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The Control of Avoidance: The United States Alternative

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The Control of Avoidance: The United States Experience

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Introduction

Ten years ago one of us (with help and advice from, amongst others, the other) wrote a series of articles on the judicial doctrines developed in the United States for the control of avoidance of tax.[1] The general conclusions were that the United States rules were a natural feature of a system which was very different from that in the United Kingdom and that considerable care should therefore be exercised by United Kingdom judges before incorporating such doctrines into United Kingdom law. That care was demonstrated by the House of Lords in *Craven v. White*[2] where the House, in a memorable moment, said to second counsel for the Revenue that there was no need for him to take them on his proposed world tour. Since then, and notably in *McGuckian*,[3] the House has indicated that this does not mean that the United Kingdom doctrines have come to a complete and ossified halt. Thus the rule or approach or doctrine, whichever it might be, has not reached the state of a developed and formalised rule against perpetuities around which parties may safely (if carefully) arrange their affairs or into which they may dangerously (if carelessly) blunder; it is a living doctrine which is part of a general approach to the interpretation of statutes. The recent Tax Law Review Committee Report prefers a "sensible" statutory general anti-avoidance rule to a continued development of judicial doctrine.[4] In the United States there has been little call for such a change. This may be because, deep down and despite their preference for substance over form, the United States tax community (whether judges, lawyers or the IRS[5]) are aware of the value of certainty and, while they have become accustomed to the uncertainty generated by the broad doctrines (and other developments), they have no wish for the even greater uncertainty of a general anti-avoidance rule.

The United States judicial doctrines have been created outside the statute and are therefore hypnotically attractive to the outside observer. There is however evidence that, as Gustafson points out, the frequency of the use of the technique seems to be diminishing as, perhaps following the pattern already laid down in the United Kingdom, Congress and the IRS have found other ways of combating avoidance.[6] As this article repeatedly shows, schemes which have been explored in our *Ramsay* cases would not have been attempted in the United States. United States legislation now routinely deals with avoidance and Gustafson cites the Hobby Loss provisions, Subpart F, the Passive Activity Loss

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1 [1987] B.T.R. 180, 220; [1988] B.T.R. 63, 108.
2 [1988] S.T.C. 476.
3 [1997] S.T.C. 908.
4 At para. 4.18.
5 In this article we use the term "IRS" to cover the Service, its officers and its Commissioner. The term "Commissioner" is used in case names where this is the correct citation.
6 Gustafson in *Tax Avoidance and the Rule of Law* (ed. Cooper, IBFD, 1997) pp. 349–376.

Limitation and the Alternative Minimum Tax as examples. The sweeping Partnership Regulations, on which we comment below, follow the same approach. Yet what lies behind this may be even more interesting. What the United States now has are rules which do not turn on taxpayer intent but on broad categories of transactions. In these ways the United States is coming to look more like the United Kingdom—Taxes Act 1988, s.703 is never far from a United Kingdom fiscal mind.

A further and separate United States development recognises the range of choice which taxpayers face in planning their affairs, choices which are given by the real world to which the tax law has to be applied. Taxpayers are therefore being given the chance to settle their tax affairs or, if one prefers, to select the relevant tax regime in advance; the most of which the system demand by way of payment is consistency in applying the regime selected. Sometimes the choice is implicit; here the system provides clear sets of tax rules and allows taxpayers to bring their facts into one or other legal category as they choose (*e.g.* alimony payments in the U.S.).[7] Sometimes however the choice is explicit; in the United States one could cite the transfer pricing rules with their advance pricing agreements as an example. Another would be the "tick the box" regulations for the classification of an entity as either a company or a partnership[8]; this applies to United States entities but not to foreign entities as viewed from the United States perspective. These indicate a change from the normal *ex-post* way of dealing with tax problems to an *ex-ante* administrative regime. Their implications of such developments are intriguing but beyond the scope of this article.

Despite these developments the judicial doctrines have not gone away. We do not seek to re-examine them at length here. We begin with a brief discussion of the nature of Regulations in the United States tax system before using the 1995 Partnership regulations as an example of one way of dealing with tax avoidance (which, if copied elsewhere in the U.S. system, would appear to make a general rule less necessary). We then turn to some of the United Kingdom's cases since *Ramsay* to see how they would have been dealt with in the United States and at one recent United States decision in which tax planning succeeded—the *Esmark* case. Some of the United Kingdom cases will be decided the same way in the United States and others not—most are the subject of specific legislation. We then comment briefly on the United States advance ruling system since the TLRC requires an advance clearance procedure as part of their "sensible" general anti-avoidance rule.

Our conclusions are that while the United States system has a much more developed judicial approach to counter avoidance this has not stopped either the courts or the Congress from upholding or specifically allowing some avoidance schemes. In our view the key difference has lain in the approach to statutes as sources of law and the much greater rule-formality in the United Kingdom system. However, even here, there are signs of convergence. Just when the House of Lords in *McGuckian* is indicating a more purposive approach to interpretation and a broader approach to the application of the statutes to the facts in front of them, a lead followed with at least superficial enthusiasm by other United Kingdom judges, some United States courts are emphasising the role of textual formalism in the interpretation of statutes, a move associated especially with Justice Scalia. This school of thought goes beyond the search for the intention of congress (intentionalism) or for the purpose or objective of the statute (purposivism) and finds its basis in what

[7] See below.
[8] Treas. Reg., paras 301.7701–2, 301.7701–3.

Eskridge calls "holistic textualism".[9] The approach was set out by Justice Scalia in the following terms in *Green v. Bock Laundry Machine Co.*:

> "The meaning of terms in statute books ought to be determined, not on the basis of which meaning can be shown to have been understood by a larger handful of the members of Congress; but rather on the basis of which meaning is (1) most in accord with context and ordinary usage, and thus most likely to have been understood by the *whole* Congress which voted on the words of the statute (not to mention the citizens subject to it), and (2) most compatible with the surrounding body of law into which the provision must be integrated—a compatibility which, by a benign fiction, we assume Congress always has in mind."[10]

The extent of this contrast is matter for much deeper reflection but for now we simply note the evidence of convergence; whether the United Kingdom will reach the point at which it will consider an argument based on United States cases is also a matter for speculation. The question whether this greater rule formality is a good thing or bad thing is likewise ignored.[11]

Regulations—general status

When United States tax officers come across a tax avoidance scheme they may seek to challenge it in a number of ways—including court action. However they may also seek to change the law. One way is to get Congress to act by making a legislative change to the Internal Revenue Code. This may sometimes be retroactive not just to the start of the current taxable year, which begins on January 1, but for a modest period before that. The Supreme Court has allowed retroaction that went back "only a modest period"—in that case to the year immediately preceding that in which the legislation was passed. The Court said that legislation was neither arbitrary nor illegitimate and Congress had acted promptly. It added that it made no difference that the taxpayer had reasonably relied on the statute as it was.[12] In one of those declamatory phrases which grip the imagination rather than the reason Blackmun J. said, "[T]he tax legislation is not a promise and a taxpayer has no vested right in the Internal Revenue Code."[13] The issue of retroactivity in the United Kingdom is another matter to be returned to another day.

Another option is not to wait for Congress but to act immediately by promulgating a Revenue Regulation stating an interpretation of the Code which catches the transaction. The United States tax system divides regulations into two categories—legislative and interpretative. The former are made under express grants of regulation (*i.e.* statutory instrument) making power, *e.g.* IRC paras 337(d) and 469(f), with which we are familiar in the United Kingdom, *e.g.* Finance Act 1993, s.165(4) (FOREX transitional regulations). In the United States these regulations have to follow the procedures in the Administrative Procedure Act, which require notice to taxpayers and opportunities to comment. This still leaves the regulation making power in the hands of the Commissioner but it needs the

[9] 37 UCLA Law Rev. 621; see also Eskridge, *Dynamic Statutory Interpretation* (1994), Chap. 1, n.64 for some later literature.

[10] 490 U.S. 504, 528.

[11] See generally Atiyah and Summers, *Form and Substance in the Anglo-American Common Law*, Chaps 1, 4 and 11; there is a summary of some of the points by Popkin at [1991] B.T.R. 284–286.

[12] *U.S. v. Carlton* 512 U.S. 26 (1994).

[13] 129 L.Ed. 2d at 30.

imprimatur of the Secretary to the Treasury and requires that the process should be open.[14] In the United States interpretative regulations are made under section 7805a which empowers the Secretary to the Treasury to prescribe "all needful rules and regulations for the enforcement of [the code] including all rules and regulations which may be necessary by reasons of any alteration of law in relation to internal revenue". These regulations do not have to follow the procedures in the Administrative Procedure Act but in practice the IRS generally follows that procedure. They are binding on IRS and taxpayer alike—so long as they are not inconsistent with the statutes.

The issue of the validity of such regulations may be raised in later cases but, according to the leading United States text on tax law, the attitude of the courts is to recognise that the legislative process in the United States is not ideal and that they should be allowed considerable leeway in filling in the gaps of the legislation.[15] It is often said that the courts will give greater effect to regulations made under a specific power than to those made under section 7805a; however the evidence (as opposed to the words) on this is at best only mildly supportive.[16] Although regulations cannot override a provision which is unambiguous and specific in its directions, this leaves a vast area in which the court sustain regulations unless they are "unreasonable and plainly inconsistent with the statutes".[17] Particular weight is placed on the contemporaneous nature of the regulations—these are even more likely to be upheld. Regulations may be retroactive as is envisaged by section 7805(b), which enables the Secretary to direct the extent to which they are not to be retroactive.[18] While there is no legal problem with a retroactive regulation which purports to interpret the existing law, a regulation designed to deal with a particular abusive transaction would if it had retroactive effect be the subject of much criticism. Many controversial regulations only have prospective effect.

A recent study by Aprill relates the status of tax regulations to more general developments in the United States law of judicial review.[19] The *Chevron* decision was given by the Supreme Court in 1984 and upheld a legislative regulation.[20] The administrative body was the Environmental Protection Agency. The regulation had been made in 1981 following the change of President and changed the requirements for a source-of-pollution review process; previously any significant change to a plant would trigger this review; now it was to be done by looking at all the changes to the plant at once to see whether the change was above a certain threshold. The court upheld the change:

> "If the intent of Congress was clear the court and the agency both had to obey it. If however the statutes were silent or ambiguous the court should not impose its own construction but should ask whether the agency's answer was based on a permissible construction of the statute. . . . The court should not substitute its own version for a reasonable interpretation made by the administrator of an agency . . ."[21]

[14] On the U.K. control of delegated legislation see Wade, *Administrative Law* (7th ed.), Chap. 22; and Bradley and Ewing, *Constitutional and Administrative Law* (1997); pp. 722–732.

[15] Bittker and Lokken, *Federal Taxation of Income Estates and Gifts* (2nd ed.), 5 vols. 1989–92 and updating supplement ("S") (hereafter Bittker and Lokken), para. 110.4.2.

[16] For words see Bittker and Lokken, pp. 110–138 and S110–7, adding to nn.14 and 15.

[17] Bittker and Lokken, p. 110–138, S para. 110.4.2.

[18] On possible challenges see Bittker and Lokken, para. 110.4.3.

[19] Aprill, "Muffled *Chevron*: Judicial Review of Tax Regulations" (1996) 3 Florida Tax Rev. 52.

[20] *Chevron USA Inc. v. Natural Resources Defense Council*, 467 U.S., 837 (1984).

[21] Esp. at 842–844.

Aprill's study also raises the issue of what material the courts will look at in deciding whether to "defer" to the regulations and in particular whether the courts should look at the legislative history, an approximately contemporaneous account of the legislative process prepared by the Congress. In *Chevron* the court said that legislative history and other traditional tools should be used at step one but "deference" should be shown at step two. Since 1984 there have been further developments and some Justices have tried to downgrade the role of the legislative history. So in 1992 we find Justice Kennedy in effect removing legislative history from step one. The result was that at step two the agency may still defend any reasonable interpretation and on any basis; it does not matter whether that basis is to be found in the legislative history.[22]

These developments must be seen against the intellectual background of the textualist revolution led particularly by Justice Scalia. As already seen this revolution places great weight on the "plain meaning" of the words of the statutes and can be seen as a return to formalism in the interpretation of statutes. The issue is of course, like every other issue in the United States, very controversial. There has been a great weight of United States scholarship devoted to the study of legislation over the last 20 years[23]; sadly there has been little counterpart in the United Kingdom law schools. A part of the revolution plays down the role of the legislative history. The position of critics of the legislative history has been summarised by Farber and Frickey as follows:

> "[The legislative history] is rarely read by members of Congress and often written by staffers under the influence of lobbyists; it represents legislators at their worst, promoting private interest deals, strategically posturing to mislead judges or abdicating all responsibility to their unelected staffs (who presumably either have their own political agendas or randomly run amok)."[24]

As Aprill explains, Justice Scalia is one of these critics, indeed the Justice once memorably likened the use of the legislative history to "entering a crowded cocktail party and looking over the guests for one's friends".[25] However these critics have their own critics, including Judge Posner.[26] For present purposes one may note three things. The first is the revival of a traditional approach to interpretation; the second is a reduction in the role of the legislative history (a matter of importance if we should ever move in that direction ourselves) and the third is to note Aprill's conclusion that this part of the new revolution does not appear to have reached the Tax Court which routinely still looks at legislative history.

The United States partnership regulations

Regulations are important in the United States system because they give the IRS the power to counteract avoidance schemes by this method rather than have to rely on the

[22] *National RR Passenger Corp. v. Boston and Maine Corp.* 503 U.S. 407 (1992), cited by Aprill at p. 66. It will be appreciated that the requirement that the agency should show that its interpretation is reasonable calls for a more searching inquiry than simply deferring to the agency—Aprill, pp. 87–88.

[23] See generally Eskridge, *Dynamic Statutory Interpretation* (1994), esp. pp. 41–47 and 225–237.

[24] 74 Virginia L.R. 423 at 437–8. Farber and Frickey add that the relationship between this vision of the legislative process and the assumptions of public chjoice theory are obvious but the effect of that relationship is disputed by Aprill at n.193.

[25] Aprill, p. 85, n.194 citing *Conroy v. Asnikoff* 507 U.S. 511 and L.Ed. 2d 229 at 238 (1993).

[26] *Sundstrand Corp. v. CIR*, 17 F 3d 865 (1994) cited by Bitter and Lokken, p. S 4–4.

broad judicial anti-avoidance doctrines; the recent "anti-abuse" regulations under the partnership tax provisions of the Code provide a striking example of this. At one time IRC paragraph 704(b) allowed the IRS to reallocate a particular item if the principal purpose was the avoidance of tax. This was changed in 1976 when the IRS acquired the power to reallocate not when there was a tax avoidance purpose but when the allocation in the partnership arrangement did not have "substantial economic effect".[27] Regulations were issued under the new statute but these were not enough. A new regulation was proposed in May 1994,[28] and then finalised, in considerably different form, in April 1995.[29] Although not a general anti-avoidance provision—its scope is limited to subchapter K of the Code (paras 701 *et seq.*)—it is best seen as an attempt at regulatory codification of some general anti-abuse principles. More ominously it may be seen as a forerunner for regulations in other areas.[30]

The proposed regulation May 1994

This provided that subchapter K was not intended

> "to permit taxpayers either to structure transactions using partnerships to achieve tax results that are inconsistent with the underlying economic arrangements of the parties or the substance of the transactions, or use the existence of the partnerships to avoid the purposes of other provisions of the Internal Revenue Code".

The proposal would have given the IRS very broad authority to recast or altogether ignore transactions that were put together using partnerships in a way inconsistent with the amorphous intent of subchapter K. Much was written on this topic but here two short points should be made. The first is that, for better or worse, partnership planning is often tax driven, some aspects of partnership tax planning in the United States being intended precisely to disregard (or at least stretch) the "underlying economic arrangement of the parties". It followed that, taken at face value, the proposal would have left almost any arrangement using the partnership form at risk. Not surprisingly, the partnership tax bar was almost universal in its condemnation of the loosely drafted, very general proposal, although some commentators defended the proposal on the ground that the IRS needed additional weapons to deal with the aggressive abuses.[31] The second is that doubts were raised as to the validity of such a regulation. The proposal was issued under paragraph 701 of the Code, which merely provides that "[a] partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." The question whether Treasury has the power to issue such a broad-ranging regulation under the authority of a provision that says nothing more than that partnerships themselves are not taxable entities is still unresolved.

The final regulation—1995

The final version was more tightly drafted and included some helpful (although

[27] The precise effect of this change is uncertain since the expression had previously formed part of a Regulation.
[28] Prop. Treas. Reg., para. 1.701–2(a) (1994).
[29] Treas. Reg., para. 1.701–2.
[30] Gustafson, *op. cit.*, p. 360 who notes the text took 13½ pages of the CCH Standard Federal Tax Reporter.
[31] *e.g.* Halperin, 64 *Tax Notes* 823 (1994).

occasionally controversial) examples to provide guidance to practitioners. It is now clear (if it had not been before) that not every partnership used to minimise federal income taxation—*i.e.* almost every partnership—is at risk. The final regulation contains two broad sets of rules—the "anti-abuse" rule and the "abuse of entity" rule.

The general but vague idea in the anti-abuse rule is that the partnership provisions should be used "in a manner that is consistent with the intent of subchapter K". If the "principal purpose" of a transaction is "... to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K", then the IRS can "recast the transaction",[32] which can mean disregarding the partnership altogether, treating some of the purported partners as non-partners for tax purposes, changing methods of accounting, reallocating partnership income or deduction items, and so on—in short, almost anything. United Kingdom readers of a certain age may recall the vigorous reaction when the Finance Act 1960, s.28 was first introduced; mercifully we have not seen too many provisions of that breadth since then.

The regulation tries to define, albeit generally, the "intent of subchapter K", so that there is at least some idea of what the anti-abuse rule is concerned with. The definition looks to the "substantial business purpose" of the relevant transactions, substance-over-form principles, and proper-reflection-of-income principles.[33] In addition, it contains some extensive examples that, in many respects, have become the substantive rules of the provision; at the least these examples provide safe harbours. Outside the safe harbour examples, however, the definitions are still not very precise, with the ultimate determination of legitimacy resting on a facts-and-circumstances analysis that looks to such factors as how much the aggregate partnership tax liability is reduced below what would have been the case had the partnership form not been used.[34] If there is a series of transactions, an important factor is a comparison between the aggregate tax liability with the steps being honoured and the aggregate tax liability with the steps collapsed.

The abuse of entity rule allows the IRS to treat a partnership as an aggregate of its partners "as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder".[35] While the potential scope of this provision is very broad its purpose is clear: parties ought not to be able to use partnerships to circumvent clear limitations in other parts of the Code. For example, two corporations that would be denied interest deductions if they were to issue "high yield debt" ought not to be able to get the deductions by forming a partnership and having the partnership issue the debt.[36] The fact that paragraph 163(e)(5), the provision that would preclude the corporate interest deductions, makes no mention of partnerships should not matter; the abuse of entity provision would treat this particular partnership as if it were an aggregate of its partners, rather than an entity. International tax practitioners who struggle with the varying characterisations of a partnership in different countries may find this rule of some interest.

The situation today

The United States partnership tax bar is much happier with the final regulation than with

[32] Treas. Reg. para. 1.702–2(b).
[33] *ibid.* para. 1.702(a).
[34] *ibid.* para. 1.701–2(c).
[35] *ibid.* para. 1.701–2(e)(1).
[36] *ibid.* para. 1.701–2(f), example 1.

the proposal partly because the regulation is less amorphous than the draft and partly because of the examples. It may also be because Treasury has been careful to emphasise, like the Inland Revenue in some of its manuals, that the regulation is directed at only the most questionable arrangements; there is no evidence that the IRS has as yet been vigorous in its invocation of the anti-abuse rules.

Nevertheless, grumbling persists, and part of the concern is uncertainty about just how far the regulation goes beyond previously existing doctrine. Interesting light is shed on the relationship between the new regulation and the judicial doctrines in this extract from the regulation:

> "[t]he Commissioner can continue to assert and to rely on applicable non-statutory principles and other statutory and regulatory authorities to challenge transactions. This section does not limit the applicability of those principles and authorities".[37]

These words suggest that the regulation may actually add something to the IRS' powers—that it goes beyond substance-over-form, step transaction, sham transaction, and all the rest of the doctrines that the IRS can already mobilise. If so, there may be a grand new regulation-based power for the IRS—a new fuzzy doctrine on top of the already existing fuzzy doctrines. If this regulation means something more than the old anti-avoidance doctrines, critics wonder where to find the authority for that something more. The best that defenders of the regulation can do is to state that the regulation does not directly add anything substantive to the Commissioner's power. What it does is emphasise those powers in a context that has seen more than its share of aggressive tax planning. Moreover by codifying the Commissioner's power to look to substance rather than form, the Treasury has perhaps made it more likely that a judge sceptical of applying substance-over-form and similar doctrines (if there should be such judges in the United States) will overcome that scepticism. The United Kingdom's history with the Taxes Act 1988, s.703 shows that initial complacency may be misplaced.

The judicial anti-avoidance doctrines

As was seen in those articles ten years ago the United States courts have devised a number of doctrines for the control of avoidance. In the articles they were broken down into different elements—sham transactions, step transactions, business purpose and substance over form and so on. The purpose of so doing was to try to identify elements which might or might not usefully be transferred to the United Kingdom and to try to see what the current United Kingdom doctrine was and where it might go. Looking back we have considered whether it was right to break these doctrines down into distinct units rather than regarding them simply as manifestations of one overarching doctrine—the preference for substance over form. However, while this may be a way of finding some basis for the rules, it does not help one to understand their rather selective application. Overall we take comfort from some positive endorsement of what we did[38] and from the fact that the leading United States text still treats them separately[39]; American literature on each doctrine continues to appear.[40] It may also be that it is inappropriate to treat them as

37 *ibid.* para. 1.701–2(i).
38 Popkin [1991] B.T.R. 283, n.1.
39 Bittker and Lokken, para. 4.3.
40 *e.g.* Brown (1992) 15 Hastings Intl. and Comp.L.Rev. 169, esp. n.2.

"bright-line" rules rather than simply as aids to interpretation. It is certainly true that in the end, as the House of Lords said in *McGuckian*, these matters have to rest on statutory interpretation because that is the authority for their being part of the legal system, whether in the United States or the United Kingdom. However if all that is meant is that the application of these different principles depends on their context then we seem to be no further on—the shifting of the rules on to the level of a more abstract principle achieves nothing of explanatory or predictive value. It still remains the firm view of the United Kingdom author that while the United States principles make a lot of sense in their context they should not be adopted as part of United Kingdom law without everyone being aware of the nature of what is being imported. We would agree with Judge Wisdom who in 1970 noted in *Waterman SS Corp. v. Commissioner* that the solution of a case requires

> "something more than easy generalisation that the substance rather than the form of a transaction is determinative of its tax effect. *Gregory* (*v. Helvering*)[41] should not be considered a 'talisman of magical powers', since in numerous situations the form by which a transaction is effected does influence or control its tax consequences . . . This generalisation does however reflect the truth that courts look beyond the superficial formalities of a transaction to determine its proper tax treatment."[42]

Even in 1939, four years after *Gregory*, we find the Supreme Court saying that the *Gregory* principle was "of little value in the solution of tax problems".[43] Nor should one forget critical tax scholars such as Isenbergh.[44]

(a) *McGuckian*: sale of right to dividends

The lesson here is that, with the United Kingdom court in *McGuckian* willing to revisit the boundary between capital and income, there is much to be gained from a look at other common law countries. The distinction is deeply ingrained in all common law countries but the precise boundaries can be different. In *McGuckian*,[45] the sum received for the sale of a right to dividends over a period of three years was characterised as income for the purpose of the Taxes Act 1988, s.739. For Lords Browne-Wilkinson and Clyde this was based on an application of the *Ramsay* principle[46]; for Lords Steyn and Cooke the conclusion could be reached without reliance on that principle.[47] As Lord Lloyd agreed with all reasons given by his colleagues[48] three judges out of five support each *ratio*.

Before turning to the United States materials it may just be worth noting an Australian decision. One of those who would have reached the same decision without relying on the *Ramsay* principle was Lord Cooke. He did not cite the decision of the Australian Full High Court in *FCT v. Myer Emporium*,[49] but one suspects that it was not unknown to him. That case concerned the sale of a right to interest. In rejecting the taxpayer's case that the sum received in return for the right to interest was capital, Mason A.C.J., speaking for the

[41] 293 U.S. 465 (1935).
[42] *Waterman SS Corp. v. Commissioner* 430 F.2d 1185, 1192.
[43] *Higgins v. Smith* 308 U.S. 473 at 476.
[44] 49 U.Chi.L.R. 859, extensively cited in the articles listed at n.1.
[45] [1997] S.T.C. 908.
[46] At 912f and 922f.
[47] At 917j and 919e.
[48] At 914g.
[49] (1987) A.T.R. 693.

whole court, suggested various (not very convincing) grounds on which *Paget v. IRC*[50] might be distinguished before concluding that "if *Paget* is not to be distinguished in this way we should be unable to accept its authority for the purposes of the Act".

When one turns to the United States for comparison one has to begin with the Code itself. The United States tax system has distinguished capital gains from ordinary income for many years and in several ways—including the rate of tax and the treatment of losses. paragraph 1222 charges gain arising from the sale or exchange of a capital asset and paragraph 1221 defines a capital asset. The leading text[51] describes the United States provisions on capital gains and losses as "a leading source of complexity in tax law, comparable in this respect to the realisation concept and the separate taxation of corporation income". The list of capital assets in paragraph 1221 includes all property other than five specifically listed categories. While none of those categories (stock in trade, depreciable property, etc.) includes the sale of a right to a stream of dividends it is reasonably clear that the proceeds of sale of a right to a stream of dividends (especially for as short a period as three years) would be treated by the courts as ordinary income and not as the proceeds of sale of a capital asset.

One of the categories of capital asset appears to come close to *McGuckian*—property that, if retained, would generate ordinary income ("accounts or notes receivable, acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1) [*i.e.*, inventory or stock in trade]"). One might infer from this a general congressional intention to limit the conversion of ordinary income to capital gain but the provision does not in terms apply directly to the sale of a right to dividends. Whatever the outcome of this debate judicial glosses on the capital-asset definition will ensure that the proceeds will be characterised as ordinary income and not capital gain. These glosses come from two relatively old cases which say that capital gain treatment should not be available for amounts that are merely substitutes for ordinary income.

The first case is *Hort v. Commissioner*, decided in 1941.[52] Here the Supreme Court held that a payment made to cancel a lease burdensome to the lessee (prevailing rental rates during the Great Depression having dropped far below the rates provided in the lease) was ordinary income to the lessor. This is the issue that would have arisen in the United Kingdom if the lessor in *Tucker v. Granada Motorway Services*[53] had been subject to tax. *Hort* is usually described as a battle between capital gain and ordinary income—and in a sense it was—but what the lessor actually argued was that he had an ordinary income loss on the transaction in that the cancellation proceeds were less than the present value of the future rental stream. The case focused on the character of the proceeds, and the Court held that no "return of capital" was involved, even though the lease may have been "property" for most purposes and, for that matter, may have been a "capital asset". What mattered was that rent derived from the capital asset would have been taxable as ordinary income; it followed that the cancellation amount "was merely a substitute for the rent reserved in the lease". *Hort* is often (and incorrectly) understood to have been concerned with a sale of the right to future lease payments. While Chirelstein argues that cancellation "really does not present quite the same compelling case for ordinary treatment",[54] it must follow that if a

[50] (1938) 21 T.C. 677.
[51] Bittker and Lokken, para. 50.1.
[52] 313 U.S. 28 (1941).
[53] [1979] S.T.C. 393.
[54] *Federal Income Taxation* (7th ed.) at p. 321.

lease cancellation payment is ordinary income, *a fortiori* the proceeds from sale of a right to lease payments are ordinary income.

The second case is *Commissioner v. P. G. Lake Inc.*, decided in 1958.[55] The Supreme Court, in a number of combined appeals, ruled that the disposition of mineral payment rights—in effect, interests entitling the recipient to a stream of ordinary income—generated ordinary income despite the connection of the interests to land:

> "The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. . . . The substance of what was received was the present value of income which the recipient would otherwise receive in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property . . . [the dispositions were] transparent devices . . . [whose] forms do not control. Their essence is determined not by subtleties of drafting but by their total effect."[56]

What would strike a United Kingdom reader as odd about the *Lake* case is the failure of the court even to cite the earlier decision in *Hort*. Instead the court relied on some assignment-of-income cases where the question was not character of income but, rather, who should be taxed on income generated by property that had been gratuitously transferred.[57] Whatever the defects in Justice Douglas's analysis, the substitute-for-ordinary-income theory clearly is at the core of *Lake*, as it was in *Hort*.

As commentators regularly note,[58] it cannot be the case that any payment substituting for ordinary income must itself be ordinary income. If that were so, there would be little or nothing left of the capital gain provisions. Thus the sale of a share of stock is, in a sense, the sale of a right to a future stream of earnings that would have been taxed at ordinary income rates, but gain on such a sale is unquestionably capital to an investor. So the substitute-for-ordinary-income rationale must be understood to apply to a limited universe of situations. Unfortunately, but inevitably, the boundaries of that universe are not precise. From the many cases involving arguable carve-outs of income interests Bittker and Lokken[59] have distilled some factors to look for. For example, the disposition of an undivided fractional interest in a property is likely to give rise to capital gain treatment, and other divisions that are "coextensive with the life of the property" are unlikely to be recharacterised. In contrast, temporal divisions, where the carve-out is for a period less than the life of the underlying property, are problematic. (Both *Hort* and *Lake* fit in that category. In *Lake*, the pay-outs were expected to occur over relatively short periods.) Also problematic are "anticipatory transactions", sales of rights to ordinary income "on the eve of an ordinary income transaction". Perhaps the best we can do is Chirelstein's short description of *Hort*: "[T]he Court's aim [in *Hort*] was to deny (a) capital treatment, and (b) an offsetting basis, to one who disposes of a right to future income which has been carved out of a larger estate." So, returning to *McGuckian*, the United States view would be that whatever the conceptual difficulties in the cases at the margin, this situation is not marginal. A carve-out of the right to future dividends for only three years from shares in absolute ownership is an easy case for ordinary income treatment. The result makes

[55] 356 U.S. 260 (1958).
[56] At 266–267.
[57] For further criticisms see Bittker and Lokken, para. 51.10.5 and articles there cited.
[58] *e.g.* Chirelstein, *op. cit.*, pp. 318–323.
[59] At para. 51.10.5.

conceptual sense, and it also makes practical sense for one typical United States reason—it avoids the need to come up with a basis for the right-to-dividends.

Before leaving *McGuckian* it may be worth noting some of those other situations which the United States courts have had to consider whether to characterise a receipt as ordinary income or capital gain. Thus the definition of capital assets excludes property held for sale to customers in the ordinary course of trade or business. Although the United States has no statutory provision widening this to cover an adventure in the nature of trade the case law on this heading when dealing with land will seem very familiar to United Kingdom readers.[60] Sums payable for ordinary personal services are excluded from capital gains treatment by paragraph 1221(4) which applies to accounts receivable in the ordinary course of business. The distinction between employment and self-employment is not relevant at this point so ordinary income treatment applies not only to sums received for unpaid services but also to compensation for loss of future income such as compensation received for breach of a contract of employment.

After reading such material it may be surprising to find the decision in *McAllister v. Commissioner*,[61] where the court held that a sum received for the sale of a life estate was capital not income; the decision is denounced by Chirelstein as almost certainly wrong while Bittker and Lokken regard the contrast with *Hort* and *Lake* as paradoxical with the paradox being inherent in the capital gain concept.[62] What mattered was that the sale was of the vendor's entire interest.

(b) *Furniss v. Dawson*

Since *Furniss v. Dawson*[63] is a much-cited case it is perhaps worth noting its United States fate. The planning device there attempted would not work in the United States either—having been pre-empted both by legislation and by judicial activity.

Furniss v. Dawson looks at first sight to be a prime target for the invocation of a wide United States general anti-avoidance rule. To simplify, D holds shares with a market value of 4 but with a base cost of 1; D wants to sell them to W for 4. D makes a share for share exchange with GJ; assuming that the Taxation of Capital Gains Act 1992, s.135 applies D will take the shares in GJ with the old base cost of 1 while GJ takes the share at the full market value of 4. GJ then sells the shares to WB; this is a genuine taxable disposal but in fact yields no gain. Today this would be stopped in the United Kingdom by the business purpose test in the Taxation of Capital Gains Act 1992, s.137. In retrospect what is odd is the absence of a business purpose test from the 1965 legislation.

The scheme would not work under United States tax law either. This is because the United States courts are quite used to filling in the gaps in their legislation by determining the basis of the shares themselves and because the legislation in fact usually anticipates the problem. The problem is solved by the principle, recognised by both case-law and legislation, that if basis is increased gain must be recognised; if D was getting a tax deferral GJ would not. Hence in the United States GH's acquisition cost would be 1 not 4 and so the scheme would not be implemented.

In the United States a corporate reorganisation may be effected in various ways. First,

60 *e.g.* Bittker and Lokken, para. 51.2.3.
61 157 F. 2d 235 (2d Cir. 1946).
62 Chirelstein, *op. cit.*, p. 324; Bittker and Lokken, para. 51.10.5, nn.72 and 73.
63 [1984] S.T.C. 153.

under paragraph 351 a deferral is recognised when property is transferred to a company in return for shares in that company and the transferor(s) control that company immediately after the transfer. Secondly, the transaction could be treated as a "B" reorganisation under paragraph 368. In both these scenarios D will keep the base cost of 1 for the shares in GJ—but GJ will have to have a base cost of 1 also.

The general anti-avoidance approach of the United States courts is of some potential relevance. While these two options do not achieve their United Kingdom objective of deferring liability, such a scheme might be of some United States interest if, as has sometimes happened, the United States corporate income tax rate is lower than the ordinary individual income tax rate. Under these circumstances the transfer to GJ using the reorganisation rules would shift the potential liability from D to GJ and so to the entity with the lower rate. The IRS might be tempted to try to recharacterise the transaction as a simple sale by D to W. However this attempt to exploit the difference in rates is not without its own risks to D—and so the IRS might just sit back and watch D proceed.[64] Because of the classical system of corporate tax in the United States a distribution by the company back to D as ordinary would attract full taxation in D's hands. If D chose to liquidate the company the money would emerge as capital gain but again the gain would have been fully taxed already in the hands of the company. The further complications of the accumulated earnings tax or personal holding company tax (which can be applied to the company) are omitted from this discussion. Until 1986 a further rule was of some relevance. If a company distributed an asset or even sold an asset in anticipation of a liquidating distribution there might be no charge on the company in respect of that gain—the so called *General Utilities* doctrine. That doctrine was repealed by the Tax Reform Act 1986 but had already been reduced by statute and eviscerated by the courts.[65]

If GJ is not to realise a gain it must take the asset over at a base cost of 4. To do this the parties must make the facts fall outside paragraph 351 and also avoid a "B" characterisation of the transaction—perhaps by demonstrating the lack of a business purpose. However one has now stumbled into ever deeper thickets while forgetting what one is trying to do. The consequence of making the transaction such that GJ has a base cost of 4 is that D has realised a gain of 3 on the transfer to GJ; hence D will have realised a gain anyway and might as well realise that gain in the simpler way of a sale to W.

(c) *Ensign Tankers* and non-recourse finance

The lesson to be learned here is the probable advantage of allowing some matters to be dealt with by case law on a principle basis rather than by rushing to legislate. Even today no-one in the United Kingdom is sure how far the principle in *Ensign Tankers* goes; the clearer United States rules on the topic look like examples of legislative overkill.

To summarise the facts in *Ensign Tankers Leasing Ltd v. Stoker*,[66] C, was a limited partnership which was to finance a film made by D so as to exploit the generous capital allowances then available. Ostensibly C put up 100 per cent of the money but in fact it put up only 25 per cent, the balance being loaned by D to C and made payable on a non-recourse basis. C owned the master negative of the film; C assigned the right to promote the film to subsidiaries of D. The House of Lords held that, on the particular

[64] On the IRS's right to do this see *infra*.
[65] See Bittker and Lokken, para. 92.3.
[66] [1992] S.T.C. 226.

facts,[67] the money provided by D to C could not be said to be expenditure incurred by C on acquiring the film rights so that C was not entitled to capital allowances on 100 per cent of the expenditure but only on 25 per cent.

So far as films are concerned the United States history is in two acts. The story begins with the 1947 Supreme Court decision in *Crane v. Commissioner.*[68] Assuming that the facts gave rise to a real loan—a rather questionable proposition given the facts in *Ensign*—the *Crane* case, the case that made tax shelters possible, allowed C to write off 100 per cent of the expenditure despite the non-recourse nature of the debt; non-recourse and recourse were treated alike provided the loan were genuine. The reason for this is that if the mortgage is not included C's depreciation deductions will not reflect actual physical exhaustion so distorting income.[69]

The second act was the 1976 Tax [Reform] Act which introduced at-risk rule for films.[70] paragraph 465 of the Code was made applicable to "holding, producing, or distributing motion picture films or video tapes". It follows that these devices had been dealt with before the 1986 Tax Reform Act. The third act, the Tax Reform Act of 1986, is of no relevance to films since they had already been dealt with. However the Act widened paragraph 465 still further and had its critical impact on real estate, which had been outside the coverage of paragraph 465. When paragraph 465 applies, depreciation deductions are limited to the amounts taxpayers have at risk—generally cash and the adjusted basis of property contributed to the activity, the amount of any liabilities for which they are personally liable together with the amount of some non-recourse liabilities (those secured by property not used in the activity). So the deductions for the partners in C would be limited to the amount of their contributions (the 25 per cent), assuming that the at-risk amount does not increase in the future (such as through undistributed revenue).

The United States legislative at-risk rules are very complex and the complexity is increased when they are combined with the passive activity loss (PAL) rules. In this combination it can be seen that the real target for the legislator should have been not non-risk finance as such so much as seller-financed debt[71]—as happened in *Ensign*. If this analysis of the United States rules is right the United Kingdom may, by case law development, have reached a solution rather better than the United States statutory rules.

[67] Quite what the relevant particular facts were is of course uncertain but one may note the description of the facts set out by Lord Goff at 245–246 and his comments at 245h: "I am prepared (with some hesitation) to accept that the composite transaction which I have just described should not be called a sham", and, after setting out the detailed arrangements for repayment, at 246g: "In the circumstances it is, I consider, a misuse of language to describe the payments made by [D] into the bank account as a loan by [D] to [C] to enable [C] to finance the making for the film by [D] on its behalf in excess of [25%]".

[68] 331 U.S. 1 (1947).

[69] Bittker and Lokken, paras 41.2.3, n.8 and 43.4.2.

[70] The film industry is one of those areas where taxpayers cannot be sure of a return on their investments—but this has not prevented the Tax Court from playing the role of film critic. IRC para. 183 resembles (distantly) T.A. 1988, ss.397 and 386 in that it creates a presumption that an activity has been conducted for profit if it has generated a net profit in three of the last five years or two out of seven for horse-breeding, racing or showing. In *Jacobson v. Commissioner* the Tax Court decided that a film had not been made for profit. The court said the film was "a slow paced melodrama, and the screen play full of trivial conversation and shallow commentary". The subplots were "pedestrian" and the supporting characters "flat". The Court of Appeals overruled the Tax Court: 915 F. 2d 832 (cited by Gustafson, p. 362).

[71] Sims, "Debt, Accelerated Depreciation and the tale of a Teakettle: Tax Shelter Abuse Reconsidered" 42 UCLA L.R. (1994).

Where the non-recourse loan comes not from the seller but from a third party—and so real dollars change hands and the nominal creditor has every incentive to enforce the loan obligations—the potential for abuse does not exist or at least is much reduced.[72]

In looking at United States rules one must begin first with the issue whether there is a loan at all (and if so for how much), issues which arose in *Ensign*; only then, having found that there was a loan, does not apply the at-risk and other rules. As an example of the schemes attempted in the United States suppose that S sells a piece of land worth $100 not for that simple price of $100 but for $10 plus a purchase-money mortgage of $1 million; in the most extreme cases the $1m would only be repayable at some far future time). If the scheme worked B, the buyer, would be entitled to deduct depreciation using a basis not of $100 but of $1,000,010. When the scheme was first created, S might seek to defer any gain attributable to the mortgage note under the instalment method of reporting. If B defaulted—as would almost certainly happen—S never reported any gain. It is true that B would be treated as receiving income when released from the debt but the tax benefits already realised by B would far outweigh the tax detriment of gain recognition.

The success of the scheme would originally turn on the question whether this was a genuine loan. The IRS would argue that the debt was not real debt at all—especially where, as here, the value of the property "securing" the note, with value measured at the time the loan was incurred, was substantially less than the amount of the note. If it was not a real loan, the amount of the loan does not get included in basis and interest deductions are not available. The transaction was in essence either an option (the buyer will make the balloon payment only if the property dramatically increases in value) or a sale of tax benefits. Either way, the desired tax results were unavailable. The IRS won in the now classic 1976 case, *Estate of Franklin v. Commissioner*.[73] There B, a tax-shelter partnership, had "paid" much more than a motel's value to the parties who would continue to operate the hotel after the sale. Most of the purchase price was in the form of a grossly inflated purchase money mortgage designed to heighten depreciation and interest deductions. B lost, having failed, in the language of the Ninth Circuit, "to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property". It is true that a recent case, the 1988 decision in *Pleasant Summit Land Corp. v. Commmissioner*,[74] goes the other way but this seems to be a distinctly minority position. In *Pleasant Summit* the court permitted a fair market value basis even when the nominal debt greatly exceeded the value of the property. In cases which have gone to other circuit courts because of the investors' different places of residence, the position taken in the 1988 case has been rejected; the general view is that was no liability at all—and no basis for the note.

If the facts show that there is a genuine debt the IRS will then invoke the "at loss" and other rules. It should perhaps be noted that the effect of paragraph 465 is not the same as altogether denying tax effects to non-recourse debt. Paragraph 465 does not come to precisely the same result that repeal of the *Crane* basis rule would have done. If the note is reflected in the basis of the motion picture, as it would be if the debt is real, the depreciation deductions would be measured by that higher basis. Thus suppose that one has property with a $100 basis, $10 of which is attributable to a cash contribution and $90 of which is attributable to a non-recourse loan. If the depreciation deduction in year 1 is 10 per cent of basis, the deduction would be $10 in that year—none of which would be limited

[72] See Jensen, 10 Va.Tax Rev. 455.
[73] 544 F. 2d 1045 (9th Cir.).
[74] 863 F. 2d 263 (3d Cir. 1988).

by the at-risk rules. By contrast, if the non-recourse loan were not reflected in basis at all, the deduction in year 1 would be only $1 (one-tenth of $10). Total deductions over time would still equal $10—$1 per year—but the at-risk rules do nothing to prevent the accelerate of deductions attributable to the enhanced basis of $100 as opposed to $10.

(d) *Sherdley*: avoidance opportunity enshrined in legislation

Maintenance or alimony is an area in which the United States tax system openly condones what one might have regarded as avoidance but the condonation takes the form of allowing the taxpayer to plan matters so that they fall on one side of the line or the other—and so falls short of an open election procedure for entity classification. In *Sherdley v. Sherdley*[75] the House of Lords upheld a planning device which had been developed which enabled a parent to make maintenance payments not only to the other spouse but also direct to the children. These direct payments would enable the payments to be set against the children's personal allowances and lower marginal rates. This system was of course dismantled in the United Kingdom in 1988 when payments, whether to the spouse or child, ceased to be deductible as such, the standardised (and now disgracefully attenuated) qualifying maintenance deduction being substituted, while all such payments ceased to be income of the recipient under Schedule D, Case III.[76]

Although the conceptual framework is quite different from the United Kingdom, United States taxpayers are still free to arrange their affairs on a quite formal basis to achieve tax reductions.[77] These enable taxpayers, within limits, to make the payments deductible or non-deductible as they may wish. The recipient, if taxable, is liable under paragraph 71; the payer's right to deduct is contained in paragraph 215. Deductibility entails taxability for the recipient; non-deductibility entails non-taxation—there is no room for what Americans call a whipsaw effect. This is achieved by legislation and cannot be assailed on the basis that is tax-driven. Whether it can be attacked for being unconstitutional is another matter.

We now consider the United States rules in more detail.[78] In the early years of the modern American income tax, there was some doubt about the constitutionality of taxing alimony—*i.e.*, whether alimony is encompassed by the term "incomes" in the Sixteenth Amendment to the United States Constitution.[79] Since 1942, however, the Internal Revenue Code, (now para. 71), lacking a general provision like Schedule D, Case III, has expressly provided that alimony and separate maintenance payments are included in the gross income of the recipient; it has equally provided that such payments are deductible by the payer. Despite the pre-1942 doubts, the constitutional issue has receded into the obscurity of academic footnotes, part of a more general reluctance to subject federal tax laws to serious constitutional examination which has been summarised by Graetz as, "The Constitution stops where the Internal Revenue Code begins."[80] The 1942 scheme had one drawback in that the scope of "alimony" was not always clear and payers could plausibly deduct amounts that payees were not reporting as income. This inconsistency was matched by the IRS—to protect the revenue. The reported cases focused on whether

75 [1987] S.T.C. 217.
76 T.A. 1988, ss.347A and 347B, added by F.A. 1988, s.36.
77 Gustafson, p. 375 gives other instances such as para. 1031 on like-kind exchanges.
78 See generally Bittker and Lokken, Chap. 77.1.
79 *Mahana v. U.S.* 88 F.Supp. 285; see also *Fairbanks v. Commissioner* 191 F. 2d 680 (9th Cir.)—the matter has never been considered by the U.S. Supreme Court.
80 *The Decline (and Fall(?)) of the Income Tax* (1997) p. 280.

amounts were in substance alimony, looking to such factors as whether the payments were periodic (periodicity pointed toward alimony treatment), whether they discharged a material support obligation, whether they were to be discontinued upon the death or remarriage of the payee spouse, and whether they were earmarked to support minor children of the payer (child support not being treated as alimony).[81]

In 1984 Congress intervened, providing a number of statutory requirements, which, if satisfied, give rise to characterisation as alimony. If those requirements were not satisfied, non-alimony characterisation followed; a non-alimony characterisation would mean that the transfer was generally regarded as a non-taxable—and non-deductible—gift.[82] While the 1984 requirements clearly derive from the pre-1984 case law, the rules are intended to be "either-or" rules, with form controlling the outcome (except perhaps at the margins). The first three 1984 requirements are that a payment is an alimony payment if (a) it is in cash; (b) it is received by or on behalf of a spouse under a divorce or separation instrument; and (c) the payments are, as a matter of law, to terminate on the death of the payee.[83] Three further rules are important: (d) if the spouses are legally separated payments between them will not be alimony if they are members of the same household; (e) perhaps most important, the parties must not have elected to characterise the payment as not alimony.[84] The power to elect is subject to the general rules (*i.e.* (a)–(d) and (f)); a transfer breaking the rules, *e.g.*, a non-cash transfer, cannot be characterised as alimony. Finally there is rule (f), the payments cannot be alimony to the extent that a divorce or separate instrument fixes particular payments as "for the support of children of the payor spouse". It is at this point that payments for and, *a fortiori*, to the children become relevant in the United States context. The parties can control their tax liabilities by denominating, or not denominating, payments as child support.[85]

The alimony provisions of the Code are thus a permissible form of assignment of income, and they are in that respect pro-avoidance. If there is an anti-avoidance aspect to this system, it is that it prevents whipsawing the government. To claim an alimony deduction, a payer spouse must indicate his payee spouse's social security number on his return.[86] Consistent treatment by the two parties is thus assured (assuming the Internal Revenue Service's computer system can handle the necessary comparison of tax returns). But, except for the requirement of consistency, it is understood that the system will lose the Treasury money.[87]

(e) Hedging transactions: *Whittles v. Uniholdings (No. 3)*—principle or garrotte?

The problem of the tax treatment of hedging transactions caused no less difficulty in the

[81] A well-known example is *Bernatschke v. U.S.* 364 F. 2d. 400 (Ct.Cl.) where the former husband bought an annuity for the benefit of the former wife. The lump sum pointed to no deduction for H but the periodic payment had the scent of alimony for W perhaps to avoid that undesirable result the Court of Claims strained to characterise the arrangements as not arising from any marital obligation and so not as alimony. This brought the symmetrical result that H could not deduct the sum and W had no income.

[82] IRC para. 1041 (governing transfers between spouses or former spouses if "incident to divorce".

[83] No substitute obligation must "kick in" at that time.

[84] IRC para. 71(b).

[85] IRC para. 71(c)(1).

[86] IRC para. 215(c).

[87] The system has been criticised by feminists. However, if the divorcing spouses are well represented both should come out better, on an after tax basis, than they otherwise would have been. The anti-female bias in the system lies in the general problem of securing adequate (*i.e.* at least equal)

United States than it has done in the United Kingdom—and with the same eventual solution of special provisions—in the form of regulations made under IRC paragraph 988(d).[88] There are also separate regulations for foreign exchange transactions and for financial instruments.[89]

The case law as developed before the regulations began with the *Corn Products* case in 1955.[90] This provided ordinary income treatment for profits and losses from corn futures realised by a company engaged in converting corn into other products. Although futures were not listed in paragraph 1221 as being excluded from the category of capital assets the Supreme Court held that they gave rise to ordinary income under an invocation of general congressional intent that profits or losses arising from the everyday operation of a business should be so considered. The preferential treatment of capital assets should be given only to transactions of property which were not the normal source of business income; capital assets should be construed narrowly.

Corn Products returned to the Supreme Court in 1988 when it (or, perhaps more accurately, lower court readings of it) was substantially narrowed. In *Arkansas Best Corp. v. Commissioner*[91] the taxpayer had bought additional stock in a failing subsidiary to protect its business reputation. Although the Tax Court held that the taxpayer's business purpose in buying the stock was enough to make the resulting loss an ordinary income loss the Supreme Court disagreed—the taxpayer's motivation was not relevant. Subsequently the Tax Court decided that a company whose business was to buy and hold mortgages was allowed to treat losses on financial transactions such as future and short sales of Treasury stocks as ordinary income losses since they were hedging transactions relating to non-capital assets.[92]

In *Whittles v. Uniholdings Ltd (No. 3)*[93] the English Court of Appeal rejected an invitation to treat the two parts of a foreign currency arrangement as one. The taxpayer had borrowed the dollar equivalent of £14 million rather than sterling itself because the rate of interest was lower. The taxpayer accepted the offer of dollars on condition that the exchange risk was eliminated by a forward purchase of dollars to repay the loan. The evidence was that the bank would not have entered into the contract without such a forward contract and would have insisted on it if the taxpayer had not done so. The facts occurred before the 1993 rules came into force and so, if the two transactions had been carried through entirely separately, the gain realised on the disposal of the rights under the forward contract would have been taxable but the loss on the dollar loan would not have been an allowable loss (being incurred in respect of a capital liability—not an asset). Sir John Vinelott held that it was a single composite transaction so that the company had neither a profit on the forward purchase nor a sterling loss on the repayment of the loan.[94] On appeal Aldous L.J. agreed with Sir John Vinelott[95] but Nourse L.J. and Sir John

representation for women to prevent conniving males from shifting more of their tax obligations on to vulnerable females.

[88] See Reg. paras 1221–2(a)–(g) and 1.446–4(a)–(h).

[89] See Bittker and Lokken, paras S45.7 and 45.8 and, for foreign exchange matters, Chap. 71.

[90] *Corn Products Ref. Co. v. Commissioner* 350 U.S. 46. For discussion see Bittker and Lokken, para. 51.10.3.

[91] 485 U.S. 212 (1988).

[92] *Federal National Mortgage Association v. CIR* 100 T.C. 541.

[93] [1996] S.T.C. 914.

[94] [1995] S.T.C. 185.

[95] [1996] S.T.C. 914 at 931g.

Balcombe[96] did not. For the majority of the Court of Appeal the taxpayer would not have been able to argue the point before the emergence of the *Ramsay* principle, which was described as the fiscal nullity doctrine, and certainly could not do so now. The new approach applied when there was no contractual arrangement. The taxpayers would have lost even if there had been a contractual tie between them and the bank and so could not use the new approach to get them home on the basis that there was a practical certainty that the second step would follow the first.

It is hard to know where to begin with the majority's analysis which seems flawed from end to end. There seem to be two main problem areas. In *Furniss v. Dawson* it is assumed that if there had been a contractual arrangement that the A–B transfer would have been followed by the B–C transfer the whole scheme would have failed.[97] The whole point was whether the same result would be reached where there was no contractual arrangement. In *Whittles* the court seems to assume that the transactions have to be taken separately even though there is a contract and yet there is little convincing authority for this or at least little that is put forward in the case. Secondly, the majority assert that the *Ramsay* case is a doctrine of fiscal nullity and by inference only available at the suit of the taxpayer. Yet this is surely the very issue which needs to be decided. Some believe that the *Ramsay* principle as developed by the courts is not just a fiscal nullity doctine but that it is part of a new approach to statutory interpretation, one in which statutes are seen to contain principles and not just rules.[98] The majority do not and one must just hope they are wrong.

In the United States taxpayers' claims to use one or other of these pervasive doctrines to escape from the normal fiscal consequences of their acts have met with widely different responses—and occasionally colourful language.[99] Speaking in favour of preventing the taxpayer from using the doctrines Judge Learned Hand said "It is true that the Treasury may take a taxpayer at his word, so to say; when that serves the purpose it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favour; it cannot be used to deplete the revenue".[100]

On the other hand we find the 9th Circuit saying, "One should not be garrotted by the tax collector for calling one's agreement by the wrong name."[101] It is not easy to find the underlying distinctions which could support a theory to enable the United States courts to make sense of this area but some solid points emerge.[102] The cases clearly show that the judicial doctrines based on substance over form are indeed a two way street and not the one way street one might infer from the comment of Judge Learned Hand alone or which Nourse L.J. propounded in 1997—in the United States some suggest that Learned Hand's comments should be read as applying only to the problem of the corporate or associaton entity.[103] There are however two intermediate positions in which the courts acknowledge that the doctrine is a two way street but impose a heavier burden of proof; as was once said, "the so-called two way street seems to run downhill for the Commissioner and uphill for

[96] [1996] S.T.C. 914 at 924f and 932.
[97] See Lord Brightman [1984] S.T.C. 153 at 166c.
[98] See also above n.47.
[99] See Bittker and Lokken, paras 4.3.6 and 4.4.6 and 7.
[100] *U.S. v. Morris and Essex RR* 135 USF 2d 711 at 713 (2d Cir. 1943).
[101] *Pacific Rock and Gravel Co. v. U.S.* 297 F. 2d 122, 125 (9th Cir. 1961).
[102] Amongst other literature see Donaldson, 48 Marq.L.R. 41; Smith, 44 Tax L.Rev. 137; and Bailliff, 48 Tax L.Rev. 289.
[103] Bittker and Lokken at para. 4–53, n.106.

the taxpayer".[104] The two intermediate positions differ in the degree of extra burden put on the taxpayer. The first imposes a "strong proof" requirement; the second requires an even heavier burden—that the taxpayer should show such proof as would be admissible to alter the construction of the contract (or to show its unenforceability) because of mistake, duress, undue influence or similar doctrines.[105] The second doctrine was laid down in a case where the taxpayer was seeking to challenge the allocation of purchase price to different items in a contract to which he was a party and makes obvious sense in such a context.

While the cases show considerable uncertainty as to the scope of the doctrine one thing which is clear is that taxpayers are more likely to be allowed to invoke substance over form if their tax reporting and actions show an honest and consistent respect for the substance of the transaction, *i.e.* this is not a new position taken in response to a challenge by the IRS.[106] In *Estate of Durkin v. Commissioner*[107] X, a 50 per cent shareholder, offered to buy the other 50 per cent from the taxpayers (H) for just over $1.2 million, a gain of $1 million. In order to avoid tax on this gain H agreed to sell the shares for $200,000 (H's base cost in the shares) and the company agreed to sell H certain property at an undervalue (of some $3 million). To United Kingdom eyes this scheme looks a complete non-starter and one can only wonder at the reputation of a tax system which allowed people to think they could get away with this sort of thing—but then the same is true of the facts of *Ramsay* or *Moodie v. I.R.C.*[108] The IRS argued that form should prevail and H should pay tax on the constructive dividend of $3 million. H argued that there were two distinct transactions—the sale of shares and purchase of the asset. However once the issue of the valuation of the property (and so the extent of the constructive dividend) had been settled H argued that there was a single transaction in which they had sold their shares for a consideration which included the $3 million—so getting capital gain treatment. Of the 20 judges in the Tax Court nine rejected H's case by applying the stricter of the two "strong proof" positions. They also said that H had reported the transactions as separate and only taken the present position 15 years after the events had been reported. They also noted that negotiations were not at arms' length and that none of the usual step transaction doctrines could apply, a conclusion which causes some surprise to United Kingdom lawyers versed in *Furniss v. Dawson.* Six judges while agreeing with the other nine said that the taxpayer should be taxed on what he had actually done—the "actual transaction" doctrine—which has United Kingdom echoes of *I.R.C. v. Fleming and Co (Machinery) Ltd.*[109] Three judges thought everyone else was completely wrong at all stages of their reasoning (including the application of the step transaction doctrine). Two judges gave no reason but one agreed with the IRS and the other with H. One might say that the Tax Court makes the House of Lords seem like a very disciplined and coherent body.

Before leaving this case two last points need to be made on the case itself. First any appeal from this decision would have lain to the Third Circuit and so to the court which applied the stricter of the two strong proof transactions. Secondly the designation of the

[104] *Rogers v. Commissioners* 29 T.C.M. 869 (1970).
[105] *Commissioner v. Danielson* 378 F. 2d 771 at 775 (3d Cir. 1967).
[106] *Estate of Weinert v. Commissioner* 294 F. 2d 750, 755 (5th Cir. 1967).
[107] 99 T.C. 561 (1992).
[108] [1993] S.T.C. 188.
[109] (1951) 33 T.C. 57 (esp. at p. 62).

taxpayers by the letter H is not accidental. The shareholders were all associates of the notorious Jimmy Hoffa, a fact treated as highly significant by one major commentator.[110]

(f) Craven v. White: Esmark a United States counterpart?

Our United Kingdom cases have attracted United States attention.[111] In a detailed article Brown[112] provides an extended critique of United States cases and compares them with the United Kingdom. After reciting the litany of the great United States anti-avoidance decisions—*Gregory*[113] itself, *Court Holding*,[114] *Knetsch*[115] and *McDonalds Restaurant of Illinois*[116]—she discusses the decision of the Tax Court in *Esmark v. Commissioner*.[117] She concludes that the Tax Court took an approach similar to that employed by Lord Oliver in *Craven v. White*.[118] As the House of Lords had done in *Craven v. White* so in *Esmark* the Tax Court rejected the IRS' attempt to interpret a two stage transaction (A–B followed by B–C) as a single transaction (A–C). She suggests this was because the court was dealing with a linear as opposed to a circular transaction and that the court placed undue emphasis on the intention of the taxpayer. This sounds all very familiar to United Kingdom ears—however surprising it may be. Less surprising is Brown's conclusion that the *Esmark* case must be wrong and she develops some interesting ideas rejecting the relevance of the taxpayer's intention and stressing instead the element of control which the taxpayer had over the particular form the transaction might take. She complains that the United States courts in cases like *Esmark* place far too great an emphasis on the presence of a legitimate business purpose. She writes:

> "In the case of linear transactions the United States and United Kingdom courts generally hold that the presence of a business aim [what Lord Brightman referred to as a business effect] does not preclude the application of step transaction analysis. The United Kingdom courts, however, have flatly refused to employ step transaction analysis where the intermediate tax-saving step is motivated by a business purpose other than tax avoidance. The United States courts have also been reluctant to employ the step transaction doctrine where an arrangement is motivated by legitimate business concerns. Often without consideration of tax policy mandates, they treat the revenue goals embodied in legislative enactments as less important than the aim of the business community. Further they have failed to require a business purpose for each step of an arrangement. If the United States courts adopt the approach found in *Esmark* they will conclude that a substance over form approach should rarely be applied to legitimate business deals."[119]

[110] Sheppard Tax Notes 119 (January 19, 1993); for comment on the case see also Faber and Keyes, 78 J.Tax 94 (1993).
[111] *e.g.* Popkin [1991] B.T.R. 221.
[112] 15 Hastings Intl. and Comp. Law Rev. 169 (1992).
[113] 293 U.S. 465 (1935) discussed at [1987] B.T.R. 220–223.
[114] 324 U.S. 331 (1945).
[115] 364 U.S. 361 (1960) discussed at [1987] B.T.R. 223–226.
[116] 688 F. 2d 520 (1987) discussed at [1987] B.T.R. 237–238.
[117] 90 T.C. 171 (aff'd 886 F. 2d 1318, 7th Cir., 1989).
[118] [1988] S.T.C. 476.
[119] 15 Hastings Intl. and Comp. Law Rev. 207. See also Axelrod, "*Esmark*'s Tax-free Disposition to a Subsidiary—Too Good to be True?" 9 J.Corp. Tax 232 and Vitek "Form over Substance" 69 Neb.L.Rev. 728.

Brown then argues that the courts should adopt a substance over form approach whenever a transaction achieves a result which is inconsistent with the interpretation of a statute and where the result is controlled by the taxpayer. If a court cannot discern a statutory purpose it should balance the interests of the taxpayer and the taxing authority.[120] This approach would safeguard the ability of the taxpayer to plan business transactions and the interest in government in preventing the manipulation of tax statutes.[121]

So controversial a case deserves at least a brief outline. Esmark (E) had a 98 per cent subsidiary (V). E had accepted a bid from Mobil (M) for the 98 per cent of V stock owned by E. However there was not to be a simple sale. The form eventually adopted (and insisted upon by E was in two steps: (a) M should make a cash tender offer to its (E's) shareholders representing about 54 per cent of E's stock; (b) M should then exchange the 54 per cent of stock in E for the 98 per cent of the stock in V which E owned. This two stage tender followed by redemption was a substitute for an earlier idea. Under the earlier plan E was going to sell the V stock and buy back about 50 per cent of its own stock. The purpose would have been to bring the market value of the stock in E back to its real value so reducing the risk of take over, redemption ensuring that there was no spare cash in the company. The preferred scheme was designed to ensure not only some protection against the risk of takeover but also a disposition of the V stock without incurring a capital gain charge on the V stock.

The IRS argued that A and B should be combined and treated as a sale by E of the V stock to M and a redemption of the stock of the tendering shareholders with the proceeds paid by M directly to the shareholders. The court, having found that the shareholders in E were independent of E, rejected the IRS recharacterisation. To follow the IRS would be to ignore the commercial realities because each step had "permanent economic consequences" a phrase which has a (repudiated) United Kingdom echo.[122] On the question of the step transaction the court said that, as E's commercial goals could only be achieved in a two step transaction, the use of the two step transaction which resulted in the lowest tax liability was not subject to the step transaction doctrine.[123] The doctrine would not apply to combine steps unless, in addition to an overall plan, a series of meaningless steps was present. While the facts demonstrated the presence of an overall plan, that plant did not involve meaningless steps.[124]

Bittker and Lokken[125] summarise the case in a less controversial way than Brown but perhaps one of more comparative interest. They state that the principle for which the case is authority is that where a rather convoluted series of transactions takes place, the form of the transactions is nevertheless given effect for tax purposes if there is no more direct route to the resulting position of the parties. As the Tax Court put it, "No route was more direct than the others. Each route required two steps, and each step involved two of the three interested parties. Each route left E, E's shareholders, and M in the same relative positions. Faced with this choice E chose the path expected to result in the least tax".[126] It

[120] At p. 214.
[121] At p. 226.
[122] See Vinelott J. in *Furniss v. Dawson* at first instance [1982] S.T.C. 267.
[123] At p. 182.
[124] At p. 184.
[125] S 4–7.
[126] 90 T.C. 171 at 176.

could not be said that one method represented "the substance" of the transaction rather than any other.[127]

Rulings[128]

Since the TLRC makes a clearance procedure part of their "sensible" general anit-avoidance rule it may be appropriate to make one or two points on the rulings procedure in the United States. The general principle is that a private letter ruling is authority only for the taxpayer to whom it is issued. The taxpayer can attach the ruling to his, her, or its return and take the position outlined in the ruling; and that position will control so long as the ruling request accurately represented the relevant facts and no retroactive change in the law nullifies the ruling. However it is clear that this system is not without flaw and we now discuss some of the reasons why letter rulings are not sought and why, therefore, one ought not to overstate their significance for tax planning.

The first two are cost and time. While the actual application fees are trivial, the legal costs in putting together even a routine ruling request can be substantial. Moreover, the likely delay in getting a ruling often makes them impractical. A wait of a few months can be expected even for straightforward requests, and if the ruling involves any controversial issues, a far longer wait can be expected (with no guarantee of a favourable ruling). Since the United States rules prescribe a 21 day period for the appropriate branch representative to contact the taxpayer,[129] the long period may seem odd. However the period is only one within which the branch representative is to make contact with the taxpayer and can be extended if "justified and approved". The TLRC proposal gives the Revenue 30 days to reply. Although the 30 day period is based on other United Kingdom models and appears very stringent the Revenue would in practice be able to extend the period by asking for further information.

Then there are some areas in which the IRS will not provide rulings.[130] The IRS regularly notes areas where it will not issue rulings or will "ordinarily" not issue rulings. This list includes factual matters, alternative plans or hypotheticals and on parts of an integrated transaction, transactions lacking a bona fide business purpose or having tax reduction as their principal purpose.[131] Thus if the IRS is re-examining its policies in a particular substantive area it may decline to do so until its new policies have been established. Again, with new, and potentially controversial, transactions, the IRS may well decline to rule—or may take so long studying the issues that the delay is the equivalent of a denial. United Kingdom readers may bear in mind a similar line taken by the Inland Revenue in relation to the anti-avoidance rule on loan relationships in the Finance Act 1996, Sched. 9, para. 13.[132] In addition, the IRS ordinarily does not issue rulings that require it to make factual determinations (*e.g.* is the compensation reasonable?), and a ruling, even if favourable, is only as good as the factual representations made in the ruling request.

Finally there is concern that one is inviting audit unnecessarily. A taxpayer may be

[127] This meets one of the concerns expressed earlier—see [1987] B.T.R. 226–235.
[128] These are discussed by Bittker and Lokken at para. 110.5.2.
[129] Rev. Proc. 98–1, 1998–1 I.R.B. 11, para. 10.
[130] Rev. Proc. 98–3, 1998–1 I.R.B. 84 (most domestic) and I.R.B. 185 (international).
[131] Rev. Proc. 98–1 para. 7, 1998–1 I.R.B. 11.
[132] See Corporation Tax Manual, para. 12680.

reluctant to seek a ruling on a potentially sensitive matter if doing so will increase the risk of audit (*i.e.* if no favourable ruling is issued but the taxpayer goes ahead anyway with the transaction). It appears that one can overstate this risk since communication between the National Office and the district director who will oversee the audit of a particular taxpayer does not necessarily occur—the IRS is not a 100 per cent efficient organisation—but the danger is there. The National Office has the power to communicate with the district offices even if the ruling request is withdrawn in anticipation of an unfavourable ruling. Moreover, if the proposed transaction is really controversial, it is not at all inconceivable that the word will get out to field agents to pay attention to transactions of a particular sort.

Despite these caveats the ruling process has at least two merits. First, the IRS will issue a ruling only if the facts fall beyond certain guidelines—the guidelines thus provide safe harbours. For example, in would-be tax-free reorganisations where continuity of shareholder interest is an issue, requesters must be able to represent (in a slightly simplified form) that shareholders of the target corporation will receive at least 50 per cent of their consideration in the form of a proprietary interest (generally stock) in the acquiring corporation. The 50 per cent test is not a rule of law; everyone agrees that less than 50 per cent continuity would survive judicial review. Secondly, while a ruling will say that it is not to be treated as authority—*i.e.* taxpayer B cannot use a favourable ruling given to taxpayer A to fight the IRS on the merits of his similar transaction—rulings are nevertheless a rich resource for tax planners. Because of the Freedom of Information Act, the private letter rulings (with identifying information deleted) are now routinely available and a lawyer who advises on a deal without knowing of these rulings is presumably at risk of being sued for negligence. It is an open question whether the world would be a better place without these things being available to everyone. There are too many of them; the only way to research them at all efficiently is through one of the electronic services, and that is often not very efficient; one often cannot tell whether the point one is interested in was really focused on or whether it just happened to be mentioned in passing. Nevertheless, the rulings are out there and it is a great source of comfort to find favourable rulings on similar transactions.

Conclusions

Given the wide variety of doctrines and devices which the United States courts, Congress and the administration can invoke, the absence of a general anti-avoidance provision scarcely seems to matter. For their part the IRS does not seem to need a general anti-avoidance measure and there must always be a risk of constitutional challenge to such a clause. Practitioners for their part do not seem to think that a general anti-avoidance rule, however sensible, would make their life any better than the present chaotic set of principles and rules. One suspects that, as in all these things, if the players are content there will be no change. One also senses that in the United States, despite the separation of powers, the courts the IRS and the Congress regard themselves as partners in the struggle to make the tax system work. Our general conclusion is that while there are some signs of convergence between the United Kingdom and United States systems in *McGuckian*, in *Esmark* and in the Scalia approach to statutes, the two systems remain clearly distinct. Our hope is that if United Kingdom judges become more inclined to a purposive approach to statutes, and if that enables them to extend the new approach, more attention will be paid by United Kingdom judges to the United States experience. For better or worse the United States tax system is the most important tax system in the modern world; its myriad instances provide both fruitful analogies and painful warnings. It is also the most written about and probably the most criticised. All this comes from a democratic system of government and from a system of legal education in which proper attention is paid to the teaching of tax law.