

1-1-2011

What Would Henry Simons Do?: Using An Ideal to Shape and Explain the Economic Substance Doctrine

Charlene Luke

University of Florida Levin College of Law, lukec@law.ufl.edu

Follow this and additional works at: <http://scholarship.law.ufl.edu/facultypub>



Part of the [Law and Economics Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Charlene Luke, *What Would Henry Simons Do?: Using An Ideal to Shape and Explain the Economic Substance Doctrine*, 11 Hous. Bus. & Tax L.J. 108 (2011), available at <http://scholarship.law.ufl.edu/facultypub/269>

This Article is brought to you for free and open access by the Faculty Scholarship at UF Law Scholarship Repository. It has been accepted for inclusion in Faculty Publications by an authorized administrator of UF Law Scholarship Repository. For more information, please contact outler@law.ufl.edu.

WHAT WOULD HENRY SIMONS DO?: USING AN IDEAL TO SHAPE AND EXPLAIN THE ECONOMIC SUBSTANCE DOCTRINE

*By Charlene Luke**

I.	INTRODUCTION	109
II.	ECONOMIC SUBSTANCE DOCTRINE OVERVIEW.....	114
	A. <i>Stakes</i>	116
	B. <i>Subjective Inquiry</i>	117
	C. <i>Objective Prong</i>	119
	D. <i>Relationship of the Inquiries</i>	121
	E. <i>ESD's Role in Tax Shelter Litigation</i>	122
III.	THE HAIG-SIMONS PRINCIPLE.....	127
	A. <i>Overview</i>	128
	B. <i>Of Departures, Gaps, and Ambiguities</i>	136
	1. <i>Timing</i>	141
	2. <i>Taxpayer Unit</i>	143
	3. <i>International Tax</i>	145
IV.	H-S ESD.....	147
	A. <i>H-S ESD Overview</i>	147
	B. <i>Possible Benefits, Lingering Problems, and Potential New Concerns</i>	149
	C. <i>Case Illustrations</i>	151
	1. <i>Knetsch</i>	151
	a. <i>Facts</i>	151
	b. <i>H-S Analysis</i>	155
	2. <i>ACM Partnership</i>	157
	a. <i>Facts</i>	158
	b. <i>H-S Analysis</i>	160

* Associate Professor, University of Florida Levin College of Law. I thank Bradley T. Borden, J. Clifton Fleming, Jr., Brian D. Galle, Leandra Lederman, and Gregg D. Polsky for their suggestions on this Article. My colleagues at the UF Levin College of Law have also provided invaluable comments at all stages of this project, and I owe special thanks to Yariv Brauner, Dennis A. Calfee, Patricia E. Dilley, Mark Fenster, Michael K. Friel, David M. Hudson, Lawrence Lokken, Paul R. McDaniel, Martin J. McMahon, Jr., D. Daniel Sokol, and Stephen J. Willis. Thanks are also due to the participants of the 2008 Critical Tax Conference and the Stetson University College of Law's Jr. Faculty Forum at which I presented my very early thoughts on this project. Finally, I thank my research assistants, Shay Moorman and Amber Morris. Any errors are, of course, my own.

2011]	<i>WHAT WOULD HENRY SIMONS DO?</i>	109
	3. Compaq	162
	a. Facts.....	162
	b. H-S Analysis	163
	4. TIFD III-E Inc. (a/k/a Castle Harbour)	165
	a. Facts.....	165
	b. H-S Analysis	167
	5. UPS	168
	a. Facts.....	168
	b. H-S Analysis	169
V.	SUMMARY OF CASE STUDIES AND CONCLUSION.....	170

I. INTRODUCTION

The law and policy governing tax shelters is incomplete, sometimes contradictory, and occasionally incoherent. Indeed, consensus has yet to emerge even as to which transactions should bear the tax shelter label.¹ Often reform efforts are grounded in theories that are largely external to tax law—for example, economic theory relating to incentives.² Fewer approaches rely on intrinsic tax policies, including that most fundamental of income tax principles—the Schanz-Haig-Simons³ income concept ("H-S").⁴ Under H-S, an income tax base should

1. See *infra* notes 77-79 and accompanying text for a discussion of the term "tax shelter."

2. See, e.g., David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 239, 246, 251-53 (2001) (suggesting the use of tax shelters may be reduced if the method of attacking tax shelters were more specifically geared towards affecting taxpayers' economic incentives); see also Leandra Lederman, *W(h)ither Economic Substance?*, 95 IOWA L. REV. 389, 395-98 (2010) (arguing the tax shelter label should not be applied to transactions to which Congress intentionally attached economic incentives).

3. The formulation is named after three individuals who all advocated similar income concepts: Georg Schanz, Robert Haig, and Henry Simons. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 60-62 (Univ. of Chicago Press 1962) (1938) (describing the relationship of Schanz and Haig to Simons' proposed definition); Robert Murray Haig, *The Concept of Income — Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX* 1, 20 (Robert Murray Haig ed., 1921) (briefly discussing Schanz); see also JOSEPH M. DODGE ET AL., *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY* 37-38 (3d ed. 2004) [hereinafter DODGE ET AL., *FEDERAL INCOME TAX*] (describing contributions of Schanz, Haig, and Simons); Stanley A. Koppelman, *Personal Deductions Under An Ideal Income Tax*, 43 TAX L. REV. 679, 684 n.18 (1988) (briefly discussing Schanz).

The title of this Article could thus more properly be "What would Georg Schanz, Robert Haig, and Henry Simons do?," but that seemed too cumbersome.

4. Of course, H-S had its origins in economic approaches to income definition, but as H-S has come to be generally interpreted and used in formulating tax policy, it is readily characterized as being an endogenous tax concept. See discussion *infra* Part III.A.

Professor Leandra Lederman has discussed how the technique of basketing could be used to combat corporate tax shelters while noting that basketing departs from the H-S

be expansive, requiring inclusion of an individual's increases in wealth and allowing reductions only for non-personal costs that reduce wealth.⁵ This Article seeks to open a line of inquiry into the possible benefits of incorporating H-S into the tax shelter discussion. Specifically, this Article discusses the potential results of injecting H-S into the debate over the Economic Substance Doctrine ("ESD")—a debate that seems unlikely to diminish in spite of the recent codification of the ESD.⁶

The ESD has generally been applied when a taxpayer's route to claiming tax benefits was unlikely to have been foreseen by Congress.⁷ The ESD consists of a subjective inquiry into whether a taxpayer had a nontax purpose for entering a suspect transaction and an objective inquiry into whether the transaction accomplished anything beyond tax effects.⁸ If a transaction lacks the requisite economic substance, it is treated as a substantive sham and the taxpayer's claimed tax benefits are denied.⁹

The ESD had been the most controversial of the judicially crafted approaches to tax-avoidance techniques, and the recent codification of ESD seems unlikely to resolve all of the issues.¹⁰ First, the ESD's substantive content is problematic.¹¹ For

norm. See generally Leandra Lederman, *A Tiskit, A Taskit: Baskets & Corporate Tax Shelters*, 88 WASH. U. L. REV. 557 (2011).

5. See Koppelman, *supra* note 3, at 684-85 & n.20.

6. See I.R.C. § 7701(o) (2006 & Supp. 2010); see also discussion *infra* Part II (for an overview of the ESD) and Part IV.C (for examples of cases in which the ESD was at issue).

7. Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 787 (2008) [hereinafter Luke, *Risk Return*].

8. The new ESD Code section contains the same two inquiries. See I.R.C. § 7701(o)(1) (stating that the transaction must change a "taxpayer's economic position" "in a meaningful way" and a taxpayer must have a "substantial purpose (apart from Federal income tax effects)").

9. See I.R.C. § 7701(o)(1). It is considered a substantive sham because the taxpayer actually undertook the transaction giving rise to the claimed tax benefit. See Luke, *Risk Return*, *supra* note 7, at 788. If a taxpayer did not actually enter into the transactions, the government would rely on factual sham or fraud arguments. See *id.* The line between factual sham and substantive sham can at times be difficult to discern, especially in the case of certain financial transactions. See *id.* (discussing factual shams).

The new ESD Code section continues the common law approach and even incorporates the common law by reference. I.R.C. § 7701(o)(5)(A) ("The term 'economic substance doctrine' means the common law doctrine under which tax benefits . . . are not allowable if the transaction does not have economic substance or lacks a business purpose.").

10. See, e.g., Yoram Keinan, *It is Time for the Supreme Court to Voice its Opinion on Economic Substance*, 7 HOUS. BUS. & TAX L. J. 93, 98 (2006) [hereinafter Keinan, *Time to Voice*] (discussing the inconsistent application of the doctrine between, and even among, the circuits).

11. See Lederman, *supra* note 2, at 442 (criticizing the economic substance doctrine because "the doctrine has evolved into one that asks the wrong questions and is easily manipulated").

example, although courts assigned a key role to a transaction's pre-tax profit in determining whether a transaction had an objectively determinable economic effect, the courts did not reach consensus as to how to measure and use pre-tax profit.¹² The new ESD Code section should help standardize the approach to pre-tax profit, but the section fails to grapple with the problems inherent in the pre-tax profit concept.¹³

Second, the ESD's general role in tax planning and litigation remains unclear. Courts, for example, have rarely expressly considered the ESD's status as an interpretive tool¹⁴ even when using the ESD to interpret tax statutes and other tax rules.¹⁵ Codification of the ESD has not clarified the role of the doctrine. For example, although codification demonstrates legislative

12. See *id.* at 435-37 (describing the "plethora of tests" used to evaluate pre-tax profits under the doctrine).

13. The new ESD Code section relies on whether "the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." I.R.C. § 7701(o)(2)(A). This approach, while likely to reduce the ability to manipulate pre-tax profit potential, does not lessen the problem of settling on a meaning of "substantial" and "reasonably." The Code section also fails to account for the effect of implicit taxes on pre-tax profit. See Luke, *Risk Return*, *supra* note 7, at 793-98 (discussing the problems inherent in a pre-tax profit inquiry). Interpretive regulations may, of course, be issued to provide further guidance. See *id.*

14. See Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, 2009 U. ILL. L. REV. 697, 700-01, 709, 717-18 (2009) (suggesting courts use ESD loosely, placing more emphasis on the facts and on the purpose of the laws at issue). Interpretive determinations are, of course, notoriously difficult and require their own theoretical framework. See *id.* at 703-06. In the tax area, such a framework is underdeveloped as evidenced in part by the current structure of most ESD decisions. See Brian Galle, *Interpretative Theory and Tax Shelter Regulation*, 26 VA. TAX REV. 357, 384-85 (2006) (noting the paucity of theory about "what it means for a collective body . . . to 'intend' something" and surmising that "[j]udicial efforts to fill in these gaps may be subjective guesswork"). For articles discussing possible approaches for interpreting tax legislation, see Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995); Alan Gunn, *Some Observations On the Interpretation Of the Internal Revenue Code*, 63 TAXES 28 (1985); and Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986). See also Lee Epstein, Nancy Staudt & Peter Wiedenbeck, *Judging Statutes: Thoughts on Statutory Interpretation and Notes for a Project on the Internal Revenue Code*, 13 WASH. U. J. L. & POL'Y 305, 324 (2003) (describing empirical project looking at Supreme Court tax cases in order to "develop a richer and more systematic understanding of how judges interpret the Internal Revenue Code").

15. See Lederman, *supra* note 2, at 389; see also Alvin C. Warren, Jr., *The Requirement of Economic Profit In Tax Motivated Transactions*, 59 TAXES 985, 989-91 (1981) (discussing the problem of "imposing a non-statutory requirement of pretax profit . . . given the existence of specific statutory provisions").

support for the use of the doctrine, the new Code section does not provide guidance as to when the ESD should be applied.¹⁶

The lack of consensus about the ESD's content and role arguably makes the ESD an ideal subject for testing the possible usefulness of H-S in the tax shelter context. This Article concludes that H-S could provide an organizing principle for anchoring the ESD's substantive content and defining its role. Thus, the H-S could be used to re-frame the current ESD, but, at the same time, the proposed H-S ESD would continue certain features of the current ESD, including some—business purpose, for example—that vex the ESD's critics.¹⁷

In applying H-S to the ESD, this Article emphasizes the aspects of the H-S concept that appear most clearly related to the two inquiries required by the ESD.¹⁸ First, under H-S a cost outlay should not reduce the tax base unless it is sufficiently tied to a business or investment purpose.¹⁹

Second, a cost outlay should not reduce the tax base unless it actually reduces wealth.²⁰ Thus, the proposed H-S ESD would deny all claimed tax benefits if the transaction lacked a sufficient tie to a non-tax business or investment purpose.²¹ Even if the requisite connection were established, the transaction's tax consequences would be determined by using H-S principles to measure the actual economic changes caused by the transaction.²² As a consequence, a tax base reduction would

16. See I.R.C. § 7701(o)(5)(C) ("The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."). See generally Bret Wells, *Economic Substance Doctrine: How Codification Changes Decided Cases*, 10 FLA. TAX REV. 411 (2010) (exploring extent to which the codified language may have altered outcomes in a selection of earlier cases).

17. See, e.g., Lederman, *supra* note 2, at 416-19 (arguing the requirement of a business purpose is insufficient to detect and prevent abusive transactions).

18. Although, as the title to this Article suggests, H-S is susceptible to numerous interpretations; this Article argues that sufficient consensus exists to carry out the proposed analysis. See *infra* note 164 and accompanying text. The most hotly debated areas of H-S application are unlikely to appear in the tax shelter context. For example, debate is particularly strong surrounding the deductibility under H-S of payments made by individuals in response to a hardship event or in support of a public good (e.g., the deductions for medical costs, casualty losses, and charitable contributions).

19. For a discussion of the similarity of this test to the subjective prong of the ESD, see *infra* Part IV.B.

20. See discussion *infra* Part IV.A.

21. See Martin J. McMahon, Jr., *Beyond A GAAR: Retrofitting The Code To Rein In 21st Century Tax Shelters*, 98 TAX NOTES 1721, 1738 (2003) [hereinafter McMahon, *Beyond a GAAR*] (stating that loss deductions for corporations must derived from a profit-seeking purpose).

22. See *id.* at 1731 (stating that "one must recognize that a codified economic substance doctrine that imposes a conjunctive test, requiring both a business purpose and

result only to the extent of actual economic loss.²³ The proposed H-S ESD thus would move from disregarding an entire transaction as a substantive sham to taxing whatever was actually accomplished, and any inquiry into pre-tax profit potential would be confined to consideration of the transaction's business or investment connection.²⁴

Because the H-S ESD would require a fresh determination of a transaction's tax consequences, a court would need to decide whether legislative intent permits setting aside the taxpayer's claimed tax rules and using the H-S ESD to tax the transaction.²⁵ The H-S ESD would also apply if legislative intent is unknown or ambiguous as to a particular transaction—which, given the novelty of many tax-avoidance transactions, may occur frequently.²⁶ Thus, the proposed H-S ESD would expressly function as a proxy for legislative intent in determining the final tax consequences of a suspect transaction.²⁷ Using H-S to frame such a proxy has the benefit of using a principle widely incorporated throughout the tax system.²⁸

Application of the proposed H-S ESD to five case studies²⁹ suggests two additional possible benefits of thinking about tax-avoidance transactions in terms of H-S: it may help delineate the boundaries of the ESD's applicability to suspect transactions, and it may help explain the outcomes of ESD cases. Given the immense literature on the ESD, any explanatory potential of H-S

a meaningful change in the taxpayer's economic position, is not a radical change at all, even if it imposes a more rigorous standard than some of the decided cases have applied").

23. See *id.* at 1725-26.

24. See discussion *infra* Part IV.A.

25. This Article does not purport to address the theoretical uncertainty surrounding an interpretive framework for tax law. See Galle, *supra* note 14. In delineating a possible use of H-S in re-framing the ESD, this Article generally assumes that the ground has been cleared through the necessary legislative intent determinations. This Article also assumes that proxies for legislative intent are a practical necessity. *But cf.* Lederman, *supra* note 2, at 396-97 ("The dividing line is whether Congress intended to provide the claimed benefit or not. While not necessarily an easy question to answer, it is the question that distinguishes abusive transactions from appropriate ones. Any other test is simply a proxy for that inquiry.").

26. *Cf.* Lederman, *supra* note 2 (Part I discusses legislative intent; Part II C. discusses complexity of transaction in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978)); Hariton, *When and How*, *supra* note 27, at 30-31 (arguing that economic substance doctrine does not adequately address tax shelters).

27. *Cf.*, Lederman, *supra* note 2 (discussing the importance of legislative intent); David P. Hariton, *When and How Should the Economic Substance Doctrine Be Applied?*, 60 TAX L. REV. 29, 30-31 (2007)[hereinafter Hariton, *When and How*] (discussing intent).

28. See discussion *infra* Part IV.B.

29. See *Knetsch v. United States*, 364 U.S. 361 (1960); *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006); *ACM P'ship v. Comm'r*, 157 F.3d 231 (3d Cir. 1998); *United Parcel Serv. of Am., Inc. v. Comm'r*, 254 F.3d 1014 (11th Cir. 2001); *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 1999).

in this area could be of greater ultimate significance than whether the proposed H-S ESD were actually adopted.³⁰

These possible benefits appear to be tied to H-S's inherent limitations. H-S, for example, is silent about important structural issues such as taxpayer identity and tax rates.³¹ Further, the tax law frequently and intentionally departs from H-S; a handful of these intentional departures are likely necessary in order to have an administrable tax system.³² Tax-avoidance techniques regularly make use of H-S discontinuities—whether structural gaps or deliberate departures—to generate or shift tax benefits.³³ This Article's case study analysis suggests that government success in using the ESD may correspond to the ease with which an H-S result can be determined with respect to a transaction. H-S may exert an unconscious influence over courts when they apply the ESD, or there may be traits or goals common to both H-S and the ESD. The proposed H-S ESD would formalize and emphasize a relationship between H-S and the ESD.

The remainder of this Article is structured as follows: Part II provides an overview of the ESD and of the controversies surrounding it. Part III discusses H-S in greater detail and begins the exploration into the use of H-S to re-frame the ESD. Part IV describes the H-S ESD and discusses the case studies. Part V is the conclusion, including a summary of the case study results.

II. ECONOMIC SUBSTANCE DOCTRINE OVERVIEW

The ESD generally consists of two inquiries — one subjective and the other objective.³⁴ The subjective inquiry looks to taxpayer intent, especially the taxpayer's business purpose for entering the transaction.³⁵ The objective inquiry analyzes whether the suspect transaction had an economic reality apart

30. Since the ESD Code section specifies that whether the ESD "is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted," study of when and how courts have used ESD is of obvious importance even after codification. I.R.C. § 7701(o)(5) (2006 & Supp. 2010). While the recent codification of the ESD admittedly lowers the likelihood of adoption of the H-S ESD, H-S could potentially serve a role in crafting interpretive regulations of the codified ESD (though discussion of such a role is outside the scope of this Article).

31. See, e.g., STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 4 (Harv. Univ. Press 1985) (explaining that H-S does not specify the taxable unit or rate schedule).

32. See discussion *infra* Part III.B.

33. With thanks to Larry Lokken for this insight.

34. See Luke, *Risk Return*, *supra* note 7, at 784.

35. See *id.* at 787.

from producing tax benefits.³⁶ The doctrine has generated an extensive amount of discussion and disagreement.³⁷ It was also the subject of numerous codification proposals³⁸ before it was finally codified on March 30, 2010.³⁹

36. See *id.*; see also I.R.C. § 7701(o)(1)(A) (2006 & Supp. 2010) (requiring "meaningful" change in "taxpayer's economic position").

37. See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5 (2000); Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939 (2005); Galle, *supra* note 14, at 357-61; Hariton, *When and How*, *supra* note 27; David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 TAX LAW. 235 (1999) [hereinafter Hariton, *Sorting Out*]; Yoram Keinan, *The Economic Substance Doctrine*, TAX MGMT. PORTFOLIOS (2007); Lederman, *supra* note 2, at 391-92; Luke, *Risk Return*, *supra* note 7, at 793 n.30; Martin J. McMahon, Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters*, 94 TAX NOTES 1017 (2002) [hereinafter McMahon, *Economic Substance*]; Martin J. McMahon, Jr., *Business Purpose: Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code*, 54 SMU L. REV. 195 (2001).

38. See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (codified as amended in scattered sections of 26 U.S.C. (2010)); American Workers, State, and Business Relief Act of 2010, H.R. 4213, 111th Cong. § 421 (2010); Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018, 111th Cong. §§ 411-413 (2010); to amend the Internal Revenue Code of 1986 to provide a temporary payroll increase tax credit for certain employers, S. 2955, 111th Cong. §§ 231-233 (2010); Responsible Fatherhood and Healthy Families Act of 2009, S. 1309, 111th Cong. § 202 (2009); Julia Carson Responsible Fatherhood and Healthy Families Act of 2009, H.R. 2979, 111th Cong. § 204 (2009); Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. § 401 (2009); Stop Tax Haven Abuse Act, S. 506, 111th Cong. § 401 (2009); James Zadroga 9/11 Health and Compensation Act of 2008, H.R. 7174, 110th Cong. § 301 (2008); Universal Homeowner Tax Cut Act of 2008, H.R. 5790, 110th Cong. § 211 (2008); AMT Relief Act of 2007, H.R. 4351, 110th Cong. § 211 (2007); Heartland, Habitat, Harvest, and Horticulture Act of 2007, S. 2242, 110th Cong. § 511 (2007); Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3501 (2007); Responsible Fatherhood and Healthy Families Act of 2007, H.R. 3395, 110th Cong. § 204 (2007); Responsible Fatherhood and Healthy Families Act of 2007, S. 1626, 110th Cong. § 204 (2007); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007, H.R. 2345, 110th Cong. § 101 (2007); Stop Tax Haven Abuse Act, H.R. 2136, 110th Cong. § 401 (2007); Stop Tax Haven Abuse Act, S. 681, 110th Cong. § 401 (2007); Export Products Not Jobs Act, S. 96, 110th Cong. § 201 (2007); Nonitemizer Real Property Tax Deduction Act of 2006, S. 3738, 109th Cong. § 3 (2006); Telephone Excise Tax Repeal Act of 2005, S. 1321, 109th Cong. § 801 (2005); Tax Relief Act of 2005, S. 2020, 109th Cong. § 511 (2005); Tax Shelter Transparency and Enforcement Act, S. 1937, 108th Cong. § 101 (2003); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 401 (2003); Rebuild America Act of 2003, S. 1409, 108th Cong. § 1101 (2003); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, H.R. 1555, 108th Cong. § 101 (2003); CARE Act of 2003, S. 476, 108th Cong. § 701 (2003); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.A. (West 2010)); American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. § 101 (2002); Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong. § 101 (2001); see also Small Business Tax Relief Act of 2000, H.R. 3874, 106th Cong. § 266 (2000) (not dealing directly with economic substance but clear predecessor to such proposals); Abusive Tax Shelter Shutdown Act of 1999, H.R. 2255, 106th Cong. § 2(b) (1999)(same); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (codified as amended in scattered sections of 26 U.S.C. (2010)) (dealing with treatment of prohibited tax shelter transactions).

39. See I.R.C. § 7701(o).

Putting to one side the benefits or detriments of codification,⁴⁰ the ESD commentary can be roughly divided into (1) writing that assumes or advocates the continuance of ESD and analyzes specific aspects of the doctrine and (2) writing that considers more generally the ESD's role in tax litigation and tax policy. This Part provides an overview of the ESD in conjunction with a discussion of the primary issues identified in both categories of writings.

A. *Stakes*

The ESD generally has all-or-nothing consequences for the taxpayer. Thus, if the transaction survives application of the ESD, the claimed tax benefits survive (although, of course, nothing prevents some other test from toppling them).⁴¹ If the transaction fails application of the ESD, the transaction is treated as a substantive sham — that is, as though it did not occur in the first place.⁴² Codification of the ESD does not change this approach.⁴³ The all-or-nothing consequences raise the stakes in the ongoing debate over particulars of the ESD. As will be

40. For a sampling of the discussion specific to the codification of the ESD, see April, *supra* note 14; Jeremiah Coder, *Korb Again Condemns Idea of Codifying Economic Substance Doctrine*, TAX NOTES TODAY, Oct. 29, 2007, available at 2007 TNT 209-6 (LEXIS); Galle, *supra* note 14, at 387-402; David P. Hariton, *Economic Substance Complaint No. 1: "Too Vague and Too Broad,"* TAX NOTES TODAY, Oct. 1, 2002, available at 2002 TNT 190-30 (LEXIS); New York State Bar Association Tax Section, *Comments on Pending Tax Shelter Legislation*, TAX NOTES TODAY, Oct. 8, 2002, available at 2002 TNT 195-89 (LEXIS); ABA Section on Taxation, *ABA Tax Section Comments on Codification of Economic Substance Doctrine*, TAX NOTES TODAY, Apr. 13, 2007, available at 2007 TNT 72-22 (LEXIS); Lee A. Sheppard, *News Analysis: Economic Substance Codification Coming*, TAX NOTES TODAY, Oct. 10, 2007, available at 2007 TNT 196-3 (LEXIS); Mark J. Silverman et al., *The Case Against Economic Substance Codification*, TAX NOTES TODAY, July 20, 2004, available at 2004 TNT 139-43 (LEXIS); Lawrence M. Stone, *Congress Should Codify Economic Substance*, TAX NOTES TODAY, Nov. 19, 2002, available at 2002 TNT 223-23 (LEXIS); Samuel C. Thompson, Jr., *Despite Widespread Opposition, Congress Should Codify the Economic Substance Doctrine*, TAX NOTES TODAY, Feb. 14, 2006, available at 2006 TNT 30-38 (LEXIS); and Bernard Wolfman, *Why Economic Substance is Better Left Uncodified*, TAX NOTES TODAY, July 27, 2004, available at 2004 TNT 144-36 (LEXIS).

41. *Cf. Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991) (holding that a transaction was materially different and thus allowed the tax benefits to survive).

42. See *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 549 (5th Cir. 2009) ("[T]he effect of disregarding a transaction for lack of economic substance is that, for taxation purposes, the transaction is viewed to have never occurred at all."). It may be possible for a loan to be disaggregated from the suspect transaction, thus allowing some interest deductions. See *Rice's Toyota World, Inc., v. Comm'r*, 752 F.2d 89, 95-96 (4th Cir. 1985) (allowing taxpayer to deduct interest on a recourse not because "a sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded"). See McMahon, *Economic Substance*, *supra* note 37, at 1020-21 n.15 (discussing *Rice's Toyota World*).

43. See I.R.C. § 7701(o)(5)(A) (defining the ESD as the "common law doctrine under which tax benefits . . . are not allowable" if the transaction fails the test).

discussed below, these consequences serve to emphasize the artificiality of setting an acceptable amount of pre-tax profit that will transform a suspect transaction into an allowed or disallowed transaction. The all-or-nothing ESD approach also provides an incentive to taxpayers to tweak aspects of a particular transaction so as to move it from failure to passing.⁴⁴ The proposed H-S ESD would tax a suspect transaction using H-S principles rather than treating the transaction as a substantive sham.

B. *Subjective Inquiry*

The subjective prong of the doctrine is a business purpose test.⁴⁵ The test is aimed at investigating a taxpayer's non-tax reasons for entering into the suspect transaction.⁴⁶ It frequently becomes a test about taxpayer motive⁴⁷ — about why the taxpayer did what it did. Of course, even if determination of that

44. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 262 (3rd Cir. 1998) (discussing how a transaction that was not intended to serve business purposes may still give rise to a deduction if it has an objective economic consequence).

45. See I.R.C. § 7701(o)(1)(B) (requiring taxpayer to have a "substantial purpose (apart from Federal income tax effects) for entering into such a transaction"); Bankman, *supra* note 37, at 27 (explaining that subjective prong is "sometimes simply referred to as the business purpose requirement").

Business purpose traces its historical roots to the *Gregory* decision, which denied the taxpayer the benefits of a reorganization undertaken for tax reasons. See *Gregory v. Helvering*, 293 U.S. 465 (1935). The Supreme Court purported, however, to reach its decision without regard to taxpayer motive: "But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 469. Thus, it is fair to say that the appellate and Supreme Court decisions in *Gregory* only built a business purpose requirement with respect to reorganizations. See *id.* at 467. Because the *Gregory* business purpose was reorganization specific, the case had sometimes been raised to support the notion that a more generalized business purpose requirement was not supported by the Code. See Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L. J. 440, 446 (1968) ("Hand's approach, which the Supreme Court adopted . . . was thus merely to interpret the language of the statute; that is, to construe . . . the definition of a 'reorganization' whose meaning had theretofore been obscure."); Lederman, *supra* note 2, at 419 (explaining that Learned Hand required that "the form in which the transaction was carried out—had to be germane to the business of one corporation or the other" and that both the Supreme Court and Judge Hand "found that Congress implicitly required a business purpose to qualify under the reorganization statute in issue").

The newly codified ESD provision, of course, now provides express legislative approval of such a requirement. See I.R.C. § 7701(o)(1)(B). It also applies to an individual "only [as] to transactions entered into in connection with a trade or business or an activity engaged in for the production of income." *Id.* § 7701(o)(5)(B).

46. See Bankman, *supra* note 37, at 27 ("The subjective leg of the economic substance doctrine looks to the taxpayer's expectations and motives . . .").

47. See Walter J. Blum, *Motive, Intent, and Purpose in Federal Income Taxation*, 34 U. CHI. L. REV. 485 (1967) (discussing the extent to which differences in meaning between "motive," "intent," and "purpose" matter in the tax law).

motive is in some sense "subjective" it must be determined through objective analysis of the evidence.⁴⁸ The evidence may include internal memoranda, meeting minutes, and e-mails.⁴⁹ It will also include affidavits or other statements.⁵⁰ Post-audit statements regarding non-tax motive will be viewed with greater skepticism than contemporaneous evidence.⁵¹ Consideration will also be given to whether the taxpayer's stated motive was supported by the facts of the transaction.⁵² For example, if the taxpayer asserts that its non-tax purpose was to make a pre-tax profit, but objective analysis of the facts demonstrates that such a profit was impossible, the court should find that the taxpayer lacked the requisite non-tax purpose.⁵³

Taxpayers are, of course, well aware of the business purpose test. A frequent criticism of the subjective prong of the ESD is that its principal effects, both in planning and after an audit, are to give taxpayers incentives to manufacture business purpose, to conceal tax-avoidance motives, and to groom supporting evidentiary trails.⁵⁴

Although anecdotal evidence suggests that taxpayers do engage in such behavior, its full extent remains an open question.⁵⁵ If taxpayers do engage in generating business purpose, whether such a ploy works depends on the perspicacity of the court.⁵⁶ As will be discussed in Part IV, the proposed H-S

48. Bankman, *supra* note 37, at 27 ("The subjective intent or business purpose doctrine must inevitably look to objective indicia of intent . . .").

49. *Id.* at 27 ("The subjective intent or business purpose doctrine must inevitably look to objective indicia of intent: contemporaneous documents, evidence of meetings, and the like."); *Klamath v. United States*, 568 F.3d 537, 545 (5th Cir. 2009).

50. *See Hock v. Comm'r*, 54 T.C.M. (CCH) 406, 412 (1987).

51. *See TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94, 111 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006) ("In evaluating the economic substance of a transaction, courts are cautioned to give more weight to objective facts than self-serving testimony . . . Were the executives' testimony the only evidence before me, I am not sure how persuaded I would be of [the taxpayer's] motives.").

52. *See Klamath*, 568 F.3d at 545 ("The evidence clearly shows that [the taxpayers] designed the loan transactions and the investment strategy so that no reasonable possibility of profit existed and so that the funding amount would create massive tax benefits but would never actually be at risk.").

53. *See id.*

54. *See Bankman*, *supra* note 37, at 27 ("A primary criticism of the business purpose test is that it leads to the creation of false or misleading documents that evidence nontax motives."); *Lederman*, *supra* note 2, at 433 ("[T]axpayers can easily generate evidence of a business purpose, [so] courts should not use it as a test for determining if a transaction is abusive.").

55. *See Bankman*, *supra* note 37, at 28 (discussing "how few steps shelter-participants in litigated cases took to establish nontax motives" and adding that "the creation of a false paper trail [may be] harder than it sounds").

56. In *ACM Partnership v. Commissioner*, 157 F.3d 231 (3rd Cir. 1998), there was a clear attempt to create business purpose. For example, the parent corporation

ESD does maintain a role for business purpose, but one that is anchored to the H-S principle.

C. *Objective Prong*

The objective prong purports to set taxpayer intention aside and to investigate whether the suspect transaction caused any non-tax economic consequences.⁵⁷ Discussion focusing on the objective prong tends to center on measurement questions—specifically what attribute(s) should be measured to determine whether a transaction has an economic reality apart from tax effects and how many of the selected attribute(s) should be sufficient to save a transaction.⁵⁸ By far the most prominent candidate for a testing attribute has been pre-tax profit potential.⁵⁹ Other contenders include the overall risk of the transaction⁶⁰ (including the presence or absence of contingencies) and the normalcy of the transaction in terms of the taxpayer's business.⁶¹

If profit is used in assessing whether the taxpayer experienced economic change, the central issue has been how much profit should be enough to satisfy the objective prong.⁶² Various tests have been put forward, two of which made frequent appearances in ESD legislative proposals. The first would require a minimum threshold of pre-tax profit tied to the

(Colgate-Palmolive) had ACM engage both in a tax shelter transaction and in purchasing some of Colgate-Palmolive's debt in order to "rebalance [Colgate's] debt profile" and make Colgate look less heavily leveraged. *See id.* at 234-35. The courts easily separated the two transactions. *See id.* at 240.

57. The new ESD Code section requires that "the transaction change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position." I.R.C. § 7701(o)(1)(A) (2006 & Supp. 2010).

58. *See* Bankman, *supra* note 37, at 23 (raising questions of "[h]ow much substance is enough? If substance is measured by pretax rate of return, what rate of return is high enough to give a transaction substance?").

59. *See* Michael S. Knoll, *Compaq Redux: Implicit Taxes and The Question of Pre-Tax Profit*, 26 VA. TAX REV. 821, 824 (2007) (noting that the "pre-tax profit test" is "frequently the centerpiece of the objective prong").

60. *See* Hariton, *When and How*, *supra* note 27, at 53-54 (advocating an approach that examines a transaction for "unique economic risk"); Luke, *Risk Return*, *supra* note 7, at 804 (suggesting comparables analysis tied to risk for analyzing return on a suspect transaction); *see also* Knoll, *supra* note 59, at 854-55 (describing the Fifth Circuit's use of risk in the Compaq transaction).

61. *See* Bankman, *supra* note 37, at 17 (discussing court cases suggesting "that transactions tied to ordinary business operations will be favorably treated under the economic substance doctrine").

62. In addition, the use of pre-tax profit as a metric suffers from technical limitations caused by the presence of implicit taxes and implicit subsidies. *See* Charlotte Crane, *Some Explicit Thinking About Implicit Taxes*, 52 SMU L. REV. 339, 350-60 (1999); David A. Weisbach, *Implications of Implicit Taxes*, 52 SMU L. REV. 373, 374-78 (1999); Knoll, *supra* note 59, at 833-38; Luke, *Risk Return*, *supra* note 7, at 793.

risk-free rate of return.⁶³ The second is a more qualitative comparison between the anticipated profits and anticipated tax benefits.⁶⁴ The new ESD Code section takes the latter, qualitative approach.⁶⁵ Although both approaches have pros and cons, it is fair to say that such approaches remain unanchored to any readily stated normative principle.⁶⁶

Even if a transaction generates no actual pre-tax profit, it would be problematic to treat a transaction as automatically failing the objective prong of the ESD. The taxpayer may have entered into an economically substantive transaction that simply failed to produce.⁶⁷ As a result, the pre-tax profit inquiry also generally requires analysis of profit potential.⁶⁸ As will be discussed in Part IV, under the proposed H-S ESD, actual outcomes would determine tax consequences, and profit potential would be implicated only insofar as it related to the taxpayer's business purpose.

Courts do not rely solely on an analysis of pre-tax profit and often review other indicators.⁶⁹ Analysis of such other factors does not appear to be foreclosed by the new ESD Code section, which only provides that if pre-tax potential is used, it must have

63. See Luke, *Risk Return*, *supra* note 7, at 795.

64. See *id.*

65. See I.R.C. § 7701(o)(2)(A) (2006 & Supp. 2010) (Profit potential is only taken into account "if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.").

66. See Knoll, *supra* note 59, at 851-54 (describing various approaches to pre-tax profit); Warren, *supra* note 15, at 987 (describing the "inherent dilemma" in using pretax profit).

In a previous article, this author argued for a market-based approach to the measurement problem and assumed the continued vitality of ESD. See Luke, *Risk Return*, *supra* note 7, at 809. This current Article explores a more fundamental re-framing of the ESD.

67. See Luke, *Risk Return*, *supra* note 7, at 793; *cf.* Hariton, *Sorting Out*, *supra* note 37, at 249 ("[A] taxpayer can derive significant profit from transactions which lack both business purpose and economic substance Indeed, where a tax-motivated transaction takes the form of an investment, the taxpayer can always contribute enough net equity to assure that there will be significant net profit (even after taking transaction costs into account).").

68. See Hariton, *Sorting Out*, *supra* note 37, at 249 ("[T]he potential for meaningful profit correlates with the presence of both business purpose and economic substance."). Of course, if the claimed pre-tax profit potential is illusory given the certainty of loss, the transaction will fail the ESD. See *id.* at 250.

69. See *United Parcel Serv. of America, Inc. v. Comm'r*, 254 F.3d 1014, 1018 (11th Cir. 2001) (discussing how insurance and re-insurance policies reduced but did not "completely foreclose the risk of loss"); *cf.* *TIFD III-E Inc. v. United States*, 342 F. Supp. 2d 94, 109-10 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006) (explaining that the government raised the lack of risk to support their contention that the suspect transaction lacked "economic reality").

a "substantial" relationship to after-tax benefits.⁷⁰ Such other indicators generally include analysis of the risks or contingencies built into the transaction. This risk/contingency analysis becomes a way to authenticate that the transaction actually happened by determining the extent to which the taxpayer's claimed pre-tax profit potential or claimed tax benefits were locked in.⁷¹ Courts may also consider the relationship of the transaction to the taxpayer's regular business activities, and there appears to be a reluctance to treat transactions as economic shams if they have a direct link to day-to-day operations or involve seemingly neutral third parties.⁷² Under the proposed H-S ESD, consideration of such relationships would be a factor in assessing business purpose, but the transaction would ultimately be taxed using H-S principles.⁷³

D. *Relationship of the Inquiries*

Whether the two inquiries of the ESD should operate conjunctively, disjunctively, or as mere components of a unitary purposive test had also generated some discussion and variance in the court opinions.⁷⁴ Most commonly, however, courts required taxpayers to satisfy both inquiries in order to have transactions respected,⁷⁵ and that is the approach taken in the codified ESD.⁷⁶

70. See I.R.C. § 7701(o)(2)(A).

71. See Knoll, *supra* note 59, at 855 ("If a transaction yields an expected before-tax loss, then the taxpayer, by eliminating all risk, ensures that it will suffer a before-tax loss. In that case, the taxpayer's risk reduction activities strengthen the government's argument Conversely, if a transaction yields a before-tax profit, then by eliminating risk the taxpayer ensures that it will enjoy a before-tax profit.")

72. See *United Parcel Serv.*, 254 F.3d at 1019 ("[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."); see also Lederman, *supra* note 2, at 401 (noting that courts are unlikely to use the ESD to disregard transactions "that are integrated into taxpayer's business").

73. Compare I.R.C. § 7701(o), which takes an all-or-nothing approach. See *supra* notes 43-44 and accompanying text.

74. See Bankman, *supra* note 37, at 26 ("[C]ourts have also stated that a transaction that has objective economic substance will be respected for tax purposes, regardless of the taxpayer's motivation. Courts are split as to whether a transaction that has subjective but not objective economic substance should be respected for tax purposes."); see also Galle, *supra* note 14, at 388 (noting continuing debate over relationship of the ESD components).

75. See Knoll, *supra* note 59, at 824 (noting that ESD is usually stated in its conjunctive form).

76. See I.R.C. § 7701(o)(1).

E. *ESD's Role in Tax Shelter Litigation*

Use of the term "tax shelter" to label tax-reduction techniques is commonplace, but there is widespread disagreement about what type of transaction should be tarnished with the tax shelter brush and what consequences should follow from such a designation.⁷⁷

The ESD as a whole has been susceptible to the argument that "tax shelter" must be defined before the ESD can be reformed.⁷⁸ This susceptibility arises primarily because the ESD remains unanchored to a normative framework and thus, arguably, the ESD can be expanded or narrowed to reflect one's view about what should constitute a tax shelter.⁷⁹ Codification of the ESD seems unlikely to significantly resolve this problem since the provision operates primarily by incorporating the common law ESD.⁸⁰ Although this Article agrees that the ESD remains in need of an anchor, tying the ESD to a normative "tax shelter" concept could have the ancillary consequence of legitimizing tax-reduction techniques missed by the ESD.⁸¹ That is, an ESD so closely aligned with "tax shelters" could create the presumption that any transactions missed by such a tax-shelter ESD must be respected by the courts.⁸²

The very real possibility of missing problematic transactions through defining "tax shelter" and then anchoring the ESD to that definition makes obvious the central problem of such an approach. It is premised on the notion that it is possible to come up with an essentialist definition of "tax shelter" even though the underlying landscape is constantly shifting.⁸³ On the other hand, if one is content with a more pragmatic approach, "tax shelter"

77. See Lederman, *supra* note 2, at 398-400 (describing "extensive discussion" on term "tax shelter" and explaining that "not everyone agrees on what known transactions should be contained within the scope of the term").

78. Cf. David P. Hariton, *How to Define 'Corporate Tax Shelter'*, 84 TAX NOTES 883, 883-84 (1999) [hereinafter Hariton, *How to Define*] (arguing in response to various "proposals for dealing with corporate tax shelters" that "[b]efore we can do anything constructive about corporate tax shelters . . . we must reach some general consensus regarding the kinds of transactions we are trying to stop").

79. See generally *id.* at 883 (describing how tax shelter may be broadly or narrowly defined).

80. See I.R.C. § 7701(o)(5)(A), (C) (defining the ESD in terms of the common law and failing to specify when the ESD should be considered relevant).

81. See Lederman, *supra* note 2, at 399-400 (arguing that "the judicial tools used in response to abusive transactions should not be limited to the tax shelter context" since "[t]he government has a legitimate interest in fighting all abusive tax behavior").

82. See *id.*

83. See *id.* at 400 (arguing "the form that tax shelters take may change over time, making the tax-shelter determination a moving target").

may be defined as whatever Congress, or its surrogate, identifies as such.⁸⁴

Congress, of course, is no more capable of addressing every transactional permutation in advance⁸⁵ than a tax shelter definition would be.⁸⁶ Thus, a pragmatic approach requires accepting that other government actors have an expansive ability to generate proxies for and guesses about congressional action and intent. This ability consists of intricate delegations of interpretive and decisional authority to agencies and to courts,⁸⁷ and this delegation is followed by the opportunity for Congress to refine or reject Code interpretations advanced by other governmental actors.⁸⁸ Even if it were not clear before codification of the ESD, the addition of the ESD to the Code has made clear that administrative agencies and courts are authorized by Congress to invoke the doctrine.⁸⁹

Even less stringent criticisms of the ESD reflect the notion that the ESD is not a sufficiently refined mechanism for determining legislative intent.⁹⁰ While codification has put to

84. Cf. Hariton, *When and How*, *supra* note 27, at 37 ("The hardest job a court has in the case of a tax-motivated transaction that lacks business purpose and economic substance is determining whether the purported tax results of the transaction are reasonably consistent with congressional intent.").

85. See Hariton, *Sorting Out*, *supra* note 37, at 237 ("No agency can foresee, let alone draft, rules to govern coherently every conceivable permutation of facts and circumstances in an increasingly complex business world.").

86. See Zelenak, *supra* note 14, at 634-35. For example, it raises the conundrum of how to determine legislative intent with respect to a transaction that had not even been invented at the time Congress enacted the provisions claimed by a taxpayer to govern such transaction. See *id.*

87. See Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131, 135 (2001) ("The courts and the Treasury have long played a significant role in making tax law, with Congress' acquiescence."); McMahon, *Economic Substance*, *supra* note 37, at 1025 ("[E]nforcement through litigation always will focus on interpreting the code and regulations consistently with the expressed policy of Congress, and when that policy is not explicitly expressed, consistently with the policy underpinnings of the statutory pattern."); see also *supra* notes 14, 18 and accompanying text (arguing how the agencies and courts should determine legislative intent is a problem in its own right); Zelenak, *supra* note 14, at 634 (noting although "[t]he weight of judicial authority favors an intent-based theory of interpretation," there are "logical difficulties" with such a position). The discussion in the main text assumes an interpretive theory grounded in legislative intent, but, of course, interpretive theories may also be more focused on audience. See *id.* at 635-36 (contrasting legislative intent approaches with reader-focused approaches).

88. See Bankman, *supra* note 37, at 11 ("A related, though somewhat stronger, claim is that the legislature assumes that long-standing common law doctrines such as economic substance will be used to interpret the statutes it enacts.").

89. See I.R.C. § 7701(o) (2006 & Supp. 2010) (dictating the circumstances in which a transaction will be treated as having "economic substance").

90. See Lederman, *supra* note 2, at 396-97 ("The dividing line is whether Congress intended to provide the claimed benefit or not. While not necessarily an easy question to

rest the notion that Congress does not approve the use of the ESD, the new Code provision is fairly skeletal. Indeed, it defines the economic substance doctrine in terms of the common law doctrine.⁹¹ As a result, courts will continue to be required to make at least two determinations related to legislative intent: (1) that there is legislative ambiguity or silence about the taxpayer's claimed application of the tax law; and (2) that the ESD is an appropriate tool for resolving that ambiguity or silence.⁹²

Courts have often applied the ESD without voicing consideration as to the ESD's status as a proxy for legislative intent. This practice seems unlikely to change since the new Code section specifies that the relevance of the ESD is determined "in the same manner as if" the Code section "had never been enacted."⁹³ Prior to codification, courts made a (usually) tacit decision that government litigators had appropriately raised the ESD, perhaps because the taxpayer had engaged in an unusual series of steps yielding a substantial tax benefit.⁹⁴ The ESD has then been applied, and passage or failure yielded an all-or-nothing tax consequence to the taxpayer.⁹⁵ The result then served effectively to confirm or disaffirm the appropriateness of using the ESD in the first place.⁹⁶

Thus, even though the ESD has functionally served to determine legislative intent with respect to a particular transaction,⁹⁷ the process by which it does so has been only loosely tied to any formal method for making such a

answer, it is the question that distinguishes abusive transactions from appropriate ones.").

91. See I.R.C. § 7701(o)(5)(A) ("The term 'economic substance doctrine' means 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.").

92. See, e.g., Bankman, *supra* note 37, at 11-12 (arguing "that a transaction that is clearly supported by the text, intent, and purpose . . . will withstand judicial scrutiny regardless of whether it otherwise meets the economic substance test.").

93. See I.R.C. § 7701(o)(5)(C).

94. See Luke, *Risk Return*, *supra* note 7, at 787 (explaining that the ESD is generally invoked when "the specific result of the transaction . . . is unlikely to have been foreseen by Congress or regulators"); McMahon, *Economic Substance*, *supra* note 37, at 1018 ("Tax shelter transactions generally take advantage of the combination and interaction of several different, often seemingly unrelated, highly specific rules.").

95. See, e.g., Bankman, *supra* note 37, at 10 (stating the ESD has been applied "to deny interest deductions on corporate-owned life insurance (COLI) to Winn-Dixie Stores, to deny foreign tax credits to Compaq Computer").

96. See *id.* at 11-12 (implying that application of ESD can be challenged through statute).

97. See *id.* at 11 ("The economic substance doctrine, like the other common law tax doctrines, can thus perhaps best be thought of as a method of statutory interpretation.").

determination.⁹⁸ Codification has solved only the more general issue of whether the courts could use the ESD to set aside a transaction; it leaves unresolved most of the important questions surrounding when and how the ESD should be applied to evaluate a transaction purportedly governed by a specific set of tax rules. Of course, taxpayers have a tremendous incentive to argue that Congress intended them to have benefit of the claimed authorities,⁹⁹ and thus, a court's failure to address specifically the question of legislative intent as to a particular set of tax rules may have little effect on the outcome.¹⁰⁰

An examination of legislative intent also requires a determination that the ESD rather than another common law tool should be utilized.¹⁰¹ Here, again, court cases fail to provide meaningful guidance regarding how the ESD fits with other judicial tools that similarly function independently of a particular Code provision.¹⁰²

These tools include the step-transaction doctrine and other permutations of the substance-over-form doctrine.¹⁰³ In practice,

98. *See id.* ("It is in one sense odd to think of the economic substance doctrine as an interpretive method. This is because the doctrine is only loosely connected to more conventional interpretive techniques or approaches."); Hariton, *When and How*, *supra* note 27, at 38-39 (describing failures of courts to address congressional intent directly in economic substance cases).

99. *See* Bankman, *supra* note 37, at 11 ("A transaction attacked through the economic substance doctrine will invariably be defended on the grounds that the transaction is supported by the statute's text, and generally by some combination of intent and purpose as well.").

100. *See id.*

101. *See id.* at 12 (listing other alternate common law doctrines).

102. The decision in *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D. N.J. 2009), is illustrative. The court determined that disregarding the taxpayer's transaction was appropriate under each of three approaches: substance-over-form analysis, the economic substance doctrine, and direct inquiry into congressional intent. *Id.* at 223. But the court failed to explain why each approach was considered or how the approaches related to each other. *See* Mark J. Silverman & Amanda P. Varma, *The Future of Tax Planning from Coltec to Schering-Plough*, 126 TAX NOTES 341, 342 (2010) (describing court's analysis in *Schering-Plough* as "fundamentally flawed" and criticizing it for engaging in inquiries in addition to its general substance-over-form analysis); *see also* Jasper L. Cummings, Jr., *The New Normal: Economic Substance Doctrine First*, 126 TAX NOTES 521, 521 (2010) (arguing that IRS fail to press grounds other than the ESD and that courts tend to go along with the IRS). The new ESD Code provision does not address the ESD's relationship to other common law doctrines. Prior versions specified that codified ESD "shall not be construed as altering or supplanting any other rule of law." Reconciliation Act of 2010, H.R. 4872, 111th Cong. § 452 (2010) (in a subsection titled "other common law doctrines not affected").

103. *See* Yoram Keinan, *Rethinking the Role of the Judicial Step Transaction Principle and a Proposal for Codification*, 22 AKRON TAX J. 45, 45 (2007) [hereinafter Keinan, *Rethinking the Role*] (discussing step transaction doctrine as well as other "common law" doctrines, such as substance over form . . . sham transaction, and economic substance"); Luke, *Risk Return*, *supra* note 7, at 788-90 (discussing general substance-over-form analysis).

however, courts consider these doctrines in tandem with the ESD and have used them to deny claimed tax benefits as to transactions when application of the ESD was problematic.¹⁰⁴

Predictably, the common law ESD's loose relationship to legislative intent occasionally gave rise to indignation about judicial over-reaching and overt advocacy for a stricter textualist approach to the tax law.¹⁰⁵ Such textualist arguments for abolishment often had a strong tax-protester flavor¹⁰⁶ and should be put to rest by codification of the ESD. More interesting are arguments calling for rejection of the ESD on other grounds.¹⁰⁷ Professors Chirelstein & Zelenak argue that the current approach to tax shelter litigation, including the ESD, causes the government to "always be playing catch up."¹⁰⁸ They have advocated codification of a "hindsight rule" that "would flatly disallow noneconomic losses and noneconomic deferrals through the use of foreign (and other tax-indifferent) counterparties."¹⁰⁹ As will be discussed in Part IV, this Article suggests a result that shares much in common with their proposal. The proposed H-S ESD is also based on outcomes and requires that tax losses be supported by actual economic losses.¹¹⁰ This Article's proposal, however, continues to envision a role for business purpose as anchored by the H-S concept.

Professor Lederman has recently argued that the ESD is an unnecessary, incoherent middleman, and she argues that the courts should instead ask directly about legislative intent rather than rely on proxies; however, she also recognizes the need to

104. See *infra* Part IV.C.4 (discussing the appellate decision in *Castle Harbour*); Bankman, *supra* note 37, at 12 (noting that the common law doctrines overlap and reinforce one another).

105. See Galle, *supra* note 14, at 366-70 (discussing the "textualist challenge to economic substance").

106. See Gergen, *supra* note 87, at 135 (describing argument that the IRS should "look to Congress and not to the courts" as "frivolous at this level of generality"); see, e.g., Hariton, *Sorting Out*, *supra* note 37, at 238 (differentiating proponents of an objective determination of tax liability from "practitioners [who support] . . . a judicious sprinkling of standards throughout a fundamentally objective set of statutes and regulations").

107. See, e.g., Chirelstein & Zelenak, *supra* note 37, at 1962 ("[T]he economic substance doctrine is simply too weak a barrier to protect the collection of income tax from assault by abusive shelter planners."); Lederman, *supra* note 2, at 442 ("Although courts often use the current economic substance doctrine to reach appropriate outcomes—disallowance of tax benefits claimed in abusive transactions—the doctrine has evolved into one that asks the wrong questions and is easily manipulated.").

108. Chirelstein & Zelenak, *supra* note 37, at 1951.

109. See *id.* at 1952. For a more thorough discussion of the approach advocated by Professor Chirelstein and Professor Zelenak, see Galle, *supra* note 14, at 370.

110. Cf. Hariton, *How to Define*, *supra* note 78, at 889 (explaining that the "very essence of a tax shelter" is to create a transaction that "result[s] in relatively little change in the taxpayer's economic position").

develop a framework for ascertaining legislative intent.¹¹¹ The proposed H-S ESD similarly requires development of such a theoretical framework for its implementation,¹¹² but because the proposed H-S ESD would require a fresh determination of a transaction's tax consequences, that need should become more apparent. Although development of such a theoretical framework is outside the scope of this Article, the proposed H-S ESD would function as the final step in such a framework because it would apply after a determination that legislative intent did not support (or was ambiguous or silent as to) the tax rules utilized in a suspect transaction. The proposed H-S ESD would, thus, function as a proxy for legislative intent, but it would be tied to a well-established principle.

III. THE HAIG-SIMONS PRINCIPLE

This Part provides an overview of the Haig-Simons (H-S) concept. In spite of its widespread influence on tax law, it is fair to say that no two writers interpreting the H-S will explain it in precisely the same manner.¹¹³ Further, some notable tax authors have argued that the H-S is so subjective and ambiguous as to be practically meaningless.¹¹⁴ Clearly, a question as open-ended as "What would Henry Simons do?" can be answered in multiple ways.¹¹⁵ In this Article, the H-S is presented as a pragmatic principle¹¹⁶ that is anchored to the ability-to-pay concept of

111. See Lederman, *supra* note 2, at 442-44.

112. See *supra* notes 14 and 30 and accompanying text.

113. See Boris Bittker, *Income Tax Deductions, Credits, and Subsidies for Personal Expenditures*, 16 J.L. & ECON. 193, 197-98 (1973) [hereinafter Bittker, *Income Tax Deductions*] ("[T]erms like 'income' and 'consumption' are irretrievably ambiguous.").

114. See *id.*; see also Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389, 1404 (2004) ("[F]or as long as the Haig-Simons idea has been in existence, academic theorists have been debating whether it serves as a useful guidepost in formulating concrete tax-reform proposals."); Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 46 (1990) ("Despite its wide acceptance, Haig-Simons income remains elusive and ambiguous . . . [S]ome writers have questioned whether the Haig-Simons formulation is, at base, a coherent one.").

115. See Thuronyi, *supra* note 114, at 55 ("[T]here could be as many ideas as to what income is as there are people to make the judgment, perhaps more.").

116. See Haig, *supra* note 3, at 76 ("The definition [of income] must be broad enough to iron out all the theoretical difficulties and solve all of the inequities and anomalies. The situation should be held in a mobile, flexible state which will permit the statutory definition of income to become progressively more precise and accurate with the improvement of the technique of our economic environment."); see also Thuronyi, *supra* note 114, at 61 ("Income is not an 'elegant' concept. It is by its nature highly practical, flexible, and ad hoc.").

fairness.¹¹⁷ While the account of the H-S principle presented in this Article will undoubtedly not be accepted by all readers, it is anticipated that this Article's version is sufficiently mainstream so as to render meaningful this Article's conclusions.

A. *Overview*

The most famous H-S definition is the one authored by Henry Simons:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning.¹¹⁸

Simons' definition should not (and cannot) be taken at face value. The H-S definition, as is implicit in Simons' own explanation, is not intended simply as a positive description of income but as a normative principle requiring implementation of conforming standards and rules.¹¹⁹

117. See J. Clifton Fleming, Jr. & Robert J. Peroni, *Reinvigorating Tax Expenditure Analysis and Its International Dimension*, 27 VA. TAX REV. 437, 457 (2008) ("Obviously, [H-S] is a way of describing an individual's taxpaying ability. Thus, [H-S] is generally understood to be based on the ability-to-pay principle and as a formula for implementing that principle."); Haig, *supra* note 3, at 75 ("It is very undesirable from the point of view of economics and equity that the judicial definition of income should develop along narrow lines . . ."); R.A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 48 (1967) ("The defense for the accretion plus consumption concept as an index of equality must rest on its superiority as an equity concept, not as a tool of economic theory."); Thuronyi, *supra* note 114, at 49 ("A careful reading of Simons suggests, however, that he did intend his definition to flow, at least in part, from judgments about tax equity."); see also SURREY & MCDANIEL, *supra* note 31, at 72 ("[T]he overwhelming majority of tax expenditure programs disproportionately benefit the upper-income groups. Not only are the tax expenditure provisions the primary cause of perceived tax inequity, but it also seems safe to say that they fail to achieve what most Americans would perceive to be a fair distribution of funds . . .").

118. SIMONS, *supra* note 3, at 50; see also Haig, *supra* note 3, at 75 ("The formal definition of *economic income*, which . . . provides the most acceptable concept of income, may be stated as follows: *Income is the money-value of the net accretion to economic power between two points of time.*").

119. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559-60 (1992) (explaining that the primary difference between the two is the degree of *ex ante* certainty); Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 723 (1990) ("The definition of a tax base developed by Haig and refined by Simons has become the normative standard for evaluating income tax rules."); Musgrave, *supra* note 117, at 47 ("Professor Bittker's impression that the

A simple example illustrates the basic contours of Simons' definition. Assume that during a particular tax period Jane wins \$100,000 of cash on a game show, spends \$50,000 of it on a luxury vacation, and saves \$50,000 of it. Assuming she has no other receipts or outlays, Jane would have to pay tax on \$100,000. To put it in more formal H-S terms, Jane would have \$50,000 of consumption and \$50,000 of increased wealth.

At one point in time, however, the tax consequences to Jane would not have been so clear.¹²⁰ In the early years of the income tax, it was debated whether nonrecurring windfalls should be treated differently from regularly recurring earned income.¹²¹ This notion was attacked by the contributors to H-S,¹²² and case law gradually foreclosed any possibility of a windfall exclusion.¹²³

advocates of the comprehensive base waver between various income concepts—including aggregate gross income minus certain expenses, personal income as defined by the Department of Commerce, as well as the accretion concept—is mistaken. As the literature clearly shows, it is the accretion concept which people have in mind, and not the other two, which have no normative value.”)

120. See *Robertson v. United States*, 93 F. Supp. 660, 664 (D. Utah 1950) (excluding prize from income), *rev'd*, 190 F.2d 680 (10th Cir. 1951), *aff'd*, 343 U.S. 711 (1952).

121. See Haig, *supra* note 3, at 69 (“[O]ne must go back as far as the fifteenth century, when, with an agricultural society where few fortuitous gains developed, the idea of receipts as being annual in character became deeply impressed upon the minds of the people. It became the habit to think of one's regular receipts as his income, and to consider irregular receipts as additions to capital.”).

122. See SIMONS, *supra* note 3, at 74-79 (explaining that Schanz “quite thoroughly” criticized the recurrence criterion and stating that “[t]he quite arbitrary character of the criterion of recurrence hardly merits further comment”).

The recurrence criterion and other closely related criteria were, of course, not the only concept of income that circulated and that was rejected by H-S. Henry Simons, for example, devoted an entire chapter to the subject “Other Definitions and Their Limitations.” See *id.* at 59-102; see also Richard Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1, 3-7 (Joseph A. Pechman ed., 1977) (describing other proposed income definitions); Koppelman, *supra* note 3, at 683-84.

The recurrence criterion is, however, arguably the only income concept other than H-S to be litigated and to still have a foothold in the Code, as evidenced by the exclusion from income of certain types of windfalls (e.g., life insurance proceeds, bequests). See Joseph M. Dodge, *The Story of Glenshaw Glass: Towards a Modern Concept of Gross Income*, in TAX STORIES 17, 34-36 (Paul L. Caron ed., 2d ed. 2009) [hereinafter Dodge, *Glenshaw Glass*] (explaining that this “theory of capital and income left behind some residue that has persisted to the present day”).

123. See Dodge, *Glenshaw Glass*, *supra* note 122, at 34-35 (describing case law and stating “upon reflection it is evident that any exclusion for non-recurring receipts would be antithetical to rational and even-handed administration by the Service and the courts”).

The Supreme Court decided that prizes such as the one received by Jane, from the example in the main text, were income in *Robertson v. United States*, 343 U.S. 711, 713 (1952). While the district court held the prize was excluded, it did so on the theory that it constituted a gift and not expressly on the notion of a windfall exclusion. See *id.* at 713 & n.2; see also *Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 515 (1921) (rejecting taxpayer argument that an increase in the value of stock between its purchase

The Supreme Court firmly put the idea to rest in its famous *Glenshaw Glass* decision.¹²⁴ As every graduate of a basic tax course knows (or should know), in that case the Supreme Court wrote that "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" constituted income.¹²⁵

Although H-S was not invoked by the Supreme Court in this famous articulation,¹²⁶ H-S was likely in the air when *Glenshaw Glass* was decided.¹²⁷ Certainly, the Court's statement, apart from its inclusion of the realization requirement, is consistent with H-S's emphasis on increases and outcomes.¹²⁸ In addition, the realization requirement is treated by both Congress and the courts as a matter of administrative convenience and not as a constitutional requirement.¹²⁹ As a result, "income" as a matter of general usage in both the Code and interpretive materials is consistent with the H-S principle.¹³⁰

The H-S principle is itself related to the idea that taxes should be determined based on a person's control over resources (ability-to-pay).¹³¹ Thus, H-S measures control during the

and sale "represented appreciation in the value of the capital assets of the estate which was not 'income'").

124. See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

125. *Id.* at 431.

126. See Dodge, *Glenshaw Glass*, *supra* note 122, at 36 ("[T]here is no evidence from the record that the Court and counsel were particularly aware of the Haig-Simons concept.").

127. See *id.* ("[I]t is significant that the reputation of *Glenshaw* . . . in the tax community grew in tandem with an increasing awareness of the Haig-Simons concept . . .").

128. See *id.* ("[I]t must be acknowledged that 'accession to wealth' sounds very much like 'increase in net wealth' . . .").

129. See *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554, 559 (1991) (citing *Helvering v. Horst*, 311 U.S. 112, 116 (1940)) ("the concept of realization is 'founded on administrative convenience'"). Congress, for example, requires mark-to-market accounting (i.e., yearly valuation of assets) for securities dealers. See I.R.C. § 475 (2006); see also Haig, *supra* note 3, at 62 (concluding that the realization requirement "is not in accord with economic facts" and stating "that certain so-called accounting principles have been evolved with other ends primarily in view than the accurate determination of relative taxpaying ability").

130. See Fleming & Peroni, *supra* note 117, at 515 ("[T]here is a strong case for characterizing the current federal income tax as an SHS tax levy with targeted tax expenditures and concessions to administrative necessity, rather than as a hybrid income/consumption tax.").

131. See Haig, *supra* note 3, at 59 (explaining that an accretion model "defines income in terms of power to satisfy economic wants rather than in terms of the satisfactions themselves. It has the effect of taxing the recipient of income when he receives the power to attain satisfactions rather than when he elects to exercise that power"); SIMONS, *supra* note 3, at 49 ("Personal income connotes, broadly, the exercise of control over the use of society's scarce resources.").

current tax period by analyzing the taxpayer's non-regenerative,¹³² personally beneficial¹³³ use of resources during the tax period (consumption)¹³⁴ and the change in the taxpayer's ability to use resources in the future (accumulation).¹³⁵ The value of both consumption and accumulation is determined objectively, with reference to their values in the market.¹³⁶ It would theoretically be possible to measure value in utility terms, but such a system would be impossible to administer.¹³⁷

For example, imagine trying to administer a system in which Jane earns \$100,000, spends \$50,000 for a personal vacation, and

The content and value of the ability-to-pay principle is itself the subject of an extensive literature. The description in the main text grossly simplifies the concept in the interest of Article brevity. For discussion of the ability-to-pay principle, as well as other fairness norms, see Walter J. Blum & Harry Kalven Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952); Joseph M. Dodge, *Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles*, 58 TAX L. REV. 399 (2005); Fleming & Peroni, *supra* note 117, at 450-60; Deborah A. Geier, *Time to Bring Back the "Benefit" Norm?*, 33 TAX NOTES INT'L 899 (2004); Ajay K. Mehrotra, *Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the U.S. Income Tax*, 52 UCLA L. REV. 1793 (2005); Richard A. Musgrave, *Equity and the Case for Progressive Taxation*, in TAX JUSTICE: THE ONGOING DEBATE 9, 9-24 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002); C. Eugene Steuerle, *And Equal (Tax) Justice for All?*, in TAX JUSTICE: THE ONGOING DEBATE 253, 253-84 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

132. See *infra* note 142 for a discussion of the selection of this term.

133. See Thuronyi, *supra* note 114, at 57 (suggesting that the "two terms, [consumption and personal benefit,] could even be interpreted as meaning the same thing").

134. See SURREY & MCDANIEL, *supra* note 31, at 186-87 ("The term 'consumption' in the [H-S] definition covers all expenditures made except those incurred as costs in the earning or production of income. Thus the term is not an independent concept . . .").

135. See SIMONS, *supra* note 3, at 49-50 ("Consumption as a quantity denotes the value of rights exercised in a certain way . . .; accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.").

136. See *id.* at 50 ("Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value . . ."); Haig, *supra* note 3, at 56-59 (discussing why income must be calculated in terms of money, the "common, universally accepted unit of value"); see also Thuronyi, *supra* note 114, at 50 ("[I]n defining income, Simons' principal concern was to propose objective, general rules as a bulwark against ad hoc exceptions that would erode the tax base in response to political whim.").

137. See Haig, *supra* note 3, at 57 ("If 'usances' and satisfactions are really the proper theoretical basis for apportioning the tax burden there is here an inequality. Certainly, everyone will agree that they constitute an entirely impracticable basis."); SIMONS, *supra* note 3, at 53 (explaining that it "would be the negation of measurement" if "income should be measured with regard for the relative pleasurable-ness of different activities"); see also Thuronyi, *supra* note 114, at 52-53 (discussing income concepts that would more expansively include 'well-being,' but concluding that "[i]f these elements were included, income would be a more meaningful measure, but would lose its practical usefulness").

132 HOUSTON BUSINESS AND TAX LAW JOURNAL [Vol. XI

is permitted to argue for a \$70,000 tax base because she experienced only a \$20,000 well-being increase from the trip.¹³⁸

A central issue in applying H-S is to determine which outlays will reduce wealth without causing a simultaneous and commensurate increase to consumption;¹³⁹ or, to put it another way, which outlays will reduce the tax base.¹⁴⁰ The term

138. Far more contentious are situations involving in-kind receipts, imputed "income," and leisure. If objectivity of measurement is viewed as an essential part of the H-S theory, the treatment of many of these issues becomes more obvious. See Dodge, *Glenshaw Glass*, *supra* note 122, at 50 & n.124 (discussing the relationship of "theory" and "practice" as too difficult-to-measure in-kind consumption, explaining that theory requiring inclusion for in-kind consumption derives from the utilitarian tradition, and noting that "there is no more reason to 'swallow whole' a philosophy-derived theory of income than there is to do so with any other 'external-to-tax' theory"); Haig, *supra* note 3, at 57-58 (asking whether there is "any theoretical injustice" in measuring income through money rather than "usances' and satisfactions" since "[w]ho . . . would seriously defend the proposition that taxes should be apportioned according to capacity for appreciation rather than according to the capacity to command the goods and services," and "[t]he only economically significant goods are those which are susceptible of evaluation in terms of money"); Thuronyi, *supra* note 114, at 52 (explaining that "the concept of utility has meaning only in the abstraction of economic theory" and "there is no way to measure levels of individual utility"); cf. Boris I. Bittker, *A 'Comprehensive Tax Base' as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 932 (1967) [hereinafter Bittker, *Comprehensive Tax Base*] ("Such concessions [relating to realization and imputed income], in other words, are adjustments to practicality, rather than an integral part of the definition."); Mark. G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an 'Ideal' Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 880 (1979) ("I do not advocate a direct tax on ability to earn . . . because I both recognize its administrative difficulties and think the tax system's respect for a taxpayer's refusal to treat potentially marketable resources as commodities represents a desirable anticapitalist strain in a market-obsessed culture."). See generally Koppelman, *supra* note 3, at 699-700 (article that "attempt[s] to sketch the way in which income might serve as a measure of economic well-being").

To the extent such items are more or less the same among socioeconomic classes and only vary significantly between classes, their direct tax treatment assumes less significance since other aspects of the tax system (e.g., tax rates) can be adjusted so that the system as a whole continues to operate along ability-to-pay lines. See DODGE ET AL., FEDERAL INCOME TAX, *supra* note 3, at 227 ("[B]enefits that might be statistically weighted in favor of one class or another . . . might better be taken into account in adjusting the tax rates . . ."); SIMONS, *supra* note 3, at 52-53 ("[T]he neglect of 'earned income in kind' may be substantially offset, for comparative purposes (for measurement of relative incomes), if leisure income is also neglected. For income taxation it is important that these elements of income vary with considerable regularity, from one income class to the next, along the income scale."); Thuronyi, *supra* note 114, at 49-50 (discussing the "general principle that the exclusion of a particular item from the definition of income is acceptable if the resulting distribution of the income tax burden would be considered equitable").

139. See Bittker, *Income Tax Deductions*, *supra* note 113, at 212 ("[A]ll expenditures reduce the taxpayer's net worth, and hence presumptively are excluded from Haig-Simons 'income.' They are brought back into income, as so defined, only if they reflect 'consumption' by the taxpayer.")

140. In their casebook, Professors Joseph Dodge, J. Clifton Fleming, and Deborah Geier distinguish between a "consumption-oriented approach" to H-S requiring (1) determining gross wealth, (2) subtracting all outlays, and (3) adding back in consumption outlays, and a "wealth-oriented approach" to H-S, which "treats the taxation of

"consumption" in early H-S accounts is frequently described in terms of resource "destruction."¹⁴¹ This term is arguably best viewed as one phrasing of a well-established H-S implementation standard: in order for an outlay to reduce the tax base, it must occur in the context of a regenerative activity.¹⁴² In other words, the cost must be incurred to facilitate at least enough income production to restore the taxpayer to its economic position prior to incurrance of the cost.¹⁴³ Outlays that do not occur in such a context represent "destructive" consumption and must be

consumption as a principle of non-deductibility." See DODGE ET AL., FEDERAL INCOME TAX, *supra* note 3, at 224-25. The Code shows traces of both versions. See Dodge, *Glenshaw Glass*, *supra* note 122, at 50 (discussing "ambivalence" in Code and regulations regarding H-S implementation). This Article's articulation of H-S is focused on the principle of non-deductibility (or non-exclusion) since this is more likely to be a central issue in a tax-avoidance scheme. Cf. DODGE ET AL., FEDERAL INCOME TAX, *supra* note 3, at 225 (noting that in "actual practice the tax base is calculated mostly according to the wealth-oriented approach").

141. See SIMONS, *supra* note 3, at 49-50 ("Consumption . . . denotes the value of rights exercised in a certain way (in destruction of economic goods) . . ."); see also Koppelman, *supra* note 3, at 686 ("Contemporary discussions of personal deductions often implicitly adopt the destruction of economic goods requirement.").

142. See SIMONS, *supra* note 3, at 54 ("[A]ccumulation or investment provides a basis for expense deductions in the future, while consumption does not."); Koppelman, *supra* note 3, at 706 ("All voluntary expenditures unrelated to a profit-seeking activity should be considered taxable consumption under an income tax based upon power to consume. Whether economic goods are destroyed is irrelevant under this concept.").

Some might quibble that the term "regenerative" is too low a threshold since the term implies that outlays aimed only at producing enough income to cover such outlays should reduce the tax base. This term is, however, consistent with a pragmatic approach to H-S and is supported by practice in the Code. For example, in the case of gray area activities, deductions are generally allowed up to the amount of income (after certain adjustments) generated by the activity. See I.R.C. § 183 (2006) (providing for hobby losses); I.R.C. § 280A(c)(5) (2006) (addressing home office expenses); cf. I.R.C. § 163(d) (2006) (detailing investment interest deduction limitations); I.R.C. § 469 (2006) (describing passive activity loss deduction limitations).

More would argue that this threshold is too high. For example, various writers add that certain involuntary costs are also deductible under H-S. See generally Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765 (2006) (arguing for additional distinction between discretionary and nondiscretionary spending); Koppelman, *supra* note 3, at 682 ("[N]ot all items unrelated to profit-seeking activities should be denied a deduction . . . Items which frustrate the power to consume, such as a lost paycheck, should be deductible."). This aspect of H-S is omitted from the main text since the categorization of involuntary costs is of little (if any) relevance to the proposed application of H-S to the ESD. Another line of argument asserts that consideration should be given to distinguishing between preclusive and non-preclusive use, which is close to requiring actual destruction in order for something to constitute consumption. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 314-15 ("A good argument can be made that taxable personal consumption should be defined to include divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is nonpreclusive . . .").

143. See *supra* note 142.

included in the tax base.¹⁴⁴ To return to the example of Jane above, assume that instead of winning an award show, Jane earned \$100,000 as a tax consultant and she incurred \$50,000 in various overhead expenses all reasonably related to earning the \$100,000. Since Jane incurs the \$50,000 outlay in order to facilitate the generation of business income, her H-S tax base will only be \$50,000—the \$50,000 increase in wealth from the prior year plus \$0 in "consumption." In other words, Jane earns \$100,000 and receives a \$50,000 deduction for her business expenses.

The regenerative activity requirement is more commonly stated as a requirement that, in order to be deductible, costs must have been incurred to further a business investment or other "for profit" activity.¹⁴⁵ This determination depends principally on taxpayer intent, which will be difficult to discern under the best of circumstances.¹⁴⁶ In addition, many cost outlays improve a person's capacity for generating future income, but without bearing a close relationship to the production of that income—the cost of meals being an obvious example. Without nexus requirements, individuals could quickly advance theories for assigning most (if not all) outlays to a "for profit" motive.¹⁴⁷

To prevent erosion of the tax base and to minimize the difficulty of determining intent, implementation of the H-S principle requires adoption of standards and rules.¹⁴⁸ For example, the Code adopts the standard that business and investment expenses must be "ordinary and necessary" to be deductible.¹⁴⁹ Of course, such standards are by their nature

144. See *supra* note 141 and accompanying text.

145. See Koppelman, *supra* note 3, at 680-81 ("All agree that expenditures for personal items . . . should not be deductible if unrelated to a profit-seeking activity."). This is also reflected in the Code. See I.R.C. § 212 (deduction for ordinary and necessary expenses incurred "for the production or collection of income").

146. See SIMONS, *supra* note 3, at 54-55 ("[O]ften the motives will be quite mixed.").

147. See Goode, *supra* note 122, at 15 (explaining that a large portion of "consumption" is "necessary in order to sustain an efficient labor force" and separating ultimate consumption from "necessary" consumption raises "philosophical questions" that are impossible to answer).

148. See Bittker, *Comprehensive Tax Base*, *supra* note 138, at 985 ("The central source of difficulty is the fact that the income tax structure cannot be discovered, but must be constructed; it is the final result of a multitude of debatable judgments."); Goode, *supra* note 122, at 15 (explaining that separating consumption from deductible outlays "depends on the intention of the spender, supplemented in practice by rules based partly on custom but with arbitrary elements"); cf. SURREY & MCDANIEL, *supra* note 31, at 5 (explaining that the H-S "definition covers only basis aspects and a few details" and that the "construction of a tax expenditure budget therefore requires an extension of the [H-S] analysis to many issues that have arisen since its initial explication").

149. See I.R.C. §§ 162(a), 212(1)-(2). The recent health care legislation added sentences and subsections to Code section 162. See Patient Protection and Affordable

imprecise, and Congress or the Department of the Treasury frequently specify *ex ante* rules to supplement the standards.¹⁵⁰

The further H-S descends into nitty-gritty reality, the more likely it becomes that rules will predominate and grow increasingly complex.¹⁵¹ Correspondingly, the necessity of relying on rough justice becomes more apparent,¹⁵² and the possibility of multiple "right" approaches to implementing H-S increases (as do disputes over which approach most correctly interprets H-S).¹⁵³

Care Act, Pub. L. No. 111-148, §§ 9014(a), 10108(g)(1), 124 Stat. 119, 868-69, 913 (codified as amended in scattered sections of 26 U.S.C. and 42 U.S.C. (2010)). For example, section 10108(g)(1) adds a new sentence to § 162(a) and section 9014(a) adds § 162(m)(6) for health insurance providers. *See id.* Litigation is underway regarding the constitutionality of the healthcare reform legislation. *See, e.g., Florida ex. rel Bondie v. United States Dept. of Health and Human Servs., No. 3:10-CV-91-RV/EMT, 2011 WL 285683, at *1 (N.D. Fla. Jan. 31, 2011).* This litigation does not affect this Article's use of section 162, nor should the healthcare litigation affect this Article's discussion of Code section 7701(o). Even though Code § 7701(o) was added by the healthcare legislation, the codification of economic substance doctrine is unrelated to the health care provisions whose constitutionality has been challenged.

150. *See generally* David B. Spence, *Managing Delegation Ex Ante: Using Law to Steer Administrative Agencies*, 28 J. LEGAL STUD. 413 (1999) (describing the trend of *ex ante* legislation evaluation).

151. *See, e.g.,* I.R.C. § 183 (hobby loss provision); I.R.C. § 274 (limitations on deductibility for travel and entertainment costs).

152. The difficulty of resolving the gray area between business and personal consumption was well understood by Henry Simons. *See SIMONS, supra* note 3, at 54-55 ("[H]ere one finds inescapable the unwelcome criterion of intention. A thoroughly precise and objective distinction is inconceivable. Given items will represent business expense in one instance and merely consumption in another, and often the motives will be quite mixed. A commercial artist buys paints and brushes to use in making his living. Another person may buy the same articles as playthings for his children, or to cultivate a hobby of his own. Even the professional artist may use some of his materials for things he intends or hopes to sell, and some on work done purely for his own pleasure. In another instance, moreover, the same items may represent investment in training for earning activity later on. The latter instance suggests that there is something quite arbitrary even about the distinction between consumption and accumulation The distinction in question can be made somewhat definite if one adopts the drastic expedient of treating all outlays for augmenting personal earning capacity as consumption. This expedient has little more than empty, formal, legalistic justification. On the other hand, one does well to accept, here as elsewhere, a loss of relevance or adequacy as the necessary cost of an essential definiteness.").

153. *Compare* SURREY & MCDANIEL, *supra* note 31, at 164 ("The standards used to determine an income tax should also recognize that there can be differing responses to particular questions and that each of those responses can constitute part of a normative tax."), *with* Bittker, *Income Tax Deductions, supra* note 113, at 203 ("There is, unfortunately, no theoretically satisfactory boundary between business expenses that provide incidental personal benefits and personal expenditures that incidentally serve business purposes."), *and* Kelman, *supra* note 138, at 876-77 (describing how "[t]he tax literature addressing the business expense has posed a number of solutions to the problem of the mixture of consumption and nonconsumption elements in one expenditure . . . [b]ut none of these approaches bears much scrutiny"), *and* Musgrave, *supra* note 117, at 57 (describing the boundary between personal and business expenses

Even if a cost outlay is sufficiently related to a "for profit" activity, a current reduction to the tax base will not necessarily be proper. An outlay is not currently deductible if the taxpayer merely transforms one resource into another resource whose useful life will extend beyond the tax period.¹⁵⁴ To put it in more formal H-S terms, a cost outlay will not reduce wealth if the outlay merely transforms one type of wealth into another.¹⁵⁵ Of course, this raises complicated tracing and valuation issues.¹⁵⁶ To again return to Jane, assume that she earned \$100,000 as a consultant and she spent \$50,000 to purchase a small building for her business. In that situation, her H-S tax base would remain \$100,000—a \$50,000 increase in cash wealth over the preceding year plus a \$50,000 increase in asset wealth (plus \$0 in "consumption"). More conventionally stated, Jane includes \$100,000 as income and receives a \$50,000 tax basis¹⁵⁷ in the office building. As will be discussed in greater detail in the next section, determining the length of the tax period is critical in distinguishing outlays that may currently reduce the tax base from those that must be capitalized (that is, give rise to basis).

B. *Of Departures, Gaps, and Ambiguities*

Most tax scholars and policymakers continue to write and legislate under the assumptions that asking H-S questions remains important and that answers to such questions are

as "an area where reference to an income concept is needed . . . [and] is helpful because it tells us that consumption is part of accretion").

154. The proposed H-S ESD requires that deductions be supported by actual declines in wealth. See discussion *infra* Part IV.

155. See discussion *infra* Part IV.

156. See Fellows, *supra* note 119, 738-40 (describing how market price may be different for seller and buyer even in fairly routine transactions). In addition, various tax rules intentionally depart from the standard that amounts spent on items with value extending into the next period should not be currently deductible. See *infra* note 184 (discussing *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992)). Deductions for business advertising and routine employee training expenses are the most obvious examples. See J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 288-89, 293 (8th ed. 2007) (describing issues surrounding deductibility of employee training and advertising). Even though advertising and employee training provide some long-term benefits, from an administrative standpoint it is arguably appropriate to allow current deductibility since allocation of the benefit to a particular period will be administratively difficult. See *id.* Well-accepted deductions for similar difficult-to-allocate business costs seem unlikely to be used to fuel a tax shelter.

157. The term "basis" is used to indicate an amount that will not be subjected to further tax. For example, if Jane sells the building for \$60,000, she will pay taxes on only \$10,000 since she already included the \$50,000 she used to purchase the building in her income.

reasonably ascertainable.¹⁵⁸ Thus, a significant portion of H-S scholarship deals with definitional problems at the margins;¹⁵⁹ that is, it analyzes whether particular items should or should not be included in the tax base.¹⁶⁰ These definitional discussions can be roughly grouped into three categories: (1) some commentators

158. See Thuronyi, *supra* note 114, at 46 ("Despite . . . theoretical objections, the [H-S] term . . . is commonly employed as if it were a relatively well-defined or well-understood concept.").

159. See Fleming & Peroni, *supra* note 117, at 453 (describing the same phenomenon with respect to the ability-to-pay concept, which is closely aligned with H-S).

160. Much of this discussion has revolved around the formulation of the tax expenditure budget rather than expressly about H-S. The Congressional Budget Act of 1974 requires an annual tax expenditure budget to be prepared (1) by the Congressional Budget Office, which has delegated its responsibility to the Joint Committee on Taxation, and (2) by the President, who has delegated that responsibility to the Treasury. See Congressional Budget Act of 1974, Pub. L. No. 93-344, §§ 202(f)(1), 601, 88 Stat. 297, 304, 323-24 (1974) (enacting legislation); Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08), May 12, 2008, available at www.house.gov/jct [hereinafter Joint Committee on Taxation] (describing process); STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* 1-14, (HARV. UNIV. PRESS 1973) (describing background of the tax expenditure budget); SURREY & MCDANIEL, *supra* note 31, at 1-30 (describing the tax expenditure concept); Martin J. McMahon, Jr., *Taxing Tax Expenditures?*, 130 TAX NOTES 775 (2011) (discussing history, critiques, and benefits of tax expenditure analysis). The tax expenditure budget requires analysis of deviations from a "normal" tax baseline. It is widely recognized that this "normal" baseline is dependent on H-S, with some deviations in order to deal with silences on structural issues and account for standard departures from H-S (e.g., realization). See SURREY, *PATHWAYS TO TAX REFORM*, *supra*, at 12-14 (explaining that the tax expenditure budget and related analysis "dr[a]w importantly on the general acceptance of the Haig-Simons approach to the definition of 'income'" but describing how some H-S departures were necessary in formulating the budget); Joint Committee on Taxation, *supra*, at 7, 19.

Stanley Surrey is widely recognized as the motivating force behind the budget. His hope was that requiring this additional deliberative process would lead to a reduction of government inefficiencies and the formulation of criteria for selecting between direct and indirect subsidies. See Joint Committee on Taxation, *supra*, at 2-3 ("Surrey hoped that, by rephrasing "tax incentive" proposals as "tax expenditures," and then by analyzing equity, efficiency and administrative consequences of those proposals as if they were spending requests, policymakers would recognize that many such proposals were inconsistent with the goal of a fair, efficient and simple income tax system."). See generally Paul R. McDaniel & Stanley S. Surrey, *Tax Expenditures: How to Identify Them; How to Control Them*, 15 TAX NOTES 595 (1982) (examining tax expenditure identification issues and explaining the need for measures to control tax expenditures). Within the last few years, the Joint Committee on Taxation has attempted to distance itself from Surrey as part of a process to re-invigorate the tax expenditure budget process. See Joint Committee on Taxation, *supra*; Edward D. Kleinbard, Chief of Staff, Joint Comm. on Taxation, *Rethinking Tax Expenditures*, Address at the Chicago-Kent College of Law Federal Tax Institute (May 1, 2008) (explaining the Joint Committee on Taxation is reexamining tax expenditure analysis in response to the criticisms against it and to make it more useful to policymakers). Review of the tax expenditure budget debate is beyond the scope of this Article. As to the impact of this debate on the importance of H-S, even the Joint Committee on Taxation notes, "[W]e recognize that our specific implementation of tax expenditure analysis is firmly wedded to the view that the current Internal Revenue code is at heart an income tax . . ." Joint Committee on Taxation, *supra*, at 16. This seems to represent a concession that H-S is still alive and well.

work to find ways to reconcile a current or desired practice with H-S—whether through adjusting the practice or a particular interpretation of H-S; (2) similarly, others argue for strict adherence and propose methods for achieving that goal; and (3) finally, some argue that a particular item would likely be taxed under strict adherence to H-S but that some other policy goal supports a departure from H-S.¹⁶¹ Each category will have its proponents, but no readily stated constraint prevents a particular commentator from shifting to a different type of response when a different item is at issue.

This apparent freedom to move easily from one type of response to another depending on the type (and popularity) of the detail at issue may help explain assertions that H-S is overly ambiguous and its application too subjective.¹⁶² Various writers

161. See Haig, *supra* note 3, at 69 ("Those who are convinced that taxation should be used for the furtherance of social ends often demand special modifications.").

To give one example of how these approaches play out with respect to a particular item, consider the deduction for charitable contributions. Should the deduction for charitable contributions be retained because, through careful interpretation of H-S, the deduction is proper under H-S; abolished because charitable contributions are indistinguishable from other items of personal consumption; or preserved even if the contributions represent personal consumption because the deduction furthers other important policy goals? See Andrews, *supra* note 142 (arguing for definition of personal consumption that would exclude charitable contributions from the tax base); Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 37 (1972) (discussing "the propriety and vitality of the federal income tax deduction for contributions to private charitable organizations"); Mark P. Gergen, *The Case for A Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1394, 1396-1433 (1988) (examining three theories advanced to support the deduction); Kelman, *supra* note 138, at 834 (seeking "to demonstrate that Professor Andrews's notion of private preclusive appropriation is unconvincing, and in any event would not logically justify the charitable deduction"); Thuronyi, *supra* note 114, at 57 (suggesting that the charitable contribution deduction might be disallowed because making contributions confers a personal benefit even if "a charitable contribution arguably does not constitute personal consumption"); cf. Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377, 378 (1971) (proposing that "we should substitute for the charitable contribution deduction a system of direct federal assistance for private charitable organizations through a matching grant mechanism").

Again, these debates often play out in the context of the tax expenditure budget. See Joint Committee on Taxation, *supra* note 160, at 1 (asserting that the tax expenditure budget has been "[d]riven off track by seemingly endless debates about what should and should not be included in the 'normal' tax base . . .").

162. In recent years, the Joint Committee on Taxation has taken the position that traditional tax expenditure analysis must be changed because of its over-reliance on the "normal" (H-S) tax. See Joint Committee on Taxation, *supra* note 160, at 1. It based this conclusion on various critiques of the notion of a "normal" (again, read H-S) tax. See *id.* at 1 ("The JCT Staff therefore has begun a project to rethink how to best articulate the principles of tax expenditure analysis, in order to . . . address the concerns raised by many commentators."). The report, for example, asserts that "the 'normal' tax is . . . not a rigorous tax framework developed from first principles" and that "[a]s a result, the 'normal' tax cannot be defended from criticism as a series of ultimately idiosyncratic or pragmatic choices." *Id.* at 7.

have addressed the question of whether H-S is an intelligible principle, many by arguing that larger economic or justice principles can be used to (or already do) provide meaningful constraints on the subjectivity of the H-S concept.¹⁶³

As the introduction to this Part already implied, this Article takes as a working assumption that H-S has sufficiently agreed upon content to be of normative value in spite of some subjectivity of interpretation.¹⁶⁴

Three interrelated, additional criticisms of H-S are of more direct concern to the proposed project of using H-S to determine the tax consequences of a tax-avoidance transaction. First, the Code and interpretive administrative authorities intentionally depart from H-S in numerous areas, often in order to advance other policy goals.¹⁶⁵ Second, even assuming Congress intended to implement H-S as fully as possible, as a result of practical limitations, some departures would almost certainly remain.¹⁶⁶ Finally, even if all practical limitations could be overcome, H-S does not address various structural issues, which are essential components of a tax system.¹⁶⁷ Since tax shelters so frequently utilize such departures and gaps as their source material, these three concerns regarding implementation of H-S have particular relevance to this Article's proposal. The response to each is somewhat different.

As to whether intentional legislative departures present a serious obstacle depends on preliminary court determinations regarding legislative intent. To illustrate, consider a technique

163. See Thuronyi, *supra* note 114, at 47 ("An adequate groundwork for the income concept . . . can be provided by basing it on tax fairness.").

164. See Fleming & Peroni, *supra* note 117, at 458 (The H-S "definition does provide a principled structure that is useful for testing the efficacy of tax provisions and opposing bad tax policy."); Thuronyi, *supra* note 114, at 63 (analogizing H-S to the concept of "poverty" and noting that the "arbitrariness and subjectivity of the concept do not—and should not—prevent it from being used, since without this concept it would be difficult to get a handle on some important social problems").

165. See Lederman, *supra* note 2, at 395 (noting that tax system "contains provisions expressly designed to alter taxpayers' behavior"); McMahon, *Economic Substance*, *supra* note 37, at 1019 (noting "that the code abounds with provisions that not only influence economic behavior, but which are *intended* to influence economic behavior").

166. Cf. Haig, *supra* note 3, at 68 ("A lively regard for the limitations of the administration is essential to the successful formulation of a tax statute.").

167. See SURREY & MCDANIEL, *supra* note 31, at 187-88 (discussing various limitations of the H-S definition); Joint Committee on Taxation, *supra* note 160, at 19 ("As numerous critics have pointed out, the Haig-Simons definition says nothing about most structural issues that must be decided under any income tax law, such as the rate structure, the proper taxpaying unit and the proper accounting period."); Koppelman, *supra* note 3, at 685 & n.21 (explaining that H-S is silent as to personal deductions, "the nature of the taxable unit . . . , the rate structure, and the taxation of foreign transactions").

that uses a Code provision for accelerated depreciation as the engine for reducing taxes and that a court must decide whether to respect the taxpayer's position. A court's findings include the possibilities that: (1) legislative intent requires that the structure of the transaction and depreciation deductions be respected; (2) legislative intent requires that the depreciation be preserved but the transaction be re-cast to allocate the depreciation differently (e.g., to the "true owner"); or (3) legislative intent requires that the transaction be treated as a substantive sham and the claimed depreciation be denied in its entirety.¹⁶⁸ As discussed in Parts II.A & E, current use of the ESD corresponds with the third possibility.

In contrast, under the proposed H-S ESD, a court would decide ultimate tax consequences only after determining either that legislative intent requires the depreciation deduction be denied or that legislative intent with respect to the taxpayer's use of the depreciation deduction is ambiguous.¹⁶⁹ The proposed H-S ESD thus moves from disregarding a transaction to taxing the transaction using H-S.¹⁷⁰ Use of the H-S ESD would, however, necessitate a preliminary legislative intent determination with respect to the tax rules at issue in a particular case.¹⁷¹ In light of *Glenshaw Glass* and its progeny, a plausible argument can be made that H-S already functions as a background presumption in the event of legislative ambiguity about the income tax base,¹⁷² and H-S is thus a reasonable choice to guide the taxation of tax-avoidance techniques.

The second two criticisms – that H-S implementation may be administratively impossible in some areas and that H-S is silent as to important structural issues – cannot be addressed through an appeal to legislative intent. In determining the tax consequences of a tax shelters, three areas of administrative difficulty or structural silence stand out as particularly problematic: (1) questions of timing, (2) problems of taxpayer unit, and (3) concerns relating to international tax.¹⁷³ As will be

168. See discussion *supra* Part II.E.

169. See discussion *infra* Part V.B.

170. See *infra* note 404 and accompanying text.

171. See discussion *infra* Part V.B.

172. Cf. Thuronyi, *supra* note 114, at 101 ("Given the extent of the internal inconsistency of our income tax statute, it would be impossible for Congress to instruct the courts to construe the statute according to any general principles.").

173. See discussion *infra* Parts III.B.1-3. This is not intended to be an exhaustive list. Character conversion, for example, is a frequent tax reduction strategy, but H-S does not address issues of tax rate. See Charlene D. Luke, *Beating the "Wrap": The Agency Effort to Control Wraparound Insurance Tax Shelters*, 25 VA. TAX REV. 129, 131-32 (2005)

discussed in the context of the case studies, under the proposed H-S ESD, a court could draw on long-standing solutions to H-S discontinuities to tax a suspect transaction.¹⁷⁴ The difficulty in resolving such H-S discontinuities would, however, serve as a signal that the H-S ESD may not, after all, have been the best tool for analyzing the transaction.¹⁷⁵

1. Timing

Tax-reduction techniques may unfold over multiple years or may depend on gaming the realization requirement.¹⁷⁶ As discussed in Part II, since a transaction's failure under the ESD results in the court disregarding the taxpayer's claimed tax consequences, under current law, a court has little need to determine how to deal with timing elements of a transaction. Timing could, however, be an issue under the proposed H-S ESD, since, as will be described in Part IV, the change in wealth actually generated by the transaction is calculated.

Pure H-S arguably requires continuous accretion¹⁷⁷ (i.e., tax periods of infinitesimal length¹⁷⁸)— an administrative

[hereinafter Luke, *Beating the "Wrap"*] (describing use of variable insurance products to convert ordinary income to income taxed at a lower rate).

174. See *infra* notes 405-07 and accompanying text.

175. See discussion *infra* Part V.

176. The straddle cases of the late 1970s, for example, depended on closing the loss "leg" of the straddle in the year before closing the gain leg. See, e.g., *Glass v. Comm'r*, 87 T.C. 1087, 1106 (1986). I.R.C. § 1092 (2006) was enacted to halt these types of straddles. See James N. Calvin et al., *Examining the Straddle Rules After 25 Years*, 125 TAX NOTES 1301 (2009); Samuel C. Thompson, Jr., *An Examination of the Effect of Recent Legislation on Commodity Tax Straddles*, 2 VA. TAX REV. 165, 166 (1983); Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 610 (1995).

177. The importance of limiting tax deferral was likely less well understood at the time Simons wrote, and he seems not to have given it serious thought. See Bittker, *Comprehensive Tax Base*, *supra* note 138, at 958-59 & n.59 (describing Simons' failure to appreciate the problem of timing); Fellows, *supra* note 119, at 724 ("Simons was generally indifferent to the timing implications of his definition."); Thuronyi, *supra* note 114, at 65 ("It appears that Simons believed that the specification of the taxable period was not of great importance. This attitude is consistent with Simons' general approach of downplaying the importance of tax deferral.").

Thus, an alternative view is that H-S is simply silent as to the length of the tax period. Bittker, *Comprehensive Tax Base*, *supra* note 138, at 958 ("The Simons definition of income does not specify the period of time to which it is to be applied: that is left to the person who uses the definition . . ."); SURREY & MCDANIEL, *supra* note 31, at 188 ("The S-H-S definition does not specify the period to be used in calculating income."). Since continuous accretion is impossible to administer, the practical difference between the two views is minimal.

178. See Thuronyi, *supra* note 114, at 65 ("[I]n terms of the Haig-Simons formulation, the term 'period' should be taken as referring to an infinitesimal length of time.").

impossibility.¹⁷⁹ Historically, the tax period has been one year.¹⁸⁰ But even as to that one year period, wealth changes caused by asset value fluctuation are generally not recognized in the tax system until there has been a realization event, such as a sale or exchange.¹⁸¹ Common justifications for the realization requirement include the need for an administrable system and concern about taxpayer liquidity.¹⁸²

A large literature has developed surrounding the realization requirement and its relationship to H-S.¹⁸³ If timing were an issue in applying the H-S ESD, a court could tax a transaction by drawing on this literature. First, if possible, end-of-tax-year valuation would be required¹⁸⁴ (annual rather than continuous since one year is the generally applicable tax period).¹⁸⁵ The rationales for maintaining the realization requirement have significantly less force with respect to the sophisticated parties likely to be involved in abusive tax schemes. Second, even if an asset is legitimately impossible to value, a possible next-best solution would be to impute a minimum return.¹⁸⁶ Of course, the

179. See Musgrave, *supra* note 117, at 59 ("[I]t is not feasible to define concurrent on an 'every minute' basis.").

180. Cf. Haig, *supra* note 3, at 63-64 (Accounting periods of "true economic length" are "in the case of the wage earner . . . a week and the salaried worker a month. In the typical business the period is, of course, a year . . .").

181. See *id.* at 65 ("For example, one might urge that no tax be placed on a gain arising from the appreciation of a fixed asset until it is actually sold.").

182. See Noël B. Cunningham & Deborah H. Schenk, *Taxation Without Realization: A "Revolutionary" Approach to Ownership*, 47 TAX L. REV. 725, 742-43 (1992) (discussing the "concerns" that led to the development of the realization requirement).

183. See generally David F. Bradford, *Fixing Realization Accounting: Symmetry, Consistency and Correctness in the Taxation of Financial Instruments*, 50 TAX. L. REV. 731 (1995); Cunningham & Schenk, *supra* note 182; Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and The Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861 (1997).

184. Cf. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 88, 90 (1992) (concluding that the litigated "transaction produced significant benefits . . . that extended beyond the tax year in question" and costs had to be capitalized). Whether the benefit obtained from a cost outlay extends beyond the taxable year has been the historical benchmark used to determine deductibility. See *id.*

185. See *supra* note 180 and accompanying text. It should be noted that the "taxable year" aspect of this requirement has been changing over to a 12-month rule in certain areas. See, e.g., Treas. Reg. § 1.263(a)-4(f)(1) (2009) ("12-month rule" for certain intangibles); Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 Fed. Reg. 12,838, 12,848 (proposed Mar. 10, 2008) (to be codified at 26 C.F.R. pt. 1) (defining "materials and supplies" to include a property unit with "an economic useful life of 12 months or less").

186. See Cunningham & Schenk, *supra* note 182, at 733 (proposing the imputation of a minimum rate of return on capital in various circumstances). Under Cunningham and Schenk's proposal, basis would be increased by the minimum return so that any necessary adjustments would automatically occur at realization. *Id.* at 733-37. For other similar proposals see Alan J. Auerbach, *Retrospective Capital Gains Taxation*, 81 AM. ECON. REV. 167 (1991) (proposing retention of the realization requirement but a retroactive

necessity of crafting such solutions highlights a central difficulty of attempting the importation of H-S into the tax shelter area, and even if such solutions were adopted, new forms of taxpayer manipulations could arise.

2. Taxpayer Unit

It is reasonably well accepted that the tax unit under H-S is the individual.¹⁸⁷ Individuals, however, frequently act in groups, such as families and businesses. Tax shelters often utilize corporations and partnerships or are entered into by corporations and partnerships. As a result, any effort to apply H-S in the tax shelter arena must account for any H-S limitations relating to taxpayer identity.

An obvious limitation, and one that may at first seem insuperable, is that the corporate tax does not and cannot conform to H-S.¹⁸⁸ In practice, however, H-S standards and rules are applied all of the time to business entities.¹⁸⁹ Calculation of

imputation of a risk-free rate of return); Fellows, *supra* note 119 (proposing a time-adjusted-realization-event tax); Charlene D. Luke, *Taxing Risk: An Approach to Variable Insurance Reform*, 55 BUFF. L. REV. 247, 281-87 (2007) (proposing current taxation of cash value life insurance inside buildup other than an amount representing the risk-free rate of return).

187. See Thuronyi, *supra* note 114, at 69 (explaining that the taxable unit is generally thought of the individual and that Simons apparently "thought of the taxable unit as the individual and not the family" because he "refer[red] to the income of 'a person'"). But see Bittker, *Comprehensive Tax Base*, *supra* note 138, at 974 (concluding that the "the concept of a CTB [comprehensive tax base] is quite independent of the choice of taxpaying units"); Koppelman, *supra* note 3, at 695 n.86 ("Simons does not address the question of the proper taxable unit.").

188. See Thuronyi, *supra* note 114, at 77-79 ("On a balance sheet, corporate assets are always offset by liabilities The net worth of a corporation in this sense is always zero; therefore, a corporation can never experience an increase in its net worth and cannot have income in the Haig-Simons sense."); see also Bittker, *Comprehensive Tax Base*, *supra* note 138, at 979-80 (explaining that the comprehensive tax base concept fails to provide guidance as to the corporate income tax); cf. Joint Committee on Taxation, *supra* note 160, at 19 (explaining that "strong arguments could be made that integrated taxation of corporations and shareholders would better implement the Haig-Simons definition"); Yariv Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, 2008 MICH. ST. L. REV. 591, 591-92 (2008) ("The corporate income tax has long been considered unjustifiable on traditional tax policy grounds.").

189. The tax expenditure budget has historically (and controversially) included corporate tax items. See Fleming & Peroni, *supra* note 117, at 506 ("[T]he considerably imperfect corporate income tax is all that prevents the C corporation business form from being utilized as a massive tax deferral machine and the corporate income tax can fill its anti-deferral role effectively only if its base is substantially inclusive of all items that should be income if earned directly by individual shareholders."); SURREY & MCDANIEL, *supra* note 31, at 215 ("Both the full integration approach and the classical separate approach are acceptable as national policies. Tax theory does not posit either as normative. But once a policy decision has been made for either approach, it is possible to identify tax expenditures."); cf. Thuronyi, *supra* note 114, at 78 (stating that "[i]t is not uncommon to find reference to the Haig-Simons income of corporations," and that "income

the corporate tax base, for example, is made in terms of wealth changes, measured through allowance or denial of certain exclusions or deductions.¹⁹⁰ Denial of a deduction for "personal" consumption outlays obviously makes no sense in terms of a corporation, and a corporation's "personal" consumption will necessarily be zero. Although that is the case, requirements like the "ordinary and necessary" clause of Code section 162 recognize that businesses can be used for non-business reasons by the individuals acting in different agency relationships to the business.¹⁹¹

A second issue emerges in the partnership area. A partnership is an accounting entity but is not a tax entity.¹⁹² That is, the partners are responsible for the tax items generated by the partnership.¹⁹³ As a result, unlike the corporate tax, the taxation of partnership income is not incompatible with H-S. On the other hand, H-S provides little guidance as to how the tax burden should be allocated when income is attributable to a group effort.¹⁹⁴ The judicially enunciated "owner/earner pays"

is a disembodied concept that can be applied to corporations in the same manner as to individuals").

190. See E. Cary Brown & Jeremy I. Bulow, *The Definition of Taxable Business Income*, in COMPREHENSIVE INCOME TAXATION 241, 243 (Joseph A. Pechman ed., 1977) ("[A]pplying the Haig-Simons definition of income to the business firm means that income will consist of accrued changes in net worth, plus distributions and less net contributions of capital.").

191. See I.R.C. § 162 (2006); Bittker, *Income Tax Deductions*, *supra* note 113, at 203-04 (discussing the problem of wasteful business expenses because the decision whether to be expansive or to economize is frequently affected by personal values). Generally, even if an outlay is not currently deductible because it is not "ordinary and necessary," it is capitalized (i.e., added to basis). See *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966) ("[C]apital expenditures, which, if deductible at all, must be amortized over the useful life of the asset."). But often any benefit from such capitalization will not be available, if ever, for many years. See *id.* ("The principal function of the term 'ordinary' . . . is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures . . .").

Welch v. Helvering, 290 U.S. 111 (1933), is the most well-known case interpreting the "ordinary and necessary" test of Code section 162. See generally Joel S. Newman, *The Story of Welch: The Use (and Misuse) of the 'Ordinary and Necessary' Test for Deducting Business Expenses*, in TAX STORIES 197 (Paul Caron ed., 2d ed. 2009) (discussing *Welch's* impact in defining ordinary and necessary business expenses). It has been used both to mandate capitalization but also to deny tax benefits business outlays that are overly "bizarre" or representative of the "personal predilections" of agents of the business. *Id.* at 221. In *Welch*, a taxpayer paid off debts that had already been discharged in bankruptcy and that belonged to a defunct corporation for which the taxpayer had been an officer. See *Welch*, 290 U.S. at 112. The taxpayer paid these debts "[i]n order to re-establish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing . . ." *Id.*

192. See SURREY & MCDANIEL, *supra* note 31, at 215.

193. *Cf. id.*

194. See Joint Committee on Taxation, *supra* note 160, at 19 ("As numerous critics have pointed out, the Haig-Simons definition says nothing about most structural issues

standard is consistent with H-S,¹⁹⁵ but determining ownership or earner status in a joint enterprise is no simple task and is not addressed by H-S.¹⁹⁶ Once, however, the economic income earned by a partnership is divvied up among the partners, the owner/earner standard could be used to require that the partners' tax consequences follow the partners' economic allocations.¹⁹⁷

3. International Tax

Various aspects of international tax are relevant to the problem of tax shelters. This section briefly considers two areas in H-S terms: deferral of the income of foreign subsidiaries and the foreign tax credit.¹⁹⁸

U.S. businesses may (and frequently do) establish foreign subsidiaries. The income generated by such subsidiaries is generally not subject to U.S. tax until it is repatriated to the U.S.¹⁹⁹ Deferral is, of course, generally inconsistent with the H-S principle.²⁰⁰ But, as discussed above, H-S does not address taxpayer identity, and, generally, the separate entity status of a

that must be decided under any income tax law, such as . . . the proper taxpaying unit . . .").

195. Under this line of cases, an individual is taxed on the income he earns and may not avoid paying tax on it through assignment. *See, e.g.,* *Lucas v. Earl*, 281 U.S. 111 (1930) (finding that the owner of the income could not escape an income tax through an "arrangement by which the fruits are attributed to a different tree from that on which they grew"); *Helvering v. Horst*, 311 U.S. 112, 119-20 (1940) (applying *Lucas's* fruit and tree analogy to interest earned from negotiable bonds); *Comm'r v. Banks*, 543 U.S. 426, 433-36 (2005) (holding that "when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee").

196. *See* Bradley T. Borden, *Taxing Shared Economies of Scale*, 61 BAYLOR L. REV. 721, 730-33, 766-70 (2009) (discussing use of economic theory to determine when Subchapter K is necessary to determine the taxation of individuals).

197. *See* SURREY & MCDANIEL, *supra* note 31, at 191 ("[A] series of normative rules must be provided to relate the partnership accounts and activities to those of the partners in order to determine the treatment of the partners. Although the task is a difficult one, it is within the realm of the development of normative tax rules."). The tax law ensures that tax consequences follow economic consequences primarily by requiring the maintenance of partnership capital accounts and mandating that these accounts control benefits and burdens at liquidation. *See* Treas. Reg. § 1.704-1 (2008).

198. *See generally* SURREY & MCDANIEL, *supra* note 31, at 166 ("The Schanz-Haig-Simons definition of income is the basic element used to structure taxation of a country's own taxpayers, but it does not specify which foreigners should be subject to the income tax and, if they are subject to tax, how they are to be taxed. The Schanz-Haig-Simons definition does not concern itself with source rules.").

199. *See* Fleming & Peroni, *supra* note 117, at 529. Code section 965 was a recent attempt by Congress to persuade businesses to repatriate by lowering the tax rate for such income. *See* I.R.C. § 965 (2006).

200. *See* Fleming & Peroni, *supra* note 117, at 532 (stating that "deferral undercuts the anti-deferral function of the corporate tax system and, thus, is a departure from the corporate income tax baseline").

foreign subsidiary would have to be set aside in order for the U.S. to tax its income.²⁰¹ There are good arguments to be made for doing so, but the possible mechanisms (e.g., assignment of income, substance-over-form) for setting aside separate entity status aside are not based in H-S even if the ultimate goal of ending deferral can be stated in H-S terms.

The U.S. tax system allows taxpayers to obtain a foreign tax credit for income taxes paid to foreign jurisdictions.²⁰² This is highly valuable, and the intended effect, generally speaking, is to place the taxpayer in the same position it would have been in *vis-à-vis* the U.S. income tax without the imposition of the foreign tax.²⁰³ If foreign taxes are viewed as merely another cost of doing business, then this credit mechanism is inconsistent with H-S and a deduction would be more appropriate.²⁰⁴ But H-S does not address the antecedent question of how foreign taxes should be viewed. For example, a credit would be appropriate if foreign income taxes are viewed as equivalent to U.S. income tax payments.²⁰⁵ The *Compaq* case, discussed below, involved the problem of characterizing foreign taxes.²⁰⁶

201. See SURREY & MCDANIEL, *supra* note 31, at 4.

202. See Treas. Reg. § 1.901-2(a)(1) (as amended in 2009) (allowing foreign tax credit if "[t]he predominant character of that tax is that of an income tax in the U.S. sense").

The credit may not, however, exceed the U.S. tax, and, arguably, this should be tested for each transaction. See Fleming & Peroni, *supra* note 117, at 543 ("Because the income tax system is based on transactions and the fundamental purpose of the foreign tax credit is to mitigate international double taxation, a theoretically pure foreign tax credit limitation would be applied on an item-by-item (i.e., transaction-by-transaction) basis."). Because that is administratively difficult, a country-by-country approach would be the next best solution. *Id.* at 543-45. The current system departs significantly from such a norm. *Id.* at 544-45.

203. See Fleming & Peroni, *supra* note 117, at 529-30; see also Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 818 (1956) [hereinafter Surrey, *Current Issues*] ("In effect, a dollar of foreign tax paid was treated as a dollar paid to the United States Treasury.").

204. Originally, foreign taxes were deductible only. This changed in 1918, and a credit has been in place ever since. Surrey, *Current Issues*, *supra* note 203, at 817-18.

By comparison, state and local taxes ("SALT") are generally viewed as being appropriately deducted under H-S when they are sufficiently connected to a business or investment. See Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax*, 82 VA. L. REV. 413, 461 (1996) ("[I]t is generally taken for granted that business taxes should be deductible by the businesses that pay them."). Considerable debate, however, surrounds the question of whether individuals should be able to deduct SALT. See *id.* at 461. But see Stark, *supra* note 114, at 1401, 1404 (suggesting that Kaplow's interpretation of H-S is overly broad and arguing that a "more fundamental question . . . [is] why we should want to reform the tax system to make it more consistent with the Haig-Simons 'ideal' in the first place."); Brian Galle, *Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the 'SALT' Deduction*, 106 MICH. L. REV. 805, 851-52 (2008).

205. See Surrey, *Current Issues*, *supra* note 203, at 821-22 (describing a possible analysis of a foreign income tax as being "like the United States income tax," in which

IV. H-S ESD

The H-S limitations described above are explored in the final section of this Part, which discusses specific "tax shelter" cases in terms of the proposed H-S ESD. This review suggests, albeit on the basis of relatively few data points, that the H-S ESD may have explanatory power with respect to ESD case law, and H-S may also provide boundaries as to the proposed H-S ESD's application to suspect transactions. Before turning to the case studies, this Part first provides an overview of the proposed H-S ESD and discusses the responsiveness of the proposed H-S ESD to the criticisms of the ESD.

A. *H-S ESD Overview*

This Article concludes that using H-S to reframe the ESD would result in a change to the ESD's function even though there would be some similarities to the current ESD. As discussed in Part II.A, if a transaction passes the ESD, the taxpayer receives the claimed tax benefits;²⁰⁷ if the transaction fails the ESD, the transaction is treated as a substantive sham and all the taxpayer's claimed tax benefits are disallowed.²⁰⁸ In effect, the ESD allows taxpayers the benefit of their claimed positions so long as they played the tax game "fairly," as determined by application of the two ESD prongs.

The proposed H-S ESD would change the ESD from yielding an all-or-nothing result to one that taxed the transaction according to H-S principles.²⁰⁹ Because H-S is about crafting ideal boundaries of the income tax base, applying H-S to reform the current ESD would require that the ESD become more

case "it is proper to consider it not as a cost but in the same manner as the United States income tax itself"). *But see* Daniel N. Shaviro & David A. Weisbach, *The Fifth Circuit Gets It Wrong In Compaq v. Commissioner*, TAX NOTES INT'L, Apr. 15, 2002, at 195 ("[T]here is no principle of tax law or good sportsmanship that requires treating foreign taxes the same as domestic taxes.").

206. *See* discussion *infra* Part IV.C.3. The new ESD Code section specifies that "[t]he Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases." I.R.C. § 7701(o)(2)(B) (2006 & Supp. 2010).

207. Of course, some other approach (e.g., step transaction) may apply to re-characterize the transaction or deny claimed tax benefits. *See* Keinan, *Rethinking the Role*, *supra* note 103, at 45-50.

208. *See* Luke, *Risk Return*, *supra* note 7, at 788.

209. *Cf.* McMahon, *Economic Substance*, *supra* note 37, at 1018 (noting that rules relied on in tax shelters "often deliberately deviate from an accurate computation of economic income").

expressly about the income tax base and less about whether the taxpayer should get the benefit of particular, claimed tax rules.²¹⁰

The proposed H-S ESD would consist of two inquiries, labeled here as the business/investment nexus analysis and economic outcomes determination.²¹¹ These inquiries would be directly tied to the H-S requirements for tax base reduction: that an outlay be sufficiently connected to a legitimate business or investment purpose and that it actually reduces wealth.²¹² Thus, the nexus inquiry would test whether the transaction supported a business or investment goal apart from tax consequences.²¹³ The economic outcomes prong would assess and tax the actual change in economic position.²¹⁴

Although the nexus inquiry would review context and taxpayer intent just as is the case under the current ESD subjective prong, any analysis of pre-tax profit potential would be of more restricted significance. This would result from the significant difference between the current ESD's objective prong and the proposed economic outcomes prong of the H-S ESD. Under the current ESD, if the objective inquiry is satisfied, the taxpayer receives the full benefit of her claimed tax benefits even if her actual economic change and her final tax consequences do not align.²¹⁵ In contrast, the proposed H-S ESD requires that even if a sufficient business or investment nexus is demonstrated, the taxpayer receives tax consequences that are matched to actual economic change.²¹⁶

A general question that may arise is whether H-S could be used directly to police the tax base in the tax shelter area. The difficulty with such a move is that H-S is a broad, theoretical principle; thus, its implementation almost always requires some other rule or standard to move H-S from theory to application. In the tax shelter context, the presence of business entities further

210. The ESD is, of course, also tangentially about the tax base since the result will affect the amount of taxes owed. In addition, in order for a court to move to a more direct inquiry about tax base, it may first need to set aside the statutory or other authorities claimed by the taxpayer. See *supra* Part III.B. (discussing need for legislative intent framework).

211. See McMahon, *Beyond a GAAR*, *supra* note 21, at 1723.

212. See Simons, *supra* note 3, at 54 ("[A]ccumulation or investment provides a basis for expense deductions in the future, while consumption does not."); see also I.R.C. §§ 162, 212 (2006).

213. See McMahon, *Beyond a GAAR*, *supra* note 21, at 1724. Professor McMahon has proposed amending § 165 to add expressly that corporate loss deductions must be supported by a profit-seeking purpose, and that "[m]erely being engaged in a trade or business should not suffice." See *id.* at 1738.

214. See *id.* at 1723.

215. See McMahon, *Beyond a GAAR*, *supra* note 21, at 1727, 1729.

216. See *id.* at 1725-26.

complicates the use of H-S. In addition, decisions will be required regarding transaction aspects as to which H-S is relatively silent or impractical. As a result, the need for some mediating standard or rule seems likely. The process of moving the H-S principle into a standard or rule is, of course, one that can prompt multiple approaches. This Article takes the approach of retaining much of the form of ESD in order to provide some continuity but recognizes that H-S may lend itself to other solutions.

B. *Possible Benefits, Lingering Problems, and Potential New Concerns*

Using H-S to re-frame the function of the ESD could yield several benefits. The doctrine as a whole would be anchored to a larger tax principle that has been influencing the development of the tax law for decades and about which there is considerable, if incomplete, consensus.²¹⁷ H-S, for example, would provide a principled rationale for using business purpose to draw distinctions among transactions. As discussed in Part III (and subject to the caveats discussed therein), H-S requires that purpose plays a critical role in calculating the income tax base—that is, the role of distinguishing non-deductible consumption from deductible business and investment expenses.²¹⁸ In other words, a business or investment nexus requirement can be viewed as a foundational component of an income tax structure. As a result, an overarching, general business or investment purpose requirement is consistent with H-S.²¹⁹ And, it follows, that the recent codification of this requirement is also consistent with H-S.²²⁰

217. See discussion *supra* Part III; see also Gergen, *supra* note 87, at 131 ("The usual objection to the standards of tax motive and economic substance is that they lead to unprincipled decisions.").

218. See discussion *supra* Part III.A.

219. *But cf.* Lederman, *supra* note 2, at 433 (arguing that neither tax motivation nor business connection should be relevant; instead "[t]he question should be whether Congress intended the claimed result").

220. See I.R.C. § 7701(o)(1)(B) (2006 & Supp. 2010); see also § 7701(o)(5)(B) (codifying ESD applicable to individuals only as "to transactions entered into in connection with a trade or business or an activity engaged in for the production of income").

Such a result also would not be inconsistent with *Gregory* because the courts' approach in *Gregory* should not be interpreted as having anything to do with the general boundaries of an income tax. See *supra* note 45. Indeed, the Supreme Court's decision in *Gregory* pre-dates Henry Simons' formulation of the income concept by approximately 3 years. See *id.* Rather, the problematic language in *Gregory* can simply be viewed as a comment about the need to establish congressional intent with respect to a particular statute. See *id.* A H-S-centric reading of *Gregory* would be that the ultimate motive of the taxpayer does not matter so long as the transaction meets any applicable

While H-S ESD would anchor business purpose to a tax principle, it would not solve the problem of taxpayer-manufactured business purpose,²²¹ nor would it resolve the question of how much business connection is enough.²²² In addition, courts would need to develop nexus frameworks similar to those in place for determining the presence of sufficient "for profit" connection²²³ (and Congress could step in with rules just as what it has done elsewhere with respect to this standard). In all likelihood, the presence or absence of the requisite purpose for a particular transaction would continue to be decided on the relative certainty of pre-tax profit or loss.²²⁴

At the same time, however, a substantial benefit from the proposed H-S ESD would be a narrowing of the role of pre-tax profit. The H-S ESD would relegate analysis of profit potential to the nexus analysis, and the ultimate tax consequences would hinge on the actual economic effect of the transaction.²²⁵ Thus, the H-S ESD would make clear that for a taxpayer to obtain a tax base reduction, the taxpayer would need to have both an appropriate purpose and an actual decline in wealth since the transaction would be taxed according to its underlying economics.²²⁶ Festooning a transaction with contingencies and potentialities might continue to influence the decision of whether the transaction had a non-tax business or investment purpose, but such trappings would only alter the tax consequences if and to the extent they actually altered the economics of the transaction as measured in terms of actual outcomes.²²⁷

Of course, as is apparent in other areas of tax litigation, measuring actual outcomes remains a difficult task, and H-S

business/investment nexus requirement. *Cf.* Lederman, *supra* note 2, at 404 (explaining that the *Gregory* opinions "do mean that having a tax-avoidance motive is not sufficient to render a transaction abusive"). Of course, determining business/investment nexus requires analysis of taxpayer purpose and intent, which can sometimes appear indistinguishable from motive. *See* Blum, *supra* note 47, at 493 ("So long as the inquiry is directed at how much the transferor's conduct is to be explained by commercial and how much by noncommercial reasons, it matters little whether we refer to his motive or his intent or his purpose.").

221. *Cf. supra* note 54 and accompanying text.

222. *Cf.* Blum, *supra* note 47, at 507-08 (describing how statutory tests resting on state of mind require analysis "of how much of the specified purpose is enough to satisfy the rule" and concluding that "[n]othing very instructive can be said" about such an issue).

223. *See id.* at 507

224. *See id.*

225. *Cf. supra* note 110 and accompanying text.

226. *See supra* notes 211-14 and accompanying text.

227. *See supra* notes 107-09 and accompanying text (discussing the similarities between this proposal and that made by Professors Chirelstein and Zelenak).

comes with inherent limitations. The proverbial elephant in the room is, of course, the continued problem of judicial determination of legislative intent. This Article does not purport to resolve when a court should take the step of setting aside a taxpayer's claimed tax authorities because Congress did not intend or foresee the taxpayer's use of them and instead use of the proposed H-S ESD, were it enacted.²²⁸ The H-S ESD analysis does, however, highlight the need to develop such a framework, and the importance of H-S in shaping tax policy makes it a plausible principle to utilize in assessing a transaction once a taxpayer's claimed tax benefits have been set aside after a preliminary legislative intent determination.

The H-S ESD also emphasizes the need for multiple approaches to the problem of tax shelters because the limitations of H-S make obvious that the H-S ESD is also limited as to which types of tax-avoidance transactions it can and should target.²²⁹ The next section illustrates the H-S ESD in greater detail through consideration of five case studies.

C. Case Illustrations

This section uses the facts from five "tax shelter" cases to illustrate the H-S ESD. Each section reviews the facts of the case and then discusses the H-S ESD result, including the explanatory role H-S may play in analyzing tax-avoidance techniques.

1. Knetsch

a. Facts

The facts of *Knetsch v. United States*²³⁰ are well known to tax practitioners and scholars.²³¹ Knetsch purchased ten deferred annuity bonds from the Sam Houston Life Insurance Company (Houston Life).²³² Each annuity was "in the face amount of

228. See *supra* notes 8 and 13. Recent codification, of course, makes it unlikely that Congress will significantly revise the ESD in the near future. See *supra* note 30.

229. See discussion *supra* Part IV.A.

230. *Knetsch v. United States*, 364 U.S. 361, 362-64 (1960).

231. See, e.g., Walter J. Blum, *Knetsch v. United States: A Pronouncement on Tax Avoidance*, 40 TAXES 296 (1962); Calvin Johnson, *Is an Interest Deduction Inevitable?*, 6 VA. TAX REV. 123, 132-35 (1986); Daniel N. Shaviro, *The Story of Knetsch: Judicial Doctrines Combating Tax Avoidance*, in TAX STORIES 313 (Paul Caron ed., 2d ed. 2009) ("No case looms larger as a cornerstone of the doctrine defining impermissible tax avoidance than *Knetsch v. United States*.").

232. *Knetsch*, 364 U.S. at 362.

\$400,000 and bearing interest at 2.5% compounded annually."²³³ Knetsch paid \$4,004,000 for each annuity bond using \$4000 cash and \$4,000,000 of debt;²³⁴ the \$4000 over the face amount represented Sam Houston Life Insurance Company's fee.²³⁵ Houston Life issued the debt, and it bore a 3.5% interest rate, payable in advance.²³⁶ Thus, Knetsch purchased an asset generating a 2.5% return with debt requiring a 3.5% interest payment.²³⁷

Knetsch regularly borrowed against any increases to the annuity cash value at the same, payable-in-advance 3.5% interest rate (although always leaving a \$1000 equity cushion).²³⁸ Knetsch was allowed to borrow projected cash value increases in advance of their actual accrual.²³⁹

His borrowing against the annuities and his payment of the interest due on that borrowing always occurred on the same day—with the implication that Knetsch used the borrowed money to make the required advance payment of the interest on that borrowed money.²⁴⁰

The bonds were scheduled to mature when Knetsch turned 90 years old.²⁴¹ At maturity, if Knetsch continued with his \$1000 equity cushion, the annuity would have been \$43 per month.²⁴² If Knetsch had fully paid off the debt secured by the cash value,²⁴³ then at maturity the contract would have paid \$90,171 per month until his death.²⁴⁴ Knetsch exited the transaction early,²⁴⁵

233. *Id.*

234. *Id.*

235. *See id.*; Shaviro, *supra* note 231, at 341.

236. *Knetsch*, 364 U.S. at 362-63.

237. *Id.* at 363.

238. *Id.* at 366.

239. *Id.*

240. *Id.* at 363.

241. *Id.* at 364. Knetsch was 60 years old at the time of the transaction. Shaviro, *supra* note 231, at 360.

242. *Knetsch*, 364 U.S. at 364; *see* Shaviro, *supra* note 231, at 346 n.5 ("Knetsch would be out of pocket about \$1.2 million as a result of paying Sam Houston about \$40,000 per year for thirty years. At a rate of \$43 per month, it would take him 27,907 months . . . [2,325.6 years] to earn this money back (disregarding the time value of money).").

243. *Knetsch*, 364 U.S. at 364.

244. *See id.*

245. *See id.* ("Knetsch . . . terminated it on December 27, 1956."). Only the first two years of the transaction, 1953 and 1954, were at issue in the Supreme Court case. *See id.* at 363. Apparently, Knetsch exited because the IRS had already issued him a notice of deficiency. *See* Shaviro, *supra* note 231, at 364.

and received the \$1000 difference between the cash value of the annuity and the loan he owed Houston Life.²⁴⁶

Each year, Knetsch relied on tax law provisions to deduct his 3.5% interest payments.²⁴⁷ The annual 2.5% increases to the cash value of the annuities were excluded from taxable income,²⁴⁸ and borrowing against the annuities was not treated as a taxable withdrawal of the increases in value.²⁴⁹ By making interest payments with non-taxable borrowed money, deducting those same interest payments, and excluding the annuities' increase in value from taxable income, Knetsch hoped to lower his taxes far in excess of the pre-tax loss generated by the differential between his interest payments and the increased value of his annuities.²⁵⁰

The Supreme Court held that Knetsch should be denied his tax benefits.²⁵¹ Knetsch was not, however, the only taxpayer to use this transaction.²⁵² The table below illustrates the court results for *Knetsch* and substantially related transactions. The table includes only determinations made by courts not yet bound by precedent. For example, the Fifth Circuit issued a

246. *Knetsch*, 364 U.S. at 364.

247. *See id.* at 362-63. In 1953, Knetsch deducted the interest payments under Section 23(b) of the 1939 Code. *Id.* In 1954, he deducted the interest payments under Section 163(a) of the 1954 Code. *Id.* Both Section 23(b) and 163(a)(2) allowed deductions for interest payments on indebtedness, including personal debt. *See* I.R.C. § 23(b) (1934); I.R.C. § 163(a)(2) (1952).

248. Cash value increases inside annuity and cash value life insurance continue to be excluded from income. *See* Luke, *Beating the "Wrap," supra* note 173, at 131-32.

249. During this time period, loans taken out against annuity cash values were not taxable. *See id.* at 142-43. Today, loans taken against annuity cash value are treated as taxable withdrawals. I.R.C. § 72(e)(4)(A) (2006). Borrowing is generally viewed as a non-taxable event under both the Code and H-S. *See* Fellows, *supra* note 119, at 788 ("Haig-Simons and the Code treat borrowing as a nontaxable event because the receipt of borrowed funds is offset by the taxpayer's obligation to repay the loan, leaving the taxpayer's net worth unchanged."). Borrowing can, however, be used to obtain the benefits (i.e., cash) from a realization event with respect to a particular asset without technically triggering realization. *See generally id.* Although ultimately any gain will be recognized when the asset is sold (assuming no basis step-up at death under I.R.C. § 1014), the benefits of deferral may be substantial. *See id.* at 730 ("[O]ne way to describe the value of tax deferral is as the equivalent of an interest-free loan from the government."). In some instances, Congress has expressly treated borrowing (or its equivalent) as triggering realization. *See, e.g.,* I.R.C. § 1259 (2006) (constructive sales for certain appreciated financial positions).

250. *See* Shaviro, *supra* note 231, at 346 (explaining that Knetsch "could hope to end up more than \$70,000 per year ahead" even with an economic pre-tax loss of \$40,000 because his claimed \$140,000 interest deductions generated \$110,000 of tax savings as a result of the high tax rates of the time period). Since the annuities were not scheduled to enter their payout phase for many years, Knetsch's tax benefits were significant even after taking into account the eventual taxation of the cash value at actual distribution. Johnson, *supra* note 233, at 133.

251. *See Knetsch*, 364 U.S. at 362, 370.

252. *See, e.g.,* *Emmons v. Comm'r*, 31 T.C. 26 (1958), *aff'd*, 270 F.2d 294 (3rd Cir. 1959).

taxpayer-friendly opinion,²⁵³ so the table does not include the taxpayer-friendly result reached by a lower court bound by the Fifth Circuit's opinion.²⁵⁴

Court	Winner	Dissent
Tax Court ²⁵⁵	Government	Yes(one judge/ first T.C. case) ²⁵⁶
S.D. California ²⁵⁷	Government	-
S.D. Texas ²⁵⁸	Taxpayer	-
D. Arizona ²⁵⁹	Government	-
2d Circuit ²⁶⁰	Government	Yes ²⁶¹
3d Circuit ²⁶²	Government	No
5 th Circuit ²⁶³	Taxpayer	Yes ²⁶⁴
9 th Circuit ²⁶⁵	Government	No
Supreme Court ²⁶⁶	Government	Yes (three dissenters) ²⁶⁷

As is apparent from the table, the courts overwhelmingly held in favor of the government, with only a Texas district court and the related appellate decision holding otherwise (perhaps not coincidentally, the taxpayer-friendly decision out of Texas involved the Sam Houston Life Insurance Company).²⁶⁸

253. See *United States v. Bond*, 258 F.2d 577 (5th Cir. 1958).

254. See *Roderick v. United States*, Civ. No. 1994, 1959 WL 11866 (W.D. Tex. Aug. 5, 1959), *rev'd*, 290 F.2d 823 (5th Cir. 1961).

255. See *Emmons*, 31 T.C. 26; *Weller v. Comm'r*, 31 T.C. 33 (1958); *Diggs v. Comm'r*, 18 T.C.M. (CCH) 443 (1959); *Williams v. Comm'r*, 18 T.C.M. (CCH) 205 (1959).

256. Judge Tietjens dissented in *Emmons* but did not file a separate opinion. See *Emmons*, 31 T.C. at 32.

257. See *Knetsch v. United States*, Civ. No. 577-57 WM, 1958 U.S. Dist. LEXIS 4564 (S.D. Cal. Nov. 5, 1958).

258. See *Bond v. United States*, Civ. No. 9152, 1957 WL 10788 (S.D. Tex. May 15, 1957).

259. See *Haggard v. United States*, Civ. No. 2749-PHX, WL 11753 (D. Ariz. Feb. 17, 1959).

260. See *Diggs v. Comm'r*, 281 F.2d 326 (2d Cir. 1960).

261. See *id.* at 330-32 (Moore, J., dissenting).

262. See *Weller v. Comm'r*, 270 F.2d 294 (3d Cir. 1959) (consolidated with *Emmons v. Comm'r*, 31 T.C. 26 (1958)).

263. See *United States v. Bond*, 258 F.2d 577 (5th Cir. 1958).

264. See *id.* at 584-85 (Wisdom, J., dissenting).

265. See *Knetsch v. United States*, 272 F.2d 200 (9th Cir. 1959).

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

267. See *id.* at 370-71 (Douglas, J., Whittaker, J., and Stewart, J., dissenting).

268. See *State Bd. of Ins. v. Sam Houston Life Ins. Co.*, 344 S.W.2d 709 (Tex. Civ. App.—Austin 1961, no writ).

It should, however, be noted for those unfamiliar with *Knetsch* that the ESD was not invoked since it had not yet even been formulated. Two considerations support using the case results to discuss the potential usefulness of the H-S ESD, even though the ESD was not actually utilized in these cases. First, *Knetsch* is an important forerunner and influencer of the ESD.²⁶⁹ Second, the more recent corporate-owned life insurance (COLI) shelters used a technique virtually identical to that in *Knetsch*, were decided under the ESD, and were almost uniformly decided in favor of the government.²⁷⁰

b. H-S Analysis

The *Knetsch* transaction was irrational but for the claimed tax provisions. The facts of *Knetsch* itself leave little room for the argument that *Knetsch* started with a reasonable investment and simply had bad luck. For example, there is no indication that *Knetsch* intended to pay down the loan principal in order to increase the likelihood of a substantial annuity (albeit one that started when he turned 90) or re-finance the debt at a rate lower than the return on the annuities.²⁷¹ Thus, under the proposed H-S ESD, any tax base reduction for *Knetsch*'s outlays would be denied under the first inquiry for lack of sufficient connection to

269. See Lederman, *supra* note 2, at 406-09 (discussing *Knetsch*'s relationship to the ESD).

270. See, e.g., *Am. Elec. Power Co. v. Comm'r*, 326 F.3d 737 (6th Cir. 2003). In *American Electric Power Company*, the corporation purchased a life insurance group plan covering a huge swath of its employees. See *id.* at 739. The corporation then borrowed against the policies' cash value. See *id.* The expected benefits and cash value increases from the plans did not exceed the policy expenses, including the interest on the loans secured by the policies. See *id.* at 739-40. The transactions only made sense after-tax because they allowed the companies to take immediate deductions for the expenses without currently including cash value increases in income. See *id.* at 740. The court, however, held that the COLI scheme lacked economic substance. *Id.* at 745. Other courts have almost uniformly reached the same decision. See, e.g., *In re CM Holdings, Inc.*, 301 F.3d 96, 108 (3d Cir. 2002) (holding that "[t]he COLI policies lacked economic substance"); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313, 1317 (11th Cir. 2001) ("[T]he broad-based COLI program lacked sufficient economic substance to be respected for tax purposes . . ."). The exception was a district court in Michigan, which surprisingly held for the taxpayer even though the transaction was virtually identical to one already held to lack economic substance by the Sixth Circuit — the appeals court to which the district court opinion would be appealed. See *Dow Chem. Co. v. United States*, 278 F. Supp. 2d 844, 850-51 (E.D. Mich. 2003), *rev'd*, 435 F.3d 594 (6th Cir. 2006). Not surprisingly, the district court's opinion was reversed, although one appellate judge dissented. See *Dow Chem. Co. v. United States*, 435 F.3d 594, 596 (6th Cir. 2006) (Ryan, J., dissenting) (stating that the COLI plan was an economic sham).

271. See Shaviro, *supra* note 231, at 361 ("[S]uppose interest rates dropped so steeply that *Knetsch* could now borrow from a third party at 1.5%. Now the pre-tax interest rate arbitrage would favor him . . . There is no evidence, however, that he was aware of this possibility, and his lawyers did not subsequently advance it as a rationale for the transaction.").

a non-tax business or investment purpose.²⁷² The same analysis would apply to the substantially similar transactions entered into by other taxpayers.²⁷³

As discussed in the previous section, courts considering *Knetsch*-style transactions have routinely held for the government.²⁷⁴ Consideration of the H-S concept provides one explanation for these results and also serves as a normative baseline against which to assess the "rightness" of the court decisions. As explained in Part III, H-S would allow a tax base reduction only if the claimed mechanism is sufficiently related to a non-tax business or investment goal. The primary mechanism for the tax base reduction in the *Knetsch*-style transactions was the claimed interest deduction on the debt secured by the insurance contracts.²⁷⁵ Interest deductions, if sufficiently connected to business and investment, are consistent with and not departures from H-S.²⁷⁶ As a result, the court results are consistent with an application of the H-S concept.²⁷⁷ Of course, the courts were likely unaware that they were using H-S, but since the tax system is an income tax system, it is not surprising that the courts reached results consistent with the H-S concept.

272. See SIMONS, *supra* note 3, at 54.

273. In the unlikely event that Knetsch could have demonstrated the requisite non-tax purpose, Knetsch's economic outcome would have been readily ascertainable. During the first year, Knetsch deducted \$143,465 of interest, and the annuities accrued \$100,000 of cash value increases. *Knetsch v. United States*, 364 U.S. 349, 362, 363 (1960). Thus, Knetsch experienced a \$43,465 out-of-pocket decrease in wealth. See Shaviro, *supra* note 231, at 346 (describing the roughly \$40,000 annual differential). Each year produced a similar differential. See *Knetsch*, 364 U.S. at 365 (asking with reference to two years worth of the contracts, "What did Knetsch get for the out-of-pocket difference of \$91,570?"). Had Knetsch successfully reached the second inquiry of the H-S ESD, he would have been allowed a deduction — albeit one that was approximately only 30% of the deduction claimed. This result does assume a legislative intent determination that Knetsch should be denied the cash value exclusion since that would be the effect of netting the cash value increases against the interest deductions.

274. See *supra* notes 255-78 and accompanying text.

275. See *Knetsch*, 364 U.S. at 362.

276. See J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 FLA. TAX REV. 544, 547 (1997) (discussing why business and investment interest is deductible under H-S).

277. See, e.g., *Knetsch*, 364 U.S. at 362. This, of course, assumes a court determination that nothing in the statute claimed by the taxpayer required a contrary approach. Although this Article generally does not address the issue of crafting an interpretive framework, H-S analysis suggests itself as a possible legislative intent presumption in the face of tax rule ambiguity. See *supra* notes 26-27 and accompanying text; see also discussion *supra* Part IV.B. In *Knetsch*-style transactions, for example, rather than resort to the H-S ESD, courts could have used the H-S concept to read a business/investment purpose into the interest deduction statute relied on by the taxpayers.

Consideration should also be given to the other mechanism contributing to the claimed tax benefits in *Knetsch*: the exclusion for insurance cash value increases.²⁷⁸ This exclusion is a departure from H-S.²⁷⁹ Requiring inclusion of these increases would have been another way to deny Knetsch a large portion of his claimed tax benefits.²⁸⁰ Yet, the courts generally analyzed the transaction as being about whether to allow or deny the claimed interest deductions.²⁸¹ This may simply have stemmed from the litigating position of the IRS. Denying the exclusion would, however, also have necessitated overturning a long-standing legislative departure from H-S.²⁸² The cash value exclusion has long been available to taxpayers regardless of their reasons for acquiring a life insurance policy or annuity contract — assuming the policy or contract is bona fide. As a result, a strategy focused on the cash benefit exclusion would likely have led a court to analyze whether the contract was bona fide using a general substance-over-form test rather than trying to use the ESD to trigger outright denial of such a well-established exclusion. Indeed, the repeated use of the word "sham" in the Supreme Court's decision in *Knetsch* is suggestive of an inquiry into whether the annuity contract at issue was bona fide.²⁸³

2. ACM Partnership

ACM Partnership involved an allocation of gain to foreign partners.²⁸⁴ Unlike *TIFD III-E Inc.*, also referred to as *Castle Harbour*,²⁸⁵ the primary strategy at issue in *ACM* took place at the partnership level.²⁸⁶

278. See *Knetsch*, 364 U.S. at 367-369.

279. See generally SIMONS, *supra* note 3.

280. Since the cash value accumulated at a slower rate than the interest payments, the inclusion would not fully offset the interest deduction. See *supra* notes 188-91 and accompanying text.

281. See *supra* notes 276-77 and accompanying text.

282. The circumstances under which a court would overturn such a Code provision would depend on the criteria a court used to determine legislative intent with respect to a taxpayer's use of a particular provision. This Article does not purport to address the antecedent problem of interpretive framework, except to recommend H-S as a proxy in the event legislative intent is ambiguous. See *supra* notes 25-28 and accompanying text; *supra* discussion Part II.E.

283. *Knetsch*, 364 U.S. at 365-67, 369 (using the word "sham" repeatedly).

284. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 235-36 (3d Cir. 1998). For a discussion of *ACM P'ship*, see Bankman, *supra* note 37, at 8-10 and McCormack, *supra* note 14, at 756-58.

285. See *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006). Like *ACM P'ship*, *Castle Harbour*, also featured allocations to foreign partners. See *id.* at 223. *Castle Harbour* will be discussed further below.

286. See *ACM P'ship*, 157 F.3d at 233.

a. Facts

ACM Partnership had three partners: (1) Southampton-Hamilton Company (Southampton), a U.S.-based, wholly owned subsidiary of Colgate-Palmolive Company (Colgate);²⁸⁷ (2) Kannex Corporation N.V., a Netherlands Antilles entity controlled by a major Dutch bank;²⁸⁸ and (3) Merrill Lynch MLCS, Inc. (MLCS), a U.S. based wholly owned subsidiary of Merrill Lynch Capital Services, an affiliate of Merrill Lynch & Co., Inc. (Merrill Lynch).²⁸⁹ Each of the three partners was created by their parent entities shortly before creation of ACM.²⁹⁰

Reduced to their essentials, the transactions undertaken by ACM were fairly straightforward. ACM was initially capitalized with cash from the partners.²⁹¹ Kannex, the Netherland Antilles entity, contributed the most for an 82.6% interest.²⁹² Southampton held a 17.1% share and MLCS a 0.3% share.²⁹³ ACM used the cash to buy private placement notes from Citicorp.²⁹⁴ A little less than a month later, ACM sold \$175 million of the Citicorp notes for \$140 million of cash plus notes whose interest rate was contingent on fluctuations to LIBOR (LIBOR notes).²⁹⁵ Payments on the LIBOR notes would be received over five years beginning in the year following the cash payment.²⁹⁶

ACM used the installment method to report the "gains" from this transaction.²⁹⁷ Because a portion of the amount received was contingent, ACM relied on a Treasury regulation that allowed it to divide its \$175 million basis in the Citicorp notes equally over the six years that payments would be received.²⁹⁸ Thus, approximately \$29 million of basis would be allocated to each of the six years that payments would be received.²⁹⁹ In the first year, this generated a large capital gain of approximately \$111 million (equal to the \$140 million of cash received minus the \$29

287. *Id.*

288. *Id.* The Dutch bank was Algemene Bank Nederland N.V. *Id.*

289. *Id.*

290. *Id.*

291. *Id.* at 239.

292. *Id.*

293. *Id.*

294. *Id.*

295. *See id.* at 240.

296. *Id.* at 245-46 n.26.

297. *Id.* at 242.

298. *Id.*

299. *Id.*

million basis).³⁰⁰ In subsequent years, when the basis was applied to the payments on the LIBOR notes, ACM reported losses.³⁰¹ Kannex remained a partner only long enough to soak up a large allocation of gains.³⁰² When the losses began to be recognized, the U.S. partners took the allocations.³⁰³ Economically, the exchange of the Citicorp notes for the \$140 million cash and LIBOR notes was a virtual wash, and after adding in the transaction costs, was unprofitable before tax.³⁰⁴

The Tax Court and Third Circuit rejected the transaction as lacking economic substance.³⁰⁵ Colgate was not the only taxpayer to attempt a similar transaction as the transaction was actively marketed by Merrill Lynch.³⁰⁶ The D.C. Circuit rejected the same scheme as entered by other taxpayers.³⁰⁷ One district court upheld the transaction as having been entered for a business purpose.³⁰⁸ The table below combines the results in *ACM* and the similar cases. In some of these cases, the court did not rely on the ESD and instead took a more general substance-over-form approach by looking at whether the parties had formed a bona fide partnership.

Court	Winner	Rationale	Dissent
Tax Court	Government	ESD (two cases) ³⁰⁹ Invalid partnership (one case) ³¹⁰	–

300. *See id.*

301. *Id.* at 245-46.

302. *See id.* at 241-42. Kannex was allocated approximately \$91.5 million, Southampton approximately \$19 million, and MLCS approximately \$325,000. *Id.* at 242.

303. *Id.* at 243-44.

304. *Id.* at 257.

305. *See id.*

306. *See Boca Investorings P'ship v. United States*, 314 F.3d 625, 629 (D.C. Cir. 2003); *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 508 (D.C. Cir. 2000); *Saba P'ship v. Comm'r*, 273 F.3d 1135, 1136 (D.C. Cir. 2001), *remanded to* 85 T.C.M. (CCH) 817 (2009).

307. *See Boca Investorings P'ship*, 314 F.3d at 632; *ASA Investorings P'ship*, 201 F.3d at 516; *Saba P'ship*, 273 F.3d at 1141.

308. *See Boca Investorings P'ship v. United States*, 167 F. Supp. 2d 298, 380 (D.D.C. 2001), *rev'd*, 314 F.3d 625 (D.C. Cir. 2003).

309. *See ACM P'ship v. Comm'r*, 73 T.C.M. (CCH) 2189 (1997); *Saba P'ship v. Comm'r*, T.C. Memo 1999-359. *Saba Partnership* was vacated by the D.C. Circuit and remanded in order for the Tax Court to apply its reasoning in *ASA Investorings*. *See Saba P'ship*, 273 F.3d at 1141. On remand, the Tax Court again held for the government but on the grounds that the partnership was invalid. *See Saba P'ship v. Comm'r*, 85 T.C.M. (CCH) 817, 824 (2003).

310. *See ASA Investorings v. Comm'r*, 76 T.C.M. (CCH) 325 (1998).

D.C. District ³¹¹	Taxpayer	Rejected ESD and invalid partnership arguments	-
Third Circuit ³¹²	Government	ESD	Yes ³¹³
D.C. Circuit ³¹⁴	Government	Invalid partnership	No

The decision in the D.C. District Court was reached after the D.C. Circuit had already invalidated the transaction as to other taxpayers.³¹⁵ Not surprisingly, that district court decision was reversed.³¹⁶

b. H-S Analysis

ACM's sale of the Citicorp notes clearly lacked a non-tax purpose since the sale was unprofitable after costs and was unrelated to Colgate's regular business.³¹⁷ On the other hand, analyzing purpose in this context is somewhat problematic given the long-standing ability of taxpayers to control the timing of realization events. On the gain side, business or investment purpose would be irrelevant since increases to wealth are included in the H-S tax base.³¹⁸ Of course, losses on personal use

311. See *Boca Investorings P'ship*, 167 F. Supp. 2d at 380.

312. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 263 (3d Cir. 1998).

313. See *id.* at 263-65 (McKee, J., dissenting).

314. See *ASA Investorings P'ship v. Comm'r*, 201 F.3d 505, 515 (D.C. Cir. 2000); *Saba P'ship*, 273 F.3d at 1141, *remanded to* 85 T.C.M. (CCH) 817 (2003); *Boca Investorings P'ship v. United States*, 314 F.3d 625, 632 (D.C. Cir. 2003).

315. See *ASA Investorings P'ship*, 201 F.3d at 515; *Boca Investorings P'ship*, 314 F.3d at 627.

316. See *Boca Investorings P'ship*, 314 F.3d at 627.

317. ACM used the payments received from the sale of the Citicorp notes to purchase fixed-rate Colgate debt. *ACM P'ship*, 157 F.3d at 240-41. Colgate expected declining interest rates, which would have made these notes more valuable to the payee and more expensive for Colgate. *Id.* at 234-35. Having the debt owned by a subsidiary would thus help Colgate to manage its overall debt and also mask the extent to which it was leveraged. *Id.* at 235. ACM alleged that the LIBOR notes were purchased to hedge the Colgate debt, which makes little sense given the stated reasons for ACM's purchase of the debt in the first place. See *id.* at 255. Yet this relationship between the Colgate debt and the LIBOR notes was given as one business motive for the transaction. See *id.* at 255-56. ACM also argued that the Citicorp interim notes were good investments. See *id.* at 254. Finally, ACM argued that the transaction had profit potential if interest rates were to rise. See *id.* at 255-57. This, of course, ran directly counter to their alleged reasons for buying the Colgate debt—that there was an expectation of declining interest rates. See *id.* at 257-58. Further, the transaction costs were large, so the transaction would have been profitable only if interest rates had risen sufficiently high so as to cover those costs. See *id.* at 257.

318. See SIMONS, *supra* note 3, at 50.

assets are disallowed, but if the asset sold is a financial asset, the presence of an investment purpose is generally assumed.³¹⁹

In the *ACM*-style transaction, the taxpayer depended on an artificial gain triggered by its allocation of basis followed by an artificial loss.³²⁰ There was an economic wash before taking into account the costs of entering into such a transaction. It would be entirely proper to hold that the transaction lacked sufficient connection to business or investment purposes. But consideration of the entrenched H-S departure of realization may help explain why some courts preferred to analyze the transaction in terms of whether the partnership itself was bona fide.

Installment reporting is also an H-S departure and is intended to smooth the reporting of large gains.³²¹ It has also been the subject of numerous legislative efforts to narrow its application.³²² Thus, even if there were some reluctance to apply a purpose test as to a realization event involving a financial asset, using H-S ESD to deny the claimed gains and losses seems fairly easy since there was no net economic change (except in the unlikely event that sufficient investment nexus was found to allow some deduction for transaction costs).³²³ Since the partnership would have had nothing to report, the allocation agreement among the partners would have become irrelevant.³²⁴

319. See I.R.C. § 165(c) (2006).

320. See *ACM P'ship*, 157 F.3d at 236-37, 260.

321. See McCormack, *supra* note 14, at 754, 758-59 (discussing relationship of installment reporting, including the contingent installment sale method, to the realization requirement).

322. See, *eg.*, I.R.C. § 453(e) (limiting the installment method on second disposition of property by related parties); *Id.* § 453(g) (limiting installment method availability for sale of depreciable property to controlled entity); *Id.* § 453(k) (requiring current income inclusion on sales of personal property under revolving credit plans or installment sales of publically traded securities).

323. See *ACM P'ship*, 157 F.3d at 238.

324. See *id.* at 252 n.42.

3. Compaq

a. Facts³²⁵

On September 16, 1992, Compaq entered into an agreement to purchase ten million of American Depositary Receipts (ADRs) in the Royal Dutch Petroleum Company (Royal Dutch) for \$888.5 million (adjusted for costs).³²⁶ Settlement was set for September 17, 1992.³²⁷

Also on September 16, Compaq agreed to sell 10 million ADR shares for \$867.9 million (adjusted for costs) with settlement on September 21.³²⁸ The decrease in value was attributable to the shares changing from *cum dividend* to *ex dividend* status between Compaq's purchase and sale.³²⁹ Compaq reported a \$20.7 million capital loss from the sale.³³⁰ Compaq had recognized a large long-term capital gain on an unrelated transaction that would soak up this loss.³³¹

Because Compaq was the shareholder of record on September 18, it was entitled to a \$22.5 million dividend.³³² Compaq received cash proceeds of only \$19.2 million after application of the Netherlands' 15% withholding tax.³³³ Compaq, however, received a \$3.4 million foreign tax credit³³⁴ for the taxes

325. *Compaq* is among the most written-about ESD cases; this Article provides an abbreviated account. For a more complete account, see generally David P. Hariton, *The Compaq Case, Notice 98-5, and Tax Shelters: The Theory Is All Wrong*, 94 TAX NOTES 501 (2002); Mitchell Kane, *Compaq and IES: Putting the Tax Back into After-Tax Income*, 94 TAX NOTES 1215 (2002); William A. Klein & Kirk J. Stark, *Compaq v. Commissioner — Where Is the Tax Arbitrage?*, 94 TAX NOTES 1335 (2002); Knoll, *supra* note 59, at 838-58; Luke, *Risk Return*, *supra* note 7, at 816-25; Daniel N. Shaviro, *Economic Substance, Corporate Tax Shelters & The Compaq Case*, 88 TAX NOTES 221 (2000); Shaviro & Weisbach, *supra* note 205.

326. *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 218 (1999), *rev'd*, 277 F.3d 778, 780 (5th Cir. 2001). The \$888.5 million price tag equaled the typical market price for the ADRs plus a \$22.5 million dividend that had been declared minus a 15% tax owed to the Netherlands. See Luke, *Risk Return*, *supra* note 7, at 818. This price indicated that price-setting investors were not able to use the offsetting U.S. foreign tax credit. See *id.*

327. *Compaq*, 113 T.C. at 218.

328. *Id.*

329. See *id.* at 215-16.

330. *Id.* at 219. However, if the original purchase price of the ADRs is adjusted to reflect the implicit tax subsidy, this loss would instead be approximately \$24.1 million. See Luke, *Risk Return*, *supra* note 7, at 819.

331. See *Compaq*, 113 T.C. at 215.

332. See *id.* at 219.

333. *Id.*

334. *Id.* "There was apparently no dispute that this was the correct amount of the tax credit under the formal rules on tax credits." Luke, *Risk Return*, *supra* note 7, at 822 n.141 (citing *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (2001)).

paid to the Netherlands. Thus, the transaction generated a significant tax benefit.³³⁵

The lower court stripped Compaq of its claimed benefits, but its decision was overturned on appeal to the Fifth Circuit.³³⁶ At least one other taxpayer entered into a substantially similar transaction, as the table below illustrates.

Court	Winner
Tax Court ³³⁷	Government
N.D. Iowa ³³⁸	Government
Fifth Circuit ³³⁹	Taxpayer
Eighth Circuit ³⁴⁰	Taxpayer

b. H-S Analysis

Although most tax scholars agree with the results reached by the circuit courts as to the *Compaq*-style transaction, there is less agreement as to what rationale should have been used to deny Compaq its claimed tax benefits. H-S analysis helps explain why this transaction is difficult to analyze. First, as discussed above in the section on the *ACM* transaction, generally, when taxpayers buy and sell financial assets, such transactions are, in practice, presumed to have an investment purpose.³⁴¹ And, again, the realization requirement is arguably the most entrenched of all the Code's H-S departures. Of course, in the *Compaq*-style transactions, there were strong indicators that the transaction was tax-motivated and that the sales took place in a rigged, not arms' length, market.³⁴² This suggests that a strategy

335. See Luke, *Risk Return*, *supra* note 7, at 822, n.143 (The total after-tax savings was approximately \$1.1 million: "\$7 million tax saving on capital loss + \$22.5 million dividend + \$3.4 million tax credit - \$7.7 million U.S. tax on dividend - \$3.4 million Netherlands tax on dividend - \$20.7 million capital loss."). Compaq was subject to a 34% tax rate. *Id.* at 822.

336. See *Compaq Computer Corp. v. Comm'r*, 113 T.C. 214, 214 (1999) (holding that "[t]he transaction lacked economic substance, and the foreign tax credit claimed by [Plaintiff] will be disallowed"), *rev'd*, 277 F.3d 778, 779 (5th Cir. 2001) (holding that an "ADR transaction of the sort . . . [had] economic substance and a business purpose").

337. See *Compaq*, 113 T.C. at 214.

338. See *IES Indus. v. United States*, No. C97-206, 1999 WL 973538 (N.D. Iowa Sept. 22, 1999).

339. See *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778 (5th Cir. 2001).

340. See *IES Indus. v. United States*, 253 F.2d 350 (8th Cir. 2001).

341. See discussion *supra* Part IV.C.2.

342. For example, the precision with which all of the numbers aligned suggests the transactions were not arms' length. See Luke, *Risk Return*, *supra* note 7, at 819-20 n.130 (describing how the promoter adjusted its fees in order "to match precisely the net dividend and the pre-fee adjusted capital loss").

targeted more at the lack of a bona fide purchase and sell may have been more appropriate — although, concededly, the circuit courts seemed to buy into the notion that the transactions occurred under market conditions.³⁴³

The presence or absence of pre-tax profit was central to the circuit courts' decisions.³⁴⁴ It would also be a factor to consider under the proposed H-S ESD when determining whether the transaction had the requisite connection to business or investment purposes. If one compares the gross dividend and the capital loss, there was pre-tax profit of approximately \$1.9 million.³⁴⁵ On the other hand, the result was a pre-tax economic loss of approximately \$1.5 million if the capital loss were compared to the dividend net of the withholding tax.³⁴⁶ The lower court and appellate court disagreed as to which comparison was appropriate.³⁴⁷

H-S analysis could be used to resolve the question, but it would require concluding that foreign taxes should be deductible and not treated similarly to U.S. income taxes.³⁴⁸ If it were first decided to treat foreign taxes as a cost outlay, the transaction clearly lacked a pre-tax profit. That is, if instead of a tax credit, it were assumed that H-S would limit Compaq to a deduction for the foreign taxes paid, Compaq would have had a post-tax loss.³⁴⁹ (ESD codification provisions specify that Treasury should enact

343. See *Compaq*, 277 F.3d at 787.

344. See *id.* at 784-86.

345. See *id.* at 787.

346. See *id.* at 782.

347. See *id.* at 785-86.

348. See discussion *supra* Part III.B.3; see also Shaviro & Weisbach, *supra* note 205, at 195 ("[T]here is no principle of tax law or good sportsmanship that requires treating foreign taxes the same as domestic taxes While the foreign tax credit and other elements of the international tax regime sometimes try to mitigate the differences between the two, in no way are they the same thing. The most they have in common is that they both happen to be taxes, but this is no reason that the pre-tax profit requirement has to treat them the same.").

349. The post-tax loss would have been approximately \$1.1 million. See Luke, *Risk Return*, *supra* note 7, at 882 n.142. ("\$7 million tax saving on capital loss + \$22.5 million dividend" + \$1.2 million tax saving on deduction of Netherlands tax - \$7.7 million U.S. tax on dividend - \$3.4 million Netherlands tax on dividend - \$20.7 million capital loss").

Interestingly, Surrey raised the possibility that a foreign tax credit would not be appropriate in instances where the taxpayer could shift the foreign tax away from itself. Surrey, *Current Issues*, *supra* note 203, at 821 ("We can assume, however, that a foreign excise tax on sales or exports is passed on to the consumer Hence, we need not give a credit for foreign excise taxes since their payment does not affect our criteria of uniform tax burden."). Compaq clearly did not bear the economic burden of the foreign tax as evidenced by the way the price of the ADRs was manipulated to reflect an implicit tax subsidy. See Luke, *Risk Return*, *supra* note 7, at 818-19.

regulations requiring foreign taxes to be treated as expenses in calculating pre-tax profit "in appropriate cases.")³⁵⁰

The inherent limitations of H-S analysis help explain the circuit court decisions. The *Compaq* transaction played at the intersection of two areas that are problematic to resolve from an H-S viewpoint: timing and international transactions.³⁵¹ Formulations of the current ESD have seemingly developed so as to share in these limitations. This suggests the need for the development of other approaches, but not the need to shelve the ESD altogether. If the boundaries of the ESD can be conceptualized, then the ESD can be used when most likely to help and be set aside in favor of other tools when necessary.

4. TIFD III-E Inc. (a/k/a Castle Harbour)

a. Facts

General Electric Capital Corporation (GECC) was in the business of leasing commercial aircraft to airlines.³⁵² Because of turmoil in the airline industry, in 1992, GECC sought to convert some of its future rental payments into current cash.³⁵³ Selling the airplanes on the secondary market was not viable,³⁵⁴ nor could GECC obtain non-recourse debt because of various contractual terms and a desire to keep its AAA credit rating.³⁵⁵ GECC submitted requests for advice from seven investment banks.³⁵⁶ Ultimately, in March 1993, GECC found an acceptable proposal and put it into action.³⁵⁷

On July 26, 1993, GECC caused three of its subsidiaries³⁵⁸ to create a new LLC.³⁵⁹ In exchange for their membership interests, the subsidiaries contributed (a) "beneficial ownership" in "63 'Stage II' aircraft worth . . . (a net value of \$272 million); (b) \$22 million of rents receivable on the aircraft; (c) \$296 million

350. I.R.C. § 7701(o)(2)(B) (2006 & supp. 2010).

351. See *Compaq*, 277 F.3d 778, 779-80.

352. TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 96 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).

353. *Id.*

354. *Id.* at 96-97.

355. *Id.* at 97.

356. *Id.*

357. *Id.*

358. TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 97 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006) (explaining that TIFD III-M, TIFD III-E, and General Electric Capital AG are the three subsidiaries of GECC). TIFD-III-E is the tax matters partner, and hence, authorized to bring suit. *Id.* at 96.

359. *Id.* at 97.

in cash; and (d) all the stock of GECC subsidiary TIFD VI, which had a value of \$0."³⁶⁰ On October 6, 1993, \$50 million of the interests in the LLC was sold to two Dutch banks.³⁶¹ Subsequently, the Dutch banks "contributed an additional \$67.5 million, bringing their total investment to \$117.5 million."³⁶² At this point, the LLC was renamed Castle Harbour.³⁶³

Castle Harbour was a partnership and the members entered into fairly elaborate allocation agreements and side agreements.³⁶⁴ Through such agreements, the Dutch banks, which were not subject to U.S. tax, were allocated virtually all of Castle Harbour's operating income for tax purposes.³⁶⁵ The projected actual return on the Dutch Banks' contributions that would be actually distributed to the Dutch banks was, however, carefully restricted to a range that hovered around 9%.³⁶⁶ The level of certainty about the projected distributed return was accomplished through the complex interaction of the partnership allocation agreements, the use of Castle Harbour's subsidiary to maintain just the right level of operating income inside of Castle Harbour, and a side guarantee agreement for the Dutch banks.³⁶⁷

The district court upheld the transaction, and its decision included analysis of the ESD.³⁶⁸ However, the district court's decision was later reversed by the Second Circuit on the grounds that "the Dutch banks' interest was, for tax purposes, not a bonafide equity participation."³⁶⁹ Instead, the Second Circuit determined that "[t]he Dutch banks' interest was in the nature of a secured loan, with an insignificant equity kicker."³⁷⁰ The Second Circuit did, however, remand the case in order for the district court to consider the taxpayer's arguments under Code section 704(e).³⁷¹

360. *Id.* at 97 & n.4.

361. *Id.* at 97-98 ("[The sale] included all of GE Capital AG's interest, to . . . ING Bank N.V. and Rabo Merchant Bank N.V. . . .").

362. *Id.* at 98.

363. *Id.*

364. *See* TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94, 98-100 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).

365. *See id.*; *see also* Karen C. Burke, *Castle Harbour: Economic Substance and The Overall-Tax-Effect Test*, 107 TAX NOTES 1163, 1167-68 (2005) (offering an insightful analysis of how the *Castle Harbour* allocations abused particular aspects of the partnership tax law).

366. *See TIFD III-E*, 342 F. Supp. 2d at 99.

367. *See id.* at 98-100.

368. *Id.* at 108-09, 121.

369. TIFD III-E, Inc. v. United States, 459 F.3d 220, 241 (2d Cir. 2006); *see also* Keinan, *Time to Voice*, *supra* note 10, at 96-98 (discussing *Castle Harbour*).

370. *TIFD III-E*, 459 F.3d at 241.

371. *Id.* at 241 n.19.

This Code provision provides that a person "shall be recognized as a partner" if the person is the owner of a "capital interest in a partnership in which capital is a material income-producing factor."³⁷² The provision was enacted to clarify that an individual who owns a capital interest will be treated as a partner even if his or her ownership was obtained through gift or intra-family sale.³⁷³ Whether an individual is an owner of a capital interest remains, however, a facts and circumstances determination.

On remand, the district court determined that the Dutch banks were section 704(e) partners in spite of the Second Circuit's holding that the Dutch banks lacked equity participation interests.³⁷⁴ Full discussion of section 704(e) is beyond the scope of this Article, but the district court's interpretation of capital interest ownership gives far too much deference to taxpayer labels and is highly problematic given the history of section 704(e)'s enactment.³⁷⁵

b. H-S Analysis

The facts of *Castle Harbour* illustrate a significant limitation of H-S and thus point to the need for the use of a tool beyond the ESD (or H-S ESD). *Castle Harbour LLC* was a joint enterprise conducting actual business operations that brought in income.³⁷⁶ During 1994, for example, *Castle Harbour* received \$100 million gross income and \$9.8 million net income.³⁷⁷ Assuming the validity of these figures, this amount would clearly be taxable income under H-S.³⁷⁸ But that income must then be allocated among the partners, and H-S is essentially silent as to the division of income arising from a joint enterprise.³⁷⁹

372. I.R.C. § 704(e) (2006).

373. See Lee A. Sheppard, *Subchapter K's Attractive Nuisance*, TAX NOTES TODAY, Jan. 11, 2010, available at 2010 TNT 6-5 (LEXIS) ("Older case law and legislative history show that section 704(e) is merely meant to allow recognition of a partner whose equity interest was conferred by gift or intrafamily purchase.").

374. TIFD III-E, Inc. v. United States, 660 F. Supp. 2d 367, 369, 395 (D. Conn. 2009).

375. See Sheppard, *supra* note 373 (using 704(e) history and general substance-over-form considerations to critique the district court's decision on remand). But see Monte A. Jackel & Robert J. Crnkovich, *Castle Harbour Strikes Again*, TAX NOTES TODAY, Nov. 2 2009, available at 2009 TNT 209-14 (LEXIS) (cautioning that a Second Circuit reversal on appeal of the remand decision "would clearly create havoc in the financial markets, in which preferred stock in corporations has been treated as equity, not debt for federal tax purposes . . .").

376. See TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94, 98 (D. Conn. 2004), *rev'd*, 459 F.3d 220 (2d Cir. 2006).

377. *Id.*

378. See discussion *supra* Part III.A.

379. See *supra* notes 194–96 and accompanying text.

While it is possible to say that H-S requires the owner of an asset to report the income from the asset, "ownership" is a flexible concept and exceptionally difficult to ascertain in the case of a joint enterprise.³⁸⁰ The complexity of the partnership tax law framework is in large part attributable to the need to ensure that the partners' tax consequences follow their economic interests (which may generally be determined by agreement).³⁸¹ Once the economic interests of Castle Harbour's partners were ascertained, its net income could have been apportioned.³⁸² The appellate court, for example, determined that there was significant evidence that the Dutch banks had no equity ownership interests and, thus, were not partners to whom tax allocations could be made.³⁸³ Treating the Dutch banks as non-partners would obviate the need to apply the ESD or H-S ESD.³⁸⁴

5. UPS

a. Facts

United Parcel Service (UPS) is a well-known shipping business. UPS had a lucrative, and taxable, side business in charging fees (excess-value charges) for package damage protection.³⁸⁵ In 1983, UPS established a Bermuda subsidiary, Overseas Partners, Ltd.³⁸⁶ UPS then purchased insurance for its customers from a third party (National Union Fire Insurance Company).³⁸⁷ The premiums UPS paid to National Union were equal to the excess-value charges it received from UPS customers.³⁸⁸ UPS remained responsible for processing damage

380. See *supra* notes 194-96 and accompanying text.

381. See I.R.C. § 704(a) (2006) ("A partner's distributive share of income, gain, loss, deduction, or credit [for tax purposes] shall, except as otherwise provided in this chapter, be determined by the partnership agreement."); see also SURREY & MCDANIEL, *supra* note 31, at 191 ("Once the decision has been made . . . to treat [a partnership] as not constituting a taxpaying unit, a series of normative rules must be provided to relate the partnership accounts and activities to those of the partners in order to determine the treatment of the partners.").

382. See I.R.C. § 704(a)-(b).

383. See TIFD III-E, Inc. v. United States, 459 F.3d 220, 240-41 (2d Cir. 2006).

384. See *id.* at 223-24.

385. United Parcel Serv. of Am., Inc. v. Comm'r, 254 F.3d 1014, 1016 (11th Cir. 2001) ("UPS turned a large profit on excess-value charges because it never came close to paying as much in claims as it collected in charges, in part because of efforts it made to safeguard and track excess-value shipments.").

386. *Id.*

387. *Id.*

388. *Id.*

claims.³⁸⁹ National Union purchased re-insurance from the UPS Bermuda subsidiary and remitted to it the excess-value charges, "less commissions, fees, and excise taxes."³⁹⁰ Because the Bermuda subsidiary did not repatriate the premiums it received, UPS's tax liability substantially decreased.³⁹¹

The Tax Court held that the arrangement was invalid as a sham, but this decision was overturned on appeal.³⁹² The Eleventh Circuit held that the UPS restructuring "simply altered the form of an existing, bona fide business."³⁹³ The appellate court did not address the possibility of an adjustment through other judicial doctrines, such as assignment of income.³⁹⁴ The court did, however, remand³⁹⁵ for consideration of section 482 of the Code, which prohibits the reallocation of income "in order to prevent evasion of taxes or clearly reflect the income" of two businesses.³⁹⁶ Transactions substantially similar to that at issue in *UPS* have not reached the courts.

b. H-S Analysis

There is little doubt that the UPS restructuring was motivated entirely by tax avoidance.³⁹⁷ Yet, the Bermuda subsidiary did apparently function as a bona fide, separate business entity from UPS (or, at least, this issue was not adequately raised in litigation).³⁹⁸ In addition, the restructuring was not the proximate trigger of the reduction to UPS's tax

389. *Id.*

390. *Id.*

391. *Id.* at 1017. It should be noted that almost all of the shares in the Bermuda subsidiary had been "distributed as a taxable dividend to UPS shareholders." *Id.* at 1016.

392. *See United Parcel Serv. of Am., Inc. v. Comm'r*, 78 T.C.M. (CCH) 262, 1999 WL 592696, at *39 (Aug. 9, 1999), *rev'd*, 254 F.3d 1014, 1020 (11th Cir. 2001).

393. *Id.* (Ryskamp, J., dissenting).

394. *See id.* at 1017–18 (The appellate court complained that it was "not perfectly clear on what judicial doctrine the [trial court's] holding rests. . . . The [tax] court did not, however, discuss at all the touchstone of an ineffective assignment of income, which would be UPS's control over the excess-value charges once UPS had turned them over as premiums to National Union."); *see also* Hariton, *When and How*, *supra* note 27, at 44–45.

395. *United Parcel Serv.*, 254 F.3d at 1020.

396. *See* I.R.C. § 482 (2006). The court also remanded for consideration of § 845(a) of the Code, *United Parcel Serv.*, 254 F.3d at 1020, a provision similar to section 482 but which is specifically applicable to the re-insurance context. *See* I.R.C. § 845(a).

397. *See United Parcel Serv.*, 254 F.3d at 1021 (Ryskamp, J., dissenting) ("[T]he evidence showed that tax avoidance was the initial and sole reason for the scheme in question, that UPS held off on the plan for some time to analyze tax legislation on the floor of the United States House of Representatives, and that a letter sent to AIG Insurance from UPS detailing the scheme claimed that AIG would serve in merely a 'fronting' capacity and would bear little or no actual risk.").

398. *See id.* at 1019.

liability.³⁹⁹ Rather, the tax benefits arose out of the fact that ownership of UPS's future income stream had been moved to an offshore entity.⁴⁰⁰ While it is possible to argue that the tax motive for the restructuring should taint the future business-related activity, this would require a fairly expansive reading of the H-S "for profit" requirement. Thus, the limitations inherent in H-S help make sense of the circuit court's decision.

In terms of economic outcomes, the Bermuda subsidiary received actual income and complied with Bermuda law in terms of reporting any taxes (of course, Bermuda is a well-known tax haven).⁴⁰¹ Although, as discussed in Part III, a plausible H-S approach would require ending deferral on foreign income, applying such a rule would not have been the best tool in evaluating the UPS case because it would require not only suspending Code sections, but would also require a decision as to the proper taxpayer identity.⁴⁰² Arguably, a better approach would have been to assert other doctrines premised on the fact that the owners of UPS retained beneficial ownership of the future income streams.⁴⁰³

V. SUMMARY OF CASE STUDIES AND CONCLUSION

This project began as an inquiry into what H-S could bring, if anything, to the tax shelter problem. The ESD seemed a natural place to begin since it has been at the forefront of the tax shelter debate. This Article concludes that H-S could provide a principle for refining the ESD's content, for positioning the ESD within an interpretive framework, and for understanding ESD case law.

The preceding section discussed five tax-avoidance transactions and how the application of H-S to their facts helps explain the court results. In each of the case studies, the taxpayer relied in part on a rule that departed from H-S or exploited a limitation inherent in the H-S concept. In cases when a court disallowed the taxpayer's transaction, such disallowance

399. *See id.* at 1016-17.

400. *See id.*

401. *See id.* at 1016-17, 1019.

402. *See* discussion *supra* Part III.B.3.

403. *See* Lederman, *supra* note 2, at 432-33 (discussing the use of § 482 of the Code or the assignment of income doctrine as alternative approaches to *UPS*). Because the case settled before the trial court, on remand from the 11th circuit, issued a decision based on the application of sections 482 and 825(a), whether or not an alternative approach would have been successful will never be known. *See supra* notes 395-96 and accompanying text.

yielded a result readily obtained through application of the business connection requirement of H-S.⁴⁰⁴

On the other hand, courts were more reluctant to use the ESD to overturn a transaction when it appeared to have a business or investment connection and when it relied on long-standing H-S discontinuities (*Compaq*,⁴⁰⁵ *Castle Harbour*,⁴⁰⁶ and *UPS*⁴⁰⁷).

In these cases, the H-S ESD analysis suggested that other tools would have been more appropriate given the difficulty of resolving the H-S discontinuities inherent in the suspect transactions.

The case studies as a whole suggest that there is a greater likelihood that a court will treat a transaction as a substantive sham under the ESD if reaching a result consistent with H-S is fairly easy. If the limitations of H-S analysis are more extensive, then it becomes more likely that a court will allow the claimed tax benefits or use a method other than the ESD to disallow them.⁴⁰⁸ If the ESD is a smell test, then how a transaction would fare under H-S may unconsciously influence the court's perception of a transaction's odor.⁴⁰⁹

The possible link between H-S analysis and the common law ESD as illustrated by the case studies also supports the proposed use of H-S to re-frame the ESD. The ESD has been controversial in part because it has been difficult to fit it into an interpretive framework and because its content remains problematic. While the proposed H-S ESD does not address what criteria a court

404. For example, the transaction in *Knetsch* would fail to meet the necessary business or investment connection. See discussion *supra* Part IV.C.1.b. Similarly, the transaction in *ACM* also lacked the necessary business or investment connection. See discussion *supra* Part IV.C.2.b. In addition, the taxpayer in *ACM* relied on a particular type of installment reporting. See *ACM P'ship v. Comm'r*, 157 F.3d 231, 242 (3d Cir. 1998). This reporting is an H-S departure of relatively weak durability, given the numerous efforts over time to narrow it. See *supra* notes 321-22 and accompanying text.

405. The *Compaq* transaction relied on the realization requirement and on ambiguities surrounding the treatment of foreign taxes. See *Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 779-80 (5th Cir. 2001). Arguably, the transaction lacked an investment purpose, though this depends on one's view regarding the applicable market conditions but also on the treatment of foreign taxes for purposes of calculating profit.

406. The taxpayer in *Castle Harbour* used ambiguities surrounding the determination of tax ownership. See *TIFD III-E Inc. v. United States*, 459 F.3d 220, 222 (2d Cir. 2006).

407. H-S analysis of the transaction is limited, however, by its failure to address taxpayer identity. See *supra* note 31 and accompanying text.

408. A more in-depth review of all ESD cases would, of course, be needed to explore fully the relationship of H-S and the current ESD.

409. Codification of ESD would not change this possibility, since the statutory language leaves unanswered the question of when the ESD should be relevant and also fails to define several key terms. See I.R.C. § 7701(o) (2006 & supp. 2010).

should use in making a preliminary determination about legislative intent with respect to a taxpayer's particular application of tax law, the proposed H-S ESD highlights the necessity for reaching such a determination.⁴¹⁰ Using the proposed H-S ESD as a last step in legislative intent analysis has the virtue of utilizing a principle already widely incorporated throughout the Internal Revenue Code.

Under the proposed H-S ESD, a court would look for business or investment connection as a necessary, but not sufficient, requirement for a transaction.⁴¹¹ The relevance of profit potential would be limited to an analysis of a transaction's business or investment connection since a court would still need to determine the economic reality of the transaction and assign tax consequences to it using H-S.⁴¹² Limitations inherent in the H-S concept would limit application of the proposed H-S ESD, but those limitations would also help clarify when this test should be used. The H-S ESD is thus not proposed as the magic bullet for tax-avoidance techniques but as one weapon among many.⁴¹³

410. See discussion *supra* Part III.B.

411. See *supra* note 216 and accompanying text.

412. See *supra* note 216 and accompanying text.

413. See Chirelstein & Zelenak, *supra* note 37, at 1939.