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By Mark E. Berg

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In this report, Berg considers where recent developments leave the time-honored principles of *Gregory* that (1) taxpayers are entitled to arrange their affairs in such a manner as to avail themselves of tax benefits bestowed by Congress, and (2) a taxpayer’s motives — be they minimizing, avoiding, or even evading taxes — are irrelevant to the business purpose requirement.

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> *It is quite true that if a reorganization in reality was effected within the meaning of [the statute], the ulterior purpose [of escaping tax] will be disregarded.* The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. *But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.*[1]

> *[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, evade, taxation.* Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes. *Therefore, if what was done here, was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of income taxes.*[2] [Emphasis added; citations omitted.]

> Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance.[3]

> In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if . . . the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[4]

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[1] *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), *aff’g* 69 F.2d 809 (2d Cir. 1934), *rev’g sub nom Gregory v. Commissioner*, 27 B.T.A. 223 (1932).

[2] *Gregory*, 69 F.2d at 810.

[3] *United Parcel Service of America Inc. v. Commissioner* (*UPS*), 254 F.3d 1014, 1018 (11th Cir. 2001).

[4] Section 7701(o)(1), enacted as part of the Health Care and Education Reconciliation Act of 2010, P.L. 111-152, section 1409(a).

I. Introduction

The non-italicized portions of the first two quotations above are no doubt familiar to every tax practitioner. Indeed, it is one of the fundamental principles of tax planning that taxpayers are not required or even morally bound to structure their arrangements in the least tax-efficient manner but rather are free to choose the most tax-efficient way to organize their affairs. If this were not the case, many readers presumably would have found other, more useful lines of work by now. Perhaps less well remembered is the adjacent language in these famous opinions, which appears in italics above.

The Supreme Court's opinion in *Gregory v. Helvering* is generally acknowledged to be the source of the principle that a nontax business purpose may be required to claim tax benefits, and it is thus considered the source of the economic substance doctrine. Significantly, the italicized language makes it clear that *Gregory* and its progeny also stand for the proposition that a taxpayer's motivation for entering into a transaction — be it tax reduction, tax avoidance, or even tax evasion — generally is (or should be) irrelevant to whether a transaction meeting the statutory and regulatory requirements for a particular tax benefit will nonetheless be denied that benefit.

However, this principle seems to have faded from view over the years as taxpayers and their advisers became increasingly aggressive in structuring transactions that appeared to meet the technical requirements for a tax benefit but seemed to flout the purpose behind the relevant statutory or regulatory provisions in some cases. What has become known as the economic substance doctrine was developed by the courts in response to the wave of retail tax shelters in the 1970s and early to mid-1980s. At the time, newspaper advertisements boldly proclaimed, for example, the ''5:1 tax shelter'' available to investors in activities (or purported activities) such as research and development, computer leasing, film production, and cattle breeding. As then articulated, the doctrine, more or less in line with the *Gregory* principles, generally denied the sought-after tax benefit if the transaction had neither economic substance in the sense of a meaningful effect on the parties' pretax economic positions (or at least a reasonable profit potential) nor a business purpose.

Congress largely shut these types of tax shelters down in 1986 when it enacted the passive loss rules under section 469. However, the IRS and the courts have since had to contend with much larger corporate tax shelters. These shelters often bear clever acronyms, are marketed with elaborate flip-charts, and purport to create large deductible losses to offset gains or other income. Because the dollar amounts at stake have grown with this new wave of shelters, the IRS has sought to apply the economic substance doctrine in an increasingly aggressive manner (in some cases with approval of the courts). The IRS in some cases has denied deductions and tax credits in circumstances in which Congress and Treasury arguably intended that the tax benefit be allowed, and in the process, it has called into question the effectiveness and propriety of traditional tax planning.[5]

After several years of further development of the economic substance doctrine by the courts, Congress in 2010 enacted section 7701(o), the so-called codified economic substance doctrine. Effective for transactions entered into after March 30, 2010, section 7701(o) provides that a transaction or series of transactions ''to which the economic substance doctrine is relevant . . . shall be treated as having economic substance only if — (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.''[6] Significantly, the statute provides that the determination of whether the doctrine is relevant in a particular case, and thus of whether section 7701(o) applies, is to be ''made in the same manner as if [section 7701(o)] had never been enacted,''[7] so that section 7701(o) ''does not

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[5]*See, e.g.*, *Historic Boardwalk Hall LLC v. Commissioner*, 136 T.C. 1 (2011), *rev'd and remanded*, 694 F.3d 425 (3d Cir. 2012) (the IRS argued that rehabilitation tax credits should be denied under many theories, including the economic substance doctrine); Notice 2014-58, 2014-44 IRB 746 (suggesting that when an overall transaction consisting of integrated steps has a nontax business objective but includes a tax-motivated step that is not itself necessary to accomplish the business objective, the economic substance doctrine as codified in section 7701(o) may be applied to test that step separately); *compare Salem Financial Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 2015); *Bank of New York Mellon Corp. v. Commissioner* (*BNY*), Dkt. Nos. 14-704-ag (L), 14-1394-ag (XAP), 14-765-cv (2d Cir. 2015) (denying foreign tax credits under the economic substance doctrine), *with Santander Holdings USA Inc. v. United States*, 977 F. Supp.2d 46 (D. Mass. 2013) (rejecting an economic substance challenge to a transaction similar to the one at issue in *BNY* and *Salem Financial*). For additional examples of this trend, see Richard M. Lipton, ''Tax Shelters and the Decline of the Rule of Law,'' 120 *J. Tax'n* 82 (2014) (citing *BNY*; the decision of the Court of Federal Claims in *Salem Financial*; *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g in part and rev'g in part*, T.C. Memo. 1997-115; *Sundrup v. Commissioner*, T.C. Memo. 2010-249; and *Pritired 1 LLC v. United States*, 816 F. Supp.2d 693 (S.D. Iowa 2011)). A full discussion of the recent FTC cases such as *Salem Financial* and *BNY* is beyond the scope of this report. For useful discussions, see Kevin Dolan, ''The Foreign Tax Credit Diaries — Litigation Run Amok,'' *Tax Notes*, Aug. 26, 2013, p. 895; and Lipton, *supra*, at 102-106.

[6]Section 7701(o)(1); *see* section 7701(o)(5)(D).

[7]Section 7701(o)(5)(C).

change present law standards in determining when to utilize an economic substance analysis."[8] At the same time, Congress significantly raised the stakes regarding when the doctrine is relevant by amending the civil penalty provisions to impose strict liability penalties (in some cases at double the regular rate) for underpayments attributable to the disallowance of claimed tax benefits because of the economic substance doctrine or "any similar rule of law."[9]

This report considers where these developments leave the time-honored principles of *Gregory* that (1) taxpayers are entitled to arrange their affairs in such a manner as to avail themselves of tax benefits bestowed by Congress, and (2) a taxpayer's motives — be they minimizing, avoiding, or even evading taxes — are irrelevant to the business purpose required in some cases to obtain the sought-after tax benefits. It argues that those common law principles remain good law in the economic substance era because courts (including the Supreme Court) have cited them with approval and Congress has never explicitly abrogated them.[10] Indeed, in section 7701(o), Congress went out of its way *not* to abrogate the *Gregory* principles.

Accordingly, this report goes back to the beginning of the business purpose requirement, attempting to distill from an examination of *Gregory* and the other early cases a list of *Gregory* principles. It looks at the later development of the business purpose requirement and pre-section 7701(o) economic substance doctrine,[11] as well as various code provisions that similarly disfavor transactions that have tax avoidance or tax evasion as at least one of their purposes. The report considers what section 7701(o) says (and does not say), its legislative history, and the administrative guidance issued under the statute. In conclusion, the report proposes guidelines for applying the economic substance doctrine and section 7701(o) in a way that gives due respect to the *Gregory* principles. The author's hope is to prevent the doctrine from becoming "a murky smell test randomly applied from court to court"[12] that throws the traditional tax planning baby out with the tax shelter bathwater.[13]

II. Business Purpose Requirement: Origins

A. *Gregory v. Helvering*

As a preliminary matter, it should be noted that although the Supreme Court's 1935 opinion in *Gregory* is almost universally acknowledged as the origin of the business purposes requirement and thus also of the economic substance doctrine,[14] the Court's 1978 opinion in *Frank Lyon Co. v. United States*[15] is sometimes cited instead as authority for the manner in which the economic substance doctrine is currently applied.[16] To be sure, the Court in *Frank Lyon* summarized its conclusions using words such as "economic substance," "encouraged by business or regulatory realities," "imbued with tax-independent considerations," and "not shaped solely by tax-avoidance features that have meaningless labels attached."[17] However, the *Frank Lyon* Court made it clear that it was applying the substance-over-form doctrine, rather than the economic substance doctrine, to determine which of the parties to a sale-leaseback transaction that it had determined was "not a simple sham to be ignored"[18] should be considered the owner of the

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[8]Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the 'Reconciliation Act of 2010,' as Amended, in Combination With the 'Patient Protection and Affordable Care Act,'" JCX-18-10, at 152 (Mar. 21, 2010) (JCT explanation); *see also* H.R. Rep. No. 111-443, Vol. I, at I-291, 295-296 (House report).

[9]Sections 6662(b)(6), 6662(i), and 6664(c)(2).

[10]*See infra* text accompanying note 172.

[11]For an admirable attempt at a comprehensive survey of the growing multitude of cases applying one version or another of the economic substance doctrine, see Yoram Keinan, *The Economic Substance Doctrine* (Portfolio 508).

[12]David P. Hariton, "When and How Should the Economic Substance Doctrine Be Applied?" 60 *Tax L. Rev*. 29, 44 (2006); *see also ACM Partnership*, 157 F.3d at 265 (McKee, J., dissenting) (suggesting that the majority's conclusion is "something akin to a 'smell test'" and that the proper inquiry is "cerebral, not visceral"); Lipton, *supra* note 5, at 82 (suggesting that the IRS and the courts have expanded the economic substance doctrine "into what appears to be a new provision in the Code — Section 'I Don't Like It'").

(Footnote continued in next column.)

[13]*Cf.* Mark E. Berg, "Practitioners' Reaction Indicates Need for Clearer Cir. 230 Rules," *Tax Notes*, July 11, 2005, p. 245.

[14]*See, e.g., ACM Partnership*, 157 F.3d at 246 (citing *Gregory* as "the Supreme Court's foundational exposition of economic substance principles" under the code); *Nevada Partners Fund LLC v. United States*, 720 F.3d 594, 607 (5th Cir. 2013) (quoting the above passage from *ACM Partnership*), *vacated and remanded on another ground*, 134 S. Ct. 903 (2014); *CNT Investors LLC v. Commissioner*, 144 T.C. No. 11, at 52-53 (2015); Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, at 4-45, para. 4.3.4 (1999); Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, at 1-21, para. 1.05[2][c] (2014); Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts: A Transactional Analysis of the Governing Tax, Legal, and Accounting Considerations*, at 6-235 to 6-237, para. 609.1 (2015).

[15]435 U.S. 561 (1978).

[16]*See, e.g., Gerdau Macsteel Inc. v. Commissioner*, 139 T.C. 67, 168-169 (2012) ("current application of the [economic substance] doctrine stems primarily from the Supreme Court's decision in *Frank Lyon*"); and *Rice's Toyota World Inc. v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985), *aff'g in part and rev'g in part* 81 T.C. 184 (1983) (setting out the two-prong economic substance test as "properly giv[ing] effect to the mandate of the Court in *Frank Lyon*").

[17]*Frank Lyon*, 435 U.S. at 583-584.

[18]*Id.* at 580.

building for tax purposes.[19] The issue was not whether the transaction should be disregarded in its entirety, which would be the question under the economic substance doctrine. Indeed, *Gregory* was not even mentioned by the Court in *Frank Lyon*.[20]

In *Gregory*, the taxpayer was the sole shareholder of a corporation (United) that owned securities it wished to sell. Having United sell the securities and distribute the proceeds to the taxpayer would have resulted in two levels of tax: a corporate-level tax on United on the sale and a shareholder-level tax on the dividend. In those days, which preceded the legislative repeal of *General Utilities v. Helvering*,[21] well-advised taxpayers would have the corporation distribute the asset to the shareholder, who would then sell it. Because of *General Utilities*, no corporate tax would be imposed on the distribution, and the shareholder would pay one level of tax on the distribution and no further tax on the sale of the asset. To improve on even that favorable result, United transferred the securities to a newly formed subsidiary (Averill) and immediately distributed the shares of Averill to the taxpayer. Shortly thereafter, the taxpayer caused Averill to distribute the securities to her in complete liquidation of Averill, and she immediately sold them. Because this series of transactions met the literal requirements of a tax-free corporate reorganization, the taxpayer apportioned a part of her basis in her United shares to the Averill shares and thereby reported a substantially smaller amount of gain on the liquidation of Averill than the amount of dividend income she would have realized had she done the usual two-step transaction.

The IRS determined that the purported reorganization was without substance and must be disregarded, with the result that the taxpayer was taxable just as if she had received the securities as a dividend from United. (Apparently, the IRS did not challenge the taxpayer's avoidance of corporate-level tax on the sale by having United distribute the securities to her before the sale.[22]) The Board of Tax Appeals (the predecessor to the Tax Court) rejected the IRS's view, holding that because the code provisions were ''so meticulously drafted,'' they ''must be interpreted as a literal expression of the taxing policy, and leave . . . only the small interstices for judicial consideration.''[23] Accordingly, the taxpayer's compliance with the literal terms of the statute was found sufficient to generate the claimed tax benefit.[24]

The Second Circuit reversed in a now-famous opinion by Judge Learned Hand. The court of appeals characterized the board's holding as having been decided on the ground that the ''transactions being real, their purpose was irrelevant,''[25] and, while reversing the board, agreed with its basic premise:

> We agree with the Board and the taxpayer that *a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, evade, taxation*. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. *Therefore, if what was done here, was what was intended by* [*the statute*], *it is of no consequence that it was all an elaborate scheme to get rid of income taxes*, *as it certainly was*.[26] [Emphasis added; citations omitted.]

The Second Circuit also held that it is ''quite true, as the Board has very well said, that as the articulation of a statute increases, the room for interpretation must contract.''[27] However, the court reversed the board on the ground that ''it does not follow that Congress meant to cover such a transaction.''[28] In this connection, the court found that the purpose of the reorganization provisions is to enable ''men engaged in enterprises — industrial, commercial, financial, or any other . . . to consolidate, or divide, to add to, or to subtract from, their holdings'' when ''the collective interests still remained in solution,'' but only if ''the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the

[19]*See id.* at 572-573 (citing such classic substance-over-form cases as *Corliss v. Bowers*, 281 U.S. 376 (1930); *Helvering v. Clifford*, 309 U.S. 331 (1940); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945)); and *id.* at 576 (''to peel away the form of this transaction and to reveal its substance'').

[20]*See Newman v. Commissioner*, 902 F.2d 159, 163 (2d Cir. 1990) (''the touchstone in determining whether the form of an agreement should govern is the opinion of the Supreme Court in *Frank Lyon*''); *Historic Boardwalk Hall*, 694 F.3d at 448 n.50 (discussing the significant differences between the substance-over-form doctrine and the economic substance doctrine). *But see Santander Holdings*, 977 F. Supp.2d at 49 (equating the substance-over-form doctrine with the economic substance doctrine).

[21]296 U.S. 200 (1935), *superseded by statute*, Tax Reform Act of 1986, P.L. 99-514, section 631.

[22]*See* Hariton, *supra* note 12, at 42; *see also Gregory*, 27 B.T.A. at 225 (noting that the IRS did not suggest that United be disregarded).

[23]*Gregory*, 27 B.T.A. at 225.

[24]*Id. at* 225-226.

[25]*Gregory*, 69 F.2d at 810.

[26]*Id.*

[27]*Id.*

[28]*Id.*

shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.'''[29]

The Supreme Court unanimously affirmed, using some equally famous language:

> It is earnestly contended on behalf of the taxpayer that since every element required by the [statute] is to be found in what was done, a statutory reorganization was effected; and that *the motive of the taxpayer thereby to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of* [*the statute*], *the ulterior purpose mentioned will be disregarded.* The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, *apart from the tax motive*, was the thing which the statute intended.[30] [Emphasis added.]

Finding that the taxpayer's transaction was not ''the thing which the statute intended'' because the asset transfer from one corporation to the other was ''in pursuance of a plan having no relation to the business of either,'' the Court reasoned as follows:

> *Putting aside, then, the question of motive in respect of taxation altogether*, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. . . . *The rule which excludes from consideration the motive of tax avoidance* is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.[31] [Emphasis added.]

Significantly, the Court in *Gregory* drew a clear distinction between the taxpayer's motivation for structuring the transaction the way she did and the ''business or corporate purpose'' for the transaction, and it emphasized congressional intent in both contexts.[32] The Court held that *the taxpayer's* motive to escape payment of a tax will be disregarded as long as ''a reorganization in reality was effected within the meaning of'' the statute.[33] By contrast, it explained the required business purpose in terms of the *congressional* purpose in bestowing the tax benefit. The Court did so by contrasting a transaction that was intended ''to reorganize a business or any part of a business'' with a transaction that intended to look like a reorganization but in reality was a disguise for the transfer of corporate assets to the shareholder.[34] Given the almost immediate liquidation of the newly created corporation in *Gregory*, the Court easily found that the transaction fell into the latter category.[35]

Viewed in this light, the principles articulated in *Gregory* do not require that a taxpayer come into a transaction with no tax motive or even have *any* motive other than tax reduction. Rather, they require that any purpose be analyzed as part of the determination of whether the taxpayer in fact did anything of substance, and if so, whether what the taxpayer did is what the provision allowing the tax benefit requires.[36] Interestingly, neither the IRS nor the courts seemed to mind that the taxpayer avoided the corporate-level tax that would have resulted had United sold the securities. The transaction form chosen by the taxpayer included steps that (in modern parlance) lacked economic substance and were presumably taken solely to permit her to sell the shares rather than have United sell them. This is another indication that the case does not really amount to an endorsement by the Supreme Court of what has since become the most expansive view of the economic substance doctrine.

B. From *Gregory* to *Knetsch*

The lower courts, and particularly the Second Circuit and Hand, had many occasions to interpret and apply the principles of *Gregory* during the 25 years between that case and the Supreme Court's next foray into this area in *Knetsch v. United States*.[37] Just six months after the Supreme Court handed

[29] *Id.* at 811.

[30] *Gregory*, 293 U.S. at 468-469.

[31] *Id.* at 469-470.

[32] *Id*. at 469.

[33] *Id.* at 468-469.

[34] *Id.* at 469.

[35] *Id.* at 470.

[36] *See* Robert T. Smith, ''Business Purpose: The Assault Upon the Citadel,'' 53 *Tax Law*. 1, 7 (1999) (''The defect in *Gregory* was not a tax-avoidance motive . . . but (i) the failure of [Averill] to have any appreciable economic significance, and (ii) the failure of the transactional elements to comport with any ascribed purpose for the applicable reorganization provisions.''); *Gerdau Macsteel*, 139 T.C. at 169 n.69 (in *Gregory*, the Supreme Court ''recognized the right of a taxpayer to avoid the payment of tax through legal means'').

[37] 364 U.S. 361 (1960), *aff'g* 272 F.2d 200 (9th Cir. 1959).

down *Gregory*, the Second Circuit decided *Chisholm v. Commissioner*.[38] *Chisholm* involved corporate shareholders who granted a third party a 30-day call option on their shares on September 26, 1928. On October 11 the optionee gave notice that it would exercise its option, and on October 22 two of the shareholders, who were brothers, transferred their shares to a partnership — something they had been discussing for months but which they did on advice of tax counsel as a way to postpone and possibly escape tax on the sale.[39] The option was exercised on October 24. The IRS asserted that the brothers were liable for tax on the sale. The IRS argued that *Gregory* requires that the partnership and its role in the transaction be disregarded because the partnership ''was formed confessedly to escape taxation.''[40] The Board of Tax Appeals agreed with the IRS.[41]

The Second Circuit reversed, distinguishing *Gregory* on the following basis:

> It is important to observe just what the Supreme Court held in [*Gregory*]. It was solicitous to *reaffirm the doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.* It is true that that court has at times shown itself indisposed to assist such efforts, and has spoken of them disparagingly, but *it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such.* The question always is whether the transaction under scrutiny is in fact what it appears to be in form; a marriage may be a joke; a contract may be intended only to deceive others; an agreement may have a collateral defeasance. In such cases the transaction as a whole is different from its appearance. True, it is always the intent that controls; and we need not for this occasion press the difference between intent and purpose. We may assume that purpose may be the touchstone, *but the purpose which counts is one which defeats or contradicts the apparent transaction, not the purpose to escape taxation which the apparent, but not the whole, transaction would realize.* In [*Gregory*], the incorporators adopted the usual form for creating business corporations; *but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world.*[42] [Emphasis added; citations omitted.]

Finding the partnership ''a genuine pool of joint capital managed jointly'' rather than ''a mere cover for continued separate management,'' the Second Circuit distinguished *Gregory* and held for the taxpayer.[43]

In other cases, the Second Circuit (and particularly but not always Hand) reiterated and reinforced these principles. For example, in 1936, in *Johnson v. Commissioner*,[44] Judge Thomas Swan stated for the court:

> *It is too well settled to require discussion that legal transactions cannot be upset merely because the parties have entered into them for the purpose of minimizing or avoiding taxes which might otherwise accrue*. Despite such purpose, the question is always whether the transaction under scrutiny is in reality what it appears to be in form.[45] [Emphasis added; citations omitted.]

In 1949 in *Commissioner v. Transport Trading & Terminal Corp.*,[46] Hand held for the Second Circuit that the principle of *Gregory* ''is not limited to cases of corporate reorganizations,'' but ''has a much wider scope'':

> It means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include

[38] 79 F.2d 14 (2d Cir. 1935), *rev'g* 29 B.T.A. 1334 (1934).

[39] Apparently, under the law in effect at the time, when property was contributed to a partnership, the partnership took the property with a fair market value basis. If the partnership sold the property, the appreciation in value before the contribution was not taxable until the partnership dissolved. *See Chisholm*, 79 F.2d at 15 (citing *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934)).

[40] *Chisholm*, 79 F.2d at 15.

[41] *Chisholm*, 29 B.T.A. 1334.

[42] *Chisholm*, 79 F.2d at 15.

[43] *Id.* at 16.

[44] 86 F.2d 710 (2d Cir. 1936).

[45] *Id.* at 712; *see also Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (L. Hand, J., dissenting) (''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 or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.''), *quoted with approval in, e.g.*, *Yosha v. Commissioner*, 861 F.2d 494, 497 (7th Cir. 1988).

[46] 176 F.2d 570 (2d Cir. 1949).

transactions entered upon for no other motive but to escape taxation.[47]

While this language might appear at first blush to contradict the earlier cases (including *Gregory*) holding that the taxpayer's motive is irrelevant, in context it is consistent. The taxpayer in *Transport Trading* distributed an appreciated asset to its parent corporation, which the parent shortly thereafter sold to a third party. The taxpayer claimed that it recognized no gain on the distribution because of *General Utilities*, and the parent claimed that it received a step-up in the basis of the asset distributed to it and thus realized no gain on the sale. The court determined that the taxpayer had an option to sell the asset to the buyer, which it exercised by purporting to distribute the asset to its parent. Citing *Gregory*, the court held that that step was not a distribution as described in the statutory definition of dividend then in the code because it ''was not a distribution for the purposes of the Parent's business, but only in order to escape a tax and such a 'distribution' is not among those contemplated in the section.''[48] Thus, the case was a straightforward application of the *Gregory* principle that the taxpayer's tax motivations aside, a transaction will be held to be outside the statutory definition if its purpose was not to accomplish the objectives contemplated by the statute but rather to merely make it appear as if the transaction contemplated by the statute was carried out.

In 1956 in *Kraft Foods Co. v. Commissioner*,[49] the taxpayer issued debentures to its sole shareholder, another corporation, and conceded that ''tax considerations were the primary motivation of the debenture issue.''[50] The IRS, citing *Gregory* and numerous other cases, argued that ''the debenture issue should be disregarded for tax purposes because it served no business purpose other than the minimization of taxes.''[51] The Second Circuit, in an opinion by Judge Sterry Waterman, disagreed:

> *We do not think that these cases hold that tax minimization is an improper objective of corporate management*; they hold that transactions, even though real, may be disregarded if they are a sham or masquerade or if they take place between taxable entities which have no real existence. *The inquiry is not what the purpose of the taxpayer is*, but whether what is claimed to be, is in fact.[52] [Emphasis added.]

Noting that the parent and the issuing corporation were both substantial enterprises and that the transaction constituted a series of ''objective acts with the intent of creating legal rights and duties,'' the court concluded that ''the transaction should not be disregarded merely because [it] was entered into in response to a change in governing tax law.''[53] For good measure, the court pointed out the following:

> There is no doctrine that taxpayers cannot adjust their affairs in response to a change in the tax law so as to reduce taxes. Indeed, the structure of the tax law deliberately recognizes tax-conscious motivations and seeks both to encourage them (e.g., rapid amortization . . . and charitable deduction for gifts of appreciated property) and to discourage them (e.g., surtax on unreasonable accumulation of surpluses . . . and provisions . . . relating to transactions between related taxpayers).[54]

The following year, Hand reaffirmed these principles in a famous dissenting opinion in *Gilbert v. Commissioner*,[55] a debt-equity case in which the taxpayer claimed a bad debt deduction on advances he had made to a corporation of which he was the 50 percent shareholder. Remanding the case back to the Tax Court for a better exploration of its holding that the advances were not debt, the majority opinion by Judge Harold Medina quoted at length from *Gregory*, *Johnson*, and *Kraft Foods*, and noted the following regarding the taxpayer's motive:

> *We think it helpful to point out that the taxpayer's motive is not the crucial factor.* This is but a corollary of the undoubted proposition, ''The incidence of taxation depends upon the substance of a transaction.'' . . . *It will be noted that in* Gregory *the Supreme Court repeatedly stated that the taxpayer's desire to reduce her taxes was irrelevant*. . . . Where the courts have spoken of tax avoidance motives, they have as a rule had reference to their conclusions rather than to the evidence. The statement that the taxpayer

[47]*Id.* at 572; *see also*, *e.g.*, *Weller v. Commissioner*, 270 F.2d 294, 297 (3d Cir. 1959) (*Gregory* ''applies to the federal taxing statutes generally.'').

[48]*Transport Trading*, 176 F.2d at 572.

[49]232 F.2d 118 (2d Cir. 1956).

[50]*Id.* at 127.

[51]*Id.* The IRS also cited *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938); *Griffiths v. Commissioner*, 308 U.S. 355 (1939); *Higgins v. Smith*, 308 U.S. 473 (1941); *Court Holding*, 324 U.S. 331; *Bazley v. Commissioner*, 331 U.S. 737 (1947); and *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[52]*Kraft Foods*, 232 F.2d at 128 (citing *Loewi v. Ryan*, 229 F.2d 627, 629 (2d Cir. 1955)) (L. Hand, J.) (''It is so abundantly settled in decisions of the Supreme Court that a taxpayer's motive is irrelevant in determining his liability that we need not cite the very numerous decisions of the lower courts.'').

[53]*Kraft Foods*, 232 F.2d at 128. The referenced change in the law is the 1934 abolition of consolidated tax returns.

[54]*Id.* at 128 n.19.

[55]248 F.2d 399 (2d Cir. 1957).

> was seeking to avoid taxes has been used as the equivalent of the statement that the taxpayer has tried to base a deduction on an advance which was in fact too risky to qualify as a loan for tax purposes. As we have shown, the motives and expectations of the taxpayer are relevant only insofar as they contribute to an understanding of the external facts of the situation.[56] [Emphasis added.]

The concurring opinion of Waterman (the author of the majority opinion in *Kraft Foods*) said the following regarding motive:

> I do not understand Judge Medina's opinion to hold that the motive of a taxpayer is never a proper subject of inquiry. Cases may arise — indeed, this may be one — in which the Commissioner may contend that the way the taxpayer reports a transaction upon his income tax return must be disregarded because it does not evidence the entire true transaction and is a mere pretense. In such a case, the desire of the taxpayer to avoid his taxes is a relevant subject for inquiry because it provides a motive for the sham which the Commissioner seeks to prove.[57]

Hand dissented on the procedural ground that the remand instructions given by the majority to the Tax Court were too vague. Those instructions spoke of "whether the transaction has 'substantial economic reality' or 'is in reality what it appears to be in form,' or is a 'sham' or a 'masquerade,' or 'depends upon the substance of the transaction.'"[58] Hand had this to say regarding the *Gregory* principle and the role of the taxpayer's motive:

> If . . . 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 of the purpose of the act to provide an escape from the liabilities that it sought to impose. When a taxpayer supposes that the transaction, in addition to its effect on his tax, will promote his beneficial interests in the venture, he will of course secure the desired reduction, for it would be absurd to hold that he must deny himself an economic advantage unless he pay the tax based upon the facts that have ceased to exist. Moreover, he will also be relieved, if he supposes that the transaction will, or may, cause him a loss, *although in that event it is true that his only motive will be to avoid the tax*. For instance, if a very rich man sells shares of stock and invests the proceeds in municipal bonds, he will not be taxed on the dividends of the shares, *although his only motive was to avoid the tax upon his dividends*. It might have been possible in such situations, *when the only motive was to reduce taxes*, to assess a tax, measured by the difference between the tax still due, and that that would have been due but for the transaction. However, there is not the slightest intimation of such a doctrine in any of the decisions; it covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally.[59] [Emphasis added; citations omitted.]

On the eve of the Supreme Court's next contribution to this area, *Knetsch*,[60] and on essentially the same facts as in *Knetsch*, the Second Circuit weighed in again in *Diggs v. Commissioner*.[61] In *Diggs*, *Knetsch*, and several related cases, the taxpayers purchased deferred annuity contracts with borrowings equal to the cash value of the annuities, under agreements providing for an interest rate payable on the loans that exceeded the rate of return on the annuity contracts. Interest on the loans was prepaid in amounts that offset specified gains that the taxpayer had realized. In *Diggs* the taxpayer conceded that his primary purpose in entering into the transactions was to reduce his income tax through the interest deduction. Although the 2-1 majority in *Diggs*, citing *Gregory*, disallowed the taxpayer's interest deduction, the court, in an opinion by Waterman, made it absolutely clear that it continued to follow its prior reasoning on the scope of *Gregory* and the role of the taxpayer's motive:

> Precise formulation of the *Gregory* principle has proved somewhat difficult. There is language in some of our opinions suggesting that *Gregory v. Helvering* applies to preclude tax relief as to any transaction the taxpayer entered into solely for the purpose of avoiding taxes. *Such an application of the holding in that case would be, however, a mistaken oversimplification. The* [*Supreme Court's*] *opinion in* Gregory v. Helvering *permits proper tax avoidance.* There it is stated, "[T]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be

[56] *Id.* at 404, 407.

[57] *Id.* at 408 n.2 (Waterman, J., concurring).

[58] *Id.* at 412 (Hand, J., dissenting).

[59] *Id.* at 411-412 (Hand, J., dissenting), *cited with approval in Knetsch*, 364 U.S. at 366; and *Diggs v. Commissioner*, 281 F.2d 326, 329-30 (2d Cir. 1960).

[60] 364 U.S. 361 (1960).

[61] 281 F.2d 326 (2d Cir. 1960).

doubted.'' And as Judge Hand has pointed out in his dissent in *Gilbert v. CIR*, as to many transactions Congress has clearly intended tax relief irrespective of the parties' motives. After surveying our more recent cases the majority stated in *Gilbert* that the principle of *Gregory v. Helvering* would operate to deny tax relief whenever a transaction was without economic substance or whenever the taxpayer's characterization of the transaction was economically unrealistic. We concluded, ''[I]n either case the taxpayer must show that his treatment of the transaction does not conflict with the meaning the Congress had in mind when it formulated the section *sub judice*.'' Consistent with the principle we thus set forth in *Gilbert*, we are of the belief that at the least *Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance.[62] [Emphasis added; citations omitted.]

The majority concluded that it was ''obvious'' that the taxpayer failed to meet that burden.[63]

In dissent, Judge Leonard Moore found the transactions, under which ''actual annuity contracts had been issued'' and ''real indebtedness'' had been incurred, to be ''very real,'' ''perfectly legal,'' and ''carefully planned under the law to take advantage of permissible deductions.''[64] He objected to the majority's conclusion as follows:

Of course, it is most obvious that the insurance company in selling, and the taxpayer in buying under the plan for borrowing to pay the premiums, were mindful of the tax advantages resulting from interest deductions. Assume that they had this motive. *Tax saving as a motive does not change a ''plan'' into a ''scheme'' to fraudulently deprive the government of taxes otherwise due*. The Commissioner argues that the interest for 19 years would exceed the contract increment. If wisdom of business judgment is to be the test, then the Commissioner will have to examine into interest paid at 6 percent on a loan to buy securities paying only 1 percent or 2 percent or in many cases nothing at all. Or should interest be disallowed on a large mortgage when the homeowner is shown to have adequate assets to own his home mortgage free. *Therefore, to impose on a taxpayer, as does the majority, the burden of showing that the transaction would have occurred ''absent the motive of tax avoidance'' imputes to Congress an intent which Congress has not yet disclosed*.[65] [Emphasis added.]

Moore also pointed out that Congress amended the code in 1932 to deny deductions for interest incurred to purchase a single-premium annuity contract, reinstated the deduction in 1934, and once again eliminated the deduction in 1954 with an effective date after the taxpayer purchased his annuity contracts.[66] He characterized the IRS's attempt to avoid the ''obvious conclusion'' from this legislative history that the taxpayer's interest was deductible as ''not construing the law but rather imposing [the IRS's] views as to the method of handling the annuity purchase.''[67]

C. *Knetsch v. United States*

Faced with a split in the circuits regarding the annuity transaction at issue in *Diggs* and the related cases,[68] the Supreme Court granted certiorari in *Knetsch*.[69] In a 6-3 decision, the Court held for the IRS but went out of its way to reaffirm the principle of *Gregory* that the taxpayer's motive is irrelevant and the business purpose requirement is focused instead on whether the transaction in substance meets the relevant statutory definition:

We first examine the transaction between Knetsch and the insurance company to determine whether it created an ''indebtedness'' within the meaning of [the Code], or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's ''only motive in purchasing these 10 bonds was to attempt to secure an interest deduction.'' As was said in *Gregory v. Helvering*: ''The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the

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[62]*Id.* at 329-330. Hand was not on the panel that decided *Diggs*. He died a little more than a year after *Diggs* was decided.

[63]*Id.* at 330.

[64]*Id.* (Moore, J., dissenting).

[65]*Id.* at 331 (Moore, J., dissenting).

[66]*Id.* at 330-331 (Moore, J., dissenting); *see Knetsch*, 364 U.S. at 367-368; and *United States v. Bond*, 258 F.2d 577, 582-584 (5th Cir. 1958).

[67]*Diggs*, 281 F.2d at 331 (Moore, J., dissenting).

[68]The interest deductions had been denied by the Second, Third, and Ninth circuits and allowed by the Fifth Circuit. *Compare Diggs*, 281 F.2d 326; *Weller*, 270 F.2d 294; *and Knetsch*, 272 F.2d 200, *with Bond*, 258 F.2d 577.

[69]361 U.S. 958 (1960).

> tax motive, was the thing which the statute intended."[70] [Citation and footnote omitted.]

Having held the taxpayer's motive in entering into the transaction irrelevant, the majority compared the form of the transactions with their substance. They found that the purported loans to the taxpayer were "in reality only the rebate of a substantial part of the so-called 'interest' payments," and held that "there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."[71] While the Court labeled the single-payment annuity transactions a "sham" and a "sham transaction," the majority opinion makes it clear that the Court was using those terms to mean that the transactions did not "create a true obligation to pay interest" within the meaning of the code.[72]

Justice William O. Douglas, joined by justices Charles Whittaker and Potter Stewart, dissented, largely on the basis of Moore's dissent in *Diggs*.[73] Like Moore, Douglas cited examples of taxpayers borrowing at 5 percent or 6 percent to purchase securities that pay only nominal interest and of taxpayers with money in the bank earning 3 percent interest who borrow from that same bank at a higher rate — situations in which the taxpayer's goal "may only be to get a tax deduction for interest paid." The dissent argued that "as long as the transaction itself is not hocus-pocus, the interest charges incident to completing it would seem to be deductible under the Internal Revenue Code as respects annuity contracts made prior to March 1, 1954, the date Congress selected for terminating this class of deductions."[74] More generally, the dissent presciently concluded as follows:

> Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. . . . To disallow the "interest" deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative. Evils or abuses can be particularized by Congress.[75]

D. *Nassau Lens Co. v. Commissioner*

In *Nassau Lens Co. v. Commissioner*,[76] an individual transferred all the assets of his sole proprietorship to a newly formed corporation in exchange for all its stock and debenture notes. In the year this occurred, the corporation claimed a deduction for amortization of the original issue discount on the debenture notes. The IRS disallowed the deduction, and the Tax Court agreed with the IRS on the ground that no business reason existed for what the court referred to as the "artificial division and allocation of the assets" of the proprietorship between those exchanged for stock and those exchanged for debentures.[77]

The Second Circuit reversed in an opinion by Judge (later Supreme Court Justice) Thurgood Marshall. Assuming *arguendo* that there was no business purpose for the allocation between stock and debt,[78] the court characterized the Tax Court's opinion as holding that because the shareholder could have allocated the entire investment to equity without adverse economic consequences, there must be a reallocation for tax purposes "so as to produce the maximum in revenue."[79] Quoting from *Gregory* and *Gilbert* and citing *Kraft Foods*, the court then stated the applicable principles as follows:

> *In the absence of statutory language or legislative history to the contrary, the desire to save taxes is not by itself sufficient cause to disregard the form adopted by the taxpayer*, for "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." While the taxpayer may of course show he had a motive other than tax saving in adopting a particular form, his case may also be based upon a demonstration "that his treatment of the transaction does not conflict with the meaning the Congress had in mind when it formulated the section *sub judice*." *In short, the courts have not attributed to Congress a general purpose underlying the entire Code to deprive the taxpayer in each case of freedom to choose between legal forms similar in a broad economic sense but having disparate tax consequences.* They have, instead, when confronted with a statutory provision not explicitly turning on the relationship between parties to a transaction or requiring an underlying business purpose, adopted a cautious approach and asked merely whether the form superimposed upon the transaction has a result similar to the one Congress had in mind when it drafted the section involved.[80] [Emphasis added; citations and footnotes omitted.]

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[70]*Knetsch*, 364 U.S. at 365.
[71]*Id.* at 366 (citing Hand's dissenting opinion in *Gilbert*).
[72]*Id.* at 367.
[73]*Id.* at 370 (Douglas, J., dissenting).
[74]*Id.*
[75]*Id.* at 371.
[76]308 F.2d 39 (2d Cir. 1962), *remanding* 35 T.C. 268, 272 (1960).

[77]35 T.C. at 272.
[78]308 F.2d at 44 n.6.
[79]*Id.* at 44.
[80]*Id.* at 44-45.

The court characterized *Gregory* as having found both "a lack of business purpose *and* a disparity between the objective result and the ascertainable legislative purpose."[81]

Turning to *Gregory* and *Knetsch*, the court viewed those cases as standing for the following proposition:

> While the existence of a tax motive or the lack of a business purpose is the starting point for a challenge to the form of a transaction adopted by a taxpayer, it is, in the absence of legislative intent to the contrary, not the finish line, for if the substantive result is of the general type considered by Congress to be within the particular provisions involved, the fact that a different but equally feasible form would have resulted in a greater tax is of no consequence.[82]

The court justified its "cautious approach in this particular area of tax law" in terms of the proper role of the courts vis-à-vis Congress. That is, without legislative guidance, there was an unwillingness to insert the courts into the question of what constitutes a sufficient business purpose. The Second Circuit also identified a concern that as "the Code grows in complexity and detail, the courts must be careful not to attribute to Congress overall purposes or meanings not reflected in the statutory language or clearly demonstrated in the legislative history."[83] The court noted that the case before it illustrated those concerns. It observed, for example, that while one could argue that it made little economic difference how the investment in this case was allocated between debt and equity, the same reasoning could support an argument by the individual taxpayer that there was little economic difference between establishing an unincorporated business or a corporation of which he was the sole shareholder. From this the court concluded that cases of this nature should be decided on the basis of whether the transaction has "substantial economic reality" rather than whether the taxpayer has a business purpose.[84] The Tax Court, it found, erroneously placed too much emphasis on whether the shareholder had a business purpose.

[81]*Id.* at 45 (emphasis in original).

[82]*Id.*

[83]*Id.* at 45-46.

[84]*Id.* at 46; *cf. Peracchi v. Commissioner*, 143 F.3d 487, 492-495 (9th Cir. 1998) (contribution by shareholder of his recourse promissory note to his closely held corporation had economic substance since the note would be an enforceable asset of the corporation in the event of a bankruptcy).

E. *Goldstein v. Commissioner*

The other early case often discussed in this connection is *Goldstein v. Commissioner*.[85] The taxpayer in *Goldstein* won the Irish sweepstakes; borrowed funds on a recourse basis from banks at an interest rate of 4 percent per annum; used the loan proceeds to purchase U.S. treasury notes paying interest at 1.5 percent per annum; pledged the treasury notes as collateral for the loans; and prepaid interest on the loans in the year she won the sweepstakes. A divided Tax Court held the loan transactions were shams that did not create genuine indebtedness, and it accordingly disallowed the interest deduction.[86] Judge William Fay's dissent, joined by four other judges, characterized the majority opinion as finding the transaction to be a sham because it was "entered into for the 'wrong' motives — that is, for tax-reduction motives," and argued that "although the existence of a tax motive creates the necessity for a searching inquiry into the substance of a transaction . . . I do not believe that motives of tax avoidance can so contaminate an otherwise legitimate transaction as to rob it of all reality."[87]

The Second Circuit, in an opinion by Waterman, disagreed with the Tax Court's reasoning but affirmed on other grounds. First, the court of appeals found that the loan transactions were not shams, pointing to the independent financial institutions involved, the recourse nature of the loans, the substantial rights granted to the banks under the loan documents, and the length of time the arrangements were in place.[88] Next, the court held that the taxpayer entered into the loan transactions "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction."[89] Then, citing *Knetsch*, *Diggs*, and related cases, the court held that no deduction is allowed for interest incurred in loan arrangements "that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences."[90]

Noting that section 163(a) does not require that interest serve a business purpose or be ordinary, necessary, or even reasonable in amount, the court found in the "underlying notion" and "underlying purpose" of the provision a requirement that a

[85]364 F.2d 734 (2d Cir. 1966), *aff'g* 44 T.C. 284 (1965).

[86]44 T.C. 284.

[87]*Id.* at 302 (Fay, J., dissenting).

[88]364 F.2d at 738.

[89]*Id.* at 740.

[90]*Id*.

taxpayer claiming an interest deduction be engaged in ''purposive activity,''[91] explaining its rationale as follows:

> In order to fully implement this Congressional policy of encouraging purposive activity to be financed through borrowing, Section 163(a) should be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, *even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way*. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. *After all, we are frequently told that a taxpayer has the right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by any means the law permits.* On the other hand, and notwithstanding Section 163(a)'s broad scope this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction. . . . Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. When it enacted Section 163(a) Congress could not have intended to permit a taxpayer to reduce his taxes by means of an interest deduction that arose from a transaction that had no substance, utility, or purpose beyond the tax deduction.[92] [Emphasis added.]

In conclusion, the court answered the question, enunciated in *Gregory* and reiterated in *Knetsch*, of ''whether what was done, apart from the tax motive, was the thing which the statute intended'' by holding that ''section 163(a) does not 'intend' that taxpayers should be permitted deductions for interest paid on debts that were entered into solely in order to obtain a deduction.''[93]

III. Summary of the *Gregory* Principles

The following principles (the *Gregory* principles) can be distilled from the Supreme Court and Second Circuit cases from *Gregory* to *Goldstein*:

> 1. There is an important distinction between (a) whether and to what extent a taxpayer's motive for entering into a transaction was to reduce or avoid tax, and (b) the business purpose that these cases held to be required. Indeed, absent that distinction, it would be impossible to reconcile the business purpose requirement regularly ascribed to *Gregory* and its progeny with either the Second Circuit's often-quoted[94] statement in *Gregory* that taxpayers are not bound to choose the least tax-efficient means of arranging their affairs[95] or the Supreme Court's even more often quoted[96] statement in *Gregory* that taxpayers have the right to decrease or eliminate the amount that would otherwise be their tax liability by means permitted by law.[97]
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> 2. A taxpayer's tax motives for entering into a transaction alone are to be disregarded and ''put aside'' in determining whether the desired tax benefit will be disallowed.[98] Indeed,

[91]*Id.* at 741.

[92]*Id.* at 741-742.

[93]*Id.* at 742 (quoting *Gregory*, 293 U.S. at 469, quoted in *Knetsch*, 364 U.S. at 365).

[94]*See, e.g.*, *United States v. Carlton*, 512 U.S. 26, 35 (1994) (O'Connor, J., concurring) (''Although [the taxpayer's executor] may have made a 'purely tax-motivated stock transfe[r],' . . . I do not understand the Court to express any normative disapproval of this course of action. . . . [L]ike all taxpayers, [the executor] was entitled to structure the estate's affairs to comply with the tax laws while minimizing tax liability.'').

[95]*Gregory*, 69 F.2d at 810.

[96]*See, e.g.*, *Boulware v. United States*, 552 U.S. 421, 429 n.7 (2008) (quoting this passage from *Gregory* with approval); *cf. Frank Lyon*, 435 U.S. at 580 (''The fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing these consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction.''); *United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 739 (1977) (''even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction''); *Commissioner v. Brown*, 380 U.S. 563, 579-580 (1965) (Harlan, J., concurring) (''the tax laws exist as an economic reality in the businessmen's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source''); and *United States v. Cumberland Public Services Co.*, 338 U.S. 451, 455 (1950) (''whatever the motive and however relevant it may be in determining whether the transaction was real or a sham'').

[97]*Gregory*, 293 U.S. at 469.

[98]*Id.*; *Knetsch*, 364 U.S. at 365.

tax benefits are not necessarily to be disallowed for tax-motivated transactions or even for transactions whose *sole* purpose is to reduce taxes.[99]

3. The focus is on congressional purpose: Did the taxpayer do ''the thing which the statute intended'' — that is, the targeted activity for which Congress intended to bestow the tax benefit?[100] If so, and if the transaction is not merely a masquerade to make it appear as if the taxpayer engaged in the targeted activity, the tax benefit will be allowed.[101] If instead the taxpayer's ''treatment of the transaction . . . conflict[s] with the meaning the Congress had in mind when it formulated the section *sub judice*,'' the tax benefit will not be allowed.[102]

4. Even if the transaction does not appreciably affect the taxpayer's pretax economic position such that it would never have occurred absent the tax benefits, the question remains whether Congress intended the sought-after tax treatment in the circumstances before the court. However, the taxpayer may have more difficulty establishing the congressional intent in that case.[103]

5. Courts should take a ''cautious approach'' in this area and not attribute to Congress an intention to deprive taxpayers of the freedom to choose between possible ways to structure a transaction that are similar to one another in economic substance but have different tax consequences. Rather, absent legislative guidance, courts should ask whether the taxpayer's transaction is sufficiently similar to the one Congress contemplated when it enacted the code provision in question, keeping in mind that ''as the articulation of a statute increases, the room for interpretation must contract.''[104]

[99]*See Nassau Lens*, 308 F.2d at 44-45 and n.6; and *Gilbert*, 248 F.2d at 411-412 (Hand, J., dissenting).

[100]*Gregory*, 293 U.S. at 469; *Goldstein*, 364 F.2d at 741-742.

[101]*See Knetsch*, 364 U.S. at 365-367; *Gregory*, 293 U.S. at 469-470; *Kraft Foods*, 232 F.2d at 128; and *Chisholm*, 79 F.2d at 15.

[102]*See Nassau Lens*, 308 F.2d at 44-45; *Diggs*, 281 F.2d at 330; and *Gilbert*, 248 F.2d at 406. *See also BNY* (citing *Gregory*, *supra* note 101, for the proposition that the economic substance doctrine ''exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit''); *Salem Financial*, 786 F.3d at 942 (citing *Gregory* for the proposition that ''under the traditional economic substance doctrine, the issue in such cases is whether the transactions are contrivances that are inconsistent with the purposes served by the Code provisions and should therefore be disregarded'').

[103]*See Diggs*, 248 F.2d at 330.

[104]*See Nassau Lens*, 308 F.2d at 45; and *Gregory*, 69 F.2d at 810.

The Tax Court recently articulated the thinking underlying the above principles as follows:

> *Gregory*, like much of the caselaw using the economic substance, sham transaction, and other judicial doctrines in interpreting and applying tax statutes, represents an effort to reconcile two competing policy goals. On one hand, having clear, concrete rules embodied in a written Code and regulations that exclusively define a taxpayer's obligations (1) facilitates smooth operation of our voluntary compliance system, (2) helps to render that system transparent and administrable, and (3) furthers the free market economy by permitting taxpayers to know in advance the tax consequences of their transactions. On the other side of the scales, the Code's and the regulations' fiendish complexity necessarily creates space for attempts to achieve tax results that Congress and the Treasury plainly never contemplated, while nevertheless complying strictly with the letter of the rules, at the expense of the fisc (and other taxpayers). In *Gregory*, the Court confronted such an extreme result and, on the basis of equitable principles, interpreted and applied the relevant statute so as to subject Mrs. Gregory's transaction to tax. Likewise, the various other judicial doctrines applied in tax cases all represent efforts to rein in activity that, while within the technical letter of the rules, deeply offends their spirit. Attempts to parse and define the doctrines merely intellectualize what is, ultimately, an equitable exercise. Those who favor transparency might prefer a strictly circumscribed taxonomy of judicial doctrines, to include exclusive definitions of the circumstances in which they should be applied. Those who favor administrability, protection of the fisc, and respect for congressional purpose might prefer that courts exercise carte blanche in disallowing results of transactions perceived as abusive. *Gregory* and its progeny represent an ongoing effort to reconcile these opposing principles and methodologies. Litigants and courts employ specialized terminology to make this effort appear more rigorous, but candidly, underneath, we are simply engaged in the difficult, commonsense task of judging.[105]

[105]*CNT Investors*, 144 T.C. No. 11, at 58-60.

IV. Business Requirement: Further Development

A. Specific Business Purpose Requirements

Many provisions of the code and regulations explicitly require that a transaction serve a business purpose in order for a particular tax consequence to apply. One example is the regulations under section 368, which incorporate the business purpose requirement articulated in *Gregory*.[106] A more general example is the regulations under what is now section 1001(c) (requiring recognition of the entire amount of a realized gain or loss unless the code provides otherwise), which also incorporate the *Gregory* business purpose principle.[107] Other provisions include section 357(b), which treats assumptions of liabilities in connection with some incorporations and reorganizations less favorably if it appears that the taxpayer's principal purpose for the assumption is to avoid federal tax on the exchange or is not a bona fide business purpose.[108] Also, sections 706(b)(1)(C), 1378(b)(2), and 441(i)(1) permit partnerships, S corporations, and personal service corporations, respectively, to have specified tax years only if they establish a business purpose for those years to the satisfaction of the IRS.

B. Other Business Purpose Requirements

There are also instances in which the courts or the IRS have decided, in the absence of statutory or regulatory guidance, whether a business purpose is required for a particular tax benefit or result. One example is section 351. Although neither the statute nor the regulations regarding incorporations requires a taxpayer to have a business purpose in order to obtain nonrecognition treatment when assets are transferred to a controlled corporation, the IRS, citing *Gregory*, sometimes maintains that a business purpose is necessary.[109] That view has had mixed success in the courts.[110] Another instance is when a taxpayer engages in a transaction to put two controlled corporations in a position to file a consolidated return. In some of those cases, the courts suggested that although a business purpose is required for the transactions, putting the corporations in a position to file consolidated returns is a valid and sufficient business purpose.[111] By contrast, in *Dover Corp. v. Commissioner*,[112] the Tax Court held that taxpayers need not have a business purpose to make an election under the check-the-box regulations to treat a corporation as a disregarded entity, which election results in the corporation being treated as if it had been liquidated under section 332.[113]

C. Provisions Addressing Tax-Motivated Activity

In a sense, the inverse of a business purpose requirement is the array of provisions that treat

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[106]Reg. section 1.368-1(b) ("The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges . . . as are required by business exigencies."); reg. section 1.368-1(c) ("Such transactions and such acts must be an ordinary and necessary incident of the conduct of the enterprise. . . . [A] mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization."); and reg. section 1.368-2(g) ("the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization"). *See also* reg. section 1.355-2(b) (requiring that the transaction be "motivated, in whole or substantial part, by one or more . . . real and substantial non-Federal tax purpose[s] germane to the business of the distributing corporation, the controlled corporation or the affiliated group . . . to which the distributing corporation belongs").

[107]Reg. section 1.1002-1(b) ("Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand.").

[108]Section 357(b)(1); *see* reg. section 1.357-1(c) (taxpayer must prove by a clear preponderance of the evidence the unmistakable absence of a purpose to avoid tax or presence of a bona fide business purpose); and *Drybrough v. Commissioner*, 376 F.2d 350 (6th Cir. 1967) (rejecting the application of section 357(b) to an incorporation of a proprietorship that served a bona fide corporate purpose, regardless of the taxpayer's motive of minimizing future taxes consistent with existing provisions of law).

[109]*See, e.g.*, Rev. Rul. 55-36, 1955-1 C.B. 340; and Notice 2001-17, 2001-1 C.B. 730.

[110]*Compare Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1987) (business purpose required), *aff'd on other grounds*, 865 F.2d 644 (5th Cir. 1989), *with Flextronics America LLC v. Commissioner*, T.C. Memo. 2010-245, *aff'd mem.* No. 11-70949 (9th Cir. 2012) (suggesting that a business purpose is not required). *See generally* Benjamin M. Willis, "The Phantom Business Purpose Requirement," *Tax Notes*, Apr. 29, 2013, p. 523.

[111]*Kerr v. Commissioner*, 38 T.C. 723 (1962), *aff'd*, 326 F.2d 225 (9th Cir. 1964) (tax savings from consolidation was held to be a bona fide business purpose but insufficient to prevent the deemed distribution from being treated as essentially equivalent to a dividend); and *Fox v. Commissioner*, T.C. Memo. 1958-205 (respecting the taxpayer's contribution of stock in one corporation to another corporation because the transferor's primary purpose to reduce taxes by consolidating is a legitimate business purpose).

[112]122 T.C. 324 (2004).

[113]*Id.* at 351 n.19; *see* reg. section 301.7701-3(a) and (g)(1)(iii). In an actual liquidation, transactions in which a parent corporation sold or made gifts of some of the stock of its subsidiary before liquidating the subsidiary — transfers that were made for the sole purpose of avoiding the application of section 332 — have been held to be effective in avoiding section 332 despite the lack of a nontax business purpose for the transfers. *See Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956); and *Commissioner v. Day & Zimmerman Inc.*, 151 F.2d 517 (3d Cir. 1945). *See also H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

some tax-motivated transactions less favorably than other transactions. The classic example is section 269(a). The provision authorizes the IRS to disallow tax benefits when the principal purpose for acquiring control of a corporation or for one corporation acquiring property of a noncontrolled corporation in a carryover basis transaction ''is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy.''[114] The regulations under section 269 describe the situations in which section 269 operates:

> Characteristic of [the] circumstances [in which tax benefits become unavailable] are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases.[115]

Applying these principles, the courts have determined that section 269 cannot be applied to deny taxpayers benefits bestowed by Congress such as those of S corporation status[116] and Western Hemisphere trade corporation status,[117] even if the taxpayer's primary purpose in creating the corporation or making the election was to enjoy those benefits. Their reasoning is that applying section 269 in a way that treats availing oneself of those types of tax benefits as tax evasion or avoidance would thwart Congress's intent in allowing those tax benefits.

More recently, the Tax Court rejected an attempt by the IRS to apply section 269 in another setting involving what the court characterized as ''aggressive tax planning'' involving an S corporation. In *Love v. Commissioner*,[118] the taxpayers owned several McDonald's restaurants and formed a management company to employ all the employees working in those restaurants. The management company — an S corporation that in 2002 became wholly owned by an employee stock ownership plan in which the taxpayers and the other employees were participants and beneficiaries — also established a nonqualified deferred compensation plan for its senior employees. Congress made that structure possible and attractive by permitting S corporations to be owned by ESOPs in 1996 (in section 1361(c)(6)) and exempting ESOPs from unrelated business income tax in 1997 (in section 512(e)(3)).

In July 2003 Treasury issued temporary regulations with a July 21, 2004, effective date that would have had significantly adverse tax consequences for the taxpayers, the S corporation, and the ESOP. The regulations define a term that had been added to section 409 in 2001 in a manner that would have caused the taxpayers to be considered disqualified persons regarding the ESOP by virtue of their deferred compensation.[119] After consulting with

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[114]Section 269(a); *see also* section 269A(a) (authorizing the IRS to allocate income, deductions, etc., between a personal service corporation and its employee-owners if substantially all the services of the corporation are performed for or on behalf of one other person and ''the principal purpose for forming, or availing of, such personal service corporation is the avoidance or evasion of Federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would not otherwise be available'').

[115]Reg. section 1.269-2(b) (citing *Gregory*, *Griffiths*, 308 U.S. 355; *Higgins v. Smith*, 308 U.S. 473; and *J.D. & A.B. Spreckles Co. v. Commissioner*, 41 B.T.A. 370 (1940)). For this purpose, an allowance is defined as any item that has the effect of diminishing tax liability. Reg. section 1.269-1(a). *See also* Jasper L. Cummings, Jr., ''The Sham Transaction Doctrine,'' *Tax Notes*, Dec. 15, 2014, p. 1239, at p. 1246 (arguing that this regulation ''essentially states a good approximation of a real statute-based economic substance doctrine in nonrecognition transfers to and by corporations,'' and that Treasury's codification of *Gregory* in this regulation ''alone should be sufficient to disprove the propriety of some lower federal courts making up another such rule without the benefit of a statute''); *but see Wells Fargo & Co. v. United States*, 2014-2 U.S.T.C. para. 50,372 (D. Minn. 2014) (report of special master granting partial summary judgment that section 269 is inapplicable to the structured trust advantaged repackaged securities FTC transaction at issue but reading *Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411 (1948), to suggest that this does not necessarily preclude a later determination disallowing the FTCs by reason of the economic substance doctrine).

(Footnote continued in next column.)

[116]*See Modern Home Fire and Casualty Insurance Co. v. Commissioner*, 54 T.C. 839 (1970); and Rev. Rul. 76-363, 1976-2 C.B. 90.

[117]*See Barber-Greene Americas Inc. v. Commissioner*, 35 T.C. 365 (1960) (''there seems to be no good reason why the deliberate organizing of [a Western Hemisphere subsidiary's] business and sales procedures to meet the other conditions specified by the legislation and thereby to qualify for the tax benefits offered should be regarded as tax avoidance''); and Rev. Rul. 70-238, 1970-1 C.B. 61.

[118]T.C. Memo. 2012-166.

[119]Reg. section 1.409(p)-1T(f)(2)(iv).

their tax advisers, the taxpayers solved the problem by purchasing the shares of the S corporation from the ESOP, making a capital contribution to the S corporation, having the S corporation pay some deferred compensation to them, and terminating the ESOP. They did so in such a manner that the deduction for the deferred compensation fell into a short year of the S corporation in which the taxpayers were its sole shareholders. The IRS determined that the taxpayers' purchase of the shares in the S corporation occurred for the principal purpose of avoiding or evading taxes by obtaining the deduction for the deferred compensation.

The Tax Court rejected the IRS's contention that section 269 applied to the transactions. Citing *Gregory*, the court noted that the taxpayers ''were entitled to arrange their affairs so as to minimize their tax liability by means which the law permits.'' The court went on to find that because the elimination of the S corporation's ownership of the ESOP ownership and the payout of the deferred compensation were actions taken in response to the temporary regulations, those transactions ''did not occur principally for tax avoidance purposes.''[120] And even though the capital contribution ''was made with the purpose and objective in mind of increasing petitioners' stock bases in the management company (in anticipation of the flow through of the . . . loss deduction from the management company),'' the contribution was found to be real, not a sham, and to have economic substance. The court concluded:

> The above transactions and steps clearly were related and planned as part of an effort to avoid problems created for petitioners by the Commissioner's temporary regulations, . . . but they represent valid and real transactions with economic effect that require our recognition as legitimate business transactions. . . . We fail to see how petitioners' aggressive tax planning in establishing the structure for their McDonald's restaurant business and in responding to respondent's temporary regulations under section 409(p) taints under section 269 the July 12, 2004, acquisition by petitioners of the management company stock.[121]

Thus, the court found that transactions whose sole motive was to avoid the tax catastrophe that would have resulted had there been no restructuring in response to the temporary regulations did not have tax avoidance as their principal purpose.

Another example of this type of provision is section 6662(d)(2)(C), which limits some defenses to the imposition of the various accuracy-related penalties for a tax shelter.[122] For a substantial understatement of income tax, the penalty under section 6662(a) generally does not apply to any portion of the understatement attributable to either (1) the tax treatment of an item for which there is or was substantial authority, or (2) an item adequately disclosed in or with the tax return with a reasonable basis for the tax treatment thereof.[123] However, neither of those exceptions applies for an item attributable to a tax shelter.[124] For this purpose, a tax shelter is defined as a partnership, other entity, plan, or arrangement ''if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.''[125] (Before 1997, for an entity, plan, or arrangement to be a tax shelter, its principal purpose had to be the avoidance or evasion of federal income tax.[126])

Treasury has yet to promulgate regulations that incorporate the 1997 change in the tax shelter standard from ''principal purpose'' to ''significant purpose.'' Nonetheless, the regulations issued under the prior standard are instructive:

> The principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions

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[120]*See Kraft Foods*, 232 F.2d at 128, discussed *supra* notes 49-54 and accompanying text.

[121]T.C. Memo. 2012-166 (citing *Arwood Corp. v. Commissioner*, T.C. Memo. 1971-2 (section 269 is not implicated merely because the method selected for carrying out an acquisition was tax motivated (*i.e.*, the taxpayer ''sought and followed competent legal advice'' regarding the tax-efficient means to effect the

(Footnote continued in next column.)

acquisition) when ''the principal motivation or primary purpose of the whole arrangement was not the evasion or avoidance of income tax'')).

[122]Section 6662(a) imposes a 20 percent (and in some cases, 40 percent) penalty on the portion of any tax underpayment attributable to negligence; a substantial understatement of income tax; a substantial valuation misstatement; a substantial estate or gift tax valuation understatement; or an undisclosed foreign financial asset understatement. And, effective in 2010, the penalty applies to a disallowance of tax benefits because of the economic substance doctrine or failure to meet the requirements of any similar rule of law. Section 6662(a) and (b); *see* section 7701(o).

[123]Section 6662(d)(2)(B).

[124]Section 6662(d)(2)(C)(i).

[125]Section 6662(d)(2)(C)(ii). Before 2004 the substantial authority exception to the penalty applied to noncorporate taxpayers even in the case of a tax shelter, but only if the taxpayer reasonably believed that the taxpayer's tax treatment of the item was more likely than not the proper treatment. This defense was eliminated by the American Jobs Creation Act of 2004, P.L. 108-357, section 812(d).

[126]The standard was changed to the current ''significant purpose'' standard by the Taxpayer Relief Act of 1997, P.L. 105-34, section 1028(c)(1).

from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement does not have as its principal purpose the avoidance or evasion of Federal income tax solely as a result of the following uses of tax benefits provided by the Internal Revenue Code: the purchasing or holding of an obligation bearing interest that is excluded from gross income under section 103; taking an accelerated depreciation allowance under section 168; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing a qualified retirement plan under sections 401-409; claiming the possession tax credit under section 936; or claiming tax benefits available by reason of an election under 992 to be taxed as a domestic international sales corporation ("DISC"), under section 927(f)(1) to be taxed as a foreign sales corporation ("FSC"), or under section 1362 to be taxed as an S corporation.[127]

It remains to be seen whether regulations implementing the 1997 legislative change from "the principal purpose" to "a significant purpose" will be materially different from the current regulations. Arguably, whatever level of purpose is required, claiming tax benefits in a manner consistent with the congressional purpose behind the legislative grant of the tax benefit should not be viewed as tax avoidance or evasion, so that even if one's *sole* motive in availing oneself of that benefit is reducing tax, the arrangement should not be viewed as a tax shelter.[128]

A somewhat more specific example of a provision addressing tax-motivated activity appears in section 1031(f)(4). Section 1031(a) provides for nonrecognition of gain or loss in some like-kind exchanges. Added to the code in 1989, section 1031(f)(1) is an antiabuse rule that denies the benefits of section 1031(a) to some exchanges between related persons followed within two years by the related person's disposition of the like-kind property received in the exchange.[129] To protect against avoidance of the antiabuse rule, section 1031(f)(4) provides that section 1031 "shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of" section 1031(f).[130] This provision represents a direct response by Congress to tax planning — that is, tax-motivated structuring in a particular manner with the intention of avoiding the limitations of section 1031(f)(1) and thereby avoiding tax.[131] There are apparently no code provisions other than section 1031(f)(4) and (h)(2)(C) in which Congress has prescribed an adverse substantive result because the taxpayer chose one way of structuring a transaction rather than another and did so motivated by the tax consequences.[132] The existence of antiabuse statutes, and particularly provisions as specific as section 1031(f)(4), arguably should give courts interpreting code sections that do not contain such a provision pause before disallowing tax benefits bestowed by Congress on the basis that the transaction was structured to take advantage of those benefits.

D. Claiming Tax Benefits Intended by Congress

In other situations outside the operation of these specific provisions, courts have permitted tax benefits to flow from tax-motivated transactions when the benefits were clearly contemplated by Congress. For example, in *Snow v. Commissioner*,[133] the taxpayer, a partner in a partnership formed to develop an incinerator, claimed a research expenditure deduction under section 174(a). The IRS denied the deduction on the ground that the partnership had not yet engaged in a trade or business by the year for which the deduction was claimed. Thus, the expenditure was not made "in connection with [its] trade or business" as required under section 174(a) but rather was in preparation for going into business. The Tax Court and the Sixth Circuit agreed, but the Supreme Court reversed, stating that the

[127]Reg. section 1.6662-4(g)(2)(ii); *see also* former Circular 230, 31 C.F.R. section 10.35(b)(2)(C) and (b)(10) (including in the definition of covered opinions specified types of written advice concerning arrangements "a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code" and providing that an arrangement that "has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose" will not be considered to have as its principal purpose the avoidance or evasion of tax), *withdrawn*, T.D. 9668.

[128]*Cf.* Berg, *supra* note 13.

[129]Section 1031(f)(1).

[130]Section 1031(f)(4); *see also* section 1031(h)(2)(C), added to the code in 1997.

[131]*See, e.g.*, *North Central Rental & Leasing LLC v. United States*, 779 F.3d 738, 741, 743 (8th Cir. 2015) (section 1031(f)(4) is "an attempt to thwart the future use of more complex transactions that technically avoid the provisions of section 1031(f) but nevertheless run afoul of the purposes of the law"; unnecessary complexity of and unnecessary parties to the transaction are indicative of the proscribed purpose); *Ocmulgee Fields Inc. v. Commissioner*, 613 F.3d 1360, 1369 (11th Cir. 2010); and *Teruya Brothers Ltd. v. Commissioner*, 580 F.3d 1038, 1046 (9th Cir. 2009).

[132]*Cf.* sections 1059(g)(2) and 1503(f)(4)(C), in which Congress directed Treasury to prescribe regulations to address cases in which stock is "structured to avoid the purposes" of a particular code provision.

[133]416 U.S. 500 (1974).

congressional purpose behind section 174(a) was to stimulate the search for new products and inventions, particularly by small and growing businesses: "We would defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market by perpetuating the discrimination created below and urged upon us here."[134]

In *Fox v. Commissioner*,[135] a tax straddle case, losses were claimed under section 165(c)(2), which allows a deduction for "losses incurred in any transaction entered into for profit." The parties disagreed regarding the degree to which a transaction must be tax motivated in order for a loss to be disallowed due to the transaction not being "entered into for profit." The taxpayer argued that a loss should be disallowed only if the taxpayer's sole motive concerned tax, and the IRS argued that it is sufficient if the taxpayer's primary motive concerned tax. The Tax Court held for the IRS on the ground that the taxpayer did not enter into the transactions primarily for profit, adding, "nor were the transactions a type of tax-motivated transaction which Congress intended to encourage."[136] Analyzing the cases decided under section 165(c)(2), the court held that the provision requires a "primary profit motive,"[137] but it "relaxed" its holding with the following comments:

> A multitude of transactions which are likely to be motivated primarily by tax reasons is nonetheless sanctioned under the tax laws. Examples of such transactions are the purchase of tax-exempt securities; purchases of property motivated by the availability of accelerated depreciation, the investment credit, and the deductibility of interest; safe-harbor leasing; renovation of historic structures; location of subsidiaries in Puerto Rico because of tax credits; acquiring interests in low income housing partnerships; and many others. Indeed, some of these transactions are arguably *solely* tax motivated.
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> We acknowledge that many such tax-motivated transactions are congressionally approved and encouraged. We therefore relax our holding that section 165(c)(2) permits loss deductions only from transactions entered into primarily for profit to allow for those essentially tax-motivated transactions which are unmistakably within the contemplation of congressional intent. The determination whether a transaction is one Congress intended to encourage will require a broad view of the relevant statutory framework and some investigation into legislative history. The issue of congressional intent is raised only upon a threshold determination that a particular transaction was entered into primarily for tax reasons.[138] [Emphasis in original.]

Finding that the taxpayer's "motive in entering into these transactions was primarily to obtain tax advantages"[139] was therefore not the end of the inquiry. The court noted that "tax planning is an economic reality in the business world and the effect of tax laws on transactions is routinely considered along with other economic factors"[140] and that "Congress has often turned this fact into a tool by which to encourage particular conduct and achieve certain policy goals."[141] It concluded that the taxpayer's transactions, "in which paper losses enormously exceeded the amounts actually at risk, were utterly outside the contemplation of Congress."[142]

The Tax Court distinguished *Fox* in *Friendship Dairies Inc. v. Commissioner*,[143] a sale-leaseback case involving an investment tax credit. The court noted that although Congress intended to encourage capital investment by enacting the ITC, the legislative history nowhere indicates "that the credit was intended to transform unprofitable transactions into profitable ones," but rather that "funds freed by the credit were expected to be used for new investment."[144] According to the court, "where the credit represents the difference between a profit and a loss, the amount of the credit necessary to recover the loss is not reinvested in the economy, as Congress contemplated."[145] The court concluded that the transaction should not be recognized because it was "a paper transaction that did not in any way affect the demand for computer equipment" and

[134]*Id.* at 504.
[135]82 T.C. 1001 (1984).
[136]*Id.* at 1019.
[137]*Id.* at 1021.

[138]*Id.*
[139]*Id.* at 1025.
[140]*Id.* (citing *Brown*, 380 U.S. at 579-580 (Harlan, J., concurring)).
[141]*Id.* (citing sections 168(f)(8), 1039(b)(1), and 103(b)).
[142]*Id.* (citing section 465); *see also Leahy v. Commissioner*, 87 T.C. 56, 72 (1986) (allowing depreciation and an investment credit for a film; and noting that the court "should not disregard the existence of an asset for which Congress intended tax advantages merely because the parties attempted to maximize the advantage of those benefits," and that the IRS "should recognize that in instances where there are no shams and depreciable assets exist, some person or entity is entitled to the intended tax advantages").
[143]90 T.C. 1054 (1988).
[144]*Id.* at 1065-1066.
[145]*Id.* at 1066.

that it "had no other purpose and could not have resulted in economic profit."[146]

By contrast, in *Sacks v. Commissioner*,[147] the Ninth Circuit allowed depreciation deductions, ITCs, and business energy investment credits for a sale-leaseback transaction involving solar energy equipment. The Tax Court had denied the deductions and credits on economic substance and sham transaction grounds.[148] The Ninth Circuit reversed, finding that the transaction had economic substance, and it criticized the Tax Court's conclusion that the transaction was a sham because it was projected to be profitable only on an after-tax basis:

> Mr. Sacks' investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections. . . .
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> . . . Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis. . . . Absence of pre-tax profitability does not show whether the transaction had economic substance beyond the creation of tax benefits where Congress has purposely used tax incentives to change investors' conduct. Congress . . . purposely skewed the neutrality of the tax system, even more than the usual tax credits and accelerated depreciation designed to encourage more investment in capital goods than would otherwise be made, because they sought to induce people to invest in solar energy. . . . *If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative.* A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. . . . If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. *Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose.*[149] [Emphasis added; citations and internal quotation marks omitted.]

E. The Role of Tax Motivation

It is by now well known that before the enactment of section 7701(o), various courts adopted diverse methods to enunciate and apply the economic substance doctrine.[150] Although it has generally been acknowledged that whether there was a nontax business purpose for the transaction is relevant to the analysis, there has been much difference of opinion on whether that business purpose is required in all cases, and even on what is meant by a business purpose. Several courts have adopted what became known as a disjunctive test, under which a taxpayer could fend off a challenge under the economic substance doctrine by showing *either* that the transaction had economic substance apart from tax benefits (that is, that the transaction appreciably affected the taxpayer's pretax economic or legal position) *or* that the transaction had a nontax business purpose.[151] Other courts have adopted a so-called conjunctive test, under which a taxpayer must show both economic substance and a business

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[146] *Id.* at 1067.

[147] 69 F.3d 982 (9th Cir. 1995) (cited with approval in, *e.g., Salem Financial*, 786 F.3d at 950), *rev'g and remanding* T.C. Memo. 1992-596.

[148] T.C. Memo. 1992-596.

[149] *Sacks*, 69 F.3d at 991-992; *see also Salem Financial*, 786 F.3d 932 ("To brand . . . transactions [involving 'nascent technologies'] as a sham simply because they are unprofitable before tax benefits are taken into account would be contrary to the clear intent of Congress. *See Sacks*. . . . Indeed, Congress often provides tax benefits to encourage socially beneficial activity that would not be pursued absent tax advantages."), *cited with approval in BNY*; and *Historic Boardwalk*, 694 F.3d at 448 n.50 (assuming without deciding that the historic rehabilitation tax credit transaction had economic substance, thus obviating the need to decide whether, under *Sacks*, the credits can be considered in evaluating whether the transaction has economic substance).

[150] *See, e.g., Gerdau Macsteel*, 139 T.C. at 169-170 ("The Courts of Appeals are split on the proper weight to be given to [the economic substance and business purpose] prongs in deciding whether to respect a transaction under the economic substance doctrine, and alternative approaches have emerged."); and House report, *supra* note 8, at 293 ("There is a lack of uniformity regarding the proper application of the economic substance doctrine.").

[151] This test was apparently first adopted by a court of appeals (the Fourth Circuit) in *Rice's Toyota World*, 752 F.2d at 91-92. The District of Columbia Circuit adopted the Fourth Circuit's test in *Horn v. Commissioner*, 968 F.2d 1229, 1236-1238 (D.C. Cir. 1992), and it is somewhat unclear whether the Eighth Circuit has also done so. *Compare WFC Holdings Corp. v. United States*, 728 F.3d 736, 743-744 (8th Cir. 2013) (neither this case nor *IES Industries Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), required the court to decide whether the test is disjunctive), *with* House report, *supra* note 8, at 293 and n.111 (the Eighth Circuit adopted the disjunctive test in *IES Industries*). For a compelling argument that the disjunctive test is more consistent with the doctrine's origins in *Gregory* than is the conjunctive test, see Cummings, *supra* note 115.

purpose in order for the claimed tax benefits to be allowed.[152] Still other courts have declined to adopt either test and instead consider the two components as part of a multifactor economic substance analysis.[153]

Whichever economic substance test a court uses, it must grapple with the question of the extent to which the taxpayer's motive is relevant. Some of the courts of appeals that do not articulate a disjunctive test (citing either the Supreme Court or Second Circuit opinion in *Gregory*) have held that as long as the transaction has changed the taxpayer's pretax economic position or legal position and thus has economic substance, a tax-avoidance motive on the part of the taxpayer is irrelevant. In those courts, the test is effectively disjunctive but only in one direction.

For example, the Third Circuit in *ACM Partnership* noted that while it is clear that a transaction having ''neither objective non-tax economic effects nor subjective non-tax purposes'' is to be disregarded for tax purposes and ''equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes'' is to be respected for tax purposes:

> it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, *it will not be disregarded merely because it was motivated by tax considerations*. In analyzing both the objective and subjective aspects of ACM's transaction in this case . . . *we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations*.[154] [Emphasis added; citations omitted.]

The Seventh Circuit has made a similar point and extended it to situations in which the taxpayer's *sole* motive is minimizing taxes:

> There is no rule against taking advantage of opportunities created by Congress or the Treasury Department for beating taxes. . . . Many transactions are largely or even entirely motivated by the desire to obtain a tax advantage. But there is a doctrine that a transaction utterly devoid of economic substance will not be allowed to confer such an advantage. . . . A transaction has economic substance when it is the kind of transaction that some people enter into without a tax motive, *even though the people fighting to defend the tax advantages of the transaction might not or would not have undertaken it but for the prospect of such advantages — may indeed have had no other interest in the transaction*.[155] [Emphasis added; citations omitted.]

Conversely, for a court applying a conjunctive test, business purpose becomes irrelevant if the transaction is found to be devoid of economic substance — that is, even if the taxpayer had a pristine, nontax business purpose, the tax benefit would be denied for want of economic substance, thus rendering the taxpayer's motives irrelevant in this circumstance as well, albeit for the opposite reason.[156]

Some of these courts have also discussed the relationship between the business purpose prong of the test and tax-motivated transactions, with some

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[152]*See, e.g.*, *Coltec Industries Inc. v. United States*, 454 F.3d 1340, 1355 n.14 (Fed. Cir. 2006) (''We think that the rule adopted by the Fourth Circuit and reiterated in *Black & Decker* — that a transaction will be disregarded only if it both lacks economic substance and is motivated solely by tax avoidance — is not consistent with the Supreme Court's pronouncements in cases such as *Frank Lyon*.''); *Dow Chemical Co. v. United States*, 435 F.3d 594, 599 (6th Cir. 2006); and *UPS*, 254 F.3d at 1018 (''Even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance.'').

[153]*See, e.g.*, *BNY* (Second Circuit employs a '''flexible' analysis where both prongs are factors to consider in the overall inquiry into a transaction's practical economic effects''); *Blum v. Commissioner*, 737 F.3d 1303, 1309-1310 (10th Cir. 2013); *Reddam v. Commissioner*, 755 F.3d 1051, 1059-1060 (9th Cir. 2014); and *Commissioner v. CM Holdings*, 301 F.3d 96, 102 (3d Cir. 2002).

[154]*ACM Partnership*, 157 F.3d at 248 n.31 (citing *Gregory*, *Northern Indiana*, and *Kraft Foods*).

[155]*Yosha v. Commissioner*, 861 F.2d 494, 497-499 (7th Cir. 1988) (citing *Gregory*); *see also Northern Indiana Public Service Company v. Commissioner*, 115 F.3d 506, 511 (7th Cir. 1997) (''A tax-avoidance motive is not inherently fatal to a transaction. A taxpayer has a legal right to conduct his business so as to decrease (or altogether avoid) the amount of what would otherwise be his taxes.'') (citing *Gregory*); *cf. Southgate Master Fund LLC v. United States*, 659 F.3d 466, 481-482 (5th Cir. 2011) (''Tax-avoidance considerations are not wholly prohibited; taxpayers who act with mixed motives, seeking both tax benefits and profits for their businesses, can satisfy the business-purpose test.''); *Stobie Creek Investments LLC v. United States*, 608 F.3d 1366, 1375 (Fed. Cir. 2010) (''structuring a real transaction in a particular way to obtain a tax benefit . . . is legitimate'').

[156]*See, e.g.*, *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537, 544 (5th Cir. 2009), *aff'g in part, rev'g in part, and remanding* 472 F. Supp.2d 885 (E.D. Tex. 2007) (adopting the ''majority view'' that ''if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations''); *Dow*, 435 F.3d at 599; *Coltec*, 454 F.3d at 1355. *But see Salem Financial*, 786 F.3d at 943 n.4, 949-950, and 951-952 (suggesting that the conjunctive test is applicable in the Federal Circuit pre-section 7701(o) but nonetheless considering the business purpose test even after holding that the transaction lacked economic substance).

taking a nuanced view. For example, the Eleventh Circuit has broadly articulated the conjunctive test as providing that "even if the transaction has economic effects, it must be disregarded if it has no business purpose and its motive is tax avoidance."[157] Citing *Gregory*, however, the court went on to explain what it meant by "business purpose":

> A "business purpose" does not mean a reason for a transaction that is free of tax considerations. *Rather, a transaction has a "business purpose," when we are talking about a going concern like UPS, as long as it figures in a bona fide, profit-seeking business. This concept of "business purpose" is a necessary corollary to the venerable axiom that tax-planning is permissible*. The Code treats lots of categories of economically similar behavior differently. For instance, two ways to infuse capital into a corporation, borrowing and sale of equity, have different tax consequences; interest is usually deductible and distributions to equityholders are not. *There may be no tax-independent reason for a taxpayer to choose between these different ways of financing the business, but it does not mean that the taxpayer lacks a "business purpose." To conclude otherwise would prohibit tax-planning*.[158] [Emphasis added; citations omitted.]

Similarly, the Federal Circuit has described the economic substance doctrine and its relationship to tax planning as follows:

> The economic substance doctrine seeks to distinguish between structuring a real transaction in a particular way to obtain a tax benefit, which is legitimate, and *creating* a transaction to generate a tax benefit, which is illegitimate. Under this doctrine, we disregard the tax consequences of transactions that comply with the literal terms of the tax code, but nonetheless lack "economic reality." Such transactions include those that have no business purpose beyond reducing or avoiding taxes, regardless of whether the taxpayer's subjective motivation was tax avoidance. We also disregard transactions shaped solely by tax-avoidance features. Whether a transaction lacks "economic reality," has no bona fide "business purpose" or was shaped solely by tax-avoidance features is an objective inquiry, evaluated prospectively. In other words, the transaction is evaluated based on the information available to a prudent investor at the time the taxpayer entered into the transaction, not what may (or may not) have happened later. . . . Asking whether a transaction has a bona fide business purpose is another way to differentiate between real transactions, structured in a particular way to obtain a tax benefit (legitimate), and transactions *created* to generate a tax benefit (illegitimate).[159] [Emphasis in original; citations omitted.]

The Tax Court used a similar analysis in *Countryside Limited Partnership v. Commissioner*.[160] In that case a partnership redeemed some of its limited partners (Messrs. Winn and Curtis) by distributing to them a third party's nonmarketable, interest-bearing promissory notes whose distribution the partners reported as nontaxable under section 731(a)(1). The taxpayers acknowledged that the liquidating distribution was structured to defer tax. The IRS argued that the partnership's acquisition and distribution of the notes should be disregarded for lack of economic substance and treated as a taxable cash distribution. The court, in an opinion by Judge James S. Halpern, granted partial summary judgment for the taxpayers on the following grounds, citing *Gregory* and *Chisholm*, as well as other cases:

> In this case, what "occurred" was a distribution of nonmarketable notes in redemption of limited partnership interests. Countryside undertook the distribution in order to eliminate Mr. Winn and Mr. Curtis as limited partners. Mr. Winn and Mr. Curtis agreed to the redemption in order to convert their interests in Countryside into interest-bearing promissory notes. All of the parties to the transaction had legitimate business purposes, and the manner in which those parties accomplished those purposes cannot be disregarded and converted by respondent into a transaction (an

[157] *UPS*, 254 F.3d at 1018.

[158] *Id.* at 1019; *see also Nassau Lens*, 308 F.2d at 44-45 ("the courts have not attributed to Congress a general purpose underlying the entire Code to deprive the taxpayer in each case of freedom to choose between legal forms similar in a broad economic sense but having disparate tax consequences").

[159] *Stobie Creek*, 608 F.3d at 1375, 1379; *see also Coltec*, 454 F.3d at 1357 ("there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate)"); *Southgate Master Fund*, 659 F.3d at 481-482 ("Tax-avoidance considerations are not wholly prohibited; taxpayers who act with mixed motives, seeking both tax benefits and profits for their business, can satisfy the business-purpose test."); and *Bass v. Commissioner*, 50 T.C. 595, 600 (1968) ("a taxpayer may adopt any form he desires for the conduct of his business and . . . the chosen form cannot be ignored merely because it results in a tax saving"), *cited with approval in Northern Indiana Public Service*, 115 F.3d at 511.

[160] T.C. Memo. 2008-3.

exchange of Mr. Winn's and Mr. Curtis's interests in Countryside for cash) that never occurred simply because the transaction that did occur was tax motivated. . . . *[The IRS], in finding a lack of economic substance, has erroneously focused on the tax-motivated means instead of the business-oriented end.* The transaction requiring economic substance is Countryside's redemption of Mr. Winn's and Mr. Curtis's partnership interests therein. *That the redemption of a partnership interest in exchange for bona fide promissory notes issued by an independent third party can serve a legitimate business purpose is beyond cavil. The question is whether such a redemption may be respected for tax purposes if the means undertaken to accomplish it are chosen for their tax advantage.* On the facts before us, we conclude that the answer is yes.[161] [Emphasis added.]

Significantly, these cases confirm the *Gregory* principle that a transaction can have a business purpose even if the taxpayer's subjective motivation is tax reduction or avoidance, and they add that whether a transaction has a business purpose is an objective inquiry based not on the particular taxpayer's motive but on what a reasonably prudent investor would have done based on the information available when the transaction was entered into.

However, in a very recent case, the Second Circuit appears to have diverged from those principles, and perhaps from the *Gregory* principles that were developed largely in that circuit. In *Bank of New York Mellon Corp. v. Commissioner*,[162] the court first clarified that the Second Circuit applies the economic substance doctrine such that a '''finding of either a lack of a business purpose other than tax avoidance or an absence of economic substance beyond the creation of tax benefits can be but is not necessarily sufficient to conclude the transaction a sham.'''[163] In discussing the nature of the business purpose portion of the doctrine, the court stated the following:

Apart from the objective [economic substance] inquiry, a court must also look to the subjective business purpose of a transaction to determine whether it has economic substance. Under the subjective inquiry, a court asks whether the taxpayer has a legitimate, non-tax business purpose for the entering into the transaction. The business purpose inquiry concerns the motives of the taxpayer in entering the transaction; it asks whether the taxpayer's sole motivation for entering a transaction was to realize tax benefits. The focus is the reasonableness of the transaction and can be articulated as: would a prudent investor, absent tax benefits, have made the deal?[164] [Citations and internal quotemarks omitted.]

It is not clear from this recent case where the Second Circuit now stands on these issues. Contrary to the cases cited above and the *Gregory* principles, the Second Circuit in *BNY* explicitly tied the business purpose inquiry to the taxpayer's motives rather than to the purpose of the tax benefit in question, and did not emphasize (or even mention) a taxpayer's right to engage in tax planning. The court also, however, adopted the objective ''prudent investor'' standard rather than seeking to determine the taxpayer's subjective motives for entering into the transaction. Time will tell whether and to what extent *BNY* will be seen as a repudiation by the Second Circuit of the *Gregory* principles or rather will be limited to its somewhat unusual facts.

V. Summary: The Law Before Section 7701(o)

Although there have been some recent attempts by the IRS to apply the economic substance doctrine in a manner seemingly inconsistent with the *Gregory* principles,[165] the regulations and cases are largely (but not entirely) consistent with those principles. The section 269 regulations, for example, focus on the reality of the transaction as well as the congressional purpose in enacting the tax benefit. Courts applying section 269 have determined that making tax elections such as for S corporation status, disregarded entity status (check-the-box), and consolidated returns does not require a business purpose and does not constitute tax avoidance. Even what the Tax Court called ''aggressive tax planning'' in response to a change in the applicable tax rules is not tax avoidance.[166] Likewise, the regulations under section 6662 focus on whether the tax benefit is being claimed in a manner consistent with the statute and congressional purpose; the purpose of the arrangement is not considered tax avoidance. The regulations list several tax benefits so clearly intended by Congress that one can avail

[161] *Id.* For a criticism of *Countryside*, see Lee A. Sheppard, ''Erroneous Application of the Economic Substance Doctrine,'' *Tax Notes*, Jan. 14, 2008, p. 259 (stating that ''Judge Halpern is the wrong sort of judge before whom to make the argument that the economic substance doctrine should clean up what the statute failed to do'').

[162] *Supra* note 5.

[163] *Id.* at ___ (quoting *Long Term Capital Holdings v. United States*, 330 F. Supp.2d 122, 171 (D. Conn. 2004), *aff'd*, 150 F. App'x 40 (2d Cir. 2005).

[164] *Id.*

[165] *See supra* text accompanying note 5.

[166] *See Kraft Foods*, 232 F.2d at 128.

oneself of them without being considered to be engaging in tax avoidance.[167]

Cases such as *Snow*, *Fox*, and *Sacks* also focused on whether the tax-motivated transactions at issue were "within the contemplation of congressional intent."[168] Those courts rejected attempts by the government to "take away with the executive hand what it gives with the legislative."[169] Moreover, the courts in at least some of the more recent cases have applied the *Gregory* principles — that is, (1) that a real business transaction that has economic substance and is the kind of transaction that some would enter into without a tax motive is not to be disregarded merely because it was motivated by tax considerations,[170] and (2) that what is to be tested for substance and purpose is not the taxpayer's choice of structure to implement the transaction but rather the underlying transaction itself.[171]

Layered on top of these authorities are statutes in which Congress has effectively expressed an intention to abrogate some of the *Gregory* principles in a specific, narrow area. For example, section 1031(f)(4) abrogates the principle that the taxpayer's motive in structuring a real transaction in one manner rather than another is irrelevant to whether the tax benefits arising from the chosen structure will be disallowed. Those enactments would be superfluous if the *Gregory* principles were not a fundamental part of the law.

VI. Effect on the *Gregory* Principles

A. Section 7701(o)

To what extent (if any) did section 7701(o) change the state of the law? In answering that question, it is important to keep in mind the long-standing canon that "in order to abrogate a common-law principle, [a] statute must speak directly to the question addressed by the common law" and there must be "clear legislative intent to do so."[172] Because the *Gregory* principles unquestionably qualify as important common law tax principles, the inquiry becomes whether Congress expressed a clear legislative intent to abrogate or modify them in enacting section 7701(o).

As noted, section 7701(o), enacted as part of the Health Care and Education Reconciliation Act of 2010,[173] provides as follows:

> In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if — (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[174]

Interestingly, the IRS (and people in general) refer to section 7701(o) as the "codification" of the economic substance doctrine, which is consistent with the title of the legislative section containing the provision, as well as with the legislative history.[175] Yet, the title of section 7701(o) itself is "Clarification of Economic Substance Doctrine."

By its terms, section 7701(o) is applicable only to "any transaction to which the economic substance doctrine is relevant." For this purpose, the statute defines the economic substance doctrine as "the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance *or* lacks a business purpose."[176] And section 7701(o)(5)(C) provides that the determination of whether the doctrine is relevant to a transaction "shall be made in the same manner as if [section 7701(o)] had never been enacted."

Despite this somewhat vague description of when the economic substance doctrine is relevant and thus when section 7701(o) is applicable, Congress in 2010 also gave section 7701(o) substantial teeth by enacting significant revisions to the civil penalty provisions. It increased the accuracy-related penalties under section 6662 from 20 percent to 40 percent for any "transaction lacking economic substance (within the meaning of Section 7701(o)) or failing to meet the requirements of any similar rule of law"[177] "with respect to which the relevant facts

[167]*See id.* at n.19; *Gilbert*, 248 F.2d at 411-412 (Hand, J., dissenting).

[168]*Fox*, 82 T.C. at 1021.

[169]*Sacks*, 69 F.3d at 992.

[170]*ACM Partnership*, 157 F.3d at 248 n.31; *Yosha*, 861 F.2d at 497-499; *see also Diggs*, 281 F.2d at 329-330.

[171]*UPS*, 254 F.3d at 1019; *Stobie Creek*, 608 F.3d at 1375, 1379; *see also Nassau Lens*, 308 F.2d at 44-45.

[172]*See, e.g.*, *Filarsky v. Delia*, 132 S. Ct. 1657, 1665 (2012) ("common-law principles . . . should not be abrogated absent clear legislative intent to do so" (internal quotation marks omitted)); and *Exxon Shipping Co. v. Baker*, 554 U.S. 471, 489 (2008) ("in order to abrogate a common-law principle, the statute must speak directly to the question addressed by the common law" (internal quotation marks omitted)).

[173]P.L. 111-152, section 1409(a).

[174]Section 7701(o)(1).

[175]*See* P.L. 111-152, section 1409; House report, *supra* note 8, at 291; and Notice 2014-58.

[176]Section 7701(o)(5)(A) (emphasis in original). Subtitle A of the code consists of the income tax provisions (section 1 through section 1563).

[177]Section 6662(b)(6). The "within the meaning" language adds yet more confusion since the term "economic substance" is not defined in section 7701(o).

affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.''[178] Congress also provided for strict liability (that is, no exception for reasonable cause, including reliance on advice of counsel) for the accuracy-related penalties under section 6662 and the civil fraud penalty under section 6663 — regardless of whether there has been a disclosure — for any portion of an underpayment attributable to one or more transactions ''lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.''[179] These higher, strict liability penalties make it all the more important to know with some certainty when the economic substance doctrine is relevant and thus when a transaction will be denied tax benefits under section 7701(o).

B. Was the Disjunctive Test Really Eliminated?

As a preliminary matter, a close reading of the language of section 7701(o) suggests that Congress may not have accomplished what it apparently set out to do in the provision — that is, to obligate courts in all cases to which the economic substance doctrine is relevant to apply the conjunctive test and thus require that taxpayers demonstrate both economic substance and a nontax business purpose to pass muster under the doctrine.[180] As noted, section 7701(o) by its terms:

1. applies only to transactions to which the economic substance doctrine is relevant;[181]

2. provides that the relevance of the economic substance doctrine is to be determined in the same manner as if section 7701(o) had not been enacted — that is, under the standards used by the courts before the enactment of section 7701(o);[182] and

3. defines the economic substance doctrine as the common law doctrine whereby tax benefits are denied if the transaction ''does not have economic substance *or* lacks a business purpose.''[183]

As we have seen, before the enactment of section 7701(o), some courts of appeals applied a disjunctive test, which denies tax benefits only if the transaction lacks *both* economic substance *and* a business purpose. Under this test, tax benefits would not be denied when only economic substance or a business purpose (but not both) is lacking. Other courts applied a multifactor analysis that does not necessarily deny tax benefits if the transaction lacks either economic substance or a business purpose but not both, for example allowing tax benefits when a transaction has economic substance but no business purpose.[184] Given how Congress chose to define the economic substance doctrine for this purpose, section 7701(o) literally provides that in cases arising in these courts, in which demonstrating that *either* a business purpose *or* economic substance is or may be sufficient to avoid disallowance of the claimed tax benefits, ''the economic substance doctrine'' as defined in section 7701(o) is not ''relevant'' to *any* transactions, with the result that the conjunctive test described in section 7701(o) can have no application in those courts unless and until they change their view and adopt the conjunctive test of their own accord.

To be sure, that reading of the statute is difficult to reconcile with such legislative history of section

[178]Section 6662(i)(1) and (2). The IRS's position is that the disclosure generally is to be made on Form 8275, ''Disclosure Statement,'' or Form 8275-R, ''Regulation Disclosure Statement.'' *See* Internal Revenue Manual section 20.1.5.12.1(2).

[179]Section 6664(c)(2); *see* section 6662(b)(6). *See also* section 6676(c), which applies the 20 percent civil penalty to erroneous refund claims without regard to the reasonable basis exception in section 6676(a), for a refund claim exceeding the allowable refund to the extent attributable to any transaction lacking economic substance within the meaning of section 7701(o) or failing to meet the requirements of any similar rule of law, whether or not disclosed, and not penalized under section 6662 or 6663. Until further guidance is issued, auditors have been directed to not apply these enhanced penalties when the transaction fails to meet the requirements of a ''similar rule of law.'' IRS Large Business and International Division, ''Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties,'' LB&I-04-0711-015 (July 15, 2011). However, that further guidance authorizing application of the enhanced penalties for some other rules of law was issued in Notice 2014-58 (applicable to transactions failing under the sham transaction doctrine but not under the substance-over-form or step transaction doctrines). For a criticism of Notice 2014-58 for equating the economic substance doctrine and the sham transaction doctrine for this purpose, see Cummings, *supra* note 115, at 1240.

[180]*See* House report, *supra* note 8, at 295 (''The provision provides a uniform definition of economic substance.'') and 297 (''The provision clarifies that the economic substance doctrine involves a conjunctive analysis.'').

[181]Section 7701(o)(1).

[182]Section 7701(o)(5)(C); *see* House report, *supra* note 8, at 295-296. The IRS has given notice that it will follow the pre-section 7701(o) authorities regarding whether the economic substance doctrine is relevant to whether particular tax benefits are allowable. It said that it ''anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop'' and that the enactment of section 7701(o) ''should not affect the ongoing development of authorities on this issue.'' Notice 2010-62, 2010-40 IRB 411.

[183]Section 7701(o)(5)(A) (emphasis added).

[184]*See supra* notes 151-159 and accompanying text; House report, *supra* note 8, at 293.

7701(o) as may exist.[185] The House report indicates that section 7701(o) was intended to prescribe the conjunctive test and ''eliminates the disparity that exists among the Federal circuit courts regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.''[186] And that reading is impossible to square with the statements in the House report and the Joint Committee on Taxation explanation that the definition of the economic substance doctrine in section 7701(o)(5)(A) ''includes any doctrine that denies tax benefits for lack of economic substance, for lack of business purpose, *or for lack of both*.''[187] Indeed, it seems to be almost universally assumed (by the IRS and commentators) that by virtue of section 7701(o), the conjunctive test has become fully applicable in all courts for transactions entered into after March 30, 2010, and that the determination of whether the doctrine is relevant in a particular case is to be made on the basis of the type of activity involved rather than on the basis of which court is hearing the case.[188]

For example, the IRS in 2010 stated that it:

> will challenge taxpayers who seek to rely on prior case law under the common-law economic substance doctrine for the proposition that a transaction will be treated as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary). For all transactions subject to section 1409 of the [2010 Health Care and Education Reconciliation] Act that otherwise would have been subject to a common-law economic substance analysis that treated a transaction as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary) the IRS will apply a two-prong conjunctive test consistent with section 7701(o).[189]

Similarly, the IRS stated in 2011 that ''enactment of section 7701(o) resolved the longstanding conflict among various circuit courts of appeal [*sic*] regarding how the doctrine should be applied by codifying a two-part conjunctive test.''[190]

However, even if the materials in which those statements were made are considered part of the legislative history of section 7701(o), those statements are inconsistent with the plain meaning of the statutory language and should arguably be given little or no weight.[191] Moreover, because section 7701(o) also prescribes numerous clarifications of various specific aspects of the economic substance doctrine, an interpretation of the provision that renders it inapplicable in courts that have not adopted the conjunctive test would not render meaningless the title of the subsection, ''Clarification of Economic Substance Doctrine.''[192] As a result, it is at least possible that if faced with this argument in a case arising after the effective date of section 7701(o), a court of appeals that does not apply the economic substance doctrine as defined in section 7701(o)(5)(A) — or the Supreme Court — would disregard these statements in favor of the

[185]The New York State Bar Association Tax Section has argued that because the House report was prepared on the basis of a 2009 explanation of an earlier, different version of what later became section 7701(o), it should not be considered part of the legislative history of section 7701(o) as enacted and that section 7701(o) may indeed have no official legislative history. NYSBA Tax Section, ''Report on Codification of the Economic Substance Doctrine,'' at 13 n.33 (Jan. 5, 2011); *see also* Cummings, *supra* note 115, at 1255-1256 n.149.

[186]House report, *supra* note 8, at 297; JCT explanation, *supra* note 8, at 153-154.

[187]House report, *supra* note 8, at 297 n.134 (emphasis added); JCT explanation, *supra* note 8, at 154 n.353. For a criticism of these statements on a different ground, see NYSBA, *supra* note 185, at 27-31.

[188]*See, e.g.*, Notice 2010-62 (''The IRS will challenge taxpayers who seek to rely on prior case law under the common-law economic substance doctrine for the proposition that a transaction will be treated as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary). For all transactions subject to section 1409 of the [2010 Health Care and Education Reconciliation] Act that otherwise would have been subject to a common-law economic substance analysis that treated a transaction as having economic substance merely because it satisfies either section 7701(o)(1)(A) (or its common-law corollary) or section 7701(o)(1)(B) (or its common-law corollary) the IRS will apply a two-prong conjunctive test consistent with section 7701(o).''); and LB&I directive, *supra* note 179 (''enactment of section 7701(o) resolved the longstanding conflict among various circuit courts of appeal regarding how the doctrine should be applied by codifying a two-part conjunctive test'').

[189]Notice 2010-62.

[190]LB&I directive, *supra* note 179.

[191]*See, e.g.*, *United States v. Ron Pair Enterprises Inc.*, 489 U.S. 235, 241 (1989) (''where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms'' (internal quotation marks omitted)); and *Davis v. Michigan Department of Treasury*, 489 U.S. 803, 808 n.3 (1989) (''legislative history is irrelevant to the interpretation of an unambiguous statute''). *But cf. Yates v. United States*, 135 S. Ct. 1074 (2015) (in light of the purpose of the Sarbanes-Oxley Act of 2002, a fish is not a ''record, document, or tangible object'' within the meaning of the statute).

[192]*See* section 7701(o)(2), (3), and (4).

language used by Congress in the statute itself and apply the disjunctive test.

C. The *Gregory* Principles After Section 7701(o)

In any event, when courts begin to consider the application of section 7701(o) to cases involving transactions entered into after March 30, 2010 (no such cases appear to have been decided yet),[193] the question will be the extent to which the *Gregory* principles continue to apply in determining whether a taxpayer having a tax motive for entering into a transaction "has a substantial purpose (apart from Federal income tax effects) for entering into such transaction." The statute itself is not terribly illuminating in this regard. It provides only that the determination of whether the economic substance doctrine is relevant in a particular case is to be "made in the same manner as if [section 7701(o)] had never been enacted." Given this extraordinary deference to the courts' development of the law before the enactment of section 7701(o) (Congress did not even affirmatively prescribe when the statute would be applicable), it seems reasonable to conclude that Congress did not intend to abrogate or change the common law, including the *Gregory* principles.[194]

The House report and the JCT explanation do provide some insight. The House report describes the economic substance doctrine as one that "denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax."[195] It also notes that the Tax Court has held that "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."[196] Interestingly, neither of those descriptions includes the taxpayer's motive as a relevant factor, although the House report also speaks of common law doctrines that "deny the tax benefits of a tax-motivated transaction, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision."[197] The House report also notes that courts have supplemented the tax laws enacted by Congress "with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved." Saying it is "desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences," the report states that section 7701(o) "shall not be construed as alter or supplanting any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and the provision shall be construed as being additive to any such other rule of law."[198] Those statements seem to be entirely consistent with the *Gregory* principles' focus on congressional intent.

Stating that the provision "clarifies and enhances the application of the economic substance doctrine" and that "the provision provides a uniform definition of economic substance, but does not alter the flexibility of the courts in other respects,"[199] the House report elaborates on the determination of when the doctrine is relevant and how it applies when it is relevant:

> The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if the provision had never been enacted. Thus, the provision does not change current law standards in determining when to utilize an economic substance analysis.[124]
>
> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of

[193]The IRS will not issue rulings on whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o). Rev. Proc. 2015-3, 2015-1 IRB 129, section 3.02(1); *see also* Notice 2010-62.

[194]*See* House report, *supra* note 8, at 292 n.106, at 294 notes 114, 116, and 117, and at 296 n.128 (citing *Knetsch*, *Goldstein*, and *Gregory*); JCT explanation, *supra* note 8, at 142 n.300, at 144 n.308, at 145 notes 310 and 311, and at 152 n.348 (same).

[195]House report, *supra* note 8, at 292 (citing *ACM Partnership*, 157 F.3d 231; *Klamath*, 472 F. Supp.2d 885, *aff'd on this issue*, 568 F.3d 537; and *Coltec*, 454 F.3d 1340); *see also* JCT explanation, *supra* note 8, at 142 (same).

[196]House report, *supra* note 8, at 292 (quoting *ACM Partnership*, T.C. Memo. 1997-115, *aff'd on this ground*, 157 F.3d 231); *see also* JCT explanation, *supra* note 8, at 143 (same).

[197]House report, *supra* note 8, at 291-292; *see also* JCT explanation, *supra* note 8, at 142 (same).

[198]House report, *supra* note 8, at 295, 298; *see also* JCT explanation, *supra* note 8, at 155 (same).

[199]House report, *supra* note 8, at 295; *see also* JCT explanation, *supra* note 8, at 152.

transactions that constitutes a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[200]

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124 If the tax benefits are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision. *See, e.g.*, Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which a deduction otherwise allowed will be disallowed are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.

The JCT's March 2010 technical explanation of the revenue provisions in the legislation that when later enacted, included section 7701(o),[201] is arguably more authoritative than the House report in this regard.[202] Significantly, that explanation largely incorporated the above-quoted discussion from the House report but shifted the focus of the (renumbered) footnote as follows:

344 If the realization of the tax benefits of a transaction is ~~are clearly~~ consistent with ~~all applicable provisions of the Code and the purposes of such provisions~~ the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed ~~if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision~~. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which ~~a deduction~~ an amount otherwise ~~allowed~~ constituting a deduction, credit, or other allowance ~~will be disallowed~~ is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.[203]

The placement of the footnote in both the House report and the JCT explanation suggests that it was intended to explain the statements in the respective texts that (1) the determination of whether the economic substance doctrine is relevant to a transaction is to be made in the same manner as if section 7701(o) had not been enacted and (2) that section 7701(o) does not change the existing common law standards for when to apply an economic substance analysis. As revised in the JCT explanation, the footnote adds helpful examples of the types of activities Congress clearly intended to encourage by bestowing a tax benefit and which therefore are not intended to be disallowed by the application of section 7701(o). In shifting the focus of the discussion, as noted, the JCT footnote also arguably provides some clarification regarding the continued applicability of the *Gregory* principles.

The footnote in the House report refers to transactions that give rise to tax benefits that are clearly consistent with the code and the purposes of the relevant code provisions but nonetheless fail the economic substance doctrine. This suggests that the

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[200]House report, *supra* note 8, at 295-296 (footnote 124 in original; other footnotes omitted). Both the House report and the JCT explanation make it clear that the four listed basic transactions whose tax treatment section 7701(o) is not intended to alter are examples that are "illustrative and not exclusive." *See* House report, *supra* note 8, at 296 n.125; JCT explanation, *supra* note 8, at 152 n.345.

[201]JCT explanation, *supra* note 8.

[202]*See* NYSBA, *supra* note 185, at 13 n.33 (arguing that because the JCT explanation, unlike the blue books issued by the JCT after the enactment of legislation, "was released four days before either chamber of Congress voted on the Reconciliation Act in its final form (and nine days before the President signed the legislation into law), and is the only piece of Congressional explanation with respect to the actual legislation that was enacted," that report "should be viewed as carrying relatively more authoritative weight than a Joint Committee [blue book] not prepared and published substantially contemporaneously with the passage of the subject legislation").

[203]JCT explanation, *supra* note 8, at 152 n.344 (markings to show the changes from House report, *supra* note 8, at 296 n.124 added).

economic substance doctrine is relevant to a transaction giving rise to such a tax benefit and that the transaction could fail the business purpose prong of the doctrine. But that suggestion appears to be inconsistent with the *Gregory* principles. Under those principles, one claiming tax benefits in a manner consistent with congressional purpose should be considered to meet the business purpose requirement regardless of the taxpayer's tax-avoidance motive — as long as the taxpayer's purpose is to do what is targeted by Congress and the taxpayer in substance does just that. As revised in the JCT explanation, however, the footnote seems entirely consistent with the *Gregory* principles: As long as "in form and in substance, a taxpayer makes the type of investment or undertakes the type of activity that the [tax benefit] was intended to encourage," the tax benefit will not be disallowed under the economic substance doctrine or section 7701(o). This is presumably because that transaction will pass muster under the business purpose test and possibly because the economic substance doctrine will not be considered relevant to the transaction in the first place.

In this connection, the IRS Large Business and International Division in July 2011 issued a directive to give auditors and their managers guidance on how to determine when to seek approval to raise the economic substance doctrine.[204] The directive provides a list of facts and circumstances that tend to show that application of the economic substance doctrine is likely inappropriate. These include not only the four basic transactions listed in the House report and the JCT explanation (debt versus equity, foreign corporation versus U.S. corporation, corporate organization or reorganization, and use of related-party entities) but also several items that call to mind the *Gregory* principles. Among the factors identified are:

- a transaction that generates targeted tax incentives is consistent with congressional intent in providing the incentives;
- a transaction creates a meaningful economic change on a present value basis (pretax);
- a transaction has credible business purpose apart from federal tax benefits;
- the transaction does not artificially generate a tax benefit;
- the transaction contains no unnecessary steps;
- the transaction is not outside the taxpayer's ordinary business operations;
- the transaction is not promoted, developed, or administered by a tax department or outside advisers;
- the transaction is not highly structured;
- the transaction is at arm's length with unrelated parties;
- the transaction does not artificially limit the taxpayer's potential for gain or loss;
- the transaction does not accelerate a loss or duplicate a deduction;
- the transaction does not generate a deduction not matched by an equivalent economic loss;
- the transaction does not involve the holding of offsetting positions that largely reduce or eliminate the economic risk of the transaction;
- the transaction does not involve a tax-indifferent counterparty that recognizes substantial income;
- the transaction does not involve the separation of income recognition from a related deduction;
- the transaction has a meaningful potential for profit apart from tax benefits;
- the transaction has a significant risk of loss; and
- the transaction is not prepackaged.[205]

Conversely, the directive states that application of the economic substance doctrine *may be* appropriate for transactions having features that are the opposite of the above factors (for example, no credible business purpose apart from federal tax benefits, no meaningful economic change, or unnecessary steps). Significantly, however, in those cases the auditor is directed to consult his manager or territory manager before seeking approval from the director of field operations (who "should consult with Counsel before a decision is made") to apply the doctrine in the following circumstances:

- the transaction is "a statutory or regulatory election" (presumably a tax election);
- the transaction is "subject to a detailed statutory or regulatory scheme" and "complies with this scheme";
- judicial or administrative precedent exists that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction without making reference to the doctrine;
- the transaction involves tax credits (such as low-income housing credits and alternative

[204]LB&I directive, *supra* note 179; *see also* IRS Large and Midsize Business Division, "Codification of Economic Substance Doctrine and Related Penalties," LMSB-4-0910-024 (Sept. 14, 2010) (requiring any auditor's proposal to raise the economic substance doctrine and thus impose the strict liability penalty to be reviewed and approved by the appropriate director of field operations).

[205]LB&I directive, *supra* note 179.

energy credits) designed by Congress to encourage transactions that would not be undertaken but for the credits;
- another judicial doctrine such as the substance-over-form doctrine or the step transaction doctrine more appropriately addresses the noncompliance being examined;
- recharacterizing the transaction (for example, recharacterizing debt as equity) more appropriately addresses the noncompliance being examined; or
- application of the doctrine is not among the strongest arguments available to challenge the claimed tax result.[206]

These examples of situations in which the auditor is directed to take special steps before challenging a tax benefit on the basis of the economic substance doctrine appear to incorporate at least some of the *Gregory* principles discussed above. For example, even if the transaction has no credible business purpose apart from federal tax benefits, auditors are directed to double-check with their managers before asserting the economic substance doctrine if the tax benefit arises from a tax election or a transaction that Congress intended to encourage or the transaction complies with a detailed statutory or regulatory scheme. One wonders whether FTC cases such as *BNY* would have ever arisen under this standard.

Left unclear in this guidance, however, is whether and to what extent the IRS will apply the *Gregory* principle that an inquiry into a taxpayer's motives for entering into a transaction is distinct from an inquiry into whether the transaction has a business purpose — that is, that a tax-motivated transaction is not necessarily devoid of a business purpose. It remains to be seen whether the IRS will apply section 7701(o) in a manner consistent with that principle. The positions taken by the IRS in recent cases involving historic rehabilitation tax credits and FTCs are not encouraging in this regard,[207] but perhaps the standards set forth in the 2011 LB&I directive will discourage those positions in the future. Or perhaps not, given the IRS's recent victory in *BNY*.

The latest guidance issued by the IRS on the application of section 7701(o) appears to be inconsistent with the further *Gregory* principle that a taxpayer is free to choose the most tax-efficient alternative to achieve the business objective even though there is little or no economic difference between the various alternatives. In Notice 2014-58, the IRS stated the following regarding the transaction to be tested in determining whether the economic substance doctrine is relevant (and presumably, the transaction to be tested under the doctrine if applicable):

> For purposes of determining whether the codified economic substance doctrine applies, ''transaction'' generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.
>
> Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the transaction includes all the steps taken together — an aggregation approach. This means that every step in the series will be considered when analyzing whether the transaction as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is unnecessary to achieve a nontax objective, an aggregation approach may be inappropriate. In that case, the transaction may be defined to include only the tax-motivated steps that are not necessary to accomplish the nontax goals — a disaggregation approach.
>
> Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered case by case, depending on the particular facts and circumstances. For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or the assumption of a specific liability was tax-motivated and unnecessary to accomplish a nontax objective, the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms, including the involvement of an intermediary that is used for tax benefits and whose actions are unnecessary to accomplish an overarching nontax objective. These are

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[206]*Id*.

[207]*See supra* text accompanying note 5; Brief for Defendant-Appellee at 35, *AIG*, No. 14-765 (2d Cir. 2014) (''AIG cannot demonstrate the absence of a genuine dispute of fact as to the subjective prong of the analysis — whether AIG had a legitimate business purpose for entering into the transactions. There is more than sufficient evidence in the record from which a reasonable fact finder could conclude that AIG's sole motivation for entering into the transactions was to realize tax benefits.'').

merely two illustrations of the potential application of the disaggregation approach; they are not exhaustive or comprehensive.[208]

Although there is arguably some support for this disaggregation approach in the purported legislative history of section 7701(o),[209] this formulation seems inconsistent with the *Gregory* principle that a taxpayer is entitled to choose the most tax-efficient means to achieve a nontax business objective. In the absence of any statutory indication that Congress intended to abrogate or modify this core *Gregory* principle,[210] it is not clear that the IRS would or should withstand a challenge if it attempted to separately test under the economic substance doctrine perceived tax-motivated steps in an overall business transaction. (That challenge would necessarily cite *Gregory* and the other authorities discussed above.) This is particularly so since, as the courts have pointed out, there is often no difference in substance between two alternative structures that could be used to achieve a business objective, apart from the difference in the tax consequences.[211]

Thus, if applied broadly, the statements in Notice 2014-58 indicating that for purposes of the economic substance doctrine, the transaction can be framed to enable the IRS to (1) disregard a tax-motivated transfer of a specific asset or assumption of a specific liability as part of a transfer of multiple assets and liabilities when the transfer or assumption in question is deemed unnecessary to accomplish the nontax objective, or (2) disregard an ''intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective,'' appear to call into question much of what one thinks of as traditional tax planning and thus to be inconsistent with the law as articulated by the Supreme Court and other courts in *Gregory* and its progeny.[212]

VII. Proposed Section 7701(o) Principles

Proposed below is a series of principles for applying the economic substance doctrine and section 7701(o). They reflect the *Gregory* principles and thus incorporate the premise that taxpayers are entitled to engage in tax planning as long as the tax benefits claimed are consistent with congressional intent. The following are intended to start, rather than end, the discussion of the role of tax-avoidance motives in applying the economic substance doctrine and section 7701(o):

1. Courts may legitimately invoke common law doctrines such as the economic substance doctrine only as a way to give effect to congressional intent as expressed in the code. They do so by limiting the scope of the tax benefits bestowed by Congress to the types of taxpayers and transactions intended by Congress.

2. The economic substance doctrine (and thus the business purpose requirement) should have little or no applicability to tax benefits granted by Congress to encourage taxpayers to engage in activity that might not be economical absent the tax benefit, such as the tax credits for historic rehabilitation, low-income housing, and alternative energy transactions. In those cases, even if the taxpayer's sole motive for engaging in the targeted activity was to reap the tax benefits granted by Congress, this should be irrelevant to whether the taxpayer is entitled to the benefits.

3. Similarly, the economic substance doctrine (and thus the business purpose requirement) should have no applicability to tax benefits that courts have held do not constitute tax avoidance or for which courts have held that no business purpose is required. Examples include tax elections — such as the check-the-box election, the S election, and the election to file a consolidated return — whose *sole* purpose is generally to reduce tax.

4. The scope of the economic substance doctrine should diminish as the level of detail and complexity of the statutory and regulatory provisions granting the tax benefit increase. In the words of Hand in *Gregory*, ''as the articulation of a statute increases, the room for interpretation must contract.'' A corollary to this principle is that if the statute contains an

[208]Notice 2014-58; *see also BNY* (''Even if the transaction at issue is part of a larger series of steps, '[t]he relevant inquiry is whether the transaction that generated the claimed deductions . . . had economic substance.''').

[209]*See* House report, *supra* note 8, at 296-297 (section 7701(o) ''does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine,'' and it ''reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits''); *see also* JCT explanation, *supra* note 8, at 153 (same).

[210]The statute provides only that the term ''transaction'' includes a series of transactions. Section 7701(o)(5)(D).

[211]*See, e.g.*, *Nassau Lens*, 308 F.2d at 45.

[212]*See, e.g.*, Cummings, *supra* note 115, at 1255-1256 (the notice ''describes precisely how taxpayers select least-taxed means of achieving a nontax objective''); Hariton, *supra* note 12, at 40-47 (describing this process as the ''framing of the transaction,'' criticizing the court's narrow framing of the transaction in *Coltec* as a ''fundamental misunderstanding'' of *Gregory* and praising the court's broad framing of the transaction in *UPS*).

antiabuse rule specific to the tax benefit, and particularly if that rule addresses the reason a transaction was structured as it was, that expression of congressional intent should diminish the role of common law antiabuse doctrines such as the economic substance doctrine.[213]

5. When a taxpayer engages in a "real" business transaction having economic substance, the taxpayer's choice among the various possible ways to structure the transaction for a more tax-efficient means of accomplishing the business objective, rather than a less tax-efficient structure, should not *itself* be tested for economic substance or a business purpose. In the parlance of section 7701(o), the economic substance doctrine should not be considered to be relevant in that context under long-standing common law principles.

6. For a transaction that has economic substance and to which the economic substance doctrine is relevant, a court should apply the substantial purpose test (if at all) in a manner that — consistent with *Gregory* and its progeny — deemphasizes the extent to which the taxpayer's motive was to minimize or avoid taxes and emphasizes (a) whether the taxpayer actually did the thing that Congress defined in the code as the object or target of the tax benefit in question and (b) whether the taxpayer had a business purpose in the sense of an intention to do what Congress targeted as opposed to a purpose to disguise something else as what Congress targeted.

[213]*But cf. Salem Financial*, 786 F.3d at 941 (the existence of an antiabuse provision in the applicable Treasury regulations does not preclude an inquiry under the economic substance doctrine). In *BNY*, the Second Circuit held that FTC transactions are not categorically exempt from the application of the economic substance doctrine, but did not directly address the argument that a statutory and regulatory scheme as complex and detailed as the FTC is not conducive to this type of analysis.

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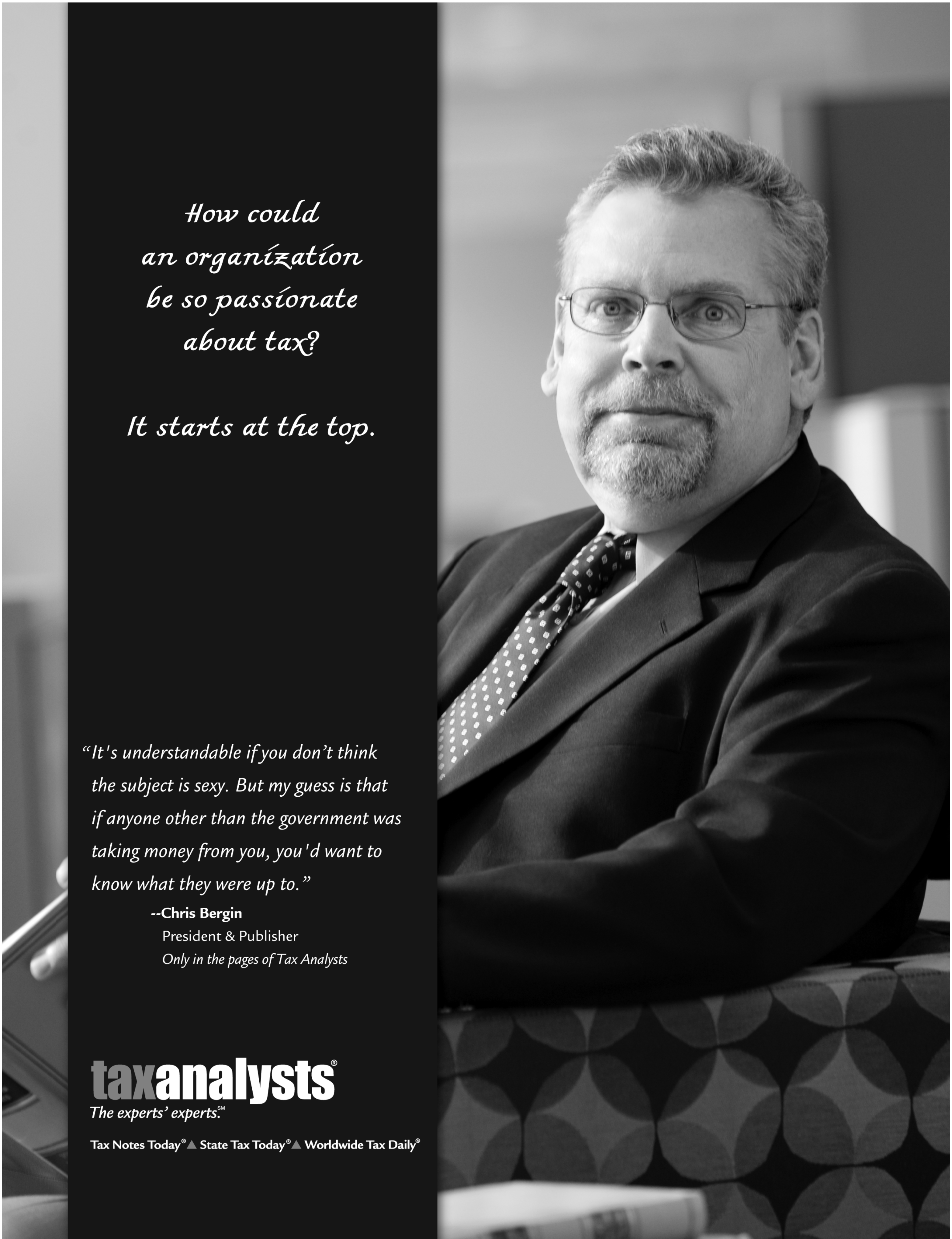
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