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# Random Thoughts on Applying Judicial Doctrines to Interpret the Internal Revenue Code

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# RANDOM THOUGHTS ON APPLYING JUDICIAL DOCTRINES TO INTERPRET THE INTERNAL REVENUE CODE

*Martin J. McMahon, Jr.\**

“SUBSTANCE controls over form, except, of course, in those cases in which form controls.” This immutable law of federal taxation lies at the heart of the ongoing controversy about the proper role of several long-standing judicial doctrines for interpreting and applying the Internal Revenue Code. Those doctrines, and the propriety of embodying, to some extent or another, one or more of them in the Code and regulations are discussed in the principal articles in this symposium.

The myriad of judicial doctrines that may be applied to police an overly literal application of the Code and regulations that could produce an absurd or unintended result cannot be neatly sorted in readily distinguishable piles. The “substance over form, except . . .” doctrine is merely one of several related doctrines. A very close relative is the venerable step transaction doctrine. Both of these doctrines, loosely speaking, can be said to be judicial tools to determine exactly what constitute the relevant fact findings, determined from the welter of evidence, to which the law in turn can be applied.

A slightly more distant relative is the “business purpose doctrine.” Variations on that theme include the “sham transaction,” “economic reality,” and “purposive activity” doctrines. While there may be abstract differences in these doctrines, and the courts in particular cases frequently find that one applies while another does not, any fair minded person would have to admit that those differences often are fairly gossamer. Picking and choosing from among these doctrines to deny a taxpayer the benefit of some mechanical application of the Code and regulations in reality turns more on an *ex-post* analysis of the specific facts than on an *ex ante* exposition of the principles that will bring one or another of the doctrines into play.

The several principal authors in this symposium take somewhat different tacks in evaluating these judicial doctrines. While they all support the application of one or more of these doctrines in certain circumstances, Mr. Canellos and Professor Gunn appear to value *ex ante* predictability,

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based on rules and principles, relatively more highly than do Professors Aprill and Gergen, for whom policing the otherwise turgid rules in the Code and regulations through the *ex post* application of judicial standards is relatively more attractive.<sup>1</sup> Nevertheless, both Mr. Canellos and Professor Gunn believe that some doctrine must be available to defeat the most egregious transactions—such as the “abusive” tax shelters discussed by Mr. Canellos and those aspects of the partnership anti-abuse regulations discussed by Professor Gunn that are based on application of the step transaction doctrine to apply Subchapter K to the substance rather than the transitory form of certain partnership transactions. One cannot help but conclude, however, that they both prefer a more limited role for supervisory judicial doctrines than do Professors Aprill and Gergen.

Although I might not agree with every detail, I find the viewpoints expressed by Professors Aprill and Gergen to be most convincing. This is not because I find application of the various judicial doctrines to be easy or without its own set of problems and inevitable errors. Application of the substance over form, step transaction, business purpose, and sham transaction doctrines is difficult and fraught with potential error. Rather, the arguments by Professors Aprill and Gergen are persuasive because they treat tax law as law—an effort to determine the “right” result—rather than as a high-stakes game in which taxpayers bet transaction costs against their ability to find and exploit anomalies in the Code and regulations. As law, the Code and regulations should serve a purpose. Broadly speaking, that purpose is to divide the cost of the public goods among taxpayers relative to their incomes according to a predetermined formula, the rate schedules. This purpose is served by rules defining the “taxable income” to which the rate schedules will be applied. If taxpayers are free to manipulate the rules defining “taxable income” to cause it to diverge from their economic income in ways not contemplated by Congress in writing the statutory rules, then the purpose of the statute will be frustrated.

This sort of thinking is common, although it is not universally accepted, among tax academicians. It is quite out of vogue, however, with much of the practicing bar. Public commentary and articles published by prominent tax lawyers—many of whom have served with distinction in important tax administrative posts such as Chief Counsel or Tax Legislative Counsel—decry the application of judicial doctrines in derogation of what they perceive to be the unambiguous results produced by the interaction of multiple sections of the Code and regulations to a complicated fact pattern, regardless of how anomalous those results might be and

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1. See generally, Peter C. Canellos, *A Tax Practitioner's Perspective on Substance, Form, and Business Purpose in Structuring Business Transactions and in Tax Shelters*, 54 SMU L. REV. 47 (2001); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159 (2001); Ellen P. Aprill, *Tax Shelters, Tax Law, and Morality: Codifying Judicial Doctrines*, 54 SMU L. REV. 9 (2001); Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. REV. 131 (2001).

without regard to the possibility that none of the drafters of any of the provisions ever contemplated that the provision could or would be applied in such a manner. Often their criticisms are bundled with the criticism that the application of these doctrines is improper because it makes “motive” the touchstone for determining tax consequences.

To be sure, the naysayers in the Bar hit the mark when they criticize the position that tax benefits should be disallowed solely because the particular form of the transaction in question was substantially, or even wholly, tax motivated. Nothing in the mainstream jurisprudence involving the business purpose, step transaction, substance over form, sham transaction, economic substance, or purposive activity doctrines denies a tax benefit produced by application of the Code and regulations *merely* because the choice of the particular road that a transaction follows was tax motivated. In one way or another, all of these doctrines are correctly, and primarily, applied only when the courts, usually at the behest of the IRS, determine either that the transaction to which the taxpayer wants the Code and regulations to apply simply was not “the real deal” or that no transaction remotely resembling either the purported transaction or the real deal would have occurred in the first place if only business considerations were relevant.

Complaints in principle about the application of the substance over form and step transaction doctrines are largely unwarranted. These venerable doctrines are—from the perspective of tax law—of ancient lineage. What’s more, when they work to the taxpayer’s advantage, the Bar finds them to be quite respectable and properly applied.<sup>2</sup> But if they are good for the goose, they are good for the gander. Nevertheless, these are not easy doctrines to apply. It often is difficult to predict whether they will be applied in the context of a new statutory provision, or even how they will be applied in a case first applying a long-standing provision to novel facts. The all too true aphorism with which this commentary began—“Substance controls over form, except, of course, in those cases in which form controls”—really does accurately describe the rule. Compare two cases decided about fifty years ago.

The first case is *Granite Trust Co. v. United States*.<sup>3</sup> Granite Trust Co. owned a controlled subsidiary, the stock of which was depreciated in value. To avoid nonrecognition of the loss under the 1939 Code predecessor of § 332, after the plan of liquidation of the subsidiary was adopted, Granite Trust Co. sold and made charitable gifts of enough stock of the subsidiary to cause its ownership of the subsidiary to fall below the 80 percent ownership requisite for nonrecognition. The Commissioner argued that the transfers should have been ignored and the predecessor of § 332 applied to deny recognition of the loss. The Court of Appeals for the First Circuit, however, found the stock transfers to be

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2. See Canellos, *supra* note 1, at 50.

3. 238 F.2d 670 (1st Cir. 1956).

real in substance, not just form, and gave effect to them. The court stated:

As for the Commissioner's 'end-result' argument, the very terms of [§ 332(b)] make it evident that it is not an 'end-result' provision, but rather one which prescribes specific conditions for the nonrecognition of realized gains or losses, conditions which, if not strictly met, make the section inapplicable. . . .

In the present case the question is whether or not there actually were sales. Why the parties may wish to enter into a sale is one thing, but that is irrelevant under the *Gregory*<sup>[4]</sup> case so long as the consummated agreement was no different from what it purported to be.

Even the Commissioner concedes that 'legal title' passed to the several transferees on December 13, 1943, but he asserts that 'beneficial ownership' never passed. We find no basis on which to vitiate the purported sales, for the record is absolutely devoid of any evidence indicating an understanding by the parties to the transfers that any interest in the stock transferred was to be retained by the taxpayer. . . .

In addition to what we have said, there are persuasive reasons of a general nature which lend weight to the taxpayer's position. To strike down these sales on the alleged defect that they took place between friends and for tax motives would only tend to promote duplicity and result in extensive litigation as taxpayers led courts into hair-splitting investigations to decide when a sale was not a sale. It is no answer to argue that, under *Gregory v. Helvering*, there is an inescapable judicial duty to examine into the actuality of purported corporate reorganizations, for that was a special sort of transaction whose bona fides could readily be ascertained by inquiring whether the ephemeral new corporation was in fact transacting business, or whether there was in fact a continuance of the proprietary interests under an altered corporate form. . . .

In short, though the facts in this case show a tax avoidance, they also show legal transactions not fictitious or so lacking in substance as to be anything different from what they purported to be, and we believe they must be given effect in the administration of [§ 332(b)] as well as for all other purposes.<sup>5</sup>

Now consider, in contrast, *Heller v. Commissioner*.<sup>6</sup> In *Heller*, the shareholders of a Delaware corporation organized a California corporation, to which they contributed borrowed cash in exchange for the stock. The California corporation then borrowed additional cash and purchased the assets of the Delaware corporation, which paid its existing indebtedness and distributed the balance of the cash to its shareholders in liquidation. The shareholder, whose basis in the stock of the Delaware corporation exceeded the liquidating distribution, claimed a deductible

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4. *Gregory v. Helvering*, 293 U.S. 465 (1935).

5. 238 F.2d at 675-78.

6. 2 T.C. 371 (1943), *aff'd*, 147 F.2d 376 (9th Cir. 1945).

loss on the liquidation. The Commissioner disallowed the loss, asserting that the series of steps was in fact a single transaction which was a reorganization under the statutory predecessors of § 368(a)(1)(D) or § 368(a)(1)(F) and that, accordingly, no loss was recognized.<sup>7</sup> The shareholder argued that even if the transaction had the same result as a reorganization, there had been no exchange of stock for stock as required by the predecessor of § 354(a)(1).<sup>8</sup> Notwithstanding the absence of the form of an exchange of stock, the Tax Court held for the Commissioner, reasoning as follows:

In determining the substance of a transaction it is proper to consider the situation as it existed at the beginning and end of the series of steps as well as the object sought to be accomplished, the means employed, and the relation between the various steps. . . .

Petitioner and two others, the stockholders and directors of the Delaware corporation, decided to have the business, assets, and liabilities of that company taken over by a new California corporation. The desired end was accomplished by a series of steps, all of which were planned in advance. The net result was that petitioner and the other two stockholders had substituted their interest in the Delaware corporation for substantially the same interest in the California corporation. The nonrecognition of gain or loss provisions of the statute are 'intended to apply to cases where a corporation in form transfers its property, but in substance it or its stockholders retain the same or practically the same interest after the transfer.'

The result achieved under the plan could have been accomplished by having the California corporation acquire the assets of the Delaware corporation for its stock, and by having the latter distribute the stock to its stockholders in complete liquidation. Petitioner and his associates apparently chose the longer route, hoping that they might thereby become entitled to a loss deduction. However, as the Supreme Court pointed out in *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613, 58 S. Ct. 393, 'a given result at the end of a straight path is not made a different result because reached by following a devious path.' The effect of all the steps taken was that petitioner made an exchange of stock of one corporation for stock of another pursuant to a plan of reorganization.<sup>9</sup>

One is left to puzzle over why the *Granite Trust Co.* transaction succeeded in achieving loss recognition while the *Heller* transaction did not. A distinction based on the fact that the transferees of the stock in *Granite Trust* were otherwise legally unrelated to the corporation but that the shareholders in *Heller* had a legally significant relationship to the corporations is too facile. The ownership of the stock of the subsidiary by the third parties in *Granite Trust* was in fact transitory and the liquidation was a practical inevitability, even if not legally inevitable. If indeed "a given result at the end of a straight path is not made a different result because

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7. See 26 U.S.C. §§ 368(a)(1)(D), 368(a)(1)(F) (2000).

8. See 26 U.S.C. § 354(a)(1) (2000).

9. 2 T.C. at 383-84.

reached by following a devious path,"<sup>10</sup> then the loss in *Granite Trust Co.* should not have been recognized. But it is equally true that the sale of the assets of the Delaware corporation to the California corporation in *Heller* was to a different corporation that actually was transacting business. Once the sale was achieved, the Delaware corporation could have been liquidated or not liquidated, as business exigencies dictated.

Are differences like the results in these cases puzzling? Of course. But, as pointed out so well by Professor Gergen, this uncertainty is the stuff of tax lawyering.<sup>11</sup> And it's the inevitable result of differences in the wording and history of the development by revision over the years of different statutory provisions, as well as the vagaries of interpretation by hundreds of judges over more than seventy five years. More importantly, as Professor Gergen notes, without the uncertainty these doctrines create, mastery of the intricacies of nooks and crannies of the Code and regulations would become even more valuable, not just for tax practitioners, but for their clients as well. That is exactly what the recent corporate tax shelter phenomenon is all about. Corporate tax departments have, in business jargon, come to be viewed as profit centers, and they are expected to go out and find transactions that contribute to the after-tax bottom line. This development makes it even more important that the IRS and judiciary have available these judicial doctrines with which to prevent the proliferation of the sale of "products"—prepackaged tax reduction transactions designed to exploit inconsistencies, lacuna, and anomalies in the Code and regulations. These products are produced and marketed by investment bankers, multi-disciplinary practice firms, and yes, even law firms, in a manner not too different, when one gets down to basics, from the manner in which a contractor builds and sells high-end spec homes. Phenomena like this, which are merely the most recent manifestation of long-standing problems in tax administration, necessitate the interposition of the substance over form, step transaction, business purpose and economic substance doctrines.

Many years ago, writing with respect corporate reorganizations, Stanley Surrey captured the importance of these doctrines.

The reorganization sections are written against a background of many varied business transactions. They are stated in terms of specific rules which chart a tax-free corridor through which may flow the corporate transactions intended to be so favored. But the very breadth of the transactions to which the rules could extend and the mechanical terms in which they are written combine to make that corridor a tempting avenue of tax avoidance to persons who were not intended to be the recipients of such a safe-conduct pass. This is especially true in the case of closely-held family corporations where the corporation may be readily maneuvered by the shareholders. From the very beginning the courts, prompted by the Commissioner, have undertaken the task of policing this tax-free corridor. Their

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10. *Id.* at 384 (quoting *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)).

11. See Gergen, *supra* note 1, at nn.36-37.

guarding has been vigorous and diligent, and many a corporation or shareholder who presented a pass carefully prepared to match the literal language of the sections has nevertheless been denied entrance. As a consequence, the literal language of the sections cannot be relied upon, and safe passage depends upon knowledge of the rules of the judicial gendarmerie. An attorney who reads section 368(a)(1)(A) and believes that a statutory merger always constitutes a reorganization may be sadly mistaken—his particular statutory merger may be on the judicial proscribed list if it fails to possess the necessary continuity of interest. Some of these judicial rules have been incorporated in the statute; part of their flavor is in the Regulations. But most of them still remain as they originated—judicial safeguards devised to protect the underlying statutory policy. Nor is the role of the judiciary confined to enforcing rules previously announced. Anyone applying for passage through the corridor runs the risk of the judicial policeman inventing a new rule on the spot if he thinks such action is demanded. And the Internal Revenue Service, in administering the statutory provisions, is alert to bring these situations before the courts. It must be remembered that most of the taxpayers who thus prompt administrative and judicial ingenuity have no real business in the corridor. But when such trespassers are in the throng, the barriers designed to separate them may catch an innocent, or may force the innocent to take added precautions to identify himself. The rules may also produce some uncertainty and confusion where the innocent too closely resembles a trespasser. Some have criticized the judicial vigilance on this score. Others believe that any effort to prescribe statutory rules covering all of the everyday transactions of the business world is bound to fail unless courts and administrators are able to cope with transactions that would otherwise involve a distorted application of those rules.<sup>12</sup>

Professor Surrey's words apply with equal, or even greater, force today when investment bankers and others are approaching corporations with transactions that have nothing to do with the corporation's business and are noneconomic apart from the tax consequences, but which produce a handsome after-tax profit if the Code and regulations are literally applied as written.<sup>13</sup> According to former Secretary of the Treasury Lawrence Summers, corporate tax shelters represent "perhaps the most serious

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12. 2 STANLEY S. SURREY ET AL., FEDERAL INCOME TAXATION 633-34 (1973).

13. See, e.g., *ACM P'ship v. Comm'r*, 73 T.C.M. (CCH) 2189, *aff'd in part and rev'd in part*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) (holding that an offshore partnership transaction organized and marketed as a package deal by Merrill Lynch involving the purchase and resale under a contingent payment installment sale contract that "involved only a fleeting and inconsequential investment in and offsetting divestment" of debt instruments that was designed to produce paper gains in early years allocable to non-U.S. partners and paper losses in later years allocable to U.S. partners was a "sham" without economic substance; investor U.S. partner's losses were limited to out-of-pocket economic losses); *ASA Investorings P'ship v. Comm'r*, 76 T.C.M. (CCH) 325, *aff'd* 201 F.3d 505 (D.C. Cir. 2000) (purported partnership interest, in an offshore corporate tax shelter partnership organized and marketed as a package deal by Merrill Lynch, was recharacterized as a lender-creditor relationship).



compliance problem the country faces.”<sup>14</sup>

Consider the transaction involved in the recent decision in *Compaq Computer Corp. v. Commissioner*.<sup>15</sup> In 1992, shortly after Compaq recognized a \$232 million long-term capital gain on the sale of a subsidiary, an investment firm, Twenty-First Securities Corp., contacted the Compaq treasury department (which focused primarily on capital preservation, typically investing in overnight deposits, Eurodollars, commercial paper and tax-exempt obligations) to suggest that Compaq take advantage of an American Depository Receipt arbitrage transaction to reduce its resulting tax liability.<sup>16</sup> The transaction involved the purchase of \$888 million of Royal Dutch Shell ADRs cum dividend, followed by sales of those ADRs ex dividend within the hour for \$868 million. Compaq then carried back \$20 million of loss against the previously-recognized gain. It also claimed a \$3.4 million foreign tax credit for taxes withheld from the \$22.5 million dividend received. The Tax Court found that the transaction lacked economic substance because the net cash flow from the transaction without regard to tax consequences was a \$1.5 million loss. Among the important facts found by the court that influenced its decision were that Compaq did not perform a cash flow analysis or investigate the investment, and it shredded the spreadsheet provided by the promoter and did not disclose any communications indicating any reliance on the advice of its tax department or counsel. The opinion stated:

To satisfy the business purpose requirement of the economic substance inquiry, ‘the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer’s conduct and . . . economic situation.’ [citations omitted] This inquiry takes into account whether the taxpayer conducts itself in a realistic and legitimate business fashion, thoroughly considering and analyzing the ramifications of a questionable transaction, before proceeding with the transaction.<sup>17</sup>

Because the ADR transaction was “marketed to [Compaq] by Twenty-First for the purpose of partially shielding a capital gain previously realized, and . . . [its] evaluation of the proposed transaction was less than businesslike with [the Assistant Treasurer] committing [Compaq] to this multimillion-dollar transaction based on one meeting with Twenty-First and on his call to a Twenty-First reference” the court concluded that the was “no business purpose for the transaction other than tax benefits.”<sup>18</sup>

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14. Christopher Bergin et al., *Summers Delivers Sharp Words on Corporate Shelters*, 89 TAX NOTES 991 (Nov. 20, 2000).

15. 113 T.C. 214 (1999).

16. American Depository Receipts (ADRs) are transferable units in a trust that represent ownership of foreign stock.

17. 113 T.C. at 224.

18. *Id.* at 215. *IES Industries v. United States*, No. C97-206, 1999 WL 973538, at \*2 (N.D. Iowa 1999), reached a similar result on summary judgment. The court disallowed the tax benefits of the ADR transactions in that case because they “did not change IES’s economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES.”

Nevertheless, as observed by Professor Gunn, one is hard pressed to find consistent “principles” in the business purpose, economic substance, and sham transaction—at least in the legal, as opposed to factual, sham transaction—doctrines.<sup>19</sup> Transactions that take advantage of anomalies or quirks in the various aspects of the tax law can be home-grown; they are not all purchased “products.” And the transactions may have very real and substantial before-tax consequences, although those consequences might not have been sought in a nirvana in which there were no taxes. These characterizations to some extent are true with respect to the transaction in *United Parcel Service v. Commissioner*,<sup>20</sup> another case in which the Tax Court applied judicial doctrines to uphold the Commissioner’s position disallowing tax benefits sought to be realized through a complex transaction.

The facts in *UPS* require some detailed explanation in order to understand the decision. UPS generally limits its liability for damages to goods in transit to \$100, but customers may pay and UPS collects “excess value charges” (EVCs) to insure the packages for greater amounts. Prior to 1984, UPS retained all of the EVCs, paid all claims, and reported the income and deduction items on its return. Beginning in 1984 UPS restructured the manner in which it dealt with and reported EVCs. Although it did not change its practices for dealing with customers in handling receipts and claims, UPS began to remit the net EVCs (the total collected from customers and other shippers minus claims paid) to an unrelated insurance company (NUF), which in turn, after deducting certain fees, remitted the net EVCs as a reinsurance premium to OPL, a Bermudan insurance company. OPL had been formed by UPS and 97.33% of its stock was owned by UPS’s 14,000 shareholders,<sup>21</sup> who had received the OPL stock as a dividend in a taxable spin-off. The OPL stock was subject to restrictions on transfer. After this arrangement was established, UPS no longer reported as income any of the EVCs collected and remitted to NUF, which amounted to \$99,794,790 for 1984 alone. However, UPS performed the same EVC functions and activities that it had previously performed, and it remained responsible for bad debts or uncollectible items because neither NUF nor OPL had any control over the customers’ premium payments.

The Tax Court upheld the IRS’s determination that under the assignment of income doctrine UPS was taxable on the \$99,794,790 of EVCs paid to OPL in 1984, regardless of OPL’s separate existence, which was accepted *arguendo*. Rather, the court found that the entire 1984 arrangement lacked business purpose and economic substance. The court rejected UPS’s proffered business purpose—that its continued receipt of EVCs was potentially illegal under various state insurance laws—because no state insurance regulator ever questioned the prior practice. UPS

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19. See generally, Gunn, *supra* note 1.

20. 78 T.C.M. (CCH) 262 (1999).

21. The case arose before UPS recently went public.

never sought legal advice on the issue, federal common carrier law probably preempted state law in any event, and if federal law did not preempt state law, the 1984 practice was probably as violative of state law as the pre-1984 practice. The court also was not convinced that the arrangement was designed to facilitate UPS rate increases. Nor was it impressed by UPS's claim that a business purpose was to leverage the excess value profits into a new reinsurance company; the opinion noted that "any investment of money into [the subsidiary reinsurer] could accomplish this purpose."<sup>22</sup> After examining UPS's pre-1984 reinsurance practices, which involved only claims over \$25,000, and the fairly consistent 70 percent ratio of net EVCs retained to total EVCs collected, the court rejected the UPS claim that the NUF/OPL arrangement sufficiently reduced the risk to UPS core transportation activity assets to have economic substance. Finally, the court found that there was contemporaneous documentation that the transaction was tax-motivated and concluded that the arrangement was "done for the purpose of avoiding taxes" and "had no economic substance or business purpose."<sup>23</sup> To top it off, because the EVC restructuring was found to be a sham transaction, the court denied UPS's deduction for approximately \$1 million retained by NUF.

Even if this transaction was entirely tax motivated, it is not so clear that there was no business or economic substance or that the transaction was a sham, at least as those doctrines historically have been known. The UPS transaction was in some essential respects a revised version of the captive insurance company transactions cases,<sup>24</sup> with the "captive" feature removed. As long as the *Moline Properties*<sup>25</sup> doctrine is respected, and the facts of UPS do not really present any reason for not respecting it, OPL was a real corporation. If OPL conducted any business, which it appears to have done, it had a business purpose from the *Moline Properties* perspective. Thousands, tens of thousands, maybe even millions, of separate corporations have been formed to gain a tax advantage for the shareholders or related corporations. That fact alone is not sufficient to recast the transaction. That UPS decided to cease conducting what was arguably an insurance business in coordination with a related sibling corporation entering that business is not unusual. UPS was simply taking advantage of the combination of several divergent tax rules, starting with the *Moline Properties* doctrine. Added to the mix were the rules dealing with foreign corporations, insurance companies, and the basic realization requirement found in §1001 and *Eisner v. Macomber*.<sup>26</sup> The deductions claimed by UPS were not offset on the other end of the transaction by full income

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22. See *United Parcel Serv.*, 78 T.C.M. (CCH) 262, 286.

23. *Id.* at 293.

24. See generally Donald A. Winslow, *Tax Avoidance and the Definition of Insurance: The Continuing Examination of Captive Insurance Companies*, 40 CASE W. RES. L. REV. 79 (1990) (discussing captive insurance cases generally).

25. *Moline Props. v. Comm'r*, 319 U.S. 436 (1943).

26. 252 U.S. 189 (1920).

inclusion, either as income at the corporate level or as gain at the shareholder level. That is not an uncommon result. It happens frequently, for example, whenever a corporation borrows from a charitable organization or pension fund by selling bonds to the tax-exempt entity. Many of these opportunities for rate arbitrage are clearly accepted as part of a theoretically imperfect tax system that must make concessions to administrability, e.g., the realization requirement, and that includes numerous deviations from a theoretically correct base to serve social and economic policy goals, e.g., the tax exemption for investment income realized by charitable organizations and pension funds.

What then was the problem in *United Parcel Service*? Perhaps the matador's cape in the *United Parcel Service* case was that UPS continued to deal with customers in much the same way that it had before and was providing without compensation virtually all of the services necessary for OPL to "earn" its premiums. Thus it "smelled" like a sham or an assignment of income. Such a transaction, however, could have been addressed under §482 rather than under the various judicial doctrines.<sup>27</sup> Arguably, since it could have been addressed under §482, a provision specifically tailored to these types of transactions, rather than under the broader, more amorphous judicial doctrines, the issue should have been so addressed.<sup>28</sup> But it was not, perhaps because motive, even though it probably should not be particularly relevant, was just too transparent on the facts. This case illustrates the difficulty in applying the various judicial doctrines to transactions that have real economic consequences but which would not have occurred but for some asymmetrical tax treatment.

The Code abounds with provisions that not only influence economic behavior, but that also are intended to influence economic behavior. Many of those provisions, particularly when they act in concert, result in noneconomic transactions becoming profitable only after tax. The transaction in *Compaq* previously discussed is one example. But the results in many other situations in which this commonly occurs are routinely accepted. The MACRS depreciation rules in §168, coupled with the inclusion of debt in basis, effectively result in purchases of assets that would be noneconomic before-tax producing an after-tax profit.<sup>29</sup> In other instances, targeted statutory provisions prevent the realization of tax arbitrage profits that otherwise could be realized in such transactions. Section 265(a)(2), disallowing deductions for interest paid on loans incurred or continued to purchase or carry tax-exempt bonds, is just one example.<sup>30</sup> How are the IRS and the courts to sort the sheep from the

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27. See 26 U.S.C. § 482 (2000).

28. For the view that the transaction might be analyzed as a constructive dividend to the UPS shareholders, followed by a capital contribution to OPL, see David L. Lupi-Sher, *As Briefs Are Filed Practitioners, Question Decision in UPS Case*, 89 TAX NOTES 200, 204 (Oct. 9, 2000) (quoting the author of this article).

29. See generally Martin J. McMahon, Jr., *Reforming Cost Recovery Allowances For Debt Financed Depreciable Property*, 29 ST. LOUIS U. L.J. 1029 (1985).

30. See 26 U.S.C. § 265(a)(2) (2000).

goats and decide which combination of mismatched rules produces an intended tax benefit, thereby exempting the transaction from the business purpose test and economic substance test, and which combination of mismatched rules produces an unintended tax benefit, thereby exposing the transaction to the business purpose test and economic substance test? This challenge is complicated by the further need to distinguish cases in which the failure of Congress to address the issue with a remedial statute such as § 265(a)(2) was intentional, indicating that the tax benefits of the otherwise noneconomic transaction should be allowed without intervention of the judicial anti-abuse doctrines, from cases in which congressional silence betokens nothing, thereby leaving room for application of these doctrines. Why are highly leveraged investments in property subject to artificially accelerated depreciation under § 168 generally immune from attack, while the corporate owned life insurance plans in *Winn-Dixie Stores, Inc. v. Commissioner*<sup>31</sup> and *In re CM Holdings, Inc.*<sup>32</sup> were struck down?

Consider the *Winn-Dixie* transaction. In 1993, Winn-Dixie entered into a broad-based leveraged corporate-owned life insurance (COLI) group plan covering approximately 36,000 of its employees. The decision to shift from its existing "key-person" COLI program of individual policies, which covered only 615 managers, was made pursuant to a proposal that emphasized the "tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains."<sup>33</sup> The proposal indicated that Winn-Dixie would incur pre-tax loss totaling \$755 million for its 1993-2052 years, but, as the result of total projected income tax savings of more than \$3 billion, would realize increased after-tax earnings of more than \$2.2 billion for the same period.<sup>34</sup> The Tax Court rejected Winn-Dixie's argument that, because for the years in issue § 264 expressly disallowed interest deductions with respect to certain other leveraged life insurance transactions but did not disallow the interest deduction with respect to its own transaction, the interest deduction was allowable under a literal interpretation of the statute. The court held that the COLI program had neither a business purpose nor economic substance and thus was a sham, and it disallowed the interest deductions.<sup>35</sup>

One of the common threads in the corporate tax shelter cases is that the transactions that have been scrutinized under the business purpose, economic substance, and sham transaction doctrines, and which have been found to be lacking, are transactions outside the ordinary course of the taxpayer's business. With the possible exception of the *United Parcel*

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31. 113 T.C. 254 (1999).

32. 254 B.R. 578 (D. Del. 2000).

33. *Winn-Dixie*, 113 T.C. at 254.

34. The COLI policies, in fact, were terminated in 1997, following an amendment of §264 in the Health Insurance Portability and Accountability Act of 1996 generally to deny the deduction for interest on loans with respect to company-owned life insurance, except for certain key-person policies.

35. See *Winn-Dixie*, 113 T.C. at 290.

*Service* case, they did not even have any semblance of a contribution to any business activity or objective that the taxpayer may have had apart from tax planning. They were, as Mr. Canellos properly observes, merely “loss generating shelters.”<sup>36</sup> This point is similar to one made by Professor Gergen when he observes,

Two general propositions tend to press on the minds of people who try to solve the puzzle of anti-abuse law. One is that ‘a more complex, tax advantaged way of executing a transaction should not lack economic substance if the transaction itself has economic substance.’ [citation omitted] The other is that anti-abuse law is peculiarly concerned with transactions designed to create artificial losses . . . .<sup>37</sup>

While Professor Gergen believes that these propositions are merely observations, not principles, I would suggest that the latter at least might serve as a minimum standard for determining when the various judicial doctrines that we are examining properly might be brought to bear. Perhaps this is not a tidy, clearly defined, and predictable principle along the lines that Professor Gunn would prefer. But in considering these issues we must remember that “[t]axation is a practical matter.”<sup>38</sup>

The last question then is whether it is necessary, appropriate, or even helpful, to codify in the Code or regulations some or all of these judicial doctrines. Is it necessary? No, the courts seem able to apply them in those cases that so warrant. Would it be appropriate or helpful? Mr. Canellos thinks not, being concerned that codification of the anti-abuse rules to fight “corporate tax shelters” might lead to the rules morphing into general anti-abuse statutory rules similar to those in some other countries, which in turn might be over-aggressively applied by the I.R.S.<sup>39</sup> In contrast, at least insofar as the partnership anti-abuse regulations are concerned, Professor Gunn finds some merit in codification of the anti-abuse doctrine, albeit largely because he approves of the safe harbors in the regulations.<sup>40</sup> He too is concerned about over-aggressive application of anti-tax avoidance doctrines by the tax administrators. As for myself, I tend to find Professor Aprill’s conclusion—that tax policy will benefit from encouraging, and even requiring, that questions of purpose and justification both be considered in applying the Code and that to this end codifying the judicial doctrines may have merit<sup>41</sup>—the most satisfying.

There may be some justifiable concerns with codification of the heretofore judicial interpretative and anti-abuse doctrines in either the Code or regulations leading to over-aggressive application by the IRS. On the other hand, currently there clearly is a critical problem with practitioners and taxpayers over-aggressively ignoring those doctrines in structuring

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36. See Canellos, *supra* note 1, at 50.

37. See Gergen, *supra* note 1, at n.144.

38. *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941) (Stone, J.).

39. See generally Canellos, *supra* note 1.

40. See Gunn, *supra* note 1, at conclusion.

41. See Aprill, *supra* note 1, at n.35.

and opining upon transactions. Although collecting empirical data is well nigh impossible, comments by many CLE panelists over the last decade and a half lead me to believe that there is an increasing trend among tax practitioners in representing their clients with zeal—and in creating products—willfully to ignore these doctrines and to rely on literalistic rather than purposive interpretations of the Code and regulations when the result is to their clients' advantage. This turn of events might be explained in part by the fact that I.R.S. enforcement, pushed by a Congress that at times appears to believe the tax laws should not always be enforced, really isn't what it used to be, notwithstanding self-serving cries based on a relatively small number of cases that the I.R.S. is over-aggressively attacking transactions on the grounds that they lack business purpose or economic substance.

Codification of the standards in either the Code or regulations, without the excruciating detail to which contemporary regulations and new statutory provisions tend to be prone, very well might have two salutary effects. First, it would provide a more salient warning to all of the continually present guardians of which Professor Surrey so eloquently wrote. Second, it would provide a firmer basis on which to ground the imposition of penalties for abusive loss generating transactions. But if the choice is codification in the detail that currently so often pervades new statutory rules and regulations, I would opt for leaving these protective doctrines solely in the hands of the judiciary. I am ever-mindful, however overstated it might be, of Professor Martin Ginsberg's warning, "Every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the Commissioner on the hind part."<sup>42</sup> A complicated comprehensive codification of the anti-abuse rules inevitably would include numerous safe harbors and examples of non-abusive transactions. And most, if not all, of those safe harbors would have the potential to metamorphose into yet another tax shelter transaction.

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42. Martin D. Ginsburg, *Making Tax Law Through the Judicial Process*, 70 A.B.A. J. 74, 76 (March 1984).