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Torpedoing A Transaction: Economic Substance Versus Other Tax Doctrines And The Application Of The Strict Liability Penalty

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TORPEDOING A TRANSACTION: ECONOMIC SUBSTANCE VERSUS OTHER TAX DOCTRINES AND THE APPLICATION OF THE STRICT LIABILITY PENALTY

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ABSTRACT

Transactions designed to intentionally reduce one's taxes often attract suspicion and become the subject of judicial review. To evaluate suspicious transactions, courts have developed special common-law doctrines that impose additional requirements beyond those in the Internal Revenue Code. These doctrines could be considered standard methods of fact finding or legal interpretation, yet they have taken on their own identity within court analyses with varying interpretations and applications. An examination of cases demonstrates significant overlap in the doctrines and exemplifies how the application of the doctrines adds confusion and uncertainty to tax law. Compounding on this uncertainty is the codification of the economic substance doctrine and related strict liability penalty for its violation, which suggests that the distinct nature of the common-law doctrines is a false assumption that only confuses tax law. Taxpayers, however, may be able to use the confusion between doctrines to avoid the strict liability penalty by arguing that even if a transaction is invalid, it is invalid not under the codified economic substance doctrine, but under one of the common-law doctrines that does not impose strict liability.

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INTRODUCTION

> *[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, to 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.*[1]

Despite the above truism, transactions designed to intentionally reduce one's taxes attract a heavy dose of suspicion.[2] As the predominant source of positive tax law, the Internal Revenue Code ("Code") draws the brightest line regarding what transactions are permissible and provides the basic framework for taxpayers to order their affairs. "[T]he very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it."[3] Courts, however, have developed special common-law doctrines to help locate the line drawn by the Code under the guise of executing Congress's intent.[4] These common-law doctrines, such as *business purpose* and *economic substance*, are judicial creations that impose additional requirements on transactions beyond those in the Code.[5] While these common-law doctrines have taken on their own identity within court analyses, they could be considered standard methods of fact finding or legal interpretation.[6] Yet, the varying interpretations and applications of these doctrines have caused uncertainty in tax law.[7] This uncertainty appears to be avoidable, as "courts have known for centuries how to determine that an ass bearing the label 'horse' is still an ass."[8]

The uncertainty surrounding the scope of these doctrines is now accentuated by the recent codification of one of these common-law doctrines, the economic substance doctrine,[9] accompanied by a strict liability penalty for its violation.[10]

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1 Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

2 JASPER L. CUMMINGS, JR., THE SUPREME COURT'S FEDERAL TAX JURISPRUDENCE: AN ANALYSIS OF FACT FINDING METHODS AND STATUTORY INTERPRETATION FROM THE COURT'S TAX OPINIONS, 1801-PRESENT 62 (2010).

3 Superior Oil Co. v. Mississippi *ex rel.* Knox, 280 U.S. 390, 395-96 (1930).

4 *See* CUMMINGS, *supra* note 2, at xii, 3 (these special legal processes have come to be known as "tax specific doctrines").

5 *Id.* at xii.

6 *Id.*

7 *Id.* at 1. *Compare* Pasternak v. Comm'r, 990 F.2d 893, 904 (6th Cir. 1993) (applying the conjunctive test of the two-pronged economic substance doctrine to find leasing schemes invalid), *with* Sacks v. Comm'r, 69 F.3d 982, 991-92 (9th Cir. 1995) (applying the two prongs of the economic substance doctrine merely as factors to consider in finding a sale-leaseback transaction valid).

8 CUMMINGS, *supra* note 2, at 4.

9 *See* I.R.C. § 7701(o) (2012).

Notwithstanding the language of the strict liability penalty provision,[11] the Internal Revenue Service has stated that it will not pursue the strict liability penalty with any transaction that is more appropriately analyzed under a doctrine other than the economic substance doctrine.[12] Such a position demonstrates the IRS's confidence that the economic substance doctrine is not only separate and distinct from the other common-law doctrines, but also that it can be easily distinguished from other doctrines. This assumption may cause more trouble than the IRS anticipates.

Part I explores the foundation of the most popular common-law tax doctrines, along with important cases illustrating their application. Part II tests these foundations by (1) analyzing each case using different common-law doctrines to demonstrate the significant overlap in their application and analysis, and (2) showing how these overlaps are apparent in the newly codified economic substance doctrine. Finally, Part III explains this confusion by arguing that all or most of these doctrines can be seen as merely variations of a singular doctrine: substance over form. If true, this malleability may permit taxpayers seeking to avoid the application of the recently enacted penalty to argue that while the transaction fails, it fails under a doctrine other than economic substance.

I. COMMON LAW DOCTRINES LEADING UP TO CODIFICATION

Transactions intentionally structured to reduce tax fall into three categories: (1) transactions intended by Congress to further an economic, social, political, or administrative objective; (2) transactions that Congress does not intend, but which share a common fact pattern that supports a statutory response; and (3) transactions that Congress does not intend, but which do not share a common fact pattern and are of an idiosyncratic nature.[13] The latter two categories are abusive transactions that should not be given effect. The legislature can address abusive transactions that share a common fact pattern by passing statutory amendments to the Code.[14] This reactive and mechanical approach to abusive transactions is a rules-based approach.[15] The third category of one-off transactions, however, is best addressed

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[10] *See* I.R.C. § 6662(b)(6) (2012).

[11] *See id.* (providing that the strict liability penalty is applied to any transaction failing the economic substance doctrine or other "similar rule of law").

[12] Heather C. Maloy, Large Bus. & Int'l Div., IRS, LB&I-4-07-015, *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties* (July 15, 2011), http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties [hereinafter LB&I, *Guidance*]; Heather C. Maloy, Large Bus. & Int'l Div., IRS, LMSB-20-0919-024, *Codification of Economic Substance Doctrine and Related Penalties* (Sept. 14, 2010), http://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties [hereinafter LB&I, *Codification*].

[13] DEBORAH A. GEIER, U.S. FEDERAL INCOME TAXATION OF INDIVIDUALS 469 (2015).

[14] *Id.* Examples include section 469 passive loss rules, section 465 at-risk rules, the capital loss limitation in section 1211, the limitations of losses on dealings with related person in section 267, the corporate net operating loss limitations in section 382, hobby loss rules in section 183, and the wash sale rule of section 1091.

[15] *See* Linda D. Jellum, *Codifying and "Miscodifying" Judicial Anti-Abuse Doctrines*, 33 VA. TAX REV. 579, 586 (2014).

through individual adjudication where a court will determine if the transaction complies with Congress's intent.[16] The granddaddy of this standards-based approach is the substance over form doctrine, with the other common-law doctrines best seen as its progeny.[17]

The substance over form doctrine is not peculiar to tax law.[18] It has been and continues to be a staple in many legal contexts, and allows a court to look beyond mere formalities to discern the true nature of the facts to correctly apply the law.[19] Hence, the substance over form doctrine is used in a wide variety of legal fields as a standard method of fact finding.[20] In tax law, this standards-based approach allows the government to combat tax abuse in situations where the rules-based approach of the Code falls short.[21]

An emblematic application of the substance over form doctrine in tax law can be found in *Old Colony Trust Co. v. Commissioner*.[22] In *Old Colony Trust*, the taxpayer, Mr. Wood, negotiated an employment contract providing that his employer would pay the income taxes owed on his salary directly to the IRS and state revenue agency.[23] Mr. Wood did not include the cash paid to satisfy his tax obligation in his gross income, but the IRS argued, and the Supreme Court agreed, that the tax paid by the company constituted additional compensation under his employment contract.[24] While in form it was a payment of cash by the company to a third party, in substance, it was additional compensation for services rendered by Mr. Wood.[25]

Another similar standards-based approach is the sham transaction doctrine, which allows a court to deny the legal effect of a transaction that appears fictitious.[26] "Sham," the operative word, is defined as "[s]omething that is not what it seems; a

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[16] GEIER, *supra* note 13, at 469.

[17] Jellum, *supra* note 15, at 595-97.

[18] CUMMINGS, *supra* note 2, at 333.

[19] *Id.*

[20] For example, the analysis has been used in contract law to establish that nominal consideration does not create a contract. *See, e.g.*, Schnell v. Nell, 17 Ind. 29, 29 (1861) (finding that an agreement to pay beneficiaries $200 in consideration of one cent was not a contract but rather a promise to make a gift even though it satisfied the formal requirements for formation of a contract). Similarly, it has been used in corporate law to disregard the corporate entity for limited liability purposes. *See, e.g.*, Mangan v. Terminal Transp. Sys., 286 N.Y.S. 666, 667 (N.Y. App. Div. 1936) (finding that the defendant's taxi-cab companies were mere devices to shelter the owner from the liabilities of ownership).

[21] While the rules-based approach has the advantage of certainty, "[i]t forces Congress and the Treasury to be reactive rather than proactive, as innovative taxpayers find new ways to work around the language of the rules." Jellum, *supra* note 15, at 586.

[22] 279 U.S. 716 (1929).

[23] *Id.* at 718-20.

[24] *Id*. at 729-31.

[25] *Id.*

[26] *See* Karen Nelson Moore, *Sham Transaction Doctrine: An Outmoded and Unnecessary Approach to Combating Tax Avoidance*, 41 FLA. L. REV. 659, 659 (1989); Jasper L. Cummings, Jr., *The Sham Transaction Doctrine*, 145 TAX NOTES 1239, 1242 (Dec. 15, 2014).

counterfeit."[27] While the Supreme Court has never used the term "sham transaction doctrine," *Knetsch v. United States* is often credited for identifying a transaction as a "sham."[28]

In *Knetsch*, Mr. Knetsch bought a single premium deferred annuity savings bonds paying 2.5% interest with mostly nonrecourse debt (borrowed from the insurance company itself) charging 3.5% interest.[29] Mr. Knetsch also immediately borrowed the first year's interest payment from the insurance company and deducted the prepaid interest on his tax return.[30] The contract allowed Mr. Knetsch to borrow the excess of the stated cash or loan value at year-end over the amount of his indebtedness.[31] He continued this arrangement for three years and deducted the interest payments each year.[32] In the fourth year, Mr. Knetsch terminated his contract by surrendering the bonds to the company, cancelling his indebtedness, and generating a small cash payment.[33] In disallowing the interest deductions, the Supreme Court found that the loan arrangement between Mr. Knetsch and the insurance company that putatively sold him the deferred annuity was a "fiction" and a "sham."[34] It was pretend debt intended only to create a series of "interest" deductions for Mr. Knetsch.

A similar standards-based approach often employed by the courts is the step transaction doctrine, which allows a court to treat multiple steps or series of closely related transactions as one event for tax purposes.[35] Additionally, courts have used the step transaction doctrine to disaggregate the final result of a series of transactions to analyze each step.[36] For example, the Supreme Court applied the step transaction doctrine to prevent the avoidance of gain recognition by a corporation in *Minnesota Tea Co. v. Helvering*.[37]

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[27] *Sham*, BLACK'S LAW DICTIONARY 1585 (10th ed. 2014).

[28] Knetsch v. United States, 364 U.S. 361, 366 (1960).

[29] *Id.* at 362-63.

[30] *Id.*

[31] *Id.* at 363.

[32] *Id.* The interest deductions would have been used to offset income during a period of time in which the highest marginal income tax rate reached ninety-one percent.

[33] *Id.* The context in which purported debt is most at risk of being considered "sham debt" is when a property seller also finances the sale and the sale price demonstrably exceeds the fair market value of the property. *See, e.g.*, Estate of Franklin v. Comm'r, 544 F.2d 1045, 1046-47 (9th Cir. 1976).

[34] *Knetsch*, 364 U.S. at 366.

[35] *See* Comm'r v. Clark, 489 U.S. 726, 738 (1989); s*ee also* Philip Sancilio, Note, *Clarifying (or is it Codifying?) the "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code*, 113 COLUM. L. REV. 138, 148-49 (2013) (comparing the step transaction doctrine to the newly codified economic substance doctrine).

[36] *See, e.g.*, Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938); Crenshaw v. United States, 450 F.2d 472, 476 (5th Cir. 1971); Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).

[37] *Minn. Tea Co.*, 302 U.S. at 609.

In *Minnesota Tea Co.*, the plaintiff company sold property and immediately distributed the cash to its shareholders, purportedly in pursuance of a plan of reorganization, in return for an agreement by the shareholders to assume the debts of the company.[38] Had the company retained the cash and paid its creditors directly, it would have been taxed on the gain realized from the property sale.[39] In applying the step transaction doctrine, the Supreme Court treated the two transactions as one, finding that the distribution to shareholders "was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands" and that the shareholders acted as a "mere conduit" of the payment to creditors.[40]

Helvering v. Gregory is universally accepted as the father of the business purpose doctrine, which states that the structure of a transaction must serve a bona fide business purpose other than tax avoidance to be respected.[41] Mrs. Gregory, the wealthy sole shareholder of a corporation, wanted to obtain portfolio investment stock owned by such corporation without triggering the high ordinary income tax rate applied to dividend distributions at the time in order to sell the stock to a buyer.[42] Thus, she created a subsidiary (Averill), transferred the stock to it, and had Averill stock distributed to herself in a transaction purporting to satisfy the tax-free "reorganization" provisions of the Code.[43] She then liquidated Averill, which triggered no tax to the liquidating corporation at the time.[44] If the form of this purported corporate "reorganization" were respected, the transaction would have allowed her to receive the portfolio stock that she wished to sell to her buyer as partially tax-free basis recovery and partially low-taxed capital gain (instead of entirely as high taxed dividend income).[45]

In refusing to give effect to the purported "reorganization," Judge Learned Hand of the Second Circuit Court of Appeals reasoned that although the transaction followed all of the formal requirements of a reorganization, Congress did not intend to cover such a transaction in the reorganization rules when the subsidiary neither

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[38] *Id.* at 610.

[39] *Id.* at 612-13. Under section 112(d)(1) and (2) of the Revenue Act of 1928, any boot received that was not "distributed" pursuant to a plan of reorganization resulted in taxable gain recognition to the recipient. By immediately distributing the cash proceeds from the asset sale, purportedly in connection with a plan of reorganization, the company argued that it satisfied the literal requirements of this section.

[40] *Id.* at 613.

[41] Helvering v. Gregory, 69 F.2d 809, 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[42] *Id.* at 809-10. If Mrs. Gregory would have caused the corporation to declare and pay a dividend to her in the form of the stock it would have triggered dividend treatment at a time in history when dividends were not eligible to be taxed at the preferential capital gains rate, as they are today. *See* I.R.C. § 1(h)(11) (2012).

[43] *Id.* The relevant reorganization provision during that time was section 112 of the Revenue Act of 1928.

[44] *Id.*

[45] GEIER, *supra* note 13, at 484-85.

conducted business nor owned any business assets and the transaction was entered into solely for the purpose of tax avoidance.[46]

After *Gregory*, courts began to consider whether a transaction changed, or had the potential to change, the economic position of the taxpayer (apart from tax savings purporting to arise under the transaction, if respected).[47] In *Goldstein v. Commissioner*, for example, the judicially created "economic substance principle"[48] was used to disallow prepaid interest deductions taken by a taxpayer for loans that had no "purpose, substance or utility apart from their anticipated tax consequences."[49]

In *Goldstein*, Mrs. Goldstein, a recent winner of the Irish lottery, borrowed cash at an interest rate of 4%, which was used, along with a portion of her winnings, to purchase United States Treasury notes paying a return between 0.5% and 1.5%.[50] Apart from tax considerations, the investment was a sure economic loser.[51] But Mrs. Goldstein then prepaid the interest owed on the loans for several years in the same year she included her lottery winnings, which would otherwise be taxed at high marginal rates.[52] Her son, an accountant who devised and executed the transaction, anticipated that the $18,500 economic loss due to the interest rate differential between the borrowed cash and Treasury return would be more than offset by the anticipated $55,000 in tax savings arising from the prepaid interest deduction.[53] The Second Circuit Court of Appeals affirmed the Tax Court's disallowance of the deductions and found that Mrs. Goldstein did not enter into the transaction with the purpose of attaining an economic gain but only to obtain interest deductions.[54]

The business purpose doctrine and economic substance principle were ultimately combined into what has become known as the "economic substance doctrine" in *Frank Lyon Co. v. United States*.[55] As courts began to invoke this doctrine to strike down transactions determined to be outside the purview of congressional intent, the

[46] *Gregory*, 69 F.2d at 810-11. In affirming the Second Circuit's opinion, the Supreme Court stated that the transaction was "[s]imply an operation having no business or corporate purpose." Gregory v. Helvering, 293 U.S. 465, 469 (1935).

[47] *See* Knetsch v. United States, 364 U.S. 361, 366 (1960); *see also* Goldstein v. Comm'r, 364 F.2d 734, 740 (2d Cir. 1966).

[48] Jellum, *supra* note 15, at 598-99.

[49] *Goldstein*, 364 F.2d at 740.

[50] *Id.* at 736-37.

[51] *See* GEIER, *supra* note 13, at 486. The U.S. Treasury bonds, which were among the safest investments, were earning Mrs. Goldstein interest between 0.5% and 1.5%. Yet, she was paying 4% interest on the loans used to purchase the Treasury bonds. *Goldstein*, 364 F.2d at 739.

[52] *Goldstein*, 364 F.2d at 736-37.

[53] *Id.* at 736; *see also* GEIER, *supra* note 13, at 485-86.

[54] *Goldstein*, 364 F.2d at 738.

[55] 435 U.S. 561, 583-84 (1978). In *Frank Lyon*, the Court combined the concepts behind the business purpose doctrine, requiring a bona fide business purpose rather than mere tax avoidance, with the economic substance principle, requiring the transaction to change or have the potential to change the taxpayer's economic position aside from any tax benefits. *Id.*

federal circuit courts began to apply the doctrine inconsistently.[56] In response to this inconsistency, Congress codified the common-law economic substance doctrine in section 7701(o) of the Code in the Health Care and Education Reconciliation Act of 2010.[57]

The codified version of the economic substance doctrine in section 7701(o) requires satisfaction of two elements for a transaction to be respected for tax purposes. First, the transaction must change the taxpayer's economic position (apart from tax effects) in a meaningful way.[58] Second, the taxpayer must have a substantial purpose (apart from tax effects) for entering into the transaction.[59] Essentially, this section codified the business purpose doctrine and economic substance principle into a "conjunctive" economic substance doctrine.[60] Aside from clarifying that the conjunctive test is required, section 7701(o)(5) provides that the economic substance doctrine is the same as "the common law doctrine"[61] and is applicable to a transaction "in the same manner as if this subsection had never been enacted."[62]

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[56] A majority of courts applied a "conjunctive" test, which required the taxpayer to establish *both* the economic substance prong *and* the business purpose prong. *See, e.g.*, Coltec Indus., Inc. v. United States, 454 F.3d 1340, 1355-57 (Fed. Cir. 2006). Several courts, however, applied a "disjunctive" test, which required the taxpayer to establish *either* economic substance *or* a business purpose. *See, e.g.*, Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 96 (4th Cir. 1985). Yet, other courts used a "holistic" test in which they considered economic substance and business purpose in conjunction with other factors. *See, e.g.*, Casebeer v. Comm'r, 909 F.2d 1360, 1363 (9th Cir. 1990). *See generally* Richard M. Lipton, *'Codification' of the Economic Substance Doctrine— Much Ado About Nothing?* 112 J. TAX'N 325, 326 (2010) (describing the "conjunctive" and "disjunctive" labels); Sancilio, *supra* note 35, at 146-47 (describing the "holistic" label).

[57] *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409, 124 Stat. 1029, 1067-70 (codified at I.R.C. § 7701(o)). Commentators suggest three reasons for the codification of the economic substance doctrine: (1) to clarify the meaning of the test, (2) to establish uniformity among courts by requiring the conjunctive test as the proper legal standard, and (3) to obtain tax revenue from the enforcement of the doctrine that could be scored officially as a revenue raiser (unlike the application of the common-law doctrine), as well as raising revenue from the newly enacted penalty. *See* GEIER, *supra* note 12, at 487-88; *see also* Jerald David August, *The Codification of the Economic Substance Doctrine, Part II*, 12 No. 6 BUS. ENTITIES 4, 8-10 (2010).

[58] I.R.C. § 7701(o)(1)(A) (2012).

[59] *Id.* § 7701(o)(1)(B). This test requires both parts to be satisfied and is known as the "conjunctive" test.

[60] It is worth noting that the business purpose doctrine continues to be an independent doctrine apart from its prong in the economic substance doctrine.

[61] I.R.C. § 7701(0)(5)(A).

[62] *Id.* § 7701(o)(5)(C). Although the rationale for codification does not appear to reflect the concern for treaty shopping, the broad language of the Code section may permit an application of the economic substance doctrine and related penalty to transactions involving treaty shopping. *See* CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 254 (4th ed. 2011). Treaty shopping is the practice of taxpayers establishing corporate vehicles in a country (country 1) different from the one where the economic activities occur (country 2) in order to take advantage of a tax treaty between the U.S. and country 1. *See id.* at 244.

At the same time that it enacted section 7701(o), Congress amended section 6662 to impose a strict liability penalty of twenty percent for any underpayment attributable to "[a]ny disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or *failing to meet the requirements of any similar rule of law*."[63] Notwithstanding this language, the IRS has stated that the strict liability penalty is limited only to the application of the economic substance doctrine and that no such penalty will be assessed if the transaction is susceptible to attack under other non-economic substance doctrines, such as the substance over form doctrine or the step transaction doctrine.[64]

Furthermore, the IRS recently clarified that "similar rule of law" is intended to mean the application of the same factors and analysis as the economic substance doctrine in section 7701(o) regardless of the label used.[65] The IRS appears to have taken this position without considering whether the economic substance doctrine is applicable in contexts independent from the other common-law doctrines and whether courts can easily determine whether a transaction is susceptible to challenge *only* under the economic substance doctrine, as opposed to another common-law doctrine. Comparison of the doctrines is warranted to shed light on whether the current IRS position is justified or sustainable.

II. THE DOCTRINES AND THEIR FOUNDATIONAL CASES

The strict liability penalty provisions for violation of the economic substance doctrine, along with the current IRS position relating to its application, leaves the future of such tax litigation in uncertainty. The most recent notice defining "similar rule of law" uses the "sham transaction doctrine" as an example of a different label attaching the same factors and analysis as the section 7701(o) economic substance doctrine, which is, therefore, a "similar rule of law."[66] The same notice, as well as prior IRS guidance, uses substance over form and step transaction doctrine as examples of non-similar rules of law that will not cause the section 6662(b)(6) strict liability penalty to apply.[67] Taken at face value, it appears that the IRS is confident

[63] I.R.C. § 6662(b)(6) (2012) (emphasis added). This penalty is raised to forty percent if no disclosure is made at the time of filing the return. *See id.* § 6662(i). Additionally, unlike other penalty provisions described in section 6662, there is no "reasonable cause exception." *Id.* § 6664(c)(2).

[64] *See* LB&I, *Guidance*, *supra* note 12; LB&I, *Codification*, *supra* note 12; *see also* Richard M. Lipton, *IRS Provides Helpful Guidance to Agents*, 115 J. TAX'N 116, 121-23 (2011).

[65] *See* I.R.S. Notice 2014-58, 2014-44 I.R.B. 746 (2014). The notice relied on the legislative history, which states that the "penalty would apply to a transaction that is disregarded as a result of the application of the same factors and analysis that is required under the provision [section 7701(o)] for an economic substance analysis, even if a different term is used to describe the doctrine." H.R. Rep. No. 111-443(I), at 304 n.161 (2010).

[66] *See* I.R.S. Notice 2014-58, *supra* note 65. According to a Treasury official, however, Notice 2014-58 was not intended to call the sham transaction doctrine a similar rule of law but only to establish that a similar rule of law is any analysis where the two-prong test is applied. William R. Davis, *Economic Substance Notice Not Intended to Implicate All Shams*, TAX NOTES TODAY, at 1 (Jan. 23, 2015).

[67] *Compare* I.R.S. Notice 2014-58, *supra* note 65, *with* I.R.S. Notice 2010-62, 2010-40 I.R.B. 411 (2010).

that the doctrines are easily distinguishable. As some scholars have pointed out, however, this is not true.[68]

These inconsistencies raise several questions about the future of tax litigation in relation to the strict liability penalty of section 6662(b)(6). By analyzing each tax doctrine in its paradigmatic context and applying the other common tax doctrines to each case we can determine that there is significant overlap among the doctrines.[69] This inquiry also reveals the prospect for a defendant taxpayer to invoke any one of the non-economic substance doctrines to avoid the strict liability penalty of section 6662(b)(6).

A. Substance Over Form & Old Colony Trust

Old Colony Trust Co. v. Commissioner is an exemplary case for the application of the substance over form doctrine. In form, the company paid cash directly to the IRS; but in substance the company paid additional cash salary to Mr. Wood "in consideration of the services rendered by the employee."[70] Mr. Wood then paid the cash to the IRS and state tax authorities to satisfy his personal tax obligation.[71] A similar result could follow from a sham transaction doctrine analysis with the sole difference being in the language used. Under a sham transaction analysis, the Court would likely have found the direct payment of taxes by the employer to be a mere "fiction" with the "reality" of the transaction being a payment in consideration for services rendered.[72]

Additionally, the language of the opinion also suggests amenability to the step transaction doctrine. While the step transaction doctrine is often invoked to combine a series of steps into one transaction for analysis, it can also be used to break apart a single transaction into its implicit, but distinct, steps for individual analysis.[73] As a whole, the transaction appears to be a simple payment of tax liability by the company, but as the Court said, this payment was the "equivalent to receipt by the person taxed" with subsequent payment to the IRS.[74] Therefore, applying the step transaction doctrine would show the first step as a payment of compensation to Mr. Wood for services rendered and a subsequent second step of a payment by Mr. Wood to the IRS for his tax liability.[75]

Although no language in the opinion hints at how the Court would have decided under the two prongs of the economic substance doctrine of section 7701(o), an application of the business purpose doctrine and economic substance principle

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[68] *See, e.g.*, GEIER, *supra* note 13, at 469 n.1; CUMMINGS, *supra* note 2, at 152-56; Jellum, *supra* note 15, at 132; Sancilio, *supra* note 35, at 138.

[69] Since the two prongs of the economic substance doctrine reflect the common law economic substance principle and business purpose doctrine, I will apply each of these two doctrines separately throughout this analysis.

[70] *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716, 729 (1929).

[71] *Id.*

[72] *See supra* note 34 and accompanying text.

[73] *See supra* notes 35-36 and accompanying text.

[74] *Old Colony Trust*, 279 U.S. at 729.

[75] *Cf. id.*

illuminates how *Old Colony Trust* would have come out under a section 7701(o) challenge. The business purpose doctrine requires a transaction to serve a bona fide business purpose other than tax avoidance.[76] What sort of business purpose could be served by assuming a liability not properly allocable to the company? A weak argument for a business purpose would be that it served as an employment incentive by eliminating his tax liability. This argument clearly collapses upon itself as it not only identifies the payment as compensation (akin to a bonus), which is taxable to the recipient, but it fails to demonstrate how structuring the payment as an assumption of tax liability, rather than a cash bonus, serves any purpose other than to reduce tax.

The company could have achieved the same employment incentive purpose by a grossed-up cash payment to Mr. Wood.[77] Of course, this would require a sum of money larger than the current payment to be paid, as it would account for the tax liability, but would serve the purpose of paying the employee's tax liability. The only purpose of a direct payment by the company to the IRS was to compensate the employee without, they hoped, a gross income inclusion by Mr. Wood. The company acted as a "conduit" of the payment of Mr. Wood's tax liability.[78] Hence, the transaction lacked a purpose other than to reduce tax and violated the business purpose doctrine.[79]

The economic substance principle requires the transaction to change or have the potential to change a taxpayer's economic position apart from the tax consequences.[80] The only effect of this transaction was to eliminate the tax Mr. Wood would otherwise owe on his compensation. There is no potential for Mr. Wood, or the company, to reap any economic gain aside from paying a cumulative lower amount to absolve the tax liability of Mr. Wood. Since there is no other aspect of this transaction besides a direct payment to the IRS rather than to Mr. Wood as additional cash compensation, the transaction lacks economic substance and was only entered into for tax reduction purposes.[81]

B. Sham Transaction & Knetsch

In holding that Mr. Knetsch's arrangement to buy deferred annuity bonds with loan proceeds borrowed from the annuity seller in order to take "interest" deductions was a sham, the Supreme Court focused on the reality of the loans and found them to be a "facade" and a "fiction."[82] The Court based its analysis on the meaning of "indebtedness" and found that the nonrecourse nature of the debt (giving Mr. Knetsch little risk of economic loss) and the terms of the arrangement between Mr.

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[76] *See supra* note 40 and accompanying text.

[77] A grossed-up cash payment is a calculated payment above the desired compensation to the employee that accounts for the tax liability. *See* GEIER, *supra* note 12, at 136; *see also* Mark Maremont, *Latest Twist in Corporate Pay: Tax-Free Income for Executives*, WALL ST. J. (Dec. 22, 2005), http://www.wsj.com/articles/SB113521937434129170.

[78] *See* Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[79] *See supra* note 41 and accompanying text.

[80] *See* cases cited *supra* note 47 and accompanying text.

[81] *See* cases cited *supra* note 47 and accompanying text.

[82] Knetsch v. United States, 364 U.S. 361, 366 (1960).

Knetsch and the lender was not true indebtedness as contemplated by the statute.[83] The substance over form doctrine is explicitly indicated by the trial judge's opinion and recited in the Supreme Court's opinion: "while in form the payments to Sam Houston [Life Insurance Company] were compensation for the use or forbearance of money, they were not in substance."[84] Instead of focusing on the sham nature of the transaction, the Supreme Court's opinion could have rested on finding that, in form, the transaction was a loan arrangement providing deductible interest payments, but in substance it was merely a fee to the company to help create the appearance of interest payments.

Although not explicitly indicated, by analyzing the purchase of the deferred annuity bonds in conjunction with the borrowing from the annuity seller, the Court applied the step transaction doctrine. Viewed superficially, Mr. Knetsch took out a valid loan with deductible interest payments, and Mr. Knetsch invested the loan proceeds in valid deferred annuity bonds, both of which are legitimate endeavors that are usually respected for tax purposes.[85] It is only when the purported seller and lender are the same person and the underlying economic investment is so weak[86] that circular cash flow begins to look, not like real debt invested in a real financial instrument, but rather a facade to create the appearance of deductible "interest."

The application of the business purpose doctrine in this case provides perspective on the evolution of judicial opinions combatting tax abuse. While the lower court found that the "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction," the Supreme Court refused to follow this reasoning by reinforcing the concept that taxpayers enjoy the legal right to decrease their taxes by any means the law permits, as stated in *Gregory*.[87] The Supreme Court appeared to reject the idea that this transaction violated *Gregory*'s business purpose doctrine, which contemplates looking at the intention or motive of the taxpayer in entering the transaction.[88] This is somewhat troubling as there was no other incentive for this transaction to Mr. Knetsch aside from the interest deductions he was attempting to claim.[89] The bare bones of the arrangement, which he likely entered into at the encouragement of the insurance company, had Mr. Knetsch paying the insurance company a fee in exchange for purported interest deductions.[90] The particular doctrine makes little difference in the end, however, as the Court had a variety of other tax doctrines at its disposal to strike the transaction down.

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83 *See id.*

84 *Id.* at 364-65.

85 *Id.* at 363.

86 "It was stipulated that if Knetsch had held the bonds to maturity [when Knetsch would be 90 years of age] and continued annually to borrow the net cash value less $1,000, the sum available for the annuity at maturity would be $1,000 . . . enough to provide an annuity of only $43 per month." *Id.* at 364.

87 *See id.* at 365 (citing Gregory v. Helvering, 293 U.S. 465, 469 (1935)).

88 *See id.*

89 *See id.* at 366.

90 *See* Cummings, *supra* note 26, at 1249.

An analysis under the economic substance principle would closely resemble the Second Circuit's reasoning in *Goldstein*.[91] The annuity contract Mr. Knetsch entered into would earn 2.5% interest return from the insurance company, while he agreed to pay 3.5% interest to the same insurance company on the loan used to purchase the investment.[92] Absent the tax savings from the interest deductions, the investment arrangement was a "sure economic loser."[93] Similar to *Goldstein*, an application of the economic substance principle to Mr. Knetsch's arrangement would have found that he did not enter into the transaction with the purpose of attaining an economic gain but only to obtain interest deductions.[94]

C. Step Transaction & Minnesota Tea Co.

The step transaction doctrine allows a court to either aggregate multiple steps of a transaction as one event or to disaggregate a seemingly single transaction into a series of steps.[95] The Supreme Court in *Minnesota Tea Co. v. Helvering* used the step transaction doctrine to aggregate an immediate distribution of proceeds from the sale of property to shareholders and the assumption of those shareholders of the liabilities of the company.[96] By aggregating the two steps, the Court determined that the transactions equated to a single step in which the company retained the sales proceeds and used them to pay its creditors directly.[97]

In similar fashion to *Old Colony Trust*, it appears that the substance over form doctrine mirrors the application of the step transaction doctrine in *Minnesota Tea Co*. The Supreme Court itself states "that by this roundabout process petitioner received the same benefit 'as though it had retained that amount from distribution and applied it to the payment of such indebtedness.'"[98] The Court could have plainly stated that, in form, this was a distribution to shareholders with a subsequent assumption of liabilities by those shareholders, but, in substance, it was merely a payment by the company to creditors from the sales proceeds without distribution.

The Court would have likely come out the same way under the sham transaction doctrine. It appears that the Supreme Court initially phrased the issue as a sham transaction question by focusing on whether the distribution to the shareholders satisfied the meaning of a "distribution" as contemplated by the reorganization statute to permit tax-free treatment of the gain.[99] Like *Knetsch*, which focused on the

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91 *See supra* notes 48-54 and accompanying text. The reason why the *Goldstein* court could not rely on the sham debt doctrine is that Mrs. Goldstein was careful to borrow from an independent third-party bank, not the U.S. government (the seller of the investment in the form of Treasury bonds). *See* Goldstein v. Comm'r, 364 F.2d 736, 736 (2d Cir. 1966).

92 *Knetsch* 364 U.S. at 362-63.

93 GEIER, *supra* note 13, at 486.

94 *See supra* notes 48-54 and accompanying text.

95 *See supra* notes 35-36 and accompanying text.

96 Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

97 *Id.*

98 *Id.* (quoting Helvering v. Minn. Tea Co., 89 F.2d 711, 715 (8th Cir. 1937)).

99 "The question for determination is whether the delivery of the [purported distribution] by petitioner to the stockholders, an equal sum thereafter being applied by them to the

meaning of "indebtedness," the Supreme Court would have focused on the meaning of "distribution" and likely held that since the proceeds from the purported distribution to shareholders were immediately used to satisfy the debts of the corporation, it was not a "distribution" as intended by the reorganization statute. The Court itself stated in the opinion that the distribution to the shareholders was "so transparently artificial that further discussion would be a needless waste of time."[100] Therefore, the distribution was a sham.

The language of the opinion also clearly implicates the business purpose doctrine. The Supreme Court stated that "[t]he preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors."[101] By highlighting the "meaningless and unnecessary" nature of the distribution, the Court established that the transaction had no business purpose aside from tax avoidance.[102] The overall purpose of the transaction was to satisfy the liabilities to the creditors, but the structure of the transaction as a distribution to shareholders in return for their assumption of those liabilities was designed only to avoid taxes.

Quite clearly there was no realistic possibility of economic profit from the unnecessary distribution step to the company. The distribution was not exercised with the hope of profit potential or even a non-economic, non-tax purpose. The structure was intended only to avoid the gain that would have been recognized for tax purposes had the company not distributed the proceeds in a plan of reorganization.[103]

D. Business Purpose & Gregory

The decision in *Helvering v. Gregory*[104] is credited with creating the modern business purpose doctrine.[105] In *Gregory*, the Second Circuit Court of Appeals refused to give effect to the purported reorganization as a means of transferring the portfolio stock to Mrs. Gregory because the subsidiary "conducted no business" and had "one purpose to reduce taxes."[106]

payment of petitioner's debts in pursuance of the resolution, constituted a distribution within the meaning of the provisions of [the reorganization statute]." *Id.* at 612.

[100] *Id.* at 613.

[101] *Id.*

[102] *See supra* note 40 and accompanying text.

[103] Interestingly, the shareholders may have had the potential to earn a profit on the transaction. The distribution granted shareholders access to immediate cash in exchange for assumption of the liabilities. The company, however, did not stipulate when the liabilities had to be paid. Therefore, it is possible that a shareholder could have invested the "distribution" in the interim between receipt and payment to the creditors, providing an economic profit potential. The economic substance doctrine, however, clearly focuses on the economic substance and business purpose from the taxpayer's perspective, which was the corporation in this case.

[104] 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[105] *See* GEIER, *supra* note 13, at 486.

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

The court's language could equally be viewed, however, as simply concluding that the substance of the transaction, while cast in the form of a reorganization, was a simple dividend of the portfolio stock to Mrs. Gregory.[107] Indeed, further in the opinion, the court stated that the transfer of property to the subsidiary "was not a true 'reorganization'" but "was merely the declaration of a dividend" by the parent company to Mrs. Gregory.[108] This language clearly implicates the substance over form doctrine, as the court was essentially stating the transaction was, in form, a reorganization but in substance, merely a taxable distribution. Any discussion of the lack of business purpose could have simply been a rationalization of the finding that the transaction was a taxable distribution in substance.[109]

The court also performed a sham transaction doctrine analysis by considering whether the purported reorganization satisfied the meaning of "reorganization" under the statute in effect at that time.[110] Mrs. Gregory argued that the transaction consisted of a valid spin-off followed by a valid liquidation and literally complied with the statute.[111] In explicitly stating that the transactions "were a sham," the court imposed a business purpose requirement into the reorganization statute and held that it was not a true reorganization within the meaning of such statute since it had no purpose aside from tax avoidance.[112] Therefore, the reorganization as a whole was a sham.

While not often considered a step transaction case, there is a clear application of this doctrine, as well, in *Gregory*. The court itself stated that all the "steps were real," thereby implying that, when viewed in isolation, the reorganization and liquidation would be upheld as valid transactions.[113] Rather than exploring the divisive reorganization and liquidation independently for tax purposes, however, the court aggregated the two steps together to find only one event: a taxable distribution of property.[114]

No discussion of the economic substance of the transaction was explicitly performed in the opinion because it is a relatively recent doctrine, but its application could have followed the business purpose analysis. Because the subsidiary was not created to conduct any business activities, there was no profit potential in the reorganization/liquidation structure.[115] The "gain" from the creation and liquidation of the subsidiary rested solely in the purported tax benefits it produced for Mrs. Gregory.[116]

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107 *See* CUMMINGS, *supra* note 2, at 87-92.

108 *Gregory*, 69 F.2d at 810.

109 *See* CUMMINGS, *supra* note 2, at 87-92.

110 *See Gregory*, 69 F.2d at 810-11.

111 *Id.* at 810.

112 *See id.* at 811; *see also* Cummings, *supra* note 26, at 1246-48.

113 *Gregory*, 69 F.2d at 811.

114 *See id.* 811.

115 *See id.*

116 *Id.* at 810.

E. Economic Substance Principle & Goldstein

The Second Circuit Court of Appeals in *Goldstein v. Commissioner* found that Mrs. Goldstein's arrangement of borrowing at 4% interest to invest in Treasury notes paying only about 1.5%, coupled with prepayment of the (deductible) interest in the same year in which her lottery winnings were included in her gross income, "was not to derive any economic gain or to improve here [sic] beneficial interest; but was solely an attempt to obtain an interest deduction as an offset to her sweepstake winnings."[117] Considering that such an arrangement was a sure economic loser (apart from tax savings), Mrs. Goldstein lacked any non-tax profit potential.[118]

An inference of a substance over form doctrine can again be made, however, from the opinion's language. "[W]hile on its face purporting to be a debtor-creditor transaction between a taxpayer and a bank, in fact there can be a situation where the banks itself is, in effect, directly investing in the securities."[119] Stated differently, the arrangement reflected, in form, bona fide loans arising from a valid debtor-creditor relationship but in substance, an investment by the bank in the Treasury notes. Therefore, the court would not give effect to the taxpayer's purported interest deductions.

The *Goldstein* court refused to follow the lower court's holding that the loan arrangements were shams and, instead, considered them to be bona fide loans.[120] The loans were considered bona fide because the money was borrowed from a third-party bank (rather than from the party selling the investments as in *Knetsch*), the loans, while secured, were recourse (meaning Mrs. Goldstein assumed economic risk if the value of the Treasury bonds— the securing collateral— should fall below the loan amounts), and the Treasury bonds were pledged as collateral security for a significant period of time.[121] In this manner, the loans did not represent "sham debt" within the colloquial meaning of debt, but this does not entirely foreclose a "sham transaction" analysis.[122] The ultimate question remained whether the purported tax benefit was encompassed in the meaning of the term "indebtedness" in what is now section 163 of the Code.[123] As in *Gregory*, the court in *Goldstein* first interpreted the statute providing the purported tax benefit.[124] Similar to *Gregory*, which imposed a business purpose requirement into the reorganization statute, the court in *Goldstein* imposed a "purposive activity," in the sense of trying to earn a nontax profit, into the

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[117] Goldstein v. Comm'r, 364 F.2d 734, 738 (2d Cir. 1966) (quoting Goldstein v. Comm'r, 44 T.C. 284, 295 (1965), *aff'd*, 264 F.2d 734 (2d Cir. 1966)).

[118] *See supra* note 51 and accompanying text.

[119] *Goldstein*, 364 F.2d at 737.

[120] *Id.* (distinguishing *Knetsch v. United States*, 364 U.S. 361 (1960)).

[121] *See id.* at 737-40; *see also* GEIER, *supra* note 13, at 486.

[122] Many tax professionals believe there is a distinction between "factual shams" and "legal shams." Courts have created this distinction by considering the process of comparing the facts to the requirements in the Code as a "legal sham," while a "factual sham" compares the facts to a general definition outside of its peculiar definition in the Code. *See* Cummings, *supra* note 26, at 1250.

[123] *See* Cummings, *supra* note 26, at 1249.

[124] *See Goldstein*, 364 F.2d at 737.

interest deduction section.[125] As in *Knetsch*, because the loan arrangement did not have a purpose besides obtaining a tax deduction, it lacked such purposive activity (nontax economic purpose) and therefore was not "indebtedness" as contemplated by the Code section.

The step transaction analysis follows the earlier conclusion reached under the substance over form doctrine: the arrangement was the equivalent of the bank investing in the Treasury notes.[126] Viewed independently, each step of the arrangement was a valid transaction. The loans were made between Mrs. Goldstein and a third-party bank, and the loan arrangement, viewed alone, was legitimate and did not represent sham debt.[127] Additionally, Treasury note investments are a permitted and encouraged endeavor. Viewed together, however, the transaction was essentially an investment by the bank in the Treasury bonds with Mrs. Goldstein as a mere conduit to obtaining interest deductions.[128]

Application of the business purposes doctrine would also result in the disallowance of the deductions. The court stated, "[I]n such a transaction the taxpayer truly can be said to have paid a certain sum to the bank in return for the 'facade' of a loan transaction."[129] This language implies that there was no non-tax purpose in the arrangement.[130] On different facts, an investment in Treasury bonds can serve a sufficient non-tax purpose as the interest income would indicate a true profit potential if not purchased with borrowed funds requiring a higher interest cost. However, there was no non-tax purpose in Mrs. Goldstein incurring the debt to invest in the Treasury bonds because she had plenty of available funds from the sweepstakes winnings to do so without incurring a net economic loss.

F. Codified Economic Substance Doctrine & Penalties

Scholars have suggested that the codification of the economic substance doctrine has done little to change the doctrine's application.[131] Others have noted that the codified version of the doctrine requires stricter scrutiny by requiring both a "*meaningful*" change in the taxpayer's economic position, as well as a "*substantial* purpose" in entering into the transaction.[132] The true power of the codification,

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125 *See id.* at 741 ("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*.") (emphasis added).

126 *Cf. id.* at 737.

127 *Id.* "Sham debt" is where the debt arrangement is fictitious and created only to claim deductions for interest payments that do not really occur. Knetsch v. United States, 364 U.S. 361, 364-65 (1960).

128 *See, e.g.*, Comm'r v. Clark, 489 U.S. 726, 738 (1989); Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938); Crenshaw v. United States 450 F.2d 472, 476 (5th Cir. 1971); Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244 (5th Cir. 1983).

129 *Goldstein*, 364 F.2d at 737.

130 *See supra* note 46 and accompanying text.

131 *See* Lipton, *supra* note 56, at 325.

132 *See, e.g.*, CUMMINGS, *supra* note 2, at 212.

however, comes from the adoption of the accompanying strict liability penalty in section 6662(b)(6) for transactions that lack economic substance.[133]

Section 6662 generally imposes a twenty percent penalty on any "substantial understatement of tax," which can be abated if the taxpayer has "substantial authority" for his position or has disclosed the details of the transaction.[134] Additionally, the penalty will be excused if the taxpayer can establish a reasonable cause for the underpayment or that he acted in good faith.[135] For transactions that fail the economic substance doctrine under section 7701(o), "[t]hese rules go out the window."[136] Rather than basing imposition of the penalty on a "substantial understatement," the section 6662(b)(6) penalty is imposed any time a transaction fails the economic substance doctrine.[137] Additionally, there is no reasonable cause exception for any transaction lacking economic substance.[138] Finally, if the taxpayer does not disclose the questionable transaction with his or her tax return, the twenty percent penalty is increased to forty percent.[139]

Considering the high stakes of this penalty, the codified version of the economic substance doctrine poses not only a threat to the validity of a taxpayer's transaction but may also result in a harsh and unjustified punishment.[140] Not only could the penalty deter legitimate tax planning but it may also change taxpayers' approach to tax litigation. In light of the IRS's stated position that it will not apply the penalty in non-economic substance doctrine cases, taxpayers with doomed transactions may argue that their transaction is more properly struck down by such non-economic substance doctrines as substance over form or step transaction to avoid the penalty. Such a fear is based on the analysis developed above that the doctrines overlap significantly.

III. THE OVERLAP OF THE DOCTRINES

What is evident from the case-by-case analysis in Part II is that the doctrines are not wholly independent from one another but contain at least some overlap in their application and analysis. This assertion appears to contradict recent IRS notices that state the IRS will enforce the strict liability penalty only with respect to transactions that fail the codified economic substance or a "similar rule of law."[141] In the IRS's

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133 *See* Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 U. PA. J. BUS. L. 445, 459-62 (2011). The article describes how the penalty is not justifiable as it is unfair and disproportionate. As the strictest tax penalty, there is no evidence of a link between economic substance doctrine violations and the worst kinds of tax abusive conduct. The Code already provides a sufficient penalty to deter such conduct, and this penalty may result in the deterrence of legitimate tax planning conduct.

134 I.R.C. § 6662(d)(2)(B), (C) (2012). These rules do not apply to "tax shelters." *Id.*

135 *Id.* § 6664(c)(1) (2012).

136 GEIER, *supra* note 13, at 488.

137 I.R.C. § 6662(b)(6) (2012).

138 *Id.* § 6664(c)(2) (hence its strict liability label).

139 *Id.* § 6662(i).

140 *See* Thomas, *supra* note 133, at 491-96.

141 *See supra* sources cited notes 63-65.

view, the "similar rule of law" language appears to refer only to the two-part test found in the statute, even if the words "economic substance" is not used.[142] For example, a recent IRS notice clarified the "similar rule of law" question by stating that it "means a rule or doctrine that applies the same factors and analysis under section 7701(o) for an economic substance analysis," using the "sham transaction doctrine" as an example.[143]

The same notice, however, maintained that the "substance over form doctrine" and the "step transaction doctrine" are not "similar rules of law."[144] Naturally, this language has led practitioners to believe that for strict liability penalty purposes, the substance over form doctrine and the step transaction doctrine will not trigger the penalty, while the sham transaction doctrine will.[145] According to a Treasury official, however, Notice 2014-58 was not intended to call the sham transaction doctrine a similar rule of law, but only to establish that a similar rule of law is any analysis where the statute's two-prong test is applied.[146]

It appears, however, that where the economic substance doctrine (or sham transaction doctrine) is applicable, the substance over form and step transaction doctrine might apply as well.[147] Some commentators believe that the economic substance doctrine and substance over form doctrine differ in that the former requires an inquiry into "why a taxpayer entered into a transaction and the benefits derived from the transaction," while the latter "looks at the true nature of the transaction."[148] This difference is essentially a subjective versus an objective inquiry. While this contrast may be accurate, the fallacy of distinguishing between the two doctrines in this manner is that ascertaining the true nature of a transaction is the ultimate goal of both of these (and other) doctrines.[149] An inquiry into *why* a taxpayer entered into the transaction is meant to illuminate the transaction's true nature.

What makes a transaction "tax-abusive" is whether Congress intended the desired tax consequences in the Code.[150] Each doctrine is designed to determine whether a transaction is within Congress's intent.[151] The broadest tool in achieving

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142 *See supra* note 65 and accompanying text.

143 *See supra* note 65 and accompanying text; *see also* Rice's Toyota World, Inc. v. Comm'r, 752 F.2d 89, 91 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonably possibility of profit exists.").

144 *See supra* note 64 and accompanying text.

145 *See supra* notes 65-68 and accompanying text.

146 *See* Davis, *supra* note 66, at 1.

147 *See supra* Part II.

148 Richard M. Lipton, Flextronics*,* Sundrup*, and the Application of the Economic Substance Doctrine*, 114 J. TAX'N 160, 161-62 (2011); *see also* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 12 (2000).

149 *See* CUMMINGS, *supra* note 2, at 347-50.

150 GEIER, *supra* note 13, at 469; CUMMINGS, *supra* note 2, at 217.

151 GEIER, *supra* note 13, at 469; CUMMINGS, *supra* note 2, at 217.

this objective is the substance over form doctrine, which refuses to accept the taxpayer's chosen form of a transaction where the result is inconsistent with Congress's apparent intent, despite formal compliance with the Code's language regarding the particular form chosen.[152] Treating a violation of one doctrine as especially deserving of a penalty, which can be viewed as merely the alter ego of another, only frustrates the purpose of these common-law doctrines.[153]

With the economic substance principle and business purpose doctrine acting primarily as helpful tools in a substance over form inquiry, the step transaction doctrine is most frequently employed to define the scope of the transaction.[154] In multiple step transactions, courts sometimes invoke the step transaction doctrine to determine whether the transaction as a whole (or an individual step) lacks economic substance or a valid business purpose. Notice 2014-58 demonstrates this use of the step transaction doctrine in its attempt to clarify the definition of a "transaction" for section 7701(o) purposes as including "any series of steps carried out as part of a plan."[155] Additionally, section 7701(o)(5)(D) provides that "transaction" includes "a series of transactions."[156] The legislative history of this section explains, "the provision does not alter the court's ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the [economic substance] doctrine."[157] All of the cases considered in Parts I and II contemplated either breaking down a transaction into multiple steps or combining multiple steps to view the transaction as a whole. This approach is what allowed the courts to apply their common-law doctrine of choice to disallow tax benefits. Therefore, in most cases where a court invokes the economic substance doctrine, it could be argued that the court will implicitly apply the step transaction doctrine to determine the scope of the transaction in its application.

There is little sense in reading Notice 2014-58 to equate the sham transaction doctrine with the economic substance doctrine, while separate and distinct from the substance over form doctrine and step transaction doctrine. The IRS likely included the sham transaction doctrine in the notice based upon some courts using "sham transaction" language to describe what appears to be the economic substance doctrine.[158] While the Supreme Court has used "sham transaction" in an opinion,[159]

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152 *See supra* note 19 and accompanying text.

153 *See* Thomas, *supra* note 133, at 485-89.

154 Sancilio, *supra* note 35, at 148-50. Sancilio, as well as other scholars, consider the step transaction doctrine to be an independent inquiry to disallow tax benefits on its own. I would argue that the step transaction doctrine is best understood as the process of aggregating or disaggregating steps in the transaction to define its scope followed by the application of another common-law doctrine to disallow the purported tax benefits. In this manner, I disagree with Sancilio that courts should apply the economic substance doctrine first with the step transaction doctrine standing behind it as a backstop. *See id.* at 173-78.

155 I.R.S. Notice 2014-58, *supra* note 65 (referencing Treas. Reg. § 1.6011-4(b)(1) (2010)).

156 I.R.C. § 7701(o)(5)(D) (2012).

157 H.R. Rep. No. 111-443(l), at 296.

158 *See, e.g.*, ACM P'ship v. Comm'r, 157 F.3d 231, 247 (3d Cir. 2012); Duffie v. United States, 600 F.3d 362, 378 (5th Cir. 2010); Black & Decker Corp. v. United States, 436 F.3d 431, 440-41 (4th Cir. 2006); United Parcel Serv. of Am. v. Comm'r, 254 F.3d 1014, 1018

it never has used "sham transaction doctrine."[160] The "sham transaction doctrine" language, however, can credit its creation to lower court opinions, where it has been used both liberally and inconsistently.[161] While many appellate courts have used the term to refer to the tests of the economic substance doctrine as defined in section 7701(o), the First and Seventh Circuits never used the term, and the Second, Tenth, Eleventh, and D.C. Circuits used the term differently than its meaning in the economic substance doctrine in section 7701(o).[162] This inconsistency among courts shows the inherit danger in doctrinal labeling.

The sham transaction doctrine derives its analysis from the term "sham" meaning "[s]omething that is not what it seems; a counterfeit."[163] Considering this, the sham transaction doctrine appears to more closely resemble the substance over form doctrine because it analyzes whether the appearance of the transaction (in form) is really something else (in substance). The economic substance principle and business purpose prongs of the economic substance doctrine in section 7701(o) are two ways of discovering whether a transaction is not what it purports to be. This contention can be demonstrated by the Supreme Court's opinion in *Knetsch*, where the Court found the loans were a "sham" but refused to consider the "motive" of the taxpayer.[164] By refusing to consider *why* the taxpayer entered into the transaction, the Supreme Court essentially disregarded a business purpose analysis. How, then, could this sham transaction doctrine case be considered the equivalent of a section 7701(o) analysis (which would cause the imposition of the strict liability penalty today) but not a substance over form doctrine (which would not)?[165]

From the *Goldstein* analysis described in Part II, the sham transaction doctrine may not share the same overlap in application as the other common-law doctrines.[166] In *Goldstein*, the court refused to call the loan arrangements "shams" because the loans were obtained from a third party rather than the seller of the investment purchased with the loan.[167] Rather, the court focused on the lack of economic substance or purpose of the overall investment in Treasury bonds with the borrowed cash to disallow the deductions.[168] In doing so, however, the *Goldstein* court followed the same analysis as in *Gregory*, which has been considered by some (rightly or wrongly) a sham transaction doctrine case (rather than a business purpose

(11th Cir. 2001); James v. Comm'r, 899 F.2d 905, 908-09 (10th Cir. 1990); Rose v. Comm'r, 868 F.2d 851, 853 (6th Cir. 1989).

159 United States v. Woods, 134 S. Ct. 557, 567 (2013).

160 *See* Cummings, *supra* note 26, at 13.

161 *See id.* at 16-20.

162 *See id.* at 16.

163 *See Sham*, *supra* note 27, at 1585.

164 *See* Knetsch v. United States, 364 U.S. 361, 365 (1960).

165 This analysis assumes that the courts will interpret Notice 2014-58 to equate the sham transaction doctrine with the economic substance doctrine.

166 *See supra* Part II.E.

167 *See* Goldstein v. Comm'r, 364 F.2d 734, 738 (2d Cir. 1966).

168 *See id.* at 741.

doctrine case).[169] Stated another way, the court in *Gregory* was satisfied in calling the failed reorganization a "sham" when it imposed an implied business purpose requirement into the meaning of a statutory "reorganization,"[170] yet the court in *Goldstein* refused to recognize the loan arrangement as a "sham" even though it also violated an implied "purpose to make a profit" requirement in the statutory meaning of "indebtedness."[171]

Much has been written attempting to explain and clarify the meaning of these doctrines, including when and where certain of the doctrines should and should not apply. Although important for academic exploration, such exhausting considerations appear to be a hopeless endeavor in practical application, as courts are willing to attach any label to any analysis to prevent tax benefits that it believes are not intended by Congress. Yet, the IRS must believe that one of these doctrines, the economic substance doctrine, is applicable to the most tax abusive transactions and, hence, more deserving of a penalty.

To avoid the strict liability penalty, taxpayers defending against a violation of the economic substance doctrine may resort to conceding that their transaction should not be given effect but by reason of a doctrine other than the economic substance doctrine. While taxpayers would likely be able to show that the substance over form doctrine or step transaction doctrine are applicable in many cases where the IRS charges an economic substance violation, the courts will be forced to resolve which doctrine applies. Having achieved the goal of preventing a transaction not intended by Congress, the resolution of which doctrine applies to defeat the transaction matters only because of the imposition of the strict liability penalty. The practical result may be that courts will choose to apply the economic substance doctrine instead of another doctrine when a transaction appears to be more egregious and deserving of a penalty. Take, for example, the recent case *Kenna Trading, LLC v. Commissioner*, where the Tax Court disallowed bad debt deductions under the economic substance doctrine for tax shelters that were created, marketed, and sold by attorney John Rogers.[172] The opinion in *Kenna Trading* was written by Tax Court Judge Robert A. Wherry, Jr., who also wrote the opinion in *Superior Trading, LLC v. Commissioner*, also involving tax shelters created by Rogers.[173] Perhaps Judge Wherry was "throwing the book" at Rogers in *Kenna Trading*, which led to the unfortunate use of "economic substance" language where that doctrine should not have been applicable.[174]

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[169] *See, e.g.*, Cummings, *supra* note 26, at 10. Interestingly, both cases were decided in the Second Circuit (albeit some years apart).

[170] Helvering v. Gregory, 69 F.2d 809, 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[171] *Goldstein*, 364 F.2d at 738. In *Gregory*, the Supreme Court affirmed the lower court's opinion without using the word "sham." The opinion, however, did indicate similar language by calling the transaction a "devious form of conveyance *masquerading* as a corporate reorganization," as well as "a disguise for concealing its real character" and discussed how any other holding "would be to exalt artifice above reality." *Gregory*, 293 U.S. 465, 469-70 (emphasis added).

[172] Kenna Trading, LLC v. Comm'r, No. 7551-08, 2014 WL 5471973 (T.C. Oct. 16, 2014).

[173] Superior Trading, LLC v. Comm'r, 137 T.C. 70 (2011).

[174] *See* Amy S. Elliot, *Economic Substance Notice's Sham Treatment Prompts Criticism*, 145 TAX NOTES 377, 378 (Oct. 27, 2014).

Recently Judge Wherry acknowledged in *CNT Investors LLC v. Commissioner* that courts have used inconsistent terminology to refer to common-law doctrines, and uncertainty remains regarding "the scope, contours, and sources of economic substance and the other, noncodified judicial doctrines."[175] In *CNT Investors* the taxpayers owned appreciated real estate through an S corporation and engaged in Son-of-BOSS transactions in order to create outside basis in a purported partnership to which the S corporation contributed appreciated real estate.[176] After a series of further transactions, the taxpayers were left holding real estate through the partnership with no one reporting recognition of the real estate's built-in gain.[177] Upon a challenge by the IRS, the taxpayers conceded the partnership was a sham but challenged the assessment of the gross valuation misstatement penalty.[178]

The Tax Court considered the application of the common-law doctrines, found the step transaction applicable, but refused to enforce the penalty assessment by finding that the taxpayers relied reasonably and in good faith on independent professional advice.[179] Although the transaction in *CNT Investors* occurred prior to codification, commentators have pointed out that had this occurred post-codification, the government would have invoked the economic substance doctrine, and the taxpayer would have been subject to the strict liability penalty without the ability to use the reasonable cause and good faith exception.[180] In this scenario, the taxpayer would try to avoid the penalty by arguing that another doctrine, rather than the economic substance doctrine, applies. Therefore, the penalty assessment would be left to the discretion of a court that acknowledged the uncertainty and overlap of the doctrines.

Attempting to raise a different common-law doctrine other than the economic substance doctrine to avoid the penalty conflicts with the perception that the assertion of common-law tax doctrines is largely a "one-way street" open to the government.[181] Typically a taxpayer is open to assert a judicial doctrine only under the most stringent conditions, such as fraud or mistake.[182] The rationale behind this precept is that the taxpayer, having chosen the form of the transaction, is precluded from disavowing it.[183] Considering this rationale, however, the choice among

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175 CNT Inv'rs, LLC v. Comm'r, No. 27539-08, 2015 WL 1285271, at *17 (T.C. Mar. 23, 2015).

176 *Id.* at *1. While there are many different types of Son-of-BOSS transactions, they all involve a tax shelter scheme that attempts to eliminate capital gains by creating artificial capital losses.

177 *Id.*

178 *Id.*

179 *Id.* at *26, *43.

180 *See* Amy S. Elliot, CNT Investors *Shines Light on Courts' Use of Inexact Doctrines*, TAX NOTES TODAY, at 3 (Apr. 6, 2015).

181 *See* Daniel M. Schneider, *Use of Judicial Doctrines in Federal Tax Cases Decided by Trial Courts, 1993-2006: A Quantitative Assessment*, 57 CLEV. ST. L. REV. 35, 50 (2009).

182 *Id.*

183 *See* Comm'r v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967) ("[T]o allow the Commissioner alone to pierce formal arrangements does not involve any disparity of treatment because taxpayers have it within their own control to choose in the first place

doctrines to avoid the strict liability penalty poses a distinct and new issue. Rather than invoking a doctrine to recast or ignore a transaction's form, the taxpayer would merely be arguing that another doctrine is more appropriate in reaching the result the government is asserting. Courts will now be forced to decide whether a taxpayer has the ability to argue which of the multiple common-law doctrines should apply in light of the strict liability penalty context. With the assertion of doctrines no longer resting on the form of a transaction in this context, it is likely that courts will allow taxpayers to make this argument.

CONCLUSION

Clarification of the economic substance doctrine by codifying it may have been a noble objective in establishing uniformity, but the introduction of a strict liability penalty to transactions failing only this doctrine and—not other common-law doctrines—adds greater uncertainty to tax law. The penalty provision causes unnecessary line drawing among doctrines that are all ultimately designed to enforce Congress's intent. Taxpayers and courts are now forced to differentiate among the appropriate applications of each doctrine in order to determine whether the new strict liability penalty should be imposed. Additionally, courts will be faced with new questions related to the penalty based predominantly on the differences among these doctrines. These issues will lead only to more uncertainty, as needless distinctions are drawn between doctrines that share the same ultimate goal.

whatever arrangements they care to make."); Bolger v. Comm'r, 59 T.C. 760, 767 n.4 (1973) ("[T]axpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted.").