Should the Internal Revenue Code Include a GAAR?

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Part of the impetus for major corporate tax reform is the perceived existence of certain “loopholes” that inappropriately allow corporations to reduce their federal income tax burden. Many of those so-called loopholes have been expressly created by Congress (for example, deferral). They will need specific legislative correction if they are to be closed. Some of the other targeted loopholes presumably include provisions that were enacted for one purpose but that have been applied by corporations and their tax advisers for another purpose that produces a meaningful but unintended tax benefit.

The code contains few specific antiavoidance provisions that might effectively preclude taxpayers from claiming unintended tax benefits. As a result, the courts have developed extrastatutory doctrines and concepts to test whether a taxpayer engaging in a transaction or pattern of activity should be allowed to receive the benefits claimed.

The business purpose and economic substance doctrines are, of course, the classic judicially created doctrines designed for this purpose. They were developed because the courts concluded that Congress could not have intended to bestow tax benefits in certain situations simply because there had been formal adherence to the letter of the law. Those doctrines reflect a recognition by the judiciary that in drafting precise statutory language describing transactions intended to produce certain tax consequences, Congress cannot always anticipate the circumstances under which taxpayers might attempt to take advantage of that language in a way neither contemplated nor intended.

There are several valid objections to having a court apply a judicially created doctrine, rather than principles of statutory
construction, to test the validity of a transaction implemented on the basis of language in the code. Not least among them is that we have many different courts, at both the trial level and on appeal, that hear tax cases. As a result, there are many different formulations of the same doctrine. For example, some courts view economic substance as having two separate requirements — business purpose and profit potential — that must be satisfied before a transaction will be accorded the tax benefits claimed. Other courts believe satisfying either requirement should be sufficient for the transaction to be respected. Still others favor a blend of subjective and objective analysis. The disinclination of the Supreme Court to provide any new guidance, despite what is now a morass of lower court opinions in the area, has compounded the problem. (The Supreme Court’s last foray into the area was over 30 years ago, when it decided *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).)

Because of the confusion as to the proper standards to be applied in any given situation, Congress on several occasions has come close to codifying the meaning of economic substance. While codification has not yet occurred, it is an item scheduled for action in the Obama administration budget proposals.

A legislative definition of economic substance would presumably allow the court reviewing a transaction to determine first whether the doctrine is relevant to its analysis. If the court concludes that economic substance is relevant, the legislative definition would take over. One element of that definition would likely be a requirement that the transaction must have a substantial nontax business purpose. Other elements would likely include a requirement that the taxpayer’s economic position must change in a meaningful way as a result of the transaction, and that if an expectation of profit is part of the taxpayer’s argument, the expectation must be reasonable and the present value of the expected profit must be measured against the present value of the expected tax benefits.

To some, this is an excessively detailed set of requirements that could cause the denial of tax benefits to legitimate business transactions that might fall short on one or another element. Moreover, a legislative definition along the lines described would inevitably place new questions with the courts: What is a
substantial nontax business purpose? What constitutes a meaningful change in economic position? What discount rate should be used to measure present value?

There is also a sense that codification of the economic substance doctrine could be counterproductive. A specific statutory definition would make more precise a flexible concept that has given the courts considerable latitude in evaluating particular transactions. Skilled tax planners might continue to plan aggressively, seeking to come within the new statutory definition with the expectation that their transactions would be immunized from challenge on other grounds.

Perhaps it is time to approach the situation from a different direction. Perhaps what the United States needs is something similar to what Canadian taxpayers have been living with for some 20 years — a statutory general antiavoidance rule.

The GAAR would replace judicial doctrines to test the validity of corporate transactions. It would be a single statutory rule that could be made applicable to all corporate transactions for which tax benefits are claimed under the code. It could provide, for example, that despite what might appear to be the favorable tax consequences of a transaction, those consequences would be realized only if the taxpayer could establish that either the primary purpose for the transaction was not tax avoidance, or the taxpayer was at risk regarding a material change in its economic position apart from the anticipated tax benefits.

Other formulations could be considered. The Canadian GAAR tests whether a transaction was undertaken primarily for bona fide purposes other than securing tax benefits. Our own code section 269, which denies some tax benefits in some types of acquisition transactions if the principal purpose for the acquisition was tax avoidance, is a mini-GAAR that could serve as a starting point.

A broad, statutory GAAR would of course present interpretive questions of its own. What is meant by primary purpose? What is meant by “at risk” in this context? Yet a case can be made that the overarching breadth of a statutory GAAR, as contrasted with a more precise statutory definition of economic substance, would help curtail aggressive tax planning.
For the vast number of business transactions undertaken — say, 95 percent — the GAAR would have no potential application because it would be obvious that the transaction was undertaken in the normal course of business operations for a legitimate business reason and not primarily for tax avoidance. Regulatory guidance from the IRS addressing normal business transactions could make that clear.

For the remaining 5 percent of transactions — the ones tax administrators sometimes refer to as “aggressive tax minimization arrangements” — the existence of a GAAR should cause corporations and their tax advisers to pause and reflect on whether a contemplated transaction would pass muster under the new rule. That would be good for the tax system.

One might ask whether corporate tax advisers are not already sufficiently reflecting on transactions that fall into the 5 percent category. Why are the business purpose and economic substance doctrines insufficient to do the job? While corporations and their tax advisers undoubtedly take those doctrines into account, perhaps because they are judicially created the doctrines do not seem to prompt as much reflection as they should — or as much as a statutory GAAR likely would.

Tax minimization is part of our corporate culture. During the period when IRS enforcement took a back seat to customer service, aggressive tax planning went into overdrive. The resulting transactions are now working their way through the system. What might make sense are some additional steps to curtail the corporate appetite for the extremely aggressive tax planning seen in the recent past. A new GAAR in the heart of the code could be one of those steps.

In short, despite the interpretive issues it would raise, a code-based GAAR would likely engender more respect than the current set of purely judge-made rules that vary from court to court. Also, a code-based rule has a reasonably good chance of producing sharper Supreme Court guidance as to its meaning.

For all of these reasons, and despite some obvious problems, the enactment of a well-designed GAAR, in lieu of a more precise statutory definition of economic substance, is worthy of serious consideration as part of an effort to achieve comprehensive corporate tax reform.