II.B. Judicial Doctrines Used to Combat ATS

Introduction

There are five judicial doctrines used to deny benefits to tax shelters. The following section outlines the JCX-84-99 discussion of these doctrines.

1. Sham Transaction Doctrine

Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as "facades" or mere "fictions"[20] and in their most egregious form; one may question whether the transactions might be characterized as fraudulent.

At a minimum, the sham transaction doctrine can be said to apply to a "sham in fact." For example, where a taxpayer purported to buy treasury notes for a small down payment and a financing secured by the treasury notes in order to generate favorable tax benefits, but neither the purchase nor the loan actually occurred, the court applied the sham transaction doctrine to deny the tax benefits.[21]

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20 See, e.g., Knetsch v. United States, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds).
21 See Goodstein v. Commissioner, 267 F.2d 127, 131 (1st Cir. 1959) (disallowing deduction because the series of transactions was entered into pursuant to a preconceived plan that lacked economic substance.) In ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2002), the Tax Court disallowed losses on the grounds that the taxpayer and the foreign bank in the transaction never actually entered into the purported partnership that was formed to effectuate the transaction, implicitly applying the sham transaction doctrine.

1. Sham Transaction Doctrine continued…

Generally, the sham transaction doctrine applies when the purported activity giving rise to the tax benefits does not actually occur. However, in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, taxpayer enters into a transaction to generate a loss. The taxpayer actually has risk with respect to the transaction, but transfers that risk to a broker through a guarantee. The only consequences to the taxpayer will be the desired tax benefits. This transaction may be found to be "in substance" a sham.[22] Finally, as discussed above, the delineation between this doctrine (particularly as applied to shams "in substance") and the "economic substance" and the "business purpose" doctrines (both discussed below) is not always clear. Some courts find that if transactions lack economic substance and business purpose, they are "shams" notwithstanding that the purported activity did actually occur.[23]

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22 See, e.g., Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988) (holding options straddles to be shams because the broker insured the clients against market risk).
23 See United States v. Wexler, 31 F.3d 117, 124 (3rd Cir. 1994) (disallowing interest deduction in a "repo transaction" because the transaction had no substance other than to create deductions).

2. Economic Substance Doctrine

To be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction.

Under the economic substance doctrine, the courts generally will deny claimed tax benefits where the transaction giving rise to those benefits lacks economic substance independent of tax considerations. The Tax Court recently described the doctrine as follows:

> 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.[24]

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in Gregory v. Helvering.[25]

In Gregory, a transitory subsidiary was established to utilize the corporate reorganization provisions of the Code, to take advantage of a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

> To dodge the shareholder's taxes is not one of the transactions contemplated as corporate reorganizations.[26]

Since Gregory, several cases have denied tax benefits on the grounds that the subject transactions lacked economic substance.[27] The economic substance doctrine can apply even when a taxpayer exposes itself to risk of loss and where there is some profit potential (i.e., where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.[28] In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine whether the transactions had "purpose, substance or utility apart from their anticipated tax consequences."[29]

24 ACM Partnership v. Commissioner, 73 T.C.M. 2189, 2215, aff'd in part and rev'd in part 157 F.3d 231(3d Cir.1998).
25 Gregory v. Helvering, 293 U.S. 465 (1935), aff'g 69 F.2d 809 (2d Cir. 1934).
26 Gregory, 69 F.2d at 811.
27 See, e.g., Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance); Sheldon v. Commissioner, 94 T.C. 738 (1990) (holding that a marginally profitable, leveraged acquisition of T-bills, and accompanying prepaid interest deduction, lacks economic substance, and imposing penalties); Ginsburg v. Commissioner, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacks economic substance).
28 See Goldstein v. Commissioner, 364 F.2d 734, 739-40 (2d Cir. 1966) (disallowing deduction even though taxpayer has a possibility of small gain or loss by owning T-bills); Sheldon v. Commissioner, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").
29 Goldstein, 364 F.2d at 740. Even this articulation of the economic substance doctrine will fall short in its application to some sets of facts. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. See, e.g., Cottage Savings v. Commissioner, 499 U.S. 554 (1991) (allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages); Doyle v. Commissioner, 286 F.2d 654 (7th Cir. 1961).

3. Business Purpose Doctrine

Another doctrine that overlays and is often considered together with (if not part and parcel of) the sham transaction and economic substance doctrines is the business purpose doctrine. Although numerous authorities apply the business purpose doctrine in the context of individuals or partnerships, the doctrine equally applies in the corporate context. Additionally, the business purpose doctrine is not limited to cases where the relevant statutory provisions by their terms require a business purpose or profit potential.[62]

In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance.[63] In essence, a transaction will only be respected for tax purposes if it has "economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached."[64]

The business purpose test is a subjective inquiry into the motives of the taxpayer, that is, whether the taxpayer intended the transaction to serve some useful nontax purpose.[65] Finally, where appropriate, the court may bifurcate a transaction in which independent activities with nontax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction.[66] Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect to the particular tax-motivated activity.

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62 ACM, 157 F.3d at 253; Goldstein, 364 F.2d at 736; Wexler, 31 F.3d at 122.
63 Rice's Toyota World, 752 F.2d 89,91 (4th Cir. 1985).
64 Frank Lyon Co., 435 U.S. 561 (1978), Cf. Esmark v. Commissioner, 90 T.C. 171, 198 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989) (not disregarding steps of a transaction where, for example, a tender offer was not a "'mere device' having no business purpose").
65 See, e.g., Rice's Toyota World, 752 F.2d at 89; ACM, 157 F.3d at 231.
66 ACM, 157 F.3d at 256.

4. Substance Over Form Doctrine

The concept of the substance over form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. For instance, two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The Supreme Court has found that a "given result at the end of a straight path is not made a different result because reached by following a devious path."[67] However, many areas of income tax law are very formalistic and, therefore, it is often difficult for taxpayers and the court to determine whether application of the doctrine is appropriate.

While tax cases have been decided both ways, the IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.[68] In National Alfalfa Dehydrating & Mill & Co., the Supreme Court ruled as follows:

> This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not.[69]

The IRS has published administrative guidance that applies the substance over form doctrine in a variety of contexts.[70] Taxpayers and tax practitioners apply these pronouncements, as well as certain favorable court cases, as an exception to the general rule that taxpayers are bound by their chosen form.

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67 Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).
68 Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967); In the matter of: Insilco Corporation v. United States, 53 F.3d 95 (5th Cir. 1995).
69 Commissioner v. National Alfalfa Dehydrating & Mill Co., 417 U.S. 134, 149 (1974), See also, Higgens v. Smith, 308 U.S. 473, 477 (1940).
70 See Rev. Rul. 78-397, 1978-2 C.B. 150, Rev. Rul. 83-142, 1983-2 C.B. 68, and Rev. Rul. 80-154, 1980-1 C.B. 68 (disregarding circular cash flows in transactions); Rev. Rul. 73-427, 1973-2 C.B. 301 (viewing a reverse subsidiary merger as a taxable stock purchase); Rev. Rul. 67-274, 1967-2 C.B. 141 (treating "B" reorganization followed by liquidation of acquired corporation as a "C" reorganization); Rev. Rul. 68-602, 1968-2 C.B. 135 (not respecting contribution of debt from a creditor-

shareholder to a debtor-subsidiary for purposes of determining whether the subsidiary is eligible for tax-free liquidation).

5. Step Transaction Doctrine

An extension of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."[71] The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end result test, (2) the interdependence test, and (3) the binding commitment test. The end result test is the broadest of the three articulations.

The end result test examines whether it is apparent that each of a series of steps are undertaken for the purpose of achieving the ultimate result.[72] The interdependence test attempts to prove that each of the steps were so interdependent that the completion of an individual step would have been meaningless without the completion of the remaining steps. The binding commitment test is the narrowest of the three articulations and looks to whether, at the time the first step is entered into, there is a legally binding commitment to complete the remaining steps.[73]

In determining whether to invoke the step transaction doctrine, the courts have looked to two primary factors: (1) the intent of the taxpayer,[74] and (2) the temporal proximity of the separate steps. If a taxpayer can provide evidence that at the time the first of a series of steps was undertaken, there was no plan or intention to affect the other steps, then the transactions should not be stepped together. An important factor that supports a taxpayer's lack of intent is found where subsequent steps are prompted by external, unexpected events that are beyond the taxpayer's control. Where there is no legally binding commitment to engage in subsequent steps after undertaking the initial transaction, the span of time between the events is an important measure in determining whether the transactions should be stepped together. A significant lapse of time between a series of transactions should prevent the application of the step transaction doctrine.[75]

The step transaction doctrine may not be invoked in all cases, irrespective of the taxpayer's intent or the temporal relationship of the separate steps.

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71 Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987).
72 King Enterprises, Inc. v. United States, 418 F.2d 511, 516 (Ct. Cl. 1969).
73 Commissioner v. Gordon, 391 U.S. 83, 96 (1968).
74 McDonalds Restaurants of Ill. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).
75 Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989) (by implication); Martin

D. Ginsburg et al., Mergers, Acquisitions, and Buyouts, para. 608.2.2 (Apr. 1999 edition).

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5. Step Transaction Doctrine Continued

Aside from a case involving a legally binding agreement,[76] if each of a series of steps has independent economic significance, the transactions should not be stepped together.[77] Also, the courts have not permitted the application of the step transaction doctrine if its application would create steps that never actually occurred.[78] This limitation is sometimes viewed as prohibiting the use of the step transaction doctrine where the alternative transaction has at least the same number of steps.[79] Another possible limiting factor to the application of the step transaction doctrine is when the steps in a series of transactions are separated by a real and meaningful shareholder vote to continue with the subsequent steps. While such a shareholder vote may be an indication of separate, unrelated steps, particularly when the corporation is publicly traded, it is not determinative. Finally, as discussed above, the IRS and not the taxpayer generally has the ability to recharacterize a series of transactions under the step transaction doctrine.

The review of the case law associated with these doctrines follow in the next section.

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76 J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995).
77 Reef Corporation v. Commissioner, 368 F.2d 125 (5th Cir. 1966); Rev. Rul. 79-250, 1979-2 C.B. 156, modified by Rev. Rul. 96-29, 1996-1 C.B. 50.
78 Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion, 886 F.2d 1318 (7th Cir. 1989); Walt Disney, Inc. v. Commissioner, 97 T.C. 221 (1991); Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973).
79 West Coast Marketing Corporation v. Commissioner, 46 T.C. 32 (1966); Rev. Rul. 70-140, 1970-1 C.B. 73.