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A Proposal for an Elective Tax Benefits Transfer System

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A PROPOSAL FOR AN ELECTIVE TAX BENEFITS TRANSFER SYSTEM

by

Professor Ronald W. Blasi

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ABSTRACT

This article proposes an elective tax benefit transfer system to be available to lessors of property who use that property in their trade or business. It describes why the current linkage of tax benefits to property ownership is economically inefficient, causing it to have several significant disadvantages to the parties and to the economy, as a whole. The article discusses how the current system reduces a firm's cash flow and reported earnings, diminishes the intended effect of tax incentive legislation, distorts competition and decision making, and inhibits investment in efficient business assets. It is submitted that the proposed system corrects all of the shortcomings, while not violating any tenet of taxation and being consistent with Congressional attempts to limit tax avoidance.

I. THE PROPOSAL

Federal income tax law has evolved to a point where it is time to abandon the linkage between property ownership and entitlement to cost recovery deductions and property related credits for leases of new equipment and software.¹ This paper proposes that lessors be granted an election to transfer to lessees cost recovery deductions (hereinafter, "CRD")² and tax credits associated with property that is leased under an arrangement that

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1. Investment during 2008 in equipment and software exceeded \$1.1 trillion. Bureau of Economics Analysis, National Income and Products Accounts, Fixed Asset Accounts, available at <http://www.bea.gov/National/FA2004/E&S.pdf>. See also, Equipment Leasing & Finance Foundation, U.S. Equipment Finance Market Study, 2007-2008.

2. The term "cost recovery deductions" or "CRD" will be used in this paper to describe both depreciation and amortizations deductions. It is common for depreciation to describe cost allocation of tangible property and for amortization to describe that allocation for intangible property. Investing in new equipment or other business property may also generate tax credits that reduce tax liability on a dollar-for-dollar basis. Discussed at Section V of this paper are two property related credits: the Low-Income Housing Credit and the New Market's Tax Credit. IRC §§ 42 and 45D.

qualifies, for federal income tax purposes, as a true lease, i.e. a lease in which the lessor is treated as the true owner of the property.³

This proposal is timely because of the proliferation of property related tax incentives. Congress has been producing an expanding inventory of accelerated cost recovery provisions and property related credits in an effort to achieve a variety of non revenue raising policy objectives. Unless tax benefits are able to be transferred, the intended impact of tax incentive legislation, including economic stimulus legislation, will likely not be achieved, and the nation's economy will not expand as expected. The proliferation of tax benefits also has exacerbated distortions in the relative competitiveness of lessors as well as in the decision making of lessees. Finally, both cash flow and reported earnings of the parties is negatively affected by current law constraints on tax benefit transferability.

As the discussion of microeconomic principles set forth below will demonstrate, permitting tax benefits to be sold will increase their efficiency. For example, a lessor of equipment may elect to sell some or all of the equipment's CRD to the lessee. The taxpayer may prefer to convert these tax benefits into cash because it may not be in a position to realize part or all of the tax savings that the deductions could generate. The tax benefits, themselves, may not be worth to the property owner what they may be worth to the transferee. If the lessor were permitted to liquidate the tax benefits, the lessor would be able to reduce rent, yet derive the same after-tax return from its investment. The government should be indifferent as to which party to the transaction utilizes the tax benefit so long as they are used for the intended purpose.

Nearly 30 years ago, in the Economic Recovery Tax Act of 1981 ("ERTA"), Congress enacted, then almost immediately repealed, legislation referred to as "safe harbor leasing."⁴ It was radical tax legislation that was

3. A true lease for tax purposes is defined in Rev. Proc. 2001-28, 2001-1 C.B. 1156. The factors set forth in the guidelines include representations relating to: the minimum unconditional at risk investment of the lessor, renewal or extension options, purchase or sale rights, the lessee's investment in the property. These guidelines superseded earlier guidelines. Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Rul. 55-540, 1955-2 C.B. 39. For a comprehensive and critical analysis of the linkage between property ownership and taxation, in general, see, Noel B. Cunningham and Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 *Tax L. Rev.* 725 (1991-1992).

4. Pub. L. No. 97-34, 95 Stat. 172 (1981). This provision was intended to increase the likelihood that the cash flow benefit would be realized from the ERTA's liberalized cost recovery and investment credit provisions. In the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, Congress repealed the safe-harbor leasing rules.

significantly different from this proposal.⁵ Although it also permitted tax benefits to be transferred, they were transferrable to the lessor, not to the actual user of the property, as this called for in this proposal. By virtue of a fictitious sale/leaseback transaction, the nominal lessor became the deemed owner of the property to whom tax benefits were thereby transferred.⁶ Fundamental tenets of taxation were violated in the process, as was noted in the Conference Committee Report that accompanied the legislation:

“The new provision is a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resemblance to a lease.”⁷

This proposal does not contravene any anti-tax avoidance statutory provision or judicial doctrines. To respect current law limits on trafficking in tax benefits, the proposed system restricts tax benefit transfers to the lessee.⁸ The proposal is limited to tax benefit transfers by the true owner of property (the lessor) to the party possessing the right to use the property (the lessee). It is consistent with the business purpose doctrine by permitting tax benefit transfers only as an adjunct to a bona fide lease of property and not when tax avoidance is the primary intent behind the transaction. The proposal also calls for adherence to the substance over form doctrine. No fiction is created to establish the owner's entitlement to the tax benefits. The lessor from

5. States have not shied away from similarly radical tax legislation. For e.g., see the Georgia Entertainment Industry Investment Act of 2008, O.C.G.A. § 48-7-40.26 (2009), which permits production companies to sell tax credits earned for film, video, or digital production in the state.

6. For a critical discussion of the fictional leasing transactions constructed by the safe-harbor leasing legislation see, Alvin C. Warren, Jr. and Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 Harv. L. Rev. 1752 (1982).

7. General Explanation of the Economic Recovery Tax Act of 1981, JCS 71-81, Title II Business Incentive Provisions, No. 7, Sec. O (1981) (Joint Comm. on Taxation).

8. Tomasulo, “Net Operating Losses and Credit Carryovers: The Search for Corporate Identity,” 20 Tax Notes 835, Sep. 12, 1983.

whom the tax benefits will be transferred will be the actual owner of the property, and the lessee or purchaser, the actual user.⁹

II. ORGANIZATION OF PAPER

This paper has five sections. It begins by establishing that improving the economic efficiency of property related tax benefits is needed and justified for several reasons: (a) consistent with the income tax being imposed on income net of reasonable business expenses, cost recovery deductions represent a business expense that should be fully deductible from gross income, (b) the reported earnings of firms should properly reflect tax expense, (c) tax deductions and credits that are designed to incentivize behavior are more likely to achieve their economic or social objectives if they are allowed to be transferred, (d) the current system distorts the competitive status of lessors, and (e) the current system distorts decision making of lessees.

In the second section, there is a discussion, with illustrations, of how laws of microeconomics support the proposal. It is demonstrated that the volume of property transfers eligible for tax depreciation or credit and the demand therefore can be predicted to increase if the parties to these transactions are free to allocate tax benefits between themselves. The effect of government tax policy on property transfers will be illustrated, and it will be shown that full utilization of intended tax benefits will avoid the inefficiency caused by underutilized tax benefits.

The third section of the paper will establish that the proposal is supported by current Internal Revenue Code provisions.¹⁰ It will be explained that even though tax avoidance may be a significant factor considered by the parties before entering into a transaction underlying the proposed tax benefit shift, there is no proscription in current law that would prevent tax benefit transfers intended as an adjunct of a bona fide business transaction. Provisions will be identified that currently allow tax benefits to be transferred among taxpayers, even taxpayers that are not owners of the property giving rise to the tax benefit and even when a tax avoidance intent influences the transaction.

In the fourth section of the paper, the judicial constraints on tax avoidance will be discussed. Judicial doctrines dealing with business purpose

9. One of the reasons for the repeal of the ERTA safe-harbor leasing rules was concern that its revenue cost was large. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, H.R. 4961, 97th Cong, Pub. L. No 97-248, p. 53. This proposal is considerably more modest in terms of its potential revenue impact.

10. All references to the "Internal Revenue Code," "Code," "section," or "IRC" are to the Internal Revenue Code of 1986, as amended.

and substance over form will be analyzed and applied to the proposal. It will be established that the proposal is consistent with these rules

The final section of the paper contains a recommendation for how the transfer of tax benefits should be taxed. The intended tax-free transfer of tax benefits will be shown to be consistent with the current treatment of realized of tax benefits, and it can be reconciled with tax benefits transferred as an adjunct of tax-free property exchanges under current law.

III. THE IMPACT OF TAX BENEFITS ON LESSORS AND LESSEES

The Constitution authorizes a tax to be imposed "...on incomes, from whatever source derived... ." ¹¹ Congress first exercised the "full measure of its taxing power [footnotes omitted]" ¹² in The Revenue Act of 1913, a statute designed merely to raise revenue to supplement federal excise taxes, tariffs, and custom duties, the primary sources of federal government revenue at the time. ¹³ As the income tax assumed the dominant revenue raising role, its ability to serve as a tool of social and economic policy was recognized. With increasing frequency, federal income tax provisions have been designed to encourage investment in targeted property and activities, promote savings, redistribute wealth, stimulate the economy, while, of course, raising most of the federal government's revenue. The ancillary objectives are accomplished largely through the use of tax incentives designed to allow taxpayers to avoid the income tax's revenue raising objective.

Tax benefits take a variety of forms. They are offered as provisions that defer or exclude income, accelerate or enlarge deductions, or permit credits against tax liability. For many commercial enterprises, one of the most significant incentives that Congress provides is the allowance for accelerated CRD. However, unless CRD are permitted to be transferred, accelerated cost recovery may fail as an incentive that influences investment behavior and the policy objective of accelerating these deductions may not be achieved.

The benefits flowing from tax incentives that are utilized are numerous. As will be discussed below, in the short-term a firm's cash flow and reported earnings will increase. Several long-term and indirect benefits also result. For example, the acquisition of new equipment made feasible by

11. U.S. Const. Amend. XVI.

12. *Comm'r. v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955), rehearing denied, 349 U.S. 925 (1955).

13. The Revenue Act of 1913, Pub. L. No. 16, 38 Stat. 114, ch. 16, contained the statutory imposition of the income tax at § II(A)(1) where it provided, in part, "[t]hat there shall be levied ... upon the entire net income arising or accruing from all sources ... a tax of 1 per centum per annum upon such income..."

the tax benefits also result. New equipment likely will operate more efficiently than the equipment it replaces, thereby further increasing reported earnings and cash flow. The firm's domestic and international competitiveness may be enhanced, especially if the depreciable property is a material factor in the firm's income generation. On a larger scale, the collective cost savings realized by improved profitability will enhance the size and strength of the nation's economy.

A. Current System Distorts Lessors' Tax Liability and Cash Flow

For tax liability and cash flow to be properly calculated, all allowable tax benefits should be taken into account. This fundamental principal of tax law was recognized in the first income tax statute, which permitted businesses to deduct most costs associated with earning the income that comprised taxable income, the income tax base.¹⁴ Principal among these deductions was the property related deduction for cost recovery. Unless tax liability takes into account allowed deductions and credits, the firm's tax liability is overstated and its cash flow is understated.

The Revenue Act of 1913 provided "[t]hat is computing net income for the purpose of the normal tax there shall be allowed as deductions: ... sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, ..." ¹⁵ CRD continues to be the most significant property related deduction. Currently, it is allowed under section 167, a section that contains language nearly identical to the 1913, provision. The section provides in pertinent part that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear ... of property used in the trade or business ..." ¹⁶

The allowance for depreciation has long been justified as a reasonable business expense on the theory that the amount of the annual deduction represents that portion of the property's initial value that is estimated to be consumed during the accounting period in generating income of that period. In 1927, Justice Brandeis wrote in *U.S. v. Ludey*:

"The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order

14. IRC § 63.

15. The Revenue Act of 1913, § II G(b), 38 Stat. 172234(a)(7). The Excise Tax Act of 1909, § 38(2d), 36 Stat. 112, 113, permitted a similar deduction.

16. IRC §§ 167 and 168.

that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant a grandual [sic] sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired.”¹⁷

Conversely, a distortion of tax liability occurs when a firm is unable to benefit from allowable deductions. The cost of the item to which the deduction relates becomes significantly greater whenever it does not yield a tax savings. By permitting CRD to be transferred for consideration, a firm is able to reduce asset cost, albeit indirectly, by the amount of the cash consideration received for the tax benefit, as the incentivized depreciation rules intend.

Ability to use tax benefits depends upon there being tax liability, before taking into account any tax benefits. A firm without adequate federal tax liability will be unresponsive to tax incentive legislation.¹⁸ Insufficient tax liability may be attributable to several factors, including market conditions peculiar to the taxpayer or general economic conditions. Moreover, it may occur during either strong or weak economic times. For instance, if the taxpayer were a tax sensitive business, in a strong business environment taxable income may be eliminated by tax deductions. Equipment leasing firms are especially vulnerable to deficiencies in taxable income. By the nature of their business they generate significant CRD from the property they purchase to lease. If the lessor is unable to deduct CRD, the cost of the property is not partially offset by tax savings, causing a rational equipment lessor to refrain from entering into new leases, unless rent can be increased. If the taxpayer were in this position, to benefit from the deductions

17. *U.S. v. Ludey*, 274 U.S. 295, 300-301 (1927).

18. Deductions in excess of current taxable income will result in a “net operating loss,” which is usually allowed to be carried over to subsequent periods. IRC §§ 172, 465, 469 are examples of sections that permit a deferral of deductions that cannot be currently used by the taxpayer. An excess of credits over tax liability before credits will result in a credit carryover. The deferral of the deduction’s benefit will reduce its present value. For example, the present value of a tax savings of \$350 that is deferred for three years, assuming a discount rate of 4.5% compounded annually, would be \$294, a 16% reduction in cost savings. A firm that is a member of a consolidated group is permitted to offset its tax losses against the taxable income of other members of the consolidated group. Treas. Reg. §§ 1.1502-2 and -21.

and credits, the tax benefits would have to be transferred for valuable consideration.

The proposal addresses the deficiency in current law by providing for the tax-free receipt of compensation for transferred tax benefits.¹⁹ The compensation received should equal the value of the benefits transferred, an amount equal to the benefit if it were retained and fully utilized by the transferor.

Realized tax benefits have a positive effect on cash flow, not only in the year of deduction, but over time. Funds not used to pay tax are available to generate additional cash flow. This cycle – generation of cash flow, reinvestment of cash flow, generation of cash flow – continues, in theory, indefinitely. For example, if \$100 of tax is saved each year for 5 years and if the after-tax rate of 4% is earned on the cash not used to pay tax, the compounded amount of additional cash at the end of the fifth year from the \$100 annual tax savings would be approximately \$563.00.²⁰ As the additional \$63 of cash flow is generated over the 5 year period, it is reinvested and it generates even more additional cash flow. This cash flow benefit is not achieved if the deductions do not result in a tax savings.

B. Current System Distorts Lessors' Reported Earnings

For financial reporting purposes, leasing transactions could be placed into one of two categories: capital leases or operating leases.²¹ In the former the incidents of ownership are transferred to the lessee. In tax parlance, this is sometimes referred to as a "conditional sales contract." An operating lease is one in which the lessor retains ownership of the leased property.²²

Generally accepted accounting principles ("GAAP"), pursuant to which firms determine their net income for financial reporting purposes, similarly require earnings to be charged for depreciation expense in order to be properly reflected. However, reported earnings can be distorted by current

19. The tax treatment of the payment and receipt of compensation for tax benefits is discussed in § VII of this paper.

20. The compounded amount of an annuity of \$100 at a 4% discount rate is the sum of the value at the end of each of the 5 periods multiplied by the tax savings. Thus, $S = \$100 (1 + .04)^5$.

21. Statement of Financial Accounting Standards 13 prescribes the factors that are to be used to classify a lease as a capital lease or an operating lease for financial reporting purposes.

22. For a discussion of the implications of off-balance sheet lease financing arrangements, see report prepared by the Office of the Chief Accountant, Office of Economic Analysis, Division of Corporate Finance, U.S. Securities and Exchange Commission, Report and Recommendations Pursuant to § 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, beginning at p. 60.

tax law whenever a firm is unable to utilize all tax benefits. The proposal eliminates potential distortion whenever potentially unused tax benefits are transferred to a party who uses them in exchange for valuable consideration.

Financial literature describes CRD as “the process of allocating the cost of assets such as plant and equipment to the period in which the company receives the benefits from these assets.”²³ A firm’s earnings for financial reporting purposes and for income tax purposes are both negatively affected when tax benefits do not reduce tax liability; however, the effect of tax benefits on reported earnings is quite different from the effect on tax liability.

Reported earnings are reduced by tax expense, just as they are by other business expenses; however, the reduction is less (a favorable result) if the tax benefit actually reduces the firm’s federal income tax liability. This positive effect on reported earnings is equal to the firm’s marginal tax rate multiplied by the deduction or by the face amount of a tax credit. For example, a firm in the 35% marginal income tax bracket will have a net reduction in reported earnings of only 65% of the cost of depreciable property if the deduction reduces federal income tax liability. In the parlance of tax planners, the deduction is “tax effected” for financial reporting purposes when it is deductible for federal income tax purposes. If, or to the extent that, the tax deduction does not result in an actual reduction in federal income tax liability, the deduction may not be tax effected. This will create a distortion in reported earnings because a portion or all of the cost of the business asset will not reduce GAAP tax expense. Financial Accounting Standards Statement No. 109 provides that if there is only a 50% or less likelihood that the item will be taken into account in the future, the item is not permitted to be tax effected for reported earnings purposes.²⁴

GAAP does not require conformity between the method used to depreciate property for tax purposes and the method used for financial reporting purposes. In fact, it is customary to employ a straight line method for financial accounting, even though accelerated depreciation is customarily used for tax purpose. This creates what is referred to as a timing difference; that is, a difference between when tax expense is charged to financial accounting income and when it is paid to the U.S. Treasury. Any excess of the financial accounting provision for income taxes over the amount reported on the firm’s tax return creates a deferred tax asset.²⁵ Timing differences of this nature do not distort reported earnings.

23. Diamond, Stire and Stire. *Financial Accounting Reporting and Analysis* 481 (South-Western College Publishing, 2000).

24. *Accounting for Income Taxes*. Statement of Fin. Accounting Standards No. 109, §§ 17e, 97 (Fin. Accounting Standards Bd. 1992).

25. Whenever an item of income or expense is taken into account in different years in determining net income for financial reporting purposes or taxable

The amount of compensation received for the tax benefits should be includible in book income as other receipts from property sales, but on a tax-free basis. By treating the amount received for tax benefits this way, the firm is placed in the same after-tax position it would be in if it realized the tax benefits directly.²⁶

C. Current System Impedes Effectiveness of Tax Incentive Legislation

Congress enacts special CRD rules to incentivize investment in a wide variety of business assets. Illustrations of some of these rules include IRC section 167(f) for computer software, IRC section 168(l) for biomass ethanol plant property, IRC section 168(e)(4) for railroad grading or tunnel bore, etc... . These provisions accelerate cost recovery by both shortening the assets depreciable life and accelerating the rate at which business assets' cost is recoverable.²⁷ Tax incentives consciously elevate macroeconomic and social objectives above the tax accounting matching concept and the tax law's revenue raising objective.²⁸

Legislation that accelerates CRD assumes that the investment behavior of a firm's manager can be significantly influenced by the allure of reduced current tax liability.²⁹ This was the rationale for 1954 Internal Revenue Code's significant liberalization of depreciation rules that allowed for the 200% declining balance method and shortened recovery periods.³⁰

income for income tax purposes the book expense for income taxes will not equal the amount of tax reported on the tax return. Financial Accounting Standards Statement No. 109 prescribes rules for determining deferred income taxes and intraperiod tax allocation.

26. The tax treatment of the payment and receipt of compensation for tax benefits is discussed in § VII of this paper.

27. It also is recognized that many types of equipment contribute more to a firm's earnings in the early years than in later years of the equipment's life.

28. A fundamental concept of tax law that appears to be violated by accelerated depreciation is the longstanding principle that income must be "clearly reflected;" that is, the expense for the period are matched with the income from the period. IRC § 446.

29. A critical analysis of accelerated depreciation is found in Yoram Margalioth, *Not A Panacea for Economic Growth: The Case of Accelerated Depreciation*, 26 Va. Tax Rev. 493 (2006-2007).

30. The amended legislation barred the IRS from challenging a taxpayer's depreciation if the useful life that the IRS determined to be accurate differed from the taxpayer's useful life of the property by 10% or less. The statutory amendments prompted the IRS to alter its pronouncement containing the period over which cost is recovered. Prior to 1962, depreciation lives were set forth in Bulletin F. In that year, Rev. Proc. 62-21, 1962-2 C.B. 418 was promulgated. It set forth useful lives for four broad groups and 56 classes of assets within those groups.

The Senate Finance Committee justified those depreciation liberalization rules saying:

“More liberal depreciation allowances are anticipated to have far-reaching economic effects. The incentives resulting from the changes are well timed to help maintain the present high level of investment in plant and equipment. The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.”³¹

Years later, in response to the weakness in the economy in 1981, ERTA was enacted. The Preamble to the act stated that it is designed “to encourage economic growth through ... acceleration of capital cost recovery of investment in plant, equipment, and real property ...”³² One of the centerpieces of the ERTA was the section 168 Accelerated Cost Recovery System. The ACRS system replaced the prior depreciation rules with an administratively simpler and accelerated system.

In connection with the most recent recession, Congress again turned to cost recovery rules to stimulate a flagging economy. Among the provisions contained in The American Recovery and Reinvestment Act of 2009 (hereinafter, “The 2009 Act”) was one that liberalized the “bonus depreciation” rules that allow for immediate expensing of the cost of many business assets.

As will be demonstrate below, there is a paradox caused by this linkage when the tax law is used to stimulate the economy: in weak economic times when incentives are most needed the incentive provided in tax benefits tends to have less of an impact, or none at all, than they do during periods when the economy is strong. By linking tax incentives to property ownership, the size and vitality of the economy as a whole is artificially retarded. Fewer transactions will take place because tax benefits may not be able to reduce cost. The “economic growth, increased production, and ...higher standard of living” expected to occur from CRD are unlikely to be realized unless stimulus legislation operates in a tax law environment in

31. S. Rep. No. 83-1622, p. 26 (1954).

32. Preamble to the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, H.R. Rep. No. 4242 (1981).

which transferability of CRD is permitted.³³ Inefficient use of tax deduction and credit legislation also created and exaggerated disparities between businesses. Those firms that are able to use the incentive are placed at a competitive advantage over those firms unable to realize the tax benefits.

D. Current System Distorts Lessors' Competitive Status

Competitive neutrality is a fundamental economic principal. It calls for all parties who operate in a market to be treated in a similar fashion. Tax policy and other governmental imposed restrictions should not distort the market equilibrium.³⁴ Under the current tax system, lessors operating in the same market can easily be in financially dissimilar positions, merely because of tax rules. One lessor may be able to utilize all tax benefits, while another lessor may not. For example, a lessor that is a member of a consolidated group of corporations which contains a corporation that generates significant taxable income is able to derive the full benefit from tax deductions and credits because the consolidate return rules permit the losses of one corporation to be offset against the income of another corporation. A leasing company without the ability to offset its tax losses against the income of another corporation would have a higher cost of operation.³⁵

Thus, those lessors who are able to benefit fully from tax incentives are in a financial position to charge lower rent than lessor's whose property cost is not reduced by tax benefits. If tax benefits are permitted to be decoupled from the lessor's property and allowed to be transferred to the lessee, the relative competitive status of lessors will become more neutral. Those lessors who are able to benefit from the tax deductions and credits associated with the property they lease will no longer be at an advantage over the lessors unable to absorb those tax benefits.

E. Current System Distorts Lessee Decision Making

The current system significantly distorts the lessee's decision making because the desire for tax benefits competes with concerns associated with obsolescence. Many lessees are inclined to lease instead of purchase property because of they believe that the property is likely to become obsolete; however, if the property is leased, the taxpayer forgoes the

33. H.R. No. 83-1337 (II), p. 4048 (1954).

34. William D. Eggers, *Competitive Neutrality: Ensuring a Level Playing Field in Managed Competitions*. Reason Public Policy Institute, How-to Guide No. 18, p. 6, Mar. 1998.

35. For this reason the current tax rule may also hampers entry of new leasing firms into the leasing market.

tax benefits associated with the property.³⁶ Tax neutrality advocates that business decisions should not be affected by tax rules. Instead, tax law should neither encourage nor discourage taxpayers from entering into certain transactions.³⁷ Although competitive factors may result in a portion of the value of the tax benefits restricted to a lessor being reflected in reduced rent, restrictions on tax benefit transfers and the absence of perfect competition make distortions likely to occur.

Obsolescence can take many forms. Economic obsolescence occurs when replacement of equipment offers lower ownership costs. As an example, an air conditioning unit becomes economically obsolete when it is less expensive to replace the unit with a more energy-efficient one than it would be to continue using the existing unit. When innovation makes an existing product inferior to a new generation of products, the existing product becomes technologically obsolete. For example, a new operating system might offer additional functionality, making the old operating system technologically obsolete but still useful. Functional obsolescence occurs when a product can no longer be used. This type of obsolescence generally occurs when a standard changes. For example, printers with parallel ports are no longer useful when current computers only possess USB ports.³⁸ In some industries, obsolescence is frequently planned by manufacturers. This planned obsolescence is “the production of goods with uneconomically short useful life so that customers will have to make repeat purchases.”³⁹ For example, automobile manufacturers regularly modify to their models so as to schedule obsolescence. If tax benefits were available regardless of whether the property were purchased or leased, as proposed, the lessee’s decision will not be distorted by tax considerations.

36. By leasing property, lessees also avoid incurring indebtedness to purchase the leased property.

37. The concept of neutrality in taxation is derived from Adam Smith’s canons of taxation. See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book V, Ch. 2, Part II, V.2.25-28 (Methuen & Co 1904) (1776). “Accelerated depreciation is almost certain to give some assets lower effective tax rates than others and so violate the tax neutrality standard.” James Mackie, *Capital Cost Recovery in The Encyclopedia of Taxation and Tax Policy* (Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, eds., Urban Institute Press 2d ed.) (2005). Additionally, under IRC § 167, only certain types of property may be depreciated, further frustrating the tax neutrality maxim

38. Attempts to make existing property compatible are usually possible, but create additional costs to the owner. In such situations, economic obsolescence and functional obsolescence frequently overlap.

39. Jeremy Bulow, *An Economic Theory of Planned Obsolescence*, 101 *Q.J. Econ.*, No. 4, p.729 (1986).

F. Examples

The following four examples illustrate the effect on a hypothetical leasing transaction of a lessor's inadequate taxable income and how the proposal addresses that deficiency.⁴⁰ The leasing transactions comply with the definition of true leases for tax purposes and operating leases for financial reporting purposes.⁴¹

In the first and second examples, the effect under current law of CRD on the computation of a lessor's taxable income and the tax treatment of rental payments to both lessor and lessee is shown. In the first example, it is assumed that the lessor is able to utilize all CRD, but in the second example some of the CRD is not utilized.

The third and fourth examples illustrate the proposed system. First, a shift of all CRD to the lessee is illustrated and then a partial shift. These examples demonstrate that the proposed system fosters transactions that otherwise would not be entered into because of the current tax system's linkage of CRD's with property ownership.

Example 1: Current System with Full CRD Utilization by Lessor

Under the current system, when a property owner utilizes all CRD, the tax savings is equal to the taxpayer's basis in property multiplied by the maximum marginal tax rate to which the taxpayer is subject.⁴² In general, tax basis is equal to the properties cost, and for most corporate taxpayers the maximum marginal tax rate is 35%.⁴³

40. The benefit from tax deductions must consider the present value of the tax savings taking into account any future period in which the benefit is realized. For a discussion of the value of more or less rapid depreciation allowances see, Douglas A. Kahn, Accelerated Depreciation – Tax Expenditure or Proper Allowance for Measuring Net Income?, 78 Mich. L. Rev. 1 (1979); Walter Blum, Accelerated Depreciation: A Proper Allowance for Measuring Net Income?!, 78 Mich. L. Rev. 1172 (1980); Douglas A. Kahn, Accelerated Depreciation Revisited – A Reply to Professor Blum, 78 Mich. L. Rev. 1185 (1980).

41. Rev. Proc. 2001-28, 2001-1 C.B. 1156. These guidelines superseded earlier guidelines. Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Rul. 55-540, 1955-2 C.B. 39.

42. Tax basis of business property is eligible for depreciation. IRC § 167(c); Treas. Reg. § 1.167(g)-1. The basis of property that may be depreciated is usually its cost. IRC § 1012. Provisions of limited application prescribe tax basis to be other than an cost, e.g., § 358 (substituted, IRC § 7701(a)(42)), IRC § 362 (transferred basis, IRC § 7701(a)(43)) and IRC § 1014 (fair market value).

43. IRC § 11 sets forth the various tax brackets for corporate taxpayers, with the 35% bracket being reached when taxable income exceeds \$10,000,000.

In this example and in the ones that follow, it is assumed that the lessor and lessee are both in the 35% federal income tax bracket and that the lessor purchases property costing \$1000 that it intends to lease. If the lessor uses all CRD associated with the property (\$1000), the net cost of the property to the lessor, excluding any residual value, is \$650 because the CRD reduces tax liability by \$350 ($\$650 = \$1000 - (.35 \times \$1000)$). It is also assumed that at the end of the lease term, the lessor sells the leased property for \$100.00, its residual value. Because the lessor has a zero tax basis in the property at that time, the proceeds would yield after-tax income of \$65.00.

The cost reduction can be passed on to the lessee through reduced rental payments, shared by the parties, or retained in full by the lessor, all depending upon competitive and other market factors. Regardless of which party benefits from the CRD, the leasing transaction would be made more feasible. The full \$350 government cost subsidy would be taken into account.

Assume further that the lessor requires a minimum after-tax return on its investment ("ROI") of 13%, and the lessee can afford to pay no more than \$715.00 in rent (after tax deduction for rent paid) over the term of the lease. The lessee is prepared to pay more than the properties net cost (\$650.00) if it were to purchase the property outright because of concerns with obsolescence and the lessor's the inability to obtain suitable financing. Under these parameters, the parties would both find a lease that calls for \$1100.00 in pre-tax rental payments to be acceptable, as set forth below:⁴⁴

<u>Income to Lessor</u>		<u>Cost to Lessee</u>
1100.00	← Rent	<1100.00>
350.00	← Tax Savings on CRD	-0-
65.00	← Residual (after-tax)	-0-
<385.00>	← Tax <Liab.> Savings on Rent →	385.00
<1000.00>	← <Cost of Property>	-0-
<u>130.00</u>	Net Benefit <Cost> to Parties	<u><715.00></u>

The lessor's after-tax ROI (13%) is calculated as equal to the lessor's after-tax income (\$130) divided by the lessor cost of the property (\$1000)). The rental income (\$1100), the tax savings from the CRD (\$350), and the income from the sale of the property after the expiration of the lease (after-tax) are cash inflows to the lessor. They are partially offset by the tax liability that the lessor is required to pay on the rental income ($\$385.00 = .35 \times \1100.00 and the cost of the property (\$1000)).⁴⁵ The lessee's rental cost

44. All positive numbers are cash inflows and all negative numbers are cash outflows.

45. Rental income is includible in a taxable income. IRC §§ 61 and 63.

net of taxes, \$715.00, is equal to the gross rent (\$1100.00) less the tax savings from deducting rental expense (\$385.00 = .35 x 1100.00).⁴⁶

Example 2: Current System: Unused CRD

If the lessor were unable to deduct CRD, the lessor's cost of the leased equipment increases. For the lessor to realize the same after-tax ROI, the rent payable by the lessee would have to increase to cover this additional cost. If the lessee is unwilling to pay increased rent to compensate the lessor for the lost tax benefit, the transaction will not be entered into. Assuming that the lessor is able to utilize only \$900 of the \$1000 cost recovery deduction, the cost of the property to the lessor, before residual, increases to \$685. The lessor's ROI drops to 9.5%, as follows:

Rental Income	\$1100.00	
Tax Savings from CRD of \$900	315.00	
Residual (after-tax)	65.00	
Tax Liability on Rent		<385.00>
Cost of Property		<1000.00>
Net Benefit to Lessor	<u>\$ 95.00</u>	

Given the lessor's requirement that the lease generate an after-tax ROI of at least 13%, the lessor's inability to realize a tax benefit from the CRD and the lessee's refusal to increase the rent would cause the lessor not to enter into the lease.

Example 3: Proposed System: Shifted Benefit from CRD

If the proposed system were adopted, and if the parties agree that the lessee will provide appropriate compensation to the lessor for the transferred CRD, the parties would be in the identical position they were in when the lessor was able to fully use CRD's.

Assume that the lessee compensates the lessor for the \$350 tax benefit with a nontaxable cash payment of \$350, an amount equivalent to the tax benefit.⁴⁷ Under this scenario, the lessor and the lessee are satisfied entering into the lease.

46. Rent expense is deductible as an ordinary and necessary expense incurred in carrying on a trade or business under IRC § 162.

47. Any amount of compensation paid for the CRD that is greater or less than \$350 results in a net benefit to the lessor or a net cost to the lessee. Section VII of this paper discusses the taxation of the payment and the receipt of the consideration for transferred cost recovery deductions.

Full Shift of CRD to Lessee
(Lessor Unable to Use \$1000 CRD)

<u>Income to Lessor</u>		<u>Cost to Lessee</u>
1100.00	← Rent	<1100.00>
-0-	Tax Savings from CRD	350.00
350.00	←Cash for Tax Savings	<350.00>
65.00	Residual (after-tax)	-0-
<385.00>	← Tax <Liab.> Savings on Rent →	<385.00>
<1000.00>	<Cost of Property>	-0-
130.00	Net Benefit <Cost> to Parties	<715.00>

Example 4: Proposed System: Shared Benefit from CRD

In this example, as in Example 3, it is assumed that the lessor is unable to use \$100 of the CRD. However, the lease would be entered into if the lessor were permitted to transfer to the lessee the \$100 of unused CRD. For the lessor to realize the same after-tax ROI an additional non-taxable cash payment of \$35, equal to the tax benefit on the \$100 of tax benefit that otherwise would be unused, would have to be made by the lessee. The cash flows associated with this transaction appear in the following chart:

Partial Shift of CRD to Lessee
(Lessor Unable to Use \$100)

<u>Income to Lessor</u>		<u>Cost to Lessee</u>
1100.00	← Rent	<1100.00>
315.00	←Tax Savings from CRD→	35.00
35.00	←Cash for Tax Savings	<35.00
65.00	Residual (after-tax)	-0-
<385.00>	← Tax <Liab.>Tax Savings on Rent →	385.00
<1000.00>	← <Cost of Property>	-0-
\$ 130.00	← Net <Cost> Benefit to Parties →	<\$715.00>

The reported earnings and cash flow of the lessor (and, presumably, the lessee) would be favorably affected in Examples 1, 3, and 4 because the benefit of all deductions is realized. As demonstrated in Examples 3 and 4, under the proposed system, it is irrelevant which party to the transaction realizes the tax benefit.

IV. PROPOSAL SUPPORTED BY MICROECONOMIC THEORY

Laws of economics, in particular, microeconomics, prove the efficiency of the proposed system by predicting increases in the supply of, and demand for, leasing transactions.⁴⁸ Microeconomics also aids in understanding the impact of government tax policy the market for leased properties.⁴⁹

An important concept in microeconomics is “elasticity.” It describes the effect on supply and demand caused by price changes. Because tax policy affects price, taxes being a component of the cost of an item, government tax policy indirectly has a significant influence on the supply and demand of an item. Examples will show the impact on supply and demand under the current law and under the proposal.

Supply and demand curves, essential tools of microeconomic analysis, visually depict the effect of tax policy on supply and demand. As discussed below, they reveal that (a) unused tax benefits associated with property will have a depressive effect on leasing transactions, (b) if market forces are permitted to influence which party to a leasing transaction utilizes the tax benefits associated with the property, the value of tax benefits will more likely equal their objectively calculated maximum possible value,⁵⁰ (c) because the proposed system reduces the likelihood that tax benefits will be sub-optimized, it should increase the supply and the demand of property eligible for lease with the attendant positive effects on the parties and the economy as a whole.

A. “Utility” Maximized/Inefficiency Minimized by Proposed System

A principal goal of market-based economic systems is to allocate resources in a way that satisfies “people’s needs and desires” in as efficient a manner as possible.⁵¹ The efficiency of the economy is optimized when as

48. Microeconomics is a branch of economics that deals with the decision making tendencies of individuals, firms, and some local governments.

49. Economics, Fifteenth Edition, p. 55 (Paul A. Samuelson and William D. Nordhaus, eds., McGraw-Hill, Inc., 1995). Classical economic theory looked to market forces alone for resource allocation. Adam Smith’s belief in the dominance of self-interest is evident from his statement that “[i]t is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.” Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book I, Ch. 2, Part I.2.2 (Methuen & Co 1904) (1776). Thus, classical economic theory looked to market forces alone for resource allocation.

50. For deductions this is the highest marginal tax rate multiplied by the amount of the deduction and for credits it is the face amount of the credit.

51. Economics, Fifteenth Edition, pp. 12, 73 (Paul A. Samuelson and William D. Nordhaus, eds., McGraw-Hill, Inc., 1995).

many efficient trades as possible are made.⁵² When this is done, the “utility,” or satisfaction that market participants derive from their limited resources, is maximized. The efficient use of limited resources, such as tax benefits, is essential for an economy to operate at the optimum level. Inefficiencies typically increase costs and decrease transactions.⁵³

The well established economic principle of utility maximization finds its origins in the writings of Jeremy Bentham, an Eighteenth Century philosopher, who defined utility as “that property in any object, whereby it tends to produce benefit ... or to prevent the happening of mischief, pain ... to the party whose interest is considered”⁵⁴ Bentham wrote “[o]f an action that is conformable to the principle of utility one may always say either that it is one that ought to be done or at least that it is not one that ought not to be done.”⁵⁵ Thus, a system that eliminates inefficiencies and maximizes the utility of the parties to a transaction “ought to be done.”

Under the current system, if a lessor fully utilizes its tax benefits, the rent charged for the item (its price) could be less than if the lessor’s cost of the item were not reduced by tax benefits. If, and to the extent that, the lessor were unable to optimize tax benefits, rent would have to be increased for the lessor to cover its increased cost. As rent increases, the demand for the item can be predicted to decrease. Of course, if a different lessor, such as a member of a profitable consolidated group, were able to fully utilize tax benefits, then the transaction would be entered into, but the tax law would have distorted the competitive status of the lessors.

52. Jonathan Gruber, *Public Finance and Public Policy*, Second Edition, p. 4 (Worth Publishers, 2007).

53. Ideally, policy makers should attempt to keep the economic pie as large as possible, while securing funds to promote their social welfare objective. Some degree of trade-off between the size of the economic pie and the government’s ability to provide for the welfare of society is preferred. Ideally, policy makers should attempt to keep the economic pie as large as possible, while securing funds to promote their social welfare objective. These are not necessarily inconsistent goals. Having a smaller economic pie may not be all bad. Funds acquired by taxing a transaction can be used to promote what the political leaders believe be the social welfare of the society. Jonathan Gruber, *Public Finance and Public Policy*, Second Edition, p. 50 (Worth Publishers, 2007).

54. John Stewart Mill significantly expanded Bentham’s philosophy. While Mill embraced the philosophical underpinning of the economic objective of Bentham’s utility theory, he argued that happiness or satisfaction varies among people and an economic system should seek to raise the quality of satisfaction as determined by a more sophisticated (educated) group.

55. Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation*, p. 2 (Hafner Publishing Co., 1948).

B. Supply and Demand Analysis Predicts Effectiveness of Proposal

The following graphs reveal the effect of CRD on the supply and demand of leased property. They will show that the current system causes a decrease in the demand for leased property when CRD are underutilized. Regardless of whether the lessee is willing to pay higher rent or the lessor absorbs the increased cost, increased cost reduces the combined “utility” to the parties of the transaction. Conversely, if tax law is amended to permit the lessor to transfer unused deductions to the lessee, both parties are benefited and utility enhanced.

The slope of supply and demand curves reveals the elasticity of supply and demand; that is, the extent to which changes in price affect the quantity of the property supplied and demanded.⁵⁶ Both rent charged for property and the price of an associated tax benefit are subject to elasticity theory. The price paid for tax benefits is elastic when the value of tax benefits to the property owner is less than to the potential transferee.⁵⁷ This occurs, for instance, whenever the nature of the property owner’s business causes it to have less of a need for tax benefits. The price paid for tax benefits is likely to be less elastic during times of general economic weakness, when both a lessor and a lessee are likely to place a lower value on deductions or credits.

The application of microeconomics laws establish that utility associated with tax benefits varies inversely with price that a transferee is willing to pay for them. The willingness of a property owner to sell tax benefits generally moves directly in proportion to their value. The demand for tax benefits reveals the degree of utility they yield to a prospective transferee. If utility declines but price is unchanged, the demand for the tax benefit also declines. The normal relationships between price and the value

56. The extent to which price is elastic is determined by dividing the percentage change in quantity demanded by the percentage change in price. The elasticity of demand may vary depending on several factors including (a) whether the item is a “necessity,” (b) whether there are substitutes for the item, and (c) whether the timing of the acquisition of the item is flexible.

57. One significant variable that could change the impact of a tax on the consumer and producer is whether the consumer has options to purchase substitute goods or services and other transactions that could provide the consumer and producer with a similar level of satisfaction. Conversely, if the transaction is merely optional or if there are substitute transactions, then demand for the financial transactions is elastic. A consequence of this elasticity would be for the drop in the quantity demanded for the financial transactions at given prices to adversely affect the profits derived by the financial institution from this type of transaction. The financial institution will have to discontinue production of financial transactions to avoid a financial loss.

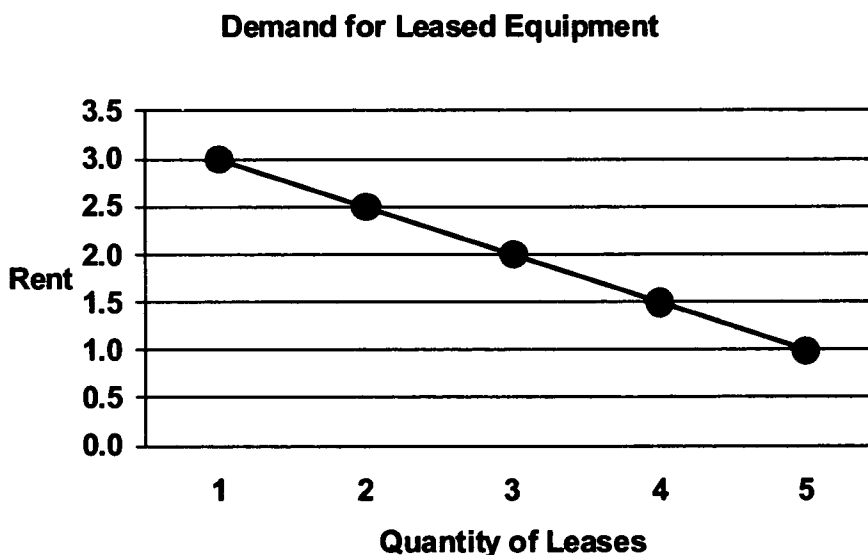
to the property owner of the deductions are what cause the classic demand curve to slope downward and the supply curve to slope upward.

C. Charting Supply and Demand of Leased Property

The application of these economic principles to a hypothetical leasing transaction is depicted on the following demand and supply charts. In the first two charts, hypothetical levels of demand and supply are graphed. In the third chart, the number of leases entered into is predicted, assuming that the lessor currently utilizes all tax benefits. What happens when tax benefits are not fully utilized is depicted in the fourth chart. The fifth chart shows the positive effect on the number of transactions when the proposed system replaces current law.

1. Demand Chart

This chart shows the quantity of leases entered into at rents ranging from 1.0 to 3.0. The quantity of leases demanded appears on the horizontal axis and the rent appears on the vertical axis.⁵⁸



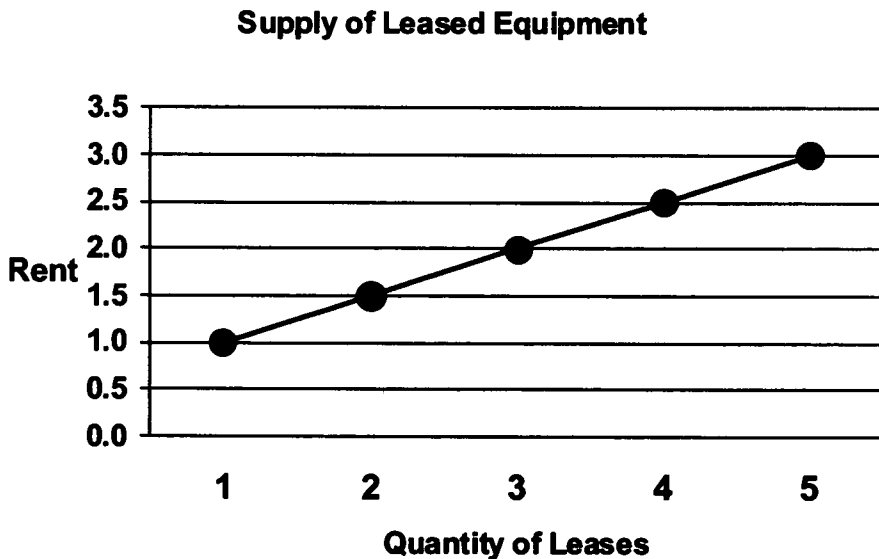
Predictably, as rent decreases from 3.0 to 1.0, the quantity of leases that are likely to be demanded increases from 1 to 5. The downward sloping

58. For illustrative purposes, the slope of this demand curve is linear. Normally, the slope will change in a nonlinear way causing the line to be curved. Moreover, it is not necessarily the case that the curved line will be a “smooth” curve. Variables can often change in a nonlinear and erratic fashion.

relationship between quantity demanded and rent charged depicts the economic “law of downward-sloping demand.” Economic theory attributes the slope of a demand curve to the “substitution effect” and the “income effect.” Because of the substitution effect, a lessee would be inclined, as rent increases to substitute other property for the more expensive leased property. A party may be more inclined to lease less productive property or property with a higher likelihood of early obsolescence. The income effect shows that a lessee’s limited financial resources constrain the lessee’s demand. Although this chart reveals the number of leases that the lessee is willing to enter into, it does not predict the number of leases that would be entered into. Only after considering the lessor’s willingness to lease the property can that be predicted.

2. *Supply Chart*

The next chart shows the hypothetical quantity of leases for that same property that the lessor is willing to enter into at those same rents, assuming that the lessor is able to utilize all tax benefits associated with the leased property.



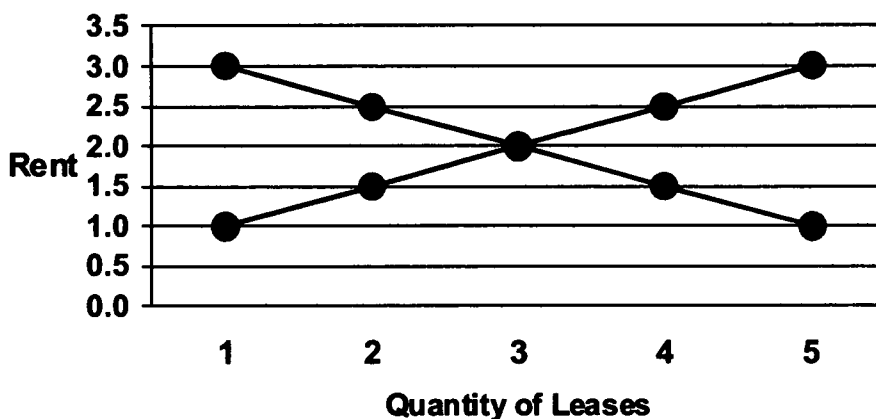
The upward slope of the supply curve reveals that as rent increases (the vertical axis) from 1.0 to 3.0 the lessor is willing to enter into an increasingly larger number, 1 to 5 units, of leases (the horizontal axis). There are several explanations for the increase in rent as the number of leases willing to be entered into also increases. Economic theory propounds a law of diminishing returns, which provides that a higher percentage of cost will

be incurred to enter into each additional lease. The higher cost could be associated with the limited supply of property available to the lessor or the diminishing capacity to utilize tax benefits. In this chart, however, all tax benefits are used.

3. *Equilibrium*

In the next chart, the previously constructed demand and supply curves are overlaid to determine the point at which the demand and supply are in equilibrium.

Supply and Demand In Equilibrium

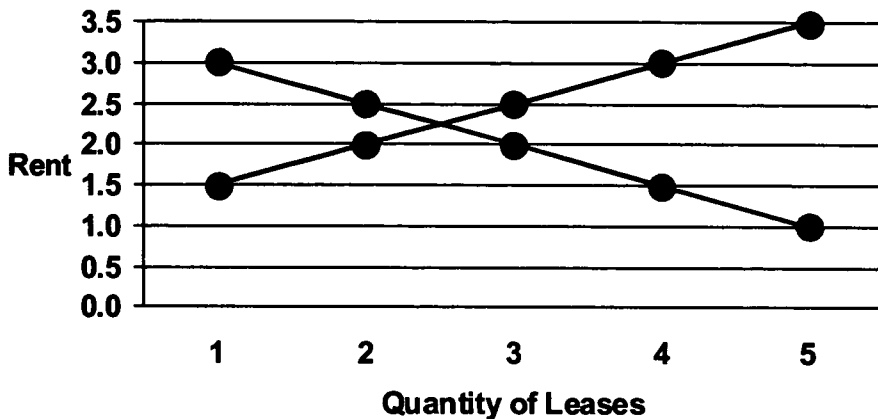


At rent of 2.0, where the supply and the demand curves intersect, the market for the leased property is in equilibrium. The quantity of leases to the left of equilibrium, 3.0, are likely to be entered into because, until 2.0 of rent is reached, the rent expense paid by the lessee and realized by the lessor are acceptable to both parties. In other words, the quantity of leases demanded and supplied are equal. Beyond this point (to the right of equilibrium), the rent sought by the lessor is incompatible with the rent that the lessee is willing to pay for the additional leases.

4. *Supply Equilibrium Shift—Deadweight Loss Created*

The next graph reveals what occurs when the lessor is unable to fully utilize CRD. The increase in the purchase price of the leased property resulting from the lessor's inability to reduce cost by tax savings creates a "deadweight loss that causes the acceptable rents to increase, or to shift upward on the chart.

Equilibrium Shift



A “deadweight loss” is the amount of lost satisfaction experienced by purchasers and suppliers when the cost of supply increases. In a situation involving a lessor and lessee it quantifies the reduced number of leasing transactions entered into because of the inefficiency caused by unutilized tax benefits.⁵⁹ The deadweight loss is greater if demand is elastic; that is, it increases at a greater rate as the tax cost increases. Increased costs that cause slight changes to equilibrium will have little or no effect on the amount of deadweight loss.

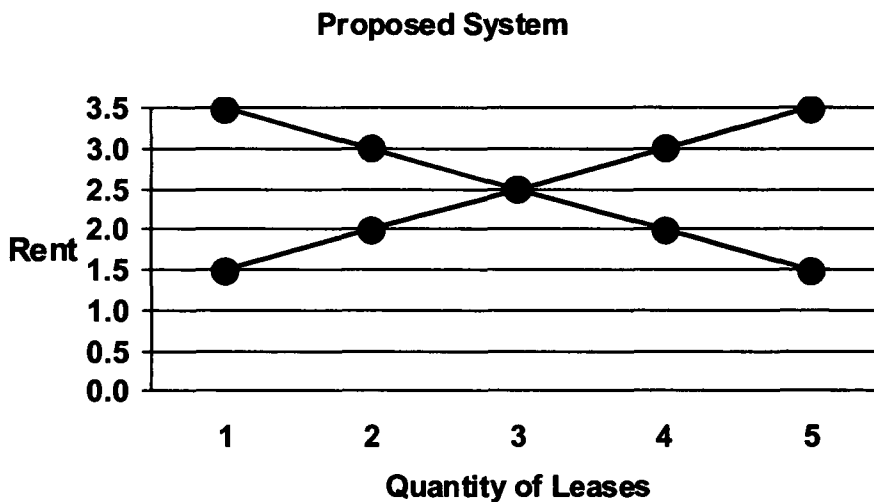
Because the lessor’s cost of the leased property increases, the rent charged would have to increase for the lessor to realize its acceptable ROI. When this occurs, the quantity of leases that are entered into, assuming demand remains static, declines by 10% (.5 fewer leases). Only if the lessor were able to increase rent to compensate for the increased cost from unutilized tax benefits, will the quantity of leases remain the same.⁶⁰ In either case, in this situation, either the lessor or the lessee would be worse off.

59. John Maynard Keynes explains this with a story in which a failing business repeatedly raises prices in order to become profitable, all the while the higher prices have the effect of increasing the business’s losses. In theory, if prices were lowered, sales may increase along with overall profits. Thus, it is often said that the economic effect of a tax increase may be a decrease tax revenues or the economic effect of a decrease in taxation may be an increase in tax revenue. John Maynard Keynes, *The Collected Writings of John Maynard Keynes* (Macmillan, Cambridge University Press, 1972).

60. The extent to which transactions will decrease is, in part, a function of the “elasticities.” For example, an inelastic demand will result no decrease in transactions.

5. *Supply and Demand Equilibrium Shift---Deadweight Loss Eliminated*

The next chart demonstrates that if the proposed system were adopted and the tax benefits were sold to the lessor, the increased cost, expressed as additional rent, would be acceptable to the lessee because it would be offset by an equal amount of tax savings. The deadweight loss is eliminated. The equilibrium point would then shift back to the right because the slope of the demand curve would also shift to the right.



Assuming that the full value of the tax benefits are exchanged for a comparable amount of rent, the quantity of leases entered into would be 3.0, the same as under the third chart when the lessor was able to deduct all CRD.⁶¹

V. PROPOSAL SUPPORTED BY CURRENT STATUTORY LAW

A. Tax Benefit Transfers

The Conference Committee Report accompanying ERTA indicated that safe-harbor leasing tax benefit transfers violated the anti-avoidance,

61. These examples do not take into account the income tax that is paid on the rental income or the deductions that are allowed on the rental expense because the tax is paid on the income or reduced by the expense regardless of whether tax benefits are utilized.

business purpose, and sham transaction tenets of taxation.⁶² Although current law would have to be amended to allow the proposed sale of tax benefits, the following discussion explains why the proposal does not violate any of these (or other) tax tenets. In fact, the proposal is consistent with modern day tax provisions that permit, or in some cases require, the mobility of tax benefits and that encourage transactions by harnessing tax avoidance intent.

The discussion begins with a review of statutory law relating to tax incentive provisions that provide for the purchase of tax credits and the transfer of tax basis. Next, statutory provisions aimed at preventing tax benefit transfers when tax avoidance is evident will be examined. These discussions will be followed by a brief analysis of judicial tax doctrines relating to tax avoidance, business purpose, and substance over form.

1. Tax Credit Transfers

Current law permits a tax-free acquisition of tax credits for cash or other property by a taxpayer who does not hold legal title to the property generating the credit and who may have no involvement with the activity in which the credit generating property is employed. The New Markets Tax Credit and the Low-Income Housing Credit are two of several examples of incentive provisions that permit tax benefit transfers despite the obvious presence of a tax avoidance intent.⁶³

The New Markets Tax Credit ("NMTC") is designed "to encourage investors to make investments in low-income communities that traditionally lack access to capital."⁶⁴ The NMTC rules allow any "taxpayer who holds a qualified equity investment" in a "qualified community development entity" to take a tax credit, spread over six years, equal to approximately 39% of the taxpayer's investment.⁶⁵ Congress designed the NMTC to provide an inducement that a development entity may employ to raise capital for the development of low-income community projects. Through the end of 2008, a total of \$19.5 billion of NMTC have been awarded to 364 applicants.⁶⁶

62. See discussion of ERTA at § I, hereof.

63. Other tax incentives are also available when taxpayers make loans to, or equity investments in, small businesses owned by socially or economically disadvantaged persons certain and licensed by the Small Business Administration.

64. IRC § 45D. The Community Renewal Tax Relief Act of 2000, Pub. L. No. 106-554, § 121(a), 114 Stat. 2763 (2000). GAO Report, "New Markets Tax Credit," Apr. 2009, GAO-09-536.

65. IRC § 45D.

66. Community Development Financial Institutions Fund, New Markets Tax Credit Program, available at www.cdfifund.gov/What_we_do/programs_id.asp?programID=5, last revised Aug. 17, 2009.

The Low-Income Housing Credit (“LIHC”) has a similar purpose. It is designed to be an “efficient mechanism for encouraging the production of low-income rental housing.”⁶⁷ The Report of the Senate Finance Committee that accompanied the legislation, describe the intended efficiency and incentive aspects of the legislation:

“The committee is concerned that the existing tax preferences for low-income rental housing have not been effective in providing affordable housing for low-income individuals. The committee believes a more efficient mechanism for encouraging the production of low-income rental housing can be designed than the variety of subsidies existing under present law.”⁶⁸

The LIHC may be claimed with respect to newly constructed or substantially rehabilitated qualified low-income housing. The credit is available to any taxpayer having a beneficial interest in a special purpose trust, which is the customary vehicle for holding title to the property. The credit is equal to the “applicable percentage” of the “qualified basis of each qualified low-income building.” In general, the applicable percentage for any month is the percentage which will yield over a 10-year period amounts of credit which will have a present value equal up to 70% of the qualified basis of the low-income building. The credit may be transferred by acquiring the underlying property. A taxpayer who purchases a building is entitled to the credit to which the prior owner of property was entitled.⁶⁹

The intention of taxpayers who invest in the properties qualifying for either the NMTC or the LIHC is to reduce their tax liability. The credit acquisitions, however, are accompanied by bona fide investments that achieve a Congressional objective. Nonetheless, the investor has a relationship to the credit generating property not unlike the relationship that a passive investor has in property held by a publicly traded corporation. The taxpayer to whom the credit is transferred does not hold title to the property that generates the credit nor does the taxpayer have to be involved in the activity in which the property was employed. Both of these provisions, and the several others that are similar in their scope, do not restrict sale of credits to a counterparty in a transaction involving the lease of property. Thus, in this respect, they are considerably more liberal than the proposed system. What they do have in common with the proposed system is the ability of the

67 IRC § 42. Pub. L. No. 99-514, H.R. Rep. No. 3838, 99th Cong. § X (1986). The credit was significantly expanded by the Community Renewal Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

68. H.R. Rep. No. 99-3838, p. 758 (1986).

69. IRC § 42(d)(7).

property owner to sell valuable tax benefits as an adjunct to a transaction that has a significant non tax purpose.

2. *Tax Basis Transfers—to Other Taxpayers*

There are several current tax law provisions that permit tax basis to be transferred in exchange transactions between unrelated taxpayers, even when the relationship between the transferor and the owner of the property after the basis transfer is quite remote. A tax basis shift often yields tax deductions to the transferee with respect to the underlying property because tax deductions typically inhere in tax basis. Consequently, the ability to shift basis under current law is usually the equivalent of shifting tax benefits.⁷⁰ So long as the transferred basis occurs in conjunction with one of the several nonrecognition provisions in the Code, a transfer of tax benefits inherent in the basis of the transferred property will be respected.⁷¹ Unrecognized gain or loss typically is preserved in the transferred basis in nonrecognition transactions.

The following discussions of sections 351 and 1041 illustrate the opportunity to transfer tax benefits inherent in tax basis. Both sections allow for tax nonrecognition because of strong policy reasons. In the case of section 351, the purpose of the nonrecognition rule is to facilitate the formation of capital in those situations where only the form of ownership has changed,⁷² and in section 1041 Congress eliminated the conflicting treatment of property transfers between spouses occasioned by different state laws. Strong policy objectives behind incentive legislation are adequate to justify the transferred basis rule of the proposed system.

Section 351 prescribes a nonrecognition rule for transfers of property in exchange for stock in a corporation controlled by the transferor or group of transferors immediately after the transfer. With its companion transfer basis rule contained in section 362, it has the effect of permitting tax benefits to be transferred from the transferee to a corporation and then shared by the corporation's shareholders.

A simple illustration reveals how significant tax benefits can be shifted to the corporation and then, albeit indirectly, to the other corporate shareholders. Assume that there are two transferors, Transferor A and Transferor B. Transferor A transfers to newly formed Corporation C property

70. Another tax benefit associated with tax basis is the reduction that it has on the amount of realized gain.

71. IRC § 7701(a)(45). A nonrecognition transaction is an exception to the general tax rule that requires the recognition of gain or loss whenever property is disposed of. IRC § 1001(c).

72. Treas. Reg. § 1.1002-1(c); *Portland Oil Co. v. Comm'r*, 109 F.2d 479, 488 (1st Cir. 1940).

with a tax basis of 40 and a fair market value of 100, and Transferor B transfers to Corporation C property with a tax basis of 160 and a fair market value of 100. Thus, there is 60 built-in gain in A's property and 60 of built-in loss in B's property. Section 351 in conjunction with section 362 will cause the tax burden associated with half of Transferor A's built-in gain to be indirectly shifted to Transferor B in exchange for one-half of the stock of the corporation and one-half of the tax benefit associated with Transferor B's built-in loss is shifted to Transferor A for the other one-half of stock.⁷³

Sharing the characteristics of tax basis is a permissible transfer of tax benefits.⁷⁴ The notion that nonrecognition is appropriate because a mere change in the form of ownership has occurred fails to account for the possible remoteness of the ownership interest after the transfer. It is irrelevant under the rules of sections 351 and 362 what the percentage of ownership that the transferor has in the transferee corporation after the transaction, what the relationship that the transferors has with the other shareholders, and what the transferors involvement is with the transferred property after the transaction. More significantly, it appears that there is no restriction on Transferor A agreeing before the transfers that Transferor B will receive more than half of the stock of the corporation in consideration of the tax benefit he is transferring. Any additional consideration received for tax benefits will not be treated as taxable boot.

Transferring tax deductions themselves is permitted in section 351 transactions by virtue of section 357. It permits deductions with respect to a liability of a transferor to be transferred to a corporation in exchange for stock.⁷⁵ To the extent that the payment of the liability generates a corporate tax deduction or an addition to the corporation's tax basis, the tax savings flowing therefrom will inure to the benefit of all shareholders.⁷⁶ To illustrate, assume that Transferor D transferred \$30,000 of liabilities for unpaid utilities, salaries, and other operating expenses to Corporation D in a transaction that qualified under section 351. Assume also that there were two other transferors. One-third of Transferor D's deductions would inure to the benefit of each of the other shareholders. Thus, with respect to both tax basis and tax deductions current law permits an indirect shift of tax

73. This assumes that Transferor B and the Corporation have made the basis election provided for in IRC § 362(e)(2)(C). For there to be a valid nonrecognition transaction under IRC § 351 there must be a valid business purpose for the transaction. The business purpose doctrine is discussed below.

74. Even before a disposition of property, the transferee corporation will realize the effect of any built-in gain or loss through greater or lesser CRD.

75. These deductions may be shifted to the corporation in an IRC § 351 transaction under the provisions of IRC § 357(a) and (c)(3) but only when the transferor transfers other property to the corporation.

76. Rev. Rul. 95-74, 1995-2 C.B. 36; *Hempt Bros., Inc., v. U.S.*, 490 F.2d 1172 (3rd Cir. 1974).

benefits.⁷⁷ The applicable section 351 and 357 nonrecognition rules and basis or deduction transfer provisions are mandatory, not elective.

Tax law provisions also prescribe a mandatory nonrecognition rule with accompanying tax basis shift in certain property transfers (not necessarily exchange transactions) between individual taxpayers. For example, section 1041, which mandates nonrecognition of gain or loss on transfers of property between spouses or former spouses incident to a divorce, requires the transferor's tax basis to be shifted to the transferee.⁷⁸ It is irrelevant whether the property may have been transferred for no consideration, for its market value, or for any other amount.⁷⁹

3. *Tax Basis Transfers—to Other Property Owned by Taxpayer*

Current law also prescribes rules for tax benefit transfers between or among properties owned by a single taxpayer in a way that may accelerate the tax benefits to the property owner. A few of the numerous nonrecognition transactions in which basis is shifted from one property owned by a taxpayer to other (usually acquired) property, include transfers to controlled corporations,⁸⁰ transfers to a partnership,⁸¹ receipt of stock or stock rights,⁸² like-kind exchanges, including exchanges of insurance contracts,⁸³ and involuntary conversions.⁸⁴

To illustrate, tax benefits can be accelerated by virtue of the like-kind exchange rules of section 1031. Assume that Transferor A exchanges vacant farm land with a basis of \$60 and a fair market value of \$100 for rental property owned by Transferor B. Tax rules permit the taxpayer to avoid recognizing the \$40 of gain on this transaction, but require the taxpayer to ascribe the \$60 farm land basis to the rental real property, the

77. That the drafters recognized the shifting nature of IRC § 351 rules can be discerned from the very different approach taken in the rules applicable to transfers of property to partnerships. IRC § 704(c) expressly prohibits the shifting of a transferor partner's tax benefits (and burdens) to the other partners. Instead, any benefits associated with tax basis and deductions are traced back to the particular transferor and are not shared by the other partners.

78. IRC § 1041(b)(2).

79. A similar rule is contained in IRC § 1015(a) for gifts, generally. Pursuant to this rule, a tax basis rule applicable when gifts are made requires the donor's tax basis to be shifted to the donee. An exception is provided when the fair market value of the property at the time of the gift exceeds the donor's tax basis and the property is sold by the donee at a loss.

80. IRC § 351 and § 358.

81. IRC § 721 and § 722.

82. IRC § 307.

83. IRC § 1031(d) and § 1035.

84. IRC § 1033(b).

“exchanged basis property.”⁸⁵ After the exchange, Transferor A is permitted to take CRD equal to the portion of the \$60 basis that is properly allocable to the building and other like-kind depreciable property acquired in the exchange. Before the transaction no CRD were allowed because the entire basis was attached to land, which is a nondepreciable asset.

B. Tax Avoidance Intent

Under current statutory law, a taxpayer’s intention to avoid tax, the principal or sole purpose for the proposed sale of tax benefits, will not prevent the proposed tax benefit transfers. As discussed below, statutory law expressly incentivizes taxpayers with tax avoidance. However, statutory provisions also exist that deny tax benefit transfers when (a) tax avoidance intent is not associated with a Code provision designed to further some Congressional social or economic objective or (b) when the transaction containing tax avoidance intent is entered into without an overriding business purpose.

1. Current Statutory Provisions Employing Tax Avoidance

Commenting on the allure of tax avoidance, the renowned British economist John Maynard Keynes is said to have quipped: “[t]he avoidance of taxes is the only intellectual pursuit that carries any reward.”⁸⁶ Realizing, as this quote reveals, the antipathy that taxpayers have toward tax liability, he advocated in favor of tax incentives and other types of governmental intervention in the economy when stimulus was needed.

The Code is replete with sections that contain implicit Congressional legitimization of tax avoidance intent. The discussion above of the NMTC and LIHC and the economic stimulus provisions are illustrations of Congressional intervention in the economy with legislation that harnesses tax avoidance tendencies. More targeted concerns associated with energy independence prompted the enactment of tax incentive provisions contained in The Emergency Economic Stabilization Act of 2008. According to the law’s preamble, its purpose was “...to amend the Internal Revenue Code of 1986 to provide incentives for energy production and conservation”⁸⁷

85. IRC § 7701(a)(44).

86. The Forbes Book of Business Quotations 820 (Ted Goodman ed., Black Dog & Leventhal Publishers) (1997).

87. Pub. L. No. 110-343, 122 Stat. 3765 (2008). See also, the preamble to the American Recovery and Reinvestment Act of 2009 that describes the purpose of the legislation as: “Making supplemental appropriations for job preservation and creation, infrastructure investment, energy efficiency and science, assistance to the unemployed, and State and local fiscal stabilization, for the fiscal year ending Sep.

The incentives enacted include accelerated CRD and tax credits for various energy related investments. For example, The 2008 Act cut in half the cost recovery period for any qualified smart electric meter and any qualified smart electric grid system,⁸⁸ and qualified all cellulosic biofuels for an immediate cost recovery deduction equal to 50% of the cost of the biofuel facilities.⁸⁹ The 2008 Act also enhanced the provisions of the existing Energy Credit by allowing the credit to be taken for investments in an expanded category of property. It increased the credit limit for fuel cell property, removed prohibition on public utility property qualifying for the credit, allowed the credit for alternative minimum tax purposes, etc...⁹⁰ The Credit for Electricity Produced from Renewal Resources,⁹¹ the Qualifying Advanced Coal Project Credit,⁹² and the Qualifying Gasification Project credit,⁹³ the Biodiesel Fuels and Alternative Fuel Credit⁹⁴ were also expanded.

Numerous other targeted provisions that depend on taxpayers' tax avoidance tendencies have been enacted over the years to advance more targeted government objectives. They provide additional evidence of Congresses approval of tax avoidance intentions. For example, special accelerated cost recovery rules have been enacted to encourage investment in pollution control facilities,⁹⁵ research and experimentation expenditures,⁹⁶ reforestation expenditures,⁹⁷ soil and water conservation expenditures,⁹⁸ etc... . These special rules are more favorable than, and, thus, provide an added incentive to, the accelerated cost recovery rules applicable to other business property.

All of these provisions evidence Congressional approval of tax avoidance as an incentive to address a social or economic policy concern. The transfer of tax benefits is the tool used to achieve the objective. So long as the underlying transaction required by the tax avoidance legislation is engaged in, the tax benefit transfer is acceptable.

30, 2009, and for other purposes." Pub. L. No. 111-5, 123 Stat. 115, H.R. Rep. No. 5 (2009).

88. IRC § 168(e)(3)(D).

89. IRC § 168(l)(1)(B).

90. IRC § 48.

91. IRC § 45.

92. IRC § 48A.

93. IRC § 48B.

94. IRC § 40A.

95. IRC § 169.

96. IRC § 174.

97. IRC § 194.

98. IRC § 175.

2. *Statutory Constraints on Tax Avoidance*

Unless appropriate limitations accompany the proposal, tax abuse is likely to result. As one court observed, “[a] tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system.”⁹⁹ Current law prescribes limits on tax benefit transfers in transactions where tax avoidance intent is evident. Although the proposed system, as discussed below, does not violate any of these limits, it should constrain its tax avoidance orientation with reasonable limitations on transferring tax benefits, and these constraints should be consistent with current statutory tax avoidance limitations. Following is a discussion of salient provisions of current statutory law that deny tax benefit transfers if tax avoidance is the intent of the transaction.

There is no absolute or overarching proscription against tax avoidance contained in the Code. Instead, Congress has designed targeted sections that deny or limit tax benefits if tax avoidance is found to exist. For example, section 532 imposes an accumulated earning tax on corporations “formed or availed of for the purpose of avoiding the income tax with respect to its shareholders ...,”¹⁰⁰ and section 7872 treats as a below-market loan to which interest is imputed any such loan “the principal purpose of the interest arrangement of which is the avoidance of any Federal tax.”¹⁰¹ With some of these provisions, tax avoidance must rise to the level of being the “principal purpose” for entering into the transaction, but with other provisions a lower threshold is sufficient to deny expected tax benefits.

The tax anti-avoidance section with the broadest scope, the one that applies to the widest variety of property transfers, and the one that probably has the richest judicial history is section 269. It employs the “principal purpose” standard.¹⁰² The section 269 “principal purpose” threshold, and not a lower threshold for denial of tax benefits, should be employed in the proposed system because tax avoidance is intended under the proposed system to incentivize the parties to engage in a purchase or leasing

99. *ASA Investerings P’ship v. Comm’r*, 201 F.3d 505 (D.C. Cir. 2000). Earlier, Mr. Justice Cardozo in *Burnet v. Wells*, 289 U.S. 670, 676 (1933) referred to the proclivity to craft tax avoidance schemes as stemming from taxpayers’ “fertility of invention.”

100. IRC § 532(a). The evidence that established the purpose to avoid income tax is prescribed in IRC § 533.

101. IRC § 7872(c)(1)(D). In addition to these sections regulations deny tax benefit transfers. For e.g., Treas. Reg. § 1.1502-15, -21, and -22, regarded as quasi-statutory provisions because of the specific grant of rule making authority in the area of consolidated returns prescribed in IRC § 1502, deny net operating loss carryovers.

102. IRC § 269 limits the transfer of tax benefits when control of a corporation takes place or when property is acquired in a transferred basis transaction.

transaction. Thus, it is expected be one of the purposes for entering into the transaction, but as a mere adjunct to a bona fide commercial transaction. Section 269 is helpful in other ways when designing anti-abuse elements of the proposed system. The section's legislative history and the regulations promulgated under the section contain useful guidance on the meaning of the term "tax avoidance," a term not defined in the Code, and when tax avoidance becomes the "principal purpose" of an acquisition. A thorough discussion of section 269 is beyond the scope of this paper, but some of the highlights of its legislative history are instructive to understand the limits on its scope imposed by the "principal purpose" standard.

Section 269 disallows "the benefit of a deduction, credit, or other allowance" in acquisitions of a controlling interest in a corporation or property of a corporation where basis is shifted, if the "principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax ...".¹⁰³ A 1943 House Ways and Means Committee report accompanying the enactment of the predecessor to section 269 states that the section was "designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability."¹⁰⁴ According to the related Senate Report, the section becomes operative whenever "the evasion or avoidance purpose outranks, or exceeds in importance, any other one purpose."¹⁰⁵ Current Treasury Regulations under section 269 state that evidence of the proscribed purpose exists whenever "the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction."¹⁰⁶

103. IRC § 269.

104. H. R. Rep. No. 78-871, § 49 (1943). The predecessor to IRC § 269 as § 29 of the Internal Revenue Code of 1939, added to the law by the Revenue Act of 1943, 58 Stat. 47 (1943). The scope of § 129 was narrowed in the Senate so that the final version of the section required more than a mere "interest" in "property." For a discussion of the events that led up to the enactment of this provision, see, Harry J. Rudick, *Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 Harv. L. Rev. 196 (1944).

105. S. Rep. No. 78-627, § 59 (1943), *as reprinted in* 1944 C.B. 973, 1017. In the earlier House version of the section, tax avoidance needed to be only one of the principal purposes of the acquisition.

106. Treas. Reg. § 1.269-2(b). The regulations say that the phrase is not limited to cases involving criminal or civil penalties for fraud. Treas. Reg. § 1.269-1. "Evasion or avoidance" is broad enough to encompass most acquisitions of a deduction or other tax benefit which lowers overall tax liability or which exempts an otherwise taxable entity from taxation. Although the regulations indicate that the absence of business purpose may be sufficient to trigger the IRC § 269 disallowance

Determining whether a “principal purpose” is present requires application of a subjective test that examines all surrounding facts and circumstances to determine the taxpayer’s state of mind.¹⁰⁷ That subjective determination is aided by examining the objectively observable purpose for the transaction. As the Fifth Circuit stated, “[t]heoretically the question of purpose is purely subjective; pragmatically, however, the trier of fact can only determine purpose from objective facts.”¹⁰⁸

VI. PROPOSAL SUPPORTED BY CURRENT JUDICIAL DOCTRINES

A. Judicial Constraints on Tax Avoidance

In the absence of an express statutory constraint on tax avoidance, there are well established judicial limitations on tax benefit transfers that encompass transactions, generally. They are vastly more expansive than the statutory rules; however, the judicial rules suffer from being less precise, and because the opinions in which they are contained are subject to the vagaries of the facts before the court, they appear to lack uniformity in their scope, applicability, and predictability. Nonetheless, as broad as the judicial limitations are, they are not so broad as to prevent tax benefits transfers under the proposed system.

rule, the 5th Circuit held otherwise when saying: “Section 269 is directed to the principal purpose for the acquisition of control of a corporation, not the absence of a business purpose in acquiring a corporation’s assets.” *Canaveral Int’l Corp. v. Comm’r*, 61 T.C. 520 (1974). The three-part test set forth in the regulations is also used in judicial scrutiny of transactions not covered by IRC § 269. See § VI.A of this paper where this is discussed.

107. Initially, the IRS was not especially successful in IRC § 269 cases because courts tended to find that most corporate acquisitions and property transfers at issue served a valid business purpose. See *Berland’s, Inc. v. Comm’r*, 16 T.C. 182 (1951) (acq.); *Alcorn Wholesale Co. v. Comm’r*, 16 T.C. 75 (1951) (acq.); *WAGE, Inc. v. Comm’r*, 19 T.C. 249 (1952) (acq. and nonacq.); *Commodores Point Terminal Corp. v. Comm’r*, 11 T.C. 411 (1948) (acq.). Beginning in 1957, however, courts adopted a narrower view of business purpose. Thus, the 4th Circuit in *Coastal Oil* was particularly skeptical of the taxpayer’s choice of vehicle for acquiring a particular loss corporation. *Coastal Oil Storage Co. v. CIR*, 242 F.2d 396 (4th Cir. 1957). The Tax Court, in *Canaveral Int’l Corp* denied tax benefits under section 269 because, while there was a valid business purpose for acquiring stock of a corporation with a high basis and low value, there was no business purpose for the particular method of acquisition. *Canaveral Int’l Corp. v. Comm’r*, 61 T.C. 520 (1974) (acq.). In all, while the courts have not compelled taxpayers to select the least favorable tax structure, they do require that the taxpayer demonstrate a substantial business reason for selecting the particular acquisition method.

108. *Bobsee Corporation v. U.S.*, 411 F.2d 231, 238 (5th Cir. 1969).

Although courts articulate similar tests for determining whether tax avoidance prevents anticipated tax benefits from being realized, they do not employ consistent language when describing key components of the tests. The terms, "intent" and "purpose," are frequently used in different ways, and the term "motive" is sometimes substituted for "intent" and occasionally for the term "purpose."¹⁰⁹

In this paper, the taxpayer's "motive" will be used to describe what caused the taxpayer to enter into the transaction, e.g., was the reason for entering into the transaction to reduce taxes, to increase profits, etc... . Motive, as thus defined, is seldom in issue in tax avoidance cases.¹¹⁰ The taxpayer's "intent" for entering into a transaction will be a term used to describe the taxpayer's subjective expectation for what the transaction will yield, e.g., did the taxpayer have as its objective for entering into the transaction to generate tax deductions, to increase cash flow, etc... . This is usually a controlling factor. The "purpose" for entering into the transaction is what the taxpayer objectively sought to obtain from the transaction, e.g., a reduction in tax liability, an increase in pretax profits, etc... .¹¹¹ In addition to possessing the requisite intent and purpose, courts examine a transaction to determine whether the form of the transaction accurately reflects its substance.

Despite the semantic confusion, the following three tests emerge from an analysis of the judicial analysis tests. In most instances, courts apply the tests conjunctively:

109. The 3rd Circuit in *ACM P'ship v. Comm'r*, 157 F.3d 231 (3rd Cir. 1998), stated that for a transaction to be respected for tax purposes it must have "objective economic substance" and it must have "subjective business motivation." The Court of Appeals for the Eleventh Circuit stated that "Naturally, the evaluation of the level of profit motive possessed by a taxpayer in entering into a transaction involves an inquiry into the subjective motive or intent of the taxpayer. *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir. 1989).

110. Apart from considering a taxpayer's intent and purpose for entering into the transaction, courts also will examine whether the structure of the transaction accurately reflects its purpose or whether its structure is intended to conceal a tax avoidance intent. This issue will be discussed below under the heading "Sham Transactions."

111. An illustration of judicial misuse of terminology that results in confusing the underlying principles is contained in *Rice's Toyota World, Inc., v. Comm'r*, 752 F.2d 89, 92 (4th Cir. 1985) where in affirming the Tax Court the it was stated: "The business purpose inquiry simply concerns the motives of the taxpayer in entering the transaction. The record in this case contains ample evidence to support the tax court's finding that Rice's sole motivation for purchasing and leasing back the computer under the financial arrangement used was to achieve the large tax deductions that the transaction provided in the early years of the lease."

- Is there a business purpose for the transaction?
- If there is no business purpose, does the taxpayer have tax avoidance intent?
- Does the structure of the transaction reflect its purpose?

Determining whether the taxpayer intended to engage in tax avoidance is a subjective inquiry. The perceived purpose of the transaction, whether it is to reduce tax liability, to maximize income, etc..., is determined from examining objective factors. Form and substance inquiries will turn on the “economic realities” of the transaction. It is beyond the scope of this paper to provide a comprehensive discussion of these three tests, but an overview of them and the relationship to the proposed system is set forth below.¹¹²

B. Is There A Business Purpose for The Transaction?

The requirement that a transaction have a business purpose was designed to ensure that tax benefits cannot be realized from a transaction if it is engaged in merely for the purpose of tax reduction.¹¹³ As with the tax-avoidance intent requirement, the business purpose requirement has never been adopted into statutory law as a condition to transfer of tax benefits in general.¹¹⁴

A business purpose exists if the taxpayer has a profit motive for entering into a transaction, and reduction of taxes is not a business purpose.¹¹⁵ In *Gregory v. Helvering*, the case most often credited with establishing the business purpose requirement, the putative corporate reorganization was struck down because it was found to have no purpose other than to reduce taxes. The Supreme Court noted that a transaction “... having no business or corporate purpose ...” but designed solely to effectuate

112. For a discussion of the business purpose doctrine, see, generally Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (Warren, Gorham & Lamont, 7th ed.) ¶ 12.61[1]. See also, *Acquisitions Made to Avoid Taxes*: Section 269, 34 Va. L. Rev. 539 and Wetzler, “Notes of the Economic Substance and Business Purpose Doctrines” Tax Notes, Jul. 2, 2001 (92 Tax Notes 127).

113. *ACM Partnership v. Comm’r*, 157 F.3d 231 (3rd Cir. 1998).

114. It is contained in IRC § 357(b), where it is a test to determine whether tax avoidance was the purpose of certain transfers of liabilities to a corporation. See also, Treas. Reg. §§ 1.368-1(c) and 1.355-2(b); Rev. Proc. 96-30, 1996-19 I.R.B. 8 (Appendix A).

115. *Rice’s Toyota World, Inc. v. Comm’r*, 81 T.C. 184 (1983).

the taxpayer's tax avoidance intention to reduce taxes would not be respected for tax purposes.¹¹⁶

C. *Does Taxpayer Have Tax Avoidance Intent?*

The taxpayer's intent for entering into the transaction is significant only if there is no business purpose for the transaction. If the taxpayer has a tax avoidance intent and if the transaction lacks any economic or commercial purpose, it will not be respected for federal income tax purposes.¹¹⁷ Conversely, if there is a business purpose, tax avoidance intent will not prevent realization of the tax benefits.

One of the threshold issues decided in *Gregory* was whether a transaction that appeared to comply with all statutory requirements for a tax-free reorganization would, nonetheless, fail to do so if the taxpayer's intent for entering into the transaction were to avoid taxes. Writing for the Second Circuit, Judge L. Hand stated uncategorically that "... a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one chooses, to evade, taxation."¹¹⁸ The Supreme Court affirmed both the decision and its reasoning saying: "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."¹¹⁹

When faced with the same issue, numerous other courts have adopted the *Gregory* holding. For example, the Seventh Circuit in 1997 stated: "[a] tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or

116. *Gregory v. Helvering*, 69 F.2d 809 (2nd Cir. 1934), *aff'd*, 293 U.S. 465 (1935); *Casebeer v. Comm'r*, 909 F.2d 1360, 1363 (9th Cir. 1990) stated: "... the purpose of a transaction should be the guide." *Casebeer v. Comm'r*, 909 F.2d 1360, 1363 (9th Cir. 1990) defined a sham transaction as a transaction that "has no business purpose or economic effect other than the creation of tax deductions." *Lerman v. Comm'r*, 939 F.2d 53 (3rd Cir. 1991). Even if a transaction has a business purpose, the part of the transaction to which it relates may be separated from another part that has no business purpose if it appears that the taxpayer attempted to cloth the segment of the transacting lacking a nontax business purpose with the mantle of respectability.

117. *Frank Lyon v. United States*, 435 U.S. 561, 583-84 (1978); *Knetsch v. United States*, 364 U.S. 361, 365-66 (1960). To the contrary, "where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations." *Holladay v. Comm'r*, 649 F.2d 1176, 1179 (5th Cir. 1981); *ACM P'ship*, 157 F.3d at 248 n.31.

118. *Gregory*, 69 F.2d at 811.

119. *Gregory*, 293 U.S. at 469.

altogether avoid) the amount of what otherwise would be his taxes.”¹²⁰ The Fifth Circuit stated: “... it is also well established that where a transaction objectively affects the taxpayer’s net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations.”¹²¹ The Tax Court echoed these sentiments saying that: “[t]axpayers generally are free to structure their business transactions as they see fit, even if motivated by tax avoidance, provided a nontax or business purpose also is present.”¹²²

D. *Does Structure of Transaction Reflect its Purpose?*

The structure of the transaction must accurately reveal a business purpose. Merely structuring a transaction in such a way as to convey the misleading impression that the transaction has a business purpose, of course, will fail to satisfy the business purpose requirement. When courts have determined that a transaction’s profit or business form is a mask to its tax avoidance purpose, the substance of the transaction will be elevated over its form, and the attempted obfuscation will fail. Thus, a leasing transaction in which possession is retained by the lessor will be ineffective under this doctrine in qualifying for the proposed system’s tax benefit transfer provisions.

The substance over form doctrine can be traced to a principle expressed by Justice Holmes in *Corliss v. Bowers*, where he wrote that “... taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.”¹²³ More recently, in *Frank Lyon Co. v. U.S.*, the Court considered whether the form of a sale/leaseback transaction should be given effect for tax purposes. It expanded upon its earlier statement and elevated it to the status of a “doctrine” saying: “[i]n applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed.”¹²⁴

This doctrine is now regularly applied by lower courts to invalidate a variety of tax avoidance schemes that are found to actually lack business purpose. Thus, in *Del Commercial Properties, Inc. v. Commissioner*, the District of Columbia Circuit stated that although taxpayers “are entitled to structure their transactions in such a way as to minimize tax,” there must be a

120. *N. Indiana Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 511 (7th Cir. 1997).

121. *ACM Partnership*, 157 F.3d at 248.

122. *Sanderson v. Comm’r*, 50 T.C.M. (CCH) 1033 (1985); *Gregory*, 293 U.S. at 469; *Rice’s Toyota World, Inc.*, 81 T.C. at 195-96.

123. *Corliss v. Bowers*, 281 U.S. 376 (1930).

124. *Frank Lyon*, 435 U.S. at 573.

purpose for the “business activity ... other than tax avoidance” and that purpose cannot be a “facade.”¹²⁵ In *ACM Partnership v. Commissioner* the Third Circuit similarly concluded that: “We must ‘look beyond the form of [the] transaction’ to determine whether it has the ‘economic substance that [its] form represents.’” [Citations omitted.]¹²⁶ The Tax Court in *Falsetti v. Commissioner* defined “sham in substance” as the “expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits.”¹²⁷

VII. TAXATION OF TRANSFERRED TAX BENEFITS

Assuming that the proposed system is adopted, three fundamental principles of tax law must be reconciled:

- 1) Converting a deduction or a credit into a tax savings does not give rise to any income to the taxpayer.
- 2) A sale or exchange of property requires gain or loss to be determined, and, unless an exception applies, any realized gain or loss thus determined is then recognized,¹²⁸ and
- 3) When property is purchased, the purchaser’s tax basis is the taxpayer’s cost of the property.¹²⁹

125. *Del Commercial Properties, Inc. v. Comm’r*, 251 F.3d 210 (D.C. Cir. 2001); *ASA Investorings P’ship v. Comm’r*, 201 F.3d 505 (D.C. Cir. 2000). See also *N. Indiana Pub. Serv. Co.*, 115 F.3d at 512 (stating that the IRS cannot “disregard economic transactions ... which result in actual, non-tax-related changes in economic position”). In *Gregory*, the transaction was in full compliance with the letter of the statute but it violated its spirit. This is not different from setting up a transaction so that its facts would appear one way but its substance was otherwise. In both of these transactions, the form is not reflecting its substance. In the reorganization area, the form may comply with the form required by the statute, but the substance may be otherwise, as in *Gregory*.

126. *ACM Partnership v. Comm’r*, 157 F.3d 231 (3rd Cir. 1998). The Supreme Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred.” *Comm’r v. Sunnen*, 333 U.S. 591 (1948); *Helvering v. Clifford*, 309 U.S. 331 (1940). *Comm’r v. Tower*, 327 U.S. 280, 291 (1946); *Helvering v. Lazarus*, 308 U.S. 252, 255 (1939). See also *Comm’r v. P.G. Lake, Inc.*, 356 U.S. 260, 266-67 (1958); *Comm’r v. Court Holding Co.*, 324 U.S. 331, 334 (1945). *Comm’r v. Duberstein*, 363 U.S. 278, 286 (1960).

127. *Falsetti v. Comm’r*, 85 T.C. 332, 347 (1985).

128. IRC § 1001(c).

129. IRC § 1012(a).

Tax benefits are property rights. Inherent in business property is the right granted by Congress to the owner to reduce tax liability by claiming various deductions and credits associated with the property.¹³⁰ If those rights are transferrable, they become property themselves because property has been defined as encompassing anything that may be transferred.¹³¹ The Supreme Court has said that “[t]he only relevant definitions of ‘property’ to be found in the principal standard dictionaries [footnote omitted] are ... that ‘property’ is the physical thing which is a subject of ownership, or that it is the aggregate of the owner’s rights to control and dispose of that thing.”¹³² Thus, assuming that amendments are made to the Code appropriate to allow the sale of tax benefits, the right of a property owner to claim CRD or tax credits would be treated as property disposed of in a transaction in which gain or loss would have to be determined and the acquiring taxpayer would have to determine its basis in the acquired property.¹³³ If these rules are applied, income or deduction may be created at the time the tax benefit is sold and the transferee would take a basis that will be equal to only 35% of the transferor’s basis.

Current law provisions that allow tax deductions and credits to be transferred treat the transfer of tax benefits as tax-free events. For example, the sale of the “qualified equity investment” that transfers a NMTC results in no gain or loss with respect to the credit to the transferor. Moreover, provisions that allow for “nonrecognition” of gain or loss never impose taxable boot status on any consideration attributable to the value of transferred tax benefits, such as built-in losses and CRD. In a section 351 transaction the transferor of property who receives stock neither realizes nor recognized any gain with respect to the value of stock attributable to the basis of the transferred property.

Consistent with the current treatment of tax benefits, the proposed system’s objective of merely shifting a tax benefit, not creating any income or deduction or altering the amount of tax basis in the process, would be achieved by expressly treating the transfer as a nonrecognition exception to the general recognition rule of section 1001.¹³⁴ The lessor would neither realize nor recognize any gain or loss on the sale of benefits. After the sale, it would have no basis in the leased property that it continues to own. If the

130. This “right” is said to have been granted as “a matter of legislative grace” *Deputy v. du Pont*, 308 U.S. 488, 493 (1940).

131. In *Hempt Bros., Inc. v. U.S.*, 354 F.Supp. 1172, 1175 (M.D.Pa.1973), *aff’d*, 490 F.2d 1172 (3rd Cir. 1974), *cert. denied*, 419 U.S. 826 (1974).

132. *Crane v. Comm’r*, 331 U.S. 1, 6 (1947).

133. Black’s Law Dictionary defines “property” as, among other things, “The right to possess, use, and enjoy a determinate thing (either a tract of land or a chattel); the right of ownership”

134. IRC § 7701(a)(45).

lessor eventually sells the property after the term of the lease expires for its residual value, it will determine its gain on the transaction by comparing its amount realized with a zero tax basis.

Granting the transaction nonrecognition treatment would yield the intended consequences for the purchaser. Instead of taking a cost basis in the tax benefit, normal nonrecognition rules call for a transferred tax basis. Because both the entitlement to, and the amount of, property related tax credits are determined with reference to tax basis, a transferred basis rule that places the transferee in the shoes of the transferor will facilitate tax credit transfers, as well.

VIII. CONCLUSION

A tax-benefit allocation system with appropriate anti-abuse safeguards will contribute toward a more efficient utilization of tax incentives. Such a system is to the advantage of both taxpayers and the government. Tax liability, cash flow, and reported earnings will be more accurately reflected, competition and decision making will not be distorted, and taxable transactions intended by the government to be encouraged by stimulus legislation will occur with greater frequency. The proposed system furthers these objectives while operating within the confines of well established anti-avoidance statutory and judicial rules.