Commentary

The Problem of Corporate Tax Shelters: Uncertain Dimensions, Unwise Approaches

GEORGE K. YIN*

I. INTRODUCTION

In 1999, the Treasury Department issued a report urging adoption of a number of legislative solutions to curb the growth of corporate tax shelters. Treasury described the shelters as proliferating and presenting "an unacceptable and growing level of tax avoidance behavior."1 As part of its evidence, Treasury pointed in the report and in later congressional testimony to a growing disparity between the book and taxable income of corporations, both in terms of their levels and rates of growth.2

In their excellent article, Gil Manzon and George Plesko attempt to identify the reasons for the book-tax disparity.3 Using data from corporate financial statements over the 12-year period 1988-1999, they calculate their own estimate of the book-tax gap, which is roughly consistent with Treasury's evidence. They then find, however, that a small set of variables is able to explain an important part of their gap. For the most part, these variables represent items that provide ready explanations for a disparity due to differences in the financial and tax accounting rules. Moreover, although the explanatory power of these variables fluctuates over the 12-year period, they discern no pattern to

---

the fluctuation that is consistent with the hypothesis that corporate tax shelter activity is on the increase. Their article therefore raises the question whether we can accurately identify either the existence or the growth of corporate tax shelters from an examination of book-tax trends.

In this Commentary, I use the recent and notorious cases of *Compaq Computer Corp. v. Commissioner,*4 *IES Indus., Inc. v. United States,*5 and *UPS, Inc. v. Commissioner,*6 as a springboard to accomplish two objectives.7 First, I analyze the apparent book-tax consequences of the transactions involved in those cases. In general, my examination illustrates the extraordinary difficulty of understanding the true dimensions of a corporate tax shelter problem. Specifically, my review suggests that the measures of a book-tax disparity used by Treasury and by Manzon and Plesko both may be too crude to capture the book-tax effects of certain corporate tax shelters. Thus, even if shelters are proliferating and causing ever greater discrepancies between financial and tax reporting, existing methods of analysis may not permit us to perceive the existence of such trends.

4 277 F.3d 778 (5th Cir. 2001), rev'd 113 T.C. 214 (1999).
5 253 F.3d 350 (8th Cir. 2001), rev'd 2001-2 USTC ¶ 50,470 (N.D. Iowa 1999).
6 254 F.3d 1014 (11th Cir. 2001), rev'd 78 T.C.M. (CCH) 262 (1999).
Second, I briefly consider some of the doctrinal implications of the three cases. My general conclusion is that tools such as "economic substance" and "business purpose" should be reserved to combat transactions that are more unambiguously objectionable than the ones involved in those cases.

Section II reviews and analyzes the Compaq, IES, and UPS transactions. Sections III and IV then discuss the book-tax effects and doctrinal aspects of the cases. Section V contains my overall conclusion.

II. The Compaq, IES, and UPS Cases

A. Compaq and IES

Compaq and IES both involved dividend capture transactions in which the taxpayers became record owners for a very brief period of time of stock interests in foreign companies in order to capture their dividend. By capturing the dividends, the taxpayers claimed entitlement to credits for the foreign taxes withheld from the dividend payments. These transactions were attractive to the taxpayers because the price of the stock interests did not fully capitalize the value to them of the foreign tax credits. Rather, the price was determined by owners who could not use such credits. Thus, the transactions were essentially transfers of foreign tax credits from owners who could not use them to taxpayers who could, with the two parties sharing the value of the credits.

Specifically, using the facts from Compaq, the taxpayer purchased the interests cum dividend for $887,577,000 and then sold them immediately after ex dividend for $868,412,000 to the same party from whom the interests were acquired. Despite paying only $19,165,000 for the dividend ($887,577,000 - $868,412,000), the taxpayer thereby captured a gross dividend of $22,546,000. The gross dividend was reduced by a 15% foreign withholding tax of $3,382,000 so that the taxpayer actually received a net dividend payment of $19,164,000 ($22,546,000 - $3,382,000), or almost exactly what the taxpayer paid for the entire dividend.8 Thus, based on the change in price, the taxpayer did not pay anything for the portion of the dividend used to pay the foreign tax and, therefore, did not bear any of the economic cost of that tax. Nevertheless, as record owner of the interest and recipient of the dividend, the taxpayer had the legal liability to pay the foreign tax and therefore claimed a foreign tax credit equal to the amount of

---

8 The plan had been to match these amounts exactly. When the cost turned out to be about $1,000 more than the amount of the net dividend, the promoter reduced its commission by that amount. See Brief for the Appellee at 34 n.6, Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001) (No. 00-60648), 2001 TNT 28-46, Feb. 9, 2001, available at LEXIS, Tax Analysts File [hereinafter Government's Compaq Brief].
the tax.\textsuperscript{9} The taxpayer incurred total transaction costs of $1,486,000 to participate in the transaction.\textsuperscript{10}

Relying upon the economic substance doctrine, the government challenged the taxpayer's entitlement to the foreign tax credit. The government asserted that the transaction failed to produce a pretax profit and that therefore, the taxpayer's sole objective was the reduction of taxes. The dispute boiled down to the proper way to measure the pretax consequences of the transaction. The taxpayer contended that to make a pretax determination, \textit{all} taxes, including the foreign taxes paid in the transaction, should be disregarded. The foreign taxes therefore should not be treated as an expense for this purpose.\textsuperscript{11} Hence, according to the taxpayer, the pretax consequences of the transaction were as follows:

\begin{table}
\caption{TAXPAYER'S PRETAX ANALYSIS}
\begin{tabular}{ll}
1. Cost of stock & $887,577,000 \\
2. Transactions cost & 1,486,000 \\
3. Gross pretax cost (1 + 2) & 889,063,000 \\
4. Proceeds from sale of stock & 868,412,000 \\
5. Gross dividend earned (unreduced by foreign withholding tax) & 22,546,000 \\
6. Gross pretax benefit (4 + 5) & 890,958,000 \\
7. Net pretax profit (6 - 3) & 1,895,000 \\
\end{tabular}
\end{table}

After taking into account the tax consequences, the effect of the transaction was the following:

\begin{table}
\caption{TAXPAYER'S AFTER-TAX ANALYSIS}
\begin{tabular}{ll}
8. Capital loss (3 - 4) & ($20,651,000) \\
9. Tax savings from loss (8 \times 34\%) & 7,021,000 \\
10. Tax on dividend (5 \times 34\%) & 7,666,000 \\
11. Net tax cost (10 - 9) & 645,000 \\
12. Net after-tax profit (7 - 11) & $1,250,000 \\
\end{tabular}
\end{table}

\textsuperscript{9} See Biddle v. Commissioner, 302 U.S. 573 (1938); Reg. § 1.901-2(f)(1), (2).

\textsuperscript{10} The counterparty to the taxpayer's transaction was a short seller of the stock interests. Government's \textit{Compaq} Brief, note 8, at 7. The party from whom the counterparty borrowed the interests bore the burden of the foreign tax but also received compensation for making the loan. Thus, the taxpayer might be viewed as having borne some part of the cost of the foreign tax through its transactions costs.

\textsuperscript{11} Commentators have split regarding whether foreign tax should be treated as an expense for purposes of making the pretax calculation. Compare Teitelbaum, note 7, at 835-36 (should not be treated as expense), with D. Kevin Dolan, Carolyn M. DuPuy & David I. Bower, Notice 98-5: Shoot Now, Aim Later, 27 Tax Mgmt. Int'l J. 174, 185 (1998) (should be treated as expense).
In summary, the taxpayer contended that the transaction produced a pretax profit (line 7) as well as an after-tax profit (line 12) and therefore had economic substance apart from tax consequences. In effect, the taxpayer claimed it gained about $1,895,000 million before taxes from the transaction (line 7), paid additional taxes of about $645,000 (34% tax rate) as a result (line 11), and therefore obtained about $1,250,000 million after taxes (line 12).

The government essentially argued that the pretax calculation must be made before U.S. taxes but after foreign taxes. Thus, in making the pretax determination, the foreign tax should be taken into account as an expense and only the net dividend received should be counted as part of the benefit obtained. The government’s pretax and after-tax analyses were therefore the following:

<table>
<thead>
<tr>
<th>Table 3</th>
<th>Government's Pre- and After-Tax Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Cost of stock</td>
</tr>
<tr>
<td>2</td>
<td>Transactions cost</td>
</tr>
<tr>
<td>3</td>
<td>Gross pretax cost (1 + 2)</td>
</tr>
<tr>
<td>4</td>
<td>Proceeds from sale of stock</td>
</tr>
<tr>
<td>5</td>
<td>Dividend received net of foreign withholding tax</td>
</tr>
<tr>
<td>6</td>
<td>Gross pretax benefit (4 + 5)</td>
</tr>
<tr>
<td>7</td>
<td>Net pretax loss (3 - 6)</td>
</tr>
<tr>
<td>8</td>
<td>Capital loss (3 - 4)</td>
</tr>
<tr>
<td>9</td>
<td>Tax savings from loss (8 \times 34%)</td>
</tr>
<tr>
<td>10</td>
<td>Tax on gross dividend ($22,546,000 \times 34%)</td>
</tr>
<tr>
<td>11</td>
<td>Tax savings from foreign tax credit</td>
</tr>
<tr>
<td>12</td>
<td>Net tax benefit (9 - 10 + 11)</td>
</tr>
<tr>
<td>13</td>
<td>Net after-tax profit (12 - 7)</td>
</tr>
</tbody>
</table>

According to the government, the roughly $19 million reduction in price and the approximately $19 million net dividend received made the transaction a wash but for the transactions costs. The roughly $1.5 million in transactions costs, however, meant that the transaction produced a pretax loss of that amount (line 7). Net tax savings converted this pretax loss into an after-tax profit (lines 7, 12, and 13), but there was no economic substance to the transaction apart from the tax savings.

In both cases, the trial court’s agreement with the government’s position was reversed on appeal. Each circuit court interpreted the government as arguing that by being record owner of the foreign stock interest, the taxpayer had acquired the right to only the net amount of the dividend rather than the gross dividend. The appellate courts re-

---

12 Notice 98-5, 1998-1 C.B. 334, 336, asserts this same position in a similar context.
jected this position on the basis of *Old Colony Trust Co. v. Commissioner*\(^{13}\) and similar cases. According to the courts, the payment of foreign tax through withholding represented the same benefit to the taxpayers as if they had been paid the gross amount of the dividend and then paid their foreign taxes directly. Thus, the courts determined that the full gross dividend, unreduced by the foreign withholding tax, should be taken into account in determining the pretax consequences of the transactions. This determination produced a pretax profit in each transaction, with the conclusion therefore that each had economic substance apart from tax savings.\(^{14}\)

The manner in which the government presented these cases, and the taxpayers’ assertion of the *Old Colony Trust* case in response, unfortunately succeeded in confusing both circuit courts. The question is not whether the taxpayers benefitted by the payment of the foreign withholding taxes. Of course they did. Rather, the question is the proper characterization of the benefit received by the taxpayers: Should it be considered a *nontax economic benefit* (and therefore properly taken into account in determining the pretax consequences of the transaction) or a *tax benefit* (and therefore properly disregarded for pretax purposes)?

To answer that question and avoid the courts’ confusion, assume the transactions did not involve any withholding taxes. Withholding is simply a convenient tax collection mechanism that is irrelevant for purposes of deciding the issue in the cases. Thus, assume that the taxpayer in each case received the gross amount of the dividend with the accompanying obligation to pay directly any foreign and U.S. taxes. For purposes of illustration, the following examples use the *Compaq* numbers:

**Example 1:** Taxpayer purchases a stock interest in foreign company *cum* dividend for $887,577,000 and receives a dividend of $22,546,000. Assume that unlike the facts in *Compaq*, the price of the interest falls by the *gross* amount of the dividend and it is taxable only in the United States. Thus, taxpayer sells the interest *ex* dividend for $865,031,000 ($887,577,000 – $22,546,000).

**Example 1** illustrates what might be considered the “normal” effect of a dividend on the price of stock. This transaction is not particularly attractive to the taxpayer. The dividend and resulting fall in price of the stock interest produce an economic wash, but the taxpayer still

---

13 279 U.S. 716 (1929).
14 *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778, 785-86 (5th Cir. 2001); *IES Indus., Inc. v. United States*, 253 F.3d 350, 354 (8th Cir. 2001).
must incur transactions costs. In addition, there may be a tax cost to the transaction: Although the capital loss and the dividend are exactly equal, restrictions on the deductibility of the loss may result in some net tax liability.\textsuperscript{15}

\textit{Example 2}: Same as \textit{Example 1}, except that the price of the interest falls by only $19,165,000 to $868,412,000.

This essentially is how the taxpayers characterized their transactions in \textit{Compaq} and \textit{IES}. They claimed that they were able to acquire two assets—a gross dividend payment of $22,546,000 and the remaining stock interest ex dividend worth $868,412,000—for the bargain price of $887,577,000. The amount of the bargain was $3,381,000 ($22,546,000 + $868,412,000 - $887,577,000) which, they claimed, represented their gross pretax profit before transactions costs.

Note how implausible the transaction is when it is presented this starkly. Why would existing owners of the stock interest surrender this windfall? Conversely, why wouldn't \textit{any} buyer be delighted to purchase this stock, subject only to consideration of the transaction and tax costs?\textsuperscript{16} Consequently, why would the dividend have this effect on market prices?

\textit{Example 3}: Same as \textit{Example 2}, except that there is a 15\% foreign tax imposed on the dividend. This tax, however, is fully creditable against the U.S. tax imposed on the dividend.

These facts are even closer to the actual \textit{Compaq} transaction. Still, as argued by the taxpayer, there is no reason to consider the foreign tax any differently than the U.S. taxes in \textit{Examples 1} and \textit{2}. The creditable nature of the foreign tax means that the \textit{worldwide} tax consequences of the transaction are unchanged. Thus, the bargain illustrated in \textit{Example 2} is unchanged in \textit{Example 3}. The taxpayer's pretax and after-tax positions could be summarized as follows:

\textsuperscript{15} See IRC § 1211.

\textsuperscript{16} Even assuming that the capital loss is fully deductible, there would be a net tax cost because the dividend received ($22,546,000) exceeds the amount of the loss ($19,165,000). But that tax cost is simply the tax on the buyer's "bargain gain."
Table 4  
TAXPAYER’S PRE- AND AFTER-TAX ANALYSIS (NO WITHHOLDING TAX)

<table>
<thead>
<tr>
<th></th>
<th>Pretax profit before transactions costs (See Ex. 2)</th>
<th>$3,381,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Transactions costs</td>
<td>1,486,000</td>
</tr>
<tr>
<td>3.</td>
<td>Pretax profit after transactions costs (1 - 2)</td>
<td>1,895,000</td>
</tr>
<tr>
<td>4.</td>
<td>Worldwide tax on dividend ($22,546,000 × 34%)</td>
<td>7,666,000</td>
</tr>
<tr>
<td>5.</td>
<td>Tax savings from capital loss (($19,165,000 + $1,486,000) × 34%)</td>
<td>7,021,000</td>
</tr>
<tr>
<td>6.</td>
<td>After-tax profit (3 - 4 + 5)</td>
<td>$1,250,000</td>
</tr>
</tbody>
</table>

Example 3’s characterization of the transaction is as implausible as Example 2’s in the sense that there still does not seem to be any reason why existing owners would participate in the transaction, why any buyer would not, and why the dividend would have this effect on market prices.

Example 4: Same as Example 2, except that the dividend received by the taxpayer is only $19,164,000, almost exactly the same amount as the drop in the price of the stock interest. In addition, however, the dividend is taxed preferentially at 19%, a 15 percentage point reduction from the taxpayer’s marginal tax rate of 34%.

This example is how the government should have presented its position in these two cases. As noted, the taxpayer’s bargain is implausible if viewed simply as an economic windfall unrelated to taxes. Rather, the taxpayer’s benefit is properly characterized as a tax break and should therefore be disregarded in making the pretax determination. By being able to claim a foreign tax credit equal to 15% of the dividend received while at the same time not bearing any of the economic burden of the foreign tax, the taxpayer in effect was able to reduce its tax rate on the dividend from 34% to 19%. This description also explains why and how the transactions came about. Existing owners had no reason to sell a one dollar dividend for anything less than one dollar. Instead, they entered into these transactions only because, unlike the taxpayer, they were ineligible for the preferential tax rate. Only certain taxpayers were both eligible and able to utilize fully the resulting capital loss; this was the reason for the seemingly unusual effect of the dividend on the equilibrium price for the stock interest. With this characterization, the government’s pre- and after-tax positions could be summarized as follows:

---

17 Cf. Teitelbaum, note 7, at 830 n.3.
18 The prior owner of the stock interest in IES was a tax-exempt entity that could not use a foreign tax credit but that, nevertheless, was subject to the foreign withholding tax. IES, 253 F.3d at 352.
The Government’s Preferred Characterization of the Case

1. Pretax loss before transactions costs ($19,165,000 fall in price less $19,164,000 dividend received) $1,000
2. Transactions costs 1,486,000
3. Pretax loss after transactions costs (1 + 2) 1,487,000
4. Preferential tax on dividend ($22,546,000\textsuperscript{19} \times 19\%) 4,284,000
5. Tax savings from capital loss (($19,165,000 + $1,486,000) \times 34\%) 7,021,000
6. After-tax profit (5 – 3 – 4) $1,250,000

This characterization of the transaction also avoids a paradox implicit in the government’s position. Because the government treated foreign tax as an expense for purposes of making the pretax calculation, the more foreign tax the taxpayer actually bore, the less likely the taxpayer could have shown a pretax profit and therefore proven its transaction had economic substance.\textsuperscript{20} Yet this is exactly the reverse of how the economic substance doctrine presumably should be applied in cases like these. Presumably, the underlying policy objection to these dividend capture transactions—and the reason to invoke the economic substance doctrine to prevent them—is the ability of taxpayers to receive credits for foreign taxes the cost of which they have not economically borne. They in effect get to reduce their U.S. taxes (through the credits) without actually increasing any of their foreign tax cost. But the more foreign tax cost actually borne by taxpayers, the less objectionable is their transaction, and therefore the less need to have the transaction flunk economic substance. By making it more likely that economic substance is flunked in that situation, the government’s application of the test does exactly the opposite of what it should.

The characterization of the transaction illustrated by Example 4 avoids this problem. Under Example 4, the more foreign tax the taxpayer actually bears, the smaller the tax preference. If the taxpayer actually bears all of the foreign tax cost, there is no tax preference at all and therefore nothing objectionable to the transaction.

B. UPS

UPS involved a business restructuring. The taxpayer, whose principal business was the delivery of small packages, reimbursed its customers up to $100 for the value of goods damaged or lost in shipping.

\textsuperscript{19} Under this characterization, the taxable amount is the $19,164,000 dividend received plus the $3,382,000 tax savings from the preferential rate, or $22,546,000.

The taxpayer collected "excess value charges" (EVCs) from customers who wished to insure against possible losses in excess of $100, and this insurance activity was highly profitable due in part to extra efforts undertaken by the taxpayer to safeguard the excess-value shipments.

Beginning in 1984, the taxpayer restructured the excess-value activity to involve two other companies: National Union Fire Insurance Co. (NUF), an unrelated domestic insurance company, and Overseas Partners Ltd. (OPL), a Bermuda-based reinsurance company. The taxpayer had previously formed OPL as a subsidiary and spun off its stock to the taxpayer's shareholders in a taxable transaction. Thus, at the time of the restructuring, OPL was owned by substantially the same shareholders as the taxpayer. Neither the taxpayer nor OPL was publicly held at the time; most of their shareholders were employees of the taxpayer.

After the restructuring, the taxpayer continued to deal directly with its customers in the same manner as prior to the restructuring, and to collect EVCs from those desiring to protect against losses greater than $100. NUF, however, agreed to assume the primary risk of the excess-value activity in exchange for receiving premiums equal to the EVCs collected by the taxpayer. NUF was licensed in each of the states to perform this type of insurance activity. OPL, in turn, reinsured NUF's risk in exchange for the same amount of premiums less the fee charged by NUF for participating in the activity. Thus, as a result of the restructuring, the profits from the excess-value activity formerly reported by the taxpayer were now reported by OPL, less the fee paid to NUF for its involvement. Because OPL was a Bermuda company not generally subject to U.S. taxation, the restructuring potentially resulted in massive tax savings.

The Tax Court refused to respect the restructuring for tax purposes and therefore held that the excess-value profits continued to be taxable to the taxpayer.\textsuperscript{21} Eschewing possible challenges based on §§ 482 or 845, the Tax Court found that the restructuring lacked economic substance including a nontax business purpose. Virtually all of the court's opinion was devoted to explaining why each of the business purposes asserted by the taxpayer were not credible, and that the taxpayer's sole motivation for carrying out the restructuring was tax avoidance.\textsuperscript{22}

\textsuperscript{21} UPS, Inc. v. Commissioner, 78 T.C.M. (CCH) 262, 293 (1999).

\textsuperscript{22} According to the taxpayer, the restructuring was necessary because it (1) ended taxpayer's involvement in an insurance activity that may have been illegal under various state insurance laws, (2) facilitated the formation of OPL as a full-time reinsurance company, (3) permitted greater rate increases than otherwise would have been possible, and (4) separated taxpayer's core delivery business from the risks of the excess-value activity.
The Eleventh Circuit reversed the Tax Court with a remand to consider the possible §§ 482 and 845 issues. It found that the restructuring had economic substance because it created genuine obligations enforceable by unrelated parties. In that regard, the court believed that both NUF and OPL were independent of UPS and that as a result of the restructuring, "UPS really did lose the stream of income it had earlier reaped from excess-value charges." Moreover, it held that the taxpayer satisfied the business purpose requirement because "business purpose" does not mean a reason for a transaction that is free of tax considerations. Rather, a transaction has a "business purpose," when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business.

III. The Book-Tax Effects of the Compaq, IES, and UPS Transactions

A. The Compaq and IES Transactions

As described above in connection with Example 4 and depicted in Table 5, the dividend capture transactions involved in Compaq and IES might be viewed as pure "tax plays." The transactions produced no economic benefits apart from tax savings; indeed, after taking into account the transactions costs, there was a pretax economic loss. But the amount of tax savings exceeded this economic cost, thereby improving the "bottom line" of the corporations engaging in the transactions. Thus, it would seem that transactions like these clearly would be revealed by an examination of book-tax disparities: The effect of the transactions is to decrease taxes and increase after-tax financial earnings as a result.

Treasury did its book-tax analysis based on information provided on Schedule M-1 of the corporate income tax return. As explained by Manzon and Plesko:

Schedule M-1 of the Form 1120 begins with a firm reporting its after-tax book income on the same consolidated entity as the return, and then adds back the provision for taxes. The sum of these two items is pretax book income. From there,

---

23 On remand, one of the issues that should be considered is whether the measurement of UPS's and OPL's profits are correct in view of the extra effort taken by UPS to safeguard the excess-value shipments. See UPS, Inc., 78 T.C.M. at 267-68.

24 UPS, Inc., 254 F.3d at 1019. Because corporations are not ordinarily in the business of surrendering valuable streams of income for nothing, this conclusion of the court suggests that the government overlooked a possible constructive dividend to UPS's shareholders. See David L. Lupi-Sher, As Briefs Are Filed, Practitioners Question Decision in UPS Case, 89 Tax Notes 200, 204 (Oct. 9, 2000) (reporting comments of Martin McMahon).

25 254 F.3d at 1019.
Schedule M-1 provides a reconciliation of the differences...

Pretax book income eventually must be reconciled with the taxpayer's reported taxable income before NOLs and special deductions. The Treasury reduced pretax book income as shown on Schedule M-1 by the taxpayer's tax-exempt interest, and then compared the result to the taxpayer's taxable income to measure the magnitude of the book-tax disparity.

If Treasury had examined Compaq's Schedule M-1 for the pertinent year, what would it have seen? Compaq included its claimed "pretax profit" from the transaction in both its financial and taxable incomes. Thus, Treasury's examination would not have discerned any disparity between those two figures as a result of the transaction. More generally, it is apparent that any time a transaction results in a savings in taxes not accompanied by a reduction in taxable income, a consideration of pretax book income and taxable income may not reveal the bottom line impact of the transaction.

Manzon and Plesko did not have access to the information provided on Schedule M-1. Instead, their basic database was publicly available corporate financial statements. They estimated a firm's taxable income by dividing its current federal tax expense (reported for financial purposes) by the statutory tax rate. They then defined the "spread" as the difference between the firm's taxable income and domestic financial income, and tried to determine how much of the spread could be explained by non-tax shelter reasons.

By starting with tax expense rather than reported taxable income, Manzon and Plesko's approach potentially permitted them to observe book-tax disparities created by transactions such as Compaq's and IES's that result in a savings in taxes not accompanied by a reduction in taxable income. It should be noted, however, that they limited their

---

26 Manzon & Plesko, note 3, at 184.
27 See Form 1120, U.S. Corporation Income Tax Return, line 28, and Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, line 10.
28 See Manzon & Plesko, note 3, at 185, fig. 1, 186 fig. 2.
29 The specific samples of corporations analyzed by Treasury and Manzon and Plesko may well have excluded Compaq, IES, or UPS. The focus of this discussion, however, is on the transactions undertaken by those corporations, under the assumption that some of the corporations included in the samples may have engaged in the same or similar activities.
30 See Appellant's Opening Brief at 26 n.11, Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001) (No. 00-60648), 2001 TNT 37-28, Feb. 23, 2001, available at LEXIS, Tax Analysts File [hereinafter Compaq Brief]. As shown in both Tables 1 and 4, Compaq claimed a pretax profit of $1,895,000.
31 Manzon & Plesko, note 3, at 188.
32 Id. at 192. The calculation of the spread required several other adjustments not relevant to this discussion.
comparison to U.S. tax expense and the U.S. share of pretax book income. As a result, it is not completely clear what impact the Compaq and IES transactions would have had on their measurement of the spread.

To understand why, first consider the likely impact of the transaction on Compaq’s tax reporting. As noted, the company reported an increase in taxable income from the transaction of $1,895,000, which increased its worldwide tax liability by $645,000.\(^{33}\) If separated into its U.S. and foreign tax components, however, the breakdown may well have been as follows:

<table>
<thead>
<tr>
<th>Effect on U.S. taxes:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on $22,546,000 dividend</td>
<td>$7,666,000</td>
</tr>
<tr>
<td>Tax savings from $20,651,000 capital loss</td>
<td>(7,021,000)</td>
</tr>
<tr>
<td>Tax savings from foreign tax credit</td>
<td>(3,382,000)</td>
</tr>
<tr>
<td>Net U.S. tax effect</td>
<td>(2,737,000)</td>
</tr>
<tr>
<td>Effect on foreign taxes</td>
<td>3,382,000</td>
</tr>
<tr>
<td>Worldwide tax effect</td>
<td>$645,000</td>
</tr>
</tbody>
</table>

If this is correct, Manzon and Plesko would have observed only the $2,737,000 reduction in U.S. taxes and converted it into an $8,050,000 reduction in taxable income ($2,737,000/.34).

Next, consider the impact of the transaction on the corporation’s financial reporting. As noted, Compaq also increased its pretax book income by its claimed pretax profit of $1,895,000. But it is not clear how Compaq reported the foreign and domestic components of the book income increase.\(^{34}\) If the increase was reported as either wholly domestic or wholly foreign income, Manzon and Plesko would have observed an increase in the spread, although of different magnitudes. In the first situation, they would have paired the $8,050,000 decrease in taxable income with a $1,895,000 increase in book income. In the second case, they would have matched the decrease in taxable income with no change in book income.

Interestingly, if Compaq determined the foreign and domestic components of the income for financial purposes in the same manner as for tax purposes, the Manzon and Plesko measure would have been distorted. For tax purposes, Compaq reported an increase in foreign source income of $22,546,000 and a decrease in domestic source in-

\(^{33}\) See Compaq Brief, note 30, at 26-27.

\(^{34}\) Financial Reporting for Segments of a Business Enterprise, Statement of Financial Accounting Standards No. 14 (Financial Accounting Standards Bd. 1996) [hereinafter FAS 14], was the controlling standard for the years involved in the Compaq and IES transactions. For years after 1997, FAS 14 was superseded by Disclosures about Segments of an Enterprise and Related Information, Statement of Financial Accounting Standards No. 131 (Financial Accounting Standards Bd. 1997). Each standard permits a fair amount of management discretion in reporting the geographic segment information.
come of $20,651,000 (for a net increase of taxable income of $1,895,000).\textsuperscript{35} Thus, under this scenario, Manzon and Plesko’s approach would have detected an $8,050,000 decline in taxable income but an even greater $20,651,000 reduction in book income from the transaction, with a resulting decrease in the spread. This would be true despite the fact that the transaction seems clearly to have increased the divergence between the corporation’s financial and tax reporting.

Would Manzon and Plesko’s approach have clearly discerned the proper effect if they had focused instead on worldwide taxes and worldwide financial income? Probably not. The question is whether Compaq reported for financial purposes an increase in foreign tax expense of $3,382,000 despite bearing virtually none of that economic cost? If it did, a comparison of worldwide taxes to worldwide financial income simply would have shown increased worldwide taxes of $645,000 (converted into increased taxable income of approximately $1,895,000 ($645,000/.34)) and increased worldwide financial income of $1,895,000. Thus, even under this alternate approach, there would have been no change in the spread, Manzon and Plesko’s measurement of the book-tax disparity.

Moreover, imputing taxable income from worldwide tax liability and comparing it to worldwide financial income has its own difficulties. Such an approach would not differentiate between U.S. and foreign law causes of changes in the book-tax disparity. For example, changes might occur purely as a result of changes in foreign tax rates, thereby further obfuscating any possible signal of corporate tax shelter activity.

\textbf{B. The UPS Transaction}

UPS’s restructuring also might be described as a pure tax play. The restructuring apparently did not change the basic economics of the excess value activity except for the fee paid to NUF for its participation in the transaction. Thus, with the exception of that fee and any other transactions costs, pretax financial income apparently was unaffected. On the other hand, the restructuring did result in a reduction in taxes that more than offset these pretax costs. In short, it would seem that this transaction also should be revealed by an increased book-tax disparity.

\textsuperscript{35} Compaq Brief, note 30, at 11-12. The source of the gross dividend of $22,546,000 was a foreign corporation. Conversely, the $20,651,000 capital loss was recognized by a domestic taxpayer, Compaq. See IRC §§ 862(a)(2), 865(a)(1).
Unfortunately, neither Treasury's nor Manzon and Plesko's approaches would likely have discerned this increase. This is because virtually all of the increase would have been realized by OPL, the Bermuda reinsurance company.\textsuperscript{36} Both the financial and taxable income of UPS were reduced by the amount of profits from the excess value activity that were shifted to OPL.\textsuperscript{37} Furthermore, for tax purposes, it is clear that UPS would not have included OPL on its consolidated tax return, and the same is almost certainly true for financial reporting purposes.\textsuperscript{38}

\section*{C. Summary and Conclusion}

Although the transactions in Compaq, IES, and UPS clearly appear to have increased the disjunction between the financial and tax reporting of the companies involved, it is doubtful that the approaches used by Treasury and by Manzon and Plesko were refined enough to capture that effect. Treasury's approach would likely have failed to identify any book-tax change as a result of the transactions in those cases. Manzon and Plesko probably would have found no change as a result of UPS's transaction, and an increasing or, possibly, decreasing book-tax disparity from Compaq's and IES's transactions. An alternative approach probably would have shown no change in the latter two situations.

Of course, despite the notoriety of these transactions, it is unknown whether they are representative of contemporary efforts to reduce corporate tax liabilities. Until they can be dismissed as isolated cases, however, the potential discrepancy between their apparent book-tax effects and the \textit{perception} of their book-tax effects using existing approaches suggests the need for caution in interpreting results using those approaches. Book-tax disparities in fact may be useful signals of corporate tax shelter activity, but we may be unable to perceive such signals at this time.

There is a final, unsettling aspect to this entire analysis. The discussion thus far essentially has been premised on the assumption that the

\textsuperscript{36} Moreover, once again, the benefit obtained was in the form of tax savings unaccompanied by a reduction in taxable income.

\textsuperscript{37} See Appellant's Opening Brief at 18, UPS, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) (No. 00-12720), 2000 TNT 180-62, Sept. 15, 2000, available at LEXIS, Tax Analysts File [hereinafter UPS Brief]. Presumably, the restructuring also reduced the U.S. tax expense reported by UPS for financial purposes.

\textsuperscript{38} See IRC §§ 1501, 1504(a); Handbook of Accounting and Auditing ¶ 13.01 (Barry J. Epstein ed., 2002). One year after the spin-off of OPL, there were about 163 million UPS shares outstanding owned by 16,297 shareholders and about 164 million OPL shares outstanding owned by 14,811 shareholders (not including an approximately 3\% interest in OPL still owned by UPS). See Taylor & Immerman, note 7, at 1091.
Compaq, IES, and UPS transactions all fall within a discrete set of cases known as "corporate tax shelters," and that if we could only perceive their book-tax effects accurately, we might be able to gauge the dimensions of sheltering activity. But should those transactions be classified in that way? I briefly consider that question next.

IV. Were Compaq, IES, and UPS Decided Incorrectly?

A. Compaq, IES, and the Requirement of Pretax Profit

Previously, I described how a proper analysis of the Compaq and IES transactions would have concluded that they failed to produce any pretax profit. Rather, the only thing achieved was a savings in taxes. Does that mean that the appellate courts erroneously held in favor of the taxpayers? Not necessarily. It is important to recognize that what Compaq and IES did was quite unremarkable. The same outcome might arise whenever a taxpayer acquires a tax-preferred asset from one who does not value the tax preference as highly. A high-bracket taxpayer who exchanges a taxable bond for a comparable tax-exempt bond, where the price does not fully capitalize the value of the exemption to the taxpayer, potentially would be vulnerable to the same challenge encountered by the taxpayers in Compaq and IES. Although there is clearly no congressional intent to subsidize corporations like Compaq and IES through dividend capture transactions, there is likewise no intent to subsidize high-bracket purchasers of tax-exempt bonds. Thus, some justification must be given to why "economic substance" in the form of a pretax profit is necessary to validate the tax benefits in the Compaq and IES transactions but not in countless other situations.

Daniel Shaviro has described well the undesirable consequences if Compaq-type transactions were permitted to be carried out without restrictions. But even if he is correct, his concern does not necessarily justify the use of blunt instruments like economic substance to curb the transactions. Other, more precise tools are available. First, there is the obvious question in the two cases of whether the taxpayer's record ownership of the stock interest should be respected at

39 Section II.A.

40 See Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 786 n.8 (5th Cir. 2001); Shaviro, note 7, at 225; Yin, note 7, at 222-23.

41 For arguments that the pretax profit requirement is incoherent, see Hariton, Tax Shelters, note 7, at 503-05; Alvin C. Warren, Jr., The Requirement of Economic Profit in Tax Motivated Transactions, 59 Taxes 985, 987 (1981).

42 See Shaviro, note 7, at 241-42.
all, given the highly ephemeral nature of its holding.\textsuperscript{43} Rules like § 901(k), not applicable to the pre-1997 \textit{Compaq} and \textit{IES} transactions, buttress this type of challenge by creating a bright-line, minimum holding period requirement as a condition to claiming the foreign tax credit. If § 901(k) proves to be ineffective, further restrictions might be placed on the cross-crediting of foreign tax credits. Alternatively, Treasury might revise § 1.901-2(f)(2) of the regulations to indicate that no foreign tax credit may be claimed in circumstances (like the ones in \textit{Compaq} and \textit{IES}) where the taxpayer clearly does not bear the burden of the foreign tax.\textsuperscript{44}

In view of these options, one wonders why the government chose to invoke the economic substance doctrine to deny the tax benefits in these transactions.\textsuperscript{45} An obvious explanation is that the doctrine is a tool with \textit{retroactive} force. After all, taxpayers have been on notice about the possibility of an economic substance challenge since at least the time of \textit{Gregory v. Helvering}.\textsuperscript{46} Thus, the economic substance doctrine provided a way for the government to collect taxes from taxpayers like \textit{Compaq} and \textit{IES} that had managed to act prior to the effective date of bright-line rules such as § 901(k).

If this was its motivation, the government was short-sighted. Given the existence of § 901(k) and other possible solutions that will likely prevent these particular transactions from succeeding in the future, the very limited, potential benefit from successfully invoking the doctrine in these cases was far outweighed by the potential harm from an unsuccessful effort. It would have been much better to save this tool for more significant controversies.

Another possible explanation is that the doctrine was used as part of the government's broader anti-corporate tax shelter strategy. In other words, it is possible that the government was not particularly concerned about taxpayers like \textit{Compaq} and \textit{IES} getting away with their past transactions, no matter how objectionable the transactions may seem. But the government was and is very concerned with taxpayers engaging in and getting away with \textit{future} corporate tax shelter

\footnotesize
\begin{itemize}
\item \textsuperscript{43} Cf. Hariton, Tax Benefits, note 7, at 611; Kingson, note 7, at 413, 417 (taxpayer's entitlement to tax attribute should be determined by whether taxpayer bears risks and benefits from owning asset associated with the attribute). The government did not pursue this argument at trial in either \textit{Compaq} or \textit{IES}. See Compaq Brief, note 30, at 13; Appellant's Opening Brief at 30, \textit{IES} Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) (No. 00-1221), reprinted in 2000 TNT 88-55, May 5, 2000, available at LEXIS, Tax Analysts File (parties stipulated to \textit{IES}'s entitlement to the dividend).
\item \textsuperscript{44} See Geier, note 7, at 552.
\item \textsuperscript{45} In Notice 98-5, 1981-1 C.B. 334, 336, the Service announced its intention to issue regulations that will incorporate this approach to prevent similar types of transactions.
\item \textsuperscript{46} 293 U.S. 465 (1935).
\end{itemize}
transactions. Thus, the government invoked the economic substance doctrine in these cases for its in terrorem effect.\footnote{See Treasury Tax Shelter Study, note 1, at 4-5 (explaining why ad hoc, after-the-fact efforts to prevent corporate tax shelters are unsatisfactory).}

In a recent article criticizing the performance of the Fifth Circuit in \textit{Compaq}, Daniel Shaviro and David Weisbach make a similar point. They agree that the court clearly was confused and ended up miscalculating the pretax consequences of Compaq's transaction. But their criticism goes further; they argue that the court failed to understand the rationale for doctrines like economic substance and business purpose, and therefore misapplied them.\footnote{See Shaviro & Weisbach, note 7, at 511-12.} And what is the role of the doctrines? They describe it in the following way:

\textit{[T]he doctrines do not seek to achieve logical precision, or to detect and reward moral purity. They are instead simply devices for roughly identifying a socially harmful set of transactions without attacking those that Congress plainly meant to encourage. \ldots [They] try to filter out the transactions that seem likely to be relatively bad.\footnote{Id. at 513.}}

The problem with this position is that it is impervious to reason. We may all oppose "relatively bad," "socially harmful" transactions not intended by Congress; the devil is in figuring out which ones they are. It is not clear to me that we should ask the courts to do the figuring, but even if we should, it seems doubtful that they will be able to do so successfully.

In any event, the Fifth and Eighth Circuits certainly did not "get it," nor perhaps did the Eleventh Circuit (although I do not know Shaviro and Weisbach's views regarding the \textit{UPS} case, discussed next). Thus, the government's novel use of economic substance arguments in dividend capture transactions, an extremely risky effort, ended up backfiring.\footnote{At trial in the \textit{Compaq} case, the government conceded that the application of the economic substance doctrine to Compaq's transaction was a question of first impression. See Compaq Brief note 30, at 14; see also Peaslee, note 20, at 80 n.6 (no finding of prior authorities using economic substance or business purpose tests in foreign tax credit cases).} Far from being terrorized, taxpayers and their advisors may now be inspired to try even more aggressive tax-saving strategies.

\textbf{B. UPS and the Business Purpose Doctrine}

Many of the same comments are appropriate for the \textit{UPS} saga. There was surprisingly little discussion in the Tax Court's opinion on the threshold questions of whether and how the economic substance
and business purpose tests should be applied in cases like that one.51 If the facts of the case are interpreted in a manner least favorable to the taxpayer, the purpose for the restructuring was to have the profits of the excess-value activity taxed under the favorable tax rules of sub-
chapter L and in a favorable tax jurisdiction.52 Do these purposes make the restructuring a “sham” not deserving of tax respect?

Consider a taxpayer who decides to incorporate a new business opportunity. As part of the plan, the taxpayer capitalizes the new venture mostly with the proceeds of debt that the taxpayer incurs directly from a lender. In addition, the taxpayer makes sure that the corporation qualifies as, and elects to be, an S corporation. Should the tax consequences resulting from these events be respected?

Assuming that the business opportunity is bona fide, there would clearly seem to be a nontax business purpose for the overall transaction. On the other hand, it is doubtful that each component of the transaction had such a purpose. The method of capitalizing the business may have been for nontax purposes (for example, a desire to keep debt off the new corporation’s balance sheet) or tax purposes (to ensure that the taxpayer has sufficient basis to deduct any subsequent losses53). The decision to comply with the eligibility conditions of sub-
chapter S, including the possible forsaking of otherwise desirable economic flexibility, appears to be a pure tax play. But for tax considerations, there is no apparent reason for the taxpayer to tailor the business arrangement to meet the subchapter S conditions.

Thus, the proper application of the business purpose doctrine depends mightily upon how the “transaction” is defined.54 If a transaction is sliced too thin with each component having to establish an independent, nontax business purpose, then any business decision with some consideration of taxes could be disregarded for tax purposes.

The UPS case presented this issue quite starkly because its restructuring arguably involved only the “tax” component of its business activity. One wonders whether the plan would have encountered the same scrutiny had the taxpayer initiated the excess-value activity with

51 UPS, Inc. v. Commissioner, 78 T.C.M. (CCH) 262 (1999), rev’d, 254 F.3d 1014 (11th Cir. 2001).
52 Qualification for the subchapter L provisions may have been important if OPL was found to be subject to tax in the United States. Apparently, this may still be an open question. Taylor & Immerman, note 7, at 1094 n.44.
53 See, e.g., Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); Harris v. United States, 902 F.2d 439 (5th Cir. 1990). In both cases, taxpayers were denied basis for loans they guaranteed on behalf of their S corporations.
54 Application of a pretax profit test also requires a definition of “transaction.” Infusion of unrelated capital into a tax-shelter investment easily could convert a pretax loss into a pretax profit. Hariton, Tax Shelters, note 7, at 509.
the restructured steps in place. If not, should there be a different result if, for whatever reason, the “tax” steps are not taken until a later time?55

The Eleventh Circuit seemed to be sensitive to this question. It noted that one class of cases whose tax benefits should be denied due to a lack of business purpose are “tax-shelter transactions or investments by a business or investor that would not have occurred, in any form, but for tax-avoidance reasons.”56 Of course, given the Tax Court’s factual findings about the purpose of UPS’s undertaking, it could be argued that its transaction fell squarely into this objectionable class of transactions. But the Eleventh Circuit did not see it that way. It went on to state:

The transaction under challenge here simply altered the form of an existing bona fide business, and this case therefore falls in with those that find an adequate business purpose to neutralize any tax-avoidance motive. True, UPS’s restructuring was more sophisticated and complex than the usual tax-influenced form-of-business election or a choice of debt over equity financing. But its sophistication does not change the fact that there was a real business that served the genuine need for customers to enjoy loss coverage . . . .57

Thus, the court defined UPS’s “transaction” broadly as including the loss protection aspects of its activity and not simply the shifting of income streams to an offshore insurance company.58

Sadly, the court did not stop there, and hold in favor of UPS simply on the basis of this broad interpretation of the applicable transaction. Instead, persuaded by the government that a business purpose is necessary, and faced with the unchallenged conclusions of the fact finder that UPS did not have one,59 the court ended up resorting to a standard tactic: It redefined the target. As noted previously,60 it concluded that a “business purpose” can include a tax-minimization purpose so long as the transaction involves a going concern engaged in a bona fide profit-seeking business.61

56 UPS, Inc. v. Commissioner, 254 F.3d 1014, 1020 (11th Cir. 2001).
57 Id.
58 Id.
59 On appeal, the taxpayer essentially took the position that a business purpose was not required.
60 See text accompanying note 25.
61 UPS, Inc. v. Commissioner, 254 F.3d 1014, 1019 (11th Cir. 2001).
This is a remarkable redefinition of the business purpose test. The only conditions stated by the court—"going-concern," "bona-fide," and "profit-seeking"—seem largely superfluous, in view of the government's ability to challenge non-bona fide activities as factual shams not deserving of tax respect. Thus, the court's test seems to say that any transaction that is not a factual sham satisfies the business purpose test.

Wouldn't Mrs. Gregory have satisfied this test? Recall that her transaction involved a purported "reorganization" so that her corporation, United Mortgage, could distribute to her its Monitor stock without dividend consequences. The transaction involved in part the creation and prompt liquidation of another corporation, Averill. Despite the government's urging, the Supreme Court refused to disregard the existence of the ephemeral corporation, Averill.

Thus, there seems little doubt that the Court also respected the bona fide, profit-seeking, going-concern nature of United Mortgage. Doesn't that mean, under the Eleventh Circuit's test, that the tax-minimization purpose in Mrs. Gregory's case qualified as a business purpose?

The Eleventh Circuit tried to distinguish Gregory as a case of individual tax avoidance (and not business tax avoidance?) because the transaction served to reduce Mrs. Gregory's taxes and not her corporation's. This seems like a meaningless distinction given the fact that Mrs. Gregory was the sole shareholder of United Mortgage. But even accepting this distinction, the court was in error. It overlooked the fact that an additional purpose of the transaction was to prevent her corporation from having to recognize any gain on the transfer of the Monitor stock. Thus, it is difficult to see why Mrs. Gregory would not have prevailed under the Eleventh Circuit's redefinition of the business purpose doctrine.

V. Conclusion

I draw two conclusions from this review of the Compaq, IES, and UPS cases. First, after analyzing the apparent book-tax consequences of the transactions involved in those cases, it seems clear that we are still far from understanding the true dimensions of a corporate tax shelter problem. My review suggests that the measures of a book-tax

---

62 See, e.g., Knetisch v. United States, 364 U.S. 361 (1960); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).

63 Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("[n]o doubt, a new and valid corporation was created" [referring to Averill]). The Second Circuit's opinion in Gregory is clearer on this point. See Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934).

64 UPS, Inc., 254 F.3d at 1019.

65 The Second Circuit's opinion in Gregory plainly makes this point. Helvering v. Gregory, 69 F.2d 809, 809 (2d Cir. 1934).
disparity used by Treasury and by Manzon and Plesko may both be too crude to capture the book-tax effects of certain corporate tax shelters. Thus, even if shelters are proliferating and causing ever greater discrepancies between financial and tax reporting, existing methods of analysis may not permit us to perceive the existence of such trends.

Second, the government’s aggressive litigation strategy in *Compaq*, *IES*, and *UPS* has backfired and left its economic substance and business purpose doctrines in shambles. As a result of the three cases, we have less understanding of when those doctrines should apply and what they mean when they do. Taxpayers may now feel emboldened to try more and more creative tax-reduction strategies.

No doubt, legislation in this area may again be proposed and considered, at least once the executive and legislative stars become more favorably aligned. The government also may consider Supreme Court review of these decisions. But before it pursues either option, the government needs to articulate more clearly the circumstances in which a pretax profit and nontax business purpose are essential to a taxpayer’s undertaking.