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## A Tisket, a Tasket: Basketing and Corporate Tax Shelters

Leandra Lederman

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## A TISKET, A TASKET: BASKETING AND CORPORATE TAX SHELTERS

LEANDRA LEDERMAN\*

### ABSTRACT

*In an income tax system that comported with the economic, or Haig-Simons, definition of income, deductible expenses would not face source-based limitations. A true Haig-Simons income tax system therefore would not take the schedular approach of sorting different types of expenses and losses into distinct conceptual “baskets” containing corresponding types of income. Practical realities often require departing from the Haig-Simons norm, however. The U.S. federal income tax system does require individuals to basket a number of types of expenses and losses. For example, individuals’ passive activity losses can only be deducted from passive income gains. By contrast, most corporations taxed under Subchapter C of the Internal Revenue Code are not subject to many of these restrictions. Thus, corporations generally can deduct their passive investment expenses and losses from their active business income. That ability allowed the creation of*

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\* William W. Oliver Professor of Tax Law, Indiana University Maurer School of Law. I am grateful to Brian Broughman, Cliff Fleming, Christopher Hanna, Susan Morse, and Bill Popkin for comments on prior drafts. I am also grateful for helpful discussions with Alice Abreu, Benjamin Alarie, Raquel Meyer Alexander, Michael Alexeev, Richard Bird, Joshua Blank, Yariv Brauner, David Fischer, David Gamage, David Hyman, Darian Ibrahim, Sarah Lawsky, Stephen Mazza, Stephanie McMahon, Bob Peroni, Lisa Philipps, Ted Seto, Jeff Stake, and participants in the 2009 Midwest Law & Economics Conference at Notre Dame Law School, the 2009 Central States Law Schools Association meeting at Capital Law School, the 2010 Law and Society Association meeting, a 2009 faculty workshop at Brooklyn Law School, a 2010 Tax Policy Colloquium at Southern Methodist University’s Dedman Law School, a 2010 Tax Law Colloquium at Washburn University School of Law, and a 2010 Tax Law & Policy Workshop at the University of Toronto Faculty of Law. Brandon Benjamin, Robert Christie, Katherine Erbeznik, Michala Irons, and Angela Moudy provided valuable research assistance.

*infamous tax strategies such as Son-of-BOSS and the CINS contingent installment sale shelter.*

*In order to prevent the resurgence of abusive tax shelters, this Article proposes to extend to the domestic corporate context the passive/active distinction that already exists for individuals. If corporations were required to basket their passive-source expenses and losses with their passive income (such as income from interest, dividends, and rents and royalties, other than those produced by an active business), many abusive tax shelters involving financial products would not work. The Article also considers the three principal objections to the proposal—that it is overbroad, underinclusive, and too complex—and argues that the proposal is tailored so as to minimize these costs.*

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## INTRODUCTION

How should expenses and losses in profit-seeking activities be taxed? Most people would probably answer that they should be deductible. The federal income tax generally does allow deductions related to business and investment activities.<sup>1</sup> However, it limits some deductions more than others. In a tax system that comported with the economic, or Haig-Simons, definition of income, all expenses and losses connected with profit-seeking activities would be fully deductible, regardless of their source.<sup>2</sup> The federal income tax frequently deviates from that norm for both policy reasons and practical reasons that include administrative difficulties and efforts to close loopholes.

One type of deviation from the Haig-Simons norm involves what is often termed “basketing,” whereby particular types of deductions are grouped with the same type of income and are only allowed to be deducted to the extent of that income. For example, a taxpayer’s capital losses can only be deducted to the extent of capital gains (plus, in the case of an individual, up to \$3,000 of ordinary income).<sup>3</sup> Basketing generally restricts individuals’ ability to deduct passive or investment-type expenses and losses from active-type income, but

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1. See, e.g., I.R.C. §§ 162, 167, 212 (2006).

2. The Haig-Simons definition of income is named after Robert Haig and Henry Simons. See Michael A. Livingston, *Reinventing Tax Scholarship: Lawyers, Economists, and the Role of the Legal Academy*, 83 CORNELL L. REV. 365, 376 n.26 (1998). It provides that income is the change in a taxpayer’s net worth, after taking into account consumption, or, more technically, “the fair market value of one’s consumption plus change in net worth during the relevant accounting period (such as a year).” Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423, 431 (2009) (footnote omitted).

3. I.R.C. § 1211 (2006).

not vice versa. For example, individuals can deduct investment-related interest expense (such as interest paid with respect to investments in portfolio stock) only from net investment income.<sup>4</sup> Similarly, they can deduct so-called “passive activity losses” only from passive income gains, not from other income (such as salary).<sup>5</sup>

The last restriction was enacted as part of an effort to halt the tax shelter activity of high-income individuals in the 1970s and 1980s.<sup>6</sup> The hallmark of many of these old-style tax shelters was an “investment” in an asset or in an activity run by someone other than the taxpayer that produced expenses (such as for interest and depreciation) or net losses, giving rise to deductions that the taxpayer used to lower tax on other income (typically portfolio or employment income).<sup>7</sup> The 1970s and 1980s tax shelter investors generally were individuals, so it is not surprising that responsive statutes exempted most corporations from their ambit.<sup>8</sup>

The 1990s saw a new breed of tax shelter, the corporate tax shelter. The new shelters were much more complex than the earlier ones, but many shelters were easily replicated once developed.<sup>9</sup> The newer shelters also shared with the older shelters the feature of using an “investment” to produce losses for tax purposes that would shelter the corporation’s other income, such as income from its business activities.<sup>10</sup> As discussed below in Part II.B, had the Internal Revenue Code (Code) required basketing of corporations’ passive-source expenses and losses with their passive-source income, many of these strategies would not have worked and therefore likely would not have been developed.

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4. *Id.* § 163(d)(1).

5. *Id.* § 469. In general, a passive activity is one that “involves the conduct of any trade or business, and . . . in which the taxpayer does not materially participate.” *Id.* § 469(c)(1); *cf. id.* § 469(c)(2)–(7) (providing exceptions and special rules).

6. See Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 3 (1988). The Tax Reform Act of 1986 also tightened up Code § 163(d), completely eliminating individuals’ ability to deduct investment interest from noninvestment income. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(a), 100 Stat. 2244, 2244–46 (codified in scattered sections of 26 U.S.C.).

7. See, e.g., James S. Eustice, *Abusive Corporate Tax Shelters: Old “Brine” in New Bottles*, 55 TAX L. REV. 135, 156–57 (2002).

8. See I.R.C. § 163(d)(1) (“In the case of a taxpayer *other than a corporation*, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.” (emphasis added)); *id.* § 469(a) (providing that § 469 applies to individuals, estates, trusts, closely held C corporations, and personal service corporations, but not to other corporations).

9. See Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 235, 239 (1999).

10. See Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615, 617–19 (1998).

Instead, the government unleashed an expensive, multi-pronged attack on corporate tax shelters that included significant litigation, specifying “listed transactions” that are subject to special rules, such as enhanced disclosure requirements, and increased penalties.<sup>11</sup> The government seems to have prevailed, at least for the moment.<sup>12</sup> In part, most companies have a lot less income to try to shelter given the current state of the economy.<sup>13</sup> However, tax shelters are a recurring problem.<sup>14</sup> It is not safe to assume that if the government has won the battle, the war is over. Requiring corporations to basket passive expenses and losses with passive income would help prevent a resurgence of corporate tax abuses by precluding the deduction of passive losses from active income.

This Article therefore proposes the extension of tax basketing to corporations in the domestic context. Part I explores the current uses of basketing domestically in the federal income tax. This part shows that basketing is often used to prevent what Congress considers to be abuse of the tax laws, and is primarily applied to individuals’ passive expenses and losses, as well as to certain personal expenses and losses of individuals.

Part II of the Article proposes the extension of basketing to corporations’ passive items. It describes the details of the proposal, including a definition of passive items that would rely on a section already used by three regimes applicable to multinational corporations—Subpart F, the Passive Foreign Investment Company regime, and the foreign tax credit—and argues that the distinction made by all three of these regimes could readily be extended to

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11. See Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 585–86 (2006). Professor Raskolnikov explains:

The recent tax shelter regulations (Regulations) identify the most typical features of transactions viewed by the government as tax avoidance and require taxpayers to disclose all transactions that possess any of these features (reportable transactions). Transactions that result in large losses, involve brief asset holding periods, or are protected by confidentiality agreements or by contingent fee and similar arrangements trigger the disclosure requirements. Taxpayers must also disclose any of the specific transactions designated by the government as, essentially, illegitimate tax shelters (listed transactions). The American Jobs Creation Act of 2004 . . . expanded the Regulations’ reach even further, and backed them up with new penalties, including an unheard-of fine for tax advisors equal to \$10,000 for each day of a violation.

*Id.* (footnotes omitted).

12. See Victor Fleischer, *The Tax Shelter War is Over*, THE CONGLOMERATE BLOG: BUS., L., ECON. & SOC’Y (Oct. 28, 2006), [http://www.theconglomerate.org/2006/10/the\\_tax\\_shelter.html](http://www.theconglomerate.org/2006/10/the_tax_shelter.html) (quoting former Treasury Assistant Secretary for Tax Policy Pamela Olson as stating, “The tax shelter war is over. The government won.”).

13. See Calvin H. Johnson & Lawrence Zelenak, *Codification of General Disallowance of Artificial Losses*, 122 TAX NOTES 1389, 1391 (2009) (“Shelters may not reemerge as a major problem soon, both because [of other] . . . forces . . . and, regrettably, because there may not be much income needing sheltering for the next few years.”).

14. See *id.* (“It would be a major mistake . . . to assume that the tax shelter dragon has been slain once and for all.”).

the domestic context. Part II also discusses the effect the proposal would have on tax shelters, applying it to specific tax shelters that would not have worked had the proposed provision existed at the time.

Part III considers possible objections to the proposal. First, it considers the argument that basketing is underinclusive (not addressing all tax sheltering). In this regard, it both (1) draws on the analysis in Part II, which shows that the proposal targets the shelters that are most easily replicated, and (2) considers possible ploys to avoid the impact of the proposal. Second, Part III addresses the point that basketing inevitably is overinclusive, throwing out some wheat with the chaff. Finally, this Part considers the issue of complexity and, in particular, the possible objection that it is simply too difficult for corporations to separate their passive and active items. However, as discussed in Part II, multinational corporations are already required to do that sorting for several other purposes. The Article therefore concludes that extending basketing to corporations in the domestic context would give rise to substantial benefits that likely would justify its costs.

#### I. TAX BASKETING IN THEORY AND IN PRACTICE

The tax base of the federal income tax is “taxable income.”<sup>15</sup> Taxable income generally is comprised of gross income less deductions, though the calculation differs somewhat for individuals depending on whether they itemize their deductions or simply claim the standard deduction.<sup>16</sup> Most deductions can be claimed without basketing.<sup>17</sup> Therefore, the federal income tax generally is not what is termed a “schedular” system, under which income is routinely sorted by type.<sup>18</sup> However, some provisions do limit certain deductions by requiring basketing.<sup>19</sup> This Part discusses the mechanics of basketing, as well as several major basketing provisions and the rationales behind them.

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15. See, e.g., I.R.C. § 1 (2006) (applying tax rates to “taxable income” of individuals); *id.* § 11(a) (applying tax rates to “taxable income” of corporations).

16. See *id.* § 63.

17. See Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499, 566 (1989) (“The use of baskets to limit deductions represents a significant departure from the long-standing approach of the federal income tax system in combining all of a taxpayer’s items of income or loss into a single basket and thus allowing any loss to offset any income, no matter how unrelated.”).

18. See Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 LAW & POL’Y INT’L BUS. 145, 159 (1998) (“Schedular systems consist of a series of different taxes, each with its own rate, on different classes (schedules) of income, such as wages, interest, rents, and business profits.” (emphasis added)).

19. See *supra* text accompanying notes 17–18.

### A. *The Mechanics of Basketing*

Basketing involves the grouping together of related income and deductions, and is an exception to the general rule under the federal income tax system of allowing deductions to be taken from income of any type.<sup>20</sup> To understand the mechanics of basketing, first consider a situation without basketing in which the taxpayer has income of \$100,000 from an investment and a business-related loss of \$20,000. The tax treatment of just those two items (that is, ignoring deductions available to individuals, such as the standard deduction<sup>21</sup> and personal exemption<sup>22</sup>) is as follows:

Gross income	\$100,000
Deduction	<\$20,000>
Taxable income	\$80,000

That example does not involve basketing; a deduction of one type (business) was allowed against income of another type (investment). Now consider an example involving basketing. Imagine that the taxpayer has \$100,000 of business income and \$20,000 of investment interest expense. As discussed below,<sup>23</sup> the taxpayer can only deduct the investment interest to the extent of net investment income,<sup>24</sup> and the taxpayer has no investment income in this example. The taxpayer therefore cannot take the investment interest expense as a deduction this year. Accordingly, the taxpayer's tax treatment of these two transactions is as follows:

Gross income	\$100,000
Deduction	<\$0>
Taxable income	\$100,000

Note that the deduction in this example was disallowed because of the absence of income of the same type. The converse is not true, however. That is, income inclusion is not limited by basketing—only deductions are.<sup>25</sup>

20. See *supra* text accompanying note 17.

21. See I.R.C. § 63(b)–(c).

22. See *id.* § 151.

23. See *infra* text accompanying notes 38–42.

24. I.R.C. § 163(d).

25. By contrast, in a “schedular” tax system, income typically is taxed only if it is of a type that falls on one of the schedules, although one schedule may be a catch-all category. See William B.



Thus, in the first example, the investment income was included in gross income despite the absence of any investment expenses.

Another illustration of this principle involves the limitation on capital losses, also discussed below.<sup>26</sup> Capital losses are deductible only from capital gains, plus, for noncorporate taxpayers, up to \$3,000 of ordinary income.<sup>27</sup> It is only capital losses, not gains, that are subject to the limitation;<sup>28</sup> regardless of the presence of capital losses, capital gains constitute gross income.<sup>29</sup> For example, if a taxpayer has \$100,000 of capital gains for the year, all \$100,000 constitutes gross income.<sup>30</sup> If that same taxpayer is a corporation and also has \$110,000 of otherwise deductible capital losses for the same year, only \$100,000 of the capital losses will be deductible.<sup>31</sup>

In each of the situations described thus far, the basketing requirement applies to items of particular types (such as investment interest or capital losses). Basketing can be done in other ways, as well. For example, it could be done with respect to a specific activity only, so that expenses and losses from one activity cannot offset the income from another activity, even if they are of the same type. An example of that is the so-called “hobby loss” rules of Code § 183 discussed below,<sup>32</sup> which allow limited deductions with respect to activities not engaged in for profit.<sup>33</sup> Under § 183, each hobby is considered separately, so that losses incurred in one hobby are not deductible from income produced by another hobby.<sup>34</sup> Similarly, the “at risk” rules of Code § 465, which restrict the loss deductions available to individuals and C corporations for borrowed amounts for which the taxpayer does not have personal liability or property at risk,<sup>35</sup> apply activity by activity.<sup>36</sup>

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Barker, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 CATH. U. L. REV. 7, 19 (1996) (“Schedular taxation gives nations the option of being highly selective in the kinds of income taxed, and they may easily use schedular taxation to tax different income at different rates. The process of assigning income to schedules limits taxable income unless there is a category for all other income.”).

26. See *infra* text accompanying notes 60–63.

27. I.R.C. § 1211(b).

28. See *id.* § 1211.

29. See *id.* § 61(a)(3).

30. *Id.*

31. See *id.* § 1211(a).

32. See *infra* text accompanying notes 71–73.

33. See I.R.C. § 183.

34. See *infra* text accompanying notes 71–73. Whether a taxpayer’s activities constitute one hobby or more than one is determined based on the facts and circumstances. Treas. Reg. § 1.183-1(d)(1) (2010) (“Generally, the most significant facts and circumstances . . . are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings.”).

35. See I.R.C. § 465(a)–(b).

36. See *id.* § 465(a)(1) (referring to “an activity to which this section applies,” and providing that

## B. Examples of Basketing Rules for Individuals

Under current law, individuals are required to basket several types of expenses and losses. Typically, business expenses and losses are deductible from income from any source. Often, passive investment items are basketed, though the hobby and gambling loss provisions impose basketing on personal expenses and losses. This Section discusses five major basketing requirements that apply to individuals and examines the rationales supporting each of them. The common thread is that, in each case, Congress desired to limit the deductibility of a particular type of expense or loss from unrelated income to protect the integrity of the tax base in some way. While some of the provisions discussed below prevent the deduction either of tax-preferred items from nonpreferred income or the deduction of personal losses, others were developed to target abusive tax shelter activity.

### 1. The Limitation on the Deduction of Investment Interest

Taxpayers generally may deduct their interest expense from their income from any source.<sup>37</sup> However, Code § 163(d) provides: “In the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.”<sup>38</sup> Accordingly, noncorporate taxpayers, such as individuals, must basket their investment interest expense for the year with their “net investment income” for the year, which is “the excess of . . . investment income, over . . . investment expenses.”<sup>39</sup> Investment income generally consists of income from investment property, with specified exceptions.<sup>40</sup> Investment expenses are those “which are directly connected with the production of investment income.”<sup>41</sup> Any disallowed deduction can be carried forward until the taxpayer has sufficient net investment income to take the deduction.<sup>42</sup>

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“any loss from *such activity* for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year” (emphasis added); *see also id.* § 465(c)(2) (providing separation and aggregation rules for identifying activities).

37. *See id.* § 163(a).

38. *Id.* § 163(d)(1).

39. *Id.* § 163(d)(4)(A).

40. *See id.* § 163(d)(4) (providing special computation for capital gains and an election to take qualified dividend income into account).

41. *Id.* § 163(d)(4)(C).

42. *Id.* § 163(d)(2).

The legislative history of § 163(d) focuses on the mismatching of income and deductions.<sup>43</sup> In part, that is because if the taxpayer invests in an asset that produces little current income, but an interest deduction were allowed, the deduction would precede the income, with the income being deferred until the taxpayer sold the asset.<sup>44</sup> In addition, if investment interest were fully deductible, an individual taxpayer could deduct investment interest at ordinary income rates but hold the underlying investment until it appreciated, giving rise to gain on sale that would be taxed at lower capital gains rates.<sup>45</sup> When enacting § 163(d) in 1969, Congress noted:

Since the amount of funds borrowed by a taxpayer for investment purposes generally is within the taxpayer's control, it would appear that a taxpayer who incurs interest expense for this purpose, which is substantially in excess of his investment income, is primarily interested in obtaining the resulting mismatching of income and the expense of earning that income, so as to be able to insulate other income from taxation.<sup>46</sup>

Congress further found that a number of high-income individuals had used excess investment interest to shelter unrelated income on their 1966 returns.<sup>47</sup>

The initial § 163(d) limitation allowed individuals to deduct up to \$25,000 of excess investment interest.<sup>48</sup> Congress subsequently reduced that amount<sup>49</sup> and, in 1986, entirely eliminated individuals' ability to deduct investment interest from other income.<sup>50</sup> Because the deductibility of interest

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43. See H.R. REP. NO. 91-413, pt. 1, at 72 (1969).

44. See *id.*; see also Zelenak, *supra* note 17, at 562 ("The preference concerned in cases to which section 163(d) applies will usually be the deferral of tax on unrealized appreciation.").

45. See H.R. REP. NO. 91-413, pt. 1, at 72.

46. *Id.*

47. *Id.* at 72-73.

48. *Id.* at 73.

49. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 209(a)(1), 90 Stat. 1542, 1542-43 (codified as amended in scattered sections of 26 U.S.C.); see also *Flood v. United States*, 33 F.3d 1174, 1175 (9th Cir. 1994) ("As amended in 1976, the § 163(d)(1) limitation on deduction of investment interest was equal to the taxpayer's net investment income during the taxable year plus \$10,000," and was limited to the taxpayer's net investment income plus \$5,000 in the case of a married taxpayer filing separately.).

50. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 511(a), 100 Stat. 2244, 2244-46 (codified in scattered sections of 26 U.S.C.); see also I.R.C. § 163(d) (2006) (limiting the deductibility of investment interest). "Investment interest" is defined as interest paid on indebtedness allocable to property held for investment. I.R.C. § 163(d)(3)(A). "Property held for investment" includes:

- (i) any property which produces income of a type described in section 469(e)(1) [in general, interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business], and
- (ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business—

was critical for many tax shelters of the 1970s and 1980s,<sup>51</sup> it served as an anti-tax shelter device.<sup>52</sup>

## 2. *The Passive Activity Loss Rules*

The passive activity loss provisions of Code § 469 apply to individuals and other taxpayers, including some corporations taxed under Subchapter C, but not to widely held corporations.<sup>53</sup> They require a taxpayer who invests in trade or business or income-producing activities (other than portfolio investments) in which the taxpayer does not “materially participate” to defer the deduction of net losses to a year in which the taxpayer has sufficient income from those activities<sup>54</sup> or disposes of the investment.<sup>55</sup> Material participation is defined as “involve[ment] in the operations of the activity on a basis which is—(A) regular, (B) continuous, and (C) substantial.”<sup>56</sup>

Section 469 was enacted in 1986 in an effort to put a stop to the tax shelters of the 1970s and 1980s.<sup>57</sup> The legislative history explains:

[I]nstances in which the tax system applies simple rules at the expense of economic accuracy encourage the structuring of transactions to take advantage of the situations in which such rules give rise to

(I) which is not a passive activity, and

(II) with respect to which the taxpayer does not materially participate.

*Id.* § 163(d)(5)(A).

51. See Zelenak, *supra* note 17, at 509–10 (“[T]he interest deduction plays a crucial role in the operation of a tax shelter. . . . [T]axable income will be less than economic income if interest is fully deductible and the related income is not fully taxed because of a preference.”).

52. *Id.* at 564 (“Considered together, sections 469 and 163(d) constitute a ‘two basket’ approach to tax shelter limitations.”); see also Daniel N. Shaviro, *Rethinking Anti-Tax Shelter Rules: Protecting the Earned Income Tax Base*, 71 TAXES 859, 867 (1993).

53. See I.R.C. § 469(a)(2). “Preservation of the corporate sector tax base was not the goal here, since most passive-type income enterprises traditionally have chosen the partnership form.” John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 VA. TAX REV. 57, 109–10 (1988) (footnote omitted). In fact:

The application of the passive loss rules to corporations is to prevent the owner from contributing portfolio income property to a C corporation that would offset corporate passive losses. Thus, while passive losses generally cannot be used by a closely held C corporation to offset portfolio income, Section 469(e)(2) permits active income (i.e., normal business income) of a closely held C corporation to be offset by passive losses.

Kenneth A. Hansen, *Strategies to Avoid Passive Activity Loss Limits*, 25 TAX’N FOR LAW. 365, 367 (1997).

54. See I.R.C. § 469(a)–(b).

55. *Id.* § 469(g).

56. *Id.* § 469(h)(1).

57. See George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209, 218–19 (2001).

undermeasurement or deferral of income. Such transactions commonly are marketed to investors who do not intend to participate in the transactions, as devices for sheltering unrelated sources of positive income . . . . Accordingly, by creating a bar against the use of losses from business activities in which the taxpayer does not materially participate to offset positive income sources such as salary and portfolio income, the committee believes that it is possible significantly to reduce the tax shelter problem.<sup>58</sup>

The passive activity loss rules were in fact highly effective in combating this breed of shelters because the high-income taxpayers who invested in them did not participate in the underlying activities; they simply invested passively.<sup>59</sup>

### 3. *The Limitation on Capital Losses*

Unlike the limitation on investment interest and the passive activity loss rules, the limitation on capital losses applies to C corporations, as well as to individuals. Under Code § 1211, corporate taxpayers can deduct capital losses only to the extent of capital gains,<sup>60</sup> and noncorporate taxpayers, such as individuals, can deduct capital losses to the extent of capital gains, plus up to \$3,000 of ordinary income.<sup>61</sup> Noncorporate taxpayers can carry forward disallowed losses indefinitely;<sup>62</sup> corporations are subject to a limited carryover period, as well as a carryback period.<sup>63</sup>

An important justification for § 1211 is the taxpayer's power to time the recognition of gains and losses by selling property with built-in losses and retaining property that would give rise to a gain when sold.<sup>64</sup> In addition, the existence of a capital gains preference provides another rationale:

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58. S. REP. NO. 99-313, at 716 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4235.

59. See Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OHIO ST. L.J. 1401, 1432-33 (2004); see also Peroni, *supra* note 6, at 3 n.12 ("The enactment of § 469 has undoubtedly led taxpayers and their advisers to place much greater emphasis on an investment's potential for making an economic profit, as opposed to its tax benefits.").

60. I.R.C. § 1211(a).

61. *Id.* § 1211(b).

62. *Id.* § 1212(b).

63. See *id.* § 1212(a).

64. See H.R. REP. NO. 94-658, at 339 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3235 ("Because taxpayers have discretion over when they realize their capital gains and losses, unlimited deductibility of net capital losses against ordinary income would encourage investors to realize their capital losses immediately to gain the benefit of the deduction against ordinary income but to defer realization of their capital gains."); Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 U. CHI. L. REV. 1189, 1196 (1989).

[T]o-day the taxpayer pays a maximum tax of 12 1/2 per cent on gains derived from the sale of capital assets, but is allowed to deduct in full from his taxable income his net losses resulting from the sale of capital assets during the taxable year. The injustice to the Government is too obvious to require much comment. . . . The Government can collect but 12 1/2 per cent of a gain, but it is compelled to lighten the burden of the taxpayer to the extent of 58 per cent of his losses.<sup>65</sup>

However, this concern does not exist with respect to corporations under current law. Currently, corporations do not benefit from reduced rates on capital gains,<sup>66</sup> unlike individuals.<sup>67</sup>

#### 4. *Hobby Losses*

In general, personal expenses are not deductible.<sup>68</sup> Personal expenses generally consist of expenses incurred in activities not engaged in for the production of income—activities that are neither investment nor business related, but are engaged in for their entertainment or consumption value. Gross income does not generally exclude personal-source income, however,<sup>69</sup> and some activities that are primarily personal may give rise to occasional receipts.

For example, the taxpayer might be an amateur tennis player who occasionally wins a cash prize, or might breed racehorses that sometimes win substantial amounts but cost much more than that each year to maintain. The prizes and awards are included in gross income.<sup>70</sup> Code § 183, which governs “hobby losses,” essentially allows expenses and losses that would be deductible if the activity were engaged in for profit to be deducted up to the income from the particular activity.<sup>71</sup> Thus, if the taxpayer plays tennis and breeds racehorses, he or she generally can deduct tennis expenses up to the income from the tennis activity for the year and horse expenses up to the income from the horse-breeding activity for the year, but cannot deduct the

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65. H.R. REP. NO. 67-1388, at 2 (1923).

66. *See* I.R.C. § 11(b)(1) (taxing corporations at rates up to 35%); *id.* § 1201 (applying maximum rate of 35% to corporations’ net capital gains).

67. *See id.* § 1(h).

68. *Id.* § 262(a) (“Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.”).

69. *See id.* § 61 (generally defining “gross income” as “all income from whatever source derived”).

70. *Id.* §§ 61, 74.

71. *Id.* § 183(b).

expenses of one activity from the income of the other.<sup>72</sup> Section 183 does not allow taxpayers to carry unused deductions over to the following year.<sup>73</sup>

Code § 183 replaced a previous section that applied if an individual had trade or business losses over \$50,000 for at least five consecutive years.<sup>74</sup> That section, termed the “hobby loss” provision, limited the losses that could offset other income to \$50,000 for each of those years.<sup>75</sup> In 1969, Congress found that the previous hobby loss provision had been unsuccessful and that the approach used by some courts of disallowing losses as relating not to a trade or business but to a mere “hobby” was more promising.<sup>76</sup>

The 1969 House bill would have applied the proposed hobby loss provision to corporations as well as individuals.<sup>77</sup> The Senate bill limited the provision to individuals “since it is primarily in the case of individual taxpayers that the problem arises of a taxpayer entering into an activity to obtain a loss from the activity which is used to offset other income.”<sup>78</sup>

Not surprisingly, the primary use of the hobby loss provision has been to police the personal/profit-seeking boundary, typically by limiting deductions incurred in loss-producing hobbies, particularly of high-income individuals.<sup>79</sup> However, at one time, § 183 was also used as a tool to tackle the tax shelters of the 1970s and 1980s by treating shelters as activities not engaged in for profit and thus requiring basketing.<sup>80</sup>

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72. See Treas. Reg. § 1.183-1(d) (2010) (“If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183.”).

73. See I.R.C. § 183.

74. See H.R. REP. NO. 91-413, pt. 1, at 71 (1969). Certain losses were disregarded for this purpose. See *id.*

75. *Id.*

76. *Id.*

77. S. REP. NO. 91-552, at 104 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2133.

78. *Id.* The Report also stated that “the application of the provision to corporations would present a number of difficulties, such as its effect on shared facilities provided on a cost basis.” *Id.*

79. See Donna D. Adler, *A Conversational Approach to Statutory Analysis: Say What You Mean & Mean What You Say*, 66 MISS. L.J. 37, 115 (1996) (“[S]ection [183] was not designed to prevent tax sheltering, rather, its purpose when enacted was to distinguish between activities that were personal hobbies and those that were engaged in with the intent of making a profit.”); cf. Treas. Reg. § 1.183-2(c) (2010) (illustrating § 183 through examples, including Example 1 (ownership of unprofitable farm by widow with substantial stock holdings “could be found *not* to be engaged in for profit”), Example 2 (self-publication of philosophical ideas by wealthy stock owner could be found *not* to be profit motivated), Example 3 (loss-producing dog- and horse-breeding activities of successful soft drink retailer could be found *not* to be profit seeking), and Example 4 (farming activity of factory worker making \$8,500 per year who does much of the farm work himself could be found to be engaged in for profit)).

80. See Calvin Johnson, *What’s A Tax Shelter*, 68 TAX NOTES 879, 882 (1995) (“The courts treat tax shelters as a branch of the section 183 hobby loss rules. Deductions from hobbies can be used only against income from other hobbies. In the Tax Court, a ‘generic’ tax shelter is a ‘not-for-profit

### 5. *Gambling Losses*

Code § 165 generally authorizes the deduction of uncompensated losses.<sup>81</sup> However, “[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions.”<sup>82</sup> The legislative history states that the reason for the provision was to stop the practice of reporting gambling losses without reporting gambling winnings as income.<sup>83</sup> Professor Deborah Geier has argued that the limitation on gambling losses of § 165(d) is analogous to the hobby loss rules of § 183:

The paradigm for *both* sections is that deductions will be allowed up to the amount of gross income, but no “loss” (deductions in excess of gross income from the activity) will be allowed, which prevents the sheltering of unrelated gross income from tax. The underlying theory is that both activities are considered personal consumption activities, not investment or business activities.<sup>84</sup>

Thus, § 165(d) targets personal activity, unlike several of the other basketing provisions. In that regard, it is like § 183; though, unlike § 183, it has not been used to combat tax shelters. In addition, § 165(d) allows losses from one type of gambling (such as playing craps at a casino) to offset wins from another type of gambling (such as betting on horse races).<sup>85</sup> This avoids the question required under § 183 of whether these are one activity or two.<sup>86</sup>

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activity.” (footnotes omitted)); *see also* Adam D. Chinn, Note, *Attacking Tax Shelters: Section 183 Leaves the Farm and Goes to the Movies*, 61 N.Y.U. L. REV. 89, 91–93 (1986).

81. *See* I.R.C. § 165(a) (2006). Section 165 does contain restrictions on the deductibility of some types of losses. For example, § 165(c) generally limits the deductibility of losses by individuals to losses incurred in a trade or business or profit-seeking activity or resulting from a casualty or theft. *Id.* § 165(c).

82. *Id.* § 165(d).

83. H.R. REP. NO. 73-704, at 22 (1934) (“Under the present law many taxpayers take deductions for gambling losses but fail to report gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses.”); *see also* *Boyd v. United States*, 762 F.2d 1369, 1374 n.4 (9th Cir. 1985) (citing H.R. REP. NO. 73-704 (1934)).

84. Deborah A. Geier, *Cheatin’ Artist Paints a Peculiar Picture*, 96 TAX NOTES 1417, 1418 (2002).

85. *See* 2007 Tax Mgmt. Portfolios: Loss Deductions (BNA), No. 527, at A-118 (“Wagering activities do not have to be segregated from each other. The combined wagering losses from all wagering transactions, regardless of type, may be used as an offset against the combined gains from all such transactions. In effect, this permits the net losses of unsuccessful wagering ventures to be offset against the net gains of those that prove to be profitable.”).

86. In addition, as Professor Geier points out, § 183(b) deductions are subject to the “two-percent floor” of Code § 67, while gambling losses are not. *See* Geier, *supra* note 84, at 1418. In this regard, as well as with respect to the breadth of the activities that can be grouped in one basket under § 165(d), the gambling loss limitation is more generous than the hobby loss provision. However, the latter provides a presumption that the activity is engaged in for profit (and thus not subject to a limitation) if



Each of these basketing provisions provides an example of an effort by Congress to restrict the deductibility of a particular type of expense or loss. In each case, the Code limits the deductibility of the expense or loss from an activity to the amount of income or gain from that activity (or all activities of the same general type). These limitations therefore reflect a congressional determination that it would be inappropriate for the taxpayer to deduct these expenses or losses from unrelated income.

## II. A PROPOSAL FOR DOMESTIC CORPORATE BASKETING

Under current law, with limited exceptions, corporations can deduct all expenses and losses from all income, regardless of source.<sup>87</sup> To the extent that losses exceed income, they can give rise to net operating losses that can be carried to other tax years to reduce tax liability for those years.<sup>88</sup> A previous article has shown that individuals' investment and business activities are not treated similarly on the deduction side; instead, investment-related deductions are subject to many more limitations.<sup>89</sup> The same is not true for corporations. Instead, for corporations, even expenses and losses from portfolio investments are deductible from income from any source.

Because (1) corporations do not face limitations on the deductibility of their investment interest under § 163(d) and (2) large corporations are not subject to the passive activity loss rules, a public corporation with a profitable business can invest passively in a tax strategy designed to give rise to tax losses used to offset business income. The basketing proposal discussed below generally would preclude that.

### A. *The Proposal*

This Article proposes the creation of a single basket for corporations' passive expenses and losses—expenses and losses not incurred in connection with their business activities. The proposal would *not* be to basket “tax shelter” items. That approach would require defining what a tax shelter is,<sup>90</sup> a difficult and inefficient endeavor.<sup>91</sup> Rather, the proposal would thus function

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the activity is profitable for a certain period of time, generally three out of the last five years. *See* I.R.C. § 183(d) (2006).

87. *See* I.R.C. §§ 162, 165(a); *cf.* I.R.C. 165(c) (limiting individuals' loss deductions).

88. *See id.* § 172.

89. *See* Lederman, *supra* note 59, at 1410–35.

90. *See* U.S. DEP'T OF TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS 118–19 (1999) (“Limiting schedular taxation to corporate tax shelters would require a definition and identification of the offending transactions.”).

91. *See* Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010); *cf.*

somewhat like Code § 469, which successfully combated the tax shelters of the 1970s and 1980s without requiring a determination of whether the passive activity constituted a “tax shelter.”<sup>92</sup> The passive items covered by the proposal would encompass capital gains and losses from the sale or exchange of investment assets, as discussed below.

### 1. *Threshold Applicability*

The proposed limitation on deductions would apply to C corporations that are not subject to specialized regimes. Thus, the proposed provision would exempt personal holding companies and other entities, such as insurance companies, that are subject to special tax treatment.<sup>93</sup> Like the passive activity loss rules of § 469,<sup>94</sup> losses disallowed under this provision would be carried over indefinitely and would be deductible from income of the same type. This would allow current recognition for accounting purposes of a future reduction in taxes due to a postponed deduction.<sup>95</sup> It would lessen the impact of the current disallowance of the tax deduction by reducing tax liabilities for accounting purposes and thus not reducing reported earnings. However, the availability of an accounting benefit should not be enough to

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Lee A. Sheppard, *Is There Constructive Thinking About Corporate Tax Shelters?*, 83 TAX NOTES 782, 784 (1999) (“[A] schedular system would avoid the problem of having to define ‘corporate tax shelter.’”). “The difficulty with defining shelters is that, like Justice Potter Stewart, we know them when we see them, but we apparently cannot agree either on what we are seeing or how to describe what we see.” Deborah H. Schenk, *Symposium on Corporate Tax Shelters, Foreword*, 55 TAX L. REV. 125, 127 (2002) (footnote omitted); see Calvin H. Johnson, *What’s a Tax Shelter?*, 68 TAX NOTES 879, 881–82 (1995). Each definition plausibly captures some manifestation of a tax shelter, but just as often leaves other manifestations out or brings legitimate tax planning into its fold.

92. See *supra* text accompanying notes 53–59.

93. “Special tax regimes often apply to corporations involved in banking, insurance, and the like.” Richard D. Pomp, *State Corporate Income Taxes: The Illogical Deduction for Income Taxes Paid to Other States*, 42 TAX L. REV. 419, 422 n.10 (1987). For example, Code § 1361 provides that the following types of corporations are ineligible to be S corporations: “(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585, (B) an insurance company subject to tax under subchapter L, (C) a corporation to which an election under section 936 applies, or (D) a DISC or former DISC.” I.R.C. § 1361(b)(2). The proposal is designed to make minimal changes to existing law while still limiting corporate tax shelter activity through basketing. Accordingly, it could subsequently be tightened, such as by extending its applicability to a broader group of corporations.

94. See I.R.C. § 469(b) (generally allowing “any loss or credit from an activity which is disallowed under subsection (a) . . . [to] be treated as a deduction or credit allocable to such activity in the next taxable year.”).

95. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 109: ACCOUNTING FOR INCOME TAXES 5 (1992) (“A deferred tax asset is recognized for temporary differences that will result in deductible amounts in future years and for carryforwards. . . . [A] deferred tax asset is recognized in the current year for the reduction in taxes payable in future years.”).

attract tax shelter investors in light of the disallowance of the tax benefits that are the primary appeal of tax shelters.

Unlike the situation under § 469, losses disallowed by the proposed provision would not simply be deductible upon disposition of the item that gave rise to them.<sup>96</sup> This is because the shelters addressed by § 469 generally allowed acceleration of deductions,<sup>97</sup> while, as discussed below,<sup>98</sup> corporate tax shelters generally create noneconomic losses (often by inflating assets' bases for federal income tax purposes). In the corporate tax shelter context, allowing the taxpayer to claim the disallowed deduction upon disposition would essentially permit the shelter to proceed unimpeded.

To reduce complexity, corporations of a certain size should be exempted from utilizing the proposed provision, at least until there is some experience with it.<sup>99</sup> To be clear, the exception should not be for *passive items* under a separate threshold, because then many corporations that ultimately would not be subject to the provisions would be required to track their passive items to see if they reach the threshold.<sup>100</sup> Rather, the exception would relate to capitalization of the business.

For example, the provision could use a definition similar to the definition of "qualified small business" in Code § 1202(d).<sup>101</sup> That section treats as a qualified small business a C corporation with aggregate gross assets of \$50 million or less.<sup>102</sup> Because § 1202 determines whether stock issued by a corporation is "qualified small business stock," the measurement date is the

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96. See I.R.C. § 469(g) (providing rules for disposition of passive activity, including full deductibility upon disposition in a taxable transaction).

97. See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 154 (2003) (Under § 469, "[t]axpayers may use passive losses to offset ordinary nonpassive income, but only at the termination of the venture, thus removing the timing advantage that is key to traditional tax sheltering activity.").

98. See *infra* Part II.B.

99. A possible objection to the proposal based on its complexity is discussed further below. See *infra* Part III.B.

100. Similarly, the two-percent floor on miscellaneous itemized deductions of I.R.C. § 67 in theory "relieve[s] taxpayers of the burden of recordkeeping unless they expect to incur expenditures in excess of the floor." STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 78 (Comm. Print 1987). However, in practice, taxpayers cannot be sure at the beginning of the year whether they will have miscellaneous itemized deductions in excess of the floor, so if they want to preserve the option of having the lowest tax liability, they do need to keep those records. See Sarah S. Batson, Note, *Administrative Expenses of Trusts: What Did Congress Mean?*, 59 S.C. L. REV. 551, 554 (2008) ("In order to reduce the record-keeping burden on taxpayers, Congress simply capped that deduction. This is no benefit to taxpayers who still have to keep records of deductible transactions in order to determine whether they exceed two percent of adjusted gross income and, if so, by how much.").

101. See I.R.C. § 1202(d).

102. *Id.* § 1202(d)(1)(B).

date of issuance of the stock.<sup>103</sup> The corporate basketing proposal is not tied to an event such as issuance of stock, so it would have to use an arbitrary measurement date, such as the first day of the tax year.

The provision should also employ a threshold designed with the context of the particular provision in mind, so it need not track Code § 1202. The threshold for applicability of the proposed provision should be set at least at the threshold at which a business falls within the Large Business and International Division of the IRS: gross assets over \$10 million.<sup>104</sup> That would mean that the Small Business/Self-Employed Division of the IRS<sup>105</sup> would not need to become familiar with the new provision.<sup>106</sup> That is, the \$10 million threshold would be more efficient than a lower one that required both IRS divisions to learn the new provision. Of course, the threshold could also be higher without raising this concern. However, the higher the threshold, the fewer corporations to which it would apply, so the threshold would need to be carefully determined to avoid excessively limiting the usefulness of the proposed provision.<sup>107</sup>

## 2. Identifying Passive Items

### a. The Passive Activity Loss Rules and the Unrelated Business Income Tax

Unlike individuals, corporations are not treated under the Code as having nonbusiness profit-seeking activity. That is, while individuals must

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103. See *id.* § 1202(c)(1)(A).

104. See Press Release, Internal Revenue Serv., IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration (Aug. 4, 2010), available at <http://www.irs.gov/newsroom/article/0,,id=226284,00.html>. This division was previously the Large and Mid-Size Business Division. See *id.*

105. For an overview of IRS's Small Business/Self-Employed Division, see *Small Business/Self-Employed Division At-a-Glance*, IRS, <http://www.irs.gov/irs/article/0,,id=101001,00.html> (last updated Aug. 19, 2010).

106. Given the cross-reference to Code § 954(c), the provision is a particularly good fit for the Large Business and International Division. See *infra* text accompanying notes 144–45.

107. The appropriate range would seem to be within \$10 million of capital (the Large Business and International Division threshold) and \$50 million of capital (the section 1202 threshold). Tax shelters are generally most useful to taxpayers with substantial income. However, during the heyday of the corporate tax shelter era, they were widely marketed:

Evidence shows that KPMG compiled and scoured prospective client lists, pushed its personnel to meet sales targets, closely monitored their sales efforts, advised its professionals to use questionable sales techniques, and even used cold calls to drum up business. The evidence also shows that, at times, KPMG marketed tax shelters to persons who appeared to have little interest in them or did not understand what they were being sold, and likely would not have used them to reduce their taxes without being approached by KPMG.

S. REP. NO. 109-54, at 33 (2005).

distinguish between trade or business and nontrade/nonbusiness activities in a number of contexts—with more favorable treatment accorded the former than the latter<sup>108</sup>—corporations generally do not have to make this distinction.<sup>109</sup>

However, there are contexts in which corporations of a specific type have to separate their passive and active items.<sup>110</sup> For example, the passive activity loss rules of Code § 469, although not applicable to publicly held corporations,<sup>111</sup> do apply to closely held C corporations and personal service corporations.<sup>112</sup>

In addition, organizations subject to unrelated business income tax,<sup>113</sup> including not-for-profit corporations, are taxed at corporate rates on their unrelated business taxable income.<sup>114</sup> However, that tax generally does not apply to many types of income that are generally considered passive,<sup>115</sup> including interest, dividends, royalties, and many rents.<sup>116</sup> Thus, not-for-profit corporations must distinguish passive and active income.

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108. See Lederman, *supra* note 59, at 1425.

109. See STEPHEN A. LIND, STEPHEN SCHWARZ, DANIEL J. LATHROPE & JOSHUA D. ROSENBERG, *FUNDAMENTALS OF CORPORATE TAXATION: CASES AND MATERIALS* 16 (7th ed. 2008). There are exceptions, however. For example, for a distribution to qualify as a nonrecognition transaction under § 355, “the distributing corporation, and the controlled corporation . . . [must be] engaged immediately after the distribution in the active conduct of a trade or business.” I.R.C. § 355(b)(1)(A) (2006). Treasury Regulations under § 355 provide in part that “[t]he active conduct of a trade or business does not include . . . [t]he holding for investment purposes of stock, securities, land, or other property.” Treas. Reg. § 1.355-3(b)(2)(iv)(A) (2010).

110. See Lee A. Sheppard, *No Partnership in Boca Investorings Tax Shelter*, 98 *TAX NOTES* 300, 304 (2003) (proposing a “scheduler system” employing a “portfolio holdings” definition based on Code § 263 or §§ 871 and 881).

111. See I.R.C. § 469(a)(2) (applying § 469 to individuals, estates, trusts, closely held C corporations, and personal service corporations).

112. *Id.*

113. The organizations subject to unrelated business income tax at corporate rates are organizations described in §§ 401(a) and 501(c) and state colleges and universities. *Id.* § 511(a)(2).

114. See *id.* § 511(a)(1).

115. There is an exception providing that the unrelated business income tax does apply to passive income to the extent that the property producing it is debt financed. See *id.* §§ 512(b)(4), 514.

116. See *id.* § 514(b)(1)–(3); see also Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 *EMORY L.J.* 1475, 1483 (2005) (“[D]ividends, interest, loan proceeds, annuity payments, royalties, rents, capital gains, and certain other categories of ‘passive’ income are specifically excluded from the [Unrelated Business Income Tax (UBIT)] tax.”). The traditional explanation for the UBIT is to eliminate unfair competition. *Id.* at 1488–89. However, Professor Stone has proposed a more nuanced explanation of the exceptions from UBIT for passive income and income related to the charity’s exempt purpose:

The UBIT was designed to channel charities away from problematic activities by setting up a tax gradient that favored income-generating activities compatible with perceptions of charitable activity. At the taxable end were highly visible activities that challenged perceptions of charitable activities—active business endeavors unrelated to any charitable purpose. Law schools that wanted to make Congress uncomfortable by running spaghetti and piston-ring factories would have to pay for the privilege. At the exempt end were activities more compatible with perceptions

These provisions reflect the reality that many corporations are not insulated from distinguishing passive and active items. However, § 469 and the unrelated business income tax do not provide a passive/active distinction that is as suitable for the basketing context as Code § 954(c) does. As discussed below, the § 954(c) definition is already applicable to multinational corporations in three distinct contexts.

*b. Section 954(c)*

Multinational corporations are required to identify their passive-source items for purposes of Subpart F of the Code, the Passive Foreign Investment Company (PFIC) regime, and the foreign tax credit.<sup>117</sup> All of those provisions, which are discussed in turn below, rely on the list in Code § 954(c) (the definition of foreign personal holding company income).<sup>118</sup>

Subpart F is an antideferral regime. Generally, shareholders in C corporations are not taxed on corporate earnings until those earnings are distributed as dividends.<sup>119</sup> Subpart F is an exception to that general rule. Under Subpart F, U.S. shareholders of controlled foreign corporations (CFCs) generally are subject to current federal income taxation to the extent the CFC earns certain disfavored types of income, including passive income.<sup>120</sup> A CFC is a foreign corporation in which more than 50% of the total value or total combined voting power is held, directly or indirectly, by U.S. shareholders.<sup>121</sup> A U.S. shareholder is a “U.S. person”<sup>122</sup> who owns at least 10% of the total combined voting power in the corporation, directly or indirectly.<sup>123</sup> Passive income includes foreign personal holding company income, which is defined in § 954(c).<sup>124</sup>

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of charitable activity—traditional, passive investment and active business endeavors related to accomplishing a charitable objective. Charities willing to “adhere to the old line” of good works and passive investment were rewarded.

*Id.* at 1554.

117. *See infra* text accompanying notes 119–42.

118. *See* I.R.C. § 1297(b)(1).

119. *See id.* § 61(a)(7); Lawrence Lokken, *Whatever Happened To Subpart F? U.S. CFC Legislation after the Check-the-Box Regulations*, 7 FLA. TAX REV. 185, 186 (2005).

120. *See* Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1525, 1528 (2001).

121. I.R.C. §§ 957(a), 958(b).

122. A U.S. person generally is any citizen or resident of the United States, a domestic partnership, a domestic corporation, or a domestic estate or trust. *Id.* § 7701(a)(30).

123. *Id.* § 951(b); *see also id.* § 958.

124. *See id.* § 954(a), (c).

The PFIC regime,<sup>125</sup> enacted in 1986, was designed to limit the use of foreign corporations as a mechanism for reducing taxes on portfolio investments.<sup>126</sup> A foreign corporation constitutes a PFIC if 75% or more of its gross income is passive or more than 50% of its assets (by value) produce passive income,<sup>127</sup> as defined in § 954(c).<sup>128</sup> If a corporation is a PFIC that is not a “qualified electing fund” (QEF) during one tax year, it generally will constitute a PFIC for all future tax years.<sup>129</sup> In general, a QEF is a PFIC that complies with certain IRS requirements with respect to which the taxpayer has made an election.<sup>130</sup>

Any U.S. person who holds PFIC shares directly or indirectly<sup>131</sup> is subject to the antiferral rules of the PFIC regime. If the PFIC constitutes a QEF, then the shareholder generally is taxed on a current basis (as a constructive dividend) on his or her pro rata share of the PFIC’s ordinary earnings, constructive distributions from earnings invested in U.S. property,<sup>132</sup> and net long-term capital gain.<sup>133</sup> If the PFIC is not a QEF, the shareholder must calculate the tax on any “excess distribution,”<sup>134</sup> or gain on disposition of the PFIC shares.<sup>135</sup>

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125. Pub. L. No. 99-514, § 1235(a), 100 Stat. 2566, 2566 (1986).

126. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1023 (Comm. Print 1987).

127. I.R.C. § 1297(a).

128. *Id.* § 1297(b)(1).

129. See *id.* § 1298(b)(1). This provision provides an exception that applies “if the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a passive foreign investment company (determined without regard to the preceding sentence)) under rules similar to the rules of section 1291(d)(2).” *Id.*

130. See *id.* § 1295(a)(2) (requiring electing PFIC to “compl[y] with such requirements as the Secretary may prescribe for purposes of—(A) determining the ordinary earnings and net capital gain of such company, and (B) otherwise carrying out the purposes of this subpart.”).

131. See Treatment of Shareholders of Certain Passive Foreign Investment Companies, 57 Fed. Reg. 11,024, 11,034 (Apr. 1, 1992) (codified as amended at 26 C.F.R. pts. 1, 602).

132. I.R.C. § 1298(b)(9) (cross-referencing Code § 951(a)(1)(B)).

133. The net long-term capital gain is taken into the shareholder’s income as a capital gain, while the other items of income are ordinary income in the hands of the shareholder. *Id.* § 1293(a)(1)(B); Treatment of Shareholders of Certain Passive Foreign Investment Companies, 57 Fed. Reg. at 11,033.

134. I.R.C. § 1291(a). An excess distribution is “any distribution in respect of stock received during any taxable year to the extent such distribution does not exceed its ratable portion of the total excess distribution (if any) for such taxable year.” *Id.* § 1291(b)(1).

135. *Id.* § 1291(a)(2) (“If the taxpayer disposes of stock in a passive foreign investment company, then the rules of paragraph (1) shall apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution.”).

The foreign tax credit also relies on § 954(c).<sup>136</sup> Under this regime, U.S. taxpayers are allowed to claim a credit for foreign income taxes paid.<sup>137</sup> One article explains:

Section 904(a) contains an “overall limitation” intended to prevent a U.S. taxpayer from using foreign tax credits to reduce its U.S. tax liability on U.S.-source income. Section 904(a) seeks to achieve this goal by capping the credit at the amount of U.S. tax a U.S. taxpayer would have paid on foreign-source income.<sup>138</sup>

Since 2007,<sup>139</sup> the foreign tax credit has had two baskets for this purpose, general income and passive income.<sup>140</sup> This “prevent[s] the excess foreign tax credits from one basket of foreign-source taxable income from being offset (cross credited) against the U.S. residual tax liability on low-taxed foreign-source taxable income in the other basket.”<sup>141</sup> As indicated above, the foreign tax credit relies on § 954(c) for the definition of passive income.<sup>142</sup>

Thus, three different provisions require multinational corporations to separate passive and active income. All three provisions rely on the definition of passive income in § 954(c).<sup>143</sup> Section 954(c) includes “[d]ividends, interest, royalties, rents, and annuities,”<sup>144</sup> except royalties and rents from an active business received from someone other than a related person.<sup>145</sup> These items exemplify passive items. It further includes certain other types of income, including income from commodities transactions, foreign currency gains, and notional principal contracts, as well as payments that are the equivalent of interest or dividends.<sup>146</sup>

136. *See id.* § 904(d)(2)(B)(i). The foreign tax credit rules do reflect certain variants on this definition. *See id.* § 904(d)(2)(B).

137. *See id.* § 901.

138. Wright Schickli, *Equipment Fee Clauses in U.S. Tax Treaties: The Unmolded Progeny of Madame Tussaud?*, 59 TAX LAW. 419, 439–40 (2006).

139. *See* Randall Jackson, *IRS Clarifies Foreign Tax Credit Limitations*, 118 TAX NOTES 114, 114 (2008) (“Changes to the law were made by the American Jobs Creation Act of 2004, reducing the number of section 904(d) baskets from eight to two, effective for tax years beginning after December 31, 2006.”).

140. *See* I.R.C. § 904(d)(1).

141. J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 542 (2008). This approach does not restrict cross-crediting across jurisdictions. *See* Timothy A. Rybacki, Comment, *Separation Anxiety: The Repatriation of Foreign Tax Credits Without Associated Income via the Technical Taxpayer Rule’s Joint and Several Liability Provision*, 19 EMORY INT’L L. REV. 1575, 1583–84 (2005).

142. *See supra* note 118 and accompanying text.

143. I.R.C. § 954(c).

144. *Id.* § 954(c)(1)(A).

145. *Id.* § 954(c)(2)(A).

146. *Id.* § 954(c)(1); *see also* Treas. Reg. § 1.954-2(a)(4)(i) (2010). However, it does not include commodity hedges related to the taxpayer’s business. *See infra* text accompanying notes 281–84.



Section 954(c) also includes gain from the disposition of an asset that gave rise to any of those types of income or did not generate any income.<sup>147</sup> That generally would include gain on the sale of stock, bonds, rental real estate, and the like. In addition, § 954(c) encompasses gain from the disposition of “an interest in a trust, partnership, or REMIC [Real Estate Mortgage Investment Conduit].”<sup>148</sup>

*c. Applying the § 954(c) Definition*

As the discussion just above has shown, Code § 954(c) provides a detailed list of the types of income that are considered passive for the foreign personal holding company rules and are used by multinational corporations for several purposes. The basketing proposal advanced by this Article is for expenses and losses relating to any of these types of items to be basketed with aggregate income from these sources, so that any deduction for passive expenses and losses would be capped by the taxpayer’s passive income for the year.

Thus, the taxpayer would basket with the income items listed in § 954(c) any otherwise allowable expenses, losses, and credits attributable to items of those types. For example, if the taxpayer had interest and dividend income and a loss on rental real estate, it would basket those three items, so that the otherwise allowable loss for the year would be limited to the amount of passive income for the year.

Under this proposal, sales of stock would generally result in basketing of gains and losses.<sup>149</sup> Gains and losses on the sale of subsidiaries may warrant an exception, however. Section 954(c) contains look-through rules for certain partnership sales<sup>150</sup> and for CFCs that are treated as related to the taxpayer,<sup>151</sup> but those provisions are not directly applicable to the question of the sale of a subsidiary corporation. The proposed provision could provide that if the taxpayer owns a certain percentage of a corporation—for example, at least 25%, by vote or by value immediately prior to the sale in question, perhaps considering constructive ownership under § 318<sup>152</sup>—then whether gain or loss on a disposition of stock in that corporation is considered active would

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147. I.R.C. § 954(c)(1)(B)(i), (iii).

148. *Id.* § 954(c)(1)(B)(ii).

149. Basketing would be done for gains and losses remaining after other rules, such as the capital loss limitations, are applied. *See infra* text accompanying notes 155–58.

150. I.R.C. § 954(c)(4).

151. *Id.* § 954(c)(6).

152. *See id.* § 318(a) (indicating that stock owned by parties related to the taxpayer within the meaning of Code § 318 is considered owned by the taxpayer).

depend on the nature of the corporation's income over a period of time, such as the preceding three years. If 25% or more of the subsidiary's income during each of those years (or its entire existence, if less) consisted of income of the types provided in § 954(c), a gain or loss on the sale of the subsidiary would be basketed with the taxpayer's other passive items.<sup>153</sup>

Such a rule would appropriately keep losses on the sale of active subsidiaries active and thus not subject to basketing. In theory, corporations might manipulate the rule to create passive gains for basketing purposes, but that would require substantial passive income for an extended period of time.<sup>154</sup> Corporations could also implicitly elect into or out of this rule by acquiring or disposing of stock in order to obtain or fall below the statutory threshold. Stock acquisition has costs, of course, and disposition of stock has tax consequences.

Although, as this discussion suggests, § 954(c) is complex, it has the virtue of already being applied by multinational corporations in several contexts. As discussed below, by relying on an existing definitional section, and one already used for other purposes by a subset of corporations, the proposal would add the minimal amount of complexity necessary to achieve its goals.

### 3. Ordering Rules

The proposed basketing provision would apply after other Code provisions.<sup>155</sup> Thus, only includible income and authorized expenses, losses, and credits would be basketed.<sup>156</sup> In addition, the proposed provision would apply after other limitation provisions. For example, if a corporate taxpayer had a capital gain of \$2 million and a capital loss of \$3 million, \$1 million of

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153. Similar rules could also apply to sales of interests in partnerships and limited liability companies.

154. That income might also subject the subsidiary to rules such as the PFIC regime (the antiferral regime discussed in *supra* text accompanying notes 125–35).

155. Like other statutes, the proposed provision would apply before judicial doctrines such as the step-transaction doctrine. *See* Lederman, *supra* note 91, at 418 n.150 (“The results when the [economic substance] doctrine is applied to [a] hypothetical tax evading retailer—good arguments that the tax evasion has both a business purpose and economic substance—support the argument that the . . . doctrine should not be applied without first ascertaining that the transaction technically ‘works’ under existing statutes and interpretive guidance.” (citations omitted)).

156. To basket credits with income and deductions, credits would be converted into their deduction equivalent. Given a top marginal corporate tax rate of 35%, *see* I.R.C. § 11(b)(1)(D), a credit, which reduces taxes dollar for dollar, would need to be divided by .35 (35%) to produce the equivalent deduction. For example, at a 35% tax rate, a \$100 credit (which reduces tax liability by \$100) is equivalent to a deduction of \$285.71. Code § 108(b)(3)(B) provides an analogy: in reducing tax attributes to reflect excluded income, it reduces credits only by 33 1/3 cents per dollar. *See id.* § 108(b)(3)(B). A 33 1/3 cent credit would offset income of \$1 at a 33.33% tax rate.

the capital loss would be disallowed under the existing limitation on capital losses of § 1211.<sup>157</sup> Thus, as under current law, the taxpayer would not be allowed to deduct the full \$3 million of capital losses for the year even if the taxpayer had \$1 million of another type of passive income, such as interest.

In addition, the \$2 million of capital loss that is not disallowed under § 1211 would be subject to disallowance under the proposed provision. That is, if the loss derived from the sale of an asset that generated dividends, interest, royalties, rents, or annuity income—or no income at all<sup>158</sup>—it would be basketed with the taxpayer's passive income for the year. If the \$2 million capital gain was from a passive source, or the taxpayer had other passive-source income of at least \$2 million, the proposed provision would not disallow the capital loss deduction.

Similarly, the dividends received deduction, which allows corporate taxpayers a deduction for dividends received from other corporations,<sup>159</sup> along with limitations on the dividends received deduction,<sup>160</sup> would apply before the proposed provision. Thus, the proposal would not eliminate any dividends received deduction otherwise available to a corporation. However, only the taxed portion of the dividend would constitute passive income for basketing purposes under the proposal.<sup>161</sup>

### *B. Limiting Passive Deductions: Effects on Tax Shelters*

The goal of the proposal to basket corporations' domestic items is to limit opportunities for corporations to invest in abusive tax shelters.<sup>162</sup> Although corporate tax shelters might be designed to comprise part of an active business, more typically they are designed as an investment in securities.<sup>163</sup> For example, the Contingent Installment Sale (CINS) transaction litigated in the well-known case of *ACM Partnership v. Commissioner*<sup>164</sup> involved an

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157. See I.R.C. § 1211(a).

158. See *supra* text accompanying notes 144–48.

159. See I.R.C. § 243.

160. See *id.* § 246; *cf. id.* § 1059 (basis reduction for nontaxed portion of extraordinary dividends received).

161. As discussed below, the proposal would also encompass amendments to Code §§ 382 and 384 to limit the ability of profitable corporations to acquire excess passive losses of other corporations. See *infra* text accompanying notes 268–69.

162. See Barker, *supra* note 25, at 25 (“[S]chedular principles have been introduced in the United States in an attempt to cure perceived abuse and to ensure the integrity of the system.”).

163. See Lawrence Zelenak, *Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters*, 54 SMU L. REV. 177, 192 (2001) (“[It] seems likely [that] most income to be sheltered is from active businesses, and . . . [it] also seems likely [that] active business shelters are much harder to design than portfolio shelters . . .”); see also *infra* notes 270–74.

164. 157 F.3d 231 (3d Cir. 1998).

investment through a partnership in floating rate Citicorp notes.<sup>165</sup> The FLIP (Foreign Leveraged Investment Program)/ OPIS (Offshore Portfolio Investment Strategy) transactions involved investment through a partnership or corporation in shares of UBS or another foreign bank.<sup>166</sup>

These and four other tax shelters are discussed below, to illustrate how they work and the effects the proposed provision would have. For ease of understanding, the Article groups them into categories. The first category, loss-generating inflated-basis shelters, includes four tax shelters of two different general types. The second category focuses on a distinct type of shelter, which does not involve a loss generated for tax purposes, but rather involves a credit, the foreign tax credit. Like the four inflated-basis shelters, however, it involves a passive investment that would be targeted by the proposed provision. Finally, this Section discusses a third category of tax strategy: those incorporated into a taxpayer's active business. The proposal would not effectively target those strategies, but, as discussed below, those strategies are harder to replicate and thus pose less of a threat to the federal fisc.

### *1. Inflated-Basis Strategies*

A number of corporate tax shelters involve claiming a tax basis that exceeds economic investment in an asset—typically stock or another security—in order to claim a loss for tax purposes once it is sold at its fair market value.<sup>167</sup> Some strategies involve an attempt to “shift” tax basis in such a way that the U.S. taxpayer investing in the shelter obtains basis from an accommodating nonresident alien who is not subject to federal income tax. The CINS and FLIP/OPIS shelters provide examples that are discussed immediately below. Other strategies involve the transfer of an asset along with an offsetting liability, coupled with a claim that the asset increases tax basis while the liability does not reduce it. The contingent liability and Son-of-BOSS shelters fit this paradigm and are discussed further below.<sup>168</sup>

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165. *Id.* at 239.

166. See Calvin H. Johnson, *Tales from the KPMG Skunk Works: The Basis-Shift or Defective-Redemption Shelter*, 108 TAX NOTES 431, 433–34 (2005).

167. Under Code § 1001, the amount of a realized loss is the amount by which the taxpayer's basis in the asset exceeds the “amount realized,” which, in a sale for cash, is the amount of money received. See I.R.C. § 1001(a)–(b) (2006).

168. See *infra* Part II.B.1.b.

a. *Basis-Shifting Strategies*

i. *Basis Shifting Across Time: CINS (ACM Partnership)*

The infamous *ACM Partnership* case involves basis shifting across time. In that case, the Colgate-Palmolive Company (Colgate) sold a subsidiary at a gain and subsequently engaged in a transaction promoted by Merrill Lynch & Co., Inc. designed to offset that gain with a tax loss.<sup>169</sup> The transaction, called “CINS,”<sup>170</sup> involved an investment through a partnership in illiquid securities—floating rate Citicorp notes.<sup>171</sup> The partnership sold most of the Citicorp notes and received in return \$140 million in cash plus approximately \$35.5 million worth of notes that had no stated principal amount but provided for twenty quarterly payments based on the London Interbank Offering Rate (LIBOR).<sup>172</sup>

Due to the periodic and uncertain payments under the LIBOR notes, the partnership treated the exchange as an installment sale without a maximum selling price.<sup>173</sup> It therefore took advantage of temporary regulations under Code § 453, which applied the installment sale rules to contingent payments and allowed the taxpayer’s basis to be allocated across the payments.<sup>174</sup> Because the payments spanned six years, the partnership allocated one-sixth of its approximately \$175 million basis to the cash payment it received.<sup>175</sup> Accordingly, it recognized in the first year a large gain reflecting the difference between \$140 million of cash received and the basis of approximately \$29.3 million.<sup>176</sup> The remaining five-sixths of the partnership’s basis was allocated to the LIBOR notes, which, as indicated above, were worth only approximately \$35.5 million.<sup>177</sup> When those notes were subsequently sold, they therefore produced a large tax loss.<sup>178</sup>

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169. *See ACM*, 157 F.3d at 233.

170. *See* I.R.S. Notice CC-2005-001 (Nov. 29, 2004). The IRS defines “CINS” as Contingent Installment Note Sales. *See id.*

171. *ACM*, 157 F.3d at 238–40.

172. *Id.* at 240.

173. *Id.* at 242.

174. *Id.*

175. *Id.*

176. *Id.* (“ACM divided its \$175,504,564 basis in the Citicorp notes, consisting of their \$175 million purchase price and \$504,564 of accrued payable interest, equally among the six years over which payments were to be received in exchange for those notes, and thus recovered one sixth of that basis, or \$29,250,761, during 1989. Subtracting this basis from the \$140 million in cash consideration for the Citicorp notes, ACM reported a 1989 capital gain of \$110,749,239.42 . . .”).

177. *Id.* at 246 n.27.

178. *Id.* at 243–44 (footnote omitted) (“For its tax year ended December 31, 1991, ACM reported a capital loss of \$84,997,111 from its December 17, 1991 sale of the . . . LIBOR notes. This loss

The tax gain in the early year and tax loss in the later year were offsetting and did not reflect economic gains and losses.<sup>179</sup> Rather, they reflected an allocation of a small fraction of basis to the first sale (producing a large gain) and a large fraction of basis to the second sale (producing a large loss).<sup>180</sup> The gains and losses were allocated to the partners in proportion to their partnership interests.<sup>181</sup> The trick to the shelter was that in the year of the first sale, a Netherlands Antilles corporation, which was not subject to U.S. tax, had an 82.6% interest in the partnership and therefore was allocated most of the gain.<sup>182</sup> The partnership interest of the Netherlands Antilles corporation was later redeemed so that, in the year of the second sale, the U.S. taxpayer, Colgate, was allocated virtually all of the tax loss.<sup>183</sup> Colgate carried the loss back to the tax year in which it had a large capital gain from the sale of its subsidiary.<sup>184</sup>

The *ACM* transaction was thus designed to allow a loss on a portfolio investment to offset a gain on the sale of an active business. As tax commentator Lee Sheppard has noted: “Putting corporations on a schedular system, as the passive loss limitation rules do for individuals, clearly would have prevented situations like *ACM*, in which the taxpayer used artificial losses from a portfolio transaction to offset capital gain incurred on the sale of one of its operating businesses.”<sup>185</sup>

*ii. Basis Shifting Between Parties: FLIP/OPIS*

The tax strategies that the accounting firm KPMG marketed under the acronyms FLIP and OPIS attempt to shift basis between parties.<sup>186</sup> They involve corporate stock redemptions (buybacks) designed to fail to qualify as sales for federal income tax purposes.<sup>187</sup> In general, corporate redemptions of stock resemble both sales, because the shareholder is selling stock, and dividend-type distributions,<sup>188</sup> because the corporation is distributing cash or

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consisted of the difference between the \$10,961,581 that *ACM* received for those notes and the remaining \$95,958,692 basis in those notes.”)

179. *Id.* at 252.

180. *See id.* at 243–46.

181. *Id.* at 242.

182. *Id.* at 239–43.

183. *Id.* at 244.

184. *Id.* at 243–44.

185. Sheppard, *supra* note 91, at 784.

186. *See* Johnson, *supra* note 166, at 433.

187. *See* I.R.S. Notice 2001-45, 2001-2 C.B. 129.

188. A dividend-type distribution is a distribution to a shareholder governed by Code § 301; it is taxed as a dividend to the extent of the corporation’s earnings and profits. *See* I.R.C. §§ 301(c)(1), 316(a) (2006).

other property to the shareholder in the shareholder's capacity as such. Code § 302 therefore provides a series of resemblance tests to determine in which category a particular redemption will be deemed to belong for tax purposes.<sup>189</sup> The shareholder-level tests generally treat more substantial decreases in stock ownership as sales and less significant ones as dividend-type distributions.<sup>190</sup> The tests take into account constructive ownership of stock<sup>191</sup> under attribution rules that encompass stock owned by related parties.<sup>192</sup>

If the redemption is treated as a sale, the taxpayer recovers tax basis in the computation of gain for tax purposes just as in any other sale.<sup>193</sup> However, in a dividend-type distribution, basis is not recovered first.<sup>194</sup> That presents the question of what happens to the taxpayer's tax basis in the redeemed shares. A Treasury regulation provided that "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed."<sup>195</sup> An example involving two owners (a husband and wife) provided that when all of the husband's shares were redeemed, the wife—whose ownership caused the redemption of the husband's stock not to qualify as a sale<sup>196</sup>—was allocated the basis.<sup>197</sup>

The FLIP/OPIS shelter took advantage of this "shifting basis" notion. Its general structure was that a corporation was incorporated offshore and bought shares in an accommodating foreign bank, such as UBS.<sup>198</sup> The U.S. taxpayer acquired options to buy stock in the offshore corporation sufficient for the taxpayer to be related to that corporation within the constructive

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189. *See id.* § 302(a) ("If a corporation redeems its stock . . . and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock."); *id.* § 302(b) (providing four circumstances under which a redemption will be treated as an exchange (that is, a sale)); *id.* § 302(d) ("Except as otherwise provided in this subchapter, if a corporation redeems its stock . . . and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.").

190. *See id.* § 302(b)(1)–(3) (treating as exchanges redemptions that are "not essentially equivalent to a dividend," are substantially disproportionate, or are complete terminations of shareholder's interest).

191. *See id.* § 302(c).

192. *See id.* § 318.

193. *See id.* § 1001(a). For example, if a taxpayer receives \$100,000 of dividend proceeds in a redemption taxed as a sale/exchange and the taxpayer has a basis of \$80,000 in the redeemed shares, the taxpayer has \$20,000 of gain (\$100,000–\$80,000) that is included in gross income.

194. *See id.* § 301(c) (taxing dividend amount before basis is recovered).

195. Treas. Reg. § 1.302-2(c) (2010).

196. *See* I.R.C. § 318(a)(1)(A)(i) ("An individual shall be considered as owning the stock owned, directly or indirectly, by or for . . . his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) . . .").

197. Treas. Reg. § 1.302-2(c) Ex. 2.

198. *See* Johnson, *supra* note 166, at 434.

ownership rules of § 318.<sup>199</sup> The U.S. taxpayer also purchased a small number of shares in UBS.<sup>200</sup> Professor Calvin Johnson has explained the next steps in the strategy:

Just as Cayman [the offshore corporation] was redeemed out of UBS, the American purchasers bought an option, under the package, to buy the same number of UBS shares . . . that Cayman was redeemed out of. Because optioned stock is considered to be constructively owned, without regard to whether exercise of the option was a realistic prospect or not, and because Cayman owned everything Taxpayer owned, Cayman was not completely redeemed out under section 302. Indeed, Cayman had no reduction of its ownership of UBS once constructive ownership was considered.<sup>201</sup>

Relying on Treasury Regulation section 1.302-2(c), the taxpayer would claim the basis in the UBS stock that was unused by the foreign corporation because the redemption was treated as a dividend shifted to the U.S. taxpayer.<sup>202</sup> The U.S. taxpayer then had a very high basis in the shares of UBS stock it owned, resulting in a large tax loss when it sold its small stake in UBS.<sup>203</sup>

This shelter, like CINS, relies on the purchase of securities.<sup>204</sup> It would thus be targeted by the proposed provision, which would have basketed the claimed tax loss only with passive income. That is, the taxpayer would not have been able to use the claimed loss to offset gain on the sale of an active business.

### *b. Strategies Involving Offsetting Transfers*

As indicated above, another way to claim inflated basis besides shifting basis from one tax year to another or from one taxpayer to another is to transfer a pair of offsetting items to a corporation or partnership and claim

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199. *See id.*; *see also* I.R.C. § 318(a)(4) (“If any person has an option to acquire stock, such stock shall be considered as owned by such person.”).

200. Johnson, *supra* note 166, at 434.

201. *Id.* at 435.

202. *See id.* Note that the offshore corporation was not subject to U.S. tax, so it was not actually taxed on the redemption.

203. *See id.*

204. This shelter is also something of a throwback to the shelters of the 1970s and 1980s in that it depends on seller financing. *See* Theodore S. Sims, *Debt, Accelerated Depreciation, and the Tale of a Teakettle: Tax Shelter Abuse Reconsidered*, 42 UCLA L. REV. 263, 265 (1994) (arguing that both the Tax Reform Act of 1976 and the Tax Reform Act of 1986 included provisions designed to combat debt-financed tax shelters). The purchase of the shares probably would not have been financed by an outside lender; the funds never actually left UBS. *See* Johnson, *supra* note 166, at 435.



that the asset increases basis while the liability does not decrease basis. The contingent liability shelter exemplified by *Black & Decker Corp. v. United States*<sup>205</sup> and the Son-of-BOSS transaction illustrate this approach.

*i. Contingent Liabilities*

The *Black & Decker* case is a prime example of a contingent liability shelter. In that case, Black & Decker Corporation (B & D) had sold three businesses for substantial profits. To shelter the resulting capital gains, it proceeded as follows:

B & D created Black & Decker Healthcare Management Inc. (“BDHMI”). B & D transferred approximately \$561 million dollars to BDHMI along with \$560 million dollars in contingent employee healthcare claims in exchange for newly issued stock in BDHMI (“the BDHMI transaction”). B & D sold its stock in BDHMI to an independent third-party for \$1 million dollars.<sup>206</sup>

Thus, B & D sold the stock in its new subsidiary for its fair value of \$1 million, the net amount invested in it. However, it claimed a \$561 million basis in the stock and thus a \$560 million loss on the sale.<sup>207</sup>

The argument for the \$561 million basis was that stock basis was not reduced by the \$560 million dollars in contingent liabilities because it was a liability covered by Code § 357(c)(3),<sup>208</sup> a provision that excludes from the general rule of § 357 liabilities that give rise to a deduction.<sup>209</sup> Code § 358 reduces tax basis for liabilities but contains an exception for liabilities excluded under § 357(c)(3).<sup>210</sup>

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205. 436 F.3d 431 (4th Cir. 2006).

206. *Id.* at 622.

207. *Id.*

B&D thus obtained the equivalent of an immediate deduction for healthcare expenses that would not accrue until 1999–2007. BDHMI [the subsidiary] may stand to obtain a second deduction when (and if) the future healthcare claims are eventually paid on behalf of B&D’s employees, even though BDHMI acquired neither the employees nor the underlying assets of the business that gave rise to the contingent liability.

Karen C. Burke, *Deconstructing Black & Decker’s Contingent Liability Shelter: A Statutory Analysis*, 108 TAX NOTES 211, 212 (2005) (footnote omitted).

208. See *Black & Decker Corp. v. United States*, [2004] 2 Stand. Fed. Tax Rep. (CCH) ¶ 50,359 (D. Md. 2004).

209. I.R.C. § 357(c)(3)(A)(i) (2006).

210. See *id.* § 358(d). Congress subsequently responded to the contingent liability shelter by enacting § 358(h), which provides for a basis reduction for certain liabilities that did not otherwise reduce basis under § 358(d). See *infra* note 214 and accompanying text.

Revenue Ruling 95-74, a taxpayer-favorable ruling, had applied Code § 357(c)(3) to contingent environmental liabilities, including those that could not be immediately deducted but rather had to be capitalized.<sup>211</sup> However, in that ruling, the facts were that the taxpayer corporation, for bona fide business reasons,<sup>212</sup> “transferr[ed] substantially all of the assets associated with the Manufacturing Business, including the manufacturing plant and the land on which the plant is located,” to the new corporation, along with the liabilities of that business.<sup>213</sup>

If B & D similarly had transferred a line of business to its new subsidiary, that would have been very close to the facts of the Revenue Ruling, and the IRS probably would not have challenged the transaction. Even the statutory change made by Congress in response to this shelter, which provides for a basis reduction for certain liabilities that did not otherwise reduce basis under § 358(d),<sup>214</sup> contains an exception where either:

(A) the trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange, or

(B) substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.<sup>215</sup>

B & D might very well have been unwilling to sell off an active business or business assets. Instead, B & D transferred liabilities to a new subsidiary without accompanying business assets and therefore sold a subsidiary that was not engaged in an active business.<sup>216</sup> “B&D used the

211. See Rev. Rul. 95-74, 1995-2 C.B. 36, 37. Code § 263 prohibits a deduction for capital expenditures, which generally consists of expenditures that give rise to benefits that extend substantially beyond the close of the taxable year or twelve-month period. See I.R.C. § 263(a); *Jack’s Cookie Co. v. United States*, 597 F.2d 395, 402–03 (4th Cir. 1979) (discussing “one-year rule”); *Blasius v. Comm’r*, 90 T.C.M. (CCH) 274, 277 (2005) (discussing “12-month rule”); see also Treas. Reg. § 1.263(a)-4(f) (2010) (providing a twelve-month rule for intangibles).

212. Rev. Rul. 95-74, at 36.

213. *Id.*

214. See I.R.C. § 358(h). That subsection provides, in part:

If, after application of the other provisions of this section to an exchange or series of exchanges, the basis of property to which subsection (a)(1) applies exceeds the fair market value of such property, then such basis shall be reduced (but not below such fair market value) by the amount (determined as of the date of the exchange) of any liability—

- (A) which is assumed by another person as part of the exchange, and  
 (B) with respect to which subsection (d)(1) does not apply to the assumption.

*Id.* § 358(h)(1).

215. *Id.* § 358(h)(2) (2006).

216. *Black & Decker Corp. v. United States*, 436 F.3d 431, 437 (4th Cir. 2006) (“Taxpayer only transferred the health claims but not the assets generating those claims . . .”).

claimed tax loss to offset tax gains from a prior sale of three of its businesses. The . . . transaction represented a ‘tax strategy’ that the Deloitte accounting firm designed and promoted to some 30 corporate clients, including B&D.”<sup>217</sup>

Note that the strategy in contingent liability cases such as *Black & Decker* involved the sale of stock in a subsidiary.<sup>218</sup> However, the subsidiary was not running a business.<sup>219</sup> The loss on the sale of the subsidiary would thus be considered passive under the proposed provision as well. Accordingly, the proposed provision, had it applied, would have barred the use of the loss to offset gains on the sale of Black & Decker’s active businesses.

## ii. *Son-of-BOSS*

“Son-of-BOSS is a variation of a slightly older alleged tax shelter known as BOSS, an acronym for ‘bond and options sales strategy.’”<sup>220</sup> Conceptually, Son-of-BOSS is similar to the contingent liability shelter described above because it relies on a claim that liabilities are uncertain and therefore do not reduce the basis in the entity to which they were transferred.<sup>221</sup> The Son-of-BOSS label is applied to more than one type of transaction, but they all involve transactions designed to produce high basis in partnership interests so as to give rise to a large loss on sale.<sup>222</sup> In Son-of-BOSS, the mechanism for obtaining the high basis typically is the transfer of assets and liabilities to a partnership.<sup>223</sup> For example, one variant is as follows:

[A] taxpayer purchases and writes options and purports to create substantial positive basis in a partnership interest by transferring those option positions to a partnership. For example, a taxpayer might

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217. Karen C. Burke, *Black & Decker in the Fourth Circuit: Tax Shelters and Textualism*, 111 TAX NOTES 315, 316 (2006).

218. *Black & Decker*, 436 F.3d at 432; see also *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1343 (Fed. Cir. 2006).

219. See Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 745–46 (“The taxpayers . . . transferred over liabilities severed from their businesses (naked liabilities) to generate capital losses from the sale of the Newco stocks.”).

220. *Kligfeld Holdings v. Comm’r*, 128 T.C. 192, 194 (2007).

221. See *id.*

222. See Karen C. Burke & Grayson M.P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 TAX LAW. 59, 62, 64 n.20 (2008) (Son-of-BOSS variants include Currency Options Bring Reward Alternatives (COBRA), Option Partnership Strategy (OPS), and Short Option Strategy (SOS)); see also I.R.S. Notice 2000-44, 2000-2 C.B. 255 (describing Son-of-BOSS variations).

223. See Burke & McCouch, *supra* note 222, at 64; see also I.R.S. Notice 2000-44, 2000-2 C.B. 255, 255.

*purchase* call options for a cost of \$1,000X and simultaneously *write* offsetting call options, with a slightly higher strike price but the same expiration date, for a premium of slightly less than \$1,000X. Those option positions are then transferred to a partnership which, using additional amounts contributed to the partnership, may engage in investment activities.

Under the position advanced by the promoters of this arrangement, the taxpayer claims that the basis in the taxpayer's partnership interest is increased by the cost of the purchased call options but is not reduced under § 752 as a result of the partnership's assumption of the taxpayer's obligation with respect to the written call options. Therefore, disregarding additional amounts contributed to the partnership, transaction costs, and any income realized and expenses incurred at the partnership level, the taxpayer purports to have a basis in the partnership interest equal to the cost of the purchased call options (\$1,000X in this example), even though the taxpayer's net economic outlay to acquire the partnership interest and the value of the partnership interest are nominal or zero.<sup>224</sup>

The taxpayer then disposes of the partnership interest, and because the taxpayer claims basis far in excess of the minimal value of that interest, the taxpayer accordingly claims a substantial loss on sale (\$1,000X in the example above).<sup>225</sup> As is the case with the contingent liability shelter, the taxpayer is not conducting business through the entity. Instead, Son-of-BOSS, like the other tax strategies discussed above,<sup>226</sup> involves a passive investment that would thus be subject to basketing under the provision proposed in this Article.

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224. I.R.S. Notice 2000-44, 2000-2 C.B. 255, 255 (emphasis added).

225. *See id.* The IRS Notice outlines multiple arguments against the deduction of these noneconomic losses:

The purported losses resulting from the transactions described above do not represent bona fide losses reflecting actual economic consequences as required for purposes of § 165. . . . The purported tax benefits from these transactions may also be subject to disallowance under other provisions of the Code and regulations. In particular, the transactions may be subject to challenge under § 752, or under § 1.701-2 or other anti-abuse rules. In addition, in the case of individuals, these transactions may be subject to challenge under § 165(c)(2). *See Fox v. Commissioner*, 82 T.C. 1001 (1984).

*Id.*

226. *See supra* text accompanying notes 169–219.

## 2. Cross-Border Dividend-Stripping Transactions

Cross-border dividend-stripping transactions are a distinct type of tax shelter in that they take advantage of the foreign tax credit, which, as indicated above,<sup>227</sup> generally allows an offset against the federal income tax for foreign taxes.<sup>228</sup> The foreign tax credit is designed to avoid double taxation by allowing a taxpayer a dollar-for-dollar credit to offset taxes paid to foreign jurisdictions.<sup>229</sup> In *Compaq Computer Corp. v. Commissioner*<sup>230</sup> and *IES Industries v. United States*,<sup>231</sup> the taxpayer invested in American Depository Receipts (ADRs), which are certificates reflecting stock ownership in a foreign corporation.<sup>232</sup> In *Compaq*, for example:

Compaq purchased the ADRs “cum dividend” for \$887.577 million and immediately resold the ADRs “ex-dividend” for \$868.412 million to the same party from whom the interests were acquired. The dividend amount was \$22.546 million. A 15% withholding tax of \$3.382 million applied, however, so Compaq received a net dividend amount of \$19.164 million. The transaction costs totaled \$1.486 million. Thus, at the end of the day, Compaq lost \$19.165 million on the sale of the stock, received a net dividend amount of \$19.164 million, and paid \$1.486 million in transaction costs.<sup>233</sup>

Compaq also paid U.S. tax on the gross dividend.<sup>234</sup> Before taxes, the transaction was therefore a net loser for Compaq: “After taking into account the loss on the sale and transaction costs, . . . Compaq reported \$1.895

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227. See *supra* text accompanying notes 136–37.

228. See I.R.C. § 901(a) (2006) (“If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) . . . .”); *id.* § 901(b)(1) (“Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a): . . . In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States . . . .”).

229. McCormack, *supra* note 219, at 714.

230. 113 T.C. 214 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001).

231. [2001] 2 Stand. Fed. Tax Rep. (CCH) ¶ 50,470 (N.D. Iowa 1999), *aff'd in part, rev'd in part*, 253 F.3d 350 (8th Cir. 2001).

232. See *Compaq*, 113 T.C. at 215 (explaining that ADRs are “trading unit[s] issued by a trust, which represent[] ownership of stock in a foreign corporation that is deposited with the trust. ADR’s [sic] are the customary form of trading foreign stocks on U.S. stock exchanges . . . .”). In both *Compaq* and *IES*, Twenty-First Securities Corporation suggested the transaction. See *Compaq*, 277 F.3d at 779; *IES*, 253 F.3d at 352.

233. McCormack, *supra* note 219, at 761 (footnotes omitted).

234. *Id.*

million in income, yielding \$640,000 in U.S. tax.<sup>235</sup> However, Compaq claimed a \$3.382 million foreign tax credit for the withholding tax in the amount referred to above.<sup>236</sup> Compaq thus came out ahead after taxes.

Compaq profited after taxes because of the combination of the foreign tax credit and the market value of the ADRs ex-dividend. It would seem that the market price of the ADRs should have fallen by the entire amount of the dividend once that dividend was paid (that is, by \$22.546 million—to \$865.031 million), rather than by \$3.382 million short of that (approximately \$19.165 million). Compaq therefore received about \$3.382 million more on the sale than one might expect. “This seemingly odd effect occurred because most taxpayers could not use the foreign tax credits. As a result, these taxpayers actually lost the \$3.382 million withheld, so they would be willing to sell the ex-dividend stock for [only] \$19.165 million (the net dividend amount) less than the original price.”<sup>237</sup>

What Compaq did, therefore, was claim a foreign tax credit for taxes it actually paid but did not economically bear.<sup>238</sup> In response to transactions of this type, Congress enacted Code § 901(k), which has a holding period requirement for the foreign tax credit.<sup>239</sup> This imposes a friction because a holding period exposes the taxpayer to market risk.<sup>240</sup> In *Compaq* and *IES*, the immediate resale avoided exposure to price fluctuations.<sup>241</sup>

Thus, *Compaq* and *IES* were dividend-stripping transactions<sup>242</sup> involving ADRs. As in the case of the four tax shelters discussed above,<sup>243</sup> these cases involved a passive investment that would result in basketing under the proposal in this Article. That is, each taxpayer would have to basket the income, deductions, and the deduction equivalent of the foreign tax credit claimed,<sup>244</sup> so the deductions and credits generated in the transaction would only be available to offset passive income. In *IES*, for example, where the

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235. *Id.* (footnote omitted).

236. *Id.*

237. *Id.* at 762 (footnote omitted).

238. *See id.* at 714.

239. I.R.C. § 901(k) (2006).

240. *See* Lederman, *supra* note 91, at 439.

241. *See* *Compaq Computer Corp. v. Comm’r*, 277 F.3d 778, 780 (5th Cir. 2001) (“23 purchase transactions and 23 corresponding resale transactions—of about 450,000 ADRs each . . . were all completed in a little over an hour.”); *IES Indus. v. United States*, 253 F.3d 350, 352 (8th Cir. 2001) (“The purchase and sale generally took place within hours of each other . . .”).

242. *See* Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, 88 TAX NOTES 221, 221–22 (2000).

243. *See supra* text accompanying notes 169–226.

244. For example, under the proposal, the deduction equivalent of the \$3.382 million foreign tax credit claimed by Compaq would be \$9.663 million. *See supra* note 156; *supra* text accompanying note 236.

taxpayer used capital losses generated in a dividend-stripping transaction to offset gain on the sale of a subsidiary,<sup>245</sup> basketing would undermine the utility of the shelter. If the transaction were used to shelter gains on the sale of portfolio stock, however, as it appears was the case in *Compaq*,<sup>246</sup> the proposal would not impede the transaction, as it is designed to restrict the use of passive deductions and credits to offset active income.

### 3. One-Off Tax Strategies

Of course, some tax strategies are not cookie-cutter portfolio shelters, but rather are incorporated directly into business activity. A prime example involves United Parcel Service (UPS), which engaged in a restructuring to put its revenue from package insurance offshore and thus not subject it to U.S. tax.<sup>247</sup> In that case,

UPS . . . form[ed] and capitaliz[ed] a Bermuda subsidiary, Overseas Partners, Ltd. (OPL), almost all of whose shares were distributed as a taxable dividend to UPS shareholders (most of whom were employees; UPS stock was not publicly traded). UPS then purchased an insurance policy, for the benefit of UPS customers, from National Union Fire Insurance Company. By this policy, National Union assumed the risk of damage to or loss of excess-value shipments. The premiums for the policy were the excess-value charges that UPS collected. UPS, not National Union, was responsible for administering claims brought under the policy. National Union in turn entered a reinsurance treaty with OPL. Under the treaty, OPL assumed risk commensurate with National Union's, in exchange for premiums that equal the excess-value payments National Union got from UPS, less commissions, fees, and excise taxes.<sup>248</sup>

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245. See *IES*, 253 F.3d at 352. IES carried back capital losses from its dividend-stripping transaction to offset capital gains recognized in previous tax years. *Id.* Most of those losses were from the sale of a subsidiary. See Kevin M. Keyes, *Evolving Business Purpose Doctrine, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2007*, at 253, 269 (PLI Tax Law & Estate Planning, Course Handbook Ser. No. 852, 2008).

246. *Compaq* used the foreign tax credit to offset capital gain on the sale of stock in a publicly traded company. *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 215, 220 (1999), *rev'd*, 277 F.3d 778 (5th Cir. 2001). Because *Compaq* was not affiliated with that company, *Compaq's* ownership interest in it probably would not be substantial enough to require look-through under the rules proposed in this Article. See *supra* text accompanying notes 152–53.

247. See *United Parcel Serv. of Am., Inc. v. Comm'r (UPS)*, 254 F.3d 1014, 1016 (11th Cir. 2001).

248. *Id.*

“Thus, if what UPS did was effective, it transferred the excess-value-charge income offshore, though the business remained unchanged and the income ultimately benefited the same shareholders as before.”<sup>249</sup> The Tax Court found that the strategy lacked a business purpose and economic substance, and was motivated by tax-avoidance concerns.<sup>250</sup> The Court of Appeals for the Eleventh Circuit reversed, finding that the transaction had both a business purpose and economic substance, but it remanded the case to the Tax Court for consideration of statutory arguments.<sup>251</sup>

The basketing provision proposed in this Article would not target strategies, like the one used in *UPS*, which are tailored to a particular company’s business. However, those shelters appear to be less common than shelters in which any company can invest.<sup>252</sup> Strategies that are tied to a particular company’s business are more costly to develop and difficult to replicate.<sup>253</sup> Thus, although the proposed reform would not put a stop to all creative ways of eliminating taxes on profits, it would address the most significant part of the problem.

### III. ANTICIPATING OBJECTIONS TO THE PROPOSAL

The discussion above<sup>254</sup> has shown that the principal benefit of basketing corporations’ passive expenses and losses only with passive income is restriction of tax shelter activity. However, it did not address the potential drawbacks of the proposal. The proposal, although targeted to address much abusive tax sheltering activity, is not perfect. The likely principal objections to it are (1) it is underinclusive, not tackling all tax sheltering; (2) it is overbroad, barring a deduction for legitimate expenses and losses; and (3) it is too complex. These objections are addressed, in turn, below.

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249. Lederman, *supra* note 91, at 429.

250. *United Parcel Serv. of Am., Inc. v. Comm’r*, 78 T.C.M. (CCH) 262, 296 (1999).

251. *UPS*, 254 F.3d at 1020.

252. *See* Sheppard, *supra* note 110, at 304 (“Doubtless most large-outlay tax shelters occur on the portfolio side of a corporation’s activities; it’s hard to construct a shelter around an active business. A company could really lose money doing that.”); Zelenak, *supra* note 163, at 192 (“[[It] . . . seems likely) [that] active business shelters are much harder to design than portfolio shelters . . . .”); *see also* Sheppard, *supra* note 91, at 784 (“Of course, under a schedular system, a corporation determined to shave taxes could design a shelter around a real operating business, but the necessity of having to run an active business to save taxes should not trouble anyone. (The only active business in most shelters seems to be the rendering of professional advice.)”).

253. *See* Zelenak, *supra* note 163, at 192 (explaining why active business shelters are harder to design).

254. *See supra* Part II.



### A. *The Underinclusiveness Objection*

There are two principal aspects to the objection that a basketing proposal will not catch all corporate tax shelters. Professor Lawrence Zelenak has explained:

It is unclear . . . how successful [the basketing] approach might be. In some cases, the income to be sheltered will itself be in the portfolio basket, and thus shelterable by a tax shelter loss in the portfolio basket. In other cases, the income to be sheltered will be in the active business basket, but shelter promoters may be able to design a shelter which also goes into the active basket.<sup>255</sup>

These concerns are not as troubling as they might initially seem. On the first issue, as Professor Zelenak goes on to state,<sup>256</sup> and as the discussion above of a number of 1990s tax shelters suggests,<sup>257</sup> it seems that most of the income that corporations have tried to shelter is active business income. This is not surprising because the main revenue stream businesses produce is business income. By analogy, the individuals who invested in the shelters of the 1970s and 1980s often were seeking to shelter salary income,<sup>258</sup> which is why the passive activity loss rules, which limit the deductibility of passive earnings from another active business to the amount of passive income gains, succeeded in eliminating those shelters.<sup>259</sup> Certainly, putting a stop to sheltering active business income through the use of abusive tax strategies would address a substantial problem.

One concern if the proposal were enacted would be “trafficking” in passive losses and credits, along the lines of efforts of profitable companies to acquire net operating losses<sup>260</sup> by acquiring companies with such losses.<sup>261</sup>

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255. Zelenak, *supra* note 163, at 192 (footnotes omitted).

256. *Id.*

257. *See supra* notes 169–251 and accompanying text.

258. *See* John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 VA. TAX REV. 57, 110 (1988) (Before 1986, “[t]he public apparently perceived that high-income individuals were using tax shelters to reduce or even eliminate the current incidence of taxation on their portfolio income and salaries.”).

259. *See supra* note 52 and accompanying text. Similarly, Code § 163(d), which limits the deductibility of individuals’ investment interest to their net investment income, functions as a real limitation on deductibility. *See* I.R.C. § 163(d) (2006); Linette M. Barclay & Christopher P. McConnell, *Interest Deductions by Individuals: Tax Planning is Essential to Get Through the Intricate Maze of New Rules*, 19 TAX ADVISER 165, 167 (1988) (“The maximum amount of investment interest that one can deduct in any year is equal to net investment income . . .”). The passive activity loss rules and limitation on investment interest are discussed in Part I.B.

260. *See* I.R.C. § 172(a) (“There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating

A company with excess passive losses or credits would have an incentive to try to monetize them rather than simply carrying them over to the next year, especially if it was experiencing cash flow issues.<sup>262</sup>

For companies with net profits, losses and credits would shelter that income, so profitable companies have an incentive to try to acquire them. The proposal advanced in this Article only imposes a limitation on the deductibility of passive items; active losses and credits would still be able to be offset against passive or active income. Therefore, a profitable company could use active losses to offset its income, whether or not that income is composed in whole or in part of passive items. However, the Code defines net operating loss as “the excess of the deductions allowed by this chapter over the gross income.”<sup>263</sup> Thus, net operating losses include active losses, but not losses that would be disallowed by the proposal.

The Code contains provisions specifically designed to eliminate trafficking in net operating losses.<sup>264</sup> However, only one provision, Code § 269, currently is broad enough to reach trafficking in net passive losses.<sup>265</sup> It provides, in part:

(a) In general. If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

loss carrybacks to such year.”); *id.* § 172(c) (“For purposes of this section, the term ‘net operating loss’ means the excess of the deductions allowed by this chapter over the gross income.”).

261. See Charles W. Adams, *An Economic Justification for Corporate Reorganizations*, 20 HOFSTRA L. REV. 117, 132 (1991) (“Over the years, taxpayers have devised a variety of schemes for transferring the net operating loss deduction so that it can be used to average income between different taxpayers, rather than between different tax years of one taxpayer. Congress and the courts have reacted by erecting a number of barriers to corporate taxpayers’ trafficking in net operating loss deductions.”). I am grateful to Christopher Hanna for suggesting this ploy in the passive loss context.

262. The proposal would allow unused passive items to be carried forward indefinitely. See *supra* text accompanying notes 94–95. However, losses and credits that are deferred for specific purposes are not as valuable as ones that are usable currently.

263. I.R.C. § 172(c). Section 172 is in Chapter 1, “Normal Taxes and Surtaxes,” which would be the logical chapter in which to situate the basketing provision proposed in this Article.

264. See *id.* § 382 (limiting the use of net operating losses following an ownership change); *id.* § 384 (disallowing the use of preacquisition net operating losses to offset built-in gains in certain corporate acquisitions); see also *id.* § 269 (giving Secretary of the Treasury authority to disallow deductions, credits, and other allowances acquired in certain contexts, where “the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy . . .”).

265. See *id.* § 269. One commentator has explained: “Section 269 has been most frequently used by the Service to disregard the acquisition of companies acquired to utilize their net operating losses or to gain multiple surtax exemptions.” Marilyn Barrett, *Independent Contractor/Employer Classification in the Entertainment Industry: The Old, the New and the Continuing Uncertainty*, 13 U. MIAMI ENT. & SPORTS L. REV. 91, 109 n.53 (1995).

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance.<sup>266</sup>

Section 269 therefore gives the IRS discretion to challenge the acquisition of tax benefits for tax-avoidance purposes. By contrast, Code §§ 382 and 384 disallow net operating losses more directly.<sup>267</sup> Therefore, if the basketing proposal advanced in this Article were enacted without changing other provisions, profitable corporations would be more readily able to acquire net passive losses than to acquire net operating losses.<sup>268</sup> To prevent that, §§ 382 and 384 could be amended to bring net corporate passive losses within their scope.<sup>269</sup>

On the second issue raised by Professor Zelenak—that “shelter promoters may be able to design a shelter which also goes into the active basket”<sup>270</sup>—most of the well-known corporate tax shelters involved passive investments.<sup>271</sup> That is not coincidental; passive investment structures are much more easily replicated. Sheltering active business income often will require tailoring a shelter to a particular business or industry, as with the offshore strategy in the *UPS* case.<sup>272</sup> It is generally less costly to design a prewired strategy involving securities than to design a shelter built into a business.

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266. I.R.C. § 269(a).

267. *See id.* §§ 382, 384.

268. One commentator explains: “Although the subjective test of section 269 enabled the Service to limit net operating loss transfers in the most egregious cases, the objective test of section 382 proved more successful in limiting such transfers.” Michelle M. Arnopol, *Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts to Protect a Corporation’s Net Operating Losses After Bankruptcy*, 68 NOTRE DAME L. REV. 133, 147 (1992) (footnote omitted).

269. An alternative would be to create a parallel regime for net passive losses. However, that would be less efficient than enlarging the scope of existing §§ 382 and 384.

270. Zelenak, *supra* note 163, at 192 (footnote omitted).

271. *See supra* text accompanying notes 162–246.

272. *United Parcel Serv. of Am., Inc. v. Comm’r (UPS)*, 254 F.3d 1014, 1016–17 (11th Cir. 2001).

Putting a stop to the development of corporate tax shelters that can be purchased “off the rack” would be incredibly valuable for the fisc, even if a niche market remains for custom “tailored” tax strategies. Professor Zelenak concludes, for similar reasons, that, despite the concerns he mentioned, “the schedular approach seems worthy of further consideration.”<sup>273</sup> He explains:

If (as seems likely) most income to be sheltered is from active businesses, and if (as also seems likely) active business shelters are much harder to design than portfolio shelters, then a schedular system would seriously impede shelter activity, even if it did not succeed in shutting down all shelters.<sup>274</sup>

It is possible, however, that if the proposed provision were enacted, corporations subject to it would respond by trying to convert passive losses into active ones to avoid the basketing requirement. For example, the general definition under § 954(c) encompasses interest and dividends, as well as income from the sale of assets that give rise to passive income,<sup>275</sup> but it provides an exception for “dealers in securities.”<sup>276</sup> For securities dealers, items from “transaction[s] . . . entered into in the ordinary course of such dealer’s trade or business as such a dealer” are not taken into account, so long as “the income from the transaction is attributable to activities of the dealer in the country under the laws of which the dealer is created or organized.”<sup>277</sup> A company might consider setting up a brokerage business to avail itself of this provision, claiming that the tax strategy was considered part of the U.S. brokerage business, so the loss was active.<sup>278</sup> However, in situations in which taxpayers purchased a cloned tax shelter, such as those in *ACM, Black & Decker*, and the other shelters discussed above, an examination of the facts and circumstances likely would reveal that the shelter was not entered into in the ordinary course of the securities business.<sup>279</sup>

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273. Zelenak, *supra* note 163, at 192.

274. *Id.* (footnote omitted).

275. See I.R.C. § 954(c)(1) (2006).

276. *Id.* § 954(c)(2)(C)(ii).

277. *Id.*

278. I am grateful to Stephanie McMahon for raising and discussing this issue with me.

279. This inquiry is a concrete one that courts should be equipped to perform. Note that, for example, Code § 954(c) requires a determination of whether a “transaction [was] entered into by the taxpayer in the normal course of the taxpayer’s trade or business” in the context of determining whether it is a “commodity hedging transaction[.]” See I.R.C. §§ 954(c)(1)(C)(i); 1221(b)(2)(A)(i); *infra* text accompanying notes 282–84. In addition, setting up a new line of business involves substantial costs, which would be a deterrent in itself. Moreover, assuming a corporation bore the costs of starting the new line of business and was successful in its claim that the shelter losses did not constitute passive items within the meaning of § 954(c), the losses still would not accomplish the company’s goal of sheltering profits from its original business if the brokerage business earned profits

Nonetheless, some taxpayers probably would escape the strictures of the proposed provision, finding a way to avoid basketing of passive deductions and credits or a way to convert active income into passive income for purposes of the basketing restriction. The proposed provision raises the cost of these efforts, however, and thus would at least serve as a friction that should reduce tax sheltering.

## *B. The Overinclusiveness Objection*

### *1. Limiting Overinclusiveness*

Another problem with basketing is that some items that are disallowed might be ones that, in theory, seemingly should be allowed. As the Treasury Department noted, “Applying such rules [as § 469] in response to corporate tax shelter transactions casts a wide net—one that would catch both taxpayers that engage in sheltering transactions as well as those that do not.”<sup>280</sup>

Importantly, the proposed basketing rule should not apply to hedges of commodities related to the taxpayer’s business, such as corn futures purchased by a manufacturer of cornstarch and corn syrup.<sup>281</sup> Code § 954(c) excludes gains and losses that “arise out of commodity hedging transactions.”<sup>282</sup> Commodity hedging transactions are defined by reference to Code § 1221(b)(2).<sup>283</sup> This includes “any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily . . . to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer.”<sup>284</sup> Thus, the proposal should not apply to hedges of commodities in order to assure a source of supply of inventory or raw materials, for example.

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at least equal to the loss from the shelter. Therefore, if the brokerage business were successful, the taxpayer would have to increase the size of the shelter in order to receive a tax benefit from the shelter loss. This would increase its cost and the likelihood that the shelter would be detected. If, on the other hand, the brokerage business were unsuccessful, that would increase the taxpayer’s pretax costs.

280. U.S. DEP’T OF TREASURY, *supra* note 90, at 113.

281. *See, e.g.,* Corn Prods. Ref. Co. v. Comm’r, 350 U.S. 46, 48 (1955) (describing taxpayer, which transacted in corn futures, as “a nationally known manufacturer of products made from grain corn. It manufactures starch, syrup, sugar, and their byproducts, feeds and oil.”)

282. I.R.C. § 954(c)(1)(C)(i).

283. *Id.* § 954(c)(5)(A) (applying I.R.C. § 1221(b)(2) with certain modifications). Section 954(c)(5)(A)(i)(III) requires the substitution of “‘controlled foreign corporation’ for ‘taxpayer’ each place it appears” in § 1221(b)(2), which should not be carried over to the basketing proposal. *Id.* § 954(c)(5)(A)(i)(III).

284. *Id.* § 1221(b)(2)(A)(i).

Aside from specific exceptions like this one, the overinclusive nature of basketing is difficult, if not impossible, to avoid without a motive test. However, adding a motive test would be unwise because motive is inherently subjective. Motive and purpose inquiries are necessarily fact-sensitive and thus costly. They also open the door to taxpayer manipulation. Such is the case with the “business purpose” prong of the economic substance doctrine, for example.<sup>285</sup>

The passive activity loss rules of § 469 also operate to deter or disallow losses without regard to whether the transaction involves an abusive tax shelter. For example, if an individual taxpayer is a passive investor in another’s active business, and the taxpayer’s investment loses money, the loss is subject to § 469 even if the transaction lacked any abusive elements.<sup>286</sup>

This is therefore a cost of the basketing proposal, and one not readily avoided. The questions this issue raises are therefore how high the costs are, how those costs compare to the benefits of the proposal, and whether another alternative offers a more favorable cost-benefit ratio. The costs and benefits are very difficult to quantify. However, the \$10 million threshold for applicability of the proposed provision will help reduce overinclusiveness and compliance costs.

Beyond that, the passive activity loss provision offers a historical analogy. The provision is widely viewed as having eliminated the individual tax shelters of the 1970s and 1980s.<sup>287</sup> That is a substantial benefit, given the deadweight loss that tax sheltering entails.<sup>288</sup> However, given its broad applicability, it likely has had some impact on passive investing in others’ businesses, such as deterring individuals from making venture capital investments.<sup>289</sup>

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285. See Lederman, *supra* note 91, at 398 n.27, 433.

286. See Lederman, *supra* note 59, at 1433 (giving example of taxpayer investing in a bakery run by a partnership).

287. See *supra* note 59 and accompanying text.

288. See Mark P. Gergen, *The Logic of Deterrence: Corporate Tax Shelters*, 55 TAX L. REV. 255, 274 (2002) (“The most easily measured social cost of corporate tax shelters is the cost to promoters and taxpayers of developing, marketing, and executing the strategies. Such expenditures yield little social benefit and so may be counted as a deadweight loss.”).

289. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1767 (1994) (“A start-up organized as a partnership could provide its partners with tax losses. However, the ability of individual partners to use those losses would be constrained by the alternative minimum tax and the passive loss rules.”). Victor Fleischer explains:

Absent unusual circumstances, . . . the passive loss rules prevent limited partners in venture capital funds from immediately using the losses, as LPs [limited partners] do not normally help manage the portfolio companies in any significant way. The tax losses in the pass-through structure flow through to the venture capital fund and then to the LPs, but individuals may not use those losses immediately to offset taxable income from nonpassive activities.

In the corporate context, the benefit of the proposed provision would be analogous to the benefit of the passive activity loss rules: a severe limitation on sheltering of active income. The dollar amounts involved in tax sheltering in the 1990s were substantial.<sup>290</sup> Although sheltering waned in the 2000s in the face of a multipronged attack by the government and, more recently, declining corporate income, this is a problem that will likely resurface once companies are profitable.<sup>291</sup> Although Congress and the Treasury have closed the loopholes that facilitated certain tax shelters,<sup>292</sup> taxpayers will inevitably find others. Disclosure requirements and increased penalties provide greater deterrence than previous rules did, but probably not enough. The IRS can

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Fleischer, *supra* note 97, at 154–55 (footnote omitted). That is one reason start-up companies seeking venture capital may be inclined to organize as C corporations despite the corporate double tax. See Bankman, *supra*, at 1754–66 (discussing a number of possible reasons for start-ups' use of the corporate form); see also Larry E. Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751, 770 (2005) (noting tax incentives of using the corporate form). Because start-up companies typically organize as C corporations, losses do not pass through, so the provision proposed in this Article should not reduce the benefits of using C corporations for venture capital start-up companies. See Fleischer, *supra* note 97, at 137. In theory, the proposed provision could apply if a corporate investor sold stock in a start-up at a loss and had capital gains sufficient to claim some or all of the loss. However, there is almost no market for stock in a privately held start-up corporation. See Fred Wilson, *A Second Market is Emerging*, A VC: MUSINGS OF A VC IN NYC (Apr. 23, 2009), [http://www.avc.com/a\\_vc/2009/04/a-second-market-is-emerging.html](http://www.avc.com/a_vc/2009/04/a-second-market-is-emerging.html). Moreover, most providers of venture capital are tax-exempt organizations. See Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSP. 145, 151 tbl.1 (2001) (corporate investors were only 2% to 17% of venture capital funds in years examined); see also Bankman, *supra*, at 1753 (“In recent years, . . . a majority of the investment in start-ups has come from tax-exempt institutional investors, such as pensions and university endowments.”); Fleischer, *supra* note 97, at 158 (“Tax-exempt entities, such as pension funds and university endowments, comprise the largest investor class in the venture capital industry.”).

290. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-171, TAX SHELTERS: SERVICES PROVIDED BY EXTERNAL AUDITORS 11, 12 tbl.3 (2005) (estimating that, in 1998 through 2003, tax shelters cost the federal fisc almost \$129 billion); Johnson & Zelenak, *supra* note 13, at 1389 (“In recent years, accounting and law firms have marketed aggressive prepackaged tax shelters called loss generators. . . . Loss generators can be very large, sometimes producing claimed tax losses in excess of \$100 million.”).

291. See Johnson & Zelenak, *supra* note 13, at 1391 (“Shelters may not reemerge as a major problem soon, [in part] . . . because there may not be much income needing sheltering for the next few years. It would be a major mistake . . . to assume that the tax shelter dragon has been slain once and for all.”) The article further argues that “[t]ax shelters could return—perhaps with a vengeance—if the federal judiciary were to become less receptive to the government’s invocation of the various common-law antiabuse doctrines.” *Id.* On March 30, 2010, Congress added § 7701(o) to “clarify” the judicially developed economic substance doctrine. See Monte A. Jackel, *Dawn of a New Era: Congress Codifies Economic Substance*, 127 TAX NOTES 289, 289 n.2 (2010). Although the new provision may foster uniformity in the application of the doctrine, it does not eliminate the substantive problems with the doctrine. See generally Lederman, *supra* note 91 (arguing that the economic substance doctrine’s focus on taxpayer intent and the prospect of pretax profit renders the doctrine easy for taxpayers to manipulate).

292. For example, Congress enacted § 358(h) to shut down the contingent liability shelter. See Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1637 n.30 (2009).

easily become overburdened with the volume of disclosures, particularly in the face of incentives for both the risk averse and the aggressive to engage in overdisclosure.<sup>293</sup> And even the higher penalties are not substantial enough to provide adequate deterrence unless audit rates are increased to unrealistic levels.<sup>294</sup> The revised Circular 230 rules, designed to limit the use of tax opinions as “penalty insurance” for shelters,<sup>295</sup> similarly are helpful but insufficient if the penalty itself is an insufficient deterrent.

The costs of the corporate basketing proposal would also be analogous to those of the passive activity loss rules. That is, the proposal would raise the cost of corporate passive investment by reducing deductions available for expenses (such as interest paid) and losses. However, because the proposal only disallows passive deductions in excess of passive income, it should have a somewhat limited deterrent effect on investments designed to produce income. That is, the proposal should effectively deter investments designed to produce losses (tax strategies). However, for real investments, such as straightforward purchases of stock, the taxpayer would need to discount the cost of the provision by the probability it would apply. For example, a stock purchase on margin (thus incurring interest expense), might have only a relatively small probability of returning income less than the interest expense.

## 2. *A Possible Alternative*

Thus, the analogy of the passive activity loss rules and the corporate context itself suggest that the overinclusive aspect of basketing imposes costs that are small in comparison to the benefits basketing offers. Nonetheless, such a rule does impose costs, so the next question is whether there is an option with a more favorable cost-benefit ratio. Commentators have noted that there does not seem to be a “silver bullet” that would address all corporate tax shelters.<sup>296</sup> However, Calvin Johnson and Lawrence Zelenak

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293. *See generally id.* (arguing that overdisclosure can be used to reduce the possibility that the government will detect abusive tax strategies).

294. *See* Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1465 (2003) (showing that, for example “an audit rate of 1% would require a \$99,000 penalty”—a penalty of 990%—for the expected value to equal payment of \$1,000 of tax). Even the 30% penalty under Code § 6662A for undisclosed “listed . . . transactions” makes the expected value of cheating equal the expected value of compliance only at a 76.9% audit rate: \$1,000 of tax due is equivalent to 76.9% of \$1,300 (\$1,000 of tax plus a \$300 penalty). I.R.C. § 6662A(c) (2006).

295. *See* 31 C.F.R. § 10.35 (2009).

296. Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1951 (2005) (“What is wanted is a silver bullet (or perhaps a broad-spectrum antibiotic) that would kill a wide variety of tax shelters, and do so in such a way that the



have proposed an amendment to Code § 165 that would address the deduction of noneconomic losses. Their proposal is to add to § 165(b) the following language:

“No deduction shall be allowed for any loss claimed to have been incurred in connection with any transaction or series of transactions except to the extent that such loss accurately reflects a reduction in the taxpayer’s net worth. Losses not allowed in a particular year under this paragraph may be allowed in a later year, when and if they reflect a measured reduction in net worth.”<sup>297</sup>

That proposal is a useful one, but, by its terms, it is limited to losses. It does not address the deductibility of expenses or the allowance of credits. Thus, although it would be very useful to address loss-generating shelters, including the four inflated-basis strategies discussed above, it would not target tax strategies such as the foreign tax credit strategy in *Compaq* and *IES*, which made use of the foreign tax credit.<sup>298</sup> Although that strategy has since been limited statutorily, it provides an example of a corporate tax shelter that is not a loss generator.

The Johnson and Zelenak proposal would thus not have quite the breadth of the basketing provision proposed in this Article. Its benefits would therefore not be as substantial. It would therefore also not entail the same costs. However, it would also have costs the basketing proposal would not have. Most importantly, the proposal would seem to require measuring the taxpayer’s net worth before and after a transaction in order to determine if and when the taxpayer’s net worth has declined. For many taxpayers, that would be a challenging endeavor, given the complexity of their finances and the complexity of the transactions in question. After-the-fact reconstruction of net worth by the IRS might also be more complex than applying a basketing provision because of disputes over what items affect net worth, and to what extent.<sup>299</sup>

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government would no longer always be playing catch up . . . . It is not immediately obvious, however, how that might be done.”).

297. Johnson & Zelenak, *supra* note 13, at 1392. The proposal would allow for exceptions:

[T]he proposal would give Treasury the authority to identify those situations by regulation and to exempt them from the application of new section 165(b)(2). There is a precedent for this approach; Treasury has successfully written partnership antiabuse rules, with many examples of transactions considered abusive and transactions specifically allowed. Also, Congress could, if it wanted, include in the legislation its own listing of particular types of artificial losses that are not subject to disallowance.

*Id.* (footnotes omitted).

298. See *supra* text accompanying notes 227–41.

299. For example, depreciation is accelerated for tax purposes. See Christopher H. Hanna, *The*

In addition, the Johnson and Zelenak proposal appears to apply to all taxpayers, not just corporations.<sup>300</sup> That would increase the compliance cost taxpayers face. For example, it would apply to individuals, although tax sheltering by individuals has not been a substantial problem since 1986 in light of the passive activity loss rules and other rules,<sup>301</sup> such as the limitation on interest of § 163(d) and the at-risk rules of § 465.<sup>302</sup> Finally, the proposal has another scope issue, which is that it does not have a *de minimis* exception, so even low-income taxpayers and small corporations would need to apply it.

*C. The Complexity Objection: Segregating Corporations' Passive and Active Items*

Most new tax provisions add some amount of complexity to an already complicated set of rules. The proposed provision is no exception. The specific complexity it would add is a requirement that corporations subject to it identify and segregate their passive items. The asset-based threshold<sup>303</sup> would eliminate that burden for small corporations, but large corporations would still bear it. Of course, it is important to note, as mentioned above,<sup>304</sup> that multinational corporations are already required to sort their passive and active items for several other purposes and that the proposed provision would rely on the same definitional section. However, the proposal would require large domestic corporations to sort out items that previously had been bundled.

The Treasury raised the complexity concern about basketing in a 1999 white paper, stating:

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*Real Value of Tax Deferral*, 61 FLA. L. REV. 203, 228 (2009) (“Under the Code, a corporation may depreciate tangible personal property under an accelerated method of depreciation.”). How does that affect net worth? Litigation on the IRS’s application of the “net worth” method of reconstructing a taxpayer’s income where the taxpayer’s records were inadequate or do not accurately reflect income suggests how complex net worth calculations can be. *See, e.g.*, *Erickson v. Comm’r*, 937 F.2d 1548, 1550–52 (10th Cir. 1991) (analyzing whether the cost of marijuana should be included in the Commission’s determination of net worth); *United States v. Walton*, 909 F.2d 915, 922–23 (6th Cir. 1990) (examining whether an airplane legally titled to a corporation should increase its sole shareholder’s net worth); *Estate of Upshaw v. Comm’r*, 416 F.2d 737, 743–44 (7th Cir. 1969) (analyzing whether accrued federal income tax liabilities reduce net worth).

300. *See* Johnson & Zelenak, *supra* note 13, at 1392.

301. *See supra* note 59 and accompanying text.

302. *See* I.R.C. §§ 163(d), 465 (2006); *see also supra* note 6 and accompanying text; *supra* text accompanying note 35.

303. *See supra* text accompanying notes 100–03.

304. *See supra* text accompanying note 117.

A broad basketing or schedular system limited to corporate tax shelters would be difficult to design, implement and enforce. Unlike individuals, corporations engage in a wide variety of activities and often grow and diversify into new activities. Because money is fungible, tracing tax benefits derived from financing transactions to taxable income from activities for which the financing is used (and vice versa) would be difficult.<sup>305</sup>

The Treasury's comparison suggests that basketing is more complex for corporations than for individuals because corporations engage in a broader range of activities. In one sense, individuals may engage in a broader range of activities than corporations because, like corporations, they engage in business activities as well as nonbusiness profit-seeking (investment-type) activities,<sup>306</sup> but, unlike corporations, they engage in personal activities as well. In fact, individuals often need to distinguish among those items, whether for basketing purposes, as discussed above,<sup>307</sup> or because of limitations on or disallowance of deductions of a particular type. For example, an individual with deductible nonemployee business expenses can deduct them above the line<sup>308</sup> but must treat expenses to produce most investment income as disfavored "miscellaneous itemized deductions."<sup>309</sup> An individual's personal expenses generally are not deductible at all.<sup>310</sup>

Yet, in another sense, corporations may engage in a broader range of activities than individuals because they can more easily expand into a range of activities that require large numbers of workers. However, corporations doing that typically will have more sophisticated record-keeping systems

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305. U.S. DEP'T OF TREASURY, *supra* note 90, at 118. The white paper also stated: "Limiting schedular taxation to corporate tax shelters would require a definition and identification of the offending transactions." *Id.* at 118–19. That concern does not apply to the proposal that is the subject of this Article because basketing would not be limited to tax shelter transactions. *See supra* text accompanying notes 90–92.

306. *See supra* text accompanying notes 108–09.

307. *See supra* Part I.B.

308. I.R.C. § 62(a)(1).

309. *See id.* §§ 62(a), 67(b). Miscellaneous itemized deductions are subject to a number of limitations on their deductibility. *See id.* § 63 (providing individual taxpayer with a choice between itemizing and claiming standard deduction); *id.* § 67 (2% floor on itemized deductions); *id.* § 68 (overall limitation on itemized deductions). As these limitations suggest, an individual's trade or business activity is often privileged over nonbusiness profit-seeking activity. *See Lederman, supra* note 59, at 1450. Under case law, the distinction between the two types of profit-seeking endeavors is whether the activity is sufficiently "active." *See id.* ("To square *Higgins* [v. Comm'r, 312 U.S. 212 (1941)] with [Comm'r v.] *Groetzinger*, [480 U.S. 23, 35 (1987)], the focus must be on the 'active' or 'passive' nature of the taxpayer's earnings.").

310. *See* I.R.C. § 262 (providing general rule that "no deduction shall be allowed for personal, living, or family expenses.").

than individuals with fewer activities. Those record-keeping systems facilitate compliance with the tax laws.

It is true that any rule that distinguishes among distinct types of items requires some sorting and tracing. However, it is very possible for corporations to do that in the passive/active context. As discussed above, multinational corporations are already required to do so in at least three contexts<sup>311</sup>: Subpart F of the Code requires separation of the passive and active income of each CFC, because the passive income is taxed currently, while active income is taxed only upon repatriation;<sup>312</sup> the PFIC regime requires identification of a foreign corporation's passive and active income and assets in order to determine whether the corporation is a PFIC, which subjects U.S. shareholders to antideferral tax rules;<sup>313</sup> and the foreign tax credit regime requires separation of passive income into a distinct basket from other income, so as to prohibit cross-crediting across categories.<sup>314</sup> Large domestic corporations should be equally well equipped to identify the passive items that fall within the § 954(c) definition and separate them out from their other items.

#### CONCLUSION

In the federal income tax, basketing of deductions with related income is an exception to the general rule that deductions can be taken from any income, regardless of source. It is nonetheless used fairly frequently in the individual federal income tax to prevent deductions from reducing tax on unrelated income. Some of the basketing provisions applicable to individuals function, at least in part, as anti-tax-shelter devices.

Many of the basketing provisions applicable to individuals could, in theory, apply to corporate taxpayers, though they generally do not. Conceptually, there is no reason why corporate expenses and losses could not be subject to basketing. In fact, many of the cookie-cutter corporate tax shelters developed in the 1990s would not have worked if corporations' passive losses were only allowed to offset passive income.

Basketing does not work perfectly to disallow only tax shelter items. As the passive activity loss rules of Code § 469 illustrate,<sup>315</sup> basketing does not capture all tax shelters, and it also sweeps in some bona fide investments.

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311. *See supra* Part II.A.2.b-c.

312. *See generally supra* notes 136-42 and accompanying text.

313. *See supra* text accompanying notes 117-30.

314. *See supra* text accompanying notes 139-41.

315. I.R.C. § 469 (2006).

However, as § 469 illustrates,<sup>316</sup> basketing can be quite effective in curbing tax shelters without impeding much legitimate activity. The proposed provision would work similarly because it would exempt from its ambit corporations with relatively low capitalization, which likely do not have the resources to invest in tax shelters, and it would allow unused losses to be carried forward.

Basketing does add complexity, but corporate taxpayers typically are better suited to bear that complexity than most individuals are. Multinational corporations already are required to identify and separate passive-source income for many purposes. The proposal would use the same definition for passive income items and require C corporations to identify expenses and losses of the same types for basketing purposes. It would therefore introduce the minimal additional complexity needed for this type of basketing.

The benefits of the proposal would be analogous to the benefits of the “passive activity loss” rules of Code § 469: the proposed provision would severely restrict the deductibility of tax shelter losses from other income. Corporations could still develop methods to remove income from the federal tax base, but those techniques typically are more specialized and thus have a lower return on investment to promoters and a lower cost to the federal fisc. Most importantly, corporations would no longer be able to use investments in securities to lower the tax rate on either their business income or gains from the sale of businesses. Unless they had substantial income from passive sources such as dividends and interest, passive losses simply would do them no good. The proposal would therefore help prevent a resurgence of the corporate tax shelter problem.

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316. *Id.*