculation of the gain for the assignor stemming from the disposition to the assignee of the asset, the assumption by the assignee of an obligation of the assignor is not equivalent to a sum of money received by the assignor pursuant to 26 U.S.C. § 357(a), subject to the application of §§ 357(b) and (c).

Pursuant to 26 U.S.C. § 357(c)(1), when the amount of the obligation assumed by the assignee exceeds the tax cost of the asset transferred by the assignor, the latter must include this surplus in the calculation of his income. Nevertheless, pursuant to 26 U.S.C. § 357(c)(3), the amount of an obligation is not taken into consideration for the purposes of the preceding calculation if an amount paid to satisfy such an obligation is deductible in the calculation of the business income of the entity that pays the amount.

Furthermore, pursuant to § 357(b), when avoidance is the main purpose of the transaction or in the absence of a genuine commercial purpose, the amount of the obligation of the assignor that the assignee assumes is equivalent to a sum of money received by the assignor. In the latter instance, the assignor must include the total amount in the calculation of the gain stemming from the assumption by the assignee of the obligation (hereinafter called the “anti-avoidance rule”).

Pursuant to 26 U.S.C. § 358(d)(1), in the calculation of the tax cost to the assignor of the assignee’s shares, the amount of an obligation assumed by the assignee is equivalent to a sum of money received by the assignor. The tax cost to the assignor of the shares then corresponds to that of the asset transferred, reduced by the amount of this obligation, but increased by the gain that the assignor realizes following the disposition of the asset to the assignee. However, pursuant to § 358(d)(2), the amount of the obligation does not reduce the tax cost of the assignee’s shares received by the assignor if the payment by the assignee of an amount to satisfy this obligation is deductible in the calculation of business income, pursuant to § 357(c)(3). These rules, § 358(d)(2) and § 357(c)(3), are hereinafter called the “exception rules.”

2.4.3 THE TAXPAYER’S CLAIMS

Based on a literal interpretation of the exception rules concerning the calculation of the tax cost, the taxpayer claimed that the tax cost of the shares of Subsidiary A held by Subsidiary B corresponded to the tax cost of the assets transferred by Subsidiary B (roughly US$379 million, including US$375 million attributable to the promissory note). According to the taxpayer, the value of the subordinated obligation assumed by Subsidiary A did not reduce the tax cost of the shares that the latter issued to Subsidiary B. Consequently, the taxpayer sustained a capital loss of approximately US$379 million at the time of the disposition to a third party by Subsidiary

B of the shares of Subsidiary A since the proceeds of disposition of the shares were US$500,000 although their tax cost was roughly US$379 million.

The taxpayer argued that a subordinated obligation was not equivalent to an obligation for the purposes of the rollover rules. Consequently, the tax cost for Subsidiary B of Subsidiary A's shares corresponded to the tax cost of the assets transferred to Subsidiary A. The taxpayer could thus deduct in the calculation of his income a capital loss stemming from the disposition by Subsidiary B to the banks of Subsidiary A's shares.

2.4.4 THE TAX ADMINISTRATION'S CLAIMS

The tax administration argued that the tax loss should be rescinded since the tax cost of Subsidiary A's shares should be reduced by an amount equivalent to the value of the subordinated obligation that the latter assumed. The tax administration based its reasoning on an interpretation of the applicable tax rules overall.

First, the tax administration argued that the assumption by Subsidiary A of the subordinated obligation did not fall under the exception rules. It opined that these rules applied solely when the taxpayer disposed both of his company and the attendant subordinated obligation. In this instance, Subsidiary B had only disposed of the subordinated obligation.

Second, it argued that the main purpose of the transaction came under avoidance or that this transaction was devoid of any genuine commercial purpose. Consequently, the entire amount of the subordinated obligation assumed by Subsidiary A was equivalent to a sum of money received by Subsidiary B pursuant to the specific anti-avoidance rule. According to the tax administration, the anti-avoidance rule took precedence over the exception rules if the applicable rules overall are interpreted coherently.

Third, the tax administration concluded that the portion of the planning scheme pertaining to the assumption by Subsidiary A of Subsidiary B's subordinated obligation should be rescinded pursuant to the economic substance doctrine.

2.4.5 DECISION OF THE COURT OF FIRST INSTANCE: LITERAL APPLICATION OF THE TAX RULES, WITHOUT THE APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

2.4.5.1 The taxpayer could claim a capital loss by literally applying the tax rules

The Court of Federal Claims granted the taxpayer the reimbursement of the tax paid. It dismissed the tax administration's three claims. In the Court's opinion, the amount of Subsidiary B's subordinated obligation assumed by Subsidiary A did not have to be included in the calculation stipulated in § 357(c)(1). It opined that an amount paid to satisfy this obligation was deductible in the calculation of income. Moreover, the Court concluded that § 358(d)(1) could not be applied since a subordinated obligation is not equivalent to an obligation as stipulated in the tax rules.

What is more, this Court decided that the main purpose of this transaction was the realization of a genuine commercial purpose.

2.4.5.2 The economic substance doctrine did not apply

The Court of Federal Claims did not apply the economic substance doctrine because, in its view, this doctrine is thought to be unconstitutional under the separation of legislative and judicial powers. Notwithstanding this position, it expressed the opinion that this doctrine could not, in any event, be applied since the taxpayer was pursuing a legitimate commercial purpose.

2.4.6 DECISION OF THE COURT OF APPEALS: THE LITERAL APPLICATION OF THE TAX RULES, WITH THE APPLICATION OF THE ECONOMIC SUBSTANCE DOCTRINE

2.4.6.1 The taxpayer could claim a capital loss by literally applying the tax rules

Following the example of the Court of Federal Claims, the United States Court of Appeals for the Federal Circuit concluded that the taxpayer could deduct the capital loss in the calculation of his income according to the tax rules at stake, taken literally. These rules do not demand that the taxpayer subtract from the tax cost of the shares of Subsidiary A an amount corresponding to the value of the subordinated obligation that it assumes.

Contrary to the Court of Federal Claims, the Court of Appeals for the Federal Circuit was of the opinion that a subordinated obligation is equivalent to an obligation for the purposes of the application of section § 358(d). Consequently, the assumption by Subsidiary A of Subsidiary B's subordinated obligation is equivalent to a sum of money received by the latter at the time of the exchange. The Court of Appeals should then determine if the exception rules applied. Where appropriate, the taxpayer did not have to reduce the tax cost of Subsidiary A's shares by an amount corresponding to the value of the subordinated obligation.

By virtue of the literal interpretation of the exception rules, the Court of Appeals was of the opinion that the taxpayer did not have to reduce the tax cost of Subsidiary A's shares by the amount of Subsidiary B's subordinated obligation assumed by Subsidiary A. In light of the documents extrinsic to the law, the general purpose of section § 357(c)(3) is to avoid a taxpayer's having to include in the calculation of his income a gain corresponding to the surplus of the amount of the company's obligations over the value of its assets when the taxpayer transfers the company. However, the rule as formulated does not only apply in the case of the sale of the entire company. This exception rule could thus apply to the simple disposition by a taxpayer of a subordinated obligation without implying the sale of a company, as in this particular case. Since any amount paid to satisfy the subordinated obligation was deductible in the calculation of income, the taxpayer did not have to reduce the tax cost of Subsidiary A's shares.

Finally, contrary to the tax administration's claims, the exception rules must be interpreted literally and independently of the other rules concerning the calculation of the tax cost and the calculation of the gain stemming from the assumption by the assignee of a subordinated obligation of the assignor. Consequently, the anti-avoidance rule pertaining to the calculation of the gain invoked by the tax administration could not take precedence over the exception rules concerning the calculation of the tax cost.

2.4.6.2 The taxpayer could not claim the capital loss by applying the economic substance doctrine

The Court of Appeals concluded that the economic substance doctrine applied to the planning scheme and rescinded almost the entire capital loss claimed by the taxpayer. In the Court's opinion, the taxpayer had no genuine commercial purpose to warrant Subsidiary B's transferring to Subsidiary A a US$375-million promissory note in exchange for the assumption by the latter of possible damages that Subsidiary B risked paying because of its use of asbestos-contaminated products.

2.4.7 REACTION OF TAXPAYERS INVOLVED IN A SIMILAR DISPUTE IN THE WAKE OF THE COURTS' DECISIONS IN THE COLTEC CASE

In the Black & Decker case,[30] the taxpayer engaged in a planning scheme similar to the one described in the Coltec case. The Sixth Circuit Appeal Court referred the case to the District Court so that the latter could examine the application of the economic substance doctrine to the planning scheme in dispute. In the meantime, the Court of Appeals of the Federal Circuit to which the Coltec case had been referred had handed down its judgment in favour of the tax administration. The taxpayer finally asked the District Court to adjourn the hearing of this case to conclude an out-of-court settlement with the tax administration.[31]

2.4.8 THE UNITED STATES SUPREME COURT REFUSED TO HEAR THE APPEAL LODGED BY THE TAXPAYER IN THE COLTEC CASE

The taxpayer lodged an appeal with the United States Supreme Court. Among the reasons mentioned for appealing the decision, the taxpayer pleaded that the Appeal Court had applied the economic substance doctrine in a manner that ran counter to other court decisions. In the taxpayer's opinion, the Supreme Court should hear the appeal to clarify the application details of this doctrine so that the courts apply it uniformly. The United States Supreme Court refused to hear the Coltec case.[32]

2.4.9 THE AMERICAN TAX ADMINISTRATION IS EXAMINING THE ADVISABILITY OF CODIFYING THE ECONOMIC SUBSTANCE DOCTRINE IN ORDER TO ENHANCE ITS UNIFORMITY AND PREDICTABILITY

On account of differences of opinion that persist between American courts on the application details of the economic substance doctrine, the American tax administration has for several years contemplated codifying this doctrine. In the opinion of certain members of the tax administration, the doctrine's codification is advisable to ensure that the courts apply it uniformly and more predictably. However, taxpayers, tax advisers and other members of the tax

[30] See *Black & Decker*, *supra* note 11.

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

[32] *Coltec*, *supra* note 12. See Sean Pheils and Patrick Gay, "Supreme Court Denies Review of Coltec, Dow, Six Tax-Related Cases," 2007 TNT 35-1 (February 21, 2007).

administration are opposed to this idea since, in their view, the application by the courts of this doctrine on a case-by-case basis makes it possible to establish a flexible dividing line between legitimate and abusive planning schemes. Instalment 6 of Part II of this study examines the questions raised by the economic substance doctrine and codification proposals.

Appendix 1

Overview of the American legal system in the realm of taxation

This appendix presents an overview of the American legal system in the realm of taxation to better situate the context surrounding the application of the economic substance doctrine and the elaboration of the American tax administration's codification proposals.

Briefly, taxpayers may lodge an appeal with a court of first instance to have rescinded or amended their notice of assessment. The taxpayer and the tax administration may appeal the decision of the court of first instance before an Appeal Court[33] and, as the case may be, before the United States Supreme Court, when given leave to do so.

COURTS OF FIRST INSTANCE

Taxpayers may appeal a notice of assessment before one of the following courts, depending on whether they decide to immediately pay the tax determined by the tax administration or according to the nature of the dispute:

- the United States Tax Court;
- the United States District Courts;
- the United States Court of Federal Claims;
- the United States Bankruptcy Courts.

[33] Taxpayers usually have appeal as of right of a decision rendered by a court of first instance. See United States, National Taxpayer Advocate, *2006 Report to Congress*, Washington, DC, Internal Revenue Service, 2006 [NTA, *Report 2006*], page 554, online on the IRS Website: <http://www.irs.gov/pub/irs-utl/2006_arc_section3.pdf>.

The United States Tax Court

Taxpayers who appeal their notice of assessment before this court do not have to pay in advance the amount of income tax determined by the tax administration.[34] The Court hears the parties either in Washington, DC or in a city chosen by the taxpayer, or failing that, by the tax administration.[35] The Court will sit in the city selected or in a nearby city.[36]

The United States District Courts

When a taxpayer challenges a notice of assessment but chooses to immediately pay the amount of tax assessed by the tax administration, he may file a motion claiming tax paid before a District Court.

District Courts are divided into 94 federal districts throughout the states and territories. The 94 districts are grouped into 11 sequentially numbered regional circuits[37] (see the illustration below of the regional division of circuits in the US).

The United States Court of Federal Claims

When a taxpayer challenges the notice of assessment but chooses to pay the amount of tax assessed by the tax administration, he may file a request with the Court of Federal Claims instead of a District Court to obtain the reimbursement of the tax paid.[38] This Court is part of the Federal Circuit, which complements the 11 regional circuits.

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34 NTA, *Report 2006*, *ibid.* page 554.

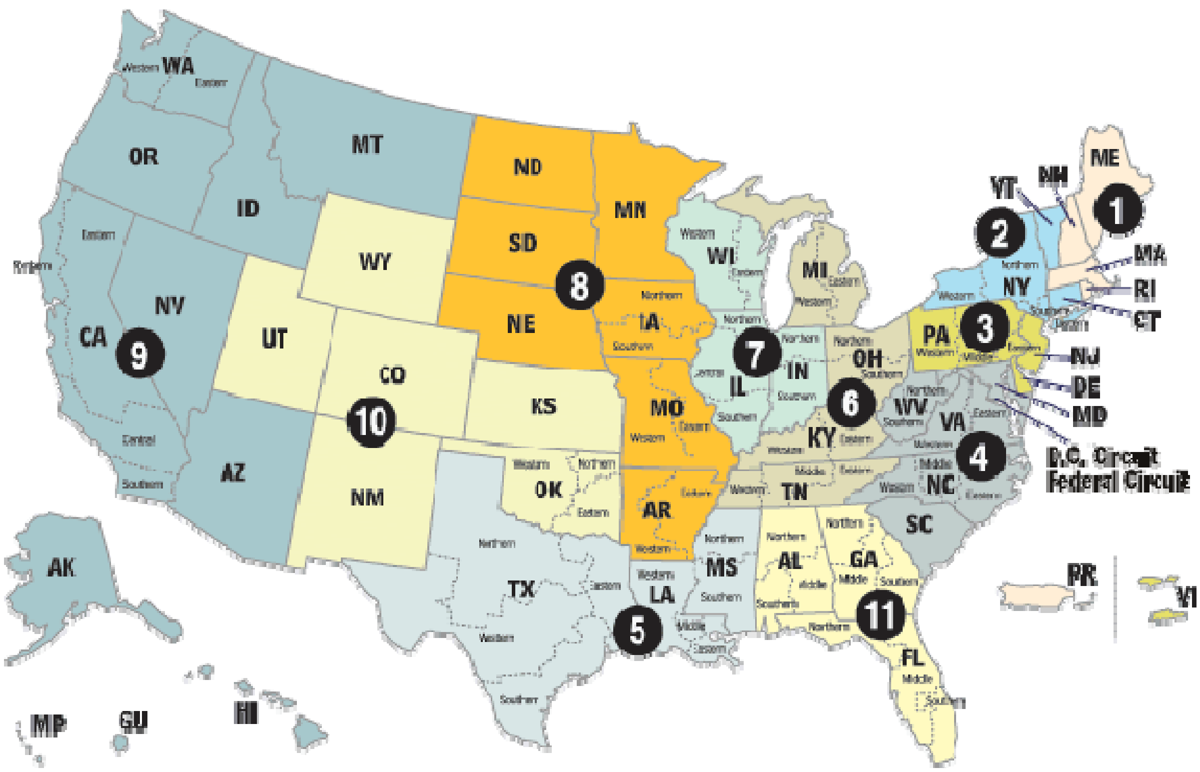
35 The court establishes a list of cities where it hears appeals. See United States Tax Court, *Rules of Practice and Procedure,* rule 140, available online on the IRS Website: <http://www.ustaxcourt.gov/notice.htm>.

36 *Ibid.*, preamble to Appendix 3 of the rules.

37 US Courts Website: <http://www.uscourts.gov/districtcourts.html>.

38 NTA, *Report 2006*, *supra* note 33, pages 553-554.

ILLUSTRATION 1.1
DIVISIONS OF THE 11 REGIONAL CIRCUITS IN THE UNITED STATES



Source: US Courts Website: <http://www.uscourts.gov/images/CircuitMap.pdf>.

The United States Bankruptcy Courts

A Bankruptcy Court exercises jurisdiction to judge any tax question in a bankruptcy case if no other legal proceeding has already settled this question in the case.[39] A Bankruptcy Court is a specialized chamber in a District Court.[40]

APPEAL COURTS

The United States Courts of Appeal

Briefly, taxpayers and the tax administration have the right to appeal a decision of a District Court or the United States Tax Court before the Court of Appeal of the regional division.[41]

In the case of the United States Tax Court, the parties must file an appeal with the regional Court of Appeal in the region where the taxpayer maintains his legal domicile. If the taxpayer is a company, the parties must launch an appeal before the Court of Appeal in the region where the company's principal place of business is located. The taxpayer and the tax administration may also mutually agree upon a given regional Court of Appeal.[42]

The United States Court of Appeals for the Federal Circuit

The Court of Appeals for the Federal Circuit exercises limited jurisdiction. It has exclusive jurisdiction to judge a decision of the United States Court of Federal Claims but does not have jurisdiction to judge a decision of the United States Tax Court or a District Court in tax matters.[43]

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[39] *Ibid.,* page 554.

[40] US Courts Website: <http://www.uscourts.gov/bankruptcycourts.html>.

[41] US Courts Website: <http://www.uscourts.gov/courtsofappeals.html>.

[42] 26 U.S.C. § 7481; § 7482(b).

[43] See 26 U.S.C. § 7481. See also 28 U.S.C. § 1291; § 1292; § 1295.

THE UNITED STATES SUPREME COURT

The Supreme Court may judge any litigation concerning legal questions of major interest pertaining primarily to the application of federal laws or the US Constitution. It chooses in a discretionary manner the decisions that it deems to be of interest according to the parameters set by the US Congress.[44]

More specifically, the Supreme Court will agree to hear a case if it believes that it deals with a major question according, among other things, to the following circumstances:

- a decision rendered by a regional Court of Appeal conflicts with a decision rendered by another regional Court of Appeal on a question of fundamental interest;
- a decision of a Court of Appeal concerning a question of national interest conflicts with decisions rendered by the Supreme Court.

Only under exceptional circumstances will the Supreme Court grant leave to appeal a decision if the appellant argues that the courts erred in the interpretation of the facts or in the application of a legal rule.[45]

[44] US Courts Website: <http://www.uscourts.gov/supremecourt.html>.
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