

Compaq: Find Another Poster Child. The Business Purpose Doctrine Is Alive and Well in the Fifth Circuit

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This article was originally written¹ in early 2002, soon after the Fifth Circuit Court of Appeals rendered its decision in Compaq Computer Corp.² At the time, we were puzzled by the assertion that the Compaq decision demonstrated the need for legislation to help the courts get to the right answer in dealing with tax motivated transactions. Fairly read, Compaq involved nothing more than the symmetrical treatment of “income” artificially deemed to exist by Treasury Regulation³ and the corresponding treatment of foreign taxes imposed on that “income.” In other words, the decision represented nothing more than a case in point for Professor Ginsburg’s maxim: “Every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part.”

Seven years have passed and Compaq is still occasionally put up as a sort of poster child for the need to take decisive action to keep the courts from the obvious error of their ways. Indeed, some enthusiasts even invoke Compaq as a reason to enact one or another of the various permutations of “Codification of Economic Substance.”⁴

Compaq has been misread by commentators who overlook the basis of the actual decision. The courts in the Fifth Circuit are doing just fine in dealing with alleged tax shelters. Specifically, several decisions have applied Compaq, and those decisions confirm that the courts are up to



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their task in applying the rule of law while dealing at the edges with the narrow class of cases that may actually warrant departure from the letter of the law.

This article will restate the original article, with minor changes to update some of the citations to commentators whose publications were not mentioned in the original version. As a Coda, I will touch briefly on several cases that have applied Compaq. Although there may be powerful fiscal incentives to increase taxes on the business sector, the post-Compaq cases confirm the original thesis that the business purpose doctrine is alive and well in the Fifth Circuit.

The Fifth Circuit Court of Appeals rendered its long-awaited decision on December 28, 2001. The Fifth Circuit reversed the 1999 Tax Court decision⁵ and held that foreign income taxes should be treated as fungible with United States federal income taxes for purposes of applying the economic substance or business purpose tests on a pretax or an after-tax basis. The Fifth Circuit decision is in accord with the earlier Eighth Circuit decision in *IES*.⁶ Indeed, the Fifth Circuit opinion explicitly refers at various points to the *IES* decision and seeks to emphasize that it is dealing with essentially the same fact pattern as is dealt with by the Eighth Circuit, and that it reaches the same opinion as the Eighth Circuit with respect to common factual elements.

Within days, the Fifth Circuit decision in *Compaq* was characterized as if it (and presumably *IES* as well) were important milestones in the development of modern judicial thinking about economic substance, economic shams, business purpose and tax shelters.⁷ This reaction was perhaps predictable in light of the extensive commentary that had followed the lower court decision in *Compaq*,⁸ but it was rather more hyperbolic than the decision really supports. In fact, neither the Fifth Circuit opinion in *Compaq* nor the Eighth Circuit opinion in *IES* is an important milestone in the economic substance and business purpose portion of the tax shelter debate. Instead, they decide only a rather narrow legal issue

(whether foreign income taxes are to be treated as fungible with domestic income taxes in testing economic substance and business purpose). Both Circuit Courts of Appeals decided that foreign income taxes should be treated as fungible with domestic income taxes and then proceeded to apply fairly well-settled economic substance and business purpose tests to the transaction in issue. Had they been decided differently, and treated foreign income taxes as expenses rather than taxes for purposes of testing economic substance and business purpose, they would have been as noteworthy (and controversial) as the lower court decisions they reversed.

Some of the criticism by commentators who find the decisions to be a setback in the war on tax shelters appears to be directed at a judicial decision that was not actually rendered, but which might have been rendered, had the cases been presented differently by the IRS. Similarly, practitioners who might long for some notion of “good old days,” or who might think that these cases open the door to a “whole new ballgame,” would be well advised to read the cases more carefully. The judicial requirement that transactions have either or both of economic substance and business (nontax) purpose are alive and well in both the Fifth and Eighth Circuits. At the same time, there also seems to be room in those circuits for a rule-based system that affords some level of predictability to the orderly administration of the tax laws based on the application of the Code and Regulations.

This article will examine the importance of the *Compaq* and *IES* decisions in the ongoing consideration of economic substance and business purpose in testing putative tax shelter transactions. We conclude that the cases are largely unremarkable in that context. The article will not review in any depth the history of, nor seek to revisit the policy behind, the rules of application of the foreign tax credit that may underlie the disquiet that some commentators have expressed about these decisions. We will assume, as did the Courts of Appeal, that the application of the foreign tax credit “technical taxpayer” rule to the cum-dividend purchaser is consistent with the regulations.⁹

The IRS’s position that foreign taxes are expenses rather than taxes for purposes of an economic substance test is contrary to this reciprocal allocation of international taxing jurisdiction.

It is worth noting at the outset, however, that introducing “economic substance” into the application of the rather arbitrary, noneconomic regime that applies to a buyer of cum dividend stock (*i.e.*, stock that is purchased after the declaration date but before the record date) is likely to engender great confusion about what we are all talking about. A buyer of cum-dividend stock (such as *Compaq*) is treated for tax purposes as the taxable recipient of a dividend, even though, as to the buyer, the dividend amount is economically an immediate return of a portion of its investment. The point of first beginning is Reg. §1.61-9(c), which specifically rejects an economic substance argument that might be made by a purchaser of cum dividend stock:

“The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax.”

Having decided to apply an arbitrary rule¹⁰ that is not particularly dependent on economic substance to tax the buyer of cum-dividend stock, it is a bit odd for the government then to turn around and disavow the rules in order to disallow a foreign tax credit for foreign income taxes actually paid on the dividend that might plausibly have been excluded from the buyer’s income altogether under principles of “economic substance.” It is, in short, a bit like Rule 42 in the trial of the Knave of Hearts in Alice in Wonderland¹¹ (a rule change invented to justify a desired result).

I. Cross-Border Dividend Capture Transaction—Market Arbitrage

In order to understand what the *Compaq* and *IES* courts decided, and what they did not decide, it is important to understand the underlying economics of the dividend capture transaction in question.

A dividend capture transaction, in its simplest form, involves the purchase of a stock that is scheduled to pay a dividend (“cum dividend”) to shareholders of record on a certain date (the “record date”), followed by the prompt (or immediate) resale of that stock without the dividend entitlement (“ex-dividend”). The settlement dates of the two transactions are scheduled so that the initial purchaser is the holder of the stock on the record date, and consequently entitled to receive the scheduled dividend.

In *Compaq*, the United States taxpayer executed a trade (on the New York Stock Exchange) to buy Royal Dutch ADRs cum dividend for settlement/delivery on (or before) the dividend record date, and immediately thereafter executed another trade (also on the New York Stock Exchange) to sell the same ADRs for settlement/delivery four days later—after the dividend record date (*i.e.*, ex-dividend). The cum-dividend price exceeded the ex-dividend price by an amount approximately equal to 85 percent of the declared dividend.¹² *Compaq* bought the ADRs cum dividend from the same party to which it sold them ex-dividend. Both the purchase and resale transactions were effected by pre-arranged cross trades at market prices on the New York Stock Exchange using open outcry in accordance with Exchange rules governing cross trades.¹³

The cum-dividend price did not exceed the ex-dividend price by 100 percent of the declared dividend because, evidently, the “market” reduced the value of the declared dividend embedded in the ADR price by 15 percent to take into account the Dutch withholding tax of 15 percent that would be imposed on the dividend when paid two weeks after the record date. The market price, in effect, reflected an assumption that the Dutch withholding tax would be a non-recoverable cost to the potential dividend recipients whose purchasing and selling behavior would determine the market price. Such market participants likely included tax-exempt institutional investors, tax-exempt retirement account investors, corporations whose foreign tax credit limitation would not permit economic utilization of the foreign tax credit, and, perhaps, other investors who could not or would not utilize a foreign tax credit to recover some or all of the cost of the Dutch withholding tax.

Market participation was not, however, confined to investors who could not or would not utilize the foreign tax credit available for the foreseeable Dutch withholding tax on the scheduled dividend. For those atypical investors, the market pricing behavior provided an arbitrage opportunity.

Assume, for example, that the stock price of the Royal Dutch ADRs, without regard to a declared dividend, is X , and that a dividend of 100 is declared, from which a Dutch withholding tax of 15 will be withheld. If the “market” treats the Royal Dutch ADRs as having a value of X plus 85, instead of X plus 100, a taxpayer able to utilize a foreign tax credit will be able to capture a portion of the value attributable to the market’s failure to take into

account the fact that foreign income taxes are (and have been since the dawn of the federal income tax)¹⁴ creditable against the federal income tax due with respect to the dividend.

The dividend amount embedded in the ADR (in the amount of 100), however only cost the taxpayer 85. The “market” sold stock pregnant with 100 units of income for X+85 (rather than X+100), leaving an economic profit of 15 (assuming that neither United States federal nor foreign income taxes are taken into account at this point). That economic profit of 15 will be subject to a combined 35 percent United States federal income tax (our assumed effective tax rate) and foreign income tax (assuming the foreign tax is creditable against the United States net income tax), but the taxpayer will still retain the benefit of 65 percent of the 15 units of dividend sold by a market that was indifferent to the pricing advantage of the crediting United States taxpayer. The resulting net after-tax profit from the market arbitrage is 9.75 (15 units of income less 5.25 combined United States and foreign tax imposed at an overall rate of 35 percent equals 9.75).

If the market were instead to have priced cum-dividend ADRs at X plus 100 (*i.e.*, reflecting an assumption that most or all investors could utilize the foreign tax credit to offset the cost of the Dutch withholding tax) there would be no market anomaly to exploit. The market would capture for the seller the economic benefit of recovering the Dutch withholding tax from the United States net income tax eventually due on the actual dividend and the purchaser would have no ability to buy 100 units of embedded income at a discount. For example if a tax-exempt seller were to sell the Royal Dutch ADRs at X plus 100, it would realize the entire 100, while the taxpayer buyer would retain 65 on an after-tax basis, having given up the 65 percent of the 15 units of market profit (*i.e.*, 9.75) that it captured in the first example. The economic benefit of the buyer’s foreign tax credit would have effectively shifted to the tax-exempt seller.

In order to capture the economic benefit of the market pricing assumption (that the buyers will have no capacity to take a foreign tax credit for the Dutch withholding tax) it is necessary that:

- the purchasing taxpayer must be able to credit the Dutch withholding tax against the federal income tax otherwise due with respect to the gross dividend (100 in our example, times 35-percent assumed tax rate); and

- the purchasing taxpayer must be able to deduct the cost of acquiring the dividend (85 in our example).

There are severe limitations on creditability of foreign taxes against federal income tax. Those limitations are designed to prevent crediting foreign taxes against the U.S. federal income tax on either (1) United States source income, or (2) various classes of income not in the same foreign tax credit limitation category (“basket” in tax-speak).¹⁵ In the *Compaq* case, these limitations were likely applied in the following manner:

Dividends¹⁶ on the Royal Dutch ADRs would ordinarily be in the “passive income” basket.¹⁷ The foreign tax credit otherwise allowable with respect to income in any basket (in this case, 15)¹⁸ is limited to the United States tax otherwise due on worldwide income (in this case, 35)¹⁹ multiplied by a limiting fraction, the numerator of which is the foreign source income in that basket (in this case, 15)²⁰ and the denominator of which is worldwide income (both United States source and foreign source—in this case, 100)²¹ in all categories. Therefore, the maximum amount of the Dutch withholding tax (15) that could offset the United States tax would be 5.25,²² and *Compaq* would owe 29.75 in tax to the United States (in addition to the 15 of Dutch withholding tax). Assuming that *Compaq* had 85 units of pre-existing capital gain that would otherwise be subject to United States tax at a 35-percent rate, it could deduct the capital loss of 85 generated in its dividend capture transaction against this capital gain²³ and save 29.75 units of tax that would otherwise be due on the 85 units of capital gain. The net effect would be that the combined effective rate of tax on the ADR dividend (29.75 United States tax plus 15 units of Dutch tax, totaling 44.75 of combined United States and foreign tax) would exceed the benefit of the deduction of capital losses (29.75) by 15, and the transaction does not appear to generate a profit (in isolation).

Therefore, in order for *Compaq* to fully utilize a foreign tax credit for the 15 units of Dutch withholding tax, it would have to have “excess” limitation (*i.e.*, other foreign source income otherwise subject to current domestic federal income tax) or, as shown above, 9.75 of the Dutch withholding tax would be non-creditable. *Compaq* and *IES* had such excess limitation (presumably as a result of the application of the so-called “high tax kickout” that would treat the dividend income as “general limitation” income if the effective rate of tax on the otherwise passive

items of income, after reduction by the amount of deductions attributable thereto, is equal to or greater than 35 percent).²⁴

The second necessary characteristic for a potential arbitrageur would be the ability to deduct the losses resulting from buying cum dividend and selling ex-dividend: that difference is treated as a capital loss and cannot be deducted from the dividend income (notwithstanding the allocation of the loss against the dividend in order to limit the creditability of the Dutch tax on the dividend). In order to deduct the 85 units of economic expense attributable to the acquisition of the dividend component of the ADR cum dividend price (*i.e.*, the sale at X of stock that cost X + 85), the purchasing taxpayer must have income in an amount and of a character sufficient to deduct the capital loss of 85. Compaq had capital gains substantially in excess of the 85 capital loss resulting from buying the ADRs cum dividend and selling them ex-dividend. It was thus able to maintain tax treatment consistent with the economics (the deduction of the 85 units of loss equal to the difference between the cum dividend purchase price and the ex-dividend sales price) but only by resort to other income.

II. Foreign Taxes Are Taxes

The IRS challenged the claim of the foreign tax credit for the Dutch withholding tax on the basis that the cross-border dividend capture transaction was a tax motivated economic sham lacking nontax economic substance and business purpose. To reach this position, notwithstanding the actual economic benefit derived from buying 100 units of income (the declared but unpaid dividend) for 85 units, the IRS asserted that a foreign income tax should be treated as an expense rather than as a “tax.”

While the litigation was pending, the IRS issued Notice 98-5,²⁵ in which it promised regulations that would, for taxes paid or accrued on or after December 23, 1997, treat foreign taxes as an expense for purposes of measuring pre-tax profit in a putative tax shelter. The Notice further provided that the economic profit so measured must be significant in comparison with the foreign tax credit to avoid having the transaction be considered an economic sham.

If the transaction is tested, for tax shelter purposes, as the purchase of stock which is pregnant with a declared but unpaid dividend of 85 (rather than a dividend of 100) for a price of X plus 85, there is no economic return on the investment. Under this

characterization, the economic dividend of 85²⁶ (rather than a dividend of 100) will be subject to an incremental U.S. federal income tax of 20 (100 taxable gross income times 35-percent tax tentatively due, minus 15 as a credit for the Dutch withholding tax), while the deductible loss of 85 from buying at X plus 85 and selling at X would give rise to an effective deduction of 29.75. The difference, 9.75, would then be viewed as attributable to a tax savings from a transaction with no economic profit ((X plus 85 paid out on purchase) = (85 dividend received, plus X in upon re-sale)). The tax benefit under this hypothetical view lies in the ability to deduct capital losses.

To reach this conclusion, the IRS had to depart from measuring gross income in accordance with Code Secs. 61, 301 and 316, and, in particular, from the specific inclusion rules in Reg. §1.61-9(c) for taxing the cum dividend buyer. It also had to depart from treating foreign income taxes as taxes creditable against federal income taxes in accordance with Code Sec. 901 and the “technical taxpayer” rule in Reg. §1.901-2(f)(1) and (2). In lieu of measuring income, expense, gains and losses using long-standing bedrock provisions embodied in the Code, the IRS used an approach that treated foreign taxes as “expenses” but treated federal income taxes as taxes in order to determine if the transaction had pre-tax economic substance. If the transaction were to pass this gauntlet, the taxpayer would then return to the Code and Regulations to prepare its tax return by treating foreign taxes as creditable taxes (not as deductible expenses).

Under this approach, the relevant cash or economic income received would be X (the sales proceeds of the ex-dividend shares) plus 85 (dividend), excluding the additional 15 of dividend income equal to the tax that was withheld at source in respect of the Dutch withholding tax. For this testing purpose only, as distinguished from the legally mandatory inclusion in income on the tax return of the cum dividend purchasing taxpayer, in the amount 100 as a dividend, the 15 of withheld tax would be treated as a transactional expense rather than as a “tax.”

The *Compaq* and *IES* Courts of Appeal flatly rejected the treatment of foreign taxes as an expense rather than as a tax for purposes of testing a transaction as a sham transaction. In order to test the economic substance (profit potential), either before tax or after tax, foreign and federal income taxes have to be taken into account as taxes. Once a foreign tax is treated as a tax rather than as a transactional expense

in testing income and expense from a putative tax shelter, the dividend capture transactions looked at in *Compaq* and *IES* become imbued with a profit (9.75 units, representing 65 percent of the market's "under pricing" of the dividend by 15). This benefit is after all taxes, domestic and foreign. Before all taxes, domestic and foreign, the economic benefit is 15. It is no great breakthrough in tax shelter jurisprudence to find a transaction has economic substance and business purpose when it has both a before-tax profit and an after-tax profit, where the transaction was virtually certain to provide the arbitrageur that profit when entered into at market prices. The arbitrage profit (9.75) is approximately equal to the net tax benefit derived by deducting capital losses of 85 (a tax benefit of 29.75, from deducting a capital loss of 85) while paying additional United States taxes on the dividend of 100 (a tax cost of 20). A one-to-one tax benefit to economic benefit ratio²⁷ is not "relatively insubstantial" even in those jurisdictions which apply the *Sheldon*²⁸ test vigorously. Even after deducting other transaction costs (commissions, fees and short interest) the tax benefit is about 2.35 times the economic benefit.²⁹

Neither the Fifth Circuit nor the Eighth Circuit discussed at length why a foreign tax should be treated as a "tax" for purposes of testing economic substance and business purpose. Some commentators have criticized *Compaq* and *IES* on the grounds that "[t]here is no principle of tax law or good sportsmanship that requires treating foreign taxes the same as domestic taxes."³⁰ A clever *bon mot*, but clearly wrong. On the contrary, there is a principle of tax law that mandates such treatment. The fundamental architecture of the foreign tax credit system clearly supports both Circuit Courts of Appeals in treating United States and foreign income taxes as fungible. The whole point of a foreign tax credit regime is to allocate and apportion (between the source country and the residence country) taxing jurisdiction over items of income derived in one country by a resident of another. Indeed, this point was explicitly made by the Congress at the time it re-enacted the foreign tax credit regime as part of the Internal Revenue Code of 1954:

The significance of *Compaq* as a tax shelter precedent is also limited by the unique nature of the longstanding rules for determining who the taxpayer is with respect to withholding taxes on dividends.

'Credit is allowed under existing law against United States tax liability for income taxes paid abroad. This provision gives foreign countries a prior tax claim on the income of United States enterprises operating abroad, and in effect treats the taxes imposed by the foreign country as if they were imposed by the United States. H.R.Rep. No.1337, 83d Cong., 2d Sess., p. 76, U.S. Code Cong. & Admin. News 1954, p. 4103.

Moreover, granting credits for the full amount of the Dutch withholding tax in *Compaq* was required by more than some principle of unilateral "good sportsmanship." Granting full credit for such withholding taxes is fundamental to the bilateral allocation of taxing jurisdiction between the United States and

foreign countries with respect to cross-border dividend flows dating back to the League of Nations. Under laws of most developed countries and under the terms of essentially all income tax treaties negotiated by the United States, countries seek to avoid penalizing

investments in shares of companies incorporated in the other jurisdiction by avoiding double taxation on dividends paid on such shares. The United States accomplishes this by allowing United States payees to credit foreign withholding taxes against their United States tax liability on foreign source income. The goal is to have the combined foreign and United States rate of tax on the foreign source income equal to the higher of the United States tax rate and the foreign tax rate by essentially treating the payment of the foreign withholding tax as if it were a prepayment of United States income tax. This was the result in *Compaq*.

Note that, for the sake of convenience, each country is permitted to tax dividend payments to residents of another country on a gross withholding basis, without the benefit of allocable deductions. This basis of taxation can easily result in withholding tax in excess of the United States income tax rate on the economic profit on the transaction, and such was the case in *Compaq*. The architects of the United States treaty system and the prevailing allocation of taxing jurisdiction on cross border dividend flows were well aware of this possibility. The general rule has been that the resulting "excess" credits from withholding

on a gross basis may be credited against other foreign source income subject to the general constraints of our foreign tax credit limitation as applied to specified baskets of income. When the United States allows such cross crediting, it suffers a net loss of tax revenue as a cost of avoiding double taxation of foreign source dividends earned by United States persons. The United States, however, generally expects its treaty partners and other developed countries to do the same for their residents who receive dividends from United States corporations that have been subjected to United States withholding tax on a gross basis. When a foreign person receives a dividend from United States sources subject to gross United States withholding tax, the United States expects the payee's country of residence to provide a foreign tax credit or comparable double tax relief even in cases where the withholding tax exceeds the local income tax rate on the net income from the transaction. The combination of gross withholding taxation and full crediting of such tax against the recipient's home country income tax is the prevailing international system for providing a simple method of taxing nonresidents while avoiding a discriminatory tax burden on cross border investment flows, and for thereby preserving "export neutrality" with respect to capital investment. The IRS's position that foreign taxes are expenses rather than taxes for purposes of an economic substance test is contrary to this reciprocal allocation of international taxing jurisdiction.

The Tax Court in *Compaq* was unable or unwilling to treat foreign taxes as taxes. Instead, the Tax Court evidently concluded that the foreign tax credit was not a mechanism to account for taxes already paid (to the Netherlands), but instead some sort of economic equivalent of a subsidy comparable to the investment tax credit. In so acting, the Tax Court simply ignored the fact that, notwithstanding a similarity in the computational mechanics of a credit (as distinguished from a deduction), the premises on which the two different "credits" are allowed are conceptually unrelated to each other. They share only a computational convention (directly reducing the amount of United States taxes due rather than reducing taxable income to be taxed).

III. *Compaq*-Like Transactions Are of Merely Historical Interest

Putting aside the legal issue for a moment, is there some challenge lurking in *Compaq* and *IES* that will

allow taxpayers now to do what the government did not like in those cases? No.

The actual dividend capture arbitrage transactions engaged in by *Compaq* and *IES* are no longer viable. Code Sec. 901(k), enacted in 1997, denies a foreign tax credit with respect to foreign income taxes imposed on dividends paid on stock held for 15 days or less. Moreover, the holding period under Code Sec. 901(k) to qualify for foreign tax credits is tolled for any periods during which risk of loss with respect to the stock is diminished.³¹ Congress thus responded to policy concerns with respect to this type of low-risk tax arbitrage by providing a specific statutory rule requiring more risk to be assumed to get the benefit of the credits. This measured legislative approach is clear in scope and avoids disrupting the fundamental assumptions of the foreign tax credit.

The sense of impending doom or catastrophe in the IRS's continuing struggle against perceived tax shelters is thus not warranted by the risk that U.S. multinationals with excess limitation and capital gains will engage in *Compaq*-type transactions. It is perhaps imaginable that some U.S. multinational taxpayers will engage in a dividend capture transaction with open position ownership risk longer than 15 days, thus avoiding the strictures of Code Sec. 901(k). That problem is hardly up to "catastrophe" standards and was presumably not what the commentators had in mind. If taxpayers are willing to take the risks associated with the holding period prescribed by Congress in specific legislation, it is hardly a catastrophe that taxpayers will be able to claim a foreign tax credit for arbitrage profits if the market prices the cum dividend and ex-dividend value of foreign issuer stock without regard to the availability of a foreign tax credit to some potential buyers.

The significance of *Compaq* as a tax shelter precedent is also limited by the unique nature of the longstanding rules for determining who the taxpayer is with respect to withholding taxes on dividends. The tax regime has long relied on a "technical taxpayer rule" to treat the record owner of a dividend as the payer (the party for whose account the tax is paid) of the withholding tax, regardless of whether the taxpayer bears the economic cost of the withholding tax.³² Whatever the merits of such a bright-line rule of convenience in today's modern world, it is not shocking that courts have not acquiesced in the IRS's attempt to retroactively overturn through litigation this long-standing rule (embedded in its own regulations). The IRS could well have more success

arguing economic sham theories in contexts where economic substance is relevant than it has had in effectively rejecting its own elaborate edifice for dealing with foreign tax credits and cum-dividend buyers by invoking Rule 42.³³

IV. What Is the Role of Ownership Risk in Evaluating *Compaq*?

The aspect of the *Compaq* decision that might be arousing the most controversy is the fact that the taxpayer prevailed despite the fleeting interest in the economic success or failure of Royal Dutch Petroleum. Although *Compaq* owned the ADRs for four days (between the settlements of its two trades), it executed the buying and selling cross trades only moments apart pursuant to a pre-arranged plan with the same counterparty. It had little or no real risk that the dividend would not be paid (although the Eighth Circuit in *IES* identified this conceptual risk as a cognizable confirmation of the requisite share “ownership” to qualify for a foreign tax credit). The amount of the dividend was mathematically certain: *Compaq* bought the ADRs after the dividend declaration date. Nevertheless, a long standing regulation deals specifically with this situation and requires *Compaq*, as the cum dividend buyer, to recognize dividend income rather than a return of cash included in the purchase price of the Royal Dutch ADR.³⁴

It is important to note, however, that the IRS made a strategic decision to litigate the case on the law rather than by challenging on the facts *Compaq*'s ownership of the Royal Dutch ADRs and its entitlement to “dividend income.” The IRS was more interested in establishing a legal foundation for its position in Notice 98-5 (which is not risk-based) that foreign taxes are an expense, than it was in proving that this particular taxpayer did not enter into a genuine transaction.³⁵ *The IRS agreed that the trades took place and that Compaq owned the shares on the dividend record date and was entitled to the dividends. This was not the result of a mistake or ineptitude. Quite the contrary, the government made a calculated decision to attempt to create through litigation a new substantive rule. It failed in that attempt.*

The IRS did not seriously contest the position that *Compaq* had sufficient “ownership” of dividend-paying stock to be required to report the gross dividend

as dividend income.³⁶ The argument that the taxpayer in *Compaq* was not sufficiently the owner of the stock (based on its limited risk) and thus should not be treated as the owner of a “dividend” on such stock is an argument that could be asserted in future cases if quantum of risk is to become the measure of an appropriate economic return in testing putative tax shelters. The fact is that *Compaq* and *IES* were not argued as cases with too little risk; the cases turned on the treatment of foreign taxes when one is required by agreed facts to assume sufficient ownership for tax purposes.

Taxpayers should bear in mind that tax ownership of the ADRs was a necessary precondition of the court's holding. Consequently, when the Fifth Circuit, citing the Eighth Circuit's *IES* decision, noted that “[t]he absence of risk that can be legitimately eliminated does not make a transaction a sham,” it was essentially saying that if one assumes that a taxpayer is already the owner of stock for tax purposes, the elimination of risk with respect to that stock does not cause a tax benefit ordinarily associated with ownership to evaporate. Of course, Congress has legislated that tax ownership, by itself, is not always sufficient to secure specific tax benefits—the ownership must frequently be sustained and unaccompanied by risk reduction. This willingness of Congress to precondition the tax benefits associated with ownership on the length of time that a taxpayer assumes undiminished market risk can be seen most clearly in (1) the rate preference granted to individuals for long-term capital gains,³⁷ (2) the denial of dividends received deduction in certain instances,³⁸ (3) the denial of a deduction for substitute payments in short sales in certain circumstances,³⁹ and (4) of course, the denial of the foreign tax credit in Code Sec. 901(k) and (l). Congressional intervention in this manner is justified, and has the added benefit of surgically targeting the precise issue in question. This approach appears to have historically been adopted by Congress (and rightfully so) in lieu of intervening in the common law of tax ownership—an area in which the *Compaq* bears no relevance.

The government might also have argued that the dividend capture transaction was really nothing more than a circular cash flow, and that the selling shareholder had already captured the economic amount of the dividend in pricing the sale and that *Compaq* did not buy shares cum dividend but rather bought shares ex-dividend with a constructive receipt of cash for the benefit of the seller to which *Compaq* was

effectively committed to return the amount of the dividend through the cross trade. Such arguments have been considered from time to time in domestic dividend capture transactions,⁴⁰ and would go directly to what seems to be most bothersome about the facts in these cases: the taxpayer really did not have much ownership for very long.⁴¹

To state the obvious, however, the dividend was not structured to compensate the recipient for risk assumed. The dividend was a specific amount to be received shortly from Royal Dutch Shell. It had been purchased as such when the amount and time of payment were virtually certain. The dividend was a return on investment to someone prior in the change of ownership, and the cum dividend price was a payment in respect of the return on investment to the last seller in the chain (or perhaps to some predecessor). The amount received by the cum dividend buyer is a “dividend” because Code Secs. 301 and 316 say it is, and it will be a “dividend” even if the Royal Dutch ADR lost either none or all of its value on or after the purchase date. Code Secs. 301 and 316 treat the payment as a dividend without regard to a risk/reward relationship. Indeed, if the dividend is to be taxable income at all, rather than a return of capital, one must accept that the characterization of a dividend as an item of income is necessarily divorced from economic compensation for risk. Indeed, the regulations dealing with cum dividend transactions expressly so provide.⁴² The mechanical rule in the cum dividend regulation may have been drafted by someone who assumed that the buyer and the seller of cum dividend stock would be taxed under similar regimes, and not by someone with a view to deciding how to account for cross-border allocations of taxing jurisdiction when some buyers would be taxed one way and other buyers would be taxed differently. The technical taxpayer rule,⁴³ however, was drafted to deal with cross border transactions and decides who is to receive a foreign tax credit.

Once the Fifth Circuit determined that pre-tax profit is measured before both foreign and domestic tax, the *Compaq* case becomes an unexceptional tax shelter case. Properly measured, based on its *stipulated* ownership, *Compaq* earned a significant pre-tax profit on its investment, even compared with the United States tax benefit achieved. *Compaq*’s pre-tax profit so measured exceeded the thresholds in the examples in Notice 98-5 and in the facts of the *Sheldon* case.⁴⁴

Coda (2009)

Since the article was first written in 2002,⁴⁵ *Compaq* has been applied or invoked in at least three cases in the Fifth Circuit. The first, *Weiner*,⁴⁶ involved a high-net-worth individual taxpayer who invested in a farm partnership that was successfully challenged by the IRS in Tax Court litigation. The District Court proceeding involved the taxpayer’s effort to recover penalty interest assessed under Code Sec. 6621(c).⁴⁷ The District Court determined that the imposition of the penalty interest for any “sham or fraudulent transaction” described in the statute was to be tested under case law. The District Court stated that the Fifth Circuit in *Compaq* did not decide whether the economic sham test was a “two-prong” test⁴⁸ or a multiple “factors” test.⁴⁹ The District Court went on to decide whether the purpose of a partner’s investment was to be measured at the partner or partnership level, an issue not involved in *Compaq*. *Weiner* is interesting in its determination that *Compaq* requires a determination with respect to both business purpose and economic substance, and the Court’s implicit acknowledgement that deciding on the need for a conjunctive or disjunctive test would depend on being presented with a case in which a decision on this point would affect the outcome. So, the suspense builds.

In March 2006, another District Court in Texas decided that a “fair reading” of *Compaq* “requires the Court to disregard [the putative shelter transaction] only if the transaction was entered into without a legitimate business purpose and lacked economic substance.”⁵⁰ The transaction at issue was a computer lease with a separation of income and loss from a burned out computer lease. The income arose from a Code Sec. 708 partnership termination and ended up with the Pequot Indian tribe. The loss ended up disallowed by the Court because: “Applying *Compaq*’s sham transaction analysis, the Court finds that [the taxpayer] had no legitimate business purpose for entering into the [transaction] ... and there was no reasonable expectation of profit.”⁵¹

The taxpayer lost the tax benefit it was seeking when it entered into the tax-motivated transaction. It lost under *Compaq*. It would also have lost under a “clarified” or “codified” economic substance statute.

In 2007, The District Court for the Eastern District of Texas followed *Compaq* in finding a putative “loan” to be devoid of economic substance without ever having to decide whether there is a “one-prong” or

“two-prong” test in the Fifth Circuit.⁵² It is probably worth noting that the government cited *Compaq* in its brief in support of its challenge to the “BLIPS” tax shelter in issue in that case. The government carefully noted that the Court had in *Compaq* declined to decide whether in some case yet to come before it, there would be a difference if only one prong of the two prong test were to be satisfied, but relied on it to demonstrate a failure by the BLIPS investors under each prong.⁵³ The Fifth Circuit Court of Appeals on May 15, 2009 affirmed the District Court’s determination although it took the occasion to decide that the “two prong” test should apply in the Fifth Circuit, whereas it had previously declined to decide if the Fifth Circuit was a “one prong” or “two prong” economic substance jurisdiction.⁵⁴

The application of *Compaq*’s learning on economic substance appeared in 2008 in the United States Court of Federal Claims. In *Jade Trading*⁵⁵ the court cited *Compaq* in support of its determination that the taxpayer has the burden of proving that a transaction has economic substance and that the government does not have the burden of proving a transaction’s lack of economic substance.⁵⁶

The IRS has also relied on *Compaq* to identify the courts’ general practice of examining two factors in evaluating whether a transaction lacks economic substance: whether the taxpayer was motivated by no business purpose other than obtaining tax benefits, and whether the transaction lacks objective

economic substance because it has no possibility of profit.⁵⁷ Nothing in the TAM suggests that the IRS was relying on *Compaq* as an example of a case in which the court misunderstood either business purpose or economic substance.

Tax shelters seem only rarely to present the situation where one but not both “prongs” or “factors” are involved. Unless, of course, the evil complained of is found in cases like *Nassau Lens*⁵⁸ (choice between debt and equity) and *Sam Siegel*⁵⁹ (choice between domestic and foreign corporations to conduct foreign business). Those “tax shelters,” interestingly enough, involved real people doing useful things, in contrast to tax planners.⁶⁰ Those cases could turn out differently under the proposed tests⁶¹ for codification of economic substance, even if there are no “real” tax shelters that would.

It is always tempting to leap to conclusions, to join the army of the defenders of the faith in protecting the country against the predations of tax planners. In order to provide a real benefit to the formulation and implementation of sensible tax policy, however, it is also necessary that the doomsday assertions are rooted in reality. Much of the criticism of *Compaq* is unencumbered by a clear recognition of what the court actually decided based on the undisputed facts as to ownership. Based in part on the chorus of doom, the Congress has continued for several sessions to pursue “codification” or “clarification” of a doctrine that it may understand only imperfectly.

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* The views expressed herein are those of the author and do not represent the views of the Treasury Department, any other Federal agency, or the United States Government.

¹ Robert H. Dilworth and L.G. “Chip” Harter, “The Fifth Circuit’s *Compaq* Decision: Foreign Taxes Are “Taxes” (Nothing More, Nothing Less)” (in annual updates of the PLI series “Tax Strategies for Corporate Acquisitions, Dispositions, Spin-offs, Joint Ventures, Financings, Reorganizations and Restructurings”).

² *Compaq Computer Corp.*, CA-5, 2002-1 USTC ¶ 50,144, 277 F3d 778 (2001).

³ Reg. § 1.61-9, discussed below.

⁴ The latest version was advanced by the Obama Administration in May 2009. U.S. Dep’t of the Treasury, “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals” (May 2009). This version reverts to calling the proposal “codification” of the economic substance doctrine. A 2006 version, re-badged as “clarification,” in section 411 of the Senate

engrossed version of H.R. 4297, was passed by the Senate February 6, 2006. 109th Cong. 1st Sess. (substituting the S. 2020 for the text of H.R. 4297). The provision was dropped in conference, but it has continued as a gleam in the eye of members of the Senate Finance Committee. See, e.g., *Education Tax Package Expected After Memorial Day Break*, TAX NOTES TODAY, May 23, 2007, 2007 TNT 100-2 (“The package is expected to focus on the HOPE and lifetime learning tax credits. Baucus told reporters the education tax package could be in the vicinity of \$15 billion to \$20 billion. When pressed for possible offsets the committee was considering, Baucus offered few details, but when asked specifically about the possibility of codifying the economic substance doctrine, Baucus said it was “certainly a pay-for on the table.”) The Congressional Research Service in March 2008 summarized the various iterations of the legislative initiatives in the 110th Congress (CRS 22846, Mar. 24, 2008). The proposal appeared in various “pay fors” in

legislation addressing various expenditures deemed worthy by the proponents. The proposed legislation included the Food and Energy Security Act of 2007, H.R. 2419, § 12521, the Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007, H.R. 2345, Title I, 110th Cong., the Stop Tax Haven Abuse Act, H.R. 2136, § 401; S. 681 § 401, 110th Cong., the Responsible Fatherhood and Healthy Families Act of 2007, H.R. 3395, § 204; S. 1626, § 204, 110th Cong., the Export Products Not Jobs Act, S. 96, § 201, 110th Cong., the Heartland, Habitat, Harvest and Horticulture Act of 2007, S. 2242, 110th Cong., the AMT Relief Act of 2007, H.R. 4351, § 211, 110th Cong., and the Tax Reduction and Reform Act of 2007, H.R. 3970, § 3501, 110th Cong.

⁵ *Compaq Computer Corp.*, 113 TC 214, Dec. 53,549 (1999).

⁶ *IES Industries, Inc.*, CA-8, 2001-2 USTC ¶ 50,471, 253 F3d 350.

⁷ See David Cay Johnston, “Ruling Eases Restrictions on Tax Shelters for Companies,”

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- NY TIMES, Jan. 3, 2002, at C.1 (noting that some believe the *Compaq* case “is disastrous for the integrity of the tax system”); Lee Sheppard, *Should Riskless Profit Equal Economic Substance?* (Jan. 14, 2002) (noting that the 5th Circuit “nearly succeeded in reading the business purpose and risk elements out of the economic substance inquiry”); Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong in Compaq v. Commissioner*, 2000 TNT 19-31 (Jan. 28, 2002) (“Even at their most narrow, Compaq and IES are abdications of the courts’ responsibility in the tax system”) (hereinafter, “Shaviro & Weisbach”).
- ⁸ Mary Heath & Darren Allen, *The Ever-Expanding Economic Substance Doctrine: How the Tax Court Took Compaq Computer Corp.’s Foreign Tax Credit Away*, 40 TAX MAN. MEMO. (Special Edition) 301 (Oct. 25, 1999); Marc Teitelbaum, *Compaq Computer and IES Industries—The Empire Strikes Back*, 20 TAX NOTES INT’L 791 (2000), 2000TNT 25-67 (Feb. 4, 2000); Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters and the Compaq Case*, 88 TAX NOTES 221 (2000), 2000 TNT 132-80 (July 7, 2000); David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999); Peter C. Canellos, *A Tax Practitioner’s Perspective on Substance, Form and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); George K. Yin, *Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. REV. 209 (2001); David P. Hariton, *Tax Benefits, Tax Administration and Legislative Intent*, 53 TAX LAW. 579 (2000). Many of these articles were cited by the 5th Circuit in its opinion (see note 5).
- ⁹ For a very thoughtful examination of the antecedents of the “technical taxpayer rule,” see James M. Peaslee, *Economic Substance Test Abused: Notice 98-5 and the Foreign Taxpayer Rule*, 79 TAX NOTES 79 (Apr. 6, 1998) (describing the basic authorities articulating the standards for determining who is liable for a foreign tax). For a very helpful review of the history of the foreign tax credit and its theoretical underpinnings, see Michael J. Graetz & Michael M. O’Hear, *The ‘Original Intent’ of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).
- ¹⁰ It has been noted that “this approach, which differs from the practice of requiring the seller of a bond to bifurcate the transaction and to report the interest accrued to the date of sale, seems largely a matter of administrative convenience.” See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, 7th Edition, ¶ 8.07[1][d].
- ¹¹ LEWIS CARROLL, *ALICE IN WONDERLAND*, Ch. XII: “At this moment the King, who had for some time been busily writing in his notebook, called out ‘Silence!’ and read from his book, ‘Rule Forty-two. All persons more than a mile high to leave the court. ...’ Well, I shan’t go, at any rate, ‘said Alice: besides, that’s not a regular rule: you invented it just now.’ ‘It’s the oldest rule in the book,’ said the King. ‘Then it ought to be Number One,’ said Alice.”
- ¹² The facts, as recited by the Fifth Circuit, indicate that *Compaq’s* aggregate purchase price for the cum dividend shares was approximately \$887.6 million. Its aggregate sales price for the ex-dividend shares was approximately \$868.4 million. As the shareholder of record on the record date, *Compaq* was entitled to a gross dividend of approximately \$22.5 million, from which approximately \$3.4 million (or 15 percent) of Dutch tax was withheld (resulting in a net cash payment received by *Compaq*, after withholding of Dutch tax, of approximately \$19.2 million). The cum dividend price (\$887.6 million) exceeded the ex-dividend price (\$868.4 million) by \$19.2 million—which equals 85.33 percent of the gross dividend amount (\$22.5 million), and which also equals the amount of the net cash received after withholding tax. In order to simplify the discussion, we will use X as the ex-dividend price, 100 as the gross dividend, and 15 as the Dutch withholding tax. This is similar to the approach used by the government in its brief to the Fifth Circuit and focuses the discussion on readily apparent numerical relationships.
- ¹³ Such a cross trade can be broken up on the floor of the Exchange—*i.e.*, another party could have intervened and sold cum dividend shares to *Compaq* or bought ex-dividend shares from *Compaq*. It is worth noting that in the *IES* case, some of the trades were not made on an exchange but were effected in after hours trading in a private sale. The government did not challenge the reality or economics of the *IES* after-hours trades, and left the issue to be resolved on the basis of the special rule for treating foreign taxes as an expense in testing economic substance rather than on the basis of a possible sham in fact argument based on lack of ownership.
- ¹⁴ See Revenue Act of 1918, ch. 18. § 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080-82 (1919) (§222(a)(1) provided a foreign tax credit for individuals, §238(a) provided a similar credit for domestic corporations, and §240(c) described creditable taxes).
- ¹⁵ See generally, Code Sec. 904(d).
- ¹⁶ The amount distributed to *Compaq* by Royal Dutch was treated as a “dividend” for United States tax purposes because of the mechanical per se rules in Code Secs. 301 and 316, and Reg. § 1.61-9(c). As previously noted (see note 10, *supra* and accompanying text), these rules are not rooted in a policy intended to reflect “economic substance,” but are largely rules of convenience. Economically, the buyer of cum dividend stock is buying a short-term receivable (two weeks in *Compaq*) that will return to it a portion of the inflated price that it paid for the stock (attributable to the foreseeable and foreseen dividend to be paid on the dividend payment date). Because of the short-term nature of the receivable and the fact that the ex-dividend market price will be less than the cum dividend market price by an amount determined by reference to the dividend amount, the buyer is effectively receiving a return of its investment (because it did not subject the amount of the distribution to significant market risk, and did not anticipate its generating any independent return), rather than a return on its investment. Therefore, another sensible rule might treat the seller of cum dividend stock as the economic recipient of the dividend of a specific amount. However, for tax purposes, rather than attempt to capture economic substance, the rules adopt a mechanical rule of convenience—the cum dividend buyer is treated as the recipient of the dividend if he buys as of the record date but not if he buys after the record date and on or before the dividend payment date. The difference in tax treatment is not based on a determination that the risk of the recipient changes based on the record date. This difference in treatment is instead the result of artificially imposed rules that specifically discard economic substance in requiring the cum dividend buyer to report and pay tax on dividend “income” that is not really an accretion to wealth in any economic sense.
- ¹⁷ Passive income is income which, if earned by a controlled foreign corporation, would be foreign personal holding company income. Dividends on the Royal Dutch ADRs, if earned by a controlled foreign corporation, would have been foreign personal holding company income. See Code Secs. 904(d)(1) and 954(c)(1).
- ¹⁸ Representing the Dutch withholding tax imposed on the dividends.
- ¹⁹ This assumes, for purposes of illustration of the calculation at this step, that the transactions described in the case represented *Compaq’s* entire worldwide income. As a result of this simplifying assumption made for purposes of the describing why *Compaq* needed other income to take advantage of the arbitrage opportunity, the tentative amount of *Compaq’s* United States tax liability would be 35 (resulting from: 100 dividend income + 85 pre-existing capital gain (from another transaction) – 85 capital loss (from the sale of the ADRs ex-dividend), multiplied by a United States

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- tax rate of 35 percent).
- ²⁰ Although the losses on the sale of the ADRs would not be deductible against the dividends in calculating worldwide taxable income by virtue of Code Sec. 1211 (another deliberate departure from “economic substance”), they do reduce the total amount of foreign source dividend income in the passive basket. See Reg. §1.865-2(b)(1). It should be noted that Reg. §1.865-2(b)(1) was promulgated in 1999, and did not apply to the years in which Compaq carried out the transactions in question. At the time *Compaq* entered into the transactions (1992), there may have been an argument that the capital losses did not need to be allocated against the dividend income under the then applicable expense allocation regulations (Reg. §1.861-8(e)(7)). See *International Multifoods, Inc.*, 108 TC 579, Dec. 52,100 (1997) (applying the sourcing provisions of Code Sec. 865 without regard to Reg. §1.861-8(e)(7)). If the argument against allocating the capital losses against the dividend income were to prevail, it would result in an increase in the numerator of the limiting fraction and increase the allowable foreign dividend from tax credit even without other excess limitation foreign source income. However, the risk of such an argument failing (especially in light of *Black & Decker*, 62 TCM 1204, Dec. 47,734(M), TC Memo. 1991-557, *aff’d*, CA-4, 93-1 USTC ¶50,125, 986 F2d 60 (holding that a worthless stock deduction should be allocated against foreign source income because dividends from such stock had been and would have been foreign source)) would have been sufficiently great that the *Compaq* would have wanted to have available limitation in the basket to which the highly taxed net passive income would have been “kicked” (the general limitation basket) if the capital losses on Royal Dutch ADRs were to be allocated against the dividends under the principles of Reg. §1.861-8(e)(7).
- ²¹ Resulting from: 100 dividend income + 85 pre-existing capital gain (from another transaction) – 85 capital loss (from the sale of the ADRs ex-dividend).
- ²² 35 (tentative United States tax) multiplied by 15/100 (the limiting fraction).
- ²³ Losses on the sale of the ADRs would not be deductible against the dividends in calculating taxable income. This results from a fixed, mechanically applied rule (Code Sec. 1211), whose departure from “economic substance” as to the cum dividend buyer/reseller is also embedded in the Code because of legislative decisions that subordinated economic substance to other priorities.
- ²⁴ See Reg. §1.904-4(c)(3).
- ²⁵ 1998-1 CB 334. [Notice 98-5 was subsequently withdrawn by Notice 2004-19.]
- ²⁶ Apparently the government views Code Secs. 301 and 316 as somehow being better expressions of economic substance than Code Sec. 901. From a strictly cash on cash “economic” standpoint it might make sense to treat distributions as first a return of capital until all of the invested capital has been recovered. A technical correction to the Code would be necessary to achieve this result.
- ²⁷ After all tax, the net benefit is 65 percent of the arbitrage amount of 15, or 9.75 and the tax benefit is approximately 9.75, the net value of the capital loss deduction in excess of the incremental United States federal income tax on the 100 dividend.
- ²⁸ *S.R. Sheldon*, 94 TC 738, Dec. 46,602 (1990). The *Sheldon* case is a precedent arising out of an individual tax shelter transaction. That case involved an individual taxpayer who entered into a series of leveraged repurchase agreements with respect to Treasury Notes, a form of tax straddle. The taxpayer incurred economic losses on most of his transactions and an overall economic loss on the series of transactions. He made a small pre-tax profit on several of the transactions. The Tax Court disallowed the tax benefits from all of his transactions, including the ones that produced small economic profits. The Tax Court dismissed the small economic profits on the profitable trades as *de minimis*, and held that tax benefits are not available where they are “substantially disproportionate” to the underlying economic profit potential. Notice 98-5, in its examples, applies a “substantially disproportionate” ratio of approximately 8 tax benefit to 1 economic benefit (or greater). The *Sheldon* test has been applied, to some extent, to corporate tax shelter analysis most notably in the Tax Court decision in *Saba Partnership*, 78 TCM 684, Dec. 53,604(M), TC Memo. 1999-359. In *Saba*, the tax benefit to potential economic benefit was approximately 17:1. A discussion of the “substantially disproportionate” test ceases to be practically relevant in *Compaq* once the proposition is accepted that foreign taxes are taxes and that in testing the tax to economic benefit ratio one looks at foreign taxes as taxes either before or after taxes.
- ²⁹ For purposes of the hypothetical used throughout this article, we will assume these expenses total 7. This “rough justice” number is calculated as follows: The Fifth Circuit opinion indicates that *Compaq* was entitled to a gross dividend of \$22.5 million. It also indicates that *Compaq* incurred \$1.5 million of expenses. Therefore, for each dollar of gross dividend it received, *Compaq* paid \$0.07 of expenses. Therefore, we assume in the current example that expenses = 7, and that this generates an additional tax deduction, the benefit of which is 2.45 (35% of 7). Therefore, the after-tax, after-expense economic profit, = 5.2 (9.75 minus 65 percent of 7). The tax benefit must also be increased by the value of the deduction of these expenses: 2.45 (or 35 percent of 7). As a result, the tax benefit to economic benefit ratio is 12.2 to 5.2, or 2.35 to 1.
- ³⁰ See Shaviro & Weisbach, note 7, *supra*.
- ³¹ Code Sec. 901(k)(5), which imports the tests under Code Sec. 246(c)(3) and (4).
- ³² See Reg. §1.901-2(f)(1) & (2).
- ³³ See note 11, *supra*.
- ³⁴ Reg. §1.61-9(c).
- ³⁵ The government has previously pursued an alternative approach to challenge the substance of domestic dividend capture transactions based on short term investments that merely recycle cash flows. See, e.g., *M. Hart*, CA-2, 64-2 USTC ¶9857, 338 F2d 410, *aff’d*, 41 TC 131, Dec. 26,376 (1963).
- ³⁶ In cases involving domestic dividend capture transactions the government has argued successfully on conventional grounds that a dividend capture transaction lacked economic substance because of a number of the factors that were also present in *Compaq* and *IES*. See *Hart*, *supra*.
- ³⁷ Under Code Sec. 1(h), individuals are subject to a lower tax rate on long-term capital gains—i.e., gains from the sale or exchange of capital assets held for more than a year. Consequently, ownership for a sustained period of time (more than a year) is required to achieve the preferential tax rate—risk-taking is a prerequisite for the tax benefit. See 1997 Bluebook, at 48 (“The Congress believed it is important to encourage risk taking and believed a reduction in the taxation of capital gains will have that effect.”) Congress has also limited taxpayers’ ability to earn the long-term capital gains rate preference while simultaneously reducing risk with respect to the holding. For example, under Code Sec. 1233, if a taxpayer owns “substantially identical property” at the time it enters into a short sale of property, the holding period of the substantially identical property is treated as beginning on the date the short sale is closed (thereby resulting, possibly, in short-term capital gain if the substantially identical property is sold).
- ³⁸ Under Code Sec. 246(c), corporate shareholders that clearly own stock and the dividends paid on that stock, are nevertheless denied the dividends received deduction if they do not own the stock for more than 45 days within a specific period immediately before and after they become entitled to receive the dividend. This holding period is tolled when the taxpayer has reduced or eliminated the risk of loss on the underlying stock.
- ³⁹ In general, substitute payments made by the stock borrower in a short sale in lieu of

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dividends are deductible under Code Secs. 162 or 212. However, if fewer than 46 days elapse between the date of the short sale and the date the stock borrower closes out the short sale by returning stock to the stock lender, then Code Sec. 263(h) precludes this deduction and requires that these substitute payments be capitalized into the basis of the stock purchased to repay the lender. As a result, if Code Sec. 263(h) applies, the stock borrower has less gain (or additional loss) equal to the amount of the in-lieu-of payments (but, of course, it is precluded from current deductions against ordinary income). This provision was enacted to prevent taxpayers from converting ordinary income to capital gain by entering into a short sale of stock just before the ex-dividend date. As seen clearly in *Compaq*, when a stock pays a dividend, the stock typically declines in value by an amount that approximates the value of the dividend distribution. A taxpayer could enter into a short sale of stock just before the ex-dividend date and receive cash representing the value of the dividend to be paid. The taxpayer would then make a substitute dividend payment to the stock lender, which, in the absence of Code Sec. 263(h), it would deduct against ordinary income. When the taxpayer subsequently purchased the stock to close out the short sale, it would pay less money for the stock than it received in the short sale — resulting in a capital gain. This creation of equal amounts of capital gain and ordinary deductions is eliminated by Code Sec. 263(h).

⁴⁰ See, e.g., GCM 38502 (Sept. 18, 1980), commenting on proposed Rev. Rul. 82-11.

⁴¹ As noted above, the basic mechanical rule is that, in the case of a sale cum dividend on or before the record date, the dividend is taxable to the purchaser. Reg. § 1.61-9(c). This rule that does not necessarily reflect economic substance, but has been retained for both convenience, certainty and revenue maximization (“The fact that the purchaser may have included the amount of the dividend in his purchase price in contemplation of receiving the dividend does not exempt him from tax.”)

⁴² It is perhaps worth noting that even in Reg. § 1.61-9(c), it is only “ordinarily” that the

dividend is taxable to the cum dividend purchaser. The government did not argue that the Compaq transaction would be extraordinary for this purpose, and took the position that it did deliberately. If what is actually wrong with the transaction is that the dividend should not have been taxed to Compaq, and that this is a really important issue in taxation of cross border investment that is not adequately reached by Code Sec. 901(k), it might be possible to expand on the concept of “ordinarily” in Reg. § 1.61-9(c). Reg. § 1.901-2(f)(1).

⁴³ See note 28.

⁴⁴ That article did not address, and this update does not address the broader philosophical foundations for allowing a foreign tax credit and the degree of nexus that might be required between the imposition of a foreign tax and the economic burden of that tax. That issue is more directly raised by the proposed regulations issued with respect to the technical taxpayer rule and with respect to highly structured transactions designed to double dip the foreign tax credit and the underlying tax. See, e.g., Notice of Proposed Rulemaking, “Determining the Amount of Taxes Paid for Purposes of Section 906,” 2007-1 CB 1015 (Apr. 23, 2007). The theoretical underpinnings are a bit obscure.

⁴⁵ *M.A. Weiner*, DC-Tex., 2003-1 USTC ¶ 50,191, 255 FSupp2d 673, *aff’d in part, rev’d in part*, 2005-1 USTC ¶ 50,137, 389 F3d 152.

⁴⁶ The Court noted that the particular provision had been repealed for years commencing after 1989. 255 FSupp2d 673, 675 (footnote 3).

⁴⁷ *Rice’s Toyota World, Inc.*, CA-4, 85-1 USTC ¶ 9123, 752 F2d 89.

⁴⁸ *ACM Partnership*, CA-3, 98-2 USTC ¶ 50,790, 157 F3d 231.

⁴⁹ *Transcapital Leasing Associates 1990-II, LLP*, DC-Tex., 2006 WL 897723, at 25 (2006).

⁵⁰ *Id.*, 2006 WL 897723 at 29.

⁵¹ *Klamath Strategic Investment Fund, LLC*, 472 FSupp2d 885 (Jan. 31, 2007).

⁵² United States Post-Trial Brief at pp. 5, 8 (“Plaintiffs rely heavily on *Compaq*, but that case has a very important distinction. As the Fifth Circuit noted in that case (277 F3d, at 786): “Compaq made both a pre-tax profit and an after-tax profit from the ADR trans-

action.” In the present case it is undisputed that plaintiffs lost money”), 22 (“It is black letter law that economic substance analysis requires not just a potential for profit—buying a lottery ticket provides a potential for profit. Rather that fundamental doctrine requires a reasonable basis for profit. *Compaq*, 277 F3d at 781-82.”).

⁵³ *Klamath Strategic Investment Fund v. United States*, ___ F.3d ___ (5th Cir. May 15, 2009). The Court of Appeals seemed to construe the District Court decision to include a determination that the taxpayers had a genuine profit motive and were not solely driven by the desire to avoid taxes. The District Court had, however, determined that the taxpayers had no tax-independent business purpose. The outcome was thus not significantly affected by the number of prongs to the test. The decision was affirmed by applying the same reasoning to both prongs, or to either.

⁵⁴ 80 Fed. Cl. 11 (Dec. 21, 2007), reconsideration denied 2008 U.S. Claims Lexis 81 (Mar. 20, 2008).

⁵⁵ 80 Fed. Cl. 11, 115 at note 67.

⁵⁶ LTR 200807015 (Nov. 7, 2007).

⁵⁷ *Nassau Lens Co.*, CA-2, 62-2 USTC ¶ 9723, 308 F2d 39 (optometrist permitted to incorporate his business using a combination of debt and equity, overcoming objection by IRS that doing so would result in a lower overall tax burden than exclusive reliance on shareholder equity to capitalize the business). It is interesting to note that the IRS took this all the way to the Second Circuit.

⁵⁸ *S. Siegel*, 45 TC 566, Dec. 27,882 (1966) (acq. 1966-2 CB 3) (incorporation of Panamanian rather than domestic corporation to conduct business in Cuba permitted over IRS objection that reduction of U.S. tax by use of a foreign corporation rather than a domestic corporation was purely tax motivated since domestic corporation with a Cuban branch would provide limited liability)

⁵⁹ See note 30 (“Another common complaint about antiabuse doctrines is that they inhibit so-called legitimate tax planning. But we should always keep in mind that even the most mundane tax planning is not the same as, say, curing sick people, inventing a new product, or even driving a bus.”)

⁶⁰ See note 4 above.

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