From the Editor:

Proposed British GAAR Pales Next To Economic Substance Doctrine

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The economic substance doctrine has been used by the government to successfully attack a myriad of tax shelters over the last 10 years. Courts have expanded economic substance jurisprudence to the extent that many commentators have fretted that future judges might be inclined to use the doctrine as a first resort, ignoring other statutory-based means of disallowing tax avoidance transactions. Congress, however, didn't think the judicial doctrine went far enough, and it codified economic substance in section 7701(e). Perhaps with an eye on the fate of their colleagues across the pond, British practitioners have made sure that their own antiavoidance rule doesn't have quite the same reach as the U.S. doctrine.

In fact, the proposed British antiavoidance rule will likely do very little, according to Lee Sheppard. Calling the rule limited and largely useless, Sheppard writes that the drafters of the white paper containing it were primarily concerned with keeping the United Kingdom business friendly. The GAAR is designed to go after only the most egregious transactions and would ask whether a transaction was abnormal, Sheppard says. The drafting of the rule is too narrow — a problem with many British laws — and would excuse even abnormal tax benefits if they were achieved with a pure motive, she writes. In other words, the GAAR would apply only to transactions with no other purpose than an abusive tax result. Sheppard also criticizes the evidentiary rules of the GAAR, which place the burden on the government to show an abnormal scheme and abusive result. The rule doesn't even increase the discretionary powers of the government, she laments. Sheppard concludes that money laundering rules show a better approach to analyzing abusive transactions and have been shown to work in countries like Belgium. (For her analysis, see p. 1182.)

U.S. taxpayers would be the first to point out that the economic substance doctrine is far from toothless. The differing approaches in the United Kingdom and the United States probably conceal a larger lesson about each nation's tax system. With a population already inured to high tax rates and a VAT, the U.K. government seems less interested in harshly punishing business as it tries to stem its debt-to-GDP crisis. U.S. lawmakers of both parties are afraid of raising taxes on the general populace and seem far more interested in playing at the fringes of the tax system to raise revenue, and they have long used penalties and antiabuse provisions as pay-fors in a variety of legislation.

Commentary

Many portions of the tax code are indexed to inflation. Without inflation adjustments, individuals would be faced with an erosion of their purchasing power and many stealth tax increases. For example, failing to index for inflation is one of the major problems with the AMT. In his special report, James Young discusses 2012 inflation adjustments to specific portions of the individual tax system that are tied to the Consumer Price Index year ending in August (p. 1219). Young analyzes tax rate schedules, standard deductions, exemptions, the annual gift tax exclusion, and some computational elements of various tax credits. Young hopes that identification of some of those provisions will assist taxpayers and practitioners in year-end and other tax planning.

Since 2008, a REIT that owns a healthcare facility has been able to lease the property to a taxable REIT subsidiary, but the subsidiary may not manage or operate it. However, the subsidiary can manage and operate traditional rental housing. Paul Decker, Ameek Ponda, and Jonathan Stein argue that this makes the definition of a REIT healthcare facility unworkable and that the IRS has struggled to draw a line between rental housing and a particular type of senior housing (independent living facilities). In their special report, the authors discuss a private letter ruling that concluded that an independent living facility is not a healthcare facility (p. 1231). A better definition of a healthcare facility would include independent living facilities, according to Decker, Ponda, and Stein. They also write that it should be possible for an independent living facility to be leased by a REIT to a REIT subsidiary and then operated by an independent manager, which is contrary to the IRS's current view. The authors conclude that it would be best for Congress to change the law to allow independent living facilities to be classified as either healthcare facilities or traditional rental housing.

When FATCA is fully implemented and effective, it will impose a variety of new burdens on foreign financial institutions. The additional reporting requirements have caused many banks to begin to drop U.S. customers. However, the act's most immediate (and overlooked) challenge is online registration with the IRS, according to Philip Cleary (p. 1249). He writes that most commentary on FATCA has ignored that hundreds of thousands of entities will soon be required to register with the IRS. The IRS has promised to build a registration portal by January 1, 2013, but it has not disclosed the extent of information required to comply with registration, Cleary writes. Coordinating groups of related foreign financial institutions will be difficult, and a failed registration can result in 30 percent withholding, he says, adding that foreign entities must get this right and that the IRS must design an effective registration system.

Complicated tax issues can result when an employee is terminated from an investment fund management company that is classified as a partnership for tax purposes. That can result in a noncompensatory capital shift between the remaining partners. Brad Martinson discusses the consequences of that kind of capital shift and how the partners might be forced to recognize income (p. 1257). There is a surprising lack of guidance in the area, according to Martinson. The lack of guidance is notable because this type of shift occurs quite often in practice, he adds. He finds that to the extent the capital shift is attributable to goodwill, there is no income recognition, but he cautions that no written guidance supports his position.

A recent article by Profs. Richard Schmalbeck and Jay Soled argued that under the $5 million estate and gift tax exemption, large amounts of tax revenue might be lost as a result of overstated basis of hard-to-value assets (*Tax Notes*, Nov. 7, 2011, p. 733). Kip Dellinger questions that conclusion, writing that the professors do not seem familiar with the types of estates in the under-$5-million category and that they overly rely on data on high-end estates in their analysis (p. 1273). Dellinger criticizes Schmalbeck and Soled's argument that the IRS is defenseless against valuation games, pointing out that it can always assert penalties under due diligence requirements and the rules governing conduct standards. Most of the advice given in estate planning becomes tax return advice when a taxpayer dies, according to Dellinger. This makes it subject to Circular 230, giving the IRS plenty of tools to fight overvalued basis, he concludes.

Donor-advised funds have gone from being a relatively rare occurrence to being a popular form of charitable giving. The funds allow the maximum tax benefits and still allow the donor to exercise some control over the disposition. Ray Madoff writes that current law is much too generous for donor-advised funds and does not ensure that the charitable sector as a whole is receiving sufficient benefits (p. 1265). Current rules also disproportionately favor the wealthy, according to Madoff. She argues that donor-advised funds should be subject to a seven-year payout requirement and should be revised to ensure that private foundations cannot satisfy their payout obligations simply by making transfers to a donor-advised fund.

In this week's Woodcraft, Robert Wood and Steven Hollingworth look at qualified settlement funds and how they interact with state law (p. 1277). State tax law conformity and return compliance is very important for funds that exist for multiple years, according to Wood and Hollingworth. In Of Corporate Interest, Robert Willens analyzes the active business requirement in the so-called Helen of Troy regulations (p. 1281). The ruling obtained by NYSE Euronext in connection with its acquisition of Deutsche Boerse shows how the substantial compliance approach can be made to work, writes Willens. On p. 1285, the Tax Policy Center provides a chart summarizing the major tax proposals of the GOP presidential candidates. ■