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August 1, 2007

Economic Substance and the Supreme Court

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Economic Substance and the Supreme Court

By Amandeep S. Grewal

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Grewal argues that the economic substance doctrine does not exist — at least not in the eyes of the Supreme Court. Although many lower courts have held that the economic substance doctrine can trump a taxpayer's compliance with the code or justify a court's refusal to examine statutory language, Grewal argues that the Supreme Court has never sanctioned that approach. Instead, says Grewal, the Supreme Court has examined economic substance principles only when the terms of the governing statutes make those principles relevant. Grewal concludes that the Court should affirm its prior holdings and instruct the lower courts that the casual disregard of statutory language is inappropriate.

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I. Introduction

The Supreme Court grants certiorari in a wide variety of fascinating cases. Occasionally, it agrees to decide tax cases, too.

Perhaps because of the perceived dryness of tax law,¹ the Court has been hesitant to address the validity of the so-called economic substance doctrine.² Although there are too many formulations of the doctrine to count,³ the lower courts often hold that even when a taxpayer has met a statute's requirements,⁴ he cannot enjoy any of its benefits unless his conduct reveals a business purpose and a reasonable expectation of profit.⁵

¹See generally Neil M. Richards, "The Supreme Court Justice and 'Boring' Cases," 4 *Green Bag* 2d 401 (2001) (describing various justices' distaste for tax cases).

²See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231, Doc 98-30659, 98 TNT 198-9 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *American Electric Power, Inc. v. United States*, 326 F.3d 737, Doc 2003-10647, 2003 TNT 82-11 (6th Cir. 2003), cert. denied, 124 Sup. Ct. 1043 (2004).

³See *Collins v. Commissioner*, 857 F.2d 1383, 1386 (9th Cir. 1988). ("The casebooks are glutted with [economic substance] tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.")

⁴See also John B. Magee and Gerald Goldman, "Uncut Gems: Judicial Review in Economic Substance Appeals," *Tax Notes*, Aug. 6, 2007, p. 481, Doc 2007-16698, 2007 TNT 152-36. ("The federal courts have long required that transactions not only comply with the express requirements of the Internal Revenue Code, but also have economic substance to entitle the taxpayer to interest and other deductions.") For a discussion of various cases that have employed the doctrine, see *infra* Part II.

⁵See *infra* note 267 for other formulations of the doctrine. The doctrine sometimes goes by other names and often overlaps with other judge-made doctrines. See Joint Committee on Taxation, "Background and Present Law Relating to Tax Shelters," JCX-19-02, Doc 2002-1891, 2002 TNT 154-23 (Mar. 19, 2002) ("In

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Economic substance cases raise many difficult factual and legal issues, and one can understand why the Court might not wish to get involved. However, the lower courts' creation of an economic substance doctrine contradicts Supreme Court precedent, has caused deep circuit splits, and is inconsistent with well-settled rules of statutory interpretation. Given that the "judicially created"⁶ doctrine is a "prerequisite" to the application of every code provision offering tax benefits,⁷ the Court should affirm its prior holdings and instruct the lower courts that the casual disregard of statutory language in favor of judicial tests is inappropriate.

While the Court itself applies economic substance principles from time to time, it does so only when the governing statute makes those principles relevant. The lower courts, contrarily, apply economic substance principles regardless of what the code says (that is, they apply a free-floating test). Through applying a rule of decision that has no statutory reference point, the lower courts have concluded that "mere compliance with the code"⁸ is insufficient to enjoy tax benefits.

This report argues that the lower courts' application of a free-floating economic substance doctrine cannot be reconciled with the Supreme Court cases that purportedly gave birth to that doctrine. Part II explains how lower courts apply economic substance principles regardless of statutory language. Part III demonstrates that the Supreme Court uses economic substance principles only to the extent that the applicable statute makes them relevant. Although this distinction may seem subtle at first, Part IV shows that the two approaches are in fact irreconcilable. Part IV also recommends that the Court affirm its prior holdings, and addresses possible counterarguments to this report's conclusions.

II. Lower Courts' Approach

Before analyzing the lower courts' approach, a few disclaimers are required. First, to suggest that courts act one way some of the time is not to suggest that they act that way all of the time. Most courts, most of the time, faithfully apply Congress's statutes. Without more, the economic substance cases discussed here should be

addition to the statutory provisions, the courts have developed several doctrines over the years to deny certain tax motivated transactions their intended tax benefits. These doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS.⁹ This report is concerned with cases in which a lower court applies a prerequisite profit potential and/or business purpose test to a taxpayer's transaction. See *infra* Part II. This test is usually, but not always, referred to as the economic substance doctrine.

⁶ACM, 157 F.3d at 259 (discussing the "judicially created economic substance doctrine").

⁷See, e.g., *Lerman v. Commissioner*, 939 F.2d 44, 52 (3d Cir. 1991). ("Economic substance is a prerequisite to the application of any Code provisions allowing deductions.")

⁸*Stauffer's Estate v. Commissioner*, 403 F.2d 611, 621 (9th Cir. 1968). ("*Gregory v. Helvering* teaches that mere compliance with the Code provisions resulting in a tax advantage will be sanctioned by the courts only when there is, independent of the tax consequences, business or corporate purpose.")

viewed as departures from a pattern, rather than as evidence of one. Nevertheless, because the lower courts that have strayed from the Supreme Court's approach have injected significant confusion into the tax laws and have decided cases worth (in the aggregate) billions of dollars, their opinions demand close scrutiny.

Second, this report is primarily concerned with *how* courts have reached their decisions, rather than the decisions they have reached. Many have objected to the substantive results that the courts have reached in the economic substance cases. This report is only secondarily concerned with those objections. To that end, the facts (and sometimes even the applicable statutes) in the following cases have been vastly simplified to highlight the courts' methods of interpretation. There is no shortage of criticism or praise for the courts' results in the existing literature, and those wondering whether courts have reached the "right" ones should review that literature.⁹

Third, and most important, this report assumes that the best evidence of legislative intent (alternatively "legislative purpose" or "legislative will") is found in the words that Congress uses in its statutes. This is the dominant view on the Court today,¹⁰ but that has not

⁹See, e.g., Karen C. Burke, "Black & Decker in the Fourth Circuit: Tax Shelters and Textualism," *Tax Notes*, Apr. 17, 2006, p. 315, Doc 2006-6237, 2006 TNT 74-28; Daniel J. Glassman, Note, "It's Not a Lie if You Believe It: Tax Shelters and the Economic Substance Doctrine," 58 *Fla. L. Rev.* 665, 711 (2006); Ethan Yale, "Reexamining Black & Decker's Contingent Liability Tax Shelter," *Tax Notes*, July 11, 2005, p. 223, Doc 2005-13102, 2005 TNT 132-29; Alexandra M. Walsh, Note, "Formally Legal, Probably Wrong: Corporate Tax Shelters, Practical Reason and the New Textualism," 53 *Stan. L. Rev.* 1541 (2001); David P. Hariton, "Kafka and the Tax Shelter," 57 *Tax L. Rev.* 1 (2003); David P. Hariton, "The *Compaq* Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong," *Tax Notes*, Jan. 28, 2002, p. 501, Doc 2002-2090, 2002 TNT 19-31; David Weisbach, "Ten Truths About Tax Shelters," 55 *Tax L. Rev.* 215 (2002); Michael L. Schler, "Ten More Truths About Tax Shelters: The Problem, Possible Solutions, and a Reply to Professor Weisbach," 55 *Tax L. Rev.* 325, 361 (2002); Daniel N. Shaviro and David A. Weisbach, "The Fifth Circuit Gets it Wrong in *Compaq v. Commissioner*," *Tax Notes*, Jan. 28, 2002, p. 511, Doc 2002-2091, 2002 TNT 19-31; Joseph Bankman, "The Economic Substance Doctrine," 74 *S. Cal. L. Rev.* 5 (2000); and David P. Hariton, "Sorting Out the Tangle of Economic Substance," 52 *Tax Lawyer* 235 (1999).

¹⁰See, e.g., *W.Va. Univ. Hosps. Inc. v. Casey*, 499 U.S. 83, 98-99 (1991) ("The best evidence of congressional purpose is the statutory text adopted by both Houses of Congress and submitted to the President."); *Connecticut Nat. Bank v. Germain*, 503 U.S. 249, 253-254 (1992) ("Canons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'"); *City of Chicago v. Environmental Defense Fund*, 511 U.S. 328, 337 (1994) ("It is the statute, and not the Committee Report, which is the authoritative expression of the law."); *Ratzlaf v. United States*, 510 U.S. 135, 147-148 (1994) ("There are, we recognize, contrary

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indications in the statute's legislative history. But we do not resort to legislative history to cloud a statutory text that is clear."); *United States v. Gonzalez*, 520 U.S. 1, 6 (1997) ("Given the straightforward statutory command, there is no reason to resort to legislative history."); *Dunn v. Commodity Futures Trading Commission*, 519 U.S. 465, 474 (1997) ("We . . . think the purposes underlying the Treasury Amendment are most properly fulfilled by giving effect to the plain meaning of the language as Congress enacted it."); *United States v. LaBonte*, 520 U.S. 751, 757 (1997) ("In determining whether [the agency's guideline] accurately reflects Congress' intent, we turn, as we must, to the statutory language."); *United States v. Lanier*, 520 U.S. 259, 267 (1997) ("The legislative intent of Congress is to be derived from the language and structure of the statute itself, if possible, not from the assertions of codifiers directly at odds with clear statutory language."); *Brogan v. United States*, 522 U.S. 398, 408 (1998) ("Courts may not create their own limitations on legislation, no matter how alluring the policy arguments for doing so, and no matter how widely the blame may be spread. Because the plain language of [the statute] admits of no exception . . . we affirm the judgment of the Court of Appeals."); *Pennsylvania Dept. of Corrections v. Yeskey*, 524 U.S. 206, 212 (1998) ("The fact that a statute can be 'applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth.'") (unanimous); *Carter v. United States*, 530 U.S. 255, 270-271 (2000) ("Legislative history is unavailing in light of this Court's approach to statutory interpretation, which begins by examining the text, not by psychoanalyzing those who enacted it."); *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) ("When the statute's language is plain, the sole function of the courts — at least where the disposition required by the text is not absurd — is to enforce it according to its terms."); *Alexander v. Sandoval*, 532 U.S. 275, 288 (2001) ("We . . . begin (and find that we can end) our search for Congress's intent with the text and structure of Title VI."); *Gilutz v. Commissioner*, 531 U.S. 206, 220, *Doc 2001-1085*, 2001 TNT 7-13 (2001) ("Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."); *Chickasaw Nation v. United States*, 534 U.S. 84, 85 (2001) (canons "are designed to help judges determine the Legislature's intent as embodied in particular statutory language"); *Barnhart v. Sigmon Coal Co., Inc.*, 534 U.S. 438, 457 (2002) ("Floor statements from two Senators cannot amend the clear and unambiguous language of a statute. We see no reason to give greater weight to the views of two Senators than to the collective votes of both Houses, which are memorialized in the unambiguous statutory text."); *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003) ("When a statute speaks clearly to the issue at hand we 'must give effect to the unambiguously expressed intent of Congress.'") (unanimous); *Engine Manufacturers Association v. South Coast Air Quality Management Dist.*, 541 U.S. 246, 252 (2004) ("Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose."); *Lamie v. United States Trustee*, 540 U.S. 526, 542 (2004) ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform it to its intent. . . . In the meantime, we must determine intent from the statute before us."); *Exxon Mobil Corp. v. Allapattah Services, Inc.*, 125 Sup. Ct. 2611, 2626 (2005) ("As we have repeatedly held, the authoritative statement is the statutory text, not the legislative history or any other extrinsic material."); *Dodd v. United States*, 545 U.S. 353, 359 (2005) ("Although we recognize the potential for harsh results in some cases, we are not free to rewrite the statute that Congress has enacted."); *Powerex Corp. v. Reliance*

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always been the case.¹¹ Further, eminent scholars (and justices) have capably argued for different conceptions of legislative intent.¹² Many tax scholars, in particular, do not consider statutory language the best evidence of legislative intent. Tax scholars have long favored a strong purposive approach, under which an "underlying" legislative intent may require antitextual interpretations of the code so as to improve the structure or integrity of the tax system.¹³ Nonetheless, to borrow Judge Easterbrook's words, "I appreciate the temptation to make every law 'the best it can be,' but that is not the Supreme Court's current mode of statutory interpretation."¹⁴ Because this

Energy Services, 551 U.S. — (2007) (Policy debates belong "in the halls of Congress, not in the hearing room of this Court. As far as the Third Branch is concerned, what the text of [a statute] indisputably does prevails over what it ought to have done."); *Ledbetter v. Goodyear Tire & Rubber Co., Inc.*, 127 Sup. Ct. 2162, 2177 (2007) ("We are not in a position to evaluate Ledbetter's policy arguments. . . . We apply the statute as written."). Although the foregoing cases do not reflect the approach taken in every Court opinion during the past 15 years, the Court almost always resolves disputes by analyzing statutory language, although Justices continue to debate which extrinsic aids may be consulted in determining the meaning of that language. The Court has not gone so far as to cite *Holy Trinity Church v. United States*, 143 U.S. 457 (1892), the seminal case for applying a statute's "spirit" rather than its words, since 1989. See *Public Citizen v. United States Dept. of Justice*, 491 U.S. 440, 453-454 (1989).

¹¹See, e.g., *Bob Jones University v. United States*, 461 U.S. 574, 586 (1983). ("It is a well-established canon of statutory construction that a court should go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute.") See also Beverly I. Moran and Daniel M. Schneider, "The Elephant and the Four Blind Men: The Burger Court and Its Federal Tax Decisions," 39 *How. L. J.* 841, 928 (1996) (discussing six "Burger Court opinions that fashioned tax law without the assistance of statutory language, regulatory guidance or legislative history").

¹²See, e.g., William N. Eskridge Jr., "Dynamic Statutory Interpretation," 135 *U. Pa. L. Rev.* 1479 (1987); T. Alexander Aleinikoff, "Updating Statutory Interpretation," 87 *Mich. L. Rev.* 20 (1988); William N. Eskridge Jr. and Philip P. Frickey, "Statutory Interpretation as Practical Reasoning," 42 *Stan. L. Rev.* 321 (1990); David P. Hariton, "Tax Benefits, Tax Administration, and Legislative Intent," 53 *Tax Law.* 579, 613-614 (2000); Stephen Breyer, *Active Liberty: Interpreting Our Democratic Constitution* 85-101 (2005).

¹³See, e.g., Deborah A. Geier, "Interpreting Tax Legislation: The Role of Purpose," 2 *Fla. Tax Rev.* 492 (1995); Lawrence Zelenak, "Thinking About Nonliteral Interpretations of the Internal Revenue Code," 64 *N.C. L. Rev.* 623 (1986). For a criticism of the antitextual approach, see John F. Coverdale, "Text as Limit: A Plea for Decent Respect of the Tax Code," 71 *Tul. L. Rev.* 1501 (1997).

¹⁴*Humphries v. CBOCS West, Inc.*, ___ F.3d ___, 2007 WL 60876 (7th Cir., 2007) (Easterbrook, J., dissenting). See also Steven A. Dean and Lawrence A. Solan, "Tax Shelters and the Code: Navigating Between Text and Intent," 26 *Va. Tax. Rev.* ___ (forthcoming 2007). ("An aggressive purposive approach to the interpretation of the tax laws regardless of the statutory language is too far outside today's jurisprudence to be a credible option.")

report argues that the lower courts' approach is inconsistent with the Supreme Court's, it is the high court's statute-based approach that guides the analysis below.¹⁵

A. *Coltec v. United States*

In *Coltec Industries, Inc. v. United States*,¹⁶ the Court of Appeals for the Federal Circuit invoked the economic substance doctrine to disregard a taxpayer's compliance with the code. In that case, the taxpayer (Coltec) engaged in a multistep transaction that created valuable tax benefits. Coltec turned a dormant subsidiary (Garrison) into a special purpose entity and then transferred to Garrison a promissory note with a face amount of \$375 million.¹⁷ In exchange for that promissory note, Garrison agreed to assume contingent asbestos liabilities in the amount of \$374.5 million.¹⁸ Coltec then sold its stock in Garrison for \$500,000, claiming a large loss on the sale.¹⁹

Sections 351 and 358 governed the tax treatment of Coltec's transaction.²⁰ Section 351(a) provides that when property is transferred to a controlled corporation in exchange for stock in that corporation, generally no gain or loss is immediately recognized. Section 358(a) provides rules determining the basis of the stock that the shareholder receives in exchange for the property transferred. That section says that the basis of stock received in a section 351 transfer is the same as that of the property exchanged, decreased by the amount of any money received by the shareholder.²¹ Although the assumption of liabilities is ordinarily treated as money received by

the transferor,²² section 358(d)(2) states that liabilities that "give rise to a deduction" will not be treated that way.²³

The Federal Circuit completed a thorough analysis of the applicable statutes. The court first found that Coltec's basis in the note transferred to Garrison was equal to its face amount (\$375 million).²⁴ The court then examined whether the assumed liabilities would give rise to a deduction such that Coltec could exclude them when determining its basis in the Garrison stock.²⁵ The government argued that Coltec could not, but after a careful parsing of various interrelated statutes, the Federal Circuit found in favor of Coltec on that point.²⁶

Because the liabilities did not reduce Coltec's basis in its Garrison stock, the stock's basis was \$375 million. However, Garrison as a whole was worth much less — the company had assumed \$374.5 million worth of asbestos liabilities. Thus, Coltec's basis in the Garrison stock was well in excess of its fair market value and on the disposition of the stock for \$500,000, Coltec claimed a large loss. The court concluded that the code in fact allowed Coltec to recognize that loss.²⁷

Although the court could "find nothing in the literal terms of the statute" that disallowed Coltec's claimed benefits,²⁸ its analysis did not stop with the language of the code. Instead, the court proceeded to apply the general economic substance doctrine.²⁹ Under its interpretation of the doctrine, "transactions that comply with the literal terms of the tax Code but lack economic reality" must be disregarded.³⁰ The court stated that various Supreme Court precedents affirmed the legitimacy of the doctrine and that the doctrine represents "a judicial effort to enforce the statutory purpose of the tax Code."³¹ The court also stated that the "economic substance doctrine is a prerequisite to the application of any Code provision allowing deductions."³² According to the court, the doctrine applies whenever a taxpayer's sole subjective motivation is tax avoidance³³ or if a transaction lacks economic reality.³⁴

The court then applied the doctrine to only the transfer of the promissory note, because "the transaction to be analyzed is the one that gave rise to the alleged tax benefit."³⁵ The court concluded that the transaction

¹⁵Although academics continue to debate which extrinsic sources one may properly consult in determining the meaning of statutory language, "all statutory interpretation theorists agree that judges must look to the words of the statute in order to resolve legal controversies." Nancy Staudt, "Judging Statutes: Interpretive Regimes," 38 *Loy. L.A. L. Rev.* 1909, 1970 n.95 (2005). (citing William N. Eskridge Jr., "Textualism, the Unknown Ideal?" 96 *Mich. L. Rev.* 1509, 1557 (1998). ("All major theories of statutory interpretation consider the statutory text primary. The plain meaning of a text, as applied to a set of facts, is the focal point for attention whether one is a textualist, intentionalist, or pragmatic interpreter of statutes.")) That general consensus notwithstanding, some tax scholars continue to question the authoritative weight of congressionally enacted statutes. This unusual approach is seen in some lower court cases, see *infra*, but is at odds with statutory interpretation theory generally. See Michael Livingston, "Practical Reason, 'Purposivism' and the Interpretation of Tax Statutes," 51 *Tax L. Rev.* 677, 710-712 (1996). ("The tax debate seems strangely uninformed by broader interpretation scholarship, which regards purpose as a rather old-fashioned concept.")

¹⁶454 F.3d 1340, *Doc* 2006-13276, 2006 *TNT* 134-10 (Fed. Cir. 2006).

¹⁷See *id.* at 1344.

¹⁸See *id.*

¹⁹See *id.* at 1345.

²⁰Section references in this report are to the provisions of the Internal Revenue Code of 1986 (or predecessor enactments) as in effect during the tax years at issue.

²¹Section 358(a)(1).

²²Section 358(d)(1).

²³Section 358(d)(2) operates via a cross-reference to section 357(c)(3).

²⁴See *id.* at 1344 n.2.

²⁵See *id.* at 1349.

²⁶See *id.*

²⁷See *id.* at 1351. ("The consequence is that under the literal terms of the statute the basis of Garlock's Garrison stock is increased by the [promissory] note and is not reduced by the assumed contingent asbestos liabilities. Ultimately, the taxpayer would not be disqualified from claiming the capital loss.")

²⁸*Id.* at 1347.

²⁹*Id.* at 1351.

³⁰*Id.* at 1352.

³¹*Id.* at 1353-1354.

³²*Id.* at 1356 (quotations and citations omitted).

³³*Id.* at 1356.

³⁴*Id.* at 1352.

³⁵*Id.* at 1356.

lacked economic substance because it did not “appreciably affect” Coltec’s beneficial interests and did not provide Coltec with any “real ‘opportunity to make a profit.’”³⁶ Because that transaction was disregarded, Coltec’s basis in its Garrison stock could not be inflated by the promissory note,³⁷ and Coltec consequently had no loss to recognize on the sale of the Garrison stock. The court thus entered judgment in favor of the government.

The Federal Circuit’s application of the economic substance doctrine to only the transfer of the promissory note (as opposed to the whole transaction) has caused some controversy.³⁸ That controversy is not relevant here. Rather, it is sufficient to observe that the court did not point to any statutory language that implicitly or explicitly indicated that economic substance principles should be applied. The Federal Circuit did not even deny that Coltec’s transaction was exactly what it was purported to be,³⁹ but instead concluded that it was empowered to go “beyond the literal language of a statute.”⁴⁰

Although the Federal Circuit performed a detailed analysis of the statutory scheme before applying the economic substance doctrine,⁴¹ much of its analysis was ultimately irrelevant. While the court did conclude that Coltec had complied with the applicable statutes, that conclusion did not bear on the ultimate disposition of the case. Indeed, at least one circuit court has concluded that statutory analysis is not at all required in economic substance cases.

B. *In re CM Holdings*

In *In re CM Holdings*,⁴² the Third Circuit addressed whether the taxpayer (Camelot) could enjoy interest deductions with respect to its corporate-owned life insurance policies.⁴³ In a highly leveraged transaction, Camelot purchased life insurance policies on account of 1,430 of its employees. The indebtedness attributable to that purchase resulted in purportedly tax-deductible interest payments. The IRS, however, argued that those deductions were unavailable under the applicable statutes and the economic substance doctrine.

The Third Circuit began its analysis by mentioning the “relatively simple” statutes that would seemingly govern the controversy.⁴⁴ The court observed that section 163(a)

allows a deduction for “all interest paid or accrued within the taxable year on indebtedness,” but section 264(a)(3) limits that deduction when the underlying indebtedness is attributable to the leveraged purchase of life insurance contracts. Camelot argued that the section 264(a)(3) limitation was inapplicable because the company qualified for a special safe harbor exception found in section 264(d).

The Third Circuit did not consider Congress’s statutes relevant, however. Rather, the court stated:

We can forgo examining the intersection of these statutory details, for pursuant to *Gregory v. Helvering* and *Knetsch v. United States*, courts have looked beyond taxpayers’ formal compliance with the Code and analyzed the fundamental substance of transactions. Economic substance is a prerequisite to the application of any Code provision allowing deductions. It is the Government’s trump card; even if a transaction complies precisely with all requirements for obtaining a deduction, if it lacks economic substance it “simply is not recognized for federal taxation purposes, for better or for worse.”⁴⁵

After concluding that statutory analysis was unnecessary, the court examined two aspects of the COLI transaction “to determine if it ha[d] economic substance: its objective economic substance and the subjective business motivation behind it.”⁴⁶ The court discovered a “damning piece of evidence” that indicated that the COLI transaction could not pass the judicial tests and consequently denied the taxpayer the claimed interest deductions.⁴⁷

The court then examined whether the imposition of accuracy-related penalties was appropriate. Camelot argued that, because the application of sections 163 and 264 to a COLI transaction raised issues of first impression, penalties should not apply. The court rejected Camelot’s arguments, however, emphasizing that it had not interpreted any statutes in reaching its holding:

Only one case has broadened the common law exception for cases of first impression, which prevents the imposition of penalties, to the field of accuracy-related penalties for substantial understatement. But even this exception is reserved for issues where the statutory language was unclear. As the District Court pointed out, in this case there is no unclear statutory language, only “applying

³⁶*Id.* at 1360.

³⁷*Id.*

³⁸See Gregory N. Kidder, “Don’t Make Coltec Problem Worse,” *Legal Times*, Mar. 26, 2007.

³⁹See also John F. Prusiecki, “Coltec: A Case of Misdirected Analysis of Economic Substance,” *Tax Notes*, Aug. 7, 2006, p. 524, *Doc 2006-13972*, 2006 *TNT* 152-83. (“The court . . . did not recharacterize any part of the transaction as being other than what it purported to be. Rather the court said that the note/liability transfers were motivated solely by tax concerns, had no meaningful nontax economic purpose, and therefore lacked economic substance.”)

⁴⁰454 F.3d at 1354.

⁴¹See *id.* at 1340-1351.

⁴²301 F.3d 96, *Doc 2002-19191*, 2002 *TNT* 161-10 (3d Cir. 2002).

⁴³Camelot purchased those policies after being approached by a third-party promoter (Newport Inc.) that designed highly leveraged COLI plans. See *id.* at 100.

⁴⁴*Id.* at 101.

⁴⁵*Id.* at 102 (citations omitted).

⁴⁶*Id.*

⁴⁷See *id.* at 102-103. (“Camelot’s COLI plan lacked economic substance. It fails the objective prong because, outside of tax considerations, the transaction had no net economic effect on Camelot’s financial position. It fails the subjective prong because at the time the plan was under consideration and agreed on, all parties focused solely on the tax benefits the plan provided. Ultimately the most damning piece of evidence against Camelot is that the marketing information presented to its executives showed that, absent tax deductions, the plan would lose money. Camelot agreed to the plan knowing the tax deductions were the only thing that made it worthwhile.”)

novel facts to the judicially created [economic substance] doctrine." *Id.* at 108 (citations omitted).

Because the first impression exception was limited to only those cases in which courts apply statutes, Camelot could not argue that that exception was available — the Third Circuit expressly declined to examine sections 163 and 264. The court thus found that the accuracy-related penalty properly applied to the taxpayer.

Unlike the Federal Circuit in *Coltec*, the Third Circuit did not perform a preliminary analysis of the applicable statutes to determine whether the taxpayer's transaction fell within their terms. Rather, the court assumed that the statutes were irrelevant and that the economic substance doctrine should be applied before a court even considers statutory language. Nonetheless, the Third Circuit's approach differs from the Federal Circuit's only in form. If a court denies a taxpayer benefits under the economic substance doctrine, it does not matter whether the court examines the applicable statutes or not. In either case, the judicially created doctrine operates independently to override statutory language. One court has even concluded that, when analyzing a taxpayer's transaction, Congress's statutes do not even merit citation.

C. *Compaq v. Commissioner*

In *Compaq Computer Corp. and Subsidiaries v. Commissioner*,⁴⁸ the Tax Court addressed whether the taxpayer could enjoy foreign tax credits resulting from a dividend-stripping transaction. Compaq had purchased \$890 million worth of American Depositary Receipts (ADRs) in the Royal Dutch Company "cum dividend," meaning that its purchase entitled it to \$22 million in dividends that had been declared with respect to those ADRs. One day after the purchase, however, Compaq sold the ADRs for \$870 million "ex dividend," meaning that Compaq (and not the subsequent purchaser) retained the right to the dividends. The purchase of the ADRs for \$890 million and their subsequent sale for \$870 million created a \$20 million loss. But the \$22 million dividend payment more than offset the loss from the sale, and Compaq enjoyed a \$2 million profit from the transaction.

Compaq nonetheless claimed a loss on its return. While the company did receive a \$22 million dividend payment from Royal Dutch, the code grants corporations a deduction for dividends received,⁴⁹ so that payment did not affect Compaq's federal tax liability. Compaq thus claimed a \$20 million tax loss on account of the sale of the ADRs, which it used to offset gain that it had realized in an unrelated transaction. Because foreign taxes were withheld on Royal Dutch's \$22 million dividend payment, Compaq also claimed foreign tax credits on account of its transaction. The availability of those credits was at issue in *Compaq*.

The commissioner argued that Compaq was ineligible for the claimed credits. Although the taxpayer's dividend-stripping transaction implicated numerous

statutory provisions,⁵⁰ the commissioner did not argue that Compaq had failed to comply with any particular statute. Rather, he argued that Compaq was not entitled to the foreign tax credits because the company's "transaction had no objective economic consequences or business purpose other than reduction of taxes."⁵¹ Compaq countered that "because it complied with the applicable statutes and regulations,"⁵² it was entitled to the credits.

The Tax Court found in favor of the commissioner. Although Compaq had complied with the statutes, the court rejected the taxpayer's argument that those statutes "completely set forth Congress' intent" and instead found that an additional economic substance requirement applied.⁵³ The court concluded that Compaq "was motivated by the expected tax benefits of the ADR transaction and no other business purpose existed,"⁵⁴ and consequently denied Compaq the claimed credits.

Although the Tax Court did not cite a single statute in analyzing Compaq's transaction,⁵⁵ it did not completely ignore the code.⁵⁶ Section 6662(a) and (b)(1) provide that if a taxpayer negligently disregards the code's rules or regulations, it will be subject to a 20 percent penalty on its underpayment of tax. The commissioner did not argue that Compaq had disregarded those rules or regulations, but instead stated that the accuracy-related penalty should be imposed because Compaq had "negligently disregarded the economic substance of the ADR transaction."⁵⁷ The court agreed with the commissioner and found that the application of the penalty was appropriate.⁵⁸

Compaq demonstrates that the economic substance doctrine will be applied even when the government does not cite a single statute in support of its position.⁵⁹ The opinion also indicates that the doctrine contradicts even penal provisions. Although the court acknowledged that Compaq had complied with the code's rules and regulations, it applied the section 6662 penalty regardless.⁶⁰

⁵⁰113 T.C. at 220.

⁵¹*Id.*

⁵²*Id.*

⁵³*Id.* at 225.

⁵⁴*Id.* (punctuation omitted).

⁵⁵Statutes relevant to a dividend-stripping transaction — but not even cited by the Tax Court — include sections 162-165, 243-246, 901(a), 904, 1001, and 1211. *See also IES Industries v. Commissioner*, 1999 WL 973538, Doc 1999-32487, 1999 TNT 196-60 (N.D. Iowa 1999), *rev'd*, 253 F.3d 350, Doc 2001-16769, 2001 TNT 116-12 (8th Cir. 2001) (addressing shelter similar to Compaq's and failing to cite *any* statutes in holding against the taxpayer).

⁵⁶In addition to citing section 6662, the court cited section 901(k). Congress enacted that subsection in 1997 to deal with dividend-stripping transactions. Compaq argued that this implied that its transaction was permissible under the law in 1992. The court, however, rejected that argument. *See* 113 T.C. at 225.

⁵⁷*Id.* at 226

⁵⁸*See id.* at 227.

⁵⁹*See also* 277 F.3d at 781. ("The Government has stipulated that aside from its contention that the Royal Dutch transaction lacked economic substance, it has no objection to how Compaq chose to report its tax benefits and liabilities concerning the transaction.")

⁶⁰*See also In re CM Holdings*, *supra* Part II.B.

⁴⁸113 T.C. 214, 215, Doc 1999-30659, 1999 TNT 183-7 (1999), *rev'd*, 277 F.3d 778, Doc 2002-184, 2002 TNT 1-5 (5th Cir. 2001).

⁴⁹*See* section 243.

The Tax Court was eventually reversed by the Fifth Circuit. However, the appellate court did not reject the Tax Court's invocation of the economic substance doctrine, but only its method of applying that doctrine to the taxpayer's transaction. The court found that the \$2 million profit Compaq enjoyed from the dividend-stripping transaction indicated that it had economic substance.⁶¹ Nonetheless, the Fifth Circuit's opinion is devoid of any meaningful statutory analysis, and although the government stipulated that Compaq had complied with the code,⁶² the court tested the taxpayer's transaction against a free-floating doctrine regardless.

D. *United States v. Wexler*

Although the Tax Court found that a violation of the economic substance doctrine could justify the application of a civil penalty, the Third Circuit in *United States v. Wexler* found that a failure to comply with that doctrine could justify a taxpayer's criminal conviction.⁶³ The defendant in that case had allegedly participated in a conspiracy to defraud the United States government. Wexler and his coconspirators allegedly generated hundreds of millions of dollars in fraudulent tax deductions through the use of so-called repo-to-maturity transactions. Those transactions created purportedly deductible interest payments under section 163(a), which provides that "there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Before the commencement of Wexler's criminal trial, the government proposed jury instructions based on the two prongs of the economic substance doctrine, as applied in the Third Circuit. The proposed instructions provided that, if the jury found beyond a reasonable doubt that Wexler had no business purpose for entering into the repo-to-maturity transactions and that Wexler could earn no profit from those transactions apart from tax benefits, the jury must find that the transactions were shams.⁶⁴ Wexler did not object to those instructions, but requested that, because section 163(a) allows interest deductions on account of indebtedness, the judge should make clear that the jury could not convict him if his interest deductions were in fact taken on account of genuine indebtedness.

The district judge adopted portions of both parties' proposed instructions. The judge's instructions contained the two-part economic substance test offered by the government but further stated that, even if Wexler's

transaction did not comply with the economic substance doctrine, the jury could "convict the defendant on the count you are considering only if you find that the interest expenses at issue were not the product of a 'genuine indebtedness.'"⁶⁵ The instructions also provided that "genuine indebtedness exists if the parties intended to create and enforce a binding obligation" and that the "government must prove the lack of genuine indebtedness beyond a reasonable doubt."⁶⁶ In determining whether the repo-to-maturity transaction created genuine indebtedness, the jurors could not heed meaningless labels, but would instead be instructed that they must consider the "substance of the transaction, as intended by the parties, not only the form that the transaction took."⁶⁷

Before Wexler's trial began, the government petitioned the Third Circuit for a writ of mandamus. It contended that the district judge had made a "clear legal error" and that his ruling regarding the jury instructions "would make tax cases involving sham transactions far more difficult to prosecute."⁶⁸ The government argued that a transaction that does not comply with the economic substance doctrine cannot generate lawful interest deductions, even if it "involve[s] the payment of interest on 'genuine indebtedness.'"⁶⁹

Wexler countered that the district judge's instructions reflected an accurate statement of law and that the economic substance doctrine should not apply when a taxpayer's obligation to pay interest is binding and enforceable. He argued that "in contrast to other sections of the Internal Revenue Code allowing for deductions, section 163 does not require any profit motive or the conduct of a trade or business in order to claim the deduction for interest expense."⁷⁰ Whereas deductions under sections 162 and 212 are limited to those relating to the carrying on of a trade or business and to transactions entered into for profit, respectively, the language of section 163 expresses no similar limitations.

The Third Circuit agreed that section 163 did not make a taxpayer's business purpose relevant, but it found that the economic substance doctrine could add requirements beyond those imposed by the statute. The court stated that "some Code sections expressly require that the deductions they provide for arise from transactions having a business purpose or profit motive, whereas section 163 does not. Nonetheless, the case law construing section 163 clearly establishes that the [economic substance] doctrine *also* bars interest deductions under that section of the Code."⁷¹ That case law demonstrated that "a key requirement is that [an] interest obligation be *economically*

⁶¹277 F.3d at 787.

⁶²*See id.* at 781.

⁶³31 F.3d 117 (3d Cir. 1994).

⁶⁴The word "sham" means different things to different courts. At times, the word sham refers to something that never happened (that is, a factual sham). At other times, sham refers to a transaction that actually occurs but that does not meet a lower court's economic substance test (that is, an economic sham). In some opinions, sham is used generally to refer to both factual shams and economic shams. *See, e.g., United States v. Atkins*, 869 F.2d 135, 139-140. In *Wexler*, sham refers to a transaction that does not pass the economic substance test, not to transactions that never occurred.

⁶⁵*Id.*

⁶⁶*Id.*

⁶⁷*Id.*

⁶⁸31 F.3d at 121.

⁶⁹*Id.* at 122.

⁷⁰*Id.*

⁷¹*Id.* at 122-123 (emphasis supplied).

substantive” in order to be deducted, meaning that the transaction creating the obligation must have a potential nontax benefit.⁷²

The Third Circuit then announced that its “rule of disregarding sham transactions for federal taxation purposes continues in full force today, with no exception for section 163 deductions,” emphasizing that “economic substance is a prerequisite to any Code provision allowing deductions.”⁷³ It further found that the Supreme Court’s decision in *Knetsch v. United States* “plainly contradict[ed]” Wexler’s arguments.⁷⁴ It thus set aside the district judge’s instruction relating to genuine indebtedness, finding that his “instruction would render the [economic substance] doctrine inert” and was “at odds with the overwhelming weight of the relevant case law.”⁷⁵

Wexler demonstrates that a free-floating economic substance doctrine can apply in criminal cases. That Wexler’s transaction might have created a genuine indebtedness within the meaning of section 163(a) was irrelevant so long as his transaction did not meet the prerequisite judicial test, even though he was facing criminal charges. One court has suggested that the application of the economic substance doctrine in a criminal case is repugnant to the Constitution,⁷⁶ but the government continues to argue that it is a proper part of a criminal trial,⁷⁷ and the lower courts usually agree.⁷⁸

E. Summary

Not all lower courts view the economic substance doctrine as a universal, free-floating test. For example, in

Horn v. Commissioner,⁷⁹ the D.C. Circuit parted ways with three circuit courts, the Tax Court, and the commissioner, and concluded that the economic substance doctrine “cannot trump the plainly expressed intent of the legislature.”⁸⁰ The statute at issue in that case (section 108 of the Deficit Reduction Act) created an irrebuttable presumption that commodities dealers, like the taxpayer, had a business purpose when engaging in some tax-motivated straddle transactions, stating that any losses suffered by those dealers “shall be treated as a loss incurred in a trade or business.”⁸¹ The Tax Court nonetheless found that the taxpayer’s lack of business purpose in entering into a straddle disqualified him from enjoying statutory benefits.

The D.C. Circuit reversed the Tax Court, stating that its failure to give credence to the statute’s irrebuttable presumption and its application of a free-floating economic substance test was “plainly and simply wrong”;⁸² it was “inconceivable that Congress intended that the [economic substance] doctrine be laid over the statute.”⁸³ The commissioner had “close[d] off any consideration of whether Congress intended the ‘loophole’”⁸⁴ offered by the statute and had thereby taken the doctrine “too far”⁸⁵ — his interpretation read the statute “completely out of existence.”⁸⁶ The court was thus “at a loss to understand the Commissioner’s suggestion, adopted by several courts, that the [economic substance] doctrine applies independently of section 108.”⁸⁷ The court concluded that economic substance principles should be used only

⁷²*Id.* at 127.

⁷³*Id.* at 127.

⁷⁴*Id.* at 123. For a discussion of *Knetsch*, see *infra* Part III.B.

⁷⁵*Id.* at 127.

⁷⁶See *United States v. Dahlstrom*, 713 F.2d 1423, 1429-1430 (9th Cir. 1983), *cert. denied*, 104 Sup. Ct. 236 (1984). (“These appellants were prosecuted in spite of the fact that no statute, regulation or court decision gave fair warning that advocacy of the creation of lawful foreign trust corporations as a tax shelter would result in a criminal prosecution if the challenged transaction might later be held to lack economic substance for purposes of a civil tax proceeding. Prosecution for advocacy of a tax shelter program in the absence of any evidence of a specific intent to violate the law is offensive to the first and fifth amendments of the United States Constitution.”)

⁷⁷See Michael J. Garcia, “Government Opposes KPMG Defendants’ Motion to Dismiss Indictment,” *Doc 2006-4307, 2006 TNT 44-9* (Mar. 3, 2006). (“*Long Term Capital and Ingredient Technology* and other cases dispose of defendants’ claims . . . that the doctrines of economic substance and substance over form are not properly part of a criminal case or are vague and unknowable. *Ingredient Technology* hardly paused in approving the use of these doctrines in a criminal case, and noted that parsing the exact distinctions among them was unimportant.”)

⁷⁸See, e.g., *United States v. Atkins*, 869 F.2d 135, 139-140 (2d Cir. 1989) (“Appellants’ further contention that the district court’s charge on lack of [economic] substance has no place in a criminal prosecution is without merit.”); *United States v. Manko*, 979 F.2d 900, 905 (2d Cir. 1992) (observing that the district court “sided with the government and charged the jury that it could convict if it found either that the transactions did not occur or that they lacked economic substance”).

⁷⁹968 F.2d 1229, 1236 (D.C. Cir. 1992).

⁸⁰*Id.* at 1231.

⁸¹See Tax Reform Act of 1986, P.L. 99-514, section 1808(d), 100 Stat. 2817 (1986). Section 1808(d) of TRA 86 amended section 108 of the Deficit Reduction Act of 1984 (DRA), P.L. 98-369, 98 Stat. 494, 630. Before amendment, section 108 provided a rebuttable presumption that commodities dealers entered into certain straddles with a business purpose. Section 108(b) of the DRA provided, “Presumption That Transaction Entered Into for Profit. . . . Any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be *rebuttably* presumed to be part of a transaction entered into for profit” (emphasis supplied). TRA 86 amended section 108(b) by eliminating the rebuttable presumption and inserting an irrebuttable one, providing, “(b) Loss Incurred in a Trade or Business. . . . Any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business” (emphasis added). The Tax Court nonetheless concluded that “Congress never intended section 108(b) to automatically characterize all dealer derived straddle losses as losses incurred in a trade or business.” *Fox v. Commissioner*, T.C. Memo. 1988-570. (Horn’s claims were consolidated with several other taxpayers’ in *Fox*. Several of the other taxpayers involved in *Fox* appealed the Tax Court’s adverse decision, but only the D.C. Circuit refused to apply a free-floating doctrine. See, e.g., *Lerman*, 939 F.2d at 52; *Gardner v. Commissioner*, 954 F.2d 836, 838 (2d Cir. 1992)).

⁸²968 F.2d at 1231.

⁸³*Id.* at 1231.

⁸⁴*Id.* at 1238.

⁸⁵*Id.* at 1231.

⁸⁶*Id.* at 1234.

⁸⁷*Id.* at 1238.

“for divining and effectuating congressional intent, not for supplanting it,”⁸⁸ and found in favor of the taxpayer.

Despite the D.C. Circuit’s strong statements, *Coltec, Inc. re CM Holdings, Compaq*, and *Wexler* represent the typical approach among the lower courts. The D.C. Circuit has been expressly criticized for its focus on statutory language,⁸⁹ and the economic substance doctrine generally serves as an additional hurdle that a taxpayer must jump whenever he seeks a tax benefit under the code.⁹⁰ A court may even grant a taxpayer’s motion for summary judgment on statutory issues, but then address the economic substance doctrine in a separate proceeding and deny the taxpayer statutory benefits anyway.⁹¹ And even if Congress expressly incorporates an economic substance test into a statute, the lower courts may apply an additional test regardless.⁹² The doctrine not only floats over the

Internal Revenue Code, but can even be used to short-circuit the Administrative Procedure Act’s notice-and-comment rulemaking procedures.⁹³ Indeed, as then-Judge Breyer wrote on behalf of the First Circuit in *Deweese v. Commissioner*, the economic substance doctrine “takes a transaction outside the statutory framework.”⁹⁴ Although courts sometimes pause before asserting “the power to rewrite laws enacted by Congress and the President,”⁹⁵ the economic substance doctrine is frequently invoked to deny taxpayers benefits, even when

⁸⁸*Id.* at 1234.

⁸⁹See, e.g., *Krumhorn v. Commissioner*, 103 T.C. 29, 50, Doc 94-6826, 94 TNT 140-10 (1994). (“We disagree with the holding in *Horn* and hold, consistent with our prior cases and all other circuit courts that have reviewed this matter . . . that it is appropriate before applying the per se rule of section 108(b) to inquire whether the straddle transactions at issue are devoid of economic substance.”) At least one judge on the D.C. Circuit continues to believe that courts must examine statutes in deciding tax cases. See Transcript of Oral Argument at 29-30 (Oct. 2, 2001), *Saba Partnership v. Commissioner* (No. 00-1328, 00-1385) (remarks of Judge Harry Edwards). (*Horn* “makes it very clear the D.C. Circuit is at odds with the Third Circuit. [We are not] going to call it a sham without regard to what the statute says. *Horn* completely rejects that, and we rejected the Third Circuit in *Horn*.”) For a longer discussion of the D.C. Circuit’s refusal to apply a free-floating doctrine, see Durham, Williamson, and Thiel, “Mrs. Gregory’s Great-Grandchildren: The Lost Generation,” *Taxation of Global Transactions* 25, 31-35 (Summer 2002).

⁹⁰See, e.g., *ACM*, 157 F.3d at 254 n.44 (economic substance test required even if “statute is drafted in broad terms that do not require a particular intent or purpose”), and *Lerman*, 939 F.2d 44 at 52.

⁹¹In *Klamath Strategic Investment Fund, LLC v. United States*, 440 F. Supp.2d 608, 615-17, Doc 2006-13753, 2006 TNT 140-14 (E.D. Tex. 2006), the court rejected the government’s arguments and found that the taxpayer’s transaction complied with the statute. The court examined the application of the free-floating economic substance doctrine in a separate proceeding, *Klamath Strategic Investment Fund, LLC v. United States*, ___ F. Supp.2d ___, Doc 2007-2603, 2007 TNT 22-9 (E.D. Tex., 2007), and held against the taxpayer. See *id.* (“The court’s [previous] summary judgment ruling determined that the tax treatment and accounting technically complied with Section 752 . . . At issue still is whether the transactions were shams or lacked economic substance.”)

⁹²See, e.g., *Duke Energy v. United States*, 49 F. Supp.2d 837 (W.D. N.C. 1999). In *Duke Energy*, the court applied an economic substance test on top of a statute which already contained an economic substance test. In that case, the taxpayer had claimed a dividends received deduction (DRD) under section 243. Although section 246(c) plainly provides an economic “risk of loss” test that limits the availability of the DRD under section 243, the court nonetheless began its analysis with the free-floating economic substance doctrine, as articulated by the Fourth Circuit in *Rice’s Toyota*, 752 F.2d at 91. Only after completing that analysis did the court examine the test found in 246(c), finding in favor of the taxpayer.

⁹³In *H.J. Heinz Co. and Subsidiaries v. United States*, 76 Fed. Cl. 570, Doc 2007-12834, 2007 TNT 103-16 (2007), the Claims Court exercised authority purportedly granted only to the Treasury secretary. In that case, Heinz’s subsidiary (HCC) sought to shelter over \$100 million in income through a transaction that had objective economic substance but was probably designed solely to reduce taxes. HCC acquired Heinz stock from the public, held it for four months, and then sold most of that stock to its parent. Through peculiarities in the code, Heinz’s payment in exchange for that stock was treated as the payment of a dividend, rather than as a distribution in exchange for stock. See section 302(d). In turn, HCC’s basis in the stock that it sold jumped to the stock that it retained, and the retained stock consequently had a basis well in excess of its fair market value. See reg. section 1.302-2(c). HCC later sold its remaining Heinz stock to an unrelated party, claiming a large loss on the sale, but the IRS disallowed that loss. At trial, the taxpayer cited 21 statutes in support of its claim (see Plaintiff’s Initial Post-Trial Brief at iii) but the Claims Court glossed over the taxpayer’s statutory arguments in a single footnote. See 76 Fed. Cl. at 591, n.36. The court instead invoked numerous free-floating doctrines (including the economic substance doctrine) to disregard the fact that the taxpayer’s transaction had “complied with each and every of the relevant requirements imposed by the Code.” 76 Fed. Cl. at 592. Congress had actually enacted a specific statute saying that there is no basis reduction on account of “extraordinary dividends” when those dividends are paid between members of an affiliated group. See section 1059(e)(2)(A). The code’s plain language thus left no doubt that, absent the issuance of regulations and regardless of the presence or absence of business purpose, HCC did not have to reduce the basis in the stock that it retained after the initial sale to Heinz. (Were it not for the section 1059(e)(2)(A) exception, HCC would be prevented from creating a built-in loss on the retained Heinz stock.) However, Congress did give the secretary the authority to change that result by regulation. See section 1059(e)(2)(A) (rule requiring basis reduction on account of “extraordinary dividends” does not apply to dividends between affiliated corporations, *except as provided in regulations*). Because the secretary did not issue regulations until after the tax year at issue in *Heinz*, the taxpayer argued that it was entitled to its desired tax treatment. The court nonetheless found against the taxpayer, essentially implementing a rule that Congress said could apply only if notice-and-comment rulemaking procedures were followed.

⁹⁴870 F.2d 21, 34 (1st Cir. 1989) (Breyer, J.).

⁹⁵See *Jacobs Engineering Group, Inc. v. United States*, not reported in F. Supp., 1997 WL 314167, Doc 97-9341, 97 TNT 64-6 (C.D. Cal. 1997). (“Though it is a well-settled rule designed to negate the tax consequences of sham transactions, [economic substance] is a somewhat disturbing doctrine. First, [the doctrine] defeats settled expectations for taxpayers already struggling to traverse a wildly complex tax code. Second, the doctrine is fundamentally anti-majoritarian, as unelected bureaucrats are given the power to rewrite laws enacted by Congress and the

(Footnote continued on next page.)

they have “complied with each and every of the relevant requirements imposed by the Code.”⁹⁶

III. The Supreme Court’s Approach

A careful review of the Supreme Court’s jurisprudence reveals that the Court has never applied a free-floating economic substance test to tax statutes. Rather, the Court examines principles of economic substance only to the extent that the applicable statute makes those principles relevant. In other words, the Court examines economic substance principles to determine whether a taxpayer’s conduct falls within a statute’s terms. The Court does not use a free-floating economic substance doctrine to deny taxpayers benefits despite their “mere compliance with the code,” nor does the Court announce that analysis of “statutory details” is unnecessary.

Before discussing the Court’s approach, however, three disclaimers are again required. First, the facts and statutes in the following discussion have been simplified to highlight the Court’s method of interpretation. Much has been written about the Court’s substantive results, but those results are not the primary focus here.⁹⁷

Second, while the cases discussed below paint a consistent picture, the Court has added requirements beyond those previously contemplated by Congress.⁹⁸ “It is much too late to deny that there is a significant body of federal law that has been fashioned by the federal judiciary in the common-law tradition.”⁹⁹ Nonetheless, the focus here is on the application of the economic substance doctrine, and the Court uses economic substance principles only to the extent that a plausible reading of the governing statute makes them relevant.

Third, and perhaps most important, the following discussion takes the Supreme Court’s opinions at face value. While economic substance cases have come to “mean all things to all men,”¹⁰⁰ this report assumes that the opinions mean what they *say*. In each of the following cases, the Court explicitly grounds its application of economic substance principles (business purpose, risk assumption, profit motivation, and so on) in the language of the governing statutes. Perhaps those principles were really imposed by the individual justices and had no

President. Finally, the doctrine blatantly favors the Commissioner, as no taxpayer would dare make a substantive tax deduction in the absence of proper form. Such a taxpayer would risk tax penalties, or worse. Simply put, this doctrine paves a one-way street upon which only the Commissioner may travel.”)

⁹⁶See *Heinz*, 76 Fed. Cl. at 591.

⁹⁷See *supra* note 9 for articles discussing the Court’s opinions in further detail.

⁹⁸See, e.g., *Paulsen v. Commissioner*, 469 U.S. 131, 144 (1985) (O’Connor, J., dissenting) (criticizing “judicially imposed ‘continuity-of-interest’ doctrine”).

⁹⁹*Northwest Airlines v. Transp. Workers Union*, 451 U.S. 77, 95 (1981).

¹⁰⁰Charles S. Whitman, “Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code,” 81 *Harv. L. Rev.* 1194, 1258 n.9 (1968).

basis in the statute, but interpretations based on legal realism are not given consideration here.¹⁰¹

A. *Gregory v. Helvering*

Any discussion of the economic substance doctrine must begin, of course, with *Gregory v. Helvering*.¹⁰² In a two-page opinion, the Court examined a purported reorganization undertaken by the taxpayer, Evelyn Gregory. Gregory wished to extract Monitor Corp. stock held by her wholly owned corporation (UMC) so that she could sell that stock in her individual capacity. If UMC had sold the stock, two levels of tax would have been imposed — one on the corporation’s sale of the stock and another on the corporation’s distribution of the proceeds to Gregory.

Gregory preferred not to pay any taxes at all, however.¹⁰³ She thus tried to “bring about a [tax-free] ‘reorganization’ under section 112(g) of the Revenue Act.”¹⁰⁴ She caused UMC to create a transitory entity, Averill, to which UMC transferred the Monitor stock. Averill simultaneously issued all of its shares to Gregory. Gregory then liquidated Averill and claimed a fair market value basis in the Monitor stock she received in that liquidation. She then sold that stock to a third party.

Section 112 provided that stock received “in the pursuance of a plan of reorganization” results in no gain or loss recognition to a shareholder.¹⁰⁵ Gregory argued that the transfers involving Averill were in fact made in the pursuance of a plan of reorganization, despite Averill’s transitory existence. The commissioner countered that the transfers involving Averill must be disregarded and that Gregory was “liable for a tax as though [UMC] had

¹⁰¹See *Trans World Airlines, Inc. v. Franklin Mint Corp.*, 466 U.S. 243, 282-283 (1984) (Stevens, J., dissenting). (“Some students of the Court take for granted that our decisions represent the will of the judges rather than the will of the law. This dogma may be the current fashion, but I remain convinced that such remarks reflect a profound misunderstanding of the nature of our work.”) Even if the economic substance cases were decided in a results-oriented fashion, however, it is the opinions themselves (and not the hidden motives of the justices) that carry the imprimatur of the Court and that the lower courts must follow.

¹⁰²293 U.S. 465 (1935).

¹⁰³Through the operation of provisions not relevant here, Mrs. Gregory actually did incur some taxes under her purported reorganization. See 293 U.S. at 467.

¹⁰⁴*Id.* at 467.

¹⁰⁵See *id.* at 468:

The provisions of the section, so far as they are pertinent to the question here presented, follow: “Sec. 112. * * * (g) Distribution of Stock on Reorganization. If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock of securities shall be recognized. * * * (i) Definition of Reorganization. As used in this section * * * “(1) The term “reorganization” means * * * (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred.”

paid her a dividend consisting of the amount realized from the sale of the Monitor shares.¹⁰⁶

The Court acknowledged that Gregory's tax motive was irrelevant. Instead, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."¹⁰⁷ It thus examined whether the transfers involving Averill constituted a reorganization within the meaning of the statute. The Court found that, via the operation of section 112(g), transfers described in section 112(i)(1)(B) must be made in the pursuance of a business plan to constitute a reorganization; transfers made only to extract property from a corporation could not qualify. The Court stated:

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' (section 112(g)) 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. Putting aside, then, the question of motive in respect of taxation altogether, and fixing 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, and the sole object and accomplishment of which was the consummation of 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.¹⁰⁸

Although many lower courts have concluded otherwise,¹⁰⁹ the Court did not create a free-floating economic substance doctrine in *Gregory*. Rather, the Court found (rightly or wrongly) that the statute itself demanded a business purpose. Section 112(i)(1)(B) (as amplified by section 112(g)) required that a reorganization be conducted in the pursuance of a plan relating to corporate business in order to qualify for tax-free treatment. That Gregory's transfers were performed in accordance with the form of a reorganization was of little consequence — the statute demanded that those transfers also be a part of a plan "to reorganize a business or any part of a business."¹¹⁰ Because Averill's existence was merely transitory, the transfers involving the corporation could not be a part of a plan to reorganize a business. The Court thus rejected the taxpayer's arguments and affirmed the Second Circuit's holding "that there had been no 'reorganization' within the meaning of the statute."¹¹¹ It closed its opinion by reiterating that Gregory did not comply with section 112, stating that her transaction "upon its face lies outside the plain intent of the statute.

To hold otherwise would . . . deprive the statutory provision in question of all serious purpose."¹¹²

It is hard to see how a holding that is rooted in the "statutory provision in question" indicates that lower courts should ignore statutory provisions.¹¹³ It is even harder to see how an opinion that puts aside "the question of motive in respect of taxation altogether" indicates that a tax avoidance motive disqualifies a taxpayer from enjoying statutory benefits. *Gregory* does not give courts the right to disregard Congress's statutes, and the lower courts' contrary interpretation exalts artifice above reality.¹¹⁴ The Federal Circuit pointed to no statutory language in applying its economic substance analysis; the Supreme Court in *Gregory* expressly grounded its economic substance analysis in the language of section 112(i).¹¹⁵ The Third Circuit did not bother to perform any statutory analysis in holding against Camelot and considered Camelot's tax avoidance motives "damning"; the Supreme Court parsed the language of sections 112(g) and 112(i)(1)(B), and refused to examine Gregory's tax avoidance motive. The Tax Court did not even cite any of the statutes implicated by Compaq's transaction; the Supreme Court in *Gregory* quoted section 112 at length. *Gregory* offers no support for the argument that "economic substance is a prerequisite to the application of any Code provision allowing deductions."¹¹⁶

One might nonetheless argue that because the Court did not interpret section 112 literally, it ignored the statute in reaching its holding. But although the Court rejected a literal interpretation of the statute (it found that the "pursuance of a plan" referred to the pursuance of a business plan and not literally any plan), that does not mean it created a judicial doctrine. For example, if a statute provides that a taxpayer must "walk three steps" to secure a tax benefit, and the Court says that "walk three steps" actually means "walk three steps and dance," the Court has not created a judicial doctrine. It has, at most, misinterpreted the statute. To create a judicial doctrine, the Court would have to say that "although the words 'walk three steps' mean 'walk three

¹¹²*Id.* at 470.

¹¹³See also Isenbergh, "Musings on Form and Substance in Taxation," 49 *U. Chi. L. Rev.* 859, 874 (1982). (*Gregory* is "couched in the language, at least, of traditional statutory interpretation. *Gregory* purports to be striving for the meaning of the tax statute.")

¹¹⁴See 2 Martin Ginsburg and Jack Levin, *Mergers, Acquisitions and Buyouts*, para. 609.1 (2003) ("It is doubtful that the Supreme Court in *Gregory* intended to create a business purpose requirement of the sort that now encumbers the tax law. . . . [T]he Court framed the issue as 'whether what was done, apart from tax motive, was what the statute intended.'"); Durham, *supra* note 89, at 26 ("The expansive reading of *Gregory* to require an a priori, or 'generic' test of economic substance has no basis in *Gregory* itself. . . 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.'")

¹¹⁵See also John F. Prusiecki, "Coltec: More Points to Ponder," *Tax Notes*, Oct. 9, 2006, p. 188, Doc 2006-20635, 2006 TNT 196-34.

¹¹⁶*Lerman v. Commissioner*, 939 F.2d at 52.

¹⁰⁶*Id.* at 467.

¹⁰⁷*Id.* at 469.

¹⁰⁸*Id.* (emphasis supplied).

¹⁰⁹See, e.g., *Stauffer's Estate*, 403 F.2d 611 at 621; *Lerman*, 939 F.2d at 52; *ACM*, 157 F.3d at 246; *Killingsworth v. Commissioner*, 864 F.2d 1214, 1216 (5th Cir. 1989).

¹¹⁰*Id.* at 469.

¹¹¹*Id.* at 468 (citing 69 F.2d 809 (2d Cir. 1934)).

steps,' we nonetheless demand that the taxpayer dance." That would be an instance of judicial lawmaking.

As long as one is concerned with only the code's reorganization provisions, the distinction just described might not mean much. Regardless of the origin of the business purpose requirement, all that a taxpayer needs to know is that it needs to meet that requirement for its transaction to qualify as a reorganization. But because the lower courts impose a business purpose requirement onto all tax statutes allowing deductions,¹¹⁷ it is critical to recognize that the Court's application of economic substance principles was grounded in the statute itself. The Court in *Gregory* may have misinterpreted the statute,¹¹⁸ but it did not ignore it.

B. *Knetsch v. United States*

The taxpayer in *Knetsch v. United States* engaged in a transaction perhaps even bolder than Mrs. Gregory's. Knetsch borrowed funds at 3.5 percent from an insurance company, invested them with the company at 2.5 percent, and still made a profit.¹¹⁹ Knetsch did this by purchasing 10 annuity bonds (each with a 30-year term) from the company for \$400,000 each and by signing \$4 million of nonrecourse notes to cover the purchase price. The interest payments on account of the notes were payable in advance, and Knetsch used amounts attributable to increases in the annuity bonds' value to make the payments. Before accounting for tax consequences, Knetsch was actually worse off as a result of the transaction — the increases in the bonds' value did not completely offset his interest payments.¹²⁰ However, the 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.

Knetsch deducted his interest payments under section 163(a).¹²¹ That section allows a deduction for "interest paid . . . within the taxable year on indebtedness." The

¹¹⁷See *id.*

¹¹⁸The Court treated the statute's operative provision (section 112(g)) as bearing on the construction of the definitional provision (section 112(i)), when in fact it should have done the reverse. Definitional provisions are not self-executing and can serve only to clarify the meaning of operative provisions. The "pursuance of a plan" language in section 112(g) should have had no bearing on the meaning of the word "transfer" in section 112(i)(1)(B). Cf. Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 12.02[2] (7th Ed. 2002 and Supp. 2006). ("Although section 368(a)(1) defines the term 'reorganization,' it does not of its own force have any operative significance. Its definitions become important only as they are employed in other provisions of the Code.")

¹¹⁹364 U.S. 361 (1960).

¹²⁰Knetsch faced such a high tax rate that the arrangement, if respected for tax purposes, would nonetheless be profitable for him. For a comprehensive discussion of the *Knetsch* tale, see Daniel N. Shaviro, "The Story of *Knetsch*: Judicial Doctrines Combating Tax Avoidance," *Tax Stories* 318 (Paul Caron ed., 2003).

¹²¹Section 23(b) of the 1939 code applied to one of Knetsch's earlier tax years. That section had language substantially similar to that found in section 163(a) of the 1954 code.

government, however, denied Knetsch's deductions, arguing his payments did not constitute interest paid on indebtedness within the meaning of section 163(a).

Before examining the facts, the Court put aside the district court's finding that Knetsch's only motive in entering into the transaction was to secure a tax deduction.¹²² As in *Gregory*, "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended,"¹²³ and Knetsch's tax avoidance motive was therefore irrelevant. The Court then examined "the transaction between Knetsch and the insurance company to determine whether it created an 'indebtedness' within the meaning of [section 163(a)], or whether, as the trial court found, it was a sham."¹²⁴ The Court found that no indebtedness had been created and that the transaction resulted in only the "façade" of a loan.¹²⁵ Knetsch had merely shuffled funds using the annuity bonds and the nonrecourse notes, and his transactions "did not appreciably affect his beneficial interest except to reduce tax."¹²⁶ Actual indebtedness requires a "true obligation to pay interest,"¹²⁷ but Knetsch had no such obligation.¹²⁸ The Court agreed with the trial court that there was "no commercial economic substance" to the transaction; "the parties did not intend that Knetsch 'become indebted to [the insurance company]'" and "no indebtedness . . . was created by any of the transactions."¹²⁹

The Court plainly relied on section 163(a) in reaching its conclusion. It held that, because the parties did not create an actual indebtedness, no interest deductions could be taken by Knetsch — there was no obligation to pay interest.¹³⁰ That conclusion was grounded in a

¹²²364 U.S. at 365. ("We 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.'")

¹²³*Id.*

¹²⁴*Id.*

¹²⁵*Id.* at 366.

¹²⁶*Id.* (quoting *Gilbert v. Commissioner*, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, dissenting)).

¹²⁷*Id.* at 367.

¹²⁸*Id.* at 366.

¹²⁹*Id.* at 364-365 (punctuation omitted).

¹³⁰This report's interpretive approach is worth reiterating here. Many commentators have concluded that Knetsch did meet all the statutory requirements but that the Court imposed an additional economic substance test to deny him the claimed benefits. But that is not what the Court said. Rather, the Court plainly held that Knetsch's transaction did not create an "indebtedness." See *id.* Knetsch's transaction was required to have substance because the statutory term "indebtedness," ordinarily understood, contemplates real borrowing, not merely any arrangement that a taxpayer labels as such. The Court thus rejected Knetsch's contention that the arrangement resulted in legitimate borrowing. "It is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly 'lent' back was in reality only the rebate of a substantial part of the so-called 'interest' payments." *Id.* at 366. Because there was no real loan and no real interest, no genuine indebtedness had been created. See *id.* at 367-368. Nothing in the opinion suggests that, had Knetsch's transaction created genuine indebtedness, the Court would ignore his "mere compliance" with the statute.

common-sense interpretation of section 163(a)'s words, not in a judicial doctrine. If two parties do not intend to create and enforce a binding obligation, no "indebtedness" under section 163(a) can possibly be created.

The Supreme Court's approach in *Knetsch* is different from the lower courts' approach in economic substance cases. Unlike the Third Circuit in *In re CM Holdings*, the Supreme Court did not declare that it could forgo an analysis of section 163(a).¹³¹ Instead, the Court expressly framed the issue as one of statutory interpretation.¹³² Unlike the *Wexler* court, the Supreme Court did not announce that *Knetsch*'s transaction could be ignored even if it resulted in genuine indebtedness.¹³³ The Court found that *Knetsch*'s transaction did not create a "true obligation to pay interest,"¹³⁴ but nothing in the opinion suggests that genuine indebtedness is insufficient to warrant interest deductions. In fact, the opinion suggests the exact opposite.¹³⁵ And unlike the Federal Circuit in *Coltec*, the Court did not state that a subjective tax avoidance motive could disqualify the taxpayer from statutory benefits. Rather, the Court explicitly set aside the district court's finding on *Knetsch*'s tax avoidance motive as irrelevant.¹³⁶

The Supreme Court even acknowledged that Congress could grant favorable treatment to *Knetsch*'s sham transaction, but found nothing in the applicable statutes to suggest that Congress had done so.¹³⁷ That the transaction lacked economic substance provided no independent basis on which to deny *Knetsch* tax benefits — rather, it was the statute itself that required actual borrowing. But if the statutory language indicated that Congress did intend to grant favorable tax treatment to payments that were merely labeled as interest, the Court would give effect to that intent.¹³⁸

C. *United States v. Consumer Life*

Although the statute at issue in *Knetsch* demanded quite a bit of economic substance, not all statutes are as

demanding. In *United States v. Consumer Life Ins. Co.*, for example, the Court addressed whether a reinsurance transaction must shift economic risk in order to qualify for statutory benefits.¹³⁹ The taxpayer in that case, *Consumer Life*, claimed that it qualified as a life insurance company under section 801(a). That section provides that an insurance company is considered a life insurance company if its life insurance reserves comprise more than 50 percent of its total reserves.¹⁴⁰ Total reserves include life insurance reserves and unearned premiums not included in life insurance reserves.¹⁴¹ Stated simply, if more than half of an insurance company's reserves do not pertain to life insurance, it cannot qualify as a life insurance company under section 801(a).

Consumer Life had issued various accident and health (A&H) policies to the public. Because the unearned premiums attributable to those policies did not pertain to life insurance, they made it more difficult for *Consumer Life* to qualify under section 801(a). To remove those unearned premiums from its balance sheet, *Consumer Life* entered into a "treaty" with another insurance company, *American Bankers*. *American Bankers* became the primary insurer on the A&H policies, but *Consumer Life* (as reinsurer) retained all the risk. Nonetheless, *American Bankers* included the unearned premiums from the A&H policies on its books.¹⁴²

The government rejected the parties' allocation of unearned premiums and contended that they must be allocated entirely to *Consumer Life*.¹⁴³ That reallocation would prevent *Consumer Life* from qualifying as a life insurance company under section 801.¹⁴⁴ Citing *Gregory* and *Knetsch*, the government argued that the treaty reflected a "sham transaction without economic substance and therefore should not be recognized for tax purposes."¹⁴⁵

The Court dismissed the government's arguments. It noted that the treaty was entered into after an arm's-length negotiation between unrelated companies.¹⁴⁶ It also found that the treaty served basic business purposes and provided various economic benefits to *Consumer Life*.¹⁴⁷ The Court acknowledged that "tax considerations well may have had a good deal to do with the specific terms of the [treaty], but even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction."¹⁴⁸

The government nonetheless demanded more substance. It argued that the Court should adopt a "reserves follow the risk" rule, such that the unearned premium reserves must be allocated to *Consumer Life*, the ultimate risk-bearer. Although the Court acknowledged that the government's position appealed to "abstract logic," the

¹³¹See *In re CM Holdings*, *supra* Part II.B.

¹³²See 364 U.S. at 361. ("This case presents the question of whether deductions from gross income claimed on petitioners' 1953 and 1954 joint federal income tax returns . . . constituted 'interest paid on indebtedness' within the meaning of . . . 163 (a) of the Internal Revenue Code of 1954.")

¹³³See *Wexler*, *supra* Part II.D.

¹³⁴364 U.S. at 367. ("The petitioners thus would attribute to Congress a purpose to allow . . . payments under transactions of the kind carried on by *Knetsch* with the insurance company without regard to whether the transactions created a true obligation to pay interest.")

¹³⁵The Court expressly acknowledged that arrangements which create actual indebtedness would give rise to interest deductions. See *id.* at 367. ("There may well be single premium annuity arrangements with nontax substance which create an 'indebtedness' for the purposes of section 163(a). . . . But this one is a sham.")

¹³⁶See *supra* note 122.

¹³⁷*Id.* at 367. ("We . . . look to the statute and materials relevant to its construction for evidence that Congress meant . . . to authorize the deduction of payments made under sham transactions. . . . We look in vain.")

¹³⁸*Id.*

¹³⁹430 U.S. 725 (1977).

¹⁴⁰*Id.* at 727.

¹⁴¹*Id.* at 729.

¹⁴²See *id.* at 734.

¹⁴³See *id.* at 731.

¹⁴⁴See *id.*

¹⁴⁵*Id.* at 736-737.

¹⁴⁶*Id.* at 737.

¹⁴⁷*Id.* at 737-739.

¹⁴⁸*Id.* at 739.

relevant issue was “whether Congress intended a ‘reserves follow the risk’ rule to govern determinations under section 801.”¹⁴⁹ The statutory language indicated no such intent:

There is no suggestion in the plain language of the section [of a “reserves follows risk” rule] . . . If anything, the language is a substantial obstacle to accepting the Government’s position. The word “risk” does not occur.¹⁵⁰

Because the statute did not provide a risk requirement, the Court had no basis to invent one, even if that requirement was “logic[al].”¹⁵¹

If the Court had decided *Consumer Life* in the way that the lower courts decide economic substance cases, *Consumer Life* would have lost. *Consumer Life* had a significant tax-reduction motive, and it did not shift risk through its transactions. Either of those factors alone could disqualify the company from favorable tax treatment under the lower courts’ free-floating test.¹⁵² However, the Court examined the applicable statutes and applied Congress’s intent, not its own, and could find nothing to suggest that the legislature required risk-shifting or the absence of a tax-reduction motive as a prerequisite to the enjoyment of tax benefits under section 801.

D. *Frank Lyon v. United States*

Although economic risk was irrelevant in *Consumer Life*, that does not mean it is always irrelevant. If Congress makes risk-taking a prerequisite to the enjoyment of a statutory benefit, the taxpayer must bear the required risk. That principle is illustrated by *Frank Lyon v. United States*.¹⁵³

In *Frank Lyon*, the taxpayer entered into a sale-leaseback agreement with a commercial bank (Worthen). Worthen wished to purchase a building out of which to operate its banking business, but regulatory restrictions prevented it from doing so.¹⁵⁴ The government regulators did offer conditional approval of a sale-leaseback transaction, however. Worthen thus purchased a suitable building and sold it piece by piece to Lyon as it was constructed. On the building’s completion, Frank Lyon immediately leased the building back to Worthen.¹⁵⁵

Under the parties’ agreement, Worthen had an option to purchase the building at the end of the lease. Worthen could exercise that option simply by paying Lyon the FMV of the building *when the lease was entered*. Thus, in the likely event that the building appreciated, Worthen could purchase the building at a below-market price. If Worthen did not wish to exercise that option, it could renew the lease at highly favorable terms. Worthen was therefore positioned to enjoy the economic appreciation

in the building, one of the most valuable rights associated with ownership in property.¹⁵⁶

Lyon nonetheless claimed that it was the owner of the building and that it was entitled to take depreciation deductions under section 167.¹⁵⁷ The Eighth Circuit, in accordance with the government’s contentions, disagreed and concluded that “the benefits, risks, and burdens which [Lyon] has incurred with respect to the Worthen building are simply too insubstantial to establish a claim to the status of owner for tax purposes.”¹⁵⁸

The Supreme Court performed an intensely factual analysis of the parties’ arrangements. The Court observed that it would not:

permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property over transferred. In applying this doctrine of substance over form, the Court has looked to the objective economic realities of the transaction rather than to the particular form the parties employed.¹⁵⁹

Although Lyon was not the owner of the property in the simple sense, the Court concluded that Lyon was the owner of property for purposes of section 167. The Court emphasized Lyon’s risk-bearing:

No matter how the transactions could have been devised otherwise, it remains a fact that as the agreements were placed in final form, the obligation . . . fell squarely on Lyon. Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk.¹⁶⁰

The Court concluded that because Lyon’s “capital is invested in the building . . . it is Lyon that is entitled to depreciation deductions under section 167.”¹⁶¹ It then reiterated its holding in more general terms:

In short, we hold that where, 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. Expressed another way, so long as the lessor retains significant and genuine attributes

¹⁴⁹*Id.* at 740.

¹⁵⁰*Id.*

¹⁵¹*See id.*

¹⁵²*See, e.g., Coltec, supra* Part II.A.

¹⁵³435 U.S. 561 (1978).

¹⁵⁴*See id.* at 565.

¹⁵⁵*See id.*

¹⁵⁶*See id.* at 571. Worthen also had various other ownership rights in the property, which caused the Eighth Circuit to conclude that Frank Lyon had “toted an empty” bundle of ownership sticks and could not qualify for deductions under section 167. *Id.* at 570-571 (*quoting* 536 F.2d 746, 751-753 (8th Cir. 1976)).

¹⁵⁷Section 167 generally allows the owner of property depreciation deductions on account of that property’s wear and tear. Section 167(a) does not explicitly provide an ownership requirement, but one is implied by a fair reading of the statute.

¹⁵⁸435 U.S. at 572 (*citing* 536 F.2d at 754).

¹⁵⁹435 U.S. at 572.

¹⁶⁰*Id.* at 577.

¹⁶¹*Id.* at 581 (punctuation omitted).

of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.¹⁶²

Lower courts have seized on the first sentence from that passage to conclude that the Court created a free-floating economic substance doctrine.¹⁶³ But it did no such thing. Although the Court did state that a transaction imbued with economic substance must be respected, that statement is simply part of the ownership test under section 167.¹⁶⁴ In fact, in the very next sentence, the Court expressed its pedestrian holding in another way: As long as a nominal lessor retains “genuine attributes of the traditional lessor status,” the form of the sale-leaseback will be respected.¹⁶⁵

In a later decision, *Nebraska Dept. of Revenue v. Loewenstein*, a unanimous Court explicitly refused to apply *Frank Lyon*'s holding to a statute that did not refer to ownership.¹⁶⁶ Given that the Supreme Court itself refused to apply *Frank Lyon* outside of the ownership context, it is hard to understand why lower courts think that case is relevant in every context. The Court's refusal to apply a free-floating economic substance test in *Loewenstein* plainly indicates that statutory language must be examined in determining whether and how to apply economic substance principles, but the lower courts have somehow missed the message.

E. *Cottage Savings v. Commissioner*

In *Cottage Savings v. Commissioner*, the Court addressed whether a reciprocal sale of mortgages qualified as a sale or other disposition within the meaning of section

1001.¹⁶⁷ Cottage Savings, a savings and loan association (S&L), held numerous long-term, low-interest mortgages that had declined in value when interest rates surged in the late 1970s.¹⁶⁸ The company wished to sell those mortgages and thereby recognize a large tax loss, but the Federal Home Loan Bank Board (FHLBB) generally required S&Ls to record losses from such sales on their books. If Cottage Savings' losses were reflected on its books, it could face closure by the agency.

In 1980 the FHLBB relaxed its reporting requirements. The agency ruled that losses from a sale of mortgages need not be reported on an S&L's books if those mortgages were exchanged for “substantially identical” mortgages held by other lenders.¹⁶⁹ That ruling cleared the way for Cottage Savings to swap mortgages with other lenders and thereby recognize a tax loss.

To accomplish its desired tax result, Cottage Savings sold its interest in 250 mortgages to four other S&Ls. It simultaneously purchased interests in 300 mortgages held by those S&Ls. The face value (and the basis) of the mortgages sold by Cottage Savings was \$7 million, whereas the FMV of the mortgages it had exchanged them for was \$4.5 million. Cottage Savings thus claimed a tax loss of \$2.5 million on account of its transaction with the other S&Ls.

Section 1001 governed the tax treatment of Cottage Savings' transaction. That section provides that to realize a gain or loss on property, the taxpayer must effect a “sale or other disposition of [the] property.” Thus, even if property held by a taxpayer declines in value, the taxpayer cannot recognize a tax loss until a “realization” event.¹⁷⁰ Regulations issued under section 1001 stated that gain or loss is realized when a taxpayer converts its property into cash, or when it exchanges its property for materially different property.¹⁷¹

In accordance with the regulation, the Court stated that Cottage Savings would realize a tax loss on its reciprocal sale if the mortgages it exchanged were materially different from those which it received. The commissioner, however, argued that the “materially different” language contemplated an economic substance analysis. The Court rejected that argument:

The Commissioner argues that properties are “materially different” only if they differ in economic substance. To determine whether the participation interests exchanged in this case were “materially different” in this sense, the Commissioner argues, we should look to the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB. We conclude that section 1001(a) embodies a much less demanding and less complex test.¹⁷²

¹⁶²*Id.* at 583-584.

¹⁶³See Yoram Keinan, “The Many Faces of the Economic Substance's Two-Prong Test: Time for Reconciliation?” 1 *NYU J.L. & Bus.* 371 (2005), for a discussion of the lower courts' various interpretations of *Frank Lyon*.

¹⁶⁴435 U.S. at 583-584.

¹⁶⁵*Id.* at 584.

¹⁶⁶See 513 U.S. 123, 133-134 (1994) (“Respondent relies on our statement in *Frank Lyon*. . . . But the dispositive question is whether the Trusts earned interest on ‘obligations of the United States Government,’ not whether the Trusts ‘owned’ such obligations. As respondent himself concedes, ‘the concept of ‘ownership’ is simply not an issue under [31 U.S.C. section 3124].”) (emphasis added). In *Loewenstein*, the Court examined the economic realities of the taxpayer's transaction in a manner consistent with statutory language. The statute at issue in that case protected interest on “obligations of the United States Government” from state taxation. See 31 U.S.C. section 3124. Thus, the Court examined the taxpayer's transaction to determine whether the interest he received was in fact on account of an obligation of the U.S. government. But the Court did not disregard the statute in favor of an examination of the taxpayer's business purposes or potential for profit, as the lower courts might have done. Rather, a unanimous Court acknowledged that the dispositive question was whether the amount the taxpayer received constituted “interest” within the meaning of the statute. See *id.* Because *Frank Lyon* focused on the issue of tax ownership, its holding simply was not relevant in *Loewenstein*. See *id.* Nonetheless, lower courts continue to believe that *Frank Lyon* creates a universal two-prong test to apply to all tax transactions. See Keinan, *supra* note 163.

¹⁶⁷499 U.S. 554 (1991), *rev'g* 890 F.2d 848 (6th Cir. 1989).

¹⁶⁸See *id.* at 556.

¹⁶⁹See *id.* at 557.

¹⁷⁰Section 1001(c) states that gain or loss realized under section 1001 must be recognized.

¹⁷¹See reg. section 1.1001-1.

¹⁷²*Id.* at 562.

Nothing in the regulation's "materially different" language suggested that the taxpayer's attitude or business purpose must be examined, and the Court refused to make those examinations. The Court flatly rejected the commissioner's contention that "exchanges of properties must satisfy a subjective test to trigger realization of a gain or loss."¹⁷³ Instead, the Court found that that so long as the properties exchanged embodied legally distinct entitlements,¹⁷⁴ they would be considered materially different, and concluded that Cottage Savings' transaction easily satisfied that test. The Court further rejected the argument that the taxpayer's losses were not real, disagreeing with the commissioner that the taxpayer's loss somehow "lacked 'economic substance.'"¹⁷⁵

Although the Court clearly relied on statutory language in reaching its decision, *Cottage Savings* is often viewed as only an exception to the economic substance doctrine.¹⁷⁶ One court has even rejected the Court's "less complex and less demanding" interpretation of section 1001 and has held that the economic substance doctrine continues to float over that statute.¹⁷⁷ One prominent commentator suggests that the Court simply erred, saying that in *Cottage Savings*:

the Supreme Court ignored the economic substance argument altogether and focused almost entirely on the obvious point that the losses were realized under section 1001. Even the dissent seems to have missed the point, arguing that the losses were not realized under section 1001.¹⁷⁸

Those comments aside, the Supreme Court did not miss anything. It had no reason to address a free-floating economic substance doctrine because it never created that doctrine. Instead, the Court followed its usual approach: It examined the governing statute and applied it to the facts in front of it.

There is no doubt that the Court's analysis in *Cottage Savings* is different from that seen in the Court's previous cases. In *Cottage Savings*, the Court did not examine whether the taxpayer had a business purpose or whether the reciprocal sale appreciably affected the taxpayer's

beneficial interest. But the Court's seemingly narrow analysis is easily explained by the governing statute. Section 1001, reasonably interpreted, is not limited to only those transactions in which a taxpayer exchanges property with a business purpose or in a transaction in which he expects to profit. If a taxpayer, solely for tax reasons, goes to an automobile dealer and exchanges his car for \$5,000 or for a different car, he has no less sold or disposed of the car than if he had done so with a business purpose or with a profit expectation. Indeed, *Cottage Savings* involved a mundane transaction, and there was no reason for the lower courts (much less the Supreme Court) to go beyond the "materially different" language in determining whether the taxpayer could recognize a loss. That Cottage Savings' simple mortgage swap was even a candidate for economic substance analysis demonstrates that the doctrine has gone too far.

Although economic substance analysis was misplaced in *Cottage Savings*, that does not mean that it is always misplaced. *Cottage Savings* does not foreclose all economic substance inquiries. Rather, it indicates that courts should not make those inquiries unless a fair interpretation of the governing statute makes those inquiries relevant. Indeed, Congress remains free to enact a statute that makes a profit motive a prerequisite to the enjoyment of tax benefits.

F. *Portland Golf v. Commissioner*

In *Portland Golf v. Commissioner*, the Court addressed whether the taxpayer's absence of a profit motive prevented it from enjoying deductions under section 162.¹⁷⁹ In that case, Portland Golf, an organization exempt from tax under section 501(c)(7), operated a private golf and country club. Although gains and losses from a section 501(c)(7) organization's social activities are generally ignored in calculating its taxable income, gains and losses from nonsocial activities must be calculated separately and are not exempt from tax. Portland Golf engaged in two activities unrelated to its tax-exempt social purposes — it sold food at its club and also made various financial investments.

Portland Golf suffered losses from its food sales and wished to use those losses to offset gains it enjoyed from its investments. The taxpayer claimed a loss on account of the food sales under section 162(a), which provides a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The commissioner did not allow that loss, finding that losses deducted under section 162 must relate to a taxpayer's for-profit activities, and that Portland Golf did not sell food to make a profit. Portland Golf countered that section 162 did not impose a profit-motive requirement and that it was entitled to deductions under that statute — it had unquestionably lost money from its sales. It argued alternatively that even if section 162 imposed a profit motive requirement, it did seek profits from its food sales.

The Court acknowledged that Portland Golf would be able to deduct losses from its food sales if those losses

¹⁷³*Id.* at 565.

¹⁷⁴*Id.* at 566.

¹⁷⁵*Id.* at 567-568.

¹⁷⁶See *infra* notes 194-198.

¹⁷⁷See *ACM*, 157 F.3d at 251. ("ACM contends that the Tax Court was bound to respect the tax consequences of ACM's exchange of Citicorp notes for LIBOR notes because, under *Cottage Sav. Ass'n v. Commissioner*, an exchange of property for 'materially different' assets is a substantive disposition whose tax effects must be recognized. We find *Cottage Savings* inapposite.") Judge McKee, writing in dissent, criticized the majority for ignoring *Cottage Savings*. See *id.* at 263. ("By finding that ACM's sales of the Citicorp notes for cash and LIBOR Notes 'satisfied each requirement of the contingent installment sales provisions and the ratable basis recovery rule,' yet, simultaneously subjecting these transactions to an economic substance and sham transaction analysis, the majority has ignored the plain language of IRC section 1001, and controlling Supreme Court precedent. We have injected the 'economic substance' analysis into an inquiry where it does not belong.")

¹⁷⁸Hariton, *supra* note 9, at 256.

¹⁷⁹497 U.S. 154 (1990).

were described in section 162. However, the Court agreed with the commissioner that the statute required a profit motive as a prerequisite to the enjoyment of its benefits. In an earlier case, *Groetzinger*, the Court observed that the statutory term “business,” commonly understood, is “that which occupies the time, attention and labor of men for the purpose of a livelihood or profit.”¹⁸⁰ Thus, the Court found that a profit motive was implicit in section 162’s reference to the carrying on of a business.¹⁸¹

The Court then examined whether Portland Golf was motivated by profit in selling food at the club. Although the Court found that the taxpayer had suffered losses from its food sales, that fact did “not, by itself, prove that Portland Golf lacked a profit motive.”¹⁸² Nonetheless, the Court found that the taxpayer “failed to show that it intended to earn gross income from nonmember sales in excess of its total . . . costs”¹⁸³ and consequently held in favor of the commissioner.

Portland Golf casts doubt on the lower courts’ interpretation of *Gregory*. If *Gregory* and its progeny indicate that “mere compliance with the Code provisions resulting in a tax advantage will be sanctioned by the courts only when there is, independent of the tax consequences, business or corporate purpose,”¹⁸⁴ and that the economic substance doctrine is a prerequisite to any Code provision allowing deductions,¹⁸⁵ then much of the Court’s statutory analysis in *Portland Golf* (and in *Groetzinger*) is superfluous. The Court would not have had to perform a careful parsing of section 162’s language and a thorough examination of the statute’s history to conclude that it required a profit motive. Rather, if *Gregory* imposes a profit requirement onto all statutes offering deductions, the Court would have stated that the “carrying on of a trade or business” language in section 162 is irrelevant — a free-floating business purpose test would apply regardless of what Congress said. But unlike the lower courts, the Supreme Court examined the statutory language and applied economic substance principles in a manner consistent with that language, not in contravention of it.

G. *Landreth Timber Company v. Landreth*

Because it is not only tax statutes that contain economic terms, the Court will examine economic substance principles whenever a statute makes those principles relevant, regardless of where it is codified. For example, in *Landreth Timber Co. v. Landreth*,¹⁸⁶ the Court interpreted the term “stock” as it found in section 2(1) of the

Securities Act of 1933.¹⁸⁷ *Landreth Timber Co.* had purchased stock from *Landreth* and argued that *Landreth* had made misrepresentations regarding the stock in violation of the securities act. *Landreth* countered that although the instrument he sold was labeled stock, an analysis of the economic substance of the instrument would indicate that it did not fit that description, and the securities act could not therefore apply to his sale.¹⁸⁸

The Court acknowledged that it had “decided a number of cases in which it looked to the economic substance of the transaction, rather than just to its form, to determine whether [the securities act] applied.”¹⁸⁹ The Court discussed its prior decision in *SEC v. W.J. Howey*, in which it held that an unusual instrument constituted a security within the meaning of the securities act “because, looking at the economic realities, the transaction ‘involve[d] an investment of money in a common enterprise with profits to come solely from the efforts of others.’”¹⁹⁰ According to the Court, mere labels cannot determine whether a financial instrument falls within the purview of the securities laws.¹⁹¹ Rather, the economic substance of an instrument must be examined. The Court proceeded to examine the “stock” at issue in *Landreth Timber* and concluded that it was what it was purported to be, finding in favor of the petitioner.

Although the Court examined economic substance principles in *Landreth Timber*, it did not create a free-floating doctrine. The application of economic substance principles was grounded in the statute. The term “stock,” in the context of the securities act, describes financial instruments bearing specific economic characteristics,¹⁹² and not simply any instrument that is labeled as such. But the Court did not examine whether the seller had a “securities act avoidance” motive in structuring his sale because a fair interpretation of the statute did not make that examination relevant. And the Court did not state that “mere compliance” with the securities act is insufficient to obtain an exemption under the statute. *Landreth Timber* is thus entirely consistent with *Gregory*, *Knetsch*, *Consumer Life*, *Frank Lyon*, *Cottage Savings*, and *Portland*

¹⁸⁷15 U.S.C.A. section 77b(a)(1).

¹⁸⁸471 U.S. at 688. If the instrument was not in fact stock, *Landreth Timber Co.* would not have been able to seek relief under the securities act.

¹⁸⁹*Id.*

¹⁹⁰*Id.* at 689 (quoting *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)).

¹⁹¹*See id.* at 688. (“Respondents are correct that in *Forman* we eschewed a ‘literal’ approach that would invoke the Acts’ coverage simply because the instrument carried the label ‘stock.’”)

¹⁹²*See id.* at 686. (“We identified those characteristics usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.”)

¹⁸⁰*Commissioner v. Groetzinger*, 480 U.S. 23, 28 (1987) (quoting *Flint v. Stone Tracy Co.*, 220 U.S. 107, 171 (1911)) (emphasis supplied).

¹⁸¹*See also* 497 U.S. at 173 (Kennedy, J., concurring). (“Although [section 162(a)] does not require a profit motivation by its express terms, we have inferred such a requirement because the words ‘trade or business,’ in their ordinary usage, contemplate activities undertaken to earn a profit.”)

¹⁸²*Id.* at 171 n.22.

¹⁸³*Id.* at 171.

¹⁸⁴*Stauffer’s Estate*, 403 F.2d 611.

¹⁸⁵*Wexler*, 31 F.3d 127.

¹⁸⁶471 U.S. 681 (1985).

Golf. In each, the Court applied economic substance principles to the extent the statute demanded, and no more.¹⁹³

H. Summary

Gregory, *Knetsch*, *Consumer Life*, *Frank Lyon*, *Cottage Savings*, *Portland Golf*, and *Landreth* demonstrate that the Court demands only as much (or as little) economic substance as Congress's statutes implicitly or explicitly require. Sometimes, as in *Consumer Life*, the applicable statute indicates that economic risk is irrelevant. At other times, as in *Frank Lyon*, the applicable statute indicates that economic risk should be the central focus of the inquiry. Sometimes, as in *Gregory* or *Portland Golf*, the statute indicates that inquiries regarding a taxpayer's motives are relevant, but at other times, as in *Cottage Savings*, the statute makes those inquiries irrelevant. One can argue that the Court erred in determining how much substance each statute required. Nevertheless, it is clear that the Court's application of economic substance principles stemmed from its analysis of the governing statutes and not from a free-floating doctrine.

That *Gregory* has long been invoked to ignore tax statutes may make one hesitant to accept this conclusion. But even if one believes that the interpretation of *Gregory* offered here is unduly narrow, the Court's subsequent cases indicate that the Court itself has adopted a similar interpretation. In none of those cases — including *Knetsch* — did the Court apply the method seen in *Compaq* and fail to cite the statutes implicated by a taxpayer's transaction. Nor did the Court ever use the *Coltec* approach and hold that a taxpayer qualified under the applicable statutes but then deny it the benefits regardless. And the Court never dismissed statutory analysis as a mere formality, as the Third Circuit did in *In re CM Holdings*. Only in *Consumer Life* did the Court even entertain the argument that the absence of a business purpose might itself invalidate a transaction, but even in that case, the Court swiftly rejected the government's contentions and focused on the applicable statutes in holding for the taxpayer.

One can offer various explanations for the Court's continued refusals to ignore statutory language. Perhaps the Court overlooks the economic substance doctrine,¹⁹⁴ perhaps the Court creates special exceptions to the doctrine,¹⁹⁵ perhaps the Court makes a "political decision" to

¹⁹³See also *Florida v. Long*, 487 U.S. 223, 235 (1988) (examining economic substance of pension plan to determine whether it violated the sex discrimination prohibitions of Title VII of the Civil Rights Act of 1964), and *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 792-793 (1984) (Stevens, J., dissenting) (examining economic substance of corporate arrangement to determine whether it constituted "combination or conspiracy in restraint of trade" within the meaning of the Sherman Act).

¹⁹⁴See Hariton, *supra* note 9, at 256.

¹⁹⁵See Gerald W. Miller Jr., "Corporate Tax Shelters and Economic Substance: An Analysis of the Problem and Its Common Law Solution," 34 *Tex. Tech L. Rev.* 1015, 1060 (2003). ("It becomes clear that *Cottage Savings* should probably stand for the proposition that the economic substance doctrine does not

(Footnote continued in next column.)

sometimes ignore the doctrine;¹⁹⁶ perhaps the Court selectively employs the doctrine;¹⁹⁷ or perhaps the Court does not apply the doctrine when it feels sorry for a taxpayer.¹⁹⁸ But the simplest explanation is the best one. In its two-page opinion in *Gregory*, the Court did not take the radical step of stating that the legislature's enactments should be tossed aside in favor of judicial tests. The statute-focused approach seen in the Court's subsequent cases confirms this common-sense conclusion.

IV. Recommended Approach

A. Extent of Substance

While the facts in the economic substance cases are complex, the difference between the lower courts' approach and the Supreme Court's approach can be illustrated by a simple example. Suppose Congress enacts a statute stating that taxpayers will receive a tax benefit on a disposition of property. Suppose further that a taxpayer, motivated solely by the statutory benefit, transfers to a third person some (but not all) rights in a piece of property.

To determine whether the taxpayer qualifies for the statutory benefit, the Supreme Court would likely examine whether the purported transfer constituted an actual disposition. Because in interpreting a tax statute the Court "look[s] to the 'ordinary, everyday senses' of the words,"¹⁹⁹ and because the word "disposition" ordinarily connotes a relinquishment of significant rights in property,²⁰⁰ the Court would likely examine whether sufficient rights had in fact been relinquished.²⁰¹ That is all the substance that the statute requires and all that the Court would demand.²⁰²

apply to non-economic transactions encountered in the taxpayer's ordinary course of business that are within the statutory ambit.")

¹⁹⁶See Lee A. Sheppard, "Corporate Shelters: A Snowball's Chance of Pretax Profit," *Tax Notes*, Aug. 7, 2000, p. 728, *Doc 2000-20826*, 2000 *TNT* 152-3. (*Cottage Savings*' transaction "had no discernable economic substance and no *raison d'être* other than the recognition of losses for tax purposes. So what? The Supreme Court made a political decision to let the struggling savings and loan industry help itself to yet more taxpayer funds. The *Cottage Savings* decision should be limited to its facts; it has no broader application than the *Bob Jones University* decision.")

¹⁹⁷See *Coltec*, 454 F.3d at 1353. ("We fail to see how the existence of other Supreme Court cases that do not rely on the doctrine undermine the authority of those that do.")

¹⁹⁸See Hariton, *supra* note 9, at 257. ("We may draw from [*Cottage Savings*] the somewhat obvious conclusion that no tax result will be disallowed for lack of economic substance if the court has sympathy for that result.")

¹⁹⁹*Commissioner v. Soliman*, 506 U.S. 168, 174 (1993) (quoting *Malat v. Riddell*, 383 U.S. 569, 571 (1966) (*per curiam*) (*in turn* quoting *Crane v. Commissioner*, 331 U.S. 1, 6 (1947))).

²⁰⁰See *Black's Law Dictionary* (8th ed. 2004) (defining disposition as "the relinquishing of property").

²⁰¹*Cf. Cottage Savings*, *supra* Part III.E. See also *id.* at 568 (discussing *Higgins v. Smith*, 308 U.S. 473 (1939), in which the Court "held that a taxpayer did not sustain a loss by selling securities below cost to a corporation in which he was the sole shareholder" and in which "losses were not bona fide because

(Footnote continued on next page.)

A lower court, contrarily, might not even examine whether the taxpayer relinquished rights in the property. Rather, the mere fact that the taxpayer was motivated solely by tax incentives might be sufficient to prevent her from enjoying the statutory benefit.²⁰³ Alternatively, a lower court might examine the transaction and agree that a disposition within the meaning of the statute had been effected, but deem “mere compliance” with the code insufficient and deny her statutory benefits regardless.²⁰⁴ The court might even impose penalties on the taxpayer, despite her compliance with the statute.²⁰⁵ If the taxpayer were facing criminal charges, the court might instruct the jury that compliance with a statute is insufficient to escape conviction.²⁰⁶

The two approaches to statutory interpretation are completely different. If a taxpayer has complied with a statute, the Court’s inquiry ends. The Court has never said that it will disregard a transaction that has “complied with each and every of the relevant requirements imposed by the Code.”²⁰⁷ The lower courts, contrarily, apply economic substance principles regardless of what Congress says.

The Supreme Court should instruct the lower courts to apply economic substance principles only to the extent that a fair interpretation of the applicable statute makes those principles relevant. This would bring tax law closer to other areas of federal law, in which it would be unthinkable for a court to disregard a citizen’s mere compliance with a statute, or imprison her despite that compliance.²⁰⁸ Further, judicial resources would be conserved in cases like *Compaq*, in which the commissioner stipulates that the taxpayer has complied with all statutory requirements.²⁰⁹ If the lower courts recognize that

the transaction was not conducted at arm’s length and because the taxpayer retained the benefit of the securities through his wholly owned corporation”).

²⁰²See, e.g., *Commissioner v. Brown*, 380 U.S. 563, 570 (1965). (“To say that there is no sale because there is no risk-shifting . . . has rationality but it places an unwarranted construction on the term ‘sale.’ . . . We reject it.”)

²⁰³See, e.g., *Coltec*, 454 F.3d at 1355. (“The doctrine may well also apply if the taxpayer’s sole subjective motivation is tax avoidance even if the transaction has economic substance.”)

²⁰⁴See also Donald L. Korb, “Korb Gives Speech on Economic Substance Doctrine,” *Doc 2005-1540*, 2005 *TNT* 16-22 (Jan. 25, 2005). (“It is not enough for a transaction to have merely occurred. The transaction must have appreciably changed the taxpayer’s net economic position before it will be given effect for tax purposes.”)

²⁰⁵See *Compaq*, *supra* Part II.C.

²⁰⁶See *Wexler*, *supra* Part II.D.

²⁰⁷*Heinz*, 76 Fed. Cl. at 591.

²⁰⁸That lower courts freely disregard tax statutes (but usually pay heed to nontax statutes) may be due to a phenomenon aptly described as tax myopia. See Paul L. Caron, “Tax Myopia, or Mamas Don’t Let Your Babies Grow Up to Be Tax Lawyers,” 13 *Va. Tax Rev.* 517, 518 (1994). (“Tax law too often is mistakenly viewed by lawyers, judges, and law professors as a self-contained body of law . . . this misperception has impaired the development of tax law by shielding it from other areas of law that should inform the tax debate.”)

²⁰⁹See *supra* Part II.C.

“mere compliance” with a statute is enough, there will be no reason to waste time addressing arguments based solely on a free-floating doctrine.

One might nonetheless question whether requiring courts to apply statutory language will make a difference in the outcomes of cases. Perhaps, even if lower courts are restricted to the statute, they will just bend over backwards to find against taxpayers. Similarly, in criminal cases, perhaps defendants will be convicted regardless of jury instructions. Perhaps the distinctions discussed here reflect nothing more than a petty debate over semantics. But “the practice of tax law is fundamentally the practice of statutory interpretation,”²¹⁰ and debates over semantics lie at the heart of that practice. The Tax Court has even been reversed for misinterpreting the word “the.”²¹¹

An examination of statutory language (rather than the application of a doctrine) will make a difference in many economic substance cases. In *Consumer Life*, for example, the Supreme Court reversed the Fifth Circuit after the lower court had used a “judicial overlay” to impose requirements that were nowhere to be found in the governing statute.²¹² In *Coltec* and *Compaq*, the Federal Circuit and Tax Court could find nothing in the applicable statutes that would deny the taxpayers their claimed benefits.²¹³ Surely those cases would have been decided differently had the courts followed the Supreme Court’s approach and observed statutory language. In *Wexler*, the government expressly stated that it would have a harder time prosecuting individuals if it could not invoke a judicial doctrine — the doctrine does make a difference in criminal cases. And in *Horn*, the D.C. Circuit reached a result entirely different from that reached by courts that had applied a free-floating doctrine.²¹⁴ The D.C. Circuit explicitly noted that the taxpayer’s transaction lacked economic substance, but it analyzed section 108 of the Deficit Reduction Act “to see whether it

²¹⁰Brian Galle, “Interpretative Theory and Tax Shelter Regulation,” 26 *Va. Tax Rev.* 357, 358 (2006).

²¹¹See *The Limited, Inc. v. Commissioner*, 286 F.3d 324, 333 *Doc 2002-8860*, 2002 *TNT* 71-10 (6th Cir. 2002), *rev’g* 113 T.C. 169, *Doc 1999-29280*, 1999 *TNT* 173-5 (1999). (“Rather than conduct the above plain-language analysis, the Tax Court focused on the term ‘the’ in the phrase ‘the banking business.’ Reading meaning into a definite article has been rejected by at least one other circuit and it is hardly the wisest place to begin statutory interpretation.”)

²¹²See *supra* Part II.C. See also *First R.R. & Banking Co. of Georgia v. United States*, 514 F.2d 675 (5th Cir. 1975) (Roney, J., dissenting). (“Had Congress desired to define a life insurance company in terms of the ultimate risk, it could have easily done so. The judicial overlay to that effect is an unnecessary intrusion into the legislative process. Reserves being the lodestar, they should control.”) *First R.R.* was consolidated with two other cases after the taxpayer filed a petition for a writ of certiorari and was reversed by the Supreme Court in *Consumer Life*.

²¹³See *supra* Part II.A and II.C.

²¹⁴See 968 F.2d at 1234. (“Although the result in this case seems straightforward to us, our judgment is offered with some trepidation in light of the contrary conclusions reached by three sister circuits, the Tax Court and the Commissioner.”)

nonetheless authorize[d] the claimed deductions,"²¹⁵ finding in favor of the taxpayer. Other circuits simply refused to undertake that analysis and reached the opposite result, stating that "section 108 does not even come into play."²¹⁶

The debate over whether courts should apply a statute's terms rather than a judicial doctrine is not frivolous.²¹⁷ Language does make a difference. "The entire concept of written law, indeed of all verbal communication, depends on the idea that words have *some* meaning,"²¹⁸ and statutory language, if observed, does place an "objective constraint on [a judge's] conduct."²¹⁹

In some cases, of course, applying a statute (rather than a judicial doctrine) will not make a substantive difference. In those cases, a judicial doctrine would merely serve as an "anodyne for the pains of reasoning,"²²⁰ and if a court undertakes the pains of statutory analysis, it will find against the taxpayer.²²¹ For example, claimed tax benefits regarding the worst variants of so-called LIFO transactions can be denied not because those transactions fail a judge-made test, but simply because circular transfers of funds and rights do not create genuine, distinct leases and should not be respected as such. See Rev. Rul. 2002-69, 2002-2 C.B. 760, Doc 2002-23195, 2002 TNT 199-1.

²¹⁵*Id.* at 1238. ("While following the parties' assumptions that the transactions at issue here were not entered into for economic profit and that no evidence has shown a nontax business purpose, we analyze section 108 to see whether it nonetheless authorizes the claimed deductions.")

²¹⁶See *Lerman*, 939 F.2d at 52. ("Because [these transactions] are not recognized for tax purposes, section 108 does not even come into play.")

²¹⁷See also Robert Thornton Smith, "Business Purpose: The Assault Upon the Citadel," 53 *Tax Law.* 1, 33 (1999). ("There is no topic more central to the integrity of the tax law than an appropriate theory of statutory interpretation for the Code.")

²¹⁸*Simpson v. United States*, 183 F.3d 812 (8th Cir. 1999) (Arnold, J.). Judge Arnold continued, "It is true that the ingenuity of lawyers can usually scrape up some tag end of ambiguity on which to hang a policy hat. But judges are obliged, unless there is a substantial uncertainty as to the meaning of the words of a statute, to apply the statute as written, unless the words are simply nonsense, or self-contradictory, or something of that kind." *Id.*

²¹⁹Hon. Alex Kozinski, "What I Ate for Breakfast and Other Mysteries of Judicial Decision Making," 26 *Loy. L.A. L. Rev.* 993, 996 (1993). ("Language has meaning. This doesn't mean every word is as precisely defined as every other word, or that words always have a single, immutable meaning. What it does mean is that language used in statutes, regulations, contracts and the Constitution place an objective constraint on our conduct.")

²²⁰*Commissioner v. Sansome*, 60 F.2d 931, 933 (2d Cir. 1932) (Hand, J.).

²²¹See, e.g., Dean Weiner and Christopher W. Campbell, "Right Results? Wrong Theories! — Coltec Industries and Castle Harbour," 34 *Corp. Tax'n* 12 (2007) (suggesting that two tax shelter cases could have been decided in favor of the government without resort to a free-floating doctrine); Glassman, *supra* note 9, at 710 (examining five types of tax shelter transactions and concluding that only two "would have been allowed in a world without the economic substance doctrine").

But even when a court would rule against the taxpayer anyway, the application of the economic substance doctrine is inappropriate. Stating that claimed tax benefits are unavailable due to the judiciary's inventions rather than Congress's statutes leaves one wondering whether the court has simply applied a "smell test."²²² Such tests do little to further the integrity of the legal system and should be discarded.

One may nonetheless argue that, as a policy matter, conclusory judicial tests are required to prevent taxpayers from manipulating the code.²²³ But many tax statutes contain substantive principles, and a taxpayer's meaningless labels should never govern the interpretation of those provisions, even in the absence of arbitrary, judicially created doctrines.²²⁴ Substance should always trump form when Congress enacts a substantive provision. For example, if, to secure a tax benefit granted to sales, a taxpayer sells property for \$100 and, under a binding, prearranged plan, buys it back 10 seconds later for \$100, it does not matter that she literally sold the property. Statutory language must be given its fair, ordinary meaning,²²⁵ not its strict, literal meaning,²²⁶ and

²²²See *ACM*, 157 F.3d at 265 (McKee, J., dissenting) ("I can't help but suspect that the majority's conclusion [is] 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.'")

²²³See, e.g., Martin J. McMahon Jr., "Economic Substance, Purposive Activity, and Corporate Tax Shelters," *Tax Notes*, Feb. 25, 2002, p. 1017, Doc 2002-4664, 2002 TNT 38-32. ("The uncertainty created by the application of these judicial doctrines should not be viewed as a problem worse than the problem their application is intended to remedy. . . . Without the uncertainty these doctrines create, mastery of the intricacies of nooks and crannies of the Code and regulations would become even more valuable for both tax practitioners and their clients.")

²²⁴See *Isenbergh*, *supra* note 113, at 864-865. ("Many of the basic terms of the Code are . . . imported into it with their contours already set. . . . The underlying idea — that it does not matter what things are called — is common to all law. No label can make a diamond of a rhinestone. This principle is more than sufficient to defeat transactions that are simply shams.")

²²⁵See *Scalia, A Matter of Interpretation* 23-24 (Princeton Univ. Press 1997). ("A text should not be construed strictly, and it should not be construed leniently; it should be construed reasonably, to contain all that it fairly means. . . . I am not a strict constructionist, and no one ought to be."). The distinction between a word's ordinary meaning and its literal meaning is illustrated in *Smith v. United States*, 508 U.S. 223, 242 (1993) (Scalia, J., dissenting). ("In the search for statutory meaning, we give nontechnical words and phrases their ordinary meaning. . . . [To "use"] an instrumentality ordinarily means to use it for its intended purpose. When someone asks, 'Do you use a cane?' he is not inquiring whether you have your grandfather's silver-handled walking stick on display in the hall; he wants to know whether you walk with a cane. Similarly, to speak of 'using a firearm' is to speak of using it for its distinctive purpose, *i.e.*, as a weapon. To be sure, 'one can use a firearm in a number of ways,' *ante*, at 2055, including as an article of exchange, just as one can 'use' a cane as a hall decoration — but that is not the ordinary meaning of 'using' the one or the other.")

²²⁶See, e.g., *Leocal v. Ashcroft*, 543 U.S. 1, 9 (2004). ("When interpreting a statute, we must give words their ordinary or natural meaning") (internal quotation marks omitted); *Sale v.*

(Footnote continued on next page.)

an illusory transfer followed by an interdependent re-transfer does not ordinarily constitute a sale.

Similarly, if a statute provides tax benefits to a corporation that distributes property to its shareholders, and if a corporation uses its shareholders as a mere conduit to transfer property to one of its creditors, any claimed tax benefits should be denied.²²⁷ A stockholder who receives property from a corporation and, as a condition of that transfer, agrees to immediately give that property to the corporation's creditor can hardly be considered the distributee, as that term is ordinarily understood.²²⁸ The distributee is the creditor, and the corporation cannot argue that it has distributed property to its shareholders.

But if the language of a statute does not make a taxpayer's motives or a change in its economic position relevant, the application of economic substance principles is unwarranted.²²⁹ For example, if Congress grants tax benefits to the title owner of property, the economic incidents of ownership are irrelevant.²³⁰ Similarly, if a taxpayer has bona fide ownership in stock, and that stock is acquired by the issuer in exchange for property, section 317(b) must apply, even if the taxpayer has no business purpose for holding or selling that stock — section 317(b) simply does not look to a taxpayer's motive.²³¹ And if a

taxpayer relinquishes all rights in property in exchange for materially different property, there can be no doubt that a disposition has occurred, even if the taxpayer performed the transaction solely for tax avoidance purposes. Indeed, because the Supreme Court consistently disregards a taxpayer's tax avoidance motive,²³² the lower courts should not say that statutes may be ignored if "the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance."²³³ Absent some statutory indication that a taxpayer's motive is relevant, lower courts should focus on what was done, not why it was done. Only when Congress says that a taxpayer's motive is relevant — which it frequently does — should a court examine a taxpayer's reasons for entering into a transaction.²³⁴ In all other cases, the lower courts should respect the legislature's choice and apply the statute as written.²³⁵

²²⁷See *Haitian Centers Council, Inc.*, 509 U.S. 155, 199 (1993) (Blackmun, J., dissenting). ("We have considered ourselves bound to assume that the legislative purpose is expressed by the ordinary meaning of the words used." Ordinary, but not literal.") (Emphasis supplied.)

²²⁸See *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (transfer of cash by corporation to its stockholders did not constitute "distribution" to those stockholders under section 112(d)(1) and (2) of the Revenue Act of 1928 when stockholders had, prior to the transfer, agreed to use those funds to pay off the corporation's creditors).

²²⁹See *Black's Law Dictionary* (8th ed. 2004) (defining distributee as a "beneficiary entitled to payment"). A person who takes a payment from another subject to the legal obligation to transfer that payment to another is not "entitled" to that payment.

²³⁰See also Isenbergh, *supra* note 113, at 879. ("When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. 'Substance' can only be derived from forms created by the statute itself. Here substance is form and little else; there is no natural law of reverse triangular mergers."); Robert Willens, "The Myths of Form and Substance in Subchapter C," *Tax Notes*, Aug. 2, 1999, p. 739, *Doc 1999-25752*, 1999 TNT 147-76.

²³¹*Cf. also* Isenbergh, *supra* note 113, at 872-873. ("All that the liquidation of a corporation ever entails is a transfer of title in its assets. When an artificial entity disappears, there results a change in the form of ownership of property. Indeed, it is hard to think of what else happens in a liquidation other than a change in the formal indicia of ownership.")

²³²Section 317(b) provides that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." That statute plainly looks to whether stock is exchanged for property, and not to why the exchange took place. The Claims Court blundered badly in holding otherwise in *Heinz*, conducting a long inquiry into the taxpayer's motives in denying it its claimed tax benefits. See *supra* note 93.

²³³See *Gregory*, 293 U.S. at 469 (stating that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended" and "putting aside . . . the question of motive in respect of taxation altogether"); *Knetsch*, 364 U.S. at 365 (setting aside the lower court's factual finding that Knetsch was motivated by tax savings); *Consumer Life*, 430 U.S. at 739. ("Even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction."); *Frank Lyon*, 435 U.S. at 580. ("The fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.") See also *Deweese*, 870 F.2d at 29 (Breyer, J.) ("The Court [in *Gregory*] examined only the transaction on its face, not the motives of the taxpayer."); Bittker and Lokken, *Federal Income Taxation of Income, Estates, & Gifts*, para. 4.3.2. ("A tax-avoidance purpose serves only the preliminary purpose of advising the IRS and courts where to dig; it does not help in deciding whether what is actually found belongs on the taxable or the nontaxable side of the statutory line.")

²³⁴*Coltec*, 454 F.3d at 1355. Some courts do hold that a tax-avoidance motive alone does not justify the disregard of statutes. See, e.g., *Carrington v. Commissioner*, 476 F.2d 704, 706 (5th Cir. 1973). ("The mere fact that the transactions here questioned were concededly designed to limit Carrington's tax liability establishes nothing with regard to the question of the proper taxation of these transactions.") (internal citations, quotations, and alterations omitted.)

²³⁵See, e.g., section 162(a) (limiting deductions to those made in the carrying on of a trade or business); section 170(f)(9) (denying charitable deductions that are made to avoid application of section 162(e)); section 269 (denying tax benefits obtained through the acquisition of a corporation, in which "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax"); section 269A (dealing with personal service corporations that are formed or availed of for the purpose of avoidance or evasion of tax); section 269B(b) (granting the secretary authority to "prescribe such regulations as may be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities"); section 306(b) (excepting transactions from the operation of 306(a) in which the taxpayer is not motivated to avoid tax); section 355(a)(1)(D) (taxpayers cannot retain stock in a section 355 transaction unless that retention was "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax"); section 357(b) (excepting tax avoidance plans from the operation

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Haitian Centers Council, Inc., 509 U.S. 155, 199 (1993) (Blackmun, J., dissenting). ("We have considered ourselves bound to assume that the legislative purpose is expressed by the ordinary meaning of the words used." Ordinary, but not literal.") (Emphasis supplied.)

²²⁷See *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (transfer of cash by corporation to its stockholders did not constitute "distribution" to those stockholders under section 112(d)(1) and (2) of the Revenue Act of 1928 when stockholders had, prior to the transfer, agreed to use those funds to pay off the corporation's creditors).

²²⁸See *Black's Law Dictionary* (8th ed. 2004) (defining distributee as a "beneficiary entitled to payment"). A person who takes a payment from another subject to the legal obligation to transfer that payment to another is not "entitled" to that payment.

²²⁹See also Isenbergh, *supra* note 113, at 879. ("When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. 'Substance' can only be derived from forms created by the statute itself. Here substance is form and little else; there is no natural law of reverse triangular mergers."); Robert Willens, "The Myths of Form and Substance in Subchapter C," *Tax Notes*, Aug. 2, 1999, p. 739, *Doc 1999-25752*, 1999 TNT 147-76.

²³⁰*Cf. also* Isenbergh, *supra* note 113, at 872-873. ("All that the liquidation of a corporation ever entails is a transfer of title in its assets. When an artificial entity disappears, there results a change in the form of ownership of property. Indeed, it is hard to think of what else happens in a liquidation other than a change in the formal indicia of ownership.")

²³¹Section 317(b) provides that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock." That statute plainly looks to whether stock is exchanged for property, and not to why the exchange took place. The Claims Court blundered badly in holding otherwise in *Heinz*, conducting a long inquiry into the taxpayer's motives in denying it its claimed tax benefits. See *supra* note 93.

One may argue that Congress cannot anticipate every possible consequence of its legislation, so judicial intervention is needed to prevent taxpayers from claiming tax benefits in a manner unforeseen by the statutory drafters.²³⁶ As one commentator put it, adhering to a statute's plain language is "fundamentally misguided" when "a statute must be applied to fact patterns that Congress did not consider when it enacted the statute."²³⁷ But, as a unanimous court recently warned, the "fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning."²³⁸ Indeed, "that a statute can be 'applied in situations not expressly anti-

of 357(a)); section 467(b) (requiring "constant rental accrual in case of certain tax avoidance transactions"); section 532 (imposing tax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders"); section 631(c) (excluding corporations used to avoid income tax on shareholders from the subsection's general rule); section 845(a) (allowing the secretary to recharacterize a reinsurance agreement involving tax avoidance or evasion); section 877 (addressing expatriations undertaken to avoid tax); section 1272(a)(2)(E)(ii) (excepting a loan from the application of section 1272(a)(2)(E)(i) "if the loan has as 1 of its principal purposes the avoidance of any Federal tax").

²³⁵See *United States v. Great N. Ry. Co.*, 343 U.S. 562, 575 (1952). ("It is our judicial function to apply statutes on the basis of what Congress has written, not what Congress might have written.")

²³⁶Perhaps a general antiabuse rule is desirable to discourage taxpayers from taking overly aggressive interpretations of the code. Indeed, one can fairly criticize Congress for failing to codify an economic substance test. But even if a general antiabuse rule would improve social welfare, there is no reason that the courts (as opposed to the legislature) must create that test. Surely, Congress is empowered to enact a statute that says "Economic substance is a prerequisite to any provision of the code allowing deductions." See also Weisbach, "Ten Truths," *supra* note 9, at 218. ("If [judicial doctrines] are desirable for independent reasons, Congress can incorporate them directly into the statute."). A vague statute will likely face political opposition, but the fact that the people's representatives will not enact a statute does not mean that the courts should invent a doctrine that has the equivalent effect of that statute. Rather, Congress should take it upon itself to improve the proposals currently under consideration so they are palatable to the public. While the current proposals do suffer from significant flaws and should not be enacted, see *infra* note 275, Congress should follow one commentator's suggestion and immediately codify a narrow rule that eliminates the worst of the loopholes in the code, leaving the knottier issues to be resolved later. See David P. Hariton, "Stop Calling It Economic Substance," *Tax Notes*, June 9, 2003, p. 1544, Doc 2003-13889, 2003 TNT 111-51.

²³⁷Zelenak, *supra* note 13, at 659.

²³⁸*Lockhart v. United States*, 126 Sup. Ct. 699, 702 (2005) (O'Connor, J., for a unanimous Court) (quoting *Union Bank v. Wolas*, 502 U.S. 151, 158 (1991) (Stevens, J., for a unanimous Court)). See also *Oncala v. Sundowner Offshore Servs., Inc.*, 523 U.S. 75, 79 (1998) (unanimous). ("[I]t is ultimately the provisions of our laws rather than the principal concerns of our legislators by which we are governed."), and *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 323 (Scalia, J., concurring) (1988) ("A 19th-century statute criminalizing the theft of goods is not ambiguous in its application to the theft of microwave ovens simply because the legislators enacting it 'were unlikely to have contemplated' those appliances.").

pated by Congress does not demonstrate ambiguity. It demonstrates breadth."²³⁹ A draftsman's lack of foresight cannot justify the disregard of statutory language,²⁴⁰ and courts should apply the provisions of the code to even novel transactions.

One may nonetheless argue that the approach outlined here will be useful only when statutory language is perfectly clear. For example, it may be difficult to determine what rights one must have in property to actually own it, or to determine how much profit one must seek to be engaged in the carrying on of a trade or business, or to determine whether two properties are materially different. A court might thus have to apply the economic substance doctrine whenever it is faced with an ambiguous statute. But that argument is based on the dubious assumption that a court can apply the economic substance doctrine but cannot apply statutory language. If a court cannot determine how much economic substance a statute requires, it probably cannot determine how much economic substance the economic substance doctrine requires, either. The "dizzingly complex"²⁴¹ doctrine has numerous formulations and is embodied in the same medium (the written word) that Congress's laws are embodied in. If statutory language is inherently and inescapably ambiguous, the same must be true of the economic substance doctrine. The problems posed by ambiguous statutory language cannot be avoided by applying a judicial doctrine.

The argument that the code is too difficult to interpret is particularly unavailing in light of the fact that many of its terms and phrases are found elsewhere in the Statutes at Large. If courts can interpret words like "ownership," "business," "stock," "partnership," "indebtedness," and "disposition" in nontax statutes, surely they can interpret those same words when they are used in tax statutes.²⁴² Although some argue that the tax laws have distinct

²³⁹*Pennsylvania Dept. of Corrections v. Yeskey*, 524 U.S. at 212 (unanimous).

²⁴⁰*Cf. West Virginia University Hospitals*, U.S. 83 at 100 ("Thus, the argument runs, the 94th Congress simply forgot; it is our duty to ask how they would have decided had they actually considered the question. See *Friedrich v. Chicago*, 888 F.2d 511, 514 (7th Cir. 1989) (awarding expert fees under section 1988 because a court should "complete . . . the statute by reading it to bring about the end that the legislators would have specified had they thought about it more clearly"). This argument profoundly mistakes our role.").

²⁴¹Bankman, *supra* note 9, at 29.

²⁴²This is not to say that a word must have a single, fixed meaning regardless of statutory context. Rather, it is a "fundamental principle of statutory construction (and, indeed, of language itself) that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used." *Deal v. United States*, 508 U.S. 129, 132 (1993). Nonetheless, it should not be too difficult for a court to determine that the word "indebtedness" in section 163(a) does not mean "only indebtedness incurred with a business purpose in a transaction that is not motivated by tax and which results in a significant change in the obligor's net economic position as measured by the excess of the taxpayer's expected return over the risk-free rate of return." The meaning of "indebtedness" might not be perfectly determinate, but the definition just

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features that demand unique methods of interpretation,²⁴³ “the Code is just another statute, which suffers from the same ailments that have afflicted legislative enactments since Parliament first tampered with the common law.”²⁴⁴ Indeed, it is a “firmly established principle of statutory interpretation that ‘the words of statutes — including revenue acts — should be interpreted where possible in their ordinary, everyday senses,’”²⁴⁵ and there is little justification for abandoning that principle, even if it means that a court has to find in favor of a taxpayer.

B. Civil and Criminal Penalties

Even if the Court decides that “statutory details”²⁴⁶ need not be examined in tax cases, it should state that a taxpayer cannot be penalized for disregarding the code’s “rules or regulations”²⁴⁷ when the reviewing court itself disregards those rules or regulations, or when the reviewing court finds that the taxpayer has complied with the applicable rules or regulations.²⁴⁸ The section 6662(b)(1) negligence penalty, by its plain terms, applies only to a taxpayer’s failure to comply with the provisions of the code.²⁴⁹ The IRS’s argument that the “negligence penalty can be applied to deficiencies resulting from the application of the economic substance doctrine”²⁵⁰ is sheer applesauce. The Supreme Court should state that it is inappropriate for the IRS and the lower courts to apply those code sections that impose penalties while disregarding those sections that grant taxpayers benefits. If the

offered is obviously too narrow. “Indebtedness” appears hundreds of times in the United States Code, and courts may draw from the numerous opinions and treatises construing that term to aid in their construction of section 163(a).

²⁴³See, e.g., Zelenak, *supra* note 13, at 630.

²⁴⁴Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 4.2.1 (3d ed. 2001). See also Livingston, *supra* note 15, at 686. (“Scholars in other fields tend to be unimpressed by the assertion of tax uniqueness, noting that the assertedly special features of taxation — detail, revision, and underlying structural principles — are shared in varying degrees by other laws. This is particularly true of broad, programmatic statutes like the Uniform Commercial Code, environmental legislation, and many regulatory programs.”)

²⁴⁵*Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962) (quoting *Crane v. Commissioner*, 331 U.S. 1, 6 (1947)).

²⁴⁶*In re CM Holdings*, 301 F.3d at 102.

²⁴⁷Section 6662(b)(1). (“This section shall apply to the portion of any underpayment which is attributable to . . . negligence or disregard of rules or regulations.”)

²⁴⁸See *Compaq*, *supra* Part II.C.

²⁴⁹Section 6662(c) provides:

“Negligence. — For purposes of this section, the term ‘negligence’ includes any failure to make a reasonable attempt to comply with the provisions of this title, and the term ‘disregard’ includes any careless, reckless, or intentional disregard.”

Because the doctrine is uncodified, a taxpayer’s failure to comply with the doctrine cannot constitute the failure to comply with the provisions of the code.

²⁵⁰IRS FSA 200217021, *Doc 2002-10141*, 2002 TNT 82-74. See also IRS FSA 200150011, *Doc 2001-30791*, 2001 TNT 242-25 (“There is precedent for recovering the negligence penalty in an economic substance case so we would assert that penalty.”)

substantive provisions of subtitle A are ignored, the penal provisions of subtitle F should be ignored as well, particularly because the application of the penal provisions depends heavily on the construction of the substantive provisions.²⁵¹

Similarly, a taxpayer should be imprisoned only if he has failed to comply with the laws of Congress. A judicially created doctrine that is a prerequisite to determining whether he has complied with those laws has no place in a criminal trial. Commentators may advocate the use of “multiple, sometimes conflicting doctrines”²⁵² to deny taxpayers statutory benefits in civil matters, but “dizzingly complex”²⁵³ judicial tests with “few bright lines”²⁵⁴ should not be applied in criminal proceedings.

If the Court nonetheless holds that it is appropriate to go “outside the statutory framework”²⁵⁵ in criminal trials, and that “mere compliance” with Congress’s statutes is insufficient to escape conviction, it should, if nothing else, make the formulation of the economic substance doctrine crystal clear. It is easy to get the impression that there are as many versions of the doctrine as there are code sections, and it is perverse to imprison a taxpayer for failing to comply with a judicial test that even the lower courts cannot apply consistently.²⁵⁶

C. Legislative Acquiescence

Because lower courts have used the economic substance doctrine to override statutes for decades, one might argue that Congress, via legislative silence, has signaled its approval of a free-floating doctrine.²⁵⁷ The Court, however, should reject that argument. If Congress is deemed to have acquiesced to a judicial method of interpretation, surely it should be deemed to have acquiesced to the Supreme Court’s statute-focused method rather than to the “inferior” courts’ misunderstanding of that method.²⁵⁸ It would be strange to conclude that Congress has acquiesced to a doctrine that contradicts the Court’s jurisprudence.

²⁵¹See *supra* note 249. See also section 7201. (“Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title shall . . . be guilty of a felony.”) (Emphasis added.) A court cannot possibly determine whether a taxpayer has evaded the tax imposed by the Internal Revenue Title if it disregards the provisions that determine the amount imposed.

²⁵²Shaviro and Weisbach, *supra* note 9, at 513. See also McMahon, *supra* note 223.

²⁵³Bankman, *supra* note 9, at 29.

²⁵⁴*Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1316, *Doc 2001-18038*, 2001 TNT 127-6 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002).

²⁵⁵*Deweese*, 870 F.2d at 34 (emphasis removed).

²⁵⁶See *infra* note 267.

²⁵⁷See Bankman, *supra* note 9, at 11. (A somewhat strong assertion “is that the legislature assumes that long-standing common law doctrines such as economic substance will be used to interpret the statutes it enacts. Under this claim, the doctrines have been implicitly adopted as part of the statute — at least where the statute does not indicate otherwise.”)

²⁵⁸See U.S. Constitution, Article III, sec. 1. (“The judicial power of the United States, shall be vested in one Supreme (Footnote continued on next page.)

One may nonetheless argue that the various legislative proposals to codify the doctrine indicate that Congress is aware of the doctrine, and that it has acquiesced to its creation.²⁵⁹ But one can just as easily argue that the legislature's numerous refusals to codify the doctrine reflect its disapproval of it.²⁶⁰ It is for good reason that "failed legislative proposals are 'a particularly dangerous ground on which to rest an interpretation of a prior statute.'" ²⁶¹ "Congressional inaction is generally a poor measure of congressional intent,"²⁶² and "it is at best treacherous to find in Congressional silence alone the adoption of a controlling rule of law."²⁶³ Indeed, "Congress takes no governmental action except by legislation,"²⁶⁴ and its lawmaking powers "may only 'be exercised in accord with a single, finely wrought and exhaustively considered procedure'"²⁶⁵ described in Article I of the Constitution.

But even if the Court concludes that Congress can legislate via acquiescence, and even if the Court concludes that it is the lower courts' free-floating doctrine to which the legislature may acquiesce, the Court should not find that the doctrine has been incorporated into the code. The canon of "legislative acquiescence is at best only an auxiliary tool for use in interpreting ambiguous statutory provisions"²⁶⁶ and should not be used to

Court, and in such inferior courts as the Congress may from time to time ordain and establish.")

²⁵⁹See, e.g., CARE Act, S. 476, 108th Cong., section 701 (2003).

²⁶⁰See *Helvering v. Hallock*, 309 U.S. 106, 119-120 (1940) ("To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities"); *Johnson v. Transportation Agency*, 480 U.S. 616, 672 (1987) (Scalia, J., dissenting) (it is "impossible to assert with any degree of assurance that congressional failure to act represents (1) approval of the status quo, as opposed to (2) inability to agree upon how to alter the status quo, (3) unawareness of the status quo, (4) indifference to the status quo, or even (5) political cowardice").

²⁶¹*United States v. Craft*, 535 U.S. 274 (2002) (quoting *Pension Benefit Guaranty Corporation v. LTV Corp.*, 496 U.S. 633, 650 (1990)).

²⁶²*Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 222 n.7 (1988). See also *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 381-382 n. 11 (1969). ("Unsuccessful attempts at legislation are not the best of guides to legislative intent.")

²⁶³*Girouard v. United States*, 328 U.S. 61, 69 (1946).

²⁶⁴*Rapanos v. United States*, 126 Sup. Ct. 2208, 2231 (2006) (plurality opinion). See also *United States v. Estate of Romani*, 523 U.S. 517, 535-536, Doc 98-13919, 98 TNT 84-9 (1998) (Scalia, J., dissenting). ("The act of refusing to enact a law (if that can be called an act) has utterly no legal effect, and thus has utterly no place in a serious discussion of the law. . . . Congress can no more express its will by not legislating than an individual Member can express his will by not voting.")

²⁶⁵*Clinton v. City of New York*, 524 U.S. 417, 439-440 (1998) (Stevens, J.) (quoting *INS v. Chadha*, 462 U.S. 919, 951 (1983) (punctuation omitted)).

²⁶⁶*Jones v. Liberty Glass Co.*, 332 U.S. 524, 533-534 (1947). Even when the Court applies the legislative acquiescence canon, it applies it to only a "consistent judicial interpretation of a statute." *Monessen Southwestern Ry. Co. v. Morgan*, 486 U.S. 330, 338 (1988). See also *United States v. Powell*, 379 U.S. 48, 55, n. 13 (1964) (refusing to apply canon when there was no "settled

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muddle the meaning of the tax laws. There are fundamental differences in the lower courts' formulations of the doctrine and it is hard to believe that Congress has sanctioned a conjunctive doctrine in some circuits, a disjunctive doctrine in others, a unitary doctrine in still some others, and a rejection of the doctrine in another.²⁶⁷ It is even harder to believe that Congress has acquiesced to the various intracircuit conflicts regarding the doctrine — different panels of judges view the economic substance doctrine differently.²⁶⁸ Even if Congress may legislate by doing nothing, it is impossible to determine

judicial construction" at time of reenactment). The lower courts' application of the economic substance doctrine is neither "consistent" nor "settled." See *infra* note 267. Further, the doctrine does not represent the "judicial interpretation" of a statute, but rather the judicial disregard of one. See *supra* Part II.

²⁶⁷Some courts apply a conjunctive economic substance test and hold that if a taxpayer fails either one of the test's prongs, its transaction will be disregarded. See, e.g., *Coltec*, *supra* Part II.A, and *Winn-Dixie Stores, Inc. v. Commissioner*, *supra* note 254. ("A transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose.") (Emphasis added.) Other courts apply a disjunctive test and hold that if a taxpayer has either a nontax motive or an expectation of profit, his transaction will be respected. See *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir.1985). Still others apply the two factors together. See *ACM*, 157 F.3d at 247. (The "distinct aspects of the [economic substance doctrine] 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.") (Citations omitted.) Courts even define the individual prongs of the economic substance doctrine differently. For example, some courts focus on a taxpayer's subjective motivations in determining whether his conduct reveals a business purpose, while others focus on objective factors. Compare *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987) ("The business purpose factor often involves an examination of the subjective factors which motivated a taxpayer to make the transaction at issue."), with *Coltec*, 454 F. 3d at 1359 ("Economic substance is measured from an objective, reasonable viewpoint, not by the subjective views of the taxpayer's corporate officers."). The preceding cases do not present an exhaustive list; there are even more formulations of the doctrine than those described here. A comprehensive discussion of the lower courts' approaches may be found in the literature cited in note 9. This report is primarily concerned with those courts that use the doctrine in its strongest form (that is, those that use it to disregard statutory language) and not those, like the D.C. Circuit in *Horn*, that use it as an aid in construing statutory language.

²⁶⁸Compare, e.g., *Howell v. United States*, 775 F.2d 887, 887 (7th Cir. 1985) (Easterbrook, J.). ("This exalts form over substance, no doubt. In tax, however, form and substance often coincide. . . . A court must apply an empty distinction with the same fidelity as it applies any other."), with *Yosha v. Commissioner*, 861 F.2d 494, 498 (7th Cir. 1988) (Posner, J.) (expressing approval of the economic substance doctrine). See also Magee and Goldman, *supra* note 4, at 488 (noting that, with regard to an appellate court's standard of review, "taxpayers are treated differently based solely on which circuit (or, in some circuits, which panel) hears the appeal").

which court's or which panel's formulation of the doctrine it has silently enacted into law. It is the Court's "duty to make sense rather than nonsense out of the *corpus juris*,"²⁶⁹ and holding that Congress has quietly sanctioned numerous unique free-floating doctrines among the circuits does little to discharge that duty.²⁷⁰

Holding that Congress, through its silence, has simply granted the lower courts the power to rewrite statutes (but has not expressed any opinion regarding the appropriate formulation of the doctrine) is similarly untenable. "The verdict of quiescent years cannot be invoked to baptize a statutory gloss that is otherwise impermissible."²⁷¹ The Constitution provides that the tax laws must originate in the House of Representatives — not in the federal district and circuit courts.²⁷² Congress cannot delegate lawmaking powers to the courts, either affirmatively or through its acquiescence.²⁷³ If Congress wants an economic substance test to apply to all tax statutes, it is constitutionally obliged to create that test itself.²⁷⁴ Indeed, there are strong arguments in favor of codification, and Congress should give them careful consideration.²⁷⁵

²⁶⁹*West Virginia University Hospitals, Inc. v. Casey*, 499 U.S. 83, 101 (1991). Of course, this principle can apply only to the extent that the text of a statute permits. See *United States v. Olympic Radio Television, Inc.*, 349 U.S. 232, 236 (1955). ("We can only take the Code as we find it and give it as great an internal symmetry and consistency as its words permit.")

²⁷⁰In perhaps the most famous tax case applying the legislative acquiescence canon, *Bob Jones v. United States*, the Court applied the canon only after finding "overwhelming evidence of Congressional awareness and acquiescence" (461 U.S. at 602 n.27 (emphasis supplied).) The Court in *Bob Jones* cautioned against drawing inferences from legislative silence, but found that the numerous hearings Congress held on the "precise issue" before the Court warranted the application of the canon. See *id.* at 600. ("Ordinarily, and quite appropriately, courts are slow to attribute significance to the failure of Congress to act on particular legislation. . . . Here, however, we do not have an ordinary claim of legislative acquiescence. Only one month after the IRS announced its position in 1970, Congress held its first hearings on this precise issue.") But even in *Bob Jones*, the question was whether Congress acquiesced to an agency interpretation of an enacted statute, not whether Congress had acquiesced to the judiciary's disregard of an enacted statute. The Court has yet to address whether the legislature can acquiesce to the disregard of its own laws.

²⁷¹*Zuber v. Allen*, 396 U.S. 168, 185-186, n.21 (1969).

²⁷²See U.S. Constitution, Article I, sec. 7. ("All bills for raising revenue shall originate in the House of Representatives.")

²⁷³See *Wayman v. Southard*, 23 U.S. 1, 43 (1825) (C.J. Marshall). ("It will not be contended that Congress can delegate to the Courts, or to any other tribunals, powers which are strictly and exclusively legislative.")

²⁷⁴See *supra* note 272.

²⁷⁵See Marvin Chirelstein and Lawrence Zelenak, "Tax Shelters and the Search for a Silver Bullet," 105 *Colum. L. Rev.* 1939 (2005), for a thoughtful proposal to codify a noneconomic loss disallowance provision in the code. See also Samuel C. Thompson Jr., "Despite Widespread Opposition, Congress Should Codify the Economic Substance Doctrine," *Tax Notes*, Feb. 13, 2006, p. 781, *Doc 2006-2513*, 2006 *TNT* 30-38; Monte Jackel, "For Better or for Worse: Codification of Economic Substance," *Doc 2004-9475*, 2004 *TNT* 96-33 (May 3, 2004); David A. Weisbach,

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D. Underlying Purpose and Economic Shams

The Court should state that references to an underlying purpose are inappropriate when interpreting the code. In an economic substance case, the question is whether Congress granted the taxpayer the claimed benefit. If a court states that, regardless of statutory language, Congress's underlying purpose is to deny the taxpayer that benefit, it has simply turned a blind eye to the issue. Courts cannot determine the legislature's purpose by ignoring the words that it uses to articulate its purpose.²⁷⁶ That approach is simply self-defeating. Even

"The Failure of Disclosure as an Approach to Shelters," 54 *SMU L. Rev.* 73 (2001). In recent years, Congress has in fact considered various proposals to codify the economic substance doctrine. But those proposals have been poorly drafted and, even if enacted, would do little to address this report's concerns because they simply state that the doctrine may apply whenever a court considers it "relevant." See, e.g., S. 96, 110th Cong., section 201 (2007) (providing for a conjunctive test "in any case in which a court determines that the economic substance doctrine is relevant for purposes of this title"). As discussed in parts II and III, *supra*, the doctrine is never relevant to the Supreme Court and some lower courts, but it is relevant to, for example, the Third and Federal circuits. Enacting a statute that supposes that the doctrine might possibly be "relevant" accomplishes nothing, and the Court's intervention will still be required. If Congress does want an economic substance test to apply as a prerequisite to the operation of any code section allowing a tax benefit, it should say so, rather than enact a "circular" statute. See Brant Goldwyn, "Congress Expected to Adopt Codification of Economic Substance Doctrine, Hill Staffer Says," *CCH Federal Tax Day* (May 18, 2007). (One panelist "objected to introductory language that applies the statute to any case 'in which a court determines that the economic substance doctrine is relevant.' He said this is circular and does not clarify the doctrine.") Alternatively, Congress may consider granting the secretary broad authority to disallow benefits obtained under tax-motivated transactions, as long as the delegating statute yields some intelligible principle to which his regulations must conform. See *Whitman v. American Trucking Associations*, 531 U.S. 457, 472 (2001).

²⁷⁶See *supra* note 10. See also *The Paulina*, 11 U.S. 52, 61 (1812) (C.J. Marshall). ("In construing these laws, it has been truly stated to be the duty of the court to effect the intention of the legislature; but this intention is to be searched for in the words which the legislature has employed to convey it."); *Aldridge v. Williams*, 3 How. 9, 24 (1845) ("In expounding this law, the judgment of the court cannot, in any degree, be influenced by the construction placed upon it by individual members of Congress in the debate which took place on its passage, nor by the motives or reasons assigned by them for supporting or opposing amendments that were offered. The law as it passed is the will of the majority of both houses, and the only mode in which that will is spoken in is the act itself."); *United States v. Goldenberg*, 168 U.S. 95, 102-103 (1897). ("The primary and general rule of statutory construction is that the intent of the lawmaker is to be found in the language that he has used."); *Devey v. United States*, 178 U.S. 510, 520 (1900). ("Of course, our duty is to give effect to the will of Congress touching this matter. But we must ascertain that will from the words Congress has chosen to employ, interpreting such words according to their ordinary meaning."); *United States v. Bitty*, 208 U.S. 393, 401 (1908). ("All will admit that full effect must be given to the intention of Congress as gathered from the words of the statute.")

if a taxpayer engages in a sham transaction (that is, one devoid of economic substance),²⁷⁷ “barring constitutional infirmity, Congress undoubtedly has the power to grant beneficial tax treatment to economically meaningless behavior.”²⁷⁸ Lower courts should follow the Supreme Court’s approach and examine whether Congress has exercised that power,²⁷⁹ not just blindly assume that a transaction that does not pass a judicial test is inconsistent with the code’s hidden, underlying purpose.²⁸⁰

Given that the lower courts deliberately ignore the text of the code, it is not even clear how they determine its underlying purpose. But even if the Court accepts “underlying purpose” as a legitimate canon of construction, the lower courts have stretched it well beyond its fair use.²⁸¹ The Federal Circuit conjured an underlying purpose to contradict statutory language.²⁸² The Third Circuit did the same to disregard statutory language altogether.²⁸³ If “underlying purpose” has a role to play in statutory interpretation, it is limited to clarifying the meaning of ambiguous statutory language, not contradicting or negating it.²⁸⁴ Indeed, “vague notions of a

²⁷⁷See *supra* note 64 for a discussion of the distinction between a factual sham and an economic sham. Although economic shams should not be disregarded unless a court examines statutory language, it is of course entirely appropriate to disregard factual shams. If something does not actually occur, there is nothing for a court to analyze, and a court is not overriding statutory language if it ignores that nonoccurrence.

²⁷⁸*Horn*, 968 F.2d at 1234.

²⁷⁹See *supra* Part III.

²⁸⁰See *Isenbergh*, *supra* note 113, at 879. (“Hard grappling with the facts of a case and the inner workings of a statute, although both difficult and intellectually admirable, is frequently passed off as a trivial or excessively ‘formal’ exercise. . . . [A court will instead make] an inquiry about the ‘larger’ nature of the statute itself. The latter exercise is in fact quite easy, requiring only the assertion of a statutory purpose that encapsulates one’s own tastes, either generally or regarding the transaction under scrutiny.”)

²⁸¹In *Heinz*, discussed *supra* note 93, the Court of Federal Claims concluded that the economic substance doctrine is not “a judicial gloss on the Code,” but is “merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance.” See *Heinz*, 76 Fed. Cl. at 592 (quoting *Coltec*, 454 F.3d at 1354). It is hard to see how a doctrine that allows a court to disregard statutes is not a “judicial gloss.” If the economic substance doctrine does is not a judicial gloss, then nothing is. Indeed, the doctrine falls squarely within the Supreme Court’s definition of federal common law. See *Atherton v. F.D.I.C.*, 519 U.S. 213, 218 (1997). (Federal common law is “a rule of decision that amounts, not simply to an interpretation of a federal statute or a properly promulgated administrative rule, but, rather, to the judicial ‘creation’ of a special federal rule of decision.”) The doctrine does not require a court to interpret a federal statute, or even cite one, to deny a taxpayer a benefit. See *supra* Part II. Indeed, many courts openly state that they are applying a judicially created doctrine rather than statutory language. See, e.g., *In re CM Holdings*, 301 F.3d at 108.

²⁸²See *supra* Part II.A.

²⁸³See *supra* Part II.B.

²⁸⁴See *Director, Office of Workers’ Compensation Programs, Dept. of Labor v. Newport News Shipbuilding and Dry Dock Co.*, 514 U.S.

(Footnote continued in next column.)

statute’s ‘basic purpose’ are . . . inadequate to overcome the words of its text regarding the specific issue under consideration.”²⁸⁵

This is not to say that courts should adopt hyperliteral interpretations of the code or blithely sanction sham transactions.²⁸⁶ A fair reading of sections 1 and 11 indicates that their purpose (as reflected by their text) is to raise revenue.²⁸⁷ If a taxpayer offers a hyperliteral interpretation of a substantive provision that would render sections 1 and 11 a dead letter, a court should reject that interpretation.²⁸⁸ But there is a significant difference between an interpretation that (if accepted) would render

122, 135-136 (1995). (“[T]he Director retreats to that last redoubt of losing causes, the proposition that the statute at hand should be liberally construed to achieve its purposes. . . . That principle may be invoked, in case of ambiguity, to find present rather than absent elements that are essential to operation of a legislative scheme; but it does not add features that will achieve the statutory purposes’ more effectively. Every statute proposes, not only to achieve certain ends, but also to achieve them by particular means — and there is often a considerable legislative battle over what those means ought to be.”)

²⁸⁵*Mertens v. Hewitt Assocs.*, 508 U.S. 248, 262 (1993). See also *Board of Governors of Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361, 374 (1986). (“Invocation of the ‘plain purpose’ of legislation at the expense of the terms of the statute itself . . . prevents the effectuation of congressional intent.”); *Durham*, *supra* note 89, at 35. (“The statute is . . . 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.”)

²⁸⁶As a general rule, courts should not adopt a taxpayer’s hyperliteral interpretation of a code provision. Rather, the language of the statute and its context (particularly, surrounding statutes) should be rigorously examined. “Statutory construction . . . is a holistic endeavor.” *United Sav. Ass’n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 371 (1988) (Scalia, J.). See also *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 809 (1989). (“Although the State’s hypertechnical reading of the [statute] is not inconsistent with the language of that provision examined in isolation, statutory language cannot be construed in a vacuum. It is a fundamental canon of statutory construction that the words of a statute must be read in their context and with a view to their place in the overall statutory scheme.”) If a tax statute yields several plausible meanings, a lower court can and should apply the one that comports best with the remainder of the code. However, if the text of a tax statute (fairly interpreted) is unambiguous, nothing is left to judicial construction, and a lower court should apply the statute according to its terms. See *United States v. Fisher*, 2 Cranch 358, 386 (1805) (C.J. Marshall). This is so even if it means that a taxpayer will enjoy a windfall or suffer a harsh result. See *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 93 (1934); *Commissioner v. Wodehouse*, 337 U.S. 369, 380 (1949); *Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962); and *Gitlitz v. Commissioner*, 531 U.S. 206 at 220. See also N. Jerold Cohen, “Too Good to Be True and Too Bad to Be True,” *Tax Notes*, Dec. 12, 2005, p. 1437, Doc 2005-23498, 2005 TNT 238-26.

²⁸⁷Section 1 imposes a tax on individuals. Section 11 imposes a tax on corporations.

²⁸⁸See *Cooper Industries, Inc. v. Aviall Services, Inc.*, 543 U.S. 157, 158 (2004) (it is a “settled rule that the Court must, if possible, construe a statute to give every word some operative effect”).

the code a nullity and one that simply suggests that Congress has (wisely or unwisely) subsidized a transaction.²⁸⁹ If a fair interpretation of the statutory language indicates that Congress did grant benefits to a sham transaction, courts should follow the Supreme Court's guidance and respect the legislature's intent.²⁹⁰

One might nonetheless argue that any interpretation that sanctions a sham transaction is inherently unfair, or perhaps even absurd.²⁹¹ But the issues are far more nuanced than that. The judicial definition of a sham transaction is broad enough to reach a transaction that even a saint would undertake. Suppose, for example, that Congress wishes to encourage retirement savings and states that investments placed in special accounts will not be subject to any tax. Suppose further that a taxpayer transfers investments from a preexisting account to a tax-sheltered account. That transfer does nothing to affect the taxpayer's beneficial interest except to reduce tax and will fail both prongs of the economic substance test. The taxpayer (by assumption) is motivated solely by tax savings in transferring her investments, so she will fail the subjective prong. Further, because "the transaction to be analyzed is the one that gave rise to the alleged tax benefit,"²⁹² it is the transfer between the accounts (and not her overall investment) that must be analyzed. Because that transfer merely puts her investments under a tax saving umbrella, it does nothing to alter the flow of economic benefits to her and will fail the objective prong of the test. Under the *Coltec* approach, at least, the taxpayer's transfer of funds would be disregarded and she would be taxed as if her funds remained in the preexisting account.

Of course, it is highly unlikely that a court would disregard the taxpayer's "mere compliance" with the statute, or that the IRS would bother to challenge the taxpayer's transfer. If the IRS did challenge the transfer, a reviewing court would almost certainly analyze the transaction by reference to the statute. Nonetheless, in the context of transactions involving business entities, the

lower courts are inclined to skip an examination of Congress's words and go straight to the economic substance doctrine.

It is hard to see the justification for that approach. Congress is empowered to subsidize both retirement accounts and business transactions, and perhaps even "backflips," too.²⁹³ Although it is doubtful that tax-motivated transactions — whether they relate to business transactions or retirement accounts — improve social welfare,²⁹⁴ whether a statute reflects "wise or unwise policy . . . is not a question that [a] [c]ourt is authorized to consider,"²⁹⁵ and a court's inquiry should be limited to determining whether a taxpayer's transaction falls within the terms of the applicable statute.²⁹⁶ Indeed, as then-Judge Stevens observed in dissent, even if the legislature enacts a dubious test for claiming a tax benefit, a court must "apply the test which Congress has specified," rather than a "nonstatutory" one.²⁹⁷ The taxpaying public, of course, can (and should) question the wisdom of

²⁹³See Schler, *supra* note 9, at 385-386. ("If Congress enacts a tax credit for backflips, Congress has determined that backflips are socially desirable. If a taxpayer learns to do backflips and earns the credit, it is doing nothing wrong. On the contrary, in the view of Congress, the taxpayer adds to the overall social welfare. . . . When Congress enacts a tax incentive, it presumably determines (correctly or not) that there is an overall benefit to society if taxpayers engage in the desired behavior.")

²⁹⁴For a list of (often dubious) social programs that are administered through the tax code, see Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2006-2010," Joint Committee Print, 109th Cong., 2d sess., JCS-2-06. Washington: Government Printing Office. Doc 2006-7856, 2006 TNT 80-14 (2006). See also Thomas L. Hungerford, "Tax Expenditures: Good, Bad, or Ugly?" *Tax Notes*, Oct. 23, 2006, p. 325, Doc 2006-20976, 2006 TNT 205-39 (observing that many "tax expenditures go to taxpayers in the upper part of the income distribution, and they often subsidize an activity for which the taxpayer receives a benefit. Further, research has questioned the effectiveness of some tax expenditures in achieving the stated social objectives").

²⁹⁵*Southern Motor Carriers Rate Conference, Inc. v. United States*, 105 S. Ct. 1721, 1738 (1985) (Stevens, J., dissenting). See also *Estate of Cowart v. Nicklos Drilling Co.*, 505 U.S. 469, 483-484 (1992). ("It is the duty of the courts to enforce the judgment of the Legislature, however much we might question its wisdom or fairness.") That a particular interpretation will open the door for taxpayers to reduce their tax liabilities cannot itself justify the disregard of statutory language. Cf. *Caminetti v. United States*, 242 U.S. 470, 490-491 (1917). ("The fact, if it be so, that the act as it is written opens the door to blackmailing operations upon a large scale, is no reason why the courts should refuse to enforce it according to its terms, if within the constitutional authority of Congress. Such considerations are more appropriately addressed to the legislative branch of the government, which alone had authority to enact and may, if it sees fit, amend the law.")

²⁹⁶See *supra* note 10.

²⁹⁷*Economy Finance Corp. v. United States*, 501 F.2d 466, 485-486 (7th Cir. 1974) (Stevens, J., dissenting). ("I am persuaded that the government's conclusion [regarding eligibility under section 801] . . . rests on a nonstatutory standard. Congress may have acted unwisely. . . . Nevertheless, we must, of course, apply the test which Congress has specified.")

²⁸⁹For a discussion of arguments that would, if accepted, render the code a nullity, see "The Truth About Frivolous Tax Arguments" (Nov. 30, 2006), available at http://www.irs.gov/pub/irs-utl/friv_tax.pdf.

²⁹⁰Of course, when the will of Congress is inimical to the Constitution, courts must respect the intent of the framers and not that of Congress. See *Marbury v. Madison*, 5 U.S. 137, 178 (1803).

²⁹¹Although commentators are often quick to argue that respecting the form of a tax-motivated transaction would be "absurd," the absurdity doctrine should not be invoked merely because the code dictates an objectionable result. Rewriting a statute because it is "absurd" is an extraordinary step and should be taken in only the most extraordinary circumstances. See *Sturges v. Crowninshield*, 17 U.S. (4 Wheat.) 122, 202-203 (1819) (C.J. Marshall). ("If, in any case, the plain meaning of a provision, not contradicted by any other provision in the same instrument, is to be disregarded, because we believe the framers of that instrument could not intend what they say, it must be one in which the absurdity and injustice of applying the provision to the case, would be so monstrous, that all mankind would, without hesitation, unite in rejecting the application.")

²⁹²*Id.* at 1356.

Congress's policy decisions, but judicial legislation is not a constitutionally permissible solution to an imperfect tax system.

V. Conclusion

The approach outlined here is hardly a cure-all for the interpretive problems posed by the code. Agreeing to apply statutory language is only the first step towards a solution. Courts must still examine that language to determine whether a transaction must have economic substance, and, if so, how much is required. It is not always easy to make those determinations, but applying economic substance principles in a manner consistent with statutory language will improve the integrity of the tax laws.

Nothing here suggests that Congress should encourage sham transactions or that courts should always tip the scales in favor of taxpayers. Optimal tax policy may very well require that taxpayers meet strict statutory tests before claiming deductions and may even require tax rates much higher than those currently seen. This report

is concerned with the courts' proper role, however, and not the country's proper tax system. The only goal here is to take a fresh look at Supreme Court cases that have been misused and misunderstood by the lower courts.

While courts should not take it on themselves to close loopholes in the code,²⁹⁸ Congress can and should aggressively amend statutes that reflect poor policy. Particularly bad statutes may even warrant retroactive repeal. Similarly, if public policy requires that taxpayers comply with an economic substance test before enjoying any statutory benefits, Congress should enact a statute providing that test. Until the doctrine is codified, however, the lower courts should let the debate remain where it belongs — in Congress — and should stop imposing a judicial test that has no basis in any Supreme Court decision.

²⁹⁸See *Iselin v. United States*, 270 U.S. 245, 251 (1926) (Brandeis, J.). ("To supply omissions transcends the judicial function.")