W(h)ither Economic Substance?

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ABSTRACT: Transactions that claim inappropriate tax benefits are a perennial problem. When the IRS claims a transaction is abusive, courts generally examine whether the taxpayer had a business purpose and whether the transaction had economic substance (essentially a prospect of profit before taxes). This two-pronged “economic substance doctrine” developed from a series of Supreme Court cases.

Unfortunately, the economic substance doctrine provides a poor proxy for the real question, which was the focus of the early cases—whether the claimed tax results are consistent with Congress’s intent. One important drawback of the shift from a focus on congressional intent to a focus on the taxpayer’s intent and the prospect of pre-tax profit is a doctrine that is much easier for taxpayers to manipulate. The result is a test that does little to distinguish tax shelters and other abusive transactions from legitimate ones.

This Article therefore argues that the modern economic substance doctrine should be abandoned and replaced with a direct inquiry into congressional intent. Others have addressed the mechanics of determining congressional intent, including how to apply the purposive method of interpretation used in such cases as Gregory v. Helvering. This Article instead examines why courts today generally do not perform this vital inquiry and explains why they should.

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In developing this argument, the Article explains that identifying abusive transactions is so difficult largely because some tax statutes merely try to measure income, while others try to provide an incentive for particular behavior. Identifying which goal is operative in a particular provision requires analysis of congressional intent. The Article traces the judicial development of the economic substance doctrine to pinpoint when its focus shifted away from congressional intent. It also critiques the existing doctrine, showing how it can be exploited to allow abusive transactions to stand simply because they are bundled with business activity.

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I. INTRODUCTION

Transactions that claim inappropriate tax benefits are a perennial problem. To distinguish abusive transactions from legitimate ones, courts typically apply the judicially developed "economic substance" doctrine. That doctrine is generally understood to have two prongs: (1) whether the taxpayer had a business purpose for the transaction, and (2) whether the transaction objectively had economic substance (essentially a prospect of profit before taxes).\(^1\) Courts do not apply the doctrine consistently, however, so the prospect of codifying the doctrine, which President Obama supports, has been on the table for a while.\(^2\)

Courts certainly need to distinguish abusive transactions—whether or not they constitute "tax shelters," however defined\(^3\)—from appropriate ones. Unfortunately, the economic substance doctrine is a terrible tool for that endeavor. The doctrine is so disconnected from the inquiry of whether a

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\(^1\) See, e.g., Compaq Computer Corp. v. Comm'r, 277 F.3d 778, 781–82 (5th Cir. 2001) (discussing courts' approaches to the business purpose and economic substance inquiries); ACM P'ship v. Comm'r, 157 F.3d 231, 247–48 (3d Cir. 1998) ("[B]usiness Purpose and economic substance do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes."). Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 171–72 (D. Conn. 2004) ("The terminology used ... is not critical, rather the analysis evaluates both the subjective business purpose of the taxpayer for engaging in the transaction and the transaction's objective economic substance ..., "). aff'd, 150 F. App'x 40 (2d Cir. 2005). The doctrine is sometimes called the "sham transaction" doctrine. United Parcel Serv. of Am., Inc. v. Comm'r (UPS), 254 F.3d 1014, 1018 (11th Cir. 2001) (explaining the function of the "economic-substance doctrine, also called the sham-transaction doctrine"). "Sham transaction" terminology is confusing, however, because it encompasses "shams in fact," which are transactions that never occurred, as well as "shams in substance," which lack economic substance. The substantive sham cases typically apply the same or similar analysis as that used in economic substance cases. See Yoram Keinan, The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine, 111 TAX NOTES 327, 330–31 (2006) (discussing the relationship between the economic substance and sham transaction doctrines).


\(^3\) See, e.g., Calvin H. Johnson, What's a Tax Shelter?, 68 TAX NOTES 879, 879 (1995) ("There is no consensus definition of a 'tax shelter' in the law or legal literature. The most authoritative definitions, alas, also make the least sense."); Deborah H. Schenk, Foreword, 55 TAX L. REV. 125, 127 (2002) ("The difficulty with defining shelters is that, like Justice Potter Stewart, we know them when we see them, but we apparently cannot agree either on what we are seeing or how to describe what we see." (footnote omitted)).
transaction was abusive that one judge has called it a "smell test." Moreover, given the doctrine's focus on the taxpayer's purpose and whether there was a prospect of pre-tax profit, taxpayers can easily manipulate it. This Article therefore argues that courts should abandon the current economic substance doctrine. Instead, courts should consider whether the claimed tax result is consistent with the intent of the applicable provisions.

To be clear, the Article does not focus on how to incorporate into tax disputes an inquiry into congressional intent; others have addressed that issue from a variety of perspectives. Rather, this Article examines why courts generally do not perform this vital inquiry today, even when claimed tax benefits do not comport with the underlying economics of the transaction, and explains why they should do so.

In developing this argument, this Article makes several connected points. First, identifying abusive transactions is so difficult largely because some tax provisions merely try to measure income while others try to provide an incentive for particular behavior. A tax-avoidance motive on the

4. ACM P'ship, 157 F.3d at 265 (McKee, J., dissenting) ("I can't help but suspect that the majority's conclusion ... is, in its essence, something akin to a 'smell test.' If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to 'put one over.'").

5. See, e.g., Steven A. Dean & Lawrence M. Solan, Tax Shelters and the Code: Navigating Between Text and Intent, 26 VA. TAX REV. 879, 905–04 (2007) (arguing that tax shelters pose problems for principles of statutory interpretation but that "the 'ordinary meaning' canon, which limits a statute's scope to those situations that come within the ordinary usage of the statutory language, and therefore are more likely to be within the law's intended domain, can well be employed to disallow tax shelters that leverage plausible, but unusual applications of statutory language" (footnotes omitted)); Deborah A. Geier, Interpreting Tax Legislation: The Role of Purpose, 2 FLA. TAX REV. 492, 497 (1995) (exploring various ways of identifying the purpose of a tax statute, including referring to "the fundamental structure underlying the income tax"); Michael Livingston, Practical Reason, "Purposivism," and the Interpretation of Tax Statutes, 51 TAX L. REV. 677, 720 (1996) (advocating the use of a "practical reason method" that would "consider statutory text, legislative history, and evolutive considerations—including judicial and administrative precedents and applicable current values—together with the consequences of alternate interpretations and the court's own policy sense"); William D. Popkin, The Collaborative Model of Statutory Interpretation, 61 S. CAL. L. REV. 541, 546 (1988) (advocating a model of statutory interpretation in which "courts collaborate with legislatures in developing statutory law"); Lawrence Zelenak, Thinking About Nonliteral Interpretations of the Internal Revenue Code, 64 N.C. L. REV. 623, 630 (1986) (arguing "that nonliteral interpretations of statutes, including the Internal Revenue Code, are sometimes proper"). For a recent argument in favor of "purposive" interpretation in the tax-shelter context, see Shannon Weeks McCormack, Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach, 2009 U. ILL. L. REV. 697 (also explaining how to identify the purposes of a statute). For an argument that the economic substance doctrine "is no more than a doctrine of purposeful statutory construction, necessary to invalidate the tax benefits from those transactions that might meet the letter of the law but thwart the law's intended purpose and the statute's framework," see Sandra Favelukes O'Neill, Let's Try Again: Reformulating the Economic Substance Doctrine, 121 TAX NOTES 1053, 1053 (2008).

6. See Alan Gunn, Tax Avoidance, 76 MICH. L. REV. 733, 749 n.51 (1978) ("Every tax provision I know of aims at one of two goals: (1) obtaining a satisfactory practical determination of net income, which is commonly thought to be an accurate measure of 'ability to pay,' or (2)
part of the taxpayer undermines the measurement function, but not the incentive function. In fact, provisions that incentivize behavior by providing tax benefits affirmatively rely on taxpayers' desire to minimize their taxes. Thus, the presence of a tax-avoidance purpose is not a reliable barometer of an abusive transaction.

Second, the business purpose requirement dates to the landmark case of *Gregory v. Helvering*, but in that case, the U.S. Supreme Court and the Second Circuit merely interpreted the governing statute as implicitly requiring a business purpose. As explained below, the fact that the courts reached that interpretation in the context of a corporate reorganization—a transaction specific to corporations—is not coincidental. Over the years, the business purpose requirement has been distorted, resulting in analyses that make little sense.

Third, case law and commentary suggest that so long as a transaction has economic substance or a business purpose (or perhaps both), the taxpayer can choose the form in which to carry it out. However, that notion is misleading. Much of the analysis of how a transaction should be treated for tax purposes depends on whether the chosen form really is consistent with that substance. As discussed below, cases such as *Gregory*, in which the taxpayer had an underlying non-tax purpose (to sell a block of shares), illustrate that a non-tax motive for the transaction is not necessarily sufficient for a court to uphold the tax consequences arising from the chosen form. A corollary to this principle, as this Article demonstrates, is that courts should not respect a transaction, even one closely connected with the taxpayer's business, simply because the taxpayer is conducting a business.

The remainder of this Article proceeds in three parts. Part II first identifies the two principal goals of federal income tax statutes: to measure income and to induce desired behavior. These goals are very different from each other because tax-motivated behavior is inconsistent with the former but is the aim of the latter. Identifying which goal is operative in a particular encouraging some activity.

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provision requires ascertaining Congress's intent. This Part also explains why the focus on whether a transaction constitutes a "tax shelter" is unhelpful.

Part III of the Article examines the case law that gave rise to the economic substance doctrine. It shows that the doctrine evolved from one focused on congressional intent to an entirely different doctrine in Frank Lyon Co. v. United States—a case in which the Supreme Court did not seem to understand the economics of the transaction in question. The result is a misdirected doctrine that taxpayers can easily manipulate.

Part IV of the Article critiques each of the prongs of the economic substance doctrine, arguing that both the subjective business purpose and objective economic substance elements of the doctrine are misguided and can give rise to nonsensical results. It shows how the courts developed the business purpose prong in a context peculiar to corporate transactions, but extended it to circumstances in which it plays no appropriate role. It further argues that, in some cases, courts have inappropriately found a business purpose simply because the transaction was integrated into the taxpayer’s business. This Part also explains that, like the business purpose prong, the economic substance prong can be applied to uphold abusive tax arbitrage simply because it is bundled with other activity.

The Article concludes that the economic substance doctrine is so deeply flawed that it must be abandoned and replaced with a direct inquiry into whether the transaction achieves results that are inconsistent with the intent of the tax laws. That inquiry, akin to Judge Learned Hand’s analysis in Gregory, would consider the applicable statutory or regulatory framework in order to determine whether the claimed tax results are consistent with its purposes.

II. IDENTIFYING TAX ABUSE

A. TWO (CONTRADICTORY) FUNCTIONS OF THE FEDERAL INCOME TAX

A fundamental difficulty the federal tax system poses is how to identify which transactions are abusive and which are legitimate. The core reason for this difficulty is that there are different kinds of tax provisions. Many federal income tax provisions are designed simply to measure the taxpayer’s

10. See Martin J. McMahon, Jr., Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code, 54 SMU L. REV. 195, 205–06 (2001). McMahon stated:
The Code abounds with provisions that not only influence economic behavior, but that also are intended to influence economic behavior . . . How are the IRS and the courts to sort the sheep from the goats and decide which combination of mismatched rules produces an intended tax benefit, thereby exempting the transaction from the business purpose test and economic substance test . . . ?

Id.
economic income and impose tax on that income at specified rates.\textsuperscript{11} Of course, imposing a tax on any behavior may result in less of that behavior. For example, taxing wages may reduce the amount of time a taxpayer works.\textsuperscript{12} If market forces resulted in an optimal amount of the activity before tax was imposed, the reduction in that activity resulting from taxation gives rise to deadweight loss.\textsuperscript{13} Accordingly, taxation of activities for which taxpayers can substitute other activities often produces inefficiencies.\textsuperscript{14} Assuming perfectly efficient markets before taxes were imposed, the most efficient tax would therefore be one that did not alter taxpayers' behavior at all.\textsuperscript{15}

If measuring income without altering taxpayer behavior were the only thing Congress sought to accomplish with the federal income tax system, then, in theory, any tax-motivated action could be considered inconsistent with the goal of the tax system, and the claimed benefits disallowed as yielding deadweight loss—though such a tax system would be impossible to administer. In that hypothetical circumstance, the taxpayer's subjective intent would be critical because tax results would depend on it.

However, it is well known that the federal income tax system does not try only to measure taxpayers' taxable income. It also contains provisions expressly designed to alter taxpayers' behavior. These latter provisions intentionally mismeasure income in order to induce more of a particular activity. For example, the individual retirement account provisions encourage people to save money for their retirement.\textsuperscript{16} More generally, certain transactions may only be profitable after taxes and may thus be

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11. See supra note 6.

12. This is an example of the "substitution effect"; the taxpayer here substitutes leisure for some amount of work. Daniel Shaviro, The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy, 64 U. CHI. L. REV. 405, 421 (1997). Alternatively, the taxpayer could decide to work more hours to earn the amount of income he or she would have retained in the absence of taxes. Id. That would be an example of the "income effect." Id.

13. See RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 511 (7th ed. 2007). Moreover, the presence of a tax system prompts tax planning, which itself has social costs. See David A. Weisbach, Ten Truths About Tax Shelters, 55 TAX L. REV. 215, 222-24 (2002) ("Tax planning... is almost always positively bad for society—it is worse than worthless. ... [T]he changed behavior imposes costs on others that the person does not take into account. ... [A]ll tax planning, all altering of behavior in response to taxes, should be suspect.").

14. POSNER, supra note 13, at 510 & n.2, cf. id. at 511 (noting that if there are excessive amounts of the taxed activity, taxation can increase efficiency).

15. See Kyle D. Logue, Optimal Tax Compliance and Penalties When the Law Is Uncertain, 27 VA. TAX REV. 241, 257 (2007) ("[T]he most efficient, or least distortive, tax is not an income tax at all but some form of lump sum tax, perhaps a head tax."); see also Joseph Bankman & David A. Weisbach, The Superiority of an Ideal Consumption Tax over an Ideal Income Tax, 58 STAN. L. REV. 1413, 1422 n.14 (2006) ("[I]f we eliminate redistribution from the analysis, the most efficient tax is a head tax. Once redistribution is added back in, a wage tax best distinguishes among individuals on the basis of their abilities.").

undertaken because of the tax subsidy the government offers. Taking the government up on proffered tax benefits is, by definition, not abusive. Accordingly, the fact that Congress intentionally provides some tax subsidies is a large part of what makes identifying abusive transactions so difficult.

The question thus becomes what distinguishes tax-influenced transactions that simply accept government incentives from those that exploit the law (whether or not they constitute tax shelters). The dividing line is whether Congress intended to provide the claimed benefit or not.

17. See Joseph Bankman, The Economic Substance Doctrine, 74 S. Cal. L. Rev. 5, 13 (2000) (providing examples of tax provisions designed to make otherwise unprofitable investments profitable). Another scholar explains:

The real difficulty in applying the business purpose, economic substance, and purposive activity doctrines derives from the fact that the code abounds with provisions that...are intended to influence economic behavior. Many of those provisions, particularly when they act in concert, result in transactions that are not economic before-tax becoming profitable after tax. The tax results in many situations in which this occurs commonly are accepted as "correct."

Martin J. McMahon, Jr., Economic Substance, Purposive Activity, and Corporate Tax Shelters, 94 Tax Notes 1017, 1019 (2002) (emphasis added); see also Gunn, supra note 6, at 749 n.51 (pointing out that the goal of some tax provisions is "encouraging some activity"); Rosenberg, supra note 6, at 366–67 ("To the extent that the system attempts to encourage people to change their behavior in certain ways, one might expect a person's taxable income to reflect the extent to which she has so changed her behavior.").

18. See Bankman, supra note 17, at 13 (arguing that applying the economic substance test to transactions that use tax benefits in a way intended by the legislature is not supportable); Amandeep S. Grewal, Economic Substance and the Supreme Court, 116 Tax Notes 969, 995 (2007) (explaining that "Congress is empowered to subsidize both retirement accounts and business transactions, and perhaps even 'backflips,' too[,] so "a court's inquiry should be limited to determining whether a taxpayer's transaction falls within the terms of the applicable statute").

19. Not all abusive transactions are tax shelters. For example, some constitute tax fraud. See Dean & Solan, supra note 5, at 882 ("[T]ransactions that intentionally disobey the law [are typically not considered to be tax shelters]. These constitute tax fraud."). There may also be a category of non-fraudulent transactions that reach results contrary to Congress's intent that do not constitute tax shelters. See Michael L. Schler, Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach, 55 Tax L. Rev. 325, 330–31 (2002) (raising this issue and pointing to Gitlitz v. Comm'r, 531 U.S. 206 (2001), as a possible example).

20. Cf. Sacks v. Comm'r, 69 F.3d 982, 991 (9th Cir. 1995) ("Absence of pre-tax profitability does not show 'whether the transaction had economic substance beyond the creation of tax benefits,' where Congress has purposely used tax incentives to change investors' conduct."); In re CM Holdings, Inc., 254 B.R. 578, 624 (D. Del. 2000) ("The Court is unaware of any statute or legislative history indicating Congress has condoned, much less encouraged, policy loan interest deductions of the type and magnitude involved in Camelot's broad-based COLI VIII plan."); aff'd, 301 F.3d 96 (3d Cir. 2002); Dean & Solan, supra note 5, at 882 ("[W]e adopt the position, taken by others, that tax shelters are generally characterized as transactions that appear to comply in a literal manner with the Code, but which are designed to reach a tax result that Congress would not have intended."); David P. Hariton, When and How Should the Economic Substance Doctrine Be Applied?, 60 Tax L. Rev. 29, 31 (2006) ("[A] court's inquiry is not finished when it concludes that a transaction lacks business purpose and economic substance. The tax benefits arising from such a transaction should not be disallowed unless they are clearly
While not necessarily an easy question to answer, it is the question that distinguishes abusive transactions from appropriate ones. Any other test is simply a proxy for that inquiry. The results of this inquiry can be diagramed as follows:

<table>
<thead>
<tr>
<th>Congress intended the tax result</th>
<th>Congress did not intend the tax result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allow claimed tax results to stand.</td>
<td>Disallow claimed tax results.</td>
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</table>

Note that, as this diagram suggests, unless the tax law provides otherwise, the taxpayer's intent is irrelevant to whether the transaction is abusive. For example, a taxpayer may decide to attend college solely because tax credits make it affordable or may acquire a business-use machine solely because the Internal Revenue Code ("Code") provides an election to deduct its entire cost. In each of these situations, the taxpayer's behavior had a tax motivation. However, not only are the transactions not abusive, they are exactly what Congress intended to subsidize. The critical question to distinguish between legitimate tax benefits and exploitation of the tax laws is whether Congress intended the claimed benefits.

Current law generally relies on judicial doctrines, including the economic substance doctrine, to distinguish between "real" transactions—including those that provide permissible, favorable tax results—and those that constitute abusive tax-avoidance transactions. Professor Brian Galle explains:

> In general, the [economic substance] doctrine operates to disallow a taxpayer's characterization of a particular business transaction where, although the transaction in form meets the literal terms of the statute, in substance it "seeks to claim tax benefits, unintended by Congress." In this context Congress is usually understood to intend to give tax-favorable treatment only to a transaction that has

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21. Congress and the U.S. Department of the Treasury are of course free to require a particular intent (such as a business purpose) or the absence of a particular intent (such as the absence of a tax-avoidance motive) as a condition for receiving a particular tax result. See infra note 145 and accompanying text (providing examples of statutes requiring a business purpose).


23. See id. § 179 (allowing taxpayers to deduct, up to a certain amount, the cost of certain business-use property). Absent this provision, the cost of the property would have to be capitalized, id. § 263, and generally would be recoverable over time rather than all at once, see id. §§ 167, 168 (providing a deduction for depreciation of, among other things, business-use property).

a meaningful effect on the taxpayer's real economic situation or that was entered into with a real business purpose.25

Notice how the inquiry is described as shifting from what Congress intended with a particular law to the effects on (or motives of) the taxpayer, although one cannot discern congressional intent from either the taxpayer’s motives ex ante or the results of the transaction ex post. The inquiry is therefore simply a proxy for the real question. That question—whether Congress “intended” particular tax benefits—may not have an immediately obvious answer, but it can be answered by reference first to the specific purposes of the provision in question, and, if necessary, to general principles of tax law.26 Moreover, the taxpayer can manipulate or manufacture evidence of its own intent—such as developing an after-the-fact “business” purpose for a tax strategy27—but cannot readily create evidence of Congress’s intent.

B. DOES A “TAX SHELTER” DETERMINATION MATTER?

The economic substance doctrine is typically used in cases involving transactions that are at least arguably tax shelters, and at least one commentator has argued that the shelter context is the only one in which the doctrine should be used.28 There is extensive discussion in the literature


26. See McCormack, supra note 5, at 721–25 (setting forth a framework for purposive interpretation of tax laws in tax-shelter cases). Professor McCormack proposes that courts ask the following question: “[C]onsidering the provisions of the Code and Regulations at issue, and the materials relevant to their construction and development, does the result of the transaction in question fall within any of the provisions’ purposes?” Id. at 720. She further advocates looking at the specific purposes of the provision in question before examining general principles of tax law. Id. at 721. General principles include “the concept that one’s basis in an asset should reflect one’s economic investment in that asset [and] ... the notion that ‘the same dollars should not be taxed to the same person more than once or deducted by the same person more than once.’” Id. at 723 (quoting Geier, supra note 5, at 497). It is wise to consider specific purposes first because Congress is free to choose to deviate even from core principles of tax law.

27. Professor Linda Beale explains:

A [business] purpose resulting from post hoc rationalization is inherently suspect as not founded in the client’s business needs but rather in its tax desiderata. In practice, the conjecture may take place in a context in which client and practitioner discuss the transaction and the practitioner effectively suggests a purpose that the client then represents to the practitioner. Such interchanges may appear almost ordinary to many practitioners.

Linda M. Beale, Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges, 25 VA. TAX REV. 583, 601 (2006); cf. infra text accompanying notes 234–37 (discussing how, in both Gregory and UPS, a legitimate transaction was structured in a particular way for tax reasons).

28. See Hariton, supra note 20, at 30. Hariton states,
on what constitutes a tax shelter, which is in line with the notion that shelters should be singled out for special treatment. Unfortunately, there is no single definition of what constitutes a tax shelter, in part because tax shelters are difficult to describe generically, and in part because not everyone agrees on what known transactions should be contained within the scope of the term.

Unless courts actually need a separate mechanism to combat abusive tax shelters, the judicial tools used in response to abusive transactions should not be limited to the tax-shelter context. It might be the case that certain strategies generally considered hallmarks of shelters—such as literally construing the tax law in a way that appears inconsistent with its underlying purpose—may require a particular type of treatment; but, since there is no agreement on what falls within the “tax shelter” rubric, it is impossible to determine if there is a particular tool designed only to combat tax shelters.

I argue that the economic substance doctrine should be applied to “tax shelters,” which I would define as transactions that, when considered as a whole, serve primarily to generate net losses, deductions or credits that can be used to eliminate the tax that otherwise would be imposed on unrelated income.

Id. 29. See, e.g., Karen C. Burke, Black & Decker in the Fourth Circuit: Tax Shelters and Textualism, 111 TAX NOTES 315, 325 (2006) (“Tax shelters are typically designed to comply with the literal words of the statute while circumventing its purpose.”); David P. Hariton, Essay, Kafka and the Tax Shelter, 57 TAX L. REV. 1, 11-12 (2003) (arguing that the hallmark of a tax shelter is the sheltering of unrelated income); Johnson, supra note 3, at 879 (“For a number of years now, I have collected definitions of ‘tax shelters’—my butterfly collection—and it is surprising how varied the collection has become.”); Schler, supra note 19, at 328-29 (“One of the biggest problems in any discussion of tax shelters is that there is no established definition of the term. . . . Any number of definitions of tax shelter are possible.”).

30. See supra note 29 (discussing the lack of agreement on a definition of the term “tax shelter”).

31. For example, there is disagreement as to whether the transaction in Gitlitz v. Commissioner, 531 U.S. 206 (2001), was a tax shelter. Gitlitz involved the use of non-taxed discharge of indebtedness income to increase basis in the stock of an insolvent corporation taxed under Subchapter S of the Code. Gitlitz, 531 U.S. at 208. Compare Marvin A. Chirelstein & Lawrence A. Zelenak, Essay, Tax Shelters and the Search for a Silver Bullet, 105 COLUM. L. REV. 1939, 1947 (2005) (“Gitlitz was not a tax shelter case, and the economic substance doctrine was not discussed in the opinion . . . .”), with Dean & Solan, supra note 5, at 900-01 (referring to Gitlitz and Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), as involving “cleverly designed tax shelters”). At a minimum, Gitlitz did not involve a transaction that was structured with taxes in mind. See Scott A. Schumacher, MacNiven v. Westmoreland and Tax Advice: Using “Purposive Textualism” to Deal with Tax Shelters and Promote Legitimate Tax Advice, 92 MARQ. L. REV. 33, 95 (2008) (“[T]he taxpayers [in Gitlitz] did not order their affairs to obtain a certain result or create a transaction out of whole cloth, but merely took advantage of the tax law (‘exploited the loophole’) to get the most favorable tax treatment for their genuine transaction.”).
In addition, the form that tax shelters take may change over time, making the tax-shelter determination a moving target. Corporate tax shelters differ in many ways from the earlier breed of individual tax shelters (and even from each other).\textsuperscript{32}

Furthermore, asking if a transaction constitutes a tax shelter narrows the focus of the abuse inquiry to a mere subset of tax-compliance concerns. The government has a legitimate interest in fighting all abusive tax behavior, and not all tax abuse is a tax shelter. To take a generally uncontroversial example, a business owner who accepts cash compensation “under the table” so as not to pay taxes on it is committing tax evasion. That is abusive, but few people would call it a tax shelter.\textsuperscript{33} A more controversial example would be business transactions that result in claimed tax benefits inconsistent with their underlying economics: at least some experts do not consider such transactions to be tax shelters if they involve unique, “one-off” structures and/or occur in the course of the taxpayer’s business (such as in United Parcel Service of America, Inc. v. Commissioner (UPS)\textsuperscript{34} and Gitlitz v. Commissioner\textsuperscript{35}).

\textsuperscript{32} See Lawrence Zelenak, Codifying Anti-Avoidance Doctrines and Controlling Corporate Tax Shelters, 54 SMU L. Rev. 177, 191–92 (2001) (discussing the difference between individual tax shelters and corporate tax shelters).

The problem with the analogy to the passive loss rules, [a government tax official] said, was that individual shelters were structurally so similar that a one-size-fits-all solution was possible, but that corporate shelters “all involve different areas of the code and they’re different shapes and sizes so we would love to find a silver bullet one size fits all but these things are just too varied to try to get at.”\textsuperscript{Id. at 192.}

\textsuperscript{33} See Dean & Solan, supra note 5, at 882 (explaining that transactions designed to disobey the law constitute tax fraud, not tax shelters).

\textsuperscript{34} United Parcel Serv. of Am., Inc. v. Comm’r (UPS), 254 F.3d 1014, 1020 (11th Cir. 2001) (upholding a taxpayer’s restructuring of its “excess-value charge” program, under the economic substance analysis, as insurance provided by an overseas affiliate). In UPS, the Tax Court had disallowed the claimed tax benefits. See United Parcel Serv. of Am., Inc. v. Comm’r (UPS), 78 T.C.M. (CCH) 262, 293 (1999) (“[W]e find that the restructuring was done for the purpose of avoiding taxes and that the arrangement . . . had no economic substance or business purpose.”). The Eleventh Circuit reversed on that issue, see UPS, 254 F.3d at 1020, but one of the three judges dissented. \textit{Id.} at 1020–22 (Ryskamp, J., dissenting).

Accordingly, analyses of what constitutes a tax shelter sometimes conclude, based on case law, that transactions that are integrated into the taxpayer's business do not constitute tax shelters. This may simply reflect an observation that courts generally do not apply the economic substance doctrine to these transactions. If the lack of application of the economic substance doctrine actually means that a transaction is not a tax shelter, then the inquiry of what constitutes a tax shelter (to which the economic substance doctrine will apply) becomes circular.

There is also a risk that the positive observation about what courts do will evolve into a prescriptive principle that one-off transactions (or those closely linked to the taxpayer's business) should not be subject to scrutiny under judicial doctrines such as the economic substance doctrine. The principal structural difference between a one-off transaction and a cloned one is that the latter is more costly for the government if it is not stopped.

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3. See supra note 17, at 17 (“The treatment of Cottage Savings [Ass' n v. Commissioner, 499 U.S. 554 (1991)] by the ACM and Saba [Partnership v. Commissioner, 78 T.C.M.(CCH) 684 (1999)] courts suggest that transactions tied to ordinary business operations will be favorably treated under the economic substance doctrine.”); McMahon, supra note 10, at 206 (“One of the common threads in the corporate tax shelter cases is that the transactions that have been scrutinized under the business purpose, economic substance, and sham transaction doctrines, and which have been found to be lacking, are transactions outside the ordinary course of the taxpayer's business.”).

35. Gitlitz v. Comm'r, 531 U.S. 206 (2001) (upholding taxpayers' use of non-taxed discharge of indebtedness income to increase basis in S corporation stock because discharge of indebtedness is "item of income" under Code section 1366 and increases shareholder basis under section 1367). There is some disagreement about whether Gitlitz involved a tax shelter. See supra note 31.

36. See, e.g., UPS, 254 F.3d at 1019 ("[A] transaction has a 'business purpose,' when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business."); Black & Decker Corp. v. United States, 340 F. Supp. 2d 621, 623–24 (D. Md. 2004) ("A corporation and its transactions are objectively reasonable, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based business transactions."). aff'd in part, rev'd in part, remanded, 435 F.3d 431, 441 (4th Cir. 2006) ("In so reasoning, the district court mischaracterized the . . . test, which focuses not on the general business activities of a corporation, but on the specific transaction whose tax consequences are in dispute.").

37. See, e.g., Bankman, supra note 17, at 17. ("At present, the dynamics of corporate tax planning seem to support the positive view, expressed above, of the ordinary course of business exception.").

38. For example, Professor Martin McMahon argues:

McMahon, supra note 10, at 207 (citing Mark P. Gergen, The Common Knowledge of Tax Abuse, 54 SMU L. Rev. 131, 144–45 (2001)); see also Bankman, supra note 17, at 20 ("At present, the dynamics of corporate tax planning seem to support the positive view, expressed above, of the ordinary course of business exception.").

39. See Bankman, supra note 17, at 18. Bankman explains:
As discussed below, the fact that a strategy is integrated into the taxpayer's business, rather than existing alongside it, should not affect the determination of whether that strategy is abusive. If the activity is abusive, it is socially wasteful regardless of how connected it is to the taxpayer's business. Thus, as argued above, the real question is not whether a transaction is a "tax shelter" but rather whether the claimed tax results are consistent with the intent of Congress.

III. THE PATH FROM CONGRESSIONAL INTENT TO TAXPAYER INTENT

The origins of the economic substance doctrine lie in several transactions in which taxpayers applied the literal terms of the Code to reach results at least arguably inconsistent with its intent. Gregory v. Helvering, Knetsch v. United States, and Frank Lyon Co. v. United States are typically identified as developing what became the economic substance doctrine. The discussion below traces the development of the doctrine across these cases, detailing its evolution from a test that focused on Congress's intent into the two-pronged test that current courts generally apply.

A. GREGORY V. HELVERING

Gregory v. Helvering is almost universally identified as the first major case applying a precursor of the modern economic substance doctrine. In Gregory, the taxpayer, Mrs. Gregory, was the sole owner of the United Mortgage Corporation (“United Mortgage”), which, in turn, held a block of shares in a real estate development company. The corporation purchased the shares with borrowed funds, and the shareholder claimed to have incurred a loss equal to the amount of the loan. The Commissioner disallowed the loss deduction, and the taxpayer challenged the disallowance. The Supreme Court held that the disallowance was proper because the transaction did not reflect the economic realities of the situation, but instead was a tax shelter. This case is often cited as the first in which the Court applied the economic substance doctrine.

A rule that allows taxpayers to take advantage of loopholes that naturally present themselves in the course of business operations will be expensive to the federal coffers, but that cost will be limited to the number of "naturally present" loopholes. A rule that allows taxpayers not only to take advantage of loopholes but to manufacture circumstances in which they arise would be ruinous to the fisc.

Id. 40. Cf. Philip A. Curry, Claire Hill & Francesco Parisi, Creating Failures in the Market for Tax Planning, 26 VA. TAX REV. 943, 948 (2007) (“[T]ax planning efforts are for the most part unproductive, socially wasteful activities.”).

41. In the context of a regulation, the question is whether the regulation, as applied, is consistent with the intent of the Treasury Department. Cf. Schler, supra note 19, at 330 (“[A]ny tax shelter achieves a tax result unintended by the drafters of the Code or regulations. In fact, it seems impossible to define a tax shelter except in terms of congressional or regulatory intent.”).

45. Bankman, supra note 17, at 7-8 (listing those three Supreme Court cases, as well as Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), which is mentioned briefly below).

46. See id. at 8 n.4 (“Gregory is widely seen as a precursor to ACM Partnership v. Commissioner and other recent cases . . . .”).
stock that Mrs. Gregory wished to sell. Had United Mortgage sold the stock and distributed the proceeds, the sale would have been taxed at the corporate level and the distribution would have constituted a dividend, which would have been taxed in full at ordinary income rates. Mrs. Gregory could simply have caused United Mortgage to distribute the stock to her and then sold it, but that distribution would have constituted a dividend as well.

Instead, to accomplish the same end, Mrs. Gregory undertook a corporate division known as a spin-off, using a newly created corporation (Averill Corporation), which existed for only a few days. If the form of the transaction were respected, Mrs. Gregory received the shares in an exchange transaction, resulting in capital gain and a partial-basis offset (a portion of her basis in the United Mortgage shares). The sale of the shares would give rise to no additional gain because the recognition of gain on the exchange would provide her with a fair-market-value basis in those shares.

In the Court of Appeals for the Second Circuit, Judge Learned Hand famously found for the government, and the Supreme Court affirmed, adopting Judge Hand's reasoning. The courts reasoned that the transaction did not constitute a "reorganization" within the meaning of the statute because it lacked a business purpose. These opinions have "a curious dual quality." Each opinion says that tax planning (and even tax avoidance) is acceptable but finds the particular tax-minimization device

47. Gregory, 293 U.S. at 467.
49. Id. In that scenario, no corporate-level tax would have applied under the doctrine of Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935), which was still in effect at the time. Id. at 12.
50. "In a spin-off, a corporation distributes one or more of its businesses, held in subsidiary form, to its shareholders." Lily Kahng, Resurrecting the General Utilities Doctrine, 39 B.C.L. REV. 1087, 1114 (1998).
51. Gregory, 293 U.S. at 467.
53. Id.
55. Gregory, 293 U.S. at 469 ("The reasoning of the court below . . . leaves little to be said."). The Supreme Court's opinion in Gregory has been described as "legally more authoritative, albeit less eloquent" than Judge Hand's opinion. Daniel N. Shaviro, The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance, in TAX STORIES 313, 323 (Paul L. Caron ed., 2003).
56. Gregory, 293 U.S. at 469 ("[F]ixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character . . . ." (emphasis added)); see also Gregory, 69 F.2d at 811 ("[T]he transactions were no part of the conduct of the business of either or both companies . . . ."). Judge Hand used a purposive interpretation to determine the meaning of the term "reorganization." See id. at 810-11.
57. Shaviro, supra note 55, at 321.
used by Mrs. Gregory unacceptable. For example, the Second Circuit's opinion reads, in part, as follows:

[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here, was what was intended by section 112(i)(1)(B), it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was.58

Similarly, the Supreme Court stated:

The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.59

Each opinion thus states that tax minimization is acceptable only if it is consistent with Congress's intent.60 This reading of the cases renders each Gregory opinion internally consistent: they do mean that having a tax-avoidance motive is not sufficient to render a transaction abusive. However, if the tax reduction claimed is not consistent with the intent of the applicable statute, the result will not stand.

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58. Gregory, 69 F.2d at 810 (emphasis added) (citations omitted). To contextualize Gregory, it helps to understand that the issue of the morality of legal tax avoidance was an issue that was being debated during the period in which Gregory was decided. See Assaf Likhovski, The Story of Gregory: How Are Tax Avoidance Cases Decided?, in BUSINESS TAX STORIES 89, 115–20 (Steven A. Bank & Kirk J. Stark eds., 2005) (contextualizing Gregory in this way); see also Marvin A. Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 YALE L.J. 440, 445 (1968) (noting that Hand stated that there was "nothing reprehensible about minimizing taxes").

59. Gregory, 293 U.S. at 469 (emphasis added) (citations omitted).

The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt arifice above reality and to deprive the statutory provision in question of all serious purpose.

Id. at 470.

60. See, e.g., Kenneth W. Gideon, Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters, 5 VA. TAX REV. 825, 827 (1986). Gideon argues:

The Gregory Court rested its decision on a determination that Mrs. Gregory's reorganization was outside the intent of Congress in enacting the reorganization provision. This test ought to be the first inquiry in any tax-shelter case, for if a court concludes that Congress intends the result sought by a taxpayer, that ends the matter, without regard to whether a judicial test has been offended.

Id. (footnote omitted).
This analysis explains why the courts in *Gregory* held for the government although "[t]he spinoff was merely the most tax-efficient means of accomplishing [a] distribution" of the stock to Mrs. Gregory. Choosing the most tax-efficient method of accomplishing a result is fine—but only if Congress intended the particular tax savings. In *Gregory*, the courts effectively found that Congress did not intend the use of the reorganization provisions for reduction of shareholder-level tax on what amounted to a dividend distribution.

Commentators have correctly noted that the approach Judge Learned Hand took in *Gregory* (which the Supreme Court also applied) was simply to interpret the statute, although Judge Hand did consider other Code sections as evidence of Congress's intent. For example, Professor Marvin Chirelstein, in an analysis of Judge Learned Hand's tax opinions,


63. See *Gregory*, 69 F.2d at 810 (explaining that the Commissioner "ruled that the whole transaction was merely the declaration of a dividend by the United Mortgage Corporation consisting of the Monitor shares in specie, on which the taxpayer must pay a surtax calculated at their full value"); id. at 811 (holding for Commissioner and explaining that "the result is the same whether the tax be calculated as the Commissioner calculated it, or upon the value of the Averill shares as a dividend"). But cf. Hariton, supra note 61, at 244. Hariton claims:

Judge Hand's statutory analysis was a bit self-serving. The tax deferral arising from a tax-free spinoff followed by a sale was not beyond the pale of what the drafters of the reorganization provisions could reasonably have intended. As one commentator has put it, where the reorganization provisions are concerned, "substance is form and little else; there is no natural law of reverse triangular mergers."

Id. (quoting Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 879 (1982)).

64. See, e.g., RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION 148 (1937) ("The Gregory case was . . . a statutory construction case. The issue, correctly stated, was whether the 'reorganization' exemption provision of the 1928 Act applied to a letter-perfect reorganization having no business or corporate purpose."); Grewal, supra note 18, at 979 ("[T]he [Gregory] Court found (rightly or wrongly) that the statute itself demanded a business purpose.").

65. Judge Hand's opinion for the Second Circuit in *Gregory* explained:

[T]he act itself gives evidence that, on occasion anyway, the purpose of a transaction should be the guide; thus in section 115(g), the cancellation of shares is to be treated as a dividend—though otherwise it would not be such—if it is "essentially equivalent to the distribution of a taxable dividend"; again in section 112(c)(2), a distribution is in part taxable as a dividend, if it "has the effect of the distribution of a taxable dividend."

*Gregory*, 69 F.2d at 811 (citations omitted).
commented that Judge Hand’s “holding that the transaction was a device with no business purpose . . . led to the conclusion that the transaction in that respect fell short of the definitional requirements of the statute.”66

Judge Hand himself also expressed the sentiment that all he did was ascertain the intent of Congress67:

It is reported that Judge Learned Hand said on June 16, 1938, on the oral argument of Cogan v Comm., 97 F (2d) 996 (CCA 2d 1938): “I have been violently criticized by the tax lawyers for having originated a revolutionary doctrine in the Gregory case whereas all that I did was to note the plain intention of Congress which tax practitioners had preferred to ignore in order that they might be able to provide simple methods of tax avoidance for their clients.”68

B. KNETSCH V. UNITED STATES

The fact that Judge Hand’s approach, which relied on purposive interpretation to determine congressional intent, was unpopular with tax planners may be suggestive of its efficacy in limiting abusive transactions. In any case, the Court did not abandon this approach after Gregory. In Knetsch v. United States, the Court similarly considered the taxpayer’s intent, found the existence of a tax-avoidance motive to be irrelevant, and emphasized Congress’s intent.69

In Knetsch, the taxpayer borrowed at 3⅜% interest to finance the purchase from the same party of savings bonds paying 2⅓% interest.70 The

66. Chirelstein, supra note 58, at 446.
67. Note that although Judge Hand found the presence of a tax-avoidance motive to be perfectly acceptable, he also found that, in the reorganization provisions, Congress’s intent was to require a specific purpose—a business purpose. The logic of requiring a business purpose in the context of the corporate reorganization provisions is discussed further below. See infra text accompanying notes 168–71.
68. PAUL, supra note 64, at 125 n.388.
69. Knetsch v. United States, 364 U.S. 361 (1960); see also Goldstein v. Comm’r, 364 F.2d 734, 742 (2d Cir. 1966) (“[T]he question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.” (quoting Gregory v. Helvering, 293 U.S. 465, 469 (1935))). A more recent case, Horn v. Comm’r, 968 F.2d 1229, 1230–31 (D.C. Cir. 1992), also applied this approach:

[W]e are called upon to decide whether Congress intended to authorize a deduction for losses incurred by certain taxpayers who engaged in transactions of a type designed to secure tax benefits while avoiding any economic risk. More specifically, we must decide whether section 108 of the Tax Reform Act of 1984, as amended, permits commodities dealers to deduct losses incurred in the disposition of the legs of straddle transactions, even if the taxpayer’s pattern of trading reveals that the transactions were designed only to produce tax benefits.

70. Knetsch, 364 U.S. at 362–63. The bonds cost $4,004,000 but involved only a $4000 cash outlay. Id. at 362. The $4 million of debt consisted of “nonrecourse annuity loan notes” secured only by the bonds. Id. at 362–63.
contract also allowed Knetsch to borrow any amount by which the value of
the bonds at year-end exceeded his indebtedness. Five days after entering
into the contract, he borrowed $99,000, again providing 3 1/4% notes.21
Interest on the debt was payable in advance, so Knetsch paid the first year’s
interest on the day of purchase and sought to deduct it.22 In total, “Knetsch
paid the insurance company $294,570 during the two taxable years involved
and received $203,000 back in the form of ‘loans.’”23 The Court asked:
“What did Knetsch get for the out-of-pocket difference of $91,570? . . . The
$91,570 difference retained by the company was its fee for providing the
facade of ‘loans’ whereby the petitioners sought to reduce their 1953 and
1954 taxes in the total sum of $233,297.68.”24 Thus, before taxes, the
transaction cost $91,570.25 After taxes, the taxpayer would be ahead by
$141,727.68 for the tax years in question26 if the transaction was upheld. The

If held the thirty years until maturity, at which point Knetsch would be ninety years
old, the bonds would produce a monthly annuity of $90,171 or “such smaller amount as
would be produced by the cash or loan value after deduction of the then existing indebtedness.” Id. at
362, 364. Because the contract allowed Knetsch to borrow against the value of the bonds, and
he did so, the net cash value of the bonds was only $1000. Id. That would provide a monthly
annuity of $43.

71. Id. at 363.
72. Id. at 362–68. A similar pattern occurred for the next two years, at which point the
contract was cancelled and Knetsch received the $1000 excess in bond value over the loan
amount at that time. Id. at 364.
73. Id. at 365.
74. Id. at 365–66. One of my favorite tax limericks describes the Knetsch case:

“There once was a guy named Knetsch
Who concocted a scheme quite far-fetched
The Code on its face
Supported his case
But the rules had been shamfully stretched.”

By Erik M. Jensen, Case Western Reserve Law School


75. Professor Shaviro observed:

One could conceivably imagine a scenario in which Knetsch would actually earn a
profit before tax—although this might, in the words of Peter Pan, require “happy
thoughts and faith and trust, and a sprinkling of Tinker Bell’s pixie dust.”
Specifically, suppose interest rates dropped so steeply that Knetsch could now
borrow from a third party at 1.5%. Now the pre-tax interest rate arbitrage would
favor him. . . . There is no evidence, however, that he was aware of this possibility,
and his lawyers did not subsequently advance it as a rationale for the transaction.

Shaviro, supra note 55, at 329.

76. That is, $233,297.68 in tax savings minus $91,570 in out-of-pocket costs. As a whole,
the transaction was designed to accelerate deductions while postponing income and converting
ordinary income into capital gain. See Rosenberg, supra note 6, at 409 n.126 (“The tax result was
a substantial current deduction for interest paid, which would be offset by income when the
annuity was sold or forfeited in payment of the debt . . . . [The] income . . . was both deferred
transaction thus involved straightforward tax arbitrage—"whereby you profit after-tax from both paying and receiving a dollar because the dollar you pay is treated more favorably than the dollar you receive." It is hard to imagine a clearer case in which a taxpayer's behavior was influenced by the tax system than a transaction in which the taxpayer has little chance of a pre-tax profit. While in *Gregory*, only the form of the transaction was tax-motivated, in *Knetsch* the substance—and in fact, the entire existence—of the transaction was tax-motivated.

The Supreme Court applied *Gregory* to "put aside a finding by the District Court that Knetsch's 'only motive in purchasing these 10 bonds was to attempt to secure an interest deduction'" because of *Gregory*'s admonition that the taxpayer has the legal right to avoid taxes. It went on to consider "whether what was done, apart from the tax motive, was the thing which the statute intended." Thus, the Court considered whether Knetsch's transaction involved "indebtedness" within the meaning of the Code section providing for an interest deduction or whether it was a sham. It found that "Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax .. .' For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction." It found the transaction to be a "fiction" and a "sham" and referred to the loans as a "facade." Accordingly, the Court held that there was no "indebtedness" for purposes of the interest-deduction provision.

and taxed at low capital gains rates ..."; see also Calvin H. Johnson, *Is an Interest Deduction Inevitable?*, 6 Va. Tax Rev. 123, 134 n.37 (1986) ("It is a paean to the power of both mismatches and the 90% tax rates effective at the time ... that a mere 1.5% after-tax discount rate and three-year deferral ... sufficed to make the negative tax cover Knetsch's $40,000 cash cost.").

77. Tax arbitrage violates what Robert T. Smith terms the "self-defeating principle"—the notion that Congress could not have intended, when enacting statutes to collect revenue, to undermine that very purpose. Robert Thornton Smith, *Business Purpose: The Assault upon the Citadel*, 53 Tax L. 1, 4 (1999).

78. Shaviro, supra note 55, at 315. "Knetsch used amounts attributable to increases in the annuity bonds' value to make the payments. ... [T]he increase in the bonds' value was tax-deferred, while the interest payments could be deducted as they were made. That timing mismatch made the investment attractive, from a tax perspective." Grewal, supra note 18, at 980.

79. Professor Shaviro has pointed out the steep interest rate drop that would be required for Knetsch to make a profit, and that there was no evidence that Knetsch was aware of the possibility. See Shaviro, supra note 55, at 329.


81. *Id.* (quoting *Gregory v. Helvering*, 293 U.S. 465, 469 (1935)).

82. *Id.*

83. *Id.* at 366 (omission in original) (quoting *Gilbert v. Comm'r*, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting)).

84. *Id.*

The Court also analyzed Congress's intent in considering a statutory-interpretation argument advanced by the taxpayer. Congress had enacted a Code section that denied an interest deduction for amounts paid after March 1, 1954, to purchase or hold a single-premium annuity contract.\textsuperscript{86} The taxpayer argued that the new provision indicated that Congress had intended to allow deductions for similar transactions before that date (such as the taxpayer's transaction).\textsuperscript{87} The Court considered both the Code section itself and legislative history and found no such intent.\textsuperscript{88} Instead, it found that "[t]he 1954 provision extending the denial [of an interest deduction] to amounts paid on indebtedness incurred to purchase or carry single-premium annuities appears to us simply to expand the application of the policy in respect of interest allocable to partially exempt income."\textsuperscript{89}

Thus, the Court disallowed the taxpayer's claimed interest deductions because it found that the interest-deduction provision was not intended to encompass the tax result claimed by Knetsch. As in \textit{Gregory}, the Court used phrases like "sham" in the context of any inquiry into what Congress intended the statute in question to encompass.

\textbf{C. Frank Lyon v. United States}

The modern economic substance doctrine stems principally from language in \textit{Frank Lyon Co. v. United States}.\textsuperscript{90} \textit{Frank Lyon} differs from \textit{Knetsch} in that the transaction was not entirely motivated by tax benefits, but rather had an underlying business purpose for Frank Lyon's counterparty. The counterparty, Worthen (a bank), wanted to build a new building—a business objective\textsuperscript{91}—but could not obtain conventional mortgage financing and would not have been able to obtain approval from the Federal Reserve System to invest the substantial amount the building would cost to build.\textsuperscript{92} Worthen therefore decided to use a sale-leaseback transaction.

As the bank building was built, Worthen sold the building to Frank Lyon (the taxpayer) at a "total price not to exceed $7,640,000"\textsuperscript{93} and leased it back.\textsuperscript{94} New York Life provided Frank Lyon with a $7,140,000 twenty-five-year mortgage.\textsuperscript{95} Frank Lyon therefore invested $500,000 in cash. "Worthen's annual rent for the first 25 years of the building lease

\begin{itemize}
\item \textsuperscript{86} \textit{Id.} at 367 (discussing I.R.C. § 264(a)(2) (1954)).
\item \textsuperscript{87} \textit{Id.}
\item \textsuperscript{88} \textit{Id.}
\item \textsuperscript{89} \textit{Id.} at 368.
\item \textsuperscript{90} \textit{Frank Lyon Co. v. United States}, 435 U.S. 561 (1978).
\item \textsuperscript{91} \textit{Id.} at 563.
\item \textsuperscript{92} \textit{Id.} at 563-64.
\item \textsuperscript{93} \textit{Id.} at 566.
\item \textsuperscript{94} \textit{Id.} at 564-65.
\item \textsuperscript{95} \textit{Frank Lyon}, 435 U.S. at 566.
\end{itemize}
represent[ed] the exact amount necessary to fully amortize the . . . New York Life mortgage.96

The bank building cost over $10 million to build,97 but Frank Lyon did not simply negotiate a terrific deal by locking in a $7.64 million purchase price. Worthen had a series of options to repurchase the building at specified amounts, "plus assumption of the [remaining] balance of the New York Life mortgage."98 If Worthen exercised a purchase option during the first twenty-five years, it would pay Frank Lyon cash in the amount of $500,000 plus interest, computed at a rate of six percent.99 If Worthen did not exercise the option but continued to pay rent under all extensions of the lease (forty more years), Frank Lyon would receive something short of $500,000 plus six percent interest.100 Six percent was a below-market rate; that was all Worthen was allowed to pay under state banking regulations, and its obligations were not marketable at that rate.101 The New York Life mortgage bore a 6% percent interest rate.102

The question before the Court was whether Frank Lyon was entitled to the depreciation and other deductions it had claimed. In other words, was it the true owner of the building, or was Worthen the owner although Worthen did not hold title to the building?103 The deal was structured such that Worthen had a synthetic ownership interest in the building—the economic equivalent of ownership—and Frank Lyon was in the same economic position as a lender.104 That is, Worthen was almost certain to exercise the purchase option because it would be able to purchase the

97. Frank Lyon, 435 U.S. at 568.
98. Frank Lyon, 536 F.2d at 749.
99. Id. To quantify that:

   For example, at the end of the 25th year, when the mortgage was fully paid off, the exercise price was $500,000 plus interest at six percent compounded for 25 years, or $2,150,000 total. The building, which cost $10 million, would have to lose nearly 80 percent of its value before exercise of the repurchase option would no longer make sense.

Stephen B. Cohen, Even Before Enron: Bank Regulators, the Income Tax, the S&L Crisis, and Deceptive Accounting at the Supreme Court, 5 GREEN BAG 2D 387, 388 (2002).
100. Frank Lyon, 536 F.2d at 749.
101. See Frank Lyon, 435 U.S. at 563 (noting that Arkansas law limited the interest rate Worthen could pay and that "the proposed obligations would not be marketable at that rate"); Frank Lyon Co. v. United States, 75-2 U.S. Tax Cas. (CCH) ¶ 9545, at 87,588 (E.D. Ark. 1975), rev’d, 556 F.2d 746 (8th Cir. 1976), rev’d, 435 U.S. 561 (1978).
102. Frank Lyon, 536 F.2d at 748.
103. Frank Lyon, 435 U.S. at 568–69.
building for well below what it cost to build. Frank Lyon had no power to prevent Worthen’s exercise of the option. Frank Lyon therefore did not stand to benefit from upside potential—Worthen did. Frank Lyon did bear downside risk, however. If Worthen went bankrupt, Frank Lyon remained liable on the $7,140,000 mortgage provided by New York Life. Why would Frank Lyon agree to a transaction involving a recourse loan and a below-market return on its $500,000 cash investment? First, the security for the loan included the building that cost over $10 million to build, the land it was on, and a parking facility. Thus, Frank Lyon would have faced liability in the event of Worthen’s bankruptcy only if the assets securing the loan were worth less than the loan balance at that time. That risk was no greater than what a lender would face.

Second, and more important, the claimed tax benefits made the deal viable for Frank Lyon. The court of appeals explained that if Worthen exercised the first option (at the eleven-year mark), Frank Lyon would obtain approximately $1.5 million in tax benefits. That amount more than

105. Cohen, supra note 99, at 388 ("Worthen was virtually certain to exercise the option because it was 'in the money,' that is, the exercise price was almost certain to be substantially less than the building's market value.").
106. See Frank Lyon, 435 U.S. at 585-86 (Stevens, J., dissenting). Justice Stevens stated:

The value of the repurchase option is ... limited to the cost of the financing, and Worthen's power to exercise the option is cost free. Conversely, petitioner, the nominal owner of the reversionary estate, is not entitled to receive any value for the surrender of its supposed rights of ownership. Nor does it have any power to control Worthen's exercise of the option.

Id. (footnote omitted).
107. See Grewal, supra note 18, at 982 ("Worthen was ... positioned to enjoy the economic appreciation in the building, one of the most valuable rights associated with ownership in property.").
108. See Frank Lyon, 435 U.S. at 587 (Stevens, J., dissenting) (noting that Frank Lyon assumed the risk of Worthen's insolvency). I am grateful to Charlotte Crane for this point.
109. Frank Lyon Co. v. United States, 536 F.2d 746, 748 (8th Cir. 1976), rev'd, 435 U.S. 561 (1978). In addition, "[a]s additional security, taxpayer, assigned to New York Life its interest in the building lease and ground lease. By separate agreement with New York Life, Worthen consented to this assignment and agreed not to terminate the building lease as long as the mortgage remained outstanding." Id.
110. Cf. Knoll, supra note 104, at 81 n.63 (making the same point using a hypothetical transaction between GE Capital and United Airlines).
111. See Cohen, supra note 99, at 390 n.12 ("Frank Lyon's potential liability was simply a financing risk"); Knoll, supra note 104, at 79 ("Worthen's interest in the building was equivalent to owning the building subject to a $2 million nonrecourse loan from Frank Lyon"); see also Frank Lyon, 435 U.S. at 585 (Stevens, J., dissenting) ("During that [initial twenty-five-year] period, the economic relationship among the parties parallels exactly the normal relationship between an owner and two lenders, one secured by a first mortgage and the other by a second mortgage.").
112. Frank Lyon, 536 F.2d at 749. "In addition, by investing $500,000 of loose cash in the deal, Lyon apparently avoided imposition of a penalty tax, the accumulated earnings tax of
compensated for the below-market return on Frank Lyon's $500,000 investment, and, when combined with that return, was sufficient to justify Frank Lyon's limited exposure.\textsuperscript{113}

The Supreme Court nonetheless found that Frank Lyon had undertaken a genuine economic risk,\textsuperscript{114} so it was the true owner and was thus entitled to the depreciation and interest deductions it had taken.\textsuperscript{115} The government had argued that Worthen was acquiring equity in the building during the term of the purported lease.\textsuperscript{116} The Court responded, "In order to establish the presence of that growing equity, however, the Government is forced to speculate that one of the options will be exercised and that, if it is not, this is only because the rentals for the extended term are a bargain."\textsuperscript{117} The district court found that "it is most unlikely and improbable that Worthen will exercise its option to purchase at the end of the first eleven years of the lease or at the end of any of the subsequent option periods."\textsuperscript{118}

It is true that there was no legal obligation for Worthen to purchase the building.\textsuperscript{119} However, as indicated above, exercise of the option is what makes the deal make sense for Worthen, and Frank Lyon had no power to prevent Worthen from exercising it.\textsuperscript{120} It is not surprising that the parties structured the deal that way. Frank Lyon stood to maximize its tax benefits if

\textsuperscript{113} Frank Lyon actually competed with others to obtain the transaction and offered Worthen an additional $21,000 inducement. \textit{Frank Lyon}, 435 U.S. at 564–65.

\textsuperscript{114} \textit{Id.} at 583.

\textsuperscript{115} \textit{Id.}

\textsuperscript{116} \textit{Id.} at 581.

\textsuperscript{117} \textit{Id.} The government argued "that because the purchase option prices were far below fair market value, Worthen would be economically compelled to purchase the building." Wolfman, \textit{supra} note 112, at 1082. However, the taxpayer responded that, because the lease terms were so favorable to Worthen, it would cost less for Worthen to rent the building than to buy it. \textit{Id.}


\textsuperscript{119} The Supreme Court found "the absence of any understanding between Lyon and Worthen that Worthen would exercise any of the purchase options." \textit{Frank Lyon}, 435 U.S. at 583.

\textsuperscript{120} \textit{See Frank Lyon}, 435 U.S. at 585–86 (Stevens, J., dissenting) (noting that Frank Lyon's exercise of the option was free of cost and that Worthen had no control over the exercise).

So who was right? Although economic substance is determined \textit{ex ante}, not \textit{ex post}, in \textit{Frank Lyon}, we have the benefit of using hindsight to determine whose prediction was correct. According to Professor Wolfman's article, in 1981 (shortly after the eleven-year mark), Worthen purchased the building. Wolfman, \textit{supra} note 112, at 1101. Worthen used as consideration $500,000 of cash plus stock with an aggregate par value of $14 million. \textit{Id.} Lyon had the right to put the stock to Worthen in twenty years for redemption in cash at the par value plus accrued dividends. \textit{Id.} Professor Wolfman explains that the consideration equals the option price, assuming a discount rate of 17.69\%, a reasonable figure for early 1981. \textit{Id.} at 1101 n.130.
the first option were exercised; after that point, Frank Lyon would have taxable income.121

The Supreme Court also seemed to be influenced by the fact that Worthen itself would have been able to claim depreciation deductions had it not entered into the transaction; it commented that "those deductions would have been equally available to Worthen had it retained title to the building."122 In upholding the claimed tax benefits, the Court relied in part on "the absence of any differential in tax rates and of special tax circumstances for one of the parties,"123 meaning that, in its view, the depreciation deductions were worth just as much (and would cost the federal fisc as much) in Worthen's hands as in Frank Lyon's.124

However, the reality is not this simple. Professor Bernard Wolfman has explained that Worthen did face "special tax circumstances": Although Worthen and Lyon were subject to the same rate schedules, because Worthen was a commercial bank—and was thus, unlike other taxpayers, entitled to deduct interest expense incurred in holding tax-exempt bonds—it could effectively control its taxable income and thus its tax rate by exercising control over its investment mix.125 Worthen therefore did not need the depreciation deductions to reduce its taxable income.126

Tax scholars have rightly criticized Frank Lyon.127 There are several problems with the Court's analysis. One commentator explained, "the Court

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122. Frank Lyon, 435 U.S. at 580.
123. Id. at 583 ("[Other factors] and the absence of any differential in tax rates and of special tax circumstances for one of the parties—all convince us that Lyon has far the better of the case."). Professor Wolfman commented:

The Court seemed to believe that the government's loss in tax from Lyon would be equal to the revenue gained from Worthen. That factor, if true, might cause an observer to wonder why the government would bother to litigate this particular case. Would the government with nothing immediately at stake press a case like this only to establish a precedent for cases in which there was a tax differential, or just to establish a principle? Perhaps. For surely one would not expect the Court to enunciate a rule applicable only to pairs of taxpayers in the same tax bracket.

Wolfman, supra note 112, at 1088.
124. Frank Lyon, 435 U.S. at 580 ("It is not inappropriate to note that the Government is likely to lose little revenue, if any, as a result of the shape given the transaction by the parties.").
125. Wolfman, supra note 112, at 1095-96.
126. See id. at 1096 (explaining that banks therefore have much more control over their taxable income than other businesses, such as Frank Lyon, do). Moreover, Worthen and Lyon's attorney stated that "Worthen Bank has always sought to be taxed in the maximum tax bracket." Id. (quoting Letter from J. Gaston Williamson to Bernard Wolfman (Oct. 19, 1981)). Professor Wolfman notes that the attorney did not explain why Worthen would seek to be taxed at the highest possible rate. Id. at 1097.
127. See Louis A. Del Cotto, Sale and Leaseback: A Hollow Sound When Tapped?, 37 TAX L. REV. 1, 40-41 (1981) (noting that the Frank Lyon Court "confused form with substance, business purpose with economic reality, a lender's risks with those of a landowner, and arm's length
put the business motivation for leasing—the banking regulators—ahead of the economic terms of the lease itself.\textsuperscript{128} What made the deal economically viable was that Worthen essentially sold depreciation deductions (which technically are non-transferable) to the highest bidder, who turned out to be Frank Lyon.\textsuperscript{129}

Where the Supreme Court went astray in Frank Lyon is that, unlike in the Gregory and Knetsch cases, the Court did not consider Congress’s intent.\textsuperscript{130} The Court’s different approach in Frank Lyon may reflect larger societal changes,\textsuperscript{131} changes in approaches to statutory interpretation,\textsuperscript{132} the negotiations with allocation of ownership rights among the parties independent of tax considerations’); Charles I. Kingson, The Confusion over Tax Ownership, 93 TAX NOTES 409, 411 (2001). Kingson explained that:

Owing both to the language and the holding, references to Lyon became a staple of tax shelter prospectuses for many years. Corporations with little use for deductions could transfer to high-bracket individual taxpayers the value of real estate depreciation deductions, without the builder having to give up either current cash or future appreciation of the property.

\textit{Id.;} Alex Raskolnikov, Contextual Analysis of Tax Ownership, 85 B.U. L. REV. 431, 473 (2005) ("[Frank Lyon] has been widely criticized for its lack of clear standards and the uncertainty it created regarding the importance of taxpayers’ tax avoidance intent."); Daniel Shaviro, Risk-Based Rules and the Taxation of Capital Income, 50 TAX L. REV. 643, 677 (1995). Shaviro noted that:

In the notorious Frank Lyon case, . . . the Supreme Court treated the aim of evading the substance and apparent purpose of banking regulations (with the regulating agency’s connivance), in combination with various other factors, as good enough to establish the requisite business purpose and thus prevent the application of the substance over form doctrine.

\textit{Id.;} Lee A. Sheppard, Drafting Economic Substance, Part 3, 106 TAX NOTES 1020, 1021 (2005) ("[In Frank Lyon, t]he Supreme Court was impressed by the presence of an unrelated third party in the deal; the case was a precursor of the unrelated party accommodation that features in modern shelters. Frank Lyon is wrong and is based on a false premise.").

128. Kingson, supra note 127, at 411; see also Del Cotto, supra note 127, at 40 (stating that the Court "confused . . . business purpose with economic reality").

129. See Wolfman, supra note 112, at 1086–87 (explaining that potential investors were not bidding for the prospect of six percent return or appreciation sixty-five years down the line, but rather "to garner the income tax benefits of ownership: the early interest and accelerated depreciation deductions to shelter their high-bracket income from other sources"). Professor Wolfman adds, "If mere bidding for a non-assignable depreciation deduction creates economic reality, one wonders why the Court said 'sham' in Knetsch." \textit{Id.} at 1087.


131. Over forty years passed between the Supreme Court decisions in Gregory and Frank Lyon, and the regulatory state significantly expanded during that time. I am grateful to Ajay Mehrotra for this point.
parties' litigation strategies, or even the complexity of the facts. Regardless of the reasons, the Court simply did not question whether Congress's intent with respect to the depreciation and interest provisions was to allow deductions to a taxpayer who held legal title but lacked any upside potential in the property—that is, a taxpayer who was in the same economic position as a lender. Instead, the Court shifted the focus from Congress to the parties. It held, in the paragraph that gave rise to the modern economic substance doctrine:

[W]here, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

As discussed below, the Frank Lyon test leads to absurd results. Thus, Frank Lyon is more than just wrongly decided. In theory, the Court could have developed a useful test that simply reached the wrong result in the case before it or an unhelpful test that happened to reach the right result in Frank Lyon. Instead, the Court misunderstood the economics of the transaction before it. Impressed by the involvement of an independent third party (despite tax-oriented structuring of the transaction) and the

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133. The district court's opinion frames the parties' arguments as involving substance versus form—an issue also addressed by the Supreme Court—and focuses on the parties' "subjective" and "objective" intentions. See Frank Lyon, 435 U.S. at 572-73; Frank Lyon, 75-2 U.S. Tax Cas. (CCH) ¶ 9545, at 87,588.

134. See Yoram Keinan, It Is Time for the Supreme Court to Voice Its Opinion on Economic Substance, 7 HOUS. BUS. & TAX L.J. 93, 101 & n.45 (2006) (explaining that Frank Lyon "established the foundation for the two prongs of the economic substance test" and quoting the relevant language of the case). Subsequent cases distilled the two-pronged test, with one of them being business purpose. A Tax Court case, Rice's Toyota World, Inc. v. Comm'r, 81 T.C. 184, 201-02 (1983), aff'd in part, rev'd in part, 752 F.2d 89 (4th Cir. 1985), was particularly influential in developing the test.

135. Frank Lyon, 435 U.S. at 583-84 (emphasis added). This sentence has been called "the most quoted (and risk-disregarding) sentence in recent tax history." Kingson, supra note 127, at 410. The Court also relied on a list of over twenty-six factors in reaching its holding. See Wolfman, supra note 112, at 1099 (making this point).

136. See infra notes 150-52, 253-57 (showing that even tax fraud can pass muster under the business purpose and economic substance prongs of the doctrine).

137. Cf. Wolfman, supra note 112, at 1099-100 ("A Supreme Court opinion ought not become the basis for tax lawyers to make a laughingstock of the Court as they now do when quite routinely they add unnecessary third parties to financing transactions in order to qualify for the shelter of Frank Lyon.").

138. See id. at 1098:
regulatory restriction that prohibited Worthen from holding actual title to the building, the Frank Lyon Court developed a test that has nothing to do with whether Congress intended to provide the claimed tax benefits. One unfortunate effect of this misguided approach, as discussed in the next Part, is a doctrine that is subject to much greater manipulation by taxpayers.\textsuperscript{189}

IV. DOES THE CURRENT ECONOMIC SUBSTANCE DOCTRINE TARGET TAX ABUSE?

As indicated above, under current law, the economic substance doctrine is generally understood to have two components: (1) subjective business purpose, and (2) objective economic substance\textsuperscript{140}—though courts disagree about how to apply the test\textsuperscript{141} and whether the taxpayer need meet both prongs or only one.\textsuperscript{142} For example, in ACM v. Commissioner, an early corporate tax shelter decision that has been called "the modern reincarnation of Gregory v. Helvering,"\textsuperscript{143} the Court of Appeals for the Third Circuit stated:

\begin{quote}
It is not credible that Worthen and Lyon, while sharing the same tax lawyer, with both Mr. Lyon and the lawyer sitting on the Worthen board, were unaware of their differing tax needs and the way each might be helpful to the other at the expense of only the United States Treasury.
\end{quote}

\textit{Id.} Note that "Worthen retained the rights to the investment tax credit and sales tax savings generated by the building project." Frank Lyon Co. v. United States, 536 F.2d 746, 748 (8th Cir. 1976), rev'd, 435 U.S. 561 (1978). Although the presence of a tax-avoidance motive is irrelevant, this kind of coordination suggests that courts should scrutinize the deal to determine what actually is being transferred. See Leandra Lederman, Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance, 60 STAN. L. REV. 695, 737–38 (2007) (raising the issue with respect to transactions between familiar parties).

\textsuperscript{139} See \textit{infra} Part IV (showing that taxpayers can generate evidence to meet the business purpose and economic substance elements of the doctrine).

\textsuperscript{140} See supra text accompanying note 1 (identifying the two components of the economic substance doctrine); see also Bankman, supra note 18, at 9–10 (discussing the two components).

\textsuperscript{141} Yoram Keinan, \textit{The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?}, 1 N.Y.U. J. L. & BUS. 371, 373 (2005) ([C]ircuits and courts have been divided with respect to the application of this two-prong test, and several variations have emerged.).

\textsuperscript{142} See \textit{id.} at 393. Keinan writes:

\begin{quote}
Some circuits have required that a transaction satisfy both the economic substance and business purpose standards (\textit{i.e.}, a conjunctive test) to validate a transaction. Other circuits have determined that the existence of \textit{either} economic substance or business purpose (\textit{i.e.}, a disjunctive test) validates a transaction. In addition, some courts have given more weight to one prong than the other, and in several cases, focused primarily on one prong and disregarded the other.
\end{quote}

\textit{Id.} (footnotes omitted); Sheppard, supra note 127, at 1021 ("The various circuits have different, and often unsatisfactory, versions of the economic substance test that grew out of the easy tax shelter cases of the previous era, which featured overvaluations, unenforceable nonrecourse debt, and occasionally out-and-out fraud.").

\textsuperscript{143} Eustice, \textit{supra} note 34, at 168.
The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. . . . However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. 144

This Part of the Article argues that neither of these prongs is helpful for identifying abusive transactions. It argues that the presence or absence of a business purpose is irrelevant except where Congress (or, in the case of a regulation, the Treasury Department) made such a purpose a requirement of the tax benefits claimed, either explicitly 145 or implicitly, as in Gregory. 146 It also shows that the economic substance prong—which does not focus on whether the tax results reflect the underlying economics but rather on the pre-tax prospect of profit—is misguided because even abusive transactions can be structured to qualify under it. Both elements of the doctrine also privilege integration of a shelter into non-shelter activities, although that bundling in no way reduces the abuse.

A. THE BUSINESS PURPOSE PRONG

1. When Should a Business Purpose Be Required?

At first blush, a business purpose requirement is appealing. A transaction motivated by a business purpose sounds like it lacks a tax-avoidance motivation and is thus socially efficient because the tax system did not alter the taxpayer's behavior. 147 However, that is a false dichotomy. First, all profit-motivated transactions in a world with taxes are motivated by post-tax profit. 148 Second, many transactions have both tax and non-tax purposes,

145. See, e.g., I.R.C. § 357(b)(1) (2008) (considering whether a taxpayer's principal purpose "(A) was a purpose to avoid Federal income tax on the exchange, or (B) if not such purpose, was not a bona fide business purpose"); I.R.C. § 441(i)(1) ("[T]he taxable year of any personal service corporation shall be the calendar year unless the corporation establishes, to the satisfaction of the Secretary, a business purpose for having a different period for its taxable year."); Treas. Reg. § 1.701-2(a)(1) (2009) ("[E]ach partnership transaction or series of related transactions . . . must be entered into for a substantial business purpose.").
146. See Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934) (finding that corporate reorganizations had as an "underlying presupposition" a purpose related to the corporate venture).
147. See POSNER, supra note 13, at 511.

and it can be hard to separate and quantify them.\textsuperscript{149} Moreover, even if business purposes motivated the underlying transaction, tax considerations may have altered the form the transaction took, and that is critical.

To illustrate how irrelevant a business purpose can be to the question of what constitutes an abusive transaction, consider the situation of a hypothetical retail-business owner whose livelihood depends on the success of the business. The retailer, who sells an array of items, decides to sell certain items (say, cartons of cigarettes) only for cash, in a special location in the store where there is no cash register. The owner charges a low, flat price per carton and does not add sales tax. The retailer intentionally pockets the cash and does not report it.\textsuperscript{150}

The retailer's behavior clearly violates the tax laws. Yet, several business reasons can be advanced for it. First, the retailer can expedite other sales by removing cigarette customers from the regular lines. Second, he can get by with one less cash register, thus saving the expense of buying and maintaining another register. Third, the retailer can charge a lower price on the cartons of cigarettes because of the evaded taxes, which include state income taxes and state and local sales taxes.\textsuperscript{151} This increases both sales of cigarettes, and most likely, traffic to the store, which may increase the retailer's other sales.

Despite all of these arguments, the knowing failure to report the cigarette sales constitutes tax evasion. There is nothing abusive about the underlying substantive transaction—sales of cigarettes. It is the tax aspect of the transaction—failure to report the sales for tax purposes—that is abusive.

Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.”).

\textsuperscript{149} Cf. Gunn, supra note 6, at 738 n.20 ("Every transaction necessarily involves foregoing other opportunities; thus, no transactions are entered into 'solely' to reduce taxes. The distinction between solely and partially tax-motivated transactions is entirely imaginary and can be safely ignored.").

\textsuperscript{150} This is, of course, tax fraud. The economic substance doctrine typically is not applied to fraudulent transactions. The results when the doctrine is applied to the hypothetical tax-evading retailer—good arguments that the tax evasion has both a business purpose and economic substance—support the argument that the economic substance doctrine should not be applied without first ascertaining that the transaction technically "works" under existing statutes and interpretive guidance. See, e.g., Karen C. Burke, Deconstructing Black & Decker’s Contingent Liability Shelter: A Statutory Analysis, 108 TAX NOTES 211, 221 (2005) ("To avoid overworking the economic substance doctrine, it is essential that the government seek to resolve tax disputes based on technical arguments derived from the statutory language whenever possible."); Lee A. Sheppard, Economic Substance Update, 110 TAX NOTES 1137, 1138 (2006) ("Only if the taxpayer has technically complied with the statute, but its lack of business purpose, expectation of profit, and risk in the deal mean that it should not have the benefit of technical compliance, should the economic substance doctrine be invoked.").

\textsuperscript{151} The retailer may even argue that evading state and local taxes constitutes a business purpose. Legitimate reduction of these liabilities can constitute a business purpose under the federal income tax. See Rev. Rul. 76-187, 1976-1 C.B. 97 (ruling that a substantial reduction in state and local taxes is a business purpose for purposes of Treasury regulation § 1.355-2(c)).
The form of the transaction (cash sales only, no cash register tracking the sales) provides evidence that the omission is intentional and thus constitutes tax fraud.\textsuperscript{152}

As this example suggests, the use of the business purpose doctrine to detect abusive transactions is suspect. It played a key role in the \textit{Gregory} case, but not because the courts thought it mattered whether Mrs. Gregory could advance a business motive for removing shares from corporate solution. As discussed above, the Court was quite clear that Mrs. Gregory's intent in structuring the transaction the way she did was to reduce tax liability and that such an intent was perfectly legitimate.\textsuperscript{153}

Judge Learned Hand explained that the corporate reorganization itself—that is, the form in which the transaction was carried out—had to be germane to the business of one corporation or the other:

The purpose of the section is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, to add to, or subtract from, their holdings. . . . \textit{But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand}, not as an ephemeral incident, egregious to its prosecution.\textsuperscript{154}

Judge Hand therefore held that although each of the steps was real, the transaction was a sham because it did not fit within the statutory definition of "reorganization."\textsuperscript{155} The Supreme Court agreed, stating that

\textit{[w]hen [the Code section] speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here.}\textsuperscript{156}

Both courts therefore found that Congress implicitly required a business purpose to qualify under the reorganization statute in issue.\textsuperscript{157}


\textsuperscript{153} See supra text accompanying notes 58-59 (noting that the \textit{Gregory} cases found tax avoidance acceptable).

\textsuperscript{154} \textit{Helvering v. Gregory}, 69 F.2d 809, 811 (2d Cir. 1934) (emphasis added), aff'd, 293 U.S. 465 (1935).

\textsuperscript{155} Id.

\textsuperscript{156} \textit{Gregory}, 293 U.S. at 469 (citing § 112 of the Revenue Act of 1928) (referring to the transaction as "having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character" (emphasis added)).

\textsuperscript{157} See Noël B. Cunningham & James R. Repetti, \textit{Textualism and Tax Shelters}, 24 VA. TAX REV. 1, 14 (2004) ("[T]he Court of Appeals determined that the provision should not apply to a
a. The Role of the Corporate Form

The role of business purpose in Gregory makes more sense once Gregory is contextualized. As Professor Chirelstein has explained, a developing question at the time that Judge Hand faced in numerous cases was how to treat the corporation for tax purposes. It was not until 1943—almost a decade after Gregory—that the Supreme Court decided Moline Properties, Inc. v. Commissioner, which generally upheld the separate existence of corporations for federal tax purposes. In the interim, numerous tax cases struggled with how to treat corporations, particularly closely held ones. Corporations are of course legal fictions, and some taxpayers were using them to try to reduce their taxes. Mrs. Gregory's use of Averill Corporation was an example of this phenomenon.

In Gregory, Judge Learned Hand explicitly rejected the Commissioner's argument that the court should disregard Averill merely because its existence was transitory, noting that "[t]he Averill Corporation had a juristic personality, whatever the purpose of its organization; the transfer passed title to the Monitor shares and the taxpayer became a shareholder in the transferee." Judge Hand's opinion therefore respected the separate corporate entity but found that the use of the reorganization provisions as a bail-out was not within the scope of Congress's intent.

This approach differed from the approach that another judge on the panel, Judge Augustus Hand, had advocated in an internal memo; Judge Augustus Hand would have applied the approach the IRS urged, disregarding Averill as a sham. The Second Circuit's opinion, authored by

transaction that was not part of the conduct of business, but rather part of a plan to reduce an individual's tax liability.

158. See Chirelstein, supra note 58, at 442 (referencing "the extended series of decisions on recognition of the corporate entity").

159. See id. at 452. Professor Chirelstein states

Hand's characteristic interpretation of the Gregory doctrine was one which emphasized its limitations rather than its scope or breadth. This, perhaps, reflects the fact that in Gregory itself, as in [certain] other decisions . . . , the problem of permissible tax avoidance was presented to him, at least in part, as if it involved the question of regard or disregard of the corporate entity.


161. Id. See infra text accompanying notes 198-202 for further discussion of Moline Properties.

162. See Chirelstein, supra note 58, at 442-43 (discussing this difficulty and noting that the Supreme Court had begun to distinguish between closely held and publicly held corporations).

163. See id. at 444 (referring to "overtly conceived tax-minimization schemes" involving corporations).

164. Helvering v. Gregory, 69 F.2d 809, 811 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935); see also Likhovski, supra note 58, at 96-97 (examining Judge Learned Hand's analysis).

165. Likhovski, supra note 58, at 95.
Judge Learned Hand, effected a compromise. It reached the same outcome as Judge Augustus Hand, but respected the corporate entity. In addition, although Judge Learned Hand reached a different outcome from the internal memo of the third member of the panel, Judge Swan, he agreed with Judge Swan’s point that a tax-avoidance motivation did not warrant disregarding the corporation.

Thus, business purpose played a very specific role in Gregory. First, the Second Circuit found that it reflected Congress’s intent behind the statutory scheme in question. But equally important, the statutory scheme involved corporate reorganizations. Congress specifically created those provisions to apply to the legal fiction known as the corporation. The regime allows corporations to merge, subdivide, and generally rearrange their structures without bearing federal income tax. To the extent that it subsidizes corporate business, it could be termed “corporate welfare.” However, the regime makes sense once set against the backdrop of Congress’s desire to allow corporations to pursue certain business considerations unimpeded. Moreover, corporate reorganizations necessarily involve corporations, so there will always be an entity to examine for a business purpose (unlike in the case of a transaction involving only individuals, where the activity might be personal or might be profit-seeking but not rise to the level of a trade or business).

166. Id. at 95–96.
167. Id. at 95.
169. See id. at 83 (using this term).
170. See id. at 52 (discussing the justifications of the reorganization provisions). Professor Mehrotra explains, with respect to the 1924 Revenue Act, which enacted the spin-off provision:

As Secretary Mellon described it, the reorganization section was “rewritten to eliminate existing uncertainty in the present [1921] act and to include other usual forms of corporate reorganization in aid of business.” In broadening the scope of readjustments covered by the tax preference and, at the same time, limiting the use of the reorganization rules to legitimate transactions, Congress and Treasury explained their intent by resorting to both old and new justifications. Some of the 1924 revisions were defended under the initial theory that the tax benefit was meant for mere formal not substantive changes to business organizations. Meanwhile, other policymakers, with the interests of business in mind, justified the expansion of the preference as providing greater tax predictability and an added stimulus for corporate consolidations.

Id. at 78. (footnote omitted) (quoting Mellon Reveals Tax Law Changes in Draft to House, N.Y. TIMES, Dec. 17, 1923, at 1); see also id. at 55–56.
Several years after its Gregory decision, in a lesser-known pre-Moline Properties case involving a purported abuse using the corporate form, the Supreme Court, in a muddled opinion, seemed to expand the scope of Gregory's statements about business purpose. In Higgins v. Smith, the taxpayer, Mr. Smith, had organized a wholly owned corporation, apparently for the purpose of reducing both income and estate tax liabilities. The corporation's principal activity consisted of buying stock from and selling stock to Mr. Smith. In the transaction in question, which took place in 1932, Mr. Smith sold at market value shares of stock that had declined in value to the corporation, resulting in a realized loss. However, the IRS denied Mr. Smith's claimed deduction for a loss "sustained" under Code section 23(e) (predecessor of current section 165).

The issue in Smith was whether the fact that the sale was to the taxpayer's wholly owned corporation resulted in disallowance of the loss for tax purposes. No provision disallowing losses on sales between related parties existed at the time of the transaction, though Congress had enacted one in 1934. Like Mr. Knetsch, Mr. Smith argued that the change suggested that Congress's intent previously had been to allow the claimed deduction. As in Knetsch, the Court disagreed.

In Smith, the government evidently believed that the allowance of a loss for tax purposes on the sale of stock to a corporation entirely controlled by the taxpayer was abusive. It argued that Gregory applied to disallow the loss. In the Court of Appeals for the Second Circuit, Smith's three-judge

173. Id. at 474.
174. Id.
175. Id. at 474-75.
176. Id. at 475-76.
177. See 5 Fed. Reg. 378 (1940); see also Dewees v. Comm'r, 870 F.2d 21, 33 (1st Cir. 1989) (noting that I.R.C. § 23(e) was the predecessor of I.R.C. § 165(c)).
178. Smith, 308 U.S. at 474.
179. See id. at 479-80 (referring to I.R.C. § 24(a)(6), predecessor of § 267).
180. See id. at 479 ("Respondent makes the further point that the passage of § 24(a)(6) of the Revenue Act of 1934 which explicitly forbids any deduction for losses determined by sales to corporations controlled by the taxpayer is convincing proof that the law was formerly otherwise." (footnote omitted)).
181. Id. at 480. The Court stated:

At most it is evidence that a later Congress construed the 1932 Act to recognize separable taxable identities between the taxpayer and his wholly owned corporation. As the new provision goes much farther than the former decisions in disregarding transfers between members of the family it may well have been passed to extend as well as clarify the existing rule.

182. Id. at 476.
panel consisted of Judge Learned Hand; Judge Augustus Hand; and Judge Chase, who authored the opinion. The Second Circuit stated that a tax-avoidance motive was irrelevant. However, it distinguished Gregory, stating, "Though the case just mentioned is relied on by the government it is not of help to it for it had to do with a pretended reorganization not within the scope of that statute. The present case differs in that it involves a real sale to an actual buyer."

The Supreme Court reversed the Second Circuit's decision in Smith, and cited Gregory as possibly standing for a much broader proposition:

The Government urges that the principle underlying Gregory v. Helvering finds expression in the rule calling for a realistic approach to tax situations. As so broad and unchallenged a principle furnishes only a general direction, it is of little value . . . . If, on the other hand, the Gregory case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration.

Professor Chirelstein commented, “[T]he Supreme Court’s decision in Higgins v. Smith undoubtedly surprised Hand—as it did others—because it appeared to go well beyond the Gregory decision, which it nevertheless cited as authority for its position.”

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184. Id. at 458.
185. Id. The implication of the decision appears to be that Mr. Smith’s sale and the resulting realized loss were within the scope of what Congress contemplated in § 23(e), though the opinion does not explicitly say so.
186. Smith, 308 U.S. at 476 (footnote omitted).
187. Chirelstein, supra note 58, at 447 (footnote omitted). Nine years later, without citing Smith, Judge Hand stated:

The doctrine of Gregory v. Helvering, . . . which we here hold to be controlling, is not limited to cases of corporate reorganizations. It has a much wider scope; it means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.

Comm’r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949). However, this formulation, which extends the business purpose requirement beyond the context of the reorganization provisions, does not have nearly the breadth of Smith. Transport Trading involved a corporate transaction known as a “bootstrap sale”—the taxpayer distributed an appreciated asset to the taxpayer’s parent company, which treated as a dividend subject to an eighty-five percent dividends-received deduction, took a fair-market-value basis, and sold it to a purchaser that had previously been arranged. Chirelstein, supra note 58, at 454.
To the extent that Smith required a business purpose for a transfer of assets, it certainly went far beyond Gregory. It makes little sense to require a business purpose for asset transfers as a broad proposition because asset transfers occur in many contexts. For example, a mother may transfer portfolio stock worth $10,000 to her son as a gift. That transfer—proceeding from “a 'detached and disinterested generosity'”—has no business purpose. The gift may even be largely tax-motivated: it may be designed to minimize future estate-tax liability through an inter vivos transfer that is below the annual gift tax cap. Yet, in this simple scenario, the transfer has no federal income tax consequences.

The Smith Court spoke hypothetically, however, seemingly unsure of whether Gregory provided so broad a precedent. It was, after all, responding to the government's argument that Gregory “call[ed] for a realistic approach to tax situations”—presumably meaning an approach that looked beyond the taxpayer's technical compliance with the literal terms of the statute. Nonetheless, the Court did seem to be reaching for a general anti-avoidance tool. In a portion of the opinion that distinguished an earlier case, the Court used language of "sham" and substance over form:

[T]he Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.

Professor Chirelstein explained that, in Smith, the Court went beyond interpretation of the statutory term “loss sustained,” apparently “bent on arming the Commissioner with a broad form-piercing doctrine which could be employed in defense of the revenues even where the taxpayer had actually succeeded in meeting the requirements of the statute.” He also noted the limitations of the Smith opinion:

While the Court apparently assumed that this doctrine would produce results similar or analogous to those that occurred in

189. See I.R.C. § 2503(b) (2008) (providing annual exclusion from gift tax). Note, however, that at least one motive is personal—the mother's desire to provide for her son.
190. See I.R.C. § 102(a) (excluding the gift from the donee's income); Irwin v. Gavit, 268 U.S. 161, 166 (1925) ("[T]he net income is to include 'gains or profits and income derived from any source whatever, including the income from but not not [sic] the value of property acquired by gift, bequest, devise or descent."") (quoting Income Tax Act of 1913 ch. 16, § 2(B), 38 Stat. 114)).
191. Smith, 308 U.S. at 476.
192. Id. at 477 (emphasis added).
193. Chirelstein, supra note 58, at 449.
Gregory, the opinion failed to specify the conditions which would render the doctrine operative and did not make clear what the Commissioner would be authorized to do once those conditions were present.194

Perhaps because the "sham" doctrine espoused in Smith was not tethered to anything in the statute and provided little direction to the government, the Smith opinion seems to have played relatively little role in the development of the business purpose, economic substance, sham transaction, and related doctrines.195 Moreover, the Court decided Moline Properties only three years after Smith. In Moline Properties, the Court distinguished Smith, relegating it to a specific and limited exception196 involving "situations [in which] the form is a bald and mischievous fiction."197

Moline Properties was a case in which the taxpayer tried to disregard the corporate form, arguing that the corporation was acting as the agent of its sole stockholder when it sold certain real estate at a gain.198 The corporate taxpayer had been organized for use as a security device for a mortgage, but also engaged in other activities.199 The Court held:

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of

194. Id.

195. Professor Chirelstein explained:

While the Smith decision was commended by some for its simple realism in dealing with an obvious effort at tax-avoidance, even those who praised it conceded that its rationale was—especially in view of [subsequently decided] Moline Properties—difficult to isolate. Hand, it appears, found the decision extremely puzzling. His own construction of Gregory, as revealed in Chisholm [v. Commissioner, 79 F.2d 14 (2d Cir. 1935)], emphasized a requirement of economic function in respect to the entity or other status for which the taxpayer claimed some consequence, and it was obviously a construction much more limited than the broad form-piercing doctrine that the Court seemed to support.

Id. at 450 (footnote omitted).

196. See id. ("[I]t is clear from the way in which the Moline Properties opinion is structured that the Court now viewed the Smith decision as but a limited exception to the customary and much more general rule of corporate recognition.").


198. Id. at 436. This was not the first case in which the taxpayer made such an argument. The Court granted certiorari "because of the volume of similar litigation in the lower courts and because of alleged conflict of the decision below with other circuit court decisions." Id. at 436–37.

199. Id. at 437–38.
business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.200

Note that the Court called for a business purpose in order to respect the existence of the corporation for tax purposes. Requiring a business purpose makes sense in the context of an artificial entity that is a legal fiction and can be created at will.201 As suggested above, respecting the corporate existence is the paradigmatic context for requiring a corporation to have a business purpose.

In distinguishing Smith, the Moline Properties Court referred to "recognized exceptions . . . [where] the corporate form may be disregarded where it is a sham or unreal."202 Thus, the seeming—if perhaps hypothetical—extension of Gregory in Smith as standing for a broad business purpose requirement was unwieldy, short-lived, and makes sense only insofar as it applied to the recognition for tax purposes of the corporate entity or its specifically corporate activities (such as the corporate reorganization in Gregory). As discussed above, a transfer of assets need not necessarily have a business purpose to be respected for tax purposes.

The futility of business purpose as a general anti-abuse principle comes into stark relief when considering cases such as Knetsch and another tax-arbitrage case, Goldstein v. Commissioner.203 Knetsch involved an individual taxpayer who borrowed money, which can occur for personal, investment, or business reasons. Knetsch does not mention business purpose at all.204 In Goldstein, which also involved borrowing by an individual in a tax-arbitrage transaction,205 the Court of Appeals for the Second Circuit held "that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now

200. Id. at 438–39 (emphasis added) (footnotes omitted).
201. See supra text accompanying note 163 (noting that corporations, such as Mrs. Gregory's Averill, which was transitory, are legal fictions). Yet, in Gregory, the Court did not disregard Averill's existence as a sham; it specifically upheld the separate existence of Averill, even though it found that a lack of a business purpose meant that the transaction did not constitute an effective corporate reorganization. See supra text accompanying notes 166–67 (discussing the decision in Gregory to validate the existence of Averill).
202. Moline Props., 319 U.S. at 439. While limiting Smith, this language provided no basis for determining the instances in which the corporation was a sham. See Chirelstein, supra note 58, at 451–52 ("[t]he Court ... has been found to be a bold and mischievous fiction."
This, in turn, raised doubts concerning the specific content of the business purpose requirement . . . ).
205. The taxpayer won a sweepstakes. In order to reduce her tax liability, she entered into two loans and used the proceeds to buy treasury bonds that were used as collateral for the loans. Goldstein, 364 F.2d at 736. The interest rate on the bonds was 11½% and the interest rate on the loans was 4%. Id. at 736, 739. Thus, as in Knetsch, the transaction was not profitable pre-tax. See id. at 739.
before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.” The Second Circuit cited Knetsch, among other cases, for this proposition. The Tax Court in Rice’s Toyota World v. Commissioner referred to this “purposive activity” test—which, on its face, is not limited to business contexts—as having been abandoned by the courts after Frank Lyon.

As discussed above, Frank Lyon was fundamentally misguided, and it confused Worthen’s underlying business purpose with a non-tax motivation.

206. Id. at 740 (emphasis added). Similarly, in Salley v. Commissioner, which involved a Knetsch-style transaction, the court stated, “The real inquiry in this appeal is whether or not the loan transaction in question demonstrates sufficient economic substance, ‘business purpose,’ or ‘purposive activity’ to come within the scope of the interest deduction allowed under Section 163(a)-cum-Knetsch.” Salley v. Comm’r, 464 F.2d 479, 482 (5th Cir. 1972). Salley cited both Knetsch and a court of appeals decision that had distinguished Knetsch: Campbell v. Cen-Tex, Inc., 377 F.2d 688 (5th Cir. 1967).

Campbell involved a family-owned company that insured the lives of five family members. Campbell, 377 F.2d at 689. The company prepaid the first five premiums by borrowing against the policies, and each year, prepaid an additional year by borrowing against the value of the policy. Id. The district court found that the “systematic payment of 4% interest on loans derived from the increasing loan value of the policies as a result of plaintiff’s prepaying premiums at a 3% discount has a very real and discernible substantial business purpose.” Cen-Tex, Inc. v. Campbell, 65-2 U.S. Tax Cas. (CCH) ¶ 9599, at 96,584 (N.D. Tex. 1965), aff’d, 377 F.2d 688, 694 (5th Cir. 1967). It stated that “[e]ach policy provides death benefits substantially in excess of the maximum indebtedness which could be incurred against the policy.” Id.

207. Goldstein, 364 F.2d at 740.

208. Robert Thornton Smith notes, “The Second Circuit so phrased its analysis because, unlike Gregory, there is no requirement that deductible interest serve a business purpose.” Smith, supra note 77, at 8.

209. Rice’s Toyota World, Inc. v. Comm’r, 81 T.C. 184, 200 (1983) (“The Court of Claims has developed the ‘purposive activity’ standard established in Goldstein . . . . This approach, however, is not one taken by this Court in cases decided subsequent to the Supreme Court’s decision in Frank Lyon Co. v. United States.” (citation omitted)), aff’d in part, rev’d in part, 752 F.2d 89 (4th Cir. 1985).

Cases after Frank Lyon distilled the two-pronged test. See, e.g., Bail Bonds by Marvin Nelson, Inc. v. Comm’r, 820 F.2d 1543, 1549 (9th Cir. 1987) (“[D]etermining whether a transaction is a sham, courts typically focus on two related factors: 1) has the taxpayer shown that it had a business purpose for engaging in the transaction other than tax avoidance? 2) has the taxpayer shown that the transaction had economic substance beyond the creation of tax benefits?” (citing Frank Lyon Co. v. United States, 435 U.S. 561, 583-84 (1978))); Braddock Land Co. v. Comm’r, 75 T.C. 324, 329 (1980) (agreeing with the IRS’s argument that the transaction lacked “a business purpose and economic substance”). Rice’s Toyota World was particularly influential in developing the test. See Lee A. Sheppard, Pondering the Fate of Lease-In, Lease-Out Deals, 82 TAX NOTES 1723, 1726 (1999) (discussing Frank Lyon’s importance in developing the test). Sheppard explained that:

After Frank Lyon, a line of tax shelter cases asked whether investors had a business purpose and economic substance for entering into equipment leases . . . . In Rice’s Toyota World Inc. v. Commissioner, the Tax Court asked for both a business purpose, which it saw as a subjective motive test, and economic substance, which it saw as an objective test of sufficiency of profit and lesser ownership of the leased asset.

Id. (citation omitted).
for the sale-leaseback transaction. Frank Lyon's principal purpose appears to have been to obtain federal tax benefits. The presence of a business purpose for the construction of the bank building should not have influenced the outcome of the case.

2. Business + Purpose = Business Purpose?

One unfortunate effect of the business purpose inquiry is that courts may be more likely to respect transactions closely tied to a business—such as the bank-building purchase in Frank Lyon. UPS v. Commissioner provides a prime example of such a taxpayer-favorable outcome. The UPS case involved a going business with an existing income stream that was simply restructured for tax purposes—not a cookie-cutter transaction designed to create a loss unrelated to UPS’s core business of shipping packages.

The income in UPS came from amounts paid by customers to insure their packages for more than $100 (known as the “excess value charge”). UPS earned substantial profits from these charges because it rarely lost packages. In order to reduce its income tax on this revenue, UPS restructured the excess-value-charge business as follows:

UPS ... form[ed] and capitaliz[ed] a Bermuda subsidiary, Overseas Partners, Ltd. (OPL), almost all of whose shares were distributed as a taxable dividend to UPS shareholders (most of whom were employees; UPS stock was not publicly traded). UPS then purchased an insurance policy, for the benefit of UPS customers, from National Union Fire Insurance Company. By this

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210. See Bankman, supra note 17, at 18 (“An aggressive play on the contingent sales regulations, for example, works if it is discovered ‘accidentally’ in the course of ordinary business operations but does not work if it is part of a prearranged plan that is unrelated to business operations.”); Lee A. Sheppard, Bury Your Tax Shelter in a Business, 106 TAX NOTES 20, 22 (2005) (“Successful tax shelter advisers say that the deals that work are the ones in which the tax shelter is built into an existing business, rather than being a hokey portfolio add-on with no separate justification for its existence.”).

211. United Parcel Serv. of Am., Inc. v. Comm’r, 254 F.3d 1014 (11th Cir. 2001).

212. Another example, albeit not one arising in a court case, is the restructuring of Fortress Investment Group LLC and Blackstone Group LP as publicly traded partnerships that, despite the general rule of corporate taxation of such partnerships under I.R.C. § 7704, avoided the corporate tax. See Susan Beck, Daring and Controversial Legal Structures Help Fortress and Blackstone Avoid Tax and SEC Scrutiny, AM. LAW., Nov. 5, 2007, available at http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1193994248659. The design of those structures exploited both tax and non-tax regimes. See id. (“Through a dazzlingly complex structure, [Fortress] managed to avoid nearly all corporate tax and steer clear of SEC scrutiny of its investments. . . . [Blackstone] went a step further, dispensing with corporate governance protections for public investors.”).

213. UPS, 254 F.3d at 1016. “UPS’s insurance broker suggested that UPS could avoid paying taxes on the lucrative excess-value business if it restructured the program as insurance provided by an overseas affiliate.” Id.

214. Id.

215. Id.
policy, National Union assumed the risk of damage to or loss of excess-value shipments. The premiums for the policy were the excess-value charges that UPS collected. UPS, not National Union, was responsible for administering claims brought under the policy. National Union in turn entered a reinsurance treaty with OPL. Under the treaty, OPL assumed risk commensurate with National Union’s, in exchange for premiums that equal the excess-value payments National Union got from UPS, less commissions, fees, and excise taxes.\textsuperscript{216}

Thus, if what UPS did was effective, it transferred the excess-value-charge income offshore, though the business remained unchanged and the income ultimately benefited the same shareholders as before. The Eleventh Circuit found in favor of UPS, stating that any transaction that “figures in a bona fide, profit-seeking business” passes muster, and further finding that its “concept of ‘business purpose’ is a necessary corollary to the venerable axiom that tax-planning is permissible.”\textsuperscript{217}

The result and reasoning in \textit{UPS} and other cases suggest that a tax strategy might be respected if it is well integrated into a business.\textsuperscript{218} Would that be true even for tax arbitrage? In \textit{Knetsch}, the Supreme Court refused to uphold a tax-arbitrage transaction, but that transaction was not undertaken by or integrated into a business.\textsuperscript{219} If Knetsch had simply been a corporate taxpayer, rather than an individual, the outcome presumably would have been the same.

The well-known \textit{ACM} case,\textsuperscript{220} which involved a much more complex structure than \textit{Knetsch}, is nonetheless analogous and thus provides additional insight into the role of business activity. In \textit{ACM}, the deal was structured to generate a loss for tax purposes that the Colgate-Palmolive Company (“Colgate”) could use to offset a gain from the sale of a subsidiary.\textsuperscript{221} \textit{ACM} involved a tax strategy known as “CINS” (which stands for

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.}
\item \textit{Id.} at 1019.
\item See supra notes 36-37 (citing cases suggesting that tax shelters are more likely to survive judicial scrutiny if they are integrated into a business, as well as commentators making this inference).
\item See \textit{Knetsch} v. United States, 364 U.S. 361, 365-70 (1960).
\item ACM P’ship \textit{v. Comm’r}, 157 F.3d 231 (3d Cir. 1998).
\item \textit{Id.} at 233. Professor James Eustice remarked:

Prepackaged and marketed by an investment bank promoter, fully “wired” transactions, downside risk fully hedged by derivatives, no significant upside profit potential, participation of a tax-indifferent party to absorb the burden of taxable profits, generation of a temporary artificial loss by the challenged transaction itself, total lack of any credible business purpose, this deal had it all. The \textit{ACM} transaction was not merely a tax shelter, it was a tax palace.

Eustice, \textit{supra} note 34, at 154-55 (footnote omitted).
\end{enumerate}
\end{footnotesize}
Contingent Installment Note Sales). The CINS strategy applied regulations addressing the tax treatment of installment sales involving contingent payments. The transaction gave rise first to a non-economic gain and then to an offsetting loss but was structured as a partnership between a Colgate subsidiary and a tax-exempt partner, with almost all of the gain allocated to the tax-exempt partner before the partnership dissolved. In ACM, the Court of Appeals held that the transaction lacked economic substance.

To illustrate the effect of integrating a transaction into a business, Professor Joseph Bankman has described a hypothetical transaction that is a variant of the ACM transaction, in which the contingent installment sale occurs not as an add-on but as part of a business venture:

Colgate-Palmolive finds itself in a joint venture with a corporation with otherwise unusable net operating losses. The principal business of the venture is sold. The sale price includes contingent payments and the contingent installment sales regulations in effect at the time of the original transaction are still in effect. Neither the joint venture, the decision to sell the principal business, nor the decision to sell for contingent payments is tax motivated. The default provisions in the contingent installment sale regulations will produce a noneconomic tax gain in the year of sale, and a noneconomic tax loss in later years. Colgate-Palmolive is about to petition for relief from that provision under the regulations when it realizes that it can turn the rules to its advantage—but only if it redeems the interest of its joint venturer after the joint venturer has “absorbed” a share of the noneconomic gain in the first year.

He concludes, “Presumably, the company can redeem the joint venturer and claim the loss, unimpeded by the economic substance doctrine.” The reason for that result is because the hypothetical transaction is “tied to ordinary business operations.” He queries whether the same result would occur in variations in which the decision to require the contingent payment or the sale itself was tax-motivated.

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223. ACM P'ship, 157 F.3d at 242.
224. Id. at 263.
225. Bankman, supra note 17, at 17.
226. Id.
227. Id.
228. Id.
229. Id. at 17–18. The contingent-liability shelter used by Black & Decker provides a good analogy on this point: the transaction there involved a transfer of $560 million of contingent liabilities arising out of its business and $561 million of cash to a wholly owned subsidiary,
This example is terrific because it reveals how a tax-arbitrage transaction can appear to pass muster under the business purpose doctrine if it is well integrated into the taxpayer’s business, although it provides the same offsetting noneconomic gain and loss as it did when it was simply a separate loss-generating transaction. In fact, at least if literally applied, the UPS approach would seem to bless any means of carrying out a business transaction. To take an extreme example, consider the hypothetical retail-business owner who intentionally sells cartons of cigarettes for cash only, tax-free. The retailer’s intentional failure to report the profits is tax evasion, as discussed above, despite the fact that these transactions, in the words of the UPS opinion, “figure[] in a bona fide, profit-seeking business.” It is uncontroversial that this strategy fails despite its existence as part of a legitimate business.

The cigarette-retailer example involves outright tax fraud, but less-extreme scenarios illustrate the same point. For example, recall that Gregory involved a disposition of a block of stock for valid non-tax reasons. Mrs. Gregory could have accomplished the transaction in ways that a court would almost certainly respect. For example, distribution of the shares as a dividend—which might have been the way the transaction would have occurred absent tax considerations—would likely have been respected for federal income tax purposes. The problem was the form of the transaction (a purported spin-off), not the substantive event that occurred (disposition of the shares). The form of a transaction is, in fact, often the primary focus of a tax planner:

There is a common awareness among practitioners that different legal procedures will often lead to different tax consequences, although in economic terms the end results are essentially the same. In selecting the form in which a proposed business transaction shall be cast, therefore, it is said to be vital for the tax followed by a sale of the stock of the subsidiary for $1 million. Black & Decker Corp. v. United States, 436 F.3d 431, 432 (4th Cir. 2006). The transfer of the liabilities to the subsidiary appears not to have been for business reasons, but as a tax strategy. See id. at 433. The key to the shelter is the claim of basis in the amount of the cash, unreduced by the liabilities, so a sale at market value results in a substantial loss for tax purposes. See id. at 434. The Fourth Circuit’s decision did not resolve all issues, however, it remanded for a determination on objective economic substance. See id. at 442–43.

230. The bundling aspect of this example is similar to Professor Shaviro’s Knetsch hypothetical discussed below. See infra text accompanying notes 260–63 (discussing a hypothetical that bundles tax arbitrage with a gamble).

231. That is, the UPS approach is essentially that a business + a purpose = a business purpose. I am grateful to Joshua Blank for suggesting a similar formulation.

232. See supra text accompanying note 150 (posing the hypothetical).

233. United Parcel Serv. of Am., Inc. v. Comm’r (UPS), 254 F.3d 1014, 1019 (11th Cir. 2001).

234. See supra text accompanying note 47.
planner to consider and evaluate "all of the possible routes to his client's destination," and the ability to generate a multiplicity of formal alternatives, however sterile the exercise in any other context, is usually thought to be the true mark of a creative tax adviser.\textsuperscript{235}

In \textit{UPS}, the critical question should have been whether the result claimed by UPS was consistent with Congress's intent. In both \textit{Gregory} and \textit{UPS}, a separate corporation was used, and the separate corporate entity should be—and was—respected.\textsuperscript{236} In both cases, the taxpayer took a legitimate, non-tax-motivated transaction (distribution of shares in \textit{Gregory}; sale of excess-value insurance in \textit{UPS}) and found a way to structure the transaction that arguably removed substantial income from the federal income tax base. In \textit{Gregory}, the courts disallowed the claimed tax benefits, finding that the reorganization provisions required a business purpose, so one of the elements of the form selected for the transaction was not present.\textsuperscript{237} Congress simply did not intend the reorganization provisions to eliminate the taxation of dividends.

Similarly, in \textit{UPS}, by allowing amounts earned by overseas corporations to escape federal income taxation, Congress likely did not intend to extend that exemption to amounts earned in the United States by a domestic corporation that directs the proceeds to an overseas corporation with the same owners as the domestic corporation.\textsuperscript{238} Code section 482\textsuperscript{239} or the

\begin{itemize}
\item \textsuperscript{235} Chirelstein, \textit{supra} note 58, at 440 (footnote omitted).
\item \textsuperscript{236} See McMahon, \textit{supra} note 10, at 204. McMahon wrote:
\begin{quote}
As long as the \textit{Moline Properties} doctrine is respected, and the facts of \textit{UPS} do not really present any reason for not respecting it, OPL was a real corporation. If OPL conducted any business, which it appears to have done, it had a business purpose from the \textit{Moline Properties} perspective. Thousands, tens of thousands, maybe even millions, of separate corporations have been formed to gain a tax advantage for the shareholders or related corporations. That fact alone is not sufficient to recast the transaction.
\end{quote}
\textit{Id.} (footnote omitted).
\item \textsuperscript{237} See \textit{Gregory v. Helvering}, 293 U.S. 465, 469 (1935) ("When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' . . . of corporate business . . . .").
\item \textsuperscript{238} Professor Shannon McCormack argued that "[i]t seems extremely unlikely UPS could have . . . proven that it had a non-tax purpose for transferring the insurance business abroad." McCormack, \textit{supra} note 5, at 716.
\item \textsuperscript{239} Section 482 provides:
\begin{quote}
In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in
\end{quote}
\end{itemize}
assignment-of-income doctrine may well apply. A transaction involving a prohibited assignment or allocation of income that does not withstand scrutiny under section 482 should be resolved on that basis. As in the case of the hypothetical retailer evading income tax on profits from the sale of cartons of cigarettes, UPS's transaction should not simply be upheld as having economic substance regardless of whether it passes muster under applicable tax laws.

Just as tax motivation should make no difference as to whether or not the claimed tax result is upheld, a link with the taxpayer's business should not either. The question should be whether Congress intended the claimed result. Unless the statute provides a result that hinges on the taxpayer's intent, Congress's intent will not vary with the taxpayer's state of mind. Tax arbitrage should therefore be disallowed whether or not it is bundled in business garb.

Moreover, because taxpayers can easily generate evidence of a business purpose, courts should not use it as a test for determining if a transaction is abusive. For example, non-tax regulatory requirements seem to provide a business purpose, even if the regulator condones a way to evade those requirements. In Frank Lyon, compliance with Federal Reserve requirements prompted the transaction's structure, but the Federal Reserve essentially allowed Worthen to use deceptive accounting to avoid the prohibition on owning the bank building. Worse yet, the regulator may develop a tax strategy. In Cottage Savings Ass'n v. Commissioner, the Supreme Court upheld, without applying the economic substance doctrine, a financial institution's claimed loss on the exchange of participation interests in a pool of devalued home mortgages for participation interests in an economically identical pool of mortgages. "By exchanging merely participation interests

order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.


240. See United Parcel Serv. of Am., Inc. v. Comm'r, 78 T.C.M. (CCH) 262, 278 (1999) ("The incidents of taxation cannot be avoided through an anticipatory assignment of income. . . . Respondent does not, and need not, challenge OPL's separate existence as a valid corporate entity. The classic assignment of income cases involve persons and entities whose separate existence was unquestioned."); Hariton, supra note 29, at 6 n.12 (noting that the Tax Court relied in part on the assignment-of-income doctrine in holding in favor of the government).

241. See Cohen, supra note 99, at 389 ("The Federal Reserve apparently wanted to permit Worthen to evade the statutory limits on the amount a bank can spend on its own premises. In order to achieve this objective, however, the banking regulator condoned deceptive accounting.").


243. See id. at 556–66. The Tax Court had found no business purpose for the transaction. See Cottage Sav. Ass'n v. Comm'r, 90 T.C. 372, 385 (1988) ("[T]hese transactions were solely tax-motivated and had no business purpose other than to secure refunds of previously paid
rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S&L [savings and loan association] continued to service the loans on which it had transferred the participation interests and made monthly payments to the participation-interest holders. The Federal Home Loan Bank Board ("FHLBB") developed the transaction to allow banks to claim losses for tax purposes without having to report the losses for accounting purposes because of the lack of change in the bank's economic position. Thus, in Cottage Savings, FHLBB (the regulator) condoned deceptive accounting in a transaction it designed to produce tax losses.

Judge Hand demonstrated the proper role of business purpose in Gregory. If the intent of the statute is that the tax consequences be respected only if the transaction has a business purpose, then a business purpose is required. Congress most clearly requires a business purpose when it explicitly includes the requirement in a statute. In addition, in situations like the one in Gregory, involving functions unique to an artificial entity, the structure of the statute may reveal that Congress sought to limit the statute's benefits to transactions with an underlying business or corporate purpose. Otherwise, the presence or absence of a business purpose should be irrelevant.

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244. Cottage Sav., 499 U.S. at 557–58 n.3.
245. The Supreme Court explained:

In a regulatory directive known as "Memorandum R-49," ... the FHLBB determined that S & L's need not report losses associated with mortgages that are exchanged for "substantially identical" mortgages held by other lenders. The FHLBB's acknowledged purpose for Memorandum R-49 was to facilitate transactions that would generate tax losses but that would not substantially affect the economic position of the transacting S & L's.

Id. at 557 (footnote omitted).
246. See Cohen, supra note 99, at 390–91. Professor Cohen explains:

The FHLBB objective in promoting the mortgage swaps was to enable S&Ls to deduct tax losses without recording the losses on their balance sheets. The FHLBB understood that financial accounting disclosure of the losses would have revealed that many S&Ls were actually insolvent, and federal statutes would then have required the FHLBB to shut down the insolvent S&Ls. Thus, the FHLBB, like the Federal Reserve in Frank Lyon, was circumventing statutory rules intended to protect the public.

Id. at 391.
247. See supra note 145 (listing statutes in which Congress explicitly stated business purpose as a requirement).
B. THE ECONOMIC SUBSTANCE PRONG

Unlike the business purpose prong of the economic substance doctrine, the economic substance prong takes an objective look at the transaction. It is supposed to test whether the transaction had economic reality apart from the tax consequences. However, it does not test whether the claimed tax results are consistent with the underlying economics of the transaction—an inquiry that could help elucidate whether the tax results are consistent with congressional intent. Instead, this prong focuses on the very different question of whether the transaction altered the taxpayer's pre-tax economic position.

One commentator summarized three approaches to this inquiry, describing the first one as follows:

Under [one] view, economic substance is determined by an objective evaluation of the changes in the taxpayer's economic position, aside from tax benefits. Specifically, a transaction would be viewed as satisfying the objective prong of the economic substance doctrine if the transaction changes in a meaningful way (apart from Federal tax effects) the taxpayer’s economic position.

Under this approach, if the taxpayer experienced a pre-tax non-de minimis economic loss or gain, the transaction passes muster. Consider again the extreme example of the hypothetical retailer who sells cartons of cigarettes for cash in order to evade taxes. Of course, the retailer's actions constitute tax fraud. Yet the sales meaningfully change the taxpayer’s economic position, both through profits on the cigarette sales (even ignoring tax savings) and through increased traffic, which increases sales of other items and thereby increases post-tax profit on those items.

The second approach to the economic substance doctrine is as follows:

248. See ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 1998) ("The inquiry into . . . economic substance . . . turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation, behind them.'" (quoting Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990))).

249. See id. ("[T]hese distinct aspects . . . represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes.").

250. See Hariton, supra note 61, at 235 ("A transaction only has economic substance . . . if it alters the taxpayer's economic position in a meaningful way (apart from its tax consequences).”).

251. Keinan, supra note 141, at 395 (footnote omitted).

252. "[M]any [tax] shelters involve an outside chance of a nontax profit, even though the pretax expected return on the taxpayer’s investment is clearly negative." Calvin H. Johnson & Lawrence Zelenak, Codification of General Disallowance of Artificial Losses, 122 TAX NOTES 1389, 1392 (2009). Arguably, a transaction involving several million dollars of fees paid to accommodation parties assisting in the creation of a non-economic loss, and resulting in a pre-tax negative return on investment, would meet the literal language of this version of "economic substance."
[N]ot only the taxpayer's position must change, ... it must be a change providing a benefit to the taxpayer. For example, sometimes a taxpayer derives a profit from the form of entity, incorporation (limited liability), or accounting and other benefits not specifically translated into "profit."^{253}

Under this test, a negative economic alteration will not suffice. However, a minimal pre-tax profit or nonquantifiable benefit is sufficient, even if it is dwarfed by the tax benefits. The cigarette retailer's evasion strategy is equally successful under this approach. The hypothetical tax-evasion strategy may not result in benefits that are not readily quantifiable, such as accounting benefits, but it does increase pre-tax profits.

The third approach is narrower still:

[It] would focus on the taxpayer's reasonably-expected profits from the transaction. In contrast to the previous views, this approach would require a quantification of benefits in the form of an economic profit. Thus, this standard is narrower than the previous ones, because a meaningful change in the taxpayer's economic positions will include potential profit, but may also include other elements that are not reflected in the profit potential test.^{254}

The cigarette evasion strategy would remain successful even under this stricter approach because, as noted above, the evasion strategy increased pre-tax profits.

A fourth approach requires a comparison of pre-tax profits with the tax savings from the transaction.^{255} Pre-tax profits need not necessarily exceed the tax savings, but they must not be insubstantial.^{256} The hypothetical retailer's tax-evasion strategy might pass muster, even under this approach. The retailer increased pre-tax profits on both cigarettes and other items. In addition, he saved state sales and income taxes. The benefits, other than federal tax savings, from this strategy are therefore likely to be substantial in relation to the federal income tax benefits.

As the plethora of tests suggests, there is no single place to set the bar for pre-tax profit:

The requirement ... involves an inherent dilemma because either the tax effect of a transaction turns on the presence of some positive, but trivial, pretax profit or, if more than a trivial pretax

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253. Keinan, supra note 141, at 396.

254. Id. (footnotes omitted).

255. See Cunningham & Repetti, supra note 157, at 25 & n.121 (citing cases that compared "the magnitude of profit potential to the tax benefits": Keeler v. Comm'r, 243 F.3d 1212, 1220-21 (10th Cir. 2001); ACM P'ship, 157 F.3d at 257-58; and Pasternak v. Comm'r, 990 F.2d 893, 904 (6th Cir. 1993); Sheldon v. Comm'r, 94 T.C. 738 (1990)).

256. See id. at 23 (explaining that "the courts will deny tax benefits if the purported pre-tax economic benefit is insubstantial" in comparison to the expected tax benefit).
profit is necessary, there is no logical limitation on the amount of such profit required, short of what the market would command in such transactions if no tax benefits were involved. ... [R]equirement of a full market return ... is logically incoherent because it ignores the fact that the capital markets will take preferential tax treatment into account in setting relative prices. ... Finally, any intermediate position—such as requiring a "reasonable" pretax return ... —is unsatisfying because choice of the intermediate position is also necessarily arbitrary.\textsuperscript{257}

The profit test has other problems as well. David Hariton pointed out that it is always possible to produce a profit simply by including equity in a transaction.\textsuperscript{258} That should not necessarily mean that the transaction has economic substance.\textsuperscript{259}

In addition, economic substance tests for profit potential, which can be manipulated. Professor Daniel Shaviro explains, in Knetsch, for example (which, as explained above, involved a pure tax arbitrage)\textsuperscript{260}:

Knetsch might have won his case if only the return on the deferred annuity bonds, while still on average an expected 2.5%, had been double or nothing (50\% chance of earning 5\% and 50\% chance of earning zero.) If a coin toss to determine the payoff seems too frivolous, the parties could have made it depend, say, on whether oil prices went up or down. Knetsch could then have argued that the deal had economic substance, a 50\% chance of obtaining a pretax profit, and even a business purpose ("I was feeling lucky").\textsuperscript{261}

The reality is that the hypothesized transaction is economically equivalent to the actual \textit{Knetsch} transaction, except that it contains more risk. The amount of risk certainly affects a taxpayer's calculus regarding whether to enter into a transaction.\textsuperscript{262} Many taxpayers are risk-averse and would avoid the hypothesized bet.\textsuperscript{263} Requiring the taxpayer to bear risk in order to obtain a particular tax benefit therefore reduces the frequency of


\textsuperscript{258} Hariton, supra note 61, at 235–36. For example, in Frank Lyon, the taxpayer received a six percent return on the cash it invested in the transaction. See supra text accompanying note 101. That is a positive return, seemingly giving the taxpayer profit. However, six percent was a below-market rate, see id., so the taxpayer was losing money pre-tax compared to alternative investments.

\textsuperscript{259} Hariton, supra note 61, at 235–36 ("A complicated way of investing cash lacks economic substance—even though it obviously produces a profit—if it leaves the taxpayer in substantially the same position as if the cash had been left in the bank.").

\textsuperscript{260} See supra text accompanying notes 75–78 (explaining the tax arbitrage in \textit{Knetsch}).

\textsuperscript{261} Shaviro, supra note 55, at 316.

\textsuperscript{262} See id. at 368–69.

\textsuperscript{263} See id.
the transaction. However, a taxpayer who is willing to bear the risk in a *Knetsch* style transaction that is modified to allow for either a possible five percent return or a possible zero return still should not benefit from the claimed interest deductions. What the hypothesized transaction does is bundle a transaction with a non-tax purpose (a fifty-fifty gamble) with a tax-arbitrage transaction. As discussed below, cloaking an abusive transaction in a conceptually separate, risky transaction does not legitimize the abusive transaction.

Professor Terrence Chorvat has argued "that tax shelters are a form of arbitrage;"264 that classic arbitrage involves riskless positions, but tax arbitrage is not limited to classic arbitrage because "taxpayers might very well be willing to undergo some risk in order to obtain significant tax benefits,"265 and therefore, "the key to attacking tax shelters is then [examining] the level of . . . risk undertaken in a transaction or series of transactions as compared to the tax benefits derived. Fortunately, this appears to be the focus of the economic substance doctrine."266

This analysis does not show, however (nor does it seem to intend to), that the presence of risk actually separates abusive transactions from appropriate ones. In theory, the assumption of risk could reflect entrepreneurial or other business activity.267 However, as Professor Chorvat noted, taxpayers are also willing to take on risk if substantial tax benefits are at stake.268 Professor Shaviro has argued that:

> The use of an economic substance concept that is based on accepting certain risks of ownership provides a tax incentive to take those risks relative to not taking them. Yet it is hard to see any direct policy reason why the tax authorities should care what risks a taxpayer . . . chooses to take or shun.269

Shaviro argues that efficiency analysis suggests that tax considerations should not alter the taxpayer's decision of how much risk to take on, and additionally, that risk-bearing provides no information furthering the measurement function of income tax.270 Thus, a tax requirement of a

265. Id. at 876.
266. Id.
267. Cf. Lederman, *supra* note 171, at 1454 (arguing that because entrepreneurial activity is riskier than passive investment, it is unsurprising that federal tax law imposes limits on the deductibility of individuals' investment losses that it does not impose on active businesses).
268. See *supra* text accompanying note 265 (quoting Chorvat, *supra* note 264, at 876).
270. Id. at 222–23.
certain quantum of risk may simply be a "friction" that reduces the incidence of tax arbitrage.\footnote{271}

A prime example of the frictional nature of a requirement that a taxpayer bear risk in order to obtain certain tax benefits is a holding period that provides an artificial bright line between a favorable and unfavorable tax result,\footnote{272} such as the general forty-six-day holding period for a corporation to obtain a dividends-received deduction.\footnote{273} There is no magic distinction between forty-five days and forty-six days, but the holding period requires the taxpayer to bear market risk in order to receive the deduction.\footnote{274} This deters transactions designed to obtain the arbitrage resulting from dividend income effectively being taxed at a lower rate than the loss on the sale of the stock that gave rise to the dividend.\footnote{275} Unfortunately, the holding period is probably inefficient.\footnote{276}

\footnote{271} Id. at 223. Professor Shaviro illustrates this as follows:

[T]hink of taxpayers as metaphorically headed downstream with a foot on each of two rafts: the economic planning raft and the tax planning raft. Each taxpayer aims to end up with the best economic results and the best tax results. Absent an economic substance approach, she can in effect lash the two rafts tightly together, steer wherever she likes from an economic standpoint, and also end up with the tax result she likes. Under an economic substance approach, however, the two rafts may drift sufficiently far apart that she must jump off one raft, letting it drift away while she stands entirely on the other.

\footnote{272} See id. (referring to holding period in dividend-stripping context).

\footnote{273} I.R.C. § 246(c)(1)(A) (2008). The dividends-received deduction, as its name suggests, is a deduction (applicable to corporations) in connection with the receipt of dividends from another corporation. See id. § 243 (providing for deductibility of seventy, eighty, or one-hundred percent of dividends received).

\footnote{274} See Shaviro, supra note 269, at 224. Shaviro argues:

[In many cases [CFOs] or their bosses were unwilling to take on the economic risk of owning otherwise undesired stock for 45 days—even in exchange for the tax benefit and notwithstanding that they could pick any declared-dividend stock they liked and face only the ordinary market risks that millions of stock market investors embrace every day.

\footnote{275} Shaviro described this tax arbitrage as follows:

Fertile minds . . . realized that corporations with capital gains could . . . benefit from buying stock just before a declared dividend was paid and selling the stock for a loss just afterwards. Even if such a purchaser lost money before tax by reason of transaction costs, it would make hay at the expense of the Treasury due to the mismatch between the tax treatment of the dividend receipt and the capital loss (assuming capital gains against which the loss could be deducted).

\footnote{276} (footnote omitted).

For example, if a corporate taxpayer bought publicly traded stock for $1200 just before receiving a $100 dividend on that stock, it would be taxed on no more than $30 of the dividend ($100 of gross income less a $70 dividends-received deduction under § 243(a)(1)). Assuming no holding-period requirement, the taxpayer could resell the stock the next day
The passive activity loss provision of Code section 469 provides an analogy. It was highly successful (at least combined with previous reforms) in eliminating the individual tax shelters of the 1970s and 1980s, but that does not mean that "passive activity" was the problem. It just means that requiring the wealthy individuals invested in tax shelters to actually include labor in their "investment"—like a hypothetical backward-somersault requirement—was so much of a friction that they would no longer invest in those shelters.

Privileging risk raises the question of how the bundling of tax arbitrage with a risky transaction, such as Professor Shaviro’s modified Knetsch hypothetical, should be treated. Is it really the case that Knetsch should have won the lawsuit if he had been willing to couple the gamble with his tax arbitrage? Note that the element of risk in the gamble does not eliminate the abuse of the tax arbitrage. The same is true if the hypothetical double-or-nothing bet had not been bundled with the tax arbitrage he engaged in, but rather involved the same dollar amounts in an unrelated transaction giving rise to no tax benefits.

Consider the latter scenario: Knetsch engages in the tax-arbitrage transaction the Supreme Court considered and simultaneously engages in a separate wager with a third party, giving him a fifty percent chance of earning a five percent return on the same amount he paid the bank and a

without forfeiting the $70 deduction. Assuming that the value of the stock dropped by the full $100, the sales price would be $1100, giving rise to a $100 loss, deductible under I.R.C. § 165(a), subject only to the capital-loss restrictions of § 1211(a) (because the stock is a capital asset under § 1221). In total, the taxpayer would have a $100 capital loss (deductible from capital gains) for the price of only $30 of income.


[A]s far as frictions go, risk is not a particularly effective one. It typically functions as a weak, continuous friction that can be avoided by a minor adjustment in behavior. Imposing this type of friction does little to reduce elasticity of taxable income and, therefore, is likely to be rather inefficient.

Id. (footnotes omitted).


278. See Shaviro, supra note 269, at 223. Shaviro stated:

[O]ne might as well condition favorable tax consequences on whether the taxpayer’s chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool’s Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting requirements that are pointless in themselves.

Id.

279. See Chirelstein & Zelenak, supra note 31, at 1951 (“The passive status of the taxpayers investing (so to speak) in the shelters was crucial, as no busy shelter-seeking doctor or lawyer was willing to devote any significant portion of his time to the business activities of the shelter.”).
fifty percent chance of earning zero. It is unlikely the Court would consider the effect of the separate transaction in its analysis of the tax-arbitrage transaction—nothing links them but the amount in question and the timing. The Court would therefore likely hold for the government, just as it did in the actual case. If Knetsch instead made the wager with the bank as part of the same transaction, the addition of the conceptually separate gamble to the admitted tax arbitrage should not change the result. Moreover, it should not change the result whether or not Knetsch is lucky and actually receives the five percent return, since pre-tax prospect of profit is calculated ex ante.

Similarly, "design[ing] an elaborate superstructure of liability management functions around . . . [a] tax shelter transaction" should not be effective to create economic substance. An abusive tax shelter cloaked in business clothing is still an abusive tax shelter. However, the reality is that litigation is after the fact, so the relevant players know how much profit the taxpayer earned. If Knetsch had engaged in the hypothesized double-or-nothing transaction (which he might not have been willing to because of the risk) and had won the bet, the presence of actual pre-tax profit might have influenced the courts' analyses.

In short, the economic substance prong, like the business purpose prong, does little to distinguish abuse cases from legitimate activity. A risk analysis does impose a friction that provides a disincentive to engage in tax arbitrage, but it does not help distinguish tax benefits that Congress intended from abusive transactions. Worse yet, a risk analysis can allow tax arbitrage that is cleverly packaged with market risk to pass muster although the same tax arbitrage unbundled would not. The two situations should be treated the same way; courts should not uphold abusive tax arbitrage.

280. The same is true in the analogous hypothetical posed in Jason Quinn, Comment, Being Punished for Obeying the Rules: Corporate Tax Planning and the Overly Broad Economic Substance Doctrine, 15 GEO. MASON L. REV. 1041, 1041-42 (2008) (describing an identical tax strategy entered into by Corporation A and Corporation B, with only Corporation A hedging away risk). Mr. Quinn argues that because Corporation B did not hedge the risk, it "has undergone a risky transaction, with a real business motive." Id. at 1042. He further argues that "the mere existence of a salable tax package and Corporation A's misuse of that package serve to rationalize an appellate court's presumptive bias against Corporation B's use of the same package[, which] . . . cuts against notions of allowing each case to stand or fall on its own merits." Id.


V. CONCLUSION

The economic substance doctrine is an odd weapon in the war on tax abuse. An examination of the Supreme Court cases that gave rise to the current economic substance doctrine shows that courts have extended the doctrine well beyond its appropriate scope. Judge Learned Hand considered whether Mrs. Gregory’s transaction had a business purpose in a context specific to corporate entities (reorganizations) because he found that Congress’s intent was to require such a purpose. Frank Lyon added the economic substance prong in a case that upheld Frank Lyon’s right to deductions available to an owner when the economic reality was that its counterparty, Worthen, owned the building in question.

Although courts often use the current economic substance doctrine to reach appropriate outcomes—disallowance of tax benefits claimed in abusive transactions—the doctrine has evolved into one that asks the wrong questions and is easily manipulated. It can be applied to uphold claimed tax benefits where the taxpayer can provide a plausible business purpose, even if the transaction is abusive. It can also uphold transactions that yield a small amount of pre-tax profit—or the prospect of pre-tax profit—even if that profit is less than what would be obtained from other equally risky investments, and even if the deal makes economic sense only because of the tax benefits. If the doctrine is applied before it is clear that the transaction complied with the tax law’s statutory and regulatory requirements, even an egregious tax-law violation could pass muster, as the tax-evading-retailer example demonstrated.

In addition, the business purpose prong of the doctrine yields results that differ depending on whether an abusive tax strategy, including a tax-arbitrage transaction, is incorporated into a business. Conceptually and economically, the two situations are no different, and neither should be upheld. Similarly, a transaction may be treated as having a business purpose because its structure appears to be constrained by regulatory requirements regardless of whether the structure results in claimed tax benefits that otherwise would not be upheld.

Given all of these problems, courts should abandon the current version of the economic substance doctrine and Congress should not codify it in its present form.283 The purpose of this recommendation most certainly is not

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283. For analysis of the prospect of and issues surrounding codification of the economic substance doctrine, see generally Ellen P. Aprill, Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines, 54 SMU L. REV. 9 (2001); Steven A. Bank, Codifying Judicial Doctrines: No Cure for Rules But More Rules?, 54 SMU L. REV. 37 (2001); Monte A. Jackel, Farming for Economic Substance: Codification Fails to Bear Fruit, 119 TAX NOTES 59 (2008); O’Neill, supra note 5, at 1061–62; Samuel C. Thompson, Jr., Despite Widespread Opposition, Congress Should Codify the ESD, 110 TAX NOTES 781 (2006); Dennis J. Ventry, Jr., Save the Economic Substance Doctrine from Congress, 118 TAX NOTES 1405 (2008); Wolfman, supra note 8. Discussion of the details of the codification debate is beyond the scope of this Article.
to foster or even tolerate abusive transactions. Rather, its intention is to eliminate business purpose and economic substance doctrines that are poor proxies for the real question of whether the claimed tax results are abusive. Courts should instead address the heart of the matter—Congress's intent.\textsuperscript{284}

To determine congressional intent, courts need to undertake a purposive inquiry, as Judge Learned Hand did in \textit{Gregory},\textsuperscript{285} and as other scholars have argued.\textsuperscript{286} In other words, courts should look to any relevant legislative history, surrounding statutes, and general tax principles to determine whether the claimed noneconomic benefit is consistent with federal tax law.

This inquiry could be systematized. For example, Professor McCormack has developed a framework for courts to use in tax-shelter cases to identify the specific purposes of a particular Code section or regulation. That framework includes a nonexhaustive list of categories into which tax provisions fall\textsuperscript{287}: (1) "provisions that are part of the general structure of the Code";\textsuperscript{288} (2) two types of "giveaways";\textsuperscript{289} and (3) two types of deviations from general principles to reflect administrative realities.\textsuperscript{290} Applying this
framework, Professor McCormack identified the contingent installment sale regulations at issue in *ACM* as reflecting a compromise between taxing gains and losses as they occur and the administrative considerations underlying the realization doctrine.291 Because the regulations seek to correct misallocations of gains, her approach would find the CINS transaction inconsistent with the purpose of the regulations.292

Professor McCormack's proposal is explicitly limited to tax-shelter cases. However, it need not be so constrained. As argued above, the "tax shelter" moniker does not encompass all tax abuse, and an examination of congressional intent is the key to distinguishing between appropriate and illegitimate tax benefits. Courts should not hesitate to apply a systematic approach to purposive interpretation to all cases involving claimed abuse of the tax laws.

The approach proposed in this Article would eliminate the unhelpful question of whether the taxpayer had a subjective non-tax purpose for the transaction, except where the provision in question calls for such a purpose. It would also eliminate the existing "economic substance" inquiry, which does not focus on the actual economics of the transaction. Instead, the proposed test would ask a question of tax law: whether the claimed tax results are consistent with the statutory or regulatory scheme in question. This approach has the virtues of (1) asking the right question and (2) being more difficult for taxpayers to manipulate. As a result, it should increase predictability and more effectively combat abusive transactions than the current economic substance doctrine does.


292. McCormack, *supra* note 5, at 760 ("The CINS transactions produce the very type of substantial distortion the reallocation provisions seek to correct.").