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OFFICE MEMORANDUM

TO: Clients of the Firm

FROM: Christopher S. Rizek

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RE: Codification of economic substance

In response to the problem of corporate tax shelters, many tax policy experts have suggested codifying in the Internal Revenue Code the "economic substance doctrine," which is a common law tax doctrine the courts apply in order to prevent unintended results from, and even intentional abuse of, provisions of the Code. This memorandum summarizes the current status of efforts to codify the doctrine.

I must caution at the outset that the tax legislative situation this year is extraordinarily fluid and subject to change. As of this writing, the two houses of Congress have entered a budget resolution, but the final revenue parameters (and particularly the scope of any further tax cut, as requested by the President) are still under negotiation. The outcome of that effort (which may become clearer as early as the end of this week) will significantly affect all tax legislation this year. Thus any comments or predictions I make in this memorandum will almost certainly be obsolete by the time you read them, and I would urge you to check with me for a current update if you plan any action in reliance on these observations.

Proposals to codify the economic substance doctrine have been introduced several times in the House in recent years, including last year in a bill sponsored by the Chairman of the Ways and Means Committee, and they have passed out of the Senate Finance Committee in two consecutive Congresses. The most recent drafts of this provision can be found in several places: § 101 of H.R. 1555 and § 111 of H.R. 1661, both of which were introduced by House Democrats in April, 2003; and in § 701 of the CARE Act of 2003, S. 476, which passed the full Senate on April 9, 2003.

These bills characterize the proposal as a "clarification" of the economic substance doctrine, which would be inserted into section 7701 of the Code ("Definitions"). They direct the courts to apply the doctrine with two prongs, both of which must be met. The first test requires determining whether the transaction being considered "changes in a meaningful way … the taxpayer's economic position;" an important parenthetical instructs that this test is to be performed without taking into account Federal tax effects, and if there are any such effects, without taking into account foreign, State, or local tax effects. The second test is whether the taxpayer has a "substantial nontax purpose" for the transaction, "and the transaction is a

reasonable means of accomplishing" that purpose. A variety of other technical rules elaborate on these two basic tests.

The Joint Committee on Taxation estimated that the anti-tax shelter provisions in the CARE Act would raise $13.1 billion within the 10-year budget horizon, of which this proposal alone would raise $11.5 billion. (Many observers consider that a very high estimate for what is in essence a codification of common law, but JCT's views are final.) Because they raise so much revenue, this provision and other anti-tax shelter rules have been attached to popular tax-cutting bills to make them revenue-neutral. This is what happened in the Senate with the CARE Act, which contains the Administration's proposals for increasing charitable contributions. Although the fate of the CARE Act itself is very uncertain at this point — Ways and Means Chairman Thomas is not considered an enthusiastic supporter — the revenue-raising anti-tax shelter provisions are likely to be attached to other legislation as well (perhaps pension or energy tax bills, FSC-ETI legislation, or even the President's tax cut proposal).

Consequently, most observers expect that the anti-tax shelter provisions, including codification of the economic substance doctrine, will be enacted in some form this year. Even Pam Olson, the Assistant Treasury Secretary for Tax Policy, who opposes the codification on behalf of the Administration, recently admitted that some version of the economic substance doctrine will probably pass.

As enactment has become more likely, however, more scrutiny is being devoted to the specific text. The ABA Tax Shelter Task Force (on which I sit) recently provided technical comments, even though it (like the Administration) generally opposes the idea. Even Senator Grassley, whose committee passed the legislation, has expressed reservations about the drafting, and his staff acknowledges that the parenthetical regarding foreign and state or local taxes in the first prong of the test is problematic. House Republican staffers with whom I have spoken have indicated that they may wish to re-draft the provision before the House enacts it, focusing in particular on the parenthetical. Many commentators believe that the parenthetical should not prevent consideration of foreign, state, or local taxes, only of U.S. Federal taxes, in determining whether the taxpayer's economic position has been materially changed.

Another issue is when the bill will become effective. The Senate version is fully prospective — it would apply the codified rule to transactions entered after Feb. 15, 2004 — but the House Democrats' versions would apply to any transaction occurring after Feb. 13, 2003. Given Congress's general disinclination to enact retroactive legislation, particularly if it raises significant revenue, it seems more probable that the codification of the economic substance doctrine will be applied prospectively and that an effective date like the Senate's will be enacted.