Mrs. Gregory's Great-Grandchildren: The Lost Generation[1]

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Thomas C. Durham, Joel V. Williamson and Stuart E. Thiel discuss the case of *Gregory v. Helvering*, the "economic substance doctrine" and the continuing controversy surrounding this concept.

I. Introduction

Another article on *Gregory v. Helvering*?[2] Does the world really need another article on *Gregory v. Helvering*? We believe it does. As have others, "we approach this subject with considerable humility" and hope that our efforts "will stimulate others to better attempts."[3]

Recent events demonstrate that the meaning of *Gregory* is perhaps less clear than ever before. In a string of recent, high-profile cases, the Circuit Courts of Appeals have reversed lower court decisions interpreting the economic substance doctrine.[4] Four years ago, the Third Circuit's formulation of the economic substance doctrine as set forth in *ACM Partnership*[5] was regarded as a major victory for the IRS. In recent months, however, the Court of Appeals for the District of Columbia[6] has declined to follow *ACM,* and a decision by the District Court for the District of Columbia[7] has also departed from the *ACM* rationale. These events have generated a spate of new articles on the economic substance doctrine.[8]

We believe that this confusion[9] can be attributed, at least in part, to a fundamental misunderstanding of the message of *Gregory*. The proper role and scope of the economic substance doctrine as set forth in *Gregory v. Helvering* has been one of the most controversial subjects in tax law. As long ago as 1940, a

leading commentator stated: "Few cases have been the subject of such violent disagreement and confusion as the *Gregory* case. The case is all things to all men."[10] The intervening 60 years have only produced further "disagreement and confusion," as the recent cases and articles demonstrate.

> We believe the only remedy for the current confusion in the law is to return to the original meaning of *Gregory v. Helvering*. Thus, in every case, the inquiry must be "what actually occurred" and whether these events are "the thing which the statute intended."

Two years before *Gregory*, perhaps anticipating the confusion his opinion in Mrs. Gregory's case would later cause, Judge Learned Hand derided "such vague alternatives as 'form' and 'substance'" as "anodynes for the pains of reasoning."[11] Issues of "economic substance" should be treated as questions, not answers. All too often, resort to claims of economic substance is used to shut off further inquiry.[12] Any discussion of economic substance ought to be the springboard for an informed discussion of the structure and policy of the Internal Revenue Code, and not simply another opportunity for the rote application of concepts developed against a completely different statutory and factual background.

The problem of textualism in tax law is a familiar one and beyond the scope of this article.[13] Strict adherence to the terms of the statute may present possibilities of abuse by taxpayers, but broader readings of the statute create uncertainty and risk undermining Congressional intent. These competing concerns appear to be a permanent feature of tax law.

In recent years, however, the problem of textualism has been taken to a new level by several courts, including the Third Circuit in *C.S. Lerman*, which have declared that economic substance is a "prerequisite" to the application of the Code.[14] Under this formulation of economic substance, the text of the Code is not merely given an expansive reading; the text of the Code is not even consulted unless the taxpayer first passes an *a priori* test of economic substance.

It is our belief that the expansive reading of *Gregory* to require an *a priori*, or "generic" test of economic substance has no basis in *Gregory* itself or other Supreme Court precedent and is misguided. *Gregory* requires a rigorous analysis of the language and purpose of the underlying Code provisions. As such, issues such as the taxpayer's intent, business purpose and the profit potential and economic effects of a transaction should be analyzed in light of the particular Code section at issue in each case.

The expansive reading of *Gregory* set forth in *C.S. Lerman* and other cases shows signs of faltering. Recent cases such as *Compaq* and *UPS* reject this broader application of economic substance, and thus Mrs. Gregory's legacy continues to be as elusive as ever.

The purpose of this article is to explore the changing manner in which the courts have interpreted the economic substance doctrine. Therefore, we have described the facts of specific cases only to the extent necessary to illuminate the application of the economic substance doctrine.

II. The Rule of *Gregory v. Helvering*

In *Gregory*, the taxpayer, Mrs. Gregory, owned all of the stock of United Mortgage Corporation ("United"), which in turn owned 1,000 shares of Monitor Securities Corporation ("Monitor"), which had appreciated in value. Mrs. Gregory wanted to sell the stock of Monitor and receive the proceeds in cash without being taxed on the receipt of a dividend from United. In order to bring about this result, Mrs. Gregory caused United to transfer the shares of Monitor to the newly formed Averill Corporation ("Averill"), which then issued its stock directly to Mrs. Gregory. Averill then dissolved and distributed its only asset (the Monitor stock) to Mrs. Gregory, who promptly sold it. Claiming that the receipt of the Averill stock was pursuant to a "plan of reorganization" under Act Sec. 112(i)(1)(B) of the Revenue Act of 1928 and therefore tax-free, Mrs. Gregory reported a capital gain on the receipt of the Monitor shares in liquidation of Averill and no further gain on the sale to the third party.[15]

Mrs. Gregory's plan required that the distribution of the shares of Averill to her qualify as being made "in pursuance of a plan of reorganization," rather than being treated as a dividend. The Board of Tax Appeals treated the transaction as a "reorganization," and ruled in Mrs. Gregory's favor.[16]

The Second Circuit reversed. Judge Learned Hand understood that the issue before the Second Circuit was a matter of statutory interpretation, stating:

> Therefore, if what was done here, was what was intended by §112(i)(1)(B), it is of no consequence that it was all an elaborate scheme to get rid of income tax, as it certainly was.[17]

Mrs. Gregory's purpose to save taxes was therefore irrelevant, so long as her actions, *i.e.*, "what was done," were consistent with the statute. Since, however, Mrs. Gregory had no intention of reorganizing her business, but instead intended to sell a portion of her business to a third party, her transaction did not fit within the definition of a "reorganization" as set forth in the statute:

> 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. Such transactions were not to be considered as "realizing" any profit, because the collective interests still remained in solution. 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.[18]

On appeal, the Supreme Court also approached the issue as one of statutory interpretation, stating that "what actually occurred" was not a "reorganization in reality" and therefore not "the thing which the statute intended."[19]

The most controversial portion of *Gregory* is the Supreme Court's description of Mrs. Gregory's purpose. The Supreme Court correctly observed that Mrs. Gregory had no "business or corporate purpose … to reorganize a business or any part of a business."[20] Some courts have taken this passage to state a general requirement that all tax transactions must satisfy a "business purpose" test. The Supreme Court's opinion, however, does not justify such a sweeping generalization. Mrs. Gregory's lack of business purpose was relevant only because the statute by its very terms required purposive conduct, *i.e.*, that her actions be "'in pursuance of a *plan* of reorganization' … of corporate business," and the facts left no doubt that Mrs. Gregory had no such "plan" to reorganize her business, but had only a "plan" to receive a dividend.[21] The Supreme Court's reference to "business or corporate purpose" merely acknowledges that the statute under consideration required purposive conduct—"a plan"—to reorganize a business, and that Mrs. Gregory plainly had no such plan.

Although Mrs. Gregory's transaction did not qualify as a "reorganization," the Second Circuit did not accept the Commissioner's claim that her transaction should be ignored as a nullity:

> We do not indeed agree fully with the way in which the Commissioner treated the transaction; we cannot treat as inoperative the transfer of the Monitor shares by the United Mortgage Corporation, the issue by the Averill Corporation of its own shares to the taxpayer, and her acquisition of the Monitor shares by winding up that company. The 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. All these steps were real, and their only defect was that they were not what the statute means by a "reorganization" …[22]

Since the distribution of the Averill shares to Mrs. Gregory matched both the statutory definition of a dividend and Mrs. Gregory's underlying purpose to receive a dividend, Mrs. Gregory was taxed on the receipt of the Averill shares, not on the receipt of the Monitor shares as the Commissioner had urged. In other words, while "what actually occurred" may have lacked the economic substance of a reorganization, it did have the economic substance of a dividend and was taxed as such.

Gregory v. Helvering thus stands for three basic principles:

1. The economic substance doctrine is a rule of statutory interpretation, which examines whether the transaction in issue is consistent with the purpose of the specific statutory provision at issue in the case.[23]
2. The taxpayer's motive to reduce its tax burden is irrelevant, except when the taxpayer's tax-avoidance intent conflicts with statutory requirements.[24]
3. In deciding "what actually occurred," a reviewing court *may not* treat actual events as nullities, but *may* recharacterize them in accordance with their substance rather than their form.[25]

Judge Hand added an important coda to *Gregory* several months after the Supreme Court's decision. In *G.H. Chisholm*,[26] two brothers, shareholders in a corporation, planned to sell their stock. In order to avoid tax on this sale, the brothers transferred their stock to a partnership, which then sold the stock. Under the law of that era,[27] the gain inherent in the stock transferred to the partnership would not be taxed until dissolution of the partnership.

The IRS argued that, since the partnership "was formed confessedly to avoid taxation," *Gregory* required that the transfer be ignored. Judge Hand, elaborating on *Gregory*, disagreed:

> It is important to observe just what the Supreme Court held in that case. It was solicitous to reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it …The question always is whether the transaction under scrutiny is in fact what it appears to be in form … We may assume that purpose may be the touchstone, but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation …[28]

While the brothers in *Chisholm* undoubtedly meant to avoid taxation, in order to obtain this objective, they formed an "enduring firm" that continued "to hold the joint principal and invest and reinvest it."[29] The partnership was not a "mere cover" for "continued separate management" of the brothers' assets; the brothers had actually transferred control over the assets to their new partnership. Since the brothers' purpose to avoid taxation necessarily required a genuine transfer to their partnership, their purpose matched the form of their transaction. The brothers' transfer was genuine and conveyed ownership to the partnership, and therefore their purpose to effect a genuine transfer was the only purpose that mattered.

> The proper role of a taxpayer's motive to avoid tax in assessing his liability for tax is thus a continuing conundrum in tax law. At the risk of appearing obvious, it is our belief that a taxpayer's motive to avoid tax should be relevant only when a reasoned interpretation of the statute makes it relevant.

Mrs. Gregory's purpose, on the other hand, contradicted the form of her transaction, not because she meant to escape taxation, but because she had not "really meant to conduct a business by means of the two reorganized companies" and thus had not intended to engage in a "reorganization."[30] Therefore, when a taxpayer intends to secure tax benefits by engaging in a specific transaction, the taxpayer's intent is relevant only to the extent that it reflects whether the taxpayer actually entered into the legal relationships necessary to secure the tax benefit as described in the tax law.[31] "The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact."[32] A taxpayer's "motive and expectations are relevant only insofar as they contribute to an understanding of the external facts of the situation."[33]

In the years after *Gregory*, transactions motivated solely by tax considerations were repeatedly upheld when the taxpayer's conduct actually created the legal relationships contemplated by the statute, *i.e.*, the substance of the taxpayer's conduct was consistent with its form.[34] These decisions repeatedly rejected the notion that *Gregory* requires a "business purpose." Each of these cases upholds the principle that the purpose "to escape taxation … [is] legally neutral" and that the taxpayer's purpose is relevant only insofar as it demonstrates the taxpayer's intent (or lack thereof) to create the legal relationships called for by the statute.[35]

III. The Departure from *Gregory*

It is difficult to pin down the exact moment when courts began to depart from the statute-centered mode of analysis set forth in *Gregory*, but the Supreme Court's decision in *K.F. Knetsch*[36] has certainly served as the basis for many expansive readings of the economic substance doctrine. The taxpayer in *Knetsch* purchased $4,004,004 in deferred annuity savings bonds, but paid only $4,000 and borrowed the remainder on a nonrecourse basis. Mr. Knetsch then prepaid the first year's interest on his debt. Then, several days later, Mr. Knetsch borrowed against the next year's growth in value of his bonds, and

again prepaid the interest on this debt. As a result of his borrowings, Mr. Knetsch's annuity never had a cash value of more than $1,000. The Court held that this transaction did not create a genuine indebtedness.

The transaction at issue in *Knetsch* can be viewed as a factual sham,[37] *i.e.*, it did not result in a "true obligation to pay interest,"[38] and some subsequent decisions have treated it as such.[39] Even though the Court treated the transaction as a factual sham, however, the Court nevertheless undertook an extensive review of the legislative history to ensure that Congress had not intended to protect such transactions. The Court ruled against Mr. Knetsch only after reviewing the legislative history and concluding that Congress had not intended to protect Mr. Knetsch.[40]

The Second Circuit's decision in *K. Goldstein*[41] perhaps represents the key turning point in the expansion of the economic substance doctrine. Tillie Goldstein, seeking to shelter her winnings from the Irish sweepstakes, borrowed $965,000 and invested the proceeds in Treasury notes, which were pledged as collateral for the loans. Mrs. Goldstein then prepaid $81,000 of interest on the loans and claimed this amount as a deduction, thus partially offsetting her income from the Irish sweepstakes.

The Second Circuit rejected the Commissioner's argument that Mrs. Goldstein's loans were "shams" which did not create a genuine indebtedness; thus, Mrs. Goldstein's case could not be decided on the same basis as *Knetsch*.[42] The Second Circuit instead premised its holding on the factual finding that Mrs. Goldstein entered into the "transactions without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction."[43]

The Second Circuit did not rest, however, on its conclusion that Mrs. Goldstein's transactions lacked any realistic expectation of profit. The court next examined the purpose of Code Sec. 163 to determine whether Mrs. Goldstein's deductions were nonetheless allowable: "[A] close question whether a particular Code provision authorizes the deduction of a certain item is best resolved by reference to the underlying Congressional purpose of the deduction provision in question."[44]

The Second Circuit concluded that Congress intended to allow an interest deduction under Code Sec. 163 only when a taxpayer has "incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity."[45] The Second Circuit's claim that Code Sec. 163 implicitly includes a "purposive activity" requirement is certainly debatable. The court recognized that this requirement cannot be found in the statute:

> Admittedly, the underlying purpose of Section 163(a) permitting the deduction of 'all interest paid or accrued within the taxable year on indebtedness' is difficult to articulate because this provision is extremely broad: There is no requirement that deductible interest serve a business purpose, that it be ordinary and necessary, or even that it be reasonable.[46]

Without citations to any legislative history, the Second Circuit divined a "Congressional policy" that a taxpayer borrowing for a "purposive activity" should not "fare worse from an income tax standpoint than one who finances the venture with capital that otherwise would have been yielding income."[47] Thus, following *Gregory*, the court held that a "purposive activity" requirement was an essential element of "the thing which the statute intended."[48]

The Second Circuit therefore felt compelled to ground its analysis in the statute, however tenuous that link might have been. This link was broken in subsequent cases, as numerous courts have applied both *Knetsch* and *Goldstein* in contexts outside of Code Sec. 163 interest deductions.[49] In particular, the "purposive activity" requirement that the Second Circuit found in Code Sec. 163 has been routinely applied in other contexts.

Recent cases have completely abandoned the statutory analysis found in earlier cases, and have substituted the familiar "two-pronged inquiry" set forth in *Rice's Toyota World, Inc.*[50] Under this formulation, a transaction must be upheld unless it has "no business purpose other than obtaining tax benefits" (the subjective test) and has "no reasonable possibility of a profit" (the objective test). The Fourth Circuit, adopting the Tax Court's reasoning in *Rice's Toyota*, attributed the "two-pronged inquiry" to the Supreme Court's decision in *Frank Lyon Co.*[51] The "two-pronged inquiry" cannot easily be found in *Frank Lyon*, however, and appears to be an overly simplistic attempt to summarize the more nuanced approach of *Frank Lyon*.

In recent months, many commentators have argued that the current state of the law regarding economic substance is broken beyond repair.[52] As for the "profit potential" requirement, some commentators have pointed out that it is possible to inject a realistic potential for profit into virtually

any transaction, no matter how egregious the tax consequences.[53] On the other hand, the "profit potential" test is ill-suited for transactions such as the purchase of insurance, corporate reorganizations or the choice of capital structure, which are not directly linked to the creation of a profit.

The business purpose test has its own problems. A "narrow notion" of the business purpose test, which examines whether a transaction has a business purpose aside from obtaining tax benefits, is inevitably at odds with *Gregory's* requirement that the motive to avoid tax must be "disregarded."[54] Many concededly legitimate transactions would not take place in their current form but for the associated tax benefits. The indiscriminate application of a business purpose requirement risks undermining the intent of Congress.[55] In particular, notions of "business purpose" developed in the context of individuals may be unsuitable for application in business contexts.[56]

We believe the only remedy for the current confusion in the law is to return to the original meaning of *Gregory v. Helvering*. Thus, in every case, the inquiry must be "what actually occurred" and whether these events are "the thing which the statute intended."

IV. The Third Circuit's and the D.C. Circuit's Divergent Views of Economic Substance

A. The Third Circuit's View

The contemporary confusion in the law of economic substance is well represented by the Third Circuit's and the D.C. Circuit's divergent decisions in *C.S. Lerman* and *T.J. Horn*. These conflicting views are particularly important because, as discussed in greater detail below, the Third Circuit's views of the economic substance doctrine as set forth in *ACM* can be directly traced to *Lerman*.

The taxpayer in *Lerman* had invested in silver option-straddle transactions on the London Metals Exchange. These transactions were designed to create an ordinary loss in one year, with a deferral of gain to the second year. The Third Circuit's decision in *Lerman* is based on the Tax Court's earlier decision in *B.S. Glass*,[57] and thus a brief digression to discuss *Glass* is necessary to understand the background of *Lerman*.

The Tax Court held in *Glass* that since the London option-straddle transactions did not present a reasonable opportunity for profit, the losses claimed were not allowable. This conclusion appears to be entirely unexceptional. Code Sec. 165(c)(2), as it applies to individuals, permits the deduction of losses only if the losses were incurred in a "transaction entered into for profit."[58] The evidence in *Glass* "overwhelmingly demonstrate[d] that petitioners did not enter into these transactions primarily for profit."[59]

The Tax Court in *Glass* understood *Gregory* as requiring an examination of the specific Code provisions at issue:

> [D]id the … Petitioners' tax straddle scheme fit within what sections 165 and 1234, and new Section 108(a) intended? In the words of the Supreme Court, '[t]he question for determination is whether what was done, apart from the tax motive, is the thing which the statute intended.' *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).[60]

The Tax Court therefore understood that the ecoomic substance inquiry must be firmly rooted in the statute. Given the Supreme Court's findings of fact and the plain language of Code Sec. 165(c)(2), however, it is not clear why the Tax Court felt compelled to resort to *Gregory* and the economic substance doctrine. The taxpayer's transactions did not satisfy the plain terms of Code Sec. 165(c)(2) and could have been easily disallowed on that basis alone.

After the decision in *Glass*, in *Lerman* and other cases, a number of commodities dealers challenged the IRS's assertions of tax resulting from the dealers' participation in London option transactions. The facts of these cases were generally identical to *Glass*, with one critical exception: each of these taxpayers was a commodities dealer, and thus claimed protection under the special rule set forth in Act Sec. 108(b) of the Deficit Reduction Act of 1984, as amended by the Tax Reform Act of 1986.[61] Act Sec. 108(a) provided that "any loss" from a straddle entered into before 1982 would be allowed if the loss were "incurred in a trade or business." Act Sec. 108(b), in turn, created an "irrebuttable presumption"[62] that "any loss incurred by a commodities dealer … shall be treated as a loss incurred in a trade or business." The purpose of Act Sec. 108(b) was to eliminate the "profit" and "trade or business" restrictions of Code Sec. 165(c) and therefore "make it clear that losses incurred by commodities dealers trading in commodities are deductible under section 108."[63]

Given the provisions of Act Sec. 108, commodities dealers argued in *Lerman* and other cases[64] that they were "a favored class" entitled to prevail as a matter of law,

notwithstanding the fact that their transactions were unlikely to produce a profit.[65] They argued that Act Sec. 108(b) made the "'profit motive' test inapplicable to them" and that Act Sec. 108(b) allows losses even if the underlying "*transactions are unquestionably economic shams*."[66]

The IRS responded by arguing that Act Sec. 108 did not apply to transactions lacking in economic substance, and therefore the irrebuttable presumption of Act Sec. 108 was not applicable. The Third Circuit agreed, stating that while Congress had "eliminated the profit motive inquiry in cases involving dealers ... *it did not prevent inquiry into the economic substance of a dealer's commodity trading*."[67]

This conclusion appears to be highly questionable, given the statutory background of the London option cases. *Glass* was decided on the basis that the taxpayers' transactions lacked any realistic prospect for profit, and therefore their transactions lacked economic substance as measured against the profit motive test of Code Sec. 165(c)(2). This conclusion therefore clearly carries out "the thing which the statute intended."[68]

Based on *Glass* and other cases, the Third Circuit concluded that Lerman's transaction lacked economic substance and therefore was not protected by Act Sec. 108.[69] It is difficult to understand, however, how case law developed in the context of the "profit motive" of Code Sec. 165(c)(2) can be applied to a statute which has stricken any profit motive requirement. Since the economic substance doctrine (or at least the "profit potential" prong of the doctrine) depends upon whether a transaction is expected to produce a profit, it seems anomalous to apply the economic substance doctrine when, as the Third Circuit recognized, Congress has "eliminated the profit motive inquiry."[70]

The Third Circuit's opinion makes sense only if one views economic substance as a separate requirement, independent of the Code. Indeed, that is exactly what the Third Circuit held: "economic substance is a *prerequisite*" to the application of the Code.[71]

The Third Circuit's conclusion that "economic substance is a *prerequisite*" to the application of the Code turns *Gregory* on its head; while the Supreme Court in *Gregory* held that the economic substance doctrine should examine "the thing which the statute intended," in *Lerman,* the Third Circuit held that the statute is essentially irrelevant if the taxpayer fails to meet an *a priori* definition of economic substance.

In *V. Wexler*,[72] the Third Circuit took this analysis one step further in a writ of mandamus arising out of a criminal trial. The government charged Mr. Wexler with criminal tax fraud for his role in a plan to create fraudulent interest deductions. Mr. Wexler's attorneys proposed a set of jury instructions that provided he could not be convicted if the deductions in question were the result of "genuine indebtedness." The district court largely accepted this instruction.

The government filed for the extraordinary relief of mandamus, arguing that the district court's instructions represented clear legal error, which would place the prosecution of current and future cases in jeopardy.

On appeal, Wexler argued that Code Sec. 163 does not contain a "profit motive" or "trade or business" requirement and therefore interest expense is deductible if it arises from genuine indebtedness. Relying on *Knetsch*, *Goldstein* and other cases, the Third Circuit held that Mr. Wexler's interest deductions lacked economic substance even if they resulted from genuine indebtedness. In the course of doing so, the court repeated its view that "economic substance is a *prerequisite* to *any* Code provisions allowing deductions."[73]

B. The D.C. Circuit's View

In *Horn*, the Court of Appeals for the District of Columbia placed itself squarely at odds with the Third Circuit's formulation of economic substance as set forth in *Lerman* and *Wexler*. The *Horn* case involved a commodities dealer with facts identical to those of *Lerman*. Based on his status as a commodities dealer, the taxpayer in *Horn* argued that as a result of the irrebuttable presumption of Act Sec. 108(b) of the Deficit Reduction Act of 1984, as amended, he was entitled to claim losses from option-straddle transactions even if the transactions were devoid of any profit potential or business purpose.

The IRS once again argued, as he did in *Lerman*, that the transactions at issue in *Horn* lacked "economic substance" and therefore must "f[a]ll outside section 108."[74] The D.C. Circuit emphatically rejected this argument, holding that the Commissioner's position (and thus *Lerman*) was "plainly and simply wrong."[75]

> The principal problem that we find with the Commissioner's argument is that it takes the sham transaction doctrine too far. Although useful in determining congressional intent and in avoiding results unintended by tax code provisions, the doctrine cannot trump the plainly

> expressed intent of the legislature. In this case, the plain meaning of the statute authorizes the claimed deductions, and the Commissioner has utterly failed to provide any other colorable interpretation.[76]

The D.C. Circuit understood that the "economic substance" test as applied in *Glass* and other cases based on Code Sec. 165(c) was irrelevant to cases involving Act Sec. 108(b), since Act Sec. 108(b) had eliminated any "profit motive" requirement:

> Therefore, Glass and the cases following it, which refuse to recognize the losses because the straddles held no economic risk or possibility of profit, are beside the point.[77]

The formulation of "economic substance" set forth in *Horn* is therefore fundamentally different from the test set forth in *Lerman*. According to the D.C. Circuit, the economic substance test is a rule of statutory interpretation which is used to carry out Congressional intent. Thus, *Gregory* can be understood only as "an attempt to give effect to Congress' intent,"[78] and the economic substance doctrine is "simply an aid" to understanding Congressional intent.[79]

Since the economic substance doctrine is "simply an aid" to interpreting the statute, the D.C. Circuit was "at a loss to understand" the Commissioner's argument that the economic substance doctrine applies "independently" of Act Sec. 108. The D.C. Circuit thus squarely rejected *Lerman's* claim that "economic substance is a *prerequisite* to the application" of the Code.[80]

Since the provisions of Act Sec. 108 were similar to the traditional tests of economic substance, the D.C. Circuit found it "inconceivable that Congress intended that the 'sham' transaction doctrine be laid over the statute."[81] Therefore, since the transactions at issue satisfied the plain terms of Act Sec. 108, there was simply no room for the application of the economic substance doctrine and the taxpayer's losses were therefore allowable.

ACM and *Saba*

The Third Circuit's and D.C. Circuit's divergent views concerning the economic substance doctrine were again on display in *ACM Partnership* and *Saba Partnership*. The subject of each of these cases was the Merrill Lynch contingent note transaction; this transaction has been the subject of numerous articles,[82] and we do not repeat the details of the transaction here. Suffice it to say that, from the taxpayer's point of view, in order for the transaction to generate the expected losses, the taxpayer must meet four tests:

1. It must prove that it sold private placement notes in exchange for LIBOR notes within the meaning of Code Sec. 1001.
2. It must prove that the gain and loss on the sale are to be calculated by reference to the ratable basis recovery rule set forth in Temporary Reg. §15A.453-1(c)(1).
3. It must prove that the losses calculated under the installment sale rules are deductible under Code Sec. 165.
4. It must prove that the gains and losses were generated within the context of a partnership as defined by Code Secs. 761 and 7701.

The Tax Court's decision in *ACM* followed the logic of *Lerman* and *Wexler* by declaring that "[only] after we conclude that a transaction has economic substance will we consider the transaction's tax consequences under the Code."[83] The Tax Court therefore applied a test of economic substance independent of the Code, and held that ACM's transactions lacked both a business purpose and a prospect for profit.

In its appeal to the Third Circuit, ACM, relying on *Gregory*, argued that the use of a "generic 'tax-independent purpose/prospect for profit' test, fashioned without reference to the statutory provisions applicable to ACM's transactions" was contrary to law.[84] ACM further argued that *Gregory* requires an analysis of the specific Code provisions at issue:

> [T]he Supreme Court in *Gregory* did not prescribe a single, generic, purpose-oriented test to be applied before considering the tax consequences under the Internal Revenue Code. To the contrary, because the tax consequences of transactions are controlled by a wide variety of Internal Revenue Code provisions, and because those Code provisions contemplate a broad range of actions by taxpayers, the Supreme Court adopted a test that, of necessity, varies from case to case depending upon the statutory provisions at issue.[85]

Applying this analysis, ACM argued that the "unambiguous statutory language, legislative history, and accompanying regulations"[86] supported ACM's interpretation of Code Secs. 1001 and 453. Since those Code sections do not require a "prospect for profit or other tax independent purpose," ACM argued that the application of the

"two-pronged" test of economic substance was improper.

The Third Circuit disagreed, stating that the two-pronged analysis applies even when the statute "does not require a business purpose or profit motive."[87] The Third Circuit's reliance on *Goldstein* and *Wexler* to support this proposition is questionable. As described above, the Second Circuit explicitly based its decision in *Goldstein* on the "Congressional policy" underlying Code Sec. 163(a), and *Wexler* merely followed *Goldstein*. The Third Circuit did not explain how the "Congressional policy" underlying Code Sec. 163 could be engrafted onto Code Secs. 1001 and 453.

Judge McKee dissented from the majority decision in *ACM*, stating that the "majority has ignored the plain language of section 1001."[88] Relying on *Cottage Savings Ass'n*,[89] Judge McKee agreed with ACM's argument that its transactions fully complied with the plain language and Congressional policy underlying Code Sec. 1001. Thus, Judge McKee agreed with ACM that the determination of "economic substance" must be determined in light of the specific Code provision at issue:

> [I]t is the definition of "economic substance" that is the sticking point. Here, the "economic substance" inquiry must be governed by the "material difference requirement" of Cottage Savings, not by the tax avoidance intent of the taxpayers.[90]

The *Saba* case involved another of the Merrill Lynch transactions, and thus presented issues similar to those decided in *ACM*. The Tax Court applied the traditional two-pronged analysis and ruled that *Saba's* transactions lacked economic substance.[91] *Saba* was appealable, however, to the D.C. Circuit Court of Appeals. On the appeal, Saba argued that its transactions had economic substance as defined by the D.C. Circuit's decision in *Horn*. In particular, Saba argued that its transactions satisfied the plain meaning of Code Secs. 1001 and 453, and that the economic substance doctrine could not be applied "independently" of these Code provisions. Saba argued that its transactions had economic substance as defined by *Gregory* and *Horn*, since its transactions fully complied with both the language and purpose of Code Secs. 1001 and 453 and were "the thing which the statute intended."

> Why should ownership of an office building be treated differently than ownership of an AA-rated note (assuming the ownership is genuine in each case)?

Saba's argument consisted of two parts. First, the Tax Court had found as a fact that "Saba had sold the [private placement notes] and [certificates of deposit] for cash and LIBOR Notes." Thus, there was no dispute that Saba had transferred ownership of property in exchange for property with materially different characteristics. The transfer of the private placement notes and certificates of deposit in exchange for cash and LIBOR notes created a substantial change in Saba's economic position, since the characteristics of the LIBOR notes were quite different from the instruments Saba had given up. This transaction clearly qualified as a taxable sale for purposes of Code Sec. 1001, and qualified as a "sale" as defined in *Cottage Savings*.[92]

The Tax Court held, however, that this sale lacked "economic substance." Saba argued that the Tax Court's holding was a *non sequitur*; since the economic substance doctrine cannot be applied "independently"[93] of the Code, the Tax Court erred in applying the economic substance doctrine to a transaction which clearly qualified as a "sale" for purposes of Code Sec. 1001. In other words, if the transaction that "actually occurred" does in fact qualify as a sale "in reality,"[94] the role of the economic substance doctrine comes to an end; it cannot be applied "independently" to deny economic substance to a transaction that plainly falls within the scope of Code Sec. 1001.

Second, Saba argued that if its transactions qualified as sales, the gains and losses from these sales must be taxed under Code Sec. 453. On the appeal, the IRS conceded that Saba had correctly calculated its losses under the rules of Code Sec. 453, but argued that Code Sec. 453 was not intended to allow the creation of "paper," *i.e.*, noneconomic losses.

There is no denying that, when any given year is viewed in isolation, Code Sec. 453 creates losses which do not correspond to economic reality. The IRS nonetheless agreed that Code Sec. 453 would produce the

"correct result over the period of the transaction."[95] And there is ample evidence that Congress fully understood that the Code Sec. 453 regulations would produce noneconomic results in any given year. After all, the regulations were deliberately designed to create gain at the beginning of the transaction and to defer losses to the end of the transaction. The regulations carry out Congress' intent by "maximizing the selling price" and accelerating payments to the earliest date permitted under the sale agreement.[96] Since the regulations accelerate the taxation of cash but defer the recovery of basis when cash is not received, the regulations will inevitably produce noneconomic results. Indeed, the regulations acknowledge that their operation may create "substantial distortions" of income.[97] This distortion of economic income is perfectly consistent with tax accounting principles, which are designed to accelerate revenue and defer deductions.[98]

Since Congress clearly intended that Code Sec. 453 accelerate gains and defer losses, it seems absurd to suggest that this pattern of gains and losses lacks economic substance. Indeed, there can be little doubt that the IRS would insist on following Code Sec. 453 to the letter when the shoe is on the other foot.[99]

These arguments were played out during the oral argument in *Saba*. While the commentary during oral argument is obviously not dispositive as to a court's views, the D.C. Circuit once again displayed disagreement with the Third Circuit's version of economic substance as set forth in *ACM*, *Wexler* and *Lerman*. At oral argument, the IRS's counsel argued that *Horn* should be limited to the narrow issue presented by the application of Act Sec. 108(b). Judge Edwards disagreed:

> [T]he Horn decision is at odds [with the 3rd Circuit]. It makes it very clear the D.C. Circuit is at odds with the 3rd Circuit. We don't read the statute the same way … We don't agree with that … We're not going that approach. Horn clearly rejects that. The sham [doctrine] is … I'm just going to call it a sham without regard to what the statute says. Horn completely rejects that, and we rejected the 3rd Circuit in Horn.
>
> The different statute [Act Sec. 108] is an argument, but the approaches that we use are quite different. The 3rd Circuit tends to simply lay on a sham … and that's exactly what the dissent [in the 3rd Circuit] is about—sham analysis without regard to the statute.[100]

The D.C. Circuit thus refused to follow the IRS's request that it apply the economic substance doctrine to Saba's transaction, and accordingly declined to affirm the Tax Court's opinion in *Saba* and declined to follow *ACM*.

As an alternative to its claim on economic substance,[101] the IRS argued that the D.C. Circuit should apply its earlier decision in *ASA Investerings*[102] and hold that Saba did not qualify as a partnership for federal tax purposes. The D.C. Circuit declined to apply *ASA*, however, as the Tax Court had not made factual findings or ruled on the partnership issue.[103] The D.C. Circuit therefore remanded the *ASA* issue to the Tax Court for further proceedings.

The D.C. Circuit's decision in *ASA* focuses on the issue of whether a given arrangement should be treated as a partnership for federal tax purposes. In *ASA*, the D.C. Circuit upheld the Tax Court's opinion that one of the Merrill Lynch partnerships did not in fact qualify as a partnership for tax purposes. By focusing on the narrower issue of whether the parties' actions and intent are consistent with partnership status, the *ASA* decision avoids some of the problems with the *a priori* test of economic substance and thus is arguably consistent with *Gregory*.

The decision in *ASA* presents its own issues, however. The Tax Court made a series of factual findings in *ASA* that called into question the partnership's status as such. In particular, the Tax Court found that the purported partners in ASA had no intent of living up to their written partnership agreement, and instead negotiated an unwritten agreement (the "Bermuda Agreement") which actually governed their conduct.[104] As part of this Bermuda Agreement, one of the partners was promised a specified return and thus did not share in the partnership's profits. Similarly, the partners did not share in expenses.[105] To the extent that the D.C. Circuit's opinion is based on these factual findings, the result hardly seems surprising.

The opinion in *ASA*, however, also contains language stating that "the absence of a nontax business purpose" is fatal to partnership status. This language appears to be in conflict with the Supreme Court's decisions in *W.O. Culbertson* and *F.E. Tower*, which emphasize that the partnership issue requires an examination of "all the facts."[106] *Tower* and *Culbertson* both indicate that a motive to avoid tax is only one fact out of

many that must be taken into account.[107] Similarly, the decision in *Chisholm* gave effect to a partnership "formed confessedly to avoid taxation."[108] The language in *ASA* is also inconsistent with the legislative history of the partnership rules, which indicates that Congress intended to eliminate "business purpose" and the "subjective intent" of the parties as tests for partnership status.[109]

To the extent that the *ASA* test focuses solely on the partners' subjective intent and ignores objective events, it would appear to violate *Gregory's* requirements to "fix the character of the proceeding by what actually occurred." If taxpayers have actually pooled their capital and have shared the profits and expenses of their venture, it is difficult to understand why they should not be treated as partners.

The decision in *ASA* relies, in part, on *Moline Properties, Inc.*[110] The D.C. Circuit read *Moline Properties* as creating a "unitary test" for partnership status under which the "absence of a nontax business purpose is fatal." Thus, "business activity" alone would not be sufficient to uphold partnership status. This interpretation of *Moline* is debatable; most circuits have read *Moline* as creating a two-part test under which an entity will be recognized if it either engages in business activity *or* is formed for a business purpose.[111] In any event, *Tower* and *Culbertson*, not *Moline*, are the proper authorities for determining partnership status.

ASA is likely not the D.C. Circuit's last word on the partnership issue, as two recent cases, as well as the remand in *Saba*, may give the D.C. Circuit an opportunity to further clarify its decision in *ASA*.[112]

It may well be true, as one commentator has suggested, that Congress would not have approved of the *ACM* transaction.[113] The economic substance doctrine should not be applied, however, by attempting to second-guess what Congress would have done or not done in a particular situation. While some (but not all) schools of thought hold that courts should attempt to enforce Congress' intent, the "zeal 'to effectuate the intent of Congress'" should not shortcut careful statutory analysis.[114] The statute is, after all, the clearest and best evidence of Congress' intent, and any analysis of economic substance that does not take into account the words of the statute will inevitably lead to a usurpation of Congress' proper role.

V. The Statutory Theory of Economic Substance

A statute-based theory of economic substance will inevitably have important consequences for economic substance analysis. The reversal of several recent Tax Court cases[115] can, at least in part, be attributed to an emphasis on economic substance as opposed to clear statutory analysis.

A. Tax Avoidance Intent, Profit Potential and Business Purpose in a Statutory System

In recent cases, the Tax Court has placed an increasing emphasis upon evidence relating to a taxpayer's motive to avoid tax. This mode of analysis obviously contradicts *Gregory's* requirement that a tax avoidance motive is to be "disregarded," and thus several of these decisions have been reversed.[116]

The proper role of a taxpayer's motive to avoid tax in assessing his liability for tax is thus a continuing conundrum in tax law. At the risk of appearing obvious, it is our belief that a taxpayer's motive to avoid tax should be relevant only when a reasoned interpretation of the statute makes it relevant. There are numerous provisions in the Code that depend upon a taxpayer's motive; for example, Code Secs. 162, 165(c), 167, 183 and 212, to name only a few, explicitly depend upon a determination that a taxpayer is either engaged in a business or engaged in the production of income. Therefore, in any case governed by these provisions, it is eminently reasonable to demand that the taxpayer's conduct be motivated by a "business purpose" or a "potential for profit." Thus, the familiar two-pronged analysis makes sense in such cases.

Even in such cases, however, a taxpayer's motive to avoid tax should not necessarily lead to a determination that the taxpayer has not complied with the statute. The motive to avoid tax should be determinative only when such a motive so impinges upon any business or profit motive that it can properly be held the taxpayer had no such purpose or motive. To paraphrase Judge Hand in *Chisholm*, the only "purpose which counts" is the purpose that "defeats or contradicts" the claim that a taxpayer has engaged in a transaction for purposes of business or profit. A motive to avoid tax is not necessarily inconsistent with these purposes and therefore is neutral in itself.

Again at the risk of stating the obvious, when the statute does not provide, either directly or by clear implication, that the taxation of a transaction depends upon the

taxpayer's motive, the motive to avoid tax should be irrelevant. The Tax Court followed this rationale in *Cottage Savings*. In that case, the IRS argued that an exchange of mortgage participations in exchange for mortgage participations with materially different characteristics lacked economic substance because the transfers were, as the Tax Court found, "solely tax-motivated."[117] The Tax Court stated that such a motive was not decisive, although it would have been in the context of Code Secs. 183(a) and 165(c)(2). Thus, Cottage Savings was entitled to the loss claimed because the property given up was materially different from the property received and therefore this transfer qualified as a "sale" for tax purposes, without regard to the motive to avoid tax.

The Sixth Circuit applied an economic substance analysis and reversed, holding that the taxpayer's "economic position" was not changed by the exchange of the mortgage participations. The Sixth Circuit's application of the economic substance doctrine is unclear; the court acknowledged that the "taxpayer's motive … does not control deductibility," but a few sentences later claimed that every transaction must "have some business purpose."[118]

The Supreme Court reversed, basing its decision upon a thorough analysis of the purpose of Code Sec. 1001. The Court concluded that the purpose of Code Sec. 1001 required a simple and straightforward test, and therefore rejected the IRS's argument that Code Sec. 1001 includes an "economic substance" requirement.

Much has been made of the fact that the IRS downplayed his "economic substance" argument at the Supreme Court. We believe that the failure of the IRS to pursue the economic substance argument at the Supreme Court reflects a simple reality: it is impossible to construct a coherent argument that a transaction that actually conveys the ownership of property does not constitute a "sale" for tax purposes. A transaction that actually results in a transfer of the "benefits and burdens of ownership" to the buyer is a sale in fact as well as in form and must be respected as having economic substance.

Since *Gregory* requires an examination of "what actually occurred," an inquiry into motive has no role when the taxpayer has actually transferred ownership of property.[119] A "sale" would lack economic substance only when the purported transaction did not actually convey ownership of property to the purchaser.[120] For this reason, no case has ever held that a genuine transfer lacks substance as such simply because the transfer was undertaken for tax purposes.[121]

The decision in *UPS* may be viewed as consistent with this line of cases. The issue in *UPS* was whether UPS or OPL should be taxable on income generated from excess value coverage. The Eleventh Circuit concluded that OPL was taxable on this income, in large part because UPS had ceded ownership of the business of providing excess value coverage:[122]

> OPL is an independently taxable entity that is not under UPS's control. UPS really did lose the stream of income it had earlier reaped from excess-value coverage. UPS genuinely could not apply that money to any use other than paying a premium to National Union: the money could not be used for other purposes, such as capital improvement, salaries, dividends, or investment. These circumstances distinguish UPS's case from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone. (citation omitted) Here that benefit ended up with OPL. There were, therefore, real economic effects from this transaction on all of its parties.

To put it another way, the purpose to avoid tax is not inconsistent with, and does not contradict, the purpose to make a genuine transfer. In fact, the Chisholm brothers understood that their plan to avoid tax *required* a genuine transfer of ownership. If this was their purpose, they succeeded, since "they performed consciously and successfully the legal acts" that established a transfer of ownership.[123]

Judge McKee appears to have followed a similar analysis in his dissenting opinion in *ACM*: "ACM's sales of the Citicorp Notes for cash and LIBOR Notes resulted in the exchange of materially different property. I believe our inquiry should proceed no further."[124] Although it is certainly not clear from the D.C. Circuit's opinion in *Saba*, it appears that the D.C. Circuit may have declined to follow *ACM* for similar reasons.

The recent decision in *Compaq* further illustrates the difficulty of attempting to apply the two-pronged analysis in contexts where it does not fit well, if at all. *Compaq* involved a cross-border dividend stripping transaction designed to create foreign tax credits for the taxpayer. In the Tax Court, Compaq argued that the court "should not apply an economic

substance test" because the foreign tax credit provisions provide a "highly articulated statutory limitation,"[125] and therefore Compaq's claim to the credit carried out Congressional policy as set out in an extremely detailed statute.

The Tax Court disagreed and applied the traditional two-pronged analysis. Emphasizing that the "petitioner was motivated by the expected tax benefits of the ADR transaction," the Tax Court ruled that the transaction lacked economic substance.

On the appeal, the Fifth Circuit reversed, holding that the transaction produced both a "pre-tax profit and an after-tax" profit, and that the intent to capture this profit constituted a business purpose.

The parties' respective arguments in *Compaq* concerning the potential for profit are almost entirely circular. If one agrees with the Fifth Circuit that the portion of Compaq's dividend that was used to pay Netherlands income tax was income to Compaq and that the corresponding tax should not be treated as an expense in calculating pre-tax profit, it inevitably follows that Compaq earned a profit. If, on the other hand, one agrees with the Tax Court that only the net dividend should be treated as income to Compaq, it inevitably follows that Compaq did not earn a profit.

Thus, the outcome of *Compaq* depends upon broader principles than the simple application of the economic substance test. If one agrees that foreign taxes should be treated the same as U.S. taxes, *i.e.*, the profit of a transaction should be determined before the application of both U.S. and foreign taxes, the Fifth Circuit's decision in *Compaq* would appear to be correct. If one disagrees, as some commentators have,[126] the Tax Court's decision in *Compaq* would more likely be correct.

Resolution of this issue, in turn, requires understanding the purpose of Code Sec. 901 and the foreign tax credit, and the two-pronged test is of no help in this inquiry. The purpose of Code Sec. 901 is to avoid international double taxation. In its brief in the Fifth Circuit, Compaq argued persuasively that this purpose requires that U.S. tax and foreign tax be treated in the same manner. While the Fifth Circuit did not refer to this argument, it may explain the Fifth Circuit's conclusion that Compaq was indeed subject to double taxation "[w]ithout the tax credit."

After all, it appears to be undeniable that Compaq was subject to both U.S. and Netherland tax *if* one assumes that Compaq really owned the Royal Dutch ADRs. Although it might have been possible to argue that Compaq was not the beneficial owner of the Royal Dutch ADRs, the government explicitly declined to raise this argument.

B. "Practical Economic Effects" and "Meaningful Economic Consequences"

While an examination of the "practical economic effects" of a transaction is certainly important in determining economic substance, this inquiry alone is not sufficient if the inquiry does not take heed of the statute. For example, the purchase of a Treasury bill with funds held in an interest-bearing savings account has almost no "practical economic effects," but no one would seriously argue that this transaction lacks economic substance.[127] Similarly, the *Cottage Savings* transaction had no "practical economic effects" other than the triggering of tax losses, but the transaction was nevertheless upheld because Code Sec. 1001 embodies a "materially different characteristic" standard, not the change in "economic position" standard that the Sixth Circuit applied.

The "practical economic effects" test also runs the risk of ignoring exposure to risk. The ownership of a CD that produces a four-percent return may have the same "economic effects" as ownership of an Internet stock that produces a four-percent return, but no one would suggest that these are equivalent instruments. Since courts necessarily operate with hindsight, judicial decisions that apply the "practical economic effects" test to treat equivalent outcomes as identical in all respects distort economic reality. Thus, a careful examination of risk must necessarily play an important role in the application of the economic substance doctrine, even when potential risks do not produce practical economic effects.

In this regard, it seems impossible to deny that the transaction in *ACM* had "meaningful economic consequences."[128] In *ACM*, the ACM partnership bought over $200 million in Citicorp notes. The purchase of these notes exposed ACM to credit risk, event risk, credit spread risk and liquidity risk. Reasonable men and women can certainly disagree about the significance of each of these risks. It cannot be denied, however, that ACM actually took on the unique benefits and burdens of owning the Citicorp notes, and it is not clear why its ownership of these instruments may be disregarded. While the owner of a Treasury bill may be regarded as owning a safe investment, he cannot be regarded as any less an "owner" of the Treasury bill than an owner of volatile stock

should be regarded as the owner of the stock.

Much has been made of the fact that ACM owned the Citicorp notes for only 24 days. It is not clear, however, why the length of a holding period should have legal significance so long as the owner clearly bears the benefits and burdens of ownership during his or her period of ownership. Fortunes have been lost in less than 24 days. Day traders can go broke in a matter of minutes. One imagines that Enron shareholders, who saw their stock fall from $11.17 to $0.36 in the 24 days between November 5 and November 29, might feel that a 24-day holding period was more than long enough to have economic substance.

It is even more clear that ACM's sale of the Citicorp notes in exchange for LIBOR notes had "meaningful economic consequences"; indeed, in upholding ACM's claim to the actual economic losses incurred on the sale of the LIBOR notes, the Third Circuit held that "ACM's possession of the LIBOR Notes, although not intended to serve non-tax purposes, had significant non-tax economic effects, consisting of several million dollars in economic losses."[129] If ACM's possession of the LIBOR notes had "significant non-tax economic effects," it is difficult to understand how the transaction by which ACM gained such possession can be disregarded.

VI. Conclusion

We conclude by repeating an example included in David P. Hariton's article on economic substance: "Colgate would not have lost [in ACM] under the economic substance doctrine if, for example, it had purchased an office building, rather than an AA-rated note, and sold it the following year for cash plus contingent payments."[130]

Mr. Hariton may be right; it is not clear, however, *why* he is right. Why should ownership of an office building be treated differently than ownership of an AA-rated note (assuming the ownership is genuine in each case)? Why should a holding period of 24 days be treated differently than a holding period of a year (once again, assuming in each case that the ownership is genuine)? There are no clear answers to these questions, and one cannot, at least on certain occasions, escape the conclusion that the application of the economic substance doctrine has been "something akin to a smell test."[131] One way—perhaps the only way—to escape such suspicions is to return to a method of analysis that focuses on the statute.

ENDNOTES

1 *See* Kenneth W. Gideon, *Mrs. Gregory's Grandchildren: Judicial Restriction of Tax Shelters*, 5 VA. TAX REV. 825 (1986).

2 *Gregory v. Helvering*, SCt, 35-1 USTC ¶9043, 293 US 465, 55 SCt 266.

3 *Supra* note 1, at 825.

4 *Compaq Computer Corp. and Subsidiaries*, CA-5, 2002-1 USTC ¶50,144, 277 F3d 778; *United Parcel Service of America, Inc.*, CA-11, 2001-2 USTC ¶50,475, 254 F3d 1014 (herein referred to as "*UPS*"); *IES Industries, Inc.*, CA-8, 2001-2 USTC ¶50,471, 253 F3d 350.

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

6 *Saba Partnership*, CA-DC, 2002-1 USTC ¶50,145, 273 F3d 1135.

7 *Boca Investerings Partnership*, DC-D.C., 2001-2 USTC ¶50,690, 167 FSupp2d 298.

8 *See, e.g.*, Daniel N. Shaviro and David A. Weisbach, *The Fifth Circuit Gets it Wrong in Compaq v. Commissioner*, 2002 TNT 19-31 (Jan. 28, 2002); David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory is All Wrong*, 2002 TNT 19-30 (Jan. 28, 2002).

9 Confusion over the economic substance doctrine even extends to the terminology used to describe the doctrine. Some courts have used the term "sham" transaction to refer to transactions lacking in economic substance. *See, e.g.*, David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235, 258 (1999). In this article, we use the term "sham" to refer solely to transactions that did not actually take place according to their terms, *i.e.*, transactions that are "factual shams." The term "economic substance" has often been used to refer to the "objective" component of the two-pronged analysis set forth in *Rice's Toyota World, Inc.*, CA-4, 85-1 USTC ¶9123, 752 F2d 89. *See T.J. Horn*, CA-DC, 92-2 USTC ¶50,328, 968 F2d 1229, 1237. In this article, however, unless stated otherwise, we use the term "economic substance" to refer to the general inquiry of whether a transaction should be respected in accordance with its form.

10 RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION, 125–26 (3d Series 1940).

11 *F.A. Sansome*, CA-2, 3 USTC ¶978, 60 F2d 931, 933 (1932).

12 "Nor do we think a dog is to be hanged simply by giving him a bad name." *Fabreeka Products Co.*, CA-1, 61-2 USTC ¶9678, 294 F2d 876, 878, note 2.

13 *See, e.g.*, Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982); John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997).

14 *See, e.g.*, *C.S. Lerman*, CA-3, 91-2 USTC ¶50,480, 939 F2d 44, 52, *cert. denied*, SCt, 502 US 984 (1991).

15 *E.F. Gregory*, Dec. 7841, 27 BTA 223, 226 (1932).

16 *Id.*

17 *Helvering v. Gregory*, CA-2, 1934 CCH ¶9180, 69 F2d 809, 810.

18 *Id.*, at 811.

19 *Supra* note 2, at 469.

20 *Id.*

21 *Id.* (citation omitted) (emphasis supplied) ("a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner").

22 *Supra* note 17, at 811.

23 *Horn*, *supra* note 9, at 1236–38.

24 Therefore, when a specific Code provision requires purposive conduct, such as pursuit of a trade or business, or an expectation of profit, a transaction motivated solely by tax considerations will lack economic substance because its purpose will not match the purpose required by the statute. *See* Part V, *infra*.

25 *See, e.g.*, *Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, 582, 98 SCt 1291 (Government's "theorizing" that transaction was a financing failed to explain certain facts); *P. Grove*, CA-2, 73-2 USTC ¶9591, 490 F2d 241, 247 (court refused government's request to recast "actual trans-

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actions" into "fictional transactions"); *Esmark, Inc.*, 90 TC 171, 188–89, Dec. 44,548 (1988) (IRS's argument failed to account for actual events).

26 *G.H. Chisholm*, CA-2, 35-2 USTC ¶9493, 79 F2d 14, *cert. denied*, SCt, 296 US 641, 56 SCt 174 (1935).

27 *Helvering v. Walbridge*, CA-2, 4 USTC ¶1284, 70 F2d 683, *cert. denied*, SCt, 293 US 594, 56 SCt 174 (1934).

28 *Supra* note 26, at 15 (citations omitted).

29 *Id.*, at 15–16.

30 *Id.*, at 15.

31 *Kraft Foods Co.*, CA-2, 56-1 USTC ¶9428, 232 F2d 118, 122. ("In other words, taxpayer intended to become indebted because the desired deductions could be secured only if it created genuine indebtedness … If it was their 'purpose' or 'intent' to do so, then they succeeded because they performed consciously and successfully the legal acts that establish a debt.")

32 *Id.*, at 128.

33 *B.D. Gilbert*, CA-2, 57-2 USTC ¶9929, 248 F2d 399, 407.

34 *See Granite Trust Co.*, CA-1, 57-1 USTC ¶9201, 238 F2d 670, 677–78 (purpose for entering into a sale was irrelevant under *Gregory*); *Kraft*, *supra* note 31, at 127–28 (rejecting IRS's claim that *Gregory* requires a business purpose); *see also Peter Pan Seafoods, Inc.*, CA-9, 69-2 USTC ¶9683, 417 F2d 670, 673 (tax avoidance does not establish liability); *Nassau Lens Co., Inc.*, CA-2, 62-2 USTC ¶9723, 308 F2d 39, 44–45 (lack of business purpose not controlling); *H. Humphreys*, CA-6, 62-1 USTC ¶9401, 301 F2d 33, 34; *Evans v. Dudley*, CA-3, 61-2 USTC ¶9729, 295 F2d 713, 714; *Fabreeka Products*, *supra* note 12, at 878; *Maysteel Products, Inc.*, CA-7, 61-1 USTC ¶9283, 287 F2d 429, 431.

35 *Supra* note 26, at 15.

36 *K.F. Knetsch*, SCt, 60-2 USTC ¶9785, 364 US 361, 81 SCt 132.

37 Hariton, *supra* note 9, at 246.

38 *Supra* note 36, at 367.

39 *See, e.g., W.P. Doyle*, CA-7, 61-1 USTC ¶9237, 286 F2d 654, 660.

40 *Supra* note 36, at 367–69.

41 *K. Goldstein*, CA-2, 66-2 USTC ¶9561, 364 F2d 734, *cert. denied*, SCt, 385 US 1005, 87 SCt 708 (1967).

42 *Id.*, at 738.

43 *Id.*, at 740.

44 *Id.*, at 741.

45 *Id.*

46 *Id.*

47 *Id.*

48 *Id.*, at 742.

49 *See, e.g., ACM*, *supra* note 5, at 248; *L.B. Yosha*, CA-7, 88-2 USTC ¶9589, 861 F2d 494, 498; but *see Horn*, *supra* note 9, at 1236 (interpreting *Knetsch* as focusing on "the primacy of Congress' intent").

50 *Rice's Toyota World, Inc.*, 81 TC 184, Dec. 40,410 (1983), aff'd in part and rev'd in part, CA-4, 85-1 USTC ¶9123, 752 F2d 89.

51 *Id.*, at 92 (citing *Frank Lyon*, *supra* note 25).

52 *See, e.g.,* Hariton, *supra* note 8.

53 Hariton, *supra* note 9, at 235.

54 *UPS*, *supra* note 4, at 1019.

55 *Nassau Lens*, *supra* note 34, at 45–46.

56 *UPS*, *supra* note 4, at 1019–20.

57 *B.S. Glass*, 87 TC 1087, Dec. 43,495 (1986). The *Glass* case involved more than 1,000 individual taxpayers, and the separate cases of these individual taxpayers have been repeatedly upheld on appeal. *See, e.g., Yosha*, *supra* note 49.

58 *Glass*, *id.*, at 1163. The court also reviewed the provisions of Act Sec. 108 of the Deficit Reduction Act of 1984 (P.L. 98-369), as amended by the Tax Reform Act of 1986 (P.L. 99-514), and concluded that, in the case of persons who are not commodities dealers, the language of Act Sec. 108 "parallels the section 165(c)(2) language." *Glass*, *id.*, at 1167. As discussed in the text in connection with *Lerman* and *Horn*, Act Sec. 108 provides an entirely different rule for commodities dealers.

59 *Glass*, *supra* note 57, at 1164.

60 *Id.*, at 1175.

61 Since Act Sec. 108 of P.L. 98-369 is entirely retroactive in its application, it has never been included as part of the Code.

62 *Horn*, *supra* note 9, at 1234; *Lerman*, *supra* note 14, at 50. Prior to the revisions made by the Tax Reform Act of 1986, this presumption was rebuttable.

63 *Glass*, *supra* note 57, at 1167.

64 *See, e.g., H.P. Gardner*, CA-2, 92-1 USTC ¶50,079, 954 F2d 836 (*per curiam*), *cert. denied*, SCt, 504 US 910 (1992); *R.G. Kazi*, 61 TCM 1759, Dec. 47,144(M), TC Memo. 1991-37, aff'd, Massey, CA-3, (unpublished opinion), 950 F2d 723 (1991) (*per curiam*) (table).

65 *Lerman*, *supra* note 14, at 52.

66 *Id.*

67 *Id.*, at 53 (quoting *R. DeMartino*, CA-2, 88-2 USTC ¶9608, 862 F2d 400, 407).

68 *Glass*, *supra* note 57, at 1175 (quoting *Gregory*, *supra* note 2, at 469).

69 The Third Circuit also held that Lerman's transactions did not result in a "loss" and were "prearranged." These conclusions are also difficult to support in light of the history of Act Sec. 108 of P.L. 98-369. *Horn*, *supra* note 9, at 1239.

70 *Lerman*, *supra* note 14, at 53.

71 *Id.*, at 52.

72 *V. Wexler*, CA-3, 94-2 USTC ¶50,361, 31 F3d 117.

73 *Id.*, at 124 (second emphasis in original) (quoting *Lerman*, *supra* note 14, at 52).

74 *Horn*, *supra* note 9, at 1233.

75 *Id.*, at 1231.

76 *Id.*

77 *Id.*, at 1235.

78 *Id.*, at 1236.

79 *Id.*, at 1238.

80 *Id.*

81 *Id.*

82 *See, e.g.,* Hariton, *supra* note 9.

83 *ACM Partnership*, 73 TCM 2189, 2217, Dec. 51,922(M), TC Memo. 1997-115, aff'd in part, rev'd in part, CA-3, 98-2 USTC ¶50,790, 157 F3d 231.

84 Brief for the Appellant/Cross Appellee at 17 (Dec. 15, 1997), ACM Partnership, *id.* (No. 10472-93).

85 *Id.*, at 22.

86 *Id.*, at 15.

87 *ACM*, *supra* note 5, at 253.

88 *Id.*, at 263 (McKee, J., dissenting).

89 *Cottage Savings Ass'n*, SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503.

90 *Id.*, at 265.

91 *Saba Partnership*, 78 TCM 684, Dec. 53,604(M), TC Memo. 1999-359, vacated and remanded, CA-DC, 2002-1 USTC ¶50,145, 273 F3d 1155.

92 *Supra* note 89.

93 *Horn*, *supra* note 9, at 1238.

94 *Supra* note 2, at 469.

95 Brief for the Appellee at 35 (Aug. 1, 2001), ACM Partnership, *supra* note 5 (No. 97-7484, 97-7527).

96 Temporary Reg. §15A.453-1(c)(2)(i)(A).

97 *Id.*, at -1(c)(7).

98 *Thor Power Tool Co.*, SCt, 79-1 USTC ¶9139, 439 US 522, 542–43, 99 SCt 773.

99 *See* Kenneth W. Gideon, *Assessing the Income Tax: Transparency, Simplicity, Fairness*, 98 TNT 225-71 (Nov. 23, 1998).

100 Transcript of Oral Argument at 29–30 (Oct. 2, 2001), Saba Partnership, *supra* note 6 (No. 00-1328, 00-1385). Judge Harry T. Edwards, who was on the panel in *Saba*, wrote the opinion in *Horn*.

101 On the appeal, the IRS actually advanced the *ASA* "partnership" argument as its primary argument and requested that the court affirm the Tax Court on the basis of *ACM* only if it did not decide the *ASA* argument in the IRS's favor. During oral argument, Judge Edwards indicated his belief that the IRS adopted this strategy because the IRS knew *ACM* could not be sustained in light of *Horn*.

102 *ASA Investerings Partnership*, CA-DC, 2000-1 USTC ¶50,185, 201 F3d 505, *cert. denied*, SCt, 121 SCt 171 (2002).

103 *Supra* note 6, at 1136.

104 *ASA Investerings Partnership*, 76 TCM 325, 328, Dec. 52,845(M), TC Memo. 1998-305.

105 *Id.*, at 335.

106 *W.O. Culbertson*, SCt, 49-1 USTC ¶9323, 337 US 733, 742, 69 SCt 1210; *F.E. Tower*, SCt, 46-1 USTC ¶9189, 327 US 280, 66 SCt 532.

107 *Culbertson*, *id.*, at 744, note 13; *Tower*, *id.*, at 289.

ENDNOTES

[108] *Supra* note 26, at 15.

[109] *D.L. Evans*, CA-7, 71-2 USTC ¶9597, 447 F2d 547, 550–51; *A. Pflugradt*, CA-7, 63-1 USTC ¶9112, 310 F2d 412, 415–16.

[110] *Moline Properties, Inc.*, SCt, 43-1 USTC ¶9464, 319 US 436, 63 SCt 1132.

[111] *See, e.g., G.A. Sargent*, CA-8, 91-1 USTC ¶50,168, 929 F2d 1252, 1259; *Gulf Oil Corp.*, CA-3, 90-2 USTC ¶50,496, 914 F2d 396, 411; *Humana, Inc.*, CA-6, 89-2 USTC ¶9453, 881 F2d 247, 252; *P.J. Vaughn*, CA-FC, 84-2 USTC ¶9706, 740 F2d 941, 943; *P. Taylor*, CA-1, 71-2 USTC ¶9521, 445 F2d 455, 457; *F.A. Kimbrell*, CA-5, 67-1 USTC ¶9179, 371 F2d 897, 901; *W.I. Dodd*, CA-4, 62-1 USTC ¶9223, 298 F2d 570, 577.

[112] *Supra* note 7; *Andantech, LLC*, 83 TCM 1476, Dec. 54,714(M), TC Memo. 2002-97.

[113] Hariton, *supra* note 9, at 245, note 30.

[114] *The Limited, Inc.*, CA-6, 2002-1 USTC ¶50,353.

[115] *Supra* note 4.

[116] *Id.*

[117] *Cottage Savings Ass'n*, 90 TC 372, 385, Dec. 44,636 (1988), *rev'd*, CA-6, 89-2 USTC ¶9662, 890 F3d 848, *rev'd*, SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503 (1991).

[118] *Id.*, 890 F2d, at 853–55.

[119] *Granite Trust*, CA-1, 57-1 USTC ¶9201, 238 F2d 670, 677 ("why the parties may wish to enter into a sale … is irrelevant under the Gregory case so long as the consummated agreement was not different from what it purported to be.")

[120] *Higgins v. Smith*, SCt, 40-1 USTC ¶9160, 308 US 473, 60 SCt 355.

[121] *C.B. Brown*, SCt, 65-1 USTC ¶9375, 380 US 563, 573–79 (transfer to tax exempt organization designed to convert ordinary income to capital gain had substance as a sale); *W.B. Rushing*, CA-5, 71-1 USTC ¶9339, 441 F2d 593, 594–98 (installment sale designed to minimize tax had economic substance since taxpayers transferred ownership); *Supra* note 26, at 15–16 (sale designed to avoid tax had substance as a sale); *Granite Trust*, *supra* note 34, at 677–78; *see F.D. Stranahan Est.*, CA-6, 73-1 USTC ¶9203, 472 F2d 867, 869–70; *A. Strangi Est.*, 115 TC 478, Dec. 54,135 (2000). The Third Circuit in *ACM* relied on several cases in which it claimed the taxpayers' transactions were not recognized for tax purposes even though they had "actually and objectively disposed of this property." *Supra* note 5, at 249. These cases are inapposite, however, since they either involved the profit motive test of Code Sec. 165(c)(2), *see, e.g., Lerman* and *Yosha*, *supra* notes 14 and 49, or represented situations where the purported purchaser "surrendered total control" to the seller. *L.A. Merryman*, CA-5, 89-1 USTC ¶9338, 873 F2d 879, 882.

[122] *UPS*, *supra* note 4, at 1019.

[123] *See Kraft*, *supra* note 31, at 122.

[124] *Supra* note 5, at 265.

[125] Brief For Petitioners (Royal Dutch ADR Issue) at 48 (Dec. 8, 1998), Compaq Computer Corp., 113 TC 214, Dec. 53,549 (No. 24238-96). Compaq also argued that its transactions satisfied the economic substance doctrine.

[126] Shaviro and Weisbach, *supra* note 8.

[127] "For instance, if a very rich man sells shares of stock and invests the proceeds in municipal bonds, he will not be taxed on the dividends of the shares, although his only motive was to avoid the tax upon his dividends." *Supra* note 33, at 411 (Hand, C.J., dissenting).

[128] *See* Hariton, *supra* note 9, at 269.

[129] *Supra* note 5, at 262.

[130] Hariton, *supra* note 9, at 235.

[131] *Supra* note 5, at 265 (McKee, J., dissenting).

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