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Economic Substance and the Standard of Review

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Traditionally, appellate review hinged on the distinction between law and fact, producing a simplistic exercise – appellate courts review legal conclusions de novo while factual findings are reviewed under a clearly erroneous standard of review. The systemic difficulty with the fact/law distinction is defining fact and defining law. While appellate courts often create sound bites and offer elaborate musings on the definition of each, they maintain the misguided illusion that a trial court determination is either a question of law or a question of fact. In essence, appellate courts use the fact/law distinction and the attendant standard of review to promote its view of the “correct result.”

Instead of focusing on hollow labels, Legal Proceduralists focus on the structure of decision making within an institution, placing primary emphasis on the meting out of responsibility among decision makers. Utilizing judicial responsibility as a benchmark, appellate courts should focus on developing the law in a particular area as guidance for future cases and rectifying egregious errors in particular cases even if unrelated to developing the law.

In the economic substance context, a clearly erroneous standard of review accomplishes both purposes. Economic substance is a fluid concept that eliminates the pretenses of manufactured transactions and gives the Internal Revenue Service the ability to challenge technical tax results based on subjective standards that overlay the objective rules prescribed by the Internal Revenue Code. A transaction has economic substance if the transaction is rationally related to a useful non-tax business purpose and/or if the transaction results in a meaningful and appreciable enhancement in the net economic position of the taxpayer other than the reduction of taxes.

Under both tests, a decision of a trial court, while likely to be significant in terms of dollars at issue, is unlikely to have any appreciable impact on the development of the law in the economic substance area because both questions focus on factually intensive, case specific questions with little value beyond the case at issue. Appellate decisions have no impact on the predictability of future cases and do not advance uniformity in the law. In such cases, judicial responsibility dictates the adoption of a clear erroneous standard of review.
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I. INTRODUCTION

Just as “a melody is more than notes,”¹ tax law is more than unadorned words of a statute.² Judicial safeguards were created and

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¹ Helvering v. Gregory, 69 F.2d 809 811 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).
² The phrase originates from Gregory v. Commissioner, 27 B.T.A. 223, 225 (1932), rev’d, 69 F.2d 809 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935) but reaches a much different conclusion – “a statute so meticulously drafted must be interpreted as a literal expression of the taxing policy and leaves only the small interstices for judicial consideration.”
designed as supplemental concepts to disallow certain tax advantages not contemplated by the literal words expressed in a statute. The economic substance doctrine, a judicially created concept, can be described generically as a one-edged sword used by the United States to attack certain transactions that, while “firmly anchored” in the Internal Revenue Code, nonetheless contain tax avoidance features that circumvent the spirit of the congressionally authorized language used in a statute.\(^3\) While there has been a relative resurgence of the economic substance doctrine in recent years based on the proliferation of corporate tax shelters,\(^4\) the economic substance doctrine, in its current incarnation, was born in 1935 in *Gregory v. Helvering*.\(^5\)

At its foundation, economic substance is designed to be a fluid concept that eliminates the pretenses of structured transactions and can be applied to a unlimited range of transactions, giving the Internal Revenue Service the ability to challenge technical tax results based on

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\(^3\) Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 870 (1982), reviewing Boris I Bittker, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* (Warren, Gorham & Lamont 1981). “The [economic substance] doctrine has assured us that neither the government nor practitioners will succeed in their roles if they are excessively literal and mechanical in their reading of the statute; if they fail to read it as part of a statutory scheme through which Congress seeks to accomplish a goal that has breadth and durability.” 104 Tax Notes 445 (July 26, 2004).

\(^4\) From 1995 through October of 2006, the United States utilized the economic substance doctrine to challenge taxpayers in 170 decided court cases involving over $4.4 billion in taxable income. Petition for a Writ of Certiorari, *Dow Chemical Co v. United States*, 06-478, at p. 12-13 (Oct. 4, 2006). This, of course, does not reflect assertions by the United States of the economic substance that were settled or otherwise resolved prior to trial. In Coltec Industries, Inc. v. United States, the Court of Federal Claims questioned the validity of the economic substance doctrine as violating the separation of powers based principally extra-legislative requirements imposed through the economic substance doctrine not enacted by Congress. *Coltec Indus., Inc. v. United States*, 62 Fed. Cl. 716, 718, 730 (2005). This conclusion was vacated and remanded by the Federal Circuit, reiterating the viability of the economic substance doctrine. *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1357 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (2007).

subjective standards that overlay the objective rules prescribed by the Internal Revenue Code.  

Economic substance itself contains an element of the subjective and an element of the objective. All courts agree on the test, phrased in differing terminology, that the economic substance doctrine has two measuring standards. First, a transaction has economic substance if the transaction is rationally related to a useful non-tax business purpose. Second, a transaction has economic substance if the transaction results in a meaningful and appreciable enhancement in the net economic position of the taxpayer other than the reduction of taxes.

Since Gregory, the subjective element of economic substance – the business purpose doctrine – has been used by the Internal Revenue Service to reclassify an otherwise valid transaction entered into by private parties with advantageous tax consequences. The nature of a transaction permits taxpayers to select its form giving a taxpayer the ability to effectuate the transaction that gives rise to tax benefits without involving the government as a party in interest. Not surprisingly, when parties to a transaction are not adverse and the only non-participating adverse party is the tax collector, there is a necessity to protect against manipulating the tax consequences of a transaction.

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While many commentators debate the intricacies of the economic substance doctrine, this is merely half of the story. Economic substance cases universally involve significant tax liabilities and an equally significant number of cases with variations on the same type tax planning or tax sheltering activities. Because of the significant stakes involved in these cases, a decision of the trial court is routinely challenged in an appellate forum.

As a result, business purpose and profitability initially define the inquiry in the trial court. Because the Supreme Court has avoided the standard of review question in economic substance cases, appellate courts determine the ultimate winner and ultimate loser and standards of review determine the rules of the game. The rules, however, differ depending on the where the game is played with five circuits favoring a clearly erroneous standard of review, three circuits


The five circuits favoring the clear error test are the Second Circuit, the Third Circuit, the Fourth Circuit, the Seventh Circuit, and the D.C. Circuit. See, e.g., Nicole Rose Corp. v. Commissioner, 320 F.3d 282, 284 (2d Cir. 2002) (“Whether a transaction lacks economic substance is a question of fact that we review under the clearly erroneous standard.”); ACM Partnership v. Commissioner, 157 F.3d 231, 245 & n.25 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (“[W]e review [the Tax Court’s] factual findings, including its ultimate finding as to the economic substance of a transaction, for clear error.”); Black & Decker Corp. v. United States, 436 F.3d 431, 441 (4th Cir. 2006), following Rice’s Toyota World, Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985) (“Whether … a particular transaction is a sham is an issue of fact, and our review of the tax court's subsidiary and ultimate findings on this factual issue is therefore under the clearly erroneous standard.”); Yosha v. Commissioner, 861 F.2d 494, 499 (7th Cir. 1988) (“The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard.”); N. Ind. Pub. Serv. Co. v. Commissioner, 115 F.3d 506, 51 (7th Cir. 1997) (“Our review of decisions regarding the economic substance of transactions for federal income tax purposes is for clear error”); ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 511 (D.C. Cir. 2000), cert. denied, 531 U.S. 871 (2000) (stating that in sham partnership
favoring a de novo standard of review,\textsuperscript{13} and four additional circuits unequivocally conflicted in the application of a standard of review.\textsuperscript{14}

\textsuperscript{13} The three circuits that favor the de novo test are the Sixth Circuit, the Tenth Circuit, and the Federal Circuit. See, e.g., James v. Commissioner, 899 F.2d 905, 909 & n.5 (10th Cir. 1990) (“[W]e review de novo the ultimate characterization of the transactions as shams.”); Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1357 (Fed. Cir. 2006) (“[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference”); Dow Chemical Co. v. United States, 435 F.3d 594, 599, cert. denied, 127 S. Ct. 1251 (2007) (6th Cir. 2006) (“The district court's ultimate conclusion that a transaction is or is not an economic sham is reviewed de novo.”).

\textsuperscript{14} The four circuits in conflict are the Fifth Circuit, the Eighth Circuit, the Ninth Circuit, and the Eleventh Circuit. Cf. Gulig v. Comm’r, 293 F.3d 279, 281 (5th Cir. 2002) (review under “clear error” standard), and Lukens v. Comm’r, 945 F.2d 92, 97 (5th Cir. 1991) (“reviewable under the clearly erroneous standard.”) with Compaq Computer Corp. v. Comm’r, 277 F.3d 778, 780-81 (5th Cir. 2001) (“reviewed de novo.”).

\textit{Cf. Massengill v. Comm’r}, 876 F.2d 616, 619 (8th Cir. 1989) (economic substance inquiry as “essentially factual,” and, therefore, subject to clearly erroneous standard of review) with IES Indus., Inc. v. United States, 253 F.3d 350, 351 (8th Cir. 2001) (economic substance of transaction is a question of law and subject to de novo review).

\textit{Cf. Harbor Bancorp v. Commissioner}, 115 F.3d 722, 727 (9th Cir. 1997), cert. denied, 522 U.S. 1108 (1998) (“finding of fact we review for clear error.”); Erhard v. Commissioner, 46 F.3d 1470, 1476 & n.7 (9th Cir. 1995), cert. denied, 516 U.S. 930 (1995) (“economic substance is a factual determination that this court reviews for clear error”); Casebeer v. Commissioner, 909 F.2d 1360, 1362 & n.6 (9th Cir. 1990) (“We review the tax court’s ultimate conclusion . . . for clear error.”) with Sacks v. Commissioner, 69 F.3d 982, 986 (9th Cir. 1995) (“application of the legal standards to the facts found [in economic substance cases is] reviewed \textit{de novo}”).

\textit{Cf. Karr v. Commissioner}, 924 F.2d 1018, 1023 (11th Cir. 1991), cert. denied, 502 U.S. 1082 (1992) (“[T]he Tax Court’s finding . . . subject to the clearly erroneous standard of review.”) with United Parcel Service of America, Inc. v. Commissioner, 254 F.3d 1014, 1017 (11th Cir. 2001) (“The question of the effect of a transaction on tax liability, to the extent it does not concern the accuracy of the tax court's fact-finding, is subject to de novo review.”);
Because the selection of a deferential standard of review often dictates the outcome, this article considers the second question vital to the economic substance doctrine. How should the judicially created economic substance doctrine operate in an appellate proceeding?

Kirchman v. Commissioner, 862 F.2d 1486, 1490 (11th Cir. 1989) (standard of review is de novo).


16 The government has taken the position that the standard of review in some cases is a de novo standard while, in others, it claims that a clearly erroneous standard of review applies. Cf. American Electric Power Co. v. United States, 326 F.3d 737, 741 (6th Cir. 2003), cert. denied, 540 U.S. 1104 (2004) (asserting a clearly erroneous standard of review after decision of the trial court in favor of the government); Cashman v. United States, 931 F.2d 896 (Table), 1991 WL 67902 (9th Cir. May 2, 1991), cert. denied, 502 U.S. 1075 (1992) (same); Newman v. Commissioner, 902 F.2d 159, 162 (2d Cir. 1990) (same) with Brief for Appellant, Dow Chemical Co. v. United States, 2004 WL 5329408, at *33 (6th Cir. Oct. 28, 2004) (citing American Electric Power v. United States, 326 F.3d 737, 742 (6th Cir. 2003), cert. denied, 540 U.S. 1104 (2004) and arguing that Dow’s COLI plans were not shams is reviewed de novo after decision of the trial court in favor of taxpayer). See also Rexnord, Inc. v. United States, 940 F.2d 1094, 1096 (7th Cir. 1991) (government argues mixed question of law and fact requiring a clearly erroneous standard).

The change in position concerning the standard of review leads to a logical conclusion that the United States is trying to achieve favorable results on a case by case basis. Tax policy and the rule of law should dictate consistency of position notwithstanding the result reached by a court below thereby dictating its position on appeal. See Richard M. Lipton, What Will Be the Long-Term Impact of the Sixth Circuit’s Divided Decision in Dow Chemical?
Traditionally, notions of the level of appellate review hinge on the distinction between law and fact. Application of these notions to appellate review is a rather simplistic exercise – appellate courts are free to review legal conclusions de novo and factual findings are allowed a level of deference such that findings of fact, whether based on oral or documentary evidence, shall not be set aside unless “clearly erroneous.” While seemingly straightforward, the distinction between a factual finding and a legal conclusion is often murky. The problem is describing what constitutes fact, what constitutes law, and what constitutes both. Determining the level of review under the economic substance doctrine illustrates the inherent problem in defining the fact/law distinction.

In the context of economic substance cases, appellate review should be guided by the division of responsibilities in the judicial system. Appellate courts have two primary objectives and the distribution of discretion along the judicial hierarchy should relate to those two purposes. Appellate courts should serve to develop the law in a particular area as guidance for future cases and to rectify egregious errors in a particular case. In considering subjective and objective economic substance, these purposes are accomplished through the application of a clearly erroneous standard of review.

Under both the subjective and objective economic substance tests, decisions of trial courts, while likely to be significant in terms of dollars at issue, are unlikely to have any appreciable impact on the development of the law in the economic substance area. The subjective

104 J. Tax'n 332, 337 (2006) (“The expansive interpretation of Knetsch . . . is likely to continue the impression that the government is more interested in favorable results than the rule of law, which can only lead to long-term adverse consequences.”).

While unrelated to carousel of positions by the Internal Revenue Service on the standard of review issue, Professor Ginsburg’s point seems appropriate – “Every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the Commissioner on the hind part.” Martin D. Ginsburg, Making Tax Law Through the Judicial Process, A.B.A. J., Mar. 1984, at 76.

17 Isaacs, The Law and The Facts, 22 COLUM. L. REV. 1 (1922) (defining the distinction between law and fact in terms of “delusive simplicity”).
economic substance test incorporates the concept of business purpose and, as a result, relies on the particularized exigencies of a specific business. Necessarily, business purpose for one business may or may not be a business purpose for another business, even if both businesses are similar in nature. A trial court decision considering whether one business satisfied the subjective business purpose doctrine is irrelevant to finding business purpose of another. The result in one case, therefore, fails to advance to law in another.

The second rationale is related to the first. Because subjective business purpose does not appreciably advance the law, decisions relate to particular cases. Through a clearly erroneous standard of review, appellate courts maintain their role in the judicial structure in ensuring that a trial court is not too wrong in reaching a result in a particular case.

Under the objective business purpose doctrine, subjective factors are not considered; however, a determination of whether there is a meaningful increase in the net economic position of the taxpayer other than the reduction of taxes will fail to advance the law with respect to other cases, notwithstanding disparities or similarities in business operations. Just as under the subjective economic substance test, the result of this mathematical calculation has little, if any, bearing on results that occur in other cases. Moreover, appellate courts, using the clearly erroneous standard of review, may rectify egregious errors of the trial court.

Under the objective standard, there are no particularized business exigencies similar to those that arise under the subjective economic substance standard and that the objective economic substance test relies on external factors unrelated to the inherent uniqueness of a particular business. As a result, the clearly erroneous standard of review should be adopted under economic substance test, whether the

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18 But see Petition for a Writ of Certiorari, Dow Chemical Co v. United States, 06-478, at p. 27-28 (Oct. 4, 2006); John B. Magee and Gerald Goldman, Uncut Gems: Judicial Review in Economic Substance Appeals, 116 Tax Notes 481 n.9 (Aug. 6, 2007) (“Even under the objective prong of the two-prong test, the taxpayer's subjective business plans logically must be considered simply to establish the terms of the transaction whose objective economic substance is to be assessed.”).
conjunctive or disjunctive test is adopted by a particular circuit or whether Congress codifies the economic substance doctrine.

II. ECONOMIC SUBSTANCE

Economic substance is described in a variety of ways by a variety of courts and commentators but generally prohibits taxpayers from obtaining the tax benefit of a transaction unless the transaction has an appreciable economic benefit distinct from the tax savings resulting from the transaction.\(^1\)

Under the economic substance doctrine, a taxpayer may therefore comply with the words of a statute or regulation but may nonetheless be denied the form of the transaction because the transaction lacked economic substance. Under these inquiries, transactions that do not impact the economic position of a taxpayer have no effect, thereby denying the tax benefits otherwise permitted under the relevant statutory or regulatory language.

Economic substance consists of two elements – the subjective intent of the taxpayer in entering into the transaction and the objective economic impact of the transaction absent the tax implications. The subjective aspect of economic substance requires a taxpayer to have a non-tax business purpose for the transaction while the objective economic substance test requires a taxpayer to demonstrate that its economic position is enhanced by engaging in the transaction.

\(^1\) The Tax Court, in ACM Partnership described economic substance in the following terms:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.

Subjective tax avoidance motives and objective inquiries have been part of our tax landscape as early as the time of the first income tax law in 1913. While many, if not most, of the provisions in the Internal Revenue Code are objective, subjective features do permeate the Code. Both aspects form the basis of the economic substance test.

Courts apply the economic substance tests in either the conjunctive or the disjunctive. The conjunctive test requires a

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20 In the Revenue Act of 1913, an accumulated earning tax was enacted that taxed the shareholders on the earnings of any corporation if the accumulation of income in the corporation was for the purpose of avoiding the surtax. Revenue Act of 1913, ch. 16, § 2, 38 Stat. 166.

21 See e.g. IRC § 163(h)(2)(C) allowing the deduction for interest on a qualified residence. Thus, the mortgage interest deduction creates a tax subsidy to encourage home ownership notwithstanding that a taxpayer’s motive may be in large part tax avoidance. In this sense, a taxpayer can deduct interest payments on a qualified residence owned but not a residence that is rented. If a taxpayer confesses his tax avoidance motive in buying a house instead of renting, the mortgage interest deduction is not denied. See Alan Gunn, Tax Avoidance, 76 MICH. L. REV. 733, 750 (1978).

22 At present, there are 47 references in the Internal Revenue Code to “principal purpose,” suggesting a subjective element incorporated in the particular code section at issue, thereby granting tax-favored status to those business transactions that are not tainted by tax avoidance. See IRC §§ 23, 38, 41, 48, 119, 136, 170, 172, 197, 269, 269A, 302, 306, 311, 336, 355, 357, 367, 382, 409, 414, 453, 467, 468B, 501, 514, 614, 643, 751, 864, 877, 904, 953, 954, 1022, 1031, 1272, 1298, 2107, 2501, 4911, 6015, 6050D, 6662, 7872, 7874, and 9722. In addition, there are nine references in the Internal Revenue Code to “business purpose.” See IRC §§ 274, 341, 357, 441, 444, 593, 706, 1378, and 2032A.


24 Rice’s Toyota World v. Commissioner, 752 F.2d 89, 91-92 (4th Cir. 1985); IES Industries v. United States, 253 F.3d 350, 358 (8th Cir. 2001); Horn v.
taxpayer to satisfy both aspects of the economic substance test -- that the taxpayer had a non-tax business purpose for the transaction and the transaction had objective economic substance. Conversely, the disjunctive test requires a taxpayer to satisfy either of the tests to obtain the tax benefits of the transaction -- the transaction has economic substance if the taxpayer had either a non-tax business purpose for the transaction or the transaction had objective economic substance.

Congress is moving toward codification of the economic substance doctrine. In its detailed description of codification efforts, the Senate Finance Committee proposes a conjunctive test -- (1) the transaction changes in a meaningful way (apart from Federal income

25 A number of cases also apply the strictly apply the conjunctive test but have not adopted the disjunctive test. See, e.g., ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); Pal International Corp. v. Commissioner, 69 F.3d 982, 985 (9th Cir. 1995); Sacks v. Commissioner, 69 F.3d 982, 985 (9th Cir. 1995); James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990).

26 A two prong disjunctive test was created by the Supreme Court in 1943 in Moline Properties v. United States to determine whether the separate existence of a corporation should be recognized for tax purposes. Moline Properties v. United States, 319 U.S. 436 (1943). Under this test, a separate corporate existence would be recognized if a taxpayer was able to demonstrate a legitimate, non-tax business purpose that is advanced by selecting a separate corporate existence or that the entity engaged in sufficient business activity. Moline Properties, 319 U.S. at 439. See Rogers v. Commissioner, 34 T.C.M. (CCH) 1254, 1256 (1975) (“In applying the Moline test, courts have looked most frequently to the language following the disjunctive ‘or,’ i.e., the business activity of the corporation. Little emphasis has been placed on business purpose. Courts have recognized, however, that Moline establishes a two-pronged test, the first part of which is business purpose, and the second, business activity.”) See also Elot H. Raffety Farms, Inc. v. United States, 511 F.2d 1234, 1238 (8th Cir., cert. denied, 423 U.S. 834 (1975); O'Neill v. Commissioner, 271 F.2d 44, 49 (9th Cir. 1959); Jackson v. Commissioner, 233 F.2d 289, 290 (2d Cir. 1956); Harrison Property Management Co., Inc. v. United States, 475 F.2d 623, 626 (Ct. Cl. 1973); Collins v. United States, 386 F. Supp. 17, 19 (S.D. Ga. 1974), aff’d, 514 F.2d 1282 (5th Cir. 1975); Carver v. United States, 412 F.2d 233, 236 (Ct. Cl. 1969); Tomlinson v. Miles, 316 F.2d 710, 714 (5th Cir. 1963).
tax consequences) the taxpayer’s economic position, and (2) the taxpayer has a substantial non-Federal-tax purpose for entering into such transaction. Codification of the economic substance doctrine, under this or any other bill introduced on this topic, do not consider, much less address, standard of review parameters. As a result, codification is not relevant to my premise.

A. SUBJECTIVE ECONOMIC SUBSTANCE TEST

Subjective economic substance requires that a taxpayer demonstrate a business reason for engaging in a transaction other than the tax savings obtained through the transaction. In other words, a taxpayer must have a business purpose for entering into a transaction.

1. HISTORICAL PERSPECTIVE OF BUSINESS PURPOSE

Gregory v. Helvering is universally given credit for founding the business purpose doctrine in 1935. The foundations for Gregory, however, were developed by the Fifth Circuit in Pinellas Ice & Cold Storage v. Commissioner and the Second Circuit in Cortland Specialty Co. v. Commissioner in 1932. In Pinellas Ice, the Fifth Circuit held that, although a transfer satisfied the literal reorganization provision that admittedly covered the particular transaction, the transaction could

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27 The Senate Finance Committee has issued a detailed description of the economic substance doctrine amendment added to the Heartland, Habitat, Harvest, and Horticulture Act of 2007, which the Committee approved on October 4, 2007.

28 The business purpose test “examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved.” Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990); Rice’s Toyota World v Commissioner, 752 F.2d 89 (4th Cir. 1985).

29 Pinellas Ice & Cold Storage v. Commissioner, 57 F.2d 188 (5th Cir. 1932); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir.), cert. denied, 288 U.S. 599 (1932).
not be categorized as a reorganization because of the lack of continuity of interest in the owners of the business.\textsuperscript{30}

More interesting is the legacy of \textit{Cortland Specialty Co.}\textsuperscript{31} In this case, Judge Augustus Hand, writing for the Second Circuit, determined that a “‘reorganization presupposes continuance of business under modified corporate forms.’”\textsuperscript{32} Two years later and with Augustus Hand on the panel, his cousin and close friend, Learned Hand, wrote the opinion for the Second Circuit in \textit{Helvering v. Gregory}.\textsuperscript{33} Judge Learned Hand concluded that the reorganization provision at issue presumed that the reason for the reorganization was germane to the enterprise itself and not as a by-product of the minimization or deferral of taxes.\textsuperscript{34}

On appeal, the Supreme Court, with Justice Sutherland writing, adopted the reasoning and decision by Judge Hand, concluding that the proposed tax-free reorganization had no business purpose and the transactions at issue were a “‘mere device that put on the form of a corporate reorganization as a disguise for concealing its real character.’”\textsuperscript{35} In this case, the transactions fell outside the bounds of the “plain intent of the statute.”\textsuperscript{36} The Court, accordingly, disregarded the form of the transactions and determined that the transactions were taxable, noting that “[t]o hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.”\textsuperscript{37}

\textsuperscript{30} \textit{Pinellas Ice & Cold Storage v. Commissioner}, 57 F.2d 188, 189 (5th Cir. 1932).

\textsuperscript{31} \textit{Cortland Specialty Co. v. Commissioner}, 60 F.2d 937 (2d Cir.), cert. denied, 288 U.S. 599 (1932).

\textsuperscript{32} \textit{Cortland Specialty Co.}, 60 F.2d at 940.

\textsuperscript{33} \textit{Helvering v. Gregory}, 69 F.2d 809 (2d Cir. 1934), rev’g, 27 B.T.A. 223 (1932).

\textsuperscript{34} \textit{Helvering v. Gregory}, 69 F.2d at 811.

\textsuperscript{35} \textit{Id.} at 469.


\textsuperscript{37} \textit{Gregory v. Helvering}, 293 U.S. at 470.
Gregory, as articulated by Judge Hand and adopted by the Supreme Court, began as a continuity of interest test. As decades passed however, the continuity requirement morphed into the business purpose doctrine.

Initially, Gregory was limited to transactions in which a newly formed corporation was liquidated shortly after its creation and its impact was “confined strictly to the facts there presented.” In 1943, however, the Tax Court, relying on Gregory, held that the absence of a business purpose prevented a corporation from deducting interest payments on a loan made to shareholders that benefited the shareholders in their individual capacities.

As originally developed by Judge Hand, it appears that a business purpose is inherent in the continuity of business requirement under the reorganization provisions. Subsequently, it appears that Judge Hand expanded the scope of his original creation, dissenting in Gilbert v. Commissioner –

The literal meaning of the words of a statute is seldom, if ever, the conclusive measure of its scope. Except in rare instances, statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover; and their ‘interpretation’ demands the projections of their expressed purpose, upon occasions, not present in the minds of those who enacted them... If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part

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38 See Bremer v. White, 10 F. Supp. 9, 12 (D. Mass 1935) (without proof that the newly created corporation dissolved, the court assumed a continuity of business existed and a reorganization took place).


of the purpose of the [Internal Revenue Code] to provide an escape from the liabilities it sought to impose.\(^{41}\)

Applying Gregory, a business purpose is the subjective condition to the objective manifestation of business continuity.\(^{42}\) Taking Gregory in light of its subsequent interpretation, a business purpose is the subjective condition to the objective manifestation of economic substance.

2. MODERN APPLICATION OF BUSINESS PURPOSE

The business purpose doctrine is a non-statutory method used by the government to recast transactions that comply with the literal wording of the Internal Revenue Code but are nonetheless prohibited from receiving the tax advantages resulting from those provisions because such tax advantages were not intended by the Internal Revenue Code.\(^{43}\) From its initial narrow interpretation, Gregory and “business purpose” have grown such that the use of the term evokes a range of meanings that promotes greater vagueness. It is the very vagueness in the definition of business purpose that makes it a more adaptable definition.\(^{44}\)

Business purpose is an attempt to reach the correct result based on the specifics of a transaction in light of the specifics of a particular business, considering the motives of a taxpayer and whether the transaction served a useful non-tax purpose.

The Tax Court, in ACM Partnership, described the subjective business purpose doctrine:

\(^{41}\) Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957 (Hand, J., dissenting).


[T]he transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and useful in light of the taxpayer’s economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.\footnote{ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 2189, 1997 WL 93314, at *39 (1997), citing Cherin v. Commissioner, 89 T.C. 986, 993-994 (1987).}

Business purpose also recognizes that taxes play a major part of business decisions and corporate behavior. Business purpose does not exclude taxes from consideration but instead seeks to impose limits on their impact.\footnote{Robert Thornton Smith, Business Purpose: The Assault Upon the Citadel, 53 TAX. LAW. 1, xxx after Fn 43 (1999).} It does not permit a “high-stakes game in which taxpayers bet transaction costs against their ability to find and exploit anomalies in the Code and regulations.”\footnote{Martin J. McMahon, Jr., Business Purpose, Economic Substance, and Corporate Tax Shelters: Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code, 54 SMU L. REV. 195, 196 (2001). See Ellen P. Aprill, Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines, 54 SMU L. REV. 9 (2001); Mark P. Gergen, The Common Knowledge of Tax Abuse, 54 SMU L. REV. 131 (2001).}

According to the IRS, a determination of whether a transaction has “business purpose” must consider a number of factors –

(i) whether a profit was even possible;

(ii) whether the taxpayer had a non-tax business reason to engage in the transaction;

(iii) whether the taxpayer, or its advisors, considered or investigated the transaction, including market risk;
(iv) whether the taxpayer really committed capital to the transaction;

(v) whether the entities involved in the transaction were entities separate and apart from the taxpayer and engaging in legitimate business before and after the transaction;

(vi) whether all the purported steps were engaged in at arms-length with the parties doing what the parties intended to do; and

(vii) whether the transaction was marketed as a tax shelter in which the purported tax benefits significantly exceeded the taxpayer’s actual investment.48

In attempting to demonstrate that these factors favoring a business purpose are not satisfied, the Internal Revenue Service may attempt to show that --

(i) documents or other evidence that the transactions at issue were sold as tax shelters with limited consideration of the underlying economics of the transaction;

(ii) evidence that the taxpayer, or its advisors, did not investigate the market risk prior to entering into the transaction;

48 Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995); Winn-Dixie, Inc. v. Commissioner, 113 T.C. 254 (1999), aff’d, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002); Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989); Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Newman v. Commissioner, 894 F.2d 560, 563 (2d Cir. 1990); Salina Partnership v. Commissioner, T.C. Memo 2000-352 (2000); Kirchman, v. Commissioner, 862 F.2d 1486 (11th Cir. 1989); Nicole Rose Corp. v. Commissioner, 117 TC 328 (2001); IES Industries Inc. v. Commissioner, 253 F.3d 350, 355-356 (8th Cir. 2001); James v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993). See Donald L. Korb, Remarks at the 2005 University of Southern California Tax Institute, The Economic Substance Doctrine in the Current Tax Shelter Environment (Jan. 25, 2005).

I do not concede that these factors are the appropriate factors nor that these factors constitute an exclusive list. For my purposes, these factors demonstrate potential considerations that may be relevant to a determination of business purpose.
(iii) evidence that the independent parts making up the transaction were not entered into at arm’s length, and

(iv) evidence that a prudent investor would have or could have accomplished similar objectives using much simpler or more direct methods. 49

These types of considerations inevitably consider written documentation concerning the transaction. Simply because the benefits are achieved does not violate the subjective element of business purpose. While the Internal Revenue Service may consider the relationship between the tax benefits and the amount of income to be offset, 50 more important is whether there is also a business purpose to the transaction, demonstrated through competent evidence that non-tax considerations were evident in considering the transaction.

B. OBJECTIVE ECONOMIC SUBSTANCE TEST

The objective economic substance test requires a taxpayer to demonstrate that its economic position is enhanced by engaging in the transaction. 51 In order to satisfy the objective element, clairvoyance is not required. The transaction is not required to actually produce a profit to satisfy this test; instead, it is the potential for profit that is measured. 52 Profit potential applies a reasonable person standard – in

49 See Donald L. Korb, Remarks at the 2005 University of Southern California Tax Institute, The Economic Substance Doctrine in the Current Tax Shelter Environment at 14 (Jan. 25, 2005).

50 See Donald L. Korb, Remarks at the 2005 University of Southern California Tax Institute, The Economic Substance Doctrine in the Current Tax Shelter Environment (Jan. 25, 2005).

51 See, e.g., Rice's Toyota World v. Commissioner, 752 F. 2d 89, 94 (4th Cir. 1985) (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits). See also Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 781 (5th Cir. 2001); IES Industries v. United States, 253 F.3d 350, 354 (8th Cir. 2001).

52 Knetsch v. United States, 364 U.S. 361, 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Abramson v. Commissioner, 86 T.C. 360 (1986). Some courts have utilized the economic substance doctrine if economic risks and profit potential, while existent, were nonetheless in
this case a reasonable businessman standard – by determining whether a potential for profit exists such that a reasonable businessman would invest in the venture based on standards applicable to the particular industry. As a result, the transaction must be potentially profitable to satisfy this inquiry.

The objective economic substance test does not determine liability based on a subjective thought process but, neither does it grant favorable tax consequences based on the mere absence of thought. With the absence of thought protection, self-induced ignorance does not create a tax advantage.

Demonstrating that the economic position of a taxpayer is enhanced can avoid investigating the subjective intentions of a taxpayer because the answer to that inquiry can be determined on the basis of the facts of the transaction itself. Necessarily, business purpose is absent from such a determination because objective economic substance lacks an inquiry into motives of a transaction but instead views the significant compared to the tax benefits. See, e.g., Goldstein v. Commissioner, 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990) (stating that “potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions”). See Walter J. Blum, Motive, Intent, and Purpose in Federal Income Taxation, 34 U. Chi. L. Rev. 485, 499 (1967) (“there may currently be no tax rules which specifically provide that classification of an action is to be postponed until the outcome of the action is known”).


54 See Commissioner v. Wilson, 353 F.2d 184 (1965) (“so much in the way of liability for taxes can hardly be allowed to depend solely upon what goes on in someone’s mind”). See also Walter J. Blum, Motive, Intent, and Purpose in Federal Income Taxation, 34 U. Chi. L. Rev. 485, 519-20 (1967).

55 But see Petition for a Writ of Certiorari, Dow Chemical Co v. United States, 06-478, at p. 27-28 (Oct. 4, 2006); John B. Magee and Gerald Goldman, Uncut Gems: Judicial Review in Economic Substance Appeals, 116 Tax Notes 481 n.9 (Aug. 6, 2007) (“Even under the objective prong of the two-prong test, the taxpayer's subjective business plans logically must be considered simply to establish the terms of the transaction whose objective economic substance is to be assessed.”).
transaction as an objective manifestation of itself. This, of course, does not preclude credibility determinations by a trier of fact concerning whether certain facts should be considered as part of the transaction that is to be measured objectively. For example, the question as to whether a commitment to invest future cash in a corporate-owned whole life insurance (“COLI”) plan should be considered in determining whether there is an appreciable enhancement in the net economic position of the taxpayer does not alter the objectiveness of the economic substance test.  

The underlying concepts of business purpose and profit potential define the measure by which trial courts initially resolve whether a transaction has economic substance in addition to satisfying the literal terms of the Internal Revenue Code. Thus, to qualify for the benefits permitted under the Code, the doctrine produces an additional impediment that a taxpayer must navigate to otherwise obtain the tax benefits expressly permitted by the tax code. A standard of review determines how an appellate court approaches a determination by a trial court that considers the economic substance doctrine.

III. STANDARDS OF REVIEW

Standards of review define the rules of the game by defining the scope of power between judicial actors, each functioning within a statutory or rule-based scheme and carrying out specified responsibilities under that system.

56 See Petition for a Writ of Certiorari, Dow Chemical Co v. United States, 06-478, at p. 2 (Oct. 4, 2006)
57 Knetsch, 364 U.S. at 367.
58 Lerman v. Commissioner, 939 F.2d 44, 52 (3d Cir.), cert. denied, 502 U.S. 984 (1991) (“it is settled federal law that for transactions to be recognized for tax purposes they must have economic substance. Therefore, economic substance is a prerequisite to the application of any Code provisions allowing deductions.”)
59 See Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 NOTRE DAME L. REV. 645, 645 (1988) ("Rule 52(a) serves a vital institutional role in allocating responsibility and power of decision between district courts and the courts of appeals.").
A standard of review reflects the degree to which the original decisionmaker must be wrong for a reviewer to reverse the original decision. Traditionally, judicial review utilizes three standards – de novo, clearly erroneous, and abuse of discretion.

In short, de novo review applies to questions of law while a clearly erroneous standard of review applies to questions of fact. The de novo standard of review is the least restrictive to reviewing courts as it provides no degree of deference and permits a reviewing court to determine the correct resolution of an issue on its own accord. In essence, de novo review provides no deference but is a judicial determination of an issue entirely independent of prior resolution. Under a de novo standard, a reviewing court is “willing to reverse a conclusion of law solely on the basis that it believes that conclusion to be incorrect.”

The clearly erroneous standard of review applies to questions of fact and gives a significant amount of deference to the trier of fact.

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65 Id.

Under the clearly erroneous standard of review, "[a] finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." 68 In other words, a reviewing court will not substitute its judgment for the judgment of the trier of fact notwithstanding that had the appellate court been sitting as a trial court, it may have reached a different finding. 69 Any determination of the trial court under this standard carries with it significant weight. 70


68 Id at 573 (quoting U.S. Gypsum Co., 333 U.S. at 395; clearly erroneous standard "plainly does not entitle a reviewing court to reverse the finding of the trier of fact simply because it is convinced that it would have decided the case differently.").

69 Anderson, 470 U.S. at 574 (if determination of fact finder "is plausible in light of the record viewed in its entirety, the [reviewing court] may not reverse it even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently.").

Under the clearly erroneous standard of review, a level of discretion is given to the trier of fact and the appellate court does not alter a recommendation unless it holds a “definite and firm conviction that a mistake has been committed.” Utilizing such a standard, an appellate court must accept the determination of facts of the trier of fact as correct unless clear evidence suggests an alternative.

As such, a clearly erroneous standard of review would not entitle an appellate court to “reverse the finding of the [ trier of fact] simply because it is convinced that it would have decided the case differently.” Consequently, the role of the appellate court under a clearly erroneous standard of review is “not to decide factual issues de

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73 Anderson, 470 U.S. at 573.
Where there are two permissible views of the evidence, the factfinder’s choice between them cannot be clearly erroneous.\(^75\)

**A. HISTORICAL PERSPECTIVES**

The scope of review by appellate courts is not a new question. Beginning with the Constitution over 200 years ago, the question first surfaced with a provision that provides that the “supreme court shall have appellate Jurisdiction both as to Law and Fact, with such Exceptions and under such Regulations as the Congress shall make.”\(^76\)

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\(^75\) United States v. Yellow Cab Co., 338 U.S. 338, 342 (1949) ("Such a choice between two permissible views of the weight of evidence is not ‘clearly erroneous.’"). See Inwood Labs., Inc. v. Ives Labs., Inc., 456 U.S. 844 (1982). In more colorful language, the Seventh Circuit equated the clearly erroneous standard and permitting reversal only if decision is “wrong with the force of a five-week old, unrefrigerated dead fish.” Parts and Elec. Motors v. Sterling Elec., 866 F.2d 228, 233 (7th Cir. 1989).

\(^76\) U.S. CONST. art. III, § 2 cl. 2. The scope of review of jury determinations has been of an equal historical perspective. The Sixth Amendment provides that “[i]n all criminal prosecutions, the accused shall enjoy the right to a speedy and public trial, by an impartial jury of the State and district wherein the crime shall have been committed . . . .” while the Seventh Amendment provides that “[i]n Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law.” U.S. CONST. AMEND. VI; U.S. CONST. AMEND. VII. In this context, a jury makes credibility determinations, determines the weight applied to evidence presented, draws inferences from the evidence presented. Robert L. Stern, *Review of Findings of Administrators, Judges and Juries: A Comparative Analysis*, 58 Harv. L. Rev. 70, 73-74 (1944-45). This construction permits a body of persons representing the community, without particular legal expertise, to make factual determinations. Robert L. Stern, *Review of Findings of Administrators, Judges and Juries: A Comparative Analysis*, 58 Harv. L. Rev. 70, 81 (1944-45); Bohlen, *Mixed Questions of Law and Fact*, 72 U. Pa. L. Rev. 111, 116 (1924). The scope is this article, however, is restricted to facts determined by a trial judge.
Historically, suits initiated under common law were heard by juries and suits in equity were heard by judges.\textsuperscript{77} In the equity context, an appellate court considered factual and legal questions independently of a determination by a trial judge.\textsuperscript{78} As a result, appellate courts possessed unlimited power to review the entire record of the trial court. In essence, this practice considered the manner in which a case was presented, through depositions and interrogatories, that were conducted by the parties in private. As a result, an appellate court was in as advantageous of a position for making decisions of factual issues as was the trial court.\textsuperscript{79}

In 1912, courts in equity began to hear oral testimony pursuant to the Federal Equity Rules and appellate courts, recognizing that the previous de novo method of review placed them at a disadvantage compared to the judge who heard the testimony, abandoned the de novo standard in favor of standard giving great weight to the findings of trial judges.\textsuperscript{80} This self-imposed limitation was based principally on the ability to make credibility determinations and represented the superior position of the trial judge on matters of credibility. Because the trial judge heard the testimony that served as the basis for the finding of


\textsuperscript{78} 3 Moore, Federal Practice § 52.01 (1938); District of Columbia v. Pace, 320 U.S. 698, 701 (1944); Morley Construction Co. v. Maryland Casualty Co., 300 U.S. 185, 191 (1939); Keller v. Potomac Elec. Power Co., 261 U.S. 428, 444 (1923); La Abra Silver Mining Co. v. United States, 175 U.S. 423, 464-65 (1899).


\textsuperscript{80} Federal Equity Rule 46. See Clark and Stone, \textit{Review of Findings of Fact}, 4 U. CHI. L. REV. 190, 203-04 (1937). See also Butte & Superior Copper Co. v. Clark-Montana Realty Co., 249 U.S. 12, 30 (1919) (findings of fact by a trial judge were presumptively correct and were not disturbed on appeal unless clearly wrong); Baker v. Schofield, 243 U.S. 114, 118 (1917) (“when two courts have reached the same conclusion on a question of fact, their finding will not be disturbed unless it is clear that their conclusion was erroneous.”).
fact, findings of fact by trial judges were not disturbed unless such findings were clearly erroneous.\textsuperscript{81}

Thus, the predecessor to the “clearly erroneous” rule, later adopted in the Federal Rules of Civil Procedure, applied to findings based on conflicting testimony or facts derived or inferred from such testimony. In cases of uncontradicted evidence or evidence by document or deposition, appellate courts did not consider themselves bound by trial court determinations since the appellate courts considered themselves just as qualified to make such factual determinations.

Distinctions between law and equity were confused at best and, in 1934, a new set of rules attempted to eliminate the distinctions. Initially, the draft rules provided that facts determined by a judge as opposed to a jury would “have the same effect as that heretofore given to findings in suits in equity.”\textsuperscript{82} The draft rule prompted a discussion that highlighted the distinction between a heightened deference standard that was applied to findings by a jury at law or a lower standard of review given in equity practice.\textsuperscript{83} The rule ultimately was

\textsuperscript{81} See Warren v. Keep, 155 U.S. 265 (1984); Furrer v. Ferris, 145 U.S. 132 (1892); Tilghman v. Proctor, 125 U.S. 136 (1888); Kimberly v. Arms, 129 U.S. 512 (1889); Silver King Coalition Mines Co. v. Silver King Consolidated Mining Co., 204 F. 166 (8th Cir.), cert. denied 229 U.S. 624 (1913); Morimura, Arai & Co. v. Taback, 279 U.S. 24, 33 (1929); The Marsodak, 94 F.2d 339 (4th Cir. 1938); Kaeser & Blair, Inc. v. Merchants’ Ass’n, 64 F.2d 575 (6th Cir. 1933); Uihlein v. General Electric Co., 47 F.2d 997 (7th Cir. 1931); Nashua Mfg. Co. v. Berenzweig, 39 F.2d 896 (7th Cir. 1930); The Natal, 14 F.2d 382, 384 (9th Cir. 1926); Irving Bank-Columbia Trust Co. v. Stoddard, 292 Fed. 815 (1st Cir. 1923); Photoplay Pub. Co. v. LaVerne Pub. Co., 269 Fed. 730 (3d Cir. 1921); Munro v. Smith, 259 Fed. 1 (1st Cir. 1919); The Santa Rita, 176 Fed. 890 (9th Cir. 1910). See also Clark and Stone, Review of Findings of Fact, 4 U. CHI. L. REV. 190, 208 (1937); Robert L. Stern, Review of Findings of Administrators, Judges and Juries: A Comparative Analysis, 58 HARV. L. REV. 70, 113-14 n. 192 (1944-45).

\textsuperscript{82} 9 C. WRIGHT & A. MILLER, FEDERAL PRACTICE & PROCEDURE § 2571, at 682 n.14 (1971), quoting Draft Rule 68.

drafted using the “clearly erroneous” language applicable to review in equity of findings based on oral testimony.\textsuperscript{84}

The Advisory Committee note accompanying the Rule provided that the “clearly erroneous” standard of review should apply whether the finding of fact was determined based on conflicting testimony or “deduced or inferred from uncontradicted testimony.”\textsuperscript{85} According to William D. Mitchell, former Attorney General and the Chairman of the Advisory Committee appointed by the Supreme Court to draft the Federal Rules of Civil Procedure, the adopted rule –

\begin{quote}
appl[ies] to all cases tried by a judge without a jury is practically the modern equity rule; it is not the ancient equity rule which allowed trial \textit{de novo} on the facts in the appellate court – it is a limited provision – the appellate court may not set aside the findings unless they are clearly erroneous or against the clear weight of evidence.\textsuperscript{86}
\end{quote}

As a result of this rule, the appellate court must examine the entire record, and determine for itself the appropriate findings of fact, subject to the major restriction that the appellate court must accept as practically conclusive, findings of fact by a trial judge that are based on the credibility of witnesses.\textsuperscript{87} Should the appellate court disagree with the findings of the trial court, it will reverse only if it is convinced that the findings of the trial court are “unquestionably wrong.”\textsuperscript{88}

As of the enactment of the Federal Rules, particular emphasis was given to findings based on the testimony of

\begin{footnotes}
\item[86] Proceedings of the Symposium at New York City, American Bar Ass’n at 287 (1938).
\end{footnotes}
witnesses. In such cases, in which the evidence was contradictory, appellate courts did not disturb the findings of the trial judge.\(^{89}\) By contrast, if the findings were either undisputed or were based on a factual determination consisting solely of documentary evidence, the appellate court sat in a comparable position to the trial court.\(^{90}\)

The Federal Rules nonetheless provided that the findings of fact by a trial judge are to be accepted unless “clearly erroneous.”\(^{91}\) It was not explicit, however, that this standard should be applied to documentary evidence.\(^{92}\) Since 1938, the only major modification to Rule 52(a) was in 1985 with the addition of language that the standard of review – clearly erroneous – applied to findings of fact “whether based on oral or documentary evidence.”\(^{93}\)

B. FACT/LAW DISTINCTION

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\(^{91}\) Fed. R. Civ. P. 52.

\(^{92}\) See United States v. General Motors Corp., 384 U.S. 127 (1966) which seemed to raise a question concerning the applicability of Rule 52 to factual findings based on documentary evidence.

the trial court’s customary opportunity to evaluate the demeanor and thus the credibility of the witnesses, which is the rationale behind Rule 52(a) . . . plays only a restricted role here. This was essentially a ‘paper case’/ It did not unfold by the testimony of ‘live’ witnesses. Of the 38 witnesses who gave testimony, only three appeared in person. The testimony of the other 35 witnesses was submitted by either affidavit, by deposition, or in the form of an agreed-upon narrative of testimony given in the earlier criminal proceeding before another judge. A vast number of documents were also introduced, and bear on the question for decision.

Id. at 141-42 n.16.

The systemic difficulty in the fact/law distinction is defining fact and defining law. Just as defining the level of deference under the clearly erroneous standard is impractical, defining the distinction between fact and law is just as unworkable. While courts often create sound bites and elaborate musings on the definition of each, the distinction is neither separable or definable to objective certainty.

94 “In the articulation of a standard of review, words are insufficient to objectively measure any standard.” However, the uniformity of terms that promotes consistency in application . . . It is, of course, impossible to pinpoint the definition of the traditional standards of review such as “clearly erroneous” or “abuse of discretion,” however, courts are nonetheless able to apply these standards because they are universal and commonly articulated. See Christopher M. Pietruszkiewicz, Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity, 44 Houston L. Rev. xxx (2007). “It is because of the imprecision of language and the unrealistic view that infinite degrees can exist that standards of review should be limited to a familiar set of gradations.” Christopher M. Pietruszkiewicz, Conflating Standards of Review in the Tax Court: A Lesson in Ambiguity, 44 Houston L. Rev. xxx (2007). See Kevin M. Clermont, Procedure’s Magical Number Three: Psychological Bases for Standards of Decision, 72 Cornell L. Rev. 1115, 1148 (1987).


96 Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 Notre Dame L. Rev. 645, 645 (1988). See, e.g., Tupman v. Haberkern, 280 P. 970, 973 (Cal. 1929) (stating that questions of fact are decided by the trial court and that questions of law are decided by the appellate court). Rule 52 of the Federal Rules of Civil Procedure also make this distinction, providing that “[f]indings of fact, whether based on oral or documentary evidence, shall not be set aside unless
Professor Clark noted this dilemma – “There seems to be no hard and fast distinction between questions of law and questions of fact; ... and since there are so many cases on the border line between ultimate facts and conclusions of facts, i.e., law, the way is open to a court with understanding to accomplish substantial justice, whatever the formula.”

The lack of clarity of language to define the difference between fact and law creates a clear ability of appellate courts to cast results as either fact or law depending on whether the appellate court has designs on reversing the result of a trial court. As a result, an appellate court can produce a “correct result” utilizing the fact/law distinction, and the attendant standards of review to achieve its design. Based on the less clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of witnesses.” Fed. R. Civ. P. 52(a). By negative implication, Rule 52(a) promotes independent review of legal questions. See Pullman-Standard v. Swint, 456 U.S. 273 (1982).

97 Clark & Stone, Review of Findings of Fact, 4 U. CHI. L. REV. 190, 211 n.93 (1937); Jaffe, Judicial Review: Question of Law, 69 HARV. L. REV. 239, 240 (1955) (defining a the fact-law distinction as imperceptibly blending into each other).


99 Paul L. Caron, Tax Myopia Meets Tax Hyperopia: The Unproven Case of Increased Judicial Deference to Revenue Rulings, 57 OHIO ST. L.J. 637, 644-45 (1996) (“The precise verbal formulation used by a court is mere window-dressing that does not have any effect on the ultimate resolution of the case.”); Richard J. Pierce, Jr., Legislative Reform of Judicial Review of Agency Actions, 44 DUKE L.J. 1110, 1110 (1995) (“a court can often write an opinion that reverses a major agency action as easily as it can write an opinion that upholds the same action.”). See also Patricia M. Wald, The Rhetoric of Results and the Results of Rhetoric, 62 U. CHI. L. REV. 1371, 1391 (1995) (contrasting the tones of two opinions written in the same circuit, one of which upheld a NLRB determination and another overturning a NLRB
than clearly defined line between law and fact, an appellate court has the ability to more easily review and decide a factual issue by simply and expeditiously recasting the factual matter as a legal matter and reviewing the findings under a de novo standard instead of the more stringent clearly erroneous standard.\textsuperscript{100} As Professor Wright laments –

\begin{quote}
The Principal means by which appellate courts have obtained such complete control of litigation has been the transmutation of specific circumstances into questions of law [and] . . . unless the appellate judge handling the case is a dullard, some doctrine is always at hand to achieve the ends of justice, as they appear to the appellate court.\textsuperscript{101}
\end{quote}

This is not a new problem and the adoption of the Federal Rules of Civil Procedure had no impact on resolving the distinction, notwithstanding that courts referred to the lack of a clear distinction as

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\textsuperscript{100} Charles Alan Wright, \textit{The Doubtful Omniscience of Appellate Courts}, 41 MINN. L. REV. 751 (1957) (appellate courts can control outcome thereby diminishing significance of trial courts); David Frisch, \textit{Contractual Choice of Law and the Prudential Foundations of Appellate Review}, 56 VAND. L. REV. 57, 92 (2003); Paul, \textit{Dobson v. Commissioner: The Strange Ways of Law and Fact}, 57 HARV. L. REV. 753, 812 (1944) (“When the courts are unwilling to review, they are tempted to explain by the easy device of calling the question one of ‘fact’; and when otherwise disposed, they say it is a question of ‘law.’”).

\textsuperscript{101} Charles Alan Wright, \textit{The Doubtful Omniscience of Appellate Courts}, 41 MINN. L. REV. 751, 751 (1957). \textit{See} Evan Tsen Lee, \textit{Principled Decision Making and the Proper Role of Federal Appellate Courts : The Mixed Questions Conflict}, 64 S. CAL. L. REV. 235, 236 (1991) (“the labels ‘law and fact’ often amount to little more than divisions of decision making authority between judges and juries or between appellate courts and trial courts.”); Weiner, \textit{The Civil Nonjury Trial and the Law-Fact Distinction}, 55 CALIF. L. REV. 1020, 1022 (1967) (“Since law application cannot be meaningfully described as either lawmaking or fact-finding, such terminology is not a useful analytical tool in answering the question confronting the court.”).
\end{footnotesize}
a “mixed question.” In fact, proper application of such mixed questions was debated as early as 1786.

Courts, however, have not grasped the distinction or, more specifically, the lack of distinction between law and fact and continue to maintain this misguided illusion that review is either a determination of law or a determination of fact. This perception continues notwithstanding that the Supreme Court, since 1944, alluded to the lack of a clear dividing line, questioning whether review was a question of fact or a question of law and the distinction is “never self-executing.” This trend continued with Pullman-Standard v. Swint, describing the distinction between fact and law as “vexing” and in Bose Corp. v. Consumers Union of the United States, Inc., suggesting that the fact and law distinction “varies according to the nature of the substantive law at issue.”

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102 Cf. Walling v. Plymouth Mfg. Corp., 139 F.2d 178 (7th Cir.), cert. denied, 322 U.S. 741 (1944) (bound by “clearly erroneous” standard in reviewing determination of a trial judge of facts to statute); Gary Theater Co. v. Columbia Pictures Corp., 120 F.2d 891 (7th Cir. 1941) (same) with United States v. Anderson, 108 F.2d 475 (1939) (not bound by “clearly erroneous” standard in reviewing determination of a trial judge of facts to statute); Murray v. Noblesville Milling Co., 131 F.2d 470 (7th Cir. 1942), cert. denied, 318 U.S. 775 (1943) (same).


104 Carrington, The Power of District Judges and The Responsibility of Courts of Appeals, 3 GA. L. REV. 507, 518 (1969) (“findings of fact may be defined as the class of decisions we choose to leave to the trier of fact subject only to limited review, while conclusions of law are the class of decisions which reviewers choose to make for themselves without deference to the judgment of the trial forum”).


Professor Cooper sums up the application of a fact/law determination, noting that “[t]he fundamental secret is out, and notoriously so. Characterization of an issue of law application as fact or law for purposes of identifying a formalized standard of review depends on the perceived need for review, not on the actual status of the issue.”

This follows a similar conclusion in 1927 that “any factual state or relation which the courts conclude to regard as sufficiently important to be made decisive for all subsequent cases of similar character becomes thereby a matter of law for formulation by the court.”

C. DIVISION OF RESPONSIBILITY IN FACT/LAW ANALYSIS

Legal Realists and Legal Proceduralists share the jurisprudential theme of discretion in decisionmaking. Realists recognize discretion as a key component of the decisional process and provide a rational basis for justifying decisions. Necessarily, Realists reject the notion of


legal formalism in favor of deciding cases in contradictory ways and subsequently find adequate grounds for reaching such a result. Proceduralists focus attention on the institution and structure of decisionmaking and that the function of discretion describes the meting out of responsibility among those decisionmakers. While Realists focus on the individual thought process in reaching a result, Proceduralists focus on the relationship in an effort to determine the correct answer in law.

Because of institutional factors and the relationship within the judicial system of appellate courts, the fact/law distinction necessarily involves discretion. If one refers to describing the relationships between the trial court and the court of appeal as procedural (as opposed to substantive), appellate judges are less likely to struggle with adopting a clearly erroneous standard for factual determinations.

The question then is how much discretion is appropriate for each decisionmaker in the judicial hierarchy. The answer cannot be based on a mere reflection of the current judicial practice as defined by the imprecise rules that have been debated for centuries about what is

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115 Intuitively, appellate judges should be more comfortable with determinations that suggest that they have considered other inferences and reject those inferences based on a well-grounded rationale.
fact and what is law. More ambitious is to look at the function of federal courts and the role of appellate review.

D. ROLE OF APPELLATE REVIEW

Appellate courts have two primary objectives and the distribution of discretion should relate to those two purposes. Appellate courts should serve to develop the law in a particular area as guidance for future cases and to rectify egregious errors in particular cases.\textsuperscript{116}

It is too restrictive to complain that an increasing number of cases on appeal should dictate the level of review by an appellate court.\textsuperscript{117} One resolution would be to increase the capacity of the

\textsuperscript{116} See P. CARRINGTON, D. MEADOR & M. ROSENBERG, JUSTICE ON APPEAL, 2-3 (1976). See also Robert J. Martineau, Modern Appellate Practice, at 19 (“Although some commentators identify other functions, these other purposes are usually aspects of either error correction or law development.”). I recognize, of course, the difference between a jury determination and findings of fact as articulated by a trial judge. Judges can make or be coerced to make detailed findings which may be reviewed by an appellate court that cannot be duplicated in a jury trial. See Edward H. Cooper, \textit{Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review}, 63 NOTRE DAME L. REV. 645, 650 (1988).

\textsuperscript{117} See Edward H. Cooper, \textit{Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review}, 63 NOTRE DAME L. REV. 645, 650 (1988) (“It would be remarkable if the actual working standard of review were not affected by the shifting functional ability of the courts of appeals to devote attention to the wisdom of specific findings in particular cases.”). As the Ninth Circuit noted, [i]t can hardly be disputed that application of a nondeferential standard of review requires a greater investment of appellate resources [than] does application of the clearly erroneous standard. Appellate courts could do their work more quickly if they applied the clearly erroneous standard in most circumstances, because the courts then need only determine if the lower court’s decision is a reasonable one, not substitute their own judgment for that of the trial judge. United States v. McConney, 728 F.2d 1195, 1201 n.7 (9th Cir. 1984), \textit{cert. denied}, 469 U.S. 824 (1984).

A related question which is not susceptible to measurement is the level of judicial review afforded to district judges based on past history or reputation. District judges and appellate judges who review their decisions, including findings of fact, do not act without influence from previous cases. In this
appellate courts to “handle” all appeals. This result is not feasible or desirable. Instead, appellate courts should focus their energy on getting the decision “right” in the context of those cases in which the error below rises to a level that warrants appellate attention and reversal.\footnote{Anderson v. City of Bessemer, 470 U.S. 564, 575 (1985) ("Documents or objective evidence may contradict the witness’ story; or the story itself may be so internally inconsistent or implausible on its face that a reasonable factfinder would not credit it. Where such factors are present, the court of appeals may well find clear error even in a finding purportedly based on a credibility determination.") See, e.g., United States v. U.S. Gypsum Co., 333 U.S. 364, 396 (1948).}

A standard of review — clearly erroneous — accomplishes this result. The standard of review, therefore, describes more than the level of deference, it defines the level of responsibility of appellate court.\footnote{See Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 NOTRE DAME L. REV. 645, 652 (1988) ("it may be wise to serve the interests of all litigants by adopting standards of review that help sift out all but the more extreme claims of error"). This division of responsibility may also rest on the belief that trial court judges and appellate court judges possess and further develop skills essential to each function and, over time, increases competency in the area with which they become most familiar. See David Frisch, Contractual Choice of Law and the Prudential Foundations of Appellate Review, 56 VAND. L. REV. 57, 77 (2003).}

The effect of the division of labor using responsibility as a guidepost accomplishes both purposes. First, appellate courts can focus sense, appellate review can dictate a specified level of review but a history of an appellate court with the findings of a particular district judge may influence, subconsciously or otherwise, the level of inquiry notwithstanding the stated level of discretion. Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 NOTRE DAME L. REV. 645, 655 (1988). See F. James & G. Hazard, CIVIL PROCEDURE § 12.8, at 668 (3d ed. 1985) ("[A]n appellate court's inclination to accept a trial judge's findings depends . . . on the court's unstated degree of confidence in the trial judge's fair-mindedness."). See also Martin B. Louis, Allocating Adjudicative Decision Making Authority Between the Trial and Appellate Levels: A Unified View of Review, The Judge/Jury Question, and Procedural Discretion, 64 N.C.L. REV. 993, 1015-16 & n.160 (1986) (Off the record, former appellate law clerks “[r]egularly attest that both important cases and the decisions of certain notorious trial judges are scrutinized more carefully than others.”).
their capacities on developing law as opposed to focusing on factually intensive, case specific questions with little value beyond the case at issue.\textsuperscript{120} Second, a clearly erroneous standard of review allows an appellate court to monitor trial courts for major errors even if a particular cases does not relate to the first objective of developing the law in a particular area.\textsuperscript{121} Deference is appropriate in cases based primarily on “multifarious, fleeting, special narrow facts that utterly resist generalization”\textsuperscript{122} and that the “investment of appellate energy will . . . fail to produce the normal law-clarifying benefits that come from an appellate decision on a question of law.”\textsuperscript{123} Simply then, trial courts sort through evidence, written or oral, credibility based or not, and make determinations of fact and appellate courts take those facts as determined by a trial court and develop the law in a particular area.\textsuperscript{124}

Judge Posner ascribes to this view – “[T]he main reason for appellate deference to the findings of fact made by the trial court is not the appellate court's lack of access to the materials for decision but that its main responsibility is to maintain the uniformity and coherence of


\textsuperscript{121} Some have argued that a clearly erroneous standard of review may discourage a party that did not prevail at the trial level from taking an appeal with little chance of success. See Anderson, 470 U.S. at 575 (“the parties to a case on appeal have already been forced to concentrate their energies and resources on persuading that trial judge that their account of the facts is the correct one: requiring them to persuade three more judges at the appellate level is requiring too much”).


\textsuperscript{124} Mucha v. King, 792 F.2d 602, 605-06 (7th Cir. 1986) (Posner, J.).
the law, a responsibility not engaged in if the only question is the legal significance of a particular and nonrecurring set of historical events.”

Utilizing a clearly erroneous standard of review, the appellate function is not to determine whether the findings of fact as determined by the trial court are correct but, instead, to determine whether the findings of fact as determined by the trial court are clearly wrong. Under this rationale, close to correct factual determinations are close enough to correct that making a finer determination of factual issues on appeal is either not possible or not worth the time and effort, considering the dual role of error correction and development of the law by appellate courts. In factual determinations and the drawing of inferences from those determinations, the clearly erroneous standard suggests that, given the theoretical nature of fact finding, no amount of

125 Mucha v. King, 792 F.2d 602, 605-06 (7th Cir. 1986) (Posner, J.). See also Charles Alan Wright, The Doubtful Omniscience of Appellate Courts, 41 MINN. L. REV. 751, 779 (1957) (“From the earliest times appellate courts have been empowered to reverse for errors of law, to announce the rules which are to be applied, and to ensure uniformity in the rules applied by various inferior tribunals. . . .”); Evan Tsen Lee, Principled Decision Making and the Proper Role of Federal Appellate Courts: The Mixed Questions Conflict, 64 S. CAL. L. REV. 235, 240 (1991) (if an appellate court does not create useful precedent through its decision or to promote uniformity, there is no good reason to undo the work of the lower court through means of non-deferential review).

126 Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 NOTRE DAME L. REV. 645, 657 (1988). See United States v. Aluminum Co. of America, 148 F.2d 416, 433 (2d Cir. 1945) (L. Hand, J.). Reluctance to reverse the findings of a trial judge “is true to a considerable degree even when the judge has not seen the witnesses. His duty is to sift the evidence, to put it into logical sequence and to make the proper inferences from it; and in the case of a record of over 40,000 pages like that before us, it is physically impossible for an appellate court to function at all without ascribing some prima facie validity to his conclusions.”).

additional consideration at an appellate level is likely to produce, in theoretical terms, a more correct result.\textsuperscript{128}

Professor Maurice Rosenberg best describes the phenomenon as the difference between primary discretion and secondary discretion.\textsuperscript{129} While referring to legal decisionmaking and how discretion impacts those choices, the theory is equally applicable to the standard of review created artificially by legal rules and common law jurisprudence.

Primary discretion is grounded in the ability to act independently when rules do not exist to guide the resolution.\textsuperscript{130} More interesting for these purposes is secondary discretion that concerns the relationship among judges in the hierarchical judicial system.\textsuperscript{131} These relationships define how much an appellate court is willing to restrain its own views in light of the responsibility of the trial court.\textsuperscript{132} In other words, a trial court can be wrong to a certain extent without an appellate court finding “enough” error to reverse its determination. Secondary discretion defines how wrong a trial court must be for an appellate court to substitute its views.\textsuperscript{133}

De novo review is appropriate for rules, i.e. law determinations. If the responsibility of an appellate court is to develop the law, then review of action by a trial court that impacts the development is appropriate.\textsuperscript{134} Appellate courts insure that lower courts follow the

\textsuperscript{129} Maurice Rosenberg, \textit{Discretion of the Trial Court, Viewed From Above}, 22 SYR. L. REV. 635 (1971).
\textsuperscript{130} Maurice Rosenberg, \textit{Discretion of the Trial Court, Viewed From Above}, 22 SYR. L. REV. 635, 637 (1971).
\textsuperscript{131} Maurice Rosenberg, \textit{Discretion of the Trial Court, Viewed From Above}, 22 SYR. L. REV. 635, 637 (1971).
\textsuperscript{132} Maurice Rosenberg, \textit{Discretion of the Trial Court, Viewed From Above}, 22 SYR. L. REV. 635, 637 (1971).
\textsuperscript{133} Maurice Rosenberg, \textit{Discretion of the Trial Court, Viewed From Above}, 22 SYR. L. REV. 635, 637 (1971).
\textsuperscript{134} P. CARRINGTON, D. MEADOR & M. ROSENBERG, JUSTICE ON APPEAL, 2 (1976) (“[T]he review for correctness serves to reinforce the
law, promote efficiency, predictability, and ultimately provide a legitimacy grounded in the rule of law.\textsuperscript{135} Legal determinations are justified by a trial court by demonstrating the application of the factual issues to the appropriate controlling rule.

Appellate courts, by the nature of their responsibility within the judicial hierarchy and its attending institutional structure, are deemed to know more about the law and the appropriate rule that controls the legal issues.\textsuperscript{136} Thus, de novo review in this context fits within the system of judicial institutional goals. Considering the entire judicial system as integrated, appellate resources should be devoted to matters that are most important to the proper functioning of the judicial system – promoting uniformity and predictability in the law.\textsuperscript{137} In this context,

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\item P. CARRINGTON, D. MEADOR & M. ROSENBERG, JUSTICE ON APPEAL, 2 (1976) at 147 (stating that uniformity is “one of the imperatives of appellate justice”); Gerald Gunther, Congressional Power to Curtail Federal Court Jurisdiction: An Opinionated Guide to the Ongoing Debate, 36 STAN. L. REV. 895, 911 (1984) (“Although the uniformity-assuring function of the Court does not strike me as a constitutionally mandated one, as a matter of policy, our system--any system-- would be poorer and less coherent in the absence of a single, ultimately authoritative court at the apex of the judicial hierarchy.”); See David Lyons, Formal Justice and Judicial Precedent, 38 VAND. L. REV. 495, 496 (1985) (“The reason most often given for the practice of precedent is that it increases the predictability of judicial decisions.”); Earl Maltz, The Nature of Precedent, 66 N.C. L. REV. 367, 368 (1988) (“The most commonly heard justification for the doctrine of stare decisis rests on the need for certainty in the law.”). Without predictability, individuals would be unable to plan their affairs--business or otherwise--with any degree of legal certainty. See Lewis F. Powell, Jr., Stare Decisis and Judicial Restraint, N.Y. ST. B.J., July 1990, at 15, 18 (noting that predictability of outcome “is especially important in cases involving property rights and commercial transactions”)
\end{itemize}
it would be logical to conclude that as appellate courts expend their resources to promote uniformity of the law and promotes results that are more certain, parties to a proceeding and courts will be able to utilize fewer resources in prosecution of trials.\textsuperscript{138}

Appellate courts, through its law developing function, act affirmatively and negatively in directing the trial court on the legal decision making process. Of course, affirmative action consists of announcing a legal position or precedent to be followed by a trial court. Just as importantly, however, appellate courts restrict the choices of trial courts in ruling out particular options or raise a concern, suggesting to a trial court that a particular option will be ruled out if presented to an appellate court.\textsuperscript{139} The law development function promotes outcomes that are based within the range of acceptable legal result and advances predictability as a welcome consequence.

Such a view comports with the notion that language is not a sufficient basis for communicating a precise rule.\textsuperscript{140} Because language and therefore rules of law cannot be defined with particularized clarity, appellate courts must constantly refine their guidance to trial courts on the basis of the law and how that law is applied to a specific set of facts as determined by a trial court.\textsuperscript{141} Appellate courts, through its responsibility to develop the law, should more easily reverse those decisions by the trial court that have an impact on its development.

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This is not simply done by the creation of more elaborate rules but by its ability to reverse those determinations that are warranted based on the division of responsibility of trial courts and appellate courts.

Trial judges find facts in the context of all facts considered in arriving at a factual determination. It is because of superior institutional competence that an appellate court does not reverse a trial court even if it would have reached a contrary conclusion on the facts presented or inferences that can be drawn from those facts. Upholding the factual determinations of the trial judge does not demonstrate that the trial judge was correct in those determinations, but it does impart the institutional competence of the trial court. As long as the findings do not rise to the level of clearly wrong, i.e. clearly erroneous, the factual findings are not subject to reversal.\(^{142}\)

Others have argued that parties who know that a reversal on appeal because of a heightened standard is unlikely will devote more energy to the initial trial.\(^{143}\) While seemingly plausible, there is a significant difference in “making a record” for appeal and devoting the energies necessary to be successful in an initial trial. It appears unconvincing that a party would rely on an appellate court to remedy a perceived injustice at the trial stage when the party itself did not advance an effort to successfully convince a trier of fact of its basis for prevailing at trial.\(^{144}\) While success on appeal utilizing a heightened standard of review is reduced, a de novo standard should not alter an


\(^{144}\) "It is hard to believe that there has been any great public dissatisfaction with the restricted appellate review which was traditional in this country.”Charles Alan Wright, *The Doubtful Omniscience of Appellate Courts*, 41 MINN. L. REV. 751, 780 (1957). Citing Chief Justice Ellsworth, Professor Wright observed that “surely, it cannot be deemed a denial of justice, that a man shall not be permitted to try his case two or three times over.” Id. at 780-81, quoting, Wiscart v. Dauchy, 3 U.S. (3 Dall.) 320, 329 (1796).
approach by a party to the trial initially. In other words, it is nearly
unbelievable that a party would simply try a case for appeal in a
circumstance in which additional evidence cannot be introduced on
appeal.\footnote{A heightened standard, however, reduces the chances of the losing party from successful resolution on appeal and, theoretically, would reduce the number of appeals.}

More influential, however, is the argument that creating
findings of fact with a panel of three appellate judges is more accurate
than the findings of one judge at the district court level.\footnote{Edward H. Cooper, \textit{Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review}, 63 \textit{Notre Dame L. Rev.} 645, 653 (1988) ("it is easier to criticize a symphony than to write one, and much easier for one person to write a symphony than for a panel of three"). Moreover, three of eight appellate judges were promoted from the district court bench. See Judges of the Federal Courts, 901F.2d VII-XXX (1990) (excluding the Federal Circuit, eighty-one judges of 206 federal appellate judges are former district judges).} As the Supreme Court suggests, “duplication of the trial judge's efforts in the court of appeals would very likely contribute only negligibly to the accuracy of fact determination at a huge cost in diversion of judicial resources.”\footnote{\textit{Anderson}, 470 U.S. at 574-75.} More significantly, appellate review of factual issues arising from findings by a trial court present no value in developing the law and are case specific determinations lacking in impact on predictability and uniformity.\footnote{David Frisch, \textit{Contractual Choice of Law and the Prudential Foundations of Appellate Review}, 56 \textit{Vand. L. Rev.} 57, 79 (2003); David P. Leonard, \textit{The Correctness Function of Appellate Decision-Making: Judicial Obligation in an Era of Fragmentation}, 17 \textit{Loy. L.A. L. Rev.} 299, 301 (1984) (stating that “[t]rial courts are at the front lines of fact-finding... [and] therefore, do not exist for the purpose of making law”).} In short, the division of responsibility should be the bellwether of the fact/law distinction.

\section*{IV. Applying Standards of Review
in the Context of Economic Substance}
Courts can make principled distinctions as to whether the economic substance test should be conjunctive or disjunctive. The question here, however, is the standard of review to be applied to economic substance as articulated by an appellate court charged with reviewing a determination by a trial court. The division of responsibilities argument provides an adequate basis for creating a clearly erroneous standard of review under either the subjective economic substance test and the objective economic substance test. Moreover, in the context of subjective economic substance, business purpose is central in that inquiry. The business purpose doctrine involves a subjective inquiry into the motives of the taxpayer in determining whether the transactions offer a useful non-tax purpose, leading to an inquiry that affects only the business under consideration.

A. THE RULE 52(A) PHENOMENON

The objective economic substance and the subjective economic substance tests differ in one major respect. Objective economic substance focuses on the reasonable businessman model, determining if a potential for profit in a particular industry exists by applying a reasonable businessman standard. Under the subjective economic substance test, the question is whether the taxpayer believed that he was acting for non-tax business reasons, notwithstanding whether a reasonable businessman standard would otherwise be met. In considering the standard of review in economic substance cases however, there is insufficient reason to treat these tests differently.

The traditional analysis of the fact/law distinction has been historical in nature -- judges hear witnesses and to the extent that a determination is based on testimony, appellate courts should defer to the experience of the trier of fact in light of the ability to weigh credibility issues. In fact, Rule 52(a) expressly considers the ability of a trial court to judge the demeanor of a witness – “due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.” The “due regard” language, combined with the

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151 Fed. R. CIV. P. 52(a).
precursor to this clause – “[f]indings of fact . . . shall not be set aside unless clearly erroneous” – serves as a demanding hurdle to reverse a finding of fact on appeal based on the testimony of a witness. Under this circumstance, unless a witness is unbelievable, it is hardly believable that an appellate court could or should reverse a finding of fact when the testimony of two or more witness is plausible. To resolve such questions in this manner, however, is likely too simplistic.

This is so particularly in light of the language intentionally omitted above from Rule 52(a). Rule 52(a) provides in full that:

Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.  

The italicized language, added in 1985, makes clear that it is not simply the demeanor and credibility of witnesses that justifies the level of deference accorded a trier of fact. Instead, this language suggests that it is the responsibilities of each court in the judicial structure that justify the result. In this sense, a Proceduralist interpretation of discretion would apply. Institutional as opposed to ideological factors contribute to the division of responsibility.

Cases often do not implicate conflicting testimony or testimony at all, but are instead submitted on a paper record. In such a case, an appellate court has the same information as the trial court but Rule 52(a) dictates that findings based on the a written record – documentary

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152 Fed. R. Civ. P. 52(a) (emphasis added).

153 McConney, 728 F.2d at 1201 (noting that the application of Fed. R. Civ. P. 52(a)'s clearly erroneous standard “emphasizes . . . the trial court's opportunity to judge the accuracy of witnesses' recollections and make credibility determinations”). Upon adoption of the rule change in 1985, the rules advisory committee noted: “To permit courts of appeals to share more actively in the fact-finding function would tend to undermine the legitimacy of the district courts in the eyes of litigants, multiply appeals by encouraging appellate retrial of some factual issues, and needlessly reallocate judicial authority.” Fed. R. Civ. P. 52(a) advisory committee's note.
evidence – shall nonetheless remain undisturbed unless clearly erroneous.\textsuperscript{154}

While Rule 52(a) suggests that the clearly erroneous standard applies to all factual evidence,\textsuperscript{155} the Supreme Court recognized that, compared to a paper record, greater deference should be given to findings of fact based on the credibility of witnesses.\textsuperscript{156} In addition, the Supreme Court looks to a more pointed inquiry if a conflict exists between documentary evidence and oral testimony.\textsuperscript{157}

This distinction does not alter the clearly erroneous standard for documentary evidence and, even with a more searching inquiry, does not modify the clearly erroneous standard for documentary evidence under Rule 52(a) nor does it suggest that a de novo standard of review should apply in this context.\textsuperscript{158}

As Professor Wright suggests, Rule 52 does not say that “[f]indings of fact shall not be set aside unless clearly erroneous if the

\textsuperscript{154} Prior to the 1985 amendment, the Second Circuit viewed its factual determination as at least equivalent to that of the trial court. \textit{Orvis v. Higgins}, 180 F.2d 537 (2d Cir.), \textit{cert. denied}, 340 U.S. 810 (1950) (if a trial court “decides a fact issue on written evidence alone, we are as able as he to determine credibility, and so we may disregard his finding.”).

\textsuperscript{155} \textit{See McFarland v. T. E. Mercer Trucking Co.}, 781 F.2d 1146, 1148 (5th Cir. 1986) (finding of a trial judge based on depositions is entitled to the same deference as a finding “based on oral, in-court testimony”).

\textsuperscript{156} “When findings are based on determinations regarding the credibility of witnesses, Rule 52(a) demands even greater deference to the trial court’s findings; for only the trial judge can be aware of the variations in demeanor and tone of voice that bear so heavily on the listener's understanding of and belief in what is said.” \textit{Anderson}, 470 U.S. at 575.

\textsuperscript{157} “Where such testimony is in conflict with contemporaneous documents we can give it little weight, particularly when the crucial issues involve mixed questions of law and fact. Despite the opportunity of the trial court to appraise the credibility of the witnesses, we cannot . . . rule otherwise than that [the finding] is clearly erroneous.” \textit{United States v. United States Gypsum Co.}, 333 U.S. 364, 395-96 (1948).

\textsuperscript{158} \textit{See Anderson}, 470 U.S. at 575 (while greater deference applies to testimony based on the credibility of witnesses, the clearly erroneous standard of review nonetheless applies documentary evidence”).
The trial court has had the opportunity to judge the credibility of the witnesses.\textsuperscript{159} It does say that “[f]indings of fact . . . shall not be set aside unless clearly erroneous, \textit{and} due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.”\textsuperscript{160}

The rationale of Rule 52(a) is inexorably intertwined with the division of responsibility among judicial actors. There is no principled distinction between a trial judge and an appellate panel of judges in deciding factual questions based on documentary evidence except for the appreciation of the role of a trial court and the role of an appellate court in the efficient adjudication of cases.

Moreover, there is no policy reason why, particularly in document intensive cases, an appellate court should give the findings of a trial judge greater weight than legal conclusions. If compared to a jury system, it would seem that appellate judges which are at least three in number, would better reflect a representative sample of the community than a single trial judge.

The clearly erroneous standard cannot then be a reflection of whether a trial court or an appellate court is in a better position but, instead, is inescapably linked to the function and responsibility of each court within the judicial system. This desirability of a division of responsibility is not grounded, as in the case of a jury, in the Constitution, but on the grounds of judicial administration. There is nothing that requires or precludes how findings of fact by a court must be treated by an appellate court. The application of the clearly erroneous rule is grounded in its creation by choice of the courts.

The Supreme Court is empowered with the creation of the rules of procedure and has chosen, in the interest of a division of responsibility, to create a clearly erroneous standard in Rule 52(a) by

\textsuperscript{159} Charles Alan Wright, \textit{The Doubtful Omniscience of Appellate Courts}, 41 MINN. L. REV. 751, 769-70 (1957) “That Rule 52 required application of the ‘clearly erroneous’ test to all findings, regardless of the nature of the evidence, should thus have been apparent to anyone who understands the difference between a hypothetical and a conjunctive proposition.” \textit{Id.} at 770.

\textsuperscript{160} FED. R. CIV. P. 52(a) (emphasis added).
which to separate lines of authority within the courts.\textsuperscript{161} The subjective and objective economic substance tests, just like Rule 52(a), should follow judicial responsibility, deferring to a trial court on matters that do not advance to law in a particular area.

It is tempting, of course, for appellate courts to consider individualized objectives in ensuring that an appropriate result occurs in a particular case. In light of the institutional factors guiding the responsibilities of the courts, however, the function of appellate courts is to provide guidance for future cases and promote predictable resolution. Individualized justice does not promote this result.

B. TAX AVOIDANCE V. TAX MINIMIZATION

Code sections intertwine objective rules and subjective elements. These subjective elements are primarily reflected in the use of terms such as “principal purpose” for a transaction or the lack of a tax avoidance motive as part of the transaction, or specific references to the “business purpose” of the transaction. These anti-avoidance principles appear to rest exclusively on the state of mind of the taxpayer, suggesting that if tax avoidance is a motive, the tax advantages of a transaction will be or should be disallowed.

Unquestionably, however, taxpayers can arrange their affairs in order to minimize taxes and oft-famously quoted endorsement of Judge Learned Hand is universally known in that tax community that “[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”\textsuperscript{162} Thirteen years later, Judge Hand sounded the same chord –

Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich and poor; and all do right, for nobody owes any public duty to pay more than


\textsuperscript{162} Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).
the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.\textsuperscript{163}

Because of the lack of involvement of the sovereign in the transaction, there is, of course, a temptation to believe that tax avoidance is so pervasive that in looking to the state of mind of the taxpayer, i.e. the business purpose of the transaction, courts require overwhelming evidence to suggest that business decisions were based on aberrations or eccentricities of the taxpayer in issue.\textsuperscript{164} Courts must guard against such a requirement.

If saving taxes is an acceptable form of human behavior, it could hardly be prohibited. If tax minimization is acceptable but tax avoidance is not tolerable, there must be a manner in which distinctions can be drawn. Tax avoidance and tax minimization both involve subjective thresholds. The problem, however, is that if both involve a mental undertaking, it is subjectively impossible to distinguish a desire to reduce taxes from a desire to avoid taxes.\textsuperscript{165}

It is not adequate to define tax avoidance as a heightened level of tax minimization. Instead, the difference must balance the interests being considered. Under this rationale, tax avoidance must contemplate circumstances in which the non-tax goals of a transaction are insufficient in weight when compared to the goal of tax minimization.\textsuperscript{166}

\begin{footnotesize}
\begin{enumerate}
\item Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir.) (Hand, J., dissenting), cert. denied, 331 U.S. 859 (1947).
\item Walter J. Blum, \textit{Motive, Intent, and Purpose in Federal Income Taxation}, 34 U. CHI. L. REV. 485, 516 (1967). \textit{Cf.} Alan Gunn, \textit{Tax Avoidance}, 76 MICH. L. REV. 733, 738 (1978) (“If the tax success of a transaction depends on a business purpose, and if ‘business purpose’ means what it seems to mean – a purpose other than that of reducing taxes – the principle that tax-avoidance purpose does not count against the taxpayer has been seriously undermined.”)
\end{enumerate}
\end{footnotesize}
In the case in which tax avoidance appears to be a motive, a taxpayer must demonstrate the existence and the significance of a non-tax objective – the business purpose of a transaction. If able to demonstrate a non-tax goal that is comparatively more compelling than the tax objective, then tax reduction as opposed to tax avoidance provides a sufficient basis to provide a taxpayer with the tax benefits of the transaction. If unable to elevate the non-tax goal over the tax objective, then tax avoidance objectives should disallow the tax benefit of the transaction.

It is no easy task to describe much less define or prove state of mind. As a result, the subjective “state of mind” focuses on whether the non-tax goals were plausibly compelling enough to justify the tax advantages that resulted from the non-tax goals.

By its very nature, the subjective economic substance test must consider all of the facts of the transaction that generated the tax benefit to determine whether the transaction also maintained an appreciable business purpose. As a result, pinpointing a test applicable to all taxpayers based on business purpose is inherently difficult, if not impossible. Subjectivity necessitates an individualized review of the particular circumstances of the taxpayer engaged in the transaction.

The notion that appellate courts are superior to trial courts and should guide the degree of deference to trial courts is archaic. While

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167 But see Alan Gunn, Tax Avoidance, 76 Mich. L. Rev. 733, 740 (1978) (arguing that a strong tax motive is fatal despite the assurance by the Supreme Court in Gregory v. Helvering that a strong tax motive is not fatal).


this notion may have been true long ago, such a notion is does not fit the modern complexities of presented at the trial level.\textsuperscript{170} Economic substance mandates an inquiry of all relevant facts and circumstances of a transaction. In the context of the economic substance doctrine, trials tend to last weeks rather than hours.\textsuperscript{171} For example, in \textit{Dow Chemical Co. v. United States}, the Internal Revenue Service asserted a

\begin{footnotesize}


\textsuperscript{171} See Bose Corporation v. Consumers Union of the United States, Inc., 466 U.S. 485, 500 (1984) (a level of deference “tends to increase when trial judges have lived with the controversy for weeks or months instead of just a few hours). “The factual records in [unity business] cases . . . tend to be long and complex. . . . It will do the cause of legal certainty little good if this Court turns every colorable claim that . . . state court erred in a particular application of those principles into a de novo adjudication, whose unintended nuances would then spawn further litigation and an avalanche of critical comment. Rather, our task must be to determine whether the . . . court applied the correct standards to the case; and if it did, whether its judgment "was within the realm of permissible judgment." See Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983), \textit{citing ASARCO v. Idaho State Tax Commission}, 458 U.S. 307, 326 n.22, 23 (1982).

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$22 million assessment challenging Dow’s corporate-owned whole life insurance (“COLI”) plans as lacking economic substance.\textsuperscript{172}

After a two month bench trial, 26 witnesses, and over 1,500 exhibits, the district court issued a 139-page opinion and a 15-page post-judgment decision,\textsuperscript{173} rejecting the economic substance argument advanced by the United States and allowed the claimed deductions by Dow.\textsuperscript{174} Moreover, Coltec Industries, Inc. v. United States involved a ten day trial and 29 witnesses.\textsuperscript{175} In such circumstances, the review by an appellate court should be more deferential.\textsuperscript{176} Professor Cooper claims that this deference should reflect the “familiarity of prolonged exposure [that] can enhance the empathetic and intuitive aspects of decision.”\textsuperscript{177}

Because the test measures the business purpose of the transaction, a number of considerations may evidence business purpose. Necessarily, business purpose cannot be conceived after challenge by the Internal Revenue Service, but instead must consider

\textsuperscript{172} Dow Chemical Co. v. United States, 435 F.3d 594, 596-98 (6th Cir. 2006), cert. denied, 127 S. Ct. 1251 (2007).


\textsuperscript{174} The district court determined that “Dow has established by a preponderance of the evidence that both . . . its . . . COLI plans . . . had substantial effects on the beneficial interest of the taxpayer apart from the income tax deductions.” Dow Chemical Co. v. United States, 250 F. Supp. 2d 748, 811 (E.D. Mich.), modified by, 278 F. Supp. 2d 844 (2003), rev’d in part, 435 F.3d 594 (6th Cir. 2006), cert. denied, 127 S. Ct. 1251 (2007).


\textsuperscript{177} Edward H. Cooper, Civil Rule 52(a): Rationing and Rationalizing the Resources of Appellate Review, 63 NOTRE DAME L. REV. 645, 654 (1988).
the planning of the transaction prior to undertaking the transaction. This presumes that a business purpose justification did, in fact, exist but the subjective aspect of the test must require that its contemplation preceded undertaking the transaction.

Business purpose necessarily involves subjectivity because no application can be the same because no entity can be in precisely the same position to determine whether a business purpose for one entity is a valid or invalid business purpose for another entity. Business purpose of one entity should not be imputed to another merely because a transaction was deemed to fail to satisfy business purpose of the first entity. By tailoring a set of facts to a particular business, the business purpose component of economic substance can alter what would appear to be the correct result in a particular case.

Subjective business purpose can “override both the formal mechanics and purported effect of the transaction as structured by the parties” but must be justified based on the circumstances of each particular case. As the Tax Court recognized in 1959, “[w]e are convinced . . . from our study of all the facts and circumstances that none of the alleged [corporate] advantages . . . constituted any actual business purpose in this case.”

The Supreme Court in *Ornelas v. United States* provides some context. While addressing probable cause, the Court noted that “*de novo* review tends to unify precedent and will come closer to providing law enforcement officers with a defined ‘‘set of rules which, in most instances, makes it possible to reach a correct determination beforehand as to whether an invasion of privacy is justified in the interest of law

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179 Aldon Homes, Inc., 33 T.C. 582, 597-98 (1959). See Thompson v. Commissioner, 631 F.2d 642, 646 (9th Cir. 1980), cert. denied, 452 U.S. 961 (1981) (economic substance requires the Tax Court “to focus on the facts and circumstances of particular transactions and resolve whether, as a practical matter, those transactions have any economic impact outside the creation of tax deductions.”).

The Court continued, “[i]t is true that because the mosaic which is analyzed for a reasonable-suspicion or probable-cause inquiry is multi-faceted, “one determination will seldom be a useful ‘precedent’ for another.”

The reasonable suspicion or probable cause analysis is equally applicable to economic substance. A definitive, precise and objective definition of business purpose is implausible. Business purpose rationalizes the practical position that even “the smartest drafters of legislation and regulation cannot be expected to anticipate every device.” Business purpose does not describe a baseball box score and similarly cannot describe a double play as 6-4-3 or Tinker to Evers to Chance. This is precisely because business purpose is not an

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184 ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 513 (D.C. Cir. 2000).

185 Baseball’s Sad Lexicon, also referred to as Tinker to Evers to Chance, refers to a baseball poem by Franklin Pierce Adams written in 1910 referring to a double play “turned” by Chicago Cubs shortstop, Joe Tinker, second baseman Johnny Evers, and first baseman Frank Chance against the New York Giants. In full, the poem reads –

**Baseball's Sad Lexicon**

> These are the saddest of possible words:
> "Tinker to Evers to Chance."
> Trio of bear cubs, and fleeter than birds,
> Tinker and Evers and Chance.
> Ruthlessly pricking our gonfalon bubble,*
> Making a Giant hit into a double--
> Words that are heavy with nothing but trouble:
> "Tinker to Evers to Chance."

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objective measurement and cannot be listed in a box score. Moreover, it is impossible to foresee, much less write rules that produce an intended result in a complex financial world in which taxpayers utilize sophisticated tax lawyers to construct new transactions and permutations of existing transactions.186

In such a case, review should be deferential simply because it of the improbability that there will exist two identical cases and, therefore, provides a classic example of a type of case that suggests limited appellate inquiry.187 Accordingly, the responsibility of the appellate court for maintaining or promoting uniformity is not triggered and, therefore, de novo review is unwarranted.188 “Considerations which favor a de novo standard, such as the desire to create a uniform rule, are not present [under the subjective construct] since no single rule could embrace the varied fact patterns which may arise. . . .”189

As a result, the determination of economic substance as it relates to the subjective test is a factual determination focused on the facts of circumstances of a particular transaction to determine whether it has economic impact beyond the tax deductions created by the transaction.190 However, the mere creation of a complex transaction that provides a tax savings or tax advantage should not lack economic substance if the underlying transaction itself has economic substance.191 Under this formulation, judges have the discretion to view the entire transaction to determine business objectives and distinguish between

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188 Mucha v. King, 792 F.2d 602, 606 (7th Cir. 1986).
189 Rexnord, Inc. v. United States, 940 F.2d 1094, 1097 (7th Cir. 1991).
genuine business transactions and artificial tax shelters, permitting tax planning but disallowing tax avoidance.

Tax avoidance may have become the only acceptable justification for construing a statute outside the words of a statute. If words cannot sufficiently define what is an acceptable form of tax minimization, then it is wise to accept a non-literal justification for denying tax benefits not contemplated by those that enacted the Internal Revenue Code.

V. CONCLUSION

“One man’s tax shelter being everyone else’s budget deficit, all taxpayers ultimately have an interest in the reasonable interpretation of the tax laws.”192 The economic substance doctrine provides an appropriate balance between the objective results contemplated by the Internal Revenue Code with the subjective constraints necessary to achieve its purposes.193

Economic substance cases are decided based on the particularized facts and circumstances associated with each case. Because of this type of inquiry, appellate decisions, except for the test to be applied by a trial court, offer little in developing the law and are case specific determinations lacking an impact on predictability and uniformity in subsequent considerations of economic substance.

The subjective economic substance test inquires into the business purpose of a transaction while the objective economic substance test determines whether the economic position of the taxpayer is enhanced by engaging in the transaction. Courts differ as to whether a taxpayer must satisfy either the subjective economic substance test or the objective economic substance test or whether a taxpayer has to satisfy both tests. Under either construction, institutional considerations suggest that a clearly erroneous standard of review should be adopted.

