Common Trust Funds: The Living Fossil of Passthroughs

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A common trust fund (CTF) is a pool of trust funds invested by a bank. The CTF benefits from an early, primitive, and easily manipulated system of passthrough taxation. The CTF tax regime has exploitable flaws that allow a replication of a tax loss and sale of the tax loss to new participants who do not suffer any economic loss. The CTF flaws must be fixed. The proposal considers a narrow remedy for replication and sale of built-in losses, which is to allocate preexisting losses to new participants, but then simply disallow them. It also looks at other remedies. The proposal recommends a simple repeal of the CTF form, so that antiabuse changes to partnership tax law are made to the CTFs automatically.

The proposal is made as a part of the Shelf Project, a collaboration among tax professionals to develop and perfect proposals to serve Congress when it is ready to raise revenue. Tax shelf proposals should become part of a new Treasury study, like the studies that preceded the Tax Reform Act of 1986 and other reform acts. Congress faces a revenue crisis because government receipts are at 13.4 percent of GDP and long-term projections for government spending are at 22.4 percent of GDP, which implies an increase in necessary revenue on the order of 168 percent of current yields. Provisions that are politically impossible in ordinary times will become political necessities in an impending revenue crisis.

Shelf Project proposals are intended to raise revenue without raising rates, because the best systems have the lowest feasible tax rates. Shelf projects defend the tax base and improve the rationality and efficiency of the tax system, but shelf projects do not shift the burden of tax to low-income individuals. Given the current calls for economic stimulus, some shelf projects may stay on the shelf for a while. A longer description of the Shelf Project is found at "The Shelf Project: Revenue-Raising Projects That Defend the Tax Base," *Tax Notes,* Dec. 10, 2007, p. 1077, *Doc 2007-22632*, or *2007 TNT 238-37*.

Congress adopted its first Shelf Project on March 18, 2010. New section 871(1), enacted in the HIRE Act, is based on the Shelf Project proposal by Reuven Avi-Yonah, "Enforcing Dividend Withholding on Derivatives," *Tax Notes*, Nov. 10, 2008, p. 747, *Doc 2008-22806*, or *2008 TNT 219-34*.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

A common trust fund (CTF) is a fund maintained by a bank exclusively for the collective investment of the funds of trust clients. Under section 584 of the code, a CTF pays no tax, but each participant must include its proportionate share of income and losses computed at the CTF level, even if the common trust makes no distributions.

Examining the Common Trust Fund bears a resemblence to coming upon a coelacanth, a fish with four almost legs that was thought to be extinct for 65 million years, before a specimen was discovered off the coast of Africa.[1] Section 584 was adopted in 1936 in substantially its current form, even before the codification of the partnership tax system in 1954. The CTF system is a primitive passthrough system, with faults that tax planners have exploited. A new participant can buy built-in losses that arose before the participant joined the fund by buying a participating interest in the CTF from an old participant. An old participant can recognize loss by selling its participation, and yet there will remain a duplicate loss at the CTF entity level. Tax losses can happen by natural fluctuation but they also can be manufactured. Apparently, the participants do not even

[1] *See, e.g.*, Sally Walker, *Fossil Fish Found Alive: Discovering the Coelacanth* (2002).

need to have basis to take losses. Promoters have exploited the CTF form to create multimillion-dollar tax shelters.

The tax system is open to attack daily by tax planners who are like malicious computer hackers and exploit any faults in the system to minimize tax. The faults in the CTF must be fixed.

The project examines several alternative remedies against the selling and replication of losses by sale of a CTF interest and reaches the following conclusions:

1. Antiabuse doctrines. While antiabuse doctrines would accurately condemn the marketing and duplication of losses in CTFs and other shelters, the doctrines are raised only during an astute audit. Artificial losses should ideally be cured by structural improvements, so that the antiabuse doctrines are not the first line of defense.

2. Limiting losses to basis. Limiting losses to the basis of new participants is a necessary addition to the CTF tax regime, but it is not sufficient to prevent abuse. A limitation of losses remedy allows a shelter to use bought tax losses to shelter capital within the CTF. Basis may also be augmented by debt, and debt is inconsistent with tax-free investment of capital within the CTF. Participants' losses should be limited to a participant's basis, but that limitation is not a sufficient remedy for the replication and sale of losses.

3. Reducing inside basis by outside loss. Partnership tax now reduces the inside basis by the amount of substantial outside losses. Even if made mandatory for CTFs, however, the adjustment would allow a new participant to buy old built-in losses that remain. The remedy would eliminate replication of losses but not their transport to shelter buyers.

4. Allocate losses to new participants and then disallow them. Within the usual CTF rule that losses are allocated proportionately to all participants, a remedy would be to allocate old losses to new participants and then disallow the new participants from taking them. This remedy would stop both the replication and sale of the losses.

5. Abolishing participant level interest. A more general remedy would treat all sales as if they were sales of assets on the CTF entity level. CTF participation interests, divorced from assets, would be invisible to tax. The remedy would prevent replication of both gains and losses and prevent the sale of tax losses. It is feasible for simple entities, which CTFs usually are. The major reason that this remedy is not recommended is that double gains are not a material problem because taxpayers fix gains by self-help — that is, they sell assets at the CTF level to avoid the double gain, but exploit double losses.

6. Mark-to-market. To qualify as a CTF, the fund must value its assets at least once every month. Using the mandatory nontax accounting for tax purposes would tax gains, and allow losses, without sale. The monthly valuation rule would be ineffective against CTF abuse because losses can be manufactured between valuation dates, and it would probably end bank use of the CTF.

7. Repeal section 584. CTFs were a first take on passthroughs, adopted in 1936 without the mechanisms in partnership law to check abuses. The faults of CTFs have been and will continue to be exploited by tax shelters. Simplicity would repeal the form and require the banks to use some sort of a mutual fund, partnership, or other form of passthrough entity.

The proposal recommends 7, complete repeal of CTFs. But it also recommends 4 for partnerships — allocating losses to new participants but then disallowing them.

A. Current Law

A CTF is defined by section 584(a) to mean a fund maintained by a bank exclusively for the collective investment of money the bank holds in its capacity as a trustee, or with trustee-like fiduciary responsibilities to beneficiaries. This definition includes, for instance, situations in which the bank acts as executor for an estate, administrator for an incompetent or minor, or guardian of accounts under the Uniform Gift to Minors Act. A CTF qualifying under section 584 must also conform to banking regulations regarding the collective investment of funds. The applicable bank regulations have no tax element or safeguards against tax manipulation. The regulations of the comptroller of the currency on collective investment funds, for instance, require a plan in writing, disclosure of fees, audited annual financial statements, and valuation of marketable investments at least once every quarter. The comptroller's regulations also prohibit various conflicts of interest between the administering bank and the beneficiaries. Tax issues, however, are not implicated.[2]

The IRS has issued guidelines for qualification as a CTF, which are meant to supplant the need for revenue ruling requests in routine cases. The IRS guidelines for qualification, however, have no tax focus or limits on tax manipulation to them. The guidelines provide that the bank must act as a trustee, guardian, or fiduciary regarding the beneficiaries of the CTF. The guidelines do not permit the delegation of management and investment of the fund to anyone but officers and employees of the bank. The plan must provide that admissions to and withdrawals from the fund by participants be made on the basis of a valuation of the assets in the fund.[3]

A CTF does not itself pay tax, but each participant in the fund must compute its taxable income to include its proportionate share of gains and losses of the trust, even if there are no distributions.[4] Section 584 arose in the Revenue Act of 1936, substantially in its current form, in reaction to a court decision that would have taxed the CTF as a business association.[5] Under section 584, CTF computes the tax items as if it were an individual, as all trusts do, except that it is allowed no charitable deduction.[6] The CTF must segregate short-term and long-term capital losses, and ordinary gains and losses, because the nettings of short- and long-term capital gains and losses

[2]Comptroller of the Currency, (U.S. Treasury Dept.), *Collective Investment Funds*, 12 C.F.R. section 9.18 (1996).

[3]Rev. Proc. 92-51, 1992-1 C.B. 988.

[4]Section 584(b) and (c).

[5]Revenue Act of 1936, section 169 reversing *Brooklyn Trust v. Commissioner*, 80 F.2d 865 (2d Cir.), *cert. denied*, 298 U.S. 659 (1936). *See* James Saxon and Dean E. Miller, "Common Trust Funds," 53 *Geo. L. J.* 994, 1003-1006 (1965).

[6]Section 584(d).

are done at the individual level, not at the fund level.[7] If the CTF has items that would be unrelated trade or business income to a charity or pension, the character as unrelated trade or business income passes through to the taxpayer.[8] The CTF itself does not get any net operating loss deduction to carry over losses to other tax years, but the participants are allowed loss carryovers with the character as if the participant had realized the loss directly.[9]

The trusts or guardianship accounts that participate in the CTF increase their basis in the CTF by income and gain allocated to them, and they decrease basis by losses allocated to them, by withdrawals of cash from the CTF, and by the fair market value of property distributed to them by the CTF.[10] Distributions are a taxable sale or exchange to taxable participants, with gain or loss computed as cash and fair market value of the distributed property less the participant's basis in the CTF. The CTF itself, however, has no gain or loss from either admission or withdrawal by participants.[11]

Items of income, loss, and gain must be allocated among participants strictly in proportion to the fractional share of each participant when the gain or loss is realized. The regulations also require that allocations "must clearly reflect the income of each participant."[12] There are no special allocations of any item of a special tax character to a participant who would prefer that tax character or away from a participant who would like to avoid that character. In this way the taxation of CTFs is stricter than the taxation of partnerships.[13] Tax withheld on CTF income must similarly be allocated in proportion to fractional interest. The fund can, however, close its books and allocate gains and losses to participants who are the participants in the trust when the gains or the losses are realized[14]; and that allows allocation of gain to zero or low-bracket participants and losses to high-income participants.

B. Reasons for Change

The rule that gains and losses must be allocated strictly in proportion to participant share has not prevented the sale and replication of losses. A shelter-seeking taxpayer can buy an interest in a CTF that has tax losses built into its assets. The selling participant can recognize a tax loss on the sale without jeopardizing a reported loss on CTF assets that is passed through to a shelter-seeking purchaser. A CTF can allocate gains in one month to one set of tax-exempt participants and allocate built-in losses recognized in the next month to taxable participants who can use them. Change in participation is not a taxable event at the CTF level, so taxpayers can buy into losses built into the assets at the time of sale of participation in the CTF. If the taxpayer bought the assets directly, the built-in loss would disappear, but if the purchasing taxpayer buys a participation in a CTF that has assets with built-in losses, the losses survive. Some losses are unanticipated market fluctuations, while some losses are manufactured, guaranteed losses — for instance from offsetting options. In either case, the fact that a transfer of loss from low- to high-bracket taxpayers can be accomplished using the CTF is intolerable tax policy.

1. Market loss. Assume a CTF receives $10 million from two tax-exempt trusts and invests them in a volatile investment such as options in foreign currency. Foreign currency options can also generate ordinary income or loss, absent election.[15] Assume that the CTF has ordinary assets that start with a basis of $10 million and decline to $4 million, so that there is a potential $6 million ordinary tax loss. A $6 million tax loss could save tax of $2.1 million to taxpayers in a 35 percent bracket. The CTF form allows a transfer of the loss to taxpayers who would get value from the loss.

Assume for instance, Taxpayer A, a 35 percent bracket taxpayer, forms a grantor trust that offers to buy the participation in the CTF from the charitable trusts. The parties agree to split the value of the tax loss between them about evenly, so the grantor trust pays $5 million to become a 100 percent participant in the CTF.[16] Thereafter the CTF sells its assets, recognizing a $6 million loss, passed through to Taxpayer A, which saves $2.1 million tax by the loss. Taxpayer A now is the only participant in a CTF worth $4 million and has $2.1 million in tax savings. The passive activity limitations of section 469 limit losses, but not for portfolio investments not connected with a trade or business.[17] The at-risk rules also limit losses to the amount at risk,[18] but the limits are raised by debt to be paid long in the future with little interest, or the loss can be used, at considerable advantage, to make continuing investments within the CTF with a zero basis.[19]

Losses taken by a participant reduce the participant's basis so that Taxpayer A will recognize a $6 million gain if its participation in the CTF is terminated. Taxpayer A, however, may postpone the recognition event indefinitely or avoid recognition altogether by waiting until death wipes out all basis accounts. Moreover, the character of any future gains may not match the current ordinary loss.

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[7]*Id.* Netting of short-term gains and losses and long-term gains and losses, and overall gains and losses is accomplished by section 1222(5)-(11).

[8]Reg. section 1.584-2(c)(3) (1996).

[9]Section 584(g); reg. section 1.584-6 (1956).

[10]Reg. section 1.584-4(c) (increases in basis) and -4(d) (decreases in basis) (1996).

[11]Section 584(e).

[12]Reg. section 1.584-2(c)(1) (1996).

[13]*See, e.g.,* Mark Gergen, "Reforming Subchapter K: Special Allocations," 46 *Tax L. Rev.* 1 (1990).

[14]Reg. section 1.584-2(c)(4) (1996) illustrates allocations of gains and losses among participants who participate for only part of a tax year.

[15]Section 988.

[16]It might take two trusts to make the CTF a "collective investment fund" but that can be met by making the purchase through two grantor trusts, which probably in planning should be nonidentical for a persuasively substantial reason.

[17]Section 469(c)(ii).

[18]Section 465.

[19]*See* discussion of the inefficacy of limiting losses to basis, in B.

The CTF can also put the government into a lose-lose situation. If the volatile investment appreciates by $6 million, the CTF will recognize the gain while the exempt participants own all of the participation, allocating all gain to the tax-exempt beneficiary, but if assets drop in value the Taxpayer A trust will buy the CTF. Tax will then add value — $2.1 million in tax savings — to a transaction without any special merit. In a time of desperate revenue needs, a tax regime should not be handing out a $2.1 million tax subsidy. If the transaction works, then it can be replicated indefinitely and multiplied in value.

2. Double deduction. The sale of losses to Taxpayer A can also be profitable if the CTF starts with fully taxable participants. If the CTF recognizes a loss on the entity level and allocates it to a participant, the participant must reduce basis by the loss. But if the loss occurs first at the participant level, there is no correlative adjustment in basis at the CTF entity level. Thus assume now that the original participant is a taxable corporation investing $10 million in the CTF through a trust. When the investment declines to $4 million, the original participant can recognize the $6 million loss by selling its interests. That sale has no effect on basis at the CTF level. The CTF can recognize the loss after participation has shifted, and the new participant will also get a $6 million loss. It is not necessary that the original owner be a tax-indifferent entity.

The same phenomenon of miscoordination can lead to a double taxation of the gain if the asset appreciates. Assuming the CTF assets go up in value to $16 million, a sale of the CTF participation, followed by sale of the assets, will generate two $6 million gains. However, the gain part of this issue can be avoided by selling the appreciated asset first. Thus the doubling at both the participant and the entity level will be used, by adequately counseled taxpayers, for losses but not gains.

3. Losses on steroids. A fundamental law of economics is that if an opportunity for abuse of the tax system is available, taxpayers will exploit it as much as possible. Options give promoters a cornucopia of ways to create and separate tax gains and losses out of a transaction that overall has neither gain nor loss. The losses can be manufactured far beyond the level in the prior example, and the transactions can be created to guarantee a tax loss of any size with only modest nontax transaction costs. The CTF form does not prevent exploitation of the pumped-up losses.

During the years at the start of this decade, promoters marketed a shelter, called the Common Trust Fund Tax Straddle Shelter, which created multi-million-dollar deductions based on fake losses, relying on straddles held by CTFs.[20] The Common Trust Fund Tax Straddle Shelters created tax losses by splitting up a straddle, allocating the gain leg of the straddle to a pair of tax-exempt charitable trusts, and then allocating the loss leg to taxpayers who were buying tax losses. A straddle is an offsetting set of options that will produce both a large gain and a large loss which will substantially or wholly offset each other. The gains and losses can be hundreds of millions of dollars, but the net position can be trivial because the positions offset each other. It is not unusual to see the cost of option positions that are offset by the premium received for writing an option except for 0.1 of a percent. There is a large variety of different kinds of transactions that will generate big gains or losses, including the following transaction.

Assume, for example, that a CTF buys a call option for $50 million to buy yen at a set strike price denominated in dollars and at the same time pays $50 million for a put option allowing it to sell yen at almost the same strike price. If the yen goes up relative to the dollar, the call will be exercised and the put will be worthless, and if the yen goes down, the put will be exercised and the call will be worthless. There will be a big loss from the worthlessness of the unexercised option and some gain from the position that becomes valuable.[21] Simultaneously, however, the CTF writes a put option allowing the counterparty to force the CTF to sell yen at (almost) the same strike price as on the options it holds, and receives $49.99 million for it, and also writes a call option giving the counterparty the right to buy and also receives roughly $49.99 million for writing the call. The two $49.99 million amounts from writing options would be used to fund the purchased call and put options.[22] The net cost of the purchased options would be a modest $10,000 for each, once the money from the written options reduced the net cost, and the value of the tax losses is worth a thousand times more than that. The only pretax profit possible would be from the small difference in strike price or date of maturity of the options, and that would be reduced by fees. The purchased options, however, must expire within the month following the month the written options expire.

After both sets of options end, the CTF position will be close to zero. The expired $50 million option creates a loss, but expiration of the symmetrical option the CTF has written allows it to keep $49.99 million, whether the yen goes up or down vis-à-vis the dollar. Similarly, the exercised options (one by the CTF and the other against the CTF) will offset each other in the gain they produce, whether the yen goes up or down.

Regardless of whether the yen moves up or down, however, the sale of a favorable position will generate a taxable gain, and the sale or expiration of a worthless position will create a $50 million reported loss. But the

[20]Notice 2003-54, 2003-1 C.B. 363, *Doc 2003-16790, 2003 TNT 137-8*. Even before the notice, Lee A. Sheppard published a lovely analysis of the Common Trust Fund Tax Straddle Shelter in Sheppard, "A Shelter That Only Banks Can Sell," *Tax Notes*, Mar. 26, 2001, p. 1755, *Doc 2001-8726*, or *2001 TNT 58-3*.

[21]The expected value of the gain from exercise should be $50 million if arm's-length buyers are willing to pay $50 million for the position beforehand, but the gain may be larger or smaller than that viewed after the fact. It does not matter what the size of the gain is after the fact, however, because the gain is (almost) fully offset by the CTF's satisfying the exercise of the option it has written that is almost identical to the option is has purchased.

[22]It is not unusual to see the premium received from writing options that is only about a thousandth (0.001) below the cost of the premium for the nearly offsetting option the CTF holds.

gain will be recognized first and allocated to one set of participants, and the loss will be recognized second. Taxpayer B can buy tax losses by becoming the new participant in the CTF before the loss is recognized. A tax loss of $50 million, without an actual cash or other economic cost of $50 million, is worth as much as $17.5 million to someone like Taxpayer B in the top bracket, so the taxpayer will pay the promoter something short of that to get into the transaction. These tax losses are very cheap to manufacture with offsetting options and very valuable if they work.

The CTF in the shelter entered into its straddle before the shelter-purchasing Taxpayer B became involved, both writing the put and call options and then using the proceeds from the writing to buy the offsetting put and call options. Money from writing an option is not taxable when received, but it is taxable when the option matures. If the option lapses, the money received for writing the options is short-term capital gain,[23] and if the option is exercised, the money received for writing the option is part of the sale price of the underlying property.[24] When the straddle is acquired and the written options mature, substantially the only participants in the fund are two charitable trusts.[25] The charitable trusts recognize the taxable gain from the straddle, and the charities are indifferent to large tax gains not accompanied by large cash distributions.[26]

The CTF in the shelters adopted monthly valuation so that the income from each month could be allocated to participants in that month. Under the monthly valuation method, the taxable gain is allocated to the charitable trusts, which do not pay tax on such gain. After the gain was allocated to the tax-exempt participants, the shelter-purchasing taxpayer bought substantially all of the interest of the charitable trusts.

When participation in the CTF has flipped to the new owner, the losses from the CTF would pass through to the new shelter-purchasing taxpayer in the CTF. The economic value of the straddle position within the CTF was trivial at that point. Almost all the cash paid by the shelter-purchasing taxpayers went directly to fees. While the CTF held a good exercisable option that would generate a profit (either the put or the call depending on whether the yen increased or dropped), it also has the symmetrical duty to satisfy the good option held against it (which would be either the put or the call, just as the exercisable *held* option was a call or a put), which would largely offset the value of the good option. By the end of the tax year, the trust realized the tax loss inherent in the worthlessness of the option that was not exercised, or $50 million in our example. So the new participant would get a passthrough of a $50 million tax loss by buying a participation of trivial nontax value. As noted the $50 million cash-free tax loss is worth $17.5 million to the highest-bracket taxpayer.

The taxpayers buying the tax losses and the promoters selling the shelter are indifferent as a matter of economics to the mechanics of the offsetting positions, or indeed whether the purported trades are really executed, as long as the fund will report the tax losses that are advertised. But offsetting options quite routinely make it possible to set up multimillion-dollar losses without the actual loss of millions of dollars in cash.

Section 1092 was enacted in 1981 to remedy the shelter abuse, like that in the Common Trust Fund Tax Straddle Shelters, of splitting up offsetting positions to create a gain and a tax loss. The remedy in section 1092, however, is to defer the loss until the gain position is recognized, so that the tax accounting can describe the true net near-zero position of the overall straddle. The CTF shelters kept the evil that was the target of the section 1092 remedy, but they avoided the remedy because the gain from the straddle was recognized before the loss was recognized.

The CTF form allows the separation of gains and losses because a sale of participation is not considered to be a sale of the underlying assets. The CTF does not recognize the loss as the participation flips from charity to taxable user of the loss. Marketable tax losses, unconnected to any cash loss, are both terrible policy and routinely available under the CTF.

C. Possible Remedies?

This section considers seven alternative remedies to prevent the replication and sale of tax losses via the CTF.

The recommendation is to repeal section 584, which allows the CTF regime, and require the CTFs to use the partnership tax regime instead. It is also proposed that partnership tax be amended to allocate built-in losses to a new partner and then disallow them (fourth alternative).

1. Antiabuse doctrines. In 2003 the IRS issued a notice that the tax losses from Common Trust Fund Tax Straddle Shelters would not be allowed.[27] The notice throws the not-for-profit doctrine at the shelter, and then uses everything but the kitchen sink to support its conclusion:

> The offsetting positions entered into by the CTF did not have any effect on the CTF's net economic position or nontax objectives and did not serve any nontax objectives of the CTF or afford it a reasonable prospect for profit. Therefore, the losses purportedly resulting from this transaction are not allowable. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 260 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999), *Doc 98-31128*, *98 TNT 202-7*. Also, the Service may disallow the loss of an individual under section 165(c)(2) by asserting that the loss was not incurred in a transaction undertaken for

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[23]Section 1234(b).

[24]Rev. Rul. 78-182, 1978-1 C.B. 265, 267.

[25]Having two participants allows the shelter to claim that the CTF is not just the alter ego or separate pocket book of a participant and it therefore is less likely to be ignored by the law.

[26]The straddle option does not need a tax indifferent party because the gain can be recognized at the CTF level and allocated to the first participant and then the first participant can recognize the loss by selling the interest at the participant level. The loss would be replicated, both washing out the gain by the first participant and also being available to the shelter purchasing Taxpayer B.

[27]*Supra* note 19.

profit. See *Smith v. Commissioner*, 78 T.C. 350 (1982) and *Fox v. Commissioner*, 82 T.C. 1001 (1984) (disallowing losses from straddle transactions). Further, the IRS may, under appropriate circumstances, assert that the CTF does not meet the requirements of section 584, including the requirement that it be operated in conformity with the rules and regulations of the comptroller of the currency, as set forth in 12 C.F.R. section 9.18 (2003). In that event, the Service will recharacterize such a CTF as a partnership and reallocate the gains and losses in accordance with the economics of the transaction and the interests of the participants (see section 704(b)). Also, it may challenge the allowance of the loss deduction based on other statutory provisions, including section 988, and judicial doctrines.

It is odd that the notice says the CTF might be recharacterized as a partnership in order to impose the requirement of section 704(b) that allocations have a substantial economic effect. There is no tax component to the banking regulations on collective investment funds, so any violation of those regulations that would make the CTF a partnership would be incidental to the tax abuse. Moreover, CTFs are already subject to an arguably stricter requirement than partnerships. Under the regulations, allocations by CTFs must ''clearly reflect the income of the participants.''[28] The allocations of the $50 million tax loss to the taxpayers purchasing the shelter had no cash impact. Cash is the ultimate measure of economic transactions. There was no net cash to distribute to either set of participants in the CTF at any point. The new participant in the CTF did not in fact have a $50 million loss reported for tax, once the cash in and cash out was counted up. An accounting method that reports a $50 million artificial tax loss for a participant when none exists does not come close to clearly reflecting ''income of the participant.''[29] The IRS did not, however, make the ''clearly reflect income'' argument.

The not-for-profit doctrine, cited by the notice, should also have worked. The fees in the shelters are large enough to preclude an expected positive outcome, ignoring tax. Sometimes, however, it is hard for the IRS to make a not-for-profit case, especially when the transactions are camouflaged in a briar patch of complicated transactions, even when the true heart of the transaction is the sale of a $50 million tax loss.

In any event, the grab bag of arguments that the notice offered were apparently sufficient. The IRS later offered a settlement in which taxpayers were required to give up all tax losses and pay a 10 percent penalty plus interest.[30]

There have been no reported cases of the taxpayer challenging the IRS's notice in court.[31] These are big-dollar shelters which would have supported litigation by the best litigators in the country had the taxpayers' case had any glimmer of merit. Apparently all the taxpayers involved in these shelters took wise advice from experienced tax litigators and folded their hand, gave up their tax losses, and took a penalty rather than litigating.

Still, the not-for-profit doctrine, the ''clearly reflect income'' regulation, and the other various antiabuse rules should not be used as the first line of defense against abuses that are allowed by the structure. For antiabuse doctrines to be applied, the transactions must be found by smart agents during an audit. Audits and agents can be fooled by complicated transactions. Some courts also have trouble taking away big fake losses that arise under ''normal structure'' of the tax law and refuse to put themselves into the role of policeman against abuses that would overturn the abnormal structure.[32] Abusive shelters and the transfer of losses to taxpayers willing to pay for them need to be met by structural changes, not by ad hoc, after-the-fact remedies applied, sometimes, only after an especially intelligent audit. The system structure needs to block the doubling and transfer of tax losses even if there is a business rationale for the transaction or an expectation of pretax profit.

2. Limit losses to basis? Neither statute nor regulation expressly limits the losses that can be taken by a participant to the participant's basis in a CTF. One possible interpretation of the statute is that if the loss is computed at the CTF entity level with its tax accounts and basis, then that is a sufficient justification for participants' taking the loss. The code explicitly limits the losses owners of partnerships and S corporations may take by the amount of the owner's basis.[33] If losses are allowed in excess of basis as to CTFs, the participant can have a negative basis when losses allowed to the participant exceeds the participant's basis in the CTF.[34] A decrease in basis and even negative basis will have no substantial

[28]Reg. section 1.584-2(c)(1) (1996).

[29]*See, e.g.*, for a typical application of clearly reflect income, *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979) (saying that on its face, section 446 vests the commissioner with wide discretion in determining whether the accounting should be disallowed as not clearly reflective of income); *ACM Partnership v. Commissioner* (saying that a loss allowable for tax cannot result solely from the application of a tax accounting rule).

[30]Announcement 2005-80, 2005-46 IRB 967, *Doc 2005-21864, 2005 TNT 208-11*.

[31]The German Bavarian Bank (called HvB for short) in its deferred prosecution agreement said that it had participated in 23 CTF shelters, while admitting that they were fraudulent and unlawful. *Available at* http://www.justice.gov/usao/nys/pressreleases/February06/hvb-exhctodpastatementoffacts.pdf, para. 5.

[32]*See, e.g.*, *Sala v. United States*, 2008-1 USTC para. 50,308 (D.C. Colo. Apr. 22, 2008), *Doc 2008-9012, 2008 TNT 80-10*, *motion for new trial denied*, 2008-2 USTC para. 50,452 (July 18, 2008) (finding both business purpose and pretax profit when neither is plausible because the judge thought the result was required by current law). Calvin H. Johnson, ''Closing Deferred Revenue,'' *Tax Notes*, Nov. 24, 2008, p. 965, *Doc 2008-24022, 2008 TNT 228-37*, argues that *Sala* got the technical law wrong as well. *Sala* is an outlier case, but the attitude is not extinct.

[33]Section 704(d) (deferring partner's deduction of excess of loss over basis until the partner achieves more basis); section 1366(d) (allowing loss up to basis in both stock and S corporation debt held by shareholder).

[34]Negative basis is allowed, *e.g.*, by excess loss accounts in consolidated returns. Reg. section 1.1502-19 (2005) (excess loss accounts).

effect, however, if the interest in the CTF is held until the death of individual taxpayer beneficiaries. When CTFs were given their tax system in 1936, it was said bank investment of fiduciary accounts was such that the CTFs could not take any risks or engage in speculation.[35] Plausibly, the assumption was that banks never had any losses to pass through to their participants.

An alternative interpretation of the statute is that no loss may be taken in excess of basis, no matter what the form of the passthrough.[36] The IRS has a long-standing opposition to negative basis, perhaps because negative basis indicates an impermissible overrecovery of basis and because with negative basis the taxable gain would exceed the amount realized.[37] Loss deducting in excess of basis without negative basis is not a coherent tax system.

Limiting losses to basis would not, however, be a sufficient remedy. In the early example, Taxpayer A paid \$5 million for an interest in a CTF with \$6 million of built-in loss. A limitation on loss deductions to basis would not limit the loss because if Taxpayer A contributed another \$1 million, he would have the immediate \$6 million tax loss worth \$2.1 million.[38] The taxpayer would also have a perfectly fine \$6 million investment in the CTF with a zero basis. An investment with zero basis is a wonderful thing. Ordinarily in an income tax, one can invest funds after already paying tax on them. A zero basis for the \$6 million investment will mean in effect that the taxpayer has no reduction in his internal rate of return for his investment for the period of time that the \$6 million remains invested.[39]

Basis, moreover, can also be raised under ordinary income tax principles by borrowing cash to put into the CTF or by incurring a liability to the CTF or assuming its debts.[40] The rule increasing basis by debt is not, however, consistent with the recognition of the loss. Expensing of the investment as allowed by the \$6 million purchased loss, combined with the exclusion of borrowed principal and the interest deduction, leads to a negative tax automatically — that is, a tax impact that increases the taxpayer position.[41] A basis increase achieved by borrowing or by taking on liabilities compounds the abuse and does not remedy it.

Adjustments to basis are not an adequate remedy. The purchasing taxpayer must reduce basis in the CTF by \$6 million once it takes the tax loss. The reduced basis will lead to \$6 million more taxable gain when the taxpayer liquidates its interest. But there is no timetable that requires a liquidation of the CTF, and death and section 1014 will eventually clean out the adverse basis accounts. The \$6 million gain caused by the basis adjustment can also be of the wrong character. For instance, if the CTF started with an ordinary asset like foreign currency and then gradually moved to capital assets over time, then the initial loss would be an ordinary loss regarding foreign currency and the extra gain would be capital gain on a CTF that holds nothing, for instance, except public stock. For the time of investment, moreover, whether long or short, the taxpayer has a zero-basis investment which is equivalent to a zero effective tax rate.

Limiting the participant's loss to the participant's basis in the CTF is recommended as a necessary remedy for artificial losses claimed by participants. Losses without basis are always erroneous. Tax accounting does not need to take out of the tax system that which has not been put into the tax system.[42] But limiting losses to basis would not be an effective remedy to block the purchase of tax losses that arose in other hands.

3. Section 754-like adjustments. If assets are sold first, the CTF form prevents double tax or double loss by adjusting owner basis when the entity first recognizes gain or loss. Gains or losses at the entity level cause adjustment of owner basis. When the taxable event occurs at the owner level first, however, the CTF system does not work because there are no general correlative adjustments at the entity level.[43] Thus, as noted, even if a participant in the CTF with the built-in \$6 million loss sells its CTF interest at a loss first, the CTF will still have a \$10 million basis in its assets, and the CTF will therefore have a second \$6 million loss when it sells the asset. Both the old and the new participant will share in the loss.

Sections 754 and 743 of the code allow a partnership to elect to adjust basis in partnership assets to reflect the loss on the sale of the partnership interests. If the election is made, the partnership reduces the basis of the partnership assets by the amount of the loss. In the 2004 Jobs Creation Act, Congress made negative adjustments to partnerships mandatory, even without a section 754

[35]*See, e.g.,* Testimony of Gilbert I. Stephenson of American Bankers Association, Hearings on the Internal Revenue Act of 1936 Before Senate Finance Committee, 74th Cong., 2d Sess. 792 (1936) (saying that CTFs operated under regulation of banking authorities to avoid taking any risks, and to avoid becoming overcommercialized or being used for speculative purposes).

[36]*See, e.g.,* section 165(b) (limiting loss deduction to basis).

[37]*See, e.g., Hall v. Commissioner*, 595 F.2d 1059 (5th Cir. 1979) (refusing to find a negative basis when depreciation exceeded cost because of long IRS opposition).

[38]The argument in text would be identical if Taxpayer A paid only \$4 million for the CTF interest ignoring tax, except that Taxpayer A would have to invest another \$2 million to get an immediate \$6 million loss. Taxpayer A would still have a perfectly fine \$6 million investment inside the CTF with a zero basis and hence zero reduction in the pretax return.

[39]*See, e.g.,* Calvin H. Johnson, "The Effective Tax Ratio and the Undertaxation of Intangibles," *Tax Notes*, Dec. 15, 2008, p. 1289, *Doc 2008-24799*, or *2008 TNT 242-46* (arguing that the tax-caused reduction in internal rate can be measured by the ratio of basis to fair market value of investments).

[40]*Cf.* section 752(a) and (c) increasing partner basis by partner's share of liabilities of partnership.

[41]Calvin H. Johnson, "Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation," 61 *Texas Law Rev.* 1013 (1983), explains the inconsistency.

[42]*See, e.g.,* Calvin Johnson, "Was it Lost?: Personal Deductions Under Tax Reform," 59 *SMU L. Rev.* 689, 708-711 (2006) (criticizing deduction of unrealized gain given to charity).

[43]Section 743(a) (providing that basis in partnership property is not adjusted for a partner level sale, absent the election).

election in place.[44] The mandatory adjustment applies only if the partnership has a net loss of more than $250,000. The adjustment, moreover, applies only on a partnershipwide level.

The adjustments of section 743 could be made mandatory for CTFs. Thus, if a new participant pays $4 million for the CTF interest, the CTF itself would reduce its basis in its assets from $10 million down to $4 million, and that would eliminate the second, entity-level $6 million loss.[45] A CTF is administered by a single bank administrator, and the bank presumably should know when participation changes hands and at what price, so the bank should be able to make the required adjustments. We should not expect voluntary section 754 elections as to losses because no selfish taxpayer would want to take away the double deduction of losses, but the mandatory adjustment would take away the loss anyway.

The mandatory adjustment Congress required in 2004, however, would not be adequate to cure the abuse. First, allowing $250,000 of fake losses to be transferred to new shareholders mischaracterizes the appropriate default rule. The structure should not allow fake losses arising out of the structure in any amount.

The section 743 adjustment, secondly, adjusts the overall partnership basis in assets and does not prevent transfer of the remaining losses from tax-exempt to shelter-purchasing taxpayers. Mandatory section 743 adjustments would work well enough when the entire participation in the trust changes hands, but it would not prevent transfer of losses when less than all the participation changes. For example, assume the new participant buys only 40 percent of the interest in the CTF when there is a $6 million built-in loss in assets. The participant pays 40 percent * $4 million or $1.6 million (ignoring tax benefits in the deal for a minute), and the assets have a reduction in basis in assets by 40 percent * $10 million - $1.6 million,[46] which equals $2.4 million. There would still, however, be a $3.6 million built-in loss in the assets, even after the adjustment was made and the old and new participant shared the $3.6 million partnership level loss when the partnership sold the asset. The new participant would receive a loss of 40 percent * $3.6 million or $1.44 million (worth $504,000 in a 35 percent bracket), even after the mandatory adjustment.

The Jobs Act limitations on built-in losses would apparently also allow special allocations of big losses within a partnership. A partnership that overall has no built-in loss, or at least has an overall basis that is not higher than overall fair market value of its properties by $250,000 can have a built-in loss on identifiable property that is tens of millions of dollars in size. The partnership could give the losses in identified properties to the shelter-purchasing partner even while not having overall losses that trigger the Jobs Act section 743 adjustment.

There is, finally, no section 743 adjustment for a contribution to the partnership in which the new participant acquires its interest without a sale by any old participant.[47] Thus a taxpayer seeking a shelter buys a 50 percent interest by contribution to the CTF, the $6 million loss is unaffected, and the purchasing taxpayer can get $3 million of it.

Thus even a mandatory adjustment like that under section 743 would not prevent the transfer of losses to a new tax-loss-purchasing participant.

4. Allocate loss to new participants and then disallow them forever. The appropriate rule needs to both reduce the entity-level basis when the participating interest in the CTF changes hands and also prevent the new participant from getting access to any of the remaining built-in loss. A rule that seems to work is to allocate the built-in loss to the participant, under the normal CTF rules for allocation of gains and losses pro rata to fractional participants in the whole, but then prohibit the new participant from using the loss amount. The loss would disappear, much as if the new participant were a tax-exempt entity.

Assume again that the assets of a CTF decline in value from $10 million to $4 million and that a new participant, seeking shelter, pays 40 percent * $4 million or $1.6 million for a 40 percent interest. The selling participant recognizes a loss of 40 percent * $10 million less $1.6 million or $2.4 million on the sale, and the loss should not be duplicated as to the seller with a loss on the CTF level. The buyer needs to have a basis of only $1.6 million in the CTF asset, even though the partnership has a 40 percent * $10 million basis that it would use to allocate gain or loss to the new participant.

The section 743 adjustment is the transferee's share of adjusted basis of the partnership minus the transferee's basis of its partnership interest. Here that adjustment is 40 percent * $10 million - $1.6 million or $2.4 million. If we forced allocation of gain or loss to the new participant according to the normal CTF rule that all participants share equally, but then reduce the participant's allowed loss, or increase his gain, by that $2.4 million, then we would have neither a replication of the $2.4 million loss for the old participant, nor a buy into the built-in loss by the new participant.

There is no need to reduce the new participant's basis by the allocated loss that he was not able to take. The new participant's basis in his CTF interest is $1.6 million, its fair market value, and as long as he is not getting an allocation of any built-in loss that arose before he joined, his basis in his interest remains correct.

[44]P.L. 108-357, section 833(b)(1), (2), and (3) amending section 743(b) and (d) provided the partnership's adjusted basis in its assets exceeds the fair market value of the assets by more than $250,000.

[45]Reg. section 1.743-1(b)(2) (2000) reduces partnership basis by the transferee's share of adjusted basis of the partnership minus the transferee's basis of its partnership interest. For the 100 percent transferee, the reduction is 100 percent * $10 million - 100 percent * $4 million or $6 million reduction in basis.

[46]Reg. section 1.743-1(b)(2) (2000) reduces partnership basis by the transferee's share of adjusted basis of the partnership minus the transferee's basis of its partnership interest. For the 40 percent transferee, the reduction is 40 percent * $10 million - $1.6 million or $2.4 million reduction in basis.

[47]Reg. section 1.743-1(a) (2000).

Built-in losses need to be taken away even as to sheltering new participants' gains. There is no meaningful distinction between an internal shelter in which the built-in losses shield real future gains, and an external shelter in which the built-in losses are used against unrelated income. Both need to be limited.[48] The rule would also need to be applied when the participant acquires his interest by contribution to the CTF rather than by sale of the CTF interest from another participant. Allocation of loss away from the old participant is ordinary section 704 allocation, and reduction of the new participant's interest.

For nontax fiduciary purposes, a CTF has to know the value of its assets when participation changes hands. It would be a breach of fiduciary duty to require a new participant to pay $10 million for an investment now worth $5 million. To apply the limitation on the use of losses, it only requires that the wisdom of pretax fiduciary duties be available to the tax system.

5. Abolishing sales at participant level for tax. The replication and sale of losses arise because sales of a CTF interest are considered to be not sales of assets but rather sales of something that does not require recognition of gain or loss at the CTF entity level. A more general remedy would treat all sales as occurring as sales of assets on the CFT entity level. CTF participation interests, divorced from assets, would be invisible to tax. The old participant always sold assets. It is always an abuse if tax results for sale of a participant's interest are better than for sale of the real underlying assets.

The remedy would prevent a replication of both gain and loss and would also prevent sale of tax losses. It is feasible for simple passthroughs, which is what CTFs usually are. The major reason that this remedy is not recommended is that that double gains are not a material problem. Taxpayers fix gains by self-help — that is, they sell assets at the CTF level to avoid the double gain but exploit double losses. The remedy can focus on losses only, as remedy 4 would, and let double gains be solved as they are by tax planning under current law.

6. Mark-to-market system. A mark-to-market system could solve the problems of the transfer of losses, by forcing recognition of losses before the participation interests changed hands. If the CTF elected a mark-to-market system for all its assets as they occur, then it can appropriately get tax recognition for its losses before participation changes, without actually selling the property. Valuation, not by actual arm's-length sales, but according to market price quotes can sometimes be problematic, but a CTF does have to value its assets to allow new participants to replace old ones at a fair price.

The mark-to-market system, however, would need to be applied consistently to gains as well as losses. If a taxpayer can cherry-pick losses but not gains, then the tax system gives refunds or tax savings without getting revenue from the symmetrical gain, and that leads to an expected tax that is negative. Elective mark-to-market systems will, as well, only be used when the CTF anticipates losses but not gains.

Indeed if mark-to-market were mandatory for gains, that would probably kill the use of the CTF form, simply because the real tax burden of a 15 percent tax rate on mark-to-market basis is much higher than a 15 percent tax rate on realized gains only.

7. Kill common trust funds. A final alternative is to force the banks to use the trust or partnership forms of passthrough taxation. CTFs are an obscure corner of the code. Not enough intellectual capital has been invested in them to prevent multimillion-dollar abuses. Partnerships restrict losses to basis,[49] limit transferee use of large net built-in losses,[50] require that allocations have substantial economic effect,[51] and have a backup antiabuse rule for exploitation of the partnership form.[52] The CTFs have none of that. In 1936, passthrough regimes tolerated a step-up in basis without tax by contribution to a partnership.[53] If CTFs continue to have access to that rule, any taxpayer could avoid tax on sale of appreciated property by contributing the property to a CTF and having the CTF sell the property and hold the cash proceeds within the CTF until death wipes out all basis accounts.

No one has enough foresight to see all future abuses. We learn, like craft artisans, by doing. Every system of taxation has glitches built into it. Tax planners are like malicious computer hackers. They break into a system that apparently works fairly well, just to extract hundreds of millions of dollars of value. We might not have the government resources to spend on security for the tax system. Perhaps we may diminish the complexity of the code and have a chance of protecting the system by falling back into the tax systems that get more attention.

If section 584 is retained, it needs a lot of work. Participants' losses need to be restricted to basis and built-in losses should not be transferable. CTFs cannot have a high basis in any assets than contributing participants have. Allocations need to have substantial economic effect. There needs to be a backup antiabuse rule like that enacted for partnerships.[54] In 1936, when section 584 was adopted, partnership tax systems did not do enough to avoid abuses. So section 584 has none of the antiabuse protections. Even if all our learning by experience with partnership taxation were incorporated into section 584, which would be a daunting task of drafting, current reforms cannot block the next abuse. It is far better just to repeal the archaic passthrough system of section 584.

Moreover, partnerships need to have a better remedy for the specific problem of replicated and transferred losses. As noted, section 743(b) and (d) of the code

[48]Contrast section 1015 (1921) which applies the lower fair market value at transfer (if lower than donor's cost), but only to compute loss. The text argues for a unified basis applying the same basis for gain and loss, as well as for depreciation.

[49]Section 704(d).

[50]Section 743(b) and (d).

[51]Section 704(b)(2).

[52]Reg. section 1.701-2 (1995).

[53]*Chisholm v. Commissioner*, 75 F.2d 14, 15 (2d Cir. 1935) (Hand, J.).

[54]Reg. section 1.701-2 (1995).

require the partnership to reduce basis in its overall assets by the built-in loss on its assets, if the built-in loss exceeds $250,000. Allowing fake losses of up to $250,000 is not an appropriate default rule. The adjustment of overall partnership basis, moreover, does not prevent sale of the remaining losses, for example, from tax-exempt to taxable participants.

Section 584 does have a virtue that subchapter K does not in requiring allocation of all tax items strictly in proportion to fractional interest in the whole CTF. Partnership tax allows special allocations of partnership items. These allocations slice and dice partnership income giving each item to a taxpayer who can best handle it.[55] Still, special allocations should be addressed as a separate issue within partnership law.

D. Conclusion

The proposal would repeal section 584 and require the CTFs to use partnerships or a mutual fund form. Section 584 is an early attempt at a passthrough system adopted in 1936 before bitter experience had taught us that passthrough regimes need serious protection against abuses. The war between tax planning and antiabuse remedies is ongoing and perpetual. At least without a separate CTF, reforms to subchapter K will show up automatically in the CTFs, without a 74-year lag.

Having examined the problem of replication and transfer of built-in losses, the project also concludes that the limitations added by the 2004 Jobs Act in the partnership context, under section 743 on the replication and transfer of built-in losses, are insufficient. There is no room or reason for $250,000 of transfer of fake losses under the structure. The adjustment at the partnership level on all assets still allows built-in losses to be transferred from tax-exempt to high-bracket partners. The proposal is that built-in losses would be allocated to new participants and then simply disallowed.

[55] *See, e.g.*, Myron Scholes and Mark A. Wolfson, *Taxes and Business Strategy: A Planning Approach*, 412-415 (1992), showing a dramatic increase in after-tax return by allocating stock appreciation to a foreign partner and dividend income from same stocks to a domestic corporation.