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In this installment of Reflections With Reuven Avi-Yonah, Avi-Yonah argues that despite the fiduciary duty of corporate managers to maximize shareholder profit, they should not take frivolous positions to try to reduce tax.

In two recent cases, corporate taxpayers have made legal arguments that seem on their face to be frivolous.

The first example, as Robert Goulder explains in his excellent recent column,[1] is the argument made by Liberty Global (LGI) involving the source of the gain on the sale of a foreign subsidiary.[2] LGI sold the shares of a Japanese subsidiary for a gain of $3.25 billion, of which $438 million was dividend income under section 1248. The issue was the source of the remaining $2.8 billion gain. LGI argued that it should be foreign source despite the explicit source rule for capital gains in section 865.

The way LGI did this was to rely on the overall foreign loss (OFL) recapture rule in section 904(f). That would enable it to treat as foreign source not just the dividend income but also its OFL balance of $474 million. But this still left about $1.9 billion in gain that, based on the normal source rule of section 865, would be U.S.-source income. To prevent that, LGI argued that the entire gain was foreign-source income, thereby increasing its foreign tax credit limit, enabling it to shield other income from tax.

To make this argument, LGI relied on section 904(f)(3). That section states that:

> The taxpayer, notwithstanding any other provision of this chapter, shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition, by reason of such disposition, in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of the overall foreign losses which were not used.

LGI's argument is that because of the "notwithstanding" language, this provision eliminates the application of the rest of the code (including section 865) to characterize as foreign source not just the OFL balance but the entire gain. While the cited language clearly only applies to the OFL balance, LGI argues that because the normal source rule does not apply, Congress intended that the remainder of the gain be sourced in the same way as the OFL balance.

Goulder does not characterize this position as frivolous, instead calling it "inventive":

> Was LGI making this stuff up? I suppose there's a difference between an inventive

[1] Robert Goulder, "*Liberty Global*: Do Litigants Believe Their Own Tax Planning?" *Tax Notes Int'l*, Mar. 4, 2024, p. 1403.

[2] *Liberty Global Inc. v. Commissioner*, 161 T.C. No. 10 (2023). Michael Smith, "Tax Court Denies Liberty Global's FTCs From Japanese Sale," *Tax Notes Int'l*, Nov. 13, 2023, p. 1015. The case is under appeal. *See* Andrew Velarde, "Liberty Global to Appeal FTC Loss," *Tax Notes Int'l*, Feb. 26, 2024, p. 1210.

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> legal theory and a flatly spurious one. No penalties were assessed.
>
> Finally, Goulder concludes:
>
> LGI's two tax disputes, the Colorado case and the Tax Court case, share a common element. They depict a multinational corporation that buys and sells a lot of other companies, and incurs a lot of transactional gain in the process. There's nothing wrong with not wanting to pay tax on those gains. LGI's shareholders should expect nothing less. Nor is there anything wrong with taxpayers testing the waters of novel legal theories, provided they comply with the accompanying UTP disclosures, are willing to accept the risk that their actions may be challenged and result in penalties, and book whatever reserve is appropriate for the scope of their adventure.
>
> I return to my earlier thoughts. Should taxpayers believe in the merits of their own tax planning? Must they manage their expectations of what tax planning can accomplish? No, not really. We might as well ask whether gamblers believe they're going to win their next wager. For those reasons, I'm happy to see courts push back against such zeal when they encounter it. I'm also happy to hear from readers who think otherwise.[3]

As explained below, I think otherwise. The argument is frivolous, LGI knew that, and it should not have made it.

The second example of a frivolous argument by a corporate taxpayer is the argument made by Medtronic in its recent appeal of its transfer pricing case. Ryan Finley explains the issue:

> The brief's principal argument is that transactional (or "direct," to quote the brief) transfer pricing methods are inherently superior to "indirect" or income-based methods like the CPM, echoing a long-abandoned regulatory preference for transactional comparables-based methods. This imagined preference for direct methods is so strong, the company suggests, that it swallows the regulatory prerequisites for applying them. Specifically, Medtronic argues that comparability adjustments can remediate a failure to satisfy a bright-line comparability requirement. (Prior coverage: *Tax Notes Int'l*, Sept. 20, 2021, p. 1567.)
>
> Medtronic's viable alternatives may be limited, but its headline argument still cannot have been its best option. . . . There is no statutory basis for a hierarchy of methods: The regulations expressly contradict it and there's no binding or persuasive case law precedent that suggests otherwise . . . let's remember that the section 482 regulations establish the framework for selecting and applying transfer pricing methods. No plausible reading of the first sentence of section 482 compels Treasury or the IRS to favor transactional or so-called direct methods over other methods. . . .
>
> In other words, the statute gets Medtronic nowhere. But what about the ethereal transactional preference, sometimes cited by expert witness economists, that silently looms over the regulations and selectively overrides them? Well, there's no such thing: Laws consist of words, not innate spirits, and section 482 is no exception. (Prior analysis: *Tax Notes Int'l*, Nov. 14, 2022, p. 803.)[4]

A bit of history is useful here: In the 1993 temporary version of the new transfer pricing regulations, the comparable profits method was

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[3] Goulder, *supra* note 1. The Colorado case is *Liberty Global Inc. v. Commissioner*, No. 1:20-cv-03501 (D. Colo. 2023), which is being appealed. For a discussion, see Reuven S. Avi-Yonah, "Why Did the IRS Win? A Remarkable Year in Tax Litigation, Part 2," *Tax Notes Int'l*, Jan. 15, 2024, p. 349; Stephen J. Olsen, "*Liberty Global*: Codified Economic Substance Doctrine's Day in Court, Part 1," *Tax Notes Federal*, Mar. 18, 2024, p. 2219; and Olsen, "*Liberty Global*: Codified Economic Substance Doctrine's Day in Court, Part 2," *Tax Notes Federal*, Mar. 18, 2024, p. 2223. The case involved a transaction that the court found lacked economic substance.

[4] Ryan Finley, "In New Appeal, Medtronic Goes All In on Shakiest Arguments," *Tax Notes Int'l*, Mar. 4, 2024, p. 1279.

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superior to the other methods and could be used as a check on them. But the Europeans objected that, because of the loose standard of comparability required for the CPM, it was not an arm's-length method, and in the final version of the regulations it was relegated to just one of the five accepted methods; the best method rule that states there is no hierarchy of methods was adopted. The OECD, on the other hand, persisted in treating the traditional transfer pricing methods (comparable uncontrolled transaction, cost-plus, and resale price) as superior to the profit-based methods (CPM, which it names the transactional net margin method, and profit split), but even the OECD (that is, the Europeans) relented and in 2010 adopted the best method rule.[5]

Thus, under the current regulations, there is no basis for Medtronic's argument. It is frivolous.

But should corporate taxpayers be allowed to make frivolous legal arguments they do not believe in because they might be upheld and that would benefit their shareholders?

If the taxpayers were individuals, the answer is no: Frivolous legal arguments should not be made and are usually penalized (see the tax protester cases and code section 6702). But corporate managers can argue that it is their fiduciary duty to maximize shareholder value even if it requires making what they know to be a frivolous argument.

To evaluate this claim, it is useful to address it in the context of the long debate of the validity of corporate social responsibility (CSR). According to the prevailing view in U.S. legal academia, CSR is illegitimate unless it maximizes shareholder value.[6] From this point of view, the sole legitimate function of the corporation is shareholder profit maximization, and any CSR activity that is not related to long-term profit maximization is an illegitimate "tax" imposed by management on the shareholders, without the accompanying democratic accountability.

It is easy to see how this view can lead to aggressive tax behavior. If tax is considered a cost like any other cost imposed on the corporation, it behooves the management to try to minimize this cost, or even turn it into a profit. Thus, the goal of shareholder profit maximization can naturally lead to corporations trying to minimize taxes and thus enhance earnings per share.

What is wrong with aggressively reducing taxes as a way of maximizing shareholder returns? The basic problem is that under this view most CSR activities are illegitimate. This necessarily means that they devolve upon the state, which is supposed to use its legitimate taxing function (unlike the illegitimate tax imposed by management upon the shareholders if the corporation engages in CSR) to raise money to fulfill these obligations. But if all corporations engage in aggressive tax behavior, the state may not be able to raise sufficient money to fulfill its exclusive social responsibility functions.

It will immediately be argued that this scenario is unrealistic: Because in OECD member countries the corporate tax amounts to less than 10 percent of total tax revenue, the state can replace the lost revenue from corporate tax avoidance by raising other taxes. But even if one sets aside issues of distribution and fairness (lowering taxes on capital usually means higher taxes on labor), this answer is inadequate for three reasons. First, there may be political constraints to raising other taxes; especially in the U.S. context it seems glib to say that politicians could respond to a decline in the corporate tax by raising individual tax rates. Second, individual tax rates may already be set so high that it becomes highly inefficient and potentially counterproductive to raise them further. If individual rates are set very high, there will be an effect on both the labor/leisure trade-off and on the willingness of individuals to pay taxes, on which the system depends. Finally, in many non-OECD countries the corporate tax amounts to a far higher percentage of total revenues.

In developed countries, the state may delegate some of its social responsibility to the nonprofit sector. But this is no solution, because under the prevailing view, for-profit corporations are also prohibited from donating funds to nonprofits, unless it can be shown that the contributions enhance shareholder returns (which is doubtful).

[5] For the history, see Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," 15 *Va. Tax Rev.* 89 (1995), and the 1995 and 2010 versions of the OECD transfer pricing guidelines.

[6] For the origin of this view, see Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *The New York Times*, at SM 17, Sept. 13, 1970. The following is based on Avi-Yonah, "Corporate Taxation and Corporate Social Responsibility," 11 *NYU J. Law & Bus.* 1 (2014).

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Moreover, the nonprofit sector is weak or nonexistent in developing countries, where the CSR issue is most acute.

Thus, if the sole function of corporations is profit maximization, it seems to follow that corporations should maximize profits by minimizing their taxes. But if all corporations avoid paying taxes, the result can be inadequate revenue for the government to fulfill those obligations for which, under the prevailing view, it bears sole responsibility. The result would be that neither corporations nor the government can address social problems, and I do not think even Milton Friedman, who established the prevailing view, would regard that outcome as desirable.

To me, this analysis suggests that even corporate taxpayers should not engage in transactions they know lack economic substance or make legal arguments they know are frivolous, even if they think they have a chance of prevailing in court. Given the uncertainties of the audit and litigation process, it is unlikely that any legal reforms (like the uncertain tax position schedule or increased penalties) can achieve this goal. Therefore, the only real solution is to change the attitude of major U.S. corporations to where it was when the 1986 Tax Reform Act was enacted. Back then, a tax director of a major U.S. corporation would typically see aggressive tax-motivated transactions as inconsistent with CSR and would simply reject them. The proper response of a corporate tax director to a proposed transaction known to be motivated by an invalid business purpose (even if it can be dressed up as valid and even if it might possibly prevail in litigation), or to a proposal to make a legal argument that is patently frivolous, is to just say no. ■

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